QUARTERLY REPORT

JUNE 2018 PERFORMANCE UPDATE

PENGANA INTERNATIONAL EQUITIES LIMITED (ASX: PIA)

DESCRIPTION AND FEATURES

Pengana International Equities Limited provides access to an actively managed core portfolio of 30-50 companies across developed and developing markets via a listed investment company structure.

Investments are made predominantly in companies that deliver stable yet growing free cash flow throughout cycles (which we classify as ‘Core’ holdings) whilst also taking positions in more cyclical companies (‘Cyclical’) and those whose valuation has been materially misconstrued by the market (‘Opportunistic’).

We avoid investments in companies that are, in our opinion, harmful to people, animals or the environment.

Visit our website for more information on the Company.

Portfolio managers	Jordan Cvetanovski Steven Glass
ASX code shares	PIA
ASX code options	PIAO
Founded	19 March 2004
Mandate inception	1 July 2017
Asset class	International Equities
Fees	Management fee: 1.23% p.a. Performance fee: 15.38% of any return greater than the MSCI World [3]
DRP	Yes
Share price[1]	$1.16
Option price[1]	$0.01
NTA (pre-tax) [1,2]	$1.23
NTA (post-tax) [1,2]	$1.21
Premium/discount to pre-tax NTA[1]	(6.07%)
Ordinary shares on issue[1]	247.45m
Bonus options on issue[1]	242.68m
Benchmark	MSCI World [3]

[1] At 30 June 2018.
[2] The figures are unaudited.
[3] MSCI World refers to the MSCI World Total Return Index, Net Dividends Reinvested, in A$.

THE PORTFOLIO UNDERPERFORMED IN AN ENVIRONMENT THAT ACTIVELY REWARDED RISK TAKING

PERFORMANCE

Net performance for periods ending 30 June 2018[4]

	1 mth	3 mths	FYTD	Since Inception p.a.[5]
PIA	1.0%	1.0%	11.9%	7.9%
Benchmark	2.4%	5.6%	15.4%	7.2%

Pengana International Equities Limited has been managed under the new investment mandate by the Pengana investment team since 1 July 2017. The performance since inception in the table above refers to the movement in net assets per share since the inception of PIA in March 2004. See footnotes 4 and 5 below for further details.

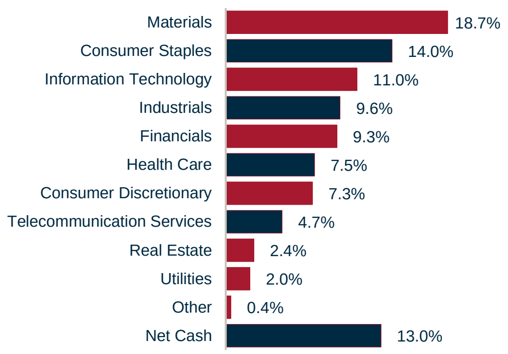
PORTFOLIO INFORMATION

Top 10 stocks

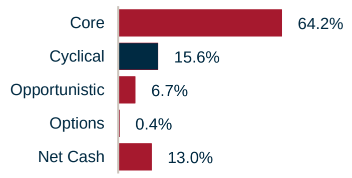
Name	Country	Sector
Bharti Infratel	India	Telecommunication Services
Cigna	United States	Health Care
Dollar General	United States	Consumer Discretionary
Heineken	Netherlands	Consumer Staples
KAR Auction Services	United States	Industrials
Newmont Mining	United States	Materials
Reckitt Benckiser	United Kingdom	Consumer Staples
Sabre	United States	Information Technology
Tencent Holdings	China	Information Technology
Wacker Chemie	Germany	Materials

Largest 3 contributors (for the quarter)	Largest 3 detractors (for the quarter)
Sabre	Wacker Chemie
Electronic Arts	Becle
China Maple Leaf Educational	Bharti Infratel

