Merlon Concentrated Value Strategy

Quarterly Report

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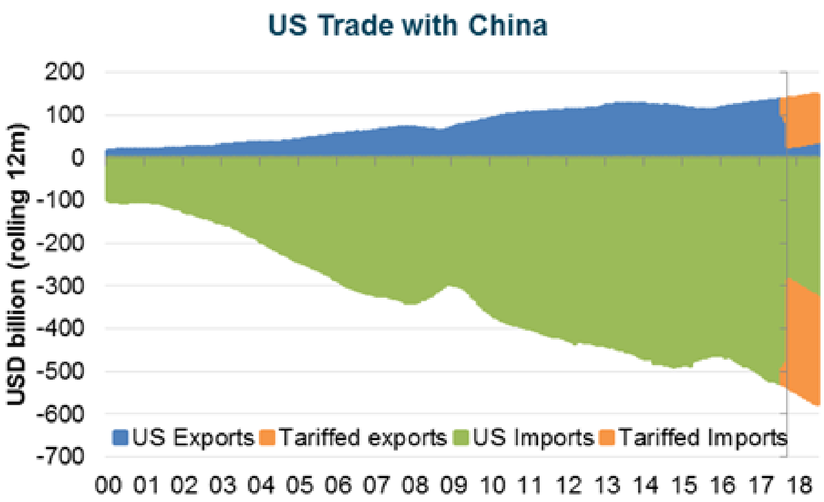
Trade wars and the peak of the Chinese growth model

Snapshot: China's export-led growth model is reaching its limits. While China's exports grew rapidly from admission to the WTO in 2001, declining competitiveness saw China's share of global exports peak in 2015. Now, tariffs imposed by the United States on around half of China's exports, see further impediments to the continuation of the current model. China needs to transform to avoid the middle-income trap. But the rapid development of high tech industry is at growing risk of western world pushback. As such, a quick resolution to the current trade dispute appears increasingly unlikely, which is likely to weigh on commodity prices.

Clash of the titans

The United States and China are the world's two largest economies. They are linked heavily by trade, with the US being China's largest export customer. In contrast, China's imports of US goods are modest in comparison, and have triggered a backlash in the form of tariffs, applied to around half of China's US exports. In the latest round of tariffs applied, President Trump has threated to escalate further, applying tariffs of up to 25% on 100% of imports from China.

Figure 1: China's trade with the United States has peaked



Source: Federal Reserve Bank of St. Louis. Analysis: Merlon.

To understand how we got to this point, we need to understand China's growth model and how it is becoming an economic and strategic threat to the US as well as other developed and emerging nations.

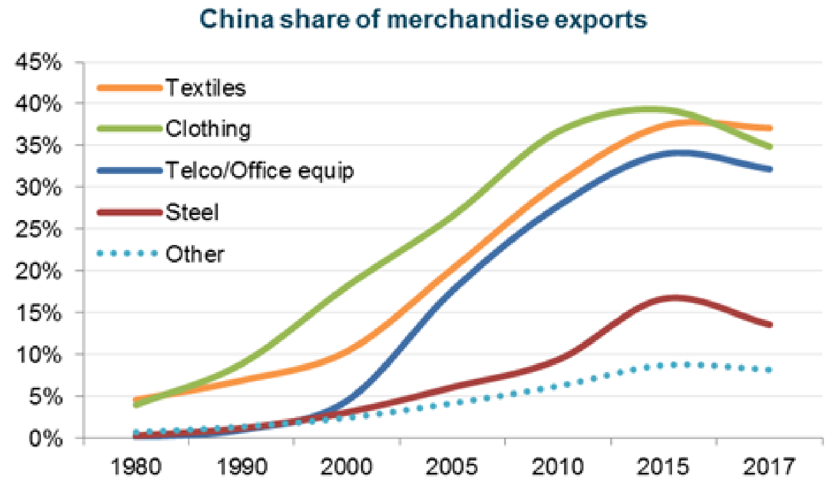
China's Growth Model

China's entry to the WTO in 2001 saw growth accelerate…

China's admission to the World Trade Organisation (WTO) in 2001 enabled China to transform its economy, which was mired in the aftermath of the Asian Financial Crisis and the end of a property boom. China's abundant and cheap agricultural labour force migrated to the coast and manufactured low end textiles and clothing, as well as cheap assembly of electronic equipment. The Chinese economy saw a rapid increase in productivity, while lifting a large proportion of its population out of poverty. The development of a world leading export hub facilitated significant fixed asset investment, in the form of manufacturing plants, infrastructure and real estate.

…but more recently, China's share of low-end exports has peaked

Figure 2: China's dominance of low end manufacturing exports has peaked



Source: World Trade Organisation. Analysis: Merlon.

This phase peaked in 2015 as China's cheap labour advantage was eroded by rising wages and 'cheaper' neighbours such as Bangladesh, Vietnam and Malaysia. Multinational corporations also sought to increase diversification given the concentration of activity that had built up in China since 2001. And now, we see the Trump administration applying tariffs to imports from China, a further impediment to the China growth model.

Leaping the divide

Made in China 2025 is key to China's transition

In light of China's peaking export market share coupled with tariffs, how does the leader in low value-added manufactured exports move up the value-added chain? The answer is in the form of President Xi Jinping's signature 'Made in China 2025' policy. The policy seeks to invest more than a quarter of a trillion US dollars into the development of industries including robotics, artificial intelligence, and biotechnology. These sectors will receive subsidies, preferential loans, free land and tax incentives. The policy targets 70% self-sufficiency across these segments, forcing Chinese buyers of the technology to purchase components domestically.

Foreign firms wishing to operate within China have been required to form joint ventures with domestic Chinese companies, and then share their intellectual property. It is through this mechanism that technology is acquired, enabling modernisation of industry and supporting China's movement up the value chain. Local companies also receive government subsidies that create an un-level playing field for foreign competitors.

The trade war is about technology rather than trade

What Trump wants

The United States Trade Representative's 2018 investigation into China provides the justification for tariffs (see box below). Rather than trade deficits, each of the four points references the transfer of technology from the US to China.

As outlined above, the Made in China 2025 policy facilitates technology transfer and forced use of local company products. On a long-term view, this would be catastrophic to economies relying on heavy investment in technology to export globally, such as the United States, Japan, South Korea and Germany.

Excerpt: Office of the United States Trade Representative (September 2018)

In March 2018, USTR released the findings of its exhaustive Section 301 investigation that found China's acts, policies and practices related to technology transfer, intellectual property and innovation are unreasonable and discriminatory and burden or restrict U.S. commerce. Specifically, the Section 301 investigation revealed:

- China uses joint venture requirements, foreign investment restrictions, and administrative review and licensing processes to require or pressure **technology transfer** from U.S. companies.
- China deprives U.S. companies of the ability to set market-based terms in licensing and other **technology-related negotiations**.
- China directs and unfairly facilitates the systematic investment in, and acquisition of, U.S. companies and assets to generate large-scale **technology transfer**.
- China conducts and supports **cyber intrusions** into U.S. commercial computer networks to gain unauthorized access to commercially valuable business information.

Source: Office of the United States Trade Representative.

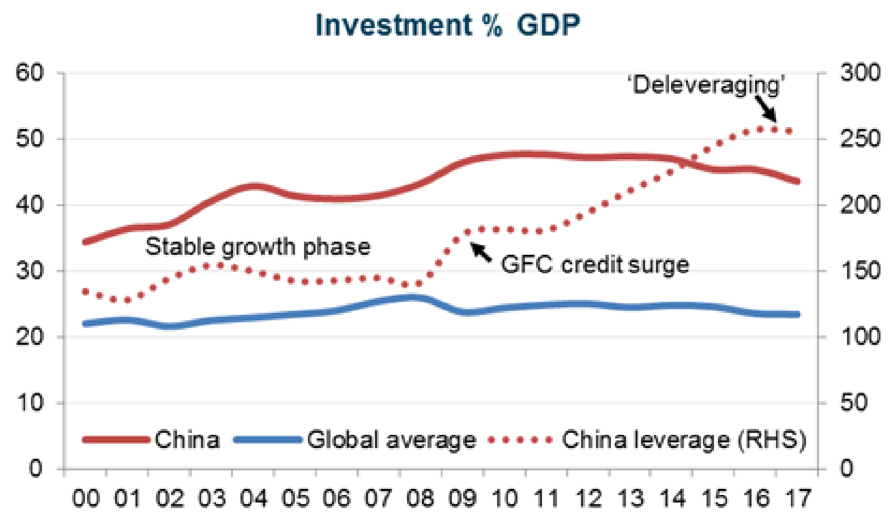
From this investigation, we can see how attacking China's significant trade surplus with the US, through the implementation of tariffs, Trump is applying pressure on China to change its current forced technology transfer practices, as well as the uncompetitive aspects of its Made in China 2025 plan. It is also relevant to note an unintended consequence of this pressure, which has been to disrupt China's more immediate goals of deleveraging, rebalancing and reducing pollution.

