

FIRETRAIL ABSOLUTE RETURN FUND

MONTHLY REPORT | SEPTEMBER 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	(0.79%)	1.35%	4.37%	(1.78%)	1.60%	1.95%	-	-
Strategy composite ⁴	(0.79%)	1.35%	4.37%	(1.78%)	1.60%	-	2.90%	7.52%
Benchmark	0.33%	1.02%	3.51%	1.39%	1.20%	1.23%	1.28%	1.37%
Excess Return	-1.12%	+0.33%	+0.86%	-3.17%	+0.39%	+0.72%	+1.63%	+6.16%

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 SEP 2023

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

FUND DETAILS

Unit Prices	30 September 2023
Application Price	\$1.0944
Redemption Price	\$1.0868
NAV Price	\$1.0910
Fund Details	
APIR Code	WHT5134AU
Benchmark	RBA Cash Rate
Inception Date	14 March 2018
Risk/Return Profile	High
Fund Size	\$276mil
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 SEP 2023

	Portfolio Exposure
Long Equity	195.2%
Short Equity	-197.5%
Net Equity Exposure	2.3%

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 negative 0.79% for the month ending 30 September 2023, underperforming the RBA Cash Rate by 1.12%.

For the quarter ending 30 September 2023 the Fund returned 1.35%, outperforming the RBA Cash Rate by 0.33%.

CONTRIBUTORS TO RETURNS

Positive contributors to monthly returns included long positions in Incitec Pivot, Santos, and NextGen Energy. Detractors included long positions in Star Entertainment Group, CSL, and Tabcorp Holdings. We discuss each further in our commentary below.

POSITIVE CONTRIBUTORS

Incitec Pivot

Incitec Pivot shares outperformed in September on the back of a strong ammonia price. The ammonia price rallied ~50% in September, driven by higher European gas prices. Incitec Pivot upgraded FY2023 production guidance for its Explosives division, but downgraded guidance for the Fertilisers division. The company also confirmed that it remains in discussions to sell its Fertiliser business.

Santos

Santos shares outperformed during the month as the oil price rallied more than 10%. Santos also hosted an investor tour to its Pikka project in Alaska, which was attended by one of our portfolio managers. The Pikka project is progressing well. In our view, it has strong potential to be extended in the future at high returns.

NexGen Energy

Uranium project developer NexGen Energy shares advanced strongly during the month as the uranium price rose +15.5% to ~\$70/lb, levels not seen since February 2011. The strong uranium price was driven by supply disruption and positive sentiment that followed an industry conference in London, along with the re-emergence of financial buyers such as the SPUT ETF. The uranium market remains fundamentally undersupplied and we expect prices need to rise to >U\$80/lb to justify building additional mines.

NEGATIVE CONTRIBUTORS

Star Entertainment Group

Star Entertainment Group shares underperformed during the month after undertaking an equity raise at a discount to its share price. The company also announced new \$450 million debt facilities as part of a refinancing process. The capital raise and debt facility will together eliminate the casino operators large debt load and help fund the development of Star's Queen's Wharf casino in Brisbane.

CSL

CSL shares underperformed alongside most other healthcare names in September. There was no company specific news.

Tabcorp Holdings

Tabcorp Holdings underperformed during the month due to investor concerns around softness in the wagering market. UK peer Entain (owner of Ladbrokes and Neds) announced that its net gaming revenue was softer than anticipated. Despite the short-term softness, we expect the Victoria wagering license announcement later this year to be a positive catalyst for Tabcorp, driving future earnings upgrades.

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:

- 195.2% long exposure across a diversified portfolio of 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 who are well placed to strengthen their competitive position through the cycle, including CSL, SEEK and James Hardie Industries.
 - 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:

- 197.5% 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 bond proxies where we see increasing near term earnings risks.

TREASURY WINE ESTATES DEEP DIVE

Treasury Wine Estates (Treasury) is a new position which was added to the Fund during the quarter. While the business is facing pressures in its two smaller divisions (Americas and Treasury Premium Brands), what matters for this stock is the performance of its Penfolds division and upside optionality from the potential removal of Chinese tariffs on Australian wine. We discuss the outlook for these drivers in our commentary below.

What Matters? Penfolds.

