Merlon Concentrated Value Strategy

Quarterly Report

March 2018

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Analyst:
Hamish Carlisle

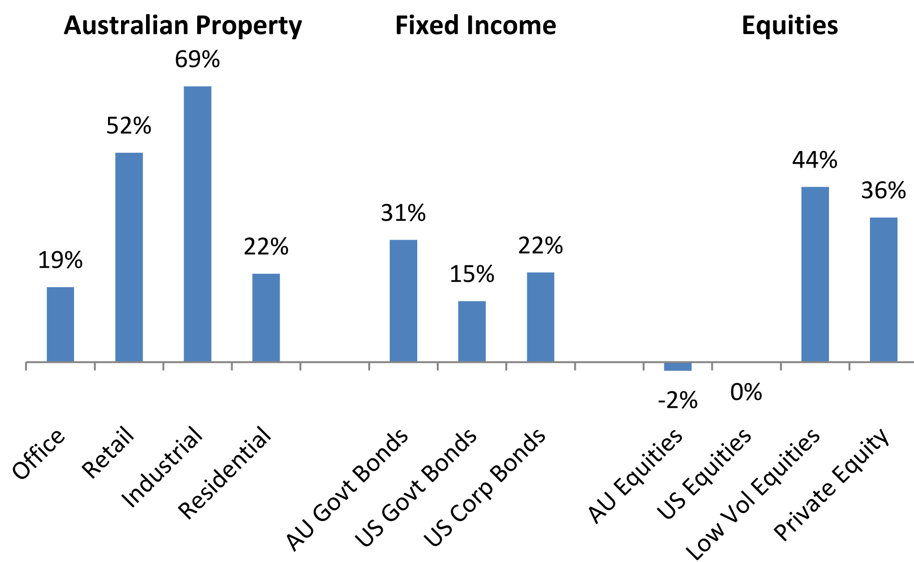
Some Thoughts on Asset Prices

This time last year we outlined some thoughts on Australian house prices and noted the premium at which dwellings in this country traded relative to historical averages. In this paper we position this analysis within the context of global asset prices.

The issue of high asset prices is not isolated to Sydney houses. Other global cities have experienced similar price appreciation and most asset classes – with the notable exception of listed equities – are trading well above historic norms.

Most asset classes are expensive relative to post 1990 averages…

Figure 1: Current Valuation Multiples Relative to Post 1990 Averages



Source: Bloomberg, AMP, ABS, RBA, S&P Capital IQ, Merlon Analysis

Forecasting a widespread correction in asset prices is highly speculative in our view. Similarly, while there is a loose correlation between market wide valuation multiples and subsequent returns, we think forecasting long term returns is equally futile.

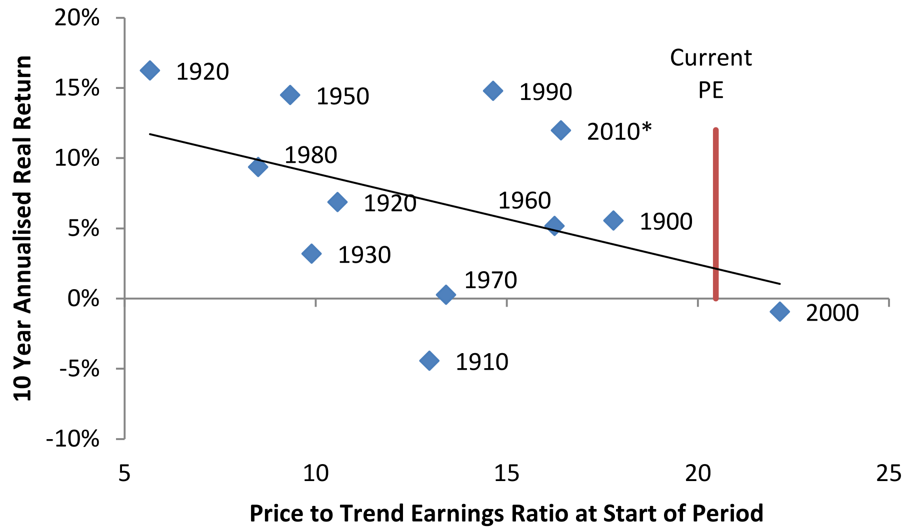
That said, it is clear to us that assets prices have benefitted from low interest rates and that asset prices are vulnerable if expectations of low and stable inflation turn out to be wrong.

A tilt towards listed equities is sensible in the current environment…

Of course, we could be worrying about nothing in which case listed equity valuations will probably catch up to other assets. Either way, we think a portfolio tilt towards listed equities is sensible in the current environment.

Forecasting long term returns and market timing is difficult…

Figure 2: S&P 500 Valuation Multiples & Subsequent 10 Year Returns



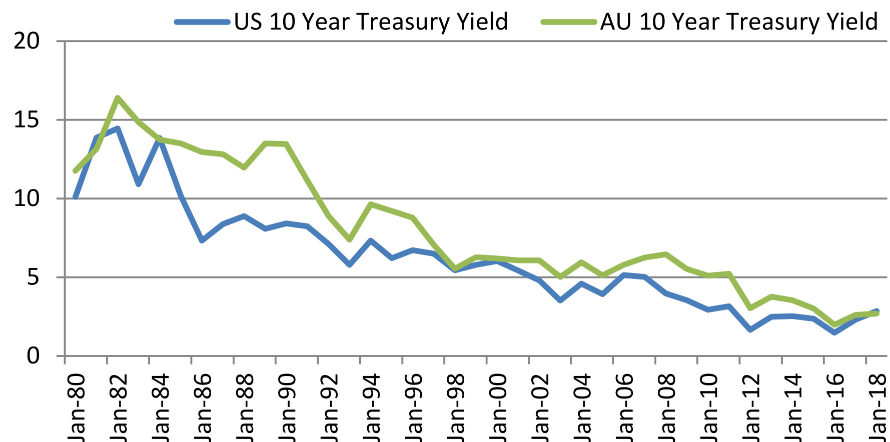
*Source: Robert Schiller, Bloomberg, Merlon Analysis, * 8 years & 2 months to February 2018*

Interest Rates & Inflation – A Long Term Perspective

A key driver of currently high valuation multiples appears to be the complacency among many investors that interest rates will remain low for an extended period of time. The corollary of this is that inflation expectations will remain low and stable for an extended period of time. This is because perceived certainty about inflation creates perceived certainty about a bond's real return, making the bond a less risky investment.

Global growth is accelerating…

Figure 3: Bond Yields



Source: Bloomberg, Merlon Analysis

Investors tend to over-extrapolate short term trends too far into the future…

Much of our value investing philosophy at a stock level is premised on the behavioural tendency of investors to over-extrapolate short term trends too far into the future and ignore the lessons of longer term historical periods. Investors come up with new rules for the new world and are quick to dismiss tried and tested valuation frameworks.

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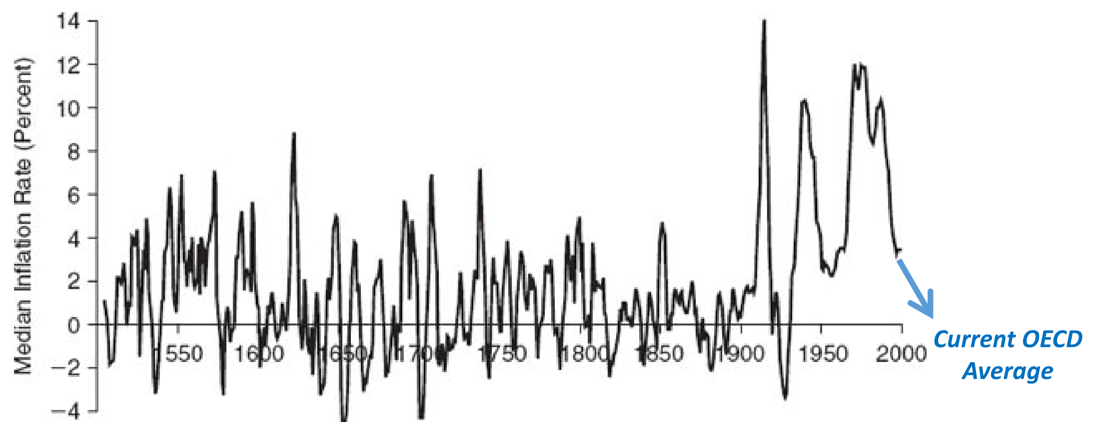
It is unprecedented for the world to escape periods of high and volatile inflation…

This is an example of what psychologists call the “availability heuristic”, or our tendency to heavily weigh our judgements towards more recent information, making new opinions biased toward that latest news.

When we discuss and consider individual company investments at Merlon we always view current conditions within the context of the long term. This is always at least 10 years but preferably longer, particularly when it comes to macroeconomic conditions. This helps us avoid falling into the trap of placing two much weight on current conditions.

In the case of inflation, there are centuries of data to consider. What we would note is that high and volatile inflation is the norm and the current environment is highly unusual.

Figure 4: Global Inflation



Source: Carmen M. Reinhart & Kenneth S. Rogoff (2009), OECD, Merlon Analysis

There have been many reasons postulated as to why such conditions might prove sustainable:

- Dr Philip Lowe, Governor of the RBA recently commented that officials were still trying to figure out what the new “normal” level of interest rates might be, because wages growth and inflation were not behaving as they have in the past.”;
- Central banks have postulated that increased life expectancy and an aging population put downward pressure on real interest rates as people build up higher savings;
- Others have suggested that technology means most economies would struggle at times to achieve sustainable inflation rates of 2% or more over the medium run.

