Merlon Concentrated Value Strategy

Quarterly Report

December 2018

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MERLON CAPITAL PARTNERS

Analyst:
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Building materials stocks have sold off…

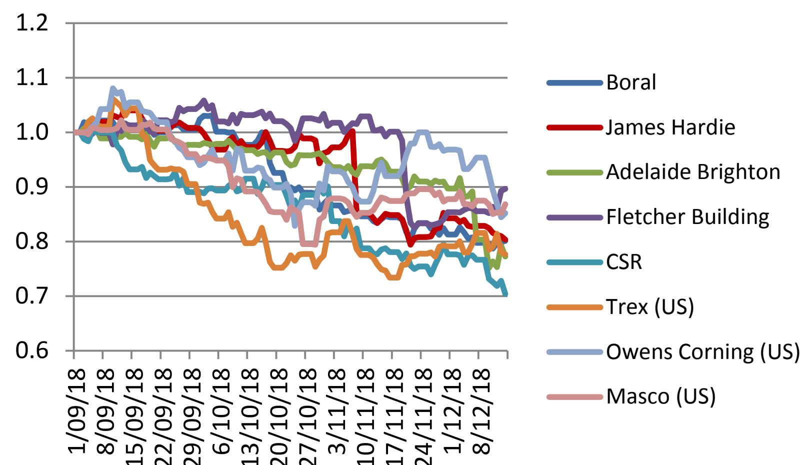
Housing cracks present material opportunities

Australian house prices are falling. Credit availability is tightening. US mortgage rates are rising. These and other factors have put building materials stocks under pressure. In this paper we assess value across the building materials sector given our assessment of "mid-cycle" housing starts and take a view on where we are in the housing construction cycle.

Significant underperformance creates a value investing opportunity

Australian and NZ focused building materials stocks were out of favour in 2018 while stocks exposed to the US housing recovery were well held. However, stocks across each of these markets underperformed their respective market indexes during the fourth quarter of 2018 (Figure 1) as sentiment towards the US turned. The market is of the view that the Australian and NZ housing cycles have peaked and that the US recovery has stalled.

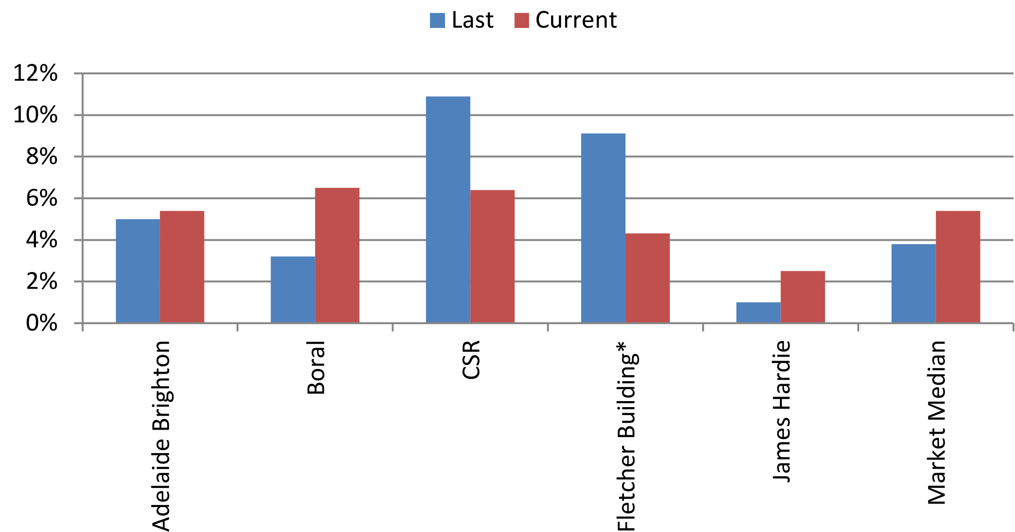
Figure 1: Share price performance relative to respective index



Source: Bloomberg. Analysis: Merlon. Boral, James Hardie, Adelaide Brighton, Fletcher Building and CSR performance is relative to the ASX 200. Trex, Owens Corning and Masco is relative to the S&P 500

Of course relative performance over a quarter does not indicate value because it depends on the starting point. Rather, current free cash flow yields provide a better initial guide to assess value (Figure 2).

Figure 2: Free cash flow yield



*Source: Company reports. Analysis: Merlon. * Fletcher Building free cash flow yield excludes cash outflows associated with their loss-making building projects given this business is being exited.*

…and now look undervalued on headline measures and Merlon's fundamental assessment

With the exception of James Hardie (where large market share gains continue to be priced in) the other four stocks appear generally cheaper than the market median. This is also evident in more simplistic measures such as enterprise value-to-EBIT, with a range of 5.5x to 9.0x compared to the market average of approximately 15.0x.

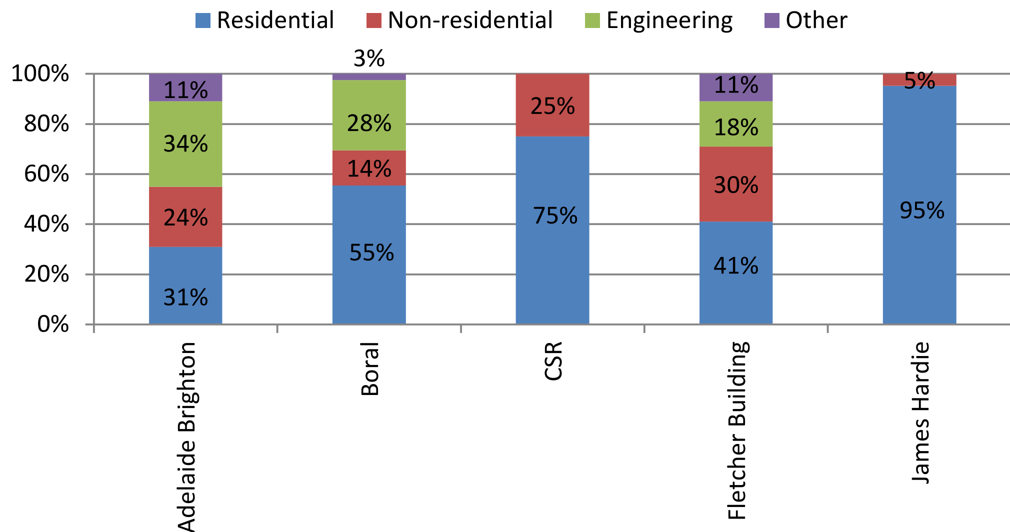
Of course, Merlon valuations are based on sustainable free cash flow rather than current free cash flow. For cyclical stocks such as building materials, we determine sustainable free cash flow with reference to mid-cycle building activity levels. Furthermore, valuation is one of two research outputs, the other being analyst conviction. Conviction is about market misperceptions which Merlon can refute backed by evidence. For example, if the market is over extrapolating favourable cyclical conditions, we are likely to have lower near term earnings estimates than the market and lower conviction. Conversely, if the market is too pessimistic, we are likely to have higher estimates and higher conviction.

Residential construction is a key driver…

Mid-cycle housing starts a key driver of sustainable free cash flow

While end market exposures vary by stock, residential construction is clearly the key driver for the sector overall (Figure 3).

