PARAGON FUNDS MANAGEMENT

# THE PARAGON FUND // JULY 2015

| PROFILE | | PERFORMANCE *(after fees)* | | DETAILS | |
|---|---|---|---|---|---|
| **Fund Managers** | John Deniz & Nick Reddaway | **1 month** | +4.3% | **NAV** | $1.4707 |
| **Strategy** | Australian absolute return | **3 month** | +2.8% | **Entry Price** | $1.4729 |
| **Inception Date** | 01/03/2013 | **6 month** | +10.1% | **Exit Price** | $1.4685 |
| **Net Return p.a.** | +20.3% | **1 year** | +5.8% | **Fund Size** | $31.1m |
| **Total Net Return** | +56.3% | **Financial YTD** | +4.3% | **APIR Code** | PGF0001AU |

## FUND STRATEGY

The Paragon Fund is an Australian equities long/short fund established in March 2013. The Fund's strategy is fundamentally driven, concentrated and transparent for investors. The manager's research process and active portfolio management is overlaid with strong risk management and a focus on capital preservation.

## OVERVIEW & POSITIONING

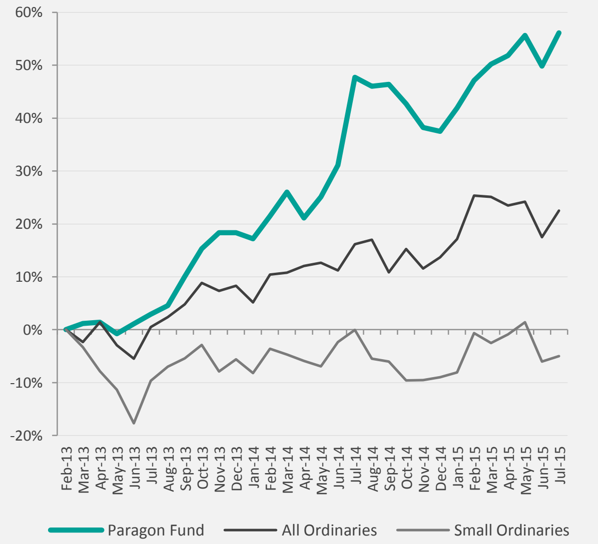
The Paragon Fund returned +4.3% after fees for the month of July 2015. Since inception the Fund has returned +56.3% after fees vs. the market +22.5%.

The Australian equity market rallied in July, led by defensive buying, and outpacing global equity markets. Investors were relieved by the Greek decision to remain in the Euro, averting further political and financial uncertainty for the region. M&A continued in the transport sector with a takeover bid for Asciano while the falling AUD benefitted those companies with offshore earnings. Problems continued for the resource sector as most commodity prices continued their march lower on weaker demand cues and a rallying USD. Oil prices fell 18% on prospects of Iranian sanctions being lifted (increasing the potential for additional crude supply), concerns around China's growth and high US oil production.

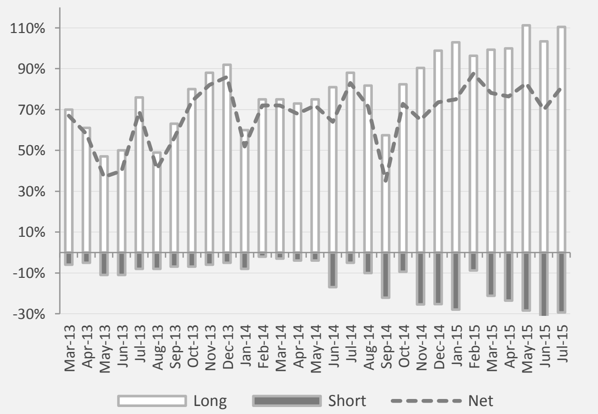
Key positive contributors for July included Yowie Group, Henderson Group, Orora, Mayne Pharma and Senetas. At the end of the month the Fund had 30 long positions and 15 short positions.

| INDUSTRY EXPOSURE | Long | Short | Net |
|---|---|---|---|
| Resources | 24.6% | -18.2% | 6.4% |
| Industrials | 62.0% | -9.3% | 52.7% |
| Financials | 23.8% | -1.9% | 21.9% |
| **Total** | **110.4%** | **-29.4%** | **81.1%** |
| **Cash** | | | **18.9%** |

**HISTORICAL PERFORMANCE** *(after fees)*




**HISTORICAL EXPOSURE**




## 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% | -0.5% | **15.9%** |
| **2015** | 3.2% | 3.6% | 2.1% | 1.1% | 2.4% | -3.8% | 4.3% | | | | | | **13.5%** |

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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## STOCK HIGHLIGHTS

### Yowie Group

Yowie Group is an Australian confectionary company, selling chocolate encapsulated animal based toys. The company launched the original Yowie chocolates in 1997, enjoying significant success in Australia, New Zealand and Japan before the brands owner, Cadbury, discontinued the brand due to legal battles with the creators. The rights to the brand were acquired in 2012 and Yowie was rejuvenated in 2013 with a focus on the US market where it has received the sole patent to sell chocolate encapsulated toys.

