ELLERSTON CAPITAL

Ellerston Overlay Australian Share Fund (OASF)

Performance Report | October 20

PERFORMANCE SUMMARY

Performance Class A (%)	1 Month	3 Months	FYTD	Rolling 12 Months	5 Year (p.a.)	Since Inception (p.a.)
Net^	0.31	0.85	0.97	-10.64	3.06	5.34
Benchmark*	1.93	0.98	1.48	-8.15	6.80	7.64

Past performance is not a reliable indicator of future performance

MARKET COMMENTARY

Market Overview

In October, equity markets were mostly weaker as a spike in COVID-19 infections globally, the absence of any agreement on fresh fiscal stimulus in the US and in-line earnings from the tech giants dampened investor enthusiasm. In Australia the ASX 200 markedly outperformed the MSCI Developed Market's benchmark by ~5%, as a highly stimulatory budget was well received. The AUD fell on more dovish comments from the RBA governor about further rate cuts and the prospect of QE, and general 'risk-off' sentiment. Global bond yields rose modestly, but inflation expectations continued to fall, due to softer oil prices driven by anticipated weaker demand for transport fuels from new shutdowns.

USA

US equities finished lower for the second month in a row, as COVID-19 cases surged to record levels and a consensus on a new two trillion dollar fiscal stimulus package was unable to be achieved. Additionally, the prospects of a messy Presidential election outcome weighed on investor sentiment. The Federal Reserve chairman, Jerome Powell, reiterated his warning that the recovery would stutter without further stimulus.

The NASDAQ Composite finished the month in negative territory with a return of -2.3%, but remains strongly in the black for the calendar year to date. The S&P 500 posted a -2.7% return and the Dow Jones was down 4.5%.

Activity indicators remain mixed. The manufacturing ISM retraced to 55.4 (consensus: 56.5, previous: 56.0), however, the composite services ISM was better than expected, rising to 57.8 (consensus: 56.2, previous: 56.9).

The US printed a record snapback in economic activity in 3Q (+7.4% quarter-on-quarter GDP growth and +33.1% quarter-on-quarter annualised), with strength apparent in personal consumption, residential investment and equipment investment.

Europe

European markets were particularly badly hit. Fears of a severe second coronavirus wave were realised with fresh lockdowns announced in the major economies of the UK and France. The markets were also impacted by the uncertainty around further fiscal stimulus in the US and Brexit risks.

The Euro STOXX 50 Index was crunched, falling 7.3%. Among the major exchanges, Germany's DAX's fared the worst, with a return of -9.4%, followed by the UK's FTSE 100, -4.8% and France's CAC 40, -4.4%.

Activity indicators in Europe were again mixed. The flash Eurozone manufacturing PMI for October was ahead of expectations, rising to 54.4 (consensus: 53.0, previous: 53.7), whilst the composite PMI fell to 49.4 (consensus: 49.2, previous: 50.4).

Asia

Unlike US and European markets, Asian markets bucked the trend and were broadly stronger in October. The economic data out of China was below expectations but still strong, with 3Q GDP rebounding to +4.9% year-on-year. The Hang Seng Composite Index returned +2.8%, the Chinese SSE Composite Index, +0.5%, and India's BSE SENSEX was up 4.3%, but Japan's Nikkei 225 Index was down 0.9% and Korea's KOPSI was down 2.6%.

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	1 July 2011
Portfolio Manager	Chris Kourtis
Application Price	$1.0042
Net Asset Value	$1.0017
Redemption Price	$0.9992
Liquidity	Weekly
No Stocks	22
Management Fee	0.90%
Performance Fee	15%
Buy/Sell Spread	0.25%/0.25%

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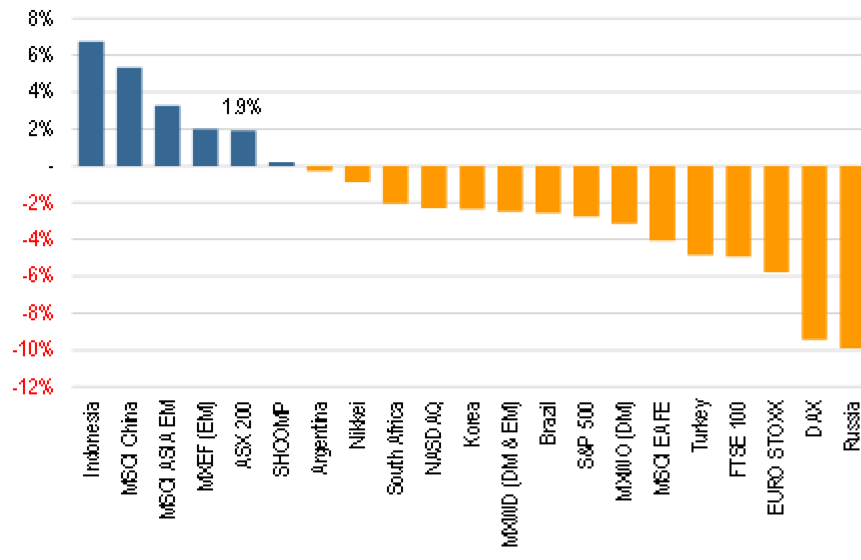
Global markets performance in October 2020

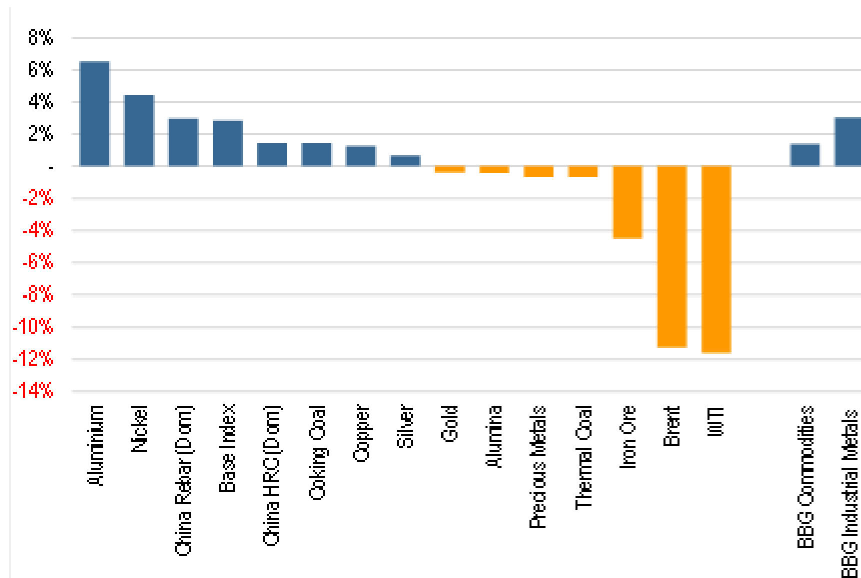


Source: JP Morgan, Bloomberg

Commodities

Commodity prices were mixed in October. Fears of another lock-down hit oil prices with Brent oil down 11%. Iron ore prices also fell as Chinese inventories continued to rise from increased supply by Brazil, but remain at elevated levels. Despite a broadly 'risk-off' environment, gold prices declined slightly to US$1,882/oz.

