Merlon Concentrated Value Strategy

Quarterly Report

March 2021

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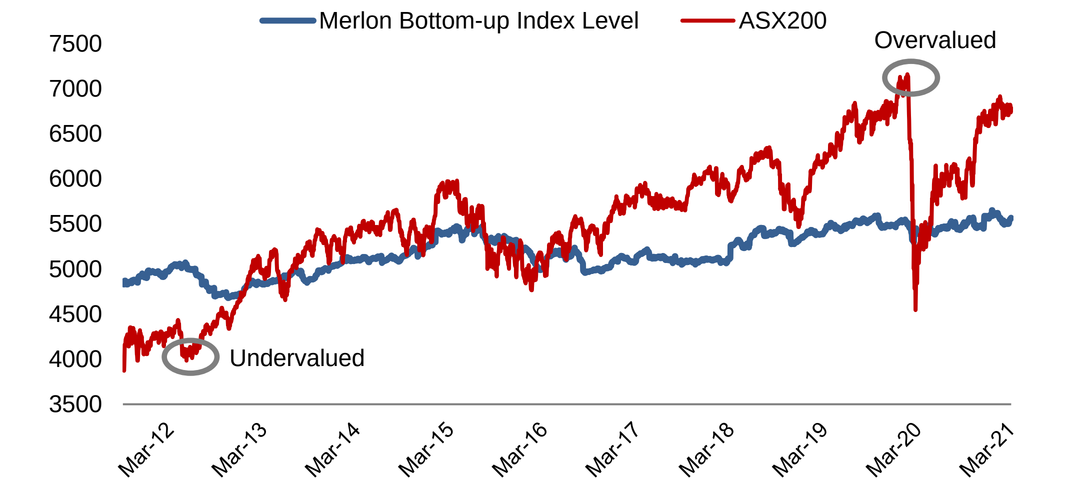
Neil Margolis

Market approximately 19% overvalued using consistent bottom-up approach

Market Outlook and Portfolio Positioning

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 160 stocks we actively cover. On this basis the market appears approximately 19% overvalued after rallying more than 4% during the quarter.

Figure 1: 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.

Confidence indicators and markets are leading economic activity …

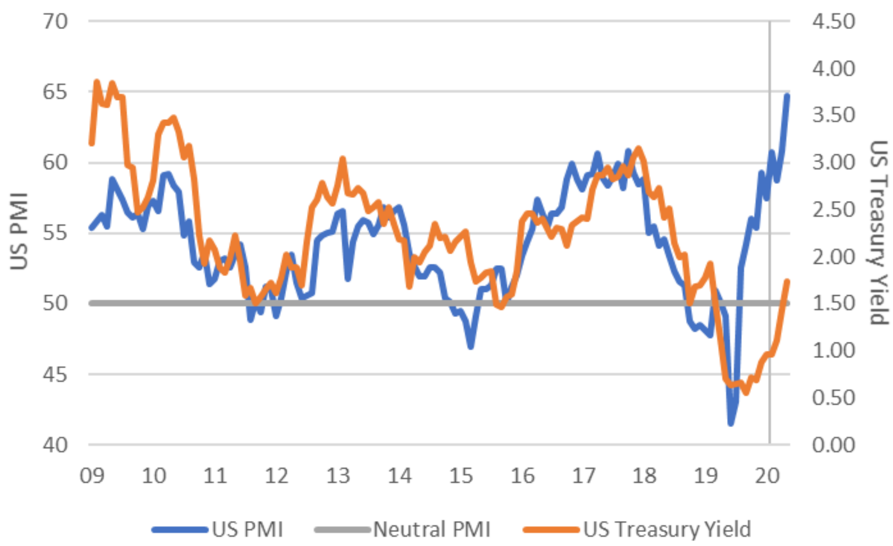
We always maintain a long-term view. In that respect, as we indicated in prior updates and in our **March 2020 COVID Roadmap** we were optimistic that at some point there would be a vaccine, herd immunity will develop, and ordinary life will bounce back. It is not surprising to us therefore that the market accumulation index recently set a new record high (at the time of writing) although record low rates have continued to manifest in very wide valuation dispersion between sectors and stocks. This quarter we have updated our **COVID Roadmap One Year On**.

