# Paragon Fund Monthly Performance Report

December 2013

PARAGON FUNDS MANAGEMENT

# PARAGON FUND UPDATE – December 2013

## KEY FUND FACTS

| | |
|---|---|
| Fund Managers | John Deniz & Nick Reddaway |
| Strategy | Australian absolute return |
| Inception Date | 01/03/2013 |
| Total Net Return | 18.7% |

## FUND PERFORMANCE (net of fees)

| | |
|---|---|
| 1 month | 0.0% |
| 3 month | 7.8% |
| 6 month | 17.5% |
| 1 yr | - |

## COMMENTARY

The Paragon Fund returned +0.0% net of fees for the month of December 2013 vs. the market (All Ordinaries Accumulation Index) +0.9%. Since inception 01 Mar 2013 to 31 Dec 2013 (10 months), the Paragon Fund has returned +18.7% net of fees vs. the market +8.3%.

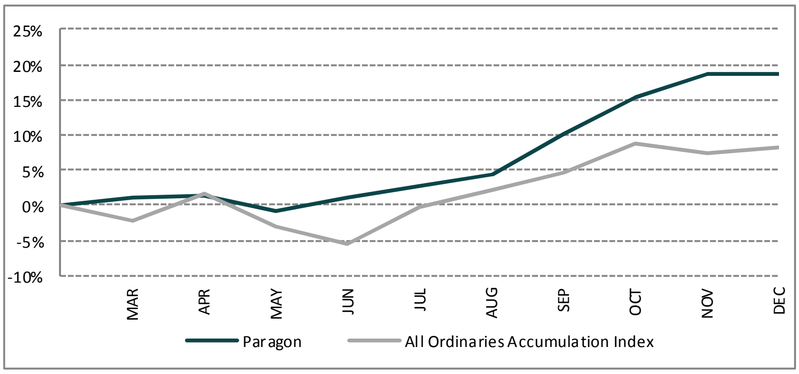
Global markets were sold in the first two weeks of the month with the Australian market down almost 5% and underperforming international markets. Big downgrades by QBE and Qantas and around half of the 20+ IPO's in December under-water on day 1 did little to support investor confidence. Nevertheless, markets took on board the start of QE tapering (US$10b reduction to US$75b per month) and bounced off month lows with the ASX getting back into positive grounds by month end.

Key drivers of the Paragon Fund performance for December included a combination of:

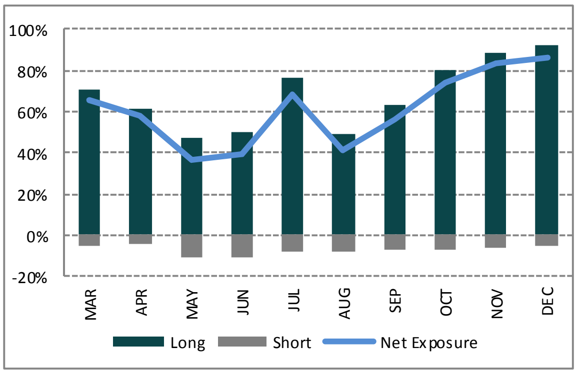
- Strength in core holdings 21st Century FOX and Orocobre offset by a decline in our emerging infrastructure holding
- Maintaining net equity exposure ~70% on average for the month

This month we discuss **'Dr Copper' and our preferred exposure, Tiger Resources (TGS).**

## HISTORICAL PERFORMANCE (net of fees)




## HISTORICAL EXPOSURE




| | JAN | FEB | MAR | APR | MAY | JUN | JUL | AUG | SEP | OCT | NOV | DEC | YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2013 | | | 1.1% | 0.3% | -2.2% | 1.8% | 1.8% | 1.6% | 5.3% | 4.9% | 2.8% | 0.0% | 18.7% |

## PORTFOLIO BREAKDOWN

*INDUSTRY EXPOSURE*

| | Long | Short | Net |
|---|---|---|---|
| Resources | 22.3% | 5.5% | 16.8% |
| Industrials | 51.3% | 0.0% | 51.3% |
| Financials | 18.3% | 0.0% | 18.3% |
| **Total** | **91.9%** | **5.5%** | **86.4%** |
| **Cash** | | | **13.6%** |

*HOLDINGS*

| | |
|---|---|
| Long | 21 |
| Short | 5 |
| Total | 26 |

*CONCENTRATION*

| | |
|---|---|
| Top 5 | 38.5% |
| Top 10 | 62.0% |

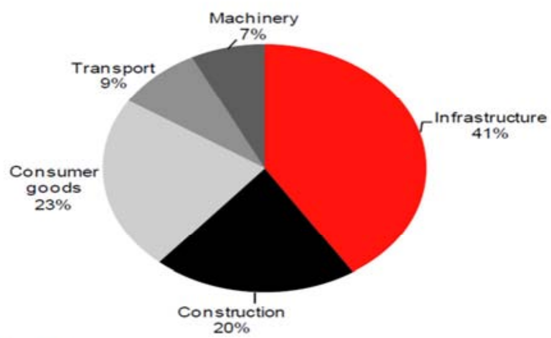
Copper ("Dr Copper"), the base metal, is regarded as having a Ph.D. in economics because it has historically been an excellent barometer of the overall state of global economic activity. Given copper's widespread applications in most industrial applications, rising copper demand and subsequent price increases are often seen as a reliable market leading indicator for economic growth. Dr Copper is not infallible as an economic indicator however given its price and outlook are driven by both supply side and demand side factors. For example, excess copper supply creating a sustained industry inventory surplus may cause lower prices despite robust global economic growth.

