PARAGON FUNDS MANAGEMENT

5 YEARS 2013 - 2018

# PARAGON AUSTRALIAN LONG SHORT FUND // September 2018

## PERFORMANCE SUMMARY *(after fees)*

| | 1 month | 3 months | 6 months | Financial YTD | 1 year | 2 year p.a. | 3 year p.a. | 5 year p.a. | Net Return p.a. | Total Net Return |
|---|---|---|---|---|---|---|---|---|---|---|
| **Paragon Aust. Long Short Fund** | -3.2% | -13.7% | -22.1% | -13.7% | -5.1% | -7.0% | +4.9% | +9.8% | +10.6% | +75.5% |
| **ASX All Ordinaries Accum. Index** | -1.1% | +1.9% | +10.0% | +1.9% | +14.6% | +11.5% | +12.3% | +8.4% | +8.4% | +57.0% |
| **RBA Cash Rate** | +0.1% | +0.4% | +0.8% | +0.4% | +1.5% | +1.5% | +1.6% | +2.0% | +2.0% | +11.8% |

## RISK METRICS

| | |
|---|---|
| **Sharpe Ratio** | 0.5 |
| **Sortino Ratio** | 1.1 |
| **Correlation** | 0.3 |
| **% Positive Months** | 61% |
| **Up/Down Capture** | 80%/24% |

## UNIT PRICE & FUM

| | |
|---|---|
| **NAV** | $1.6519 |
| **Entry Price** | $1.6544 |
| **Exit Price** | $1.6494 |
| **Fund Size** | $50.0m |
| **APIR Code** | PGF0001AU |

## FUND STRATEGY

Established in March 2013 as an Australian equities long/short fund that is fundamentally driven with a concentrated portfolio of high conviction stocks, managed by a dedicated investment team and offering transparency to investors. Paragon's proprietary research and extensive investment process which includes active portfolio management, is overlaid with a strong risk management function and a focus on capital preservation. The objective of the Fund is to return in excess of 10% p.a. after fees over a 3-5yr investment horizon.

## OVERVIEW AND POSITIONING

The Fund returned -3.2% after fees for the month of September against a backdrop of lower Australian share market indices. Positive contributors for the month were Orocobre, Mayne Pharma, Beach Energy and our short position in Qantas. These were more than offset by declines in A2 Milk, Lynas, Wattle Health and Kidman. The US-China trade war escalated during the month, whilst the Fund was impacted by extraordinary stock specific events in Lynas and Kidman, discussed in detail below.

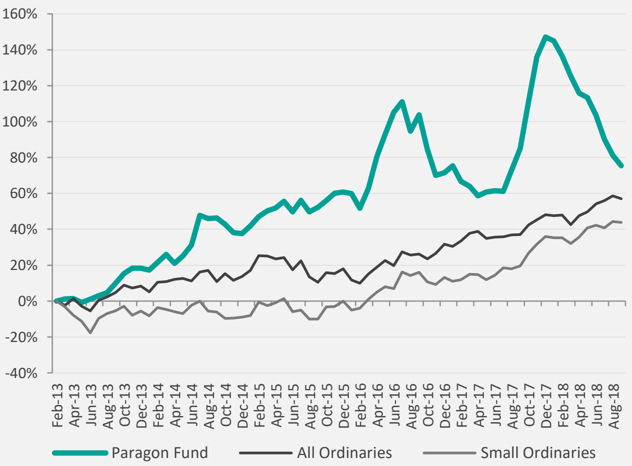
## FUND POSITIONING

| | |
|---|---|
| Number of Longs | 32 |
| Number of Shorts | 11 |
| Net exposure | 59% |
| Gross exposure | 103% |
| Index futures | 0% |
| Cash | 41% |

