PARAGON FUNDS MANAGEMENT

THE PARAGON FUND // AUGUST 2015

PROFILE		PERFORMANCE *(after fees)*		DETAILS	
Fund Managers	John Deniz & Nick Reddaway	**1 month**	-4.2%	**NAV**	$1.4096
Strategy	Australian equity absolute return	**3 month**	-3.8%	**Entry Price**	$1.4117
Inception Date	01/03/2013	**6 month**	+1.8%	**Exit Price**	$1.4075
Net Return p.a.	+17.5%	**1 year**	+2.6%	**Fund Size**	$30.5m
Total Net Return	+49.8%	**Financial YTD**	+0.0%	**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

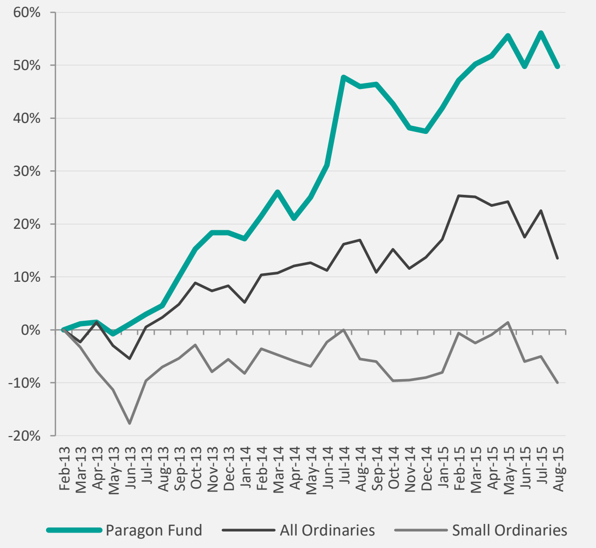
The Paragon Fund returned -4.2% after fees for the month of August 2015. Since inception the Fund has returned +49.8% after fees vs. the market (All Ordinaries Accumulation Index) +13.5%.

The Australian equity market fell -7.3% in August, the worst monthly fall since the GFC in 2008, and global markets suffered their worst falls since 2012. Risk aversion rose dramatically after China moved to devalue its currency raising uncertainty around the beginning of the US Federal Reserve tightening cycle. The Australian market weakness was led by the banks as they moved to bolster their capital positions while energy shares suffered amidst weak oil prices and strained balance sheets.

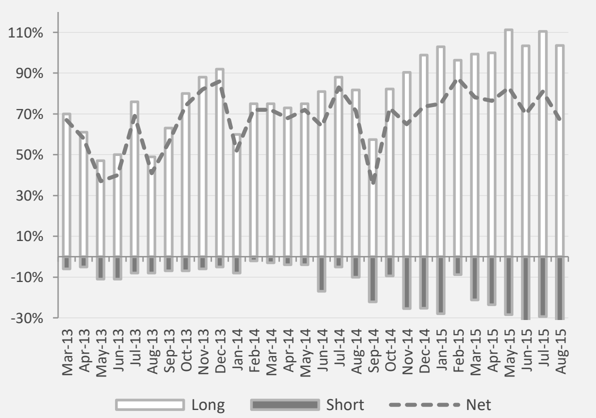
Key positive contributors for August included Longs in APN Outdoor, NetComm Wireless and St Barbara Gold and Shorts in Origin, Santos and Orica (compliments of a 15% downgrade in August). These were offset by our net positive equity exposure, and holdings in Nanosonics, Senetas and Orocobre. At the end of the month the Fund had 29 long positions and 17 short positions.

INDUSTRY EXPOSURE	Long	Short	Net
Resources	18.5%	-12.6%	6.0%
Industrials	57.7%	-13.1%	44.6%
Financials	27.4%	-10.7%	16.7%
Total	**103.6%**	**-36.4%**	**67.2%**
Cash			**32.8%**

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%	-4.2%					**8.9%**

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.

STOCK HIGHLIGHTS

Santos Ltd (STO) & Origin Energy (ORG) – Energy Shorts

We wrote about our oil price bear market view **"Oil markets – OPEC initiates a price war; implications"** in our November 2014 monthly. In brief, we discussed that the US shale revolution and OPEC inaction (reluctance to cut supply) had led to oil markets being oversupplied by ~1.5m bbl/day with global inventories at excess levels. Fast forward to today and the oil surplus position has worsened, with oil markets currently estimated to be oversupplied by ~2.5m bbl/day.