Monetary stimulus and external borrowing have always been tempting devices…

… to avoid hard decisions about spending and taxing

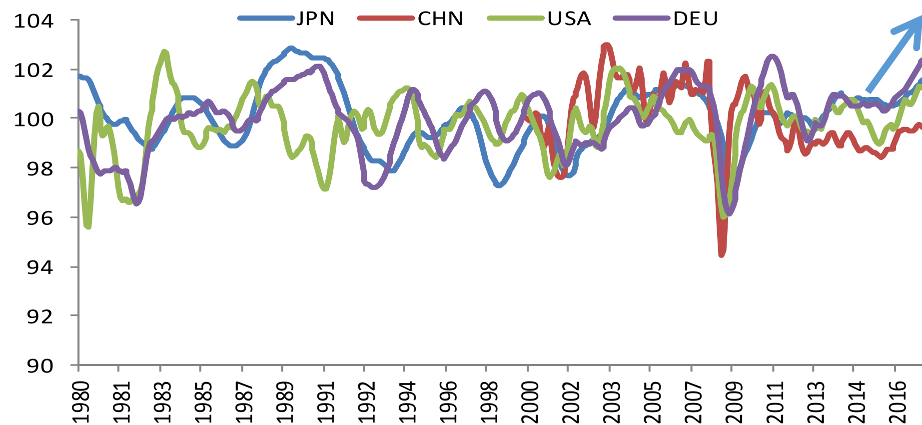
Stepping back from some of the miniature, history shows how difficult it is for the world to escape periods of high and volatile inflation. The underlying cause is debatable and arguably academic. Having said that, weak institutional structures and a problematic political system, have always made monetary stimulus and external borrowing tempting devices for governments to employ to avoid hard decisions about spending and taxing.

Current Inflationary Pressures

Turning to the current environment, it is worth noting that a number of factors that have served to depress inflation in recent years appear to be receding. First, global economic growth is synchronised and accelerating. In particular, business confidence is improving which would typically be associated with higher demand for labour and capital goods. This lift in demand may well flow through to higher prices.

Global growth is accelerating…

Figure 5: Business Confidence

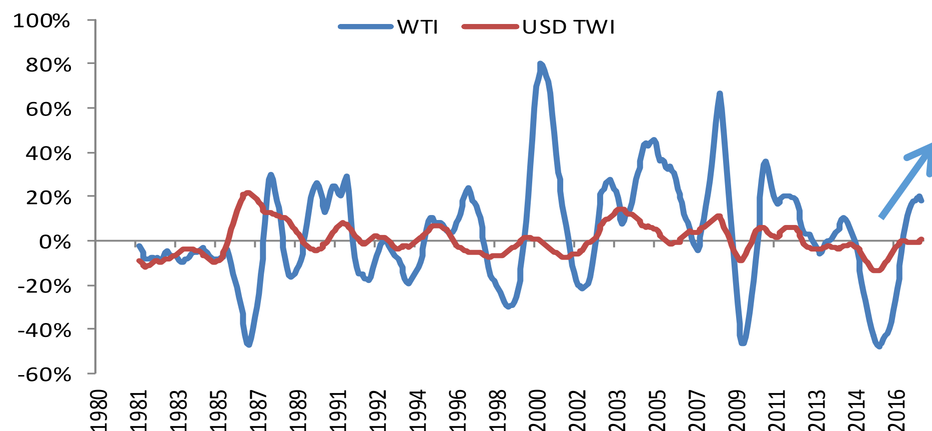


Source: OECD, Merlon Analysis

Second, there have two critical cyclical factors that have dulled CPI growth in the US in recent periods being the falling oil price and the strong US dollar. Both these trends have reversed. Additional deflationary impacts have also been felt from owners equivalent rent, health and communications. Again, a normalisation of these components will lead to a notable pick up in the rate of growth of the CPI.

Transitory factors that have dulled inflation are fading…

Figure 6: Transitory Factors impacting the US CPI



Source: Federal Reserve, Merlon Analysis

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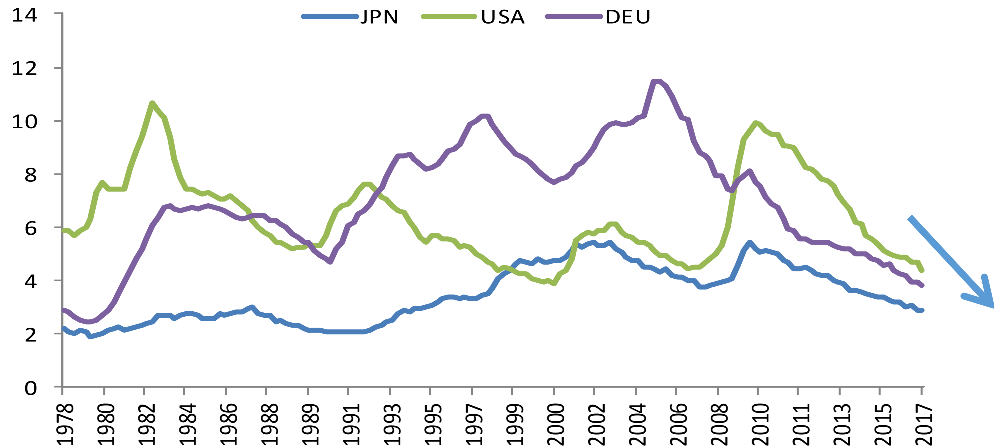
Capacity utilisation is high…

Third, major economies are approaching historically low unemployment. At some point low unemployment will create wage pressures as businesses seek to entice new workers into the labour force.

Figure 7: Unemployment Rate



Source: OECD, Merlon Analysis

In addition to these aspects is the significance of Trump's massive fiscal stimulus in the US. These measures were only just passed, are not reflected in any of the data presented and the quantum of these initiatives at a time when the world economy is growing and where capacity utilisation is tight is unprecedented. Trade barriers will only serve to drive up US wages and inflation.

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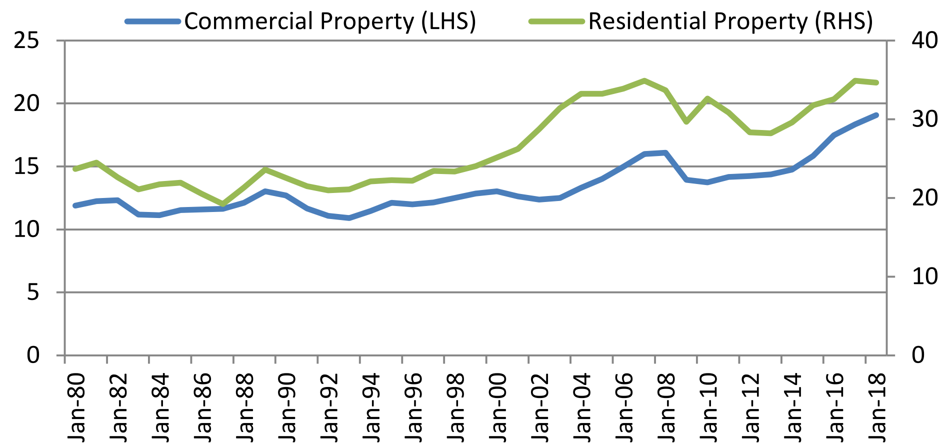
Commercial Property could be More Expensive than Residential

Relative to recent history, commercial property is more expensive than residential property…

While there has been much focus on residential property in recent years, the rapid increase in commercial property prices has been less well publicised. We note that while residential property is passing hands at a price-to-rent ratio that is approximately 20% above its post 1990 average, commercial property is trading at around a 30% premium.

Figure 8: Price-to-Rent Ratios

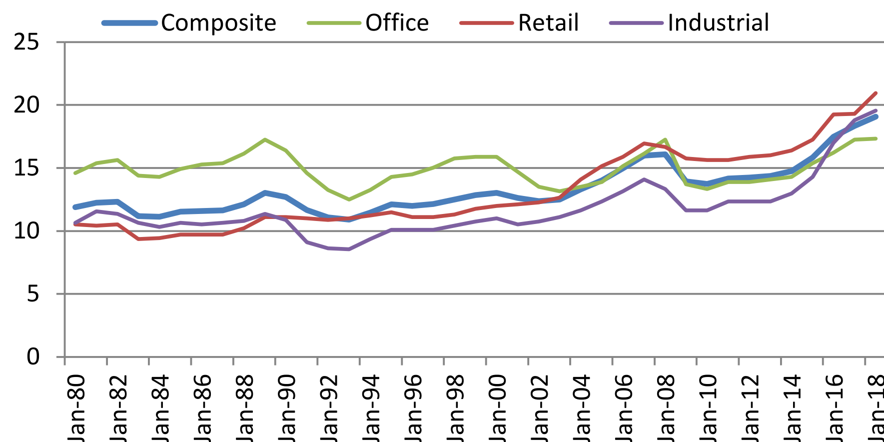


Source: ABS, Bloomberg, AMP, Merlon Analysis

This commercial property price inflation has been most conspicuous in the "industrial" category. This is particularly concerning to us given the lower lead times in adding supply in this category and the often enormous incentives provided to new tenants, particularly during economic downturns.

Industrial property prices are particularly concerning…

Figure 9: Price-to-Rent Ratios



Source: Bloomberg, AMP, Merlon Analysis

A final point to note about residential house prices is that Australia – and Sydney in particular – is not that unusual when compared to other global cities with geographical constraints to growth. In short, booming asset prices are a global phenomenon. If we go down, we may all go down together.