Figure 3: Revenue exposure by end market

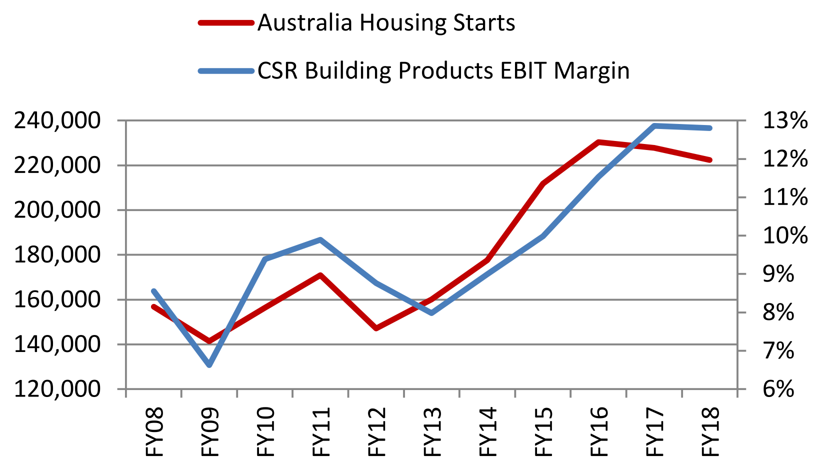


Source: Company reports. Analysis: Merlon.

…with housing starts in the market's focus

Within residential, the market focuses on housing starts since this is the key driver of demand. For example, with 66% of CSR's revenue driven by new housing construction, its Building Products EBIT margin has been closely correlated with housing starts (Figure 4).

Figure 4: Australian Housing Starts and CSR's Building Products EBIT Margin*

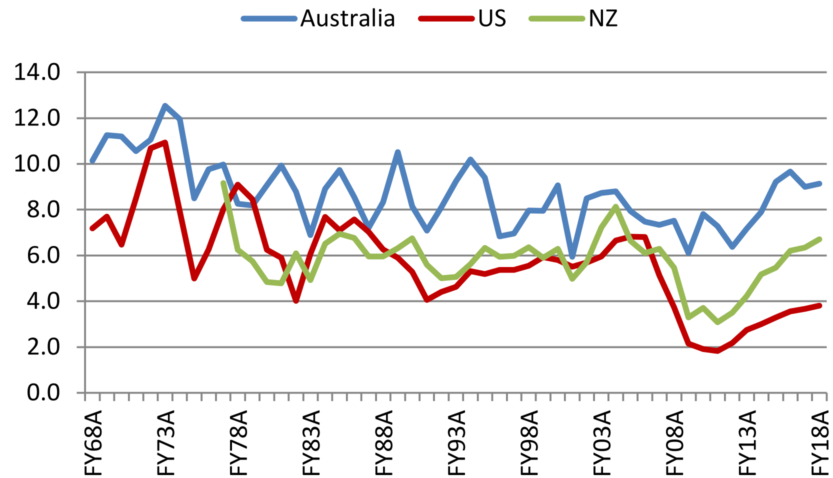


*Source: ABS, Company reports. Analysis: Merlon. *March year end.*

We estimate mid-cycle housing starts by observing the trend in housing starts per capita. Perhaps surprisingly, housing starts per capita has been declining in all three markets if we take a very long term historical view (Figure 5). In addition, Australia sits well above NZ and the US (partly as a result of a higher proportion of apartments).

Housing starts per capita have been in a long-run downward trend…

Figure 5: Housing starts per 1,000 persons



Source: ABS, Stats NZ, US Census Bureau. Analysis: Merlon.

Increasing additions and renovations activity likely explains part of the decline (these now represent 11% of total Australian residential activity, up from 3% in 1974).

…with long-run assumed starts of 190,000 in Australia, 26,000 in NZ and 1.5 million in the US

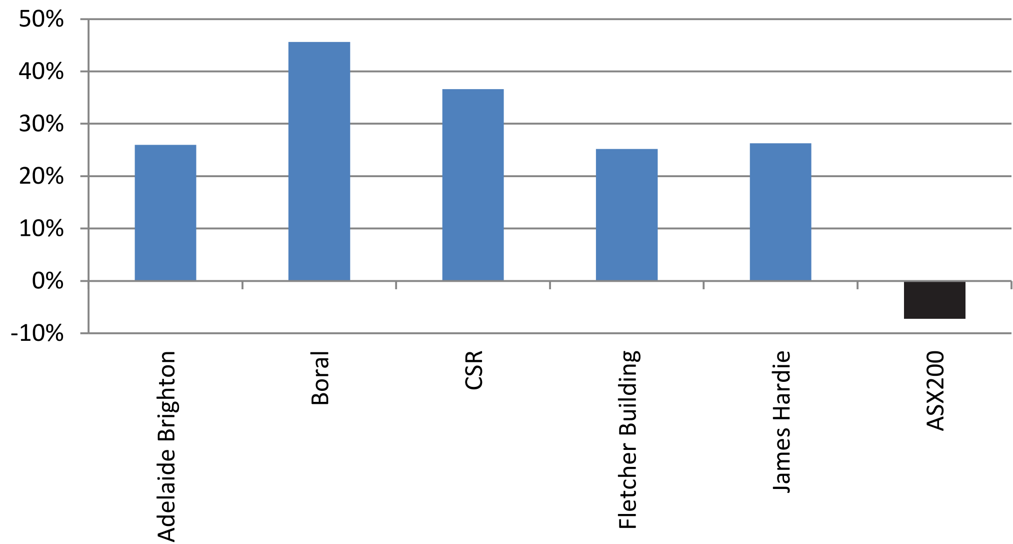
That said, the decline in housing starts per capita is less pronounced in recent years. Therefore, we derive our long run housing starts estimate using projected housing starts per capita in FY21. This gives 190,000 starts for Australia (7.2 per 1,000 persons), 26,000 for NZ (5 per 1,000 persons) and 1.5 million for the US (4.5 per 1,000 persons, higher than trend but accounting for the significant impact of the GFC on the trend line).

In the context of current activity, free cash flow for Australian and NZ based residential businesses should be lower in the long run than current free cash flow. Conversely, long run free cash of US based residential businesses should be higher than current levels.

Given our assessed sustainable free cash flow and franking for each stock, we forecast significantly positive expected returns for the whole sector relative to the market (Figure 6).

Expected returns for the sector are high relative to the market

Figure 6: Expected return (Merlon valuations)



Source: Company reports. Analysis: Merlon.

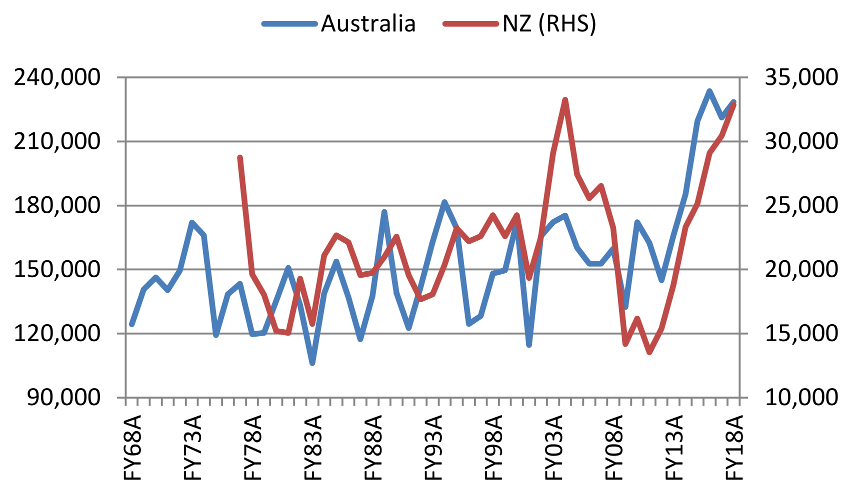
Having formed a view on valuation, we now assess conviction with reference to where we are in the building cycles and whether the market is overly extrapolating cyclically favourable or depressed conditions.

