

FIRETRAIL ABSOLUTE RETURN FUND

MONTHLY REPORT | MARCH 2023

PERFORMANCE (AFTER FEES)¹

	Month	Quarter	1 Year	3 Years p.a.	Fund inception p.a. ³	5 Years p.a.	7 Years p.a.	Strategy inception p.a. ⁵
Fund ²	1.17%	(1.53%)	(11.74%)	4.96%	1.15%	-	-	-
Strategy composite ⁴	1.17%	(1.53%)	(11.74%)	4.96%	-	1.03%	4.04%	7.33%
Benchmark	0.30%	0.81%	2.06%	0.78%	0.96%	0.96%	1.13%	1.19%
Excess Return	+0.88%	-2.34%	-13.80%	+4.18%	+0.18%	+0.08%	+2.91%	+6.14%

1. Past performance is not a reliable indicator of future performance.

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.

ABSOLUTE RETURN FUND

The Absolute Return Fund ("Fund") is a market neutral strategy with minimal correlation to equity market direction. It aims to generate positive returns in all market environments. 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 RBA Cash Rate over the medium to long term (after fees).

PORTFOLIO POSITIONING

31 March 2023

Top 3 Overweight Holdings (Alphabetical)
CSL Ltd
Newcrest Mining Ltd
Santos Ltd

FUND DETAILS

Unit Prices	31 March 2023
Application Price	\$1.0421
Redemption Price	\$1.0349
NAV Price	\$1.0385
Fund Details	
APIR Code	WHT5134AU
Benchmark	RBA Cash Rate
Inception Date	14 March 2018
Risk/Return Profile	High
Fund Size	\$303mil
Management Fee*	1.28% p.a.
Performance Fee*	20% of outperformance above an annual Hurdle

*Please read the Product Disclosure Statement for more details

FUND EXPOSURE

31 March 2023

	Portfolio Exposure
Long Equity	185.2%
Short Equity	-184.9%
Net Equity Exposure	0.3%

Past performance is not a reliable indicator of future performance.

The Product Disclosure Statement ('PDS') and Target Market Determination ('TMD') of the Fund are available at <https://firetrail.com/firetrail-absolute-return-fund/>.

2. Firetrail Absolute Return Fund ('Fund'). Net Fund returns are calculated based on exit price with distributions reinvested, after ongoing fees and expenses but excluding taxation. 3. Fund inception is 14 March 2018. 4. 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 Absolute Return Strategy Composite ('Strategy') which has been operating since 30 June 2015. 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 Pure Alpha Fund (after fees) between 30 June 2015 to 23 November 2017. The Fund employs the same strategy as was used by the same investment team that managed the Macquarie Pure Alpha Fund as at 23 November 2017. Firetrail has records that document and support the performance achieved as the Macquarie Pure Alpha Fund. The composite returns for the Strategy and the RBA Cash Rate (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. 5. Strategy inception 30 June 2015.

PORTFOLIO COMMENTARY

The Fund returned 1.17% for the month ending 31 March 2023, outperforming the RBA Cash Rate by 0.88%.

For the quarter ending 31 March 2023 the Fund returned negative 1.53%, underperforming the RBA Cash Rate by 2.34%.

CONTRIBUTORS TO RETURNS

Positive contributors to monthly returns included long positions in Newcrest Mining, Origin Energy, and The Lottery Corporation. Detractors included long positions in Domino's Pizza Enterprises, Lendlease, and Lynas Rare Earths. We discuss each further in our commentary below.

POSITIVE CONTRIBUTORS

Newcrest Mining

Newcrest outperformed the broader market by 16%, which was consistent with the broader Gold sector, following an ~8% rise in the Gold price through March. Gold was buoyed by a number of macro factors, led by the collapse of Silicon Valley Bank and hastened sale of Credit Suisse to UBS, which stoked fears of a broader banking crisis and drove a rally in US Treasuries.

