Ellerston Global Investments (ASX: EGI)

Investment Update – June 2017

Fund Performance (Net)

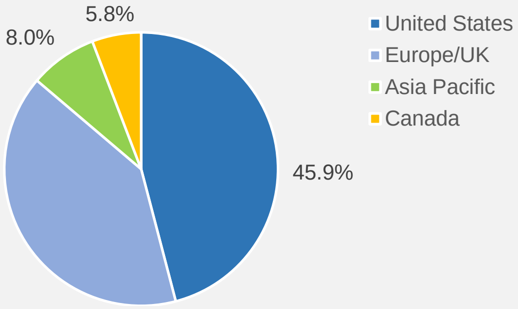
	1 Month	3 Months	6 Months	1 Year	1 Nov 2014	Annualised Return^
EGI*	-0.04%	4.08%	5.26%	13.70%	28.76%	9.94%
MSCI World Index (Local)	0.02%	2.67%	8.25%	18.82%	22.94%	8.05%

*Net Return (before tax)
^1 Nov 2014 p.a

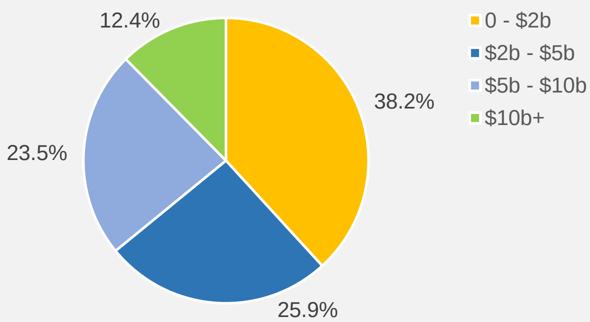
Key Facts	
Listing date	Oct 2014
NTA (before tax) **	**$1.1559**
NTA (after realised tax)	$1.1465
NTA (after tax)	$1.1348
NTA Fully Diluted (after realised tax)	$1.1015
Share price at 30/06/2017	**$1.01**
EGI Market Capitalisation	$76.6m
Option price (ASX: EGIO)	$0.05
Exercise price	$1.00
Management Fee	0.75%

Top 10 Holdings	Weight
Entertainment One Ltd	8.18%
Equiniti Group Plc	5.26%
Philips Lighting NV	5.06%
Zayo Group Holdings Inc	4.65%
QTS Realty Trust Inc	4.19%
Interxion Holding NV	4.02%
Snap-On Inc	3.68%
Jeld-Wen Holding Inc	3.10%
Northstar Realty Europe Corp	3.03%
PTC Inc	2.97%

Geographic Gross Exposure (% of Invested Capital)



Market Capitalisation (% of Invested Capital)



Sector	Portfolio	MSCI World Index
Information Technology	19.34%	15.65%
Consumer Discretionary	18.58%	12.32%
Health Care	2.20%	12.55%
Energy	0.00%	6.04%
Financials	13.73%	18.01%
Consumer Staples	0.00%	9.67%
Industrials	13.77%	11.51%
Telecommunications	5.53%	2.95%
Materials	0.00%	4.90%
Utilities	0.00%	3.19%
Real Estate	10.64%	3.21%
Other	9.13%	0.00%
Cash	7.08%	0.00%
Total	**100.00%**	**100.00%**

** **NTA before tax** - Includes taxes that have been paid. **NTA after realised tax** - Includes a provision for tax on realised gains from the Company's Investment Portfolio. **NTA after tax-** Includes any tax on unrealised gains and deferred tax. **NTA Fully Diluted (after realised tax) - If all of the remaining 2018 options had been exercised by 30 June 2017.**

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Portfolio Update

The EGI portfolio decreased 0.04% net during the month of June. The NTA (before tax) at the end of June was $1.1559.

