

Ellerston Global Investments (ASX: EGI)

Investment Update – September 2017

Fund Performance (Net)

	1 Month	3 Months	6 Months	1 Year	1 Nov 2014	Annualised Return [^]
EGI*	4.64%	5.36%	9.66%	10.59%	35.66%	11.02%
MSCI World Index (Local)	2.32%	3.94%	6.72%	17.89%	27.79%	8.77%

*Net Return (before tax)

[^]1 Nov 2014 p.a.

Key Facts

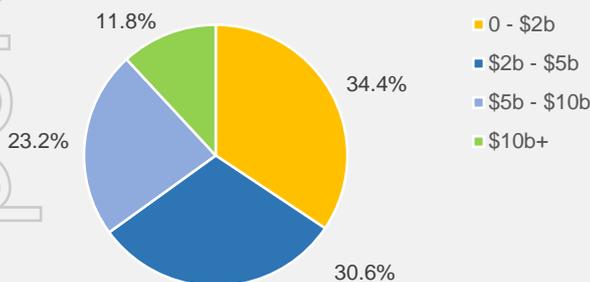
Listing date	Oct 2014
NTA (before tax) **	\$1.1996
NTA (after realised tax)	\$1.1868
NTA (after tax)	\$1.1649
NTA Fully Diluted (after realised tax)	\$1.1301
Share price at 29/09/2017	\$1.00
EGI Market Capitalisation	\$75.82m
Management Fee	0.75%
Option price (ASX: EGIO)	\$0.041
Exercise price	\$1.00
Dividends Paid FY 2017	2.0 cps
Dividends Declared (payable 06/10/17)	1.5 cps
Dividend Profit Reserve ^{^^}	9.4 cps

Top 10 Holdings

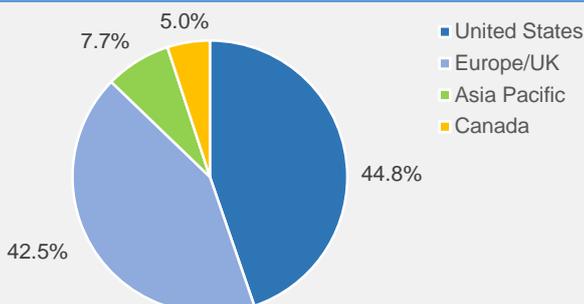
Top 10 Holdings	Weight
Entertainment One Ltd	8.49%
Equiniti Group Plc	6.58%
Zayo Group Holdings Inc	4.85%
Philips Lighting NV	4.78%
Stars Group Inc-The	4.37%
Venator Materials Plc	4.04%
XPO Logistics Inc	3.91%
Interxion Holding NV	3.89%
QTS Realty Trust Inc	3.76%
Hostelworld Group Plc	3.44%

Sector	Portfolio	MSCI World Index
Consumer Discretionary	16.29%	12.16%
Industrials	15.79%	11.48%
Information Technology	14.83%	16.36%
Financials	12.96%	18.17%
Telecommunications	7.73%	2.87%
Real Estate	7.09%	3.12%
Materials	5.39%	5.13%
Energy	1.82%	6.21%
Consumer Staples	0.00%	9.01%
Health Care	0.00%	12.39%
Utilities	0.00%	3.10%
Other	5.45%	0.00%
Cash	12.65%	0.00%
Total	100.00%	100.00%

Market Capitalisation (% of Invested Capital)



Geographic Gross Exposure (% of Invested Capital)



** 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 29 September 2017. EGI went ex-dividend a 1.5 cent fully franked dividend on the 5th of September 2017, with a payment date of the 6th October 2017.

^{^^} After the payment of the 2017 final dividend the Company will have a dividend profit reserve of 9.4 cents per share based on shares on issue at 29/09/17. Cps refers to cents per share.



Portfolio Update

The **EGI portfolio** increased 4.64% net during the month of September. The NTA (before tax) at the end of September was \$1.1996.

