MERLON

CAPITAL PARTNERS

Merlon Concentrated Value Strategy

Quarterly Report

September 2020

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Analyst:
Ben Goodwin

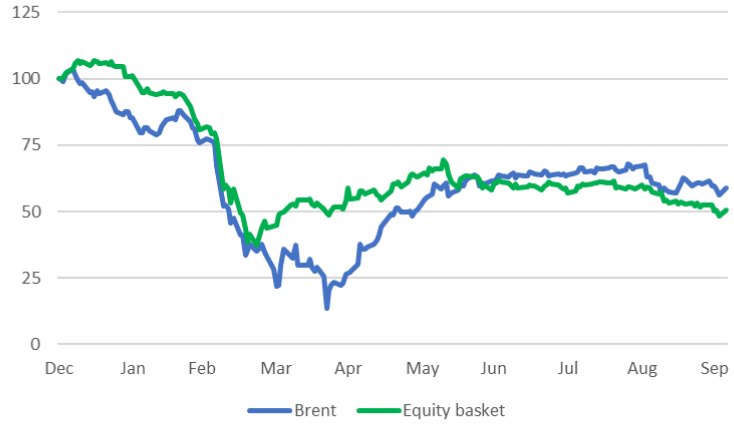
Oil – Pricing in More Realistic Recovery

Oil remains in a holding pattern between USD40-45/bbl as the 7.7mbpd OPEC+ supply reductions balance demand, which is currently ~10% below pre-COVID levels. In comparison, oil exposed equities are currently 40-50% lower than pre-COVID levels. Should a vaccine be developed, an outcome we consider likely, then we would expect to see a normalisation of demand, implying equities return to pre-COVID levels. Should the current cuts to capex result in a decline in supply, then we would expect to see prices rise above pre-COVID levels.

We explore the outlook for oil and related equities in this paper, with the key points being:

1. The recovery in **demand** has continued cautiously, despite second waves, with a normalisation of demand considered likely in the event of a successful vaccine.
2. Prices have been supported in the current demand environment by **OPEC+ discipline**
3. The longer oil remains below USD50/bbl, the larger the **supply impact** from the US is likely to be, given rig counts at historic lows and a high decline rates.
4. Any reduction in US supply is likely to be exacerbated following years of **underinvestment** outside the US, as the US growth disincentivised investment elsewhere.
5. **Oil-exposed equities** are trading at levels roughly half of pre-COVID levels – we believe it is increasingly likely they will ultimately trade at levels above these levels for the above reasons.

Figure 1: Oil and equity indices



Data source: Apple Mobility Trends / Flight Radar 24. Calculations: Merlon Capital. October 2020.

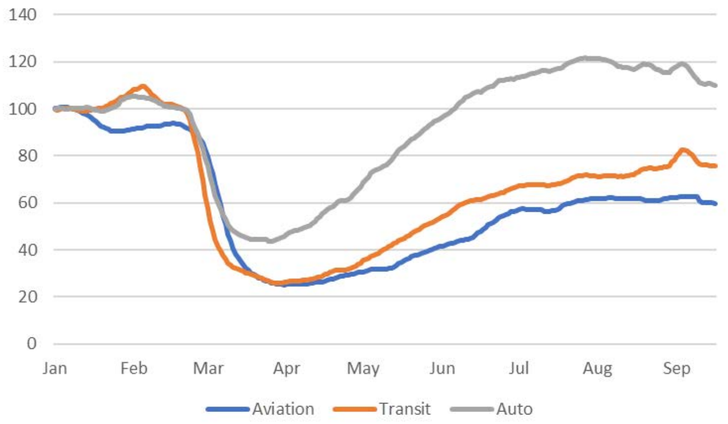
As written by Fama and French in 2015, investment at the firm level is inversely correlated with future returns. We believe this is a function of low returns driving capital out of a company / industry, driving low investment and in turn reduced supply, thereby increasing future returns. We believe the oil market, and associated equities, is no different.

Demand recovery is underway, albeit slower than expected

1. Demand recovery – auto lags, diesel steady, jet lags

Following the trough in demand experienced in April, roughly 25% below normal levels, we have seen a recovery back to less than 10% below normal. While social-distancing has seen a marked reduction in public transport usage, this has been offset by personal auto usage, enabling 'socially-distanced transport'. This leaves aviation as the major source of oil demand decline still evident. A recovery in this sector will be largely vaccine dependent.

Figure 2: Activity indices CYTD

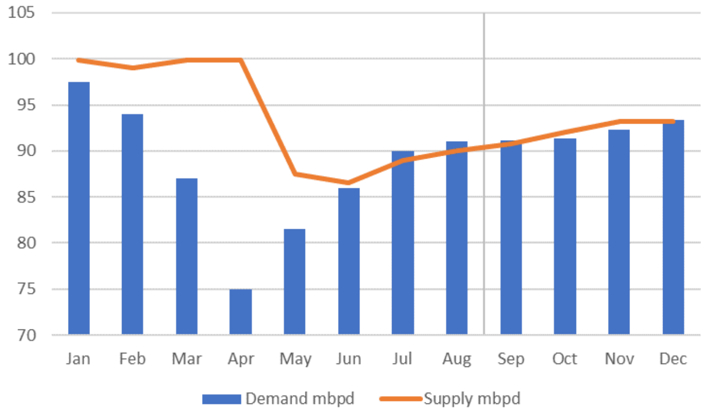


Data source: Apple Mobility Trends / Flight Radar 24. Calculations: Merlon Capital. October 2020.

2. Supply discipline – OPEC+ steadies the market

While demand troughed in April, supply took an additional month to be fully implemented, driven largely by the efforts of the OPEC+ cartel. The increase in supply that has followed this trough has come predominantly from the OPEC+ agreement loosening, which saw an additional 2mbpd added to supply. These efforts have seen the supply / demand balance largely restored, albeit not at a level sufficient to drain the ~1.3 billion barrels of oil stockpiles built during the crisis.

Figure 3: Oil Production Evolution – 2016 Crisis Response to COVID-19



Source: Rystad Energy. Calculations: Merlon Capital, October 2020.