Australian cycle above trend and turning down, NZ also peaking

Australian and NZ housing starts have peaked…

Australia and NZ are at different points in the cycle to the US. Australian housing starts and NZ housing approvals (starts not available) are at record levels with their current cycles being stronger for much longer than prior cycles (Figure 7).

Figure 7: Australian Housing Starts and NZ Housing Approvals



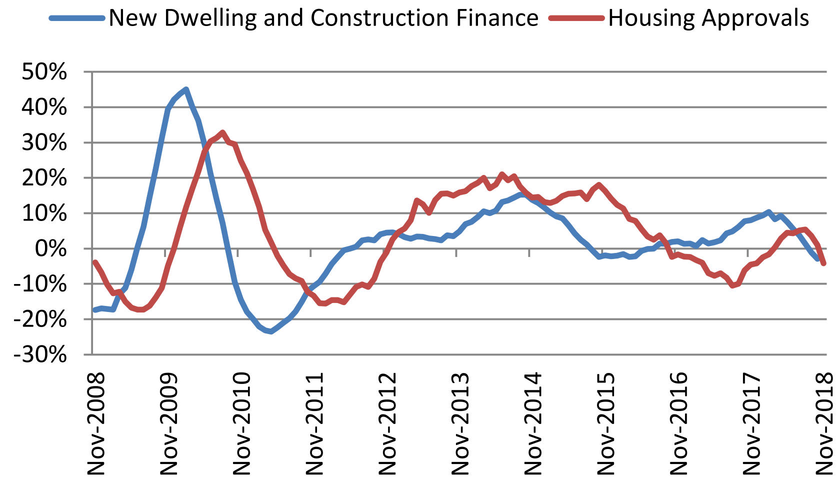
Source: ABS, Stats NZ. Analysis: Merlon.

Until recently, the market was overly optimistic on Australia, hence our earnings estimates were generally below market and we had lower conviction. However, there are now clear signs that Australian and NZ housing starts have peaked and estimates are coming down.

...given falling housing finance and housing approvals

In Australia, both housing finance approvals and housing approvals have rolled over (Figure 8). Alarmingly, housing approvals were down 33% in November 2018.

Figure 8: Rolling annual growth in Australian housing finance and housing approvals



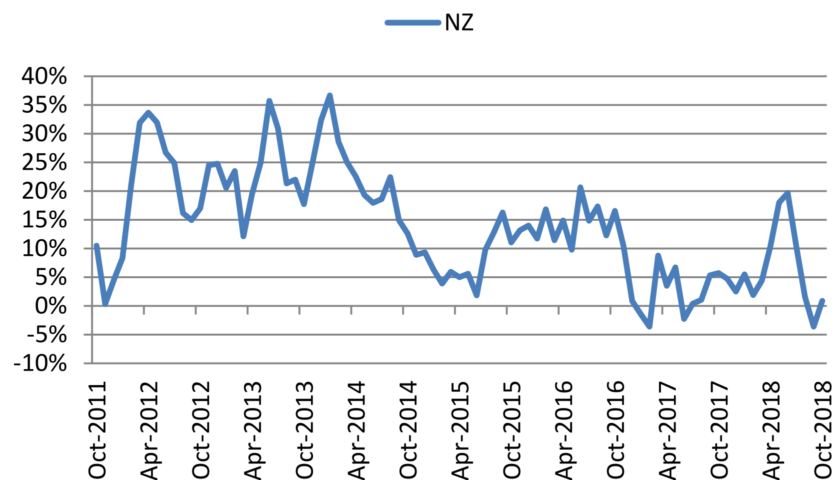
Source: ABS. Analysis: Merlon.

Recent feedback from Fletcher Building and various property developers also point to a slowdown, particularly for apartments.

With earnings estimates now coming down and market expectations better calibrated to mid-cycle levels, our conviction is beginning to increase (most recently for Boral)

While housing finance data is no longer available for NZ, the quarterly growth in NZ housing approvals has begun to turn negative (Figure 9).

Figure 9: Growth in NZ Housing Approvals (pcp)



Source: Stats NZ. Analysis: Merlon.

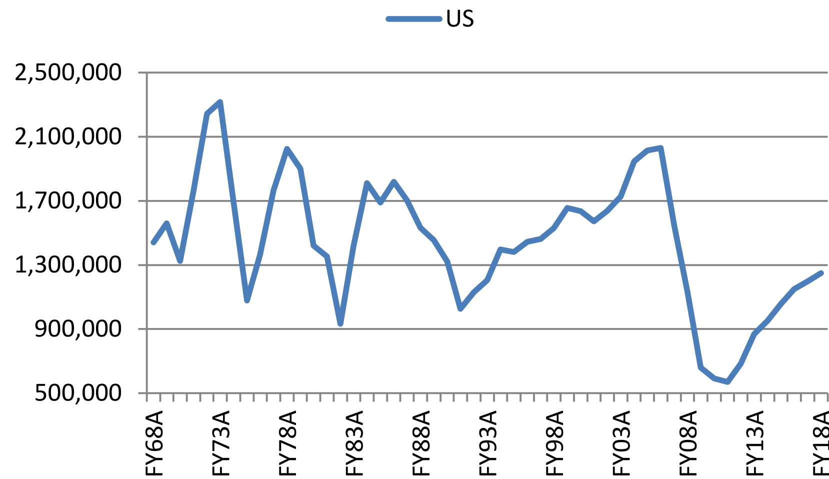
NZ house price growth is also moderating, particularly in Auckland (the key driver of NZ house construction). This will likely put some pressure on construction.

US cycle below trend but might peak below mid-cycle this time

US housing starts had been recovering…

Meanwhile, the US has experienced a very prolonged yet very slow recovery in housing starts off record low levels following the GFC in 2008 (Figure 10).

Figure 10: US Housing Starts

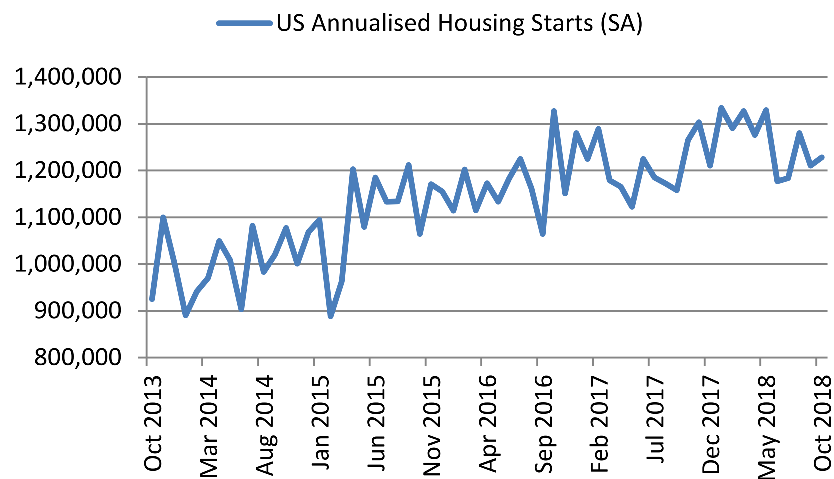


Source: US Census Bureau. Analysis: Merlon.

Up until recently there has been universally optimism on the US recovery. This constrained our conviction on Boral and James Hardie. However, the seasonally adjusted annualised figures now suggest that the recovery is slowing if not stalling (Figure 11).

