PARAGON FUNDS MANAGEMENT

THE PARAGON FUND // NOVEMBER 2014

PROFILE		PERFORMANCE *(after fees)*		DETAILS	
Fund Managers	John Deniz & Nick Reddaway	**1 month**	-3.1%	**NAV**	$1.3302
Strategy	Australian absolute return	**3 month**	-5.3%	**Entry Price**	$1.3322
Inception Date	01/03/2013	**6 month**	10.4%	**Exit Price**	$1.3282
Net Return p.a.	20.3%	**1 year**	16.5%	**Fund Size**	$22.4m
Total Net Return	38.2%	**Financial YTD**	5.3%	**APIR Code**	PGF0001AU

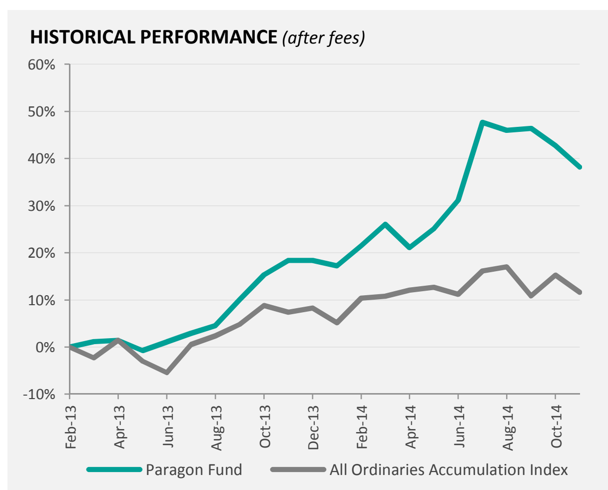
OVERVIEW & POSITIONING

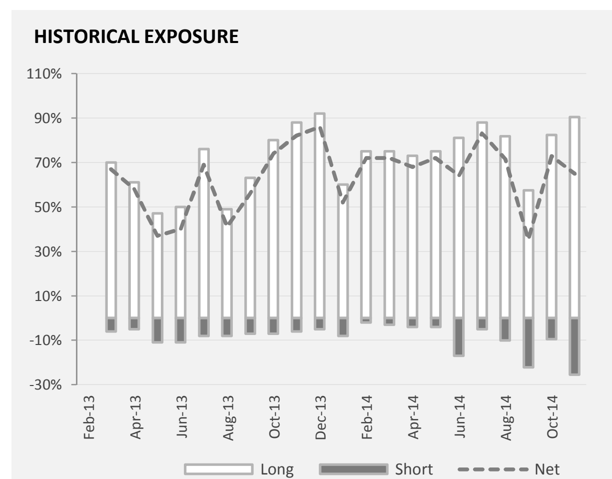
The Paragon Fund returned -3.1% after fees for the month of November 2014. Since inception the Paragon Fund has returned +38.2% after fees vs. the market (All Ordinaries Accumulation Index) +11.6%.

The Australian equity market fell -3.2% in November as energy shares suffered their worst falls since 2008 under a falling oil price with sentiment weighing on the overall resource sector (down -9%). Markets globally were broadly positive as the Chinese stock market continues to rally on stimulus measures while European and American equity indexes were also positive driven by improving prospects for next year.

Key drivers of the Paragon Fund performance for November included solid returns from long positions in Qantas and Henderson Group and short positions in Woodside and Computershare, offset by falls in G8 Education, TFS Corp, Donaco and our resource holdings generally. At the end of November the fund had 29 long positions and 10 short positions.

