Newgate

NEWGATE ABSOLUTE RETURN FUND

# JUNE QUARTER 2018

The **Newgate Absolute Return Fund** takes long and short positions in equity securities. We are a research and evidence based fund manager seeking to generate our investors absolute returns through the identification of incorrectly priced agents of change in companies and industries.

| QUARTERLY PERFORMANCE - FINANCIAL YEAR 2018 | | | | | |
|---|---|---|---|---|---|
| | SEPTEMBER QTR | DECEMBER QTR | MARCH QTR | JUNE QTR | TOTAL FY RETURN |
| 2018FY | 7.22% | 13.09% | 7.39% | 8.27% | 41.00% |

## QUARTERLY SUMMARY

*"The theft of US industrial information and intellectual property constitutes the greatest transfer of wealth in history"*

**- US General Keith Alexander, United States Cyber Command, July 2012**

*"Our fears are always more numerous than our dangers"*

**- Lucius Seneca, Roman Philosopher, 4 BC**

*"Probability is the very guide to life"*

**- Marcus Cicero, 63 BC**

Over the June quarter 2018, the **Newgate Absolute Return Fund** generated a +8.3% return, taking the rolling **12 month return** to **41.0%**. This saw the Fund placed in the **top 5 best performing managed funds** in Australia for Financial Year 2018 across all investing styles[1].

The June Quarter's strong positive performance came from a variety of sources including Sundance Energy (SEA), Whitehaven Coal (WHC) and Telstra (TLS), all of which are discussed on the following pages.

FUND PERFORMANCE AS AT 30 JUNE 2018

| TIME PERIOD | RETURN |
|---|---|
| 3 month return | 8.27% |
| 6 month return | 16.28% |
| 12 month return | 41.00% |
| Since Inception (total) | 47.27% |
| Since Inception (annualised) | 22.59% |
| Observed Volatility | 11.6% |

AVERAGE FUND STATISTICS

| STATUS | MOVEMENT |
|---|---|
| Number of Positions: | 54 positions + Cash |
| Net Position: | 2% (longs less shorts) |
| Total Long Positions: | 125% |
| Total Short Positions: | 123% |
| Gross Exposure: | 248% (longs plus shorts) |

NOTABLE STOCK CONTRIBUTIONS

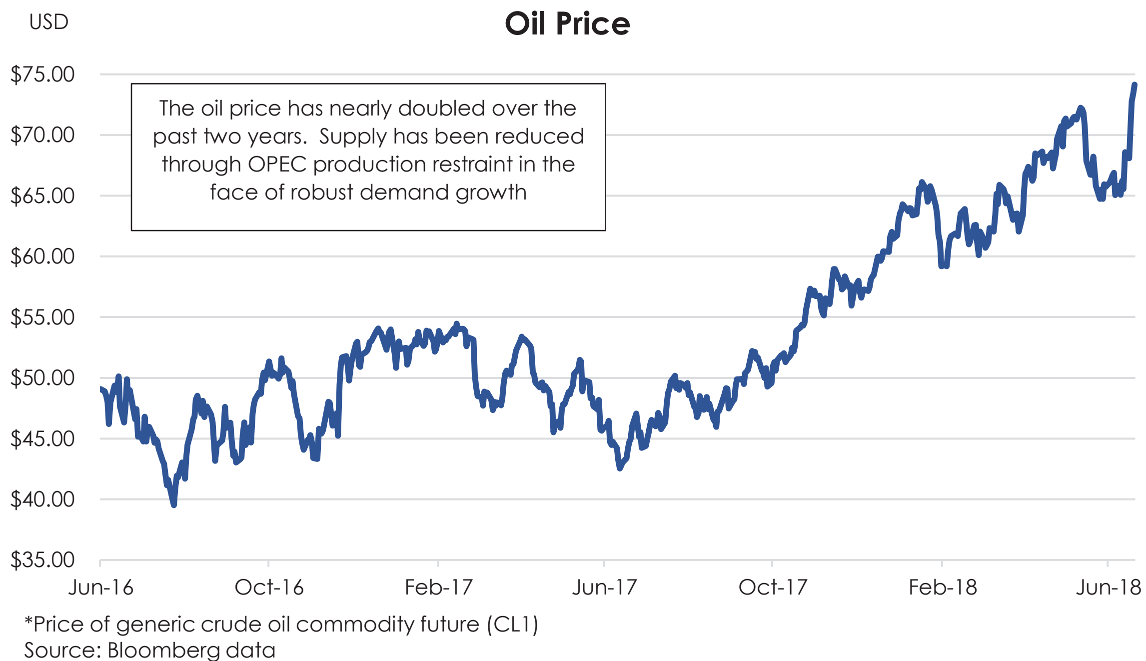
| POSITIVE CONTRIBUTORS | NEGATIVE CONTRIBUTORS |
|---|---|
| Sundance Energy (SEA) | Lynas Corporation (LYC) |
| Mitula Group (MUA) | APA Group (APA) |
| Sino Gas & Energy (SEH) | |
| Whitehaven Coal (WHC) | |
| Telstra (TLS) | |

