Merlon Income Strategy

Merlon Australian Share Income Fund

Quarterly Report

September 2019

Contents

Analyst:

Hamish Carlisle

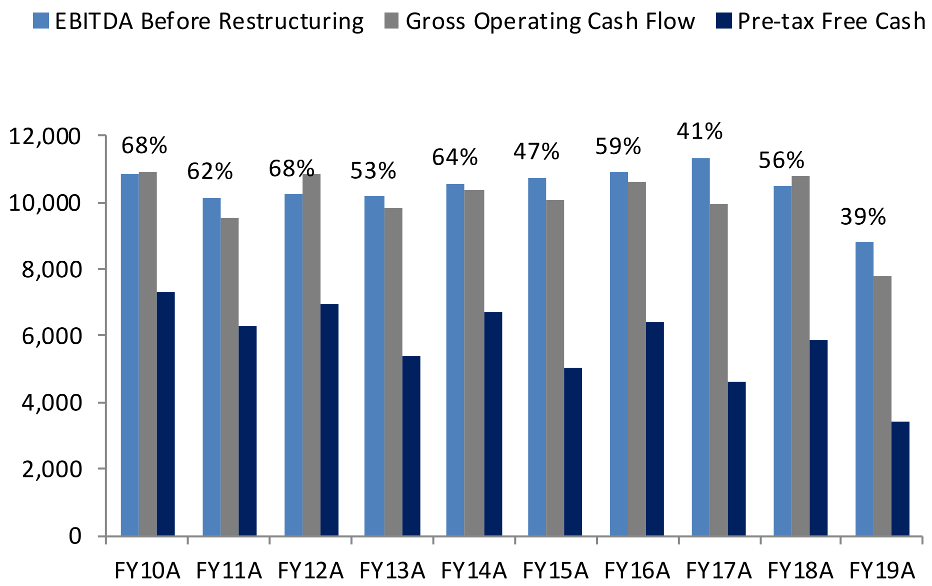
Why Telstra Could be Worth Less than $2

Telstra's earnings quality is poor…

We have discussed our Telstra investment view in earlier commentary and we don't believe much has changed in relation to our long-term expectations. However, the most recent result surprised in its complexity and is indicative of ***weak accounting, short termism and weak board oversight of management***. Critical elements of our thesis remain:

1. ***EBITDA metrics being trumpeted by management are a poor proxy for cash flow*** and valuations based off this metric are fundamentally flawed. Merlon's preferred measure of intrinsic value is to compare a company's enterprise (or unleveraged) value with its sustainable enterprise-free-cash-flow.

Figure 1: Telstra EBITDA, Cash Flow & Cash Conversion



Source: Company Accounts, Cash flow includes cash receipts from asset sales to NBN Co and is net of benefit of $551m from "supply chain finance" in FY19 and benefit of "back-to-back" retail leases

2. **Retailing *NBN services will remain a loss leader*** for Telstra with current cost cutting initiatives destined to offset margin compression from the NBN transition rather than deliver absolute upside.

3. ***Mobile margins are high*** by historic standards and high relative to international peers.

…with the most recent result a case in point

Weak accounting in Telstra's most recent report add to our concerns and we see risk skewed to the lower end of our $1.80 and $4.50 valuation range. In particular we note (i) persistent references to EBITDA; (ii) unintelligible footnotes; (iii) "innovative" approaches to working capital management; and, (iv) an over-emphasis on earnings projections.

Excluding unsustainable fixed line earnings **Telstra's FY19 EPS was $0.09 to $0.12** which would yield valuations of $1.35 to $2.40 if capitalised at 15 to 20x.

Introduction

Before calling out specifics of the most recent Telstra result, we thought it would be worthwhile highlighting a few comments made in Berkshire Hathaway's 2002 annual report.

Figure 2: Extract from Berkshire Hathaway's 2002 Annual Report (emphasis added)

Three suggestions for investors: First, beware of companies displaying weak accounting. If a company still does not expense options, or if its pension assumptions are fanciful, watch out. When managements take the low road in aspects that are visible, it is likely they are following a similar path behind the scenes. There is seldom just one cockroach in the kitchen.

Trumpeting EBITDA (earnings before interest, taxes, depreciation and amortization) is a particularly pernicious practice. Doing so implies that depreciation is not truly an expense, given that it is a "non-cash" charge. That's nonsense. In truth, depreciation is a particularly unattractive expense because the cash outlay it represents is paid up front, before the asset acquired has delivered any benefits to the business. Imagine, if you will, that at the beginning of this year a company paid all of its employees for the next ten years of their service (in the way they would lay out cash for a fixed asset to be useful for ten years). In the following nine years, compensation would be a "non-cash" expense – a reduction of a prepaid compensation asset established this year. Would anyone care to argue that the recording of the expense in years two through ten would be simply a bookkeeping formality?

Second, unintelligible footnotes usually indicate untrustworthy management. If you can't understand a footnote or other managerial explanation, it's usually because the CEO doesn't want you to. Enron's descriptions of certain transactions *still* baffle me.

Finally, be suspicious of companies that trumpet earnings projections and growth expectations. Businesses seldom operate in a tranquil, no-surprise environment, and earnings simply don't advance smoothly (except, of course, in the offering books of investment bankers).

Source: Berkshire Hathaway 2002 Annual Report (http://www.berkshirehathaway.com/2002ar/2002ar.pdf)

"There is seldom just one cockroach in the kitchen"

In particular, Buffet shares our cynicism about (i) "EBITDA" as a measure of value (we focus on free-cash-flow); (ii) complex accounts (free-cash-flow is more difficult to manipulate); and (iii) short term earnings projections (we take a long-term mid-cycle view).

We examine Telstra against this backdrop.

Trumpeting EBITDA is a particularly pernicious practice

The Telstra result includes 8 categories of EBITDA…

Buffet's first suggestion is to beware of companies displaying weak accounting. This suggestion is an absolute foundation of the Merlon investment process that unwaveringly focuses on free-cash-flow not accounting earnings or asset values as the primary driver of valuation.

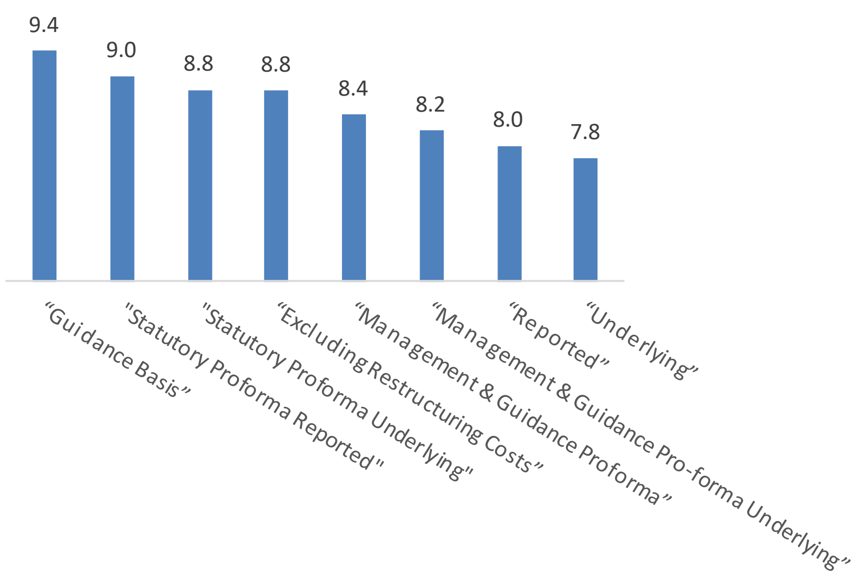
The Telstra financial report for the year to June 2019 made 71 references to the acronym "EBITDA"; the notes to Telstra's result presentation made 62 references; while the transcript from the results briefing made 49 appearances. The presentation itself made at least 35 more references to EBITDA in as many slides but these could not be counted electronically so this should be treated as a conservative estimate.

If this doesn't fit Buffet's definition of "trumpeting EBITDA" then we're not sure does. Telstra's result includes (at least) 8 categories of EBITDA:

- "EBITDA excluding restructuring costs";
- "Underlying EBITDA";
- "Guidance Basis EBITDA";
- "Reported EBITDA";
- "Statutory Proforma Underlying EBITDA";
- "Statutory Proforma Reported EBITDA";
- "Management & Guidance Proforma EBITDA"; and, our favourite,
- "Management & Guidance Pro-forma Underlying EBITDA"

These definitions range from $7.8 billion at the low end to $9.4 billion at the high end.

Figure 3: Telstra FY19 "EBITDA" As Reported in Result Presentation (A$b)



Source: Company Presentation

A useful distraction from actually analysing the business and the industry…

Ignore the cash flow statement at your peril

It is easy to spend hours and hours trying to reconcile the various definitions of EBITDA. It is scary to contemplate the aggregate number of hours spent by security analysts working through this exercise across the investment community at large. This provides a useful distraction from actually analysing the trends in the business and the industry.

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

As we persistently highlight, management teams and boards are becoming ever increasingly creative about how they define profitability. Some of the measures highlighted above are examples of this. "Management & Guidance Pro-forma Underlying EBITDA" is yet again not a measure of profitability defined in any accounting textbook.

Non-statutory measures of performance are easily manipulated…

The bottom line is that management teams can define profitability however they choose but can't as easily hide from the realities of the cash flow statement. Every 6 months we work through the gruelling process of trying to reconcile Telstra's various definitions of "EBITDA" to the company's statutory cashflow statement.

Eventually realities come home to roost and when this happens stocks with low earnings quality tend to underperform.

Earnings are opinion; cash is fact; but not always

To Telstra's credit, the company has partially graduated from EBITDA to measures of cash flow. Having said that, nothing is simple when it comes to Telstra and the company's definition of "free cash flow" differs from our own. Managements and boards are increasingly finding ways to distort cash flow statements. This is deeply concerning to us.

…and unfortunately so is the cash-flow statement.