INDUSTRY EXPOSURE	Long	Short	Net
Resources	21.1%	-10.4%	10.7%
Industrials	47.9%	-7.0%	41.0%
Financials	21.3%	-8.1%	13.2%
Total	**90.4%**	**-25.5%**	**64.9%**
Cash			**35.1%**





PORTFOLIO INSIGHT

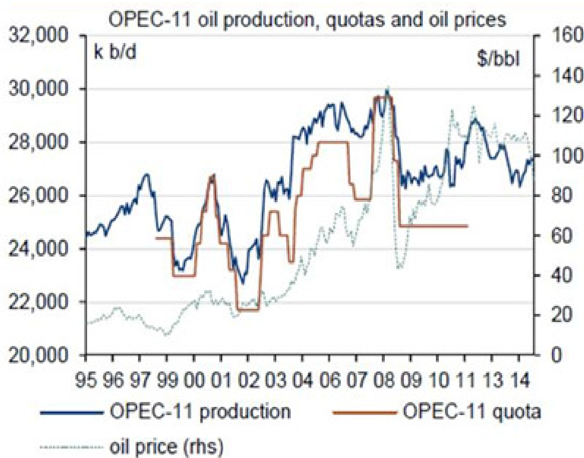
Oil markets – OPEC initiates a price war; implications

On the 27th of November the Organization of the Petroleum Exporting Countries (OPEC) surprised global markets by deciding to not cut its oil production quota to support the falling oil price. West Texas Intermediate (WTI) crude oil and Brent crude oil have both now fallen ~40% since June 2014, largely due to surging US oil production led by US Shale growth, OPEC's inaction and the strengthening USD.

Markets were looking for OPEC to cut its production by ~1m bbl/d as an interim measure towards balancing global oil markets but instead OPEC stated that they will allow the market to set the price. (OPEC comprises of ~40% of global

oil supply, of which Saudi Arabia – the largest and leading member of the cartel - produces ~9m bbl/d).

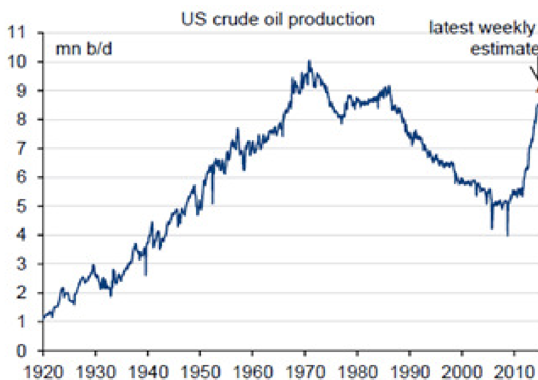
OPEC has historically supported oil markets by curtailing production in periods of oil price weakness. Their systematic approach worked well to balance oil markets when oil prices collapsed in 1998-1999, in 2001 and again during the GFC - as illustrated in the chart below.



Source: IEA, Bloomberg, BofA Merrill Lynch Global Commodities Research

By willingly allowing the oil price to remain weak, OPEC and namely the Saudi's have essentially started a price war with US shale oil production. Key OPEC members Saudi Arabia, Kuwait and UAE all boast production costs averaging ~US$20/bbl, substantially less than the marginal cost US shale producers, some with production costs of up to US$80/bbl.

The US shale revolution has transformed the country's energy supply outlook and dependence, with proven oil reserves and production rising to their highest level since 1975. As illustrated below, the US shale revolution has from 2009 driven strong oil production growth of 4m+ bbl/d to 9m+ bbl/d (vs US oil demand of ~19.3m bbl/d). This has driven oil markets into surplus and has started to challenge OPEC's market share and dominance.



Source: EIA, BofA Merrill Lynch Global Commodities Research

Given the aggressive stance taken by OPEC and despite the dramatic fall in oil prices already, in our view oil prices are likely to trade lower until there is evidence of a pull-back from US shale oil producers. Global oil supply is currently ~94.4m bbl/d versus global demand of ~93m bbl/d. Current OECD oil inventories are set to grow by another ~300-400m bbl to ~2.8b bbl through CY15 creating excess inventories (a high of ~60 days of consumption) not seen since the GFC (accompanied by US$40/bbl oil). To rebalance global oil markets, 1-1.5m bbl/d of production cuts would be required to reduce inventory surpluses.

Sustained pricing at or below US$60/bbl is likely the level which would materially slow marginal-cost US shale production growth. However despite current low oil prices, committed exploration and production capex in progress, as well as producer hedging, combined are likely to drive a lag in ultimately lower drilling activity and the closure of marginal capacity. Such announcements of large-scale production and capex expenditure cutbacks should be confirmed in 2015 capex guidance market updates from late January 2015. There is unlikely to be any near term help from OPEC given their next meeting is scheduled for June 2015.

