Merlon Concentrated Value Strategy

Quarterly Report

March 2017

Contents

Some thoughts on Australian house prices 3

The case for Fairfax Media over REA Group 11

Market Outlook 16

Portfolio Positioning 17

March Quarter Portfolio Activity 20

March Quarter Market Review 21

Portfolio Performance Review 21

Analyst:
Hamish Carlisle

Some Thoughts on Australian House Prices

The state of the housing market remains a key consideration for any Australian equity investor. There is a constant flow of speculation as to the outlook for residential property ranging from predictions of a catastrophic collapse through to justifications for ever increasing house prices. In addition there is heated political debate about housing affordability and the future of tax benefits provided to owners of investment properties.

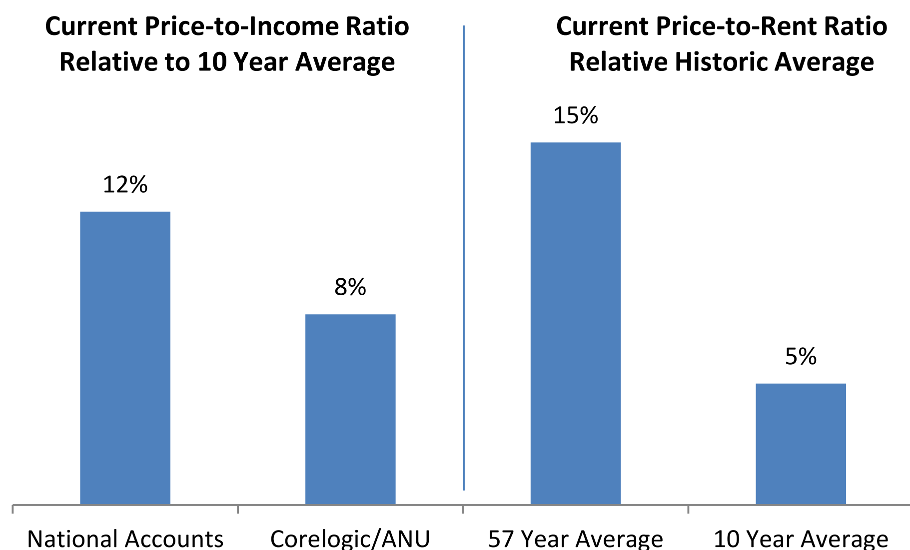
The listed banks are justifiably at the pointy end of this issue partly because the majority of their lending is secured by residential property and partly because their own lending standards play a role in driving demand for housing assets. Beyond the banks, changes in house prices can impact consumer spending, dwelling investment and small business investment. So any major correction would be a problem for the broader economy.

It seems conventional wisdom that the housing market in Australia is currently at a cyclical high point. House prices, housing finance activity and building approvals are all at historically elevated levels. At the same time, interest rates are at record lows and have begun to increase, particularly for investors.

In this paper, we consider house prices in Australia within a long term context and within the context of the Australian tax system that favours owner occupied housing over all other asset classes. On balance, we think the housing market is 5-15% overvalued relative to "mid-cycle" levels. Contrary to recent commentary, we do not find this over-valuation to be concentrated in the Sydney market.

Dwelling valuations are 5-15% above historic averages…

Figure 1: Current Dwelling Valuations Relative to Historic Averages



Source: National Accounts; Treasury

We don't find modest system wide "overvaluation" to be particularly surprising at the current point in the economic cycle and note that we are a long way off what we consider to be "mid-cycle" interest rates. Rising interest rates - as we are currently experiencing - are likely

…but this is unsurprising given currently low interest rates

We think regulator concerns are overblown…

…and will encourage unregulated lenders to enter the market.

to be a precursor to a turn in the cycle so it is likely we will enter into a phase of more subdued house price inflation.

That said, favourable tax treatment of housing coupled with historically low interest rates and favourable fundamentals (income and rental growth) mean we have low conviction that house prices will retrace to "mid-cycle" levels in the foreseeable future.

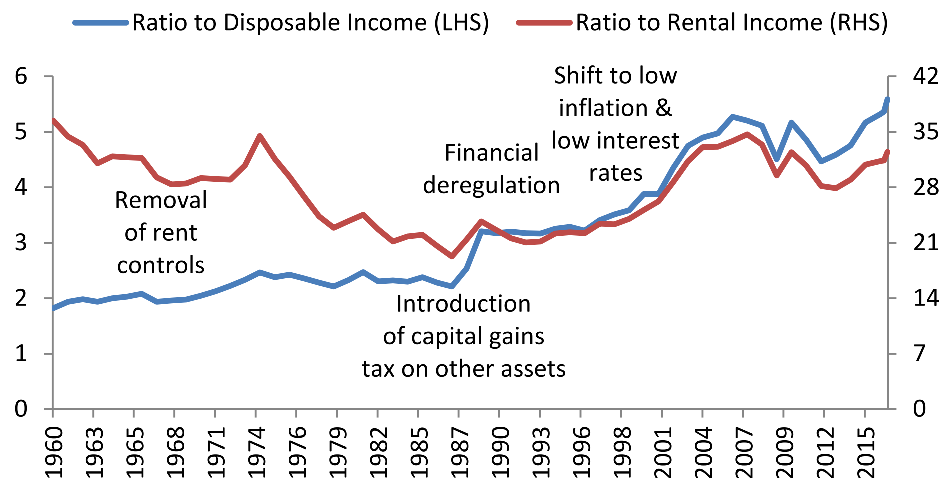
It follows that we think regulator concerns about house prices are overblown. Regulations that have forced banks to ration lending are probably unnecessary and will achieve little other than improving short term bank profitability through higher interest rates for borrowers. In the long term, the Reserve Bank of Australia (RBA) will take bank pricing decisions into account when setting official rates and unregulated lenders will emerge if market fundamentals remain sound.

We continue to hold banks in our portfolios although have no exposure to companies benefitting from unsustainably high residential development profits.

House Price Valuation Metrics

Within the context of Merlon's investment philosophy, it's not just the direction of economic indicators that matter but also the starting point. First and foremost we are value investors and we value companies on the basis of sustainable conditions. So the question must be asked – are current house prices in Australia sustainable?

