Ellerston Overlay Australian Share Fund (OASF)

Performance Report | November 19

PERFORMANCE SUMMARY

Performance Class B	1 Month	3 Month	6 Month	FYTD 2020	1 Year	5 Year (p.a.)	Since Inception (p.a.)
Net^	6.80	11.32	15.08	14.54	18.51	8.22	9.96
Benchmark*	3.28	4.80	9.24	5.34	25.98	9.90	11.53

Source: Ellerston Capital

^Net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance.

*S&P/ASX 200 Accumulation Index.

MARKET COMMENTARY

Market Overview

In November, equity market rallied strongly. Developed Markets rose 3.2% in local currency terms, while Emerging Markets rose more modestly (+0.6%). Developed Markets were buoyed by ongoing optimism on a likely resolution to the trade dispute. And markets and investor sentiment were supported by central banks remaining accommodative.

USA

Optimism over a resolution to the trade dispute with China spurred markets. **The S&P 500 Index had another stellar** month, with further gains of +3.6%. The Dow Jones Industrial Average Index's return was even more impressive, up +4.1%. The NASDAQ was the strongest performer, with a return of +4.6%.

With little new concrete information on the trade dispute, markets were left analysing Mr Trump's tweets and came away more positively disposed. During the last week of the month, moves by China and the US suggested an imminent Phase 1 trade deal. The October FOMC minutes revealed that its members were split over last month's rate cut, with most participants thinking that policy was well calibrated to support the economy, barring a material reassessment of the outlook. US economic date was mixed, with manufacturing ISM missing consensus despite rising modestly to 48.3 (consensus: 48.9; previous: 47.8), but composite non-manufacturing ISM beat expectations, rising to 54.7 (consensus: 53.5; previous: 52.6).

Europe

European equities overall were in positive territory, with the Euro Stoxx returning +2.8%. Among key markets, France's CAC 40 index was the strongest performer, up 3.1%, followed by Germany's DAX, with a return of +2.9%. The UK's FTSE 100 was up 1.8%, as Brexit fears abated and a major poll indicated that the Tory government was on course for victory, with a significant majority in parliament at the upcoming general election.

Activity indicators may have bottomed, with flash Eurozone manufacturing PMI for November rising to 46.6, still weak, but ahead of consensus of 46.4 and the previous measure of 45.9.

Asia

Asian equities were mixed in November. Protest and residual concerns over trade dampened investor sentiment. In Hong Kong, the Hang Seng Index was down almost 2% and China's SSE Total Market Index returned -1.5%. But Japan and India bucked the trend: Japan's Nikkei 225 was again the best performer of the major Asian bourses, up 1.6%, followed closely by India's S&P BSE Sensex (+1.7%). Korea's KOPSI Composite Index was up modestly (+0.2).

Investment Objective

The Investment objective for the Ellerston Overlay ASF is to outperform the S&P/ASX 200 Accumulation Index (Benchmark).

Investment Strategy

The Fund uses a benchmark-independent, high conviction approach that looks beyond investing in the Top 20 Australian equity stocks in order to capture the neglected opportunities and uses derivatives to enhance income.

Key Information

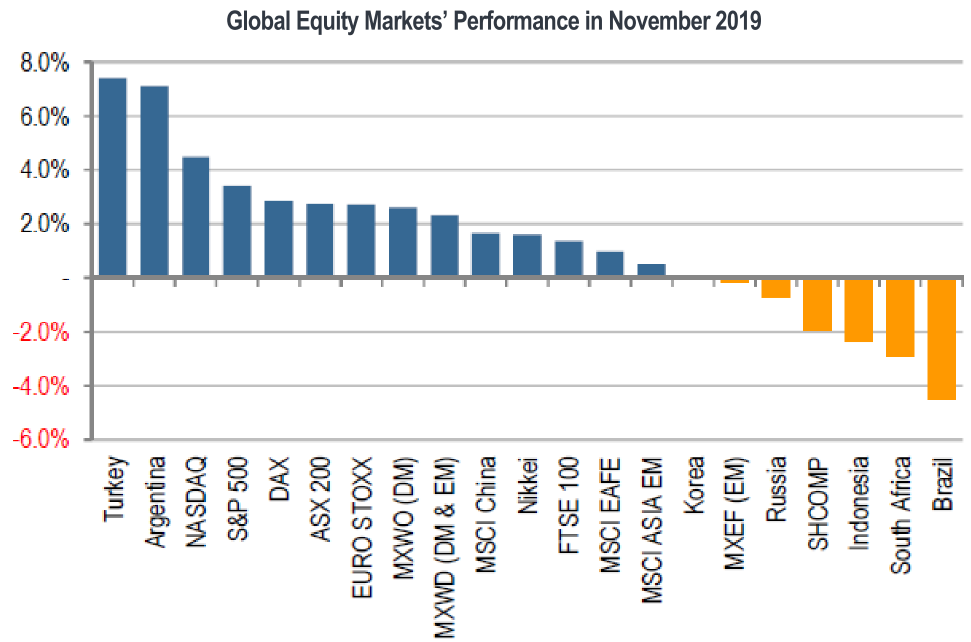
Class Inception	4 January 2012
Portfolio Manager	Chris Kourtis
Application Price	$1.2002
Net Asset Value	$1.1972
Redemption Price	$1.1942
Liquidity	Weekly
No Stocks	22
Management Fee	0.90%
Performance Fee	15%
Buy/Sell Spread	0.25%/0.25%

Ellerston Capital Limited
ABN 34 110 397 674
AFSL 283 000

Level 11
179 Elizabeth Street
Sydney NSW 2000

Ph: +61 2 9021 7797
Fax: +61 2 9261 0528

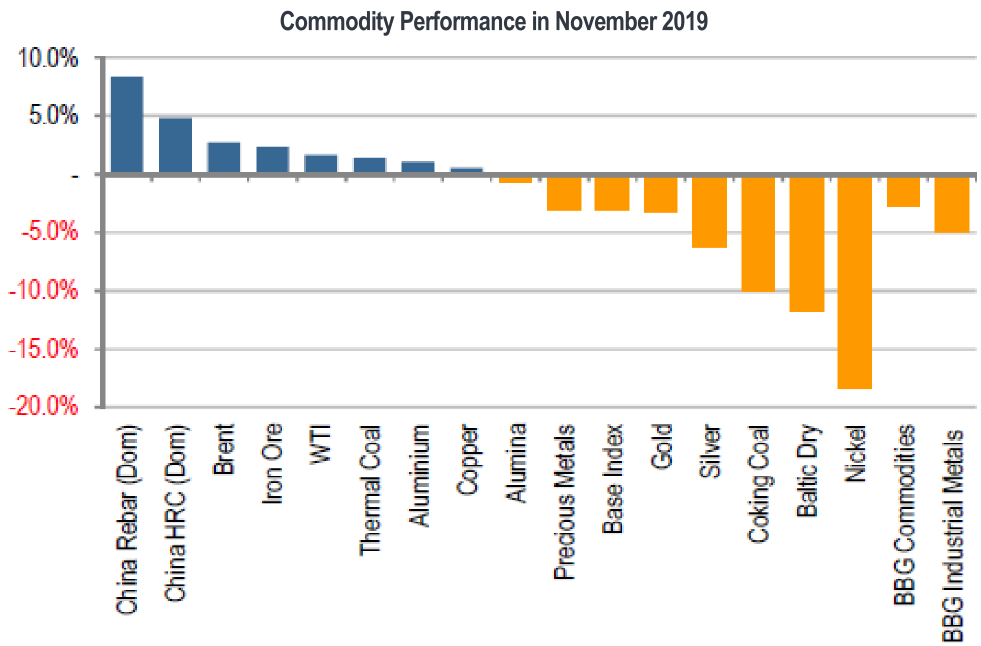
info@ellerstoncapital.com
www.ellerstoncapital.com



Source: JP Morgan, Bloomberg.

Commodities

The commodities index fell 2.7%. Base metals were down 3.1%, with Nickel falling the furthest (-18.4% on weak demand from the stainless steel industry), but Copper (+0.5%) and Aluminium (+1.1%) were in the black. Among the bulks, Iron Ore nudged higher (+2.3%) to $87.50/t, but coking coal was down 10%, while thermal coal was up 1.4%. Brent was up 2.7% to $60.49/bbl. Precious metals were weaker with Gold down 3.2% to US$1,464/oz and Silver down 6.1%.



Source: JP Morgan, Bloomberg.

Bonds

Global bond yields sold off sharply at the start of the month, but rallied towards month end. US 10-year bond yields rose a further 9 basis points to 1.78%, supported by optimism on a settlement to the trade dispute between the US and China. In contrast, the Australian 10-year bond yields fell to 1.03% from 1.14% the previous month, further widening the gap between the Australian and US 10-year bond yields.