The trade war will interrupt China's necessary economic transition

China – rebalance interrupted

More than 40% of China's GDP is fixed asset investment, around double global averages. Much of this investment has been via debt funding, resulting in rapidly escalating leverage.

Figure 3: China investment share of GDP



Source: World Bank. Bureau of International Settlements. Analysis: Merlon.

China's 2017 effort to reduce this credit-fuelled fixed asset investment dependency, via rebalancing and deleveraging, was supported by growth in exports and rising domestic consumption. In 2018, however, China's policy objectives have been disrupted by Trump's trade policy, which is reducing the ability for exports to support a deleveraging economy. China's response to these trade risks may see its rebalancing efforts thwarted and potentially reverse, exacerbating imbalances authorities are keen to address.

Policy reversal?

China – how to respond

The trade war launched by Trump occurred at a time when China was beginning its transition from debt-driven investment to a more sustainable path. Now, however, the pressure on exports will likely see a reversal of prior policy objectives. Following are the key options for addressing Trump's tariffs.

Retaliate?

China's like-for-like retaliation options are limited by the significantly lower volume of imports it purchases from the US and the fact that retaliation to date is already close to the maximum available.

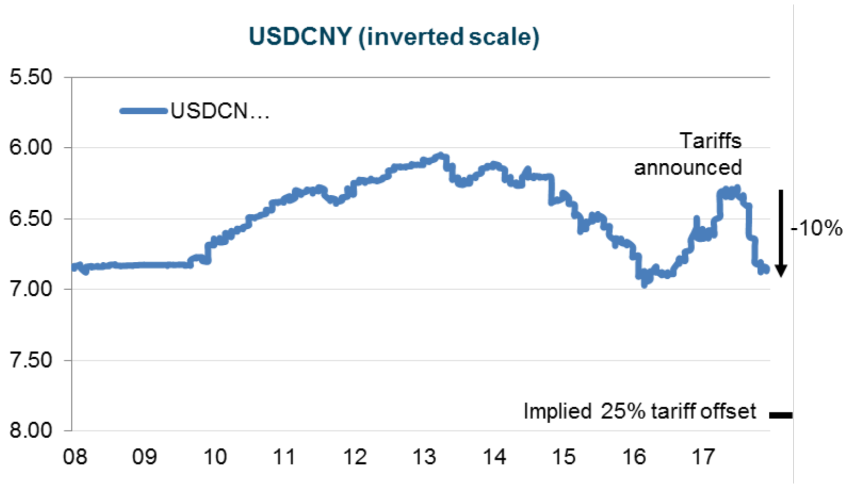
Figure 4: US exports to China

Source: Federal Reserve Bank of St. Louis. Analysis: Merlon.

Depreciate?

The Chinese yuan has depreciated by around 10% since tariffs were announced by Trump, largely offsetting the tariff. Using the currency to offset any escalation by the US to the full 25% tariff rate would require the currency to depreciate by a further 15% to USDCNY8, an unprecedented level in recent history. Beijing would be reticent to allow the currency to fall to these levels given the risk of capital outflows and further currency instability. Further, the cost impact on imports, such as oil, would see politically unpalatable inflationary pressures domestically.

Figure 5: Chinese currency vs US dollar



Source: Bloomberg. Analysis: Merlon.

Stimulate?

China's 2017 deleveraging policy has been upended by Trump's tariffs. But what is the real cost of tariffs and how significant is this relative to the scale of the Chinese economy? The table below shows that current tariffs cost USD33b, 0.3% of China's economy. It is perhaps no coincidence that China's National Development and Reform Commission (NDRC) approved this level of new fixed asset investment in September.

This cost increases to USD139b if the full 25% tariff rate is applied to the entirety of imports from China, or 1.1% of China's economy if exports decline by an equivalent amount to the tariffs.

Fully escalated tariffs could cost ~1% of GDP.

Figure 6: Cost of tariffs

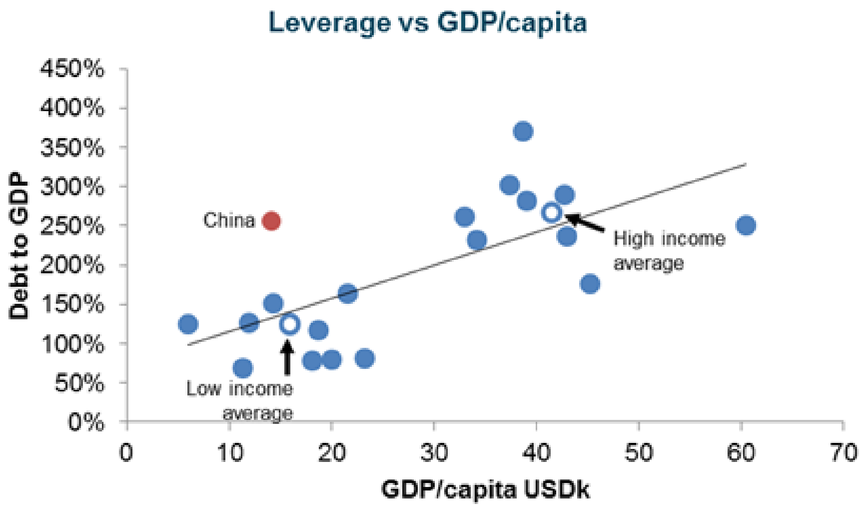
USDb	2017	Current*	Escalated*	Full*
GDP	12,015	12,796	12,796	12,796
Exports to US	505	557	557	557
Of which subject to tariffs	0	250	557	557
Blended tariff rate	0%	13%	11%	25%
Tariff cost	0	33	63	139
% GDP	0%	0.3%	0.5%	1.1%

*Source: International Monetary Fund. Federal Reserve Bank of St. Louis. The White House Statements and Briefings. Analysis: Merlon. *Estimate.*

Constraining China's ability to fully offset a full tariff scenario is that it doesn't have the per capita income to support the current levels of debt, even before adding an additional USD100b-plus required to offset a full tariff scenario. Further, as China's leverage ratio is already on par with high income economies, using further expansion of leverage to achieve high income status is constrained.

China's debt levels are well above low-income peers.

Figure 7: Chinese leverage vs wealth



Source: International Monetary Fund. Bureau of International Settlements. Analysis: Merlon.

The likely strategy is a combination of the above three options, with maximum retaliatory tariffs, limited further currency depreciation and a potentially risky ~USD100b stimulus package.

The big issue around technology transfer will take a long time to resolve

Outlook: whatever happens, it's unlikely to be quick

The multi-faceted objectives of Trump's administration, coupled with the political differences between the US and China are unlikely to result in a quick resolution. The longer a resolution takes to achieve, the less confidence businesses will be in making investment decisions, impacting capital spending and demand for commodities.

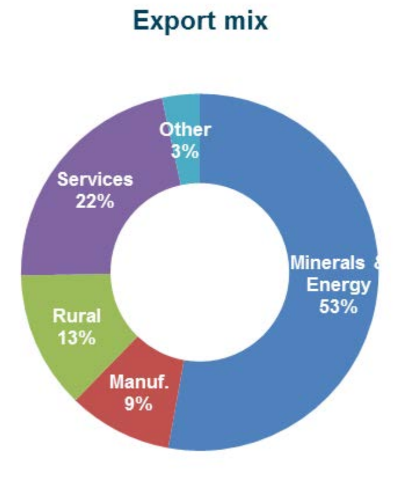
Given the broader concerns around forced technology transfer, any trade-related concessions offered by China are unlikely be sufficient to achieve a resolution. Trump is more likely to be driven by changes to industrial policy, seeking provisions made to remove the forced hand-over of intellectual property of US businesses operating in China. This may be enhanced via pressure on strategically important US firms 'reshoring' Chinese operations back to the US.

Given how important technology is for China's ability to maintain growth and grow per capita incomes, as well as continuing to develop its military capabilities, this is a concession that may be hard to achieve. As the world's largest consumer of commodities, the trade war will remain an overhang on commodity prices throughout its duration. However, longer term trends will remain driven by China's need to rebalance from investment to domestic consumption.

Resources and energy directly contribute less than 10% of Australian GDP

Australia: trade exposed, but diversified

Figure 8: Australia's export mix



Source: Department of Foreign Affairs and Trade. Australian Bureau of Statistics.

