

Ellerston Global Mid Small Cap Fund

Monthly Newsletter, May 2021

Investment Objective

To outperform the MSCI World Mid Cap NR (AUD) Index by 3% over a rolling 5 year period on a net of fees basis, with a focus on risk management and capital preservation.

Investment Strategy

The Funds investment strategy is to construct a concentrated portfolio of global mid small cap securities using the Manager's distinctively contrarian high conviction, benchmark independent investment approach. The Manager believes that the trade-off between risk and potential returns is improved by implementing highest conviction ideas from a filtered universe of securities that are in a period of "price discovery" and offer the best risk/reward.

Key Information

Strategy Inception^^	1 March 2017
Portfolio Manager	Bill Pridham
Class A Application Price	\$1.4967
Class A Net Asset Value	\$1.4930
Class A Redemption Price	\$1.4893
Class B Net Asset Value	\$1.4070
Class B Redemption Price	\$1.4035
Liquidity	Daily
No Stocks	20 - 40
Management Fee (Class A)	0.75%
Performance Fee	10%**
Buy/Sell Spread	0.25% on application 0.25% on redemption

**10% of the investment return over the benchmark return (MSCI World Mid Cap Index NR (AUD)), after recovering any underperformance in past periods.

Performance Summary

Performance	1 Month	3 Months	6 Months	1 Year	3 Years (p.a.)	Since Inception^^ (p.a.)
Class A^	2.11%	7.13%	18.30%	32.36%	18.32%	17.53%
Benchmark*	1.30%	8.55%	12.04%	25.70%	11.55%	12.68%
Alpha	0.80%	-1.42%	6.26%	6.66%	6.77%	4.85%

Performance	1 Month	3 Months	6 Months	1 Year	3 Years (p.a.)	Since Inception*** (p.a.)
Class B^	2.26%	7.25%	19.41%	-	-	28.02%
Benchmark*	1.30%	8.55%	12.04%	-	-	22.81%
Alpha	0.96%	-1.30%	7.37%	-	-	5.21%

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

* MSCI World Mid Cap Index NR (AUD)

***Class B Inception Date is 18 August 2020

ESG in Focus

We will continue to hear more about the circular economy and how businesses can harness this ideal in maximising our use of finite resources while at the same time minimising external pressures on our environment. The Ellen MacArthur Foundation has a great report titled "The New Plastics Economy, Rethinking the Future of Plastics" which highlights a number of environmental concerns, along with potential solutions, regarding our use of the "ubiquitous workhorse material", plastics.

The report highlights that while plastics deliver highly functional properties at a very low cost, the drawbacks are becoming increasingly apparent. Approximately 95% of plastic packaging material value, or US\$80-120b annually, is lost to the economy due to its short first use cycle. More than 40 years after the launch of the first universal recycling symbol, only 14% of plastic packaging is collected for recycling. When additional value losses in sorting and reprocessing are factored in, only 5% of material value is retained for subsequent use.

What is more worrying is the likely acceleration of this trend. The report highlights that currently at least 8m tonnes of plastics leak into the ocean each year, the equivalent to one garbage truck every minute. If no action is taken, this is expected to increase to two per minute by 2030 and four per minute by 2050. This is unsustainable and while the plastics economy is highly fragmented, the collection and recycling infrastructure must rise to help minimise this issue.

Portfolio Commentary

The Ellerston Global Mid Small Cap Fund increased 2.11% net during the month with positive equity performance augmented slightly by a weaker Aussie dollar. The MSCI World Mid Cap (AUD) Index increased by 1.30% over the same period.

The portfolio's top three contributors Health and Happiness, Cellnex and Bed Bath and Beyond added 87bps to performance while Option Care Health, Azek and QTS Realty detracted 43bps. The Fund had 8 portfolio companies reporting quarterly results or trading updates in May rounding out the March quarter reporting season.

Flex Group is one of the largest outsourced manufacturing solution players globally and is really benefiting from its strong position in the supply chain in a time of significant component shortages. Flex has a March year end and while full year revenue of \$24.1bn was flat yoy, its Q4 exit rate came in at 14%. Despite the impact from Covid, full year EBITA grew 14.8% to over \$1bn and free cash flow came in at \$677m. Revenue and earnings guidance for the upcoming year was nicely ahead of market expectations and the share price reacted accordingly.

Option Care Health is the largest independent player in the US home infusion market and will benefit from the shift to home care at the expense of a hospital setting for the foreseeable future. It reported first quarter 2021 results with revenues and EBITDA up 7.6% and 29.5% respectively. Management marginally upgraded full year EBITDA guidance despite seeing some pressure on acute therapy pricing in antibiotics (nets out due to lower COGS) offset by referral patterns approaching pre-Covid levels and the launch of two new therapies in its network. It also purchased a small player in the Southeast for \$18.5m (high single digit multiple) and we anticipate further value accretive deals going forward.