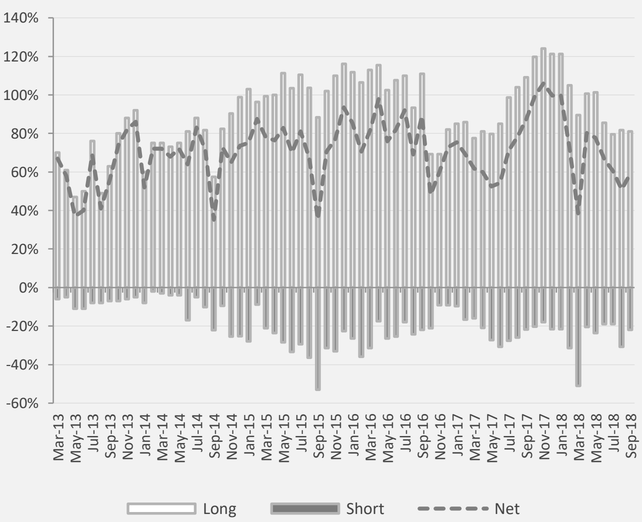
## FUND FACTS

| | |
|---|---|
| Structure | Unit trust |
| Domicile | Australia |
| Applications & Redemptions | Daily |
| Minimum investment | $25,000 |
| Min. addition/redemptions | $5,000/$10,000 |
| Administrator | Link Fund Solutions |
| Prime Broker/Custodian | UBS |

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




**HISTORICAL EXPOSURE**




## MONTHLY PERFORMANCE BY CALENDAR 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% | 1.6% | 2.5% | 2.6% | 0.3% | **16.8%** |
| **2016** | -0.5% | -5.2% | 7.4% | 10.8% | 7.0% | 6.3% | 2.9% | -7.8% | 4.3% | -9.0% | -7.9% | 0.8% | **6.8%** |
| **2017** | 2.3% | -5.0% | -1.6% | -3.2% | 1.3% | 0.4% | -0.2% | 7.3% | 7.0% | 14.0% | 11.9% | 4.7% | **44.1%** |
| **2018** | -1.3% | -3.0% | -4.7% | -4.2% | -1.2% | -4.7% | -6.5% | -4.6% | -3.2% | | | | **-29.0%** |

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 daily unit pricing methodology based on historical data.

## Market and Portfolio Insights

**US-China trade escalation**

The ongoing US-China trade tensions which escalated further in early September, have to date been met with a rather orderly market reaction. Early in the month, the US proceeded to implement tariffs on US$200b of Chinese imports (tariff rates of 10% from 24/9/2018, rising to 25% from 1/1/2019) resulting in China retaliating with $60b of tariffs on US imports. The Chinese government also cancelled planned talks with the US and are unlikely to re-engage until after US mid-term elections in November 2018.

The view is that China has emerged from this protracted trade war worse off, with its share market down 25% off recent highs versus US markets trading at all-time highs. In amidst the trade war fears, Resources have been sold off, particularly at the small cap end, despite many of these companies boasting strong fundamentals. In mid-September, China advised it will boost its economic growth via material stimulus measures which will take effect this quarter. Further fixed asset investment is being targeted, which is a materials-intensive sector. Fundamentals for Resources remain constructive, as many hard and soft commodity markets continue to report exchange inventory drawdowns and low levels of global inventories, buoyant physical premia and robust global trade flows.

**Three left-field, negative surprises – all in September**

September was another challenging month for the Fund, which had to contend with three extraordinary stock specific issues impacting positions in Lynas, Kidman and Orocobre. Such significant events are unlikely and under normal circumstances might occur once in a year as opposed to three in one month. These stocks have added value to the portfolio over time and due to recent share price declines, that in our opinion were excessive, we took the opportunity to re-establish positions in these companies.

**1. Lynas (LYC)**

Lynas is a rare earths producer leveraged to our Electric Vehicle (EV) theme, boasting tier 1 upstream mining operations in WA and downstream refining operations in Malaysia. As discussed in August 2017, Lynas has been an exceptional turnaround story, compliments of Amanda Lucaze's leadership. Including its Malaysian refining operations, Lynas has established itself as the only large-scale, high-margin rare earths producer outside of China. Lynas is generating strong free cashflows, boasting a strong balance sheet and trading on <10x 12m forward PE with its key Rare Earth NdPr (leveraged to EV growth) set for both pricing and volume upside.

