Firetrail Australian High Conviction Fund

AUGUST 2019

PERFORMANCE (AFTER FEES)

	Month	Quarter	6 mnth	1 yr	Fund incept[2]	3 yrs (pa)	5 yrs (pa)	10 yrs (pa)	Strategy incept[4]
Fund[1]	-3.16%	2.90%	4.01%	-0.45%	2.36%	-	-	-	-
Strategy composite[3]	-3.16%	2.90%	4.01%	-0.45%	-	9.39%	11.89%	11.89%	9.82%
Benchmark	-2.36%	4.23%	9.33%	9.04%	12.01%	11.94%	8.52%	10.45%	7.30%
Out/Underperformance	-0.80%	-1.33%	-5.32%	-9.50%	-9.65%	-2.55%	3.37%	1.45%	2.52%

ABOUT FIRETRAIL

Firetrail is an investment management boutique which is majority owned by the Firetrail investment team. Additionally, the investment team is invested alongside clients in the investment strategies.

AUSTRALIAN HIGH CONVICTION FUND

The Australian High Conviction Fund ("Fund") is a concentrated portfolio (approx. 25 companies) of our most compelling equity ideas. The strategy is built on fundamental, deep dive research guided by the philosophy that 'every company has a price'.

INVESTMENT OBJECTIVE

The Fund aims to outperform the ASX200 accumulation index over the medium to long term.

FUND DETAILS

Unit prices	31 August 2019
Application price	$1.0173
Redemption price	$1.0123
NAV price	$1.0148

Fund Details	
APIR Code	WHT3810AU
Benchmark	S&P/ASX 200 Accumulation Index
Inception date	14 March 2018
Number of Holdings	25
Fund size	$393m
Management fee*	0.95% p.a.
Performance fee*	15% of outperformance

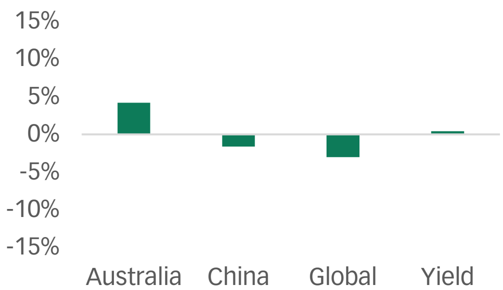
*Please read the Product Disclosure Statement for more details

PORTFOLIO POSITIONING 31 AUGUST 2019

Top 3 Overweight Holdings (Alphabetical)
Qantas Airways Ltd
Rio Tinto Ltd
Telstra Corp Ltd

THEMATIC POSITIONING 31 AUGUST 2019

Relative to the Benchmark



Past performance is not a reliable indicator of future performance.

1. Firetrail Australian High Conviction Fund ('Fund'). Net Fund returns are calculated based on exit price with distributions reinvested, after ongoing fees and expenses but excluding taxation. **2.** Fund inception is 14 March 2018. **3.** The Fund has been operating since 14 March 2018. To give a longer-term view of our performance for this asset class, we have also shown returns for the Firetrail Australian High Conviction Strategy Composite ('Strategy') which has been operating since 29 November 2005. Strategy performance has been calculated using the monthly returns (after fees) of the Fund from 14 March 2018 to current date, as well as the monthly returns of the Macquarie High Conviction Fund (after fees) between 29 November 2005 to 23 November 2017. The Fund employs the same strategy as was used by the same investment team that managed the Macquarie High Conviction Fund as at 23 November 2017. Firetrail has records that document and support the performance achieved as the Macquarie High Conviction Fund. The composite returns for the Strategy and the S&P/ASX 200 Accumulation Index (Benchmark) exclude returns between 24 November 2017 and 13 March 2018. During this period the investment team did not manage the Strategy. As such, the annualised performance periods stated are inclusive of the combined composite monthly returns, and do not include the period when the team were not managing the Strategy. For example, the annualised return over 3 years for the Strategy and benchmark are inclusive of 36 monthly performance periods available in the composite return period, excluding the period between 23 November 2017 and 13 March 2018. For additional information regarding the performance please contact us through the link on our website. Net Fund returns are in AUD terms. Net Fund returns are calculated based on exit price with distributions reinvested, after ongoing fees and expenses but excluding taxation. Past performance is for illustrative purposes only and is not indicative of future performance. **4.** Strategy inception 29 November 2005.