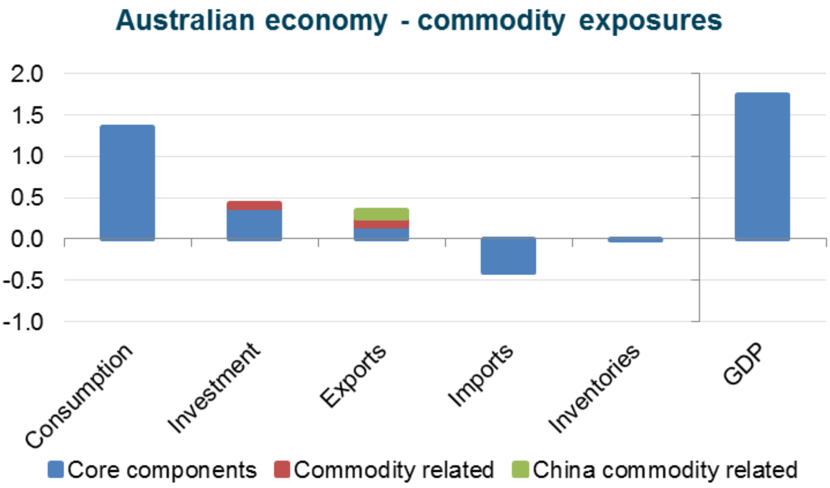
How exposed is Australia to a trade war between the US and China? Australia is a large exporter of resources and energy products, with China the largest buyer of these products.

Yet the diversified nature of Australia's economy means that the resources and energy sectors directly account for less than 10% of Australia's GDP.

The chart below isolates the direct commodity exposures of the Australian economy potentially impacted by a trade war. There are also indirect exposures as commodity related industries generate economic activity across other sectors.

Chinese demand for iron ore set to decline irrespective of trade disputes

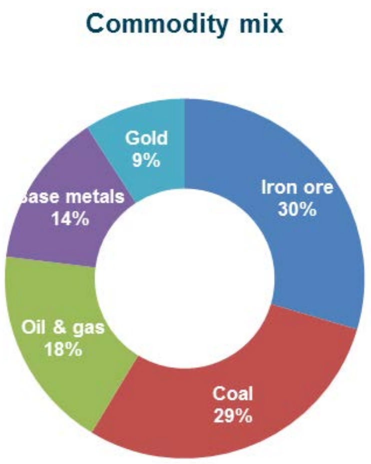
Figure 9: Australian GDP and trade war exposures



Source: Australian Bureau of Statistics. Analysis and Estimates: Merlon.

Again, we expect the rebalancing, deleveraging and maturing of the Chinese economy to be a more significant influence over time than the trade war. Of the specific commodities exported by Australia, the declining investment intensity of China's economy, coupled with a focus on less carbon-intensive steel recycling, will likely see declining demand for iron ore. Conversely, this focus on cleaner energy will see increased demand for gas, exported by Australia as LNG.

Figure 10: Australia's commodity export mix



Source: Department of Industry, Innovation and Science. Australian Bureau of Statistics.

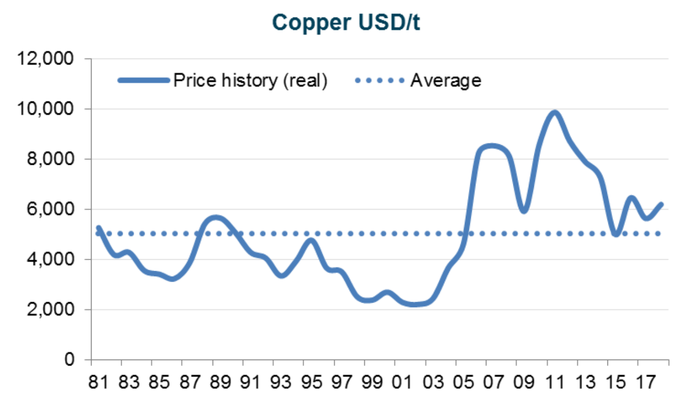
This dynamic will likely see Australia remain the world's largest exporter of iron ore, albeit at lower levels, and potentially become the largest exporter of liquefied natural gas.

Again, while Australia is a large commodity exporter, its diversified economy means volatility in these markets has less of an impact than in other commodity exporting nations.

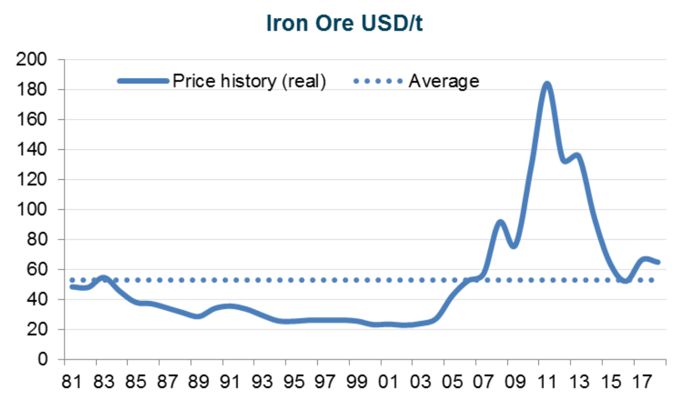
Impact on commodities

The surge in commodity prices over the past decade has been a direct result of the effects of China's admission to the WTO and associated rapid growth of its export sector. Industrial commodities are direct inputs to the infrastructure constructed to support this sector. The next phase of economic development is unlikely to be as commodity intensive. While we expect the trade war to be an overhang on commodity pricing for the duration of the dispute, there is divergence across the major markets.

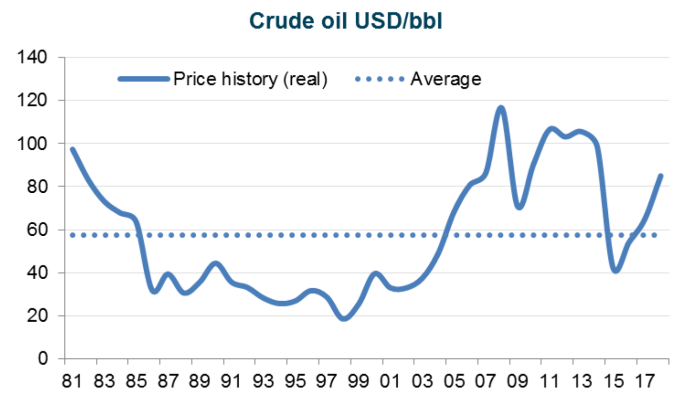
Copper: a proxy for global growth expectations. Has declined from USD7,000/t in late 2017 to just above USD6,000 on trade concerns. Longer term copper pricing should be supported by ageing mines, declining grades and a lack of large scale new projects.



Iron ore: China's response is likely credit-driven steel-intensive investment, which drives demand for iron ore, albeit offset by its oversupply. Longer term, China's deleveraging and rebalancing, coupled with growth of steel recycling will see lower iron ore pricing.



Oil: has ignored trade war concerns and risen on Iran sanctions, while currencies such as the RMB have declined, risking demand. Longer term, low investment in conventional projects, coupled with non-cash generating US shale, should see prices supported at USD60-70/bbl.



Source: Bloomberg. UBS. Analysis: Merlon.

Fund positioning

Resource free cash-flows are driven by price, margin and capital intensity

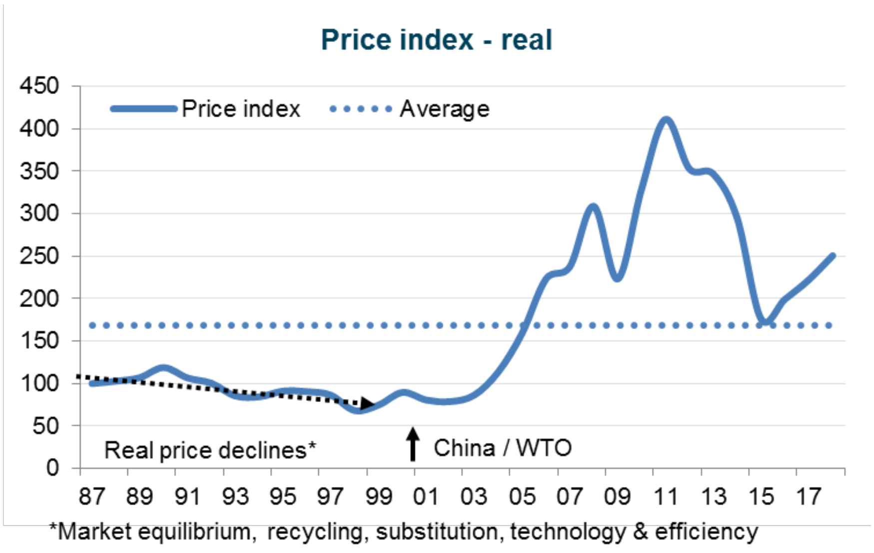
Merlon's investment approach values companies on the basis of sustainable free cash flow as opposed to current cash flow. For mining and energy companies, the key drivers of sustainable free cash-flow are price, margin and capital expenditure. While the trade war is seeing pressure on some commodities, over the longer term we expect more fundamental supply and demand factors to dominate prices as outlined previously. We will now analyse how these factors affect energy and resources companies, using BHP, the world's largest miner, with a diversified set of high quality assets, as our example.

Cash-flow driver 1: price

Using BHP's portfolio of iron ore, crude oil and copper to create a price index we can discern two clear periods: firstly a phase of price declines as a result of recycling, substitution, technology and efficiency in response to high prices; and secondly, the impact of the scale of China's WTO-led growth. Despite prices having declined significantly from their peak, they remain well above normal levels.

