Merlon Concentrated Value Strategy

Quarterly Report

March 2019

Contents

Iron Ore: Supply disruption is temporary 3

A Case Study in Poor Capital Allocation 12

Market Outlook 31

Portfolio Positioning 33

March Quarter Portfolio Activity 36

March Quarter Market Review 37

March Performance Review 37

Analyst:
Ben Goodwin

Disruption of iron ore supply is temporary

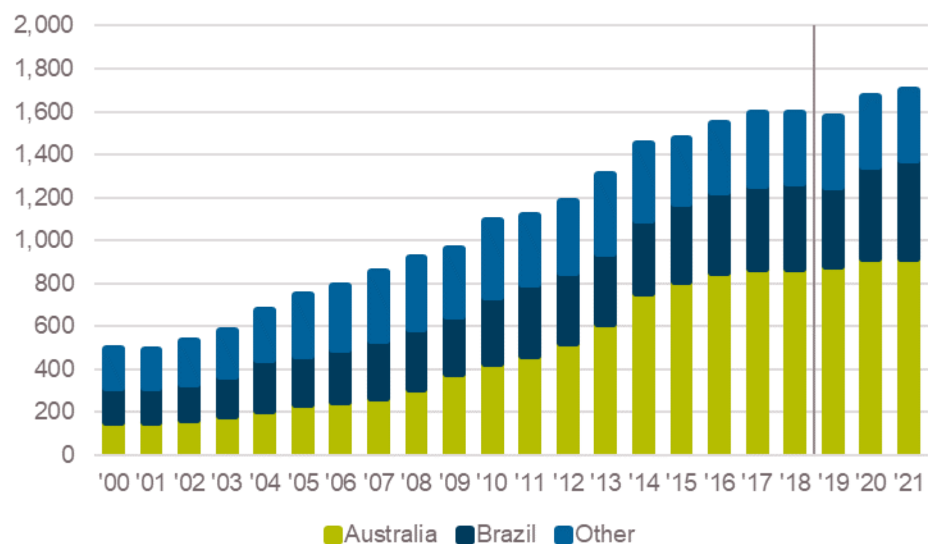
Iron ore: supply disruption is temporary; the transition to recycling is permanent

The effect of Vale's tragic dam collapse in early 2019 has seen iron ore prices rally. As a result of forced mine closures, the global seaborne supply of iron ore is expected to be 20mt lower in 2019 than in 2018, or 1.2% of the total seaborne market. Despite a slowing economy, Chinese steel demand in 2018 remained relatively strong, albeit importing ~10mt less iron ore relative to 2017 as use of scrap steel increased, a trend expected to continue for some time. This note summarises the implications of these factors and how they affect the longer-term market balance and pricing.

Supply

The short-term iron ore market has tightened unexpectedly on supply interruptions in Brazil, and exacerbated by cyclone activity in Western Australia. As a result of these events, we forecast a 20mt reduction in seaborne iron ore in 2019 relative to 2018 (1.2% of the 1.6 billion tonne global seaborne iron ore market). Vale exported 366mt of iron ore in 2018 (~20% of the 1.6bt seaborne market), albeit having produced 385mt, building stockpiles by ~20mt, reflective of a weakening demand environment.

Figure 1: seaborne iron ore supply



Source: Evans & Partners / forecasts: Merlon Capital Partners

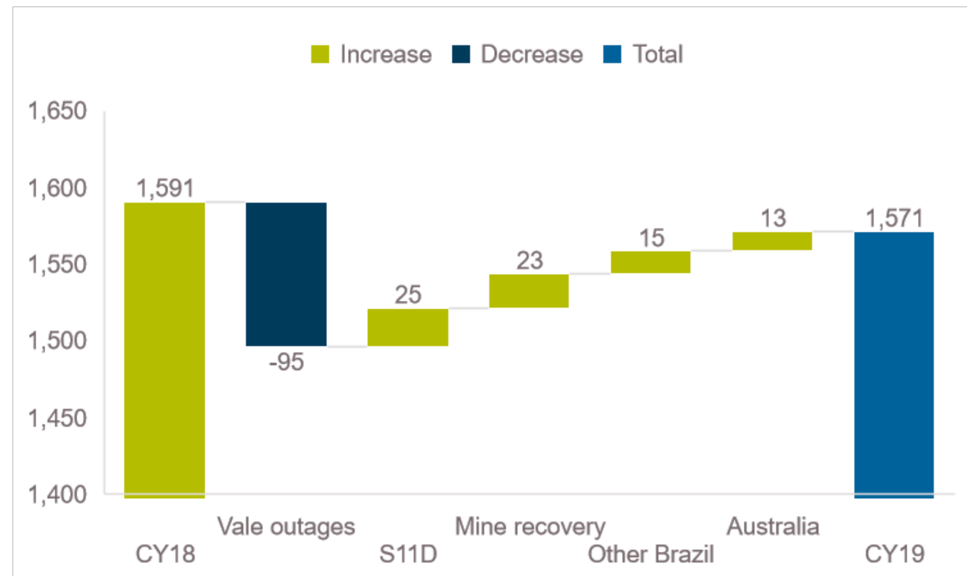
Vale's dam burst has seen supply impacted via a 40mtpa dam remediation program over two years, and the court-ordered shut-downs of the Brucutu (30mt), Timbopeba (15mt) and Alegria (10mt) mines. Countering these disruptions is Vale's continued ramp up of its 100mt S11D project (+25mt in 2019), and the likely return of the Brucutu mine. The net effect of these changes is a loss of 48mt. Outside of Vale, I expect Anglo American's Minas Rio mine to add 15mt of production, while BHP and RIO are expected add a further 8mt (including the effect of recent cyclone activity), and Roy Hill 5mt. The net effect is that

The impact on global iron ore supply in 2019 will be limited by growth elsewhere

China is holding excess inventories

2019's global seaborne supply of iron ore likely to be 20mt lower than 2018 (see chart below).

Figure 2: 2019 seaborne iron ore supply – base case

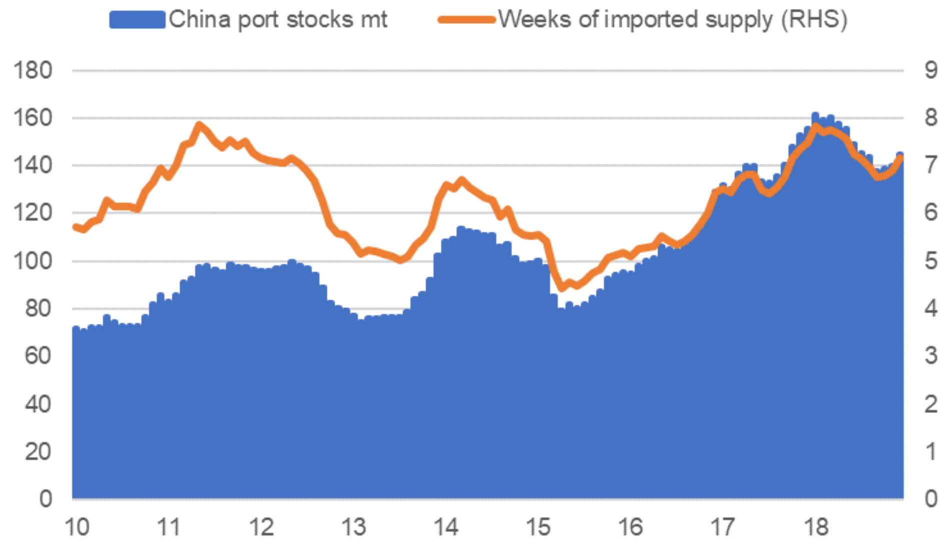


Source: Company reports / Merlon Capital Partners.

The above analysis factors in expected mine activity in the major producing hubs of Australia and Brazil. In addition to this activity, additional potential offsets are as follows:

1. The likely unwind of Vale's ~20mt inventory build from 2018, likely a function of Vale's S11D project ramp up, coupled with weakening demand for iron ore and a desire from major producers not to destabilise the market with excess supply growth.
2. China's domestic production of iron ore is currently operating at levels less than 50% of its 400mt capacity. Early expectations are for at least 10mt of supply to be added in response to elevated iron ore pricing.
3. China's port stockpiles of iron ore are at elevated levels (see chart). Drawing down these stockpiles to 6 weeks of imported supply (average level) would release more than 25mt of iron ore into the market.

Figure 3: China iron ore inventories



Source: Bloomberg / Calculations: Merlon Capital Partners.

These three additional offsets amount to an additional 55mt of supply and would more than offset Vale's net 48mt production losses. And this is before factoring in any (likely) response from higher cost, 'non-traditional' producers such as South East Asia, West Africa and South America, or a return to export markets from India, once a 100mt exporter.

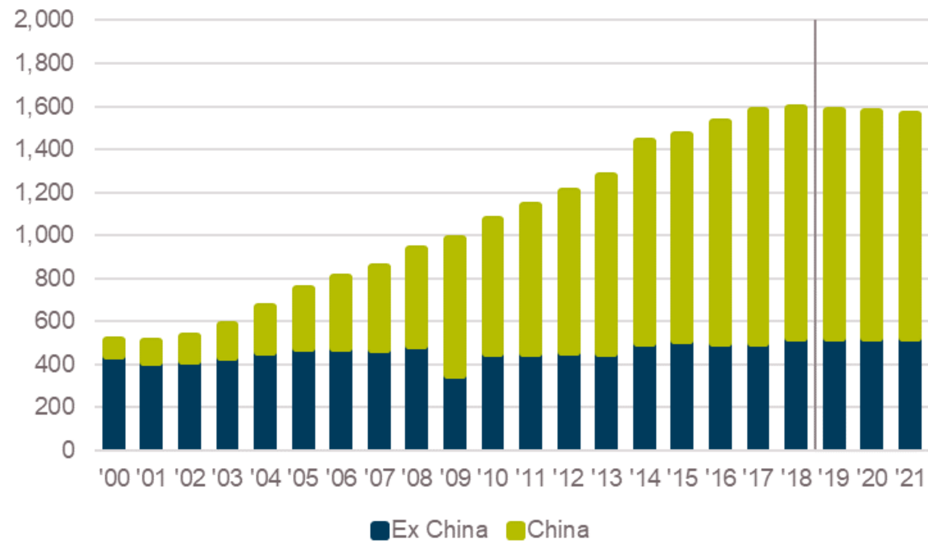
Demand

China's imports of iron ore peaked in 2017

The spike in iron ore prices in early 2019 has been a supply-driven event. It is worth assessing demand, however, with China producing half of the world's 1.8bt steel and accounting for 2/3rds of the 1.6bt seaborne iron ore market.