A change of Malaysian government earlier this year has been followed by Malaysian media reports in September that a government review on its Malaysian operations are to be led by a former staunch critic, Ms Salleh. Consequently, sentiment has suffered with the market fearing a negative outcome of sorts. Nevertheless, Lynas has been subject to various independent reviews previously and has been compliant with regulatory requirements for the past six years.

**2. Kidman (KDR)**

Kidman has had a legacy issue with its Mt Holland tenements as a result of an opportunistic forfeiture claim on the basis of a shortfall in minimum expenditure from 2014-2016 of a mere $100k by the prior owners (Convergent Minerals). Kidman acquired its Mt Holland tenements two years ago from the Administrators of Convergent Minerals and applied for an exemption of the expenditure commitments in question – basically to have the claim thrown out. The case was heard by the WA Warden's court in November 2017. In September, the Warden unfortunately recommended for the WA Mining Minister to not grant the exemption, and while we await the final decision from the Minister, which we believe will be a granting of the exemption, increased uncertainty resulted in a sell-off of the shares. *(Our investors may recall Kidman has had to deal with a previous opportunistic claim on its Lithium rights ~18 months ago by Marindi Metals, which caused volatility at the time for the Fund. This was ultimately thrown out and Kidman shares re-rated strongly and performed well for our Fund).* This current, and based on company disclosure, final outstanding issue has been well-flagged and disclosed by Kidman in its financials for the last two years, withstanding due diligence by SQM and Tesla and their respective team of lawyers.

Noteworthy is that WA Mining Minister, Bill Johnson, is pro-mining and a strong advocate for the Mt Holland JV. The Warden's recommendation is not binding on the Minister and there are numerous situations where the Minister can grant an exemption from expenditure requirements. *(For example,. RIO Tinto ~10 years ago found themselves in a similar situation on WA-based Iron Ore tenements, only to see the mining minister vote in their favour).* It is highly unlikely that a decision will go against the Kidman-SQM Mt Holland JV and we expect Bill Johnson to grant an exemption in the next 5-6 weeks.

We are confident in this outcome for the following reasons:

a. Bill Johnson has known about this opportunistic claim all along and has proceeded to give the Mt Holland JV project 'WA state government lead agency status' (declaring the project of state significance);
b. Kidman has made a world class Lithium discovery on its own right after acquiring the tenements from the Administrators;
c. Kidman has attracted the world's best Lithium producer, SQM (NYSE: US$10b+ market cap), creating the Kidman/SQM Mt Holland (50%/50%) JV, which has since spent >$55m on exploration and development work to date;
d. Kidman has attracted Tesla as an offtake partner and is shortly expected to sign further offtakes with tier 1 EV battery and/or auto manufacturers;
e. The JV is about to invest a further $600m - $1b into both the upstream mine and downstream refinery – both residing in WA - creating jobs, state royalties and tax revenues;
f. WA is set to become the largest Lithium production source globally, where Bill Johnson has actively promoted WA as set to become the leading 'Lithium Valley' - of which Mt Holland is an integral part; and
g. Importantly, we believe the plaintiff in this forfeiture claim is an opportunistic individual that lacks the credibility, capacity and partners to fund and develop the asset.

We have conducted our own rigorous due diligence on this matter and are aware of all potential outcomes. Ultimately, we remain comfortable with our investment and we believe that once the uncertainly is removed, Kidman shares will re-rate strongly once again.

