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K2 Australian Equity Update
Quarterly Report - 31 December 2017

Market Review

The K2 Australian Absolute Return Fund returned 8.1% and the K2 Australian Small Cap Fund returned 8.7% for the quarter ended 31 December 2017.

Australian equities closed out 2017 on a positive note as commodities rallied and offshore suitors circled domestic companies like seagulls to a chip. Frank Lowy recommended Westfield investors accept a bid from Europe's Unibail-Rodamco, while the heavily shorted Aconex delivered a bitter Christmas present to the bears as Oracle bid a ~50% premium. The 19th National Congress in China delivered no surprises, while cyclicals outperformed as Chinese growth expectations continued to hold firm. Australian politics suffered a turbulent quarter as dual citizenship cases went to the High Court and the banking sector became a political football as PM Turnbull announced a Royal Commission in late November. With loan growth muted, national house prices -0.3% QoQ, a struggling consumer and the overhang of a Royal Commission, it is understandable investors remain guarded on the big 4 banks into 2018. The RBA left rates on hold at 1.5% while the AUD fell -0.3% to USD0.781.

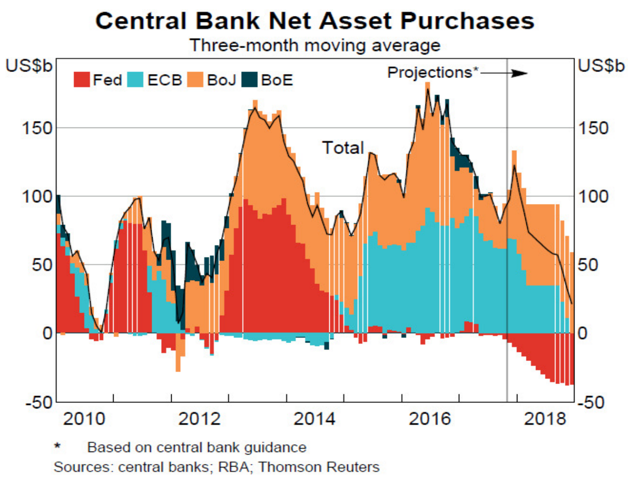
Energy (+17.9%) and materials (+12.9%) were strong quarterly performers as commodity prices remained firm, while technology (+15.6%) stocks pushed higher globally. Financials (+2.0%) were a key underperformer given the headwinds discussed above.

Outlook

FY2018 has so far been a constructive period for equity investors. For the financial year to date the K2 Australian and Small Cap funds have delivered returns of 10.0% and 15.0% respectively after fees. K2's Australian team identified a number of investment opportunities during the first quarter and net equity exposure gradually rose to over 80% by late October. As investor confidence resurfaced we subsequently enjoyed strong returns throughout the second quarter.

The Australian equity market continues to look relatively appealing on global valuation metrics. The median PE of Australia's largest 20 companies is 11% lower and the dividend yield is 160 basis points higher than leading developed market peers. Bureaucratic dilution has played an important role in this valuation disparity; Australia's banks have been forced to raise $100 billion of additional capital only to be recently subjected to a tax on selective liabilities. More capital and less profits does not typically attract global investors. We believe that this banking ROE dilution will be partly offset by an improved performance from the resource sector. Historically the ROE of the resource sector has moved in-line with the CRB Price Index in Australian dollars. Over the past 6 months this price index has risen by 12% yet the ROE projections for the resource sector has averaged just 10%. Between 2009 and 2014 the resource sector consistently delivered ROE's of at least 15%. Given that global economic conditions have dramatically improved, we believe there is meaningful upside in the return profile for Australia's largest resource companies. As a result we feel that Australia's ROE will rise over the coming 12 months and the PE discount to global peers will subsequently contract.

Discount rates will be another important valuation consideration over the coming 12 months. It is common knowledge that over the years ahead central banks will increasingly become net sellers of government bonds. At some point speculators will look to "front run" this structural trend. It is likely that long bond yields will exhibit more volatility and this should lead to higher valuation discount rates. Equity markets can still perform well under these conditions but earnings growth must offset higher discount rates.