Global commodity performance in October 2020



Source: JP Morgan, Bloomberg

Bonds

Bond yields rose in October with the US 10-year government bond yield rising sharply by 17 basis points to 0.85%, perhaps taking a view on the upcoming election, whist the Australian 10-year bond yield rose more modestly, up 4 basis points to 0.83%.

Australia

The S&P/ASX 200 Accumulation Index was up 1.9% in October and proved to be one of the few global markets to deliver a positive return. It was a rather volatile month in Australia also, as the domestic market was buffeted by negative international sentiment but offset by the highly expansionary government budget and soaring consumer confidence.

The Financials sector was the most significant contributor to the index's performance, adding 1.6%, followed by Information Technology (+0.3% contribution) and Consumer Staples (+0.3% contribution).

The ASX 200 Industrial Accumulation Index was the top performing sub-index, with a return of +2.8%, followed by the Small Ordinaries Accumulation Index, +0.5% and then the ASX 200 Resources Accumulation Index which was down 1.3%.

The top five stocks that detracted from the performance of the S&P/ASX 200 Accumulation Index were: BHP Group (-31 points), Transurban Group (-10 points), Newcrest Mining (-10 points), Brambles (-8 points) and Telstra Corporation (-7 points).

The top five stocks that made a positive contribution to the index's return were: Commonwealth Bank of Australia (+58 points), Australia and New Zealand Banking Group (+ 26 points), Westpac Banking Corporation (+ 23 points), Afterpay (+22 points) and National Australia Bank (+17 points).

As expected, immediately post month end on Melbourne Cup day, the RBA cut official cash rates to 0.1% from 0.25% and embraced quantitative easing, with a $100 billion bond buying program at maturities of around 5 to 10 years over the next six months, in an effort to keep a lid on longer-term interest rates.

COMPANY SPECIFIC NEWS

The Market Misses

Mayne Pharma (MYX -23.1%)

Regulatory approval of its generic version of a popular female contraceptive in the US (Nuvaring) has been delayed by the FDA after it asked for further information. The delay increases the risk that other generic manufacturers will get their version of the product to market ahead of MYX and capture market share that MYX was expecting to achieve.

Flight Centre/Corporate Travel Management (FLT -18.2%/CTD -15.3%)

The uncertain nature of COVID-19 continues to play havoc with the travel names and reopening trade. Second wave case surges across the US and Europe, have delayed cross border re-openings and with it the prospect of international travel. Closer to home, Pacific travel bubbles may provide some relief, though sentiment is likely to remain fickle.

Austal (ASB -17.4%)

Austal underperformed due to the combination of uncertainty around US defence spending pending the election outcome and ongoing commercial orders, as well as some negative press speculation of misconduct by the Australia Border Force as it relates to the payment of the Cape Class program in 2015.

Regis Resources (RRL -17.2%)

RRL was weaker after releasing a lower than expected gold production report for the September quarter. A number of factors contributed including; a pit wall slip at the Erlistoun mine restricting access to higher grade ore, mill outages as well as grade variability in the early stage of the Rosemont underground mine.

New Hope Corp (NHC -16.7%)

NHC announced a 75% reduction in its corporate office, further to the 150 workers previously made redundant, due to the ongoing uncertainty around approvals for stage three of its New Acland coal mine in Queensland. This, together with reports of China enforcing import quotas on coal (especially from Australia), weighed on NHC's stock price.

Resolute Mining (RSG -14.0%)

The gold miner's share price collapsed following the announcement of the sudden and unexpected departure of its CEO, followed a few days later with a weak quarterly production report.

Bravura Solutions (BVS -13.8%)

BVS announced during the month that it had won an initial 7 year contract with Aware Super to provide a suite of administration software solutions, as well as an acquisition of UK-based Delta Financial Systems for $41.5 million. However, it underperformed following the announcement that guidance for FY21 NPAT will now be significantly weighted to the second half of FY21.

Jumbo Interactive (JIN -13.0%)

A run of low jackpots in the Lotteries division saw JIN post weak sales growth for the Sep quarter (-2% on pcp). The market had become accustomed to the company delivering positive revenue growth, regardless of the jackpot run, as it is a primary beneficiary of the shift in lottery sales from traditional retail distribution channels to online.

The Market Hits

Coca-Cola Amatil (CCL +30.8%)

CCL jumped sharply on the announcement that it was in takeover discussions with Coca-Cola European Partners (CCEP). The Coca-Cola Company agreed to sell its ~30% stake in CCL at a discount to the $12.75 bid price tabled for other shareholders. With CCL Board endorsement, it would appear that the proposed deal is highly likely.

Pilbara Minerals (PLS +29.2%)

PLS entered into an implementation deed with the senior secured loan noteholders of Altura Mining (in receivership) to potentially acquire Altura's lithium operations (ALO) for US$175m. PLS has proposed to fund the acquisition through an equity raising and has secured binding commitments for a total of A$240m. The receiver plans to put ALO on care and maintenance, whilst a formal process to market the sale or recapitalise the ALO assets is completed. PLS has secured the right to match any competing proposal. The logical consolidation of two neighbouring lithium operations was taken positively by investors.

Link Administration Holdings (LNK +27.9%)

On 16 October, LNK confirmed that it received a non-binding indicative bid from a consortium of private equity participants to acquire 100% of its shares. The bid was at $5.20 and received the backing of LNK's largest shareholder, Perpetual. The consortium subsequently increased its cash offer price to $5.40. The previous offer included a scrip alternative which comprised of a cash offer for Link Group ex-PEXA of $3.80 per share and an ability to take a holding in Link Group's PEXA interest. The Board has granted the consortium access to non-exclusive due diligence information, subject to appropriate confidentiality agreements and including a stand-still provision.

Virgin Money (VUK +26.6%)

Having underperformed materially the previous month after the Bank of England speculated publically about negative interest rates and market concerns about the impact on net interest margins and a slowing economy, VUK shares jumped sharply in October from technically oversold levels. The spike was driven by a broker upgrade and evidence that UK banks were repricing loans to increase margins.

Challenger (CGF +25.6%)

CGF has underperformed sharply after it raised equity in June at $4.89. The market has been concerned about credit defaults, retail property exposure, declining margins in a low interest rate environment and falling sales. Markets rebounding off their COVID-19 induced lows provided investors with some comfort and CGF provided an update in October that demonstrated that sales were rebounding. Trading below book value, the update saw investors and bargain hunters buy back in.

Sims Metal Management (SGM +25.5%)

The market is expecting SGM to benefit from a recovery in steel scrap prices and volumes as US steel companies increased output, driven by stronger hot rolled coil steel prices from improving demand, especially from US automobile manufacturers.

HUB24 (HUB +24.2%)

HUB’s incredible share price run and re-rating continued as it kept winning flows and increasing market share. In October, HUB successfully completed a $50 million fully underwritten placement and subsequently announced that it would acquire 100% of Xplore, which is expected to be materially accretive to HUB’s earnings.