Contributors to performance included **Equiniti** and **Northstar Realty Europe**. Detractors from performance included **Entertainment One, Zayo Holdings** and **PTC**. EGI had one company, **Hostelworld**, report a trading update in June. Hostelworld reported that the *"improved trading momentum which commenced in the latter part of 2016 has continued".* As shares of Hostelworld continued to rise in June we began to trim this position.

While there was no direct news from **Equiniti**, the sale of UK-based Capita Asset Services (CAS) by Capita Plc to Link Administration Holdings at an implied acquisition multiple of approximately 12.4x EV/EBITDA is supportive of Equiniti's current valuation (c10x). The composition of CAS's business is similar to Equiniti in part, but we believe Equiniti's market leading position and portfolio of businesses are superior.

During the month, the team travelled to Europe meeting portfolio companies including **Philips Lighting** and **Interxion** in the Netherlands, **Equiniti**, **Hostelworld** and **Entertainment One** in London as well as attending conferences in both London and Berlin. The visit reinforced our thesis on current holdings and delivered insights into competitors positioning as well as potential themes and companies for further research.

A few interesting comments, thoughts, insights:

- **Brexit** has seemingly unified Europe, a positive for Euro stability. With the French election complete and German election result looking more certain, the prospects for Europe look brighter.
- The **Italian** Government finally looks set to tackle the problem of non-performing loans at Italian banks.
- Recent **cyber-attacks** highlight the need for enterprise and government to invest in security. German Defence force receives 4,500 cyber-attacks a day.
- **Growing e-commerce penetration** creates opportunity for logistics companies – for every tonne of e-commerce ordered you need three times as much physical space in the warehouse.
- Going forward, the opportunity for **'smart buildings'** is likely to attract attention with 70% of greenhouses gases being produced from buildings, not cars.

Market Commentary

Global equity markets were mixed in June, with the MSCI World Index up 0.02%. June turned out to be a fairly somber month, however equity markets globally performed very well during the Financial Year ending 2017. Investors generally looked through the unravelling of the Trump reflation trade and ongoing geopolitical turmoil to lock in strong gains for the year.

US equity markets experienced a volatile June, impacted by the global 'risk-off' trade and prompted by the ongoing political events pertaining to Trump's sacking of former FBI Director Comey and pending Russian intervention probe. The S&P500 ended the month up 0.48% and the Dow Jones Industrial Average up 1.62% with economic data painting an increasingly positive picture and activity surveys continuing to suggest economic expansion coupled with solid labor force data.

The Tech sell-off in the US mid-month caught investors off-guard, with some of the more crowded big cap names giving back recent gains, leaving investors wondering whether the curtains were being drawn on the multi-year rally in Tech. The NASDAQ fell 0.94% for the month.

Following a two-day meeting, Federal Reserve officials forged ahead with an interest-rate increase and delivered additional plans to tighten monetary policy, despite growing concerns over weak inflation numbers. The Federal Reserve's decision brings the Fed funds target rate to a range of 1.0% to 1.25%.

European markets sold off during the month. The Euro Stoxx 50 was down 3.17% with the ECB removing its interest rate easing bias, arguing the risks to the outlook were now broadly balanced. UK equities underperformed (FTSE100 -2.76%) after the shock election result which saw the Conservative Party unexpectedly lose its majority. More reassuring for the Eurozone was the French political backdrop, where Emmanuel Macron cemented his presidential victory with his party winning a clear majority in the parliamentary elections.

In Asian markets, the importance of China in the Asian investment region was further elevated with the China A-shares finally qualifying for inclusion in the MSCI Emerging Markets Index following a lengthy 2-year courting process. The Shanghai Composite was up 2.41%. Japanese and Hong Kong equities rallied throughout June (Nikkei 225 +1.95%, Hang Seng +0.41%). Domestically, the **Australian** S&P/ASX 200 Accumulation Index was up 0.17% after digesting a raft of local earnings downgrades during the so called 'confession season'.