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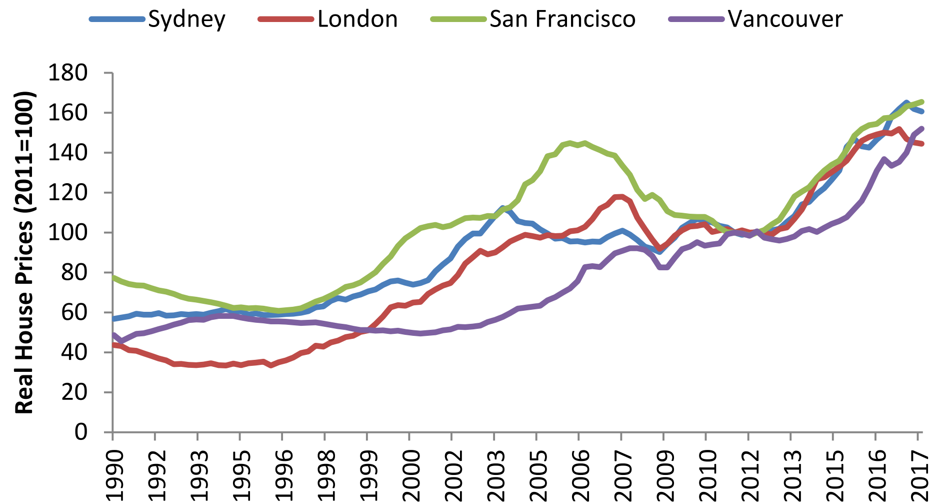
Rising house prices is not unique to Sydney…

Figure 10: Real Dwelling Prices (2011 = 100)



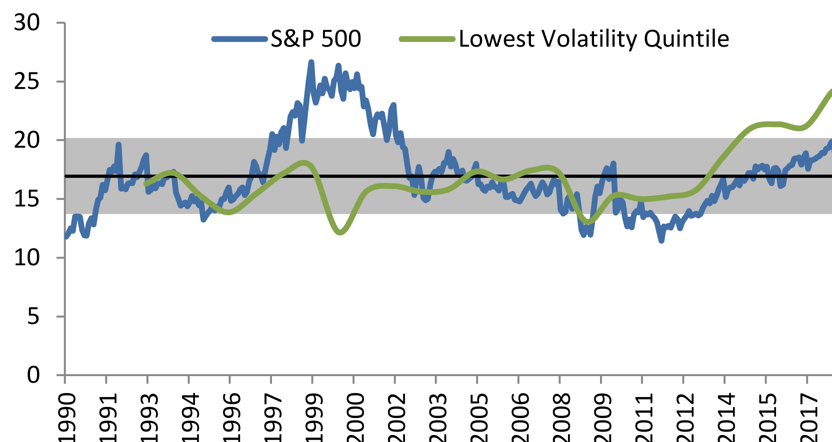
Source: Bloomberg, Merlon Analysis

Divergent Equity Valuations

Aggregate equity market valuations are broadly in-line with recent historical averages. However, there are key components that appear very expensive. In particular we observe the recent inflation in "low volatility" stocks. These stocks are often viewed as the least risky option for investors seeking equity market exposure and include a number of REITS which, as we have already discussed, appear expensive relative to historic norms.

"Low vol" equities appear expensive relative to history…

Figure 11: S&P 500 P/E Ratio

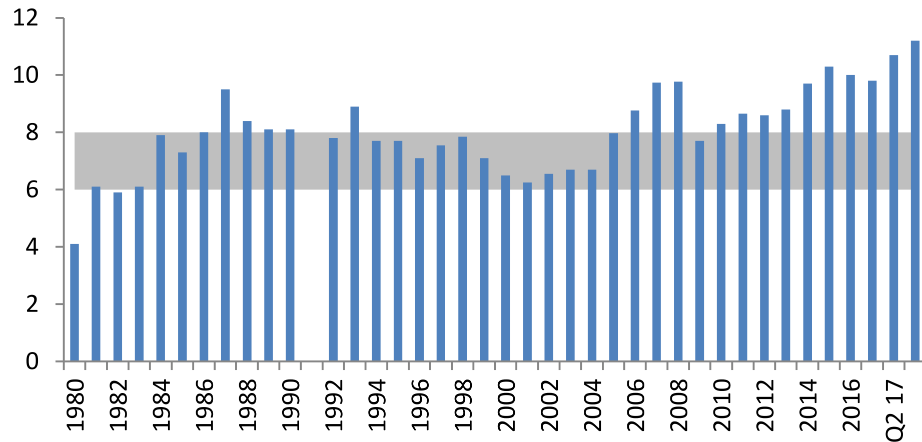


Source: Bloomberg, Merlon Analysis

Another trend has been investors seeking exposure to unlisted assets as means to avoid market volatility. This too looks like a crowded trade with private equity multiples excessively high compared to historic averages and compared to listed equities.

As do private equity transactions…

Figure 12: Average EBITDA Purchase Price Multiple for US LBO Transactions

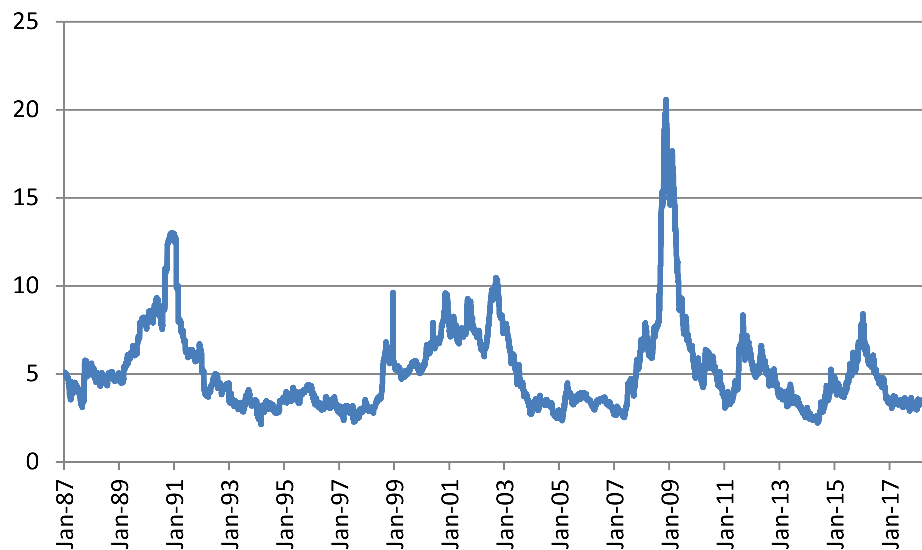


Source: S&P Capital IQ, LSE Research, Merlon Analysis

This trend is arguably symptomatic of cheap funding with credit spreads at cyclically depressed levels.

And corporate debt…

Figure 13: US High Yield Credit Spread – 10 Year



Source: Barclays, Merlon Analysis

Merlon Perspective

Since we founded Merlon in 2010 we have consistently valued businesses on the basis of sustainable cash flows discounted at sustainable interest rates and sustainable risk premiums. We do not subscribe to the view that inflation is permanently lower than it has been in the past but even if we did we would not be positioning the portfolio differently as we think it would imply the parts of the Australian equity market to which our portfolio is exposed are absurdly undervalued compared to bonds, property and so-called “low vol” equities.

Our approach has increasingly positioned us away from many of the sectors that have benefitted from falling interest rates which has created a short-term headwind for our investors. We think this will reverse in time, at least in a relative sense.

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Analyst:
Joey Mui

Traditional media share of ad spend declining in all markets

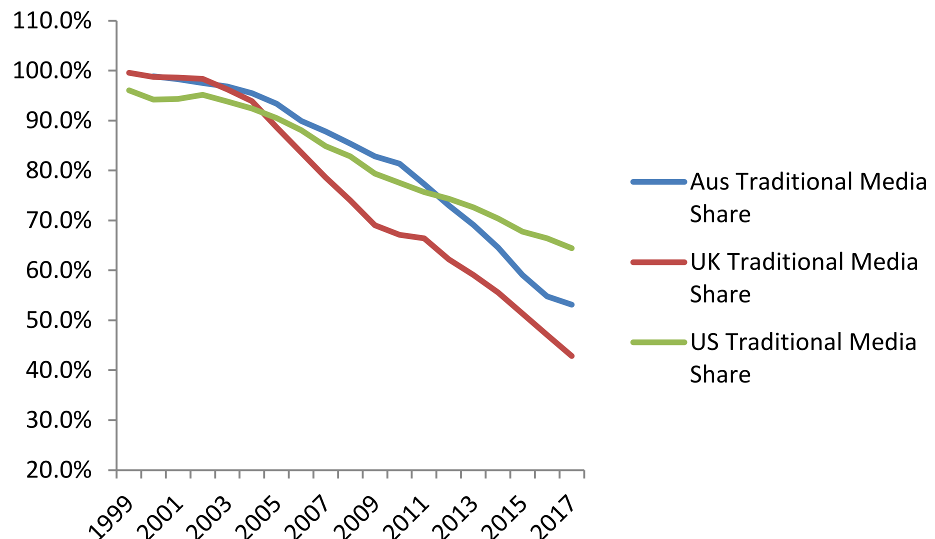
Digital vs Traditional Media – A Global Trend

It has been challenging few years for traditional media companies globally with share of the advertising pie increasingly allocated to digital players such as Facebook and Google. And Australia has not been immune from this trend.

That said, we think there are signs that the rate of change may be slowing as advertisers become more sceptical about how digital dollars are being spent, more focused on long term brand health and more focused on data transparency.

Further, both locally and globally, advertisers are experiencing deteriorating brand strength and revenues, possibly due to an over-allocation to digital relative to traditional brand marketing.