Lynas Corp (LYC +22.0%)

The stock price jumped after China passed export control laws allowing the government to ban exports of strategic minerals, including rare earths, to specific foreign companies. Given China's overwhelming dominance of the rare earth market, its potential impact on pricing would be significant if widely enacted.

Afterpay (APT +20.9%)

APT broke through the $100 per share mark in October. During the month it announced a collaboration agreement with Westpac to introduce APT savings accounts and cash flow tools. More importantly, APT also received a final notification from AUSTRAC that it will not take any further regulatory action against the company.

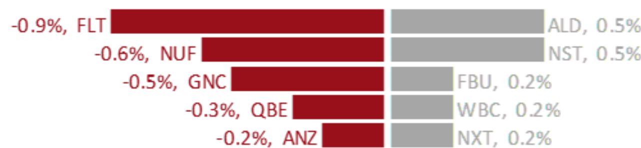
FUND PERFORMANCE

In a volatile month where the market pared back early strong gains and came off its recent highs, the Fund return of 0.41% lagged the benchmark return of 1.93%.This brings the return for the 2021 FYTD to 1.35%, broadly in line with the benchmark return of 1.48%.

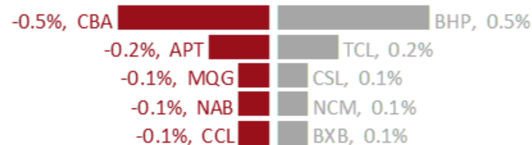
RETURNS^ (%)	GROSS	BENCHMARK*	EXCESS	NET
1 MONTH	0.41	1.93	-1.53	0.31
3 MONTHS	1.13	0.98	0.16	0.85
FYTD	1.35	1.48	-0.14	0.97
ROLLING 12 MONTHS	-9.70	-8.15	-1.56	-10.64
5 YEARS (P.A)	4.00	6.80	-2.81	3.06
SINCE INCEPTION (P.A)	6.44	7.64	-1.19	5.34

Past performance is not a reliable indicator of future performance

Securities Held



Securities Not Held



Source: Ellerston Capital.

The main positive contributors to this month's relative performance were overweight positions in: Ampol (ALD +8.3%), Northern Star Resources (NST +8.9%), Fletcher Building (FBU +8.7%), Westpac Banking Corporation (WBC +6.4%) and NEXTDC (NXT +3.7%).

Zero weight positions that helped performance included BHP Group (BHP -5.1%), Transurban (TCL -4.6%), CSL (CSL +0.2%), Newcrest Mining (NCM -6.4%) and Brambles (BXB -8.6%).

The main detractors to relative performance for the month were overweight holdings in: Flight Centre Travel (FLT -18.2%), Nufarm (NUF -10.6%), GrainCorp (GNC -6.3%), QBE Insurance (QBE -4.2) and Australia and New Zealand Banking Group (ANZ +9.2%).

Not holding larger cap shares that outperformed the broader market and also constrained returns included: Commonwealth Bank of Australia (CBA +8.5%), Afterpay (APT +20.9%), Macquarie (MQG +6.0%), National Australia Bank (NAB +4.8%) and Coca-Cola Amatil (CCL +30.8%).

FUND ACTIVITY

The Fund was highly active in the month of October, with 4 new stocks added in order to reposition the portfolio with fresh ideas, and 3 stocks were exited.

We also used the intra-month highs in the market and in select stocks, as an opportunity to take profits, in Northern Star Resources, South32, Ramsay Healthcare and NEXTDC, all of which had performed strongly.

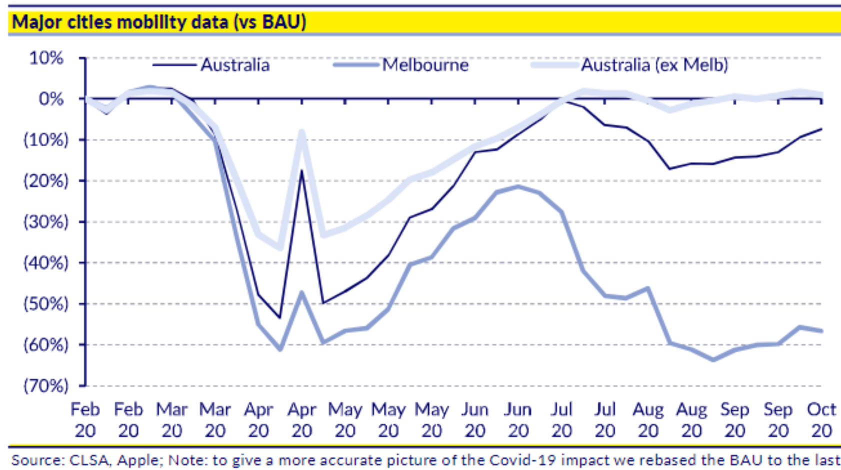
NEW STOCKS ADDED	STOCKS EXITED
• Ampol	• Goodman Group
• Australia and New Zealand Banking Group	• Janus Henderson
• Medibank Private	• Telstra
• Tabcorp Holdings	
INCREASED	**DECREASED**
	• Northern Star
	• NEXTDC
	• South32
	• Ramsay Health Care

Ampol (ALD)

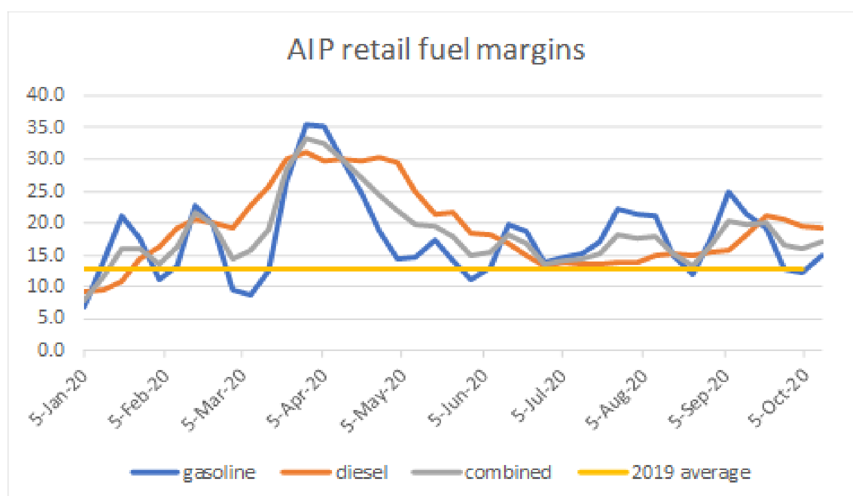
During the month we reintroduced Ampol Ltd (formerly Caltex) to the portfolio. We sold out of Caltex (CTX) at top dollar when it was trading over $34 per share earlier this year, after receiving an improved takeover proposal from Canada's Couche-Tard on February 13th at $35.25 cash, less any dividends declared by CTX. The negative impact of COVID-19 on transport fuel demand and convenience retail volumes, due to the lock downs and consequent financial uncertainties, resulted in Couche-Tard ultimately walking away from their bid in April. ALD's current underperformance reflects a weak 2Q and 3Q trading update, particularly from its Lytton refinery and lack of capital management initiatives, with the market disappointed after the sell-down of 203 freehold sites raised $682 million in August. This has provided us with a very attractive re-entry level.

