Merlon Concentrated Value Strategy

Quarterly Report

September 2017

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Analyst:
Hamish Carlisle

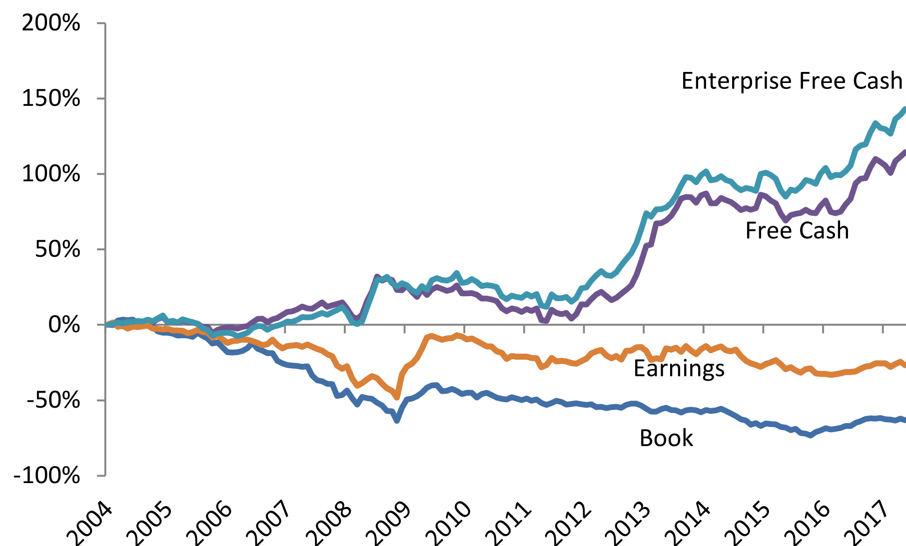
Value Investing – An Australian Perspective: Part II

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 second of what will now be a three part series discussing value investing from an Australian perspective. In the first paper we concluded 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.

Value investing on the basis of free-cash-flow has performed well

Figure 1: Returns - "Value" Portfolios Relative to "Glamour" Portfolios (Australian Data, March 2004 to August 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.

In this second paper, we begin to explore the question of ***why*** value strategies based on free-cash-flow outperform the broader market. Consistent with our philosophy, we present findings that show a linkage between value investing on the basis of free-cash-flow and earnings quality. We then go on to dismiss the notion that value investing is "riskier" than passive alternatives.

“Value stocks” do not outperform because they are “cheap”…

…but rather because there are misperceptions in the market

Why do stocks with high free-cash-flow yields tend to outperform?

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 underpins 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.

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.

Value investing & earnings quality

The outperformance of stocks with high ratios of free-cash-flow to enterprise value could capture two sources of mispricing:

- The well documented value premium; *and/or*
- The accruals anomaly,[1] representing the degree to which accounting earnings are backed by cash flows

To further explore this question, we compared the returns from a strategy of investing in companies with good “earnings quality” – which we define as the ratio of enterprise-free-cash-flow to enterprise-accounting-profits – with the returns from the enterprise-free-cash-flow classification of value.

[1] See: “Do Stock Prices Fully Reflect Information in Accruals and Cash Flows about Future Earnings?”, R Sloan - The Accounting Review 1996.

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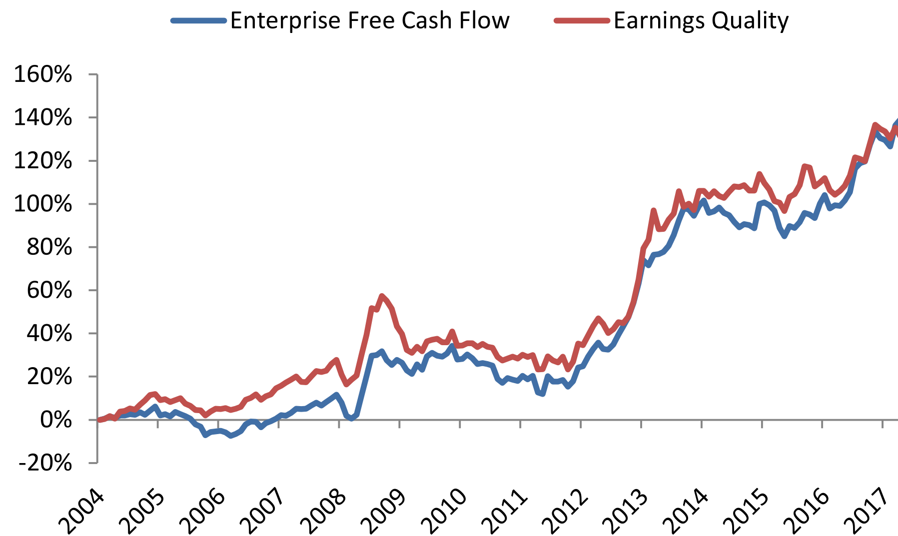
Earnings quality and value investing on the basis of free-cash-flow are interrelated…

Figure 2: Returns - "Value" Portfolios Relative to "Glamour" Portfolios (Australian Data, March 2004 to August 2017)



Source: Merlon Capital Partners. Portfolios are formed using two valuation ratios: enterprise-free-cash-flow-to-enterprise-value (EF/EV); and enterprise-free-cash-flow-to-enterprise-earnings (EF/EE). Portfolios are formed at the end of each month by sorting on one of the two 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.

We find that the returns from investing on the basis of earnings quality are remarkably similar and remarkably correlated to the returns from investing on the basis of value as measured by enterprise-free-cash-flow. This could be interpreted in a number of ways:

- "Value" has been arbitraged away while the accruals anomaly has persisted; *or*
- The value and accruals anomalies are one in the same[2].

It is difficult to definitively answer this question but in our experience both explanations are valid in particular circumstances. With regard to earnings quality, management teams and boards are becoming ever increasingly creative about how they define profitability. Our favourite notorious measure is "pro-forma adjusted EBITDA". This measure usually and conveniently ignores capital expenditure, working capital requirements, restructuring costs, discontinued operations and asset impairments to name a few. It is often used to justify expensive acquisitions and even more cynically, used as a basis for management remuneration.

