Merlon Concentrated Value Strategy

Quarterly Report

June 2021

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MERLON CAPITAL PARTNERS

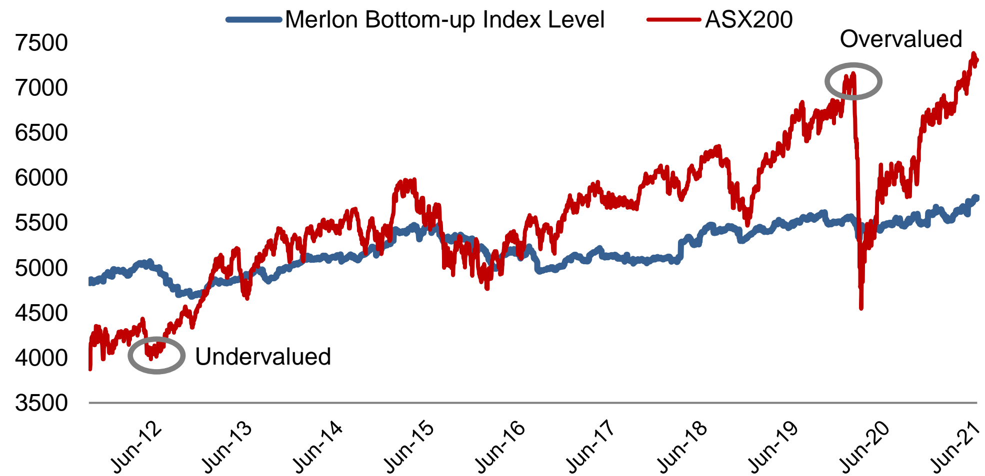
Neil Margolis

Market Outlook and Portfolio Positioning

Market approximately 19% 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 150 stocks we actively cover. On this basis the market appears more than 20% overvalued after rallying by more than 8% 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.

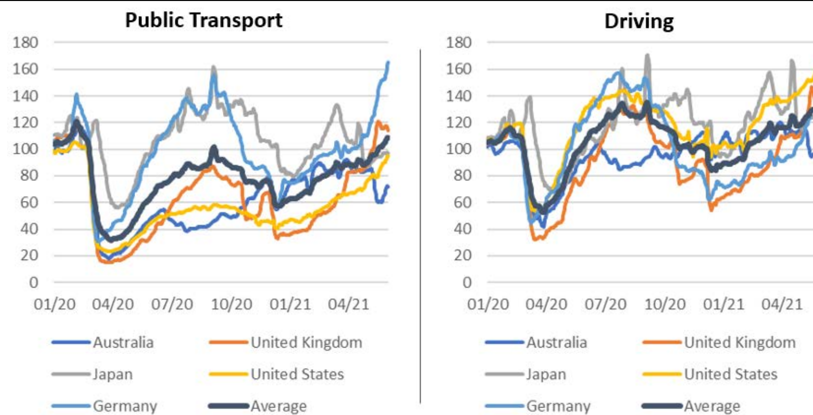
Confidence indicators and markets are leading economic activity …

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. In our March quarter report, we updated our **COVID Roadmap One Year On**.

The past financial year has seen sizeable geopolitical, social, and economic transitions, with Republican Trump ceding power to the Democratic Biden, the development of multiple COVID vaccines, enabling people to look beyond the pandemic and towards normality.

Mobility indices show that while driving activity is now above pre-pandemic levels, usage of public transport remains below, showing energy-intensity has risen. The final piece of mobility that has yet to recover is air travel, with international travel activity remaining at a third of pre-COVID levels, and likely to remain depressed until the vaccine rollout is sufficiently progressed globally.