Figure 2: Average Dwelling Asset Values, 1960-2016



Source: National Accounts; Treasury

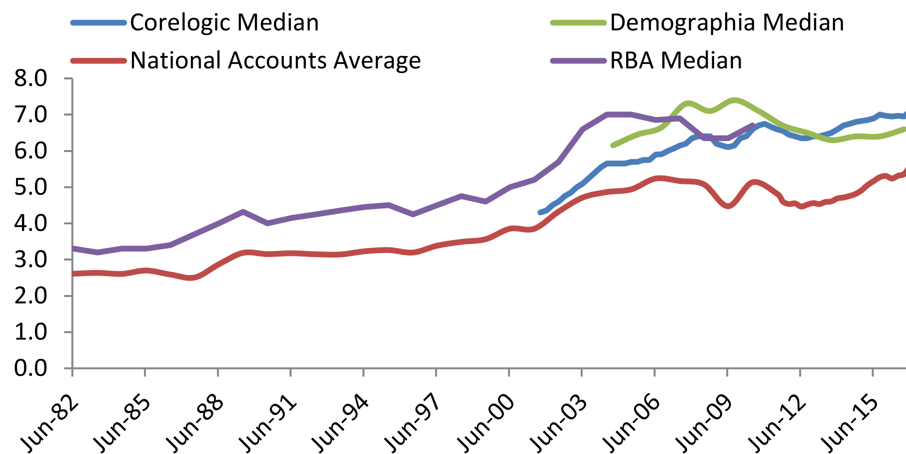
Price-to-income ratios

A popular approach to answering this question is to compare current house price-to-income ratios to historic averages. During the 1960s the ratio was around 2 times. During the 1970s, the ratio increased to approximately 2.5 times. This coincided with the unwind of rent controls which existed in full or part from 1939 until the mid-1960s. Indeed, price-to-rent ratios during this period were historically high.

Subsequent expansion in the price-to-income ratio has widely been attributed to deregulation of the financial sector during the 1980s and the shift to a low inflation and low interest rate environment during the 1990s. It is also worth noting that capital gains tax was introduced in Australia in 1985 and applied to assets other than the family home. This change arguably increased the attractiveness of owner occupied housing over other types of investments.

The evolution of the average price-to-income-ratio from the National Accounts (depicted above) is consistent with other commonly reported calculations based on median prices and median incomes. This is illustrated in Figure 3. The difference in the absolute level of the series is due mainly by the inclusion of certain non-cash income items in the National Accounts not captured in surveys conducted by the Australian Bureau of Statistics (ABS).

Figure 3: Dwelling Price-to-Income Ratios



Source: Corelogic Housing Affordability Report (December 2016); 13th Annual Demographia International Housing Affordability Survey (2016: 3rd Quarter); National Accounts; Treasury; Fox & Finlay, Dwelling Prices and Household Income, RBA Bulletin, December 2012

It's inappropriate to compare current price-to-income ratios to very long term averages…

…but the ratio has been more stable over the last 10-15 years.

Given the sustained upward trend in price-to-income ratios since the 1960s and associated structural changes to the market, we don't think it's appropriate to compare current ratios to very long term averages. However, it is interesting to note that price-to-income ratios have fluctuated within a tighter band over the last 10-15 years. Along these lines, we note that price-to-income ratios are currently between 8% and 10% higher than 10 year averages depending on whether we utilise average or median data series.

Price-to-rent ratios

Consistent with our investment philosophy, we believe the only way to value assets is based on the cash flows they deliver to their owners. For residential property, this cash flow is roughly proportionate to rental income (or rental savings in the case of owner occupiers). It follows that we think the price-to-rent ratio is a better indicator of fundamental value in the housing market than the price-to-income ratio.

The price-to-rent ratio is like the price-to-earnings ratio in the stock market…

…and is about 15% higher than the average over the last 57 years.

Rents have a history of consistently growing above inflation…

…which means this gap could easily close within a 5 year timeframe without house prices falling.

As illustrated in Figure 2 using data from the National Accounts and Treasury papers we also constructed a longer term time series of the price-to-rent ratio. The data we utilised includes the aggregate imputed and actual rent for all dwellings in Australia.

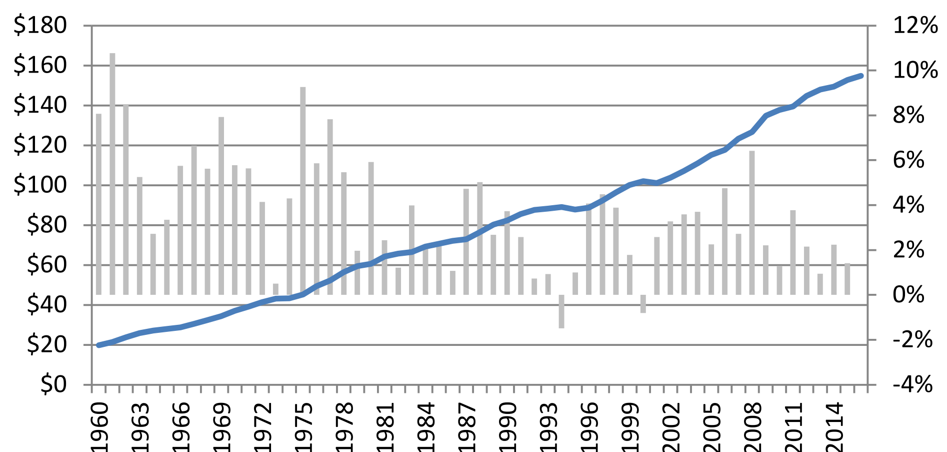
The analogy to the stock market is straight forward: the price-to-rent ratio in the housing market is like the price-to-earnings (P/E) ratio in the stock market. By this standard, the value of dwelling assets is approximately 15% above the 57 year average and 5% above the 10 year average.

Interestingly, what can also be seen in Figure 1 is that - relative to rents - house prices bottomed out in 1987. Coincidentally this is the first year for which Australian Bureau of Statistics house price data is readily available and has thereby become the anchor point for popular analysis.

Of course when valuing companies, we look very closely at the sustainability of cash flow. If earnings and cash flow are cyclically inflated the multiples we're prepared to pay are lower. Similarly, it's worth considering whether dwelling rents are sustainable at current levels. A collapse in rents would significantly undermine any assessment of value.

Dwelling rents are notably resilient to the economic cycle and have shown a remarkable tendency to grow above inflation over a long period of time. There are a variety of reasons why this might have been the case, most obvious of which is that over time productivity gains allow wages to grow faster than inflation and housing quality/location has consistently ranked high in consumer preferences. As households' basic needs are met (after all, how many flat screen TVs we need?), households have shown a willingness to allocate an increasing proportion of their income to their homes.