…but now appear to be stalling…

Figure 11: US Annualised Housing Starts (Seasonally Adjusted)



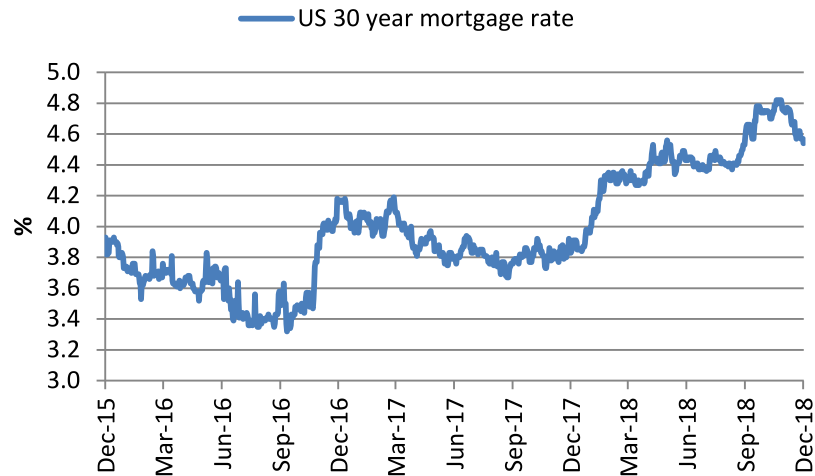
Source: US Census Bureau. Analysis: Merlon.

Along with anecdotal feedback from US homebuilders, there are three leading indicators of US housing starts that may explain the slowdown.

First, the US 30 year mortgage rate has been rising steadily, notwithstanding a slight pullback in recent weeks (Figure 12). As a result this is impacting house affordability.

Figure 12: US 30 year mortgage rate

…given rising mortgage rates…

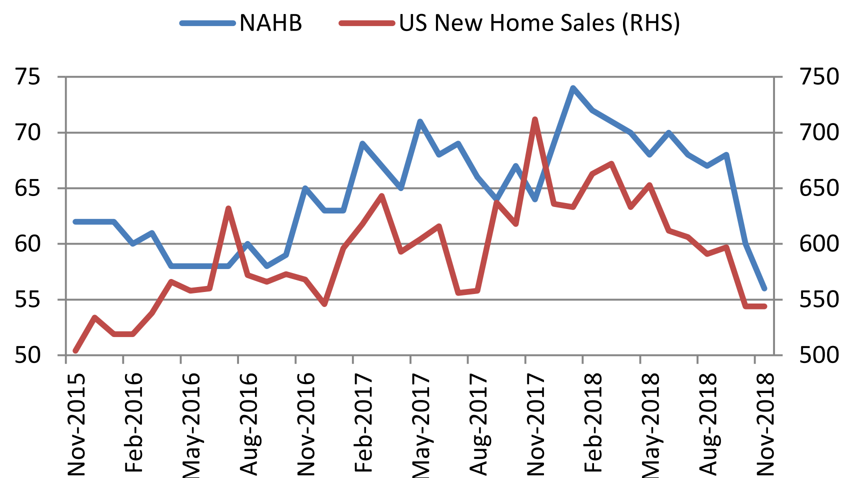


Source: Bloomberg. Analysis: Merlon.

Second, the NAHB (a measure of US homebuilder's activity) fell quite sharply in October and continued to fall in November (Figure 13). Finally, new home sales have been falling for quite a while now.

…and sharp declines in new home sales and the NAHB…

Figure 13: US NAHB and US New Home Sales



Source: Bloomberg. Analysis: Merlon.

While we believe our long run estimate of 1.5 million starts is reasonable, we may find that the current cycle will peak at a level well below that.

…leading to lower market optimism, hence improving our conviction…

Less market optimism on the US recovery and concerns about margins are feeding into lower earnings forecasts for Boral and James Hardie (more on this below). Our conviction is therefore building.

Market misperception around operating leverage

The leverage of operating margins to the US cycle for Boral and James Hardie had been overestimated by the market. However, this is being corrected as consensus FY20 EBITA

forecasts for Boral and James Hardie's US segments have fallen by 15% and 17% respectively since August 2017.

We would expect some margin expansion through a housing construction recovery given fixed cost fractionalisation and improved pricing power as capacity in the market is utilised.

However, we believe the market continues to somewhat underestimate the level of cost inflation. A stronger US economy is leading to higher labour, raw material and energy costs and there are costs in ramping up production. This was my biggest takeaway from a recent tour of BLD's and JHX's US operations.

…though US segment forecasts still appear optimistic

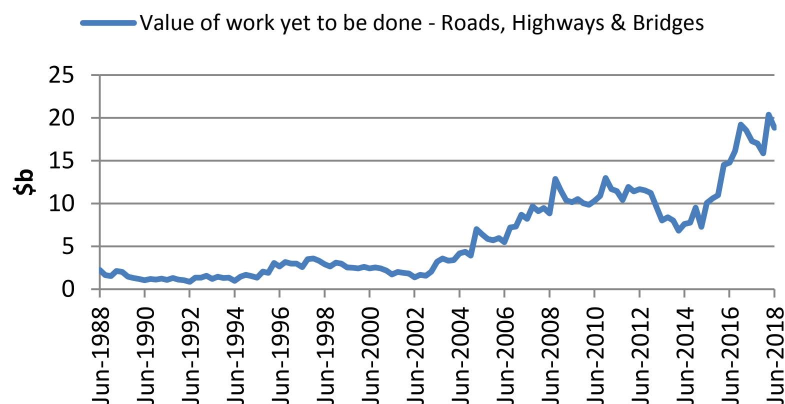
While our conviction is improving as US forecasts for Boral and James Hardie become more realistic, we remain below consensus. Therefore, we are looking for further consensus downgrades before lifting our conviction further.

Infrastructure spending to provide some offset

While there are emerging earnings concerns in the residential segment, increased government spending on infrastructure will be supportive of free cash flow over the next few years (Figure 14). This is particularly important for the likes of Boral's and Adelaide Brighton's construction materials businesses. Much of this work is concentrated in NSW where Boral's market position is strongest.

A boom in Australian roads spending will benefit Boral and Adelaide Brighton

Figure 14: Value of work yet to be done – Roads, Highways & Bridges (Australia)



Source: ABS. Analysis: Merlon.

The positive outlook for US infrastructure spending also supports Boral's fly ash business.

M&A a spanner in the works

Our analysis of building materials stocks is not just about the cycle. We are also focused on company specific issues, of which there are many.

Assessment of James Hardie's "35/90" strategy is critical to estimating its sustainable free cash flow. James Hardie's objective is to drive the fibre cement category to a 35% share of the total US siding market (currently less than 20%) while retaining 90% share of the

category. Our current estimates factor in 25/90 and margin expansion, though we plan to refresh our analysis.

Boral's US business following the Headwaters acquisition in 2016 remains a concern. While the strategic rationale was sound, we felt Boral overpaid at the time (Boral's High Price Acquisition of Headwaters). Given the significant recent decline in US exposed building materials stocks, Boral would have arguably been in a better position had it waited (though that is with the benefit of hindsight).

Retention of Headwaters synergies is questionable…

Our focus on Headwaters now centres on the sustainability of the base earnings and how much if any of the quoted synergies will be retained? While synergies were a key justification for the acquisition (as they usually are), in our experience they rarely hit the bottom line in full. Rather, some if not all synergies usually offset cost inflation and/or customer losses as existing management departs. Consensus forecasts originally seemed to imply that most, if not all, of the quoted synergies (initially US$100m but later upgraded to US$115m) hit the bottom line. However, as discussed earlier, we have seen Boral's US segment forecasts cut. Indeed, US$39m of synergies were achieved in FY18 but these were more than offset by weather, lost volumes, operational issues and cost increases.

