Merlon Concentrated Value Strategy

Quarterly Report

December 2016

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Analyst : Ben Goodwin

Iron ore at USD80/t is well above sustainable levels

Iron Ore Is Well Above Sustainable Levels

Along with a number of commodities, iron ore rallied sharply in 2016. This was in stark contrast to the prior three years when continually rising supply met flat demand growth. Last year, however, saw an exit of high cost producers, the shutdown of Samarco, and declines in Chinese production. The year also saw a credit surge as Beijing saw growth deteriorating faster than anticipated, with the US Federal Reserve in particular citing China as a key reason for pausing its rate hike program.

At Merlon we invest in undervalued companies (measured on the basis of our assessment of sustainable free cash-flow) where misperceptions in the market are adversely impacting share prices. When assessing the sustainable free cash-flow of iron ore miners, we need a long-term view on what a sustainable iron ore price is. Our fundamental research, discussed in detail below, analyses demand, supply and cost to estimate a normalised price.

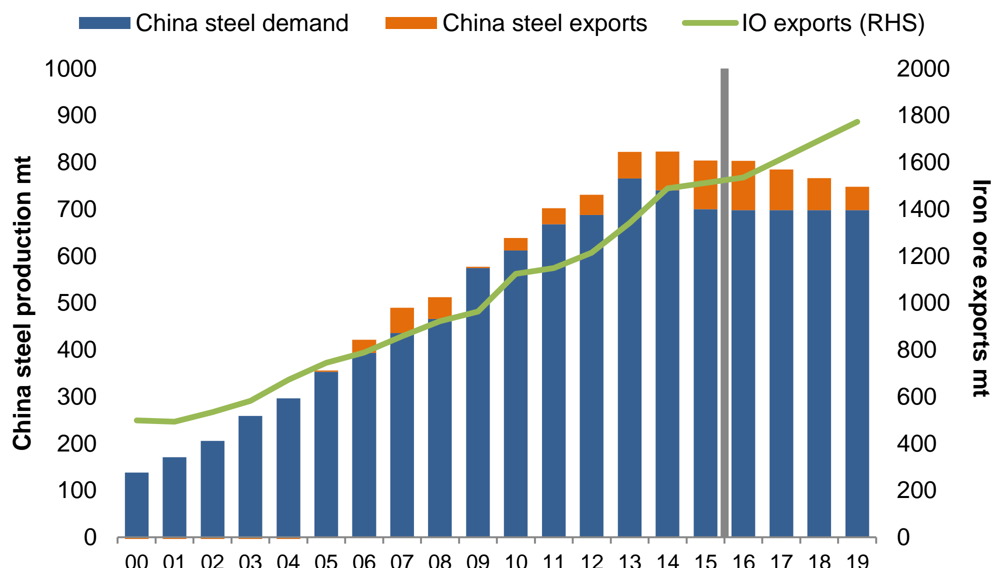
In the short run, as we saw in 2016, prices can deviate from fundamentals, through the effects of transitory events such as policy, supply disruption and speculation. Over the long term, the investment horizon we use at Merlon, price will be based on the cost of supplying a tonne of iron ore to a marginal buyer. We review each of these long term factors below.

Falling Demand: China Steel Production

China's 2016 credit surge supported steel demand but did not drive it notably higher

Chinese steel production, as we know, has risen strongly (Figure 1), and now accounts for more than half of the world's production.

Figure 1: China steel consumption, exports vs global iron ore exports



Source: World Steel Association (WSA), Merlon

In recent years, however, domestic demand has declined, with greater volumes sold into export markets. We consider the outlook for demand via four key drivers of Chinese steel production below:

Beijing remains determined to remove unprofitable capacity

- **Supply side reform:** One downside risk to Chinese steel production comes from government policy aimed at reducing excess steel-making capacity. Although 2016 saw the permanent closure of 45mt of capacity, much of this was idle, with no impact on production. There is an additional 50-100mt of further cuts directed by Beijing, which is more likely to affect active capacity. Addressing active capacity will more directly support steel pricing and the financial viability of loss making enterprises, and will have a direct effect on iron ore demand.

- **Pollution control:** The government is also under growing pressure to address the level of pollution evident across China. Much of this pollution comes from steel mills and coal-fired power generation. While growth of less emissions intensive power generation continues, authorities have to date relied on a 'name and shame' strategy for heavy emitters. We expect this stance to harden as the environmental effects of heavy industry impacts an increasingly middle-class population.

- **Credit**: Chinese steel demand in 2016 has been supported by aggressive credit expansion. This has served to stabilise what had been three years of declining demand. As the effects of these policies diminish, so too will the demand for steel, an effect potentially exacerbated by any negative debt effects of both consumers and producers of steel. Debt is approaching 3 times the size of the Chinese economy, with debt servicing costs consuming 15-20% of GDP.

- **External pressure:** We also know that more recently a growing amount of this production has been exported (Figure 1). This is because China's demand for steel has peaked, consistent with prior examples of rapid industrialisation and economic development seen in Europe, the US and Japan. With rising pushback from export destinations and an increasingly insular political impulse globally, exports are likely to decline from here. Chinese domestic demand, having enjoyed the effects of stimulus in 2016, will likely see this impulse retreat as noted above.

Rising supply: iron ore production growth

Low cost iron ore supply growth continues

Global iron ore exports have grown three-fold, from 500mt in 2000 to 1,500mt in 2015. This supply growth is set to continue, with Merlon forecasting total supply of 1,800mt by 2019, driven by a number of low cost miners completing projects as set out in Figure 2, below.