Figure 4: Rent per Head of Population (2016 Dollars, LHS) & Annual Growth (RHS)



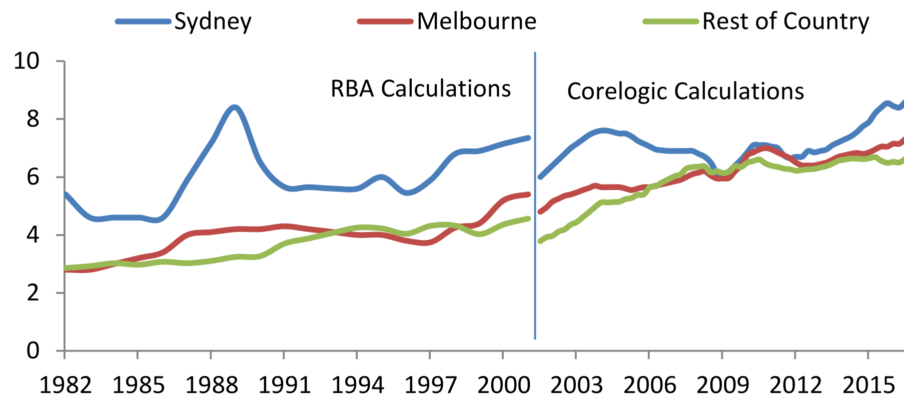
Source: ABS; Rental income includes imputed rent for owner-occupiers

Regional Comparisons

Recently rapid inflation in the Sydney market represents "catch-up" following a period of underperformance …

Our analysis to this point has focused on national level statistics. It is also worth comparing valuations across various regions. This has been topical of late with Demographia.com finding Sydney to be the fourth most expensive city in the world at a price-to-income ratio of 12.2x. Median dwelling price-to-income ratios are presented in Figure 5.

Figure 5: Median Dwelling Price-to-Income Ratios



Source: Corelogic Housing Affordability Report (December 2016); Fox & Finlay, Dwelling Prices and Household Income, RBA Bulletin, December 2012

The key takeaway here is that Sydney and Melbourne have historically traded at a premium to the rest of the country. Although Sydney has experienced more rapid price inflation recently, this is arguably catch up following a period of underperformance between 2004 and 2010. The "Sydney premium" is currently broadly in line with historic averages.

…and the price-to-income ratio is much lower than some commentators suggest

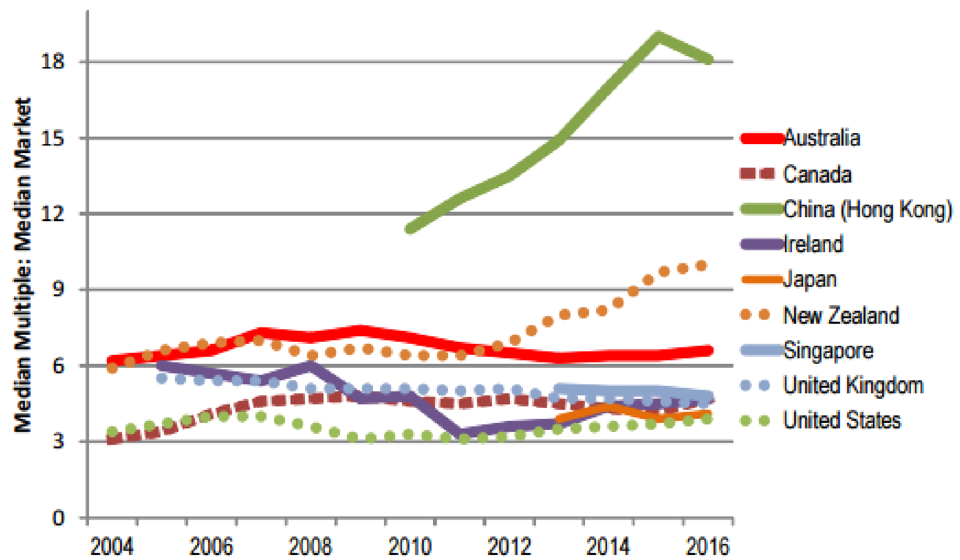
Interestingly, the price-to-income ratio for Sydney calculated by Corelogic – arguably the most comprehensive property information source in Australia – of 8.4x is significantly lower than the headline grabbing 12.2x publicised by Demographia. This largely reflects the median *dwelling* price of $785k utilised by Corelogic compared to the $1,077k median *house* price utilised by Demographia. It is likely, in our view, that median incomes are higher for house owners compared to apartment owners and therefore likely that the Demographia calculation is overinflated.

International Comparisons

Another popular approach to assessing house prices has been to compare different geographies. Similar to longitudinal studies these types of headline grabbing analyses usually raise more questions than answers. Differences in tax systems, wealth and household preferences are some of the reasons why comparisons across countries should be treated with caution.

International comparisons should be viewed with caution…

Figure 6: Housing Affordability According to Demographia (2004-2016)



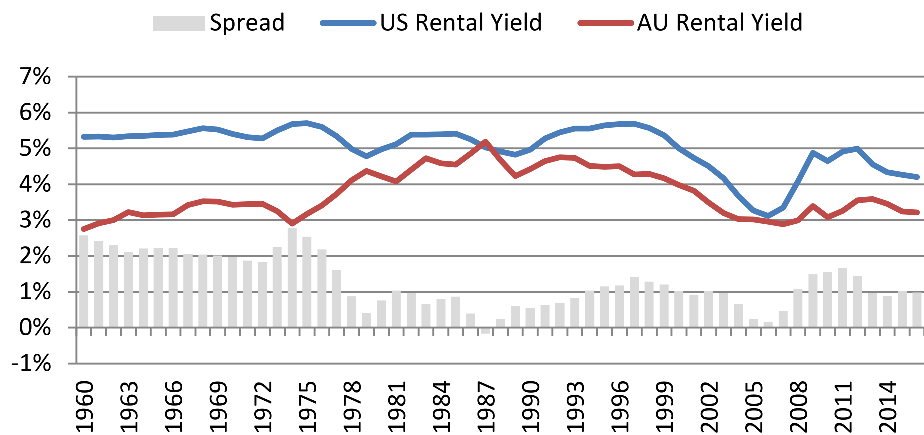
Source: 13th Annual Demographia International Housing Affordability Survey (2016: 3rd Quarter)

This has led many such comparisons to focus on "English Speaking Countries" where (arguably) wealth and household preferences are more closely aligned. Even here though there are major structural differences. For example, in the United States interest on mortgages is tax deductable, land taxes are levied on property owners while at the same time states and cities can levy income tax on their residents. All of these factors have the capacity to greatly distort headline comparisons.

Having said all that, in the chart below compares a commonly quoted rental yield index for US dwellings with the rental yields imputed for Australia. The obvious point to make is that while Australian property does indeed look expensive relative to the United States, this has been the case for many years.

MERLON CAPITAL PARTNERS

Figure 7: Comparison of Residential Property Rental Yields, 1960-2016



Source: Australia: National Accounts; Treasury; Rental income includes imputed rent for owner-occupiers; US: Case Schiller 20 City Composite

Tax Advantages

It is owner-occupiers rather than investors that enjoy tax breaks…

There has been much debate about the impact of the tax system on property values in Australia. Oddly enough, the perception seems to be that negative gearing is a tax break for investment property owners and has served to inflate property values. In fact, the tax and welfare system in Australia is enormously favourable to owner occupiers when compared to investors.