Figure 2: Activity normalisation



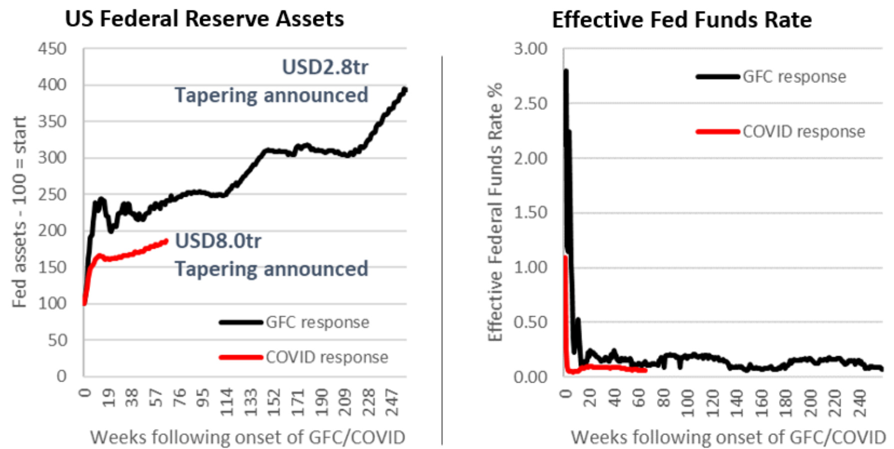
Data source: Apple Mobility Trends. Calculations / analysis: Merlon Capital.

But with this return to normality, investors will need to contend with an environment of policy normalisation also, which comes with its own set of risks. Yet history would suggest the ability to 'normalise' policy is difficult, with neither rates nor the Fed's balance sheet returning to anything near pre-GFC levels. In the case of QE, it took five years from the onset of the GFC for the Fed to talk about tapering, let alone achieve any kind of meaningful normalisation. And with inflation expectations 'normal' at 2.0-2.50%, but not elevated, the need to tighten on account of inflation appears low.

Figure 3: Inflation normalisation

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

Figure 4: Policy normalisation?



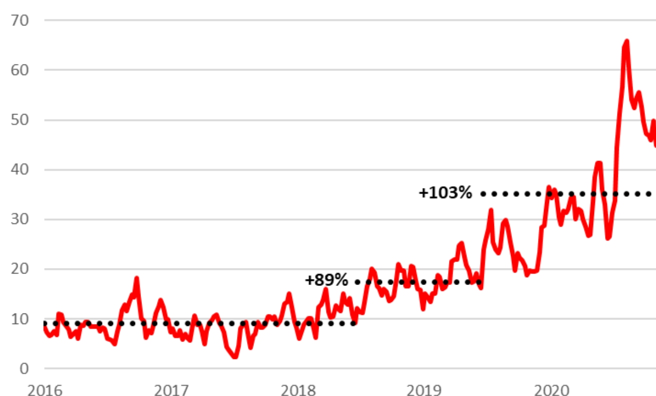
Data source: Federal Reserve Bank of St. Louis. Calculations / analysis: Merlon Capital.

Looking ahead: Google Search Trend data shows decarbonisation looking increasingly set to dominate the narrative, with interest having accelerated significantly over the past 18 months as the effects of climate change have become more visible in the media, and with Biden re-signing the Paris Agreement.

While the Australian economy has been backstopped by China's desire to build ever more apartments, domestic political tensions pinned to climate are escalating, highlighting the fragility of the coalition government. While the decarbonisation equation in most developed economies rests on the cost of changing the type of electricity being generated, the equation in Australia is more fraught as the world's top supplier of carbon-intensive energy (LNG and thermal coal).

Our work suggests that in the case of decarbonising Australia's own electricity generation, it will cost more than is justified by current electricity prices, with this cost ultimately being borne by consumers, whether via higher taxes or electricity prices. We expect demand for carbon-intensive energy raw materials to be persistent for longer than is expected, lending an upward risk bias to the pricing of these commodities, valuable for those with existing operations.