The cash-flow statement doesn't lie

The bottom line is management teams can define profitability however they choose but can't as easily hide from the realities of the cash flow statement. Eventually these realities

[2] See, for example: "Value-glamour and accruals mispricing: One anomaly or two?", H Desai, S Rajgopal, M Venkatachalam - The Accounting Review, 2004

come home to roost and when this happens stocks with low earnings quality tend to underperform. So long as investors place weight on measures such as "pro-forma adjusted EBITDA", we think the accruals anomaly is likely to persist.

At the same time, we think it would be irresponsible to "pay-any-price" for companies with high earnings quality (or indeed high quality businesses in general) and this style of investing is prone to many of the behavioural biases that support excess returns from value investing in the first place.

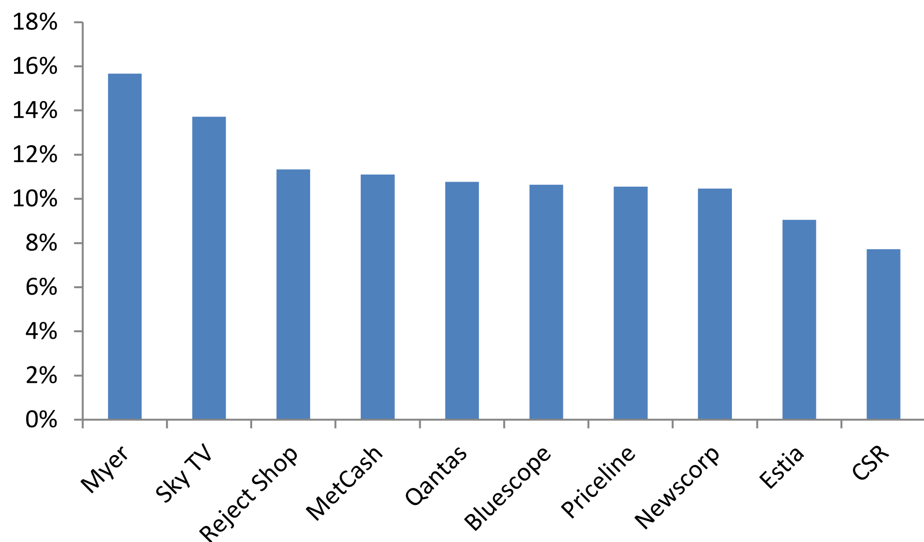
Are value strategies riskier than glamour strategies?

There are two schools of thought as to why value strategies have historically outperformed glamour or growth strategies. The first is value strategies are riskier than passive strategies. This is intuitively appealing when we consider the nature of value stocks. These companies are typically plagued with investor concerns, surrounded by popular pessimism and often have high levels of financial and operating leverage.

A brief look at the top 10 industrial stocks in the ASX200 ranked by free-cash-flow-yield highlights this point.

"Value stocks" are often perceived to be risky investments…

Figure 3: Top 10 Industrial Stocks in ASX200 Ranked by Free Cash Flow Yield (data as at 22 September 2017)



Source: Bloomberg, Company Accounts, Merlon Capital Partners analysis

Different investors will perceive risk differently but for us the most crucial measure of risk is how particular portfolios perform in down markets. Figure 4 illustrates the performance of value strategies based on enterprise-free-cash-flow through a variety of market conditions. The point to note is that there is little difference in performance in up markets and down markets. If anything, the value portfolios perform better in more adverse market conditions.

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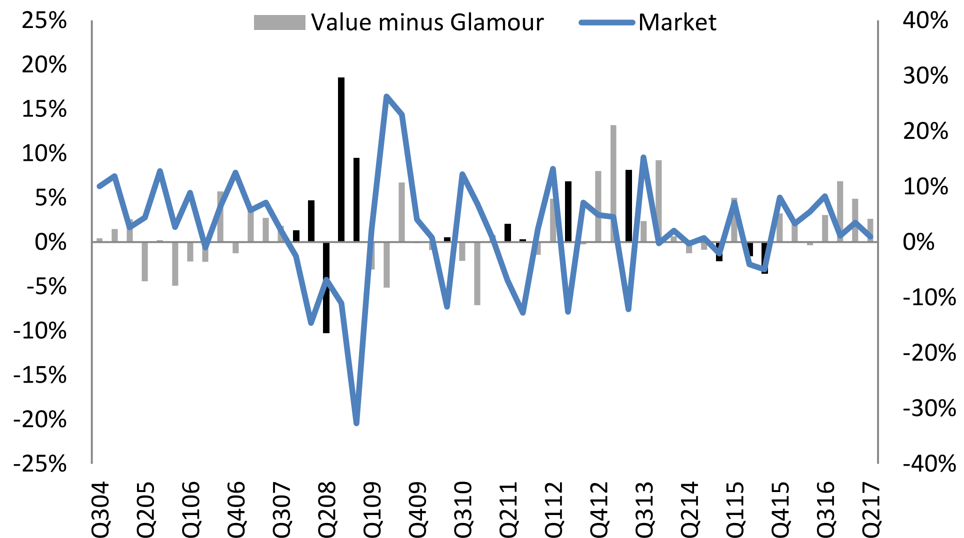
But at a portfolio level, value strategies based on free-cash-flow have performed well in down markets…

Figure 4: Returns - "Value" Portfolios Relative to "Glamour" Portfolios (Black Bars Represent Negative Market Returns)



Source: Merlon Capital Partners. Portfolios are formed using enterprise-free-cash-flow-to-enterprise-value (EF/EV). Portfolios are formed at the end of each month by sorting on the ratio 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.

Figures 3 and 4 highlight one of the challenges faced by many investors and their sponsors. The challenge is distinguishing between diversifiable risk (or company specific risk) and non-diversifiable risk (or systematic risk). By definition, company specific risk can be diversified away whereas systemic risk cannot. Myer - a department store - might appear to be a risky investment. However, investors should be only be concerned with how the stock performs within the context of a portfolio and how such a portfolio is likely to perform in a meaningfully down market.

Indeed, when we invest in businesses we place significant weight on understanding and quantifying downside valuation scenarios and their dependencies on uncontrollable external influences such as macroeconomic conditions. These are "systematic risks" that cannot be diversified away. This "margin-of-safety" concept is explicitly considered when we develop our "conviction scores" that combine with valuation to determine portfolio weights.

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Concluding comments

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 underpins 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.