China, as the world's largest importer of iron ore, saw its imports of iron ore peak in 2017. This was followed by a decline of 1% in 2018 as the policy driven transition towards scrap steel recycling began.

Figure 4: global iron ore imports – China is key

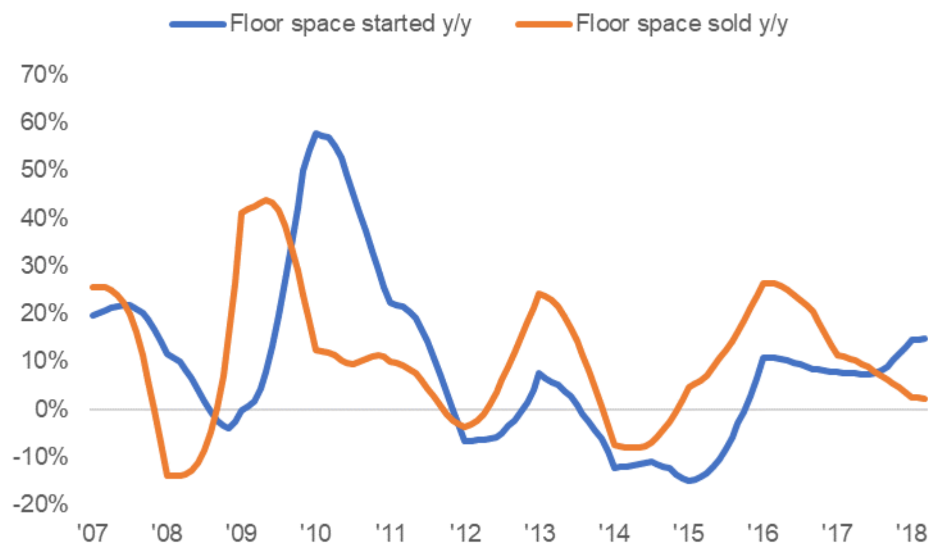


Source: World Steel / Forecasts: Merlon Capital Partners.

In terms of downstream demand for steel in China, roughly half of steel demand is attributable to the property market, Housing starts were surprisingly strong in 2018, outpacing housing demand significantly in 2018 – as the chart shows, new starts ultimately follow sales activity. It is worth noting that only 30% of apartment sales are attributable to first home buyers, down from 70% in 2008 – in short, the market is becoming increasingly speculative. In addition, more than 2/3rds of new starts occur outside of China's Tier 1 cities, regions where inventories are most elevated.

Weakening property sales are expected to lead to weakening new starts

Figure 5: China's residential property cycle



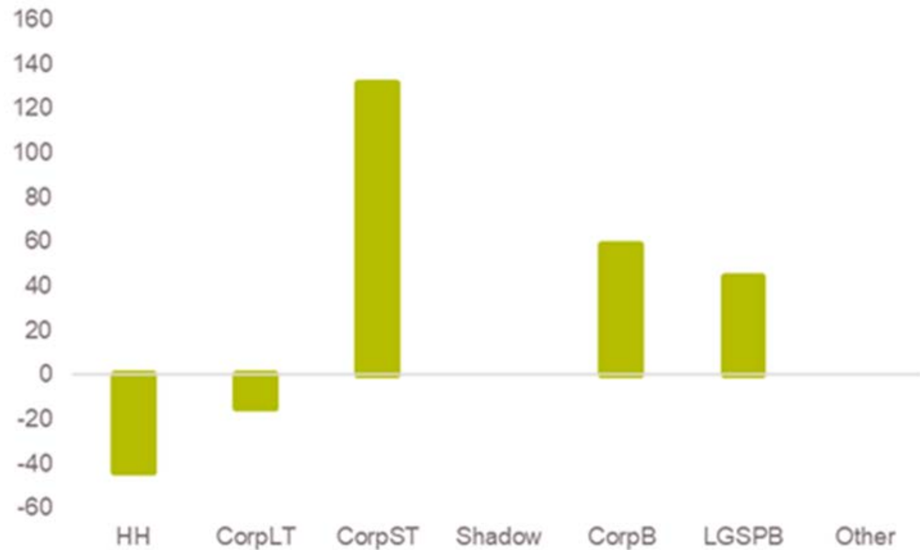
Source: Bloomberg / Calculations: Merlon Capital Partners.

China's weakening economic activity indicators have seen growing expectations of a 2015/16-style stimulus. However, stimulus to date has focused on tax cuts (consumer / SME targeted) and infrastructure (local government financing), coupled with a January

China's credit growth has been led by short term corporate loans

rebound in credit flows (see chart below), albeit focused on short term corporate financing, rather than long term investment directed lending.

Figure 6: China credit growth by sector USDb – Jan/Feb 2019 vs pcp

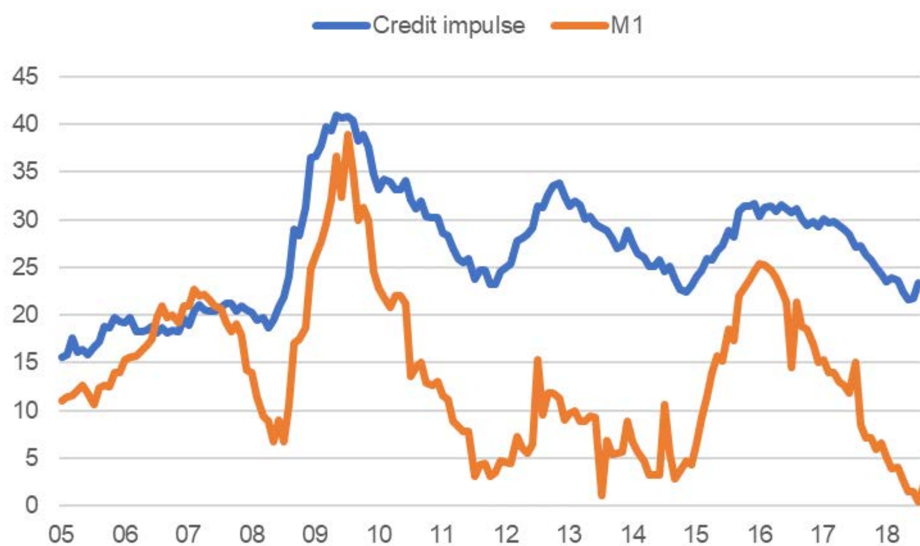


Source: Macquarie.

Further, although early 2019 credit flows demonstrated a rebound, it would require a significantly larger, and more sustained effort to impact the real economy in the manner seen in 2016 (measured by Money Supply) given the diminishing effectiveness of credit on economic growth.

Credit growth is not leading to activity in the real economy

Figure 7: China credit growth vs money supply (M1)



Source: Bloomberg. Credit impulse (new credit as a percentage of GDP) / M1 (money supply).

Importantly, unlike 2015/16 stimulus, the property market remains in relatively tight policy mode given already elevated property prices.

Putting it together: CY19 market balance

While the effects of seasonality and unexpected supply outages have seen pricing at elevated levels, we do not expect the market to remain tight as these factors are likely to be largely offset by supply growth elsewhere. This is our base case expectation, resulting in a slight market deficit of less than 1% (see table below) for 2019.

Table: base case iron ore market balance for 2019

	mt	Comments
Supply	-20	A 20mt decline in iron ore exports – our base case (see above)
Demand	-10	A repeat of China's 2018 recycling-driven 10mt decline in imports
Balance	-10	A deficit of less than 1%, managed via 10mt draw-down of China's 140mt inventory

**The table provided in the appendix provides the detail across these scenarios.*

Other scenarios (see appendix) are also considered, albeit less likely. Should demand surprise to the upside, via a resumption of China's historical growth trajectory, then the likely production upside will be more incentivised, again leading to a deficit of less than 1%.

A scenario where China resumes its growth trajectory and production does not respond is considered unlikely, albeit a scenario that is currently being factored into prices. As this scenario is proven less likely over time, pricing is expected to revert.

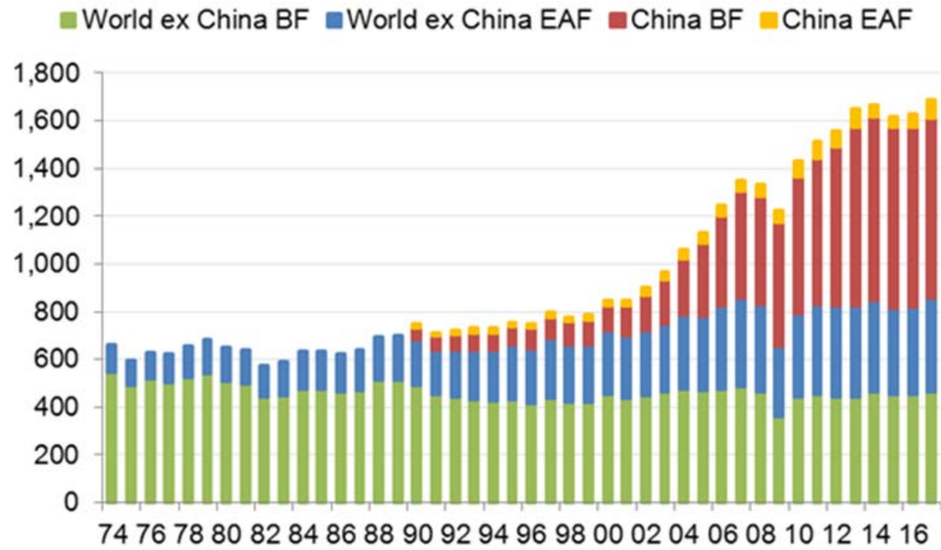
Beyond 2019, while Vale's production outages have seen the focus of the market become more short term focused, the supply disruptions will unwind over subsequent years, with the 95mt of affected production is returned to the market. Should this occur in conjunction with price-incentivised production growth elsewhere, the negative effect on pricing could be pronounced. And that is before considered the most dominant factor likely to affect iron ore demand in the medium to long term.

Substitution

The key factor driving the demand for iron ore over the medium to long term will be the transitioning of China's steel production from iron ore fed blast furnaces to recycled steel fed electric arc furnaces. Chinese EAFs currently account for less than 10% of total steel production (this figure is 45% for the rest of the world). This proportion will grow as Chinese policy favours any new capacity to be achieved via EAFs. Over the long term, should China's recycling rate approach that of the rest of the world, approximately 350mt of steel currently produced using iron ore would switch to being produced using recycled steel.