2021 to date has featured a stimulatory-Biden administration and an accelerated global COVID-19 vaccine rollout. Despite the incidence of additional waves of COVID globally, stimulus and confidence in vaccine-efficacy have served to boost confidence, seen most

.. *with bond yields poised to follow suit*

directly in US ISM Manufacturing PMI. This link was detailed in our December 2020 report and has continued to prove a reliable indicator, despite Federal Reserve efforts to suppress Treasury yields. While a 60-plus PMI appears unsustainable, we expect it to remain firmly expansionary given additional stimulus measures announced by the Biden administration, and increasingly aggressive vaccination effort. Therefore we can expect further upward pressure on bond yields (see chart below), perhaps presaging an environment more favourable for value-based investing.

Figure 2: US 10 Year Treasury Yields



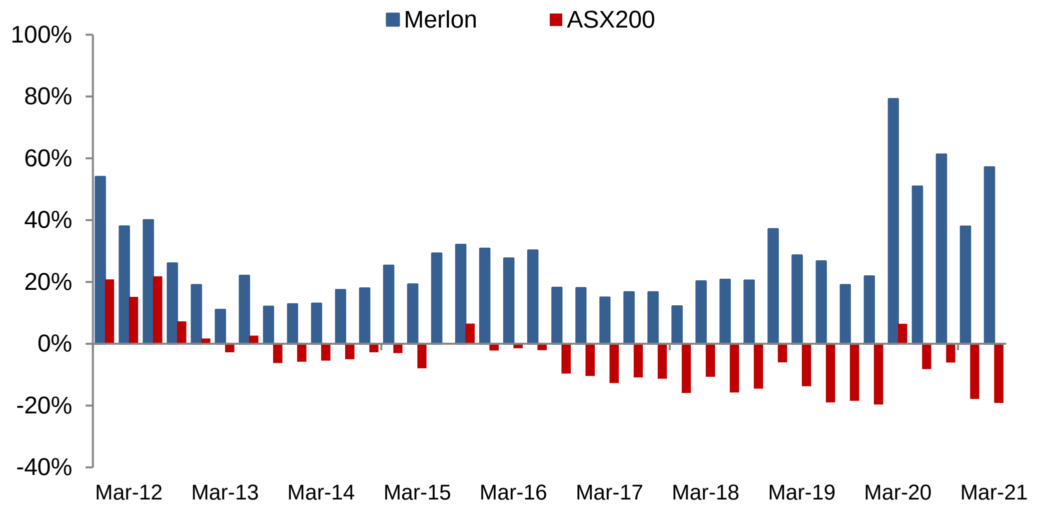
Data source: Federal Reserve Bank of St. Louis. Calculations / analysis: Merlon Capital.

This quarter we have produced a paper on **Interest Rates & Inflation**, outlining the historical context, investor complacency, growing risks and Merlon's consistent approach which leaves our portfolio largely impervious to a normalisation of interest rates.

The risk of permanent loss is mitigated by owning undervalued assets

Our view is that the risk of permanent loss from COVID economic impacts and resultant financial risks from measures to avert the crisis are 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.

Figure 3: Expected return based on Merlon valuations



Source: Merlon

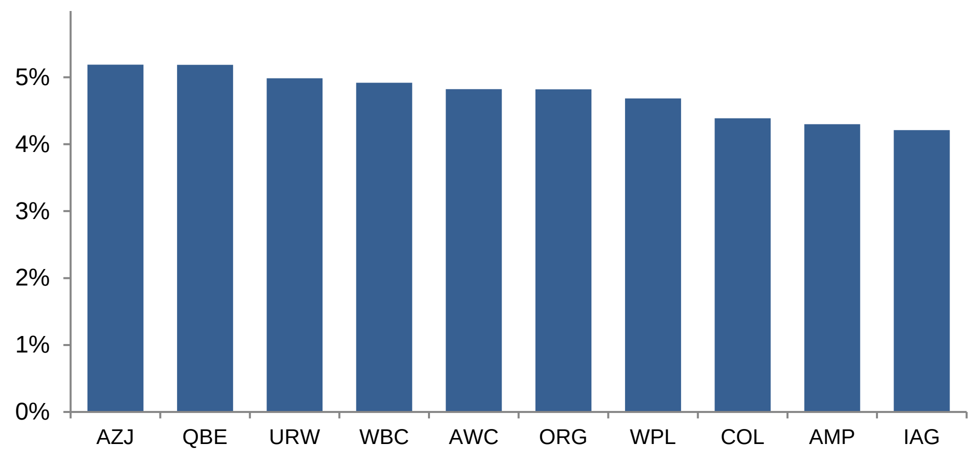
The Merlon portfolio continues to offer truly exceptional expected returns…

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

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 4: Top ten holdings (gross weights)



Source: Merlon

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

While we are not macro investors, as discussed above there are clearly some macro themes inherent within 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.