The Fund returned (3.16%) for the month ending 31 August 2019, underperforming the ASX200 Accumulation index by (0.80%).

Top positive contributors for the month included Qantas and Woolworths. The top detractors were positions in Worley & Cleanaway. Below we provide key commentary from reporting season as well as key positions in the portfolio.

REPORTING SEASON COMMENTARY

Reporting season is a busy time and a great chance to see how companies are progressing in executing their strategies. The worst performing sector was metals and mining, energy and materials. The best performing sectors were defensives including healthcare, property and consumer staples. Below we highlight our key takeaways from the August reporting season:

1) **The Australian consumer has been slowly recovering from the low point in April, but it is patchy**
    a. JB HiFi and Super Retail Group both reported improving sales trends and positive sales in their core businesses
    b. Qantas, Virgin and Flight Centre reported consumer weakness and tepid recoveries post 30 June 2019
    c. Housing exposed companies Bunnings and Nick Scali saw minimal bounce back in the consumer
    d. Casino operator Star Entertainment summed up the consumer with "gentle green shoots appearing"

2) **Australian corporates are driving costs down to support earnings amid slowing revenue**
    a. Telstra continues to remove costs
    b. The Big 4 banks continue to slow spending to offset slowing revenue and rising regulatory costs
    c. Advertising data indicating media spend in the September quarter was negative as companies pulled back to cut costs

3) **The market continues to crave revenue growth**
    a. SEEK (not held) delivered an outlook leading to a 28% earnings downgrade for FY20, while revenue growth was better than expected. Amazingly, the stock performed strongly as the market was enthused with the outlook for revenue growth. We applaud Seek for continuing to invest in the business, however we are surprised at the market reaction given the almost myopic focus on short-term earnings across the broader market.
    b. Technology stocks with long dated revenue growth performed strongly during the month

4) **Financial sector continues to point to headwinds**
    a. Low rates and low (but improving) credit growth are pressuring the top line
    b. In addition, regulatory costs continue to rise. For example, financial advice group IOOF is going back through seven years of data for all 788 current advisors and has taken a provision for expected remediation.

5) **Resources**
    a. The investment cycle is returning gradually with some cost / capex pressures appearing (Rio Tinto, Iluka)
    b. Capital management remains a key focus for resource companies
    c. Commodity prices fell during August. Iron ore fell on China demand concerns as well as a bounce back in Brazil exports

PORTFOLIO COMMENTARY

Qantas & Woolworths both produced strong results over the month. The Woolworths result showed that the core supermarkets business is generating strong top line results. They continue to reinvest in the business and appear very focused on growing the online delivery channel where sales grew 30%. Management know there is a land grab, and the stronger their proposition and user base, the less likely a competitor can enter without significant capital expenditure. Whilst the share price performance has been strong, we continue to see positive catalysts for the Woolworths share price including capital management from the sale of the drinks business, continued strength in supermarkets and potential to reduce losses in Big W.

Qantas

Qantas produced a strong result. Qantas generated EBIT of around $1.5bn. 25% of the earnings contribution came from one of Australia's best businesses, Qantas Frequent Flyer. Frequent Flyer EBIT delivered $374m and grew 8% for the year and a double-digit growth 2H19 on 2H18. Qantas has been incredibly shareholder friendly over the past few years with strong capital discipline. Since 2015, Qantas has reduced shares on issues by 32%. That number of shares on issue is set to shrink further after Qantas announced an off-market buyback of $400m.