Contributors to performance included **Equiniti**, **The Stars Group** and **Entertainment One**. Detractors from performance included **CityFibre**, **QTS Inc** and **Interxion**. EGI had two companies report in September. **Entertainment One** reported a 1H18 trading update with all divisions performing on track and management confirming previous full year financial guidance. Importantly, ETO's independent library valuation increased to US\$1.7bn from the previous September 2016 valuation of US\$1.5b and now includes the success of PJ Masks and Designated Survivor. The commentary around the business momentum was very strong.

CityFibre reported 1H17 sales and earnings that were slightly weaker than expected due to delays in public sector roll-outs. While disappointing, the public sector segment was disrupted by the UK general elections and delays to government funding contracts. As a reminder, the UK has one of the highest rates of internet penetration in the world, but in terms of fiber UK infrastructure lags nearly all OECD nations. Post the recent capital raising (£201.8m) and given the strategic value of **CityFibre's** network (largest independent fibre network in the UK) we are comfortable with our position and conscious that results may be volatile. Management is well aware of the need to densify and 'backfill' the network and over time this will drive incremental value. While the market reacted negatively to this result it provided an opportunity for EGI to incrementally add to its position. The stock has recovered significantly during the month of October.

During the month, **Equiniti**, completed its £122m rights issue post the acquisition of the Wells Fargo Share Registration & Services business for US\$227m. **Equiniti** will bring its proprietary technology to enhance the WFSS platform which services companies such as Hewlett-Packard, General Electric and Berkshire Hathaway. The deal will be earnings accretive and provides **Equiniti** the opportunity to cross-sell its services to a US client base. EGI subscribed for its entitlement of rights (3 shares for every 14 at £1.90) on 29th September.

Lastly, **The Stars Group** raised full year guidance on 15th September with more favorable expectations for poker and consumer response to Star Rewards.

Market Commentary

Global equity markets were strong in September with the MSCI World Index up 2.32%. Against the backdrop of North Korea's declaration that it would not hesitate to shoot down US warplanes (even if flying in international air space) stocks brushed aside rising political tensions and squeezed higher.

US equity markets continued to rise with the S&P 500 rallying 1.9% to finish at 2,519.4. The NASDAQ (+1.1%) and Dow Jones (+2.1%) were also both up for the month. Technology shares continued to soar with the NASDAQ returning over 20% CYTD. The Dow Jones and S&P 500 have now both notched up eight consecutive positive quarters, with the NASDAQ recording its fifth consecutive positive quarter. Bloomberg's dollar index jumped the most since January, as the Fed Chair said raising interest rates gradually was the appropriate policy stance considering the uncertainty surrounding inflation. Investors were also monitoring the chances of meaningful tax reform in the world's biggest economy.

In Europe, the Euro Stoxx 50 performed strongly, up 5.1% (led by Germany's DAX which surged 6.4% and France's CAC40 +4.9%). While Angela Merkel won the election, the gains of the far-right party in Germany may signal a new populist undercurrent on the continent. In London, the FTSE100 ended the month down 0.7%. Theresa May said in an official speech that Britain would broadly honor its financial commitments to the European Union (EU). The pound strengthened in September with comments from the Governor of the Bank of England on the likelihood of rising interest rates.

In Asian markets, the Nikkei closed at 20,356 (+4.1%), with Japan's Prime Minister Shinzo Abe dissolving the lower house of the national parliament on 28 September, ahead of an election to be held on 22 October (12 months earlier than needed). Hong Kong's Hang Seng fell 1.2% to 27,554.3 (but still up an astonishing +25% CYTD) after hitting an air pocket late in the month as Chinese property developers tumbled on fresh mainland home curbs. China's Shanghai Composite Index fell -0.4% in September.

The **ASX/S&P 200 Accumulation Index** closed the month broadly flat (-0.02%) in September, and has traded within a tight range of approximately 100 points since May. Like international equity markets, the Australian market, has proven to be resilient, despite the global geopolitical uncertainty and the decline in the price of Iron Ore (down ~20% in September).



Quarterly Stock Spotlight

Philips Lighting NV (Market Cap €4.7b, Share Price €33.53)

Spin Off – The global lighting market is undergoing a paradigm shift driven by energy efficiency and functionality from conventional lighting to LED and connected LED lighting. Philips Lighting is the global leader and at the epicentre of that shift.