Figure 14: Traditional Media spend % of total Advertising Spending – Australia, UK, US



Source: Group M, Merlon Estimates

Currently, spend on digital advertising represents around 47% of overall ad spending in the Australian market. This compares to digital ad spend of 57% in the UK, 36% in the United States.

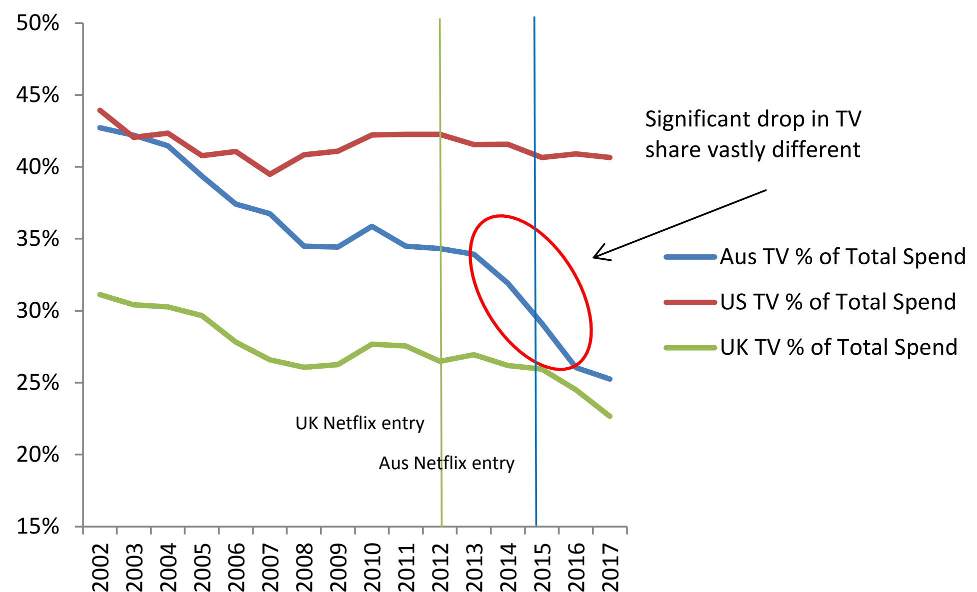
While it is likely that Australia's digital share will continue to trend up over time, we do note that both Australia and the UK are higher than other comparable markets, especially the US.

Australian TV advertising has had a horrid two years…

Australian TV Declines Over-extended

When we look specifically at Television, there have been some pronounced differences in market share between these markets. Arguably some of Australia's TV ad share decline can be attributed to impact of Netflix's entry in 2015. Industry feedback has pointed towards overconfidence in digital marketing due to superior headline return on investment (ROI) data. Linear television has suffered disproportionately from the view that it is an expensive and "old-fashioned" medium that is inferior to the "data-rich", short term ROI digital mediums.

Figure 15: TV Market Share of Advertising Spending



Source: Group M, Merlon Estimates

That said, there is some evidence that media buying agencies have been incentivised to "over-index" to digital mediums. This issue has attracted a lot of attention in the US since 2010 and since then agencies have been subject to much more stringent audits of the way clients' funds are disbursed.

To understand the trajectory, it is worth recapping the evolution of digital marketing in Australia as this is poorly understood and the history is highly instructive in understanding the future trajectory.

For many years, traditional publishers were able to achieve over-inflated prices for their inventory…

The Early Days of Digital

Up until 2010, the majority of digital advertising sales between publishers and advertisers were no different to traditional media sales. Advertisers would approach media buyers who would buy inventory on their behalf adding value through leveraging their purchasing power to buy large blocks of advertising at discounted prices.

A key issue with the model was the long tail of small publishers that media buyers were unable to access for their clients. This led to the creation of the first "ad networks" which allowed smaller publishers to pool inventory and access the market.

Early on, mainstream publishers and their agencies had vested interests in dismissing ad networks as delivering ad impressions that were less effective and less transparent than traditional mediums. This has meant that for many years mainstream publishers were able to achieve prices for their inventory well above what might otherwise have been the case.

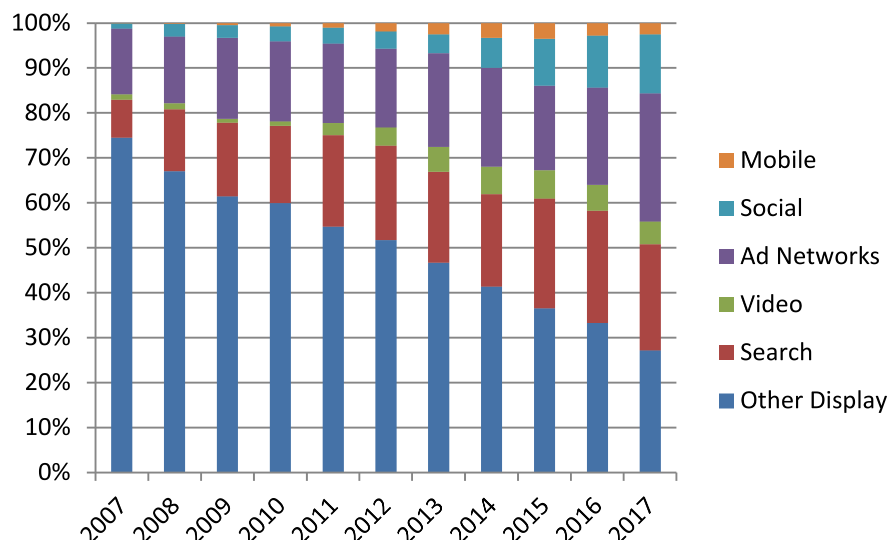
The Rise of Real Time Bidding

But real time ad-networks brought much more inventory to market…

At the same time, the rapid growth and enormous success of search engine marketing was driving a push for increased transparency and effectiveness across all mediums. Search advertisers were able to specifically target outcomes whereas display advertisers appeared quite nonselective and haphazard by comparison.

More advertising was being transacted through Real-Time Bidding (RTB) methods and so campaigns needed to be adjusted in real time rather than annually or quarterly.

Figure 16: Composition of Digital Advertising Spending – Australia



Source: SMI, Merlon Analysis

The Rise of "Ad Networks" & Incentives to Overweight Digital

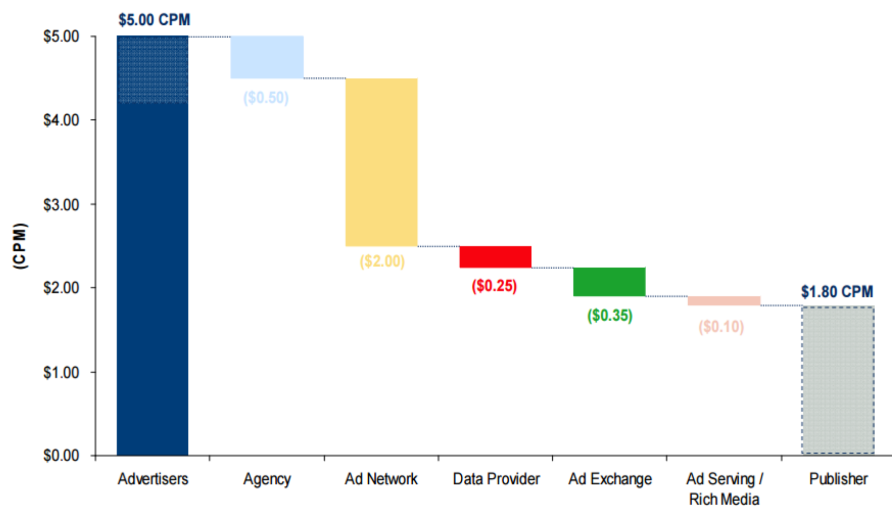
As discussed earlier, mainstream publishers and their agencies initially had vested interests in dismissing ad networks as delivering ad impressions that were less effective and less transparent than traditional mediums.

However, as time went on large publishers began to embrace ad networks as a means to monetising excess inventory. At the same time, more sophisticated advertisers were benefitting from shifting spend away from mainstream publishers.

When compared to traditional media buying fees, ad networks were earning very high margins. Major agency holding companies sought to capture a portion of that margin for themselves and their clients by establishing "trading desks".

The ad-network model was bad for publishers…

Figure 17: Ad Networks & Advertising Value Chain

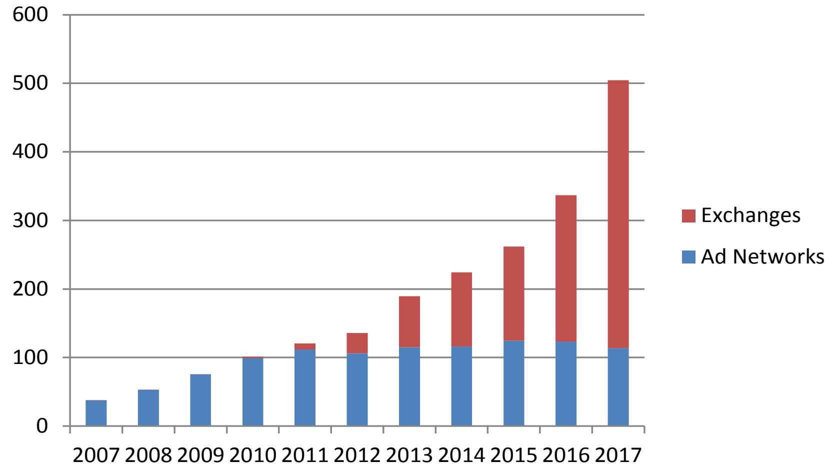


Source: Terence Kawaja Presentation, 2010

While the specific business models vary, there are a number of common features of agency trading desks and approaches to marking up other products and services that make them very different from the way media buying agencies have traditionally operated.