Estia Health

Estia was up significantly through March following an indicative non-binding proposal from Bain Capital to acquire the company. Under the proposal shareholders would receive \$3.00 per share subject to a number of conditions including completion of due diligence on an exclusive basis. In early April the Estia Board responded to the Bain proposal labelling it not compelling with regard to both price and conditionality. It has offered to provide Bain access to limited non-public information on a non-exclusive basis.

Origin Energy

Origin entered into a binding agreement with the consortium comprising Brookfield and MidOcean Energy for the acquisition of the company by way of a scheme of arrangement for an implied consideration of \$8.92 per share. This binding agreement follows the original indicative offer by the consortium in December 2022.

NEGATIVE CONTRIBUTORS

Lynas Rare Earths

Lynas Rare Earths underperformed following Elon Musk's comments that Tesla's next drive unit will not use any rare earth materials. This is not a new phenomenon. Many car manufacturers do not use rare earths in their motors. However, this practice does necessitate trade-offs on performance. The market also became more cautious on Lynas' ability to ramp up its new facility in Kalgoorlie without any meaningful time delays.

Challenger

Challenger underperformed the broader market despite no stock-specific news. The underperformance was driven by broader ructions impacting the Financials sector and concerns around valuations and defaults in the commercial real estate market. Challenger has 15% of its assets in property, of which 55% are in commercial real estate.

Virgin Money UK

Virgin Money UK underperformed along with the European bank sector on concerns of liquidity and credit contagion from SVB, Signature Bank and Credit Suisse. While it is still too early to determine if there will be material flow-on impacts, Virgin Money UK is in a strong position with 80% of its loan portfolio in mortgages, a diversified customer base, and substantial excess capital above regulatory minimums and internal targets.

PORTFOLIO POSITIONING

The Firetrail Absolute Return Fund is a market neutral portfolio (long/short) with zero net market exposure and beta (+/- 0.1) to ensure Fund performance is uncorrelated to equity market direction. The Fund is driven by our best long and short ideas. Overall, we see the portfolio as follows:

The long portfolio can be summarised as:

- 185.2% long exposure across 40-60 stocks with upside based on our medium-term earnings forecasts.
- Overweights include:
 - Energy companies exposed to commodities where supply is constrained in the medium term, such as Santos and Incitec Pivot.
 - Commodity companies exposed to decarbonisation such as Mineral Resources and Lynas Rare Earths with attractive cost positions and strong growth.
 - Market leaders including ResMed, SEEK, and James Hardie Industries who are well placed to strengthen their competitive position through the cycle.
 - Financials with leverage to interest rate rises including QBE Insurance, Medibank, and Virgin Money UK.
 - Undervalued companies with defensive attributes including Newcrest Mining and The Lottery Corporation.

The short portfolio can be summarised as:

- 184.9% short exposure across a diversified portfolio of earnings shorts and risk-reducing shorts
- Earnings shorts aim to profit from companies that downgrade near term earnings. The current market is creating heightened opportunities as companies deal with rising costs and easing demand at a time of peak margins.
- Risk-reducing shorts offset equity market exposure and control portfolio risk such as style, size, sector, and thematic biases to ensure returns are driven by stock specific factors.
- The short portfolio is overweight consumer cyclicals, and expensive bond proxies where we see material near term earnings risks.

INCITEC PIVOT DEEP DIVE – An explosive outlook for shareholder returns

Incitec Pivot is a key holding in the Firetrail Absolute Return Fund. Incitec Pivot consists of two businesses:

1. **Explosives** – Incitec Pivot operates integrated explosives manufacturing and distribution businesses in Australia and North America. Explosives are essential to breaking rock and are primarily supplied to mining, quarrying and construction customers. Surface mines in the coal, metal and non-metal sectors rely on these explosives to uncover mineral deposits.
2. **Fertilisers** – Incitec Pivot is Australia's largest supplier of fertilisers with a dominant share of the Australian east coast market.