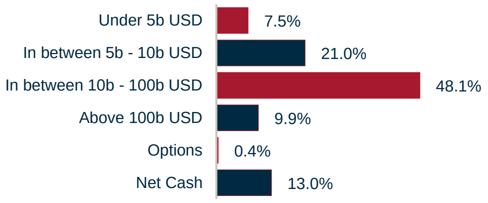
SECTOR BREAKDOWN



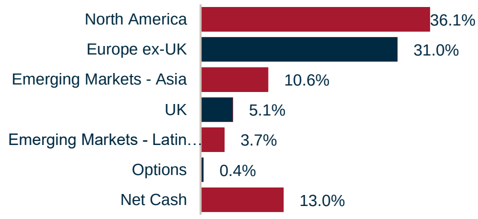
SEGMENT



CAPITALISATION



GEOGRAPHIC



4. Performance figures refer to the movement in net assets per share plus dividends per share paid in the period, reversing out the impact of option exercises, before tax paid or accrued on realised and unrealised gains. Past performance is not a reliable indicator of future performance, the value of investments can go up and down.

5. Inception date of PIA: 19 March 2004, new investment team with new mandate adopted: 1 July 2017

PERFORMANCE COMMENTARY

Aim

We aim to achieve superior AUD-denominated returns with low volatility. The superior returns aim can be disaggregated into (i) capital preservation; (ii) capital appreciation. While these aims make no mention of the benchmark, we believe that fulfilling our aims will result in superior returns to the benchmark over the medium-to-long term. Since inception, the portfolio has delivered compounded returns of 7.9%, net of fees, while the benchmark has delivered 7.2% p.a.

Quarterly Performance

The portfolio delivered 1.0% in 2Q18 while its benchmark, MSCI World (AUD), returned 5.6%. During the quarter, the portfolio continued to hold up on weak days, but these weaker days were few and far between in an environment that is actively rewarding risk taking.

Drivers of the negative relative performance were:

- Stocks we own – Wacker declined 13% following a change in Chinese polysilicon subsidies. Becle declined 21% following its 1Q18 result and senior management departures.
- Stocks we don't own – not owning the 'FAANGs' (Facebook, Amazon, Apple, Netflix, and Google) cost the portfolio about 1% in relative performance.
- Cash – cash is a drag on relative performance in an upward market. This was exacerbated by the fact we hold our cash in AUD, which depreciated relative to the USD, and we hedged a large portion of our USD exposure. The portfolio's cash holdings cost the portfolio about 1% in relative performance.
- Portfolio insurance (put options) – the puts cost the portfolio 0.7% in absolute performance as markets rallied.

On the flipside, some of our stocks generated pleasing returns, including: China Maple Leaf Education, Dollar General, Electronic Arts, Nutrien, and Sabre.

MARKET COMMENTARY

In 2Q18, the MSCI World was up 3.6% in local currency and up 5.6% in AUD terms as the AUD depreciated against most major currencies. This performance follows a continued trend over the past two years, with the market only delivering one negative quarter in local currency and no negative quarters in AUD since March 2016.

The best performing sectors were once again, Information Technology and Consumer Discretionary: which was largely driven by Amazon. Energy also performed strongly during the quarter. The extent of the outperformance of IT is best viewed over a longer time frame. According to our calculations, IT has been the best performing sector by a considerable margin having delivered 71% over the past two years, while the second best performing sector (Materials) delivered 42%.

The worst performing sectors over the quarter were Financials, Telecommunication Services, Industrials, and Consumer Staples. Telcos, Industrials and Consumer Staples have also been among the worst performing sectors over the past two years.

The best performing (major) regions during the quarter were the UK, Australia and Canada. Emerging markets were broadly weak with Brazil, Indonesia and Malaysia being the worst performing major markets. China was another notable underperformer.

With North America not represented in the best performing countries but US-centric segments being the better performing sectors during the quarter, we think it is a fair inference that segments outside of growth-related IT in the US performed relatively poorly.

PORTFOLIO

The portfolio is divided into three segments:

(1) Core (60-80% of the portfolio) – Core is intended to provide a stable base for the portfolio. Companies in this segment are growing, reasonably priced, have low business cyclicality, strong cash generation, dominant presence in their industries, strong management teams and favourable structural tail-winds.