Quarterly Macro

As was the case throughout fiscal year 2017, political events again took centre stage during the quarter. In early May, Emmanuel Macron convincingly won the second round of the French presidential elections, defeating the anti-EU populist candidate, Marine Le Pen. Macron's political ascendency was cemented six weeks later with his fourteen month old party, En Marche!, winning an absolute majority in the Legislative elections. After calling a snap election for the 8th of June, when an election was not due until 2020, Theresa May's election results were much less convincing. With Brexit negotiations officially beginning 11 days' post-election and May barely holding on to power, the process is now in a more precarious position than it already was.

Despite weak inflation data, the Federal Open Market Committee (FOMC) took the Fed Funds Rate range to 1.00%-1.25% as expected. The 'dot-plot' was broadly unchanged from the March release, with the FOMC anticipating one more hike in 2017. Market consensus now sees one more hike in December 2017, with the balance sheet unwind to begin in September. Looking slightly further out, there does appear to be a divergence in expectations which the market will need to address. Based on the latest dot plot, the FOMC expects the Fed Funds Rate range to sit at 2.00%-2.25% at December 2018, whilst the market is currently only assigning this a probability of 5.6%. The result of this divergence will no doubt have a significant effect on bond and equity markets. The month of June also saw a number of more hawkish comments from the ECB, Bank of England and Bank of Canada, suggesting that Canada and the UK would more than likely tighten policy in the second half of 2017.

Despite these significant political and monetary policy happenings as well as escalating tension between the US and North Korea, markets globally continued higher, with US, UK and German equity markets hitting all-time highs during the quarter. Conversely, the Volatility Index (VIX), often referred to as the fear index, on June 2 closed at its lowest daily level since 1993. In the upcoming quarter, we are mindful of the German election in September and increased activity from central banks globally.

Quarterly Stock Spotlight

Entertainment One (Market Cap £0.9b, Share Price £2.20)

Fallen Angel – Leading independent global studio benefitting from a transforming media industry, the expansion of new media distribution platforms and the international rollout of Peppa Pig and PJ Mask children's franchises.

The global media landscape is experiencing a fundamental shift in the way content is distributed and how it is viewed, driven by the entry of new distribution platforms such as Amazon Prime, Netflix and Hulu. At the same time the demand for quality content has continued to rise. Whether it be movies, TV or music, the consumer's appetite for content has never been greater with the ability to now watch 'on the go' via tablet or smartphone. The traditional studios of Disney, Universal (owned by Comcast) and Warner Bros (owned by Time Warner/AT&T) are still the 'gorillas' in the room when it comes to content. However, the changing landscape of media whether it be streaming services or the rise of the independent film has meant that studios such as Entertainment One (ETO) have become a genuine force in delivering world class content.

Entertainment One is a global leader in independent content ownership and distribution with a library of over 100,000 hours of film and television content. The company is well known for its Family division led by **Peppa Pig,** the world's leading pre-school brand and more recently *PJ Masks*, a 50/50 joint venture with Disney. In television production, ETO produced the recent global hit *Designated Survivor* and in film the popular movies *Girl on the Train* and Steven Spielberg's *The BFG*. Its network includes film and television studio The Mark Gordon Company; Amblin Partners with Steven Spielberg and leading feature film production and sales company, Sierra Pictures.

At ETO's current share price of £2.20, we believe we are paying a fair price for ETO's Family division – *Peppa Pig*, *PJ Masks* and the Family pipeline (*Sir Winston Steinburger, Ricky Zoom*, etc.) and paying very little for the rest of the current enterprise (TV, Music, Film). Beyond this, there is a free option on a continued music division turnaround, future Mark Gordon (ETO owns 51%) projects and a newly restructured film business focused on partnerships (Amblin, Makeready). ETO is currently trading on a forward EV/EBITDA multiple of 7.5x.