An example of this is Telstra's cash flow which may be misleading through the increased use of "reverse factoring". Among the dozen or so highly paid sell side analysts covering the stock, it took Martin Lawrence from independent governance adviser Ownership Matters to publish research on this issue.

“supply chain finance” boosted Telstra’s cash flow by $551m…

Figure 4: Extract from Testra’s 2019 Financial Report (emphasis added)

From time to time, Telstra’s suppliers utilise supply chain finance, i.e. they transfer their rights of the amounts due from Telstra to third parties. However, Telstra’s obligation is to pay for goods and services purchased from our suppliers on the original due date without any change in payment terms. As at 30 June 2019, the amount payable under this arrangement was $593 million (2018: $42 million) and we have reclassified it from ‘Trade payables’ to ‘Other payables’.

Source: Telstra 2019 Financial Report (https://www.asx.com.au/asxpdf/20190815/pdf/447hcwytc63l76.pdf)

The implication of the disclosure above is that the increase in usage of “supply chain finance” boosted Telstra’s cash flow by $551 million for the year.

2019 was not the first year Telstra’s cash flow benefited from “innovative” working capital management schemes. In 2018 Telstra called out “improving working capital initiatives including Go Mobile Swap leasing.”

And prior periods were impacted by “back-to-back” mobile leases…

Figure 5: Extract from Testra’s 2019 Financial Report (emphasis added)

We also lease handsets which we then sublease to our retail customers in a back-to-back arrangement.

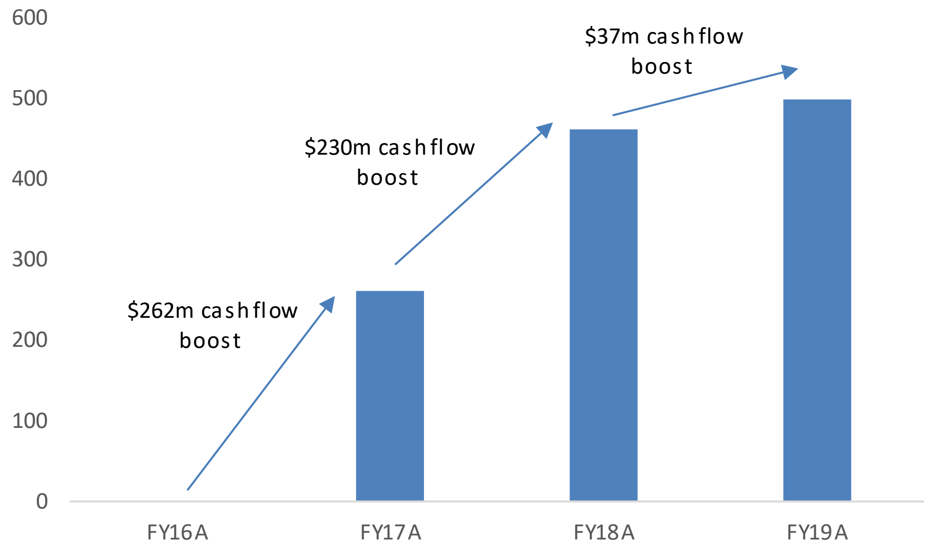
Table D sets out our future minimum lease receivables from retail customers under non-cancellable operating leases (Telstra as lessor).

Table D Telstra Group	As at 30 June 2019 $m	As at 30 June 2018 $m
Within 1 year	380	332
Within 1 to 5 years	119	130
	499	**462**

Source: Telstra 2019 Financial Report (https://www.asx.com.au/asxpdf/20190815/pdf/447hcwytc63l76.pdf)

The implication of this disclosure is that this “back-to-back arrangement” boosted Telstra’s cash flow by $37 million. The real action, however, was in 2017 and 2018 where these arrangements boosted cash flow by around $500m over two years.

Figure 6: Telstra minimum lease receivables from retail customers



Source: Company Accounts

The timing of Telstra's decision to stop selling mobile lease plans is curious…

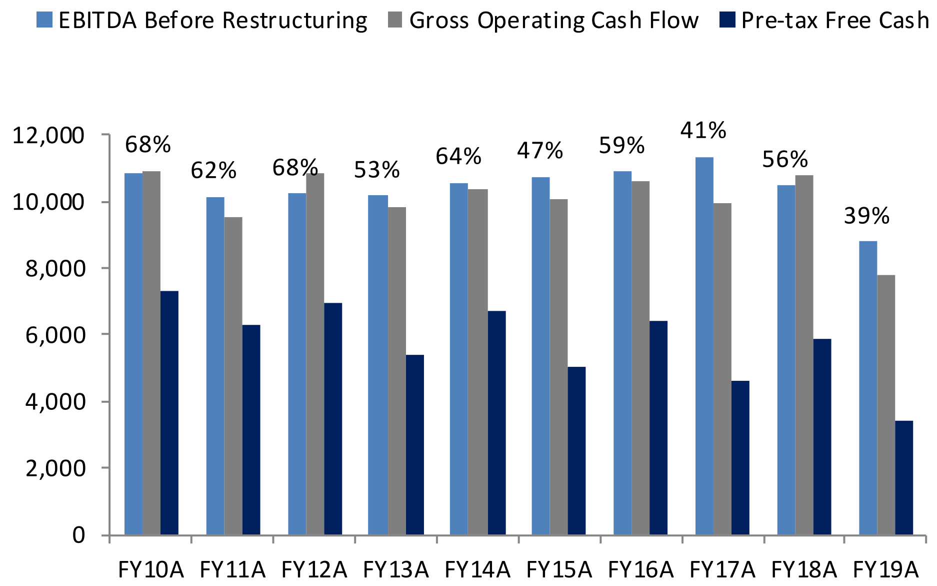
The timing of Telstra's decision to stop selling mobile lease plans in June 2019 is curious. The decision coincides with the introduction of AASB16 which requires mobile leases be recognised as a liability on the company's balance sheet. Telstra have stated that 2020 cash flow will be impacted by "*a significant working capital increase of approximately $1 billion, driven predominantly from the exit of our mobile lease plans*"

It seems the new accounting standards for operating leases have thwarted the cosmetic appeal of the "back-to-back" lease arrangement and led Telstra to revert to a more conventional approach of carrying receivables on its own balance sheet.

Taking these adjustments into account, Telstra's earnings quality is poor with the company converting just 39% of its FY19 "EBITDA Before Restructuring" into pre-tax cash flow.

Telstra's earnings quality is poor…

Figure 7: Telstra EBITDA, Cash Flow & Cash Conversion



Source: Company Accounts, Cash flow includes cash receipts from asset sales to NBN Co and is net of benefit of $551 from "supply chain finance" in FY19 and benefit of "back-to-back" retail leases in FY17 & FY18

People Respond to Incentives

"Most of economics can be summarized in four words: "People respond to incentives." The rest is commentary."

— Steven E. Landsburg, Armchair Economist: Economics And Everyday Experience

Management respond to incentives set by the board…

The "EBITDA Before Restructuring" set by the board for the purposes of determining management remuneration was $9.2 billion. A cursory glance at the various definitions of EBITDA included in Figure 3 highlights that this target was missed by all but one of the measures disclosed in the result presentation including the measure upon which the target was supposed to be based.

…and boards appear flexible in relation to how performance is measured.

That said, the board took it upon itself to create a ninth definition of EBITDA "for the purpose of the EVP [Executive Variable Remuneration Plan] performance measure. This figure came in at $9.1 billion but only after adding back more restructuring than initially envisaged ($0.8 billion vs $0.6 billion) and more software write-downs than initially envisaged ($0.5 billion vs nil).

The inclusion of "Free Cash Flow" in as an EVP performance measure may also explain the company's "innovative" approaches to working capital discussed earlier.

Unintelligible footnotes indicate untrustworthy management

Buffet's second suggestion is that if you can't understand a footnote its usually because the CEO doesn't want you to. On that front, Telstra's result presentation is littered with footnotes. Remember that the presentation is meant to summarise the company's results. Overleaf are some of the footnotes from Telstra's result presentation.

Even something as seemingly simple as explaining how Telstra arrived at its 16 cent per share dividend appears wrought with complexity. This is a big issue for a company with such a large retail shareholder base who rely on dividend yield as a key measure of valuation.

If you can't understand a footnote it's usually because the CEO doesn't want you to…

Figure 8: Telstra Explanation of Decision to pay 16 Cent Dividend

Group results: dividends

	FY18	FY19	CHANGE
Earnings per share			
Basic earnings per share (cents)	30.2	18.1	-40.1%
Underlying basic earnings per share (cents)[1]	21.7	17.0	-21.7%
Dividends (fully-franked)			
Ordinary dividend	15.0	10.0	-33.3%
Special dividend	7.0	6.0	-14.3%
Total dividends	**22.0**	**16.0**	**-27.3%**
Payout Ratios[3]			
Ordinary dividend of underlying earnings[3]	69%	59%	
Special dividend of net one-off nbn receipts	65%	63%	
Total dividends of earnings per share[3]	**73%**	**88%**	

FY19 total dividends of 16 cents per share (cps) fully franked, including total ordinary dividends of 10cps and total special dividends of 6cps

Final dividend of 8cps fully franked, including ordinary dividend of 5cps and special dividend of 3cps

2H19 dividends consistent with 1H19

FY19 ordinary dividend payout of underlying earnings[1,2] below indicative 70% to 90% range with the board taking into account capital management framework

64% of cumulative net one-off nbn™ receipts received life to date[4] returned via fully-franked special dividends[1,2]

Overall FY19 dividend payout ratio of 88%

Underlying earnings excludes restructuring costs, impairments and guidance adjustments as well as net one-off nbn receipts[1]

Remain committed to capital management framework including maintaining balance sheet settings consistent with an A band credit rating

1. Underlying earnings is defined as NPAT from continuing operations excluding net one-off nbn receipts and guidance adjustments. Guidance adjustments include one-off restructuring costs, impairments in and to investments or property, plant and equipment and intangible assets, proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. "net one-off nbn receipts" is defined as net nbn one off Definitive Agreement receipts (consisting of PSAA, Infrastructure Ownership and Retraining) less nbn net cost to connect less tax. FY19 underlying earnings were $2,019m (FY18 $2,582m), net one-off nbn DA receipts less nbn net C2C less tax were $1,129m (FY18 $1,285m), and total guidance adjustments less tax and non-controlling interest were -$994m (FY18 -$276m).
2. The dividend is subject to no unexpected material events, and is subject to Board discretion having regard to financial and market conditions, business needs and maintenance of financial strength and flexibility consistent with Telstra's capital management framework.
3. FY18 payout ratios have been restated consistent with restatement of earnings based on AASB15 and underlying earnings definition. Ordinary dividend payout ratio including guidance adjustments was 116% in FY19 (77% FY18).
4. "Life to date" defined as since beginning FY18 and implementation of new dividend policy with restated earnings based on AASB15.