High inventories may cap prices in the short-term

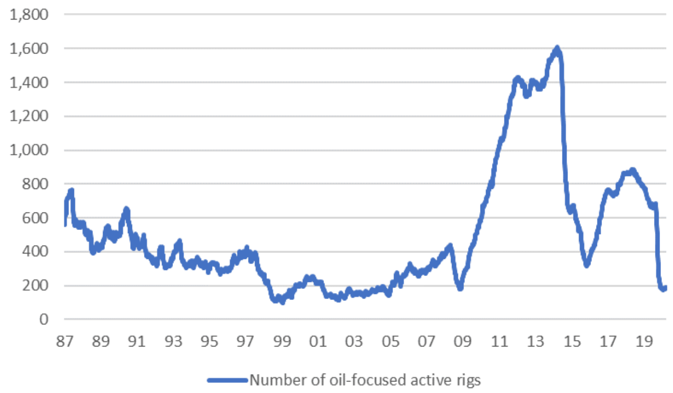
Given the market has been stabilised, notwithstanding any outsized 'second-wave' effects, the focus is to work off inventories, which stand at more than three-times 2014-16 levels. We expect the OPEC+ production agreement will be extended, albeit not at a level that would see prices rally quickly enough to re-incentivise US onshore production (see below).

3. Unconventional: shale's excessive decline rates may finally be revealed

US Shale decline rates could soon be exposed

The market share of US oil and associated liquids production has risen from 8% to 17%, driven by aggressive horizontal drilling and fracking across onshore fields. Yet this activity, while delivering stellar growth in production, has always lost cash as an industry – a function of the high decline rates in the sector. To date, these decline rates have been hidden behind growth in drilling activity, combined with concentration on higher grade deposits. Yet at current prices, there is little incentive to drill, with a survey by the Dallas Federal Reserve showing 1% of producers looking to increase drilling activities from current low levels at today's prices, and only 10% should prices reach USD50/bbl. This price-disincentive has seen the rig count plummet. Perhaps more importantly, while the intention to drill may grow on higher prices, access to capital may be limited, with the negative oil prices seen in early 2020 still fresh in the minds of financiers.

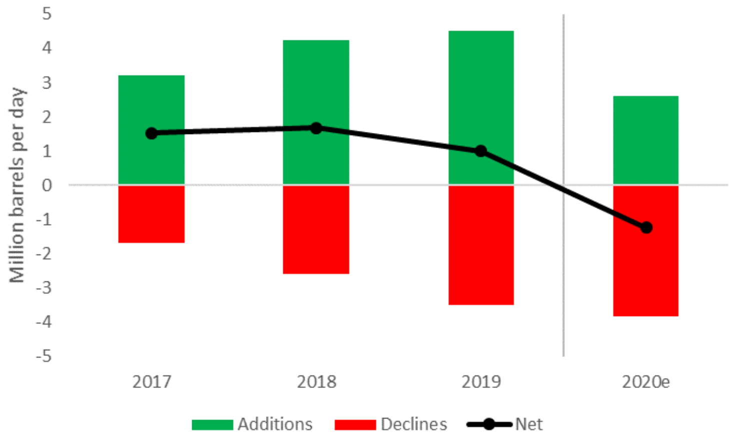
Figure 4: US shale patch – decline rates to be exposed by lack of activity



Source: Baker Hughes. Calculations: Merlon Capital, October 2020.

Yet, the US needs significantly more activity to at least offset declines (ie to maintain production). Rystad Energy estimates the need for an additional 100+ rigs just to avert declines. While small in the context of prior peaks in activity, it represents a greater than 50% increase from current levels, where current pricing is only incentivising 1% of producers to invest.

Figure 5: US shale patch – decline rates to be exposed by lack of activity



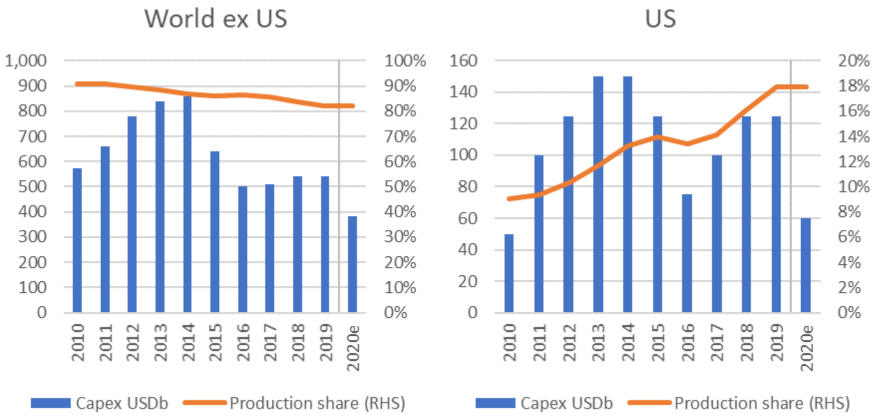
Source: Rystad Energy. Calculations: Merlon Capital, October 2020.

4. Conventional: from underinvestment, to disinvestment and energy pivots

Prices could overshoot on the upside when demand recovers

Investment in conventional oil supply, which still accounts more than 80% of total supply, has suffered from a period of underinvestment. Capital expenditure from 2015 to 2019 was roughly 25% below that of the prior five-year period. With 2020 investment likely to be significantly below these already-low levels, the effects of this underinvestment is increasingly likely to worsen. Combined with subdued US volumes, this underinvestment could further limit any supply response to higher prices, with the potential for sharply higher prices as demand recovers.

Figure 6: Conventional oil – crowded out



Source: Rystad Energy. Calculations: Merlon Capital, October 2020.

5. Equities: Upside from demand recovery enhanced by supply constraints

Merlon process: At Merlon, our process is aimed at ensuring we minimise our exposure behavioural biases and exploit misperceptions about risk and future growth prospects.

Commodity stocks are a good illustration of Merlon's process …

The first step in our process is determining sustainable free cash-flow. Commodity exposed stocks generally fare poorly in terms of undifferentiated product, high capital intensity and pro-cyclical capital allocation. However, opportunities can arise when commodity prices are low, and industry investment is also low, as supply ultimately tightens and prices normalise.

