Merlon Concentrated Value Strategy

Quarterly Report

June 2017

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Value Investing – An Australian Perspective

While the long term returns from "value investing" are strong and well documented, the approach has struggled over the past decade prompting many investors to question its merits.

This paper represents the first of a two part series discussing value investing from an Australian perspective. The paper examines alternative classifications of "value" and concludes that value investing on the basis of free-cash-flow has performed well through a number of market cycles and has displayed low levels of volatility when compared to traditional classifications of value such as earnings, book value and dividends.

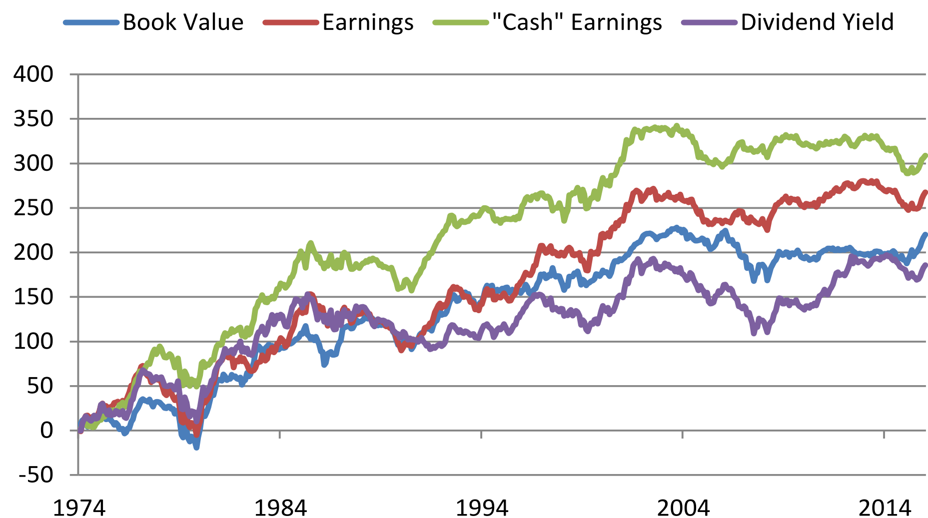
These conclusions support Merlon's investment philosophy which is built around the notion that companies undervalued on the basis of free cash flow and franking will outperform over time.

Value Investing – A Long Term Australian Perspective

The performance of "value stocks" is well documented. The chart below highlights the phenomena within an Australian context using more than four decades of data provided by Professor Kenneth French.

The performance of value strategies is well documented…

Figure 1: Returns - "Value" Portfolios Relative to "Glamour" Portfolios (Australian Data, December 1974 to December 2016)



Source: Professor Kenneth French. Portfolios are formed using four valuation ratios: book-to-market (B/M); earnings-price (E/P); cash earnings to price (CE/P); and dividend yield (D/P). Portfolios are formed at the end of December each year by sorting on one of the four ratios and then computing value-weighted returns for the following 12 months. The "value" portfolios contain firms in the top 30% of a ratio and the "glamour" portfolios contain firms in the bottom 30%. The raw data are from Morgan Stanley Capital International for 1975 to 2006 and from Bloomberg for 2007 to 2016.

Over the 42 year time period for which data is available value portfolios have outperformed glamour portfolios by between 5 and 9 percentage points per annum depending on the way "value" is defined.

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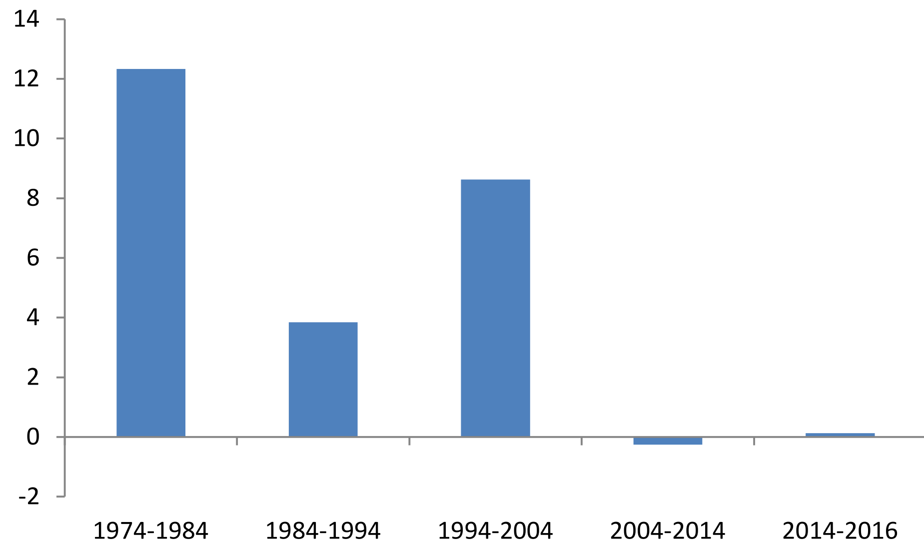
Value Investing in Australia – 15 Years of Poor Performance

One interesting point to note in the data presented above is that returns to value investors in more recent periods has been less than stellar, prompting some commentators to question the merits of the approach.

But returns from value strategies have been poor in more recent times

Figure 2: Average Annual Returns - "Value" Portfolios Relative to "Glamour" Portfolios (Australian Data, December 1974 to December 2016)



Source: Professor Kenneth French. Portfolios are formed using four valuation ratios: book-to-market (B/M); earnings-price (E/P); cash earnings to price (CE/P); and dividend yield (D/P). Portfolios are formed at the end of December each year by sorting on one of the four ratios and then computing value-weighted returns for the following 12 months. The "value" portfolios contain firms in the top 30% of a ratio and the "glamour" portfolios contain firms in the bottom 30%. The raw data for Australian are from Morgan Stanley Capital International for 1975 to 2006 and from Bloomberg for 2007 to 2013. US data is from CRSP. Chart represents average of four portfolios.

Value Investing in Australia – A Crowded Trade

Anecdotally there has been more institutional asset allocation towards value strategies. Many value strategies within Australia have explicitly focused around the traditional classifications used in mainstream academic literature. Perhaps of equal significance is that many commonly deployed "risk models" have measured the extent of a portfolio's value exposure with reference to these mainstream classifications.

It is possible therefore that institutional asset allocation towards simple strategies focused on the four classifications presented above has acted to reduce the excess returns available from pursuing such strategies. The growing prevalence of so called "smart beta" strategies usually focused around fairly simple and observable value classifications will only serve to accentuate this situation.