Merlon's process, structure and culture is aimed at minimising our exposure to behavioural biases…

Any investment philosophy needs to be supported by an understanding of ***why*** a particular approach is likely to generate excess returns. In this paper we begin to explore this question. Consistent with our philosophy, we present findings that show a linkage between value investing on the basis of free-cash-flow and earnings quality. We then go on to dismiss the notion that value investing is "riskier" than passive alternatives.

In our third paper in this series to be released next quarter we will highlight a number of well documented behavioural biases that are empirically and anecdotally evident in the Australian market. We will also point to various elements of the Merlon investment process, structure and culture that are aimed at minimising our exposure to these biases.

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Analyst:
Hamish Carlisle

Telstra Revisited

When Merlon was established in 2010 and we first formally reviewed Telstra, the stock was trading at $2.64. The top down (and perhaps consensus) view at that time was that the company faced enormous structural challenges stemming from the ongoing decline in fixed line voice services, intense competition in mobile and broadband, and the loss of its monopoly position as provider of last mile access to 9 million homes and small businesses. At that time, we valued Telstra at between $3.20 and $4.35 per share.

Fast forward to 2017 and not a lot has changed, least of all our valuation of Telstra shares which currently stands at between $2.70 and $4.35 per share. Taking into account the stock's high dividend yield over the intervening period the shares have delivered a total return on our initial valuation in line with our standardised equity discount rate of 12 percent.

Nonetheless, the poor performance of the stock in more recent years has prompted questions from many of our clients and stakeholders so we thought it might be worthwhile outlining our current thinking.

Case study: US railroad industry

By the mid-1950s the US railroad industry was already in decline before being hit with its own equivalent of the National Broadband Network (NBN) in the completion of the interstate highway system creating severe competition from the trucking industry and reduced passenger travel. At the same time, airlines were taking almost all long haul passengers away from the railroads.

Nevertheless, since 1957 railroad stocks have outperformed not only the airlines and trucking industries but also the S&P 500 index itself. This occurred simply because the "top down" issues facing the industry were well and truly factored into investor expectations and only small improvement was necessary for these companies to beat such a dim outlook.

An industry in decline can offer good returns if investor expectations are sufficiently low…

And better times were coming. In 1980 there was a major deregulation of the railroads that spurred consolidation and greatly increased their efficiency. Despite falling revenues, rail productivity has tripled since 1980, generating healthy profits for the carriers.

The lesson: An industry in decline can offer good returns if investor expectations are sufficiently low. If such a firm can halt its decline – and pay dividends – its shares can deliver excellent returns.

The question with Telstra is whether expectations are sufficiently low.

Gauging market expectations

Comparing a company's share price with some measure of intrinsic value can give some indication as to whether market expectations are optimistic or pessimistic. Merlon's

preferred measure of intrinsic value is to compare a company's enterprise (or unleveraged) value with its sustainable enterprise-free-cash-flow.

To give a guide to management's expectation of Telstra's "sustainable free-cash-flow", Telstra's most recent result presentation noted:

- Telstra generated "recurring core" EBITDA in the 2017 financial year of $10,068m;
- The recurring impact on 2017 EBITDA from the NBN is likely to be around $2.5 billion;
- The company is targeting a capex to sales ratio of around 14% from 2020.

Putting these pieces together one might conclude that the Telstra's board and management expect the company's enterprise-free-cash-flow to settle at around $2.5 billion.

Management commentary suggests the company can sustain free-cash-flow of around $2.5b per annum…

Figure 5: Implied Management Expectations for Telstra's Sustainable Free-Cash-Flow

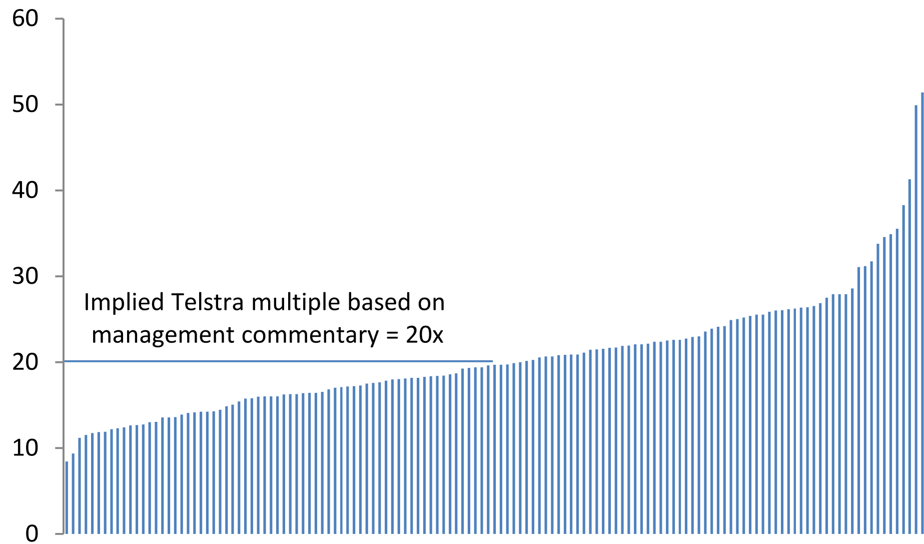
2017 EBITDA	**$10.7b**
One-off NBN receipts	($1.8b)
NBN cost to connect & other expenses	$0.5b
Restructuring & impairment	$0.5b
New business	$0.2b
Company defined 2017 "recurring core" EBITDA	**$10.1b**
Recurring impact from NBN	($2.5b)
Sustainable 2017 EBITDA	**$7.6b**
Capex at 14% of sales (management 2020 target)	($3.9b)
Tax at 30%	($1.1b)
Implied sustainable free cash flow	**$2.5b**
Market capitalisation at $3.50 per share	$41.6b
Net debt	$16.3b
Anticipated one-off NBN receipts (undiscounted)	($9.0b)
Enterprise value	**$49.0b**
Enterprise value / sustainable free cash flow	**20x**

Source: Company 2017 full year result presentation, Merlon Capital Partners

Taking into account anticipated one-off NBN receipts this would imply the company is trading on approximately 20x sustainable-free-cash-flow. This is hardly a bargain but in line with the median multiple for ASX200 companies under our coverage. This suggests to us that the market has largely taken management estimates of profitability and cash flow at face value.

