

FIRETRAIL ABSOLUTE RETURN FUND

MONTHLY REPORT | JUNE 2023

PERFORMANCE (AFTER FEES)¹

	Month	Quarter	1 Year	3 Years p.a.	5 Years p.a.	Fund inception p.a. ³	7 Years p.a.	Strategy inception p.a. ⁵
Fund ²	0.73%	3.67%	(3.16%)	1.51%	1.17%	1.78%	-	-
Strategy composite ⁴	0.73%	3.67%	(3.16%)	1.51%	1.17%	-	3.56%	7.59%
Benchmark	0.33%	0.94%	2.93%	1.07%	1.07%	1.10%	1.20%	1.28%
Excess Return	+0.41%	+2.73%	-6.08%	+0.44%	+0.09%	+0.69%	+2.36%	+6.31%

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 – 30 JUNE 2023

Top 3 Overweight Holdings (Alphabetical)
Newcrest Mining Ltd
Origin Energy Ltd
Santos Ltd

FUND DETAILS

Unit Prices	30 June 2023
Application Price	\$1.0799
Redemption Price	\$1.0723
NAV Price	\$1.0761
Fund Details	
APIR Code	WHT5134AU
Benchmark	RBA Cash Rate
Inception Date	14 March 2018
Risk/Return Profile	High
Fund Size	\$290mil
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 – 30 JUNE 2023

	Portfolio Exposure
Long Equity	187.1%
Short Equity	-186.2%
Net Equity Exposure	0.9%

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

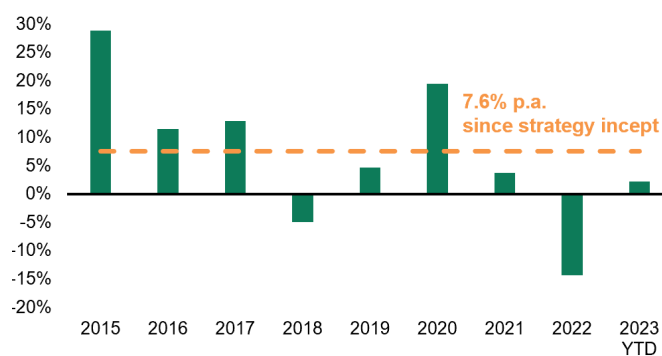
The Fund returned 0.73% for the month ending 30 June 2023, outperforming the RBA Cash Rate by 0.41%.

For the quarter ending 30 June 2023, the Fund returned positive 3.67%, outperforming the RBA Cash Rate by 2.73%.

It was a pleasing finish to the financial year. The Fund has continued to build momentum over the past 9-months, following a challenging performance period in the first three quarters of CY2022. While we are encouraged by the turnaround, there remains significant work to do. We are determined to return Fund performance to above our internal objective of the RBA Cash rate plus 7% over the medium-term.

Despite a challenging backdrop for corporate profits due to higher interest rates and sticky inflation, we are seeing outstanding stock-specific opportunities on the long and short side. The narrow market leadership we have seen in equity markets (for example, seven stocks driving the majority of S&P 500 returns year-to-date) highlights the elevated opportunities for active management to identify mispriced stocks. We enter FY2024 confident in the outlook for the portfolio to deliver meaningful positive returns over the medium term, irrespective of equity market movements.

Figure 1: Firetrail Absolute Return Strategy composite returns by calendar year (after fees)



Source: Firetrail, Morningstar, June 2023. Strategy inception 30 June 2015

CONTRIBUTORS TO RETURNS

Pleasingly, both the long and short portfolios outperformed during June. Long portfolio performance was driven by key small company holdings and event-driven trades. Outperformance in the short book was due to weakness in consumer discretionary names. The Fund has remains underweight consumer discretionary due to near-term earnings risks.

POSITIVE CONTRIBUTORS

Estia Health

Estia Health’s share price increased over June after Bain Capital submitted a revised proposal to acquire the company at A\$3.20 per share. The Estia board has decided to grant due diligence to progress the proposal. The aged care sector has been through a period of significant disruption and reform over the past 5 years. We believe the industry now has significant tailwinds thanks to constructive regulatory reform and constrained supply. In addition, there are attractive consolidation opportunities for scaled players like Estia. Against this backdrop, we view the proposal from Bain as opportunistic.