Figure 2: Low cost supply additions

Producer	Volume additions mt
Vale	80
Roy Hill	30
BHP Billiton	20
Rio Tinto	30
Samarco	30
Total	**200**

Source: Company Reports

Chinese currency depreciation is a risk to seaborne supply

With flat to declining demand as discussed above, we expect a growing surplus. Furthermore, continued RMB depreciation, as capital seeks better investment opportunities outside China, an effect now magnified by rising US interest rates, will see Chinese domestic iron ore production more competitive in USD terms, and pose a 50-100mt addition of supply which had previously exited on low cost supply growth.

An additional risk is substitution, in the form of steel recycling through the form of melting scrap steel generated through an ageing car fleet and property demolition and reconstruction. Our iron ore demand forecast assumes no change to current 165mt of scrap used in China. However, at some stage this number will rise as the economy continues to mature, and the environmental appeal of recycling grows, an effect seen elsewhere, such as the US where recycling now accounts for two-thirds of steel production.

Cost: Iron ore cash production costs

Despite higher oil prices, cost deflation has not ended

We have seen headlines of miners aggressively addressing costs as prices have declined as supply has grown and demand moderated. The majority of this cost out has come via lower currencies, lower oil prices and reduced staffing. While 2016's price rally has seen expectations grow of the end of cost out phase, Merlon expect cost deflation to continue, driven by the following factors:

- **Commodity currency depreciation** – key currencies such as the Australian dollar and Brazilian real are all experiencing downward pressure and will continue to do so as Chinese growth moderates and domestic financial conditions deteriorate.

- **Chinese currency depreciation** – despite importing 1bt of iron ore in 2016, China is also a major iron ore producer. As the Chinese currency (RMB) depreciates, an increasing volume of domestic capacity becomes competitive relative to imports, a factor driving steadily higher production rates throughout the year.

- Increased use of **technology** – technology is a continuous process, driven by

competition. As tonnages have increased significantly, so has the investment in technology, as seen in driverless haul trucks, driverless trains, automated ore wagon maintenance, and centralised control centres.

- **Declining labour** unit costs – in addition to using less labour per tonne of ore produced, driven by technological gains, the cost per unit of labour is expected to decline. This is to be driven by declining demand for labour, as automation advances and as higher cost producers exit the market. Recent research by Merlon has found that this effect is already occurring, particularly on the east coast of Australia.

Greater scale benefits available

- Leveraging greater **scale** – the major producers have all increased production volumes 3-5 fold but are still harnessing the additional scale as incremental tonnes are added (Figure 2) and efficiency gains are realised.

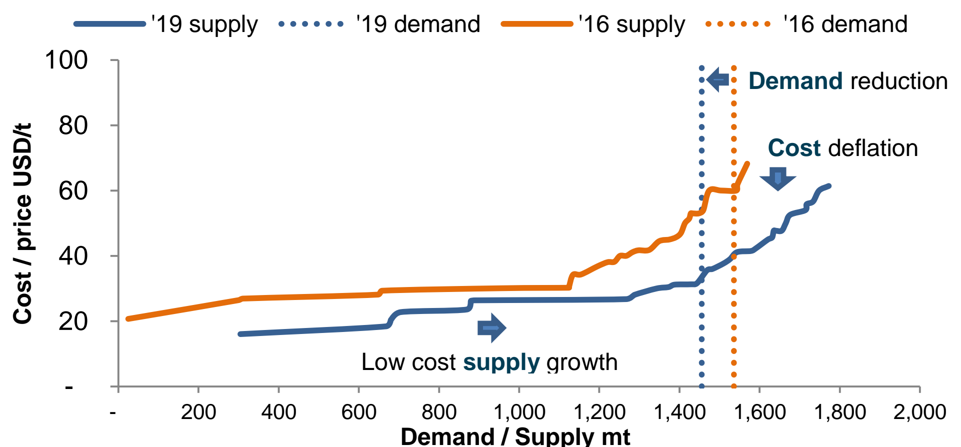
- Consumables **deflation** – a recent trip by Merlon to China saw major miners increasingly confident in using Chinese made plant and equipment, as quality rises and cost competitiveness remains.

The effect of reduced costs is seen in Figure 3.

Impact on our price forecast

The combination of lower Chinese steel exports, continued low cost supply growth, and underlying cost deflation is represented graphically in Figure 3. The point at which forecast demand of iron ore intersects the forecast supply curve is USD32/t (or USD30/t in real or 'inflation adjusted' terms).

Figure 3: Cost curve / price forecast



Source: Company Reports, Merlon

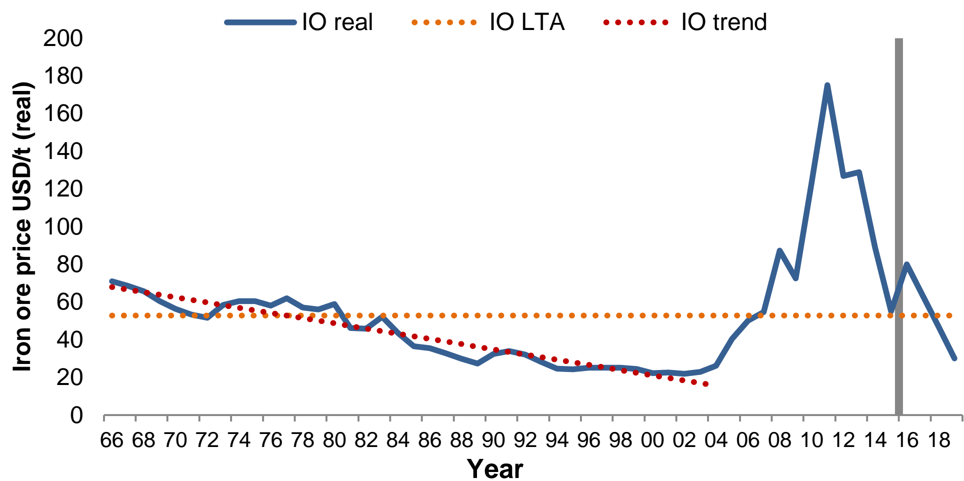
MERLON CAPITAL PARTNERS

Putting it into context

So where does our USD30/t price forecast fit in the context of history? Our forecast of USD30/t clearly appears low relative to current pricing at around USD80/t. Compared to the long term average of USD50/t (a commonly used assumption), our forecast also appears low. However, spot prices as we have mentioned, have been driven by transitory factors such as policy, supply disruption and speculation.