…though Boral is in the driver's seat for plasterboard

A resolution on the ownership structure of the Boral USG Plasterboard joint venture also looms large. This has been brought on by Knauf's pending acquisition of USG. On this front we are optimistic that Boral is in a strong bargaining negotiation since it is not compelled to buy or sell. If it does acquire the other half of the joint venture it should be on somewhat favourable terms. We trust Boral will factor in the Australian residential slowdown into its offer price.

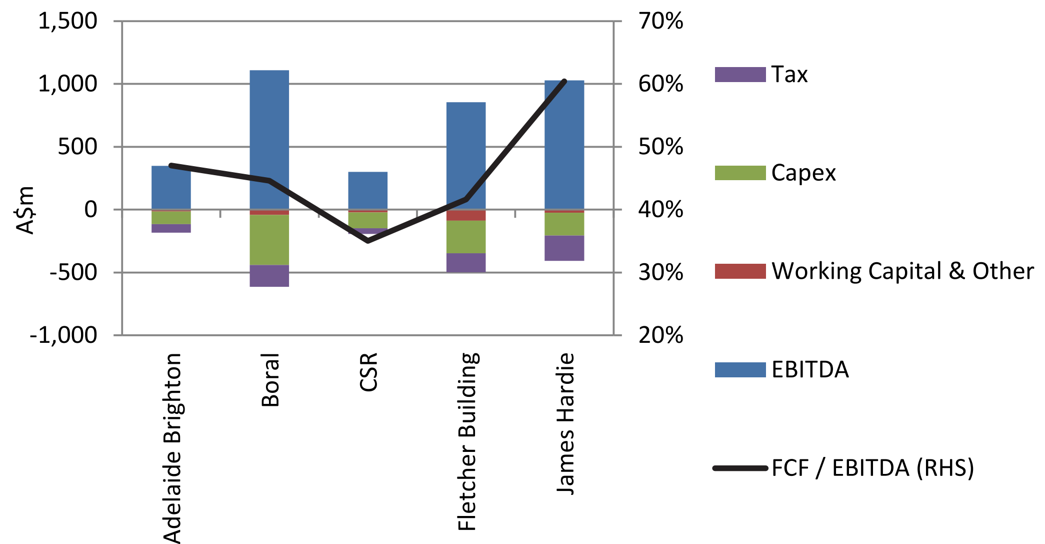
Fletcher Building's balance sheet looks better, question marks still hang over construction

For Fletcher Building, key issues relate to the state of its balance sheet and construction losses that have been an ongoing source of disappointment. On the former, the recently announced sale of Formica will enable the restatement of the dividend while leaving plenty of room to buy-back shares. On the latter, we are reasonably confident that there will be no further provisions taken on its buildings and interiors (B&I) construction projects given the large provision taken by the new CEO in 2018. However, we remain wary of potential losses in its infrastructure business (albeit the downside is more limited than B&I).

Free cash flow generation varies across the sector

While many companies focus on EBITDA, we are most concerned with how much EBITDA converts to free cash flow since this impacts our valuation of a business. Despite all operating within the same sector, there are significant differences across the companies with respect to their cash generation (Figure 15).

Figure 15: Free cash flow composition based on normalised forecasts



Source: Company reports. Analysis: Merlon.

James Hardie excels at converting EBITDA, others less so

Generally speaking, light building products (eg fibre cement, plasterboard etc) are better converters of EBITDA than heavy construction materials (eg concrete, cement, bricks etc) that are more capital intensive. If all else was equal, we would prefer James Hardie given it is the best cash converter of the group. Its capacity additions are well covered by the high margins it earns on its products. Conversely, despite CSR's exposure to light building products, its conversion is hamstrung by its poor cash generating Aluminium business.

Boral's move to increase its light building products exposure through the Headwaters deal has led to improved conversion. Meanwhile, Fletcher Building's conversion is depressed by its low returning Australian business.

Fund positioning

We have room to increase our holdings in the sector…

Overall, there is room to add to our positions in the sector as conviction increases with valuations not expected to change (anchored to mid-cycle assumptions).

Adelaide Brighton, once a market darling, has lost its lustre following several earnings downgrades and management departures. With valuation now more compelling, we have work to do to build conviction.

We observed earlier that CSR's EBIT margin has typically moved in-sync with Australian housing starts. As housing starts moderate, we continue to see downside risk to CSR's EBIT margin relative to consensus estimates given this historical relationship. As such we are looking for further consensus downgrades before we raise our conviction.

James Hardie offers an opportunity given its more reasonable valuation provided we can build more conviction on long run market share gains and margin expansion.

We retain our position in Fletcher Building and recently acquired a positon in Boral.

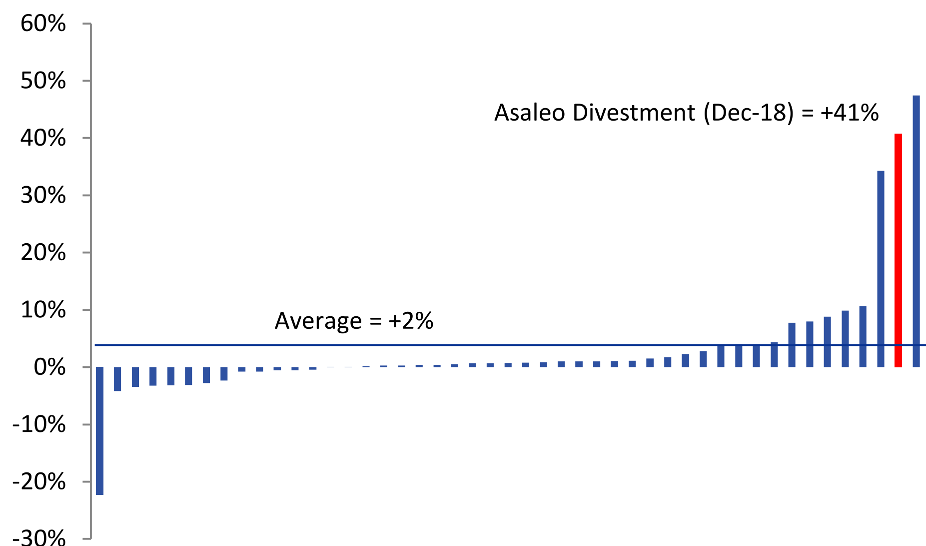
Analysts:

Joey Mui

Asaleo Divestment Well Received

Last month we published an analysis of all divestment announcements of ASX100 companies in Australia since the year 2000. Of approximately 1,200 announcements, there were 46 cases where the sale proceeds exceeded 10% of the sellers' enterprise value. On average, share prices responded positively to divestment announcements.

Figure 16: Share Price Reaction on Day of Divestment Announcement (ASX100 Companies, 2000 to Today, Proceeds > 10% of Enterprise Value)



Source: Bloomberg, share price reaction relative to all ordinaries accumulation index Asaleo Care reaction as at 2pm on day of announcement. Note that Asaleo Care is not an ASX100 company.

On average, divestments are well received by investors…

This overall finding is consistent with overseas academic research dating back to the 1980s that showed gains to shareholders around the announcement of divestments.

…Asaleo Care's sale of its Australian consumer tissue business was no exception.

The market reaction to Asaleo Care's 6 December 2018 announcement that it had reached agreement to sell its consumer tissue business was particularly well received against this backdrop with the share price outperforming the market by 40% on the day.