AGL

AGL outperformed in June after providing FY2024 earnings guidance ~15% above consensus forecasts and clarifying future capital expenditure intentions. Of the \$20 billion that AGL has earmarked for investment on the energy transition, roughly half will be on AGL’s balance sheet, and only \$4 billion will be spent between now and 2030. This capex profile enables AGL to pay out 50-75% of profits as dividends, providing a strong, sustainable yield for investors.

HMC Capital

HMC Capital outperformed in June after several positive developments. Firstly, one of the company’s main investments, Sigma Group, increased in value by 30% after winning a contract with Chemist Warehouse. This will result in significant performance fees and profits for HMC shareholders. Secondly, the company announced it had raised capital in two unlisted funds that focus on healthcare and logistics assets. In a very tough environment for fundraising and acquiring assets, HMC have demonstrated impressive execution.

NEGATIVE CONTRIBUTORS

CSL

CSL shares underperformed after the company released an update on FY2023 and FY2024 earnings expectations. FY2023 guidance was moved to the top end of the previous range. However, expected profit growth of 13-18% in FY2024 fell short of market expectations. We are seeing very strong improvements in the cost of inputs for CSL's plasma business. However, we expect this to take 9-12 months to flow through to improved margins in the P&L.

Lynas Rare Earths

Lynas Rare Earths underperformed during the month in sympathy with weaker commodity prices and a delay to the ramp up of its new rare earths plant in Kalgoorlie, WA. The company cited lack of suitably qualified labour to complete parts of the project. This is an unsurprising development in the current construction market. Several of our trips to WA in the last few months have highlighted that a shortage of skilled construction labour is causing significant delays and cost overruns for projects.

SEEK

SEEK underperformed during the month as a number of brokers revised FY2024 earnings forecasts lower. May job ad volumes declined 1% month-on-month and are now down 22% year-on-year. While the economic environment will pose short-term headwinds, we believe SEEK is materially undervalued on a medium-term view considering its quality growth characteristics.

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 the equity market. The Fund is driven by our best long and short ideas.

The long portfolio can be summarised as:

- 187.1% 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 with attractive cost positions and strong growth, such as Mineral Resources, Allkem and Lynas Rare Earths.
 - 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 Private and Suncorp.
 - Undervalued companies with defensive attributes including Newcrest and The Lottery Corporation.

The short portfolio can be summarised as:

- 186.2% 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 banks, large cap iron ore miners and expensive bond proxies where we see increasing near term earnings risks.

Key portfolio changes:

Key changes to the long portfolio actioned over the June quarter were:

- Initiated new long positions in Suncorp and Worley.
- Increased our positions in CSL, Incitec Pivot and Domino's Pizza.
- Reduced our positions in Santos, ResMed, Newcrest Mining and Origin Energy

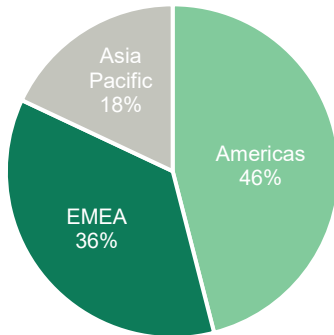
STOCK DEEP DIVE – WORLEY

Worley is a contracting firm that provides engineering expertise to clients around the world. We initiated a new position in Worley during the quarter due to our view that end-market demand and an improved competitive environment will enable Worley to grow earnings materially over the next three years. We outline our thinking below.

Worley’s end markets are firing

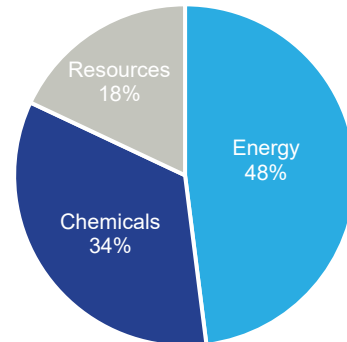
Worley is one of the three largest global engineering firms. It generates annualised revenue of over A\$10 billion, predominantly earned in the US and EMEA.