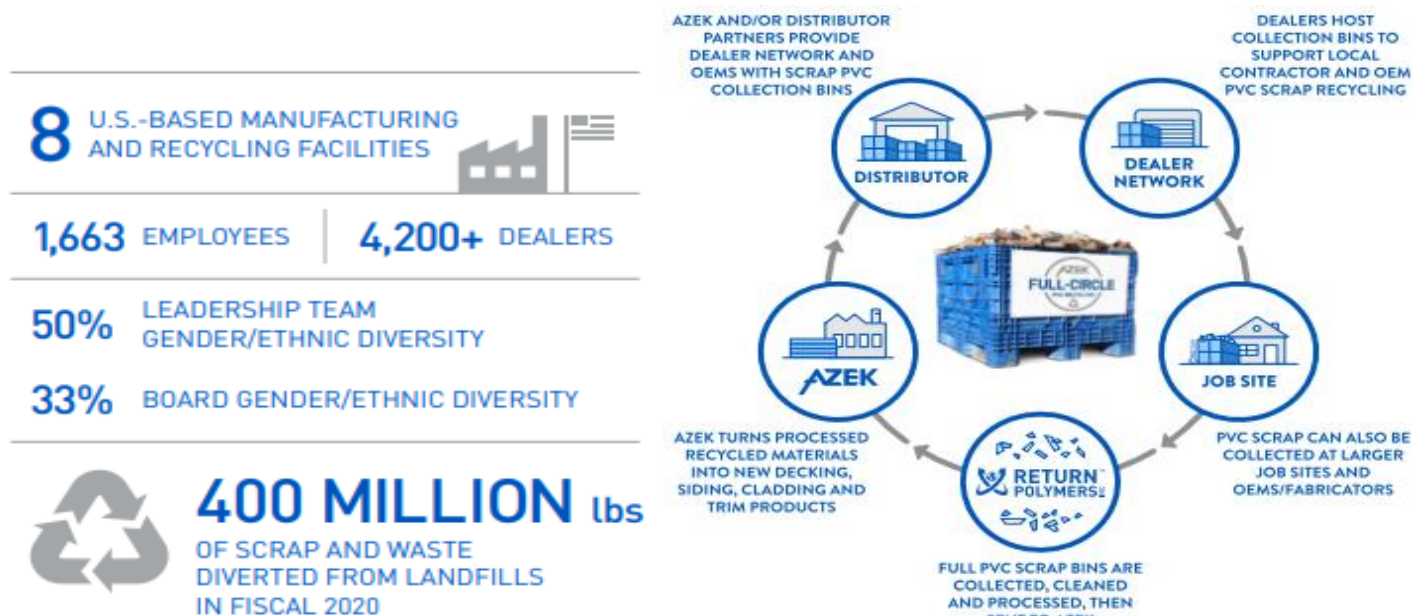
STOCK IN FOCUS: The Azek Company (AZEK US, \$6.5b Market Cap)

THE AZEK COMPANY

After 30 years of private ownership, in June 2020, The Azek Company completed its IPO and made its trading debut on the NYSE. Azek has a strong leadership position in the US composite decking and exterior market, operating in a domestic duopoly with industry leader Trex. It designs and manufactures low maintenance and environmentally sustainable products focused on the highly attractive and fast growing outdoor living market which is pivoting away from lumber. Wood currently represents about 65% of the \$7.6bn US decking, railing and trim markets however composite alternatives such as Azek's offering are increasing market share at roughly a 2% annual clip and growing at >10% compared with the underlying market at just under 6.0% between 2014 and 2019.

Azek has created an operating platform that is centered around sustainability, which extends across its value chain from product design to raw material sourcing and manufacturing, and is increasingly utilizing plastic waste, recycled wood and scrap in its products. It has also made significant recent investments in expanding its recycling capabilities, including its recent acquisition of Return Polymers, which further enhances the sustainability of its manufacturing operations while concurrently expanding margins. Its TimberTech PRO and EDGE decking lines offer high-quality products made from approximately 80% recycled material. Through its recycling programs, approximately 400 million pounds of waste and scrap were diverted from landfills in fiscal year 2020. Furthermore, approximately 98% of scrap generated is re-used, and the majority of TimberTech, AZEK Exteriors and Versatex products are recyclable at the end of their useful lives.

In its recent ESG report, Azek unveiled its Full Circle initiative which is aimed at increasing the amount of scrap waste recycled from 400m pounds in 2020 to 1bn pounds by the end of 2026. With on-site collection programs in place, Azek provides a real solution to PVC disposal concerns and once the scrap is processed and sorted at its Return Polymer facility, the clean recycled material is utilised across multiple product lines. Azek estimates that recycled PVC has a carbon footprint 75-80% lower than virgin PVC therefore the more it can utilise, the more it can reduce the overall impact on the environment.