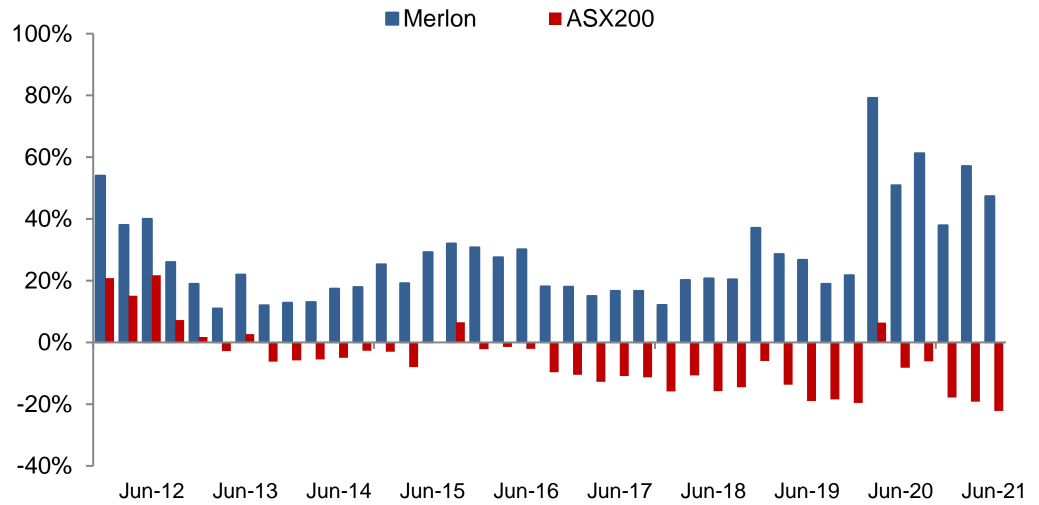
Figure 5: interest in decarbonisation is accelerating



Data source: Google Search Trends. Calculations / analysis: Merlon Capital.

The Merlon portfolio continues to offer truly exceptional expected returns…

Figure 6: Expected return based on Merlon valuations



Source: Merlon

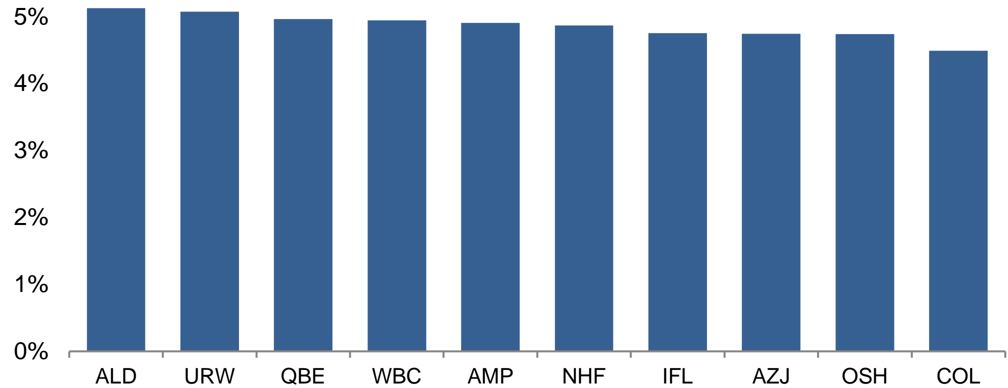
We expect the environment over the next year or so will continue to present appealing investment opportunities for investors with long-term horizons, who are prepared to look through short term noise and who are comfortable having unpopular views.

Portfolio Aligned to Value Philosophy and Fundamental Research

The portfolio 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 7: Top ten holdings (gross weights)



Source: Merlon

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:

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.

UNIBAIL-RODAMCO-WESTFIELD

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.

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.

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.

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.

NHF is Australia's third-largest health insurer, operating in an industry underpinned by a two-tier system. The past twelve months has seen a reduced level of claims, coupled with member growth. The market has concerns around the company's loss-making travel insurance and student businesses, yet we see both issues as

transitory, making the company relatively cheap. We see this value as enhanced by the likelihood of a provision release and the potential for capital management.