Both explosives and fertilisers share common nitrogen-based chemistry. Ammonia (NH₃) is a key ingredient in both manufacturing processes. However, the two businesses have very different earnings profiles. Explosives provides a stable earnings stream given customer volumes and margins are locked in under three-to-five-year contracts. Fertiliser earnings are linked to the agricultural price cycle and are more volatile as a result.

Figure 1: A Dyno Nobel (Incitec Pivot's explosives business) engineer watches on as Dyno explosives break up rock at a mine site.



Source: Incitec Pivot

Path to value creation

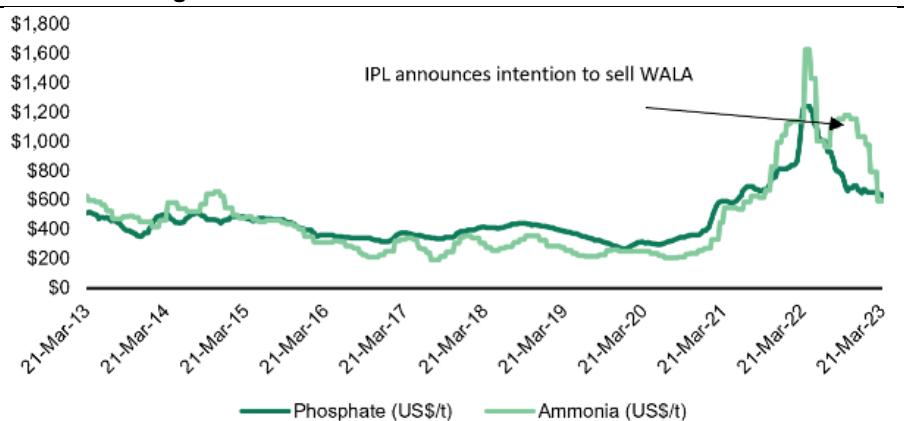
The conflict in Ukraine and subsequent impact on global agriculture, energy and gas markets provided a major boost to global fertiliser producers over the last two years. Prices for everything from oil, gas, corn, and fertilisers such as ammonia increased substantially.

Incitec Pivot’s earnings surged, led by its Fertiliser manufacturing assets in Queensland and its ammonia plant in Waggaman, Louisiana (WALA). Incitec Pivot only uses about 25% of the ammonia produced at WALA for its explosives business in North America, selling the remaining 75% at a small discount to market prices, mainly through commodity traders.

In March 2023, Incitec Pivot reached an agreement to sell its WALA ammonia facility to CF Industries for a total value of US\$1.675 billion. The transaction is positive for shareholders for the following reasons:

1. **The sale has been secured at the top of a decade-long pricing cycle.** We estimate the sale amount implies a long-term ammonia price of US\$500 per tonne versus a long-term average of US\$300 per tonne.
2. **As part of the deal, Incitec Pivot has secured a 25-year supply agreement** from CF Industries at equivalent producer cost allowing it to capture the full manufacturing margin.
3. **Incitec Pivot no longer faces the capital and operating risks** associated with running the plant.
4. **The transaction reduces the volatility of group earnings** and simplifies earnings exposure.
5. **Incitec Pivot will have substantial scope to undertake capital management** initiatives such as buybacks.

Figure 2: Incitec Pivot’s WALA sale is taking place while fertiliser prices are near decade highs



Source: CRU

Figure 3: Based on our estimates, the sale of WALA results in net proceeds of A\$1.25 billion available for debt reduction and buybacks.

WALA sale		
WALA ownership sold	%	75%
Sale proceeds	US\$m	1,250
Tax cost base	US\$m	0
Taxable net	US\$m	1,250
Less expected tax	US\$m	-413
Tax rate	%	23%
Advisory/other costs	%	2%
Net proceeds	US\$m	837
AUD:USD	FX-rate	0.67
Net proceeds for debt reduction / Buybacks	A\$m	1,249

Source: Incitec Pivot, Firetrail estimates

Buybacks coming

The WALA transaction is expected to take around six months to settle. Incitec Pivot will have a net cash balance sheet post-settlement. The company has a leverage target of between 1x-1.5x. As a result of the excess cash, management will have scope for additional shareholder returns such as buybacks.