1 Australian Fund Monitors, AFR 20 July 2018 'Value investing is consistently being beaten by growth'

# FUND OVERVIEW

## Sundance Energy (SEA)

Over the quarter, we participated in a $260 million placement by oil company **Sundance Energy (SEA)** to fund the acquisition of shale oil assets in the USA. The deal was very well priced, and oil subsequently rallied strongly after the deal closed. This caused SEA's share price to perform strongly and contribute materially to the Fund's June quarter's performance.




*Price of generic crude oil commodity future (CL1)
Source: Bloomberg data

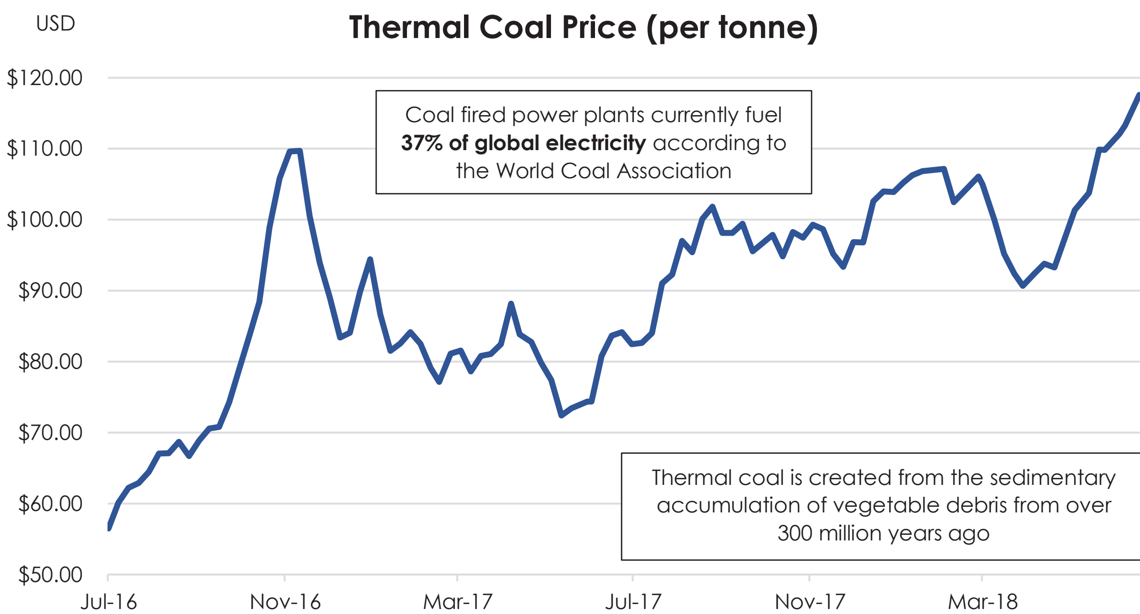
NEWGATE ABSOLUTE RETURN FUND

## FUND OVERVIEW

### Whitehaven Coal (WHC)

The Fund's long position in Australian coal producer **Whitehaven Coal (WHC)** contributed strongly to performance over the quarter.

Thermal coal prices have risen sharply over the past 12 months, driven by **China reforming their domestic coal industry** by closing inefficient and environmentally damaging coal mines.



*Australia Newcastle Port Thermal Coal 6000 kcal/kg FOB Spot Price (COASNE60)
Source: Bloomberg data

After rationalisation of inefficient coal mines, China has struggled to grow supply sufficiently in 2018 to meet robust demand. China's domestic under-supply has created the need for China to import more coal, pushing up traded seaborne thermal coal prices. WHC sells coal into this seaborne market.