As a reminder, ALD operates 2 main businesses: Retail Convenience; with over 800 sites and Fuels & Infrastructure; which includes the largest finished product import terminals in Australia and New Zealand, the Lytton oil refinery in Queensland, 94 bulk fuel storage and distribution hubs and over 300 kilometres of fuel pipelines. Lytton's loss making days appear to be numbered, despite potential government support, with the company announcing a comprehensive review to be concluded over the next 6-9 months, which is likely to result in its closure. This is an industry wide trend, with BP announcing the closure of its large refinery in W.A and we believe would be taken positively by investors.

Whilst fuel retailing is a competitive industry, it is by no means cut-throat. The volume collapse caused by lockdowns from COVID-19 has demonstrated that industry behaviour remains rational.



Despite the COVID-19 volume impact caused to major cities mobility, the industry's retail fuel margins have held up particularly well, as can be seen in the chart below. Margins are the key driver to ALD's earnings and this was reinforced when the company released its 3Q results on 19 October, with a very strong Convenience Retail result of $87m EBIT that significantly beat analyst expectations.

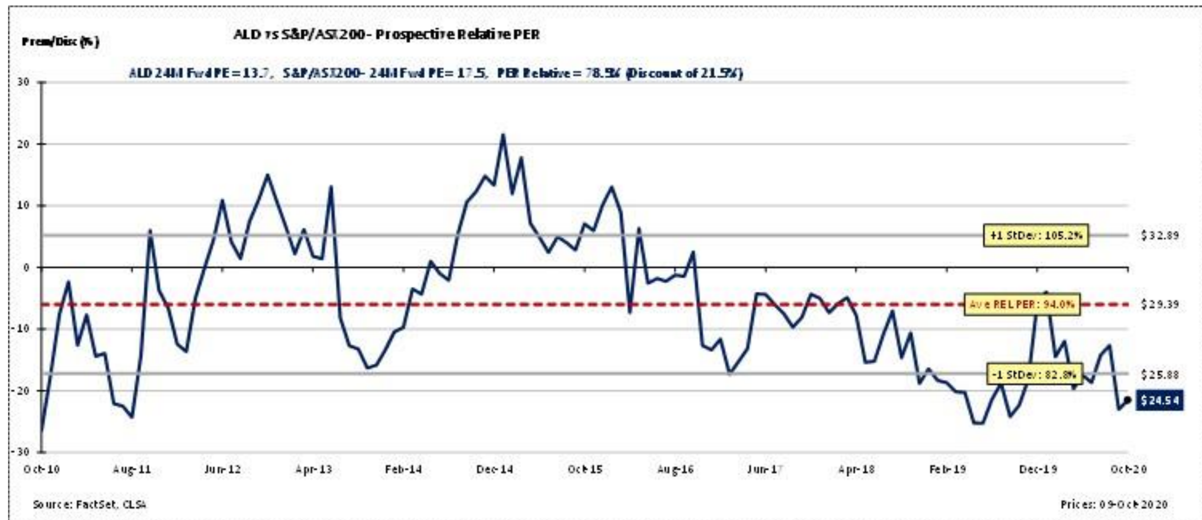


Source: Australian Institute of Petroleum

ALD's financial position has been strengthened through the sale to Charter Hall of a portion of its retail sites into a property vehicle, with further assets sales likely. The company also has a large surplus of franking credits which could be released either via a special dividend, off-market buyback or some other form of capital management. Given the uncertainty with the pandemic, the company has been reluctant to date to unlock the franking and release capital. However, as conditions continue to improve, it becomes compelling and more likely.

We believe there is far too much market focus on Lytton's volatile refining margins which is not the main game, given it represents only ~10% of ALD's overall valuation. We believe that closure would remove those wild earnings swings and lead to a rerating of the shares. Most of the value is in the Convenience Retail and Fuels & Infrastructure businesses, both undervalued businesses.

We have bought into ALD at what we believe is a very attractive valuation multiple.



Australian and New Zealand Banking Group (ANZ)

We have long-held and articulated concerns that earnings and returns in the Australian banking sector would decline in the face of various headwinds, including slowing credit growth, shrinking margins and rising regulatory costs. These have mostly come to pass. Valuations of the sector now are more realistic, especially the price to book multiples given the collapse in their ROE's. This year, the impact of coronavirus was another significant exogenous event that negatively impacted cash earnings.

The government responded to the health crisis with an aggressive stimulus and support package. This was a life line for about 10% of the banks' loan book that suspended or deferred loan repayments. Interest rates have been cut to record low levels. The fall in official cash rates exacerbated the decline in net interest margins. The crisis forced the banks to put aside significant provisions for COVID-19 based on their best estimate of future economic losses. Earnings were slashed, dividends were cut or suspended and the sector underperformed materially.

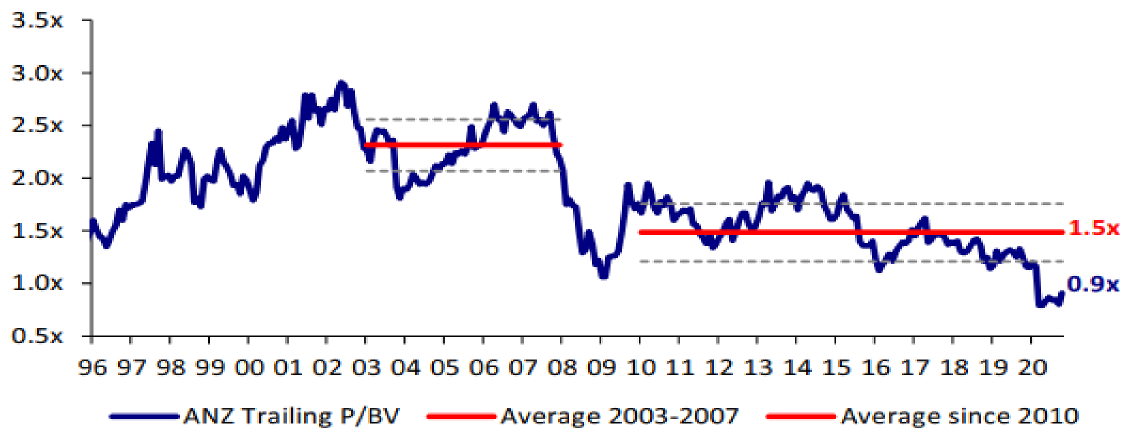
We are now seven months into the crisis and the worst fears, of the government and those embedded in the banks' economic modelling, have not been realised, yet the sector continues to trade at a large historic discount to the market and at a discount to book value. The sector clearly still faces structural and secular headwinds. However, we expect that the outlook for credit growth could be better than feared, provisions are likely adequate for now, cost reductions are in focus and capital levels are comfortably above the "unquestionably strong" 10.5% of common equity tier one (CET1) capital requirements. Given our cautiously more benign outlook, we have bought ANZ (in addition to WBC already held), having previously exited our ANZ position back in late 2014!