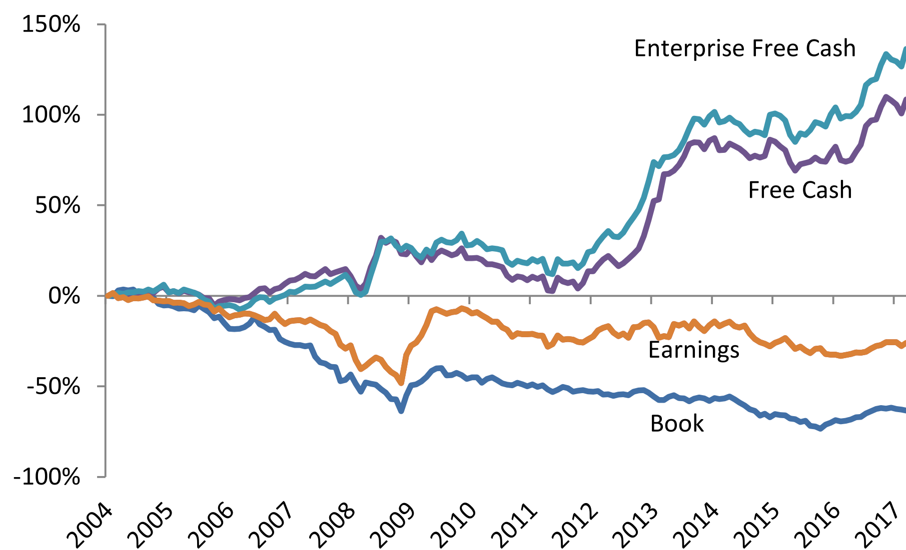
Cash is King

Now more than ever, traditional classifications of value based on accounting earnings and dividends are readily manipulated by management. The recent ramp up in dividend payout ratios and the growing divergence between statutory and "underlying" earnings are examples of this. Of course, this situation is not sustainable but can lead investors to mistakenly classify stocks as "cheap" at particular points in time leading to poor investment outcomes.

A sensible approach to dealing with this issue is to classify stocks based on their capacity to generate cash flow over and above that needed to sustain and grow their businesses ("free-cash-flow"). The use of free-cash-flow rather than accounting earnings or dividends is important because the measure is less readily manipulated by management and less readily observable by investors.

Measures of value based on free cash flow have performed much better…

Figure 3: Returns - "Value" Portfolios Relative to "Glamour" Portfolios (Australian Data, March 2004 to June 2017)



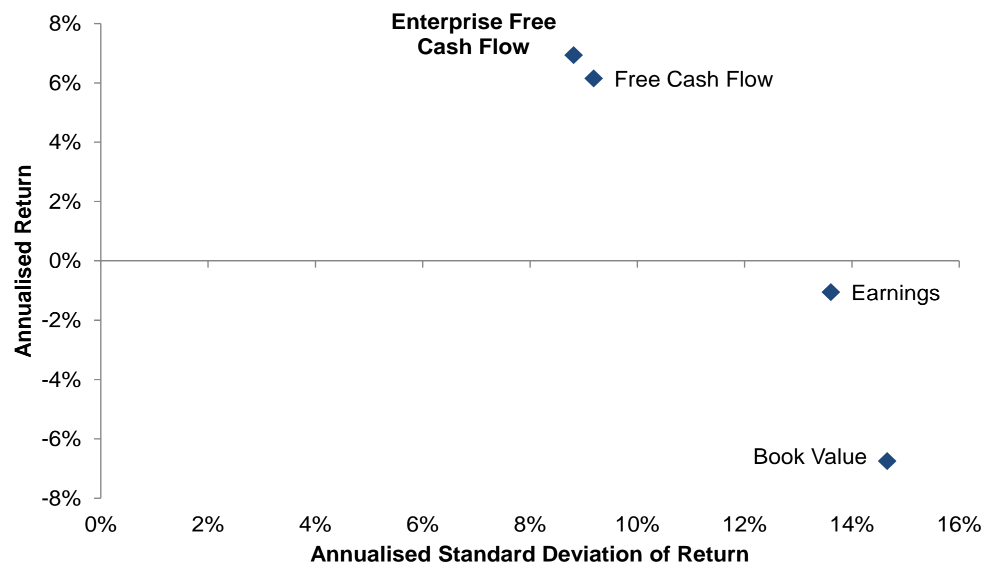
Source: Merlon Capital Partners. Portfolios are formed using four valuation ratios: free-cash-flow-to-price (F/P); enterprise-free-cash-flow-to-enterprise-value (EF/EV); earnings-to-price (E/P) and book value-to-market (B/M). Portfolios are formed at the end of each month by sorting on one of the four ratios and then computing equally-weighted returns for the following month. The "value" portfolios contain firms in the top one third of a ratio and the "glamour" portfolios contain firms in the bottom third. The analysis is based on S&P/ASX200 constituents and the raw data is from Bloomberg.

The performance of a value strategy that classifies stocks based on free-cash-flow is summarised in the chart above and has performed well compared to traditional accounting based alternatives.

Not only have value portfolios classified on the basis of free-cash-flow outperformed portfolios based on traditional accounting based measures but they have also delivered returns with a significantly lower risk profile.

...and with lower levels of risk

Figure 4: Returns & Risk - "Value" Portfolios Relative to "Glamour" Portfolios (Australian Data, March 2004 to June 2017)



Source: Merlon Capital Partners. Portfolios are formed using four valuation ratios: free-cash-flow-to-price (F/P); enterprise-free-cash-flow-to-enterprise-value (EF/EV); earnings-to-price (E/P) and book value-to-market (B/M). Portfolios are formed at the end of each month by sorting on one of the four ratios and then computing equally-weighted returns for the following month. The "value" portfolios contain firms in the top one third of a ratio and the "glamour" portfolios contain firms in the bottom third. The analysis is based on S&P/ASX200 constituents and the raw data is from Bloomberg.

The performance of value investing on the basis of free-cash-flow in an Australian context has been compelling and, in our view, represents a strong foundation for active stock selection. This key finding support Merlon's investment philosophy which is built around the notion that companies undervalued on the basis of free cash flow and franking will outperform over time.

Why do cash flow based value strategies outperform?

A second key tenant of Merlon's investment philosophy is that markets are mostly efficient. We don't believe that value stocks outperform simply because they are "cheap" but rather because there are misperceptions in the market about their risk profiles and their growth outlooks.

We are focused on identifying and understanding potential misperceptions in the market. 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 a second paper to be released next quarter, we will explore the question of why value strategies based on free-cash-flow outperform the broader market. Consistent with our philosophy, we will present findings that dismiss the notion that value investing is "riskier" than passive alternatives and support the presence of persistent behavioural biases in investor expectations.