Top holdings:

A position in **Aurizon** was established during the quarter. The company operates the monopoly Queensland rail network for large, low cost and predominantly metallurgical (rather than thermal) coal miners. The stock had become cheap, relative to our estimate of a mid-cycle return on capital-based valuation. The stock had been affected by concerns relating to Chinese restrictions on a range of imported Australian goods, including coal. We expect Chinese import restrictions on met coal to abate, given the lack of access to high quality coals, which will likely see the share price appreciate towards our valuation.

QBE is a leading global insurer, seeing the strongest rate increase environment in 20 years. The company is undervalued relative to our valuation, as the market is concerned by persistent earnings disappointments, as well as shorter term claims risks from business interruption. With these concerns already reflected in the price, and our expectations that insurance margins are likely to overshoot to the upside given rate increases, we anticipate the market will ultimately recognise and value a likely 8% mid-cycle free cashflow yield, plus franking.

The position in **Alumina Limited** was established during the second half of 2020, with COVID-19 related market concerns providing attractive entry points for investment. While the stock has been impacted by the effect of COVID-19 on demand, as well as continued growth in Chinese alumina refining capacity, we expect Alumina's low-cost position to enable it to prevail relative to higher cost peers. Also, we expect China's capacity growth to rationalise and global fiscal stimulus to drive a recovery in demand for aluminium and its alumina-input.

Westpac is undervalued with the market concerned by the potential impact of COVID-19 on bad debts, in addition to prior concerns regarding declining industry returns associated with lower interest rates and increased regulatory scrutiny. Despite having a very similar business mix and track record of returns relative to CBA, the bank continues to trade at an unusually large discount reflecting concerns about management instability, near-term market share loss and rising compliance costs. We expect these concerns to ease over time, with investors rewarded with a 7% mid-cycle free cash flow yield in the interim.

Origin Energy is remains cheap despite the rally in oil prices, as the market is concerned by the effect of low electricity pricing on Origin's wholesale and retail electricity businesses. We see low electricity prices as having been driven by 1. the effect of low gas prices, 2. an unseasonably cool summer, and 3. the growth in renewables supply. In addressing these points, we expect gas pricing to normalise as onshore demand recovers, the Bureau of Meteorology-declared end of the current La Nina weather system, and post-COVID demand recovery should enable some recovery of electricity prices. We are also not convinced the current price environment is sustainable for investment in sustaining existing generation assets, nor does it incentivise new investment required to offset planned retirements.

Woodside Petroleum remains a large position as it remains undervalued relative to our assessment of value, and despite the rally in oil prices. The market is currently discounting the value of Woodside's cash-generative operating asset base, in addition to its large undeveloped reserve profile. We expect oil prices to continue to strengthen as demand recovers to pre-COVID levels, while the underinvestment in conventional and now unconventional oil supply, as evidenced by an active global rig count nearly 40% below pre-COVID levels, manifests in a reduced ability of supply to meet demand.