**3. Orocobre (ORE)**

Orocobre's Lithium brine operation in Argentina was impacted by President Macri announcing a temporary export tax of 8% - in effect until 31/12/2020 – to alleviate short term budget concerns. Orocobre's shares were initially sold off, despite this temporary tariff having only a marginal impact on cashflows and our valuation of the stock. (Note tariffs are largely offset by the spread between FX and inflation with ~45% of Orocobre's cost base being in local currency). Pleasingly the share price has recovered from its initial decline due to the export tax release, to end the month higher. Orocobre's peer FMC (NYSE-listed), is currently pricing the IPO of its Lithium division spin-off 'Livent' - listing ~15% and retaining ~85%. Livent provides a sound pricing benchmark for Orocobre as Livent is a pure play producer with brine-based operations also in Argentina – listing at an implied ~US$2.8n market cap and forward EV/EBITDA of ~13x. This is more than double Orocobre's multiple, despite both companies having similar growth profiles, except that Orocobre is fully funded (having recently raised $361m of equity at >$7/sh vs today's share price of $4.54/sh). We remain confident in the outlook for Orocobre and continue to hold a long position.

**Looking forward – an update on our key holdings**

As theme-led fundamental investors, our early identification and entry into various stocks ahead of the market has been solid. However, this year many of our long positions have corrected 20-40%, predominantly as a result of short-term macro fears. Critically, the fundamentals of the companies have not changed, they are just now more attractively priced. During a performance drawdown, it may be tempting for investors to sell their holding, however we are of the belief that the Fund will recover and in fact currently offers a great opportunity. Despite being hit by a 'perfect storm' of consecutive events this year, we remain passionate and confident in the Fund's latent alpha opportunities and the strong outlook for many of our key holdings, as outlined for some of our investments below.

**1. Energy – Longs - Beach Energy, Santos and Origin; Shorts - Qantas and Caltex:**

We discussed our view on oil markets in November 2014. To recap, global oil supply at that time was ~94.4m bbl/d exceeded global demand of ~93m bbl/d. OECD oil inventories were set to blow out 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). In turn, oil prices crashed ~76% from its highs in July 2014 to its lows in Jan 2016. Our positioning through the crash was long Qantas (beneficiary of low oil prices) and shorts in Origin, Santos (over-extended balance sheets, high-cost/complex assets) and Woodside. Qantas performed very well for the Fund (although we sold too early), as did shorts in Origin and Santos. Both companies had to conduct highly dilutive discounted capital raises in late 2015 which we covered our short positions into.

Regular readers will also recall we anticipated a recovery in oil markets, premised on marginal cash cost support, curtailed global production, under-investment, natural depletion and solid demand growth which all ultimately stabilise oil prices. With the subsequent oil price recovery, we have now seen the opposite effect, with operating and financial leverage on display and re-rating share prices for both Origin and Santos. Similarly, for Beach Energy, which has also made a clever acquisition in Lattice, Origin's conventional oil and gas business. All three stocks are discounting oil prices well below spot, offering solid risk-reward.

Global oil demand continues to rise and is expected to top 100m bbl/d this quarter, and is likely to increase by a further 1.5m bbl/day in 2019. This in our view will exceed global supply, and will see global inventories falling further, which will only drive oil prices higher. Rising oil prices (which are almost back at 2014 highs in AUD terms) is a headwind for Qantas and Caltex (we shorted both in August 2018). Whilst Qantas has gone from market-dog to market-darling, high AUD oil prices are a huge drag on its earnings. We do not expect its oil price hit ($500m+ at spot oil and FX equating to about half its FY18 profits) to be offset by top line growth (ie. price rises).

Consensus views were wrong at the bottom and are most likely going to be wrong at the top. Qantas' forward PE multiple of 9x is a classic value trap and in our view, compressing for a reason. Given Qantas' short-term oil hedging, oil prices rises will start to hit in CY20, where earnings could be 30% lower and implying an adjusted forward PE of ~13x. Our belief is that this is too high in a rising oil price environment. Global airlines are also starting to de-rate and we view that Qantas' risks are weighted to the downside. Caltex is being impacted by rising oil prices too, with petrol prices nearing highs of 2012-2014. Premium fuel volumes are falling and this is likely to gain momentum to the downside if AUD oil prices keep rising, combined with the decrease wealth effect from falling house prices. Caltex earns twice the margins on premium fuels over standard, so declines here are problematic. Also, its 'infrastructure-play carrot' has gone with the company flagging only a modest level of retail asset sales. Refiner margins have scope for improvement but are unlikely to offset losses elsewhere. Finally, whilst it is longer dated, Caltex will likely see its PE multiple compress further from EV market penetration impacts. FY18 came in at the bottom end of guidance, and we view FY19 earnings at risk to the downside.