…and good for ad agencies

Figure 18: Composition of "Ad Network" Spending – Australia (A$m)



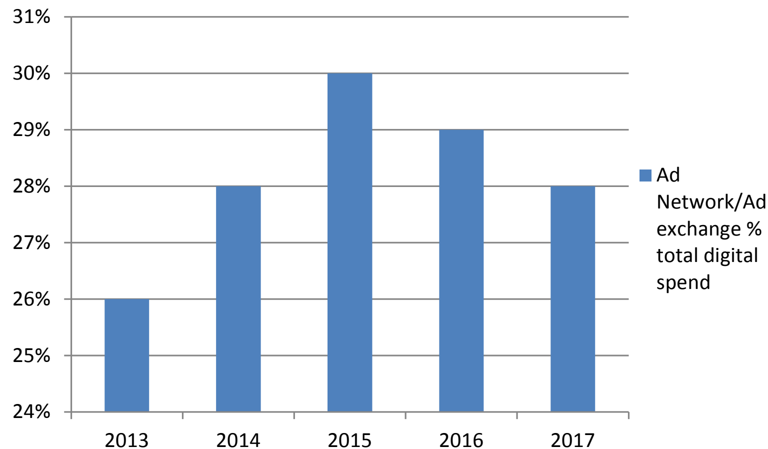
Source: SMI, Merlon Analysis

Instead of buying on behalf of clients as they have historically done, through agency trading desks, media buyers are now buying as principals and then repacking and selling "product" to clients. The result is reduced transparency for clients.

In some cases, agencies can profit from the spread between their cost price and what they resell to their clients even without bearing significant risk. In the US, this is referred to as "media arbitrage". The practice of buying ahead of clients and on-selling marked up media inventory to them is akin to stockbrokers "front-running" clients in the share market, the latter of which is illegal in most countries.

In US and Europe, this concern over transparency and arbitrage has been rising since 2014 and has contributed to reductions in the growth of arbitrage "pass-through" revenue reported by global agencies. For now, Australian companies seem less focused on enforcing transparency requirements with "trading-desk" spend continuing to expand over the same period. (See Figure 18)

Figure 19: US Ad network/trading desk revenues under pressure post-2015



Source: SMI, Merlon Analysis

USA ahead of the curve on trading desk scrutiny…

Agencies have a financial interest in selling "packaged" digital media…

Regardless of whether these revenue models represent good value for advertisers, the reality is agencies (or their holding companies) have a financial interest in certain outcomes (i.e. more digital display advertising) and these interests are not always fully disclosed and understood by all clients.

A pull-back from short termism?

We agree that headline ROI and targeted reach of digital is an attractive proposition. However, we believe the effectiveness of overall marketing spend is still dependent on an allocation across mediums to meet both short and long term goals. We also think some features of the agency model have led to over indexation of digital.

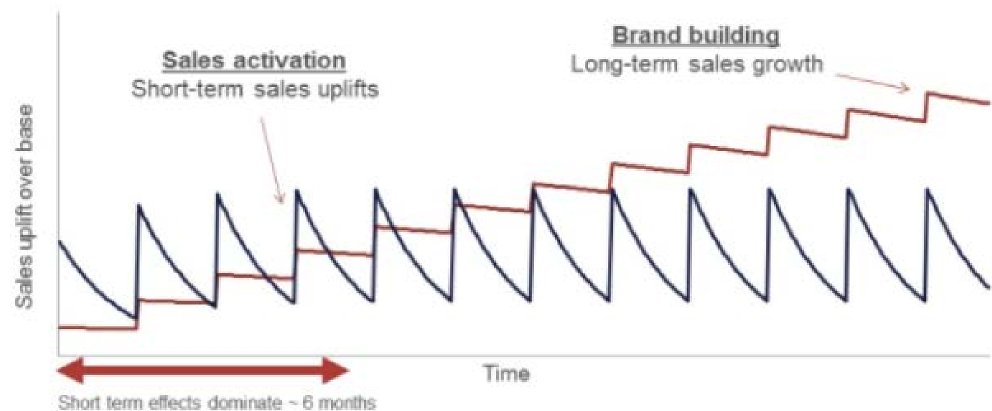
Where linear television's share matures long term is debatable but we think it would be foolish to assume free-to-air television has zero relevance in the "digital age" and equally foolish to assume free-to-air businesses cannot adapt to the digital environment.

Simplistically, marketing activity can be divided into two components:

1. ***Sales Activation:*** Marketing that aims to generate short term sales uplift via promotional campaigns. The advantage is that the impact of spending is immediately measurable through sales activity during a campaign.

2. ***Brand Building:*** Marketing spend that is targeted to drive a longer term, more emotional connection with a brand. This is essential not only for the target market but also to develop brand awareness amongst future consumers and loyalty amongst existing customers. Brand building and loyalty are not easily measured by short term ROI metrics.

Figure 20: Sales & Activation & Loyalty in Advertising



Source: Effectiveness in the digital era. 2016, Binet & Field IPA

There has been less investment in brand building in recent years…

As marketing budgets get tighter (and CEO tenures shorter), there is an incentive for companies to reduce brand building spend in favour of sales activation via digital marketing. This strategy can provide short-term sales uplift and strong 'return on investment' but doesn't do much in terms of brand building, acquisition of future customers and building a platform for sustainable growth.

Given Merlon's focus on assessing ***sustainable free-cash-flow,*** we play close attention to both the level and composition of marketing expenditure. There are many examples of companies that have underinvested in brand marketing only to find themselves struggling for growth and then (often under a new CEO) "resetting" budgets at much higher levels.

Added to potential under-investment in brand are the increasingly conflicted business models of agency "partners" who are incentivised to over allocate spending to packaged digital "products" rather than simply negotiate the best possible deals with publishers as has historically been the case.

Research and industry feedback rates television as the best medium for brand building due to its mass appeal and the degree of trust relative to digital content. Brand building requires a broad reach which has traditionally been the key advantage of television and newspapers. With newspaper readership declining at an even faster pace, TV remains the last medium with mass market reach available to advertisers.

TV best in class adjusted ROI

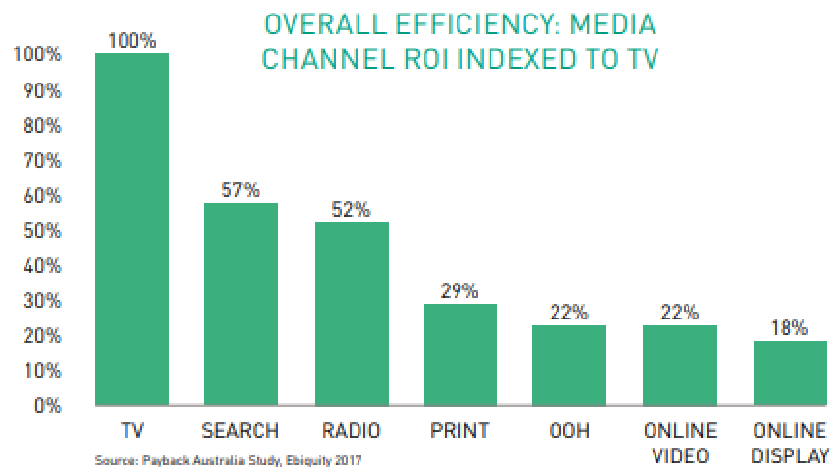
On top of the increasingly opaque pricing of digital advertising, concerns about effectiveness have also been raised, specifically the difficulty in assessing actual viewership and retention. Given the positioning of digital display around content, it is difficult to track whether eyeballs actually view advertising and whether this translates to real audience outcomes. By sharing "pixel coverage" on the screen with other content this can

reduce the effectiveness of digital display advertising compared to television which commands 100% of pixels during an advertisement.

“Independent” research by Ebiquity measured the impact of TV over 3 years compared to other media mediums. It found that TV is best in class for ROI by measuring actual sales instead of hypothetical customer reach per dollar spend. Of note, online display is the worst medium despite agency “exchanges” being most active in this category at present.

TV has its merits…

Figure 21: Overall Efficiency: Media Channel ROI Indexed to TV

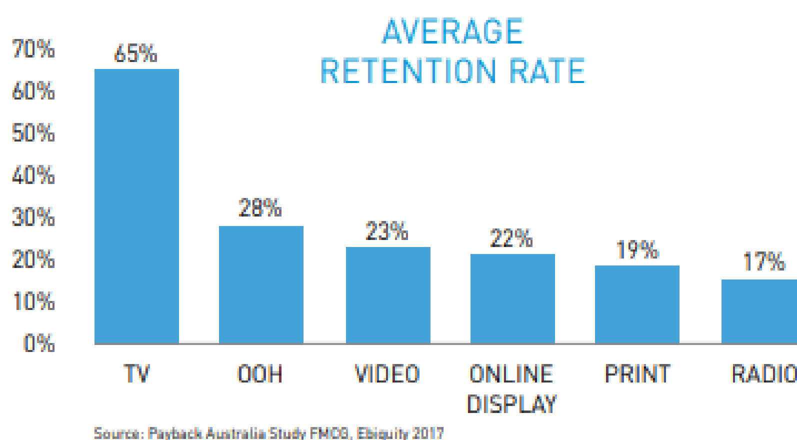


Source: Ebiquity

The study also found that TV continues to influence customers post-campaign for the longest length of time relative to other mediums.