The expectation is for lower iron ore prices as China's steel consumption has peaked and recycling rates remain well below international levels. While the timing of this demand decline is difficult to predict, iron ore pricing will also come under pressure as new known high grade supply comes on stream at a low cost of production. In contrast, oil prices are expected to remain supported longer term as unprofitable US onshore oil production exits, and underinvestment in conventional projects sees supply constraints. Copper is also subject to supply constraints given the lack of large scale new projects to replace aging existing mines and declining grades.

Figure 11: BHP commodity portfolio price index

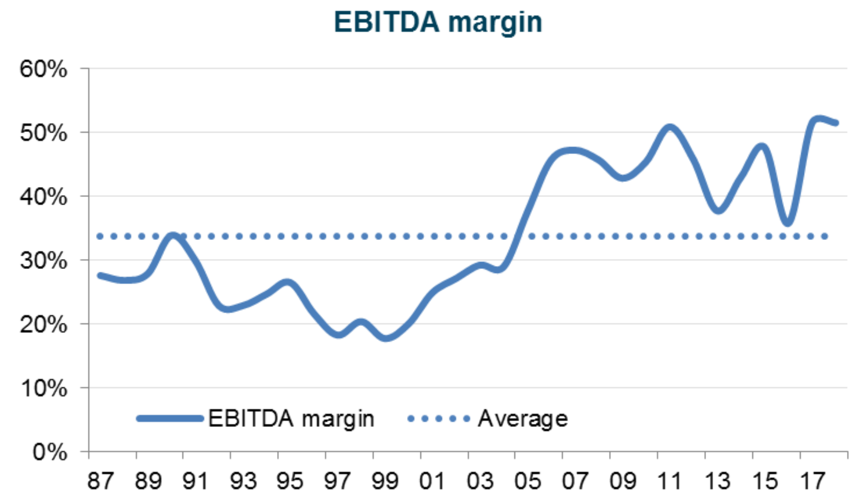


Source: Bloomberg. Analysis: Merlon.

Cash-flow driver 2: margins

Margins continue to reflect incentive pricing, which is likely to end as China's investment heavy phase of growth normalises. As commodity markets move into oversupply, particularly in the case of iron ore, margins will contract and incentivise production cuts.

Figure 12: EBITDA margins

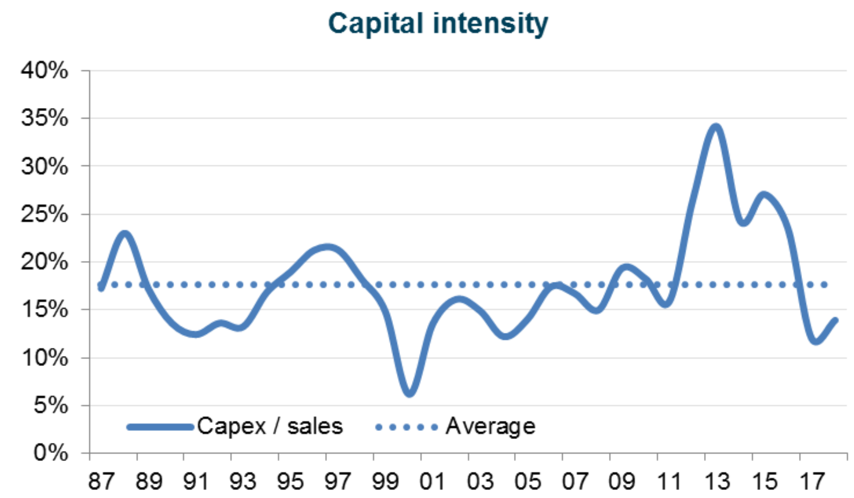


Source: Company Reports. Analysis: Merlon.

Cash-flow driver 3: Capital expenditure

Capital investment is currently unsustainably low, which will need to rise in order for production levels to be supported. Alternatively, capital spending can be withheld, leading to lower volumes, both of which will impact cash-flows.

Figure 13: Capital intensity

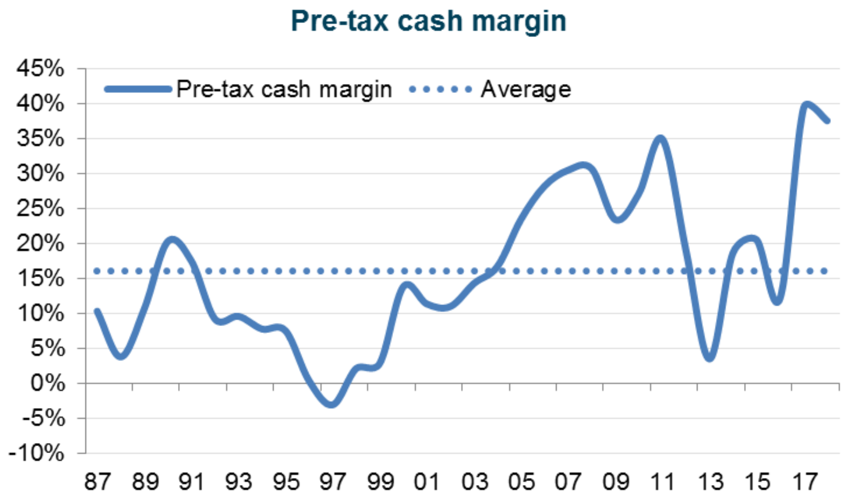


Source: Company Reports. Analysis: Merlon.

Putting it all together

From the chart below, we can clearly see how resource company cash-flows are extremely volatile and are currently over-earning on the basis of unsustainably high prices and margins, coupled with unsustainably low levels of capital expenditure.

Figure 14: Pre-tax cash-flow



Source: Company Reports. Analysis: Merlon.

In applying the above themes to valuing BHP, we can see in the following table the effects of a normalised operating environment across the key drivers of free cash-flow:

A normalised commodity environment sees valuation downside.

Figure 15: Summary financials

USDb	FY18	Normalised	Comments
Revenue	43,638	27,016	Limited oil & gas reserves / lower iron ore price
EBITDA margin	51%	47%	Above long term averages
Capital intensity	14%	19%	In line with long term averages
Pre-tax cash-flow	16,393	7,626	Reflects currently over-earning
Pre-tax cash margin	38%	28%	Above long term averages
Free cash-flow	11,475	5,338	Delivers ~AUD25 per share valuation

Source: Company Reports. Analysis: Merlon.

The effects of normalisation demonstrate the degree to which the company is over-earning in terms of cash-flows, particularly in terms of prices, the relatively short term nature of the oil & gas division, and under-spending on capex. The majority of the cash-flow decline comes from the run-off of the oil & gas business, coupled with lower iron ore earnings. The modelled pre-tax cash-margin per tonne of iron ore is above USD10/t, which is in line with pre-boom averages and delivers an attractive (for a commodity producer) 14% return on net assets.

Conclusions

There are clear risks to the global economy, and in turn, commodities and commodity producers, from the trade war. However, the more dominant factor driving commodities in the long term is China's outdated growth model. Australia's diversified economy is likely to prove resilient, with less than 10% GDP growth derived from the resources and energy sector. For resource companies, however, there are growing downside risks to free cash-flow from the anticipated normalisation of prices, margins and capital intensity, supporting an underweight portfolio exposure.

Analyst:
Hamish Carlisle

Some more thoughts on Telstra

We provided some detailed thoughts on Telstra about one year ago. Over the last year we note the following developments:

- Telstra has underperformed the broader market;
- The company's strategy has dramatically pivoted from aspirations of becoming a global technology company to a cost-out and product simplification agenda;
- Telstra has bought itself some breathing space and improved its ability to compete by materially downgrading its expectations for 2019 which more closely align with our own view of the company's sustainable cash flow.

That said, what hasn't changed is that the company continues to face 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.

As a value investor, we are not averse to investing in businesses that face growth challenges…

As a value investor we are not averse to investing in businesses that face growth challenges. The caveat of course is that market expectations have to be sufficiently low to make such companies good investments. If these types of businesses can halt their declines they can become great investments.

The question remains with Telstra is whether expectations are sufficiently low and whether the company's pace of contraction is close to moderating.

Regauging Market Expectations

As we have indicated previously, 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 2018 result announcement reiterated its 2019 guidance.