Source: Telstra FY19 Result Presentation

Figure 9: Selected Footnotes from Telstra's FY19 Result Presentation

1. This guidance assumed wholesale product price stability and no impairments to investments or core assets, and excluded any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumed the nbn™ rollout and migration in FY19 was broadly in accordance with the nbn Corporate Plan 2019. The guidance was provided on the basis of AASB15. Capex was measured on an accrued basis and excluded expenditure on spectrum and externally funded capex.
2. Total income excludes finance income.
3. Underlying EBITDA excludes one-off nbn DA receipts less nbn net C2C, and guidance adjustments.
4. In-year nbn headwind defined as the net negative recurring EBITDA impact on our business based on management best estimates.
5. Total dividends of 16 cents per share fully franked comprising total ordinary dividend of 10 cents per share and total special dividend of 6 cents per share.

---

1. This guidance assumed wholesale product price stability and no impairments to investments or core assets, and excluded any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumed the nbn™ rollout and migration in FY19 was broadly in accordance with the nbn Corporate Plan 2019. The guidance was provided on the basis of AASB15.
2. Total income excludes finance income.

---

1. Fixed excludes one-off nbn connection income FY19 $106m (FY18 $113m) and includes TUSOPA income FY19 $159m (FY18 $167m). One-off nbn connection income included in one-off nbn DA and connection.
2. Recurring nbn DA restated to include ISA power.
3. Global connectivity includes other income FY19 $5m (FY18 $15m).
4. Other includes media, nbn commercial works (sale of assets), M&A, and miscellaneous.
5. New business includes Telstra Health and Ooyala.
6. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule.

---

1. Restated due to accounting changes and review of fixed costs - underlying and other inclusions. Sales and fixed costs exclude costs associated with one-off nbn DA and nbn cost to connect (C2C).
2. Fixed costs - underlying was ~$8.3b in FY16 and targeted to decline by our net cost productivity target of $2.5b by FY22.
3. Fixed costs - other includes items supporting revenue growth including relevant NAS costs, mobile lease, and product impairment.
4. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule

---

1. Product EBITDA restated due to accounting changes and review of fixed cost allocation methodologies to products. Mobile & fixed restated to include International network costs previously included in Other.
2. Fixed includes TUSOPA income FY19 $159m (FY18 $167m).
3. Fixed excludes one-off nbn C2C net of connection income FY19 $362m (FY18 $284m) represented against net one-off nbn DA less net C2C. This includes one-off nbn connection income FY19 $106m (FY18 $113m) and one-off nbn cost to connect (C2C) FY19 $468m (FY18 $397m).
4. Other includes media, nbn commercial works (sale of assets), and miscellaneous.
5. New business includes Telstra Health and Ooyala.
6. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule.

---

1. Working capital movement from operating activities.
2. Includes net investments, interest received, proceeds from lease assets, proceeds on disposal, and non-cash EBITDA items (including impairments and gain on disposal of PP&E).
3. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule. Guidance adjustments include M&A disposals and spectrum.
4. This guidance assumed wholesale product price stability and no impairments to investments or core assets, and excluded any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumed the nbn™ rollout and migration in FY19 was broadly in accordance with the nbn Corporate Plan 2019. The guidance was provided on the basis of AASB15.Capex was measured on an accrued basis and excluded expenditure on spectrum and externally funded capex.
5. Capex is measured on an accrued basis and excludes expenditure on spectrum and externally funded capex and capitalised leases under AASB16 leases.

---

1. Underlying earnings is defined as NPAT from continuing operations excluding net one-off nbn receipts and guidance adjustments. Guidance adjustments include one-off restructuring costs, impairments in and to investments or property, plant and equipment and intangible assets, proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. "net one-off nbn receipts" is defined as net nbn one off Definitive Agreement receipts (consisting of PSAA, Infrastructure Ownership and Retraining) less nbn net cost to connect less tax. FY19 underlying earnings were $2,019m (FY18 $2,582m), net one-off nbn DA receipts less nbn net C2C less tax were $1,129m (FY18 $1,285m), and total guidance adjustments less tax and non-controlling interest were -$994m (FY18 -$276m).
2. The dividend is subject to no unexpected material events, and is subject to Board discretion having regard to financial and market conditions, business needs and maintenance of financial strength and flexibility consistent with Telstra's capital management framework.
3. FY18 payout ratios have been restated consistent with restatement of earnings based on AASB15 and underlying earnings definition. Ordinary dividend payout ratio including guidance adjustments was 116% in FY19 (77% FY18).
4. "Life to date" defined as since beginning FY18 and implementation of new dividend policy with restated earnings based on AASB15.

---

1. Represents position after hedging based on accounting carrying values. Gross debt comprises borrowings and derivatives.
2. Represents gross interest cost on gross debt.
3. Debt servicing calculated as net debt over EBITDA. Gearing calculated as net debt over total net debt and equity. Interest cover calculated as EBITDA over net interest expense (excluding capitalised interest and revaluation impacts on our borrowings and derivatives).
4. Capex was measured on an accrued basis and excluded expenditure on spectrum and externally funded capex.
5. ROE is calculated at PATMI as a percentage of equity.
6. ROIC calculated as NOPAT as a percentage of total capital. Underlying ROIC calculated as NOPAT excluding net one-off nbn DA less C2C and guidance adjustments less tax as a percentage of total capital. Guidance adjustments include one-off restructuring costs, impairments in and to investments or property, plant and equipment and intangible assets, proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. Historical numbers restated based on updated definition and - underlying ROIC including guidance adjustments 5.0% (FY18 9.1%)
7. This estimate is illustrative only and actual impacts will depend on final accounting interpretations and assumptions. See 'AASB16 "leases" FY19 Proforma & FY20 indicative impacts" slide
8. Post-nbn defined as FY23 and beyond on AASB16 basis

---

1. Impacts shown are based on a projection of current lease portfolios and provided to give a directional sense of the quantum. Actual impacts may differ from numbers shown.
2. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule.
3. Finance costs also relate to mobile swap.
4. This estimate is illustrative only and actual impacts will depend on final accounting interpretations and assumptions

---

1. This guidance assumes wholesale product price stability and no impairments in and to investments or property, plant and equipment and intangible assets, and excludes any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumes the nbn rollout and migration in FY20 is broadly in accordance with the nbn Corporate Plan 2019. Guidance is provided on the basis of AASB16 Leases and assumes impacts consistent with management estimates and current interpretation of the standard. Capex is measured on an accrued basis and excludes expenditure on spectrum and externally funded capex and capitalised leases under AASB16 Leases.
2. Excluding finance income.
3. Underlying EBITDA excludes net one-off nbn DA receipts less nbn net C2C, guidance adjustments and includes amortisation of mobile operating lease costs.
4. In-year nbn headwind defined as the net negative recurring EBITDA impact on our business based on management best estimates including key input of the nbn Corporate Plan 2019.
5. FY20 free cashflow defined as operating cash flows less investing cash flows less operating leases (reported in financing cash flow under AASB16 Leases).
6. FY20 free cashflow guidance includes ~$1b working capital increase including from exit of mobile lease plans, remaining outflows from restructuring costs announced in May 2019, and an increase in nbn receivables

---

1. Underlying earnings is defined as NPAT from continuing operations excluding net one-off nbn receipts (as defined in footnote 2) and guidance adjustments. Guidance adjustments include one-off restructuring costs, impairments in and to investments or property, plant and equipment and intangible assets, proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum.
2. "net one-off nbn receipts" is defined as net nbn one off Definitive Agreement receipts (consisting of PSAA, Infrastructure Ownership and Retraining) less nbn net cost to connect less tax.
3. The dividend is subject to no unexpected material events, and is subject to Board discretion having regard to financial and market conditions, business needs and maintenance of financial strength and flexibility consistent with Telstra's capital management framework.
4. Capex is measured on an accrued basis and excludes expenditure on spectrum and externally funded capexand capitalised leases under AASB16 Leases.

---

1. Product operating expenses restated due to accounting changes and review of fixed cost allocation methodologies to products.
2. Fixed excludes one-off nbn cost to connect (C2C) FY19 $468m (FY18 $397m). One-off nbn C2C included in one-off nbn DA and nbn C2C.
3. Recurring nbn DA restated to include ISA power.
4. Other includes media, nbn commercial works (sale of assets), and miscellaneous.
5. New business includes Telstra Health and Ooyala.
6. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule.

---

1. TUSOPA is run by Department of Communications and the Arts and the income is net of the levy paid.
2. Included as sales revenue. Restated to include ISA power.
3. Included as other income.
4. Included as other income. Includes receipts for assets transferred under the nbn Definitive Agreements (DAs). Restated to exclude ISA power.
5. included as other income. Includes income from nbn disconnection fees (Per Subscriber Address Amount (PSAA)).
6. nbn commercial works – products and services revenue is recognised as NAS revenue.

Source: Telstra FY19 Result Presentation

Be Suspicious of Earnings Projections

Earnings simply don't advance as smoothly as guidance implies…

Despite Buffet's suspicions about earnings projections, no Telstra result presentation would be complete without guidance. And no Telstra guidance would be complete without an updated definition of "Underlying EBITDA" ("includes amortisation of mobile leasing costs") and without six accompanying footnotes. Whether these footnotes meet Buffet's criteria of "unintelligible" we will leave to our readers' discretion.