China is transitioning to recycling, which will permanently displace iron ore

Figure 8: steel production by production type



Source: World Steel

What does this mean for equities & value investing?

Perhaps the simplest way to describe value investing is the desire to pay 50c for a dollar coin. Conversely, a value investor will seek to avoid paying $1.50 for the dollar coin. This is relevant in today's market for iron ore exposed equities.

Using Rio Tinto (RIO) as an example, the current share price is factoring in around USD80/t to price RIO's equity. Less than spot pricing of USD93/t perhaps, yet still a hefty 50% above the long-term average iron ore price (see chart). This is before factoring in any effects of structural change on iron ore demand (see above transition towards recycling), a factoring happening now and to set to increase over time, and highly unlikely to reverse.

Equity markets are currently factoring in an unrealistic iron ore price assumption

Figure 9: equity-implied iron ore price

Source: Merlon Capital Partners.

The efficient market hypothesis requires the market to price in all available information. Of course, the most visible and available information is today's iron ore price. While short term rational, it does not question whether USD93/t (or the USD80/t current priced) is sustainable – so potentially long-term irrational.

At Merlon Capital, we value assets on the basis of sustainable earnings, investing where the market is undervaluing sustainable earnings and avoiding companies where the market is pricing in unsustainable earnings, regardless of the current environment. It is this position, which, over time as earnings gravitate towards sustainable levels, that alpha is generated.

In the current iron ore environment, on the assumption that disruption driven pricing is sustained for a year, the maximum additional value which is created is $1.15 free cash-flow per share. The remainder of the asset value is unchanged as our assessment of a sustainable iron ore price is unchanged. Again, we do not wish to pay $1.50 for a dollar.

While cash-flows generated by the iron ore exposed miners are attractive, they are built on the combination of unsustainably high prices, and unsustainably low capital expenditure. The recent ~30% decline in the thermal coal price reminds us of the volatile nature of commodity prices. And if the dam issues experience by Vale tell us anything, it is the risk that miners are not spending enough on their assets.

MERLON CAPITAL PARTNERS

Conclusion

The market's expectation of stimulus, coupled with the uncertainty regarding Vale production, has seen iron ore pricing and associated equities rally strongly, driven by the 'sticker shock' of the headline, unadjusted supply outages. However, when factoring in offsetting activity, the net disruption on the overall market balance appears modest, while there is a risk is that low blast furnace spreads will see substitution and demand for scrap rise, potentially accelerating the transition to recycling, displacing iron ore more rapidly than expected.

Appendix: market balance scenarios

Table: 2019 demand vs supply changes – market balance

Supply	mt	%
CY18 supply	1,591	
CY19 base case		
Vale dam related outages	-95	-6.0%
Expected mine recoveries	23	
S11D growth	25	
Minas Rio (Anglo American)	15	
Australia	13	
CY19 supply - base case	-20	-1.2%
CY19 seaborne supply	1,571	
CY19 potential upside		
China production response	10	
China port stockpile drawdown	25	
Vale stockpiles drawdown	20	
CY19 upside scenario	36	2.2%
Demand & market balance	**mt**	**%**
CY19 base case		
Repeat of CY18 import decline	-10	
Base case supply change	-20	
CY19 balance - base case	-9	-0.6%
CY19 potential upside		
China demand upside scenario	49	
CY19 supply upside scenario	36	
CY19 balance - S&D upside scenarios	-13	-0.8%
CY19 tight market scenario		
China demand upside scenario	49	
Base case supply change	-20	
CY19 balance - tight market scenario	-68	-4.3%

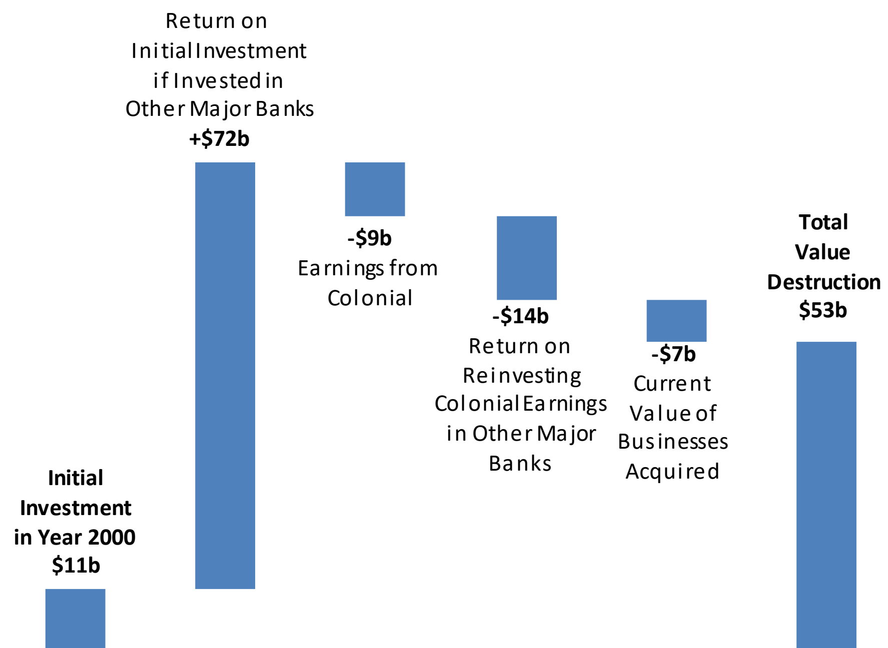
Analyst:
Hamish Carlisle

A Case Study in Poor Capital Allocation: The Need for Greater Shareholder Protections

We examine the shareholder value implications of CBA's acquisition of Colonial in 2000 as a case study in poor capital allocation.

We calculate that the acquisition destroyed $53 billion in shareholder value relative to investing in the other major banks, equating to $30 per CBA share.

Figure 10: Calculated Value Destruction Associated with Acquisition of Colonial Limited



Source: Company Accounts, Merlon Analysis, Calculations detailed in Appendix 1

The CBA acquisition of Colonial was value destructive in the order of tens of billions …

We believe the true value destruction was probably greater than our calculation given the low benchmark set by the other major banks; the opportunity cost of management focus diverted to the acquisition; and the brand damage incurred by managing the bank to meet short term financial targets.

Impacting retirement savings outcomes of millions of Australians…

Large transactions by large companies have broad ramifications against the backdrop of an increasingly passive approach to managing Australian equities and high Australian index concentration.

And highlights the importance of stronger shareholder protections to prevent reoccurrence…

We advocate for stronger shareholder protections more aligned to the UK regime that requires shareholder approval for any deal exceeding asset, profit or value thresholds including 25% of acquirers market capitalisation.

Introduction

Poor capital allocation decisions are one of the most frustrating parts of being a patient and contrarian investor. We conduct detailed independent research and invest considerable resources and energy in developing a deep understanding of the value of the businesses we own. We focus on long-term fundamentals. We examine the underlying cash flows that businesses generate rather than the elaborately contrived measures of performance advertised by some management and boards. We do not subscribe to the "greater fool theory".

Our approach allows us to patiently hold investments for long periods of time when many others are fearful, overly pessimistic, short term oriented and/or unwilling to deviate from popular opinion.

It is very disillusioning when all our efforts are tossed aside by boards and management teams that become fixated with chasing the latest growth opportunity or management fad through over-priced acquisitions or "simplifying the business" through inopportune and under-priced divestments.

Big companies, big bets, more stakeholders

The Colonial acquisition probably cost CBA shareholders much more than the $53 billion we calculated…

When big companies make big bets, the issue of poor capital allocation impacts a much broader group of stakeholders. Millions of Australians hold equities through their superannuation funds and a large and increasing allocation of these funds are invested in proportion to index weights. When companies with large index weights underperform through incompetent management, retirement savings are depleted and government funded pension costs rise.

The two largest companies listed on the ASX are BHP Group Limited (BHP) and Commonwealth Bank of Australia (CBA). Combined these two businesses make up 15% of the ASX200 index. Decisions made by the management and boards of these two companies have arguably been more influential in shaping retirement outcomes for millions of Australians than any other organisations.

In 2017 BHP's capital allocation track record was called into question with claims the company had wasted $40 billion of capital. In this paper we examine CBA's capital allocation track record. We calculate that the single decision in March 2000 to purchase Colonial Limited under the leadership of CEO David Murray ended up costing CBA shareholders $53 billion in today's dollars. Taking into account qualitative factors, the true cost was probably much higher than this. Even at $53 billion, this cost is equivalent in size to REST Industry Super writing all of its investments down to zero, an event that would no-doubt prompt calls for a Royal Commission.

MERLON CAPITAL PARTNERS

The Need for Change

What is remarkable against this backdrop is the lack of capacity for shareholders to voice concerns in relation to large acquisitions. Australia is unique in this regard. Last year we argued that shareholder rights should be better protected in relation to divestment decisions. In this article, using the Colonial acquisition as a case in point, we further argue that listing rules should be tightened to give shareholders a greater say in capital allocation decisions.

Many in the corporate community have suggested that shareholders elect directors to make decisions on their behalf and that overly cumbersome rules and regulations would make it difficult to get deals done. What is overlooked is where it impacts retirement savings the most – big companies making big bets – shareholders are more fragmented making it more difficult to hold boards to account. There are also instances – such as the recent AMP divestments – where unelected directors are making company shaping decisions with massive shareholder value implications.

The ASX is an Outlier

We advocate strongly for stronger shareholder protections for large transactions…

The ASX listing rules are out of sync with equivalent rules in the UK, the US, Hong Kong, Canada and Singapore where stronger shareholder protections exist. We advocate strongly for a UK style regime that requires shareholder approval for any deal exceeding asset, profit or value thresholds including 25% of acquirers market capitalisation.

The Colonial Acquisition – Background Information

On 10 March 2000, under the leadership of CEO David Murray, CBA announced it had reached agreement to acquire Colonial Limited, a life insurance, funds management and banking group created through the amalgamation of 18 different businesses over the 5 years prior.

In consideration, CBA issued 351 million new Commonwealth Bank shares and paid $800 million in cash to Colonial income security holders. The equity issuance represented 39% of CBA's pre-acquisition issued capital.