The company already has a \$400 million buyback program underway. Using the low end of its leverage target and assuming no free cashflow, we estimate an additional \$1 billion capacity for buybacks over FY24-25. We estimate 25% of Incitec Pivot's current market cap could be returned to shareholders.

Our strong preference is for the Board to return the WALA sales proceeds to shareholders. We believe buybacks provide the most prudent use of shareholder funds for the following reasons:

1. If full net proceeds were applied to a buyback, we estimate 7% value accretion for shareholders.
2. Incitec Pivot shares are trading very cheap below 1x Price/Book value – it is hard to see alternative uses providing similar value.
3. Buybacks are a low-risk use of capital without the execution issues associated with M&A.

Figure 4: We estimate the WALA transaction will be 13% accretive to earnings per share if 100% of net proceeds are applied to buybacks.

Buyback impact		
Amount applied to Buybacks	A\$m	1,249
% of net proceeds		100%
Shares re-purchased		392
EPS accretion		13%

Source: Incitec Pivot, Firetrail estimates

Positive earnings outlook

Incitec Pivot's earnings outlook continues to look favourable due to three key drivers:

1) Energy costs are bottoming:

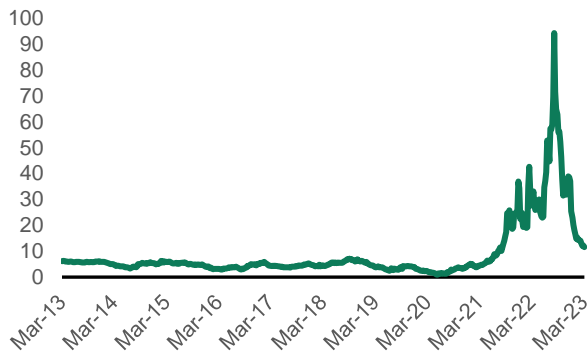
The disruption to global energy markets from the Ukraine conflict will impact the fertiliser and explosives industries until at least the middle of the decade. Gas is a key input in the production of fertilisers and explosives.

The disruptions to Russian exports of cheap gas to Europe have shifted the competitive landscape in Incitec Pivot's favour in key end markets. Incitec Pivot has long-term gas supply arrangements in Australia and accesses cheap gas in the US, providing a major cost advantage when global energy prices are rising.

At the height of gas prices in late-2022, over 60% of European nitrogen supply was either idled or permanently shut due to prohibitive gas costs. That figure still sits at 30% despite an 80% retracement in gas prices from last year's highs. European gas price futures are still indicating higher prices over 2023 and 2024.

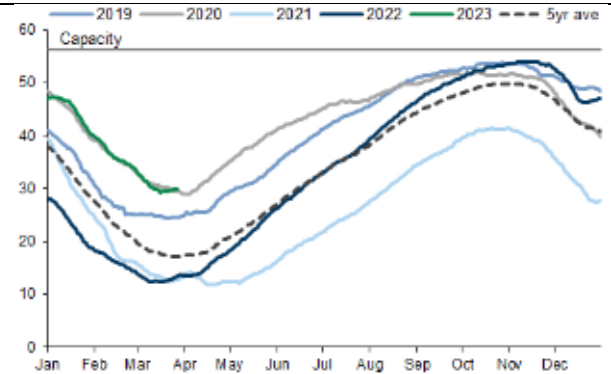
The recent gas price weakness appears temporary and driven by high storage levels after a mild European winter. We expect gas prices to begin to rise again through the September quarter as storage levels are replenished. Higher gas prices will lead to higher fertiliser and explosives prices as high-cost producers again feel the pinch of rising input costs.

Figure 5: European gas prices have retraced from their highs in late 2022 (\$/mmbtu)...