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Analyst:
Adrian Lemme

Amazon Not Introducing Internet to Australia

Every day it seems the media is reporting how Amazon will destroy Australian retailers.

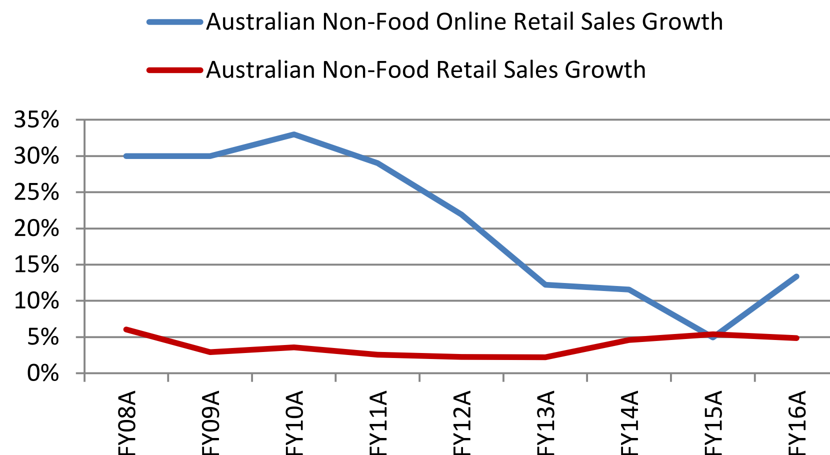
We are under no illusion that Amazon will take market share and reduce the profitability of Australian retailers. It would be foolish to think otherwise given that Amazon grew its North American sales by 25% to US$80b during 2016 and this remarkable growth shows no signs of abating. However, after reviewing key differences between Australia and other markets, we believe the impact of Amazon is being overplayed and continue to see excellent value in the retail sector.

Online retail is maturing

The growth of online retailing in Australia has slowed from around 30% pa up until FY11 to an estimated 13% in FY16 (Figure 5). In recent months this growth has fallen further to 7-8%. We believe the lower growth in recent years has partly been a function of the lower Australian dollar which has reduced the price incentive to purchase from international online retailers. Nevertheless, we expect Amazon's expansion and the associated media coverage will see online sales growth accelerate.

Amazon's expansion will see online sales growth accelerate

Figure 5: Growth in Online Retail Sales (Non-Food) vs Retail Sales (Non-Food)



Source: ABS, NAB, Merlon

Amazon's Australian entry

It must be recognised that Amazon already has a market presence in Australia through the amazon.com.au site (Kindle) as well as export sales. While not disclosed, market estimates put Amazon's sales in Australia at between $500 and $700 million. This obviously provides a good launching pad but also means at least initially that sales in Australia will somewhat cannibalise their current sales.

Amazon's decision to expand in Australia at this time is closely linked to the upcoming introduction of GST for low value imports. Former Amazon executives have told us that

until now Australia was considered to have been well serviced by Amazon's other sites. With the change to the GST threshold, Amazon has lost an important competitive advantage and has therefore taken the view that it needs to establish a local presence to defend and grow its sales here.

Amazon 'Prime' will be aggressively marketed following launch

Amazon is likely to start with Fulfilment Centres in Brisbane, Sydney and Melbourne. Amazon Prime (as discussed later) will likely commence within two years of entry as per the Mexico experience. Amazon 'Prime' memberships will be aggressively marketed following launch by heavily discounting the first year's annual fee as was done in Italy.

Amazon's competitive advantage and impact on industry structure

Our investment process places significant emphasis on industry structure and competitive advantage

In assessing the impact of Amazon on the Australian retail sector, we draw on our investment process which places significant emphasis on industry structure and competitive advantage. We believe that high returns on capital and hence free cash generation can only be sustained through a combination of favourable industry structure and strong competitive positioning. Through our qualitative scorecard, we explicitly consider Amazon's impact on industry structure and the competitive advantages enjoyed by the listed retailers.

Amazon will facilitate entry for niche retailers

Amazon will impact the ***industry structure*** of Australian retailing by reducing barriers to entry for niche retailers through its third party marketplace. The bargaining power of customers will also increase with increasing price transparency and product choice. On the other hand, it is reasonable to expect further industry consolidation as existing online operators become marginalised and weaker physical retailers exit.

Amazon also clearly possesses ***competitive advantage*** across cost, product differentiation and service.

Amazon has a cost advantage relative to traditional stores

Amazon has a ***cost advantage*** by avoiding retail rents and store labour, both of which are high in Australia by global standards. Through its wide range and Amazon Prime, Amazon can fractionalise delivery costs relative to mono-line retailers.

Importantly, we do not believe Amazon will have a sustainable advantage sourcing branded products cheaper than large domestic retailers. Global suppliers will have no choice but to offer equivalent prices to local retailers and domestic warranties will remain important.

Amazon offers an unparalleled range

With regards to ***product differentiation***, no retailer in the world can match Amazon's range. Amazon operates in virtually all retail categories including fresh food and its US site is estimated to have approximately 500 million products for sale. It is able to achieve this principally through the use of its third party Marketplace that greatly enhances the range beyond what Amazon could stock alone.

Amazon's ability to develop ***intimate relationships*** with its customers through bundling its offers and convenient fulfilment is perhaps its greatest source of competitive advantage. Through Amazon Prime, US customers qualify for free two day shipping on orders of at least $25 for an annual fee of $99. Amazon is estimated to have 60 million US households

Amazon has a history of developing intimate relationships with its customers

signed up to Amazon Prime and is rolling out similar services in other markets. This service is made even more attractive by the bundling of the Prime Video streaming service. Additionally, the Amazon Prime Now service enables free two hour delivery on a range of over 25,000 items. Same day delivery will threaten traditional retail profit pools generated from categories such as high margin accessories.

Retailers with large store footprints will need to compete on in-store experience and service, while utilising store networks for instore ordering and shipping to store for 'click and collect'.

There is no doubt that the entry of Amazon will diminish the attractiveness of the retail industry structure in Australia and place pressure on incumbent retailers to cut costs, improve their propositions and strengthen their relationships with customers.