Figure 16: Implied Management Expectations for Telstra's Sustainable Free-Cash-Flow

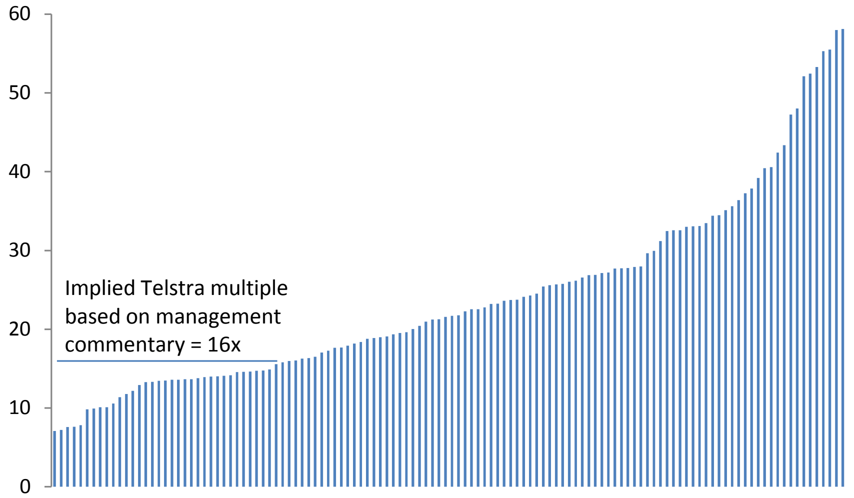
Mid-point of 2019 EBITDA Guidance	$8.6b
One-off nbn receipts	(1.9b)
Restructuring & impairment	$0.6b
Implied sustainable EBITDA	**$7.3b**
Mid-point of 2019 Capex Guidance	($4.2b)
Estimated "Strategic Investment" included in above	$1.0b
Implied sustainable capex	**($3.2b)**
Implied sustainable free cash flow before tax	$4.2b
Tax @ 30%	($1.2b)
Implied sustainable free cash flow	**$2.9b**
Market capitalisation at $3.00 per share	$35.7b
Net debt	$16.3b
Anticipated one-off nbn receipts (undiscounted)	($4.4b)
Enterprise value	**$47.6b**
Enterprise value / sustainable free cash flow	**16x**

Source: Company 2019 full year result presentation, Merlon Capital Partners

Taking into account anticipated one-off NBN receipts this would imply the company is trading on approximately 16x sustainable-free-cash-flow. This is cheaper than the 20x multiple we calculated in September last year and cheaper than the median multiple of 21x for all companies we cover suggesting to us that ***the market is sceptical about the management estimates of profitability and cash flow***.

If we accept management commentary, Telstra looks cheaper than the rest of the market…

Figure 17: Enterprise Valuations / Sustainable Free Cash Flow (Merlon Coverage Universe, data as at 15 August 2018)



Source: Bloomberg, Merlon Capital Partners

Key Issues

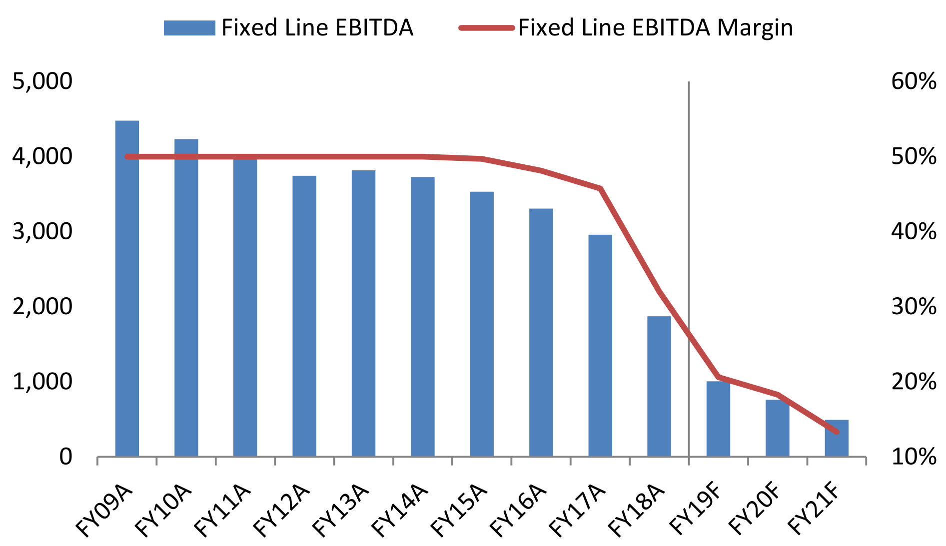
A key tenant of Merlon's investment philosophy is that markets are mostly efficient and that cheap stocks are always cheap for a reason. We are focused on understanding why cheap stocks are cheap. To be a good investment, market concerns need to be priced in or deemed invalid. We incorporate these aspects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

In the case of Telstra, we flag three key issues:

1. ***Telstra generated $1.9 billion in EBITDA from its fixed line business in 2018***. This earnings stream is likely to deteriorate to a negligible amount over time but still probably contributes to the 2019 guidance estimate above. We note that margins for resellers are typically in the order of 5 to 10 percent but that NBN margins are currently tracking at levels below this. We also note that large segments of Telstra's customer base are paying rates significantly higher than contemporary NBN products. In short, we don't think 2019 will be the bottom for Telstra's fixed line business;

We don't think 2019 will be the bottom for Telstra's fixed line business…

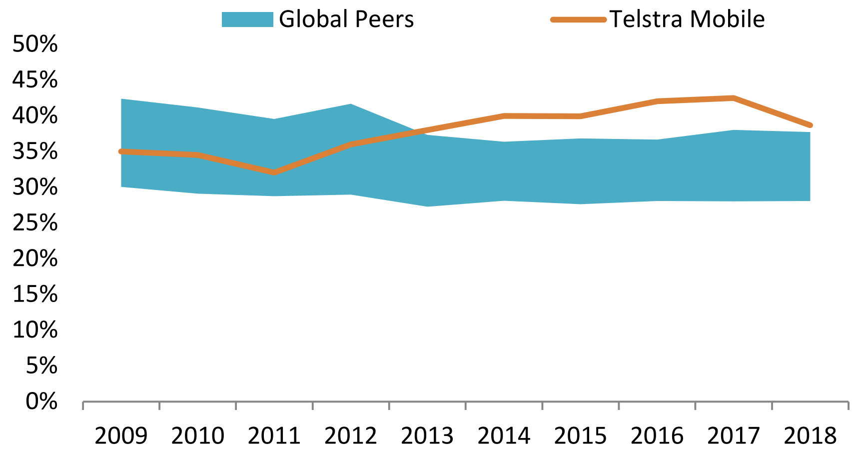
Figure 18: Telstra Fixed Line EBITDA & Margin



Source: Bloomberg, Merlon Capital Partners

2. ***Telstra's mobile business is extraordinarily profitable by global standards***. In 2018 the Telstra mobile business generated an EBITDA margin of close to 40 percent. While the company's guidance no doubt builds in some margin compression, we again note that large segments of Telstra's customer base are paying rates significantly higher than contemporary offers. At the same time, TPG has not yet launched in the Australian market;

Figure 19: Telstra Mobile Margin vs. Global Peers

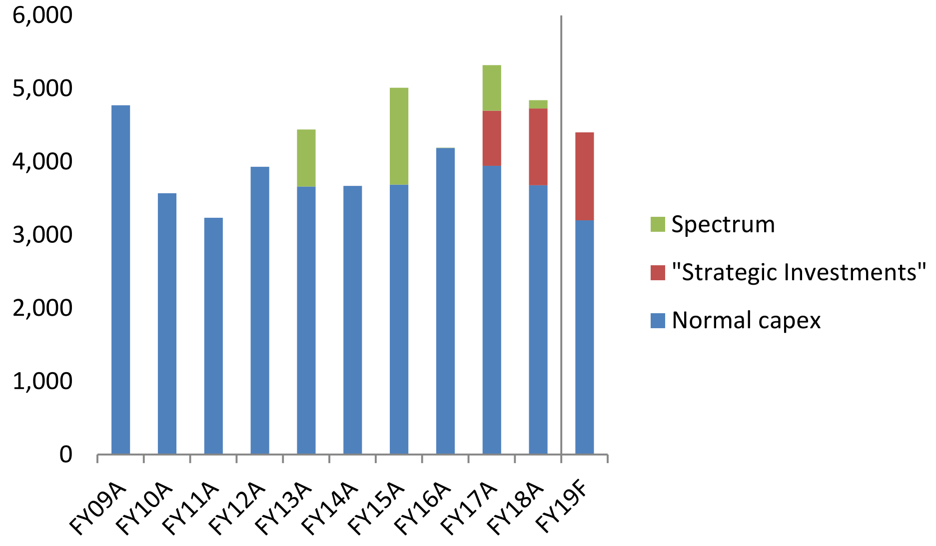


Source: Bloomberg, Merlon Capital Partners

Telstra's mobile margin is highly profitable relative to global peers…

3. ***Telstra's capex aspirations could be optimistic.*** The $3.2 billion sustainable capex implied by management guidance would be the lowest in a decade for Telstra. We acknowledge that the company has no capex associated with its fixed line network as the NBN rolls out but arguably it has not spent much here over the last 12 months so the 10 year comparison is still valid. Further, we are unconvinced it is appropriate to exclude spectrum payments when considering sustainable capex;

Figure 20: Telstra Capex



Source: Bloomberg, Merlon Capital Partners

Telstra's implied sustainable capex is very low relative to the company's history…

Valuation Scenarios – Preparing for the Worst

We can deal with issue 1 (***legacy fixed line profits***) simply by excluding the fixed line business from our analysis. We estimate that the fixed line business will generate about $0.5 billion in free cash flow during FY19 which would take the sustainable free cash flow estimate above down to about $2.4 billion and increases the market multiple to approximately 20x. This is not particularly cheap.