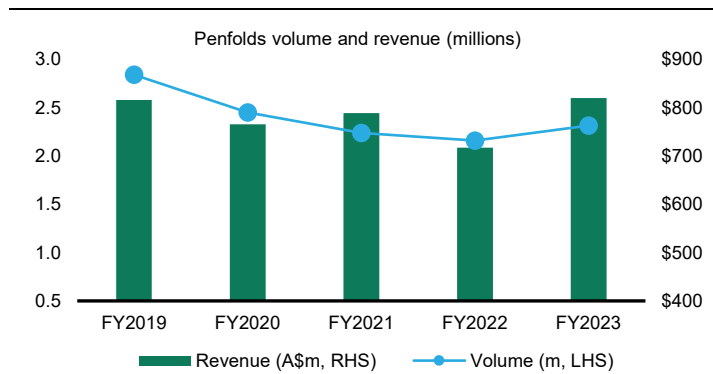
Penfolds accounts for a third of Treasury's revenue. However, in FY2023 the division was responsible for 63% of earnings before interest and tax (EBIT). It is by far the most valuable division within Treasury, with its strong global brand strength providing pricing power and high margins.

During 2020, the Penfolds business encountered two significant headwinds:

1. COVID impacted the global movement of goods and the consumption of wine in bars and restaurants.
2. A Chinese anti-dumping investigation ultimately led to 200%+ tariffs on Australian wine.

From a high point of 2.84 million cases sold in FY2019, Penfolds volumes progressively fell to 2.16 million cases in FY2022 before returning to growth in FY2023. Revenues have performed better. Treasury has increased prices and its volumes have shifted towards higher quality product. Revenue grew 14% in FY2023 and is now back above FY2019 levels.

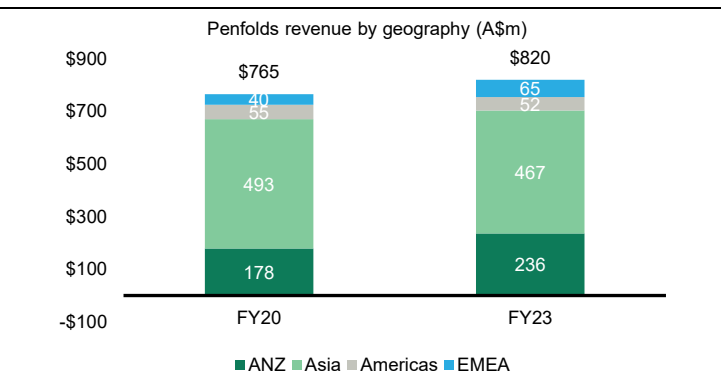
Figure 1: Penfolds volumes are still below FY2019 levels, but revenues have now fully recovered



Source: Treasury Wine Estates, Firetrail

Despite the loss of almost all revenue from China from FY2021 onwards, Penfolds revenue from Asia has only fallen 5% due to the successful reallocation of wine to other markets, and potentially some continued leakage into China. Sales to Australia/New Zealand (ANZ) have grown strongly as distribution points have broadened and price increases have been implemented.

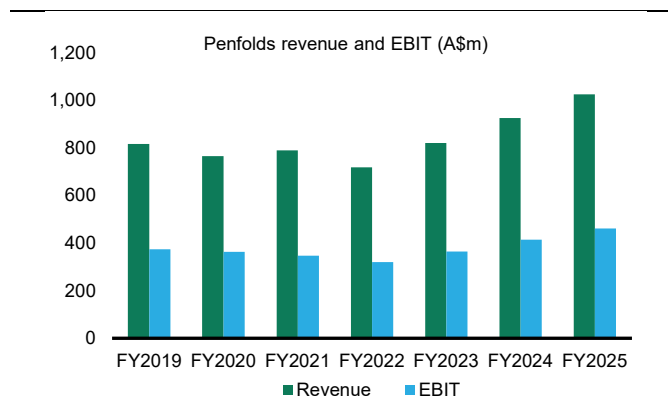
Figure 2: Penfolds revenue from Asia has been resilient despite China tariffs, while ANZ revenue has grown strongly



Source: Treasury Wine Estates, Firetrail

Given the momentum that has returned to the business, we believe Penfolds can continue growing revenue at double-digits in FY2024-25 while holding margins constant at ~45%. Note: this assumes China tariffs are not lifted.