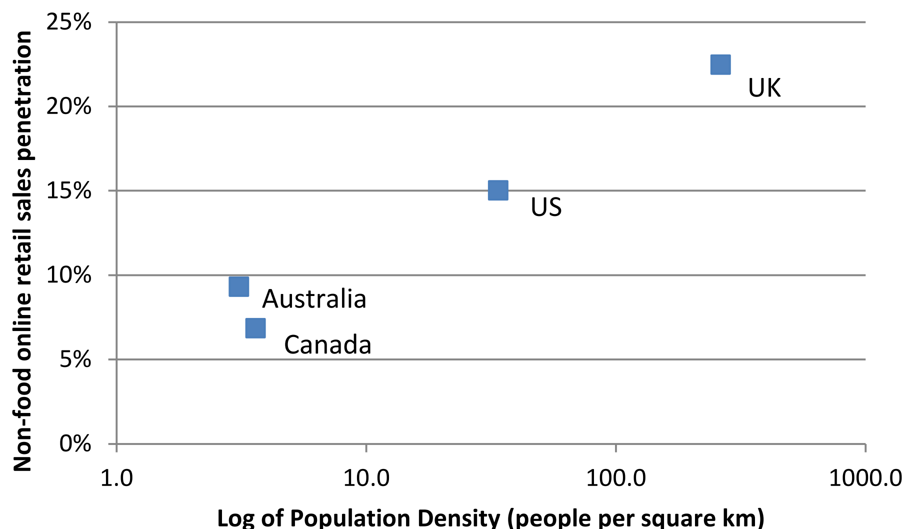
Contrasting the overseas experience with Australia

Amazon has been in the US, UK and Canadian markets for well over a decade. We have therefore studied these markets to gain a better understanding of Amazon's likely impact in Australia.

Australia's low population density may pose a challenge for Amazon

A key observation when comparing these four countries is that the success of not only Amazon, but online retailing in general, is significantly linked to population density (Figure 6).

Figure 6: Non-food online retailer sales penetration vs population density



Source: ABS, NAB, US Census Bureau, UK Office for National Statistics, Statistics Canada, Merlon

As shown by the chart, non-food online retail sales penetration is highest in the UK, which also has the greatest population density. Correspondingly, penetration is lowest in Canada and Australia where density is lowest. Importantly, Canada's official data excludes international online sales. Given Canada's close proximity to the US, it is reasonable to

assume that Canada's penetration including international online purchases is in line or slightly above Australia.

This relationship is perfectly logical given that the more dense an area is, the faster and more cost effective it is to fulfil an online order (since there will be many other orders in the same area).

Sceptics will say that Australia is actually very dense on the east coast. But this is no different to Canada which has similar levels of density in its main cities along the southern border to the US.

Amazon has been less successful in Canada

Linking this back to Amazon, it has clearly struggled in Canada. Amazon entered Canada in 2002, later launching Consumer Electronics in 2008 and remaining categories in 2010. While Amazon does not disclose its Canadian retail sales, we can infer from its segment accounts that it is doing at most US$2b of sales (excluding third parties) out of a total Canadian retail market of US$320b. This pales in comparison to Amazon's US retail sales of approximately US$78b. Even adjusting for lower population, Amazon has not been nearly as successful in Canada as it has been in the US and has admitted as such.

US sales tax arbitrage helped in the early years

Sales tax is an important feature of Amazon's US experience that will not be replicated in Australia. For many years, Amazon enjoyed an enormous free kick because it was not required to collect state and local sales taxes in states where it did not have a physical presence (for example, a fulfilment centre). For example, in 2011 it only levied these taxes on sales from five states. This gave it a distinct price advantage over its store based competitors where state and local government taxes can quickly add 7-10%. Today, Amazon collects sales tax in all 45 states with a sales tax regime but this was mostly addressed only this year. At this point it's a non-issue in the US given the scale and customer acceptance that Amazon has already achieved. Clearly though, Amazon's growth in Australia will not benefit from the same circumstances since it will be required to collect the 10% GST from day one.

Australia will not offer the 'sales tax arbitrage' afforded in the US

Convenience of delivery will be another challenge for Amazon. Missed deliveries will either incur a costly redelivery or force the customer to collect from the Post Office, Courier Depot or other pick-up point. This is a much poorer customer experience than very dense US cities like New York, where some customers can simply collect their delivery from their doorman as they return home.

Impact on retail sector stocks

Given Australia's similarities to Canada and differences to the US, we expect it will take longer than many expect for Amazon to have a meaningful impact on the Australian market. Nevertheless, Australian retailers will lose share and endure margin pressure as Amazon expands, but the extent will vary by category and competitive position of individual retailers.

eBay will probably be most impacted by Amazon's entry into Australia

Established pure play online retailers will be among those first impacted. Clearly, eBay will be challenged since it is most comparable to Amazon domestically (particularly with respect to Amazon's Marketplace). In the US, Amazon dwarfs eBay and we therefore expect Amazon will eventually overtake eBay here.

In terms of individual retail categories, Amazon's success will be linked to the extent of service and importance, or lack thereof, of in-store experience. Amazon does best in categories that have products with low service requirements and that are easy to ship in a box. While there is very little sales mix data available for Amazon, it is true to say that its market shares are highest in Media, Electrical, Sports and general merchandise. On the flip side, it has very low share in large whitegoods (approximately 1% in the US), furniture, Auto and grocery.

The Department store sector will contract

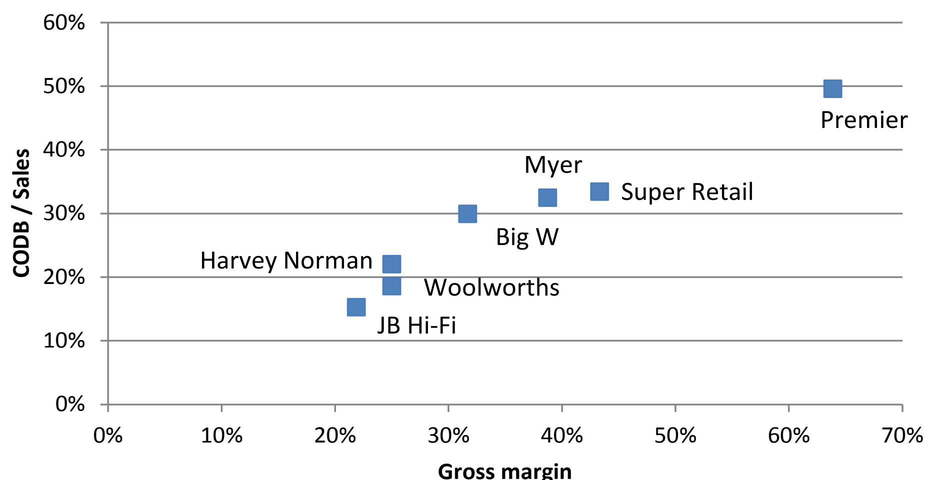
From this perspective, we also see Department stores as being significantly impacted by Amazon's entry. In the US, this category has been contracting for the last 10 years with store closures now accelerating. Of particular note is Kmart, which has very high margins and very low prices. Ironically, these low prices make the shipping cost far more significant and will be at high risk once Amazon Prime launches with free one or two day delivery.