If we accept management commentary, Telstra looks about fair value relative to the rest of the market…

Figure 6: Enterprise Valuations / Sustainable Free Cash Flow (Merlon Coverage Universe, data as at 22 September 2017)



Source: Bloomberg, Merlon Capital Partners

Ignore the cash flow statement at your peril

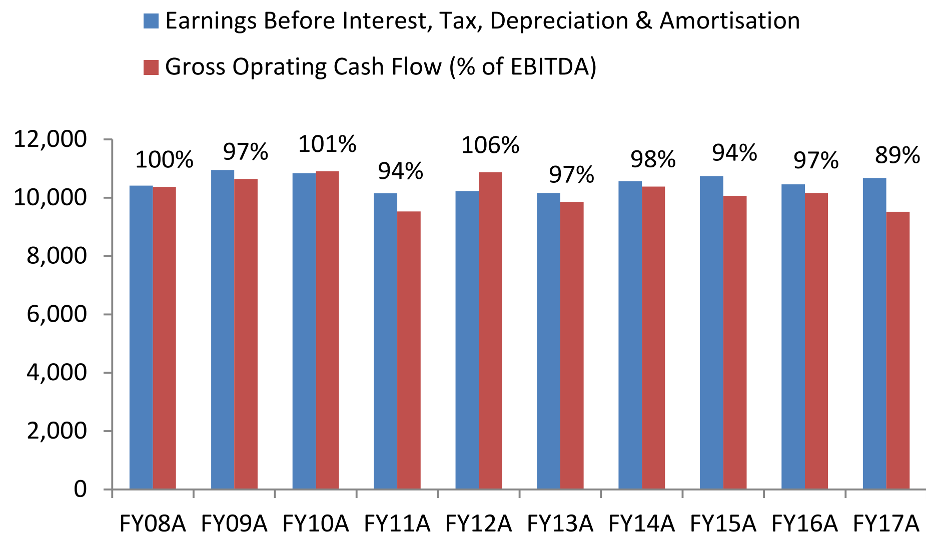
As we persistently highlight, management teams and boards are becoming ever increasingly creative about how they define profitability. Some of the measures in Figure 5 are examples of this. "Recurring core EBITDA" is not a measure of profitability defined in any accounting textbook and guidance about the "recurring impact from the NBN" is an estimate at best and a guess at worst. We discuss this further below.

The bottom line is that management teams can define profitability however they choose but can't as easily hide from the realities of the cash flow statement. Eventually these realities come home to roost and when this happens stocks with low earnings quality tend to underperform.

Along these lines it is important to note that Telstra's earnings quality is poor. The company's gross operating cash flow ("GOCF") of $9.5 billion (which can be found on page 74 of the company's annual report) bears little resemblance to the EBITDA figure of $10.7 billion quoted in Figure 5.

Telstra's earnings quality is poor…

Figure 7: Telstra EBITDA, Gross Operating Cash Flow & Cash Conversion



Source: Bloomberg, Merlon Capital Partners

At Merlon, our focus is on the cash flow statement rather than measures of "advertised" earnings. Typically listed companies do a good job singing the virtues of such advertised metrics often with advisers, brokers, analysts, journalists and other commentators cheering on from the sidelines. Often these advertised metrics form the basis for variable remuneration prompting board members to join the chorus.

Listed companies do a good job singing the virtues of "advertised" earnings…

…often with advisers, brokers, analysts and other commentators cheering from the sidelines

Focusing on the cash flow statement reveals a vastly different picture of Telstra's continuing businesses. Had it not been for non-recurring NBN receipts and the network cost holiday being enjoyed ahead of NBN rollout, Telstra would have been in cash flow deficit during the 2017 financial year.

Figure 8: Telstra – Merlon Defined Free Cash Flow (2017 Full Year)

Gross Operating Cash Flow	$9.5b
Payments for property, plant & equipment	($3.7b)
Payments for intangible assets	($1.6b)
Proceeds from sale of property, plant & equipment	$0.7b
Free cash flow before tax	**$4.9b**
Tax paid	($1.8b)
Tax shield on net interest	($0.2b)
Free cash flow	**$2.9b**
NBN receipts (after tax)	($1.2b)
Recurring impact from NBN (after tax)	($1.8b)
Recurring free cash flow	**($0.1b)**

Source: Company 2017 full year result presentation, Merlon Capital Partners

If nothing else, the above analysis highlights the significant work ahead of Telstra management to meet market expectations.

The NBN earnings gap

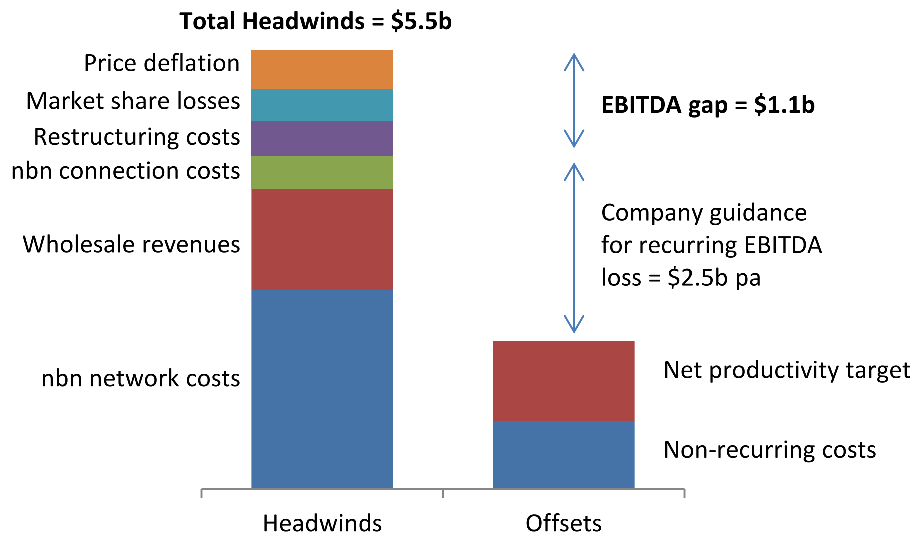
As highlighted in the tables above, management have indicated that "the recurring impact from the rollout of the NBN" is likely to be around $2.5b per year. Our analysis suggests that the ultimate outcome could be much worse than this. Key headwinds we highlight are as follows:

1. ***Incremental NBN costs of approximately $2.5 billion per annum:*** The NBN's corporate plan has the company achieving revenue of $5 billion in the 2020 financial year. We think it is reasonable to assume Telstra will account for 60 percent of this amount, or $3 billion. About $500m of this amount is already reflected in Telstra's 2017 accounts so the incremental cost from here is likely to be about $2.5b.
2. ***Loss of wholesale revenues amounting to approximately $1.3 billion per annum:*** Telstra currently generates revenues from wholesaling its products and renting out its network to other retailers such as TPG/iiNet, Vocus, and Optus. These revenues will not continue following the rollout of the NBN.
3. ***Potential recurrence of NBN connection costs of around $0.4 billion per annum:*** Telstra has incurred significant costs in connecting customers to the NBN. While the company has excluded these costs from recurring earnings it is possible that a component these costs will prove to be ongoing due to normal customer churn.
4. ***Potential recurrence of restructuring costs of around $0.4 billion per annum:*** Given the scale of cost reductions required to deal with the above items and the company's history of incurring restructuring costs, it is likely that at least some component of restructuring will prove to be ongoing.
5. ***Potential market share loss due to structural separation of network:*** Prior to the rollout of the NBN, Telstra enjoyed a monopoly position with regard to its ownership of the fixed line network. It is likely that the progressive levelling of the playing field as the NBN rolls out will see heightened competition and some market share loss for Telstra.
6. ***Potential repricing of fixed line services:*** Telstra currently enjoys average monthly revenues per user of around $95 compared to more competitive offers in the market ranging from $55 to $75. It is likely that Telstra will see progressive price deflation with regard to its products.

Offsetting these factors Telstra has targeted annualised productivity gains of $1 billion by 2020 and is adamant that restructuring and cost to connect costs will not persist. Our analysis suggests that these aspects may not be enough to offset headwinds with an additional $1.1 billion of cost savings or additional revenues required to achieve the company's ambition of limiting the recurring impact of the NBN to $2.5 billion.

Our analysis suggests the impact from the NBN rollout could be much worse than suggested by management…

Figure 9: Telstra Recurring Annual EBITDA Headwinds from NBN Rollout (Relative to 2017 Financial Year)



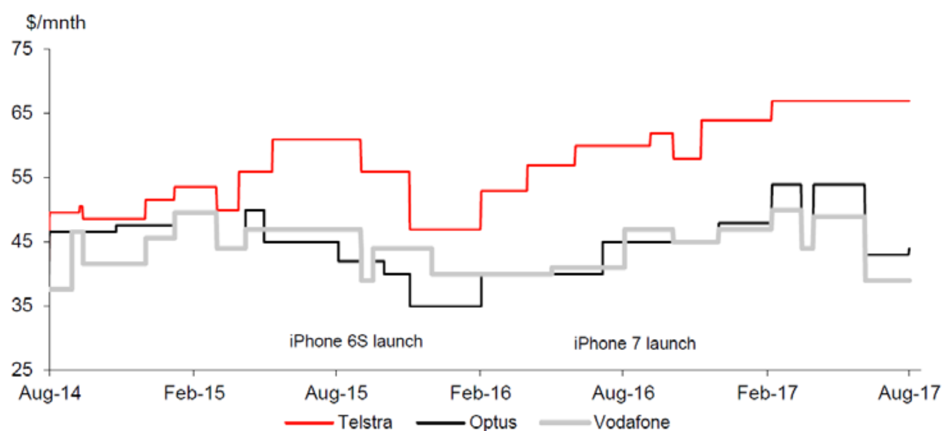
Source: Company reports, Merlon Capital Partners

Mobile pricing

The mobile division delivered a strong result in 2017, ahead of both our own internal and market expectations. A key driver of continued strong performance within this division has been Telstra's capacity to maintain a meaningful price premium to its major competitors.

Telstra's mobile pricing premium is high relative to history…

Figure 10: Telstra Post Paid Mobiles Implied Monthly Service Fee



Source: Macquarie Equities Research

…and could come under pressure as TPG enters the market and no-SIM mobile devices are launched

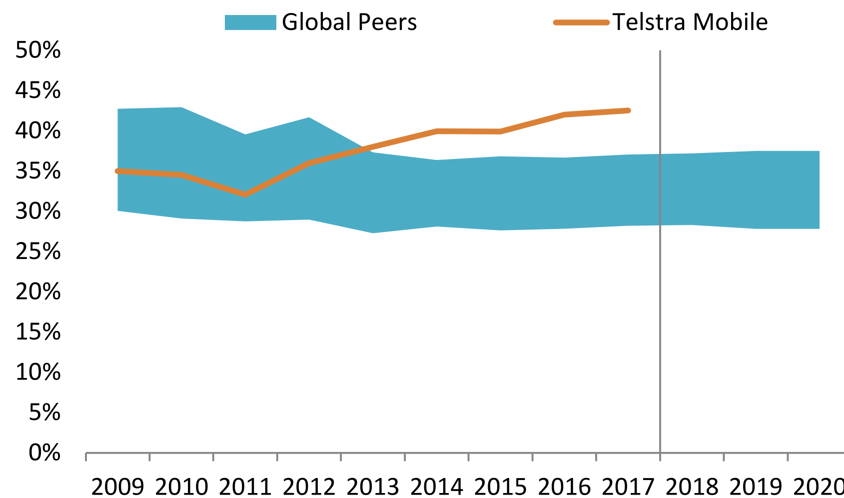
It would appear that the company has further increased its pricing premium since the result which may represent an earnings tailwind for the current period. We are cautious about the sustainability of this pricing premium and cautious about the sustainability of margins within Telstra's mobile division. We believe Telstra's network advantage is not as material as it was 5 years ago, particularly for metro areas. We note the entry of TPG into the market and we note the likely emergence of no-SIM mobile devices in coming years.

As we have discussed in previous commentaries, our investment process explicitly deals with industry structure and competitive advantage through our qualitative scorecard. We do not screen companies in or out of the portfolio based on these scores but believe deeply that returns on capital are ultimately determined by the qualitative characteristics of the industry and each player's competitive positioning. High returns on capital support high cash conversion and hence have a direct impact on our assessments of sustainable free-cash-flow and valuations.