Each year The Treasury publish a "Tax Expenditure Statement" which estimates the cost to taxpayers of situations where the "actual tax treatment of an activity differs from the benchmark tax treatment".

No Capital Gains Tax

This Tax Expenditure Statement highlights that the single largest tax exemption offered by the Australian federal government relates to the capital gains tax exemption on owner occupied housing. If capital gains on owner occupied housing were subject to the same treatment as capital gains on other assets (including investment property) the government would be better off to the tune of approximately $30 billion per annum.

The approach to capital gains tax is not unique to Australia although it is worth noting that many countries (including the United States) have caps on the amount of capital gains income from primary residencies that can be treated as tax exempt.

No Tax on Imputed Rent

The Tax Expenditure Statement also notes that imputed rent from owner occupied housing is not included in taxable income. Similarly, expenditure incurred in earning imputed rent is not deductable. Interestingly, The Treasury do not include this favourable treatment as a gift to owner-occupiers despite acknowledging that it departs from the "Schanz-Haig Simons definition of income".

Owner occupier tax breaks total approximately $50 billion per year…

Estimating the size of this tax break is complex and requires assumptions about the distribution of marginal tax rates amongst homeowners and borrowers. Having said that, using data from the Australian Bureau of Statistics Survey of Income and Housing, we estimate that taxing owner occupiers on imputed rent and allowing deductions on housing related expenses would raise $15 to $20 billion per annum in net taxes.

A popular approach to capturing this revenue in other countries is simply to levy land tax on owner occupied property. Indeed, the introduction of land taxes was a recommendation of the Henry Tax System Review commissioned by the Rudd Government in 2008 as was allowing tax deductions on mortgage debt for owner occupiers and introducing capital gains tax.

Table 1: Tax Breaks Afforded to Owner-Occupied Housing in Australia

Benefit Provided	Annual Cost to Government
No capital gains tax on primary residence	$30b
No tax on imputed rent, net of deductions	$15b
Exclusion of home in pension asset test	$7b
Total	$52b

Source: ABS; Rental income includes imputed rent for owner-occupiers

Primary Residence Excluded Assets When Testing for Pension Eligibility

A further feature of the Australian housing market is that owner occupied properties are excluded from the “asset test” when assessing eligibility for aged pensions. The Grattan Institute – a public policy “think tank” – estimate that including owner owner-occupied housing in the pension assets test could improve the Commonwealth’s budget position by about $7 billion a year.

No surprise, this was also a recommendation of the Henry Tax Review.

Concluding Remarks

It is easy to forget that 75 percent of the dwelling assets in Australia are unencumbered by mortgage debt. For the fortunate owner occupiers falling into this category, the imputed rents on these property assets are tax free and for all owners in aggregate virtually certain to grow at a rate above the Consumer Price Index over the long term.

The limited prospect of owners of dwellings foregoing a largely tax free and growing income stream in favour of the currently pitiful and taxable interest on bank deposits mean we have low conviction that house prices will retrace to its historical average levels while interest rates remain below long term average levels.

We think the risk of catastrophic collapse in the housing market is low…

As with all our investing, we work on the basis that, over time, interest rates will revert back to long term levels as will aggregate housing valuation metrics. Against this, we think aggregate rents and household incomes will continue to grow which will cushion the overall impact on dwelling prices and that the exposure of the household sector to higher interest rates means that the time frame over which interest rates will rise could be quite protracted. As such, we think the risk of a catastrophic collapse in the housing market is low.

MERLON CAPITAL PARTNERS

Analyst:
Hamish Carlisle

Value vs Glamour:

The Case for Fairfax Media Over REA Group

Frost and Sullivan, a market research firm, estimate that Australians spend between $1.1 and $1.3 billion each year on real estate classified advertising, of which approximately two thirds is spent online. This is a small cost relative to the price of a house as well as agent commissions and stamp duty. In addition, companies such as banks and utility companies spend money to display their brands and products on real estate websites. As most readers would be aware, realestate.com.au and domain.com.au represent the majority of this market with approximately 60% and 30% market share respectively.

In the table below we present key financial information and valuation metrics for the two businesses. As value investors, perhaps the most interesting point to note is that he market is valuing realestate.com.au on a revenue multiple almost double that of domain.com.au.

Realestate.com.au trades on around the revenue multiple of domain.com.au

Table 2: Key Financial & Valuation Metrics

12 Months to Dec-16	Realestate.com.au	Domain.com.au
Online revenue	$634m	$210m
Print revenue	Small	$95m
Total revenue	**$634m**	**$305m**
Deduct: Operating expenses	-$272m	-$194m
EBITDA[1]	**$362m**	**$112m**
Market Capitalisation[2]	$7.5b	$2.2b
Add: Debt	$0.1b	$0.1b
Deduct: Other businesses[3]	($0.4b)	($0.4b)
Implied Valuation	**$ 7.3b**	**$2.0b**
Implied Revenue Multiple	**11x**	**6x**
Implied EBITDA[1] Multiple	**20x**	**18x**

Source: Company announcements
[1] EBITDA = Earnings before interest, tax, depreciation & amortisation
[2] Market capitalisation based on REA share price of $56.88 and FXJ share price of $0.97
[3] Valuation of other businesses detailed in appendix

Reasons to be Cautious

A key tenant of Merlon's investment philosophy is that markets are mostly efficient and that cheap stocks are always cheap for a reason. We are focused on understanding why cheap stocks are cheap. To be a good investment, market concerns need to be priced in or deemed invalid. We incorporate these aspects with a "conviction score" that feeds into our portfolio construction framework.

In the case of Domain.com.au, there are many reasons for caution:

1. ***Domain.com.au has material exposure to the print advertising market***. Excluding this revenue from the above calculations would bring the implied revenue multiple up to 9x, a more modest discount to realestate.com.au;

MERLON CAPITAL PARTNERS

But it's a more difficult story to sell…

2. ***Domain.com.au's market position is inferior to realestate.com.au*** generating half the revenues and (according to REA Group) half the number of site visits;
3. ***Domain.com.au is less profitable*** than realestate.com.au generating an EBITDA margin of 37% during the period compared to Realestate.com.au's margin of 57%. Adjusting for this difference by focusing on earnings multiples rather than the revenue multiples again yields a much more modest valuation discount;
4. ***Domain.com.au's digital revenues are growing more slowly*** than realestate.com.au posting digital growth of 16% relative to the prior year compared to the 22% growth delivered by realestate.com.au. If this growth differential persists it would justify a lower multiple for domain.com.au; *and,*
5. ***Domain.com.au has an equity sharing model*** with real estate agents that is not accounted for in "advertised" earnings but rather treated as a "minority interest". This is immaterial at present but could become meaningful as the business grows.