In-store experience needs to improve and costs need to come down

One of Amazon CEO Jeff Bezos's famous quotes is "Your margin is my opportunity".

On a stock level, we consider the retailers at most risk from Amazon are those that exhibit both high levels of gross margin selling commodity products and high costs of doing business (CODB). Retailers with these characteristics may very well find their lunch cut by Amazon through its low price strategy and low operating costs. Given this, we have plotted a subset of Australian retail stocks using these two metrics (Figure 7).

Figure 7: Australian retailer gross margins and CODB / Sales



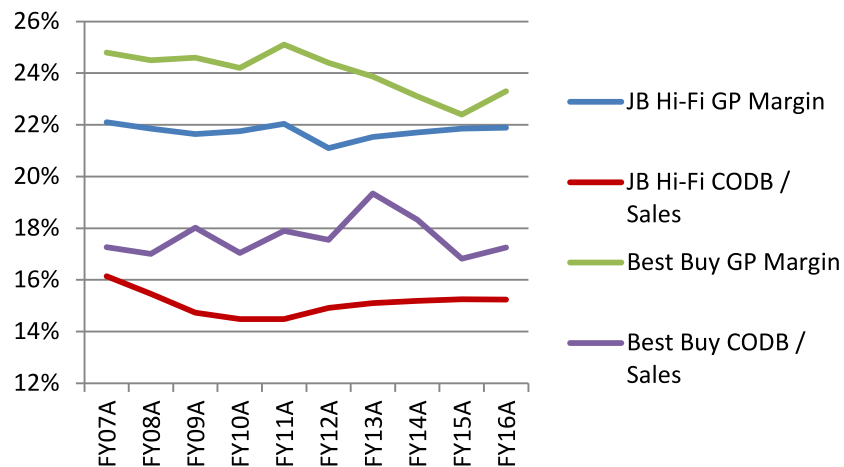
Source: Company Reports, Merlon

Super Retail, Myer and Big W are among the listed players we are most concerned about

JB H-Fi is well positioned to compete with Amazon given it has both a very low gross margin and low operating costs (which is partly a function of its very high sales per square metre). On the other hand, retailers such as Super Retail, Myer and Big W face more challenges because both their gross margins and cost bases are substantially higher than Amazon's (which we estimate has a retail gross margin of 22-25% and a retail CODB / sales of approximately 15-20% of sales). While Premier stands out as most exposed on these metrics, it sells its own products not available elsewhere. Furthermore, its Smiggle and Peter Alexander brands are particularly differentiated in the marketplace.

We have also compared JB Hi-Fi and Harvey Norman to offshore electrical market retailers Best Buy (US) and Dixons Carphone (UK). From this, we expect that JB Hi-Fi and Harvey Norman can each hold sales and earn reasonable margins after a period of adjustment given the experience of both Best Buy and Dixons Carphone. For example, Best Buy took a hit to profitability in 2013 but started with a higher gross margin and CODB / Sales than JB Hi-Fi has currently, meaning that JB Hi-Fi is comparatively better positioned (Figure 8). In any case, Best Buy's margin has since largely recovered.

Figure 8: JB Hi-Fi EBITDA* Margin Composition vs Best Buy



*Source: Company Reports, Merlon *EBITDA = Earnings Before Interest, Tax, Depreciation & Amortisation*

JB Hi-Fi has competitively priced products and a competitive cost structure…

Underscoring JB Hi-Fi's low gross margin, our sampling of prices by electrical category suggests that the differential in pricing on Amazon's US website to JB Hi-Fi (when adjusting for GST and currency) is minimal aside from a few categories such as Accessories, Headphones and AV receivers. In the case of the latter two categories, we believe this is mostly a function of suppliers charging more here because they can but we expect these suppliers will be forced to adjust their pricing to better reflect US prices.

…while Amazon's low exposure to white-goods and furniture leaves Harvey Norman somewhat insulated

From a category perspective, while Amazon is the number two player in US electronics, JB Hi-Fi's recent acquisition of The Good Guys and Harvey Norman's exposure to whitegoods and furniture (approximately 40% of sales) should offer some insulation given Amazon's miniscule (1%) US Appliances (Kitchen/Laundry) share. We also expect both JB Hi-Fi and

Harvey Norman to benefit from further consolidation, with Department stores most likely to exit this category as well as smaller, sub scale electrical players. In any case, Harvey Norman's international businesses and conservatively valued commercial property portfolio will also act to buffer any impact from Amazon on its Australian franchise operations.

With regard to Supermarkets, Amazon's recent acquisition of Whole Foods in the US is evidence that Amazon Fresh will be a premium rather than price-led proposition. This supports our view that bricks and mortar is critical to any omni-channel strategy and plays into the strengths of Woolworths and Coles. Amazon has been dabbling in physical retailing since 2015 although to date focused on bookstores and showcasing its own gadgets.

Retail REITs will ultimately bear the brunt of rising online penetration

Finally, we believe that retail Real Estate Investment Trusts (REITs) will need to reduce rents over time to enable retailers to better compete with Amazon. Clearly, a specialty retailer with rental expense representing 25% or more of sales will struggle to be able to match the pricing of Amazon whose total costs to sales is below that. While the market has started to price this into retail REITs such as Scentre Group, we believe it is still not fully priced in.

A lot is already factored in

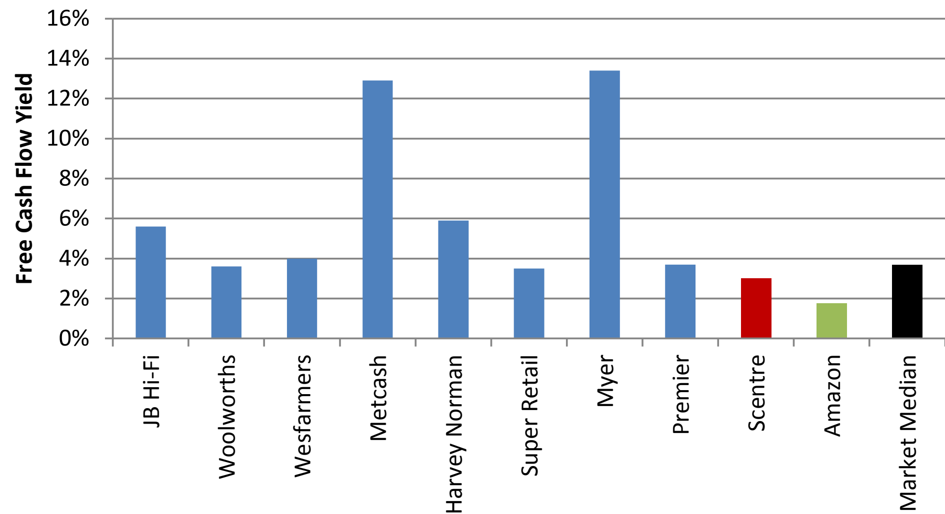
Merlon's investment philosophy is built around the notion that companies undervalued on the basis of sustainable free cash flow and franking will outperform over time. That said we also believe that markets are mostly efficient and that cheap stocks are always cheap for a reason. It follows that we are focused on understanding why cheap stocks are cheap. To be a good investment, market concerns need to be already priced into the current share price or deemed invalid. We incorporate these aspects with a "conviction score" that feeds into our portfolio construction framework.