Figure 3: We expect double digit revenue growth supported by stable margins in FY2024-25



Source: Treasury Wine Estates, Firetrail estimates, September 2023

The China upside option

In recent months, we have seen the Chinese Government remove tariffs on Australian barley, remove a trade ban on Australian hay, and propose a compromise package to lift tariffs on Australian wine. Unfortunately, the terms of the wine package were not acceptable to the Australian Government. But given the positive direction of change, we see removal of wine tariffs as a question of “when” not “if”.

At its peak, China was buying ~600 thousand cases of Penfolds Bins & Icons ranges (i.e. higher priced product), which accounted for the vast majority of the margin Treasury was making from the region. Given the long lead times associated with increasing luxury wine production, it will take at least a few years for Penfolds to completely satisfy the increased demand if tariffs are removed. However, with a supply shortage we believe Penfolds is in a strong position to realise greater prices globally, driving strong revenue growth and margin improvement.

In evaluating the potential upside from the removal of Chinese tariffs, we consider two scenarios for Penfolds’ profitability.

1. No change to volume, global pricing lifted 15%, operating expenses increased 10%.
2. As above, but with a ~10% lift in volume (~300k cases), achieved by tapping into Treasury’s extensive grower network.

Figure 4: There is material incremental upside to Treasury shares if China’s wine tariffs are lifted

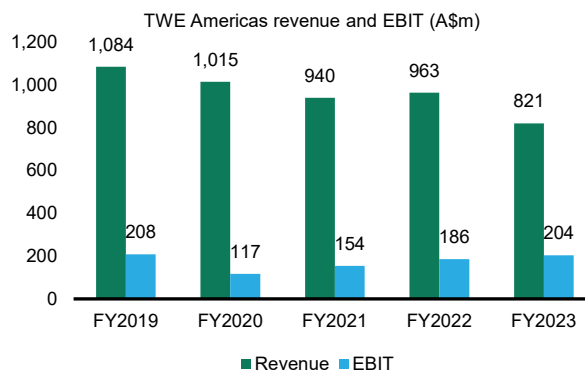
Scenarios for removal of China tariffs (A\$m)		
	Scenario 1	Scenario 2
Incremental NPAT	65	123
Multiple	22x	22x
Value	1,425	2,715
Valuation uplift	17%	32%

Source: Firetrail, September 2023

Is the Americas a reason not to hold the stock?

A key concern holding investors back is the weakness in Treasury’s Americas division. Due to a shift away from the commercial (less than \$10 per bottle) segment, Americas’ revenue has declined by 25% since FY2019. However, margins have improved, meaning EBIT has remained flat.

Figure 5: Treasury’s Americas’ has held EBIT flat despite revenue declines



Source: Treasury Wine Estates, Firetrail

The short-term does appear challenging for the Americas, with volume declines accelerating in the second half of 2023 and evidence that Treasury’s ‘19 Crimes’ brand is under pressure.

However, taking a medium-term view, we believe Treasury Americas’ evolution towards a more premium/luxury business is progressing well and underpins the investment case.

1. Premium and Luxury product is now 94% of revenue, up from 70% in the first half of 2020.
2. The acquisition of Frank Family Vineyards in December 2021 has been very successful to date.
3. Availability of luxury product is currently constrained and will remain so for FY2024. However, it will return in FY2025, driving higher margins as supply returns to a more resilient consumer segment.

Earnings and valuation

While we believe there is some modest downside risk to Americas' earnings guidance in FY2024, this is already factored into consensus estimates. The more important driver for earnings and valuation is the upside that we observe in the Penfolds business.

Treasury Wine Estates is currently trading at a 43% premium to the ASX 200, ~5% below its long-term average. Based on our three-year P/E-relative framework, we forecast 15% valuation upside on current settings, with 20-40% additional upside if China reopens.

ONE INTERESTING THING THAT HAPPENED THIS MONTH...

The Firetrail team did a lot of travelling offshore in September. One of our analysts visited the team responsible for Stratos, a Direct Air Capture plant being built by Occidental in Texas. Once operational, Stratos is expected to remove 500kt of emissions from the atmosphere each year at an estimated cost of \$500/t initially, with an aim to ultimately reduce this to \$200-250/t. We see Direct Air Capture as one of the economically viable ways to reduce emissions in the future, with offtake demand from businesses that will find it difficult to decarbonise themselves (e.g. technology firms, airlines).

Figure 7: Stratos Direct Air Capture plant



Source: Occidental, September 2023

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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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