Riding the Wave of Streaming

The most significant change within the media industry in recent times has been the advent of streaming services. Netflix will spend US$6b on content in 2017 and Reed Hastings (CEO of Netflix) has said it will be *"a lot more"* in the future. Amazon is expected to spend US$4.5b this year. More recently, even Facebook has been in discussions with studios to produce original programming for the social network. All of ETO's content divisions: television, film, family and music are benefitting significantly from the growth of streaming services and subsequent demand for original programming.

For example, in **Television**, *Designated Survivor* was broadcast domestically in the US with the ABC network, but exclusively in international territories with Netflix. With the addition of streaming services in the bidding process, ETO has been able to collect higher fees in many instances and the complexity of deals has been reduced (no longer have to deal with networks in multiple international territories). With ETO **Music**, an underperforming division until recently, the rise of Spotify and Apple Music has delivered new distribution platforms and dramatically improving margins. **Family** properties such as *Peppa Pig,* where revenue is largely generated from licensing royalties on merchandise sales, are also benefitting from a new path to market. In China, for example, *Peppa Pig* has generated more than 24.5 billion views on multiple streaming (SVOD) platforms since the brand was first launched two years ago. While *Peppa Pig* is broadcast on China Central Television (CCTV), the streaming services provide a new platform with which to reach consumers and serves as a great indicator of the potential for merchandising in China.

ITV bid for Entertainment One

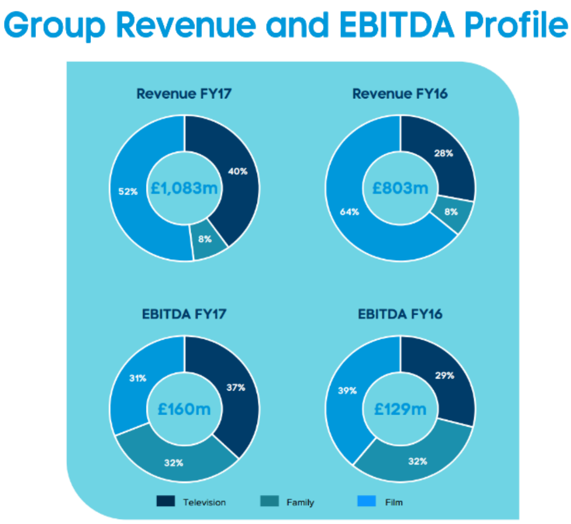
In June 2016, we purchased ETO in the low £1.60s and have continued to purchase opportunistically, as recently as this month. A few months after our initial purchase, on 10 August 2016, ITV Plc bid £2.36 a share for Entertainment One. The bid was rejected by ETO on the basis that the offer did not reflect the company's recent growth or the value of its assets. Given ETO's recent success we believe this was the right move.

To provide context, when ETO reported FY2017 results in March 2017 (March year-end), 7 months post the ITV bid, they announced the following:

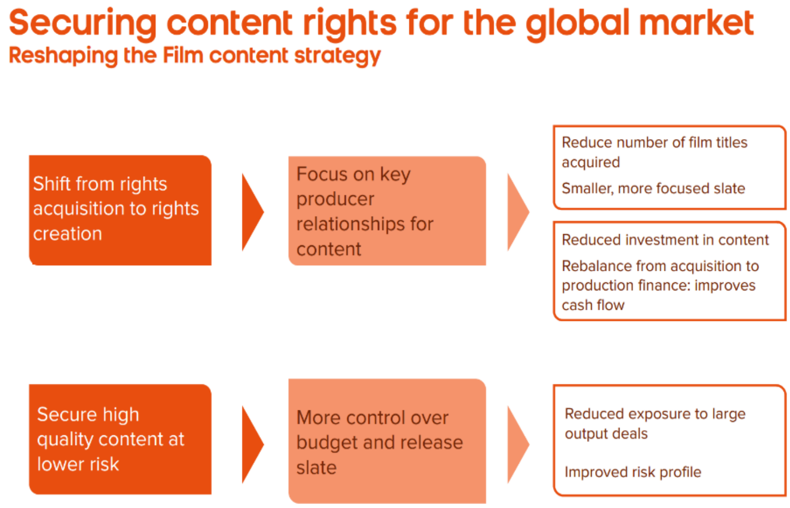
- **Peppa Pig US Retail Sales:** ETO disclosed for the first time that *Peppa Pig* reached US$200m of retail sales in the US in calendar year 2016 (Peppa's first real Christmas trading period in the US) well beyond expectations. The company also announced that it will be rolling out *Peppa Pig* in China, Russia, France, Canada and South East Asia.
- **Announced Second Season of Designated Survivor:** The first episode of *Designated Survivor* premiered post the ITV bid date, on 21 September, 2016. The series has been a breakout hit and has recently been greenlit for Season 2 (as a result ETO is paid overages for Season 1 and receives a higher fee for Season 2).
- **Unprecedented Demand for PJ Masks:** *PJ Masks'* retail merchandise offering only launched in September 2016 (post the ITV bid) in the US and in FY17 ETO saw "*unprecedented demand"* with *PJ Masks* the number one selling stock keeping unit (SKU) at Toys'R'Us. We estimate PJ Masks achieved $200m in US retail sales in FY2017. With retail merchandising set to launch in the UK and France and Season 2 in production, the potential for this franchise is now real and significant.
- **Music Turnaround:** Music revenue increased 28.2% (YoY) to £54.1m with EBITDA up 185% (YoY) to £5.7m as the music library benefits from recent acquisitions and the surge of music streaming services.
- **Updated Independent Library Valuation:** Reaffirmed the independent library valuation of US$1.5b received on 30 September 2016 (post the ITV bid) which was an increase from US$1.0b the previous year. With the next update due in September 2017, it is likely that the valuation has materially increased again to account for the success of *Designated Survivor, Peppa Pig* and *PJ Mask* success in the US among other content produced during the year.

A 'show me' story

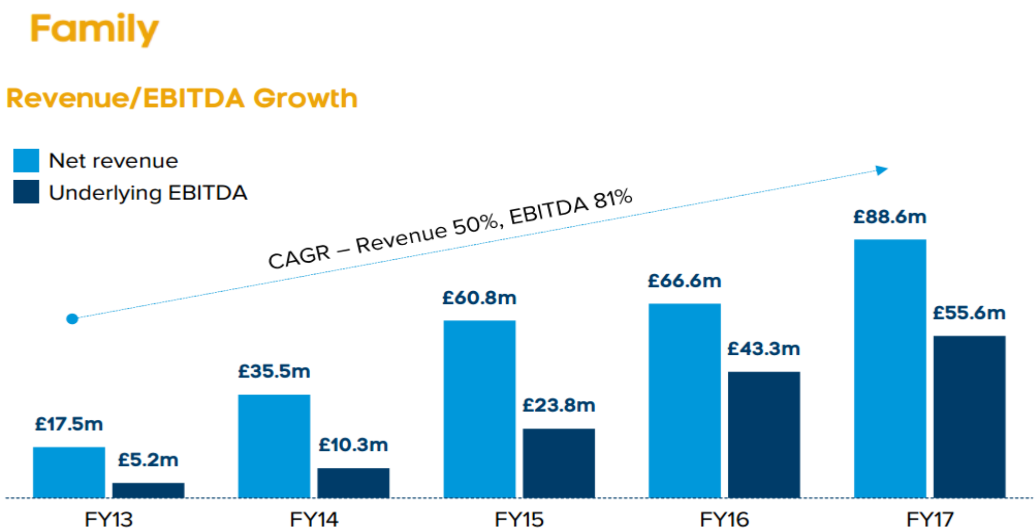
ETO's share price has steadily risen since EGI's first purchase. However, we are of the view that investors and analysts are still only beginning to appreciate ETO's transformation and potential. In FY15, the film division comprised more than two thirds of ETO as compared to one third today, a result of the success of Family, TV and Music. Also, while free cash flow is currently being depressed by ETO's decision to invest in additional content (which will ultimately drive EBITDA and library value) we suspect that investors are starting to focus on investment returns on content as well as the future impact of the higher margin Family division.