As discussed above, our qualitative scorecard provides a vantage point from which to consider Amazon's impact on the retail industry structure and the competitive advantages enjoyed by incumbent players. This qualitative assessment weighs into our projected growth rates and sustainable cash flow estimates for the retail stocks that we cover. For JB Hi-Fi and Harvey Norman we have modestly trimmed our estimates of sustainable free cash flow in recent months on the basis that their growth and margins will be impacted by Amazon but on balance think that they will still remain strong, viable businesses.

The market has aggressively sold off discretionary retailers

It follows that we believe the market has become overly pessimistic. Since 4 November 2016 when Amazon's expansion was first speculated in the press to 30 June 2017, discretionary retailers such as JB Hi-Fi, Harvey Norman, Super Retail and Myer have underperformed the ASX200 by between 23% and 36% resulting in relatively high free cash flow yields (Figure 9). The supermarket stocks have understandably held up better given their strong grocery businesses and Wesfarmers' diversification in Hardware and Coal etc.

Figure 9: Last reported free cash flow yields



Source: Company reports, Merlon

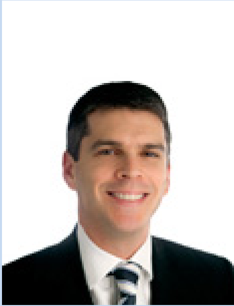
On balance we think concerns about Amazon and the macro environment are overblown

Rather than the entry of Amazon, we view elevated housing prices and highly indebted consumers as the most significant issues facing the listed retailers. As we discussed in our March quarterly, we think house prices are modestly overvalued but not to the extent many commentators suggest. Further, household savings rates are historically high and balance sheets historically strong which somewhat tempers our concerns.

We retain positions in Harvey Norman, JB Hi-Fi, Wesfarmers, Woolworths and Metcash but have no exposure to retail REITs, Super Retail or Myer.

Market Outlook and Portfolio Positioning

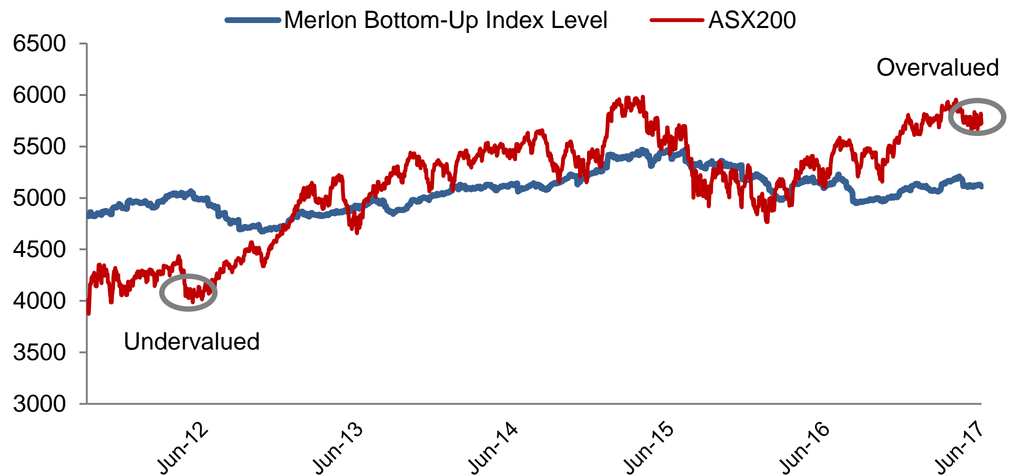
Neil Margolis



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 10). This is a modest improvement from March after the market retreated slightly over the past quarter. There continues to be a wide dispersion across sectors, with resources, healthcare, property and infrastructure overvalued relative to other parts of the market.

Figure 10: Merlon bottom up market valuation vs ASX200 level

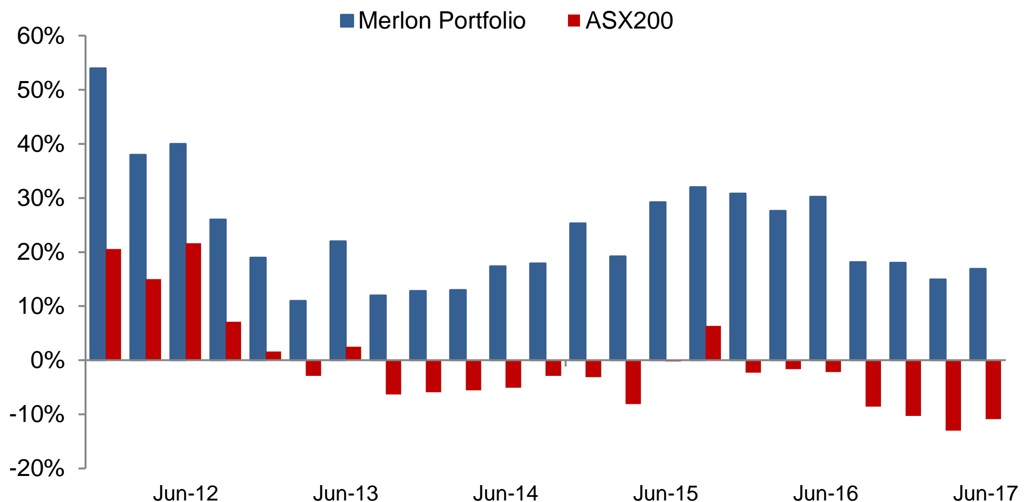


Source: Merlon

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 17% absolute upside representing a 28% premium to the market. As seen in Figure 11, the Merlon portfolio is looking increasingly attractive relative to the capitalisation-weighted index.

Figure 11: Expected return based on Merlon valuations



Source: Merlon

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. Even if rates were to remain low, we would expect this to lead to a re-rating of our investments given their strong cash flow appeal.

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 **Magellan Financial**, **News Corporation, QBE Insurance, 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 (Some Thoughts on Australian House Prices). 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 bad as what is currently priced into the stocks.