The second step is to determine an unbiased and consistent measure of value based on sustainable free cash flow and franking, net of debt. This allows us to determine whether other investors have become too concerned (or complacent) about risks and growth.

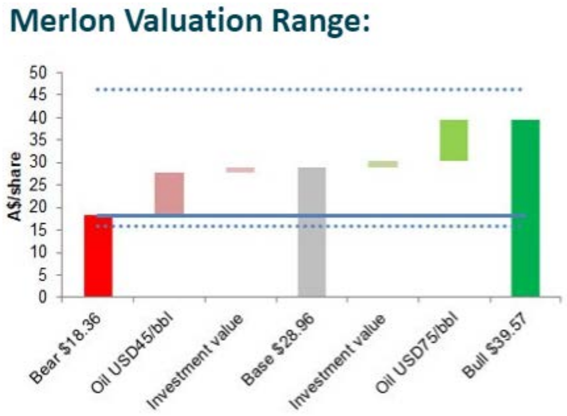
We then set conviction, which recognises that to be a good investment, we need evidence the market's concerns are either priced in or invalid. One way we determine whether the market is overly pessimistic is to produce valuation scenarios focused on the risk of permanent capital loss (bear case) relative to the upside scenario (bull case).

Oil is pricing in a more subdued recovery, offering downside protection relative to the broader market

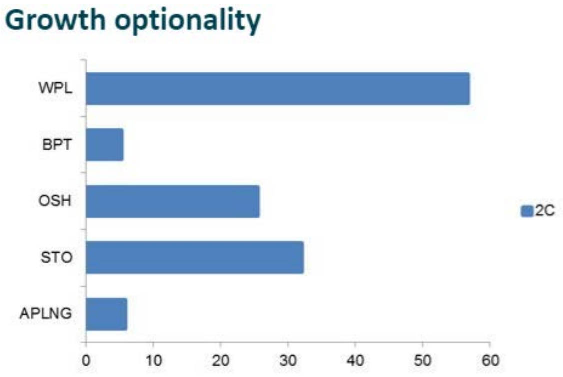
Merlon positioning: We hold upstream positions in **Woodside Petroleum**, **Origin Energy** and **Oil Search**, established based on an expected tightening of global oil markets over the medium term. The current price environment is pressuring the conventional and unconventional oil and gas businesses, leading to lower investment in future supply. We expect this, in conjunction with a vaccine-led normalisation of demand, to lead to higher prices for oil and gas.

Even if we are wrong and oil prices do not recover to the extent we expect, we see the downside in these names as limited given their low cost of production and improved balance sheets. As such, the risk / reward is skewed to the upside. We also hold downstream positions in **Ampol** and **Viva Energy**, based on a favourable industry structure, and upside to refining margins given historic cyclicality of this industry.

Company overview: Woodside Petroleum (WPL) is the leading Australian LNG producer, with significant Western Australia-based conventional oil and gas operations. The company has generated strong cash-flows since the commissioning of Pluto in 2012. The company has significant growth potential, as evidenced by its undeveloped reserve position, via key projects such as Browse and Scarborough, in anticipation of continued growth in demand for cleaner gas fuels, as well as its conventional oil Sangomar field in Senegal.



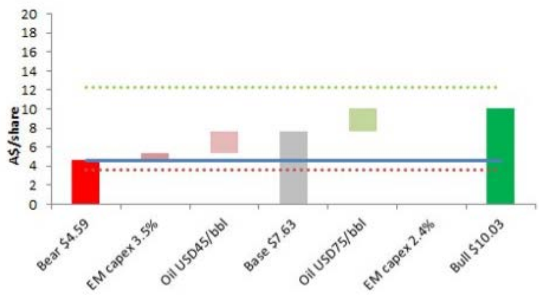
Valuation & market reasoning: We value Woodside at AUD29.96 per share, within a range of AUD18-40/share, based on its sustainable free cash flow under a range of scenarios. The company has underperformed due to concerns over its declining production profile, coupled with the demand interruption driven by COVID-19. At USD42 spot oil, WPL is cash-flow positive, yielding 4%, rising to 11% should oil demand recover, and 18% if supply declines. Our bull case reflects under-investment outside of the US and ironically becomes more likely the longer prices stay low. On this basis the risk/reward skew is very favourable even if oil prices drift lower in the short-term.



Merlon view: We believe the market is underappreciating the long dated value of its growth optionality in light of recent acceleration in China’s pollution-driven demand for gas fired generation, coupled with an expected long term crude oil price, which forms the basis of its LNG contract pricing, being supported at USD60-70/bbl. We see upside to this price from a phase of underinvestment in conventional oil and gas globally, and more recently across US unconventional oil and gas activity.

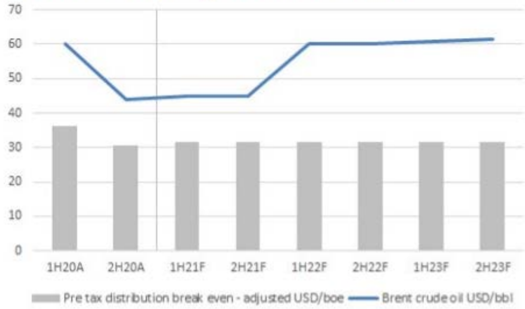
Company and quality overview: Origin Energy (ORG) is the leading Australian east coast energy retailer, with four million customers, supported by upstream coal and gas generation, as well as owned and contracted renewables generation. The company has been operating its LNG facility on Curtis Island (QLD) since 2016, having received more than $2.3b in distributions, and which is expected to contribute further significant cash flows as oil prices normalise.

Merlon Valuation Range:



Valuation & market reasoning: We value ORG at $7.63 per share, within a range of $4.50-$10 per share, based on its sustainable free cash flow under a range of sensible scenarios. Currently trading at the bottom of this range, the market is concerned about low near-term oil prices due to COVID demand impacts and long-term headwinds for oil demand. The market is also concerned about low electricity prices, a function of renewables growth as well as the pandemic, as well as some loss of market share as the company sought to maintain margins .

