Firetrail Australian High Conviction Fund

OCTOBER 2018

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 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 PERFORMANCE TO 31 OCTOBER 2018

	Net Fund	Benchmark	Net Excess
1 Month (%)	(7.29)	(6.05)	(1.24)
3 Months (%)	(10.61)	(5.92)	(4.69)
Inception (%)	(4.00)	0.46	(4.46)

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.

FUND DETAILS

Unit prices	31 October 2018
Application price	$0.9616
Redemption price	$0.9568
NAV price	$0.9592

Fund Details	
APIR Code	WHT3810AU
Benchmark	S&P/ASX 200 Accumulation Index
Inception date	14 March 2018
Fund size	$265m
Management fee*	0.95% p.a.
Performance fee*	15% of outperformance

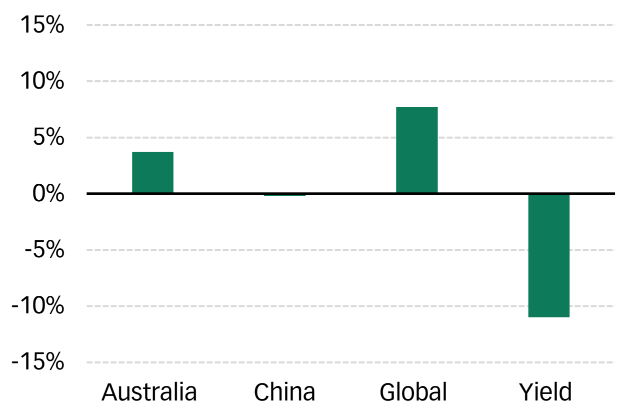
*Please read the Product Disclosure Statement for more details

PORTFOLIO POSITIONING

Top 3 Overweight Holdings (Alphabetical)
Amcor Ltd
Nufarm Ltd
WorleyParsons Ltd

THEMATIC POSITIONING

Relative to the Benchmark



PORTFOLIO COMMENTARY

The Fund returned (7.29%) for the month ending 31 October 2018, underperforming the ASX200 Accumulation index by (1.24%).

The strategy benefitted from positions in Woolworths and Fortescue Metals. Key detractors included positions in Worley Parsons and Clydesdale Bank.

The fundamental story for Woolworths is very strong. A quick way of assessing most companies' future prospects can be as simple as looking at industry market growth and then market share growth.

The supermarket sector is not a high growth sector. But it is a sector that we believe is set to have slightly higher sales growth over the next three years compared to the 3% growth witnessed in recent times. Drivers of the higher sales growth include higher inflation and less promotional activity. Higher sales growth and inflation are both tailwinds for the sector.

The market is best defined as 'competitively rational'. The promotional tag lines of 'Cheap Cheap' (Woolworths) and 'Down Down' (Coles) hit the scrap heap this year replaced with 'That's why I pick Woolies' and 'Good things are happening at Coles'. That is a clear sign to us that a myopic focus on price is over, and the proposition for customers is overall value and service along with very competitive prices.

The Woolworths market share story is a solid one, acknowledging it is hard to grow market share when you are the dominant incumbent! Woolworths is the market leader commanding 35% market share. The pressure has been on Woolworths over the past five years. Woolworths was complacent after years of winning, allowing room for an improving Coles and a focused Aldi.

Woolworths has been shaping up under the leadership of CEO Brad Banducci. He is an inspirational leader who lives supermarkets. Key changes made include:

- a lower cost, more focused private labelling offering to match Aldi
- better customer experience including a focus on stock availability and in-store customer service
- improved online offering across both home delivery and 'click & collect'
- investment across the business including supply chain, DC automation and online

While Woolworths will need to continue to be focused, the most material changes are now implemented, and we believe Woolworths will improve market share over the coming years.

So, what about the valuation? Woolworths isn't down and out by any stretch. In fact, it is trading on a 20x FY19 PE. A premium to the market of around 30%. But there are a couple of things you need to take into account in assessing the valuation. We like to look out three years, and here is why think 20x is still a good price for Woolworths:

1. Petrol sale – Petrol is likely to be sold for more than $1.5bn. Proceeds will be tax free post the Masters hardware debacle. Woolworths has $2.6bn of franking credits on the balance sheet. It is highly likely that these proceeds are returned via a tax effective Off Market Buyback
2. Big W – Big W is losing money. In FY18, the losses were $110m. We believe it is hard to stop these losses, but to capitalise them forever is incorrect even after adjusting for lease liabilities of more than $2bn. We expect Big W to breakeven in three years' time. Remembering the business made $200m just a few years ago.
3. Earnings trajectory – Supermarkets can have meaningful operating leverage. Operating leverage is as simple as if revenues grow above costs, earnings can rise quickly. FY18 Woolworths supermarket earnings were 39% below the 2015 level. While we don't expect the earnings to jump back to those levels any time soon, we can see high single digit EBIT growth. Not bad.

