PERENNIAL GROWTH MANAGEMENT

May 2015

Diversified pairs trade delivers results

The **Perennial Absolute Return Trust** employs a "market neutral" strategy which aims to provide a lower risk equity portfolio with positive returns irrespective of whether the overall market is rising or falling. We achieve this by employing a pair trading methodology whereby we are equally long and short two stocks with similar underlying share price drivers but have differing stock-specific outlooks.

Some market neutral funds simply buy the stocks they like and short the stocks they don't like, which could multiply portfolio risk. At Perennial, we choose to utilise pair trading to provide another level of risk reduction, providing one integrated portfolio. Our strategy not only reduces or potentially eliminates market risk but also larger systemic risks (i.e. macroeconomic or market thematic risks). These factors are simply reduced to an input into our individual, fundamental stock analysis.

Pairs trade spotlight: Incitec Pivot and Orica

Incitec Pivot Limited

Incitec Pivot in brief:

Listed on ASX: 2003

Market capitalisation: ~$6.45b

Sector: Materials

Incitec Pivot Limited (Incitec Pivot) is an ASX listed international company that manufactures, markets and distributes a range of industrial chemicals, fertilisers and explosives.

Incitec Pivot is the largest supplier of fertilisers in Australia; the largest supplier of explosives products and services in North America; and the second largest supplier of explosives products and services in the world. Employing approximately 5,000 staff worldwide, Incitec Pivot has extensive operations throughout the United States, Canada, Mexico and Australia.

www.incitecpivot.com.au

ORICA

Orica in brief:

Listed on ASX: 1961

Market capitalisation: ~$8.15b

Sector: Materials

Orica Limited (Orica) is the largest provider of commercial explosives and blasting systems to the mining and infrastructure markets, the global leader in the provision of ground support in mining and tunnelling, and the leading supplier of sodium cyanide for gold extraction.

Orica has a strong portfolio of manufacturing and distribution assets strategically located across Australia Pacific, Asia, EMEA, Latin America and North America which enables them to provide valuable supply chain capabilities to their customers.

www.orica.com

Why we took and held a position in the pair:

- While both are exposed to the increasingly difficult global explosives market, Incitec Pivot benefits from long term, take-or-pay contracts and Orica is exposed to declining pricing and thus margins
- Incitec Pivot will benefit from its greenfield ammonia plant that comes on line in 2016
- Orica is in the midst of management upheaval coupled with a much greater exposure to the quickly declining eastern USA coal market
- Incitec Pivot has valuation support, while Orica appears expensive based on our valuation methodology

Adding a long position in Incitec Pivot relative to a short position in Orica

Incitec Pivot and Orica are the two major players in the global explosives industry providing product and services to major miners and quarry operators. During the mining boom both companies prospered as high commodity prices led customers to be less price sensitive with respect to their cost inputs including explosives. With the boom now over, customers have become far more cost conscious which has led to a reduction in prices, volumes and thus margins.

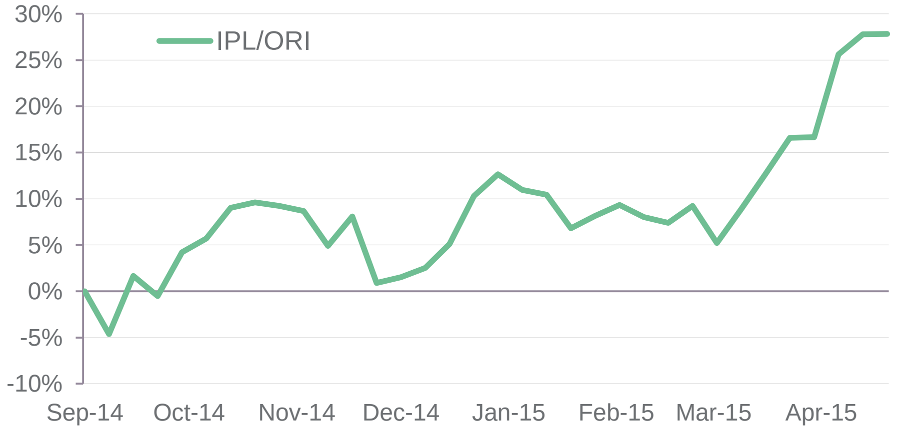
Within this environment we believe Incitec Pivot is much better positioned than Orica primarily due to its contractual position and their geographic mix. We added a long position in Incitec Pivot relative to a short position in Orica in November 2014.

During the boom Incitec Pivot committed to a new explosives plant in Moroonbah, Queensland but realising that booms don't last forever, only went ahead with the project once it had take-or-pay contracts effectively locking in returns for the early years of the project. Conversely, Orica has added capacity in Indonesia with a new plant in Western Australia scheduled to come on stream shortly. Both of these operations, as well as Orica's existing operations, are exposed to the declining prices now being experienced. We also believe that while Incitec Pivot is not immune from falling prices, their North American focus on the Powder River Basin leaves the company less exposed than Orica which has a much larger position in the Appalachian coal mines which are in structural decline.

We believe Incitec Pivot will benefit going forward from its early decision to commit to a greenfields ammonia plant (a major input into explosives) in the USA in response to the cheap gas from the burgeoning shale gas fields. With a fixed price, turn-key contract, Incitec Pivot has all but locked in strong returns from this asset when it comes on line in 2016.

David Rosenbloom
Portfolio Manager, Perennial Absolute Return Trust

Relative Share Price Movement: Incitec Pivot vs Orica



Source: Perennial