

13 January 2017

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**ELLERSTON GLOBAL INVESTMENTS LIMITED (ASX: EGI) INVESTMENT UPDATE**

Please find enclosed Investment Update for December 2016.

For any further enquiries please contact Link Market Services on 1300 551 627 or Ellerston Capital Limited Investor Relations on 02 9021 7797.

Yours sincerely



**Ian Kelly**  
**Company Secretary**

# Ellerston Global Investments

Investment Update – December 2016

## Monthly Review

**The EGI portfolio** increased 2.11% net during the month of December. The NTA (before tax) at the end of December was \$1.119.

**Global equity markets** rallied in December with both European and Japanese markets posting significant gains. US equities continued to perform while China declined sharply. The MSCI World Index (Local) increased 2.78%.

**US equity markets** saw continued strength. The S&P 500 rose 1.82% and the NASDAQ increased 1.12%. December saw the Federal Reserve increase rates by 25bps for the first and only time in 2016, to a target range of 0.50%-0.75%. The Fed also updated their 'dot plot' and now anticipates three rate hikes in 2017 up from two it had forecast previously.

**European markets** had an exceptionally strong month with the Euro Stoxx rising 7.83%. The German DAX increased 7.90% while the FTSE100 climbed 5.29%.

**In Asian markets**, Japanese equities had another strong month with the Nikkei 225 Index rising 4.40% on the back of the Yen's weakness against the US Dollar. The Hang Seng and Shanghai Composite were both down 3.46% and 4.50% respectively. Domestically, the **Australian** S&P/ASX200 Accumulation Index rose 4.38%.

**EGI Portfolio:** Contributors to performance included Northstar Realty Europe, eBay and Entertainment One.

During the December quarter, EGI added new investments to the portfolio including Patheon and Hostelworld.

**Patheon**, which listed in July 2016, is global leader in outsourced drug development and production providing both large and small pharmaceutical companies with a fully integrated outsourcing solution. This includes early stage drug development right through to clinical and commercial scale drug manufacturing. It operates in a \$40bn addressable outsourcing market which is organically growing at a mid to high single digit rate. Currently only c.30% of pharmaceutical industry spending on formulation, development and manufacturing is outsourced. With customers facing growing complexity in drug development as well as more demanding regulatory and compliance requirements, the changing industry dynamics favour a continued trend to increased outsourcing and above industry growth opportunities for Patheon. Patheon delivered strong full year 2016 results on December 20<sup>th</sup>. It indicated that it expects 10% revenue growth in 2017 with EBITDA growing at twice the pace of revenue. This highlights the strong margin expansion inherent in its operating model.

UK-based **Hostelworld** was also added to the portfolio early in the December quarter. A more in depth overview of this new investment is included below.

## Key Information

ASX Code: Shares	EGI
Listing date	Oct 2014
<b>NTA (before tax) *</b>	<b>\$1.119</b>
NTA (after realised tax)	\$1.116
NTA (after tax)	\$1.103
NTA Fully Diluted (after realised tax)	\$1.080
<b>Share price at 30/12/2016</b>	<b>\$0.965</b>
EGI Market Capitalisation	\$73.1m
ASX Code: Options	EGIO
Option price	\$0.044
Exercise price	\$1.00
Management Fee	0.75%

\* 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 31 December 2016.

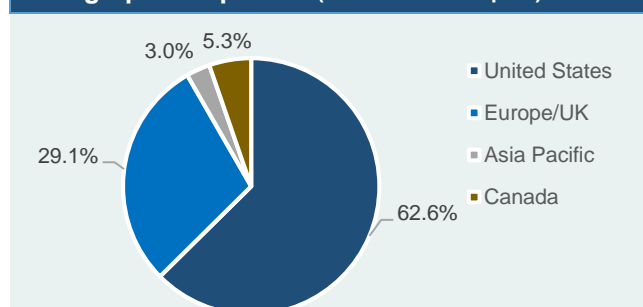
## EGI Performance

	EGI (%)*	Index (%)
1 Month	2.11	2.78
3 Months	-0.28	4.78
6 Months	8.02	9.76
One Year	7.27	9.00
1 Nov 2014	22.33	13.57
Annualised Return	9.75	6.05