We like ANZ for a number of reasons:

1. Its FY20 results were largely in-line with expectations, the bank's balance sheet looking well-placed for this economic environment.
2. Underlying (ex-large and notable items) costs were flat on FY19. The bank indicated that it would continue to focus on costs given the ongoing pressure (across the sector) on revenue. It confirmed a medium-term – likely by FY23 – underlying cost ambition of $8 billion (from $8.6 billion as at FY20).
3. The credit provisions, including the COVID-19 overlay, would appear to be adequate for now. Total Collective Provisions (CP) balance is currently just over $5 billion, with the CP balance to risk weighted assets ratio at 1.4%. We would also caution that the sector would have better clarity on provisions only after the first quarter of 2021, when the various government support mechanisms end.
4. ANZ has more than sufficient capital, with a pro forma CET1 of around 11.4%. APRA has been clear that it would expect banks to run down their surplus capital buffers to absorb losses and importantly to support growth.
5. ANZ paid a final dividend of 35 cents per share, fully franked (or 49% of statutory earnings). The board declared an interim dividend of 25 cents per share, fully franked (or 46% of 1H20 statutory earnings) at the time of its last trading update. It confirmed that risk weighted asset pro-cyclicality from credit risk weight migration was now forecast to be lower given improved economic assumptions. Capital generation with a recovery in earnings and a target pay-out ratio in the mid-60s per cent, should see the bank distribute a growing dividend, providing yield support.
6. Valuation provides some support. **FY20 NTA was $20.04** (+2% on FY19). The charts below highlight a historical discount to book value and to the Industrials.

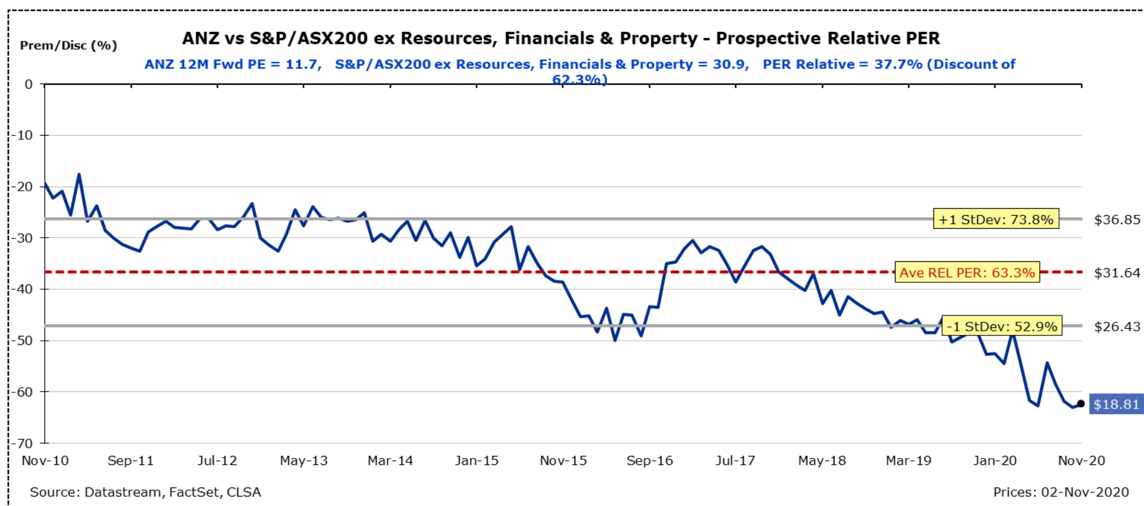
So, despite softer revenue, net interest margin pressure and EPS downgrades across the banking sector, with the ANZ FY20 and WBC FY20 results now out of the way, much of the tail risk associated with deteriorating credit quality has diminished, with loan deferrals trending much better than expectations. We believe cost control, a strong capital position (with pro-forma CET1 OF 11.4% for ANZ) and a lower risk profile help to compensate for ongoing revenue headwinds. At the same time, ANZ's early decision to simplify its business model and its effective capital management in recent years, offers the best dividend and ROE recovery profile of the majors, with solid valuation appeal. Consensus FY21 dividend forecasts of 90c implies a dividend yield of ~5.0%.

ANZ price to book value



Source: Morgan Stanley Research

ANZ PE relative to the Industrials



Tabcorp Limited (TAH)

After exiting the position at ~$4.80 back in April 2019, TAH returned to the portfolio in October. TAH is an Australian based lottery and wagering provider with licences in all States except Western Australia. The stock has dramatically underperformed the ASX 200 by ~20% in 2020 and more than 25% since our exit.

The core business for TAH is **Lotteries**. TAH's lotteries licences are monopolies granted in each State and benefit from Federal legislation that effectively prohibits synthetic lottery products, such as those offered by Lottoland in other countries. The primary distribution channel is retail outlets (newsagents and convenience retail stores), although digital distribution is a fast growing, increasingly meaningful and a significantly more profitable sales channel.

The attractiveness of the lotteries business is multi-faceted, including:

- Monopoly licences protected by legislation.
- Long dated licences – no licence expires before 2025 (Tasmania), the Victorian licence runs to 2028 and licences in the other large key States of NSW and Queensland do not expire until 2050 and 2072.
- Incumbency is a huge advantage when licences come up for renewal/retender – jackpot pooling across States is important to maximise sales given the direct link between jackpot size and tickets purchased.
- Fixed gross product margins and a largely fixed cost base provides material operating leverage to volume and price increases.
- Ageing population tailwind – propensity to play lotteries increases as people get older.
- Low price elasticity - the small purchase value (a single game entry costs <$1.40) ensures that large but infrequent price increases, usually bundled in with game structure changes, predominantly stick.
- Increasing digital penetration boosts revenue growth and margins – online sales are growing fast but still <30% of the total. Digital account customers buy 50% more tickets than retail only customers – a function of availability, purchase ease, higher propensity to reinvest small wins and direct marketing capability. The gross margin on a digital sale is approximately twice that achieved on a retail sale. TAH retains the retail commission that otherwise would have been paid to the newsagent or convenience store owner.
- Strong cash generation – annual capital expenditure demands of circa $60m (excluding infrequent licence renewals) are modest on approximately $600m of EBITDA.

The Lotteries business has been a net beneficiary from COVID given restricted access to alternative gambling and discretionary entertainment options. However, that tailwind has recently been more than offset by a poor run of luck in the jackpotting games, which will ultimately normalize in coming periods. The 15 to 30% growth in like-for-like sales at given jackpot levels reported by TAH for the September 2020 quarter, is a better reflection of the underlying health of the business than the reported headline of a 7% decline in Lotteries revenue.