The strategic rationale for the acquisition was stated as follows:

- "*The merger provides a strong platform for future international revenue growth.*"
- "*The merger will lead to enhanced revenue potential from opportunities to offer customers a wider product set, through a broader and more diverse distribution network.*"

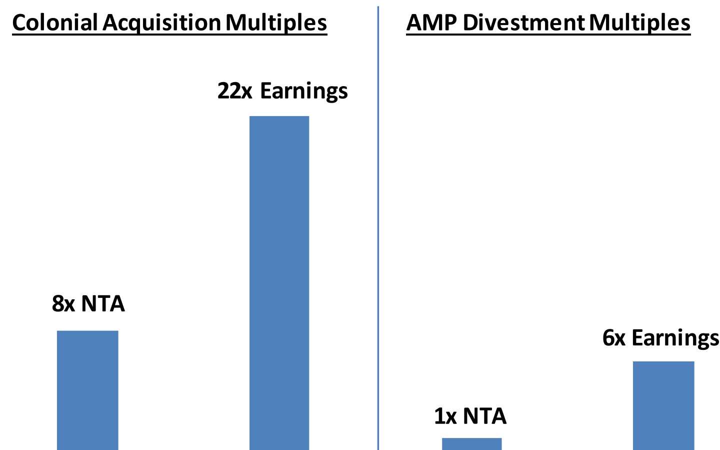
The deal had all the hallmarks of many "top-of-the-cycle" transactions with equity markets at all-time highs and asset managers trading at record multiples buoyed by the prospect of endless fund flow into compulsory superannuation.

The Colonial deal had all the hallmarks of many "top-of-the-cycle" transactions

Extreme Deal Multiples

Based on its subsequent disclosures, CBA paid approximately 8x net tangible assets, 22x earnings and an even higher multiple of cash flow for Colonial. By comparison, AMP recently sold its life insurance operations for approximately 1x net tangible assets, 6x earnings and an even lower multiple of cash-flow.

Figure 11: Comparative Deal Multiples



Source: Company Accounts, Merlon Analysis, Calculations detailed in Appendix 1

Post-acquisition Market Share Slide

Within five years of making the acquisition, CBA's banking market share had reverted to pre-acquisition levels. While it is difficult to estimate what would have happened in the absence of the transaction, the implication is that there was little net benefit in the long run.

Within 5 years, CBA's market share had reverted to pre-acquisition levels…

Figure 12: Post Acquisition Market Share Performance - Banking

Source: APRA monthly banking statistics, average market share of mortgages and deposits

Elusive Synergies

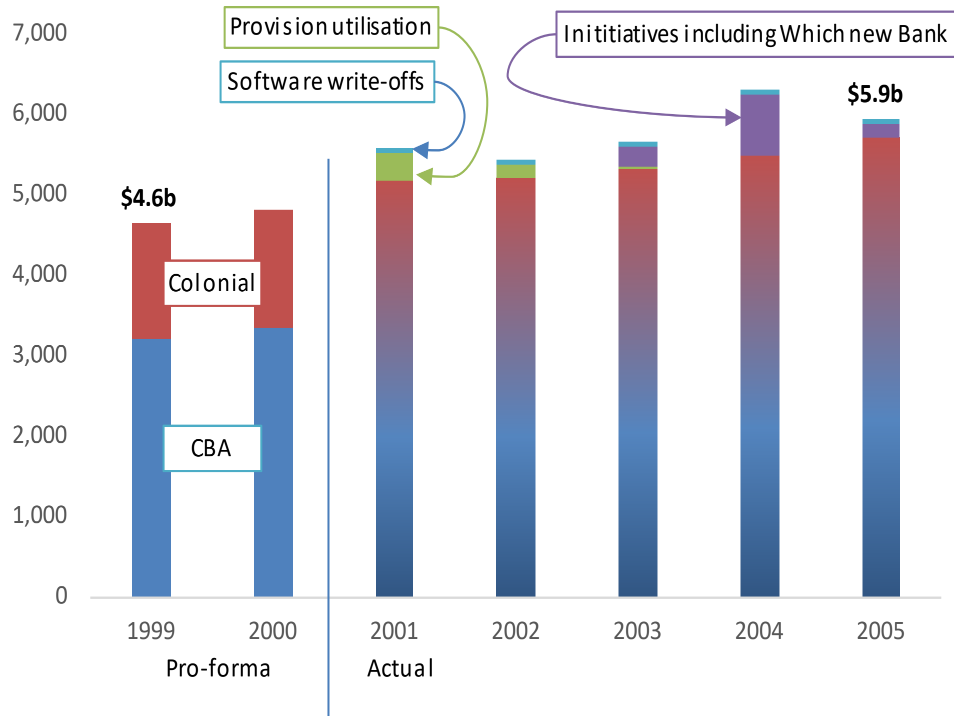
With regard to synergies, like so many acquisitions, "advertised" cost savings merely served to offset cost growth elsewhere in the business. Prior to the acquisition, the combined cost base of Colonial and CBA was $4.6 billion (12 months to December 1999). Five years later, CBA reported consolidated operating expenses of $5.9 billion representing a compound annual growth rate of 5 percent over the period.

Cost growth was masked early in the period (as is often the case) by utilisation of restructuring provisions and the benefits of writing off capitalised costs. When the provisions ran out, CBA called a new round of "one-off" costs associated with the "Which New Bank" program.

Costs grew at 5% per annum over the 5 years post acquisition,

…notwithstanding "advertised" synergies of $450m.

Figure 13: Post Acquisition Cost Performance



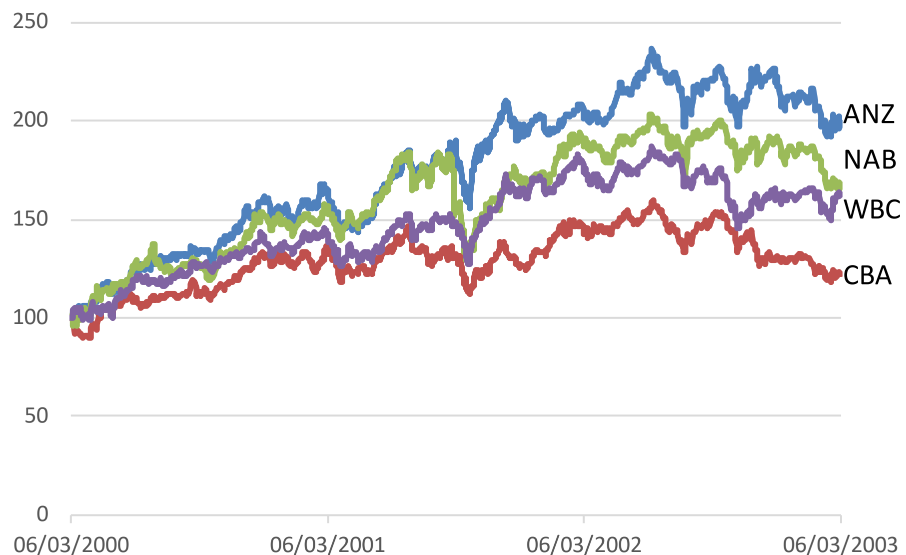
Source: Company accounts, Merlon Analysis

Negative Market Reaction

The Colonial acquisition was not well received, with the CBA share price underperforming 7% on the day of announcement. Of more significance, CBA underperformed its major bank peers by between 29% and 41% during the three years following the date of first media speculation.

The Colonial acquisition was not well received…

Figure 14: Total Shareholder Return From Date of First Media Speculation (6-Mar-00)



Source: Bloomberg

Based on CBA's market capitalisation of $23 billion on the day ahead of first media speculation, we estimate that shareholders would have collectively been between $11 billion and $19 billion better-off owning one of the other major banks over the subsequent three-year period.

Delusions of Grandeur

Despite the abysmal market share and cost performance, coupled with massive share price underperformance, CBA declared in its 2003 annual report:

"The expected synergy benefits of $450 million per annum, which were mostly banking related, were fully realised and in a shorter time frame than projected, making this a very satisfactory transaction for the Commonwealth Bank and its shareholders."

Counting the Cost

The problem with simply looking at relative share price performance is that it does not consider how CBA shareholders would have fared in the absence of the Colonial transaction. It is possible, for example, that CBA would have outperformed the other major banks in the absence of the transaction which would imply a greater quantum of value destruction.

One way to deal with this issue is to assume that the transaction had never occurred. This would have meant:

1. Equity capital that was issued to purchase Colonial could have been redeployed elsewhere;
2. Cash funding that was used to purchase Colonial could have been redeployed elsewhere;
3. CBA shareholders would have foregone earnings from the acquisition;
4. CBA shareholders would have foregone the current value of the acquired businesses.

We deal with each of these aspects separately below. In summary, we calculate that the transaction ultimately cost CBA shareholders $53 billion.

The Colonial transaction ultimately cost CBA shareholders $53 billion…

Figure 15: Opportunity Cost of Purchasing Colonial

	Historic Cost	Opportunity Cost
Equity capital issued	$9b	$70b
Cash funding	$2b	$13b
Post-acquisition earnings	($9b)	($23b)
Current value of acquired businesses	($7b)	($7b)
Total cost		**$53b**
Total cost per current CBA share		**$30**

Source: Company accounts, Merlon Estimates

MERLON CAPITAL PARTNERS

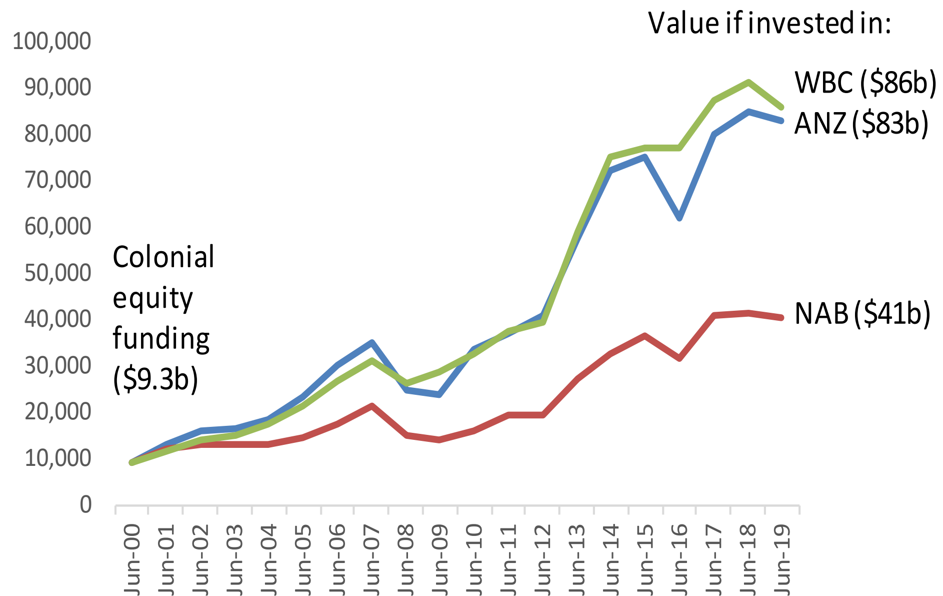
Had the equity raised to purchase Colonial been invested in the other major banks,

… it would be valued at $70 billion today.