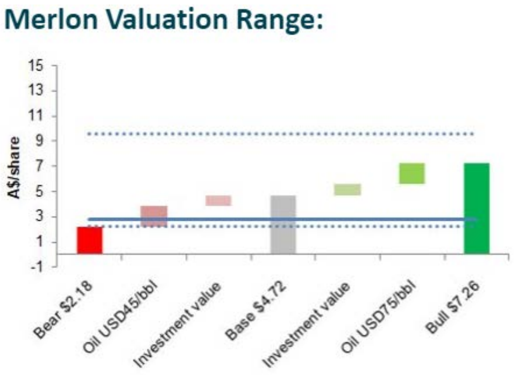
APLNG – a cash generative asset



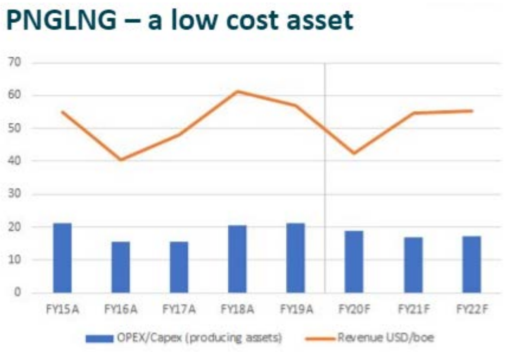
Merlon view: The market is attributing minimal value to APLNG despite the significant cash distributions it provides Origin under a normal oil price environment, and despite the cash generative nature of its dominant east coast energy markets business. We believe there is upside risks to our central case, as the longer oil prices remain at current levels, the longer US oil and gas rigs will remain at historic lows, and hence, the greater the impact on future oil supply. Similarly, current electricity prices, coupled with energy policy uncertainty, threaten private sector investment in generation, and hence risk a tighter future market.

Oil Search

Company and quality overview: Oil Search (OSH), in partnership with ExxonMobil, is the leading Papua New Guinea LNG producer. The company has generated nearly USD2b in free cash-flow since the commissioning of its large-scale conventional gas and condensate PNGLNG project in 2015. The company has large growth opportunities both within PNG and Alaska, in order to take advantage of a shift toward less carbon-intensive sources of electricity generation.



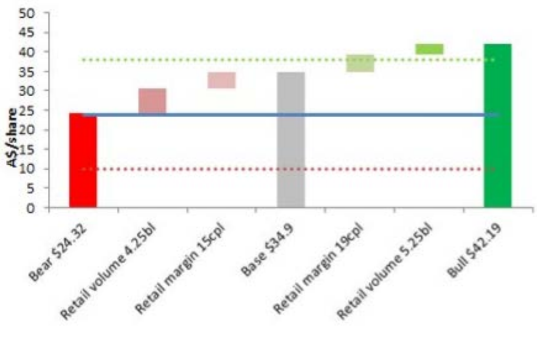
Valuation & market reasoning: We value OSH at AUD4.72/share, within a range of AUD2.18-7.26 per share, based on its sustainable free cash flow under a range of scenarios. The stock is trading towards the bottom end of this range, with the market concerned about the impact of COVID on near-term oil prices (via weak demand) and political uncertainty in PNG. OSH also has reasonably elevated debt, despite raising capital earlier in the year.



Merlon view: Lower oil prices in the short-term typically lead to deferred investment in production capacity, resulting in a decline in supply, and price normalisation. We see upside to this price from a phase of underinvestment in conventional oil and gas globally, and more recently across US unconventional oil and gas activity. At current oil prices, OSH continues to generate positive cash-flows, as at USD21/boe, OSH costs are highly competitive.

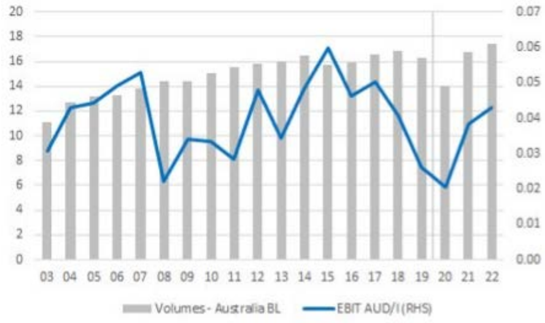
Company and quality overview: Ampol (ALD) is the leading Australian supplier of petrol and diesel product. The company has a sizeable commercial business, accounting for 50% of total volumes, combined with a one-third retail market share position, via 700 company owned and operated sites, and supply agreements to non-owned Ampol-branded sites. The industry structure is highly favourable with the top three operators supplying or retailing more than 80% of total volumes. Over time, the company has reduced its exposure to the more capital-intensive refining segment, focusing on its marketing division, with an integrated cash return on invested capital above 10%.

Merlon valuation range:



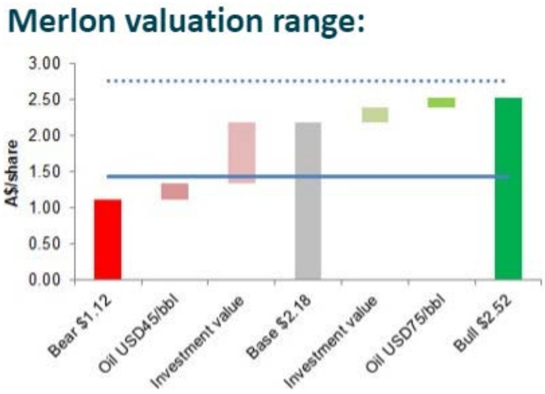
Valuation & market reasoning: We value Ampol at between $25 and $42 per share ($35 central case), with the stock currently trading towards the bottom of this range as the market is concerned about the impact of COVID on retail volumes, longer term declining fuel volumes (including the effect of electric vehicles), the sustainability of premium fuel margins, the ability to extract value from convenience sites, and weak refining margins.