The drag for TAH has been its **Wagering** business which makes up ~20% of the group valuation. It appears management will extract the targeted cost synergies from the merger with Tatts, but they have not been able to satisfactorily address the relative poor performance in the former Ubet States, nor fully offset the structural decline in its own retail wagering division. The introduction of a point of consumption tax and industry consolidation have not reduced competitive intensity. If anything, the Australian wagering market is as competitive as ever.

However, we expect wagering earnings to stabilize – all that's required for a material share price re-rate. The trading update for the September 2020 quarter was the first sign of such a stabilisation. Revenue increased 2.9%, despite government enforced retail closures in Victoria for much of the period.

TAH has now largely repositioned its wagering offer such that its level of promotions and generosity is more consistent with its online only peers. The earnings headwind from the step change in net win margins to 'meet the market' should abate.

The Ubet customer base has only just been transitioned across to the core wagering platform. This enables customers in the Ubet States (Qld, SA, Tas, NT) to access a much wider array of products for the first time, many of which are relatively high margin, including same game multi, quaddie cashout, early quaddie, big six and multiplier.

Fear the COVID induced temporary closure of retail outlets would bring forward structural decline in retail are so far misplaced. Retail wagering activity appears to have rebounded strongly post reopening, suggesting the cohort of punters that will always prefer to bet with cash is larger than expected.

The third and smallest division is **Gaming Services** which offers a combination of slot machine monitoring and management services. The business has been the hardest hit of the three from COVID and faces a large step down in earnings in FY23, when high margin legacy contracts expire. However, it makes up less than 10% of EBITDA, even less of our valuation and was up for sale when COVID hit. We expect it ultimately to be sold to further reduce debt and strengthen TAH's balance sheet that already looks much better post the $600m equity raising in August 2020.

That is a good segue into a discussion on valuation because this is where the investment thesis becomes more compelling. In our opinion, the Lotteries business should be trading on an EV/EBITDA multiple around 17x. The independent expert's report, at the time of the merger with Tatts in 2017, suggested fair value was ~15x (ex a typical takeover premium of 30%). Since then, the circa 200bps decline in the 10 year bond rate has seen the market multiple inflate significantly, especially for long duration assets. Management in the wagering business have failed to offset structural headwinds in the retail operations, so we are not inclined to give them the benefit of the doubt for improved performance, but the business can still command a 6x EV/EBITDA multiple without being overly optimistic, given its retail exclusivity in all States except WA.

We ascribe a low Gaming Services business multiple of 5x sustainable earnings, and when we put all the components in the melting pot, **we can easily arrive at a target price approaching $5.00**, representing more than 40% upside. A resumption of dividends with the 1H21 result should deliver an above market fully franked yield of 3.5%.

The quality of its Lotteries business and the opportunity for stabilisation and improved performance in Wagering should see the valuation gap close, notwithstanding the likely appointment of a new CEO in coming months.

Medibank Private (MPL)

Following the onset of the COVID-19, the market has bet that extraordinary government stimulus would cushion the economic downturn. This has seen equity markets rebound sharply off their lows, driven primarily by growth stocks. MPL's share price has drifted lower against that backdrop, underperforming in an absolute and relative sense. We believe that the stock looks attractive at current levels given it has valuation support, a very attractive dividend yield, a debt-free balance sheet and a well-regarded management team focused clearly on managing costs tightly. We have bought back into MPL.

MPL is one of Australia's largest health insurance companies and one of only two listed health insurers. MPL has 3.7 million customers and 26.9% market share. It operates two brands – Medibank and ahm and has two broad divisions: Health Insurance with 96% of premium revenue, underwrites and distributes private health insurance policies, and Medibank Health with 4% of premium revenue, includes the provision of health management and telehealth services.

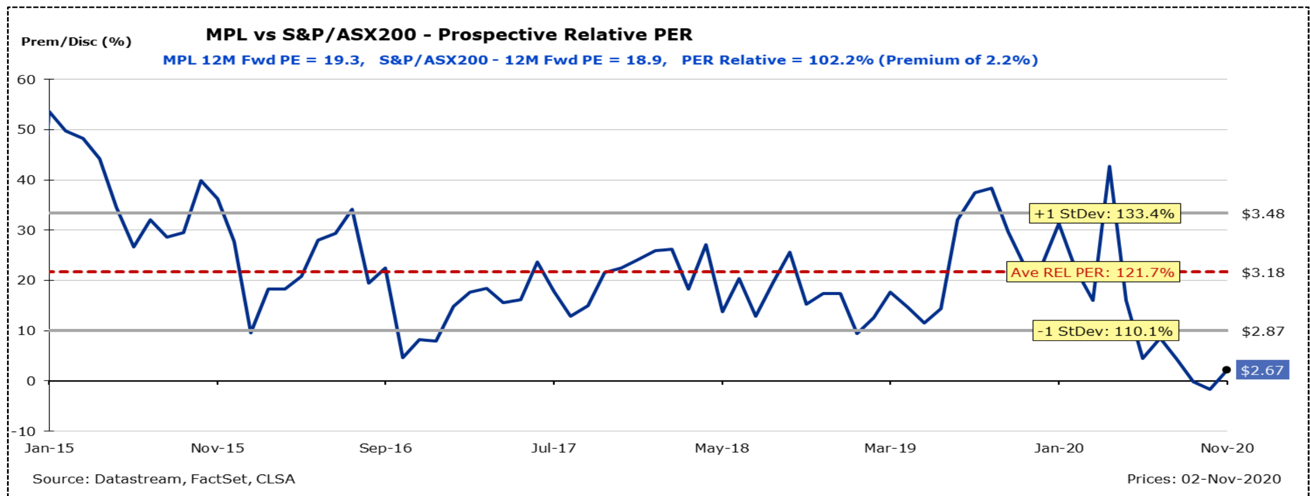
MPL faces a tough industry backdrop. Political pressure on premium rate increases and pressure on margins are headwinds. The last reported results revealed that the company benefitted from the drop off in claims, especially in ancillary claims (like dental), as COVID-19 restrictions led to a cancellation of elective surgery and a decline in the use of ancillary services. **However, the group put aside substantial provisions of $297 million for deferred COVID-19 claims, arguably with some conservatism.**

The last set of results (FY20) revealed that customer relief measures in the last quarter for COVID-19 impacted revenue by $80 million – including $65 million for a temporary waiver of the 1 April 2020 scheduled premium rate increase and $15 million as customers who suffered cash flow pressures, suspended their cover. In fact, total claims in FY20 were $364 million lower than pre-COVID expectations, but the company has put aside $297 million in provisions, prudently.

MPL currently expects that the claims benefits will largely offset the customer relief measures in FY21. However, as time passes, it will be difficult to strictly attribute a claims savings to COVID-19 specifically. It is possible that some hospital cover provision – $234 million of the $297 million balance sheet provision – is released as an overprovision in due course. We do not bank on this outcome, but 15% would be $35 million or approximately 10% of the bottom line.