And tends to provide more enduring outcomes…

Figure 22: Average Retention Rate



Source: Ebiquity

We are well aware that funding for the Ebiquity study is provided by ThinkTV who are in turn supported by Australia’s free-to-air TV networks. ThinkTV provide research and data on television’s effectiveness as an advertising medium. However, there are studies in other countries which have yielded broadly similar results. While the measurement of “ROI” is

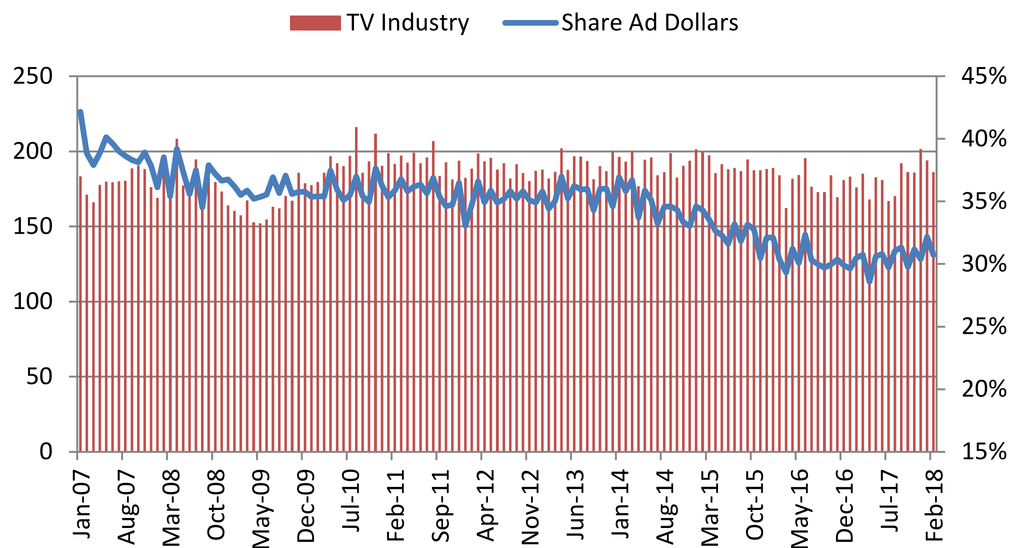
often a subjective exercise, it is clear the past perception of TV's ROI has been significantly poorer than reality and the release of the Ebiquity statistics are supportive of improving sentiment.

Signs of improvement

Contrary to general market perception, free-to-air television's share of ad spending has stabilised and grown in the past 12 months. This stabilisation may be associated with the provision of data and research by ThinkTV, which commenced in May 2016. This helps marketing departments and advertising agencies justify a reallocation of funding towards TV using evidence based metrics.

The TV market appears to have stabilised over the last 12 months…

Figure 23: TV Market Share of Advertising Spending - Australia



Source: SMI, Merlon Analysis

We also believe that companies, both locally and globally are becoming more sceptical about how their digital dollars are being spent and the lack of transparency in agency pricing models. Based on our research, Australia is behind other markets from this perspective.

Further, both locally and globally, advertisers are beginning to see the impact of the over-allocation to digital on their brand strength and longer term sales trends. Global consumer corporations, Unilever and Procter & Gamble, have been vocal in their reduction of digital marketing due to lack of transparency and effective delivery. Increasing issues around customer data privacy and potential brand damage from uncontrolled content are creating concern amongst both brand owners and customers.

At the same time, television networks have not remained stagnant in the face of digital platform competition. They have reduced costs and debt, and have invested in digital BVOD (broadcaster video-on-demand) to meet the changing preferences of their

audiences. There is enormous opportunity for free-to-air players to increase the rates they charge if the can more actively target particular audiences.

Sports Rights Need to Share in Structural Decline

Australian free to air television companies benefit greatly from anti-siphoning legislation of major sporting events that effectively shuts out subscription businesses such as Foxtel and Netflix from bidding for sporting events of 'national interest'.

We have struggled with why free-to-air broadcasters compete so hard for sports rights…

For years we have struggled with the game theory of why free-to-air broadcasters compete so hard for sports rights given that they operate under this umbrella of protection. Given Channel Ten's lower audience share, Channel Seven's AFL and debt commitments and general commentary from the various players, we had expected a more rational approach to bidding for sports rights.

To this end, we have been somewhat dismayed by Channel Nine bidding 50% more than Channel Seven's previous bid for the Australian Open and will continue to test our theory of rational competitive behaviour.

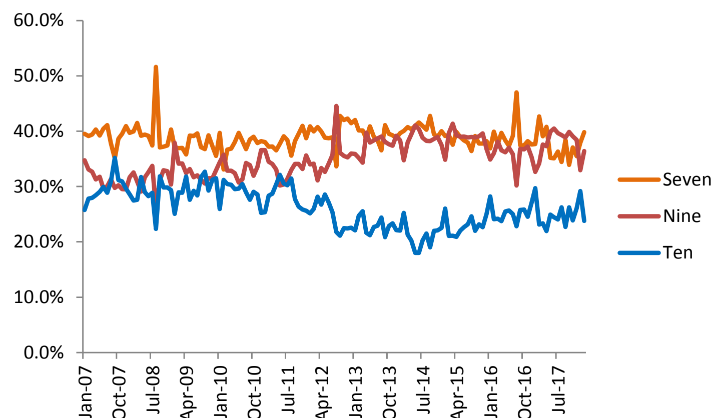
Ratings Remain Difficult to Predict

We remain cautious about trying to forecast TV ratings which are the primary driver revenue share. While we believe there is a degree of mean regression in ratings over time, it remains difficult to forecast future audience preferences and each networks ability to cater for these preferences in an economical manner. On an individual stock basis, the potential for a permanent fall in ratings share contributes to each stock's downside risk but at a portfolio level this is a zero sum game.

Other constraints such as financial leverage can limit TV players from competing for quality content to help driving ratings. These have impacted both Nine and Ten in recent years and present pose a risk to Seven who hold $725m of net debt.

TV network market shares can be volatile

Figure 24: Revenue Market Share of TV Advertising Dollars



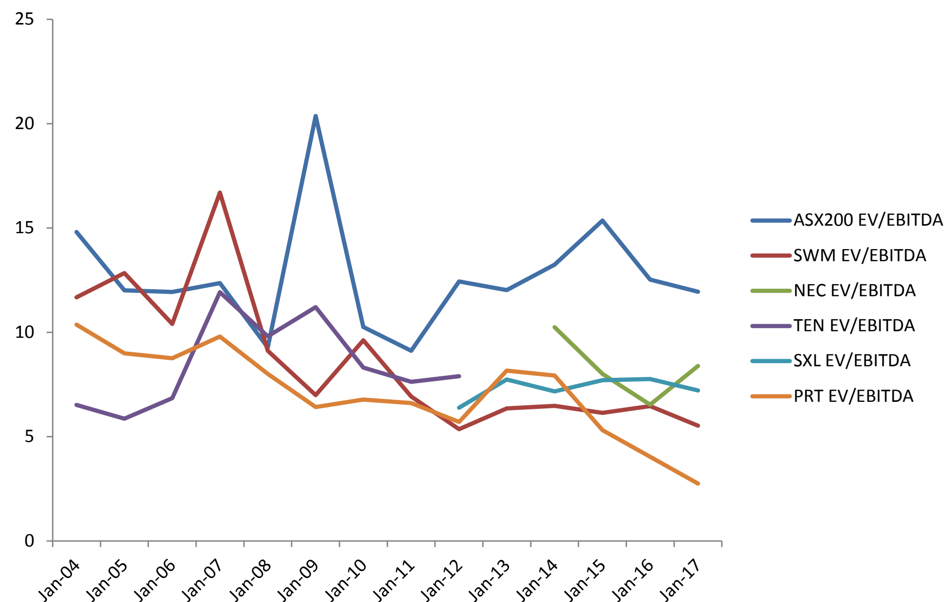
Source: SMI, Merlon Analysis

Yet the TV stocks continue to trade at heavily discounted valuations…

Listed Company Valuations Reflect Very Low Expectations

Nevertheless, we believe that the improvement in data and potential upside from positive industry developments are underappreciated by stock market investors. The spread in TV stock EV/EBITDA's relative to the overall share market remains wide and is even wider when we consider these businesses' relatively high conversion of EBITDA to free-cash-flow, our preferred measure of value.

Figure 25: Headline Valuation Multiples



Source: Bloomberg, Merlon Analysis

Given the poor momentum of television in recent years and the ongoing headwind from digital mediums, it is easy for the market to hold a negative view of the sector.

Fund positioning

We acknowledge it is uncertain whether TV's share of advertising spending represents a cyclical pullback or a permanent stabilisation. However, we believe there are some underlying drivers at play that could tilt advertisers back to the medium. The flight of advertising dollars from Australian TV has been significantly more exuberant relative to other developed markets and agencies have continued to gouge on "packaged" digital products while their offshore counterparts have pulled back due to customer backlash.

As such, we think there is some likelihood the rate of decline moderates. TV operators are actively defending their medium via evidence-based research which looks to be positive in recent advertising spend share metrics.

Uncertainty can offer opportunity as many in the market are unwilling to invest in companies with perceived structural challenges. We believe that at current prices, expectations for further declines are more than priced in for television stocks that are trading at a significant discounts to even the most bearish valuation scenarios.