Merlon owns approximately 4% of Asaleo Care on behalf of institutional and retail clients and we had been adding to the position in recent months.

At the closing price of 65c the day before the announcement, the market was ascribing NIL value to the tissue manufacturing business on our estimates. The tissue business is more commoditised and more capital intensive than the stronger branded personal care business and has been suffering from higher pulp prices, a key input cost. However higher pulp prices are an industry issue which means consumer prices will eventually rise to offset, and the trade buyer has clearly taken the same view.

Also, investors had been concerned about high debt levels which can now be partly repaid. Our investment was made on the basis of a conservative valuation that assumed all debt would have to be repaid in determining value for equity shareholders.

On a long term view, we forecast that the currently unprofitable consumer tissue would return long term industry margins of 10% (Earnings before Interest and Tax) as the 3-player tissue market adjusted to higher pulp prices. While we are happy to be patient for the business to recover and value to be realised, we are supportive of the divestment made at a compelling mid-cycle price. At a sale price of $180m, this reflects a 24x multiple of our free cash flow forecast using long term EBIT margins (a large premium to the 17x long term market FCF multiple we adopt as standard across our valuations).

Given that the value of the tissue business was largely factored into Merlon's estimates, our overall valuation rose modestly relative to the share price performance. The consumer tissue business only represented around 15% of Asaleo's normalised free cash flow.

Asaleo remains a portfolio holding as the company trades at an attractive valuation, with reduced debt and underpinned by the differentiated, lower capital intensity personal care business.

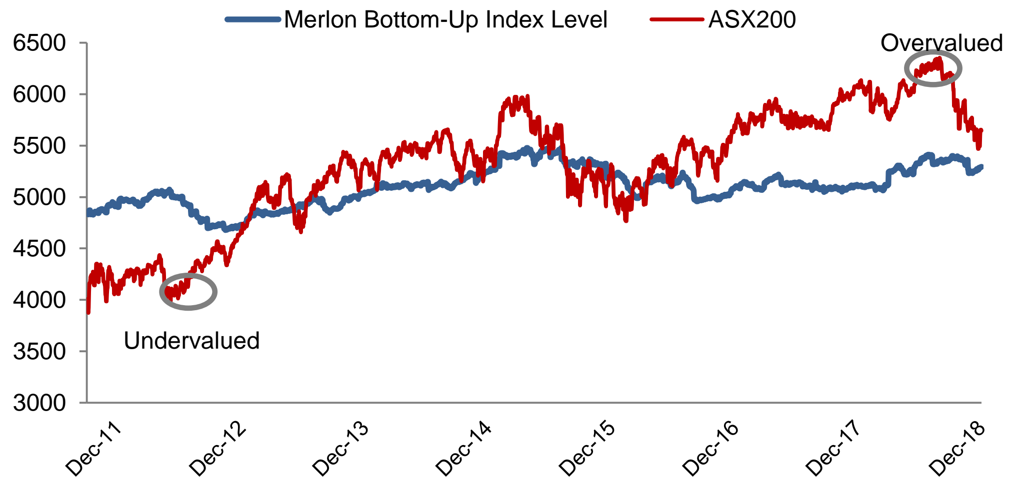
Market Outlook and Portfolio Positioning

Neil Margolis

Market approximately 6% overvalued using consistent bottom-up approach…

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 6% overvalued after declining 8% during the quarter.

Figure 17: Merlon bottom up market valuation vs ASX200 level



Source: Merlon

The market pullback has not reduced valuation dispersion, with investors still complacent towards risks in resources, bond proxies and high PE growth stocks

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. This means our valuations are more stable than share prices, as evidenced by the fact that within Merlon's universe of covered companies, well over half the share prices moved more than 10% in the quarter whereas only one in ten Merlon valuations changed by this magnitude. This creates good opportunities for patient long-term investors.

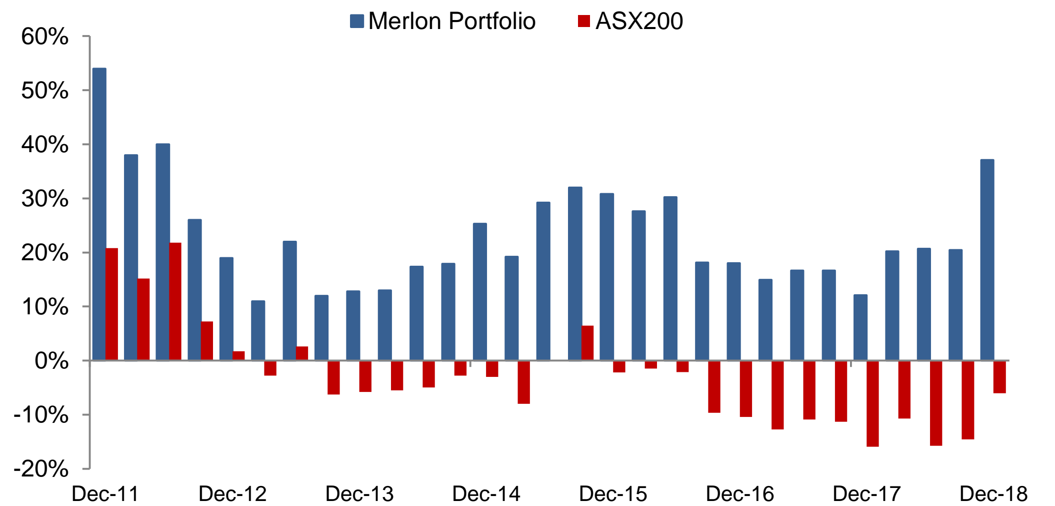
In addition to being less volatile, Merlon's consistent valuation approach across all companies also gives insight into where the market is overly concerned or overly complacent with regard to stock specific risks. This lens on valuation dispersion is more useful than predicting the precise timing of absolute valuation levels as this requires knowing when the market will price in "mid-cycle" interest rates and long-run average risk premiums.

We have flagged for some time that we believe there to be three primary areas of investor complacency in the Australian stock market. The first is resources, where we have written about unsustainably high commodity prices and unsustainably low capital expenditures (Trade Wars and the Peak of the Chinese Growth Model); the second is "low volatility" stocks such as healthcare, property and infrastructure sectors, where investors are completely disregarding inflation risk and the prospect of rising rates (Some thoughts on asset prices); and the third is "high PE growth stocks" where we wrote about the extreme

valuations of several stocks in our September quarterly. Even though the market pulled back in the December quarter, these three broad areas of absolute, but more importantly, relative overvaluation continues to exist.

Merlon's value portfolio comprises our best research ideas, based on our long-term valuations and analyst conviction. As seen in Figure 18, the Merlon portfolio offers more than 30% absolute upside and is looking increasingly attractive relative to the index.

Figure 18: 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, albeit at a tempered pace, over the next 12 to 18 months.