Whilst global demand has risen, taking advantage of lower oil prices, supply has kept rising as US shale producers are high-grading and most OPEC members are pumping more oil to try and offset the drop in the oil price. The prospects of Iranian sanctions being lifted are likely to add another 1m bbl/d of oil supply from next year, which will offset most of the lagged decline anticipated (falling rig count) from US shale.

Oil has seen a waterfall decline of >60% from June 2014 highs to post-GFC lows of US$42/bbl in August 2015 (brent crude currently at ~US$48/bbl), cutting into the cost curve of marginal supply. In our view oil prices are getting closer to a bottom. Whilst the oil market is currently materially oversupplied, the supply side will correct in time - as it always has - given capital starved Exploration & Production (E&P) companies and importantly, natural (conventional oil) decline rates of 3-5% pa (equating to natural declines of ~2.5m bbl/day). In time inventories will clear, setting up for the next medium term upswing as oil prices begin to rise to incentivise more supply. With these short to medium term oil market dynamics in mind, and after >>50% share price declines, oil short positions need to be carefully assessed.

We also wrote about our **Santos** short thesis which has played out to the downside, with the stock price now <$5.00/sh and the company still needing to raise ~$3b of what will be hugely dilutive equity. Santos has since announced a strategic review including David Knox the MD/CEO falling on his sword, as a consequence of a poorly executed strategy and driving the company to almost financial ruin - $4.2b market cap, net debt approaching $9b and with only a marginal to modest free cash flow outlook at spot oil prices (note LNG prices are indexed to brent oil).

After months of rhetoric of not needing to raise equity (and missing the chance of raising in the $5's), the company in August 2015 stated that it will finally consider all options, including asset sales, raising equity or a full takeover. A full takeover we see as unlikely in this weak oil market and given Santos' collection of challenging, capital-intensive, high-cost assets including its Copper Basin and Gladstone LNG (GLNG) assets (~2/3 of STO's NPV). Santos' GLNG project capex blowouts now seem to be contained, with train 1 production start-up anticipated for 4Q15 and train 2 in 1Q16. However this asset is barely breaking even at current oil prices.

Selling its prized asset – its 13.5% interest in PNG LNG (~1/3 of STO's NPV) – could attract interest from its JV partners Oil Search and Exxon, however the buyers are unlikely to pay up. Conducting a dilutive equity raising is now increasingly likely, and in fact we can't see how it is avoided. It is likely to be in the form of a 1:1 rights issue which would lead to a short-squeeze given the large short interest in the stock.

We initiated our short position in Santos in November 2014 at $13.80/sh. To avoid the risk of a short-squeeze, we covered our Santos short in late August 2015.

Origin is a vertically integrated energy company, with upstream LNG and oil & gas E&P assets, electricity generation and energy retailing across Eastern Australia. Origin is in a similar precarious position to Santos. Origin has an over levered balance sheet after the $8.5b investment (for its equity share, and largely debt funded) Australian Pacific LNG (APLNG) project in Queensland. Origin has a market capitalisation of ~$8.3b, net debt of ~$12b and net debt to EBITDA of ~5.5x.

Origin's APLNG investment has resulted in the company having increasing oil exposure, dwarfing its utility asset stability. Note at brent oil's recent low of US$42/bbl, APLNG and in turn Origin free cashflows and dividends evaporate.

Origin's APLNG project has experienced material ongoing capex and schedule blowouts, driving its returns to unattractive levels - IRR's <8% (< its WACC) at spot brent and AUD. Only two weeks ago in its FY15 results release Origin confirmed further material capex blow outs for FY16F, which will consume all the proceeds from its recent $600m Contact Energy NZ business sale.

Origin's credit grade rating is important to the company and its shareholders. It's rating has dropped from BBB+ to BBB-, and is at risk of being downgraded to junk status. To avoid this, Origin needs the 2017 Brent price to be ~US$65/bbl to meet the BBB- soft threshold (<4x Net Debt to EBITDA limit), vs. FY17 brent futures currently at ~US$55/bbl.

The risks of a material ($2b+) dilutive equity raising and/or cutting its dividend are becoming increasingly likely. In our view Origin should do both, however we do not expect that these decisions by the company are imminent.

We initiated our short position in Origin in May 2015 at $12.37/sh and continue to be short with the stock currently trading at $7.48/sh.