The consensus bearish view on copper is that a long-awaited supply response has finally arrived – right when economic growth is slowing in China and other major emerging markets. After a modest 2% CAGR in copper mining production over 2002-2012, production is slated to grow at ~4% for both CY14 & CY15. The consensus view argues that China is set to slow its consumption growth and the rest of the world will not be able to account for the excess supply. This view is resulting in many predicting significant copper inventory surpluses for CY14 - CY16 and a copper price reverting back to its marginal cash cost of production of ~US$6,000/t (US$2.70/lb).

We believe the broad-based recovery in the key developed market economies and robust Chinese demand this year and next, will translate into growing demand for copper. We think the reforms detailed in China's recent third plenary help derisk the Chinese growth outlook. Further, the US recovery and its housing sector surge, together with broad-based recovery across the EU, Japan and other developed market economies on the margin will support global copper demand.

Chinese demand remains the biggest swing factor for copper given it accounts for ~50% of the 21mt pa global copper market. China's copper consumption by sector is illustrated below. Infrastructure is the dominant sector, accounting for more than 40% of demand.

China Copper Demand by Industry




Source: NBS, Macquarie Research, January 2014

Power generation and transmission are large components of the Infrastructure sector. The Chinese State Grid – ~85% of China's total grid investment – has just set its CY14 investment target at US$66b, up ~12% on the CY13. Within this budget, the actual spending on the grid will rise 13%. Expenditure on the distribution network - the most copper-intensive part of the grid – is likely to rise at a faster rate given the government's desire to see the distribution network dominate the overall investment. Growth rates in consumer goods also expected to stay firm for CY14 & 15 – namely for passenger vehicles and white goods. Overall, we think that Chinese refined copper demand is likely to continue to increase by high signal digits (~7%) in CY14 to ~9mt - a US$65b+ pa market based on the spot copper price.

In terms of supply, we do not expect significant copper surpluses to emerge over the next two years. We continue to review >50% of total new capacity additions, and expect various key large-scale project start-ups with overly ambitious timelines to disappoint and come under expectations – typical for almost all resources projects. This will most likely result in new supply being delayed and/or not hitting nameplate capacity.

We believe that the global copper market supply/demand balance will end CY14 and CY15 at surplus levels of <100kt. This surplus is negligible when considered against a 21mt pa copper market that has repeatedly experienced disruptions of ~5% of global supply. Overall, we expect for copper to hold around current price levels for CY14 and CY15, with price risk to the upside.

With a stable copper price outlook we feel that Tiger Resources (TGS) is the standout copper growth stock. Tiger Resources is developing the Kipoi Copper Project in Katanga Province, Democratic Republic of Congo (DRC). TGS has a 60% interest in the Project and the remaining 40% interest is held by La Générale des Carrière et des Mines ("Gécamines"), the DRC state-controlled mining company. The Kipoi copper project is located in the central part of the Congolese copper-belt. The copper-belt contains some of the world's richest deposits of copper and cobalt.

TGS boasts all of the following preferred resource stock attributes: growth in resource, growth in production, lowest quartile cash costs, growth in cashflow, growth in mine life, strong balance sheet, financial discipline and a high likelihood of a future divendend stream. Finding a resource company with all the above attributes, producing a commodity with solid fundmentals like copper, that is attractively priced, is a rarity. TGS is one of very few resource companies that has delivered consective (7) production upgrades, whilst concurrently developing its Kipoi project expansion. Kipoi is currently producing ~44kt of Copper Concentrate (100% basis) and is set to produce ~50kt of Copper (100% basis) from CY14. Kipoi's project expansion is plain-vanilla, is fully financed, is on budget and is one of the lowest total cash cost copper producers globally at ~US$2,200/t (~US$1.00/lb) over its life of mine.


Paragon invested in TGS in August 2013 at $0.23/sh having valued the company at $0.65/sh. We forecast that once Kipoi's stage 2 expanison is complete and fully operational, TGS will generate free cashflow of ~$60m in CY14 (TGS 60% equity interest), based on current copper prices. We forecast for TGS to have a net cash balance of $66m by CY14 end (TGS 60% equity interest). TGS is currently trading at $0.35/sh and we continue to be long the stock.

We acknowledge TGS' sovereign risk – with its 60% Kipoi copper project in the DRC. We have previously avoided investments with projects across Africa however the DRC has improved considerably in recent years. Billions of dollars have been spent in Africa by two of the world's biggest miners - Freeport McMoRan (NYSE:FCX) and Barrick (NYSE:ABX) - most of which has gone into southern DRC's prolific copper belt. We take comfort in the level of M&A across the DRC copper belt, with recent transactions made by the Chinese making TGS unquestionably cheap.