We expect reform conditions in China will allow thermal coal markets to remain tight and prices at elevated levels for the next few years. Over the medium term, Chinese supply will very likely increase again causing thermal prices to move back to more appropriate long-term levels of circa $US70-80 per tonne.

Even after factoring in a short-term decline in coal prices WHC trades on a double digit free cash flow yield (15%+) and will be debt free over the coming 12 months. We expect the company will use its free cashflow to fund several profitable coal mine developments, increase dividends and potentially implement a share buyback.

## FUND OVERVIEW

### Lynas Corporation (LYC)

Rare earths producer **Lynas Corporation (LYC)** performed poorly over the quarter on the back of market concerns over an environmental review of their Malaysian rare earths facility.

We accept the review does increase LYC's risk profile, but we note **LYC has operated safely for six years** without any safety or environmental issues.

Whilst conceding the risk, we note the following:

- **Rare earth demand is expected to increase substantially** over the coming decade, driven by the electric vehicle, wind turbine and electronic industries
- Because of its application in the technologies of the future, **rare earths are strategically and politically significant**
- There is a **looming rare earth deficit** over the next three to five years. Demand for rare earth magnets from electric vehicle demand is forecast to be much greater than supply, which is constrained by technical difficulty and long production lead times
- **China has a near monopoly in rare earth production**, representing 80% of supply. This is a significant sovereign risk for those that rely solely on China for their rare earth supply
- **LYC is the only rare earths producer of significance outside China**, with a 20% global market share of rare earth production
- **LYC owns the best rare earth deposit in the world**, with the highest-grade ore body and over 20 years of reserves
- LYC have **a consistent and proven track record** in producing rare earths while lowering costs of production
- LYC's **balance sheet is now strong**
- New rare earth supply must come to market to meet demand. We expect the **incentive price** for new production is $US80 per kilogram, almost **double current prices**
- Based on the most recent result (July) LYC is generating $100 million in free cashflow. This compares to its equity market capitalisation of $1.3 billion
- This represents an **equity free cashflow yield of 7.8%.** We can see this free cashflow yield doubling over the next three years with the share price following suit

LYC remains a significant position in the Fund. We expect a three year time horizon on the investment.

# FUND OVERVIEW

## Clydesdale Bank (CYB) – Acquisition of Virgin Money in the UK

We took a position in **Clydesdale Bank (CYB)** over the quarter.

CYB is a mid-sized UK bank lending to the residential and business markets. CYB was demerged from the National Australia Bank in 2016.

Over the quarter, CYB ($4.8 billion market cap) made a $2.9 billion **takeover bid for Virgin Money**. This is a significant deal for CYB with Virgin set to represent nearly 40% of the total merged entity.

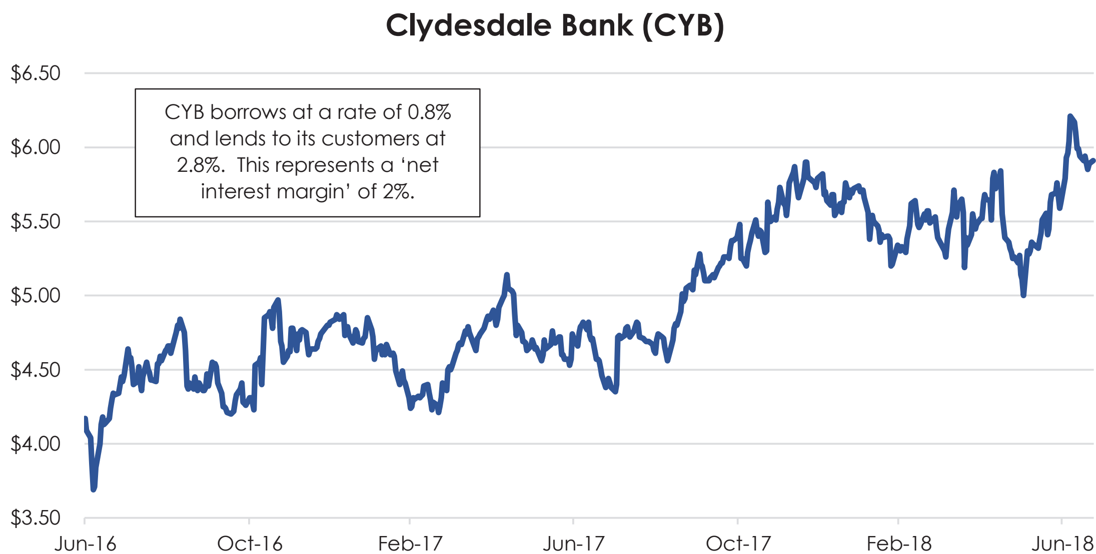
The merged businesses will have much greater scale, potentially allowing several significant efficiency gains. We estimate a **10-15% potential cost reduction** over the next three years, translating to **20-25% earnings upgrades**.