Taking these arguments - along with the fact that Fairfax Media's traditional print businesses are in rapid decline and could be worth less than zero - it is easy to write-off Fairfax Media and certainly easier for professional fund managers to justify holdings in REA Group to their clients. But long term investing is not a popularity contest.

The Pitfalls of Chasing the Latest Growth Story

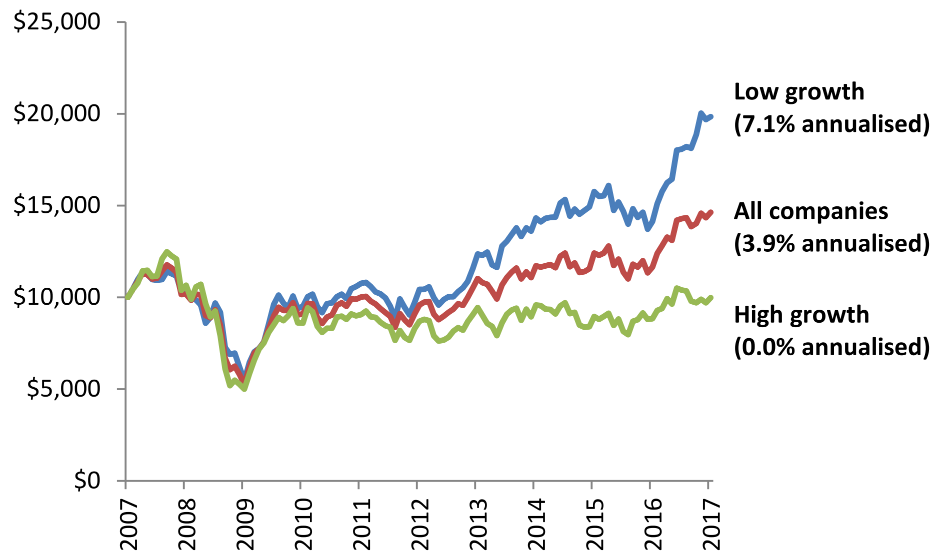
To illustrate why we think chasing the latest fads is generally a bad idea, we went back 10 years and sorted all ASX200 constituents according to their sales growth over the preceding five years. We placed higher weight on more recent sales to reflect investors' tendency to put more weight on short term results and divided sales by the number of shares on issue to adjust for companies that had grown revenues through acquisitions or heavy investment.

From this sorted list we created three portfolios representing companies ranking in the top third, middle third and bottom third for prior growth in sales. We rebalanced these portfolios on a monthly basis, adjusting index constituents and updating the sales growth calculations each time companies reported.

MERLON CAPITAL PARTNERS

Low growth companies have historically outperformed high growth companies…

Figure 8: Value of $10,000 Invested in ASX200 Constituents, Feb-2007 to Feb 2017



Source: Merlon Capital Partners. Portfolios are formed at the end of each month by sorting on growth in sales per share) over the prior 5 years weighted towards most recent year then computing equally-weighted returns for the following month. Raw data is from Bloomberg.

The results highlight that systematically purchasing stocks with deteriorating sales growth would have outperformed the market by around 3 percentage points per annum over the last decade and outperformed stocks with accelerating sales growth by around 7 percentage points per annum. These stocks are often the most difficult to justify to clients and marketing departments. It is for this reason that we believe this anomaly is likely to persist.

Mitigating Factors

There is no doubt that Fairfax Media falls into the low growth basket of companies that, statistically, suggests that the market may have become too pessimistic. Through our own research, we have formed the following opinions that mitigate many of the concerns raised earlier:

And there are reasons to be positive about the outlook for domain.com.au…

1. ***Domain.com.au operates under an umbrella of a good industry structure*** (i.e. an oligopoly) and REA Group is a rational competitor. Both players have more to gain from growing the market than shrinking industry profits;
2. ***Real estate classifieds are different to jobs and cars*** and can support two players. Alan Kohler – a journalist and media entrepreneur – summed this up nicely: “Because houses are expensive, the marketing budget for selling them is much larger than it is for cars or jobs, which means there is easily enough money to advertise on two websites. Simple as that.”
3. ***Domain.com.au’s competitive position is improving*** evidenced by its rising share of listings (currently around 90% of the market), growing site visits (particularly in mobile) and support from the real estate agent community who are fearful of

MERLON CAPITAL PARTNERS

realestate.com.au's dominant market position. These outcomes reflect ongoing management focus and investment in the business.

Our long term view is that domain.com.au will sustain and possibly improve its market position. That said, we think that realestate.com.au's superior scale probably means the business will continue to enjoy a margin premium.

Valuation Scenarios – Preparing for the Worst

From a valuation perspective we assess Fairfax and Realestate.com.au under a range of scenarios with a particular focus on potential downside outcomes. This is standard procedure at Merlon with "bull case" and "bear case" valuations prepared and considered for all companies under coverage.

Downside risk scenarios are a critical investment consideration for us…

Downside risk scenarios are another critical consideration in developing a "conviction score" that combines with our free-cash-flow based valuations to determine whether we include a stock in our portfolios.

In the case of Fairfax, our downside scenario incorporates both a loss of market share and a permanently lower margin for domain.com.au when compared to realestate.com.au. This scenario yields a valuation for Fairfax of around 25% below the current share price. Certainly enough to temper our enthusiasm but vastly superior to the circa 50% downside to our bear case scenario for REA Group.

And we think domain.com.au is exposed to less downside valuation risk than realestate.com.au

Table 3: Merlon Valuation Scenarios

	Realestate.com.au		Domain.com.au	
	Base Case	**Bear Case**	**Base Case**	**Bear Case**
Market Size	$1.1b	$1.1b	$1.1b	$1.1b
Market Share	60%	50%	30%	25%
Normalised Revenue	**$660m**	**$550m**	**$330m**	**$275**
EBITDA Margin	60%	50%	50%	40%
Normalised EBITDA	**$396m**	**$275m**	**$165m**	**$110**
Free-cash-flow Based Valuation	**$5.5b**	**$3.7b**	**$2.2b**	**$1.4b**
Implied Revenue Multiple	**8x**	**7x**	**7x**	**5x**
Implied EBITDA Multiple	**14x**	**14x**	**14x**	**13x**
Implied Value per Share	**$44**	**$30**	**$1.10**	**$0.75**
Expected Return	**-23%**	**-47%**	**+13%**	**-23%**

Source: Merlon Capital Partners

MERLON CAPITAL PARTNERS

Concluding Remarks

Fairfax Media is a good style fit for Merlon showing high level value characteristics and falling into a group of lower growth companies that are typically associated with excessive levels of investor pessimism. Conversely, REA Group is expensive but easy for other investors to justify holding because of its market leadership position, absence of traditional print assets and strong growth.