Equity capital issued to purchase Colonial

CBA issued 351 million new shares to acquire Colonial then valued at $9.3 billion. Had this $9.3 billion been invested in one of the other major banks we estimate that it would today be worth between $41 billion and $86 billion. If the amount had been deployed equally across the major banks the capital would today be valued at $70 billion.

Figure 16: Value of Investing Equity Funded Portion of Acquisition in Other Banks



Source: Bloomberg, Merlon Analysis, Total return including franking credits

Cash funding used to purchase Colonial

Our process assesses all potential investments on an unleveraged basis. In practice, our approach means we value surplus cash (or debt) on a dollar for dollar basis. In the case of financial companies, the concept of cash is replaced with the notion of surplus (or deficit) capital.

It is remarkable that Colonial's poor capitalisation was not identified during the course of due diligence…

As detailed in Appendix 1, the fair value of net tangible assets acquired from Colonial shareholders was $1,065 million. This figure grossly understated the amount of capital required to support the Colonial businesses. It is remarkable that this issue was not identified during the course of due diligence and used as a means to break or renegotiate the initial merger agreement.

We estimate that the Colonial operations required approximately $2.8 billion of net tangible asset backing at the time of acquisition. This implies that approximately $1.7 billion in funding was contributed by existing CBA shareholders.

Had the cash used to purchase Colonial been invested in the other major banks,

… it would be valued at $13 billion today.

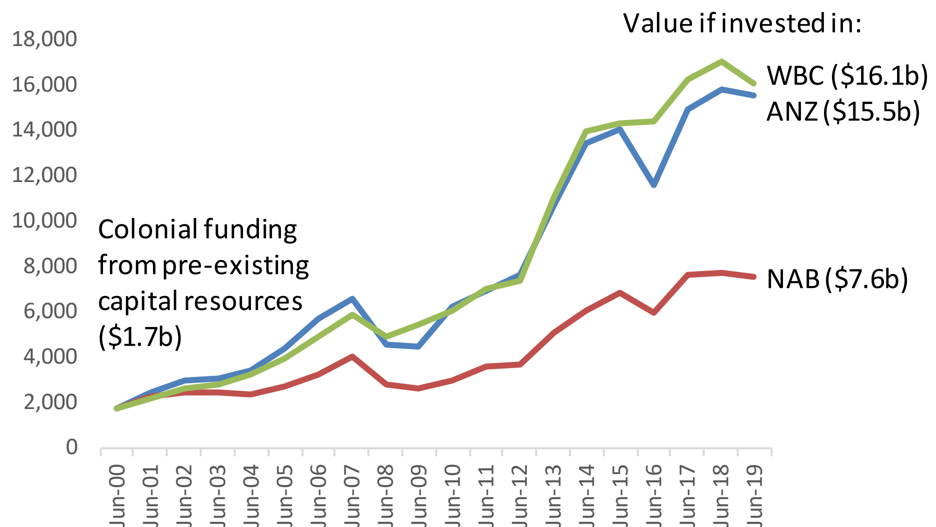
Figure 17: Colonial Capital Requirements on Acquisition

	A$m
Capital to support banking operations @ 5.5% of risk weighted assets	871
Capital to support wealth management operations @ 1.0x NTA	1,924
Tangible capital required to support Colonial operations	**2,795**
Less: Fair value of net tangible assets acquired	- 1,065
Implied funding from pre-existing capital resources	**1,730**

Source: Company accounts, Merlon Estimates

Had this $1.7 billion been returned to shareholders and reinvested in one of the other major banks (or reinvested in one of the other major banks by CBA) we estimate that it would today be worth between $8 billion and $16 billion. If the amount had been deployed equally across the major banks the capital would today be valued at $13 billion.

Figure 18: Value of Investing Internally Funded Portion of Acquisition in Other Banks



Source: Bloomberg, Merlon Analysis, Total return including franking credits

Earnings from the Acquisition

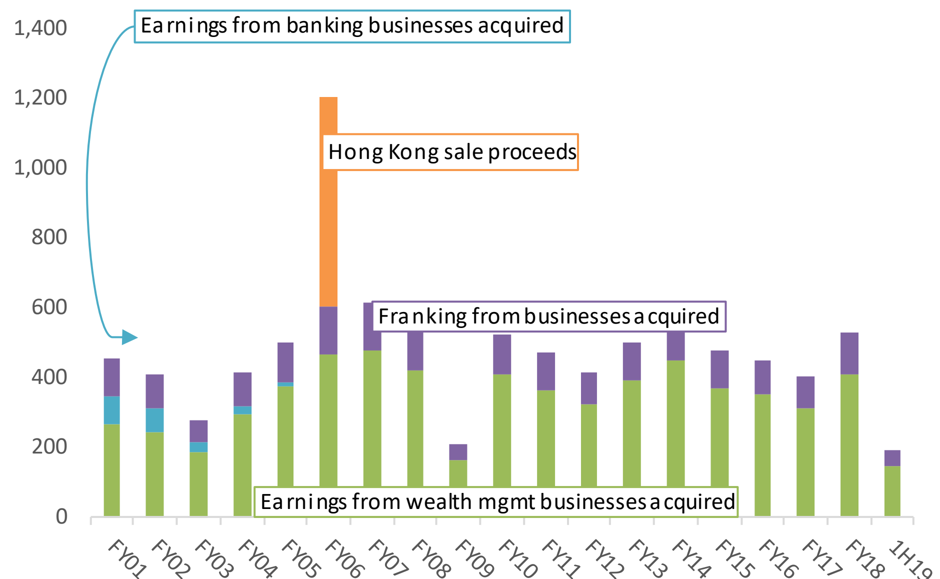
Offsetting the opportunity cost of the acquisition price outlined above, CBA has received earnings and franking credits from the businesses it acquired as well as sale proceeds from the businesses it has since sold. To estimate the amounts involved:

- We apportioned consolidated wealth management earnings based on the pro-forma contributions from CBA (43%) and Colonial (57%) as disclosed by CBA in its 2000 annual report (Appendix 2);
- We assumed that earnings from Colonial's wealth management operations were 67% franked, proportionate to the segment contribution from Australia disclosed by the company in its results for the full year to December 1999;
- We assumed that bank earnings faded down to nothing over 5 years, proportionate to the decline in combined market share between 2000 and 2006 (refer Figure 3 earlier), even though costs would likely have been retained;
- We ignored synergies in light of the fact that CBA's cost base grew at 5% per annum in the five years post acquisition; and
- We included the $0.6b proceeds from the sale of Colonial's Hong Kong life insurance business as an additional offset.

In aggregate we calculate the earnings and sale proceeds received from the Colonial acquisition to be approximately $9 billion since the date of acquisition.

Post-acquisition earnings from Colonial have totalled about $9 billion…

Figure 19: Earnings From Acquired Businesses



Source: Company Accounts, Merlon Analysis

To be consistent with our analysis so far, this $9 billion figure significantly understates the true value of the earnings because the earnings improved CBA's capacity to pay dividends and these dividends could have been reinvested by CBA shareholders elsewhere. For

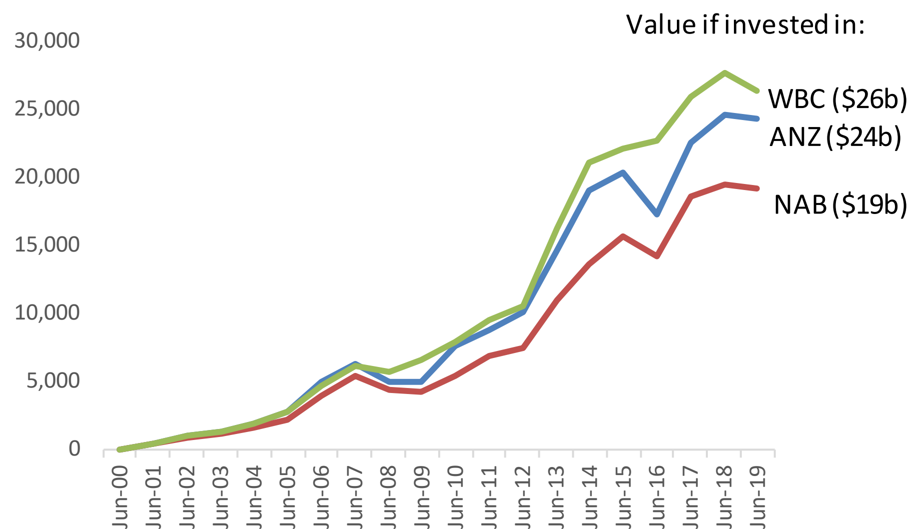
Had the earnings from Colonial been invested in the other major banks,

… they would be valued at $23 billion today.

example, if the first-year (FY01) earnings contribution from Colonial of $455 million was reinvested into ANZ shares it would be worth $2.9 billion today.

Had the $9 billion in earnings been reinvested in one of the other major banks over the years, we estimate that it would today be worth between $19 billion and $26 billion. If the amounts had been deployed equally across the major banks the capital would today be valued at $23 billion.

Figure 20: Value of Investing Post-Acquisition Earnings in Other Banks



Source: Company Accounts, Merlon Analysis, Total return including franking credits

Current Value of Acquired Businesses

We estimate that the remnants of the Colonial acquisition will net about $7 billion in value…

The remnants of the Colonial businesses acquired have all been earmarked for sale. Based on disclosed information we estimate these businesses will realise approximately $7 billion in net proceeds.

Figure 21: Current Value of Remnants of Colonial Businesses Acquired

Business	Value	Comment
Equity interest in BoComm Life	$0.6b	As disclosed
Australian Life Insurance	$1.7b	$3.8b gross proceeds less Sovereign @ $1.3b less estimated CBA contribution (32%)
CFSGAM	$2.9b	$4.1b gross proceeds less estimated CBA contribution (29%)
NewCo excluding Aussie HL	$2.6b	17x earnings
Remediation costs	($0.5b)	$1.2b disclosed cumulative spend less estimated CBA share (43%) less tax
Separation costs	($0.4b)	As disclosed for FY18 & 1H19
Total	**$7.0b**	

Source: Company accounts, Merlon Estimates

MERLON CAPITAL PARTNERS

Unquantifiable Costs

While we have attempted to quantify the financial cost of the acquisition, it is truly impossible to know how CBA would have performed in the absence of the transaction. In particular:

- The management energy on integrating the businesses could have been diverted elsewhere;
- In many respects the "major bank benchmark" was an easy hurdle given each bank had its fair share of poor capital allocation decisions (WBC - SGB acquisition; NAB - MLC & Homeside acquisitions, as well as rapid UK expansion at top of cycle; ANZ – ING acquisition, foray into Asia) *and,*
- The focus on delivering on financial targets associated with the acquisition could have led to short term decision making.