Figure 2: Worley 1H 2023 revenue by region



Source: Company reporting, June 2023

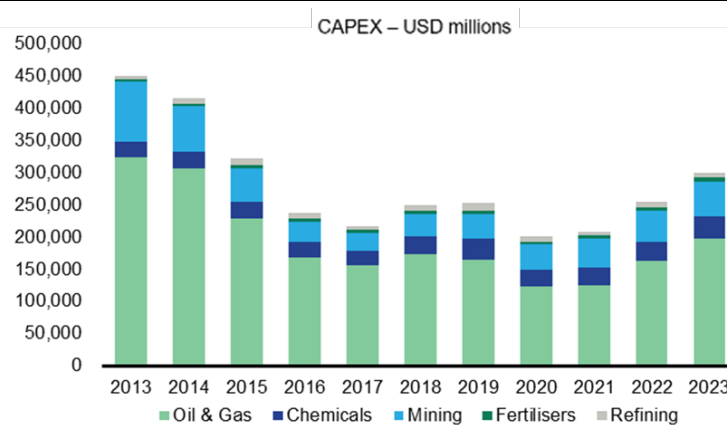
Figure 3: Worley 1H 2023 revenue by sector



Source: Company reporting, June 2023

Worley’s revenue is tied to capex investments made by its key customers in the oil & gas, chemicals and mining sectors. After a decade of declines, customers are starting to spend again. Figure 3 shows the aggregate capital expenditure across 40 large, listed companies from Worley’s key client segments. Capex appears set to recover to an 8-year high in 2023. This is still well below previous peaks.

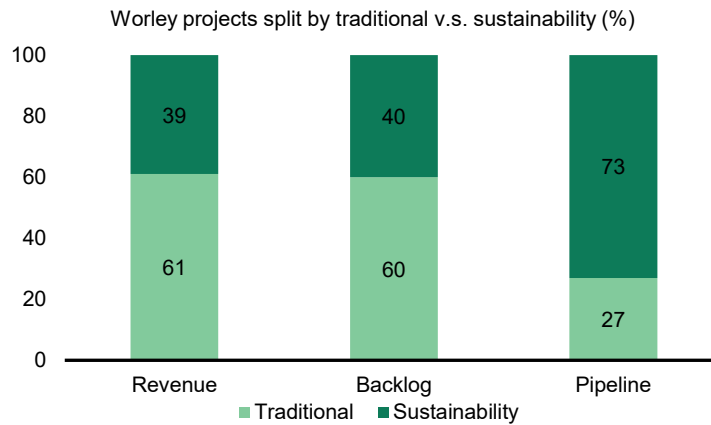
Figure 4: Capital expenditure is starting to rebound (aggregate spend across 40 large, listed companies from Worley’s key client segments)



Source: Firetrail, June 2023

The mix of investment spend is changing. Currently, 40% of Worley’s revenues and backlog are derived from projects related to sustainability. For example, carbon capture and battery materials. Worley is targeting 75% of group revenues to be derived from sustainability projects by 2026, which is supported by a pipeline skewed to sustainability projects as shown in Figure 4.

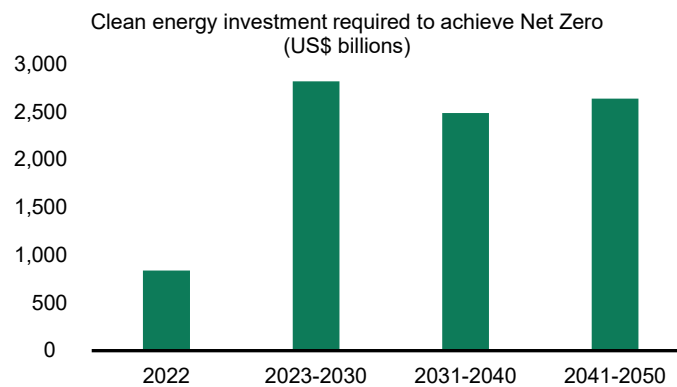
Figure 5: Worley’s mix of projects is shifting towards a higher proportion of sustainability-related projects.