Banks have been even more topical than usual the past few months. Our non-benchmark approach means we are content holding no major banks when the market is overly complacent about their risks – as in 2014 – and equally are happy to invest in them when the market is overly concerned – as is the case now. The bank budget tax is unhelpful but will be passed on like any other input cost in an industry incentivised to protect shareholder returns. Similarly, APRA's attempt to mitigate risks around high household indebtedness, whether it be through lending caps or higher capital, is providing short-term margin opportunity for the banks. Credit growth will almost certainly slow as a result but the actions of APRA and the banks should provide monetary policy flexibility back to the RBA.

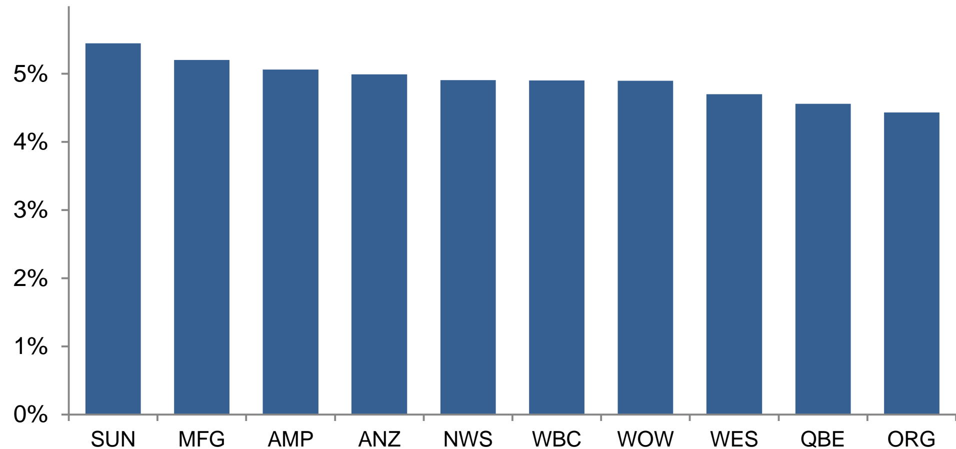
Portfolio Aligned to Value Philosophy and Fundamental Research

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 12: Top ten holdings (gross weights)

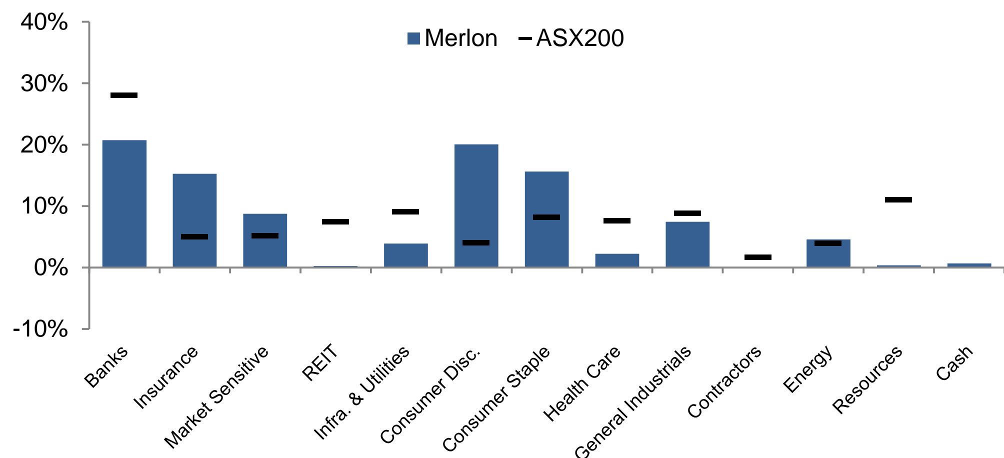


Source: Merlon

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. **Suncorp's** insurance business is under-earning despite increased industry concentration while the retail banking business has high returns and surplus capital. **Magellan Financial** generates strong and growing cash flows with upside from performance fees, a debt-free balance sheet and USD-denominated FUM. **AMP**'s trusted brand and aligned planner network generate stable cash flows being obscured by problems in its under-earning life insurance business. Similarly, **Origin Energy** is backed by its retail business, **ANZ Bank** and **QBE Insurance**, both backed by their core domestic franchises, and **News Corporation** by its subscription business, including growing digital media revenues. The supermarket operators, **Woolworths** and **Wesfarmers**, are generating good cash-flows by competing rationally on convenience, range and value, not just price. **Westpac** rounds out the largest holdings with the major banks not pricing in an improvement in returns despite exhibiting a willingness to pass on higher funding and capital costs to customers.

Figure 13: Portfolio exposures by sector (gross weights)



Source: Merlon

Some of our research ideas with the most valuation upside 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 **Seven West Media**.

Figure 14: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	29	200
Active Share	73%	0%
Merlon Valuation Upside	17%	-11%
EV / EBITDA	9.0x	11.7x
Price / Earnings Ratio	15.0x	16.8x
Price / Book Ratio	2.7x	3.5x
Trailing Free Cash Flow Yield	5.7%	4.4%

Source: Merlon

MERLON CAPITAL PARTNERS

June Quarter Portfolio Activity

We introduced new investments in News Corp, Telstra, Fletcher Building and Bendigo Bank

During the quarter we introduced four new investments and exited three.

We invested in **News Corporation**, where we have a more constructive view on digital media subscription revenue while ascribing no value to print media assets. Newscorp's majority ownership of Realestate.com comprises 30% of our valuation despite valuing the online classified's business 25% below REA's own share price. This highlights the extent to which the group's other assets are being discounted by the market. In addition to attractive valuation upside, the stock is defensive in terms of net cash position, subscription businesses such as Foxtel, and USD currency exposure.

We acquired a small position in **Telstra** for the first time in four years following protracted underperformance relative to our long-term valuation. The market has begun to share our long-held concerns regarding mobile margin sustainability and declining fixed line cash-flows but these concerns are now starting to be factored into the current share price.

We reinvested in **Fletcher Building** with the share price falling 25% since we sold last September. The market has been disappointed by short-term contract losses but we are attracted to the long-term value stemming from leading positions in several NZ building and construction sectors.

We also reinvested in **Bendigo Bank** which underperformed in sympathy with the major banks despite being a relative beneficiary of mortgage repricing linked to the budget bank tax and regulatory handbrakes applied to interest-only lending.

Funded by exiting Fairfax, BlueScope and Vocus

We continued to build on existing positions in **Navitas**, **Harvey Norman** and **Metcash**, all of which offered increased valuation upside after short-term underperformance.