Figure 4: Long term iron ore price and forecast

Beware the trend



Source: Merlon

Perhaps more importantly for our estimate of long term prices, a simple average ignores the well-established pre boom downward trend shown above. This well-known trend is the result of an interaction of several factors including:

- End product **substitution** – Consumers of a commodity end product such as steel find ways of using less of it. Steel buyers can use altered steel products, created by including alloys such as boron and molybdenum, which enable less steel to be used while retaining strength and structural rigidity, or aluminium as seen in the auto sector, directly impacting demand for raw material inputs (iron ore).

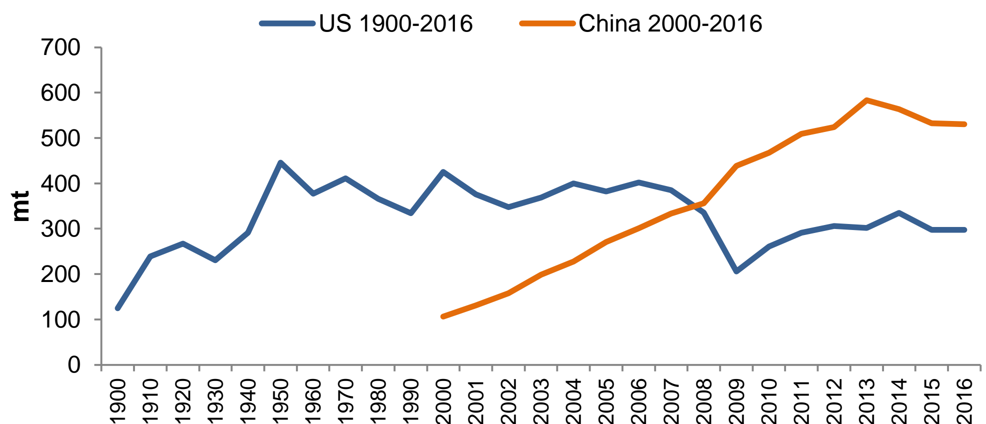
- Raw material input **substitution** – Consumers of inputs to manufacturing and end product find ways of using less. In the case of steel manufacturing, the development of electric arc furnaces enabled the recycling of scrap steel. This development has seen more than two-thirds of steel production in the United States achieved using recycled steel, whereas China has yet to significantly develop its steel recycling sector.

- **Cost** reduction – as a commodity product, iron ore producers seek to compete on the basis of cost, hence continuing to drive cost reduction through the measures

noted above.

- **Demand** maturation – although the demand for steel can be dominated by economic development on a temporary basis, as seen in the cases of China, Japan, post war Europe and the US (Figure 5), economies mature, where the need to keep building steel intensive new factories, infrastructure and accommodation declines. China's domestic steel consumption appears to have peaked, with the surplus 100mt of steel being exported, creating growing trade tensions globally.

Figure 5: Steel consumption per capita – US vs China



Source: US Geological Survey (USGS,) World Steel Association (WSA), Merlon

Portfolio implications & risks

We do not currently hold iron ore mining stocks

We believe these fundamentally based factors will ultimately dominate long term pricing, and in turn we will see pricing outcomes more in line with Merlon's US$30/t long term forecast rather than current pricing.

Should the iron ore price remain elevated for an extended period, either through additional Chinese credit stimulus (noting debt to GDP levels approaching 300%) or a global economic recovery, miners will be incentivised to invest in new capacity, significantly impacting their free cash-flow.

Share prices are factoring in sustainable prices above US$50/t

Our conviction score reflects market misperceptions as indicated by what share prices are factoring in relative to a range of sustainable iron ore prices, which we see as US$20/t – US$50/t. We will have higher conviction when share prices are factoring in the lower end and conversely, as is the case now, lower conviction when share prices are factoring in iron process above the upper end of this range. The combination of long-term overvaluation and low conviction means we remain underweight the iron ore miners at the present time.

Boral's High Priced Acquisition of Headwaters Incorporated

Analyst: Adrian Lemme

At Merlon we invest in undervalued companies as measured by sustainable free-cash-flow where we believe there are misperceptions in the market adversely impacting share prices.

Boral has been a top holding in the fund for quite some time. We had projected cash flows above market expectations based on a post-GFC recovery in US housing, combined with a more positive longer-term view on Australian housing and non-residential construction.

We were aware of Boral's aspirational target to grow the US and Asia segments to roughly equal size with Australia but expected this to be achieved through a series of bolt-on acquisitions at attractive prices.

A High Price Paid

We were shocked by both the size of the deal and the excessive multiple paid

During the quarter, Boral announced that it will acquire Headwaters Incorporated – a US listed company – for US$24.25 per share or A$3.7b in total. Headwaters traded at below US$2 per share just five years ago. While we see the strategic merit in the transaction, we were (frankly) shocked by both the size of the deal and the excessive multiple paid.