More interesting than the Qantas result was the Virgin result. Virgin is Qantas' key competitor in Australia, and while Qantas is delivering strong profitability, Virgin is not. Virgin EBIT halved with two business losing material money. Breaking down the Virgin result:

EBIT	FY18	FY19	change
Virgin Domestic	216	133	-82
Virgin International	-22	-76	-54
Tigerair	-40	-45	-6
Velocity (loyalty)	110	122	12
Total	**265**	**135**	**-130**
change		-49.0%	

In our opinion, to restore profitability Virgin needs to do two things. Firstly, reduce costs. At their result, Virgin announced a headcount reduction including a 30% reduction in head office and management. Secondly, Virgin needs to reduce capacity. Rationalising capacity, particularly on their International and Tiger routes could get Virgin back to a solid footing. A reduction in capacity would lift Virgin profits to the point of a sustainable business rather than the current situation where Qantas makes good profits, but Virgin struggles along.

On around a 10x PE, with a strong loyalty and domestic business, Qantas represents outstanding value with material upside.

KEY DETRACTORS OVER THE MONTH

Worley and Cleanaway were the two largest detractors over the month.

Worley

The result was complex given they were reporting on the combined business including the newly acquired Jacobs Energy, Chemical and Engineering business. Overall the result showed that Worley continue to execute well and win new contracts in oil, gas and chemical engineering projects. Worley also guided to good early progress in synergies from the John Guest acquisition.

The key reason for the sell-off was sentiment regarding trade wars. As Worley is directly exposed to global capital expenditure, any delay in capex intentions will impact Worley's earnings in the short term. Our view remains that while there will be uncertainty while trade negotiations are played out day by day, investments in energy, renewables, metals & mining need to grow. In addition, the acquisition of ECR makes a better, more profitable business for Worley shareholders. We have not seen any company specific reason for the Worley share price to fall. As such, it remains a top position in the portfolio.

Cleanaway

Australia's leading waste management company Cleanaway delivered 6% organic revenue and 12% organic EBITDA growth in FY19 but pointed to more moderate growth in FY20. The market was disappointed, and the stock underperformed the market during the month. FY20 EBITDA growth is now forecast to be 7%, translating to higher growth at EPS given the large capital base of the business.

Cleanaway is a well-run business that has a material opportunity around the 'circular economy'. A fancy term for recycling. The opportunity has been brought about by China's decision to reject the world's waste. Overnight, the Australian recycling model was broken. Previously, recycling operators could make profit by:

1) Picking up municipal / council recycling streams such as paper, plastic and glass for say $30 / tonne
2) Process some of the recycling material within Australia
3) Send the rest of the recycling streams to China for revenue

Photo: Stockpiled recycling at an SKM facility (sourced abc.net.au)

So, what next?

The end game is a lift in recycling within Australian borders. The implications include:

1) Firstly is disruption to economic models. We estimate Cleanaway has incurred around $10m of extra cost since China sword began
2) More consolidation with small players leaving and big, reputable players such as Cleanaway getting bigger
3) More capital will need to be deployed to process. Cleanaway at their results announced investment in turning waste plastic into plastic pellets that have strong demand globally
4) To pay for the capital, Councils and Residents will need to pay more recycling

Just days after the result, Cleanaway announced they had purchased the debt of failed recycling firm SKM for $60m and were interested in operating the assets.

PORTFOLIO CHANGES

The key portfolio change during the month was the exit of A2 Milk prior to the result as the very strong share price performance (+60% CYTD) meant the valuation captured a strong future but didn't reflect the earnings risk of continuing channel shifts. We like A2, their brands and their strategy, but every company has a price.

ONE INTERESTING THING THAT HAPPENED THIS MONTH…

During reporting season, there are always a few interesting quotes. Here is the best we could find from a mid-sized miner when asked about cost overruns.

"Just to be clear…we're **not saying specifically that there's going to be more capital associated with** <resource project>. What we're saying is that we're coming towards the conclusion of the definitive feasibility studies and optimization studies and it's becoming apparent that on the scope that we've talked about and identified there and narrowed in on, and that's looking to produce more than 300,000 tonnes per annum with first tonnes in 2021. **That capital would be higher.**"

MORE INFORMATION

General enquiries 1300 010 311
Existing client enquiries 1300 360 306
www.firetrail.com

Firetrail INVESTMENTS