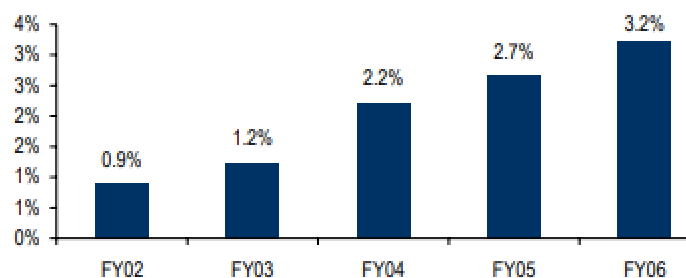
Our $54 billion estimate probably understates the true opportunity cost of the deal…

In reality, we think CBA could have massively outperformed its peers in the absence of the acquisition and that the $54 billion cost estimate materially understates the true opportunity cost of the deal.

Unsustainable Customer Outcomes

Regarding its focus on delivering short term financial targets, we note a concerted effort by CBA to increase earnings through pricing its term deposits uncompetitively through the period post-acquisition period.

Figure 22: CBA – 6 Month Term Deposit Margins



Source: Merrill Lynch, Balances below $100k

Management actions to prop up earnings post acquisition also cost shareholders in the long run …

The Australian newspaper quoted an internal email from ASIC in an article dated 29 March referring to this issue reportedly stating:

"ASIC concluded from the investigation that CBA consciously devised and implemented a strategy that … utilised the ambiguity (at minimum) of its PDS and renewal notices" and "utilised its extensive knowledge of a particular class of depositors who were price inelastic … to lower non-headline rates to levels which were at times below inflation and ensuring that customers automatically rollover into non-headline rates to obtain hugely inflated profits from the price inelastic deposit holders."

This matter was raised in Merrill Lynch research published on 25 March 2005 that stated:

"Since mid-2002, CBA has uncompetitively priced for profits across its cash management account ("CMA") and sub-$100k term deposit product ranges … We do not believe that CBA's strategy is sustainable over the medium term, which presents earnings risk (circa $250m) should the bank re-price to peer levels."

We also note that CBA persistently ranked the worst of the major banks on measures of customer satisfaction during the integration period.

MERLON CAPITAL PARTNERS

The Merlon Investment Process & Capital Allocation Risk

Over the years we have unfortunately seen many boards allocate capital poorly. These decisions are most damaging when transactions are large relative to the size of the company concerned and / or where equity is issued to fund the transactions at depressed prices.

Assessing the Risks

As part of our qualitative review process we score companies on a variety of measures relating to ***Industry Structure*** (score out of 15); ***Competitive Advantage*** (score out of 9); and ***Governance and Management*** (score out of 11). The latter category is decomposed into ***Governance*** (score out of 5); ***Capital Allocation*** (score out of 3); and ***Execution*** (score out 3). We do not screen on quality but seek to ensure our estimates of ***sustainable free cash flow*** for companies appropriately reflect qualitative characteristics. These estimates of ***sustainable free cash flow,*** in-turn, drive our assessments of ***fundamental value***.

We explicitly rate board and management's capital allocation skills as part of our investment process,

In determining our management scores, we engage with boards and management; consider the track records of the companies and individuals concerned; review board composition for diversity and appropriate balance of power; examine remuneration models/equity alignment; and, seek to understand companies' strategies to generate acceptable and sustainable returns. All our scores are subject to rigorous peer review.

Valuation

To the extent that our assessment of ***Governance and Management*** can be built into our assessment of sustainable cash flow we will attempt to do so. This is easier for companies with a track record of making regular acquisitions or investments where we can measure historical return outcomes and build a "budget" or "buffer" into our assessment of ***sustainable free cash flow.***

…try to reflect costs in our base case valuations,

From a Merlon perspective, we are always highly sceptical about acquisition synergies, particularly when coupled with dubious accounting practices and resultant margins that are out of sync with local or international peers.

Conviction

Alongside valuation, we assign a ***Conviction Score*** to each stock we cover reflecting the degree to which we think there is ***misperception*** in the market. Our ***Conviction*** scores and our assessments of relative fundamental ***value*** determine our ultimate portfolio weights.

…and deeply consider whether our views are aligned with market expectations

This important element of the process reflects whether our view on capital allocation risk is more or less pessimistic than the market. We start by factoring the risk of a capital misallocation into our ***bear case*** valuation scenarios but may also revise down our ***base case*** valuations if we think a poor decision is "more likely than not". This allows us to determine what level of capital allocation risk the market is already pricing into the stock. For example, if the share price is already trading close to our bear case scenario, we may conclude the market is equally or more pessimistic on management than us, leading to a

positive conviction bias. Alternatively, if the share price is trading well above our base case valuation, but we still consider capital allocation risk to be a key issue, this may lead us to have a negative conviction bias.

Managing Positions Post the Event

Often, the market is less pessimistic than us when large transactions are announced…

Often – as was the case with the Colonial acquisitions - poor decisions take many years to be reflected in market expectations. In these instances, if we own such companies – we may be presented with the opportunity to exit our positions. This was the case recently when ***Clydesdale Bank*** purchased Virgin Money in the UK.

…but this is not always the case

At other times, these decisions are capitalised more immediately into market expectations – as was the case with the recent ***AMP*** divestments. In these instances, it is not always in our clients' interests to exit positions at fire sale prices.

The Need for Greater Shareholder Protections

The impact of large acquisitions can be devastating and long lasting for shareholders…

Last year we wrote about Divestments and Shareholder Rights noting that generally boards have taken a conservative approach to seeking shareholder approval in relation to divestment decisions. That said, we do think the recent AMP divestments highlighted the need for tighter ASX listing rules regarding the quantum of a firm's operations that can be divested without shareholder approval.

As the Colonial case demonstrates, the impact of large acquisitions can also be devastating and long-lasting for shareholders. To compound the issue, shareholders rarely have a say in the matter. Unlike many other major exchanges, and contrary to rules in relation to divestments (if implemented properly), the ASX allows boards to deploy large amounts of capital without shareholder approval.

Overseas Benchmarks

In the US, for example, companies listed on the NYSE must obtain shareholder approval for transactions that will increase the buyers shares by more than 20%. This is not perfect, because a cash transaction requires no approval, but would be a step in the right direction and might have prevented the Colonial scenario.

In the UK, listing rules go one step further by requiring shareholder approval for any transaction exceeding asset, profit or value thresholds.

The ASX is out-of-sync with other global exchanges with regard to shareholder protections…

Figure 23: Shareholder Approval Thresholds for Transactions Involving Equity Issuance

Exchange	Threshold
Australia – ASX	Approval only required for non-public acquisitions resulting in 15%+ increase in issued capital
US – NYSE	Approval required for any deal resulting in 20%+ increase in outstanding shares
UK – LSE	Approval required for any deal exceeding asset, profit or value thresholds including 25% of acquirers market capitalisation
HK – HKEx	Approval required for any deal resulting in 25%+ increase in outstanding shares
Singapore - SGX	Approval required for any deal resulting in 20%+ increase in outstanding shares
Canada – TSX	Approval required for any deal resulting in 25%+ increase in outstanding shares

Source: Exchange listing rules

The Role of Superannuation & Index Investing

There are strong arguments, in our view, that shareholder protections in Australia should be tighter. The advent of compulsory superannuation and growing adoption of a passive investing approach to managing Australian equities are important considerations.

It has been well documented that many Australians are not actively engaged in managing their superannuation investments. Through passive investment strategies it could also be argued that many large superannuation funds are not as actively engaged in the management of individual company investments than has historically been the case.

Underperforming boards can be destructive to long term public finances…

This shift in the market structure has placed a much greater onus on company boards to act benevolently in the best interests of their shareholders. Much has been said about underperforming superannuation funds, but underperforming boards and management teams can be equally destructive to long term public finances, particularly where such companies are as large as the Commonwealth Bank.

Concluding Remarks

Boards and management could benefit from more capital allocation expertise…

In investing it is instructive to examine mistakes and study the past. An overarching observation – made by Warren Buffet among others – is that one of the most important things that a CEO does is allocate capital, yet few CEOs are trained for capital allocation because they rose through other streams in the business. Boards need to understand this and play an appropriate gatekeeping role. Yet there are not many large company directors with capital allocation expertise.

… and tightening shareholder approval thresholds would be a great step forward…

Tightening shareholder approval thresholds would be a great step forward in improving board accountability and driving better capital allocation outcomes for all shareholders – passive and active. This might well prevent the massive and long-lasting value destruction shareholders experienced with the Colonial transaction from repeating itself.

Appendix 1: Calculation of Transaction Multiples

Figure 24: Extract from CBA 2001 Annual Report Detailing Colonial Consideration

	2000 $M
Consideration	
351,409,450 new Commonwealth Bank shares @ $26.39	9,274
Income securities payout	800
Transaction costs	46
Preacquisition dividend received	(1,000)
Cost of Acquisition	9,120
Fair value of net tangible assets acquired	
As at 30 June 2000	1,303
Revisions to fair value adjustments and restructuring costs provisioned	(238)
Revised as at 30 June 2001	1,065
Outside equity interests in net assets acquired	(155)
Excess of net market value over net assets of life insurance controlled entities	2,548
Goodwill on acquisition	5,662
	9,120

Source: *Company accounts*

Figure 25: Extract from CBA 2000 & 2001 Annual Reports Detailing Colonial Consideration

	2000 $M
Consideration	
351,409,450 new Commonwealth Bank shares @ $26.39	9,274
Income securities payout	800
Transaction costs	46
Preacquisition dividend received	(1,000)
Cost of Acquisition	9,120

	Colonial $M
Interest income	1,632
Interest expense	1,117
Net interest income	515
Other income	241
Net banking operating income	756
Premium income [1]	3,277
Net investment income	1,978
Other income	445
Policy payments [1]	(3,609)
Policyholder liability expense	(409)
Net life and funds management operating income	1,682
Total net operating income	2,438
Charge for bad and doubtful debts	114
Operating expenses	1,529
Operating profit before abnormal items, goodwill amortisation and income tax	795
Income tax expense	371
Operating profit after income tax	424
Outside equity interest in operating profit after tax	11
Operating profit after income tax attributable to members of the bank	413