MPL delivered $20 million of productivity savings in FY20 and announced $50 million of additional savings between FY21 and FY23, including $20 million in FY21. The savings would come from business simplification, technology modernisation and further process improvement. The current management team's track record would suggest that there is little risk that these targets would not be delivered.

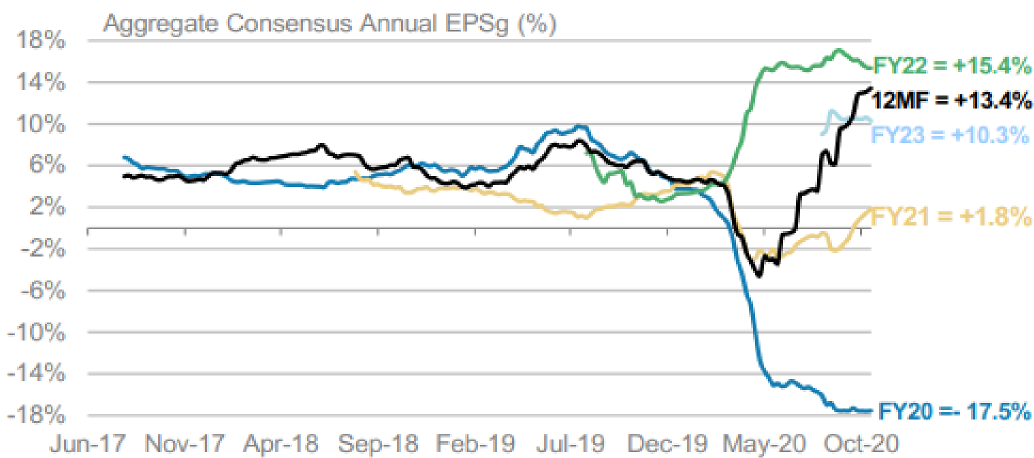
So with the stock trading at a large discount to its historical relative valuation (PER of 19.4 times FY21 vs. All Industrials ex Financials PER at 31 times) and offering a solid and reliable dividend (with an implied yield of approximately 5%), we feel that its defensive qualities offer appropriate diversification within the broader portfolio.

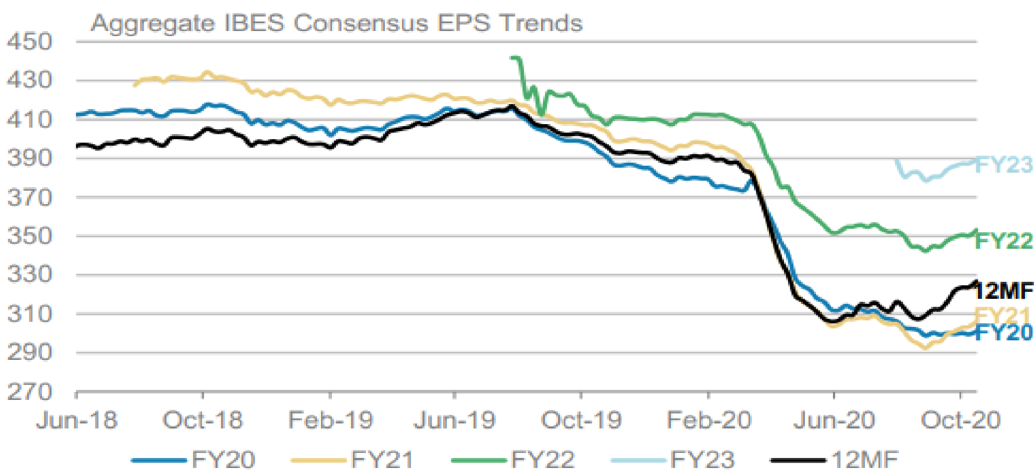


FUND STRATEGY AND OUTLOOK

We are loathe to repeat our strategy comments endlessly. PER's remain elevated in a low interest rate world and earnings are expected to recover from their pandemic lows.

ASX 200 12-month forward PE ratio





Source: RIMES, IBES, Morgan Stanley Research

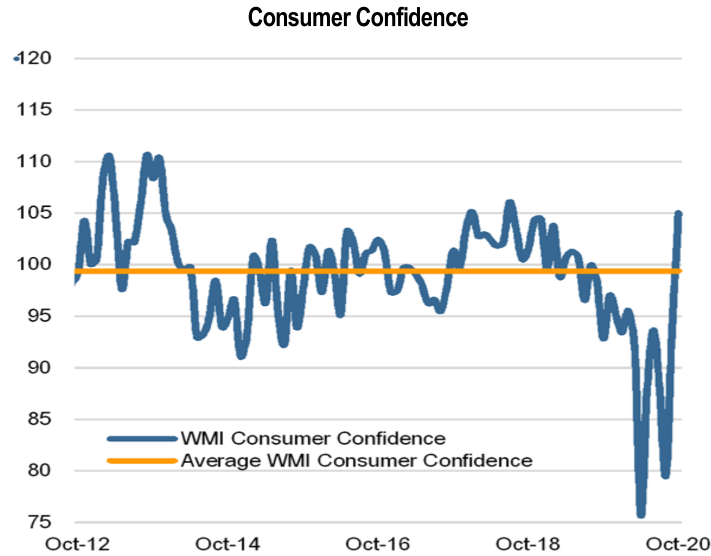
Given the pandemic's escalating second wave of lockdowns in key European economies such as France and the UK, coupled with the potential for a drawn out US election outcome and battle for the Senate, not surprisingly, we would expect volatility levels to become heightened.

Whilst still in limbo and it could be a while before the final contested results of the 2020 presidential election are known, it appears that the Blue Wave regulatory risk scenario (higher corporate taxes, Anti-Trust, etc.) has decreased meaningfully and is being priced out of the market. With a likely Biden victory, investors are also betting on skinnier stimulus, though some aid remains likely this year. A split legislature i.e. the likelihood of a divided Congress (the Senate leaning Republican and the House staying in Democratic control, but with a smaller majority) is now probable, making the path to sweeping legislative changes more problematic. This

backdrop has historically translated into higher equity returns. It needs to be emphasized that despite all the media frenzy and focus on the election race, the rebound in corporate profits has played a key role in equity market returns. In the US, S&P 500 earnings to date have been better than expected, and have been supportive of stock prices.

The outlook for Australia has become more constructive relative to the doomsday predictions feared by many investors in early March and April. The main drivers have been an expansionary Federal Budget, further accommodative action by the RBA, the re-opening of Melbourne after a protracted lockdown and finally consumer confidence, which has rebounded strongly. These tailwinds are supportive of the Australian equity market and we are starting to see increasingly positive earnings and dividend revisions. These upward trends should to persist in the near term, narrowing the considerable gap that opened up between Australia and the globe through Q2 and Q3. This improvement should also spill over and lift corporate confidence.