Figure 10: Telstra 2020 Analyst Guidance

FY20 guidance

	FY19	FY20 guidance[1] Based on new accounting standards
Total income[2]	$27.8b	$25.7b to $27.7b
Underlying EBITDA[3] - Included in-year nbn headwind[4]	**$8.2b**	**$7.3b to $7.8b** ~-$0.8 to ~-$1.0b
Net one-off nbn DA receipts less nbn net C2C	$1.6b	$1.6b to $2.0b
Restructuring costs	$0.8b	~$0.3b
Capex	**$4.1b**	**$2.9b to $3.3b**
Free cashflow after operating lease payments[5,6]	**$3.1b**	**$3.4b to $3.9b**

	Range	
FY20 Underlying EBITDA movement	-$0.9b	-$0.4b
Excluding approximate in-year nbn headwind	$0.9b	$0.9b
Growth ex-nbn headwind	$0b	+$0.5b

1. This guidance assumes wholesale product price stability and no impairments in and to investments or property, plant and equipment and intangible assets, and excludes any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumes the nbn rollout and migration in FY20 is broadly in accordance with the nbn Corporate Plan 2019. Guidance is provided on the basis of AASB16 Leases and assumes impacts consistent with management estimates and current interpretation of the standard. Capex is measured on an accrued basis and excludes expenditure on spectrum and externally funded capex and capitalised leases under AASB16 Leases.
2. Excluding finance income.
3. Underlying EBITDA excludes net one-off nbn DA receipts less nbn net C2C, guidance adjustments and includes amortisation of mobile operating lease costs.
4. In-year nbn headwind defined as the net negative recurring EBITDA impact on our business based on management best estimates including key input of the nbn Corporate Plan 2019.
5. FY20 free cashflow defined as operating cash flows less investing cash flows less operating leases (reported in financing cash flow under AASB16 Leases).
6. FY20 free cashflow guidance includes ~$1b working capital increase including from exit of mobile lease plans, remaining outflows from restructuring costs announced in May 2019, and an increase in nbn receivables

Source: Telstra FY19 Result Presentation

While the presence of such "Guidance" is hardly surprising, it is remarkable the extent to which the market relies upon it in forming expectations. One analyst report commented that "Overall, Telstra tends to be conservative in setting guidance" notwithstanding the fact that the company missed its 2019 EBITDA guidance on all but one the eight categories reported and missed its 2019 free cash flow guidance notwithstanding "innovative" working capital management initiatives.

Is Telstra a Good Investment?

We have discussed our investment view in earlier commentary and we don't believe much has changed in relation to our long-term expectations. Critical elements of our thesis remain:

1. ***EBITDA metrics being trumpeted by management are a poor proxy for cash flow.*** and valuations based off this metric are fundamentally flawed.

2. ***Reselling NBN services will remain a loss leader*** for Telstra with current cost cutting initiatives serving to offset margin compression from the NBN transition rather than deliver absolute upside.

3. ***Mobile margins are high*** by historic standards and high relative to international peers.

How to Value Telstra?

Merlon's preferred measure of intrinsic value is to compare a company's enterprise (or unleveraged) value with its sustainable enterprise-free-cash-flow. In the case of Telstra this approach gives rise to a valuation range of between $1.80 and $4.50. Our view is that risks are skewed towards the lower end of this range.

Telstra is more financially leveraged, lower growth, more capital intensive and has lower earnings quality than the market at large…

Taking a more simplistic approach to valuation yields the same conclusion. In particular we note that:

- Telstra just reported "Underlying basic earnings per share" of 17 cents;

- Telstra's fixed line business just reported "Underlying EBITDA" of $1,406 million which on after tax basis represents approximately 8 cents per share. This amount, in our view, is trending towards zero;

- Telstra is more financially leveraged, lower growth, more capital intensive and has lower earnings quality than the market at large warranting a below market earnings multiple.

Excluding unsustainable fixed line profits, Telstra's EPS looks closer to 9-12 cents…

Figure 11: Implied Telstra Valuation Based on Simple Price / Earnings Ratio

	Low	High
FY19 underlying basic earnings per share	**$0.17**	**$0.17**
Less: Fixed line contribution	($0.08)	($0.05)
FY19 EPS excluding fixed line	**$0.09**	**$0.12**
Price/Earnings ratio	15x	20x
Implied valuation based on simple price/earnings ratio	**$1.35**	**$2.40**

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

We do not hold Telstra shares in our portfolios.

Analyst:
Joey Mui

Quality in the Merlon process

Quality alone does not drive good investment outcomes: Last quarter (Good companies are not always good investments), we highlighted that there is little evidence that "quality" factors outperform over a full market cycle.

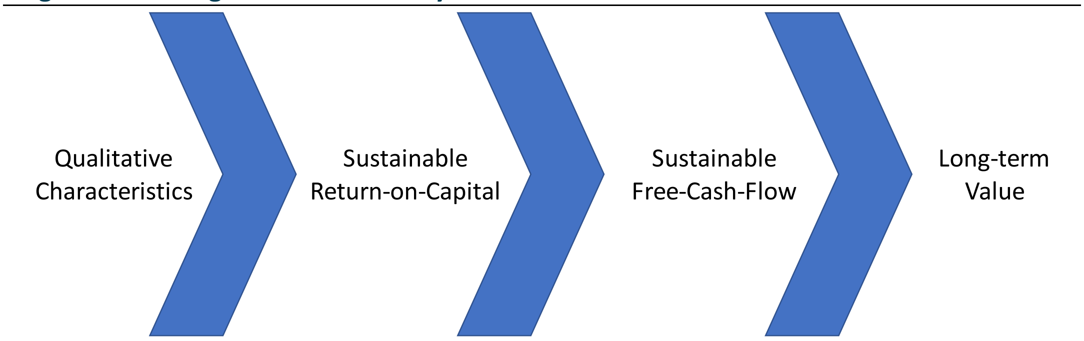
Qualitative characteristics drive sustainable returns on capital: At Merlon we do not "screen" on quality but seek to ensure our estimates of sustainable return on capital appropriately reflect qualitative characteristics. Within our qualitative framework we explicitly rate (i) industry structure; (ii) competitive advantage; and, (iii) governance and management. We are sceptical about the sustainability of high returns if our qualitative assessment is poor and vice-versa.

Sustainable returns on capital drive sustainable-free-cash-flow: Companies with sustainably high returns on capital ultimately throw off more free-cash-flow. For example, a company with a 5% sustainable return on capital will not generate any sustainable-free-cash flow if it is seeking to grow its business at the same rate. This must be the case because the company will need to expand its capital asset base by 5% per year which will require it to retain 100% of its cash earnings.

Qualitative characteristics drive our assessment of long-term value…

Sustainable-free-cash-flow drives our assessment of value: At Merlon we value companies based on our assessments of sustainable-free-cash-flow. What matters to us is not simply the quality of the business but the price paid relative to the quantum of sustainable-free-cash-flow received.

Figure 12: Linkage Between Quality & Value



Source: Merlon Capital Partners

…but valuation upside alone is an insufficient investment criterion

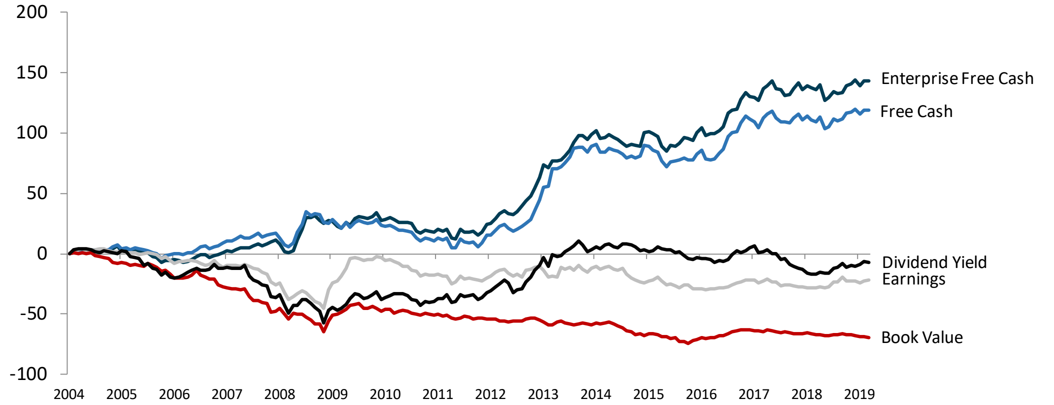
Valuation upside is a necessary but insufficient investment criterion: To be a good investment, we need to understand why the stock is mispriced, have an explicit view to the contrary and we need to understand whether expected returns are acceptable relative to the risk of capital loss.

Merlon's Investment Philosophy and Process

At Merlon we believe stocks trading below fair value will outperform through time. We value companies based on a long-term view of their sustainable free cash-flow on a debt-free basis. We also believe stocks don't outperform merely because they are undervalued but rather because the market's concerns are either invalid or priced in, and Merlon analysts ascribe a conviction score to reflect this.

Investing in companies that have a history of strong free cash flow relative to the stock price has been shown to lead to outperformance over time.

Figure 13: Returns – "Value" Portfolios Relative to "Glamour" Portfolios (Australian Data, March 2004 to June 2019)[1]



Source: Merlon Capital Partners/ Bloomberg

Sustainable free cash flow is a quality measure of a company's earnings

We have written several papers (Value Investing Part 1, Part II & Part III) explaining why free cash flow as a value factor has consistently outperformed on a risk adjusted basis. One theory we discussed is the correlation between free cash flow and the accruals factor, that is a company's advertised earnings are of higher quality when supported by free cash-flow. Conversely, when there is a large gap between accounting earnings and free cash-flow, this either reflects a low return on capital business or potential overstatement of accounting earnings, or both.