Source: CRU

Figure 6: ...but we expect prices to rise as Europe replenishes its depleted gas storage levels (European gas inventory, billion cubic metres)

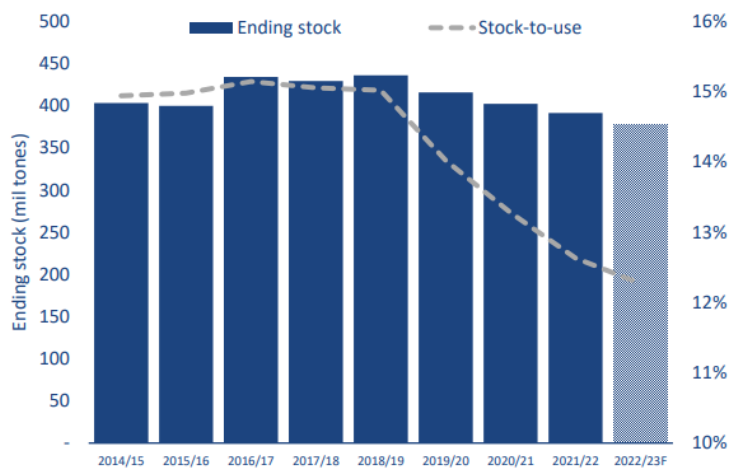


Source: Bloomberg, Goldman Sachs

2) Soft commodity inventories remain supportive of elevated prices:

Global grain stocks remain near decade lows. As inventories are built back up, this will support the prices of corn, wheat, and soy. Higher crop prices allow farmers to pay more for key inputs such as fertilisers.

Figure 7: Grain and oilseed stock-to-use (world excluding China)



Source: USDA

3) Explosives earnings at the start of the upcycle:

Once the WALA sale is completed the focus will shift back to the Explosives division. We see a supportive backdrop over the medium-term driven by a tighter explosives market in Australia. Supply and demand are now well balanced. This compares to a period of oversupply over the past five years due to new large-scale capacity additions by both Orica and Wesfarmers' CSBP business.

A more balanced market will be supportive for pricing as Incitec's contract book, which has an average tenure of three years, comes up for renewal over the next several years. We are expecting solid earnings growth from this business.

Undemanding valuation

Incitec Pivot's valuation remains undemanding despite the value-accretive WALA deal. We have undertaken a simple exercise below to highlight inherent value at the last closing price:

- We have adjusted enterprise value for the WALA proceeds plus a further 12 months of WALA cash before settlement of the sale to CF Industries.
- We have then deducted the value of Explosives using main ASX-listed peer Orica's multiple.
- The implied value of Fertilisers is just 2x our FY24 estimates.

At today's price, investors are paying a fraction of what the Fertilisers business is worth. Should this valuation gap remain, we believe it sensible for Incitec Pivot to demonstrate the sum-of-the-parts value by de-merging the Fertilisers business in the future.

Figure 8: At today's share price, investors are paying a fraction of what Incitec Pivot's Fertilisers business is worth

Implied SOTP	EBIT	Multiple	
Market cap			5,877
Add: Net debt			949
Enterprise Value			6,825
Less: WALA net proceeds			1,249
Less: FY23 WALA cash			280
Adjusted Enterprise Value	715	7.4x	5,296
Corporate (Market multiple)	-46	10.0x	-461
Explosives (ORI multiple)	460	10.9x	5,028
Implied Fertilisers value	302	2.4x	729