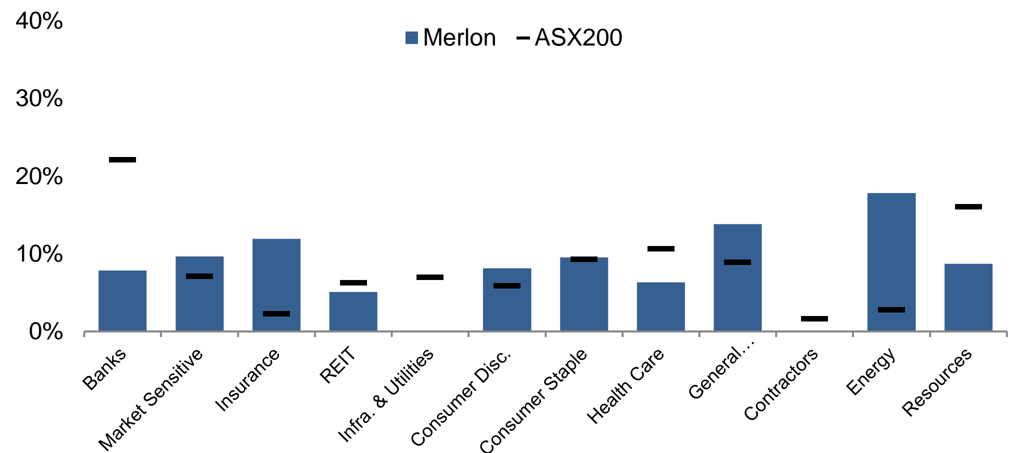
IOOF is effectively the only remaining scale operator in financial advice. While the market is concerned about competition, fee and regulatory pressures, the company is trading on just 9 x FY22 earnings. The company is generating strong cashflows, which is likely to lead to capital management, having completed its acquisition of MLC, a transaction we see as likely to enable cost out and the extraction of up to $150m of synergies.

Aurizon 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 has been affected by concerns relating to Chinese restrictions on a range of imported Australian goods, including coal. We expect Chinese import restrictions on coal to abate, given the effect of restrictions on domestic energy prices, which will likely see the share price appreciate towards our valuation.

Oil Search remains undervalued relative to our assessment of value, and despite the rally in oil prices. The market is currently discounting the value of the company's low cost, conventional core 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.

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 8: Portfolio exposures by sector (gross weights)



Source: Merlon

Figure 9: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	31	200
Active Share	83%	0%
Merlon Valuation Upside	52%	-22%
Mid-cycle Free Cash Flow Yield	7.0%	4.1%
EV / EBITDA (year ahead)	8.3x	14.2x
Price / Earnings Ratio (year ahead)	15.0x	20.2x
Price / Book Ratio (year ahead)	2.0x	5.0x
Free Cash Flow Yield (last year)	3.8%	3.1%

Source: Merlon

Portfolio Activity

There was one new investment, and one exit made during the quarter

During the quarter, we established a new position in **Suncorp**, while adding to existing positions in **AMP**, **Ampol** and **OilSearch**. These were funded by an exit of the position in **Janus Henderson**, which had reached our valuation, and reductions in **ANZ** and **QBE**.

Suncorp is a leading Australian insurance company in a highly consolidated industry. The company also operates a low risk regional bank, albeit losing some market share. An opportunity to invest came amidst market concerns surrounding weak top-line trends in banking and insurance, and risks from business interruption. While we have factored these concerns into our assessment of value, we believe the industry is entering a strong pricing cycle, enhanced by the value of excess capital.

Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	10 Years (p.a.)
Portfolio Return (inc. franking)	2.3	4.6	26.8	26.8	7.6	10.6	11.4
ASX200 Return (inc. franking)	2.3	8.5	28.8	28.8	10.9	12.5	10.7
Excess Return*	**0.0**	**-3.8**	**-2.0**	**-2.0**	**-3.3**	**-1.9**	**0.7**

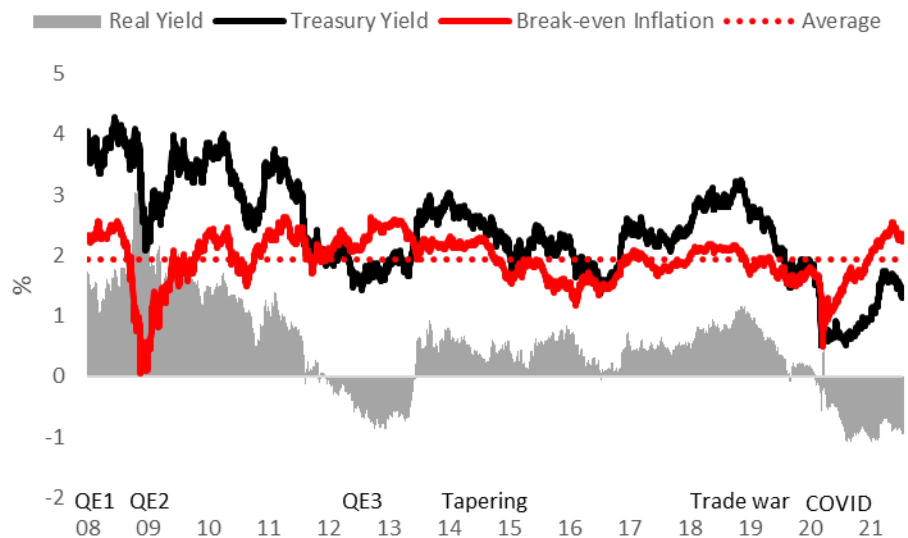
* Excess returns may not sum due to rounding, performance before fees.

June Quarter Market & Portfolio Review

Markets approached all-time highs in another strong quarter …

Markets maintained their strength through the June quarter, with the US S&P500 reaching record highs. While the Biden administration had to settle for an infrastructure program roughly half its proposed USD2.3tr initiative, markets took the acceleration in vaccination rates (see below) as a key driver of confidence. Although reported inflation figures are reflecting the combination of base effects and still-disrupted supply chains, market expectations remain only moderately above average levels. And with treasury yields dipping more recently, real yields remain firmly negative – also supportive of equity markets.

Figure 10: Yields & Inflation Expectations

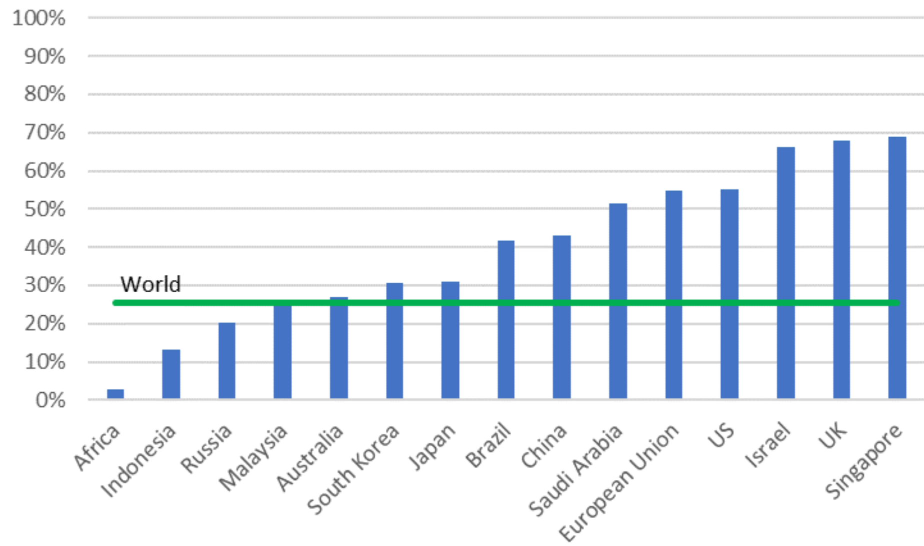


Data source: Federal Reserve Bank of St. Louis. Calculations / analysis: Merlon Capital.