We are confident in CYB's capability to deliver this cost out program given their history:

*"CYB has consistently delivered above expectations around costs through achieving operational efficiencies ahead of schedule[2]"*

CYB trades on a 2019 earnings **yield of 8.0%,** is well capitalised and will drive **solid earnings growth** over the next few years from an easy to reconcile **cost out program.**

CYB remains a stock we are confident will appreciate. We assess 15-20% upside from current levels over the coming 12-18 months.




Source: Bloomberg data

[2] Ed Henning, CLSA, January 2018

## A different take on the 'trade war'

*"There are few interferences which are capable of spreading so far and ultimately being so destructive of free enterprise as government interference in trade"*

**Milton Freidman, Capitalism and Freedom, 1962**

The consensus view is President Trump is responsible for the current trade dispute with China, and his actions are potentially going to destabilise global economic growth.

We will argue that it is quite reasonable that the USA disputes the current trade regime and seeks to **level the playing field** with China. China does not appear to conduct trade fairly and there is also a substantial issue with China acquiring US intellectual property without compensation.

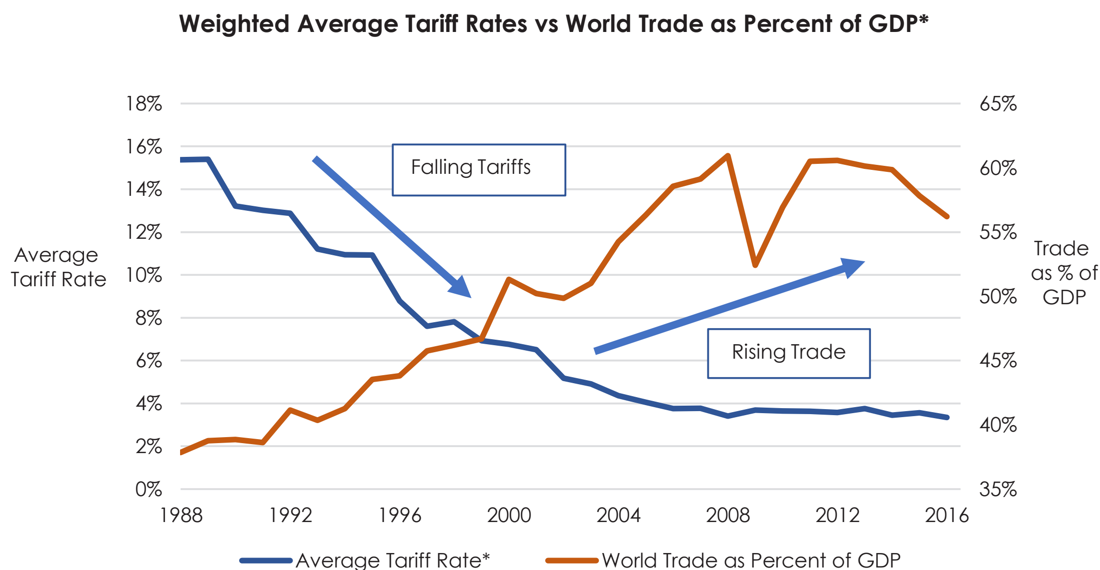
### Some background and context

The modern global trade regime began in 1946 when the **USA decided to open its markets** and led the formation of the World Trade Organisation (WTO).

The philosophy of the WTO is that open markets, transparency and non-discriminatory trade policies are conducive to the national welfare of all countries[3].

Historically, the WTO framework has been accepted by most trading countries because there was a belief **interests were aligned**. This alignment has allowed a process of bargaining and reciprocation to see trade grow strongly over **the past 70 years**.