The total global general lighting market is expected to reach €80bn by 2020 with Conventional representing €15bn, LED €53bn and Systems and Services €12bn. The vast majority of the lighting sources that we use in everyday life are incredibly inefficient. Given our reliance on artificial light, it is hard to believe that lighting technology has not meaningfully advanced since Thomas Edison's company began manufacturing the first commercially available light bulb in 1880. As an example, less than 10% of the electrical power supplied to a typical incandescent light bulb is converted into visible light, the rest is lost to heat. The inefficient use of energy by traditional lighting sources has shaped the current transformation to LED and established the foundations for a future in connected lighting. **The US Department of Energy projects US\$630bn of potential energy costs savings over the next 20 years as offices, factories, infrastructure and homes convert to LED and connected lighting.**

Philips Lighting listed in May 2016 as part of a separation from the Dutch industrial conglomerate Royal Philips. The global lighting market leader with over 125 years' experience, Philips Lighting has positioned itself strongly to capture the shift from conventional to LED and connected LED lighting as it accelerates globally. It has taken a last man standing approach in the asset heavy conventional lighting business having already reduced its manufacturing footprint from 45 to 16 facilities while continuing to generate significant free cash flow. Concurrently it has been issued with over 1,300 patents related to LED and established itself as the global leader in LED and connected LED lighting. With over 63% of its current sales LED based, Philips is adeptly managing its transition from conventional to LED and leading in the rollout of connected LED lighting.

The company is undergoing a business transition and while the timing may be uncertain we have seen this playbook before – investors over-reacting to short-term trends while under-appreciating the impact of longer term structural opportunities. In our opinion the current company valuation represents a focus on the declining conventional lighting business that more than adequately compensates shareholders for the business transition risk. It does not give any credit to the outstanding execution of management to date in repositioning the company and greatly undervalues the potential of connected lighting and the makeup of a 'new' Philips Lighting. Ultimately the emerging significant structural tailwind of connected lighting will be reflected in the valuation of the world's leading player.

Philips Lighting currently trades on a forward P/E of 13.6x, EV/EBITDA multiple of 6.5x, Free Cash Flow Yield of 7.8% and 3.6% Dividend Yield.

Industry Overview

We read a lot about electric vehicles as a way to reduce carbon pollution from transportation. Headlines talk of solar on residential rooftops and wind energy as green energy sources to reduce our environmental impact. Occasionally, we hear of smart cities and to a lesser extent connected office buildings, but lighting is rarely in the spotlight. **In that context, it is remarkable to note that office buildings consume circa 70% of all US electricity generated with lighting accounting for 16%.** This dynamic will be positively impacted as the shift from conventional to LED and connected LED lighting evolves and accelerates.

Conventional Lighting (Incandescent/Fluorescent Bulbs) – An incandescent light bulb, is an electric light with a wire filament heated to such a high temperature that it glows with visible light. This is extremely inefficient and energy consumptive. Fluorescent lamps or tubes while slightly more energy efficient contain mercury with many being treated as hazardous waste.

LED Lighting (LED Bulbs) – An LED lamp is a light-emitting diode (LED) product that is assembled into a lamp (or light bulb) for use in lighting fixtures. LED lamps have a lifespan and electrical efficiency which are several times greater than incandescent lamps, and are significantly more efficient than most fluorescent lamps. LED bulbs require less energy (50%-70% less than conventional incandescent lightbulb), emit less heat, last longer and offer better lighting quality.

Connected LED Lighting (LED Luminaires) – LED luminaires are digital devices essentially like small computers. With the right electronics on board they can be connected to data networks to create a connected lighting system leading to materially



increased functionality and energy efficiency. It enables a personalized lighting solution with software apps and controls to ensure a unique, customized experience. Data from connected lighting systems provides insight into activity patterns while remote monitoring and controls allow for the adjustment of lighting levels and schedules. Sensors can be added to provide even greater insight and functionality. Infrastructure, office buildings and homes which are the key beneficiaries of this technology are at the extremely early stages of the adoption curve.