Source: *Company accounts*

MERLON CAPITAL PARTNERS

Appendix 2: Contribution to Wealth Management Earnings

Figure 26: Extract from CBA 2000 Annual Report

Pro Forma Life Insurance and Funds Management Business for Year Ended 30 June 2000 (unaudited)

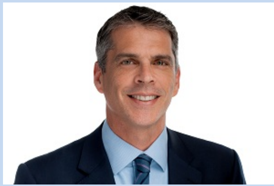
		Commonwealth Bank	Colonial	Group
Operating Profit After Tax	$M	236 43%	311 57%	547
Premiums/Deposits from Customers	$M	11,418	12,649	24,067
No. of policy and unit holders	000's	865	969	1,834
Expenses	$M	221	949	1,170
Claims & Redemptions	$M	10,267	10,721	20,988
Net Funds Flow	$M	1,151	1,928	3,079
Productivity				
Total Expenses to Funds Under Management	%	0.6%	1.3%	1.1%
Claims & redemptions to Funds Under Management	%	29.8%	14.9%	19.7%
Assets held and Funds Under Management				
Life Insurance	$M	13,217	19,346	32,563
Funds Management	$M	21,242	52,672	73,914
Total		34,459	72,018	106,477
Australia	$M	33,417	47,671	81,088
United Kingdom	$M	-	19,202	19,202
New Zealand	$M	1,042	2,228	3,270
Asia	$M	-	2,917	2,917
Total		34,459	72,018	106,477

Source: Company accounts

MERLON
CAPITAL PARTNERS

Market Outlook and Portfolio Positioning

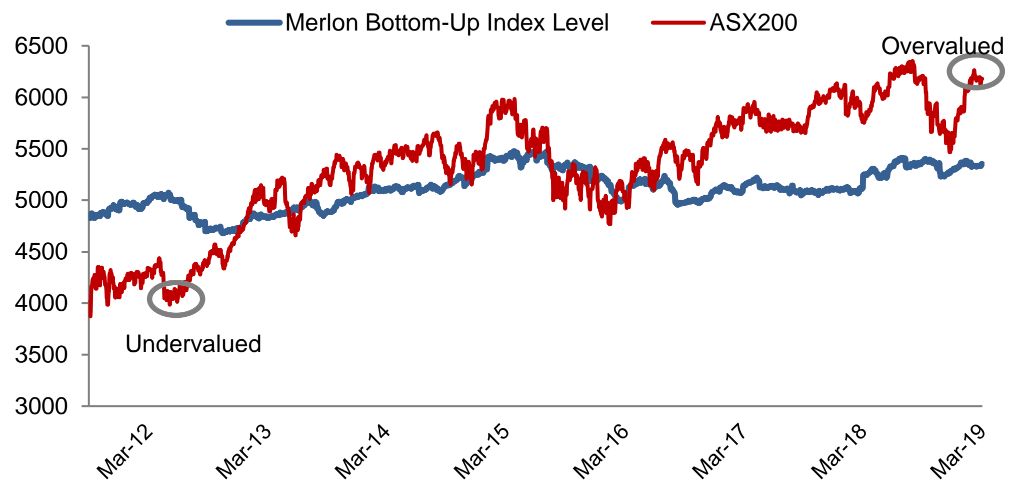
Neil Margolis



Market approximately 14% 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 14% overvalued after rising more than 11% during the quarter.

Figure 27: Merlon bottom up market valuation vs ASX200 level



Source: Merlon

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. Our valuations are long-term and generally a lot more stable than fluctuating share prices, creating 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.

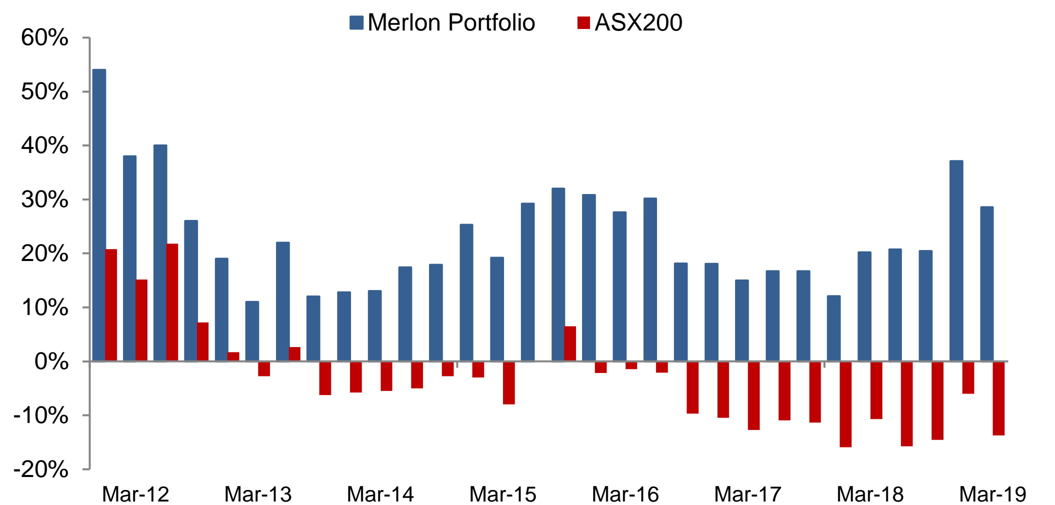
The March quarter rally was led by the three segments of the market we believe were most overvalued to begin with …

We have flagged for some time that we believe there to be three primary areas of investor complacency in the Australian stock market. The sharp recovery in the March quarter was once again led by these three groups of stocks which we believe were most overvalued to begin with; namely Resources, "low volatility bond proxy" stocks such as Real Estate Investment Trusts and "high PE growth stocks" such as Technology. With Resources, we have written about unsustainably high commodity prices and unsustainably low capital expenditures (Trade Wars and the Peak of the Chinese Growth Model). With "low volatility" stocks such as healthcare, property and infrastructure sectors, investors are completely disregarding inflation risk and the prospect of rising rates (Some thoughts on asset prices). The third pocket of overvaluation is "high PE growth stocks" where we wrote about the

extreme valuations of several stocks in our September quarterly. The group of five stocks termed the WAAAX stocks (Appen Limited, Afterpay Touch Group, Altium Limited, Wisetech Global and Zero Limited) declined 20% in the December quarter only to rise 49% in the most recent March quarter.

Merlon's value portfolio comprises our best research ideas, based on our long-term valuations and analyst conviction. As seen below, the Merlon portfolio offers more than 25% absolute upside and is looking increasingly attractive relative to the index.

Figure 28: Expected return based on Merlon valuations



Source: Merlon

This quarter saw a pause in the United States journey towards higher interest rates, despite persistent cost pressures in the economy, evident in the data (wage pressures and inflation) and confirmed during our recent trips to the US (we visited in May and September). While timing is difficult to predict, we remain of the view interest rates will be higher on a three year view, albeit at a tempered pace. In any event, the consensus view is strongly biased towards lower rates, as evident in bond yields and pricing of “real assets” and select equity sectors. This makes it wise to at least contemplate an alternative view.

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 **QBE Insurance, Magellan Financial** and **News Corporation** 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 maintained 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.

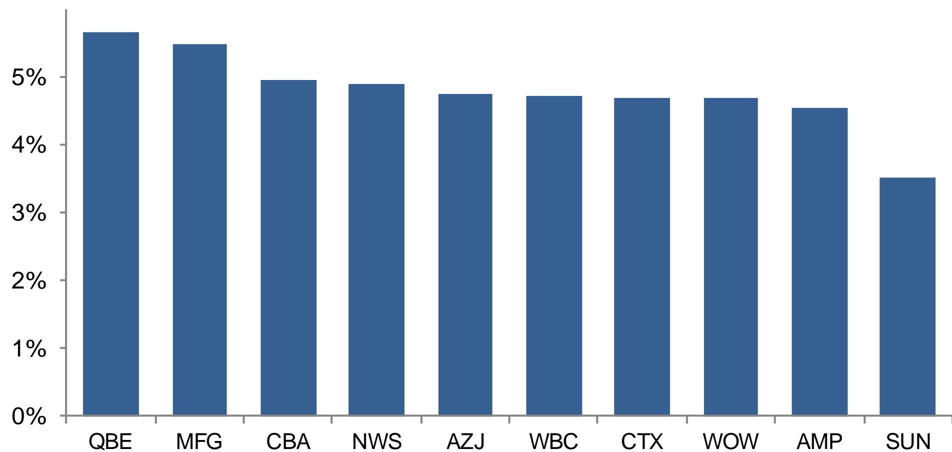
MERLON CAPITAL PARTNERS

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

Portfolio Aligned to Value Philosophy and Fundamental Research

The portfolio reflects our best bottom-up fundamental views rather than macro or sector-specific themes. These are usually companies that are under-earning on a three year view, or where cash generation and franking are being under-appreciated by the market.

Figure 29: Top ten holdings (gross weights)



Source: Merlon

…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.

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. Management is now more focused, while interest rates are turning from a headwind into a tailwind, and the insurance pricing cycle appears to be improving, or at least no longer deteriorating.

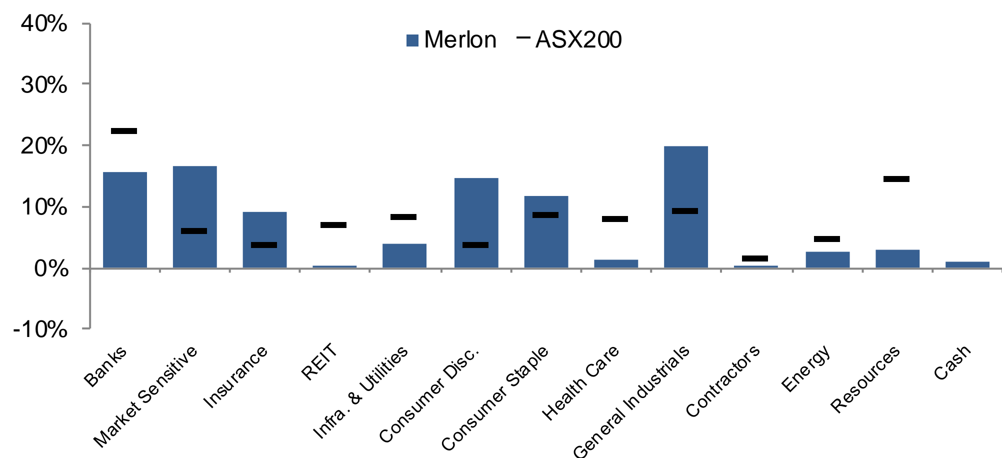
Another example is a company like **Magellan Financial**, which is trading at a discount to the ASX200 on a simplistic price-earnings ratio, and notwithstanding the company's exceptional cash conversion (as evidenced by the recent dividend increase), debt free balance sheet, low operating leverage, strong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

News Corporation is shifting away from more cyclical and macroeconomic exposed advertising income to subscription revenues. 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.

