Ellerston Capital

Ellerston Australian Micro Cap Fund

Performance Report | January 20

PERFORMANCE SUMMARY

Performance	1 Month	3 Months	6 Months	1 Year	2 Year p.a.	Since Inception (p.a.)
Net^	4.85%	9.00%	19.85%	48.76%	14.53%	24.49%
Benchmark*	3.38%	4.69%	2.76%	18.84%	7.34%	11.79%
Alpha	1.47%	4.31%	17.09%	29.92%	7.19%	12.70%

Source: Ellerston Capital

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

* S&P/ASX Small Ordinaries Accumulation Index

COMMENTARY

The Ellerston Australian Micro Cap Fund (Fund) delivered 4.85% in January, outperforming the Small Ordinaries Accumulation Index by 1.47%. The market rallied during the beginning of the month, and at one point was up over 5%. However, towards the end of January the market started to roll over amid concerns around Coronavirus, which impacted oil prices and saw bond yields move lower, along with the bushfires which weighed on the tourism sector. The strongest performing sectors in January included Utilities, Healthcare and Financials respectively. Energy was the worst performing sector returning -7.8% for the month, although this was broadly in line with our expectations.

January is generally considered a slower month in the markets but it was kept busy this year, with downgrades from Nearmap, Seven West and Kogan. On the flip side we saw strong share price movements from names like Polynovo and Data3 on the back of positive trading updates. These trading updates (both positive and negative) give us a good insight into the level of volatility we can expect heading into the February reporting season.

In January, Mitchell Service (which provides drilling services to the mining industry) was one of the stronger performers in the portfolio, finishing 5% higher for the month. The performance reflected a strong second quarter trading update, which was driven by favourable operating conditions, stronger rig pricing, and minimal impact from the bushfires. Pleasingly, the outlook for the second half remains positive, with a meaningful EBITDA uplift expected, aided by the recent acquisition of Deepcore Drilling. The company's net debt increased by $26.8 million to $39.5 million to fund the acquisition, which is performing well. Despite the additional debt, we are comfortable with the balance sheet and expect strong earnings growth and improving free cash flows will see the balance de-lever quickly.

Looking forward into reporting season we think the market is likely to focus on three key factors:

1. Earnings outlook commentary/guidance: While outlook commentary and guidance is always a key focus for the market, we think this will play an even more important role given the uncertainly around external factors, namely the trade wars, drought, bushfires and Coronavirus. We believe the market is going to be sceptical of stocks in the second half skew club, and punish any stocks which talk about deteriorating outlooks. On the flipside we think companies which are on track to achieve guidance will be rewarded.
2. Valuations: As we have been discussing for some time valuations have been toppy. Consequently, we expect companies which miss earnings expectations will be aggressively sold off, especially for the stocks trading on big earnings multiples.
3. Balance sheet optionality: Given the uncertainty around these external factors, we think company balance sheets will come under additional scrutiny. Additional focus will be on whether the balance sheets can withstand softer earnings outlooks. Alternatively, companies with excess cash on their balance sheets and flexibility to pursue accretive acquisitions will be viewed favourably.

Currently the Small Ordinaries Accumulation Index is trading on a one year forward PE of 17.3x, which is at a 10% premium to its 5 year average. Notwithstanding, we see market multiples expanding further given the low bond yields and surplus liquidity in the market. Consequently, we remain vigilant in monitoring our portfolio and rotating towards stocks which have a more favourable risk-reward ratio.

Regards

David Keelan & Alexandra Clarke

Investment Objective

The fund aims to outperform the S&P/ASX Small Ordinaries Accumulation Index over a rolling three year period by investing in Australian and New Zealand listed and unlisted securities.

Investment Strategy

The Fund employs an active, research-driven investment approach which seeks to identify and invest in companies that are believed to have the potential to deliver significant upside over the medium term and where there is a reasonable margin of safety to mitigate downside risk. Positions are actively managed within the Fund.

Key Information

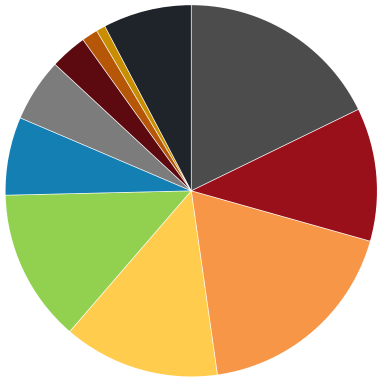
Strategy Inception	1 May 2017
Portfolio Manager	David Keelan & Alexandra Clarke
Application Price	$1.6588
Net Asset Value	$1.6547
Redemption Price	$1.6506
Liquidity	Daily
No Stocks	56
Management Fee	1.20%
Performance Fee	20%
Buy/Sell Spread	0.25%/0.25%

PORTFOLIO CHARACTERISTICS

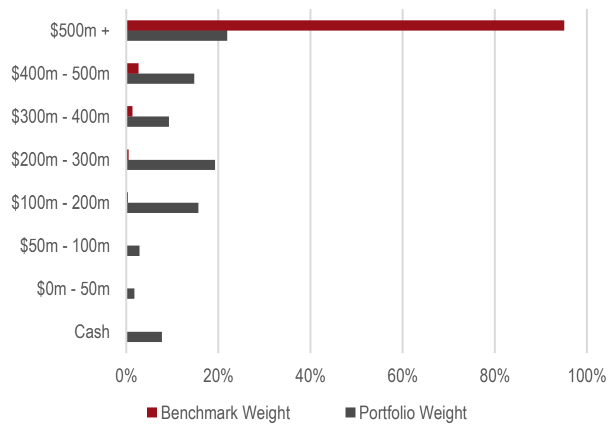
KEY PORTFOLIO METRICS

FY20e	Fund	Benchmark
Price/Earnings	18.1x	19.6x
Dividend Yield	1.7%	2.9%
Net Debt/EBITDA	0.1x	1.4x

SECTOR ALLOCATION



MARKET CAPITALISATION



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/

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