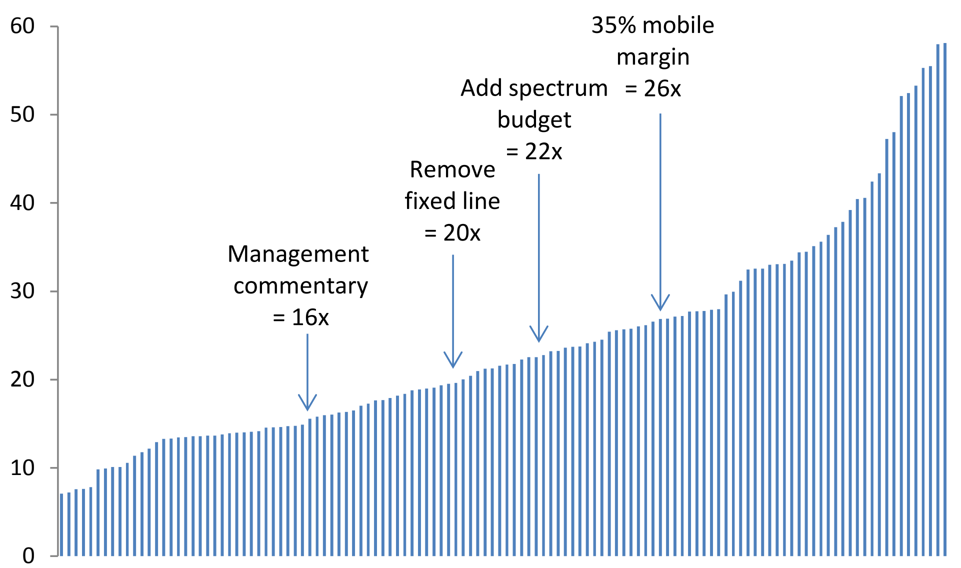
Issue 2 (***elevated mobile margins***) is more subjective and best considered as a sensitivity. It is quite conceivable to us that Telstra's mobile margin could revert to 35%. This would take about $0.3 billion from free cash flow. Not a disaster but a meaningful downside risk worth considering.

Issue 3 (***optimistic capex expectations***) is also subjective. 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. This gives us some hope that management can deliver on its aspirations.

Adjusting for various concerns leads us to conclude Telstra is not particularly cheap

Against this, we can't explain why Telstra has had so much difficulty reining in its capex budget in recent years. One explanation is that Telstra's capex is simply capitalised opex. In the least we feel it prudent to factor in a budget for spectrum payments which have averaged $0.3 billion per annum over the past decade.

Figure 21: Enterprise Valuations / Sustainable Free Cash Flow (Merlon Coverage Universe, data as at 15 August 2018)



Source: Bloomberg, Merlon Capital Partners

The conclusion we draw is that the market's caution is probably warranted. Simply removing legacy fixed line businesses and including a sensible spectrum budget would bring the Telstra valuation multiple into the middle of the pack for Australian listed companies. Using more conservative – but certainly reasonable – margin scenarios for the mobile business would start to make the company look expensive.

What About the Cost-Out Opportunities?

As highlighted above, Telstra's strategy has dramatically pivoted from aspirations of becoming a global technology company to a cost-out and product simplification agenda. The company is targeting $2.5 billion in cost savings between 2016 and 2022 and claims it has delivered approximately $0.7 billion cumulatively so far. That leaves $1.8 billion in savings from here.

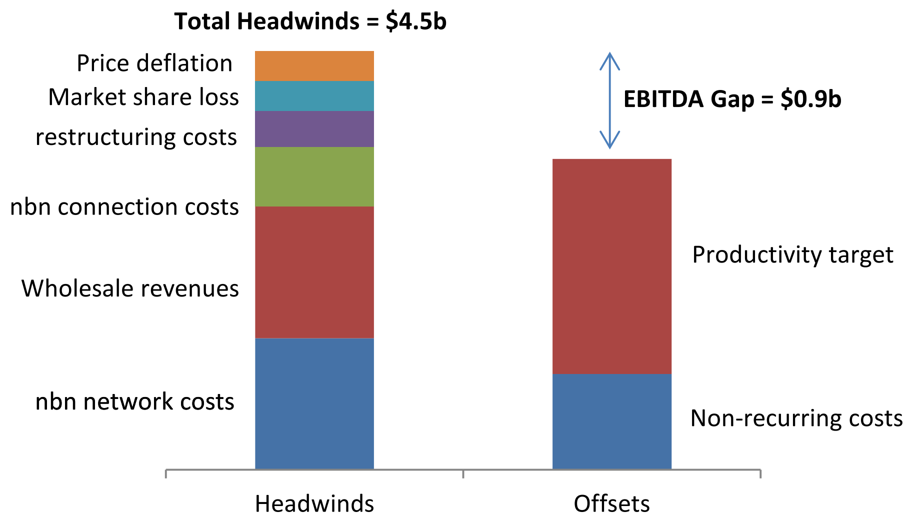
Offsetting this $1.8 billion cost save agenda are the following items:

1. ***Incremental nbn costs of approximately $2.0 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 $1.0b of this amount is already reflected in Telstra's 2018 accounts so the incremental cost from here is likely to be about $2.0b.
2. ***Loss of wholesale revenues amounting to approximately $1.1 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 $0.5 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 $0.3 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 progressive price deflation with regard to its products.

Taking into account all these factors we observe an EBITDA gap of approximately $1 billion which roughly reflects the company's anticipated stepdown in EBITDA during FY19. The good news is that this appears factored in to guidance. The bad news is that it doesn't leave much headroom if things go wrong.

Our analysis suggests the impact from the NBN rollout will more than offset Telstra's productivity agenda…

Figure 22: Telstra Recurring Annual EBITDA Headwinds from nbn Rollout (Relative to 2018 Financial Year)



Source: Company reports, Merlon Capital Partners

Fund Positioning

It is clear to us that following recent underperformance, repositioning of the strategy and rebasing of expectations that Telstra is a more attractive proposition than it was a year ago.

However, we do not regard the company as particularly cheap when we adjust for legacy fixed line cash flows and include a sensible ongoing budget for spectrum purchases. Further, we can envisage a scenario where mobile competition intensifies further than anticipated. We don't think announced (and yet to be delivered) cost programs will offset the various headwinds that the company is dealing with.

As such, we don't own Telstra.

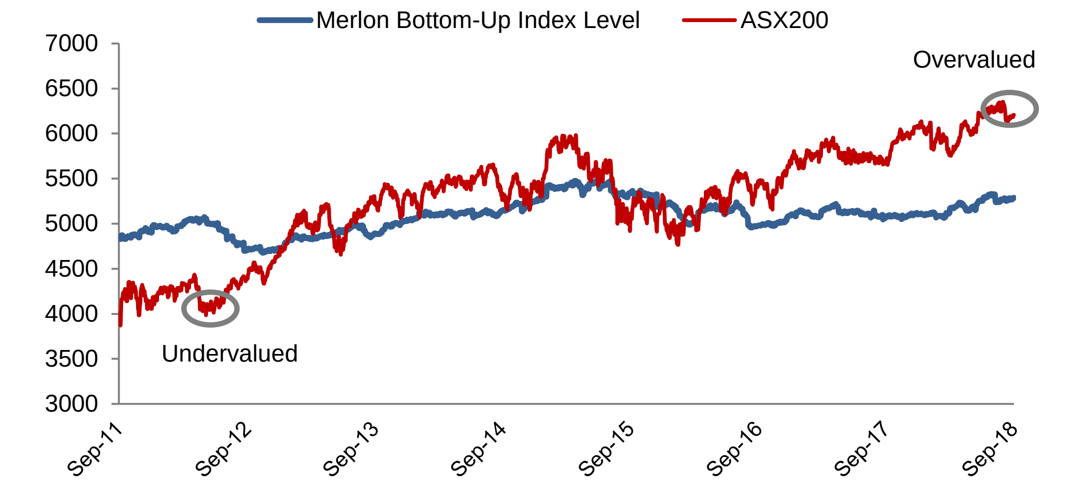
Neil Margolis

Market approximately 15% overvalued using consistent bottom-up approach…

Market Outlook and Portfolio Positioning

As has been our historic practice, we continue provide an aggregate assessment the ASX200 valuation based on the individual company valuations for the 156 stocks we actively cover. On this basis the market appears approximately 15% overvalued.

Figure 23: Merlon bottom up market valuation vs ASX200 level



Source: Merlon

The market level reflects a complacent attitude towards risk and a continuation of low interest rates…

Our individual company valuations have been established utilising our estimates of sustainable free-cash-flows and franking credits discounted at consistent mid-cycle interest rates and risk premiums.