EBITDA is a poor measure of free-cash-flow

The company cited a transaction multiple of 10.6x "pro-forma FY16 adjusted EBITDA (earnings before interest, tax, depreciation and amortisation)". Our philosophy is built around the notion that the only way to value a business is on the basis of the sustainable free-cash-flow and franking credits it generates for its owners. We think EBITDA is a poor measure of free-cash-flow. This is because the measure either ignores capital expenditures or assumes that businesses will not make any.

Boral will pay 38x free-cash-flow for Headwaters

Nowhere in its 78 page presentation outlining the acquisition did Boral reference Headwaters' statutory earnings or its free-cash-flow. By our reckoning, Boral will pay 38x free-cash-flow for Headwaters. If it wasn't high enough already, the multiple paid is all the more alarming considering there are no franking credits available from these US based earnings. Our analysis incorporates the A$175m of transaction fees including the ~A$30m poison pill to the Headwaters CEO.

Poor Capital Allocation Decisions

Boral had a track record of disciplined capital allocation decisions

Governance, attitudes towards capital allocation and management quality are important considerations in our process and provide context for our financial projections. In this respect, we had taken comfort in our numerous meetings with Boral management and the Board that acquisitions would be well considered and in line with strategy. We were also comforted by the fact that Boral's senior management would forfeit their long term

incentive compensation in the event that the company's return on invested capital ("ROIC") fell below threshold levels. To this point, Boral had a track record of disciplined capital allocation decisions in reshaping the portfolio by executing a series of valued adding joint ventures in both Bricks and Plasterboard.

Deal inconsistent with management compensation hurdles

Remarkably, this transaction will result in the forfeiture of senior managements' long term incentive compensation. We will lobby strongly against any resetting of long term incentive vesting criteria to adjust for this acquisition but fear our efforts may be in vain.

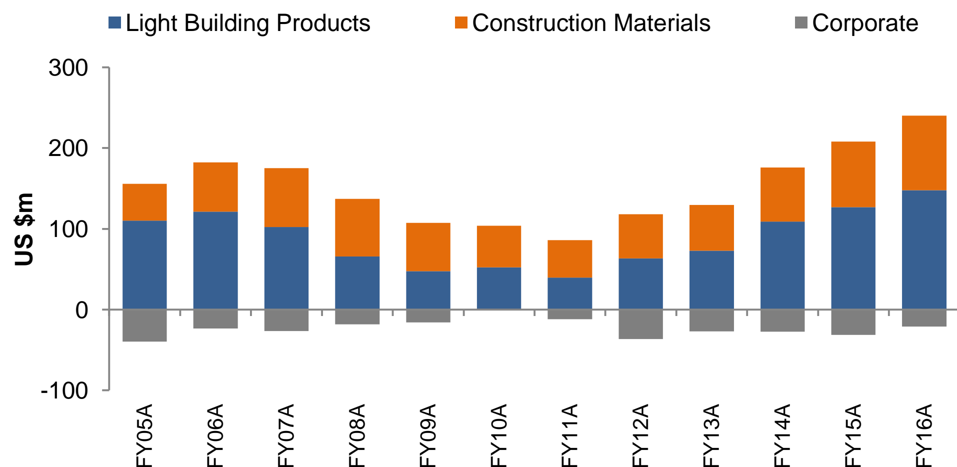
A Good Strategic Fit

Despite the high multiple paid, there are some things to like in Headwaters. The main prize is the high returning Fly Ash business, which represents approximately half the company's free cash flow. Fly Ash is a by-product of the coal combustion process in coal-fired power stations and used as a cheaper substitute for cement in the production of concrete. Headwaters has approximately 50% share of the US Fly Ash market to complement Boral's existing 15% share. Despite this high share, the business is a series of local monopolies so we do not expect significant divestments to be required for approval.

There are attractive aspects to the Fly Ash segment

The Fly Ash business is an excellent fit for our investment style given it is very capital light, with capex of only ~2% of sales. Combined with low working capital requirements, this means most of the EBITDA converts to free cash flow. While the EBITDA margin appears high, EBITDA has been very resilient through the downturn in the US housing cycle as shown in Figure 6. This is due to the business's low operating leverage and high exposure to Infrastructure spending (50% of revenue) which has not been as cyclical as housing.

Figure 6: Headwaters segment EBITDA



Source: Company Reports, Merlon

Headwaters Light Building Products segment is a diverse range of niche businesses that have been acquired over the last 15 years. These businesses span Manufactured Stone, Roof Tiles, Concrete Block, Vinyl Siding and Trim and Vinyl Windows. Each business has a strong market share either nationally or in the regional market that they operate in. This portfolio will significantly bolster Boral's existing Light Building Products suite and increase access to distribution channels. However, this segment demonstrated far more earnings variability than Fly Ash through the housing downturn as also shown in Figure 6. We are also concerned about the underlying organic growth of the business given the number of acquisitions completed over this period.

The Light Building Products segment also has higher capital intensity (~5-6% of sales) and working capital requirements than Fly Ash, making it the less appealing segment in Headwaters.

Management has outlined a target of US$100m in synergies as it merges its existing US business with Headwaters. We have only factored in the 75% that relates to operating efficiencies from removing duplicate functions as revenue synergies from distributing a wider range of products are typically hard to achieve and measure.

Being a cyclical business, we also factor in a continued recovery in US housing starts, from 1.15m currently to 1.5m on a long run sustainable basis in line with the long term average. However, a difficult aspect of Headwaters earnings is that both its segments are earning margins at or above those of a decade ago which corresponded with a more normal level of starts.