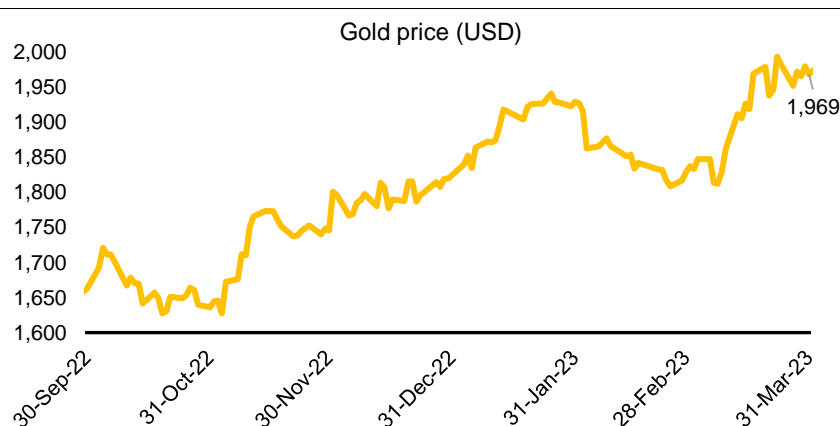
Source: Factset consensus, Firetrail estimates

ONE INTERESTING THING THAT HAPPENED THIS MONTH...

Gold has been the ultimate defensive asset and store of value for millennia. Recession fears and cracks in the banking system have led to a 20% spike in the gold price over the past 6 months.

We think gold plays an important defensive role in portfolios. Gold miners with high-quality assets like Newcrest Mining (held in the Firetrail Absolute Return Fund) are set to benefit from heightened uncertainty and a stronger gold price.

Figure 9: The gold price has rallied from around US\$1,630 to US\$1,969 in the past 6 months



Source: Factset, Firetrail

This communication is prepared by Firetrail Investments Pty Limited ('Firetrail') (ABN 98 622 377 913, AFSL 516821) as the investment manager of the Firetrail Absolute Return Fund (ARSN 624 135 879) ('the Fund'). Pinnacle Fund Services Limited ('PFSL') (ABN 29 082 494 362, AFSL 238371) is the product issuer of the Fund. PFSL is not licensed to provide financial product advice. PFSL is a wholly-owned subsidiary of the Pinnacle Investment Management Group Limited ('Pinnacle') (ABN 22 100 325 184). The Product Disclosure Statement ('PDS') and Target Market Determination ('TMD') of the Fund are available via the links below. Any potential investor should consider the PDS and TMD before deciding whether to acquire, or continue to hold units in, the Fund.

Links to the Product Disclosure Statement: [WHT5134AU](#)

Links to the Target Market Determination: [WHT5134AU](#)

For historic TMD's please contact Pinnacle client service Phone 1300 010 311 or Email service@pinnacleinvestment.com

This communication is for general information only. It is not intended as a securities recommendation or statement of opinion intended to influence a person or persons in making a decision in relation to investment. It has been prepared without taking account of any person's objectives, financial situation or needs. Any persons relying on this information should obtain professional advice before doing so. Past performance is for illustrative purposes only and is not indicative of future performance.

Whilst Firetrail, PFSL and Pinnacle believe the information contained in this communication is reliable, no warranty is given as to its accuracy, reliability or completeness and persons relying on this information do so at their own risk. Subject to any liability which cannot be excluded under the relevant laws, Firetrail, PFSL and Pinnacle disclaim all liability to any person relying on the information contained in this communication in respect of any loss or damage (including consequential loss or damage), however caused, which may be suffered or arise directly or indirectly in respect of such information. This disclaimer extends to any entity that may distribute this communication.

Any opinions and forecasts reflect the judgment and assumptions of Firetrail and its representatives on the basis of information available as at the date of publication and may later change without notice. Any projections contained in this presentation are estimates only and may not be realised in the future.

Unauthorised use, copying, distribution, replication, posting, transmitting, publication, display, or reproduction in whole or in part of the information contained in this communication is prohibited without obtaining prior written permission from Firetrail. Pinnacle and its associates may have interests in financial products and may receive fees from companies referred to during this communication.

This may contain the trade names or trademarks of various third parties, and if so, any such use is solely for illustrative purposes only. All product and company names are trademarks™ or registered® trademarks of their respective holders. Use of them does not imply any affiliation with, endorsement by, or association of any kind between them and Firetrail.

MORE INFORMATION

General enquiries 1300 010 311

Existing client enquiries 1300 360 306

www.firetrail.com