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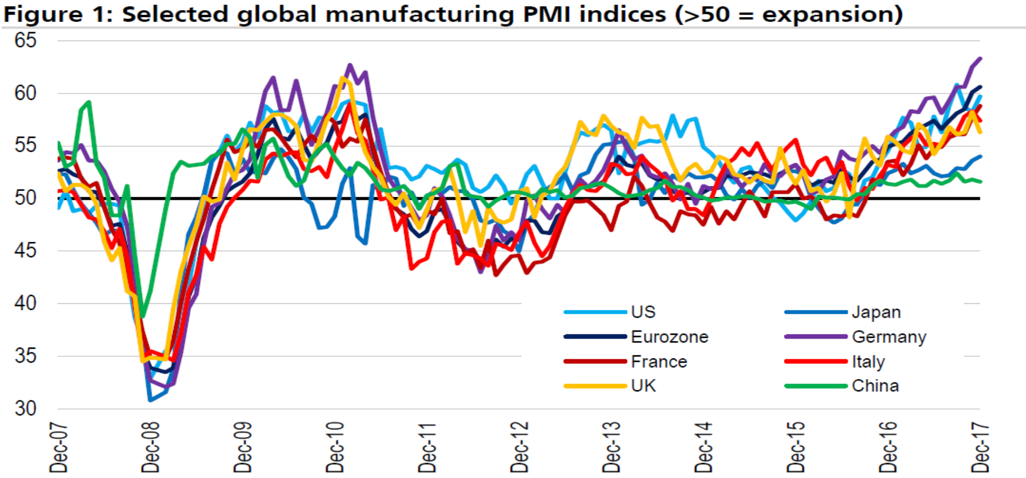
Portfolio Insight: Alumina Ltd - K2 Australian Absolute Return Fund

The K2 Australian Absolute Return Fund has approximately 30% exposure to the resource sector as key economic data demonstrates that the global economy is experiencing synchronised growth. The Purchasing Managers' Index (PMI) is considered the most reliable forward looking indicator for resource demand, the PMI forecasts future manufacturing conditions and activity by assessing forward looking factors of production levels, new order levels and supplier deliveries. The chart in Figure 1 below clearly highlights a very robust environment for all major economies indicating ongoing solid expansion. This has resulted in continued strength in commodities prices, with significant further upgrades expected.

Figure 1: Selected global manufacturing PMI indices (>50 = expansion)



Source: Bloomberg, UBS Research.

The Fund is well exposed to this upgrade cycle with key holdings in BHP Billiton, Alumina Limited, Rio Tinto, Fortescue Metals, Oz Minerals, and Woodside Petroleum.

Alumina, the Fund's second largest resource position, is benefitting from improving fundamentals in the aluminium and alumina markets from strong global demand and Chinese supply side reforms. The Chinese government is temporarily closing capacity smelters to reduce pollution over the winter months and this has caused a sharp spike in alumina prices to well over USD450/t. Prices have already started to correct from these elevated levels, however we believe it's unlikely to retreat as per market expectations (USD300/t). We recently met with Alumina management and their view is that China's supply side reforms are not one-off in nature. This potential long term structural change could result in Alumina prices being well supported at or above the marginal costs of Chinese production at USD320/t.

Alumina is entering a period of strong cash flow generation as the AWAC JV recently increased its distribution payout up to 50% from 30% and the JV presently has minimal internal capital requirements. We believe the market is under-estimating the upside potential for aluminium and alumina prices and hence under-appreciating the FCF and earnings potential. We see Alumina as having significant earnings and DPS upside. Consensus expects AUD 16.5c DPS in 2018 (6.7% DY) which may prove conservative and investors are likely to receive significant cash returns.

Portfolio Insight: Axesstoday Ltd - K2 Australian Small Cap Fund

Axsesstoday Ltd (ASX: AXL) is a specialist provider of equipment funding solutions for small to medium sized enterprises (SME's) which operate in the hospitality and transport sectors. K2 first invested in AXL at IPO in December 2016. As a core holding in the K2 Small Cap Fund, AXL has delivered strong returns for unit holders (+66% from IPO).

K2 is attracted to AXL's rapid market share growth within a large growing industry, strong profitable organic growth and guided by a highly experienced management team. We maintain our bullish view on the company as the current valuation does not reflect the runway for further growth and the achievement of some major milestones in the coming year.

AXL entered the equipment finance market in 2012 with a differentiated and compelling value proposition for merchants to offer equipment finance products to their end customers. AXL offers a seamless end to end online application process with real time credit approval and innovative funding options. The success of this offering can be seen in the fact that AXL now have over 6,631 SME end customers and a loan book of over $212m. Despite such strong growth, AXL holds an insignificant share of the $4.7b market they operate in, which still provides a material opportunity to grow earnings. Given management's strong track record for delivery, we are encouraged by two specific opportunities that lie ahead. In addition to the strong organic growth in the Australian financing business, the company has commenced a pilot program in Canada with a large, reputable retail merchant. While still early days, the Canadian market is double that of Australia and will represent a major growth driver should management execute successfully. With the company now enjoying the benefits of scale, management are re-evaluating their funding structure to include securitisation. This will drive leverage out of the business and provide a material uplift in earnings, reducing the need for further equity raisings to support growth.

With a 3 year EPS CAGR of over +20% and a 1Year forward PE 11.3x, AXL represents outstanding value and we expect a substantial re-rate upon earnings delivery.