Additional Downside Risks to Consider

There is a downside risk scenario that needs to be seriously considered

One question mark about taking the above approach to modelling the transaction is that the combination of:

(i) operating leverage from rising US housing starts;

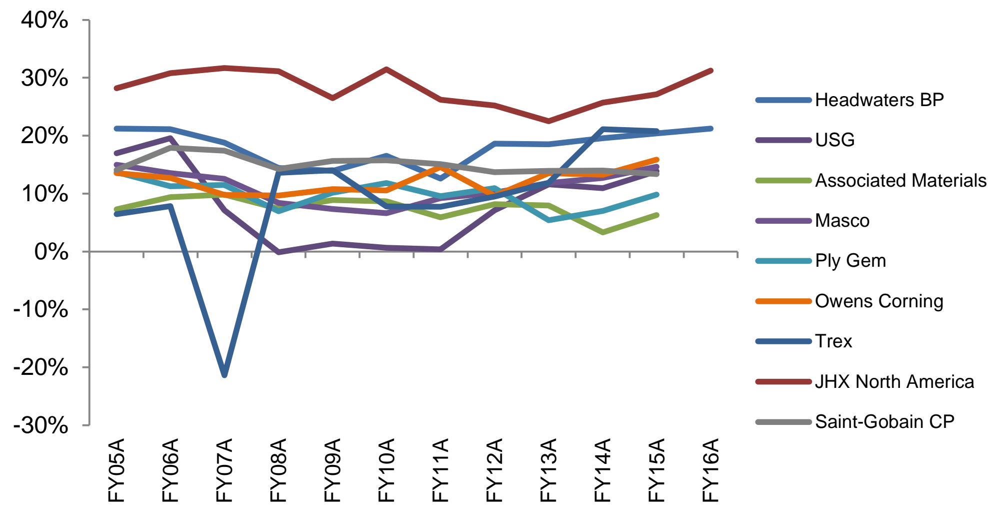
(ii) the improved market structure in Fly Ash; and,

(iii) the "advertised" deal synergies,

means that projected profit margins will increase to well above long-term averages and well above most US based Building Products peers (Figure 7). So there is a downside risk scenario that sees a significantly less profitably business that needs to be seriously considered in building an investment case.

Downside risk scenarios are a critical consideration in developing a "Conviction Score" that combines with our free-cash-flow based valuations to determine portfolio weights.

Figure 7: Headwaters Light Building Product peers EBITDA margins



Source: Company reports, Merlon

Summary

Boral overpaid for the transaction by 10% on a base case scenario and as much as 40% under a bear case scenario

In summary, we can see the strategic merit in the transaction and are attracted to the capital light components of Headwaters various businesses. That said, we believe that:

(i) Boral overpaid for the transaction by between 10% and 40% under a range of free-cash-flow based valuation scenarios; and,

(ii) there is some risk that transaction benefits and the earnings outlook have been overplayed, resulting in a lower degree of conviction that there is a misperception in the market.

The threshold to exit the position is lower than prior to the deal

Unfortunately, the market appeared to form a similar view to ourselves with the stock falling 12% (adjusting for the rights issue) following the announcement of the transaction. As a result of this share price fall, the company still ranks as one of our better investment ideas and remains a key holding in the portfolio.

However, the combination of the lower valuation and the downside risk scenario referenced to above means that the threshold to exit the position is lower than it was prior to the deal.

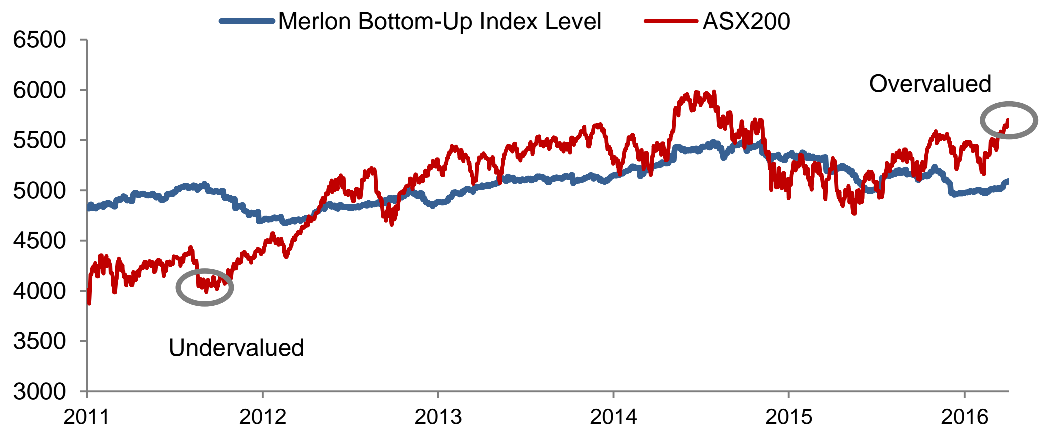
Neil Margolis

Market Outlook and Portfolio Positioning

Market more than 10% overvalued using consistent bottom-up approach

Based on Merlon's bottom-up assessment of long-term cash-flow based value, discounted at through cycle discount rates, the market is more than 10% overvalued (Figure 8). However, there is wide dispersion across sectors, with resources, healthcare, property trust and infrastructure overvalued relative to other parts of the market.