While the transition from traditional lighting to LED lighting is well underway the opportunity in connected LED lighting is still in its infancy with an extremely long runway. While it may not capture the headlines, the replacement of today's lighting infrastructure with LED products is transformational paving the way for significant energy and cost savings. Ultimately, the deployment of connected lighting systems (i.e. LED luminaires connected to data networks) will forever change the functionality of today's lighting systems and the way we interact with our environment.

Company Overview

Philips Lighting is the No.1 player in both conventional and LED lighting globally. The company is the market leader with expertise in the development, manufacture and application of innovative energy efficient lighting products, systems and services. In terms of geography, Philips business is equally split across Europe, Americas and Rest of World. When it comes to lighting, Philips is the dominant player controlling over 16,000 patents with 1,300 patents related to LED lighting and invests c5% of revenue in R&D. To give a sense of Philips long standing expertise in LED, it was Philips who won the Department of Energy's L Prize in 2011 which took four years to win and required the successful company to produce a LED lamp that met a specific set of criteria in terms of energy efficiency and lighting performance (LED lamp used less than 10 watts and emitted the equivalent amount of light as a traditional 60-watts incandescent bulb).

Philips Lighting has 4 divisions:

1. Conventional Lamps (37% FY18E EBITDA) – Philips is the global market leader in conventional lighting and this division comprises the company's conventional lamps and lamps electronics business. It produces and sells lamps based on a wide variety of non-LED based technologies including incandescent, halogen, fluorescent and HIS as well as electronic components (ballasts and drivers).

Management has been proactive in reducing the company's conventional lamp footprint (reduced manufacturing sites from 45 to 16) setting in place a strategy 8 years ago to be the *'last man standing'* in conventional lighting as other competitors depart. Philips is capturing more market share of a shrinking pie (No. 2 player is half Philip's size) and this division is being optimised for free cash flow to fund the growth of Philips other divisions. Revenue in the Lamps division declined 15.8% in 2016 with Adjusted EBITA margins improving to 20.2%. Going forward Philips expects revenue to decline c20% with Adjusted EBITA margins forecast to be greater than 16% out to 2019.

2. LED (27% FY18E EBITDA) – Philips is the global leader in the sale of LED lamps and electronics with the No. 2 player again half its size. The LED division sells a wide variety of LED lamps, namely spots, bulbs and tubes, to the professional and consumer channels as well as original equipment manufacturers (OEM). These products are replacing existing conventional lamps. Philips also sells LED electronic components consisting of LED drivers and LED modules to luminaire OEM's for professional luminaire applications in the retail, office and outdoor segments. In 2016, this segment grew revenues 16.1% with Adjusted EBITA margins of 9.4%. Volume growth continues to offset price erosion (lower prices drive shift from conventional to LED) and innovation and operational leverage should lead to mid-teens revenue growth over the medium term with management guiding for 10%-12% Adjusted EBITA margins over a similar period.

3. Professional (33% FY18E EBITDA) – Professional products, systems and services are used in multiple market segments such as offices, commercial buildings, shops, hospitality, industry and outdoor environments including smart cities. Philips is a global leader in the professional lighting market for conventional, LED luminaires, systems and services with strong positions across key geographies. While currently only a small part of the division at 19% of Professional sales, Systems & Services (connected lighting) grew 51% in 2016. The total Professional segment grew 3.6% in 2016 (excluding impact of Saudi Arabian subsidiary) with an Adjusted EBITA margin of 5.4%. The growth in professional connected LED lighting will drive new opportunities for managed and lifecycle services as well as analytics. While management has not guided to a medium term growth rate, they expect Adjusted EBITA margins to be 11%-14% in the medium term.

To give a sense of the opportunity in LED and connected LED lighting in the professional segment, less than 10% of global street lighting is LED and only 1% is connected.