Source: Firetrail, company presentations, June 2023

The outlook for spend on energy transition projects is understandably very strong. Investment spend on clean energy projects needs to step up materially to accelerate the transition away from fossil fuels. BloombergNEF estimates that the level of investment in energy transition projects needs to lift three times its current levels from 2023-2030 to set us on a path to hit net zero targets.

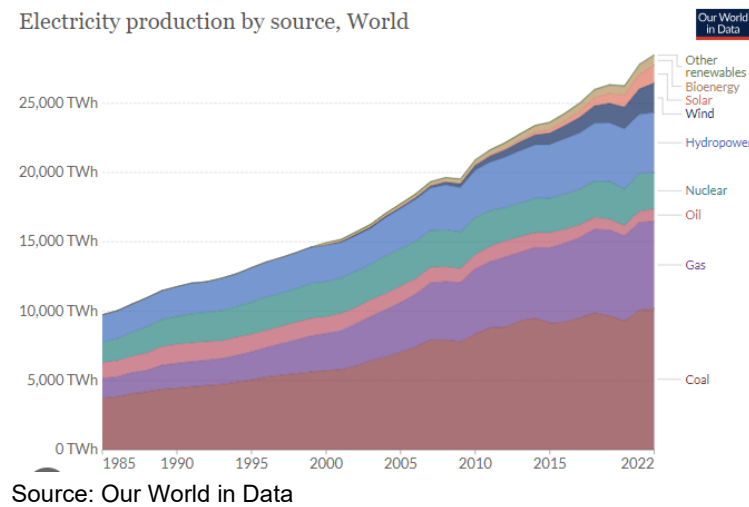
Figure 6: Annual energy transition investments need to grow at 3x the current pace from 2023-2030 to achieve Net Zero targets



Source: BloombergNEF, Firetrail, June 2023

At the same time, investment in traditional energy sources is needed to continue to support world’s overall energy needs. Over the past 30-40 years, global electricity production has grown by more than 2% p.a. and is expected to continue growing at over 1% p.a. into the future.

Figure 7: Total energy production will continue to grow. Investment in tradition energy sources is needed to support this



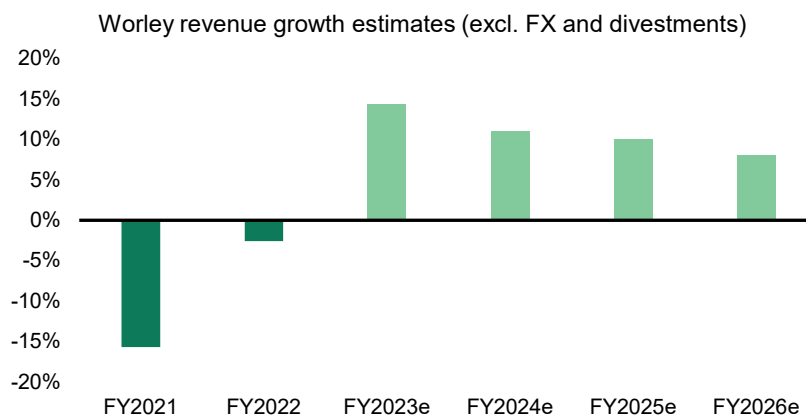
With regards to investment in traditional energy, it is not enough to just maintain historic levels of spend. Investment needs to be accelerated to account for:

1. A historic underinvestment in energy over the past decade; and
2. The loss of Russian pipeline gas, which accounted for ~25% of the global natural gas market.

On the second point, Worley has already been a direct beneficiary. The company has been awarded a 20mtpa LNG project being run by Venture Global. We estimate the project will generate US\$2-3 billion of revenue over the next three years.

We expect the abovementioned dynamics in sustainability and traditional sectors will drive a continued increase in global capex spending. As a result, we forecast Worley’s revenues to grow 14% in FY2023 and ~10% p.a. in FY2024 and FY2025. We believe these estimates could prove conservative if current trends continue.