**Weighted Average Tariff Rates vs World Trade as Percent of GDP***




*Average Tariff Rate calculated as the average of applied weighted mean of tariff rates for seven developed economies (China, USA, EU, Japan, Brazil, Australia & South Africa)
Source: World Trade Organisation Tariff Data Download Facility, The World Bank

[3] The political economy of the world trading system, Hoekman and Kostecki, 2009

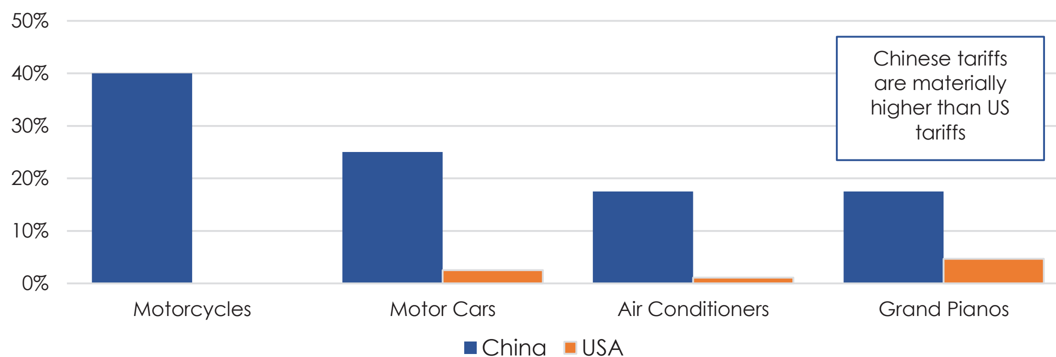
### The current tariff regime does not seem fair to the USA

The US has taken the stance that since joining the WTO in 2001 China has negotiated an unfair trade advantage that needs to be corrected.

One of the key areas of contention is that China has **developing economy status** with the WTO. This means it is permitted to have higher tariffs to protect their domestic industries. For example, China taxes US car imports at 25%, whereas the USA only tax Chinese imports at 2.5% - a huge difference for a major industry.

China have a much higher level of tariffs than the USA across major industry groups. It is clearly imbalanced, and it is easy to understand the USA's tough stance on trade with China.

**Major Tariff Disparities between the USA and China**




Source: World Trade Organisation Tariff Data Download Facility

### The problem of intellectual property

There is a much greater issue than tariffs on manufactured goods. After many years of allegations, the US is now confronting China about its **appropriation of US technology** without fair payment[4].

> *"We estimate that the annual cost to the US economy continues to* ***exceed $225 billion*** *in counterfeit goods, pirated software, and theft of trade secrets and could be as high as* ***$600 billion****.*
>
> **The Commission on the Theft of American Intellectual Property** - an independent and bipartisan initiative of leading Americans from the private sector, public service in national security and foreign affairs, academia, and politics

The US Government is **directly accusing China of intellectual property theft** of up to $US600 billion a year. To put this into context, the US has so far imposed tariffs of just $US31 billion on Chinese goods. There is a major gulf of contention here.

[4] The Evolution of the Trade Regime. Politics, Law and Economics of the GATT and the WTO. Barton et al, 2006 p65

### Intellectual property theft is not new

Emerging economies have historically acquired intellectual property from developed economies without compensation[4]. China has been at the forefront here, it has been part of their development approach since beginning its industrialisation under Deng Xiaoping in the 1970's.

> *"The Chinese were shocked at the willingness of the Europeans to open for inspection factories, offices, shops and any other facility they wanted to see"*
>
> **Source**: A 1978 Chinese high-level delegation to Europe learning how to industrialise[5].

Today, developed world governments are becoming less willing to allow free intellectual property transfer with developing countries, particularly China.

Apart from the obvious inequity or unfairness of the cost to US firms from intellectual property theft, the medium-term issue is more significant. The US government is most concerned that the theft of its intellectual property is enabling China to meet their **Made in China 2025 plan.** This plan is aimed at substituting imports of components and technology for domestic Chinese production and technology. This would mean less reliance on US technology, which could ultimately hurt the US' leadership position across many parts of the technology spectrum.

#### What is Made in China 2025?

Announced in 2015, the Chinese government plans to make China a world leader in **ten strategic industries**. Industries such as artificial intelligence, quantum computing, 5th generation wireless, and genomics.

The critics of this goal is that China' s strategy is to **appropriate US intellectual property** to replace much of the foreign technology it imports with locally-made components.