Woolworths is playing in an improving industry with an improving market position thanks to a relentless management focus on improving the business. With further simplification to come and a reasonable valuation, it's a high conviction stock that ticks all the boxes.

The largest detractor was a position in Worley Parsons. Worley Parsons is one of the world's leading engineering businesses specialising in hydrocarbons. Their core business is helping companies design complicated projects in oil, gas, chemicals and infrastructure. Engineers are rented out and Worley takes little to no major project risk.

During the month, Worley undertook a company changing acquisition to shift more of the engineering work into chemical plants and refining and lowering the weighting of hydrocarbons. It was a big deal. $4.7bn AUD in all was paid out to buy Jacobs Engineering (US Listed) ECR business. ECR stands for Energy, Chemical and Resources. So, it's a business that Worley knows well and is part of their core business.

The rationale for the deal was to:

1. Generate returns for shareholders through cost and revenue synergies
2. Be #1 across key categories (I'm paraphrasing here)
3. Deliver enhanced earnings diversification and resilience

At Firetrail, we have been talking about M&A ad nauseum and it just keeps on happening! We believe this M&A deal will be a good one for Worley shareholders.

The 'What Matters' thesis for Worley **was** simple:

- Improving hydrocarbons market – Hydrocarbons was around 75% of Worley's business. Global spend on oil and gas has fallen 40% over the past four years as oil prices fell and capex budgets were reigned in. Oil and gas are depletive resources. If you don't spend, they decline and will set up the next cycle. With oil rising from lows of $28 / bbl to highs of over $80 / bbl last month, we believe the next cycle is well underway. In FY18, Worley organic revenue growth was 0%. The cycle has bottomed, and the three-year view was very bullish on the industry. Our view on the cycle has not changed.
- Underestimated operating leverage – Worley has worked their cost line hard through this down cycle. Revenues fell from $9.6bn (FY14) to $4.7bn (FY18). The word 'fell' probably doesn't do it justice. Perhaps 'cratered' is more appropriate. The management team has worked hard to reduce costs and collect cash faster from clients. The cost program focused on shared services. With such a globally spread business, Worley had too many offices doing their own HR, finance and procurement. Worley now centrally manages a lot of things and has reduced costs materially. As the work comes back to the sector and revenues rise, Worley will benefit from a leaner cost base.

Today, the story has changed, although not to the same extent as the market thinks. The share price fell aggressively post acquisition. It is too easy to draw comparisons with failed offshore expeditions by Australian companies. We believe it is overly simplistic to draw such similarities. The key points we would make include:

1. Jacobs acquisition is in Worley's sphere of expertise – Worley is an engineering firm and they have bought another engineering firm. Both operate the same sectors of hydrocarbons and chemicals.
2. Worley have global experience – Worley spans 42 countries and 116 office with 26,000 employees. They are a global business. Worley buying Jacobs ECR is not Bunnings entering the UK, nor is it Slater & Gordon entering the UK.
3. We do not believe Worley have overpaid – 11.5x EBITDA is a full price on a headline basis. But the oil and gas, chemicals, refining and resource spends are NOT peak cycle. Chemicals has witnessed solid consistent growth, but oil / gas, refining and resource sectors remain well below mid cycle spend. Any multiple analysis must take into account where we are in the cycle and in that context, 11.5x historical earnings doesn't look too bad.
4. Synergies are real – Worley has demonstrated the ability to extract cost from a centralised hub that does HR, finance and procurement in a focused and low-cost way. Worley has reduced their costs in their own business by $500m over four years. To put that in context, the company earned $299m EBIT in FY18. Worley is targeting $130m of costs reduction by rationalising property and duplication of tasks. That is doable.
5. Little balance sheet risk – The Worley balance sheet is strong. The theme of M&A this cycle has been 'maximum equity'. No Board or CEO wants to put the business at risk after living through the GFC. The leverage ratio of Worley pre-deal of 2x ND / EBITDA (FY18) actually improves once the deal is completed to 1.9x! For investors, the cost of a safe balance sheet is the $2.9bn of extra equity swimming around the ASX. Such a large equity raising has definitely put pressure on the share price in the short term, but that is all we believe it is. At the end of the day, companies are worth the sum of their future cashflows and the market works over time.