It follows that we have built some price deflation into our assessment of sustainable free-cash-flow for Telstra's mobile division, although we accept that it is difficult to be too scientific about the quantum but directionally we feel that Telstra's mobile returns will deteriorate over the next three to five years.

Telstra's mobile division is unusually profitable relative to global peers

Figure 11: Profitability of Global Mobile Operators



Source: Bloomberg, Merlon Capital Partners

Capital intensity

At Merlon we apply a standardised approach to valuation for all investments based on our assessment of sustainable free-cash-flow. It follows that our valuations are highly sensitive to assumed levels of sustainable capital expenditure.

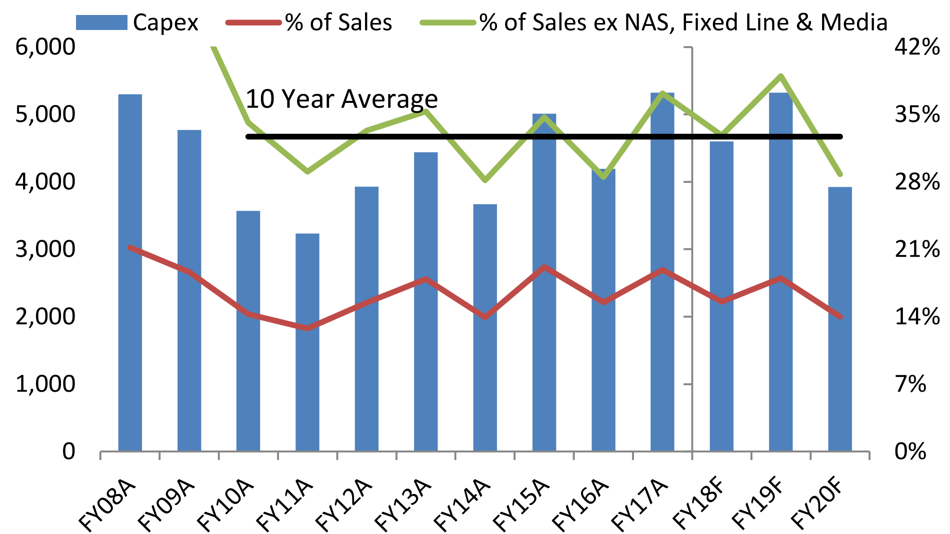
Our analysis of global network operators and telco resellers has consistently led us to conclude that Telstra's capital expenditure ***should*** be significantly lower as a reseller of fixed line services rather than vertically integrated network operator and that Telstra spends an unusually high amount on capital expenditure.

It follows that we were shocked by the company's announcement that it would be spending $15 billion in capex over the three years to June 2019. The company's capex agenda is strikingly high when we consider that 27% of the company's recurring revenue will come from fixed line services utilising third party infrastructure (i.e. the NBN).

Telstra have indicated to the market that it expects capex to reduce to approximately 14% of sales in 2020. Since the NBN was announced Telstra has had little incentive to invest in its fixed line network. It is also the case that Telstra's Network Application Services ("NAS") and Media divisions are much less capital intensive (and lower margin) than the rest of its businesses. As such, it is probably more appropriate to compare Telstra's capex to its non-fixed line, non-NAS and non-Media businesses over this period.

Telstra's core mobile and infrastructure businesses are highly capital intensive

Figure 12: Telstra Capital Intensity (Forecasts Reflect Management Commentary)



Source: Company Accounts, Merlon Capital Partners

From this perspective, the company's current capex budget appears historically high, although the 2020 guidance of 14% of sales is slightly lower than the experience over the past decade when excluding "capital light" segments.

What is clear to us is that Telstra is and will remain a highly capital intensive business with its core mobile and corporate/wholesale businesses historically absorbing between 30 and 40% of revenues in capital expenditure.

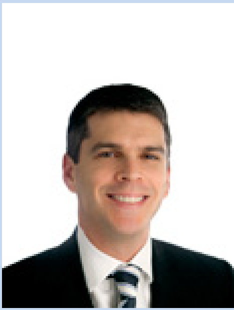
Fund positioning

Telstra's is not a core holding in the fund

It is clear to us that despite the recent share price fall Telstra is no bargain, even if management achieve what we believe are potentially optimistic targets. Poor earnings quality, headwinds related to the NBN, potentially unsustainable mobile margins and high capital intensity lead us to conclude there is probably downside to these targets and our base case valuation. As such, Telstra is not a core holding in the fund.

Market Outlook and Portfolio Positioning

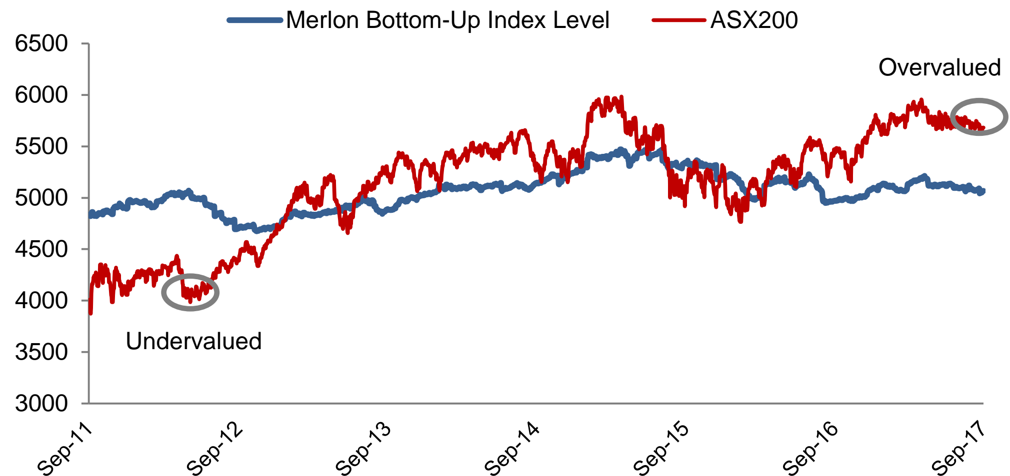
Neil Margolis



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 13). There continues to be a wide dispersion across sectors, with resources, healthcare, property and infrastructure overvalued relative to other parts of the market.