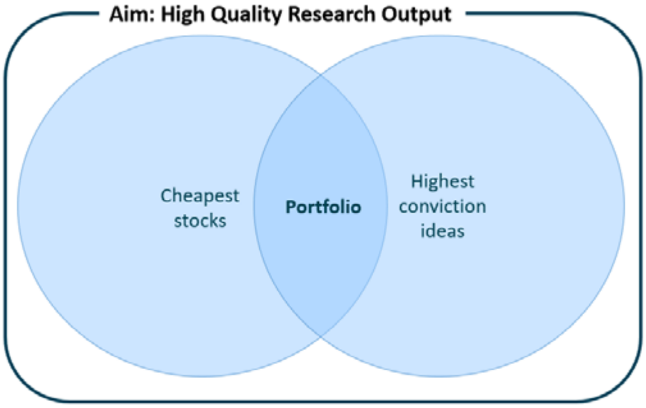
[1] Portfolios are formed using four valuation ratios: free-cash-flow-to-price (F/P); enterprise-free-cash-flow (EF/EV); earnings-to-price (E/P) and book value-to market (B/M). Portfolios are formed at the end of each month by sorting on one of the four ratios and then computing equally-weighted returns for the following month. The "value" portfolios contain firms in the top one third of a ratio and the "glamour" portfolios contain firms in the bottom third. The analysis is based on S&P/ASX200 constituents and the raw data is from Bloomberg

How Quality Integrates into the Merlon Process

Quality has an integral role in both the valuation and conviction aspects of Merlon's investment philosophy and process. Rather than using quality as a "screen" to knock in or knock out investment ideas, it assists in determining and calibrating our two key research outputs:

- **Valuation:** based on the capitalisation of sustainable-free-cash-flow and franking credits;
- **Conviction:** premised around our philosophical belief that stocks are rarely under or over-valued without good reason. To be a good investment, we need to understand why the stock is mispriced and we need to have an explicit view to the contrary. Our analysts reflect this in a numerical score between 1 and 4.

Figure 14: Merlon Research Output



Source: Merlon Capital Partners

Our conviction scores and our fundamental valuations determine our portfolio weights, subject to risk and liquidity constraints.

Merlon Valuations and the Role of Quality

Assessment of quality, including ESG ingrained in Merlon's investment process

As mentioned, 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 assessment of fundamental value.

Ultimately, we don't believe that excessive margins or returns on capital can be sustained unless they are supported by a combination of qualitative measures that we assess for each company:

1. ***Industry structure***

   Industry structure is analysed at a business segment level according to the widely used framework developed by Michael Porter. Porter's Five Forces views industry profitability as determined by five external forces: availability of substitutes, barriers to entry, competitive rivalry, and bargaining power of customers and suppliers.

   For example, we view the duopoly industry structure of the Australian supermarkets, Coles and Woolworths, as markedly strong. While there are market concerns around the competitive threats of Aldi and other overseas players, ultimately the scale benefits and dominant market positions of Coles and Woolworths reinforce the sustainability of their free cash flow.

2. ***Competitive advantage***

   Competitive advantage is determined with reference to scale or cost advantage, product differentiation and customer intimacy or loyalty. This widely-adopted framework was developed by Michael Treacy and Fred Wiersma in their book *"The Discipline of Market leaders".* The main premise is that companies must achieve market leadership in one of three disciplines and perform to an acceptable level in the other two.

   Our assessment of relevant Environmental and Social factors within ESG considerations is incorporated within the relevant competitive advantage. For example, Asaleo's use of sustainably sourced pulp is a positive differentiator when competing for supermarket private label contracts compared to their competitors' inferior sustainable sourcing standards.

Proprietary quality scores are rigorously debated during stock review meetings

3. ***Governance and Management***

   Governance and Management is decomposed into Governance; Capital Allocation; and Execution,

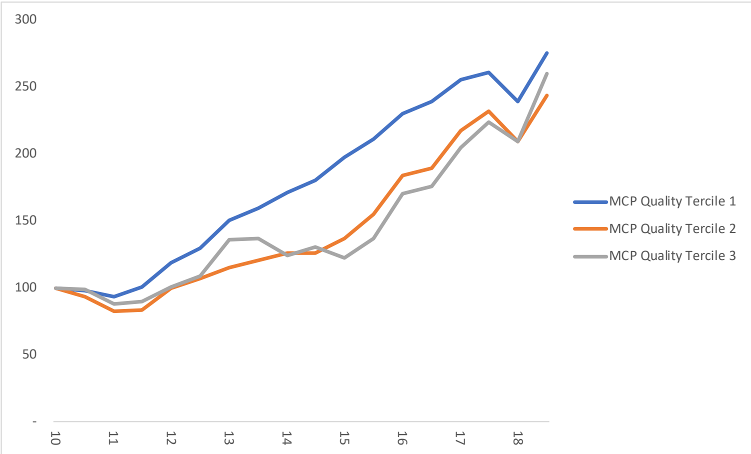
   We place extra weight on the Governance factor due to its significant influence on capital allocation and management behaviour. Merlon proactively meets with board members of companies in our portfolio and strongly advocates for optimal shareholder outcomes in the face of poor governance e.g. AMP's poor divestment of its Life Insurance business.

We described in some detail how our management score as a proxy for capital misallocation risk impacts both valuation and conviction when analysing the value destruction of CBA's Colonial acquisition in 2000 and Boral's overpriced acquisition of Headwaters in 2016.

We maintain and update quality scores on our covered stock universe and rigorously debate these before considering financial projections of sustainable free cash flow and assessing key issues for a stock.

Overall, Merlon's proprietary quality scores have proven effective in differentiating high quality from low quality.

Figure 15: Total Returns by Merlon Qualitative Score Terciles (Equally-weighted ASX100) 2010-2018



Source: Merlon Capital Partners/ Bloomberg

Qualitative characteristics are explicitly captured in our estimate of sustainable free-cash-flow

However, we would caution that the period since Merlon's inception has been defined by historically low and declining interest rates. As per our earlier analysis Good companies are not always good investments, we remain mindful that valuations for quality stocks remain above historic norms. This potential "bubble" in quality stocks increases the importance of long-term fundamental valuation for investors.

Earnings Quality

"Earnings quality" is conspicuously absent from our qualitative scorecard. This is not because we don't think earnings quality is important but rather because we value companies on the basis of sustainable-free-cash-flow rather than accounting earnings.

The ultimate test of earnings quality is the ratio of sustainable-free-cash-flow to accounting profits and sustainable-free-cash-flow is the basis upon which we value businesses.

Similarly, earnings quality and balance sheet strength are explicitly captured in our enterprise valuation approach

Balance Sheet Strength

Also absent from our qualitative scorecard is "Balance Sheet Strength". Once again, this is not because we don't think balance sheet strength is important but rather because we integrate balance sheet leverage within our valuation framework.

Merlon's sustainable-free-cash-flow based valuations are calculated on an enterprise value basis with the equity value determined after fully deducting net debt. Additionally, higher financial leverage would impact the sensitivity of our valuation scenarios creating a wider range of outcomes.

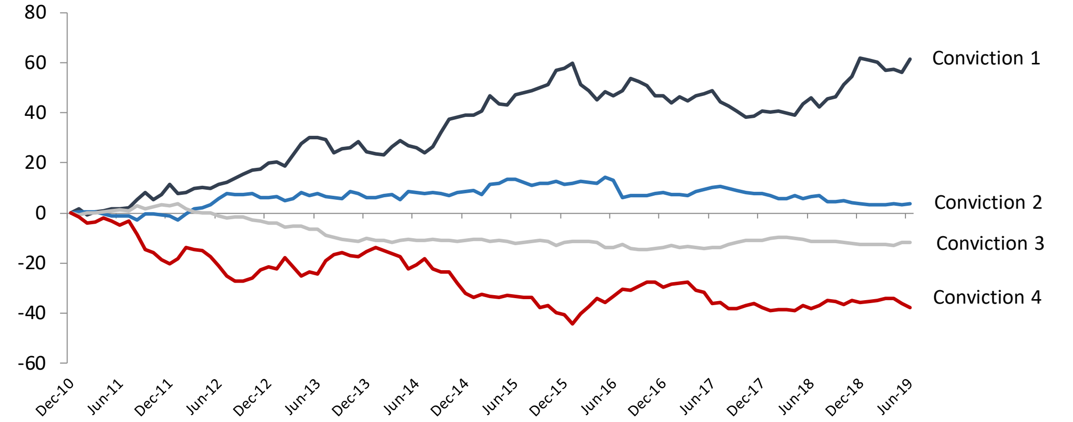
The ultimate test of balance sheet strength is the value of the equity after debt and other financial obligations have been met in full. This is the basis upon which we value companies.

Merlon Conviction Scores and the role of quality

Identifying market misperception generates significant value-add

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. Since our inception in 2010, Merlon's conviction scores have demonstrated the value-add from having differentiated, contrarian views.

Figure 16: Total Returns by Merlon Conviction Score 2010-2018



Source: Merlon Capital Partners/ Bloomberg/ Goldman Sachs Research

It is more important whether the market misperceives quality rather than absolute level of quality

In determining conviction, we need to assess whether our view on quality, whether it be industry structure, competitive positioning or management, is different to the market based on evidence. For example, we had high conviction on Woolworths when the market believed the industry structure had materially deteriorated, rather attributing the decline to poor management execution that could be corrected. With Transurban, we agree the company is very high quality (monopoly) but this view is no different to the market, leading to a lower conviction score.

Determining business segment quality and the Bear Case

It is also important to conduct any quality assessment at a ***business segment level***, rather than at a group level, as the market often over-emphasises a low-quality segment at the expense of a high quality one.

Our observation is that many listed companies in Australia have one or two very strong businesses operating under umbrellas of favourable industry structures held alongside some very poor businesses acquired or grown by weak boards and management that at some point misattributed the success of their core businesses to their own abilities rather than their privileged market positions.

A key aspect in determining conviction is producing a valuation range based on sustainable-free-cash-flow scenarios, with a higher conviction score ascribed when the share price is trading close to or below our bear/worst case scenario.