\*Net Return (before tax)

Top Holdings	%
Alphabet Inc	5.64
Paypal Holdings Inc	5.14
eBay Inc	5.13
Entertainment One Ltd	5.05
NorthStar Realty Europe Corp	4.75

## Geographic Exposure (% of invested capital)



## Hostelworld Group (Market Cap £214m)

### *Post IPO – Leading hostel-focused online travel booking platform set to leverage its unique brand and platform in a mobile first, social second world to further extend its lead in a valuable niche market*

The highly fragmented global hostel industry is in the early stages of a major transformation. Hostels are designed to provide a social travel experience which enables travellers to meet and interact. Historically, hostels have provided young budget conscious travellers with basic dormitory style accommodation and little else. This is changing dramatically, as significant capital is invested to transform hostels into offerings more akin to three star hotels or a more recently coined phrase “poshtels”. Major aesthetic and facilities upgrades, the introduction of private rooms, free wifi, and many other enhanced offerings are aimed at satisfying the core target market, millennials, that account for about 70% of hostel travellers. The global hostel market generated \$5.2b in room revenue in 2014 and is forecast to grow high single digits per year through to 2018.

**Hostelworld operates the world’s leading hostel-focused online booking platform** through the Hostelworld brand and supporting brands Hostelbookers and Hostels.com. Similar to the offerings of Expedia and Priceline in the flight and hotel sector, Hostelworld provides hostel operators a specialised online platform to display their accommodation to travellers. The company facilitates bookings between hostels and travellers offering a top-class booking experience that provides Hostelworld with commission based revenue. The site has 33,000 properties listed.

Approximately, two thirds of global hostel revenue is generated via online channels, with circa 70% of all online hostel bookings made via an online travel agent (OTA) such as Hostelworld or Booking.com (owned by Priceline). With a 40% market share, Hostelworld is the long established market leader in a niche market that has been growing and consolidating. This consolidation has led to reduced competition for marketing channels, improved commercial relationships with hostels and increasing commission fees.

In a mobile first and social second world, Hostelworld has already built the platform, brand name and user base and is now entering the next stage of its lifecycle. The company is optimising its platform via mobile and developing applications that create a social network, marketplace and communication tool for hostel travellers that will further widen the moat around its platform.

Listed in the UK, the company has a market capitalisation of £215 million and net cash in excess of £15 million. It trades on a price to earnings ratio (P/E) of 13x, free cash flow yield of 8% and a forecast dividend yield of nearly 6%. The valuation metrics are very attractive.

Hostelworld listed in November 2015 at £1.85 and was an incredibly successful IPO. The company informed shareholders in May 2016 that bookings into European destinations had been weaker driven by geopolitical events including terrorism. The subsequent excessive decline in the share price of Hostelworld created an opportunity for investors with EGI initiating a position in October 2016. We are conscious that this investment could prove to be volatile as geopolitical events may further impact travel in Europe. This may provide an opportunity to add to our holding.

Millennials are taking gap years at ever increasing rates and they are staying at hostels, which a large percentage of them book through Hostelworld. This is a powerful dynamic. The appealing demographic of its user base and its leading market position in a consolidating industry make Hostelworld a very strategic asset.

*“They aren’t just for backpackers. ‘Poshtels’ boast chic décor and the chance to be social”,* December 19, 2016 Washington Post - [See Article](#).

### Company Overview

The company is split across its flagship brand, Hostelworld and Supporting Brands.

**Hostelworld (85% of Bookings)** - the Hostelworld brand is the company’s flagship brand and since the start of 2015 the company has focused its attention and resources on this brand, increasing its relevance to and reach amongst the target young independent traveller. This brand now represents 85% of bookings and continues to achieve double digit bookings growth (albeit currently benefiting from the decline in Supporting Brands).

**Supporting Brands (15% of Bookings)** - the largest brand in this segment is Hostelbookers, but it also includes Hostels.com. This segment has seen a deliberate decline in sales as Hostelworld moves away from these brands to focus on the Hostelworld brand to improve the quality of its revenue streams. These brands are now being run for margin and not volume and we expect the Hostelworld brand to represent over 90% of bookings in the year ahead.