Source: AZEK 2020 ESG Report.

Azek has a September year end and recently released its second quarter result in mid May. The shift from lumber to composite decking is gathering pace as it sees record levels of consumer orders driving the need for increased capacity investments to satisfy long term growth opportunities. During the quarter, revenues increased 25% while adjusted EBITDA grew 28% on expanding margins. Sell through exceeded sales growth leaving system inventories below typical levels and it is upsizing its capacity investments in both recycling capabilities and decking manufacturing to satisfy market demand. The inflationary environment (especially in resins and logistics) is certainly impacting the business however Azek's strong market positioning has enabled it to institute 3 price increases in the past several months and anticipates fully offsetting the risk of input inflation in its P&L.

Management upgraded full year revenue growth to 23-26% with EBITDA expected to increase 25-29% on pcp and that is despite continued weakness in its commercial offering which is still being impacted by the pandemic. On the back of capacity expansions, the continued conversion from wood to composite and the solid underlying growth of outdoor decking we see long term double digit top line revenue growth coupled with even stronger earnings expansion as margins benefit from its recycling effort over the next few years.

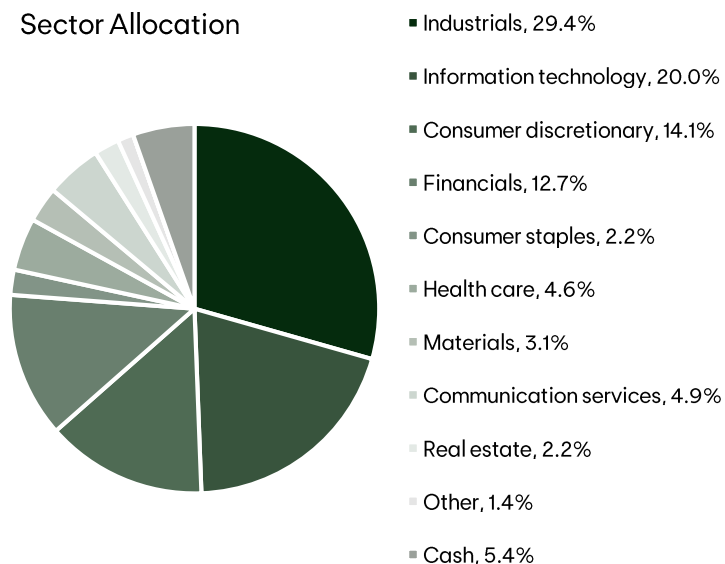
Portfolio Characteristics

Holdings

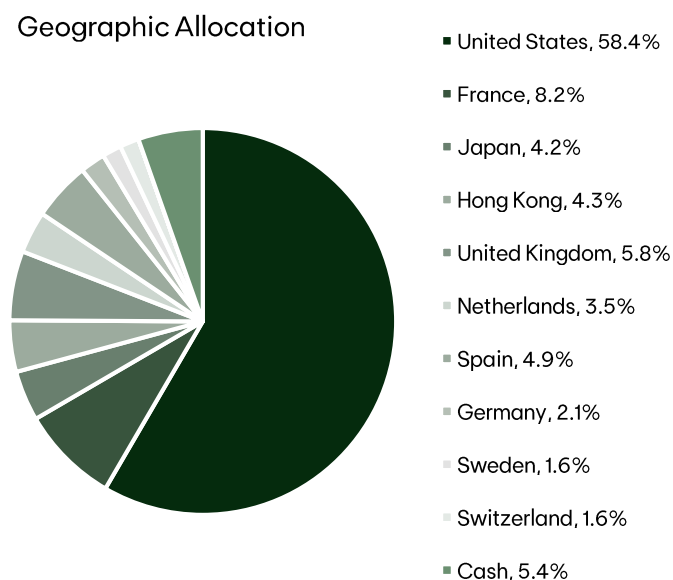
Top 10 holdings	Country	Sector	%
PTC	United States	Information Technology	5.1%
Sensata	United States	Industrials	5.1%
Cellnex	Spain	Communication Services	4.9%
Flex Ltd	United States	Information Technology	4.7%
Option Care Health	United States	Health Care	4.6%
Bureau Veritas	France	Industrials	4.3%
SEB	France	Consumer Discretionary	3.9%
Tempur Sealy	United States	Consumer Discretionary	3.7%
XPO Logistics	United States	Industrials	3.4%
Assurant	United States	Financials	3.0%

Source: Ellerston Capital.

Sector Allocation



Geographic Allocation



Source: Ellerston Capital.

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Find out more

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