The fillip to this oil bearishness is of course the boost provided by higher consumer spending, lower manufacturing costs, and the ability to maintain loose monetary policy in USA, Europe & Japan (due to weaker inflation) and should further delay the onset of any Fed rate hikes.

Santos (STO) – Short

Santos is a high-cost oil & gas exploration and production (E&P) company with challenging, capital intensive Cooper Basin E&P assets and key LNG-export development projects PNG LNG and Gladstone LNG. Santos's balance sheet has become increasingly levered in funding significant ongoing increases in exploration, sustaining and growth capex. Santos's Gladstone LNG project saw material growth capex and schedule blowouts, driving its returns to unattractive levels (IRR's ~8%) that must question why it was ever sanctioned and built.

With oil prices remaining at or below spot, we expect Santos will need to go much further in order to address its overall funding shortfall and increasing leverage position.

With sector high leverage and the largest capex needs, Santos's balance sheet remains the most exposed to the recent sell-off in oil prices. At current low oil prices, Santos's free cashflow has evaporated and its liquidity outlook is under pressure. As we expected, Santos has since announced CY15 capex and opex cuts, given its liquidity and credit rating are at risk.

Santos's flagged hybrid raising has recently been withdrawn, illustrating a lack of appetite and/or expensive financing. Santos needs fresh capital and in our view this is not yet fully priced in. At US$60/bbl oil, STO would require funding of $3.5b+, comprising in $1.5b in debt (hybrids) and $2b+ of equity - which we believe would be priced at dilutive levels in order to execute.

Corporate talk of French-major Total S.A considering Santos we view as noise and at best premature. In any case we have our Santos short position sized accordingly. We initiated our short position in Santos in September at $13.80/sh and continue to be short.

Qantas (QAN) – Long

Qantas is Australia largest airline carrier with a globally recognised brand renowned for its reputation for safety and service. The company employs over 30,000 people across its Qantas and Jetstar passenger businesses, freight and ancillary services. While Warren Buffett has long publicised his distaste for the sector ("How do you become a millionaire? Make a billion dollars and then buy an airline") it's hard to ignore the tailwind of lower oil prices given the capital intensive nature of these businesses.

Qantas has stated it will now participate in 70% of the downside from any oil price declines in 2H FY15 relative to last year where Oil averaged US$108/bbl. Qantas is also hedged against further declines in the AUD below 87c. While the net fuel benefit in 1H FY15 is likely to be ~$30m, the future earnings benefit to falling oil is significant such that should oil continue to hold closer to US$60/bbl next year as we expect, Qantas should produce a FY15 EBIT number in excess of $700m, some 40% ahead of consensus and warranting a share price closer to $3/sh next year based on Qantas's historical EV/EBITDAR multiple of 5x.

Our investment in Qantas was driven by more than just our bearish view on oil. As a consequence of more rational behaviour from both Qantas and Virgin, domestic load factors have now begun to improve for the first time in 12 months (In May 2014 Qantas announced they would be freezing capacity growth in their domestic market for 1Q FY15, and extended this to 2Q FY15 at the FY results given the weak demand environment).

Similar action was taken by the US airlines that has driven better seat profitability and seen the sector outperform the S&P500 by a factor of 3x in the last 3 years. Qantas is also undergoing a series of restructuring efforts delivering over $600m in benefits this financial year while targeting a reduction in debt by $1b and will benefit from the repeal of the carbon tax. The company is a far cry from being forced to consider selling its hugely valuable frequent flyer program last year. We initiated our position in Qantas in November at $1.65/sh and continue to be long.

MONTHLY PERFORMANCE BY YEAR

	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%**
2014	-1.1%	3.8%	3.6%	-3.9%	3.2%	4.9%	12.5%	-1.1%	0.3%	-2.5%	-3.1%		**16.5%**

Performance results are presented net of all transaction costs, investment management and performance fees incurred by the Fund. Monthly performance figures are calculated based on the lead series using a monthly unit pricing methodology based on historical data.

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