4. **Home (3% FY18E EBITDA)** – Home is a top 3 player in selected home luminaires markets and **the market leader in connected home lighting**. Philips develops and sells functional and decorative home luminaires, connected lighting systems and premium luminaires. In 2012, Home introduced Philips Hue, the world's first personal wireless lighting system for the home that enables users to control lights wirelessly through apps on smart devices, with their voice or with remote control switches. The Hue has partnered with Amazon Alexa, Google Home, Samsung SmartThings and Apple HomeKit. In 2016, sales in Home grew 11% (connected Home Systems grew 40%) with -3.6% Adjusted EBITA margins. The market for Home Systems is still in its early stages expanding in line with the growth in household penetration of smart home applications. The Home division is on track to be profitable this year.

As an example of the types of innovations possible, Philips Hue teamed up with Nest to provide features whereby Hue lights will flash red when the alarm in your house activates or turn off when your Nest cam detects you have left a room - <https://nest.meethue.com/> .

Revolution of Connected Lighting – Smart Cities, Homes and Buildings

The real story of Philips over the medium term is the potential of connected LED lighting. The switch from conventional lighting to standard LED bulbs is only a first step. The significant opportunity for Philips Lighting is in connected lighting which will create new functionality for users and further energy cost savings. LED luminaires are digital devices, essentially small computers that with the right electronics can be connected to data networks to create connected lighting systems which enable lighting to be optimised, controlled from afar, initiated by sensors and report operational data (energy consumption, hours of operation, faults, location etc.).

Philips Lighting “Connected” Case Studies:

1. Los Angeles Street Lighting



The Challenge: Los Angeles has 215,000 street lights that include more than 400 different styles distributed across 7,500 miles of roadway. Maintenance has traditionally depended on crews who scout the streets at night to identify outages and calls from citizens. The city handles 40,000 such calls per year.

The Solution: To date, 165,000 street lights have converted to LED and 110,000 of those light points have connected to Philips CityTouch (connected lighting). CityTouch provides remote monitoring, automatic notification of outages, tracks energy consumption and delivers accurate lighting asset information with real-time map based views of all connected light points.

2. Citi, Canary Wharf UK



The Challenge: To reduce energy consumption and carbon emissions at Citigroup Centre EMEA headquarters in Canary Wharf, London. At the time, lighting was estimated to account for 20-25% of Citi's energy consumption.

The Solution: LED lighting and Philips Lightmaster system. The combination of LED lighting and controls delivered energy savings of around 45% compared to the previous lighting installation. The system automatically dims the lighting fixtures in relation to natural light entering the building, ensuring that artificial light is never used more than necessary. The LightMaster control system also utilises occupancy control, which means that lights are turned off when rooms are empty as a result of motion detection sensors.



3. New Royal Adelaide Hospital, Australia



The Challenge: The new RAH had specific requirements across individual clinical offerings and wards, each with its own challenges. Also any lighting design had to achieve a Green Star rating.

The Solution: Delivered a connected lighting Philips Dynalite management solution to control 50,000 DALI light fittings and an additional 10,000 emergency fittings. Intuitive software controls all lighting functions while also providing graphical feedback on failures. Philips EnvisionManager system software offered multi-user control and monitoring providing users with complete control, scheduling tools, maintenance management and data analysis.

Investment Summary

Our position in Philips Lighting reminds us of our holding in Vivendi, the owner of Universal Music Group (UMG). At the time a modest valuation was being ascribed to UMG as the market was concerned about the decline in physical sales and the lack of traction in digital, particularly streaming music. Now streaming services have grown to be a key distribution platform and valuations for music labels have moved from a Warner Music sale price in 2011 for 10.5x EBITDA to a recent rumoured valuation of UMG at over 20x EBITDA.

If it were not for the transition Philips is undertaking from conventional to LED, the stocks valuation would be significantly higher. Ultimately, the structural tailwind of connected lighting will be reflected in the valuation of the world's leading lighting player.

REGISTER FOR ROADSHOW

Please join us for our 2017 **Investor Roadshow** in October/November where you will hear from Arik Star, showcasing the team's best investment ideas and the context in which they are investing throughout the rest of 2017 and beyond.

Dividends

If you would like to have dividends re-invested under the Company's Reinvestment Plan, click [here](#)

Options

If you would like to exercise your options, click [here](#)

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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

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