*"China views its initiative to encourage home-grown innovation. However, the US considers China's program to be directly aimed at America's manufacturing sector"*

13D Research: 21st June 2018

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[5] Deng Xiaoping and the transformation of China, Ezra Vogel,

### What are we expecting? What are the opportunities?

US concerns around intellectual property theft need to be addressed during this period of global trade tensions. The WTO needs to evolve to take into consideration the changing nature of trade, specifically dealing with the theft and application of US intellectual property by China.

China is in a weak bargaining position. We would expect to see China accept the US claims and work with them to reach an agreement on how to create a more level playing field. If not, we will see further escalation which would be very negative for global economic growth.

We expect trade related news flow to create volatility and will seek to take advantage of market anomalies that occur during periods like this.

For example, during the past month of market dislocation and uncertainty, we have taken the opportunity to purchase global cyclicals at discounted prices.

Two of the largest positions we have taken are steel companies **Sims Metal (SGM)** and **Bluescope (BSL).** These companies had the curious situation of being sold off because of concerns over the impact of tariff escalation - but the tariffs are in fact very good for their earnings.

*The STOXX 600 Basic Resources Price Index
Source: Bloomberg Data

RESEARCH NOTE

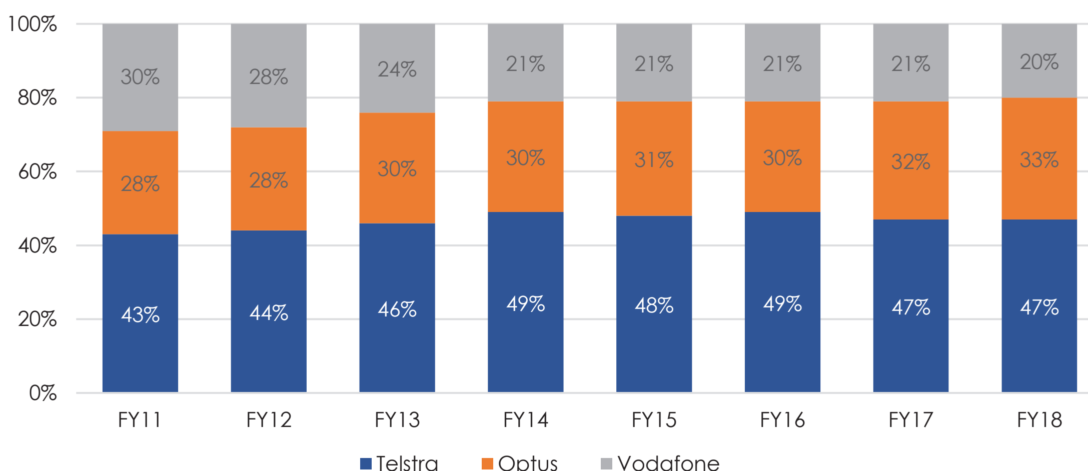
## Telstra (TLS) – the market does not appreciate the decline in mobile earnings

The impact of the NBN on Telstra's profitability is well understood as data moves from Telstra's copper wires to the government's fibre optic network[6].

What is less appreciated is the **decline in Telstra's mobile earnings now underway** (mobile earnings represent 50% of TLS' operating profit). Perhaps this is not surprising, as even Telstra has been late to acknowledge the deterioration in mobile profitability. Telstra were still targeting mobile earnings growth as recently as May 2018[7]…..

### Background: The mobile phone industry

Telstra has dominant market share in Australia's mobile sector, with almost 50% of postpaid mobile accounts[8] and circa **60% of mobile industry profits** (EBITDA). Optus is the other major player with a 30% market share, with Vodafone at 20%.




Refers to postpaid mobile market share. Source: Company data; Newgate estimates.

### Telstra's mobile pricing is too high

Telstra's mobile pricing is now **30% above Optus**. We believe the combination of Telstra's dominant market share and materially higher mobile prices have left Telstra vulnerable to intensifying mobile competition from the existing players, as well as new entrants such as TPG Telecom (TPM).