Figure 8: We forecast organic revenue growth of 14% for FY2023 and ~10% p.a. for FY24-25 but believe these estimates could prove conservative



Source: Firetrail, June 2023

Competitive environment has improved markedly

We acknowledge that the contracting industry is typified by low barriers to entry. A small number of loss-making contracts can lead to value destruction. However, we believe medium-term conditions in Worley’s major markets are conducive to sustainable, profitable growth.

Worley is one of only three truly global engineering firms that have the expertise to take on many of the projects that are currently coming to market. The other two are Wood Group and Fluor. Despite revenues of US\$5 billion and US\$14 billion respectively, both Wood and Fluor have generated minimal or negative cash flows over recent years due to problem projects. Worley has fared better, generally due to a lower risk tolerance when selecting projects.

Figure 9: Wood Group Free Cash Flow (£ millions)

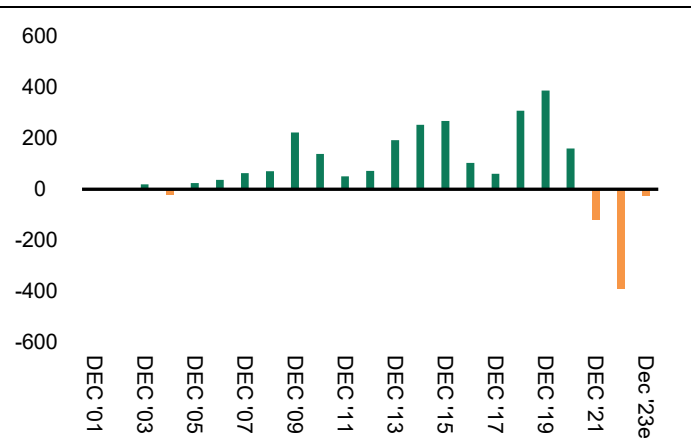
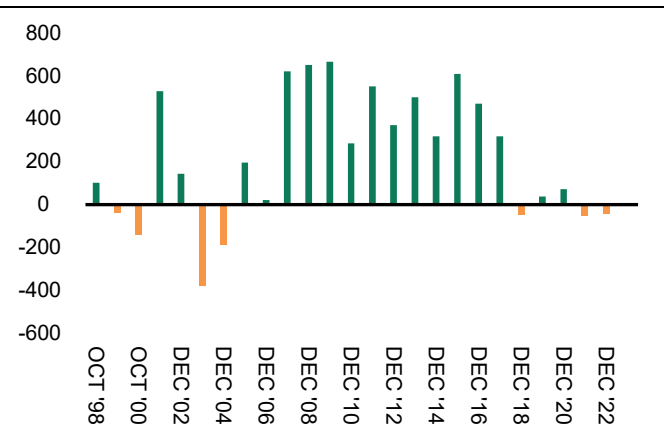


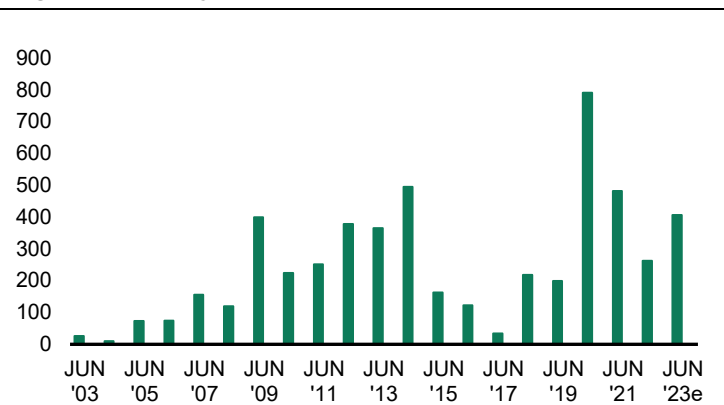
Figure 10: Fluor Free Cash Flow (US\$ millions)



Source: Factset, Firetrail, June 2023

Source: Factset, Firetrail, June 2023

Figure 11: Worley Free Cash Flow (AUD millions)



Source: Firetrail, June 2023

The good news for Wood, Fluor, and Worley is that the volume of work they are being asked to tender for at the moment is allowing them to:

1. Be selective about the projects they compete for;
2. Write more “reimbursable” contracts, which pass a lot of cost risk onto the client; and
3. Lift prices across the board.