We funded these investments by exiting **Fairfax** after private equity interest drove convergence between the share price and our valuation that already reflected the long-term cash-flow based value of Domain while attributing no value to the print media assets.

We exited our long-held position in **BlueScope**, with the market extrapolating extremely favourable domestic and global operating conditions relative to our mid-cycle view.

We exited our position in **Vocus** after our confidence in sustainable cash flows diminished and private equity interest led to a recovery in the share price. The position size was always moderated by our low conviction score reflecting the brief history as a combined group of acquired telecommunication companies.

We reduced but still hold positions in **Boral**, with less valuation upside after outperformance, and **Coca Cola Amatil**, which we were in the process of reducing on similar grounds when a profit warning caused a measure of long-term value to be restored.

MERLON CAPITAL PARTNERS

Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	Inception (p.a.)
Portfolio Return (inc. franking)	1.1	0.8	23.2	23.2	13.0	18.0	12.8
ASX200 Return (inc. franking)	0.2	-1.3	15.5	15.5	8.1	13.3	9.9
Excess Return*	**1.0**	**2.1**	**7.7**	**7.7**	**4.9**	**4.6**	**2.9**

* Excess returns may not sum due to rounding

June Quarter Market Review

The market retreated a modest 1.3% (including franking) in the June quarter, following a stellar 17.1% return in the first 9 months of the financial year. The Australian Dollar gained slightly despite commodities, especially oil (-9%) and iron ore (-19%), having a tough quarter. Bond yields initially retreated as the reflation trade unwound but bounced strongly in June leading to what appears to be 'rotating rotation' between defensives and cyclicals.

The broad market confusion was also evident in sector performance over the quarter. **Telecommunications** performed worst on the back of competition concerns, **Banks** got blindsided by the budget repair bank tax, **Energy** lagged in tandem with oil prices, **REITs** underperformed despite whipsawing bond yields, and **Consumer Staples** got hit by the Amazon media frenzy and Coke's downgrade. **Materials** were somehow flat, **Consumer Discretionary** eked out a gain despite Amazon anticipation, while Healthcare was the standout on the upside.

Earnings revisions resumed their downtrend after a positive reporting season last quarter, while Merlon's estimate of sustainable free cash flow was revised down by 2% principally as a result of the bank tax and Telstra.

Portfolio Performance Review

The Strategy outperformed due to the non-benchmark approach

The Concentrated Value Strategy returned 0.8% for the quarter, well ahead of the index mainly due to the non-benchmark approach to stock selection. Having structurally low exposure to the major banks and the top 20 largest stocks more generally benefitted relative performance in the quarter.

Fairfax Media, which we exited in June, was the best performing portfolio holding. Private equity funds launched conditional bids to acquire and separate the valuable Domain.com.au assets from the declining print business. **Magellan Financial** outperformed on the back of strong inflows and recognition performance fees might be a more recurring feature of revenue. **Boral** extended its outperformance with Headwaters quarterly earnings ahead of expectations and regulatory approval achieved sooner than expected. **Flight Centre** and **Suncorp** rounded out the top 5 contributors in the quarter.

Wesfarmers was the biggest detractor after another weak Coles sales result and concerns Amazon would impact the other retail businesses. Other detractors included **QBE**

Insurance, sneaking in another customary June downgrade relating to its emerging markets business, **Westpac** and **ANZ** impacted by the bank tax and **Coca Cola Amatil** warning on weaker volumes and pricing.

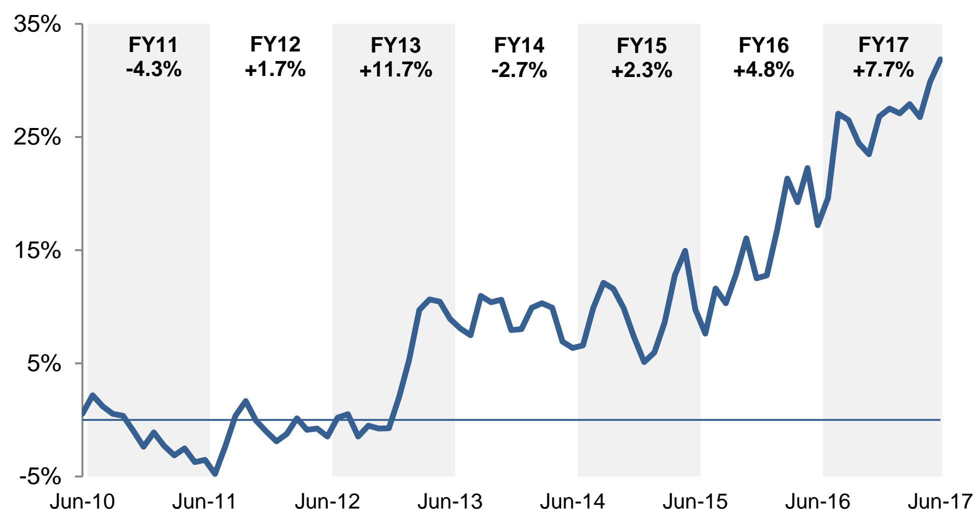
Stock selection outcomes have been very positive this financial year and over longer-term periods

The Concentrated Value Strategy performed well in the 2017 financial year, outperforming the market by 7.7%. Non-benchmark construction turned in the last quarter from a 2.2% headwind in the first 9 months to a 1.9% tailwind with the banks and several other large cap stocks retreating. Underlying stock selection added 5.8% on an equal-weight basis, driven by **Fairfax**, **BlueScope**, **Magellan Financial**, **Southern Cross Media**, as well as the banks and not owning expensive stocks with perceived low volatility or very long dated growth expectations. Not having exposure to mining stocks was been a detractor, although **BlueScope Steel** and **Origin Energy** benefitted from Chinese steel capacity cuts and oil prices respectively. **Virtus Health**, **Seven West Media** and **Sky TV New Zealand** were the worst performing investments in the period but we continue to see long-term value and added to all three during 2017.

On a five year rolling basis, the Concentrated Value Strategy has outperformed by 4.6% per annum, with underlying stock selection of 3.0% enhanced by a non-benchmark construction tailwind of 1.6%. We continue to hold the 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**, **Tabcorp**, **Suncorp**, **Pacific Brands** and **National Australia Bank** the best performers. Key detractors over this time frame include **Woolworths, Seven West Media**, **Worley Parsons**, **United Group**, as well as not owning **Aristocrat**. At a sector level, owning minimal mining and energy stocks were the most notable contributors.

Figure 15: Cumulative excess returns



Source: Merlon

MERLON CAPITAL PARTNERS

Strategy FUM	Merlon FUM
$856.8m	$1,351.4m

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.

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