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[6] Telstra has guided for NBN to have a $3bn per annum negative impact on Telstra's EBITDA by the end of the roll-out

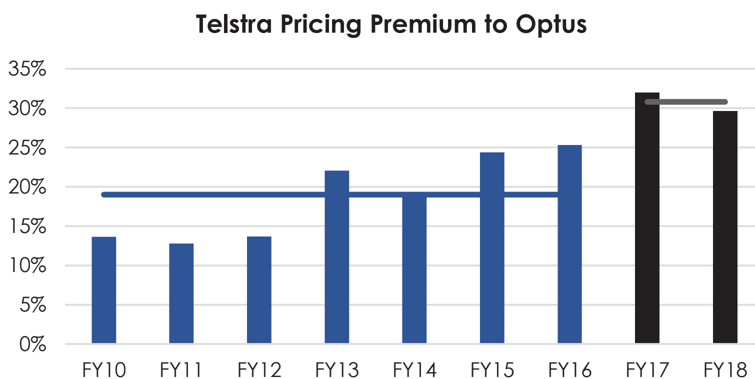
[7] Telstra presentation to Macquarie Investor Day, 2 May 2018

[8] A postpaid mobile phone is a mobile phone service provided under a prior arrangement with a mobile network operator. The user in this situation is billed according to their use of mobile services at the end of each month

### Who is leading the charge on mobile competition?

We see Optus as the key source of competitive pressure on Telstra's mobile business. After substantial investment in recent years, Optus is now widely regarded as having **comparable mobile network quality to Telstra**, which is substantiated by a recent independent study **ranking Optus as Australia's top mobile network.**[9]

### Telstra mobile pricing premium to Optus has continued to rise…



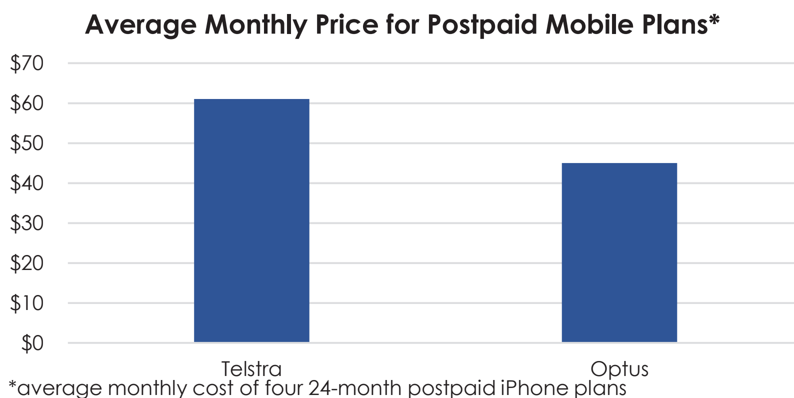

Despite Optus closing the gap on network quality, **Telstra's pricing premium has expanded** in recent years. We calculate Telstra charge an average premium of 30% above Optus, up from an average 20% premium over 2010-16.

Refers to Telstra's postpaid ARPU premium to Optus. Source: Company data

Optus has capitalised on its significant mobile phone price discount to drive market leading mobile customer growth over the last two years. This has caused **Optus' market share to increase by +2.1%** since 2016, while **Telstra's market share has declined -1%**

### Telstra competitive response is not enough

We believe intensifying competition in the face of Telstra's high pricing premiums has created **pressure for Telstra to cut mobile prices** to preserve its customer base. We are starting to see this unfold, with Telstra announcing at its June Investor Day that it will release lower priced mobile plans from July 2018.




*average monthly cost of four 24-month postpaid iPhone plans excluding cost of the handset
Source: Company data

TLS' planned price cuts are unlikely to mitigate market share loss, with Optus cutting prices even more aggressively since May. As a result, Telstra's premium to Optus' iPhone plans has now widened to 35%.

[9]Dec 2017 P3 Connect Mobile Benchmark Australian test: Optus scored #887/1000 vs Telstra #884/1000

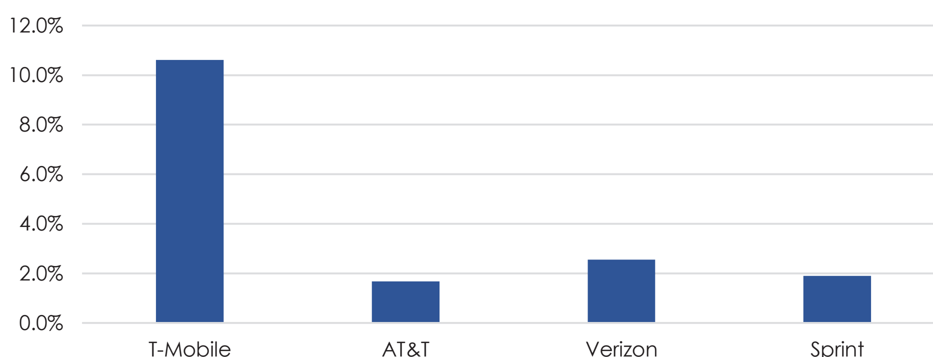
### What is Optus trying to achieve by aggressively chasing market share?

