

FIRETRAIL AUSTRALIAN HIGH CONVICTION 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	10 Years p.a.	Strategy inception p.a. ⁵
Fund ²	(2.89%)	(1.31%)	14.02%	11.87%	5.02%	5.17%	-	-
Strategy composite ⁴	(2.89%)	(1.31%)	14.02%	11.87%	5.02%	-	11.15%	8.97%
Benchmark	(2.84%)	(0.77%)	13.46%	11.00%	6.67%	7.27%	8.42%	6.91%
Excess Return	-0.05%	-0.55%	+0.56%	+0.87%	-1.65%	-2.11%	+2.74%	+2.06%

1. Past performance is not indicative 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.

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 ASX 200 Accumulation Index over the medium to long term (after fees).

PORTFOLIO POSITIONING – 30 SEP 2023

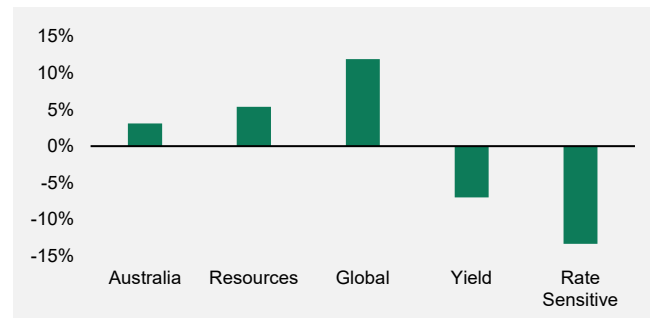
Top 3 Overweight Holdings (Alphabetical)
CSL Ltd
Incitec Pivot Ltd
Santos Ltd

FUND DETAILS

Unit Prices	30 September 2023
Application price	\$1.1701
Redemption Price	\$1.1665
NAV Price	\$1.1680
Fund Details	
APIR Code	WHT3810AU
Benchmark	S&P/ASX 200 Accumulation Index
Inception date	14 March 2018
Risk/Return Profile	High
Number of Holdings	28
Fund size	\$602mil
Management fee*	0.90% p.a.
Performance fee*	15% of outperformance above an annual Hurdle

*Please read the Product Disclosure Statement for more details

THEMATIC POSITIONING – 30 SEP 2023



Source: Firetrail. Relative to the Benchmark

Past performance is not a reliable indicator of future performance.

The Product Disclosure Statement ('PDS') and the Target Market Determination ('TMD') of the Fund is available at www.firetrail.com. Any potential investor should consider the PDS and TMD before deciding whether to acquire, or continue to hold units in, the Fund.

2. 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. 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 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. 5. Strategy inception 29 November 2005.

PORTFOLIO COMMENTARY

The Fund returned negative 2.89% (after fees) for the month ending 30 September 2023, underperforming the ASX 200 Accumulation Index by 0.05%.

For the quarter ending 30 September 2023 the Fund returned negative 1.31%, underperforming the ASX 200 Accumulation Index by 0.55%.

CONTRIBUTORS TO RETURNS

Positive contributors included Incitec Pivot, Santos and QBE Insurance. Negative contributors included CSL, BHP (underweight), and Alumina. 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.

QBE Insurance

QBE Insurance shares outperformed as global bond yields increased by 30-50 basis points. September is the peak of the US hurricane season and Hurricane Idalia and Hurricane Lee have been the most notable events so far. However, losses appear to be within normal allowances for the insurance industry.

NEGATIVE CONTRIBUTORS

CSL

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

BHP (underweight)

BHP outperformed in September on the release of improved Chinese economic data and the implementation of further policy easing measures by Chinese regulators. The iron ore price remained relatively flat at ~\$120 per tonne over the month.

Alumina

Alumina shares underperformed during the month due to continued concerns on cash flow and gearing. We continue to believe Alumina will be permitted to mine higher grade bauxite areas post the conclusion of an EPA review in WA, which will alleviate cash flow and balance sheet pressure.

COMPANY AND INDUSTRY NEWS

The ASX 200 declined -2.8% in September, bringing it back to where it started 2023. Major global indices were also down, with the S&P 500 down -4.9% and Euro Stoxx down -3.0%. As economic data has remained resilient, 'higher for longer' has increasingly become the consensus view on interest rates. Bonds sold off with yields rising by up to 50 basis points at the long end of the curve. The USD appreciated 2.5% vs global currencies.

Across the ASX 200, Energy was the strongest sector, supported by a >10% rally in the oil price. The Mining and Financials sectors also outperformed. Higher bond yields drove underperformance in the REITs, Gold, Technology and Healthcare sectors. The Firetrail High Conviction Fund benefitted from its positions in Energy names and select Financials like QBE Insurance. However, performance was negatively impacted by Healthcare holdings and an underweight position in BHP.

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.

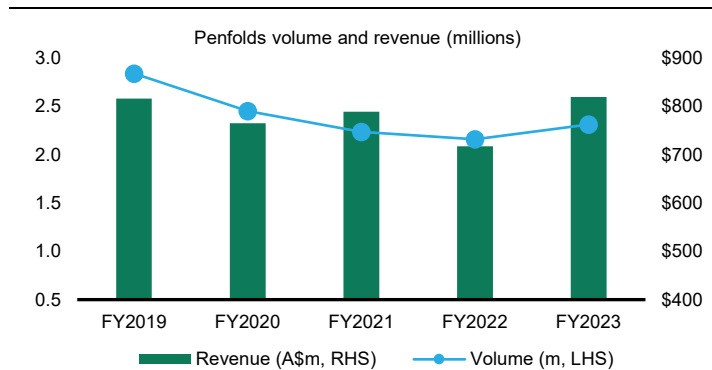
Penfolds accounts for a third of Treasury’s revenue. However, in FY2023 the division was responsible for 63% of earnings before interest and tax (EBIT). It is by far the most valuable division within Treasury, with its strong global brand strength providing pricing power and high margins.