Source: Entertainment One 2017 Full Year Results Presentation



The company's strategic goal to double the size of the business between 2015 and 2020 is well on course. With the upcoming independent library valuation likely to be greater than the previous US$1.5b (higher than the enterprise value of ETO), net debt to EBITDA of 1.2x and the Family division contributing over 1/3rd of earnings and growing, we are confident that ETO has set the foundations for long-term growth.



Source: Entertainment One 2017 Full Year Results Presentation. Note: ETO owns 85% of Peppa Pig. Revenue & EBITDA of the Family Division are calculated on a fully-consolidated basis, prior to any deduction of non-controlling interests.

Company Overview

Entertainment One is a global independent studio that specialises in the development, acquisition, production, financing, distribution and sales of entertainment content. The Company's expertise spans across film, television and music production and sales, family programming, merchandising and licensing, and digital content.

ETO has 3 divisions:

1. **Family (33% FY17 EBITDA)** – ETO owns two of the top three preschool brands in the world based on viewership. This division focuses on building a portfolio of children's properties by developing, producing and distributing a number of children's brands on a worldwide basis. The majority of revenue is generated through licensing and merchandising programmes across multiple retail categories. The Family division reported US$1.5b in total retail sales in 2017. As a rule of thumb, ETO receives a 6% royalty fee on total retail merchandise sales with Family achieving over 50% EBITDA margin.

In addition to *Peppa Pig*, the Family business has developed brands such as *Ben & Holly's Little Kingdom* and *PJ Masks* and is bringing to market *Sir Winston Steinburger and Sir Dudley Ding Dong* as well as *Ricky Zoom*.

Growth Drivers:

- **Peppa Pig International:** ETO recently announced the start of production on a new series of *Peppa Pig* with 117 new episodes set to launch on air globally from spring 2019 which will secure a pipeline of *Peppa Pig* content over the following four years. Peppa is now rolling out in China, Brazil, Russia, France, Canada and the Nordic region.
- **PJ Masks – US & Beyond:** *PJ Masks* is a 50/50 joint venture with Disney. It is now being broadcast in over 85 territories and licensing programmes for the brand in the US started in September 2016 and has continued to expand to the UK, France and Spain with full international roll-out expected by the end of FY18.
- **Family Pipeline:** *Sir Winston Steinburger and Sir Dudley Ding Dong* launched in Canada and Australia and has been sold internationally. *Ricky Zoom* is in production now (to begin rollout in 12-18 months) and is being produced by the same team as *PJ Masks,* with a terrific opportunity in merchandise focusing on cars and motorcycles.

2. **Television (36% FY17 EBITDA)** – ETO develops, produces, acquires and distributes television shows through eOne Television and the Mark Gordon Company (ETO owns 51% of MGC with an opportunity to acquire the remaining 49% in 2022). Music is also included within this division.

ETO is one of the major independent producers of high-end drama and non-scripted television content. This content is then sold through its in-house television sales teams to broadcasters globally and leading digital platforms. Due to its Canadian Heritage Status, ETO receives the benefit of significant tax credits on productions (both TV and Film).

In music, at the end of 2016, Billboard ranked ETO Music as the 2nd largest independent label in the US. The label received 9 Grammy nominations for the 2017 Grammy Awards. The current roster of artists and catalogues are benefitting from the move from physical to digital sales (streaming music) which improves both sales and margins. Recent acquisitions have turned music into a new high growth division and we expect more acquisitions in the future.