Figure 8: Merlon bottom up market valuation vs ASX200 level

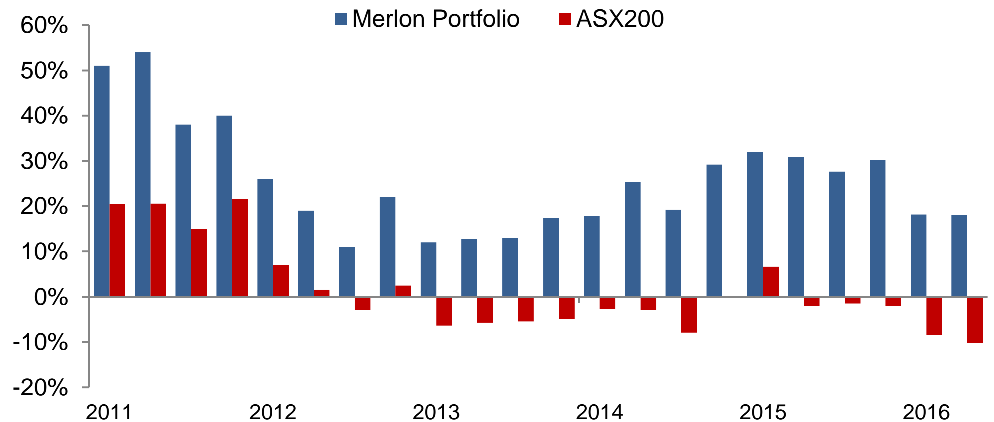


Source: Merlon

But Merlon portfolio offers significant upside

Merlon's concentrated value portfolio comprises our best research ideas in broadly equal weights, based on our long-term valuations, and offers more than 15% absolute upside or more than 25% above the market. As seen in Figure 9, this level of upside is within the range of the past few years.

Figure 9: Expected return based on Merlon bottom-up valuations



Source: Merlon

We remain wary of bond proxy and commodity stocks

The overvaluation of stocks with perceived low earnings risk, or very long duration growth prospects, has moderated as bond yields have begun to normalise. In the long-term, we expect interest rates to rise, leading to underperformance of these 'defensive

yield' names, or alternatively, ongoing low rates should lead to a re-rating of our investments given their strong cash-flow appeal.

We acknowledge commodities performed far better than we expected in 2016 but our view on sustainable commodity prices underpinning long-term cash flows has not changed. Resources stocks are generally expensive with new low-cost supply expected to more than satisfy sustainable commodity demand, which in the case with iron ore, is being flattered by Chinese exports. We discuss our outlook for iron ore in more detail on pages 3 to 8. With the exception of oil, spot prices are trading above fundamentals and incentivising the re-entry of recently idled capacity.

And see more upside in financials and select domestic industrials

We have our highest weighting in banks in some time. In recent years the market shifted from being complacent to overly concerned with credit losses, regulatory capital and intensifying mortgage and term deposit competition. In contrast, we have always used long-term assumptions for these key value drivers. The steepening yield curve and more buoyant capital markets also favour banks, insurers and fund managers.

The consumer is in reasonable shape with rising asset prices, elevated savings, strong migration and subdued inflation offsetting weak household income growth. However, high consumer indebtedness and a peak in the housing cycle present as medium-term headwinds. Further AUD depreciation and shift from monetary to fiscal policy should enable the non-mining economy to offset terms of trade weakness if commodity prices resume their downtrend.

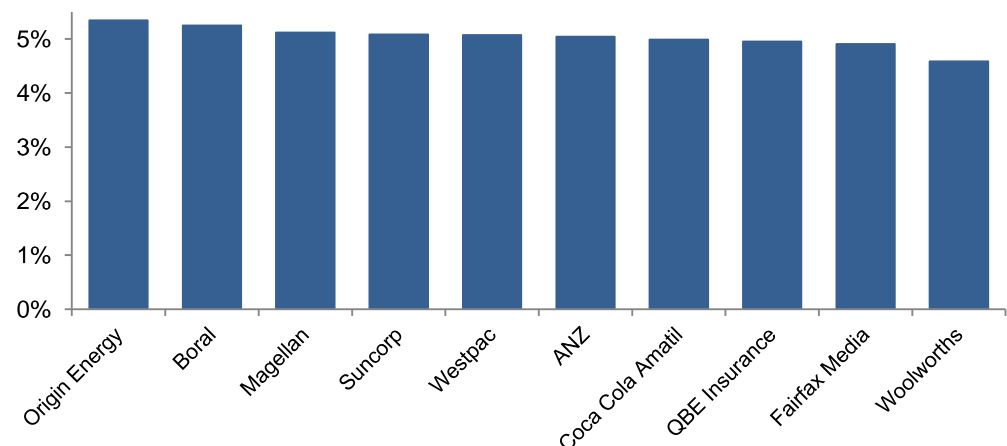
Portfolio Aligned to Value Philosophy and Fundamental Research

The Strategy invests in 'unloved' companies where sustainable cash flow is being under-appreciated

The Fund invests in companies under-earning on a three year view, or where cash generation and franking are being under-appreciated by the market.

The portfolio reflects our best bottom-up fundamental views rather than macro or sector-specific themes.

Figure 9: Top ten holdings (gross weights)

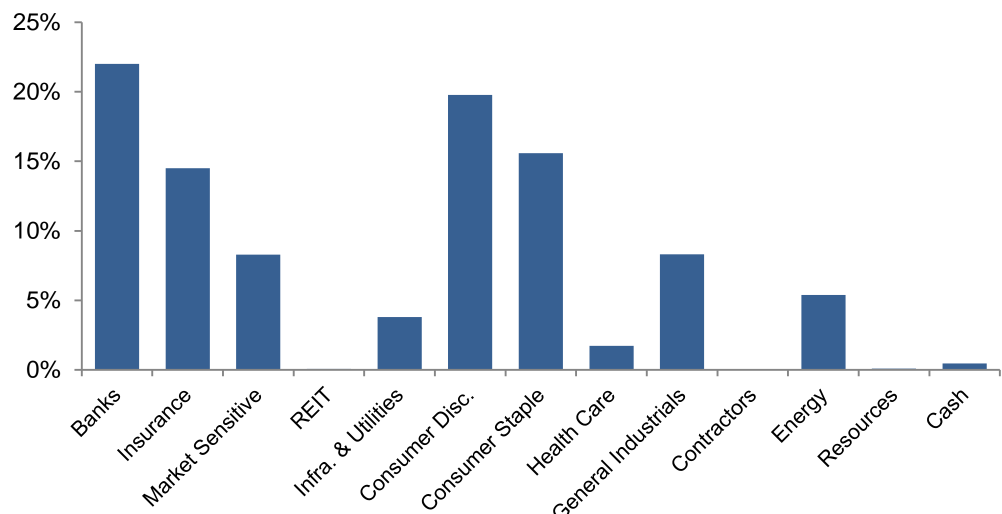


Our larger investments are typically in companies 'unloved' by the market but current prices can be justified by the higher quality and more predictable parts of their businesses.