The divergent path of US and Australian interest rates coupled with our cautious outlook for commodities 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…

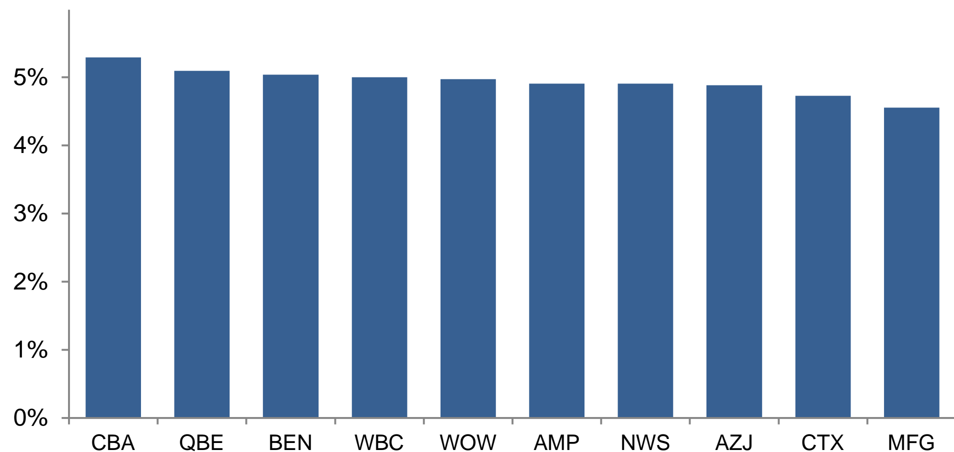
The state of the Australian housing market remains a major area of focus and concern for investors. The Royal Commission and the associated "credit crunch" has a added fuel to the fire driving bank stock and consumer discretionary stock valuations to historically low levels. While our non-benchmark approach means we are content holding no **major banks** at times where investors are too complacent, we have added some exposure to the sector, through **Commonwealth Bank**, **Bendigo Bank** and **Westpac**, 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 19: 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.

Much has been written on **AMP** after the Royal Commission caused the share price to decline by significantly more than our estimate of the fundamental value impact. Then, in an unrelated action, the directors decided to 'fire-sale' the wealth protection and mature business for 40% less than our - and the company's own disclosure - of cash-flow based value. We have written about the value and governance aspects of this un-precented divestment (Divestments & Shareholder Rights) but continue to hold, and in fact added to the investment, as the expected return remains very attractive and more importantly the downside should be limited with the company now trading at a modest premium to tangible cash asset backing.

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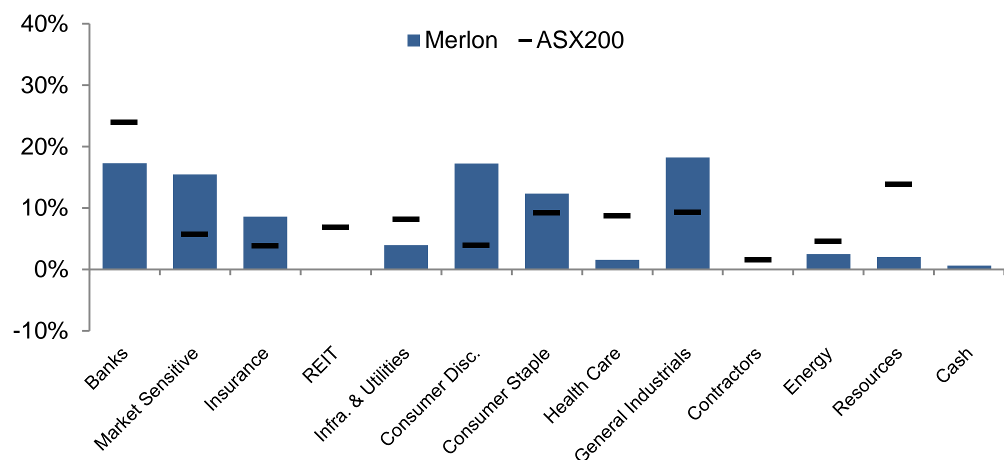
Another example is a company like **Magellan Financial**, which is trading at a discount to the ASX200 on a simplistic price-earnings ratio, and notwithstanding the company's exceptional cash conversion (as evidenced by the recent dividend increase), debt free balance sheet, low operating leverage, strong distribution and the defensive positioning of its underlying funds (high cash holdings, short Australian dollar).

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 declining global interest rates and a tough insurance pricing backdrop. Management is now more focused, while 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 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 20: 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**.

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Figure 21: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	36	200
Active Share	75%	0%
Merlon Valuation Upside	37%	-6%
EV / EBITDA	8.1x	11.3x
Price / Earnings Ratio	13.7x	15.6x
Price / Book Ratio	3.4x	3.7x
Trailing Free Cash Flow Yield	7.1%	5.1%

Source: Merlon

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December Quarter Portfolio Activity

During the quarter, we introduced six new investments at up to half our maximum position size, and topped up existing holdings that had underperformed our long-term value assessment.

During the quarter we made six new investments. None of the initial investments are above 2.5% of the portfolio value, as a result of insufficient margin of safety or liquidity constraints.

We reinvested in **Origin Energy** at an average price under $7 only a few months after exiting our long-held position close to $10. Our fundamental valuation has been stable at around $9 throughout this time and has always factored in the market's growing concerns about the declining oil price and political interference in energy prices.

Similarly we reinvested in **Boral** with the share price declining significantly more than our assessment of long-term value on the back of weakening sentiment towards US housing and moderating expectations with respect to the Headwaters acquisition.

We invested in **IOOF Holdings**, with the share price almost halving following APRA's unprecedented public action against the company and several directors for failing to act in member's best interests. We managed to acquire the position close to our $4 bear case fundamental valuation assessment. This bear case factors in an extreme halving of current earnings as a result of advisor attrition, fee rebasing and higher compliance costs. Our valuation would be even higher if ANZ cancels the sale of its business to IOOF and the funds already raised are applied to buy back shares instead.

We invested in **Sandfire Resources** which offers exposure to our preferred commodity, copper, at a very attractive free cash flow yield, as the market focuses on the lack of growth and trade war related risks to commodity prices.

We made a small initial investment in **Speedcast International**, a satellite telecommunications provider, offering a very attractive free cash flow yield as the market is concerned about earnings risks from exposure to offshore oil rigs and a string of debt-funded acquisitions. The company is trading close to the bottom-end of our valuation range which assumes no organic growth and cash margins at half management's target.

We invested in **Nick Scali**, a leading furniture retailer that has underperformed as a result of market concerns relating to declining house prices. While not immune from the cycle, the opportunity for new stores and consignment nature of the inventory reduces this risk.

We also added to existing positions in **AMP**, **Westpac** and **Southern Cross Media**, with their share prices declining significantly more than our long-term value assessment.

Funded by reducing existing positions that had performed strongly.

These investments were funded by reducing our long-held position in New Zealand's **Trade Me Group**, which was subject to a takeover offer of NZ$6.45, close to our bull case valuation. We reduced several investments that exhibited reduced, but still significant valuation upside following outperformance, namely **Aurizon Holdings**, **Commonwealth Bank**, **Magellan Financial**, **QBE Insurance** and **Woolworths**. We also reduced our investment in **JB HiFi** following lower analyst conviction.

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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)	-3.0	-8.2	-6.4	-7.1	9.2	8.3	13.2
ASX200 Return (inc. franking)	-0.1	-8.0	-6.1	-1.4	8.1	7.1	11.1
Excess Return*	**-2.9**	**-0.2**	**-0.3**	**-5.7**	**1.0**	**1.2**	**2.1**

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

December Quarter Market Review

In the worst quarter since 2011, REITs, Utilities and Materials fell the least, all sectors to which the Merlon strategy has limited or no exposure.

The market experienced its weakest quarter since 2011, declining 8.0% (including franking). The **Energy** sector performed worst as oil declined 34% on global oversupply concerns but it should not be forgotten this was after the volatile commodity doubled from its 2016 low. After performing best the previous quarter, the **Telecommunications** sector declined 15% with the ACCC expressing industry concentration concerns if the TPG / Vodafone merger goes ahead. **Consumer Discretionary** stocks fared poorly as investors fretted about negative wealth effects of declining house prices on consumption. Some growth stocks commenced a long awaited de-rating, with the **Technology** sector pulling back 14%.