Our detailed review of Fairfax Media has focused on domain.com.au where we believe the industry backdrop is highly supportive and the company's competitive position is both sustainable and improving. We ascribe very little value to Fairfax's traditional print assets.

While there are valuation scenarios that pose some risks to our clients' capital, we view these risks against the backdrop of what we think is an overvalued equity market; an excessively valued peer (REA Group); and, a view that our long term assumptions are more likely to prove conservative than optimistic.

We continue to hold Fairfax Media in our portfolios…

As such, we continue to hold Fairfax Media in our portfolios.

Appendix: Valuation of Other Businesses

Table 4: Fairfax Media – Valuation of Other Businesses

	Low	High
Metro Print	Nil	Nil
Metro Digital	$419m (2x Revenue)	$837m (4x Revenue)
Community Media	Nil	$174m (2x EBITDA)
New Zealand Media	Nil	$108m (2x EBITDA)
Macquarie Media	$114m (8x EBITDA)	$143m (10x EBITDA)
Corporate Expenses	-$647m (14x EBITDA)	-$647m (14x EBITDA)
Stan & other Associates	$67m (Book Value)	$209m (Broker Avg)
Total Value	**-$48m**	**$824m**

Source: Merlon Capital Partners

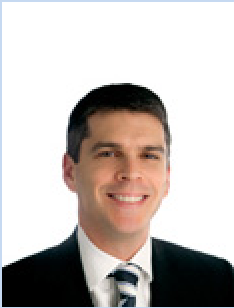
Table 5: REA Group – Valuation of Other Businesses

	Low	High
Move.com	Nil	$291m (carrying value)
Asian Business	$226m (14x EBITDA)	$751 (carrying value)
Corporate expenses	-$262m (14x EBITDA)	-$262m (14x EBITDA)
Total Value	**-$35m**	**$781m**

Source: Merlon Capital Partners

Market Outlook and Portfolio Positioning

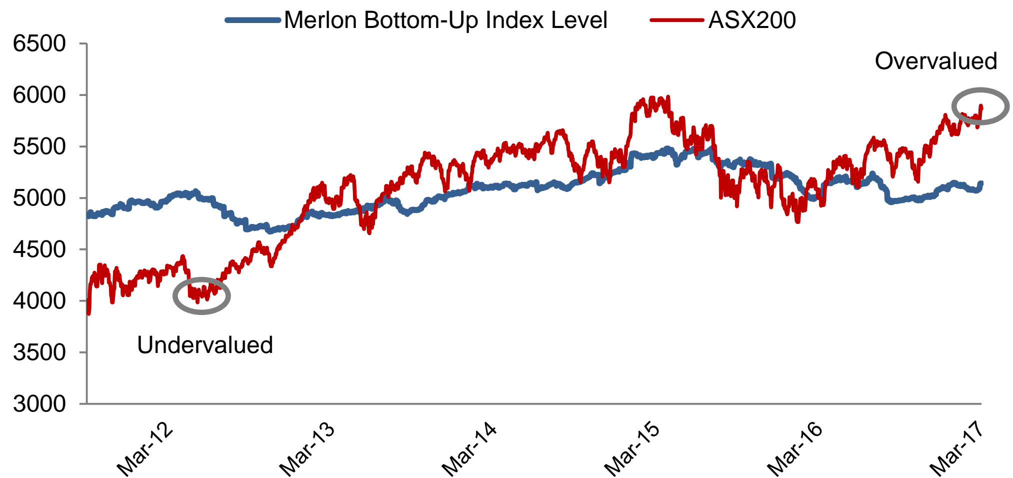
Neil Margolis



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 remains more than 10% overvalued (Figure 9). This is a modest increase in overvaluation from December largely reflecting market movements. There continues to be a wide dispersion across sectors, with resources, healthcare, property and infrastructure overvalued relative to other parts of the market.

Figure 9: Merlon bottom up market valuation vs ASX200 level

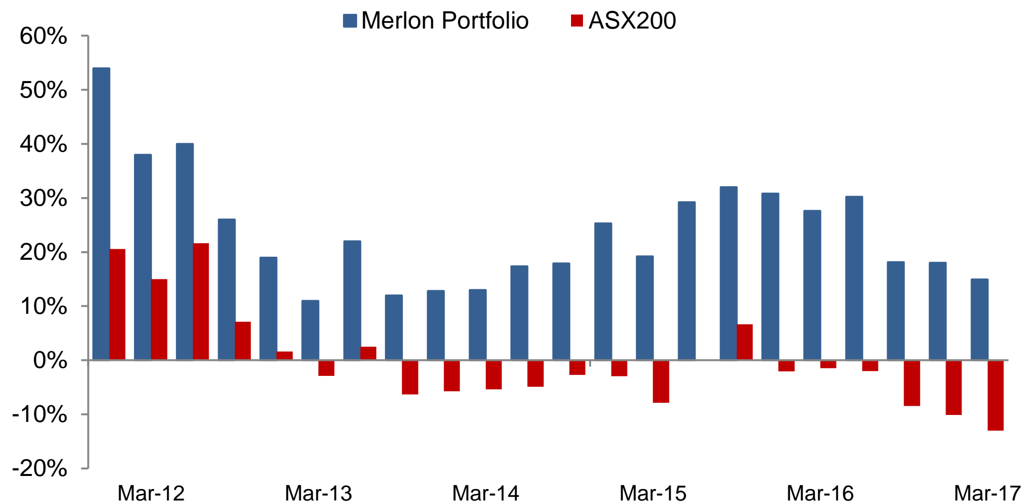


Source: Merlon

However our value portfolio is showing upside in absolute terms and relative to the market

Merlon's value portfolio comprises our best research ideas, based on our long-term valuations and analyst conviction. The portfolio offers 15% absolute upside representing a 28% premium to the market. As seen in Figure 10, the Merlon portfolio is looking increasingly attractive relative to the capitalisation-weighted index.

Figure 10: Expected return based on Merlon valuations



Source: Merlon

MERLON CAPITAL PARTNERS

Record low interest rates have distorted valuations for stocks with perceived low earnings risk

We invest on the basis that, over time, interest rates will revert back to long term levels. This will put pressure on 'defensive yield' and 'bond proxy' names to which the portfolio has relatively little exposure

The United States appears more progressed in the journey towards higher interest rates than Australia with increasingly clear signs of wage pressures and inflation. The Federal Reserve is likely to increase interest rates significantly over the next 12 to 18 months. The divergent path of US and Australian interest rates coupled with our cautious outlook for commodities (Some Thoughts on the Iron Ore Market) lead us to expect depreciation in the Australian dollar. Our positions in **QBE Insurance, Magellan Financial, Origin Energy** and **Boral** will all benefit against this backdrop.