Active share remains well above 70% with a diverse top 10 all offering above market sustainable free cash flow yields

For example, **Origin Energy** is backed by its retail business, **ANZ Bank** and **QBE Insurance**, both backed by their core domestic franchises, and **Fairfax Media** backed by the growing value of its Domain online classifieds business. **Suncorp's** insurance business is now under-earning despite increased industry concentration while the banking business is exposed to the higher returning retail segment and levelling of mortgage capital playing field. **Magellan Financial**, **Coca Cola Amatil** and **Woolworths** represent good cash generating businesses with strong competitive advantages over new entrants. **Boral's** recent acquisition aside, US housing starts remain below trend and we have a more positive longer-term view on Australian housing and non-residential construction. **Westpac** rounds out the 10 largest holdings with investments in three major banks compared to none at the beginning of 2015.

Figure 9: Portfolio exposures by sector (gross weights)



Some of our best ranked research ideas do not appear in the top 10 in terms of size as they are constrained by liquidity. These include, among others, **Amaysim**, **Flight Centre** and **Virtus Health**.

December Quarter Portfolio Activity

During the quarter we introduced two new investments into the Fund.

One new, one revisited and one sold during the quarter

The first is **Vocus**, a vertically integrated telco provider with an extensive fibre infrastructure network connecting more than 5,000 buildings. A series of large acquisitions has introduced integration risk and created confusion amongst analysts and even internal management ructions. However, this has created an investment opportunity as the infrastructure will be difficult to replicate and the retail brands have upside competing against Telstra under the NBN.

We reinvested in **Metcash** where the growing Liquor and Hardware businesses imply the market is only pricing in five years' worth of earnings from the challenged IGA grocery business. Ongoing share loss and high fixed costs make valuing the grocery business a challenge but market expectations are low, the industry is growing and rational competitor behaviour should see price deflation ease. Also, the group is positioned as the clear number two in Hardware, following Masters' demise and the acquisition of Home Timer & Hardware from Woolworths.

We exited our long-held investment in **Southern Cross Media** given reduced valuation upside following recent share price strength.

Switched from regional to major bank and participated in Boral raising

We participated in the **Boral** capital raising to acquire the US Headwaters business. We were disappointed by the very high cash flow multiple paid although we see positive attributes in the capital light fly ash segment and leverage to rising US housing starts which remain below sustainable levels. We discuss our views on this acquisition and its impact on the Boral investment case in more detail on pages 9 to 12.

We increasing our holding in **National Australia Bank**, funded by **Bendigo Bank** which has outperformed our fundamental valuation as investors have become more comfortable with the outlook for deposit pricing and the prospect of achieving regulatory capital relief.

We added to **Seven West Media** which is trading below our bear case valuation as the market extrapolates unsustainable high content cost inflation despite declining audience numbers.

Merlon Concentrated Value Strategy

Quarterly Report – December 2016

MERLON CAPITAL PARTNERS

Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	Inception (p.a.)
Portfolio Return (inc. franking)	5.7	5.0	16.3	21.7	11.8	17.4	12.8
ASX200 Return (inc. franking)	4.4	5.5	11.3	13.3	8.1	13.4	10.1
Excess Return*	**1.4**	**-0.4**	**5.0**	**8.4**	**3.7**	**4.0**	**2.7**

* excess returns may not sum due to rounding

December Quarter Market Review

Bond yields began to normalise triggering rotation into cyclicals and banks

The market powered ahead another 5.5% in the December quarter as investors rotated from bonds to equities and from defensives to cyclicals and banks on the back of Donald Trump's election win.

Underlying US economic improvement already underway combined with the prospect of pro-growth reflationary policy led to a sharp 85bp reversal in US 10 year yields. Back home economic data generally disappointed but 10 year yields were dragged 86bp in tandem with the US. The AUD declined 6%, more closely reflecting the diverging economic performance. Commodities had a standout quarter with Iron Ore up 41%, Coal 22% (189% over 12 months) and Brent 16%. Gold was the exception, down 12%.

Banks returned 14%, seen as beneficiaries of a steepening yield curve, with investors becoming less concerned about irrational competition, mining-related bad debts and regulatory capital. **Commodity**-related sectors also performed strongly as did **Utilities** with a takeover of **Duet** outweighing the dramatic bond sell off. **REITs** weren't spared although only declined 1% after recovering strongly in the last month. **Healthcare** was the laggard, with defensives out of favour but also plagued by a series of profit warnings from high PE growth stocks. The **Telco** sector has also proved to be less defensive with looming NBN competition adding to mobile market pressures. **Consumer** sectors were flat to down with fears of a disappointing Christmas ahead.

Portfolio Performance Review

The Strategy slightly underperformed this quarter but FYTD performance has been strong

The Strategy slightly underperformed the ASX200 during the quarter, with underlying stock selection of 2.0%, on an equal-weight basis, offset by the non-benchmark construction approach with the very large cap mining and banking stocks recovering some of last year's underperformance.