Quality at an individual business segment level is useful in understanding downside risk scenarios

The Merlon quality score, at a business segment level, is a critical consideration in determining the bear case. Numerous examples of market misperception due to negativity around a segment have provided opportunities in the past:

- Fairfax's share price traded below our bear case which was fully underwritten by the higher quality digital classified business with the lower quality traditional print business valued at zero;
- The same can be said for ANZ's higher quality domestic franchise when the lower quality offshore franchise was causing problems;
- BlueScope Steel's high quality Colorbond distribution business was obscured by the loss-making commodity steel export business;
- Suncorp's higher quality general insurance business when the "bad bank" was generating credit losses during the GFC;
- Asaleo Care's strong personal care brands (Libra, Tena) concealed by its loss-making consumer tissue business.

Conclusion

*"There's good assets and bad assets but **good prices** and **bad prices** supersede whether the assets are good or bad" David Abrams*

As previously discussed in Good companies are not always good investments, there is little evidence that "quality" factors outperform over a full market cycle. Understanding and measuring "quality" is better used as tool for calibrating the estimate of sustainable free cash flow. We believe that consistently paying a low price relative to a company's sustainable free cash flow is vastly more important than the "feel good" factor of owning quality companies.

Understanding and measuring "quality" is also better used as a tool for determining downside valuation scenarios to limit investment losses in the event the market concerns prove to be valid. We place a heavy emphasis on downside risk and have had many investment successes when the market has overlooked a good quality segment with strong and sustainable cash flows because of concerns over a lower quality segment that could be quarantined.

The manipulation of accounting earnings now more than ever highlights the importance of a free cash flow track record as the key metric to measure the quality of the underlying business.

At Merlon, we believe that by consistently paying a low price for a range of reasonable scenarios (measured by free cash flow) will lead to investment outperformance. What matters is the price paid relative to the quantum of cash flow received - which in turn is more sustainable for businesses with better qualitative features.

.

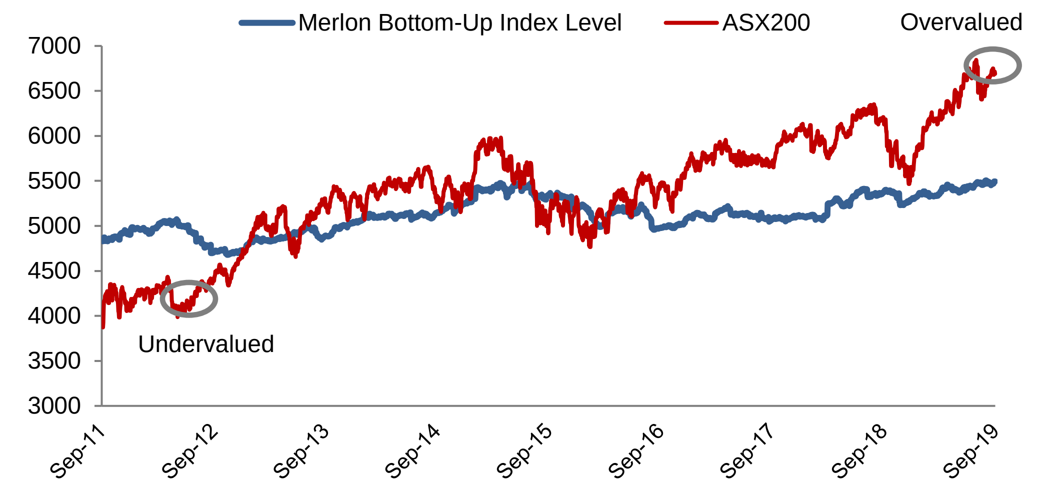
Market Outlook and Portfolio Positioning

Neil Margolis

Market approximately 18% overvalued using consistent bottom-up approach…

As has been our historic practice, we continue to provide an aggregate assessment of the ASX200 valuation, based on the individual company valuations for the 148 stocks we actively cover. On this basis the market appears approximately 18% overvalued after returning 24% this calendar year so far.

Figure 17: Merlon bottom up market valuation vs ASX200 level



Source: Merlon

…with the overvaluation concentrated in certain sectors.

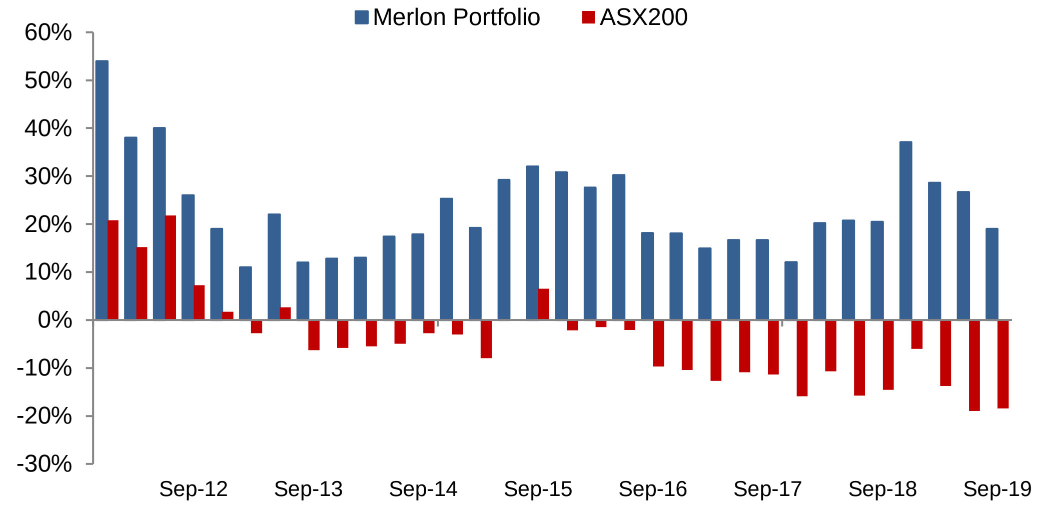
Our individual company valuations have been established utilising our estimates of sustainable free-cash-flows and franking credits, discounted at consistent mid-cycle interest rates and risk premiums. Our valuations are long-term and generally a lot more stable than fluctuating share prices, creating 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 trying to predict when and if the market will price in "mid-cycle" interest rates and long-run average risk premiums.

Merlon's value portfolio comprises our best research ideas, based on our long-term valuations and analyst conviction. Our long-term views in relation to some of the more excessively priced subcomponents of the ASX200 index, most notably "bond proxies", technology and iron ore stocks, have not changed and the portfolio remains positioned against the recent trend of rapidly inflating asset prices in these areas. The implication (as seen below), is that the Merlon portfolio offers increasingly attractive expected returns compared to the index.

The Merlon portfolio offers increasingly attractive expected returns compared to the index.

Figure 18: Expected return based on Merlon valuations



Source: Merlon

The outlook for interest rates globally appears to be lower with the Federal Reserve having cut rates for a second time, while the Reserve Bank of Australia (RBA) has now cut rates three times, with the official rate now below 1%.

While timing is difficult to predict, we do not think it is prudent to invest in companies on the basis that real interest rates will remain negative for an extended period of time. Although equity markets have rallied, gains have been narrow and we are still able to construct a portfolio of undervalued businesses using sensible interest rate and risk margin assumptions.

The Australian dollar has held up remarkably well against a backdrop of slowing global growth and the relative fall in Australian interest rates. We put at least part of this strength down to the inflated iron-ore price that has benefitted from supply disruptions, albeit having declined by 25% from its height. Our positions in **QBE Insurance, Janus Henderson, Platinum** and **News Corporation** should benefit if the Australian dollar weakens further.

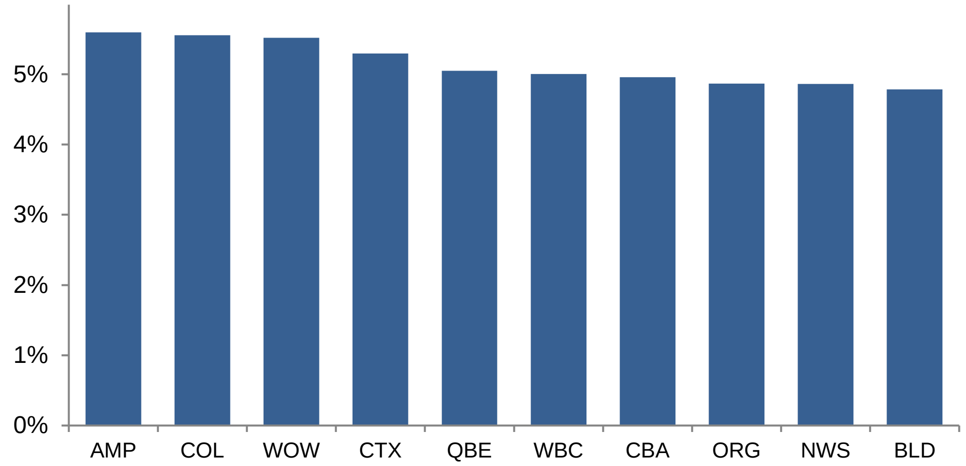
While recent interest rate cuts, tax cuts and macro-prudential easing should benefit the consumer and the housing market, this is against the tide of low wage growth, softening employment conditions and lower major bank risk appetite. That said, we believe on balance that much of this caution is reflected in low market expectations, with select bank and some domestic cyclical companies representing good investments at current levels.

Portfolio Aligned to Value Philosophy and Fundamental Research

The portfolio comprises undervalued businesses based on sensible interest rate and risk margin assumptions…

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

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 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.

Commonwealth Bank and **Westpac** both featured in our top 10 holdings at the end of September 2019. We are a non-benchmark investor and unlike many other managers we are under no compulsion to own the major banks simply because they represent a large part of major share market indices. Relative to their overall lending assets, the banks are under-earning relative to long term historic norms even after adjusting for recent wealth management divestments. Despite the perceived disruption from "fintech" and the recent Royal Commission we see little evidence of market share loss in the core transactional banking activities. Some loss of lending market share amongst the major banks is not uncommon later in economic cycles and should not in our view be attributed to "disruption".