Consumer Confidence



Source: J.P. Morgan

In Australia, there has been a notable pick up in M&A activity, as evidenced by the Northern Star/Saracen merger of equals, Opticomm's tug of war, revised proposal by Pacific Equity Partners and Carlyle Group for Link at $5.40 cash, the $12.75 bid by Coca-Cola European Partners for Coca-Cola Amatil and a $1.85 implied preliminary takeover offer for wealth manager AMP by Ares Management. M&A activity is likely to continue early into the New Year as uncertainty is removed and corporate confidence picks up.

Post the RBA cut to official interest to 0.1%, interest rates remain at all-time lows and the Federal Budget's focus on lifting employment with eye watering stimulus has provided a safety net for the economy. The Reserve Bank promised to keep its official cash rate at 0.10 per cent for at least the next three years and its bond buying QE program aims to encourage cheaper bank lending to boost the economy's jobs recovery. RBA governor Philip Lowe's announced $5 billion-per-week buying program - worth about 5 per cent of GDP in total - came with a suite of lower rates for bank funding. The record rate cut should give a further boost to the already rebounding residential property market. At the same time, he also upgraded forecasts for economic growth from 4 per cent to 6 per cent by June next year.

To summarise your portfolio's positioning:

With the **right mix of sensibly priced growth stocks** and **deeper value cyclicals**, we believe the fund is reasonably well placed to navigate the current developments and expect our stocks to deliver solid returns in the years to come. The current themes and strategies that will drive the portfolio are summarised as follows:

1. Quality Franchises, Growth at Reasonable, Attractive Valuations

Solid companies with strong/leading market positions and credible management with good balance sheets
James Hardie Industries, NextDC, Medibank Private, Reliance Worldwide, Ramsay Health, Sydney Airport, United Malt and Treasury Wines

2. Businesses that are highly cyclical or seasonal in nature, facing headwinds

Heavily discounted companies with strong market positions and strategic assets, but very sensitive to economic conditions/seasonality/weather
Graincorp, Nufarm, Downer EDI, Ampol 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
Orica, QBE, Fletcher Building and Tabcorp Holdings

4. Deep Value Resource Plays

Stocks trading at discounts to NPVs, where much of the heavy lifting has been done (cost out, self help deleveraging)
South32, Woodside Petroleum and Northern Star Resources

WE HAVE REDUCED THE UNDERWEIGHT TO FINANCIALS, WHERE WE NOW OWN 2 OF THE BIG 4 BANKS.

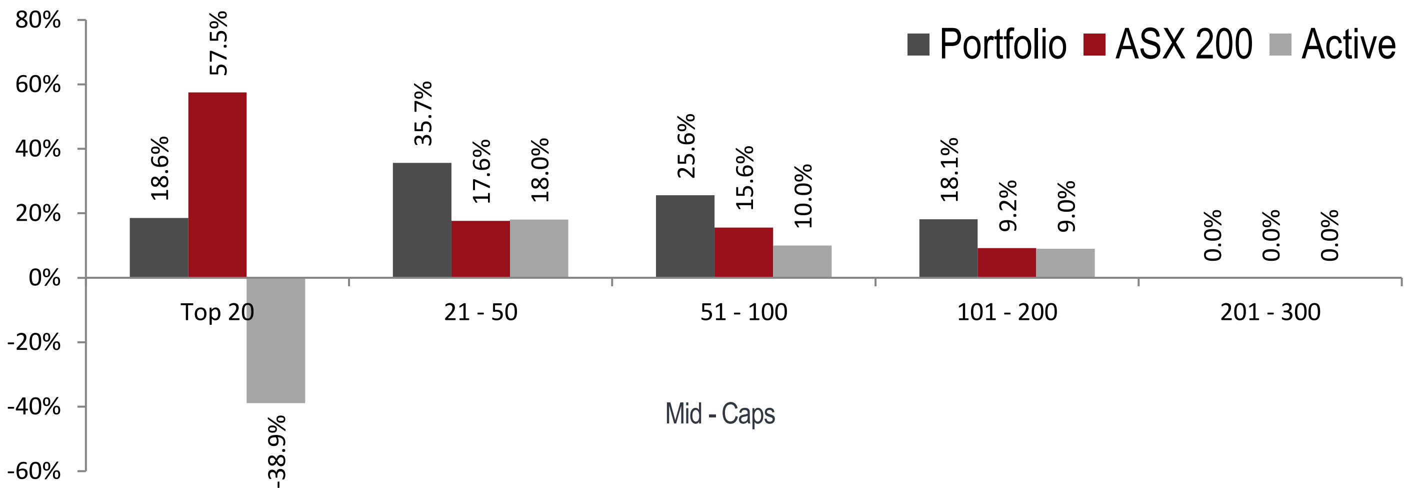
Warm Regards,

Chris Kourtis

Portfolio Manager

PORTFOLIO FEATURES

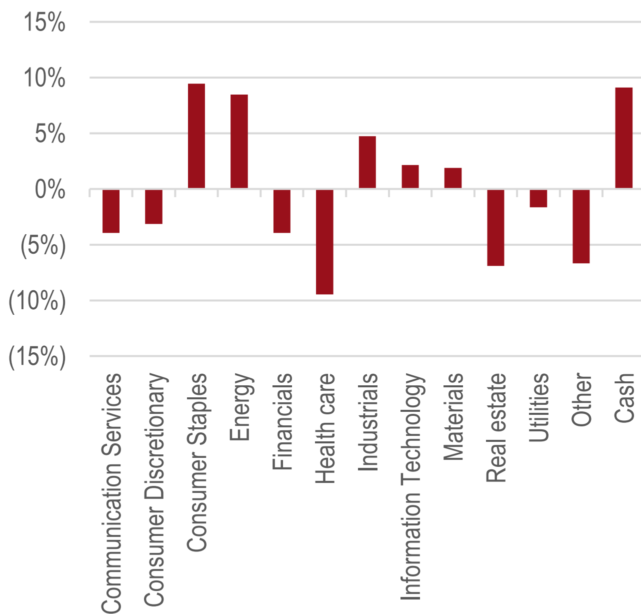
Size comparison Chart vs ASX 200^



Source: Bloomberg, Ellerston Capital Limited

^Size Comparison Data as at 30 October 2020

Active Sector Exposures*



Source: Ellerston Capital Limited

TOP 10 HOLDINGS**
AMPOL
ANZ BANKING GROUP
DOWNER EDI LIMITED
GRAINCORP
NEXTDC
NUFARM
QBE INSURANCE
TREASURY WINE ESTATES
UNITED MALT GROUP
WESTPAC BANKING CORP

ASSET CLASS EXPOSURES	
EXPOSURE (% OF NAV)	**Net**
EQUITY	97.59
LONG OPTION	0.00
SHORT OPTION	-6.68
EFFECTIVE CASH	9.09
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	$138. Million
FUNDS UNDER MANAGEMENT – OASF UNIT TRUST	$7.34 Million
APPLICATION PRICE	$1.0042
REDEMPTION PRICE	$0.9992
NUMBER OF STOCKS	22
FUND INCEPTION DATE	1 July 2011

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 7701 or info@ellerstoncapital.com

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