The outlook for the domestic economy is not as dire as many fear

A weaker Australian dollar will provide a necessary offset to housing construction activity and house prices that, at some point, will also revert back to mid-cycle levels. In conjunction with unprecedented strength in household balance sheets driven by recent house price inflation, the potential flex in the currency gives us some comfort that the outlook for the domestic economy, and by implication the discretionary retailers, may not be as dire as many fear. We discuss the current state of Australian house prices in more detail on pages 3 to 11 in this report and continue to hold positions in **JB Hi-Fi** and **Harvey Norman.**

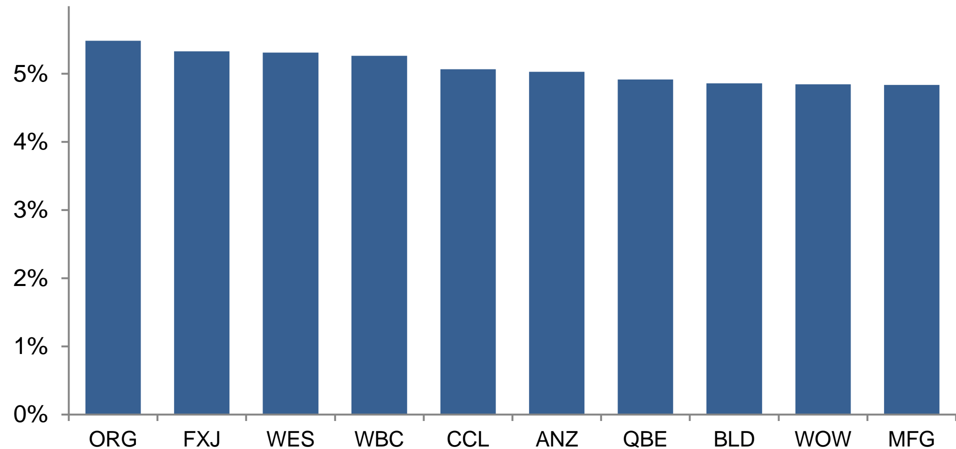
Portfolio Aligned to Value Philosophy and Fundamental Research

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

As we discuss above, there are clearly some macro themes built into the portfolio. However, these are simply outcomes of a strategy to invest in companies that are under-valued relative to the sustainable free cash flow and franking credits they generate for their owners. The markets' continued tendency to extrapolate short-term conditions too far into the future; participants' fear of forecasting a meaningful change in earnings power; and, investors' focus on nonsensical measures of corporate financial performance instead of cash flow continue to present us with opportunities.

The portfolio reflects our best bottom-up fundamental views rather than macro or sector-specific themes. These are usually companies that are under-earning on a three year view, or where cash generation and franking are being under-appreciated by the market.

Figure 11: Top ten holdings (gross weights)

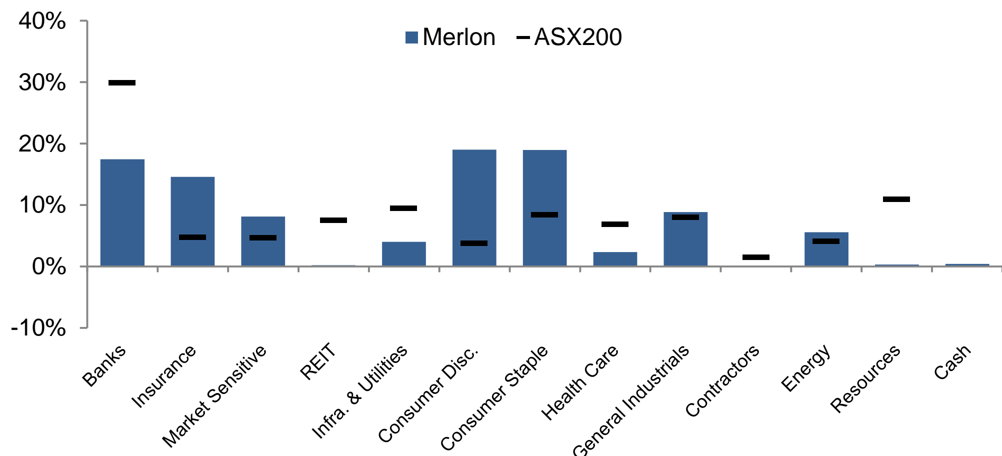


Source: Merlon

The non-benchmark portfolio comprises only undervalued companies where we have conviction around market misperceptions

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. 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. **Coca Cola Amatil**, **Woolworths** and **Wesfarmers** represent good cash generating businesses operating in sound industry structures and 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 two major banks compared to none at the beginning of 2015.

Figure 12: Portfolio exposures by sector (gross weights)



Source: Merlon

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, **Virtus Health**, **Sky TV New Zealand** and **Amaysim**.

March Quarter Portfolio Activity

Our long-term time horizon meant we mostly added to existing positions that had underperformed

During the quarter we introduced one new investment and exited two holdings.

We made an initial investment in **Navitas**, a tertiary education provider focused on pathway programs across 34 colleges worldwide. The company has a market leading position in Australia, recruiting and educating international students that less well known university partners would otherwise struggle to attract. Recent contract losses have shaken investor confidence but underlying international student demand, pricing power and the recruiting and economic sharing model with universities underpins sustainable free cash flow.

We increased our holding in **Wesfarmers** where the market has rapidly shifted from complacency to concern around Coles margins as Woolworths recovers. However we view the industry is rational and growing with share opportunity from independents and in fresh produce, and cost out from range reductions. Bunnings also continues to strengthen its position and high coal prices provide near-term cash-flow to further strengthen the balance sheet.

We invested further in **Clydesdale Bank** which has underperformed on the fallout from Brexit and subsequent calls for a Scottish referendum. The source of valuation upside is less macro dependent however, with large surplus capital relative to the major UK banks and a well progressed cost-out opportunity.

We increased our holding in **Sky Television NZ** after the market reacted negatively to the Commerce Commission's rejection of Sky's proposed merger with Vodafone NZ. While headline subscriber numbers continue to decline, the current valuation is underpinned by cash flows from the stickier sports subscriber base. Also, we were more sceptical than the market as to the sustainability of Vodafone NZ's cash-flows given capital underinvestment.

We increased our holding in **Virtus Health** with the market overly focused on near-term IVF cycle weakness and share loss to the low cost segment. Longer-term we are attracted to the above-GDP volume growth prospects and the positioning of Virtus's full service offer as lower priced competitors inevitably raise prices.

Funded by reduced bank holdings following strong share price gains

We funded these investments by exiting our position in **Bendigo Bank** which increased more than 50% over the past year as hysteria around Homesafe's exposure to property prices subsided and the outlook for share gains and margins improved as majors repriced mortgages and reduced term deposit pricing.