Australia

The S&P/ASX 200 Accumulation Index had a very strong month, with a return of 3.3%. The index is now up 26.1% for the calendar year to date.

In November, the best three performing sectors in terms of their contribution to the index's performance were Health Care (rising 8.9%, with another stellar run from CSL, up 10.7% and for the second month running, the largest contributor to the ASX 200 Accumulation Index), Materials (+4.7%, with BHP Group up 6.3%) and Consumer Staples (+8.3%, with Telstra Corporation up 10.6%). The bottom three sectors were Financials (-2.1%, with three of the four majors in the red and only Commonwealth Bank (+2.8%) delivering a positive return), Utilities (-0.6%) and Real Estate (despite a positive return of +2.4%).

The ASX 200 Resources Accumulation Index, with a return of almost +5.0% was the strongest performer, followed by the ASX 200 Industrial Accumulation Index with a return of +2.9%, and the Small Ordinaries Accumulation Index took the wooden spoon, but was in positive territory too with a return of +1.6%.

The top five stocks that detracted from the performance of the S&P/ASX 200 Accumulation Index were Westpac Banking Group (-56 points), National Australia Bank (-31points), Australia and New Zealand Banking Group (-18 points), APA Group (-4 points) and Saracen Minerals Holdings (-3 points).

The top five stocks that made a positive contribution to the index's return were CSL (+70 points), BHP Group (+38 points), Telstra Corporation (+24 points), Commonwealth Bank (+21 points) and Woolworths Group (+18 points).

NAB business conditions ticked up to +3 in October (from +2 previously), while business confidence also ticked up to +2 (from +0). But September retail sales and employment in October missed expectations.

The RBA left rates unchanged at 0.75%, as expected. But its statement contained an easing bias looking forward. The Australian dollar was down 1.9% against the US dollar, and ended the month at 0.68 cents.

COMPANY SPECIFIC NEWS

The Market Misses

G8 Education (GEM -23.5%)

GEM hosted an investor day and trading update in November. The company reduced EBIT guidance for the calendar year by 7% due to lower than expected occupancy rates.

Polynovo (PNV -20.8%)

The market expected an upgrade to sales growth guidance from this bio-tech at its AGM but it didn't come. Instead, the company provided some general commentary around sales trends, reiterating statements made at the time of its FY19 result. It clearly wasn't enough to satisfy shareholders that had witnessed a 400% increase in the share price since the start of 2019.

Smart Group (SIQ -20.7%)

SIQ sold off heavily after the long-standing CEO, Deven Billimoria, announced his retirement effective February 2020. Deven has been with Smart Group for 19 years and CEO since 2002. He will be replaced by the CFO, Tim Looi.

Speedcast International (SDA -18.6%)

A regular customer of the hits and misses page, SDA has found its way into the misses again. With its market capitalisation now less than $200 million, one has to wonder how long it will remain in the ASX 200 Index!

Nufarm (NUF -16.4%)

The Nufarm share price remained volatile. Adverse crop growing conditions in Australia and North America, a minor accounting oversight and an unexpected increase in rebates for some large European customers have combined such that NUF now expects earnings in 1H20 to be down "significantly" on the previous corresponding period, rather than in-line. The only good news is the adverse operating conditions occurred in what is normally the smallest quarter for earnings, so there is time to recover before the more important second half of the financial year. NUF continues to progress through the necessary steps to close the sale of the South American business to Sumitomo, albeit it will now likely be completed in February or March instead of January.

Saracen Mimerals (SAR -16.3%)

The company raised $800 million in equity at a 10% discount as part of its $1.1 billion acquisition of the 50% stake in the Super Pit near Kalgoorlie, from Barrick Gold. The size of the equity raising relative to the company's market capitalisation weighed heavily on its stock price, as did the nature of the acquisition, which amongst other issues, involves little free cash flow generation over the next few years.

Perenti Global (PRN -15.1%)

On 7th November, PRN advised of a tragic security incident approximately 40 kilometers from Semafo's Bongou mine site in Burkina Faso, where 19 members of the African Mining Services workforce were killed and a further 26 hospitalised during an attack by rebels.

Western Areas (WSA -13.4%)

This mid-tier nickel producer was affected by the 18% price decline during the month in that commodity. The tightness in the nickel market eased as Indonesia unexpectedly allowed exports from some producers to resume, at least until 1 Jan 2020 and also Chinese inventories started to rise.

Lynas Corporation (LYC -12.5%)

LYC was impacted by weakening rare earth prices, which have been falling since the Chinese import ban for product from Myanmar was reversed in September, together with the recent tempering of trade tensions between China and the USA

HUB24 (HUB -11.9%)

HUB and other specialty platform providers have come under pressure as a new wave of entrants look to "disrupt the disruptors" by competing on fees. From the date of HUB's AGM in the second week of November, HUB's share price came under pressure as research reports highlighted the case for further margin pressure and a new competitor, Centric, met investors highlighting the coming pressure on fees.

The Market Hits

NRW Holdings (NWH +33.3%)

At the start of the month, speculation grew that NRW was the 'preferred bidder' for the BGC Contracting assets that were up for sale. Ultimately, NRW confirmed that it had agreed to acquire 100% of BGC Contracting for an implied enterprise value of $310 million. NRW raised $120 million in equity in a well-supported placement to assist in funding the acquisition.

Virgin Money UK (VUK +29.3%)

VUK's FY19 results alleviated investor concerns on net interest margins (maintained guidance) and further PPI claims (no further top up). Also, renewed confidence on synergies from the Virgin Money acquisition and a further reduction in Brexit concerns saw the stock continue to be re-rated from its extremely depressed levels. Despite the rally, VUK continues to trade at around 0.5x book value, like many of its peer UK bank stocks.

Caltex Australia (CTX +26.7%)

CTX kicked off the excitement when it announced a strong trading update and plans to IPO its property portfolio. The enthusiastic response from the market - its shares rose 8% that day - was met with further cheers when it was revealed that Alimentation Couche-Tard (ACT) had made a takeover offer of $34.50 a share for the group. Post month end, CTX's Board rejected ACT's proposal, but left the door open by offering to provide ACT selected non-public information to hopefully improve the terms.

Technology One (TNE +25.9%)

TNE released strong FY19 results with revenue up 12.6% to $286 million and EBITDA jumping 47%, with cost control a key driver. Its commentary for FY20 was also bullish, noting that the pipeline was strong and long-term targets for $500 million in revenue and 35% PBT margins, were still achievable.

A2 Milk (A2M +22.7%)

A2M provided a positive update at their AGM in November. It increased FY20 EBITDA margin guidance to 29%-30%, up from an implied margin of 28.2% based on prior guidance, driven by improved price yield and a reduction in Cost of Goods Sold. Investors also took comfort that despite an increasing focus on revenue growth, management LTIs included a 15% per annum earnings per share growth hurdle.

Bravura Solutions (BVS +20.7%)

BVS hosted its AGM in November and re-confirmed previous guidance for FY20 of mid-teens NPAT growth excluding the impact of acquisitions, pleasing investors. BVS also provided additional guidance that its recent acquisitions of Midwinter and FinoComp will make an additional contribution of approximately $3 million to FY20 NPAT.

Bingo Industries (BIN +20.0%)

Bingo provided a trading update at its AGM, advising that the company expects to report underlying EBITDA in the range of $159 - $164 million in FY20, this compares to previous consensus expectations of $159 million. Bingo also highlighted that the integration of Dial-a-Dump is well progressed, the reconfiguration of their NSW network is now largely complete and the group is ahead of schedule in achieving in its targeted 30% group EBITDA margin.

Pendal Group (PDL +19.7%)

PDL's FY19 results were poor, with EPS down 19% but this was in line with expectations. PDL pointed to improving net fund flows and a likely rebound in performance fees. There were also green shoots of better performance across the group's funds. Better earnings forecasts, a decent dividend yield and a desire for beta saw investors bid up PDL's share price.

CSR (CSR +18.5%)

A better than expected earnings result was the catalyst for CSR's share price to continue its recent march higher. Demand in its building materials business is holding up reasonably well, for now. A well hedged aluminium book has softened the blow from a decline in spot aluminium prices and higher electricity costs. The business continues to sell off well located surplus land assets in the bricks business.