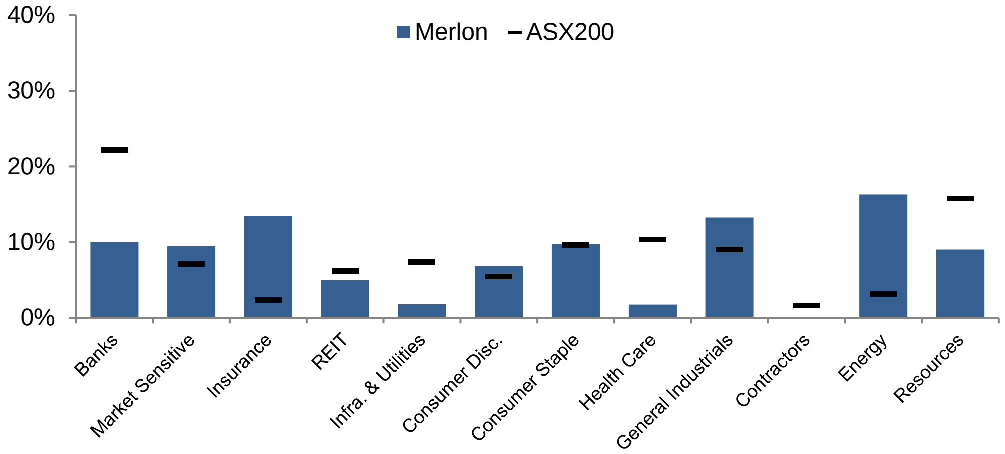
Like Westpac (above), ANZ is also undervalued, with the market's bad debt concerns, coupled with lower interest rates and regulatory scrutiny. The company has divested lower returning and higher risk assets and is returning capital from non-core assets, and now provides an attractive 6% mid-cycle free cash-flow yield plus franking.

After establishing an initial position during the COVID downturn and adding at lower levels, **Unibail-Rodamco-Westfield** has rallied to become a large position. The stock has been impacted by the effect of COVID-19 lockdowns across Europe and US, where its portfolio of high-grade shopping malls is located. While the market is also concerned by the threat of online consumer purchasing behaviour, we expect the value of its premium-grade portfolio to be reflected by the market as the rollout of the vaccine gathers pace, particularly given the backdrop of negative real interest rates.

Post completion of the life transaction and other announced transactions, **AMP** has net tangible assets (mainly cash) of $3.4b against a market cap of $4.2b. For the less than $1b 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. Governance failures are being address with a renewed board and management.

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 still generating margins below historic levels despite the COVID demand boost.

Figure 5: Portfolio exposures by sector (gross weights)



Source: Merlon

Figure 6: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	32	200
Active Share	79%	0%
Merlon Valuation Upside	55%	-19%
Mid-cycle Free Cash Flow Yield	7.6%	4.5%
EV / EBITDA (year ahead)	8.3x	13.8x
Price / Earnings Ratio (year ahead)	16.2x	20.1x
Price / Book Ratio (year ahead)	1.9x	4.5x
Free Cash Flow Yield (last year)	3.9%	3.1%

Source: Merlon

March Quarter Portfolio Activity

There were four new investments in the quarter

During the quarter, we established new investments **Aurizon Holdings** (see summary above), **AGL Energy**, **New Hope Group** and **Genworth Mortgage Insurance**, funded by exits of News Corp, Star Entertainment, Bendigo Bank, Nick Scali, Amaysim, Sims Metals and Asaleo Care, which had reached our valuations.

AGL Energy is Australia's largest electricity generator and retailer. The market is capitalising the currently low electricity prices, despite the likelihood that prices should appreciate as seasonal weather conditions normalise, and as the effect of COVID on demand reverses. The market is also concerned by continued state and federal government intervention into the sector, which may have the adverse effect of driving out private investment in new generation, as well as investment in existing generation assets.

New Hope Group is a mid-tier Australian thermal coal miner, operating in NSW and QLD. While the market was concerned by low thermal coal prices during COVID, prices have subsequently rallied and are now trading well-above pre-COVID levels. The market is also concerned by the continued delays in approval to extend its QLD New Acland operation. Despite this, we see significant upside remaining at spot prices from its low cost Bengalla (previously RIO owned) mine, and without factoring in value for the New Acland extension.

Genworth Mortgage Insurance Australia provides insurance for 1.2 million loans on behalf of major Australian banks. The stock has underperformed the market on concerns relating to the effect of COVID on the Australian housing sector. We model a lower than market-expected 10 year average loan-loss rate of 5 basis points, supported by an better quality mortgage portfolio.

Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	10 Years (p.a.)
Portfolio Return (inc. franking)	2.7	3.3	21.3	51.0	7.6	9.9	10.5
ASX200 Return (inc. franking)	2.7	4.7	18.9	38.4	11.0	11.6	9.4
Excess Return*	**0.0**	**-1.4**	**2.4**	**12.6**	**-3.8**	**-1.7**	**1.1**

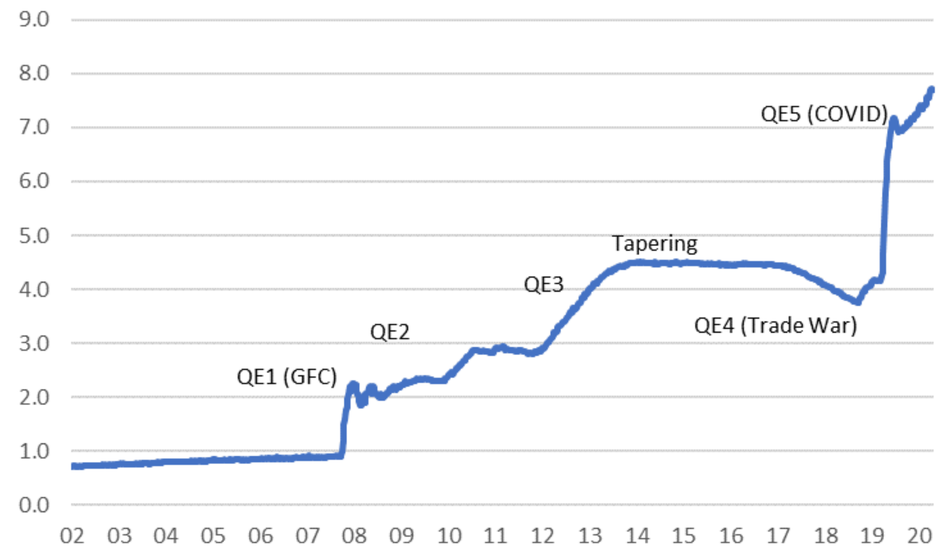
* Excess returns may not sum due to rounding, performance before fees.

March Quarter Market & Portfolio Review

Markets approached all-time highs in another strong quarter …

Markets continued to rally strongly during the quarter as additional stimulus announcements from the Biden administration combined with a positive economic outlook, outweighed the negative sentiment associated with additional waves of COVID-19. Quantitative easing programs continued, in an effort to provide some suppression to the continued rally in US treasury yields, which ended the quarter at 173 basis points, up from 93 basis points.

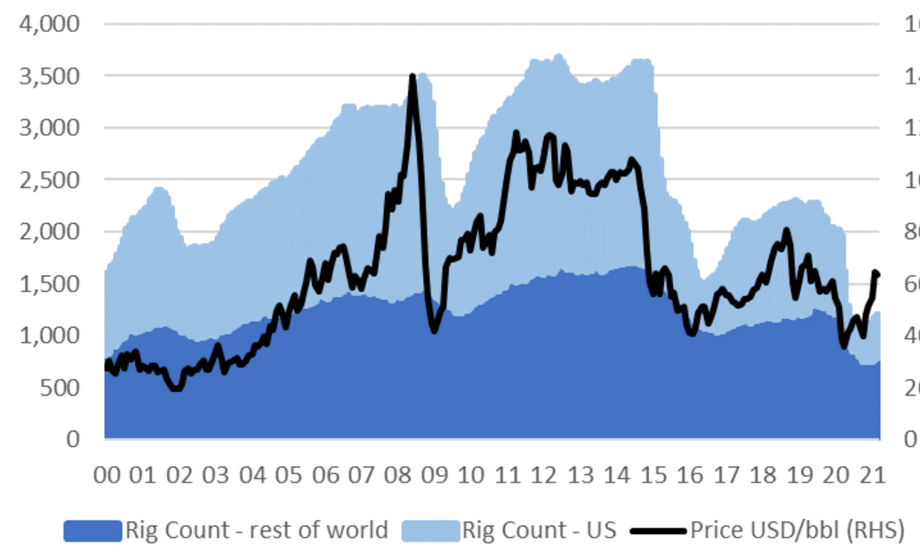
Figure 7: US Federal Reserve Total Assets USDtr



Data source: Federal Reserve Bank of St. Louis. Calculations / analysis: Merlon Capital.

Commodities continued their rally, alongside the recovery in the US Manufacturing PMI. Energy (+16%) outperformed industrial commodities (+11%) as the OPEC+ cartel displayed disciplined production restraints while US onshore activity remained subdued. The longer the activity levels remain significantly below pre-COVID levels, the larger the potential supply squeeze could be when demand normalises.

Figure 8: global rig count vs oil price



Data source: Bloomberg. Calculations / analysis: Merlon Capital.

Portfolio review

The portfolio underperformed this quarter ….