QBE Insurance was the best performing holding, benefitting from rising yields, but also starting the quarter 40% undervalued based on Merlon's long-term valuation. **Origin Energy** performed strongly in tandem with the oil price and announced a spin-off of its E&P business. Having the largest sector weight in **Banks** in several years also contributed on an equal-weight basis, as did not holding former glamour stocks, **Sirtex**, **Vocus** and **Healthscope**. Detractors in the quarter included **Boral** overpaying for the

US Headwaters business, **Virtus Health** amidst a slowdown in IVF industry volumes and some share loss to bulk bill operators, **TradeMe** on Facebook competition concerns, **Fairfax Media** on temporarily depressed listings data and **Flight Centre** suffering from lower commissions on heavily discounted airfares.

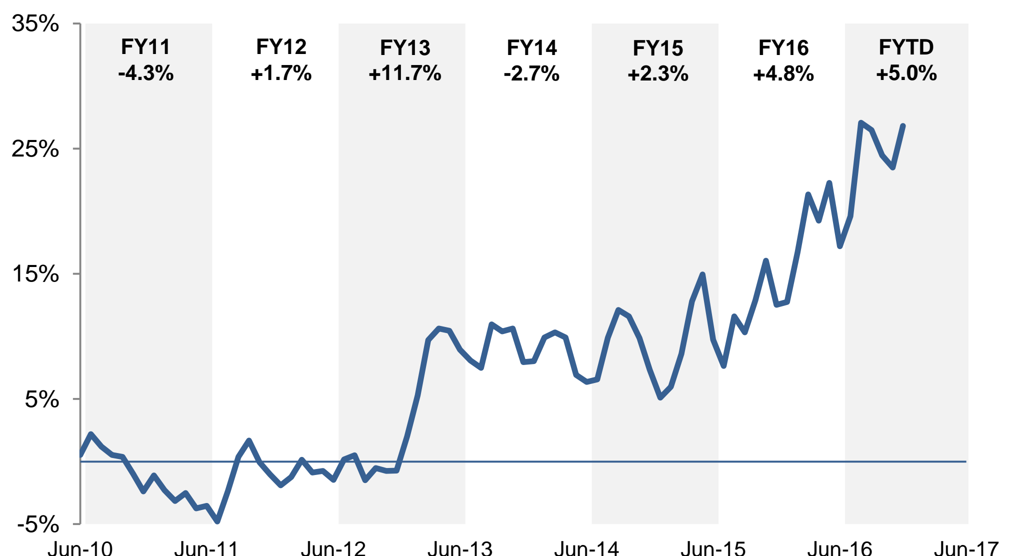
Financial year to date, the Strategy has outperformed by 5.0%. Non-benchmark construction has been a 1.8% headwind with the large cap mining and banking stocks recouping their dramatic underperformance from the prior year. Underlying stock selection has added 7.0% on an equal-weight basis, driven by banks, insurers and domestic industrials, aided by not owning expensive stocks with perceived low volatility or very long dated growth expectations. Not having exposure to mining stocks has been a detractor, although **BlueScope Steel** and **Origin Energy** have benefitted from Chinese steel capacity cuts and oil prices respectively.

Longer-term Strategy outperformance is in-line with our 3-5% per annum target in what has been a difficult environment for many value investors

On a five year rolling basis, the Strategy has outperformed by 4% per annum, with underlying stock selection of 3.5% supplemented by a non-benchmark construction tailwind of 0.5%. This supports our view there should not be any material deviation between the cap weighted and equal weighted index performance over longer time periods.

Performance contributors over this period have been broad-based, with **Macquarie Bank** and **Tabcorp** both doubling while held and subsequently sold, avoiding **National Australia Bank** and investing in **Harvey Norman**, **Pacific Brands** and the general insurers, **Suncorp** and **IAG**. Key detractors over this time frame include **Seven West Media**, **Woolworths**, and **WorleyParsons**. At a sector level, owning minimal mining and energy stocks was the most notable contributor.

Figure 10: Cumulative excess returns since inception



Portfolio Analytics[ii]

	Fund	ASX200		Fund	ASX200
Trailing Free Cash Flow Yield	5.4%	4.5%	Number of Equity Positions	28	201
EV / EBITDA	9.5x	12.4x	Active Share	74%	0%
Price / Earnings Ratio	15.0x	16.8x	Valuation Upside	18%	-10%
Price / Book Ratio	2.8x	3.0x	Tracking Error	5.1%	-

About Merlon

Merlon Capital Partners is an Australian based fund manager established in May 2010. The business is majority owned by its five principals, with strategic partner Fidante Partners Limited providing business and operational support.

Merlon's **investment philosophy** is based on:

Value: We believe that stocks trading below fair value will outperform through time. We measure value by sustainable free cash flow yield. We view franking credits similarly to cash and takes a medium to long term view.

Markets are mostly efficient: We focus on understanding why cheap stocks are cheap, to be a good investment market concerns need to be priced in or invalid. We incorporate these aspects with a "conviction score"

Footnotes

[i] **Performance (%)**

Past performance is not a reliable indicator of future performance.

Fund inception date for performance calculations is 31 May 2010.

Portfolio Total Return and S&P/ASX200 Accumulation Index Total Return stated before fees and grossed up for franking credits.

For the purposes of measuring total return, franking credits are calculated as franking credits accrued divided by the average daily NAV for the portfolio and benchmark.

[ii] **Portfolio Analytics**

Valuation upside based on Merlon estimates of sustainable free cash flow & franking credits.

Price earnings ratio based on Bloomberg consensus estimates over next 2 financial years, annualised & time weighted.

EPS growth based on annualised growth between last reported fiscal year and Bloomberg consensus EPS in 3 years' time.

Ex Ante Tracking Error calculated excluding hedging overlay using 60 month volatility and correlation data.

Disclaimer

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