Xero (XRO +17.8%)

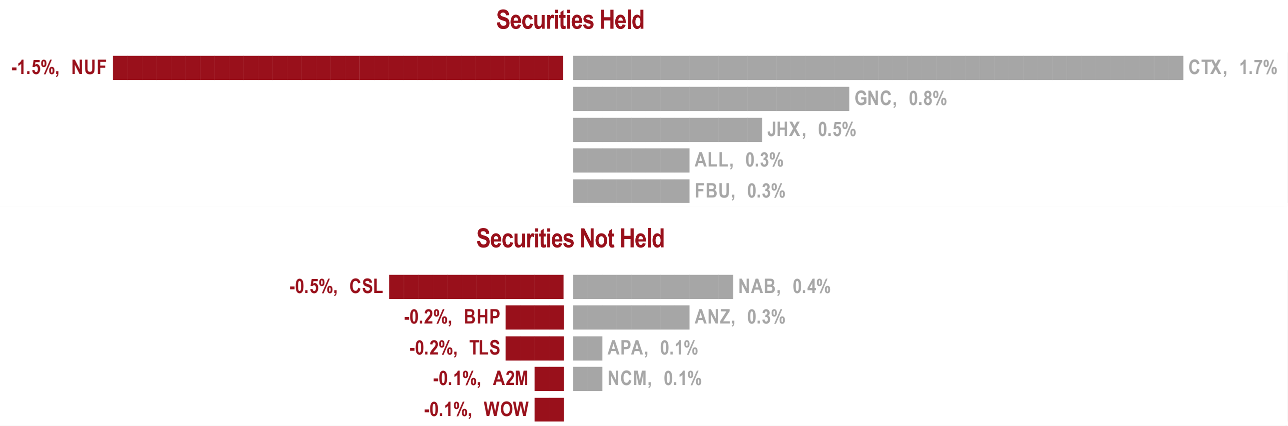
XRO returned to the winners list after delivering a solid 1H20 result with revenue up 32%, driven by strong subscriber growth which cracked the 2 million mark for the first time.

FUND PERFORMANCE

Pleasingly, the Fund continued its run of positive performance throughout the second half of the calendar year by returning 6.89% for the month of November, significantly outperforming the benchmark return of 3.28% by 361 basis points.

RETURNS^ (%)	GROSS	BENCHMARK*	EXCESS	NET
1 MONTH	6.89	3.28	3.61	6.80
3 MONTHS	11.61	4.80	6.80	11.32
6 MONTHS	15.70	9.24	6.46	15.08
FYTD 2020	15.05	5.34	9.71	14.54
ROLLING 12 MONTHS	19.78	25.98	-6.19	18.51
5 YEARS (P.A)	9.21	9.90	-0.69	8.22
SINCE INCEPTION (P.A)	11.07	11.53	-0.46	9.96

^The return figures are calculated using the redemption price for Class B Units and are and are net of fees and expenses. Returns are also calculated on the basis that distributions are reinvested. Returns of the Fund may include audited and un-audited results. Past performance is not a reliable indicator of future performance.
*S&P/ASX200 Accumulation Index
**Since Inception is 4 January 2012.



Source: Ellerston Capital.

The main positive contributors to this month's performance, were overweight positions in Caltex (CTX +26.7%), Graincorp (GNC +12.5%), James Hardie (JHX +17.0%), Aristocrat Leisure (ALL +8.3%) and Fletcher Building (FBU +16.0%).

Caltex currently remains the single biggest position in the Fund.

Being significantly underweight the major banks and miners was also a reasonable contributor to performance, with NAB (NAB -6.8%), ANZ (ANZ -4.2%), APA Group (APA -5.6%), and Newcrest Mining (NCM -1.7%) all underperforming the market.

There was only 1 company we hold that was a major detractor for the month, this was our long-term position in Nufarm (NUF -16.4%). See previous section on "The Market Misses" for commentary on NUF.

Having a zero holding in CSL (CSL +10.7%), BHP (BHP +6.3%), Telstra (TLS 10.6%), A2 Milk (A2M 22.7%) and Woolworths (WOW +6.5%) on the other hand, constrained returns.

FUND ACTIVITY

We added three new stocks to the portfolio: Tyro Payments, Westpac Banking Corporation and Medibank Private. We have detailed write-ups below.

The fund was also active during the month trimming core positions that have either performed very strongly recently or where we've decided to right size the position in the portfolio. We added to oOh! Media.

NEW STOCKS ADDED	STOCKS EXITED
• Tyro Payments - cornerstoned	
• Westpac Banking Corporation	
• Medibank Private	

POSITIONS INCREASED	POSITIONS DECREASED
• oOh! Media	• Janus Henderson Group
	• Treasury Wines
	• Orica
	• Computershare
	• Aristocrat Leisure
	• Woodside Petroleum

Tyro Payments

In response to the RBA's calls for greater competition, Tyro was founded in 2003 with a goal of becoming the most efficient acquirer of electronic payments in Australia. Sixteen years later, Tyro is today the 5th largest merchant acquirer in Australia by terminals, behind the four major banks, and currently serves over 29,000 Australian merchants. The compound annual growth rate for total transaction volume from FY17 to FY20 is anticipated to be 29%, with Tyro processing $17.5 billion in transaction value in FY19.

In a $650 billion and growing total payments market in Australia, underpinned by the secular shift from cash to card, Tyro has 2.7% market share, suggesting the potential remains for a long runway of market share gains. Tyro has focused on the three core verticals of health, hospitality and retail in which it operates, which possessed a total payment value of $171 billion in FY19. It estimates that it currently has 10.2% aggregate market share by value of these three core verticals. Given its growth profile, customer focus and technology advantage, it is not difficult to envision a runway to over 20% market share over the next few years.

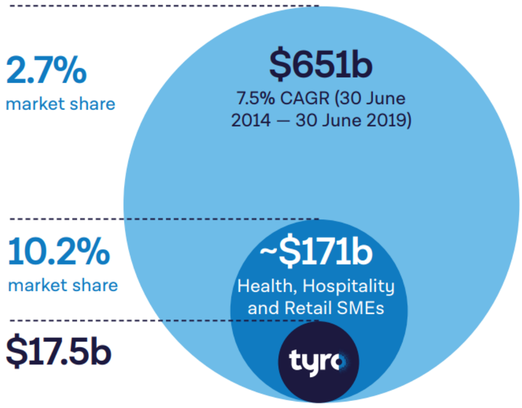
Why has Tyro been successful?

Tyro's success to date has been and will continue to be underpinned by two core features of the business: Tyro's 'end-to-end' proprietary technology platform and clear customer focus. Technology wise, Tyro began life in 2003 by building its own payment switch engine and has continued in the years subsequently to build out a proprietary technology platform, including internal switches, front-end terminal software, payment processing capabilities and security or payment authorisations. Tyro's vertically integrated technology solution provides an important competitive advantage versus their larger major bank competitors who typically rely on a number of third-party vendors to produce their own merchant acquiring solution. Examples of this advantage are: reduced processing friction - Tyro reports sub-1.5 seconds processing versus competitors at over 3 seconds, easier implementation of regulatory changes such as 'least cost' routing, and new payment types, where Tyro was the first Australian bank to deliver an integrated Alipay solution.

Furthermore, an important auxiliary benefit of this proprietary 'end-to-end' solution is that the technology architecture allows seamless direct API integration with a significant number of Point of Sale (POS) systems. As a result, Tyro has the largest number of direct POS integrations amongst payment providers in Australia, with over 286 integrations as at 1st October 2019, having added approximately 25 since January 2019.

In conjunction with this technology advantage, by being solely focussed on SMEs in its chosen core verticals and providing customers the best service experience, allows Tyro to create vertical-specific features and functions – simultaneously and continuously improving the product and the merchants' experience.

Tyro's addressable market and current market – the opportunity is significant



Source: Company Data

Banking upside

Whilst the core merchant acquiring business has a meaningful runway for growth ahead of it, over time the real gem within Tyro may in fact prove to be the banking relationship Tyro can develop with its customer base. Importantly, in 2015, Tyro became the first new domestic banking licensee in over a decade. As a result, Tyro now offers business banking to its merchants, including loans, 'Tyro Business Loan', and fee-free interest-bearing transaction accounts. Tyro forecast loan originations in FY20 is $85 million, up 63% on the prior year. Given the low loan-to-deposit ratio today and substantially growing deposit base, Tyro's opportunity to grow their lending book at highly attractive terms appears sizeable.