We also exited our position in **National Australia Bank**, with the sector outperforming as investors once again began factoring in unsustainably low bad debts and became less concerned about margin pressure and regulatory capital imposts. We have always factored in long-term sustainable assumptions for these key value drivers and as a result the relative attractiveness of banks has reduced in our process.

MERLON CAPITAL PARTNERS

Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	Inception (p.a.)
Portfolio Return (inc. franking)	3.6	5.3	22.3	23.9	12.2	16.3	13.2
ASX200 Return (inc. franking)	3.5	5.3	17.1	21.9	9.0	12.6	10.5
Excess Return*	**0.0**	**0.0**	**5.3**	**2.0**	**3.1**	**3.7**	**2.6**

* Excess returns may not sum due to rounding

March Quarter Market Review

The market posted a 5.3% return in the March quarter, the third consecutive quarter of returns above five per cent. The Australian Dollar gained 4% on a trade-weighted basis despite continued softness in domestic economic data. Bond yields paused their normalisation towards long-term averages and commodities, with the exception of gold, were flat to down.

Defensive sectors were both the best performing - **Health Care**, **Consumer Staples** and **Utilities** – and worst performing – **Telcos** and **Real Estate Investment Trusts**. **Banks** returned another 7% following last quarter's 14% gain, benefitting from repricing of investor mortgages and declining bad debts. The **Materials** sector lagged as commodity prices stalled. **Consumer Discretionary** stocks were weighed down by news flow of Amazon's looming arrival.

Reporting season was generally positive with broker forecast earnings for the year ahead revised upwards on higher commodity prices for miners, lower bad debts for banks and cost-out programs across the board. Of more relevance, Merlon's estimate of sustainable free cash flow was revised upwards by 1%.

Portfolio Performance Review

Stock selection was broadly neutral in the quarter

The Strategy returned 5.3% for the quarter, slightly outperforming the market's return.

BlueScope Steel was the best performing holding, driven by a strong result and announced buyback, coupled with improving demand expectations in the US and strong regional steel pricing. **Fairfax Media** performed strongly as the market began recognising the value of Domain.com.au which was obscured by temporarily depressed listings data and a declining print business. Both **Wesfarmers** and **Woolworths** outperformed as fears of irrational supermarket pricing behaviour subsided. **Boral** recovered after surprising the market with an expensive US acquisition. Detractors in the quarter included **JB HiFi** and **Harvey Norman** on peak cycle earnings concerns and as news of Amazon's grand entrance gathered steam. **Sky TV New Zealand** underperformed as the proposed merger with Vodafone NZ was knocked back and **Flight Centre** suffered from lower commissions on heavily discounted airfares.

MERLON CAPITAL PARTNERS

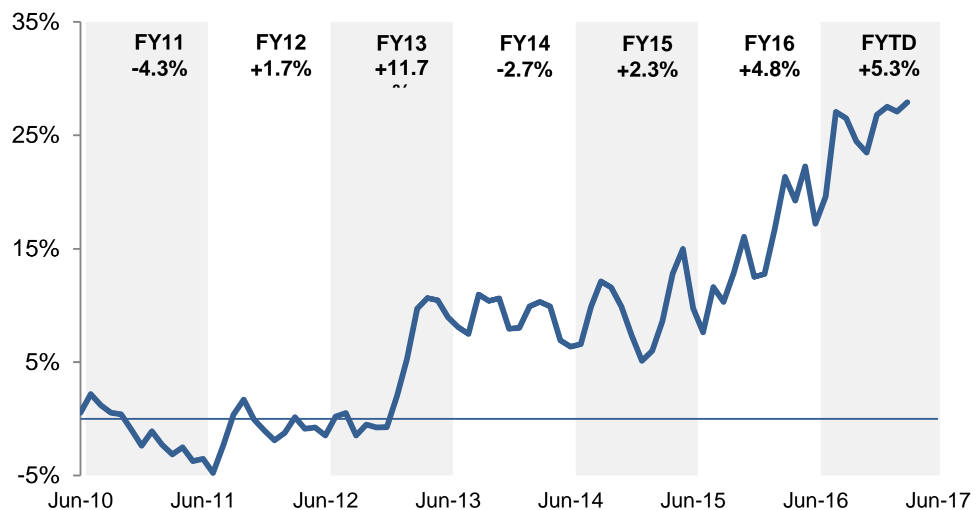
Stock selection outcomes have been very positive this financial year and over longer-term periods, in-line with our 3-5% outperformance target

Financial year to date, the Strategy has performed well, outperforming the market by 5.3%. Non-benchmark construction has been a 2.2% headwind with the large cap mining and banking stocks recouping their dramatic underperformance from the prior year. Underlying stock selection has added 7.5% 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.

On a five year rolling basis, the Strategy has outperformed by 3.7% per annum, with underlying stock selection of 3.9% partly offset by a non-benchmark construction headwind of 0.2%. 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 the long term have been broad-based, with **Macquarie Bank** and **Tabcorp** both doubling while held and subsequently sold, avoiding **National Australia Bank** and **Westpac** (until recently), and investing in **Pacific Brands**. Key detractors over this time frame include **Seven West Media**, **Worley Parsons** and **Primary Healthcare**, as well as not owning **Aristocrat**. At a sector level, owning minimal mining and energy stocks were the most notable contributors.

Figure 13: Cumulative excess returns



Source: Merlon

MERLON CAPITAL PARTNERS

Portfolio Analytics[ii]

	Fund	ASX200		Fund	ASX200
Trailing Free Cash Flow Yield	5.2%	4.2%	Number of Equity Positions	27	200
EV / EBITDA	8.8x	11.6x	Active Share	75%	0%
Price / Earnings Ratio	15.1x	16.9x	Merlon Valuation Upside	15%	-13%
Price / Book Ratio	2.7x	3.3x	Ex Ante Tracking Error	4.3%	-

Strategy FUM	Merlon FUM
$777.3m	$1,282.2m

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.

Strategy 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 using 60 month volatility and correlation data.

Disclaimer

The information contained in this publication has been prepared by Merlon Capital Partners Pty Limited ABN 94 140 833 683 and Fidante Partners Limited ABN 94 002 835 592 AFSL 234 668 (FPL) solely for recipients on the basis that they are a wholesale client within the meaning of the Corporations Act 2001 (Cth). The wholesale client receiving this publication is not permitted to pass it on, or use it for the benefit of, any other person. It should be regarded as general information only rather than advice. Any information provided or conclusions made, whether express or implied, do not take into account the investment objectives, financial situation and particular needs of an investor. Past performance is not a reliable indicator of future performance. Neither Merlon or FPL nor any member of Challenger Limited guarantees the repayment of capital or any particular rate of return.