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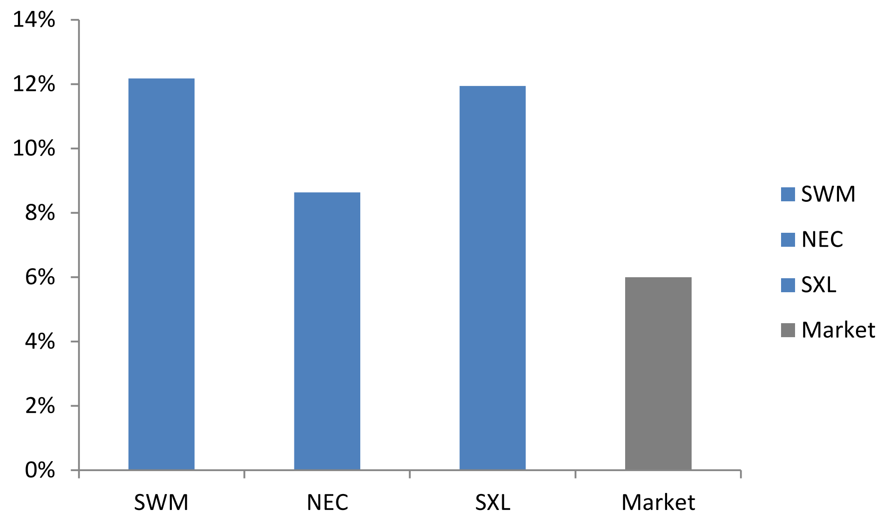
TV stocks offer some of the highest free cash flow yields in the market…

Our base case valuations indicate material upside after factoring in further declines. Furthermore the television sector continues to generate strong, fully franked, free cash flow which is very attractive relative to the broader market. In addition, we believe the shift back towards long term brand building provides an asymmetric skew to further upside.

Figure 26: Free Cash Flow & Franking Yield



Source: Bloomberg, Merlon Analysis, Undiscounted sustainable free cash flow and franking estimate divided by current market value plus projected net debt

Each TV stock offers an attractive risk/reward, but we think it is additionally prudent to own a mix of them, given the uncertainty around future ratings, debt levels and sports content cost management.

Merlon holds positions in Nine Entertainment Corporation, Seven West Media and Southern Cross Media.

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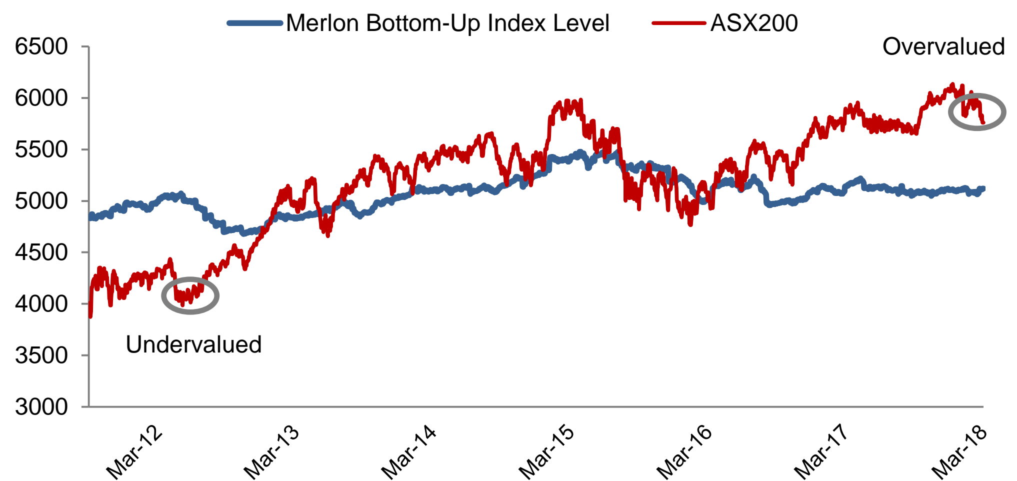
Market Outlook and Portfolio Positioning

Neil Margolis

Based on Merlon's bottom-up assessment of long-term cash-flow based value, discounted at through-cycle discount rates, the market remains around 10% overvalued post the recent pull-back (Figure 27). There continues to be a wide dispersion across sectors, with resources, healthcare, property and infrastructure overvalued relative to other parts of the market. In this quarterly report, we also reflect on asset prices more broadly and conclude equities might well be the 'least worst' option if inflation and interest rates normalise as we expect.

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

Figure 27: Merlon bottom up market valuation vs ASX200 level

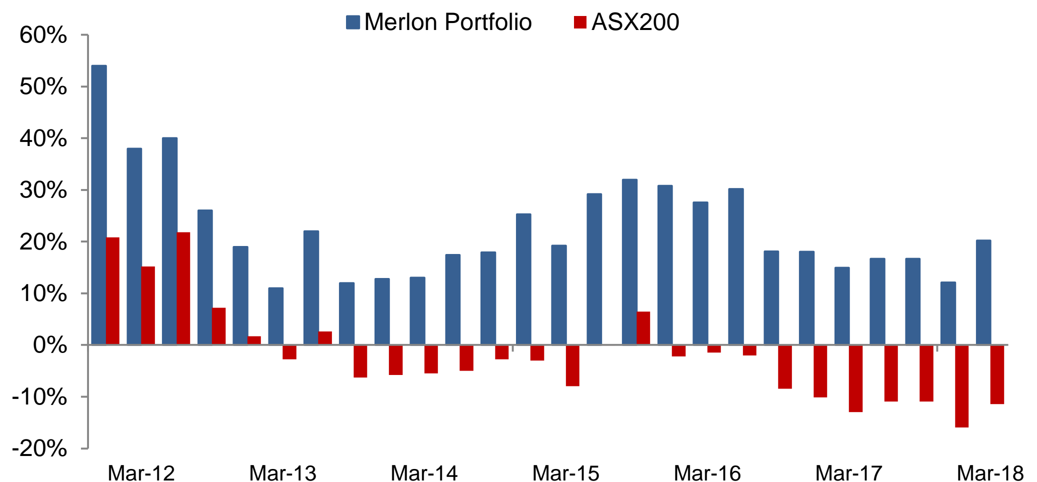


Source: Merlon

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 20% absolute upside representing a 30% premium to the market. As seen in Figure 27, the Merlon portfolio is looking attractive relative to the capitalisation-weighted index.

Figure 28: Expected return based on Merlon valuations



Source: Merlon

We invest on the basis that, over time, inflation and by implication 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 continue increasing 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, Origin Energy** and **Clydesdale Bank** 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 and media companies, 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 value in the discretionary consumer sector (Amazon Not Introducing Internet to Australia).

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. While political risks, such as the Royal Commission, cannot be ignored, we do not believe they will have a permanent impact on industry returns and cash flow generation. However, we do expect credit growth to slow, further loan repricing outside of a credit cycle to be limited and bad debts to rise towards mid-cycle levels. All this leaves the banks as moderately undervalued in an expensive market.

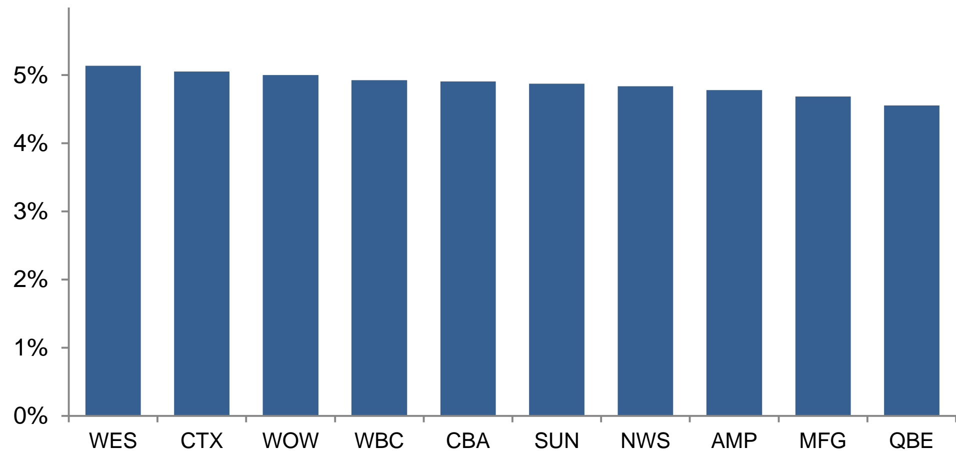
Portfolio Aligned to Value Philosophy and Fundamental Research

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.

Figure 29: Top ten holdings (gross weights)



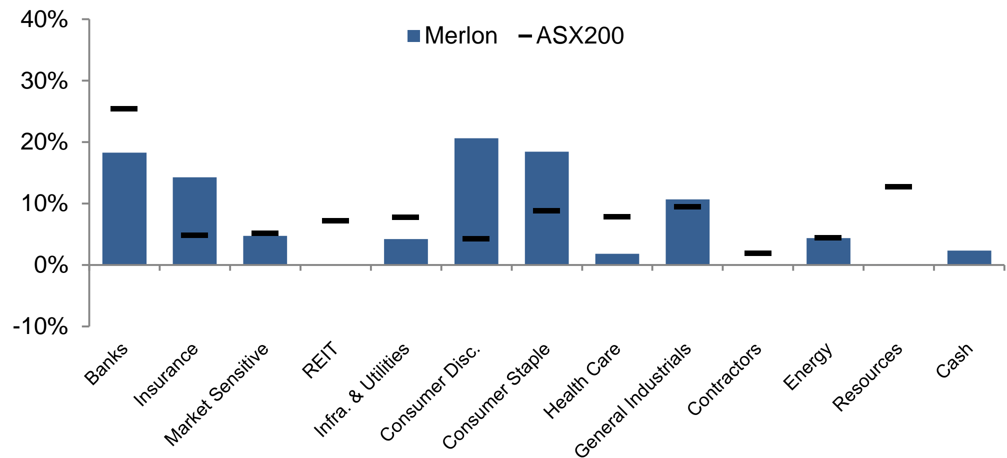
Source: Merlon

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.