Further, concerns about residential property prices have been overplayed in our view against the continued backdrop of favourable tax treatment and the low interest rates that, ironically, are being used by many investors to justify the ever-increasing prices being paid for commercial property and "bond proxy" stocks.

Coles and **Woolworths** are attractively priced both in absolute terms and more so relative to other "defensive" sectors that are included in the "bond proxy" group. We believe these businesses operate under an umbrella of a sound industry structure, provide long term inflation protection and are modestly under-earning.

QBE Insurance Group also remains a significant holding in the fund. 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. A return to positive real 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. Alternatively, if bond markets are correct and we move into a deflationary environment, QBE's longer-term claims liabilities will benefit. Management is now more focused, and the insurance pricing cycle appears to be improving, or at least no longer deteriorating.

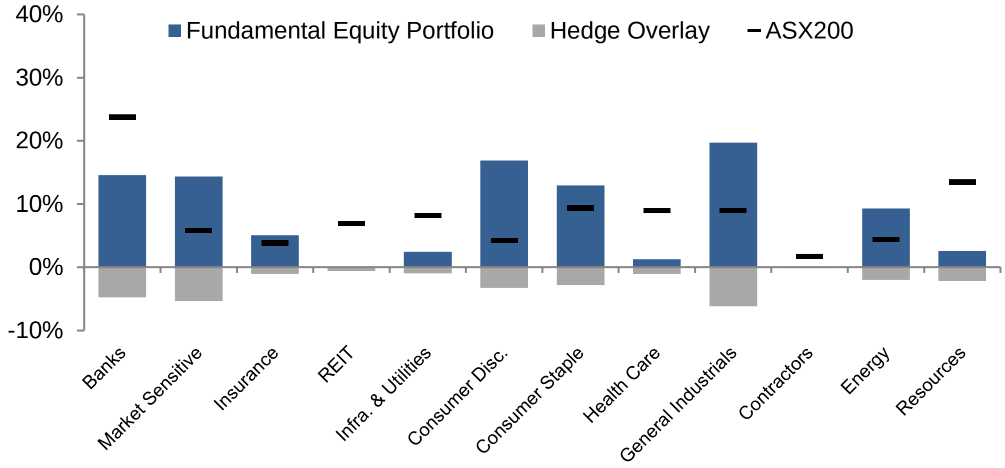
Boral presents good value given cyclical concerns of a residential construction slowdown in Australia and the US. We believe current expectations are overly cautious given US building starts that are still deflated compared to long term demand and leading indicators in Australia that are beginning to turn positive.

Caltex is an integrated oil refining and fuel supply 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 seen refining margins improve, which has yet to be reflected in the market's pricing of Caltex. The company's marketing business continues to struggle with cyclically weaker volumes, and a likely temporary period of price competition as Viva Energy seeks to restore some volumes lost during Coles Express 'out of market' pricing. Ultimately the industry structure remains dominated by vertically integrated companies capable of generating margins throughout their supply chain.

Origin Energy and **Woodside Petroleum** were both increased during the period and now sit in the top ten holdings, a function of a market undervaluing their robust LNG portfolios, and an oil price that is not reflecting the likely decline of non-cash generating unconventional US oil production, coupled with the underinvestment in conventional fields. Further, the risks surrounding Saudi Arabia's facilities amidst growing tensions in the Middle East are not reflected in current pricing.

AMP continues to feature in our portfolio notwithstanding continued concerns about the fallout of the Royal Commission on the company's financial advice businesses. We believe our investment in the company is more than underwritten by value outside the financial advice businesses consisting net asset backing, AMP Bank and AMP Capital Investors (The AMP Valuation Case).

Figure 20: Portfolio exposures by sector (gross weights)



Source: Merlon

The hedge overlay offers material downside protection

At quarter end, the hedge overlay was broadly in-line with the targeted 30% reduction in market exposure while the portfolio remained fully invested in our best value ideas for the purposes of generating franked dividend income. The overlay is structural rather than tactical but does offer protection in the event markets have risen ahead of fundamentals in the short-term.

Figure 21: Portfolio Analytics[iv]

	Fund	ASX200
Number of Equity Positions	33	200
Active Share	77%	0%
Merlon Valuation Upside	19%	-18%
EV / EBITDA	8.2x	12.9x
Price / Earnings Ratio	16.0x	18.7x
Trailing Free Cash Flow Yield	6.1%	4.4%
Distribution Yield (inc. franking)	6.8%	5.2%
Net Equity Exposure	69%	100%

Source: Merlon

September Quarter Portfolio Activity

During the quarter, we introduced three new investments …

We added to our position in **Origin Energy**, and initiated a position in **Woodside Petroleum**, with current oil prices not reflecting the effects of a likely reduction in US unconventional oil production, nor the escalating tensions in the Middle East. Both companies are generating highly attractive cashflows from existing producing assets, while Origin also benefits from a dominant position in east coast electricity and gas markets. While the market remains concerned over government intervention, we are sceptical as to whether any changes to industry structure will occur. We have always valued Origin using lower, long term margins as a function of our focus on valuing sustainable earnings and cash flow.

We invested in **Pendal**, which, had been oversold on concerns over fund outflows, in part an industry feature, yet demonstrated upside relative to its funds under management and historical valuation metrics. The business is highly cash generative and diversified, providing a degree of resilience to any individual product issues.

We re-invested in **BlueScope** which underperformed following its financial report, which indicated post-peak cycle conditions in the US and Australia. Regional steel making spreads had deteriorated to sub-average levels, indicating some level of cyclical upside, while company holds a net cash position of approximately AUD$700m, making the business far more robust than was the cast during the prior cyclical deterioration.

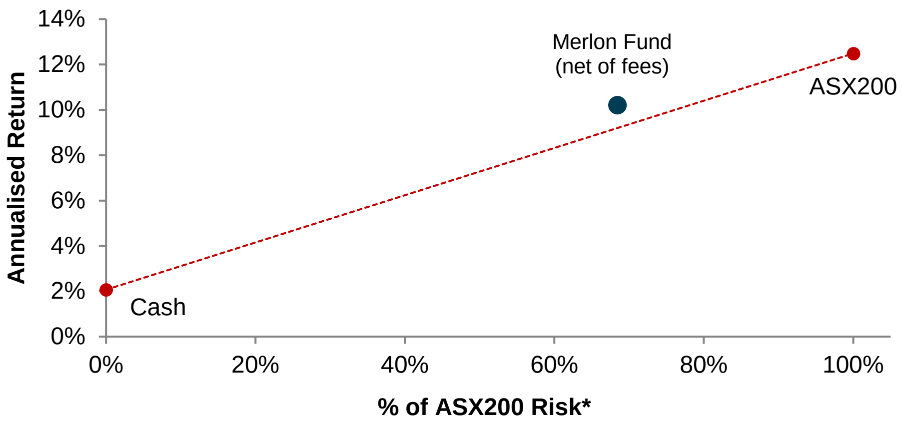
… funded by exiting three positions

These investments were funded by exiting positions in **Seven West Media**, with the market complacent over entrenched rising sports costs, in particular the significant costs associated with televising the upcoming Olympic Games; **JB HiFi**, which had rallied strongly as concerns over consumer spending eased amidst central bank easing, and **SpeedCast,** as we became increasingly concerned over the ability of the company to weather weaker operating conditions across key segments.

Performance[i] (%) (after fees, inc. franking)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	7 Years (p.a.)	10 Years (p.a.)
Fund Total Return	3.8	3.7	3.7	9.2	7.6	8.0	10.2	8.1
70% ASX200 / 30% Bank Bills	1.5	2.1	2.1	10.5	9.9	8.4	9.5	7.8
ASX200	2.0	2.8	2.8	14.1	13.4	11.0	12.5	9.7
Average Daily Exposure	70%	71%	69%	69%	69%	69%	69%	70%
Gross Distribution Yield	0.7	1.9	1.9	7.8	7.4	7.6	7.8	8.9

Past performance is not a reliable indicator of future performance. Total returns above are grossed up for franking credits. Gross Distribution Yield represents the income return of the fund inclusive of franking credits. Portfolio inception date is 30/09/05.

Figure 22: Rolling Seven Year Risk vs. Return (%p.a.)[ii]



Source: Merlon

September Quarter Market & Portfolio Review

The ASX200 posted a 2.8% gain in the quarter…

The ASX200 largely recovered August's selloff in September recording a positive 2.8% return for the quarter. Consumer exposed companies were the best performers, benefitting from the July cut in the Reserve Bank of Australia's official cash rate (and expectations for further reductions) and that the Federal Government's income tax refunds would stimulate retail spending in what has been a challenging environment for retailers.

August saw the ASX200 fall 2.1% with company reporting season disappointing with consensus earnings expectations being downgraded across the market.

with the Fund outperforming by 0.9%…

Against this backdrop the Fund increased in value by 3.7% during the quarter (net of fees and inclusive of franking credits), outperforming by 0.9%.

The hedge overlay detracted 0.4%, which was less than expected, with the momentum based approach of tilting the hedge within the portfolio partly offsetting the structurally lower equity exposure.

The underlying share portfolio outperformed by 1.5% over the quarter. Contributors within the portfolio were broad based with investments in **Coles**, **IOOF**, **Super Retail**,

Woolworths, **Flight Centre**, **QBE Insurance**, **Caltex**, **Harvey Norman** and **JB Hifi** the best performers**.** Having minimal exposure the resource sector also contributed.

Clydesdale, AMP and **Amaysim** were the laggards within the portfolio, having minimal exposure to the **Infrastructure & Utilities** sector and not owning **CSL** also detracted.

Over the last year the Fund has lagged a very strong equity market led by growth stocks, iron ore miners, bond proxies and more recently banks.

As we would expect, given the strong market returns, the hedge overlay detracted 0.7%. However, by actively managing where the hedge positions are allocated within the portfolio the Fund achieved 85% of the share portfolio's return whilst maintaining 69% net equity exposure over the year.