Other growth opportunities

Going forward, Tyro has highlighted a number of avenues for continued growth:

- Grow merchant share in existing payment verticals
- Enter new payment verticals (accommodation and services)
- Cross-sell lending and other value-added services
- Drive expansion into e-commerce & other payment types
- Develop API platform – Tyro Connect

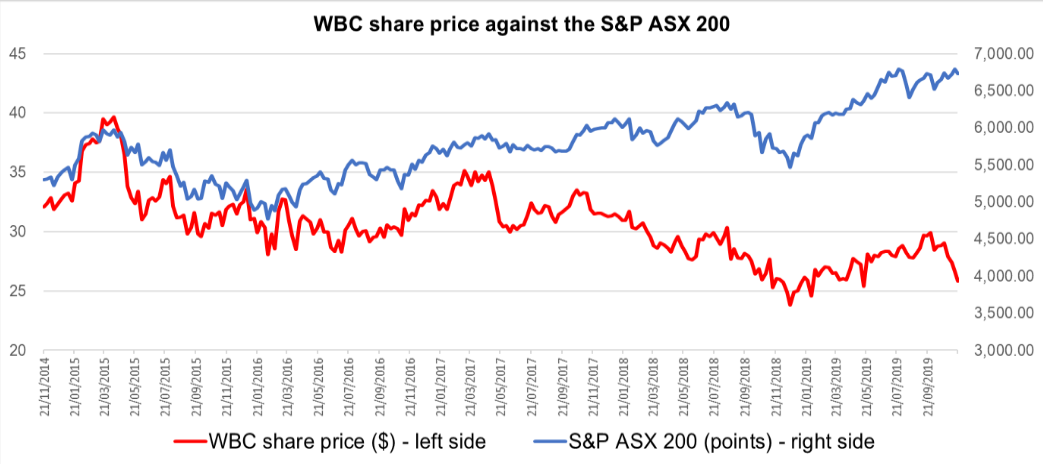
Conclusion

Given these meaningful opportunities for growth, in conjunction with Tyro's superior technology and an industry structure where slow-moving large incumbents reliant on a combination of third-party system providers still have over 95% market share – the runway for Tyro to grow with robust customer unit economics in the years to come looks highly attractive. With this backdrop and a management team led by two highly experienced and respected executives including former CEO of Tatts Group, Robbie Cook as CEO, and former Telstra executive David Thodey, as Chairman, at the IPO valuation, we believe the investment opportunity appears very compelling at $2.75 per share.

Westpac Banking Corporation (WBC)

For the avoidance of doubt, we retain a broadly cautious view on the bank sector. Most of the issues we had previously identified as headwinds and likely outcomes for the sector are playing out and are being realised. If you recall from last month's newsletter, we had identified and reinforced the following issues and consequences for the sector:

- Slowing revenue driven by weaker credit growth and compressing net interest margins to pressure cash earnings
- Higher costs coming mostly from increased regulatory and compliance spending post the Royal Commission
- Higher and ongoing remediation/litigation charges
- Higher impairment expenses, with an indebted consumer paying off debt and not experiencing wage increases
- Lower earnings and fading ROE's, as a result of the factors above and
- Inevitable cuts to the payout ratios and dividends as a result of subdued earnings and higher Tier 1 capital requirements.



Source: Factset

The sector has underperformed, but the PER de-rating to where it should theoretically trade, based on a reducing ROE and earnings profile, remains elusive. Following the last reporting season, where forecasts were slashed, consensus earnings and dividend forecasts for the sector are now more realistic. And despite the sector's underperformance, we recognise the attraction of fully franked dividends to investors, even more so post a series of RBA cuts and given the historically low interest rate environment. **The sector is also being priced on the attraction of these more realistic and sustainable dividend yields.**

Against this backdrop, we participated in WBC's recent $2.5 billion capital raising at a price of $25.32 per share.

To summarise WBC's current position

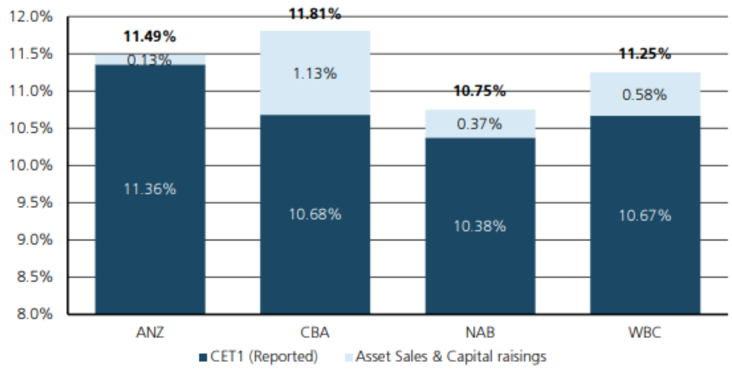
WBC is one of the big four Australian retail banks and is predominantly a mortgage lender. It has 14.2 million customers, 22% of household deposit market share, 23% of mortgage market share, and 17% of business credit market share. It also has a major presence in New Zealand with 18% NZ deposit market share, and 18% consumer lending market share. Interest only mortgages comprise 27% of the portfolio mix and 21% of new flows. Australian consumer unsecured lending represents just 3% of group loans.

In FY19, mortgage growth slowed to around 2% and is likely to remain challenging; and overall lending (including business and NZ) was flat. Net interest margins were 2.04% (down 7 basis points on last year), but are guided to be lower – much like for the rest of the sector. Impairments remain very low at 13 basis points of gross loans and there does not appear to be much stress apparent in the portfolio currently. So, in FY19 WBC's cash earnings were $6.9 billion. Like all other major banks in Australia, WBC reported significant notable items, primarily relating to customer remediation in the Wealth division, but also in Banking. In FY19, estimated customer refunds, associated costs and litigation negatively impacted the group's cash earnings by $958 million (FY18: $281 million). Cash earnings excluding notable items, came in at $7.9 billion. WBC also reported a 10.7% return on equity (12.7% excluding notable items) and 10.7% common equity Tier 1 ratio (on APRA's basis).

The negative sector trends - slowing credit, margin and cost pressure, and benign but rising impairments - are reflected in forward earnings for WBC and the sector following the reporting period just completed.

Why did WBC raise $2.5 billion of capital and cut its dividend?

WBC's CET1 capital ratio changed little over FY19 (up 4 basis points to 10.7%) but it was impacted by approximately 75 basis points from operational risk overlays, a new model for derivatives risk weighted assets, customer remediation provisions and costs associated with the exit of financial planning. WBC identified three broad reasons for the capital raising: **to respond to potential litigation or regulatory actions, meet RBNZ and APRA capital changes and to fund customer growth. Following the capital raising, pro forma CET1 increased to 11.25%.** See chart below for big four banks.



Source: Company reports

WBC also reset its dividend and cut the final dividend to 80 cents, down 15% on the interim and FY18 final dividends. This represents a more sustainable payout ratio of 71% excluding notable items and reflects the challenges facing the bank and broader sector. The sustainable medium-term payout ratio excluding notable items is now in the range of 70-75%.

As at 30 September 2019, WBC had a franking surplus of $1.6 billion. Along with CBA, it is the only other major bank to pay a fully franked dividend (ANZ recently reduced its franking to 70%). It is likely that WBC will “look through” cash earnings that will be constrained in the short-term, in order to pay a dividend in line with the final FY19 dividend of 80 cents per share (indicating a higher payout ratio than targeted). At the time of this newsletter, FY20 and FY21 consensus dividends are forecast to be $1.59 and $1.59 respectively, implying a dividend yield of over 6% pre franking.

AUSTRAC claim

On 20 November, WBC announced that AUSTRAC had made a statement of claim against it for alleged contraventions of its obligations under the Anti-Money Laundering and Counter-Terrorism Financing Act. WBC had flagged at the time of the $2.5 billion capital raising and in its contingent liabilities note released with its FY19 results, that there were potential litigation and regulatory actions likely, and referenced likely AUSTRAC action relating to international fund transfer instructions (IFTIs).

The headlines that resulted from AUSTRAC’s claim are eye-catching and staggering, in particular, the number of breaches and customer due diligence failures associated with identifying, mitigating and managing child exploitation risks. **Neither the *number* of breaches relating to IFTIs, nor suspicious transactions relating to child exploitation was mentioned specifically at the time of the capital raising. WBC maintains that it was not aware of the allegations specifically referencing child exploitation until 15 November, that is, WBC had no specific details of this matter at the time of the capital raising.** An independent inquiry is underway and ASIC has launched its own investigation too.

Since the AUSTRAC announcement, WBC was subject to headline news daily, with calls for senior management and board members to be held accountable. The company responded to the initial AUSTRAC claim immediately and in the days following the initial claim, but seemingly fell short of stakeholders’ expectations. WBC’s first *detailed* response was on 24 November when it announced a set of actions across three areas including closing LitePay (the product at the centre of the allegations), priority screening for suspicious matters, and investments to reduce the human impact of financial crime. This was deemed inadequate by the press, investors and politicians publically, and the share price remained under pressure. Calls continued for senior executives and board members to “fall on their swords”.