Margin cyclicality

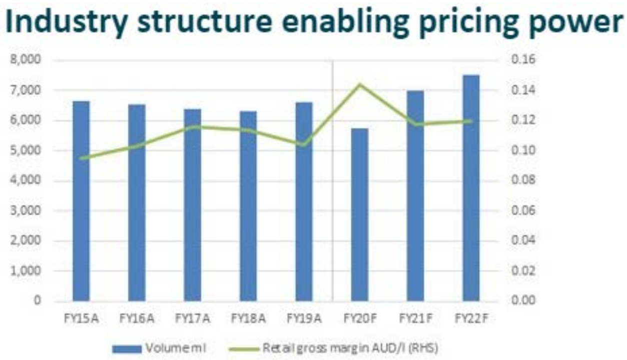


Merlon view: ALD is trading at nearly 50% below our central case. We believe historically cyclical refining margins, currently 40% below mid-cycle, will revert to normal levels. More importantly, the industry structure has enabled retail fuel margins more than offset COVID driven volume declines (1H20 retail EBIT was higher than pre-COVID levels). Further, we believe the market is not factoring in the growth in premium fuels consumption, the recently announced Woolworth’s Metro-branded and supplied convenience strategy, or the company's superior infrastructure position and regional sourcing scale.

Company and quality overview: Viva Energy (VEA) is a large-scale Australian supplier of petrol and diesel product. The company has an attractive retail model, with Coles Express operating the shop, and Viva retaining control over retail pricing and margins. Viva also has a large commercial business, accounting for 45% of total volumes, combined with a 20% retail market share position. The industry structure is highly favourable with the top three operators supplying or retailing more than 80% of total volumes.



Valuation & market reasoning: We value Viva at AUD2.21/share, within a range of AUD1.12 per share to AUD2.52 per share, based on its sustainable free cash flow under a range of scenarios. The stock is currently trad ing towards the bottom of this range as the market is concerned about the impact of COVID on retail volumes, longer term declining fuel volumes (including the effect of electric vehicles), and the sustainability of premium fuel margins.



Merlon view: VEA is trading roughly 50% below our central case. We believe historically cyclical refining margins, currently 40% below mid-cycle, will revert to normal levels. More importantly, the industry structure has enabled retail fuel margins more than offset COVID driven volume declines (1H20 retail EBIT was higher than pre-COVID levels). Further, we believe the market is not fac toring in the value of its retail model, nor the latent value of its physical asset base (including the property value of its Gore Bay terminal in harbour-front Sydney, should this be converted).

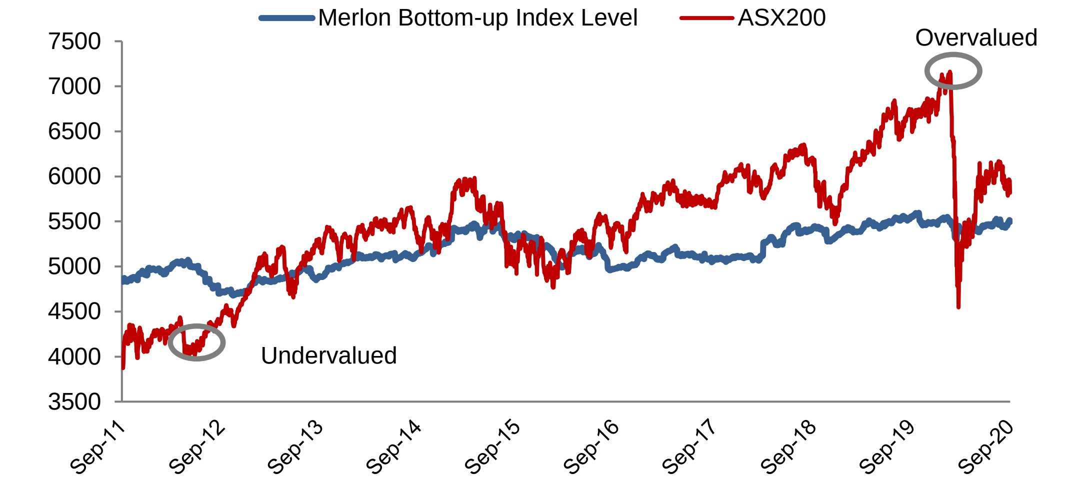
Market Outlook and Portfolio Positioning

Neil Margolis

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 154 stocks we actively cover. On this basis the market appears approximately 7% overvalued after tracking sideways during the quarter.

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

Figure 7: 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 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.

We always maintain a long-term view. In that respect, as we indicated in our last quarterly update, we remain optimistic that at some point there will be a vaccine, herd immunity will develop, and ordinary life will bounce back. The market has rallied hard off the March lows at least in-part reflecting this situation.

The global economy is unlikely to operate anywhere near pre-crisis levels for some time…

But we continue to think that a distributed vaccine and/or herd immunity is at least 12 months away and in the interim it is difficult to envisage the global economy will operate at anywhere near pre-crisis levels. The politics of the crisis are emerging as a potentially more powerful force than the virus itself.

The risks directly associated with the Covid-19 crisis are being manifested by secondary impacts such as political tensions with China, the US electoral cycle and the potential for social unrest. All these issues were bubbling below the surface prior to the crisis but have become more pertinent in recent months. None of these are good for global economic growth and all point to further fiscal and monetary stimulus as well as a more volatile and more extended recovery path.