Optus is the second largest mobile phone player but has a market share significantly lower than Telstra. Their best strategy is to **remain aggressive on price** to produce material growth in customer numbers, grow market share and leverage the significant investment they have made in improving their network quality. This appears to be what they are doing.

Our work on the US mobile industry suggests Optus could be pursuing a similar strategy to challenger network T-Mobile in the US.

In 2014, T-Mobile was the number four mobile competitor in the USA. It priced its mobile offering ~20% below its competitors. In just four years T-Mobile delivered customer growth of 11% per annum, versus peers at just 2% per annum. T Mobile's operating profits almost doubled over the same period.

**Mobile Subscriber Growth* - USA**




*Postpaid mobile subscriber compound annual growth rate since 2014

Source: Bloomberg, Company data

### Telstra earnings and free cash flow implications

We expect mobile industry profits to continue declining as competition intensifies. We expect Telstra's unsustainably high mobile phone charges compared to Optus to narrow as Telstra seeks to stem market share leakage to them.

If we factor in Telstra cutting its mobile phone charges by 20% over the next three years, we estimate a **30% decline in free cash flow** over this same time period.

This would see **free cash flow per share** decline from 20 cents to 14 cents per share, and the dividend declining to circa 12 cents per share[10]. If we assume that Telstra trades on a 6% fully franked yield then it would trade at approximately $2.00 per share, representing **25% downside from current levels.** We expect to see continued downside pressure to Telstra's share price over the months ahead.

[10] We expect not all free cash flow can be paid back to shareholders, given the need to retain cash flow for mobile spectrum acquisitions (excluded from Telstra's definition of FCF) and likely balance sheet deleveraging.

NEWGATE ABSOLUTE RETURN FUND

| FUND PROFILE | |
|---|---|
| Investment Objective | Generate returns of between 12-15% per annum over rolling three year periods with target volatility of less than 15% |
| Fund Inception | 7 August 2016 |
| Trustee: | Newgate Capital Partners, AFSL 478 388 |
| Fund Manager: | Tim Hannon |
| Administrator & Custodian: | Mainstream Fund Services |
| Prime Broker: | Macquarie |
| Auditors and Tax | PricewaterhouseCoopers |
| Legal: | DLA Piper, CNM Legal |
| Regulator: | ASIC |

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The individual fund performance figures are based on an investment in the Fund's August 2016 units, the date of the Funds' inception. The performance numbers are based on the net asset value of the Fund and are calculated net of management fees, brokerage commissions, administrative expenses, and accrued performance allocation, if any, and include the reinvestment of all dividends, interest, new issue income or loss, and capital gains.

The Firm and the Fund have a limited operating history. This report is not an offer to buy or sell any security. Offering by private Information Memorandum only.

Investing in hedge funds such as the Newgate Absolute Return Fund is risky and investors are exposed to capital loss. Investors should review the Information Memorandum for the Fund, which contains a complete description of the investment program and its risks, in its entirety before investing.

The Fund invests in listed securities, which can be volatile and subject to market factors beyond the control of the manager.

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Volatility is calculated by using the annualised standard deviation of monthly returns since inception of Newgate Real Estate and Infrastructure Fund. Standard deviation measures the distribution of returns around the mean return. Low standard deviations reflect low variation in monthly results; higher variability is usually interpreted as higher risk. Standard deviations are based on monthly results, and then annualised.

The Sharpe Ratio is the ratio of "excess return" to volatility. Excess return is defined as the annualised rate of return less the risk-free rate, using monthly returns since inception. The volatility measure is the annualised standard deviation of monthly excess returns since inception.

Any investment in the Funds is speculative and involves substantial risk, including the risk of losing all or substantially all such investment. No representation is made that the Funds will or are likely to achieve their objective, that any investor will or is likely to achieve results comparable to the estimated performance shown, will make any profit at all or will be able to avoid incurring substantial losses.

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Performance estimates are presented only as of the date referenced above and may have changed materially since such date.



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