On 26 November, WBC announced that its CEO, Brian Hartzer, would be stepping down effective 2 December, Chairman, Lindsey Maxsted, would bring forward his retirement to the first half of 2020, and board member and Chair of the Risk and Compliance Committee, Ewen Crouch, would not stand for re-election at the AGM on 12 December.

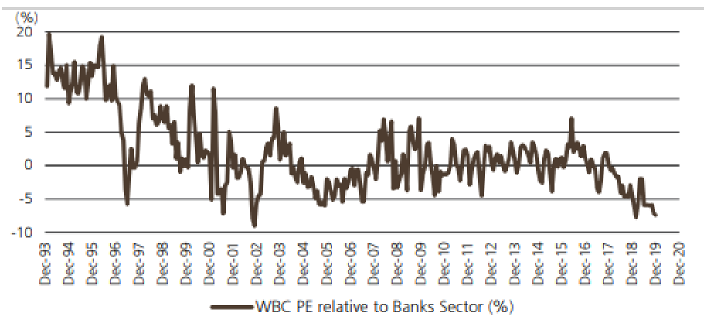
The specifics of the AUSTRAC claim were alarming and clearly disappointing, but difficult to predict. The subsequent weakness in the share price is therefore understandable, but nonetheless still disappointing given our cautious stance on the banking sector to date. However, it is worth noting that Commonwealth Bank (CBA) also underperformed following its own AUSTRAC imbroglio that occurred, resulting ultimately in a $700 million fine. CBA’s share price fell below $66 but has since rallied strongly to over $80 and the shares have been re-rated, thus a good buying opportunity with the benefit of hindsight.

These serious allegations will continue to plague the bank in the short term. It will no doubt likely lead to a large fine, higher compliance costs and more changes at the board and along various levels of management. WBC has no accounting provision for any potential financial penalty, but does have surplus capital of approximately $2.9 billion pro forma. (NAB, with $1 billion of pro forma capital surplus, has also previously disclosed that it is the subject of an AUSTRAC investigation, as has Bank of Queensland.)

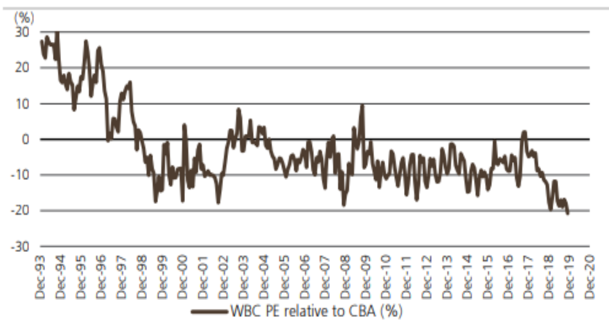
Outlook and valuation

WBC faces similar headwinds to the broader sector, with average lending and net interest margins under pressure, but impairments remain low and below long-run averages. Costs were guided to increase by 1% in FY20 given higher compliance spending. This is likely to be higher following the AUSTRAC claim, but there’s some offset from self-help cost savings of approximately $500 million. **WBC has been de-rated justifiably along with the rest of the sector, but now trades at its historical low PE relative the banks sector and the largest discount relative to CBA since CBA listed (see below)**.

WBC relative to the Banks sector



WBC PE relative to CBA – off the page!



Source: Factset, UBS estimates.

We value banks using a Gordon Growth Model and a Dividend Discount Model. Both approaches suggest that WBC is fairly valued on an absolute basis, using a relatively high discount rate of 10.7% (incorporating a risk-free rate of 3.5% **and an additional 0.5% penalty for poor governance**). This gives a valuation of approximately $25.30. The entire banks sector has scored badly on “Social and Governance” responsible investing criteria.

If we were to lower our discount rate by 1% (incorporating a risk-free rate of 2.5%), both valuation methods provide material upside. For context, ANZ has publicly stated that it believes its cost of capital is 8.5%, and will price business on that basis going forward. **If we use 8.5% as our discount rate for WBC, the upside to valuation is very significant.** We think ANZ's view of the world and discount rate are too aggressive for any bank at this late stage in the cycle. Interestingly, no other bank has followed ANZ.

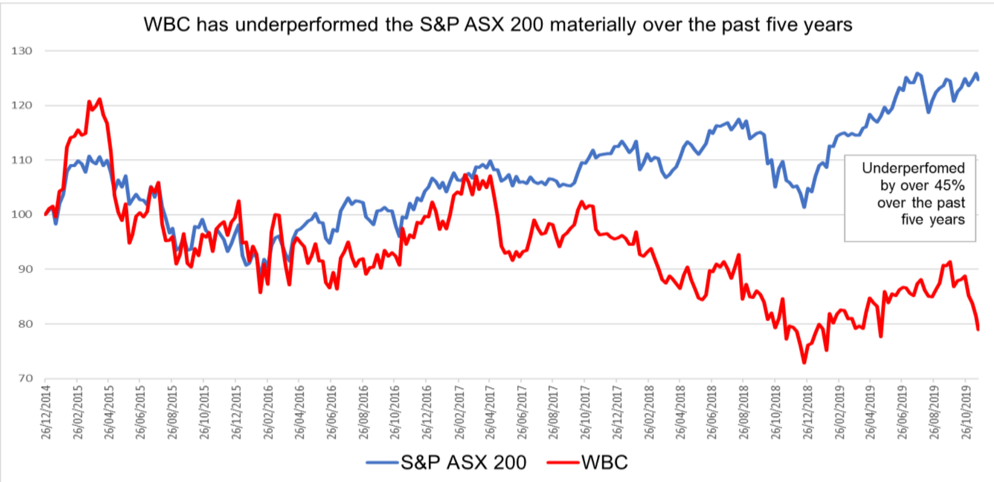
See table below for valuation range.

Discount rate	DDM	GGM	Blended valuation
8.5%	$35.19	$34.00	$34.60
9.5%	$29.86	$29.80	$29.83
10.0%	$27.77	$27.90	$27.87
10.5%	$26.21	$26.30	$26.23
11.0%	$24.37	$24.70	$24.52

While we retain our valuation discipline and recognise the importance of incorporating a risk-free rate that more closely reflects the long-term average, we are in unusual times. Official cash rates and 10-year bond yields are at historically low levels. How long will they remain at these levels? It's difficult to know, but there is a broad consensus that rates could remain low for an extended period of time (and we have commented on this in the strategy section in previous newsletters).

In the context of lower interest rates, investors are looking for dividend yield. And a fully franked yield is even more attractive. ANZ cut its franking to 70%, whilst WBC's implied dividend yield of around 6% is before franking. So, although WBC's compound annual growth rate for consensus earnings forecasts is flat over the next few years, we feel that in the context of the sector reflecting more realism and our sector concerns playing out, WBC's fully franked dividend yield is highly attractive. Valuation appears fair, but there is upside with a lower risk-free rate. WBC trades on a PE of 13.0 times consensus earnings for FY20 and 12.4 for FY21. It trades on a Price to Book value of 1.3 times and 1.2 times FY20 and FY21 respectively.

Having been zero-weighted the bank sector for a number of years, we have cautiously stepped back in. We recognise that the headwinds we had identified are now more realistically priced in.



Source: Factset

Medibank Private (MPL)

MPL is one of Australia's largest health insurance companies and one of only two listed health insurers. MPL has 3.77 million customers and 26.9% market share. In 2019, it grew market share over a full year for the first time in a decade. BUPA, which is owned by a foreign mutual corporation, has a similar market share. MPL operates two brands – Medibank and ahm. The group provides health insurance predominantly, but is slowly transforming into a broader healthcare company, branching out into telehealth and home healthcare, and also into diversified insurance, like pet insurance and some travel insurance. MPL has just over 3,400 employees, of which 31% are health professionals.

MPL has **two broad divisions**:

- **Health Insurance (HI) with 96% of premium revenue**, underwrites and distributes private health insurance policies
- **Medibank Health (MH) with 4% of premium revenue**, includes the provision of health management, telehealth services and hospital care in the home through Home Support Services (HSS), and also the sale of travel, life and pet insurance products.

Health insurance is topical and attracts political attention, as it is a contributor to customers' costs of living. **So premium revenue in the HI division is underpinned by the government-approved average premium rate increase**, up 3.88% from 1 April 2018 and 3.3% from 1 April 2019. The average revenue per policy unit increased by 2.0% in FY19. Premium increases have had a downward trajectory and this impacts revenue. Resident policyholder numbers grew by 0.8% in 2019, compared to 0.3% in 2018. The improvement was driven by a stable acquisition rate and a 50 basis point improvement in retention. Health claims paid or claims expenses are the largest cost for HI. Net claims paid represented 82.9% of HI premium revenue and a claims cost per policy unit increase of 2.3% in 2019.