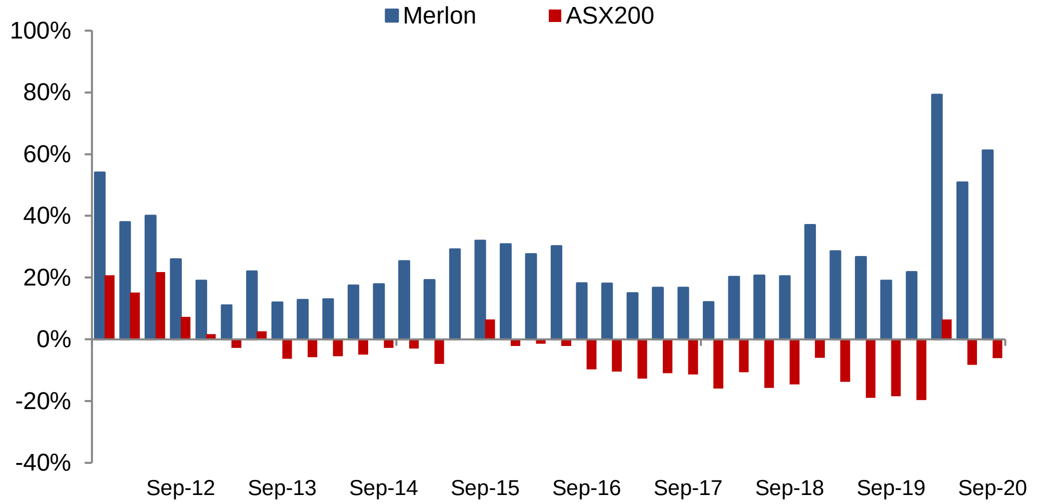
We continue to stress test all our investments against this backdrop. Some companies will face severe balance sheet strain for extended periods of time (for example the travel related businesses, cafes & restaurants and banks) while others face the prospect of permanent changes in the way they operate (for example real estate owners).

The risk of permanent loss is mitigated by owning undervalued assets…

Our view is that the risk of permanent loss through the current crisis is mitigated by owning undervalued assets. This is not to say that undervalued assets cannot fall more than expensive assets over short periods of time. Rather, our emphasis is stress testing our investments to ensure we deliver good returns relative to the risk of permanent loss.

The Merlon portfolio continues to offer truly exceptional expected returns…

Figure 8: Expected return based on Merlon valuations



Source: Merlon

The short-term outlook is difficult to predict…

Our expectation of a volatile and more extended recovery path than initially envisaged, combined with the rapid pace of the market recovery has led us to reposition the portfolio towards affected industries and cyclical businesses a little more slowly than might have otherwise been the case.

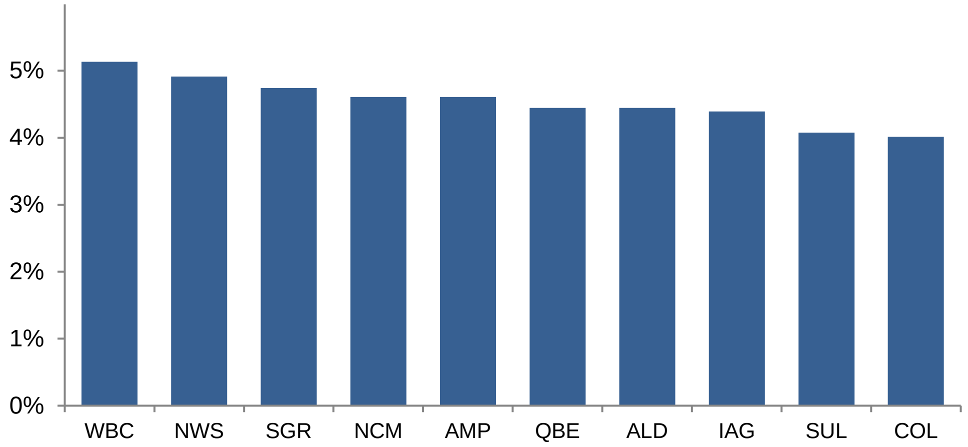
We expect the environment over the next year or so will continue to present wonderful investment opportunities for investors with long-term horizons, who are prepared to look through short term noise and who are comfortable having unpopular views.

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

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 9: 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 management manipulated measures of corporate financial performance instead of cash flow continue to present us with opportunities.

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. While they appear undervalued in a rapid economic recovery scenario, the upside in less leveraged industrials is similar without the tail risk that comes with a protracted economic downturn. However, we added to **Westpac** during the quarter and it now appears in our top 10 holdings. The bank offers material upside in a vaccine-led recovery with less downside than the other banks in a deeper recession given its high-returning retail business mix (similar to CBA) and very low market expectations on account of money laundering breaches and management turnover.

Newscorp remains a significant position in the fund. This is a stock plagued with concerns around governance, the structural decline in print media and competition in the subscription video market from Netflix, Stan and Amazon (among others). All these concerns are valid in our view but need to be weighed up against a share price that assigns minimal value to any of the affected businesses.

Star Entertainment is cheap as a result of market concerns about COVID impacting VIP and main floor customers, competition from the soon-to-open Crown Sydney and debt levels. Earnings expectations are low, with FY22 estimates 20% below pre-COVID levels, yet we expect earnings will ultimately recover on a COVID vaccine. In a protracted downturn, the company has high quality property asset backing to tilt risk/reward firmly to the upside.

Newcrest Mining now features as a significant position in our portfolio. Newcrest is one of the world's largest gold mining companies. Against the backdrop of a more extended volatile and extended recovery period coupled with further monetary and fiscal stimulus we believe the risk bias in the gold price is firmly to the upside. Newcrest continues to generate strong cash flow in the interim.

Post completion of the life transaction and other announced transactions, **AMP** has net tangible assets (mainly cash) of $3.5b against a market cap of $4.8b. For the $1.3b capital at risk, investors own a growing fund manager, AMP Capital, with $190b FUM (including $60b in "real assets"), a high returning bank ($20b in mortgages and $17b deposits), a NZ wealth business ($40m earnings), a $120b platform administration business and a loss-making advisor servicing business net of corporate costs that might break-even if cost-out targets are achieved.

QBE Insurance Group has seen a significant retracement of unrealised investment losses incurred during the early part of the Covid-19 Crisis leaving the business extraordinarily well capitalised coming into an environment of historically strong premium inflation in its core markets.