(2) Cyclical (0-30% of the portfolio) – Cyclical contains companies we expect to benefit from shorter duration trends. As these cycles tend to be transitory, timing is more important in our investment decisions than in Core. Cyclical companies offer the potential for materially more substantial short-term gains than Core, however, they are also riskier. Financials, basic materials, and agriculture are examples of industries that may be represented in this segment.

(3) Opportunistic (0-20% of the portfolio) – Opportunistic includes companies we believe are materially undervalued or whose growth has been under-appreciated. These companies offer potentially more attractive shorter-term gains than Core, however, they also tend to be riskier. Examples of Opportunistic investments include companies in the midst of a takeover, earlier stage internet/health/retail companies and companies whose share prices have markedly declined.

The portfolio's positioning at 30 June 2018 is summarised as:

- 87% of the portfolio is invested in equities and 13% is held in cash – 4% of the equities exposure is in gold-linked shares.
- Segment exposure continues to be 60-65% in "Core", 20-25% in "Cyclical" and 5-10% in "Opportunistic".
- The portfolio has some put options (portfolio insurance) over the S&P500.
- The portfolio has relatively low US exposure (36%), some direct Asian exposure (11%), relatively high European exposure (36%) and minimal LatAm exposure (4%).
- 29% of the portfolio is invested in small or mid-cap companies, 48% is in large-caps, and 10% is in mega-caps.
- Approximately 11% of the portfolio is invested in IT but none of this exposure is in the FAANGs.
- The portfolio doesn't currently hold any US banks or insurers.

The portfolio remained relatively stable during the quarter. The most notable change to the portfolio during the quarter was reducing exposure to Europe, particularly European Financials.

OPINION PIECE: IT & RISK MANAGEMENT

The most important portfolio decision that we made in 2018 was to dramatically reduce our exposure to high-growth, internet-linked companies. 'High-growth, internet-linked' is a mouthful so we have historically abbreviated this definition to the 'IT' sector. While we acknowledge the shortfalls of such an abbreviation, it makes practical sense to do so.

Until recently we have argued that IT stocks, despite their strong performance, continued to offer attractive risk/return characteristics. Up to January 2018, around 25% of the portfolio was invested in IT stocks and the largest positions have included Apple, Alphabet (Google), Amazon and IAC.

In more recent times, our IT investments have surpassed our valuations and we are not readily identifying value in that sector. This should not come as a surprise, given that the IT sector has consistently been the best performing market segment. Either: (i) these companies are delivering well beyond expectations, are going to swallow the world in an unprecedented fashion and will continue to appreciate; or (ii) they were previously materially undervalued and are now just reaching fair value; or (iii) they have become fully valued. We believe the latter is most likely and buying many IT shares at current valuations is fraught with danger.

Our view is clearly at odds with market momentum. The IT sector has enjoyed unprecedented buying over the last several years which has accelerated in the last six months. According to Goldman Sachs, more than 100% of the S&P 500's total return in the first half of 2018 is attributable to just 10 stocks where the five largest added over $820b in market capitalisation. Indeed, Amazon alone accounted for roughly 40 percent of the benchmark's advance.

We can't say for certain what is driving this insatiable demand for IT stocks, however, there are a few factors we can point to.

Firstly, IT companies are winning. They are growing, disrupting vast markets and in many cases have solid balance sheets and cash flows.

Secondly, in an investment landscape where investors are uncertain about many things like sustainability of Chinese growth, Brexit, sustainability of Europe's recovery or European politics, and trade war repercussions, the big IT companies with their enormous cash piles and continued growth look like a safe haven.

Thirdly, the unprecedented momentum in these companies' share prices make it an incredibly difficult decision for money managers to ignore this sector. This momentum has also attracted heavy flows in technology related ETFs from retail investors.