Bond proxies performed best in the quarter, with **REITs** and **Utilities** declining only 2% and 3% respectively, as yield curves flatted around the world. US and Australian 10 year bonds shed 38bp and 35bp. The Australian Dollar held up remarkably well, only declining 2.5% as Iron Ore rose 5% with speculators placing faith in more Chinese government debt fuelled stimulus offsetting any economic downside from the trade war. Other bulks declined though, including Coal down 10%. All this meant **Materials** declined less than the market overall, notwithstanding the sector's sensitivity to deteriorating global growth, in particular, that of China. Gold once again proved its safe haven status, rising 8%. Within **Financials**, the historically defensive **Banks** outperformed slightly but **non-bank Financials** continued to de-rate as the Royal Commission reached a crescendo.

It was more of the same in the month of December, except more pronounced. In a broadly flat month for the market overall, the **Resources** sector rose 5% (Iron Ore surged 10% and Gold 5%), with the defensive **Health Care**, **Utilities** and **REIT** sectors also managing positive returns, along with **Consumer Staples**. All other sectors were in the red. Oil declined 10%, the Australian Dollar 3.5% and sovereign bonds rallied again. In a sign of the increasing risk-off environment, mega large capitalisation stocks outperformed, with the capitalisation weighted index outperforming the equally weighted index by more than 1%.

Portfolio Performance Review

Disappointingly, the Concentrated Value Strategy declined boadly in-line with the ASX200 for the quarter, after having outperfomed by 2.7% in the first two months. After being a tailwind for several years, the non-benchmark approach was a headwind in the risk-off

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The strategy declined broadly in line with the market despite initially outperforming, as Resources and bond proxy sectors rose strongly in December

environment, as ultra large caps outperformed, most notably BHP, CSL and the major banks. The strategy performed better relative to the average stock, outperforming the equally weighted index by 2.4%.

Trade Me Group was the best performing holding in the quarter following a takeover offer from offshore private equity. **Woolworths** performed well with sales momentum being maintained and a sale of the petrol business degearing the balance sheet. **Aurizon Holdings** was similarly defensive in a down market and benefitted from a more favourable regulatory decision on its rail network. **IOOF Holdings** performed well for the strategy given the investment was only made after the share price plummeted on the back of APRA regulatory action. **Asaleo Care** rounded out the top five contributors after divesting its troublesome tissue business for a price in line with Merlon's valuation.

Seven West Media detracted the most from performance as the mid-year recovery in television advertising revenue faded, coupled with cyclical and leverage concerns. **AMP** underperformed following a fire-sale of its cash generative insurance business well below market expectations and prior company disclosures. **Fletcher Building** underperformed after downgrading earnings, principally in its weaker Australian division, although the well flagged Formica sale transpired at the end of the quarter, removing financial risk from the balance sheet. Other media exposures, **Southern Cross Media** and **Nine Entertainment Group**, rounded out the 5 worst performers, both seen as highly leveraged to consumer spending that might be vulnerable to declining house prices, as well as the market being less than enamoured with the Fairfax acquisition.

At a sector level, having minimal or no exposure at all to **Resources**, **REITs**, **Healthcare** and **Infrastructure and Utilities** detracted more than 3% from relative performance.

Given the Strategy performed relatively well in the first two months (+2.7% outperformance), it is worth analysing December in a little more detail, as the market was broadly flat but the strategy declined 3.0%. The non-benchmark approach was a 1% headwind with the largest index constituents outperforming the average company in the index. Similar to the quarter, having minimal or no exposure to **Resources**, **REITs**, **Healthcare** and **Infrastructure and Utilities**, all of which rose strongly in absolute terms, detracted 1.6% from relative performance. At a stock level, there were positives and negatives but nothing really stood out, with the top three stocks contributing the same outperformance as the bottom three detracted. The three best performing investments were **IOOF Holdings**, **Asaleo Care** and **Trade Me Group**, with the bottom three being **News Corporation**, **QBE Insurance** and **Magellan Financial**.

Financial year to date the Strategy has marginaly underperformed a weak market. Similar themes prevailed as the December quarter, with the non-benchmark approach proving to be a headwind, as well as having no or minimal exposure to the best peforming sectors, being **Resources**, **REITs**, **Healthcare** and **Infrastructure and Utilities**.

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The Strategy has declined broadly in line with the market financial year to date.

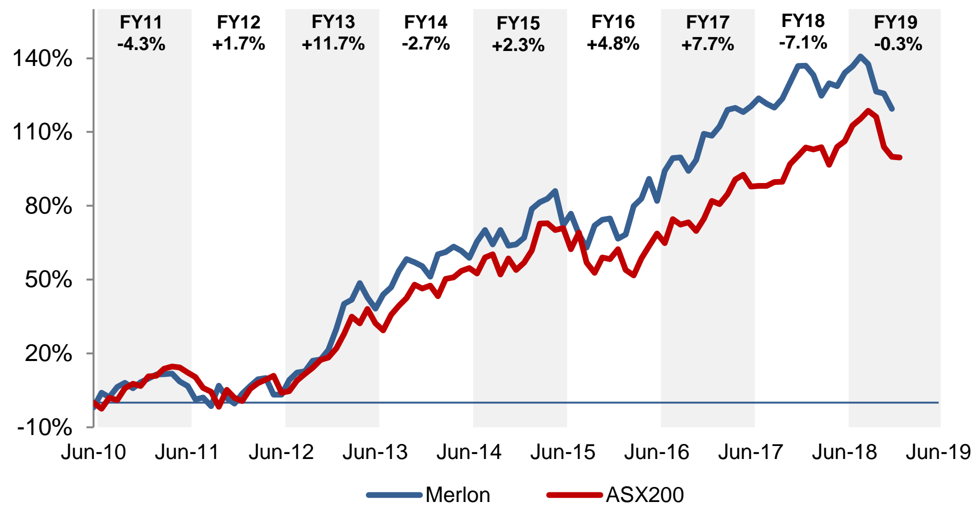
Key stock specific detractors for the financial year to date held in the portfolio included **AMP**, **Fletcher Building**, **News Corporation**, **Caltex**, and **Seven West Media**. On the other side of the ledger, the best performing investments that have contributed to performance have been **Trade Me Group**, **Magellan Financial**, **QBE Insurance**, **IOOF Holdings** and **Aurizon Holdings**.

Longer-term, the Concentrated Value Strategy has outperformed by 2.1% 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.

Stock selection outcomes have been positive over longer-term periods

Performance contributors over the long term have been broad-based, with **Macquarie Bank**, **Tabcorp**, **National Australia Bank** (not held), **Pacific Brands** and **Trade Me Group** the key contributors. Key detractors over this time frame include **AMP**, **Seven West Media**, **QBE Insurance**, **Aristocrat** (not held) and **Caltex**. 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

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Strategy FUM	Merlon FUM
$1,323.2m	$1,333.5m

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

Some Thoughts on Australian House Prices

Value Investing - An Australian Perspective: Part I

Value Investing - An Australian Perspective: Part II

Value Investing - An Australian Perspective: Part III

Some Thoughts on Asset Prices

Rethinking Post Retirement Asset Allocation

Trade Wars and the Peak of the Chinese Growth Model

Boral's High Priced Acquisition of Headwaters

Amazon Not Introducing Internet to Australia

The Case for Fairfax Media Over REA Group

Telstra Revisited

Oil: The Cycle Continues

Digital vs. Traditional Media - A Global Trend

Amazon Revisited - Muted Impact So Far

Some More Thoughts on Telstra

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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