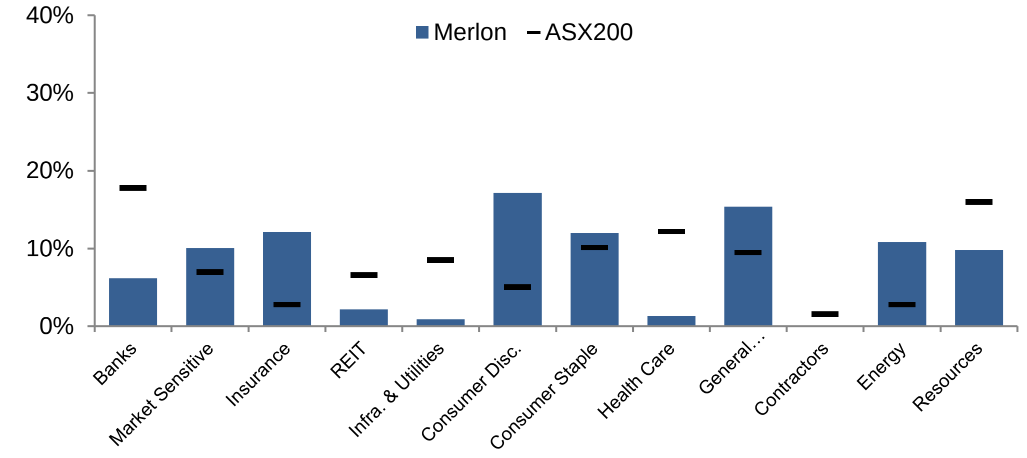
Ampol (formerly Caltex) is an integrated oil refining and fuel supply and marketing company, operating in a strong and improved industry structure dominated by vertically integrated companies capable of generating margins throughout their supply chain. Volumes are clearly impacted by COVID-19 related disruptions but the company is in a strong position to gain share with downside risk mitigated by hard property assets. We also think the take-over offer has a reasonable chance of being reinstated, with the release of franking credits, even if at a reduced headline price.

IAG is expected to recover margins following a difficult FY20, supported by a market leadership position in a good industry structure anticipated to drive growth in insurance premiums. While IAG's underlying business is strong, FY20 earnings were impacted by the effect of COVID-19 on investment earnings across both equity and credit markets.

Super Retail is Australia's leading auto, sporting and leisure goods retailer. The pandemic has provided an unexpected tailwind to all three segments but underlying market positions are strong in all segments with the online business (including click and collect) well placed to compete with pure play online competitors.

Coles remains attractively priced relative to other "defensive" sectors that are included in the "bond proxy" group. Coles and Woolworths operate under an umbrella of a sound industry structure (Kaufland exit this year is further evidence of this), provide long term inflation protection, have minimal debt and are generating margins below historic levels.

Figure 10: Portfolio exposures by sector (gross weights)



Source: Merlon

Figure 11: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	34	200
Active Share	85%	0%
Merlon Valuation Upside	62%	-6%
EV / EBITDA	8.3x	14.9x
Price / Earnings Ratio	18.7x	20.4x
Price / Book Ratio	1.9x	4.7x
Trailing Free Cash Flow Yield	7.3%	4.4%

Source: Merlon

September Quarter Portfolio Activity

There was minimal activity during the quarter.

Activity was light during the quarter with no new material positions. We added to the existing position in **IAG**, offering more upside without the banking downside risk of **Suncorp**, which we exited. We added to existing holdings in **Westpac**, **Alumina** and **Star Entertainment Group**, funded by reducing holdings in **Bapcor, Harvey Norman** and **Woolworths**, which outperformed. We switched our holding from **Pendal** into **IOOF** which now has a market capitalisation of $2.1b compared to $1.6b the day before the $1.4b MLC acquisition was announced. We agree integrating MLC will be very challenging but advertised synergies of $150m offers plenty headroom to compensate for the risk in our view.

Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	10 Years (p.a.)
Portfolio Return (inc. franking)	-5.8	-3.9	-3.9	-16.4	0.5	7.2	8.5
ASX200 Return (inc. franking)	-3.5	-0.1	-0.1	-9.2	6.2	8.7	8.4
Excess Return*	**-2.3**	**-3.8**	**-3.8**	**-7.3**	**-5.7**	**-1.5**	**0.1**

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

September Quarter Market & Portfolio Review

The ASX200 was flat although banks, insurers and energy stocks had a torrid time

The ASX200 index ended flat during a volatile quarter and behind the majority of other global share markets, which rallied on growing optimism of a vaccine and some better than expected economic readings. The Australian market lagged on account of a lower weighting of technology stocks, and higher weightings towards energy and financials. Continued monetary easing globally – in response to COVID - saw gold rise from USD1,770/oz to USD1,883/oz, albeit down from its intra-period highs above USD2,000/oz, as US treasury yields rose from 66 to 69 basis points – a small rise, but seen as a potential yield base. From the demand perspective impact of COVID, we saw oil largely flat over the quarter, perhaps most importantly from the equity market's short-term focus, was its representing a plateau following its 57% rally in the prior quarter. Iron ore continued to rally, as COVID-driven Brazilian supply weakness combined with a manufacturing-driven China recovery to rise to finish the quarter just below USD120/t. Australian house prices edged only 2% lower while the currency rallied 4%.

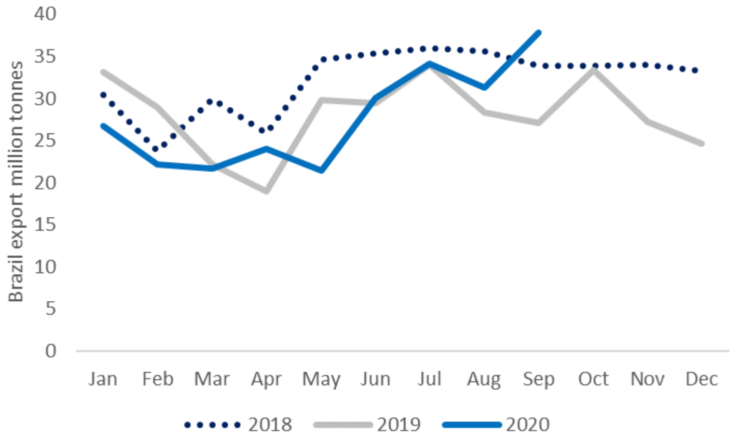
Similar to the June quarter, the best performing equity sectors over the quarter were Technology and Consumer Discretionary, while Real Estate also outperformed. Conversely, Energy reversed some of its June gains, while Utilities and Financials also declined. For some time, lower rates have disproportionately benefitted the multiples of growth stocks.