The role of MH is to complement the core HI business and enhance customer loyalty. In FY19, MH lost a key contract with the Australian Defence Force and those contributions ceased from 30 June 2019. This materially impacted this division's earnings going forward. MH now has a target to organically replace the $30 million FY18 operating profit from the lost contract by FY22. MPL expects to do this by expanding HSS, growing diversified insurance and $8 million in cost savings in 2020.

MPL has an **investment portfolio of approximately $2.7 billion**, of which approximately 20% is in growth assets (equities, property and infrastructure) and 80% in defensive assets (cash and fixed income). This earns investment income, provides liquidity and covers insurance liabilities related to the HI business. It also satisfies regulatory reserves required. **The group has a pristine balance sheet, has no debt and holds just over $650 million of cash and cash equivalents.** HI's business-related capital was 14% of premium revenue after allowance for declared but unpaid dividends, at the top end of the 12%-14% target range. From 2020, MPL has reduced the target range to 11%-13% of premium revenue. MPL believes it is well placed to implement APRA's new capital framework. The reduction in the capital range saw MPL return 2.50 cents per share as a fully franked special dividend to shareholders in FY19.

In FY19, MPL reported a group operating margin of 8.4%, with NPAT of $459 million, in line with consensus. The key positive announcement at the result was the declaration of a special dividend and a lift in the dividend pay-out ratio to 75%-85% from 70%-75% previously. The result was positively received by the market.

MPL's strategy recognises that affordability is a key issue for customers. As prices come under pressure, MPL is responding by maintaining strong cost discipline. It has delivered $40.4 million of productivity savings over the two years to FY19, and targets a further $50 million in productivity savings over the next three years including $20 million in 2020. MPL is also targeting growing Medibank volumes, with a stabilisation by the end of FY20 and growth during FY21.

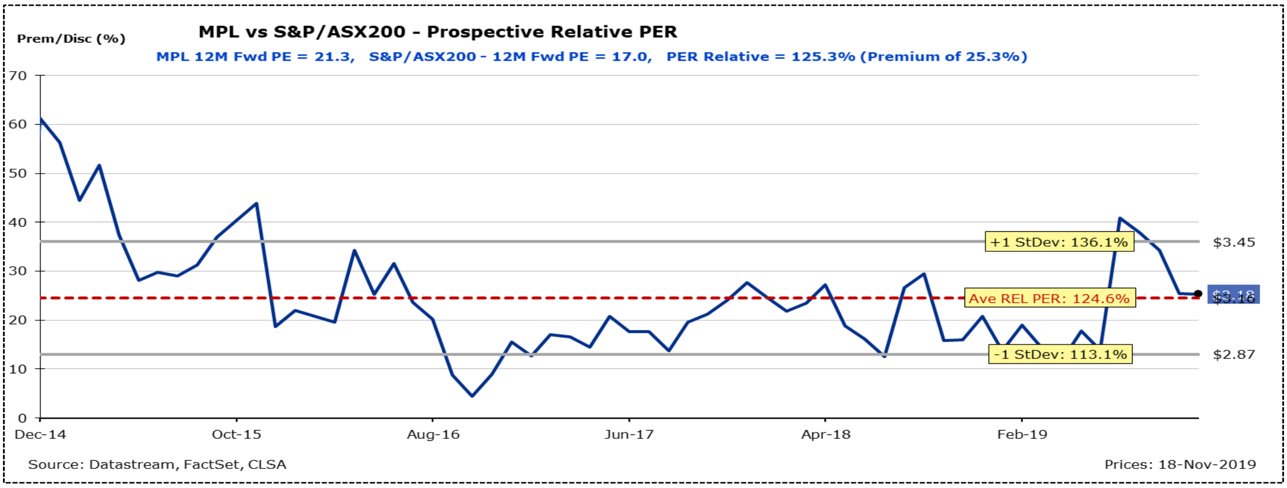
Since the FY19 results in August, **MPL updated the market in early November on a resurgence of claims inflation**, blaming higher average claims size in hospitals and an increase in prostheses volumes that offset price cuts. This meant that claims inflation now at around 2.7%, was in excess of average premium increases. This drove material cuts in consensus earnings per share as a result of operating margins declining by about 100 basis points. There is now renewed discussion on further cost cutting if margins worsen and the hope of a more favourable response from the government on reforms and premium increases. The good news from the update was that policyholder growth in 1Q20 was 0.6%, suggesting a stabilising Medibank brand.

We used the sharp sell-off in MPL's share price as a buying opportunity and moved to an overweight position.

MPL's key attractions are its strong market position, brand, superior execution and cost control, quality balance sheet, and disciplined and very well-regarded management, led by CEO Craig Drummond. Additionally, MPL has been subject to strict share restrictions since it listed in November 2014, which prevented any shareholder from owing more than 15% of the company. On 1 December 2019, this restriction no longer applies. As has been widely speculated in the media, this increases the appeal of MPL to a potential buyer who might want to acquire a quality health insurance company with a clean balance sheet and gain a material foothold in the Australian market.

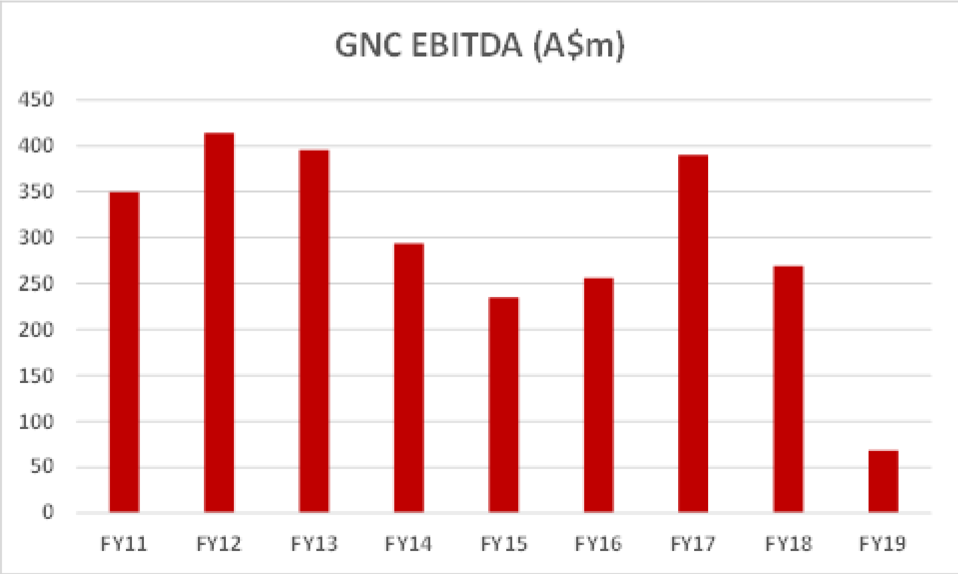
Valuation

MPL trades on a PE of around 21 times FY20 and FY21, a reasonable discount to the non-bank Industrials which trade on a PE of around 24 times. MPL has modest earnings per share growth forecast, much like the broader market. MPL's only listed comparator in Australia is NIB Holdings and it trades on 19 times FY20 and FY21, with similarly flat earnings per share forecast. MPL's implied dividend yield is 4%, fully franked. It would be fair to say that MPL's valuation premium to its listed peer reflects its superior balance sheet and some takeover premium. We also value MPL using a discounted cash flow model which suggests a fair valuation for the stock before any further cost out is incorporated or takeover premium is built into the valuation, given the imminent falling away of the 15% share register restriction.



Graincorp update

For Graincorp (GNC), history will show the 2019 financial year as the low point for earnings. Extremely adverse seasonal conditions and a confluence of factors all combined to create an earnings result well below anything achieved over the past decade. The depressed earnings weighed heavily on the share price, causing it to underperform the ASX 200 by around 17% over the 12 months to 13 November 2019 - the day before GNC released its FY19 earnings results. GNC has since outperformed by over 13%, largely as a result of the ACCC approval for the sale of its bulk liquid terminals business for an adjusted price of $332 million (approximately 13 times EBITDA).