Despite having outperformed strongly over the past 12 months, the portfolio underperformed by **1.4%** (including franking) over the quarter. While overweight positions in **Incitec Pivot**, **Super Retail**, and **QBE**, combined with underweights in **CSL** and **Afterpay** contributed, these were ultimately outweighed by negative contributions from overweight positions in **AMP**, **Ampol** and **NIB Insurance**, and an underweight position in **BHP**. In broader terms, we saw the positive contribution from the underweight healthcare position outweighed by the overweight financials exposure.

Financial year to date, the portfolio has outperformed by **2.4%**. Key contributors over the period have been overweight positions in COVID-beneficiaries **Super Retail** and **Harvey Norman**, as well as **Newcorp, Sims Metals**, and an underweight position in **CSL**. Detractors included overweight **AMP**, **Ampol**, **IAG** and **Origin Energy**, and an underweight position in **BHP**.

… but exhibited strong value characteristics by outperforming materially in the COVID recovery.

With this month marking one year from the lows experienced during the initial Covid-19 correction, the portfolio has performed strongly as markets rebounded, outperforming by **12.6%**. Key contributors from stocks held over the year included positions in market-leading retail names **Super Retail**, **Nick Scali, Harvey Norman**, and **Newscorp**, as well as other cyclicals such as **Boral**, **Southern Cross Media**, and **Sims Metals**, while **Virtus Health** also assisted. Also contributing strongly over the year was an underweight position in **CSL**. The contributions from the portfolio's retail names was particularly pronounced as the effects of the COVID-induced lockdowns assisted demand for home furnishings and other consumer recreation-related items.

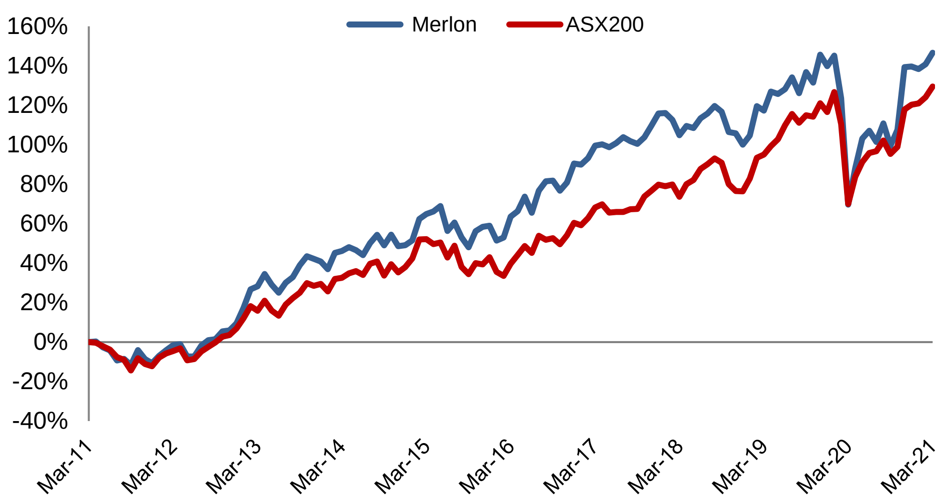
Key detractors over the year included underweight positions in iron ore miners BHP and Fortescue Metals, which benefited from the additional impact of COVID in Brazil following Vale's its 2019 dam failure. Other key detractors included overweight positions in AMP and IAG, and an underweight position in Afterpay.

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 March 2020 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.

The portfolio has outperformed over 10 years despite style-related headwinds

Over the past ten years, the portfolio has outperformed by 1.1% per annum, a pleasing result given value-style related headwinds, but nonetheless below our target, with most of the underperformance in the past few years for the reasons outlined above.

Figure 9: Rolling ten year returns



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

Strategy FUM	Merlon FUM
$985m	$988m

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

Reinventing Value Investing
The Merlon Approach to Corporate Governance
The Strategic Value of amaysim
Oil - Pricing in a More Realistic Recovery
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
Value Investing - An Australian Perspective: Part I
Some Thoughts on Australian House Prices
Iron Ore is Well Above Sustainable Levels
Why Telstra could be worth less than $2
The AMP Valuation Case
A Case Study in Poor Capital Allocation
Asaleo Divestment Well Received
Some More Thoughts on Telstra
Amazon Revisited - Muted Impact So Far
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.