The underlying share portfolio underperformed a market that was led by tech stocks, iron ore miners, bond proxies and more recently banks.

Given our calculated and deliberate positioning away from the tech sector, iron ore miners and many of the bond proxies through the year, the fund's performance was pleasing and was achieved without speculating about new valuation paradigms, the permanency of recent iron ore supply disruptions or the sustainability of negative real interest rates.

Put simply, we continue to regard such speculation to be a highly imprudent use of our clients and our own savings.

Magellan Financial was the best performing holding, with funds under management growth and performance fees surpassing market expectations. **Trade Me** the second best performing holding benefitted from a takeover offer that we believe reflected a fair price for the business, albeit without a material control premium. **Aurizon**, **IOOF, Coles, Woolworths** and **Harvey Norman** also made meaningful contributions over the year.

There were some noteworthy poor performers for the year led by **AMP** primarily as a result of the self inflicted and value destructive sale of the company's life insurance operations. **Seven West Media** (a smaller position which we have now exited) detracted, impacted by weak advertising conditions. **Fletcher Building** was impacted by further losses on construction contracts and the softening housing market. **Caltex** fell during the year on weak refining margins and poor retail results while **Sky TV** (another smaller position, which we have now exited) fell as previously loyal sports subscribers began to cancel their subsciptions.

The last seven years has seen the Fund deliver more than 80% of the market's 12.5% per annum return with a materially lower risk profile. Again, this reflects favourably on underlying stock selection which has outperformed the ASX200 by 1.7% pa. The structurally lower risk profile is demonstrated by the daily average market exposure of 69% and the seven year monthly beta of 0.70.

The additional performance information over the page is presented on a financial year basis and should be read in conjunction with the summary performance table on page 28.

Additional Performance Detail: Sources of Return

FY Performance[i] (%) (inc. franking)	20TD	2019	2018	2017	2016	2015	2014	2013	2012	7 Years (p.a.)
Underlying Share Portfolio	4.4	8.4	7.4	23.5	7.0	9.5	16.3	36.0	-3.4	14.2
Hedge Overlay	-0.4	-0.9	-2.3	-5.6	-0.9	-1.7	-3.5	-9.3	2.6	-3.0
Fund Return (before fees)	3.9	7.5	5.1	17.9	6.1	7.8	12.8	26.7	-0.8	11.2
Fund Return (after fees)	3.7	6.5	4.1	16.8	5.1	6.8	11.8	25.6	-1.8	10.2

FY Performance[i] (%) (before fees, inc. franking)	20TD	2019	2018	2017	2016	2015	2014	2013	2012	7 Years (p.a.)
Underlying Share Portfolio	4.4	8.4	7.4	23.5	7.0	9.5	16.3	36.0	-3.4	14.2
ASX200	2.8	13.2	14.5	15.5	2.2	7.2	18.9	24.3	-5.1	12.5
Excess Return	1.5	-4.8	-7.1	8.0	4.8	2.3	-2.7	11.7	1.7	1.7

FY Performance[i] (%) (after fees)	20TD	2019	2018	2017	2016	2015	2014	2013	2012	7 Years (p.a.)
Income	1.4	5.8	5.5	6.2	5.9	5.6	5.8	7.8	7.6	5.9
Franking	0.5	2.2	1.5	1.6	2.1	1.9	1.7	2.3	2.5	1.8
Growth	1.8	-1.4	-2.8	9.0	-2.9	-0.7	4.3	15.5	-11.9	2.5
Fund Return (after fees)	3.7	6.5	5.1	16.8	5.1	6.8	11.8	25.6	-1.7	10.2

FY Performance[i] (%) (after fees, inc. franking)	20TD	2019	2018	2017	2016	2015	2014	2013	2012	7 Years (p.a.)
Fund Return (after fees)	3.7	6.5	5.1	16.8	5.1	6.8	11.8	25.6	-1.7	10.2
70% ASX200/30% Bank Bills	2.1	9.9	10.6	11.3	2.2	6.0	14.0	17.8	-2.1	9.5
Excess Return	1.6	-3.4	-5.4	5.5	2.9	0.8	-2.2	7.7	0.4	0.8

Monthly Distribution Detail: Cents per Unit

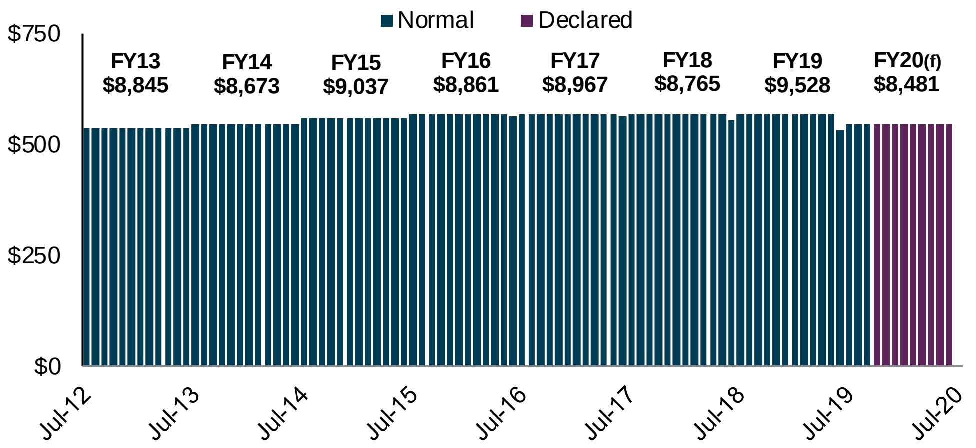
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Total	Franking
FY2013	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.29	**6.79**	2.26
FY2014	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.52	**6.13**	1.98
FY2015	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	**6.24**	2.20
FY2016	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.52	**6.35**	1.92
FY2017	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	**6.36**	2.02
FY2018	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.52	**6.35**	1.84
FY2019	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.50	**6.33**	2.57
FY2020	0.51	0.51	0.51	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	***6.12***	*1.80*

Highlighted data are estimates at the date of this report.

Monthly income will be 0.51 cents per unit at least through to May 2020…

and the franking level is projected to be in the 70-80% range

Figure 18: Monthly Income from $100,000 invested in July 2012[iii]



Source: Merlon, excludes bonus income in FY13

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

Iron Ore: Supply Disruption is Temporary

A Case Study in Poor Capital Allocation

Good Companies not Always Good Investments

The AMP Valuation Case

Fund Details

Fund size	$ 589m	Merlon FUM	$ 1,084m
APIR Code	HBC0011AU	Distribution Frequency	Monthly
ASX Code	MLO02	Minimum Investment	$ 10,000
Inception Date	30 September 2005	Buy / Sell Spread	+/- 0.20%

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"

About the Fund

The Merlon Australian Share Income Fund's investment approach is to construct a portfolio of undervalued companies, based on sustainable free cash flow, whilst using options to overlay downside protection on holdings with poor short-term momentum characteristics. An outcome of the investment style is a higher level of tax-effective income, paid monthly, along with the potential for capital growth over the medium-term.

Differentiating Features of the Fund

- **Deep fundamental research** with a track record of outperformance. This is where we spend the vast majority of our time and ultimately how we expect to deliver superior risk-adjusted returns for investors.

- **Portfolio diversification** with no reference to index weights. The benchmark unaware approach to portfolio construction is a key structural feature, especially given the concentrated nature of the ASX200 index.

- **Downside protection** through fundamental research and the hedge overlay. In addition to placing a heavy emphasis on capital preservation through our fundamental research, we use derivatives to reduce the Fund's market exposure and risk by 30% whilst still retaining all of the dividends and franking credits from the portfolio.

- **Sustainable income**, paid monthly and majority franked. As the Fund's name suggests, sustainable above-market income is a key objective but it is an outcome of our investment approach.

Footnotes

[i] **Performance (%)**

Average Daily Market Exposure is calculated as the daily net market exposure divided by the average net asset value of the Fund.

Composite benchmark is calculated as 70% S&P/ASX200 Accumulation Index and 30% Bloomberg AusBond Bank Bills Index. The Fund reduces exposure to share market volatility to a typical range of 60-80% through the use of derivatives with the remaining 20-40% option protection seeking to deliver a cash-like risk/return profile.

Fund Franking : Month 0.2%, Qtr 0.5%, FYTD 0.5%, Year 1.9%, 3 Years 1.7% p.a., 5 Years 1.8% p.a., 7 Years 1.8% p.a., 10 Years 2.1% p.a.

ASX200 Franking: Month 0.2%, Qtr 0.5%, FYTD 0.5%, Year 1.7%, 3 Years 1.5% p.a., 5 Years 1.5% p.a., 7 Years 1.5% p.a.,10 Years 1.5% p.a.

[ii] **Rolling Seven Year Performance History**

Past performance is not a reliable indicator of future performance. Returns for the Fund and ASX200 grossed up for accrued franking credits and the Fund return is stated after fees as at the date of this report, assumes distributions are reinvested.

% of ASX200 Risk represents the Fund's statistical beta relative to the ASX200

[iii] **Monthly Income from $100,000 invested in July 2012**

Past performance is not a reliable indicator of future performance. Income returns exclude 'bonus income' from above-normal hedging gains of $849 in FY13 and assume no bonus income in FY18 estimate. Income includes franking credits of; $2,420 (FY13), $2,120 (FY14), $2,356 (FY15), $2,057 (FY16), $2,159 (FY17), $1,966 (FY18), $2,752 (FY19) and $1,927 (FY20 estimate).

[iv] **Portfolio Analytics**

Source: Merlon, Active share is the sum of the absolute value of the differences of the weight of each holding in the portfolio versus the benchmark, and dividing by two. It is essentially stating how different the portfolio is from the benchmark. Net equity exposure represents the Fund's net equity exposure after cash holding's and hedging Beta measures the volatility of the fund compared with the market as a whole. EV / EBITDA equals a company's enterprise value (value of both equity and debt) divided by earnings before interest, tax, depreciation, and amortization, a commonly used valuation ratio that allows for comparisons without the effects of debt and taxation.