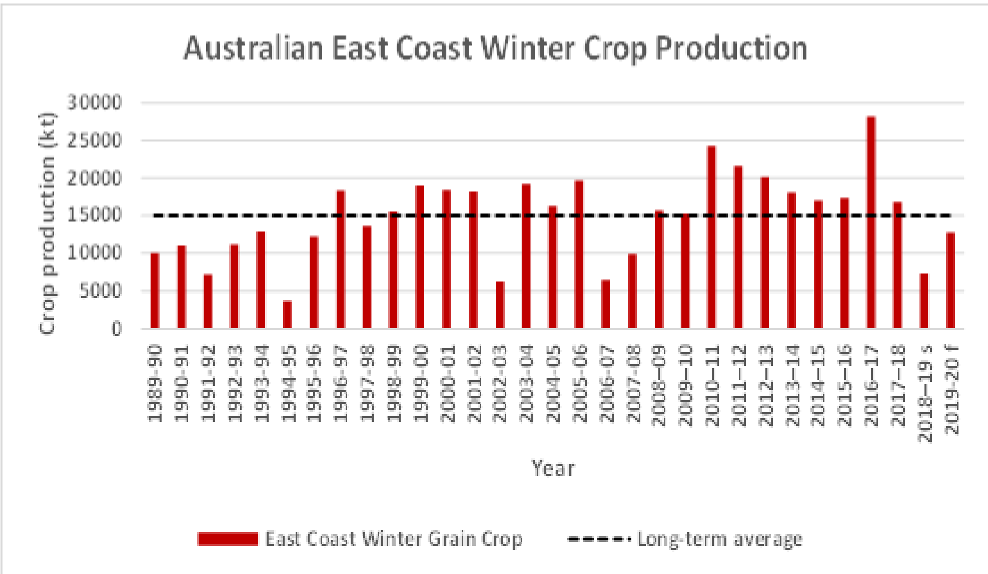


Source: Factset

FY19 was one of the worst droughts ever recorded on the Australian east coast, resulting in a dismal grain harvest (50% below the decade average). This meant that much less grain was moved, stored and exported by GNC than is normally the case. Global trade tensions disrupted grain trade flows (especially in the barley market), leading to a very large and unusual grain trading loss. Legacy rail haulage contracts with significant 'take-or-pay' components were underutilised by GNC. Oilseed crush margins were depressed due to the drought's impact on canola supply. EBITDA and cashflow were constrained, with balance sheet gearing becoming elevated. To top that all off, the "quirky" $10.42 cash takeover bid from Long Term Asset Partners evaporated.

But looking forward, the outlook is very different to what we can see in the rear vision mirror for both structural, as well as cyclical reasons. The successful sale of the bulk liquid terminals business takes away some of the concerns over balance sheet gearing. The sale proceeds of around $332 million will be applied to reduce debt (core debt was $802 million at the end of FY19). Most of the remaining debt could be carried by the Malt business post the proposed demerger, leaving the Grains and Oils division with relatively low debt levels. Lower debt is appropriate in this business given seasonal swings, this is in spite of the weather derivative overlay ironing out some of the volatility.

The east coast drought is entering a rare third successive year, but cropping conditions have improved in some areas, principally Victoria and southern NSW, such that ABARES estimate the east coast winter crop will be 5mt (over 70%) larger in FY20 vs FY19, albeit still 15% below the long-term average.



Source: ABARES, September 2019

As a reminder, in FY20, GNC now has a crop protection contract in place for the first time. If the crop size is as predicted by ABARES, GNC's crop protection contract will kick in and also reduce the volatility of future earnings, albeit for a modest cost of $10 million per annum.

The old unfavourable rail supply contract has been renegotiated. The new deal will remove an earnings drag when crop conditions are poor. This rail contract created a $15 million earnings headwind in FY19 that will not recur in FY20.

Grain trading is a little harder to forecast, but GNC now claims that global grain trade flows have started to normalise. Trade disruptions cost the company a whopping $65 million in FY19. There will be a material improvement in the earnings contribution in FY20.

ABARES expects the east coast canola crop to increase by around 80% in FY20, so the improvement in oil crushing margins that was visible in 2H19 is likely to continue into FY20.

There are also several cost reduction and revenue enhancement initiatives underway, predominantly across the Grains and Oils operations that will deliver an additional $60-90 million improvement in earnings by FY22.

The next key catalyst from here is the demerger of the Malt division. Documents will be issued to shareholders early in the new 2020 year for a vote shortly after that. Demergers, whether in Australia or elsewhere in the world, have a long track record of value creation and there is no reason to expect a different outcome for GNC. The Malt business contains a portfolio of high quality assets that generate a stable, growing stream of earnings and cash flow. The Grains and Oils business incorporates a unique set of valuable storage, transport and port assets, but has an inherently cyclical revenue stream. The two businesses are attractive to different types of investors and there are no large synergies that come from ownership under a single entity, apart from some modest corporate cost savings.

Demerged companies outperform post spin-off – Australian experience vs ASX 200 Index

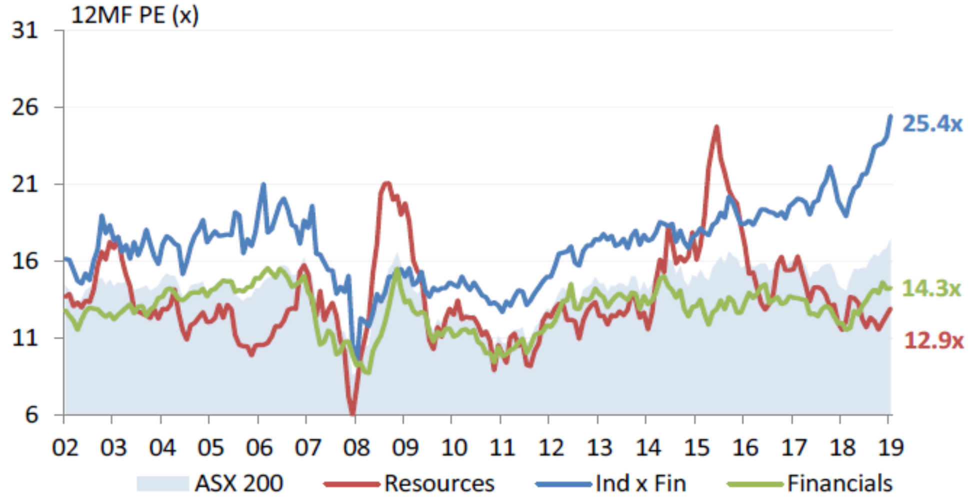
Source: Citi

We continue to see significant upside in GNC's share price that will largely come from a combination of the material improvement in earnings from the Grains and Oils division and a likely multiple re-rate post the demerger of the Malt division. The potential upside is large and the risk profile has dramatically improved.

There is substantial runway left in the GNC story and it continues to be a sizeable core holding in your portfolio.

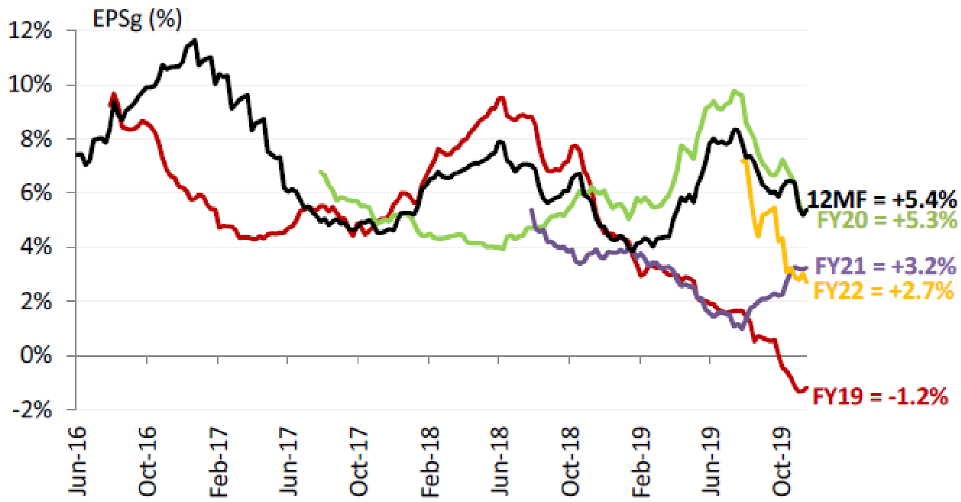
FUND STRATEGY AND OUTLOOK

The Australian equity market was stronger in November versus its global peers in local currency terms but less so in US dollar terms. Our often repeated refrain with respect to earnings growth or rather the absence of it bears repeating! Earnings revisions are negligible and valuations are stretched further despite the banks sector being under pressure last month as conduct and capital issues – well flagged in this newsletter – reared their ugly heads again. November saw overall market earnings growth forecasts at 5.3% for FY20, down from 10% in the middle of the year. While FY19 earnings are now -1.2%. **Against this weak earnings backdrop, valuations appear stretched even further, with the ASX 200 12-month forward PE ratio at 17.5 times – the highest in 17 years. The Industrials ex-Financials is even higher, soaring to 25.5x – now in the nose-bleed territory of over 3 standard deviations above its long-run average!**



Source: RIMES, IBES, Morgan Stanley Research.

Meanwhile, earnings forecasts continue to be revised downwards.



Source: RIMES, IBES, Morgan Stanley Research.