In truth, we don't really know whether our approach of utilising "mid-cycle" interest rates and risk premiums to "value the market" is the right one. We are not macro investors and don't think we have any special insights that would justify speculating with our own or our clients' money on the imminent direction of the global economy or financial markets. We can observe however, as others have done, that the current aggregate market valuation would appear to reflect a fairly complacent attitude towards risk and an expectation that interest rates will remain low for an extended period of time (Some thoughts on asset prices).

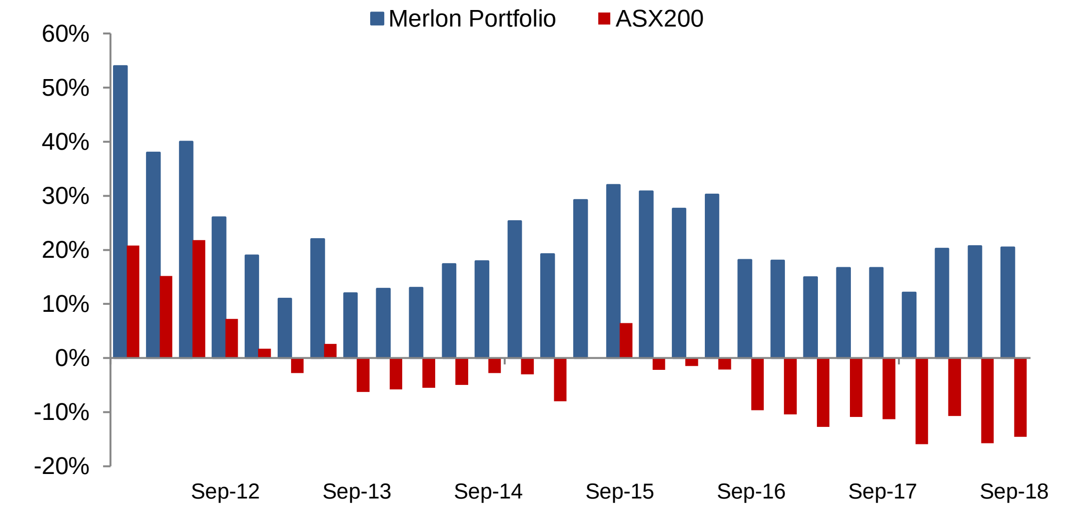
One example at the extreme end of investor apathy towards risk within an Australian context is the emergence of what one stockbroker recently coined the WAAAX stocks (**Wisetech Global**, **Altium Limited**, **Afterpay Touch Group**, **Appen Limited** and **Xero Limited**). These five companies in aggregate generated gross operating cash flow during their most recently reported 12 month periods of around $100 million and a pre-tax free cash flow loss of around $40 million. Against this financial performance, the WAAAX stocks have a combined market capitalisation (based on the average share counts during the period) of over $20 billion.

For context, this market valuation approximates estimates for the **Coles Group** soon to be spun out of **Wesfarmers,** a company that generated gross operating cash flow of approximately $2.2 billion and free cash flow before tax of $1.7 billion during the year to June 2018.

As this example illustrates, there remains dispersion across stocks and sectors. We have flagged for some time that we believe the resources, healthcare, property and infrastructure sectors to be overvalued relative to other parts of the market. We can safely add the WAAAX stocks to this list.

Merlon's value portfolio comprises our best research ideas, based on our long-term valuations and analyst conviction. As seen in Figure 24, the Merlon portfolio offers 20% absolute upside and is looking increasingly attractive relative to the index.

Figure 24: Expected return based on Merlon valuations



Source: Merlon

The United States continued on its journey towards higher interest rates during the quarter. Cost pressure in the United States is evident in the data (wage pressures and inflation) and has been a clear theme of our recent trips to the US (we visited in May and September). The Federal Reserve remains 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** and **Platinum Asset Management** should benefit against this backdrop.

Risks from the Royal Commission and "credit crunch" appear more appropriately priced…

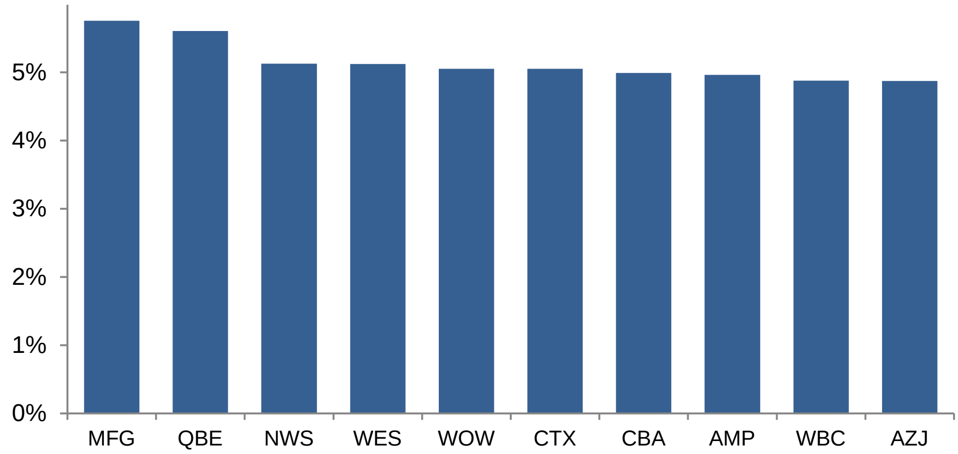
The state of the Australian housing market remains a major area of focus and concern for investors. The Royal Commission and the associated "credit crunch" has added fuel to the fire driving bank stock and consumer discretionary stock valuations to historically low levels. While our non-benchmark approach means we are content holding no **major banks** at times where investors are too complacent, we have added some exposure to the sector as these legitimate concerns have become more adequately reflected in market expectations and stock prices.

Portfolio Aligned to Value Philosophy and Fundamental Research

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

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 25: Top ten holdings (gross weights)



Source: Merlon

…however there are clearly some macro themes in the portfolio

While we are not macro investors, as discussed above there are clearly some macro themes built into the portfolio. We need to be aware of these themes and ensure they do not expose us or our clients to unintended risks. In the first instance, any such risks are mitigated by our strategy of investing in companies that are under-valued relative to the sustainable free cash flows and the franking credits they generate for their owners. Attractive valuations strongly imply that market concerns are – at least to some extent – already reflected in expectations and provide a "margin of safety" in the event conditions adversely deteriorate.

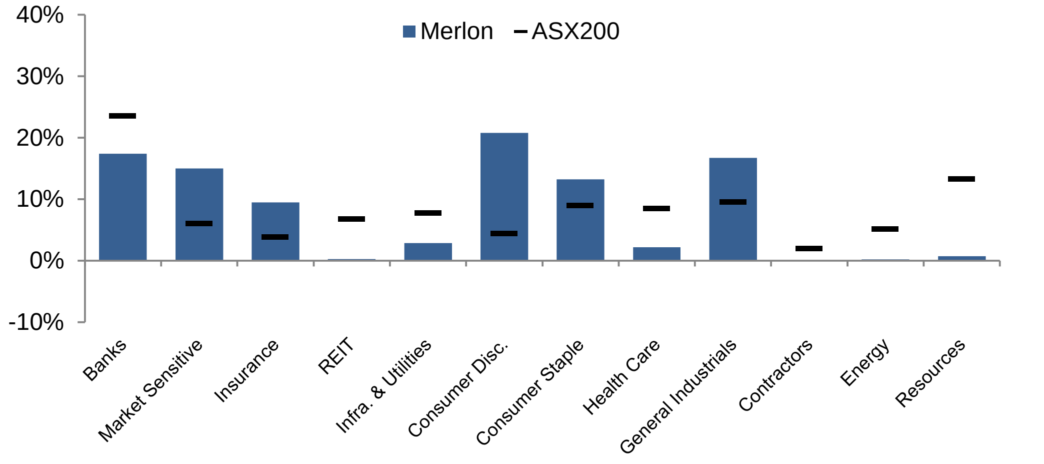
Our larger investments are typically in companies where investors have become overly pessimistic about long term prospects on account of weaker short term performance. This tendency to extrapolate short-term conditions too far into the future and investors' focus on nonsensical measures of corporate financial performance instead of cash flow continue to present us with opportunities. The WAAAX stocks are an example of this type of behaviour with little "margin of safety" should their performance deteriorate.

Conversely, a company like **Magellan Financial** is trading at a discount to the ASX200 on a simplistic price-earnings ratio notwithstanding the company's exceptional cash conversion (as evidenced by the recent dividend increase), debt free balance sheet, low operating leverage, strong distribution and the defensive positioning of its underlying funds (high cash holdings, short Australian dollar). This company has a market capitalisation that is less than a quarter of the WAAAX stocks, will generate gross operating cash flow approaching five times the WAAAX stocks and has virtually no capital expenditure so can actually return the vast majority of this cash flow to shareholders.