… with the portfolio underperforming by 3.8% over the quarter …

Against this backdrop the portfolio declined by 3.9% in the quarter (including franking), underperforming the market by 3.8%. Similar to the June quarter, being non-benchmark assisted performance (principally not being compelled to own banks), with the average company outperforming the cap weighted index. Consumer discretionary exposures **Super Retail**, **Harvey Norman**, **News Corporation**, **Nick Scali**, **oOH! Media**, **Star Entertainment Group** and **Bapcor** all featured in the top 10 positive contributors over the quarter as did **Boral**, **Virtus Health** and not owning **Commonwealth Bank**. **Unibail Rodamco-Westfield** was the biggest detractor, on debt concerns, followed by **AMP**, after a tone deaf management appointment and disappointing capital return. **Ampol** (formerly Caltex), **Origin Energy** and **Woodside** reversed some of the June quarter's strong performance, as the market become concerned with second-wave effects on the oil demand recovery story, most evident in the case of Ampol with Melbourne's second lockdown. Other detractors included non-bank financials **IAG**, **IOOF**, **NIB Insurance** as well as not owning **Fortescue Metals**.

In the case of oil-exposed names including Oil Search, Woodside and Origin Energy, as well as other downstream oil-exposed names including Ampol and Viva Energy, we expect the successful development of an effective vaccine would drive a normalisation of demand and, in turn, oil prices. We further expect the significant reduction in capex across the industry to risk future supply tightness and a possible over-shooting of prices. We elaborate on this further in our quarterly insights. In contrast, we expect Vale's dam-failure and COVID-disrupted supply to normalise, with iron ore prices to follow, having remained elevated above normal levels throughout this period. To this end, we have seen Brazil exports above pre-disrupted 2018 levels for the first time since early 2019. If this is sustained, we would expect iron ore prices to begin their reversion.

Figure 11: Monthly iron ore exports - Brazil

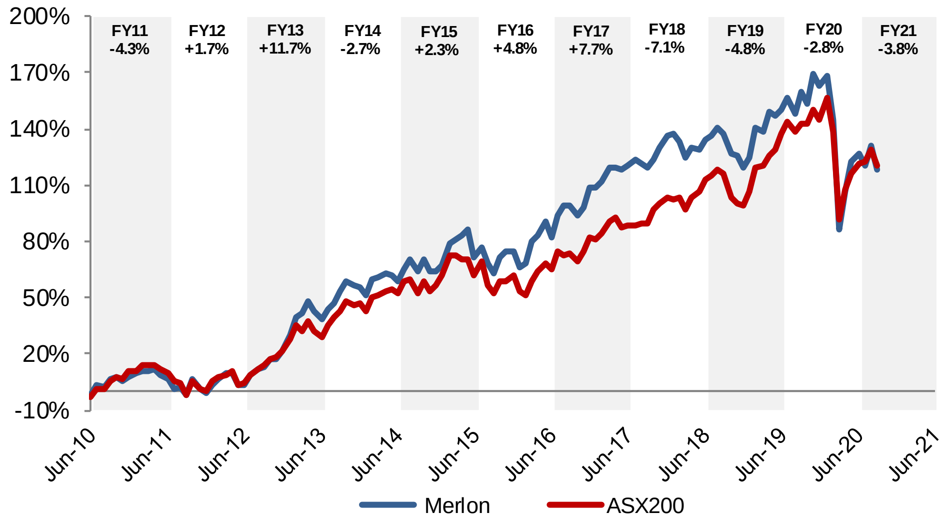


Source: UBS

The portfolio's **non-benchmark value and contrarian style** has been a headwind over the past few years and in the initial stages of the COVID-19 downturn. Investors have gravitated towards large capitalisation quality and growth stocks, even more so as interest rates have approached zero. This has only served to increase our resolve and belief in taking a long-term view based on sustainable free cash flow combined with low market expectations. As we documented in our roadmap, we are focused on the risk of permanent loss and mitigate this by taking a long-term view, focusing on owning undervalued assets and fully deducting debt in developing our investment case. At the same time, the opportunity for meaningful absolute and relative performance is significant.

Over the past ten years, the portfolio has outperformed by 0.1% per annum, below our target but with most of the underperformance in the past 3 years for the reasons outlined above.

Figure 12: Cumulative Returns since inception



Source: Merlon, returns stated before fees and inclusive of franking credits

Strategy FUM	Merlon FUM
$892m	$895m

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

Long-term Dividend Opportunity the Main Game

Oil - Pricing in More Realistic Recovery

COVID-19 Roadmap

Trade war – winners, losers and…is it over?

Good Companies not Always Good Investments

Housing Cracks Present Material Opportunities

Iron Ore: Supply Disruption is Temporary

Trade Wars and the Peak of the Chinese Growth Model

Rethinking Post Retirement Asset Allocation

Some Thoughts on Asset Prices

Value Investing - An Australian Perspective: Part III

Value Investing - An Australian Perspective: Part II

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The AMP Valuation Case

A Case Study in Poor Capital Allocation

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Some More Thoughts on Telstra

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Digital vs. Traditional Media - A Global Trend

Oil: The Cycle Continues

Telstra Revisited

The Case for Fairfax Media Over REA Group

Amazon Not Introducing Internet to Australia

Boral's High Priced Acquisition of Headwaters

Footnotes

[i] **Performance (%)**
Past performance is not a reliable indicator of future performance.
Strategy inception date for performance calculations is 31 May 2010.
Portfolio Total Return and S&P/ASX200 Accumulation Index Total Return stated before fees and grossed up for franking credits.
For the purposes of measuring total return, franking credits are calculated as franking credits accrued divided by the average daily NAV for the portfolio and benchmark.

[ii] **Portfolio Analytics**
Valuation upside based on Merlon estimates of sustainable free cash flow & franking credits.
Price earnings ratio based on Bloomberg consensus estimates over next 2 financial years, annualised & time weighted.
EPS growth based on annualised growth between last reported fiscal year and Bloomberg consensus EPS in 3 years' time.
Ex Ante Tracking Error calculated using 60 month volatility and correlation data.

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