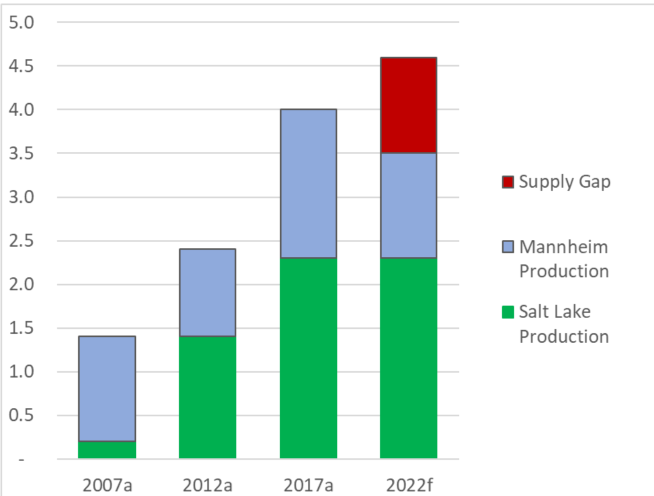
**2. Agrimin (AMN)**

We first discussed Agrimin in March 2017. Agrimin's Lake Mackay (LM) is following a similar path to Orocobre's flagship Olaroz project. Both stocks started out as emerging micro caps, de-risking and advancing world-class brine-based projects. Orocobre boasts a Lithium-rich brine-based resource, Agrimin's being potassium sulphate (SOP) rich – both world-class Resources with potential 40yr+ mine lives. We first invested in Orocobre when it was a ~$40m market cap Resource stock, after our top-down EV-theme research led us to Lithium exposures. Today Orocobre is the sixth largest Lithium producer globally with a $1.1b market cap.

Agrimin's SOP fundamentals continue to strengthen. On the demand side, China, the world's biggest producer and consumer and is about to become a material net importer. **Chinese deficits of >1mtpa SOP (>2x LM's base case production)** are anticipated over the medium-term (see supply gap in red in the chart below), and LM's SOP is unquestionably the cheapest large-scale supply option to China. As discussed in June 2018, there are very few, if any, credible supply contenders. If there were, we would be investing in them (as we have done in many other undersupplied Resource sectors approaching deficits) given the medium to long-term strength of the thematic and price upside.

Whilst SOP prices are already offering strong economics on Agrimin's LM project, we expect them to continue to rise. The SOP industry's high-cost producers are those that convert muriate of potash (MOP) via a costly, energy intensive and highly pollutive Mannheim production process. Mannheim production represents >40% of global SOP production, mostly based in China, where environmental controls continue to force pollutive supply shutdowns (decreasing production between 2017 and 2022 in light blue below). Importantly, Chinese SOP production from brine (salt lakes in green below) cannot be expanded any further.

**Chinese SOP production required to meet Chinese demand (mtpa):**




Source: Agrimin, Paragon

MOP (plus Mannheim conversion costs) sets the price floor for SOP, which is now rising, and will continue to lift the top half of the cost curve. MOP contract price settlements between India and China have surprised to the upside, settling last month earlier and higher than anticipated at +US$50/t (21-25% higher yoy) to US$290/t, illustrating tightening markets. SOP price increases typically lag MOP prices by 3-6 months as the cost of purchasing MOP makes up about 75% of the total Mannheim production cost. Global MOP fertiliser majors (Mosaic, Nutrien, Israeli Chemicals) continue to re-rate, breaking higher with strong momentum.