After first being trialled in October 2014, Yowie Group achieved a national rollout with Wal-Mart in June this year. With less than 20% of confectionary items going from trial to full rollout, it's an enormous achievement to have the world's largest retailer endorsing your product as your first major customer. While Wal-Mart are moving to a full 4300 store rollout this month, Safeway is rolling out the product to its 1300 stores and trials with additional major US retailers are ongoing (CVS, 7/11, Walgreens, Krogers, Valero). The product is also being trialled by European supermarket chain Carrefour in the UAE.

The reaction by my own children to some samples of the Yowie toys demonstrated first-hand the products potential. Kids love chocolate. Kids love toys. If parents are going to treat their kids, it makes the purchase decision easier if it is even mildly educational. The information on each animal provided in the Yowie and their stated mission to help 'Save the Natural World' makes this product a unique proposition for customers and retailers alike. The company's recent partnership with the American Association of Zoos and Aquariums (AZA) is a significant step in building brand awareness. Over 183 million people visited the 228 AZA locations across the USA in 2014, including 50 million children.

Yowie's biggest competitor, Kinder Surprise, sells close to 1.2bn units p.a. in Europe where the population is almost 500m (~2.5:1 per head of population). When Yowie was first released in Australia it sold over 60m units (~3:1 per head of population) and achieved ongoing sales of 17m p.a. (~1:1 per head of population). Importantly, Kinder Surprise is banned from selling their product in the USA as it is deemed a choking hazard (they have twice unsuccessfully applied to the FDA to sell the Kinder Surprise in the USA). Yowie's exclusive patent runs until 2019, and while the risk is that Kinder Surprise try again to gain FDA approval, it would require a decision to potentially re-design their 40 year old product (20g with small pieces inside vs. Yowie 28g and a single piece toy) for this specific market.

Successful rollout to all stores currently being trialled in the US represents ~20% of the country's total convenience stores. This could equate to 45m units p.a. and ascribing a commensurate multiple for a high growth confectionery business would place a value on the stock of $1.50/sh. Given this would represent sales per head of population of 0.14:1, there is significant upside should sales in the US approach those of its historical sell rate in Australia or of Kinder Surprise in Europe. In this scenario the stock could be well north of $5/sh and excludes assumptions for sales outside of the USA and any licensing agreements. We began buying shares in Yowie in May 2014 at $0.57/sh and we remain long the stock.

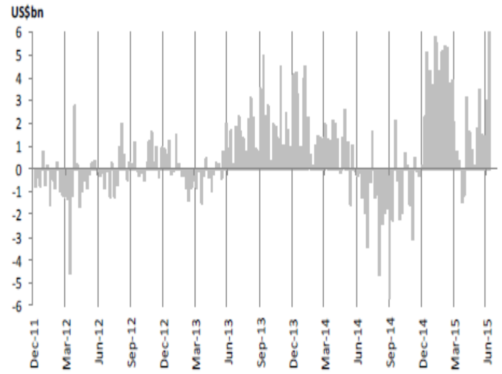
### Henderson Group

Henderson is an expanding global retail and institutional asset management firm operating in the UK, Europe, Asia, Nth America and Australia. Henderson was established in 1934 and has been growing organically and via acquisition to now have £80b+ of assets under management (AUM) which is predominantly sourced from Europe and ~60% of which is retail.

Henderson is an active investment manager and the solid performance from its underlying funds (83% of its funds outperformed over last 3yrs) continues to drive strong inflows. Boasting a world-wide platform with >40 fund products and a diversified asset mix (32% global equities, 19% in EU & UK Equities, 19% in Alternatives), Henderson is targeting to double AUM to £160b in 5 years and in our view is well placed to do this whilst concurrently improving on its operating margins.

Henderson most favourable driver is the large-scale QE program underway by the European Central Bank (ECB). The ECB's 2015 QE program at €60b/month or €720b/yr is material in both absolute terms and relative to US QE programs by the FED. The ECB's QE of €720b/yr represents >7% of its GDP vs US FED's 2013 QE program of US$1tn which represented 5.8% of its GDP. And similar to US, UK and Japanese markets, Euro QE – which represents 6.6% of its equity market capitalisation (almost double that of the US' 2013 QE) - is seeing strong flows into European Equities and income generating assets.

Fig 2 Western Europe Funds Flows improving in July as Greece uncertainty moderates




Source: EPFR, Macquarie Research, July 2015

Henderson is taking advantage of buoyant conditions across its key markets, offering annuity style earnings from its base management fees, and scope for solid ongoing contributions from its performance fees. Henderson is well capitalised with net cash of ~A$250m. We expect solid earnings growth to continue as Henderson's key drivers – very low global interest rates, large-scale Euro QE, solid net inflows, increasing alternative-asset class allocations, and AUD vs GBP risk to the downside - remain in place.

Based on our estimates Henderson is growing earnings at ~15% CAGR for the next two years. We went long Henderson at $4.01/sh in January 2015 and despite its ~57% increase, continue to like the stock's risk/reward.



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