The company generated €83.5m in revenue in 2015 and we expect that to decline this year as the majority of the transitional impact mentioned above will be completed in 2016. From 2017 onwards we expect revenue to grow in the high single digit range with more favourable margins. Hostelworld has an efficient business model that minimises working capital requirements (Hostelworld collects a non-refundable commission at the time of booking) and leads to high cash conversion.

## Significant Growth Drivers:

1. **Growing Hostel Market** – Guests are typically attracted to hostels by the price, but also the social interaction which distinguishes the sector from budget hotels. The market is estimated to be growing at 7% and is still very fragmented despite more professional hostel operators such as A&O, Generator, Meininger and SafeStay growing the sector. The sector has seen an acceleration in the quality of hostels and Hostelworld can, in some instances, represent the majority of a hostels marketing budget as it provides them with reach to a global audience.
2. **Revenue Model** – Prior to 2013, Hostelworld's revenue model was a 10% commission fee plus an incremental \$2 customer booking fee. The \$2 customer booking fee was eliminated and the commission rate was increased from 10% to 12%. This has more recently increased to a 15% base rate for new hostels coming onto the platform and this new base rate currently represents 23% of overall bookings (up from 16% in the prior year).

In addition, in 2013 the company introduced the 'Elevate' program which allows hostel operators to bid a higher commission rate for a more favourable position in search results. This gives accommodation providers the opportunity to increase their prominence in search lists dynamically in exchange for a higher commission rate of up to 8% above the relevant base commission rate. To date, 28% of the bookings on Hostelworld were delivered to properties participating in Elevate (with an effective commission rate of 16.8% on Elevate bookings).

3. **Brand Strength** - Consumers trust strong brands and Hostelworld's brand is characterised by a sense of adventure, community and social interaction, which appeals to its target millennial demographic. Hostelworld has been focused on promoting its brand resulting in an increased proportion of bookings coming from non-paid channels which significantly lowers customer acquisition costs and enhances margins.

The move to mobile is further aiding the brand and reducing marketing costs. Bookings on mobile devices now represents 45% of Hostelworld brand bookings with its mobile app growing faster than its mobile site. Not only does mobile app adoption improve engagement it also saves marketing costs as if the customer has the app then there is no need to go back to paid search.

4. **Hostelworld 2.0** – While only at an early stage, Hostelworld is looking to engage more with customers on their native mobile app to create more contextually relevant information and to improve the social experience. We view this as the next stage for the Hostelworld platform as the mobile and social worlds of its user base converge into one.

For example, in April 2016 Hostelworld added new mobile app features through its partnership with GoGoBot to create a customised experience for travellers called 'My Trips' which delivers travellers relevant information about what to see and do in their destination from the moment they book their hostel. For example, if a traveller booked a hostel in Sydney the app would show you the weather in Sydney, things to do, attractions, places to eat etc.

The company has also just released a new app experience called Hostel Noticeboard which can be found in My Trips which is a digital replica of the traditional on the wall hostel notice board that shows the different types of social events happening in hostels 24/7 and around the world. Ultimately, such a Noticeboard will allow a hostel operator to communicate with a guest in a way they have not before and for guests to communicate with each other, redefining the hostel experience.

Such interaction and types of communication should keep customers more engaged with Hostelworld improving the number of times user open the Hostelworld app, the time spent and the likelihood that a travellers next booking is done via Hostelworld. Also, it will help to differentiate the product from Bookings.com who, despite being the second biggest player in hostels, is unlikely to innovate in the same manner as Hostelworld given the hostel business represents only 1%-2% of Bookings.com revenue.

## Investment Summary

The leading brand in a consolidating industry, Hostelworld is set to benefit from the broad-based shift to mobile/social of its user base. This fundamental shift in conjunction with the specific growth drivers outlined above will only further strengthen their position as the Hostel OTA market leader. With little analyst coverage, a compelling valuation and potential catalysts from its pricing transition and platform innovations, Hostelworld represents an exciting opportunity to own a strategic asset in a unique growing market.

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](mailto:EGI@linkmarketservices.com.au)

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