Growth Drivers:

- **Content Growth:** In Television, ETO will spend £290m to produce and acquire content in FY18 (up from £258m in 2017). This will include new recommissioned seasons of *ICE*, *Cardinal*, *You Me Her* as well as new dramas such as *Burden of Proof*. The Mark Gordon Company will produce a second season of *Designated Survivor* and new projects *The Climb* for Amazon Prime and *Youth & Consequences* for YouTube. Older shows, *Grey's Anatomy* have been recommissioned for season 14 and *Criminal Minds* season 13.
- **Music:** Late 2016, ETO announced that it signed a deal with Warner Music's Alternative Distribution Alliance to handle physical distribution for its owned labels with ETO retaining the digital rights. It also brought back in-house the Death Row library which until the start of 2017 was managed by BMG. With a new CEO at Music, a focus on streaming platforms and artist management, recent growth should continue. To illustrate the changing market valuations for music labels, before streaming services became a key distribution platform, Warner Music sold in

2011 for 10.5x EBITDA. As the landscape has changed to digital, valuations have moved higher with Universal Music rumoured to be listing (currently owned by Vivendi) at over 20x EBITDA.

3. **Film (31% FY17 EBITDA)** – ETO's Film division is one of the largest independent film companies in the world covering both production and distribution. In the past, ETO has been focused on acquiring film rights both through output deals with independent production studios and through single picture acquisitions. More recently, however, the company has been focused on creating partnerships with an equity interest and distribution rights. For example, in December 2015, ETO, Steven Spielberg, DreamWorks Studios, Reliance Entertainment and Participant Media brands joined forces to create a new film, television and digital content creation company, Amblin Partners. Recent success in the venture has come in the form of *The BFG* and *The Girl on The Train.*

ETO has further mitigated risk in the Film business by reducing the size of the film slate. Last year, ETO released 170 films compared to 275 at its peak.

<u>Growth Drivers:</u>

- **Transition from Physical:** ETO has responded to an ever-changing marketplace in film recently completing the transition of their physical distribution business (i.e. DVDs) to Fox and Sony in various territories. This will enable ETO to avoid the costs of and structural decline in DVD's.
- **More Partnerships:** In May 2017, ETO announced that it had entered a new global venture with Brad Weston creating a new global content company called Makeready to develop and produce original feature films and television. ETO will distribute the new content created by the venture and will have the opportunity to acquire up to 100% of Makeready upon certain events for consideration to be determined in the future. Brad Weston was the former CEO of New Regency where in just 5 years he led the company to 34 Academy Award nominations and 12 wins – *The Revenant*, *Birdman*, *Gone Girl*, *12 Years a Slave* and *The Big Short*.
- **Upcoming Film Slate:** There is much excitement about ETO's upcoming film slate with *Molly's Game* starring Jessica Chastain and Idris Elba, written and directed by Aaron Sorkin in post-production as well as *The Post*, directed by Steven Spielberg starring Tom Hanks and Meryl Streep.
- **Merging of Film & Television Divisions:** In its most recent FY2017 results, ETO announced it will be merging its Film and Television divisions to create, ultimately, a pure studio model. By bringing together both Film and Television which have similar infrastructure (a global sales team, finance, royalties, IT systems etc.), ETO will create a more efficient business model. The combined divisions will be called eOne Studios.

Investment Summary

At the core of ETO is content. The company over the last few years has positioned itself for the current environment by restructuring its film production and distribution business, developing the Family division's 'bench' of children's properties and moving towards a studio model rather than acting as completely separate divisions. For example, the Music division did all the music supervision for *Molly's Game* as well as ETO's television series *ICE*. The film division's *Sharp Objects* was sent over to the TV division to create a scripted series which is currently being produced by HBO.

We are excited about the prospects of ETO. The company has in place the workings of a more traditional studio backed by a global sales team and distribution platform. Underpinned by ITV's bid at £2.36 and a changing media landscape where content is more valuable than it has ever been, it is difficult to see how ETO remains independent.

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Should investors have any questions or queries regarding the company, please contact our Investor Relations team on 02 9021 7797. All holding enquiries should be directed to our share registrar, Link Market Services on 1300 551 627 or EGI@linkmarketservices.com.au