These are all strong arguments for owning IT stocks. As long as this "goldilocks" scenario persists, the outperformance of the IT sector is likely to persist. This might also lead to a period of underperformance of our portfolio versus the index. Nonetheless, their unjustifiable valuations are simply a circuit breaker for us. We have seen situations like this play out before and lessons from the late 90's Dot-Com era still resonate.

Our aims, as mentioned previously in this report, are threefold. Firstly, to generate returns for our clients, but equally important, to lower volatility and preserve our clients' capital. Selling our US technology investments is a capital preservation decision.

Not investing in one sector does not mean that there aren't numerous opportunities available in various other different sectors. Our team has vast experience investing across many industries and regions over several cycles. The portfolio is well-diversified, and not reliant on any one sector's performance. To this point, our recent positive performance was derived from several sources entirely unrelated to IT and includes:

- ENN Energy (38% over 6-months) - a Chinese gas distribution business
- Bakkafrost (30% over 6-months) - a salmon farmer based in the Faroe Islands
- China Maple Leaf Education (54% over 6-months) – an education company offering British Columbia curriculum to Chinese students

With the weakness in emerging and European markets over the last year coupled with a strong de-rating in certain sectors such as Industrials we see an excellent opportunity to deploy our significant cash holdings in high quality companies at attractive valuations ensuring we are well set to continue on our path to consistent returns.

STOCK FOCUS

Last quarter we initiated a position in the global brewing and beverage company, Heineken. The 'Heineken' brand is the world's leading premium beer and the company is the world's second largest brewer with an estimated 10% market share.

Heineken has been controlled by the founding family for almost 150 years. This stability has allowed management to take a long-term perspective without being overly distracted with meeting short-term results. We think this is a key competitive advantage. Consider the success and longevity of the Heineken brand. Despite having a 150-year history and being the established leading premium beer with a market share twice its next largest competitor, the brand has grown at 5% p.a. over the last 20 years while delivering an estimated 30% EBIT margin. Delivering this level of growth over such a prolonged period is only possible by following a long-term perspective, including a willingness to invest in new countries despite it taking an average of 7-years to establish the brand in each new market (Heineken is now present in more than 179 countries).

In a company as stable as Heineken it can sometimes be easy to miss fundamental changes in the business as the company pursues its long-term strategy. Since Jean-François Van Boxmeer, was appointed CEO in 2005, the company has diversified from its European origins and towards emerging markets. The company now generates more than two-thirds of its operating profits from high growth and high margin emerging markets which benefit from favourable long-term secular trends including faster population growth, rising incomes, and increasing per capita beer consumption.

The broader industry dynamics remain mostly favourable to Heineken. The beer industry has gone through a long period of consolidation which has led to the concentration of the beer profit pool amongst a small number of rational competitors, which has created a favourable pricing environment. A lack of growth in developed markets is a headwind but premium beer sales continue to grow in these regions and the premium segment contributes two-thirds of Heineken's profits.

We are also encouraged that Heineken's key competitor, Anheuser-Busch InBev, is focussed on conserving its fat profit margins as it integrates the acquisition of SABMiller and pays down the large debt load that was required to fund the deal (5x EBITDA). Diversion of focus at its key competitor presented Heineken with a window of opportunity to successfully enter a number of SABMiller stronghold markets in Africa, which offer significant long-term growth potential. Heineken has seized this opportunity and is delivering attractive growth from that region.

Our analysis of the capital investments that Heineken is making as it enters and expands in new markets suggests that Heineken's reported margins understate its long-term potential. We also believe these investments are improving the growth profile of the business which will allow Heineken to continue delivering industry leading top-line growth and consistent margin expansion (which remain below peers) for many years to come. On our estimates, we are acquiring Heineken on a normalised free cash flow yield of over 7%.

We believe that a company with a strong market position, capable and long-term oriented management, solid growth profile, and attractive valuation is a welcome addition to the portfolio. *Of course, it would probably worth even more if it changed its name to Heineken.com.*

FOR FURTHER INFORMATION PLEASE VISIT OUR WEBSITE:

PENGANA.COM/PIA

PENGANA CAPITAL

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