Caltex is an integrated refining and marketing company, with a refining business impacted by cyclically depressed refining margins, coupled with the effects of high petrol pricing on consumer demand. We have recently seen refining margins begin to improve, which has yet to be reflected in the market's pricing of Caltex. The company's marketing business continues to struggle with slightly weaker volumes, albeit in the context of a favourable and improving industry structure following the sale of Woolworth's petrol business to EG Group, a European petroleum marketer focused more on quality of offering rather than discounted fuels.

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 (Divestments & Shareholder Rights). We have 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.

Figure 30: 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**, **Virtus Health** and **Nick Scali**.

Figure 31: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	36	200
Active Share	74%	0%
Merlon Valuation Upside	29%	-14%
EV / EBITDA	8.4x	12.2x
Price / Earnings Ratio	14.7x	17.1x
Price / Book Ratio	2.4x	5.7x
Trailing Free Cash Flow Yield	5.8%	4.7%

Source: Merlon

March Quarter Portfolio Activity

During the quarter, we introduced two new investments, Viva Energy & Sims Metal …

During the quarter we made two new investments. We invested in **Viva Energy**, a leading Australian fuel refiner and supplier that is under-earning on cyclically depressed refining margins and reduced fuel volumes on account of a stand-off with retail partner, Coles. The issue with Coles was resolved in favour of Viva Energy soon after we acquired our initial position, consistent with our view Coles was more akin to a franchisee with Viva the asset owner of well located, majority Shell-branded sites. We see further upside as some or all lost retail market share is regained and refining margins recover to more normal levels.

We invested in **Sims Metal**, a leading global scrap supplier, trading close to the value of its hard assets despite generating consistent cash-flows through time. The company has underperformed the market due to concerns over exposure to the global trade war, Turkish demand for scrap materials and China's metallic scrap import restrictions. We believe the market is not factoring in the potential for a cyclical recovery in Turkey, nor any action taken to date by Sims to invest in scrap upgrading technology. It is likely that processing of Sims non-ferrous products will continue, whether inside China or elsewhere, as it remains profitable to do so.

We added to our existing position in **Coles**, which had underperformed after negotiating a new fuel retail agreement with **Viva Energy**, and a subdued near-term outlook presented at its inaugural result. We added to our position in **AMP** that continued to underperform on Royal Commission related remediation concerns, but we estimate the Advice segment, with more than $100bn funds under advice and on platform, is being ascribed a negative value by the market, taking into account surplus cash and the value of the growing funds management and banking businesses. We also added to existing positions in **Sandfire**, **Nick Scali** and **Janus Henderson**, all of which traded below our long-term assessments of fundamental value during the period.

Funded by three investments, two of which were subjects of a take-over.

These investments were funded by exiting long-held positions in New Zealand's **Trade Me Group**, which was subject to a takeover offer of NZ$6.45, close to our bull case valuation., and education provider **Navitas**, also the subject of a private equity takeover. We also exited out position in cable television business, **Sky TV New Zealand**, after price reductions failed to stem core sports subscriber losses, leading us to reassess our central case valuation and place an increasing likelihood our reduced bear case valuation will come to pass.

We reduced several investments that exhibited reduced, but still significant valuation upside following outperformance, namely **Magellan Financial**, **Wesfarmers** and **Bendigo Bank**.

MERLON CAPITAL PARTNERS

Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	7 Years (p.a.)
Portfolio Return (inc. franking)	-1.0	9.6	2.6	7.3	11.3	9.5	13.1
ASX200 Return (inc. franking)	1.0	11.5	4.7	13.7	13.0	8.9	11.5
Excess Return*	**-1.9**	**-1.9**	**-2.1**	**-6.4**	**-1.6**	**0.5**	**1.6**

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

March Quarter Market Review

In the best quarter in almost 10 years, Resources, growth stocks and bond proxies led the market higher…

The market experienced its best quarter in almost ten years, rising 11.5% (including franking). The **Resources** sector performed strongest, increasing 20% as iron ore jumped $22 per tonne on Vale's mine collapse disaster and resultant supply curtailments. Oil climbed 27% on OPEC announced production cuts. High PE growth stocks reached new highs after leading the market lower in the December quarter, with the local **Technology** sector also positing more than 20% gains on the back of further multiple expansion (the so-called WAAAX stocks rose 49% on average). The third best performing group of stocks was bond proxies, benefitting from a 54bp reduction in 10 year bond yields (82bp over 12 months) as the RBA shifted to a dovish stance in response to falling house prices and slowing construction. A beneficiary was the **Real Estate Investment Trust** index which rose 15%. The worst performing sectors were **Consumer Staples**, **Banks** and **Healthcare**. The Australian Dollar rose 1%, a modest gain as higher commodity prices offset a widening interest rate differential with the United States.

Portfolio Performance Review

…all sectors to which the Merlon strategy has limited or no exposure, resulting in the Strategy lagging the strong market in the quarter.

The Concentrated Value Strategy returned 9.6% for the quarter, lagging the ASX200 principally by having minimal exposure to the three best performing groups of stocks as outlined above – Resources, growth stocks and bond proxies. In a risk-on environment, the non-benchmark approach to selecting stocks was a tailwind as ultra large gaps, principally the banks, lagged the market.

Magellan Financial was the best performing holding in the quarter with funds under management growth surpassing market expectations. **Viva Energy** was a positive contributor with the fuel wholesaler resolving its stand-off with retail partner Coles in its favour. **QBE Insurance** performed well after management delivered a clean result and guided to further underlying improvement on costs and the insurance pricing cycle. **Harvey Norman** outperformed after reporting results that highlighted a growing contribution from Singaporean and Malyasian stores. **Southern Cross Media** rounded out the top 5 contributors with expanding radio margins and share gains offsetting a declining, but increasingly less important regional TV business.

AMP detracted the most from performance as earnings continue to miss expectations, largely as a result of higher compliance and remediation costs, as well as fund outflows and

MERLON CAPITAL PARTNERS

lower fees. This is more than factored into current valuations, however, with a negative value being ascribed to the Advice / platform segment after taking into account surplus cash and the value of the growing funds management and banking businesses. **Bendigo Bank** detracted on a poor result with declining revenue and rising costs. Not owning **Fortescue Metals** detracted from relative performance as the iron ore priced surged on Vale supply disruptions and a narrowing of Fortescue's low grade discount. **Sky TV New Zealand** underperformed on larger than expected core subscriber losses despite reducing customer pricing. **Commonwealth Bank** rounded out the worst relative performers as the major banks lagged a very strong market and the bank reported a complicated result with declining core earnings, multiple asset sales and one-off costs.

At a sector level, having minimal or no exposure to **Resources**, **REITs**, **Infrastructure and Utilities**, and highly rated growth stocks, detracted from relative performance.

Financial year to date the Strategy has underperformed the ASX200 by 2.1%. Similar themes prevailed as the March quarter; that is having minimal or no exposure to **Resources**, **REITs**, **Infrastructure and Utilities** and growth stocks.

The Strategy has underperformed financial year to date.

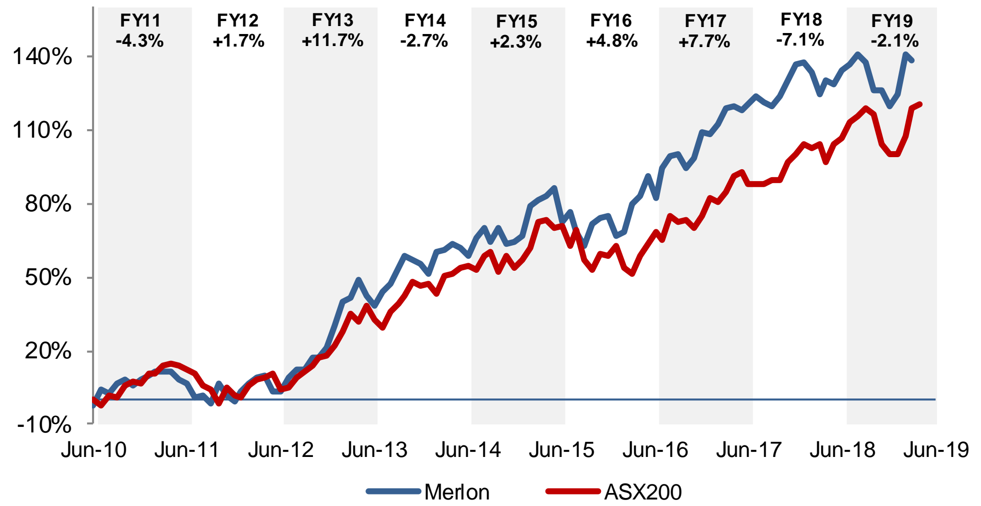
Key stock specific detractors for the financial year to date held in the portfolio included **AMP**, **Fletcher Building**, **News Corporation**, **Seven West Media** and **Caltex**. On the other side of the ledger, the best performing investments that have contributed to performance have been **Trade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

Longer-term, the Concentrated Value Strategy has outperformed by 1.6% 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 **Magellan Financial**, **National Australia Bank** (not held), **Tabcorp**, **Macquarie Bank** and **Pacific Brands** the key contributors. Key detractors over this time frame include **AMP**, **Seven West Media**, **Sky TV New Zealand**, **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

Strategy FUM	Merlon FUM
$1,422.9m	$1,434.2m

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
Trade Wars and the Peak of the Chinese Growth Model	Some More Thoughts on Telstra
Housing Cracks Present Material Opportunities	Asaleo Divestment Well Received

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.

Disclaimer

The information contained in this publication has been prepared by Merlon Capital Partners Pty Limited ABN 94 140 833 683 and Fidante Partners Limited ABN 94 002 835 592 AFSL 234 668 (FPL) solely for recipients on the basis that they are a wholesale client within the meaning of the Corporations Act 2001 (Cth). The wholesale client receiving this publication is not permitted to pass it on, or use it for the benefit of, any other person. It should be regarded as general information only rather than advice. Any information provided or conclusions made, whether express or implied, do not take into account the investment objectives, financial situation and particular needs of an investor. Past performance is not a reliable indicator of future performance. Neither Merlon or FPL nor any member of Challenger Limited guarantees the repayment of capital or any particular rate of return.