Comments from the CEOs of each of the major contractors over the past few months suggests they are taking advantage of these supportive conditions.

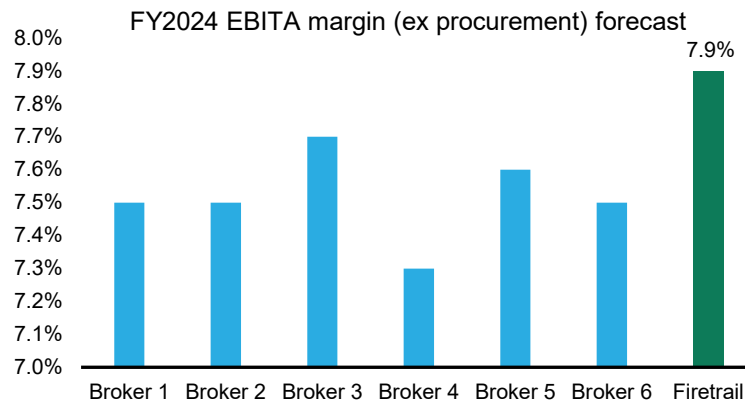
- Worley: “in 25 years, I have never seen conditions so buoyant across all our lines of business. We’re no longer willing to take low margin work, because we don’t have to.”
- Wood: “the work we are currently bidding, we see the opportunity to increase pricing.”
- Fluor: “margins on new awards have been at or above plan for the last five quarters.”

Margin improvement could surprise to the upside

In February 2023, Worley guided to 7.5%+ EBITA margins in FY2024. We believe this medium-term guidance underpins the confidence Worley has in its current backlog which has been signed up on favourable pricing terms.

We forecast higher EBITA margins than consensus estimates in FY2024 and beyond. Our assumptions drive a forecasted >20% p.a. earnings growth rate over FY2023-FY2026, underpinning substantial upside based on our three-year P/E-relative valuation framework.

Figure 12: Firetrail forecasts higher EBITA margins than consensus estimates for FY2024 and beyond



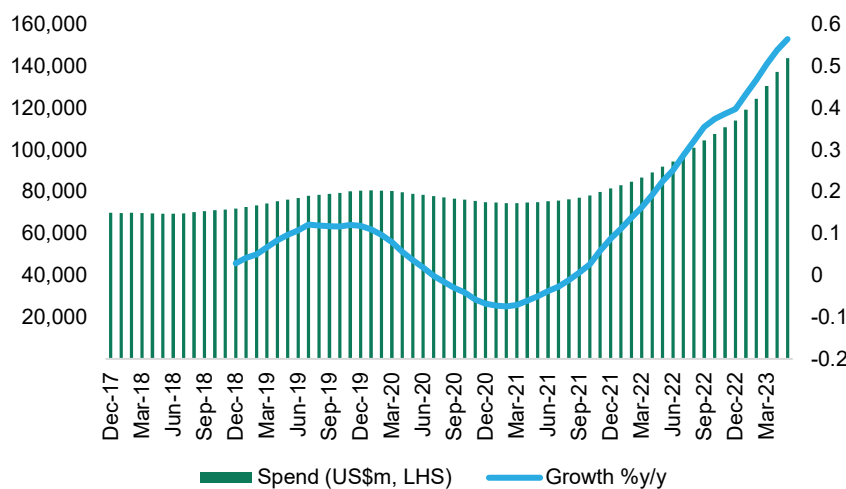
Source: Visible Alpha, Firetrail, June 2023

ONE INTERESTING THING THAT HAPPENED THIS MONTH...

The total value of manufacturing construction spend continues to accelerate in the US. The annual value of spend is now 57% above levels just a year ago. The booming spend is being driven by a wave of new reshoring projects breaking ground. These includes investment in semiconductor, electric vehicle battery, and renewables supply chain manufacturing projects.

Structural forces, led by the Biden Administration’s Inflation Reduction Act, are driving the heightened level of investment in local manufacturing capabilities.

Figure 13: Value of manufacturing construction commencements (12 month rolling, US\$ millions)



Source: US Census Bureau, Firetrail, July 2023

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

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