Figure 13: Merlon bottom up market valuation vs ASX200 level

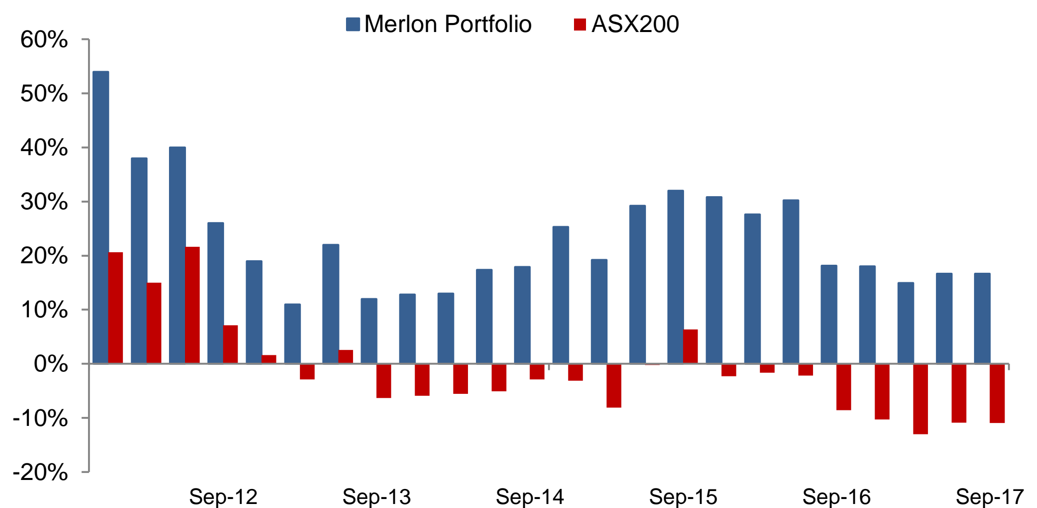


Source: Merlon

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 continues to offer 17% absolute upside representing a 28% premium to the market. As seen in Figure 14, the Merlon portfolio is looking attractive relative to the capitalisation-weighted index.

Figure 14: Expected return based on Merlon valuations



Source: Merlon

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 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, and Origin Energy** should 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. Further, 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 (Amazon Not Introducing Internet to Australia).

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 and equally are happy to invest in them when the market is overly concerned – as is the case now. 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 outcomes of a strategy to invest in companies that are under-valued relative to their sustainable free cash flow and the franking credits they generate for their owners. The market's 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.

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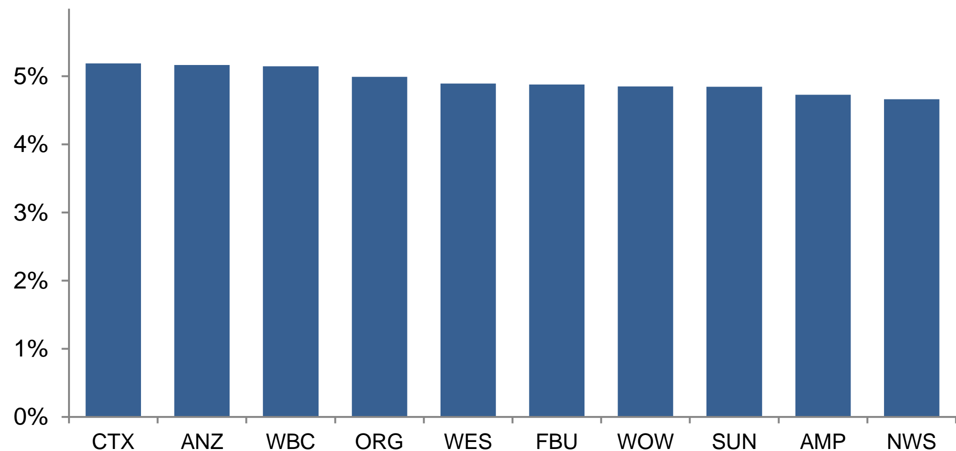
Figure 15: Top ten holdings (gross weights)

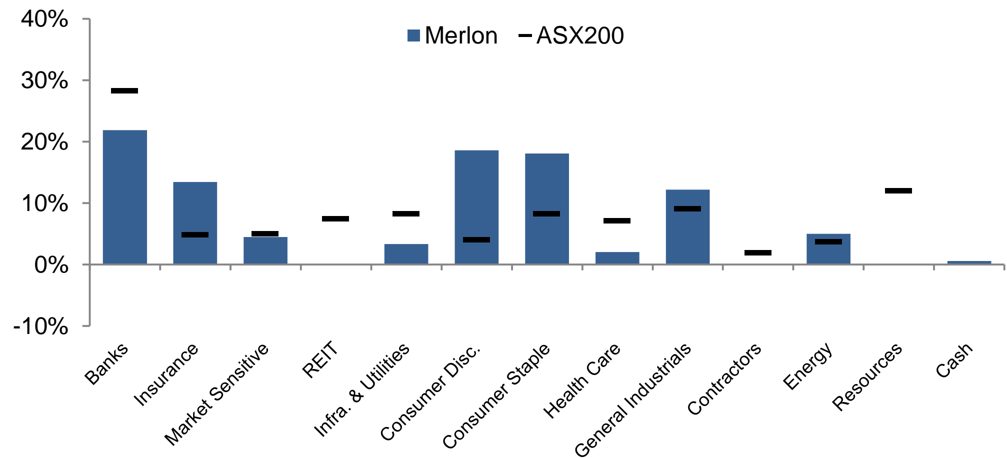


Source: Merlon

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. **Caltex's** declining capital intensity and strong industry position should offset the loss of the low margin Woolworth's supply contract. **ANZ Bank** and **Westpac** are not pricing in an improvement in returns despite demonstrating an ability to pass on higher funding and capital costs to customers. **Suncorp's** insurance business is under-earning despite increased industry concentration while the retail banking business has high returns and surplus capital. **Fletcher Building's** leading position in the New Zealand construction sector is expected to offset the impact of short term contract losses. **AMP**'s trusted brand and aligned planner network generate stable cash flows, which are currently being obscured by problems in its under-earning life insurance business. Similarly, **Origin Energy** is backed by its capital-light retail utility business 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.