All that said, this is a big acquisition that almost doubles the size of the business. Operational risks are elevated. To say we know how this will turn out would be a lie. We like Worley management, we like what they have done with their own cost base and we like where the cycle is at. If Worley does it right, they will be the market leader across their key segments delivering strong earnings growth from a business that delivers more stable earnings.

It's a big journey ahead for Worley employees and Worley investors. At current share prices roughly 12x FY20 PE, we think continuing to own Worley Parsons will be good for our investors. But we will keep a close eye on progress.

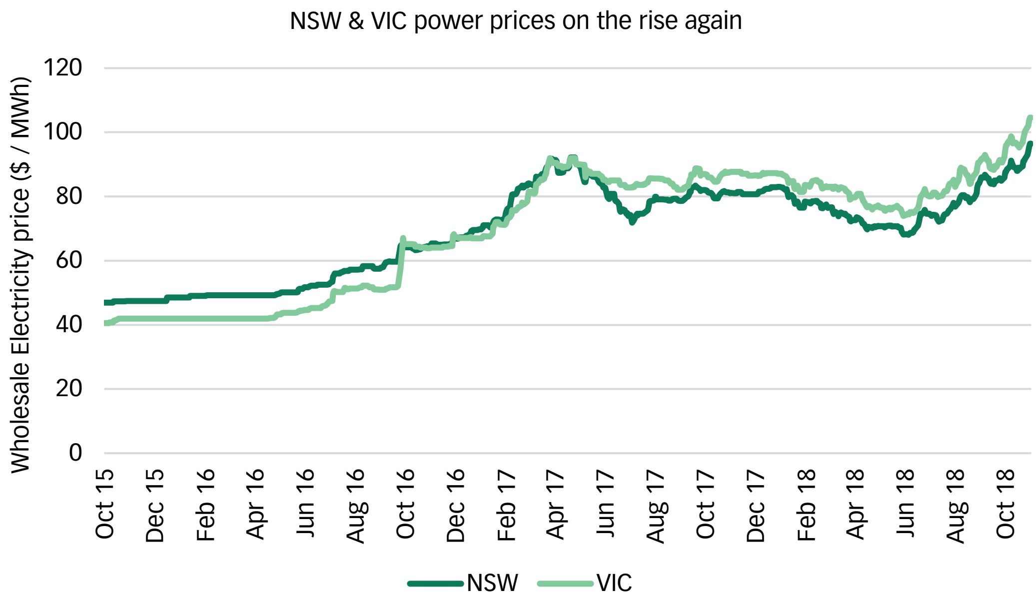
ONE INTERESTING THING THAT HAPPENED THIS MONTH

… the Government want to lower retail electricity prices to help take the pressure off the average Australian. Cost of living is a big topic in Australia right now, so it may help win some votes. To lower price, the Government have threatened extreme action including:

1. Capping electricity prices
2. Royal Commission into electricity prices
3. Forced divestiture of assets such as power stations

Post Donald Trump taking power and the UK public voting for Brexit, nothing surprises us anymore. However, on balance, we think it is unlikely the extreme outcomes will eventuate. The electricity companies such as AGL, Origin Energy and Energy Australia, who control >80% market share combined, are already actively trying to placate the Government. Origin Energy, for example, is taking $60m hit to earnings in FY19 by holding retail electricity prices flat in NSW, when the building blocks of cost (the power and the network) are rising.

What makes it so interesting right now is that the key building blocks, wholesale power, is marching higher!



Someone needs to pay for higher prices:

- retail consumers could pay by accepting higher prices
- shareholder of Australian retail electricity companies could pay through lower earnings, or
- The Australian Government via subsidies

The Government can try and cap prices but spare a thought for electricity retailers who don't own generation and have to pay market prices. On our estimates, under a hard capping of retail electricity prices, they may not exist sooner rather than later.

And less competition can't be good for long term prices.

MORE INFORMATION

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www.firetrailinvest.com

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