We expect SOP prices of US$600/t+ in the short-term, which would see LM generate annual EBITDA of $220m and free cashflows of $160m. Once LM comes online into deficit markets in 2021, SOP prices are likely to increase further to US$650-700/t, implying annual free cashflows of $180-200m and payback of less than three years on the project's capex of $550m. With native title clearance in hand, this project will be funded and built. It is a question of timing and what the funding mix and terms will be. We see the project's capex being funded as follows:

a. ~$120m 'vanilla' debt funding from the $5b Northern Australia Infrastructure Fund (NAIF), that has expressed interest in funding LM's project-related infrastructure;
b. ~$100m of debt funding from Export Credit Agencies;
c. ~$200m of equity from a minority project-level sell down to an offtake partner or downstream industry major; and
d. Up to ~$130m of Agrimin equity from a future capital raise.

It is worth noting that to date, as Agrimin has de-risked LM, it has been able to raise equity in strengthening valuations (prices of 15cps, 42cps and more recently at 80cps despite weak trade-war markets), attracting high-calibre institutional investors along the way who have subsequently followed their money. This funding package will indeed be transformational and we expect this to be done inside of 12-18 months, around the release of LM's definitive feasibility study, just as Orocobre did for its Olaroz project and similarly, most of the money will be made during this period.

Management is well-aligned with strong insider ownership and are acutely aware of LM's unrivalled world-class SOP asset potential, which mirrors SDIC's SOP asset in China, the largest production asset globally. Despite strong interest in LM, at both project level and for production offtake, Agrimin management is patiently building competitive tension amongst interested parties in order to achieve the best outcome for all shareholders. Finally, the market is paying multiples of 10-12x EBITDA on such world-class asset cashflows, implying a target EV of $2b+, supporting a very attractive risk vs reward.

### 3. Cann Group (CAN)

We discussed medicinal cannabis holding Cann Group ('Cann') in November 2017 and again in June 2018. Cann has continued to maintain its clear leadership in the sector and is only one of two companies that has actually legally grown cannabis for medical purposes under the Federal Government's licence and permit scheme. Whilst we have done well in Cann, we typically do not continue to hold stocks that enter a construction period (FY19 will be a construction year for its new northern facility), unless the thematic is strengthening, offers catalysts and is determined to be cheap. Cann meets all three criteria:

a. Medicinal and recreational cannabis markets globally continue to rapidly advance with many international stocks re-rating strongly after Constellation brands (STZ:NYSE, US$40b+ market cap) invested US$5b into Canopy (WEED:TSX, C$13.5b market cap) at a 50% premium to Canopy's already elevated share price, with the view of growing its global cannabis offering (a market opportunity of US$200b long-term). This transaction is likely to be followed by other pharma, alcohol and tobacco companies looking to position themselves into this huge growth sector. Interestingly, media reports in September suggest Coca-Cola is interested in partnering with Aurora Cannabis (which has a 22% interest in Cann) to produce a cannabis beverage;
b. Having secured its northern facility site at Melbourne Airport, Cann is expecting to complete construction of its first greenhouse by July 2019, hence FY20 will see production and cashflows; and
c. Cann is currently trading at a fraction of its North American peers' multiples. The company continues to trade at a very modest forward cashflow of <3x, and less than half that multiple if assuming (likely) that it produces and sells (both wholesale and retail) raw bud and high value-add oils.

Whilst the stock has been volatile at times, it has basically traded sideways this calendar year. With its acquisitive and major shareholder Aurora now boasting a C$11b+ market cap and a global growth agenda, Cann's modest market cap at ~$380m, its enviable competitive position and considerable strategic value are all factors that we believe limit the downside risk in the stock.

Finally, if we put aside Cann's massive export opportunity and for conservatism, only focus on the Australian medicinal cannabis market opportunity, it is expected to grow to $2b+ (for flower and extracts). Matching this with the ASX-listed players combined market cap of ~$1b (with Cann the standout and many others worth very little), the sector is trading at a mere 0.5x the expected local market opportunity. Meanwhile, the comparable metric in the Canadian market, which is leading the globe on cannabis, is >10x. The risk-reward in Cann is strongly to the upside and we continue to be long the stock.