The supermarket operators, **Woolworths** and **Wesfarmers**, are generating good cash-flows by competing rationally on convenience, range and value, not just price. We may have seen the worst in terms of industry price deflation, with Aldi market share maturing and Coles likely to be more rational as a separate listed entity. The Royal Commission might constrain sales commissions to mortgage brokers, perversely favouring incumbent retail banks with strong branch footprints such as **Commonwealth Bank**, **Westpac** and **Suncorp**. We continue to see current retail bank returns as more sustainable than consensus given the near doubling of mortgage capital in recent years and re-pricing linked to regulatory handbrakes applied to investor lending. **Caltex** is shifting to lower capital intensity within an improving industry structure; **News Corporation** is shifting from advertising to digital subscriptions and has net cash on balance sheet; **AMP** is exiting its capital intensive lower returning insurance segment and focusing on more cash generative funds management and advice; **QBE Insurance** has valuation support assuming minimal value outside of the domestic Australian and Lloyds businesses; and **Magellan Financial** generates strong and growing cash-flows with upside from performance fees, a debt-free balance sheet and USD-denominated FUM.

Figure 30: 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, **Seven West Media**, **Southern Cross Media**, **Virtus Health** and **Sky TV New Zealand**.

Figure 32: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	29	200
Active Share	75%	0%
Merlon Valuation Upside	20%	-11%
EV / EBITDA	8.5x	11.6x
Price / Earnings Ratio	14.7x	16.8x
Price / Book Ratio	2.7x	3.4x
Trailing Free Cash Flow Yield	5.3%	5.3%

Source: Merlon

March Quarter Portfolio Activity

We introduced new investments in Spark Infrastructure and Channel Nine

During the quarter we introduced two new investments.

We re-initiated a small position in **Spark Infrastructure**, the most undervalued of the utility and infrastructure companies in our view. Bond proxy stocks have underperformed more generally as interest rates have begun normalising from record low levels, and we have had no exposure for several years. With Spark, we are attracted to the larger contribution from non-regulated earnings compared to Ausnet. From a free cash flow perspective, these earnings are less capital intensive than the regulated business and support sustainable returns above cost of capital. The two core monopoly assets (Victoria Power Networks and SA Power Networks) do not face regulatory resets until 2020 and we value the Transgrid investment well below what Spark actually paid in 2015.

We invested in **Nine Entertainment Corporation**, the free to air television and digital news provider. Nine's free to air television market has been affected by a structural shift in audience numbers and advertising away from traditional media towards digital alternatives. This structural decline has resulted in the company's market value trading towards the lower end of a sensible range of sustainable free cash flow scenarios. There is some evidence advertisers are becoming more discerning about over-allocating spend towards digital. This could support a better outcome for television's share of the advertising pie going forward and we explore this in more detail in this report. Also, we are of the view television margins can be maintained based on more rational bidding for sports content rights

We continued to invest in existing positions, **Seven West Media**, **Southern Cross Media**, and **Wesfarmers**, and also added to bank positions; **Bendigo Bank**, **Commonwealth Bank** and **Westpac**, following material underperformance given our long-term cash-flow based valuations have remained broadly stable.

Funded by trimming positions with reduced valuation upside post outperformance

We funded these investments by trimming our positions in **Coca Cola Amatil**, **Harvey Norman**, **Navitas** and **Origin Energy**, all of which had outperformed as market concerns around their lower growth or higher risk profiles had dissipated.

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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)	-3.8	-5.2	2.7	3.5	8.7	11.0	11.7
ASX200 Return (inc. franking)	-3.6	-3.4	5.4	4.0	5.2	9.2	8.8
Excess Return*	**-0.2**	**-1.7**	**-2.6**	**-0.5**	**3.4**	**1.8**	**3.0**

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

March Quarter Market Review

The market posted its weakest quarter in 2 years, retreating 3.4% (including franking) in the March quarter. US 10 years bonds climbed 33bp but the yield curve flattened slightly with 2 year bonds rising by more. Interestingly, the US 10 year bond yield crossed over its Australian equivalent for the first time since 1998 (see Figure 3 – Some Thoughts on Asset Prices). Oil prices rose 7% (up 40% financial year to date) but bulk commodities declined, with iron ore down 14% in the quarter. The AUD proved remarkably resilient. According to RP Data, house prices declined 1% with Sydney 2% down over the quarter.

Healthcare and **Consumer Staples** were the best performing sectors, with **Telcos** worst performing yet again. **Banks** continue to lag with intensifying political heat and rising short-term funding costs rising. **REITs** & **Infrastructure** stocks also lagged despite the VIX volatility index soaring 81%, with US long bond yields proving too much of a headwind. Small caps continue to re-rate, with the ASX100 now trading at a record 20% discount to ex-ASX100 stocks.

Portfolio Performance Review

The Strategy underperformed due to exposures to Fletcher Building, Amaysim & Bendigo Bank

The Concentrated Value Strategy declined 5.2% for the quarter, underperforming the ASX200 by 1.7%. The non-benchmark approach was a tailwind, with the structural underweight to mega large-cap stocks contirbuting to relative performance.

Coca Cola Amatil was the best performing holding after the sparkling volume decline rate slowed and the impact of the NSW container deposit scheme was less than feared. **JB Hi Fi** outperformed on better than expected Christmas trading and a soft Amazon launch. **Vocus** was not held and underperformed on a poor cash flow result, NBN competition, high capital expenditure commitments and a sizeable debt burden. **Tabcorp** was not held and underperformed with the core business missing expectations and the market beginning to share our scepticism on Tatts merger synergies. **Nine Entertainment Corporation** rounded out the top contributors, benefitting from ratings and share gains, as well as early signs the overall television advertising market might be stabilising.

Fletcher Building was the biggest detractor after the company announced material contract losses, renegotiation of debt covenants and a broad portfolio review under the new CEO. **Amaysim** underperformed following an expectedly weak interim result amidst intense

competition in the mobile market. **Bendigo Bank** underperformed in-line with the bank sector, together with share losses and a rise in bad debts, albeit still at relatively low levels.

Not holding **A2 Milk** and **Flight Centre** rounded out the five largest detractors for the quarter in a relative sense.

The Strategy has also underperformed financial year to date

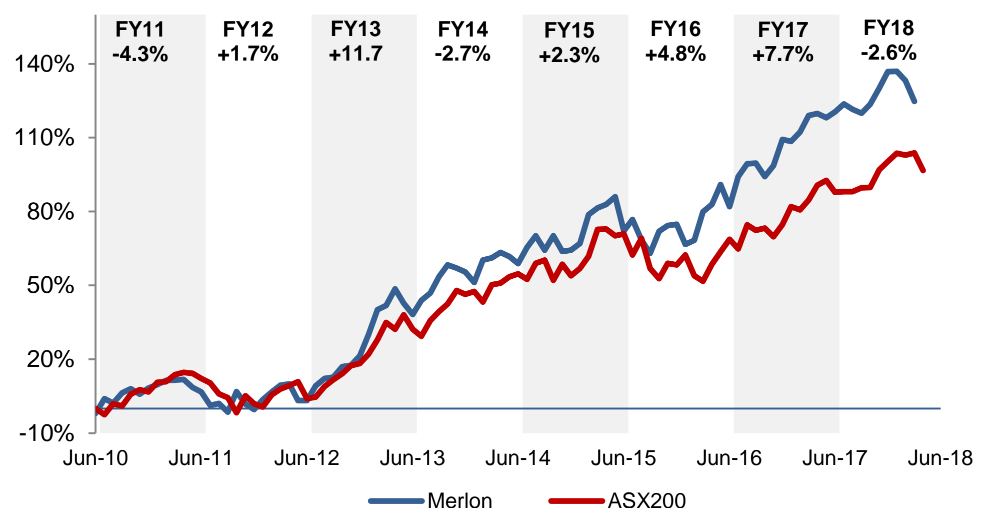
Financial year to date, the Concentrated Value Strategy has underperformed the market by 2.6%. Again, the Strategy benefitted being benchmark unaware, with a tailwind from the mega large cap stocks limiting the market's return. On an equal-weight basis, the Strategy underperformed by more, with key detractors being **Fletcher Building**, **QBE Insurance**, **Magellan Financial**, **Sky TV New Zealand** and **TradeMe Group**. On the other side of the ledger, **Origin Energy**, **Metcash**, **News Corporation** and not owing **Vocus** and **Bank of Queensland** contributed most positively to relative returns.

Stock selection outcomes have been positive over longer-term periods

Longer-term, the Concentrated Value Strategy has outperformed by 3.0% per annum over the past 7 years, with underlying stock selection of 2.2% per annum enhanced by a non-benchmark construction tailwind of 0.8%. 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 **Telstra**, **National Australia Bank**, **Tabcorp, Macquarie Bank** and **Suncorp** the key contributors. Key detractors over this time frame include **QBE Insurance, Seven West Media**, **Worley Parsons**, as well as not owning **Aristocrat** and **Treasury Wine**. At a sector level, being underweight banks and owning minimal mining and energy stocks were the most notable contributors.

Figure 31: Cumulative total returns



Source: Merlon

Strategy FUM	Merlon FUM
$1,320.6m	$1,598.9m

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	Amazon Not Introducing Internet to Australia
Value Investing - An Australian Perspective: Part I	The Case for Fairfax Media Over REA Group
Value Investing - An Australian Perspective: Part II	Telstra Revisited
Value Investing - An Australian Perspective: Part III	Oil: The Cycle Continues

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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