Figure 16: 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 17: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	27	200
Active Share	75%	0%
Merlon Valuation Upside	17%	-11%
EV / EBITDA	9.0x	11.5x
Price / Earnings Ratio	15.0x	16.8x
Price / Book Ratio	2.8x	3.4x
Trailing Free Cash Flow Yield	5.7%	5.1%

Source: Merlon

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September Quarter Portfolio Activity

We introduced a new investment in Caltex

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

We invested in **Caltex**, a leading Australian fuel refiner and distributor. Given Merlon's focus on sustainable free cash flow, Caltex's declining capital intensity following the closure of its Kurnell oil refinery is appealing, and is enhanced by more than $3/share in surplus franking credits. We saw an opportunity to invest in Caltex when its low margin wholesale supply contract with Woolworths was flagged to be ending following the sale of Woolworths service station sites to BP. Caltex has a strong industry position, which will enable it to recover these volumes and continue to push margins higher. Further, we believe BP is incentivised to support pricing given it paid a high price for the Woolworths sites. The exit of Woolworths further concentrates the industry, enabling continued strong margins and rational pricing activity amongst the majors.

We increased our position in **Fletcher Building** on share price weakness. 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 reinvested in **Coca-Cola Amatil** which underperformed following reported lower volumes and pricing. We continue to like the company's dominant branding and its distribution network and believe these will support volumes and margins over the longer term.

We also added to the position in **Trade Me Group**, which despite reporting lower margins, a function of underinvestment under its previous Fairfax ownership, maintains clear leadership in the New Zealand market for its key segments, allowing it to maintain margins while growing volumes.

Funded by exiting Boral and Perpetual

We funded these investments by exiting **Boral** following a period of outperformance, and **Perpetual** as its product quality is likely to see difficulty in addressing fund outflows.

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Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	7 Years (p.a.)
Portfolio Return (inc. franking)	-0.7	0.0	0.0	11.4	11.6	15.8	12.0
ASX200 Return (inc. franking)	0.2	1.2	1.2	10.7	8.6	11.6	9.4
Excess Return*	**-0.8**	**-1.1**	**-1.1**	**0.7**	**3.0**	**4.2**	**2.6**

* Excess returns may not sum due to rounding, performance before fees.

September Quarter Market Review

The market rose by 1.2% (including franking) in the June quarter, following the strong 2016 financial year. The Australian dollar gained around 2 cents despite key commodities, such as iron ore finishing the quarter largely flat, while other commodities such as oil and copper both rising.

Sector performance was mixed, with resources strongly outperforming a negative industrials segment. **Telecommunications** performed worst on the back of competition concerns, while **Utilities** also declined, on uncertainty surrounding domestic energy policy.

Within the resources segment, **Energy** performed strongly as oil prices increased on evidence of US inventories declining, while M**ining** (and industrial) companies exposed to aluminium benefited from expectations of Chinese supply side reforms driving higher prices, offset by expectations of fading Chinese steel (and iron ore) demand going into a seasonally weaker period.

Portfolio Performance Review

The Strategy underperformed due to exposures to Magellan Financial and QBE Insurance.

The Concentrated Value Strategy returned 0.0% for the quarter, behind the index mainly due to the pull back of several positions which had previously outperformed.

Flight Centre, which we have been reducing, was the best performing portfolio holding, with the company continuing to rise following its outperformance of market expectations. **Origin Energy** outperformed on the back of strong oil prices as well as expectations of continued deleveraging. An underweight exposure to **Vocus** also contributed as the company extended its declines with market uncertainty following lower earnings guidance and potential class action following this. **Bank of Queensland** and **Amaysim** rounded out the top 5 contributors in the quarter.

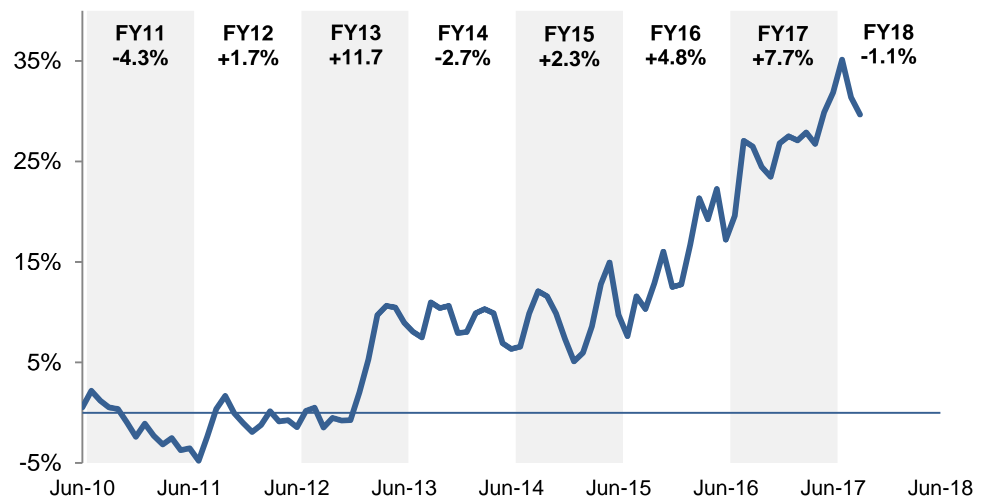
Magellan was the biggest detractor after the company disappointed on lower performance fees, leading to a slight decline in its full year profit. Other detractors included **QBE Insurance**, on the effects of cyclonic activity in key markets, and **Suncorp** on concerns over higher spending on digital technology and branding. **Trade Me Group** and **Sky Network Television** were also key detractors over the quarter.

Stock selection outcomes have been positive over longer-term periods

On a five year rolling basis, the Concentrated Value Strategy has outperformed by 4.2% per annum, with underlying stock selection of 2.2% enhanced by a non-benchmark construction tailwind of 2.0%. 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 18: Cumulative excess returns



Source: Merlon

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Strategy FUM	Merlon FUM
$1,249.1m	$1,523.9m

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"

Links to Previous Research

Iron Ore is Well Above Sustainable Levels

Boral's High Priced Acquisition of Headwaters

Some Thoughts on Australian House Prices

The Case for Fairfax Media Over REA Group

Value Investing - An Australian Perspective

Amazon Not Introducing Internet to Australia

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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