QBE Insurance Group is also a stock we like against the current macroeconomic backdrop. This company holds approximately US$23 billion of investments and cash, the majority of which is in floating rate fixed income investments and the majority of which is held outside Australia. Higher global interest rates will improve the running yield on this portfolio and increase the rate at which liabilities are discounted, the latter of which will strengthen the company's capital position and free up cash that can be returned to shareholders. QBE has struggled since the GFC partly due to mismanagement but also as a result of reducing global interest rates and a tough insurance pricing backdrop. Management is more focused, interest rates are turning from a headwind into a tailwind and the insurance pricing cycle appears to be stabilising.

News Corporation included Foxtel in its consolidated accounts for the June quarter, significantly lifting its consolidated revenues and highlighting the company's increased skew towards recurring subscription revenues and away from more cyclical and macroeconomic exposed advertising income. While Foxtel and the legacy print businesses face significant structural challenges, these assets are not really being valued by the market to any material extent once we take into account the value of the company's online real estate classified businesses.

Figure 26: Portfolio exposures by sector (gross weights)



Source: Merlon

Some of our best research ideas do not appear in the top 10 in terms of size as they are constrained by liquidity. These include, among others **Southern Cross Media**, **Asaleo Care** and **Sky TV New Zealand**.

Figure 27: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	30	200
Active Share	74%	0%
Merlon Valuation Upside	20%	-15%
EV / EBITDA	8.9x	11.9x
Price / Earnings Ratio	15.2x	17.0x
Price / Book Ratio	3.4x	4.1x
Trailing Free Cash Flow Yield	5.9%	5.0%

Source: Merlon

September Quarter Portfolio Activity

During the quarter, we added to existing investments, Aurizon and Asaleo Care

During the quarter we added to two existing investments in **Aurizon** and **Asaleo Care**, with both having underperformed relative to our long-term fundamental valuation. We initiated an investment in Aurizon Rail last quarter, with long-term fundamental value upside emerging after a poor regulatory decision on its monopoly rail business that we believe will improve over time. We similarly initiated a small investment in Asaleo Care, a manufacturer of personal hygiene and tissue products, with some strong brands and margins now more realistic after rebasing from unsustainable levels at the time of the IPO. On our estimates, the market is currently ascribing no value to the tissue business despite higher pulp prices being an industry issue, and we already assume personal care margins revert to be more in line with global peers.

Funded by exiting positions in Fairfax, Super Retail and Clydesdale Bank

We funded these investments and ended the quarter with a higher level of cash after exiting our investments in **Fairfax**, following the takeover offer from **Nine Entertainment Group**, **Super Retail Group**, after it outperformed in the lead up to its result, and **Clydesdale Bank**, following the acquisition of Virgin Money UK at a high multiple of sustainable earnings in our view. We also reduced but continued to retain an investment in **Suncorp Group**, after it outperformed following a result in-line with our expectations but ahead of the market's.

Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	7 Years (p.a.)
Portfolio Return (inc. franking)	-1.3	2.0	2.0	9.5	15.2	10.5	14.8
ASX200 Return (inc. franking)	-1.1	2.0	2.0	15.4	13.6	9.7	12.8
Excess Return*	**-0.2**	**0.0**	**0.0**	**-6.0**	**1.6**	**0.8**	**2.0**

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

September Quarter Market Review

Notwithstanding a down month in September, the market posted another strong quarter, advancing 1.8% (including franking). US 10 year bonds climbed 8bp (+53bp since December) although the yield curve continued to flatten with 2 year bonds rising by more. Interestingly, the US 10 year bond yield extended its record spread over its Australian equivalent that marginally declined in the quarter. The diverging outlook for short-term rates led to a depreciation in the AUD. Commodities were mixed, with oil continuing to rise on Iran sanctions and iron ore advancing 7% but base metals retreated on trade war fears and precious metals on tightening global liquidity.

Telecomms was the best performing sector, on the view the TPG/Vodafone merger will improve industry structure. **Energy** performed strongly in-line with the oil price and **Health Care** continued to enjoy expanding multiples. **Materials** had a negative quarter on the back of trade war concerns but bounced back strongly in September. Rising regulatory risk impacted **Utilities**, the Royal Commission continued to weigh on **non-bank Financials**, **Consumer Staples** edged lower, and **Banks** de-rated further on concerns tightening lending standards will put further pressure on house prices and credit growth.

Portfolio Performance Review

The Strategy underperformed due to exposures to AMP, JB HiFi, Magellan and Navitas

The Concentrated Value Strategy performed boadly in-line with the ASX200 for the quarter. The non-benchmark approach was a tailwind, with the structural underweight to mega large-cap stocks contributing to relative performance.

Magellan Financial was the best performing holding, benefitting from stronger markets, a weaker currency, improved retail flows and excellent cost control. **TradeMe** outperformed with a strong result highlighting market leading classified verticals in real estate, motor and jobs are less exposed to online competition than perceived. **QBE Insurance** outperformed with a clean result, favourable industry pricing environment and leverage to rising US interest rates. **Seven West Media** continued its recovery as the rate of TV advertising decline moderated and ratings share stablised. **JB Hi Fi** rounded out the top performers with The Good Guys acquisition showing signs of improvement.

News Corporation was the worst performing holding in the quarter, with the market focusing on Foxtel's deterioration while overlooking the shift from print advertising to subscriptions revenue, the value of realestate.com and net cash balance. **Asaleo Care** underperformed with share loss in the branded personal care segment, higher pulp prices impacting margins in the tissue segment and concerns around high debt levels. **AMP** continued to underperform on concerns of permanently higher compliance and remediation costs, as well as accelerating fee pressure as customers migrate to lower fee products. We continue to hold the view AMP is more diversified and the Advice franchise more resilient than the market currently perceives. **Caltex** underperformed with the market disappointed by the lack of progress divesting retail sites and risks around the retail convenience strategy, despite the latter being partly mitigated by the new Woolworths contract.

At a sector level, not owning **Telecomms** detracted while several **Consumer** exposures benefitted performance given attractive starting valuations and low market expectations.

The Strategy has materially lagged a strong market over the past 12 months

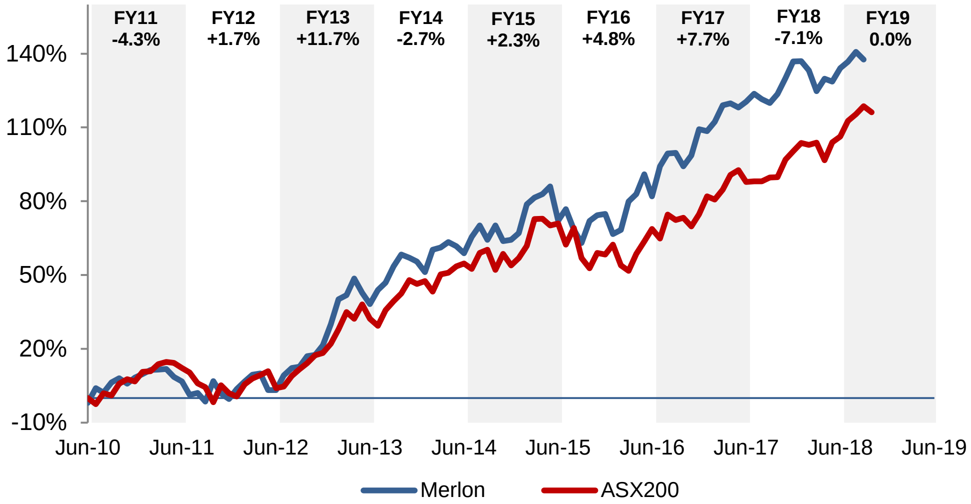
Over the past 12 months, the Concentrated Value strategy has lagged the market's strong 15.4% return (including franking) by 6.0%. The benchmark unaware portfolio construction was a slight positive as the banks weighed on the market index. Some of the underperformance was also a result of the market paying expanding multiples for stocks with low perceived earnings risk and growth stocks, as referenced in the Market Outlook section of this report. Key stock specific detractors held in the portfolio included **AMP**, **Fletcher Building**, **Caltex**, **Amaysim** and **Asaleo Care**. On the other side of the ledger, **Origin Energy**, **Seven West Media**, **Wesfarmers**, **Super Retail** and **Metcash** 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 2.0% per annum over the past 7 years, with positive underlying stock selection enhanced by being structurally underweight the mega large capitalisation stocks. 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**, **National Australia Bank**, **Tabcorp**, **Pacific Brands** and **Fairfax** the key contributors. Key detractors over this time frame include **AMP**, **QBE Insurance**, **Seven West Media**, **Worley Parsons**, as well as not owning **Aristocrat**. At a sector level, being underweight banks and owning minimal mining and energy stocks were the most notable contributors.

Figure 28: Cumulative total returns



Source: Merlon

Strategy FUM	Merlon FUM
$1,401.5m	$1,412.8m

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 take 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
Some Thoughts on Asset Prices	Digital vs. Traditional Media - A Global Trend
Rethinking Post Retirement Asset Allocation	Amazon Revisited - Muted Impact So Far

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.