In early December, as we write the newsletter, Mr Trump appears to have reopened the trade war debate by reimposing tariffs on 25% on imports of steel and aluminium from Brazil and Argentina. Hopes of a trade deal between the US and China also faded, as another of Mr Trump's tweets played down any prospect of a speedy resolution. Also, new data showed that the US manufacturing sector contracted at a slightly faster rate in November. This confounded economist and market strategists who anticipated a rebound in factory activity. This weaker print has reignited concerns over the likely fallout from US-China trade tensions.

Given elevated valuations and markets counting down the days to the looming 15 December trade deadline (when the Trump administration will clarify its intentions on whether to impose new tariffs on China), negative data points on the health of the US economy do nothing to alleviate jittery investor sentiment. With pressure on earnings, markets are looking for some resolution to the US-China trade tensions in order to have confidence to push forward.

Our stock-focussed strategy seeks to identify mispriced companies where we believe the market under appreciates the medium to longer-term earnings growth in earnings.

Our near-term discomfort on the Australian market's valuation is driven primarily by the absence of earnings growth. We continue to point out that most of this year's rally has been driven by PER expansion. Investor sentiment could be dampened further if US-China trade talks stall or get deferred.

To summarise your portfolio's positioning:

1. Quality Franchises Solid companies with strong/leading market positions and credible management with good balance sheets *Macquarie Bank, Computershare, Treasury Wines, Aristocrat, Goodman Group and James Hardie Industries*	**2. Businesses that are highly cyclical or seasonal in nature, facing certain headwinds** Companies with strong market positions and strategic assets, but very sensitive to economic conditions/seasonality/weather *Graincorp, Nufarm, JB Hi-Fi, Downer EDI and Flight Centre*
3. Turnarounds Sound businesses that have historically generated poor returns, have been poorly managed, under-earned versus their potential, are in transition, and where we think earnings/returns will improve over the medium term. Out of favour with the market, somewhat contrarian positions *Caltex, Orica and Janus Henderson*	**4. Deep Value Cyclical and Resource Plays** Stocks trading at discounts to NPVs, or with growth optionality, where much of the heavy lifting has been done (cost out, self help) *BlueScope Steel, Woodside Petroleum and Origin Energy*

We have **dipped our toes into the banks sector and added Westpac to your portfolio** (see detailed write up in the activity section).

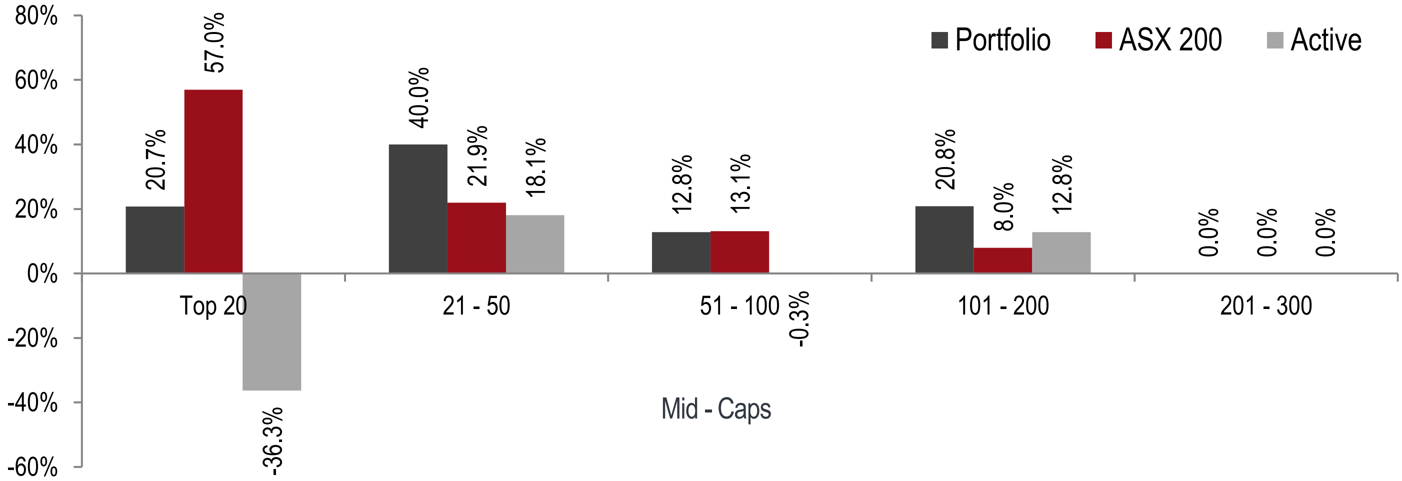
Warm Regards,

Chris Kourtis

Portfolio Manager

PORTFOLIO FEATURES

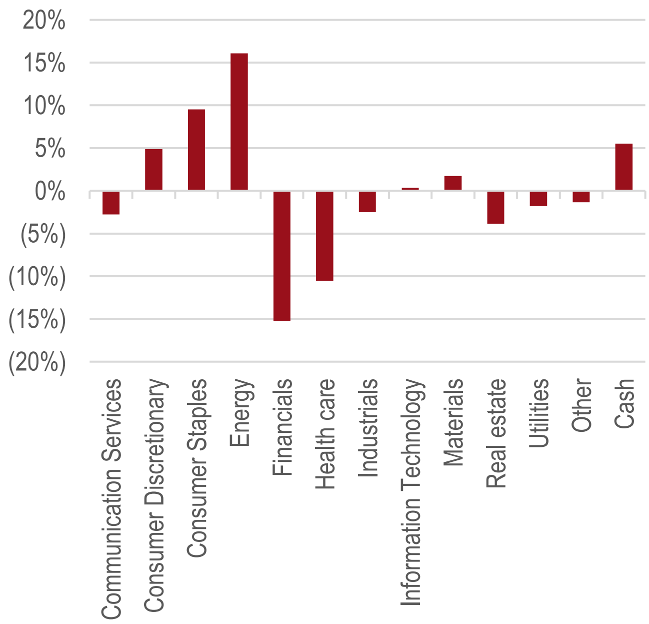
Size comparison Chart vs ASX 200^



Source: Bloomberg, Ellerston Capital Limited

^Size Comparison Data as at 29 November 2019

Active Sector Exposures*



Source: Ellerston Capital Limited

TOP 10 HOLDINGS**
ARISTOCRAT LEISURE
CALTEX AUSTRALIA
DOWNER EDI
FLIGHTCENTRE
GRAINCORP
NUFARM
ORIGIN ENERGY
TREASURY WINE ESTATES
WESTPAC BANKING CO
WOODSIDE PETROLEUM

ASSET CLASS EXPOSURES	
EXPOSURE (% OF NAV)	Net
EQUITY	96.39
LONG OPTION	0.00
SHORT OPTION	(1.91)
EFFECTIVE CASH	5.52
GRAND TOTAL	100.00

* Active sector exposures are determined by subtracting fund sector weights from benchmark weights. Positive percentages represent over-weight sector exposures relative to benchmark and negative percentages represent under-weight sector exposures relative to the benchmark.

** Top 10 Holdings are listed in alphabetical order.

ABOUT THE ELLERSTON OVERLAY ASF

The Fund aims to achieve its performance objectives by adopting a fundamental "bottom-up" investment approach to stock selection whilst delivering additional income where possible, through option strategies.

Because of the nature of the strategy, at least 75% of the Fund's exposure is aligned to the portfolio of the Ellerston Australian Share Fund.

The Investment opportunities for the Fund are identified by analysing and understanding the factors affecting (amongst other things): business model, industry structure, management team and overall valuation.

Ellerston Capital typically favours businesses that can sustain high returns or improve their return on capital and looks to invest in businesses with a market value below the value we attribute to them.

Benchmark weightings do not drive our stock decisions; our approach is totally benchmark independent.

FUND FACTS

STRATEGY FUNDS UNDER MANAGEMENT	$232 Million
FUNDS UNDER MANAGEMENT – OASF UNIT TRUST	$12 Million
APPLICATION PRICE	$1.2002
REDEMPTION PRICE	$1.1942
NUMBER OF STOCKS	22
FUND INCEPTION DATE	4 January 2012

All holding enquiries should be directed to our registrar, Link Market Services on 1800 992 149 or ellerston@linkmarketservices.com.au

Should investors have any questions or queries regarding the Fund,

please contact our Investor Relations team on 02 9021 7797 or info@ellerstoncapital.com

or visit us at https://ellerstoncapital.com/

SYDNEY OFFICE

Level 11, 179 Elizabeth Street,
Sydney NSW 2000

MELBOURNE OFFICE

Level 4, 75-77 Flinders Lane,
Melbourne VIC, 3000