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.

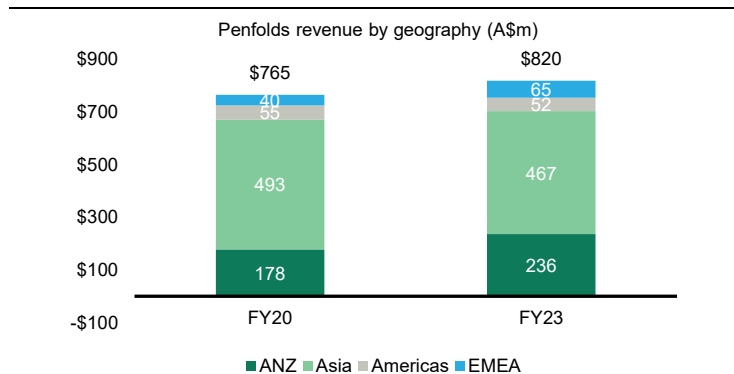
Figure 1: Penfolds volumes are still below FY2019 levels, but revenues have now fully recovered



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

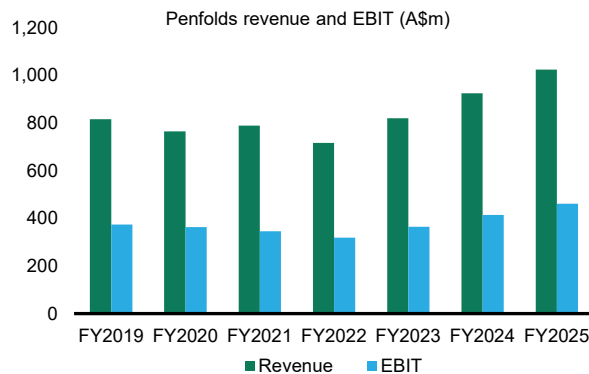


Source: Treasury Wine Estates, Firetrail

Companies mentioned are illustrative only and not a recommendation to buy or sell any particular security

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

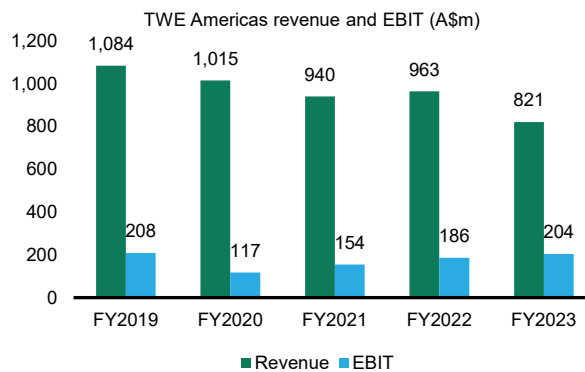
Scenarios for removal of China tariffs (A\$m)		
	Scenario 1	Scenario 2
Incremental NPAT	65	123
Multiple	22x	22x
Value	1,425	2,715
Valuation uplift	17%	32%

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.

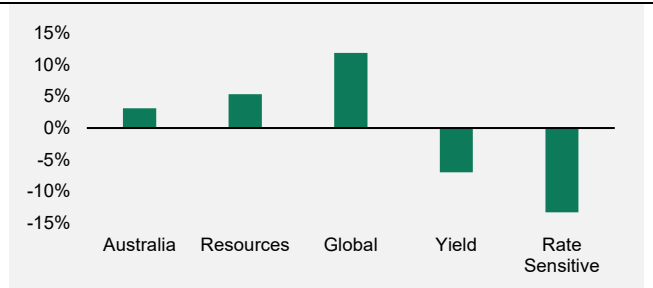
Treasury Wine Estates is currently trading at a 43% premium to the ASX 200, ~5% below its long-term average. Based on our three-year P/E-relative framework, we forecast 15% valuation upside on current settings, with 20-40% additional upside if China reopens.

PORTFOLIO POSITIONING AND CHANGES

With underweight positions in Yield and Rate Sensitive categories broadly offsetting each other, our main thematic exposure is an overweight holding in global stocks. Our positioning across each category can be summarised as follows:

- **Australia** – overweight defensives like The Lottery Corporation and Medibank Private.
- **Resources** – overweight energy and decarbonisation metals through exposure to Santos and Lynas Rare Earths. Underweight iron ore.
- **Global** – holdings in companies that either have robust demand profiles like ResMed and CSL, or businesses that are priced too cheaply for their reality, like Domino's Pizza Enterprises.
- **Yield** – underweight real estate and infrastructure stocks. Overweight gold through our holding in Newcrest Mining.
- **Rate Sensitive** – underweight Aussie banks, overweight QBE Insurance, Suncorp, and Virgin Money UK.

Figure 6: Thematic positioning as of 30 September 2023 (relative to benchmark)



Source: Firetrail

The main changes we made to the portfolio over the March quarter were:

- Initiated positions in Treasury Wine Estates, South32 and Orora.
- Increased position sizes in CSL, ResMed and Bluescope Steel.
- Reduced position sizes in Newcrest Mining, James Hardie Industries and Medibank Private.
- Exited positions in Origin Energy, Computershare and Ramsay Healthcare.

The portfolio remains highly concentrated with 78% active share and 60% stock-specific risk.

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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Link to the Product Disclosure Statement: [WHT3810AU](#)

Link to the Target Market Determination: [WHT3810AU](#)

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

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