COVID

Vaccination rates accelerated during the quarter, with just over 25% of the world's population having received at least one vaccine dosage. This rate sees a skew towards more developed economies. Both Israel and the United Kingdom have part-to-fully vaccinated their populations and are now effectively test-cases for the rest of the world, having relaxed restrictions for their populations. Rates from here will depend on supply availability, coupled with the effects of any latent vaccine-hesitancy amongst the population.

Figure 11: Global vaccination rates (% of population with at least one dose)



Data source: Our World in Data. Calculations / analysis: Merlon Capital.

Commodities

Commodities maintained their strength, with iron ore above USD200/t, thermal coal above USD100/t, and crude oil back to USD75/bbl. While much has been made of the demand environment, all commodities remain heavily supply dependent. In the case of iron ore, Brazil is still seeking some degree of post COVID normality; thermal coal awaits Indonesia's return to the export market, and; oil remans firmly under the control of the OPEC-plus alliance.

Figure 12: Oil vs Australian dollar

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

Portfolio review

The portfolio underperformed this quarter ….

Despite having outperformed strongly over the first half of FY21, the second half saw the portfolio lag the market, with the final quarter 3.8% behind the ASX200. While overweight positions in **NIB**, **IOOF**, **New Hope**, **Ampol** and **QBE** contributed, these were ultimately outweighed by negative contributions from overweight positions in **AMP**, **Incitec Pivot, Alumina,** and **Aurizon**, and an underweight position in **CBA**. In broader terms, we saw the positive contribution from the underweight healthcare position outweighed by the overweight financials position, and the overweight energy exposures, despite the continued rally in the oil price.

Over the full financial year, the portfolio underperformed the market's 29% rally with a return of 27%. Key contributors over the period have been overweight positions in COVID-beneficiaries **Super Retail** and **Harvey Norman**, as well as **Newcorp, Virtus**, and an underweight position in **CSL**. Detractors included overweight positions in **AMP**, **Origin Energy**, **IAG** and **Ampol**, and an underweight position in **CBA**.

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

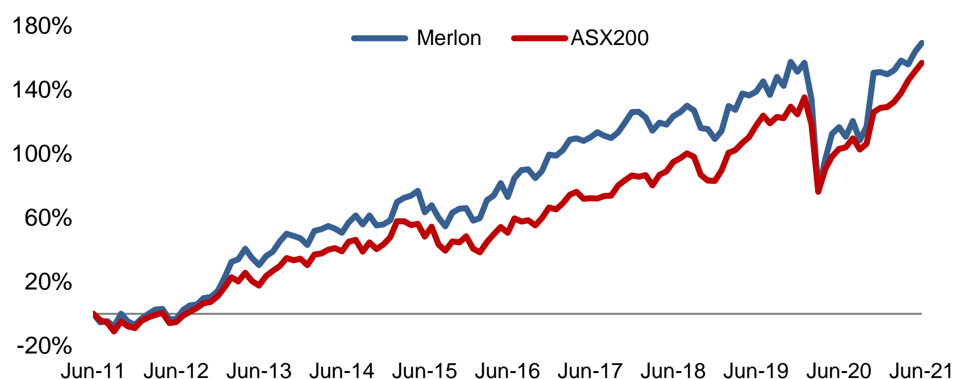
The contributions from the portfolio's retail names was particularly pronounced as the effects of the COVID-induced lockdowns assisted demand for home furnishings and other consumer recreation-related items.

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

Figure 13: Rolling ten year returns



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

Strategy FUM	Merlon FUM
$1,005m	$1,008m

About Merlon

Merlon Capital Partners is an Australian based fund manager established in May 2010. The business is majority owned by its 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

- COVID-19 - One Year On
- Interest Rates & Inflation
- 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.

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