Merlon Concentrated Value Strategy

Quarterly Report

March 2022

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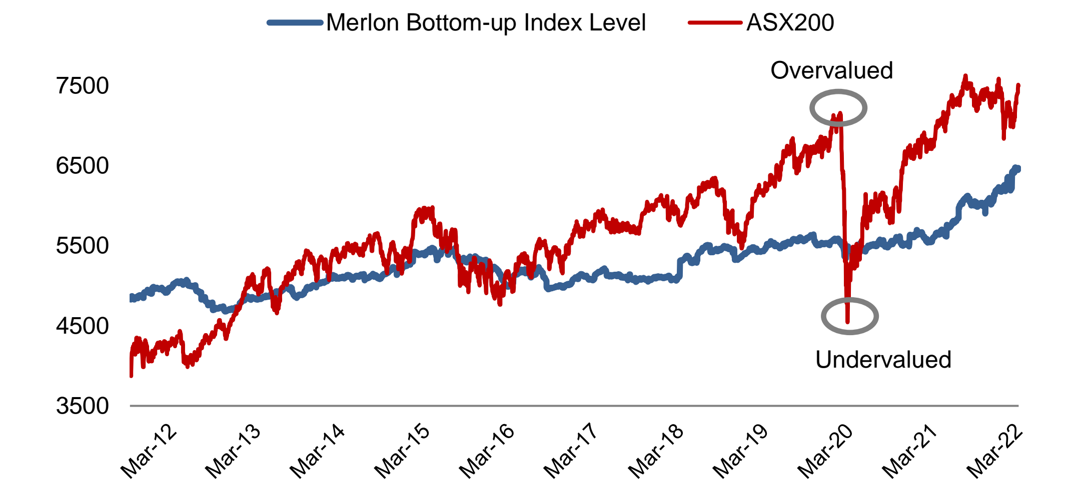
Neil Margolis

Market Outlook and Portfolio Positioning

Market around 20% 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 around 20% overvalued after advancing another 3% during the quarter.

Figure 1: Merlon bottom up market valuation vs ASX200 level



Source: Merlon

An overview of Merlon's approach and prior views

Our individual company valuations have been established using our estimates of sustainable free-cash-flows and franking, discounted at consistent mid-cycle interest rates and risk premiums. Our valuations are long-term and more stable than fluctuating share prices, creating good opportunities for patient long-term investors. Merlon's portfolio comprises our best research ideas, based on long-term valuations and analyst conviction.

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 complacent with regard to stock specific risks. This lens on valuation dispersion is more useful than trying to predict when the market will price in "mid-cycle" interest rates and long-run average risk premiums.

Complacency about inflation is shifting to concern

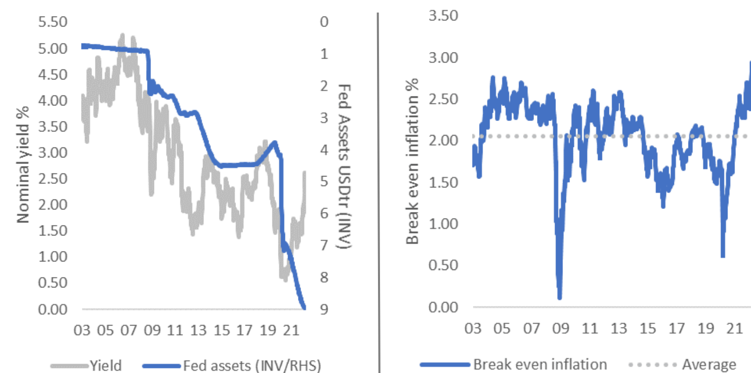
We always maintain a long-term view. In our **March 2020 COVID Roadmap** we were optimistic that there would be a vaccine, herd immunity would develop, and ordinary life could bounce back. In our **March 2021 Outlook for Interest Rates and Inflation** paper, we noted extreme complacency from investors that inflation would be transitory notwithstanding supply chain disruptions and record stimulus induced demand. We also noted our long-term approach had caused our portfolio to lag the market which was being driven higher by some stocks and sectors extrapolating record low rates almost indefinitely.

Market Outlook

Despite a surging COVID-19 Omicron variant, which peaked at more than four million cases in January, the world's attention was drawn to Russia's 'special operation' in Ukraine. The market's desire for sanctions on Russian energy exports has been thwarted by Europe's dependence on this energy so far.

From a macroeconomic standpoint, the impact on energy and food prices has seen central banks become more hawkish on policy settings. From the charts below, we can see that Fed policy may be at risk of losing control of treasury yields, driven in part by an overshooting of inflation. A quick resolution to the Russian / Ukraine conflict, combined with a post-COVID logistics easing may see inflation as transitory. A more bearish perspective would be a wage-price spiral leading to a more aggressive central bank policy on inflation, in turn driving global economic activity lower. In our view, markets appear to be pricing inflation as "transitory" which poses downside risk if it turns out differently.

Figure 2: Yield, inflation and policy

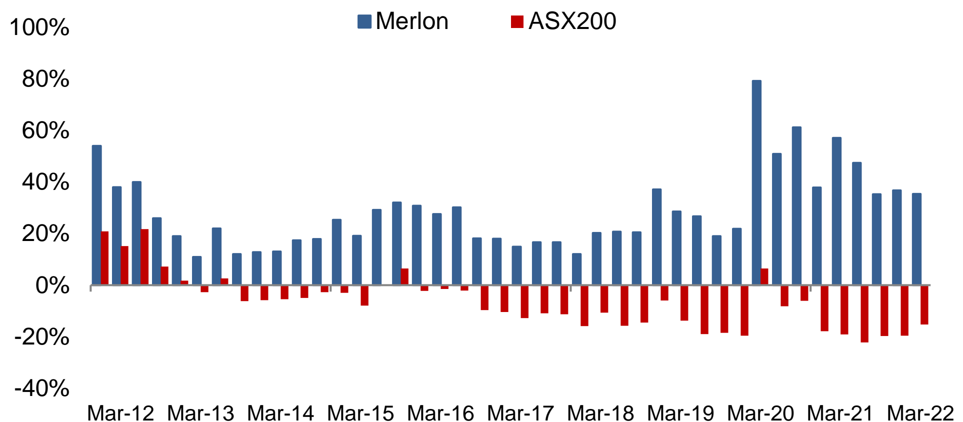


Source: Federal Reserve of St. Louis. Calculations: Merlon.

Merlon's focus on near-term cashflows rather than of long-dated growth potential may perform better in comparison to the broader market.

The Merlon portfolio continues to offer very attractive expected returns…

Figure 3: Expected return based on Merlon valuations



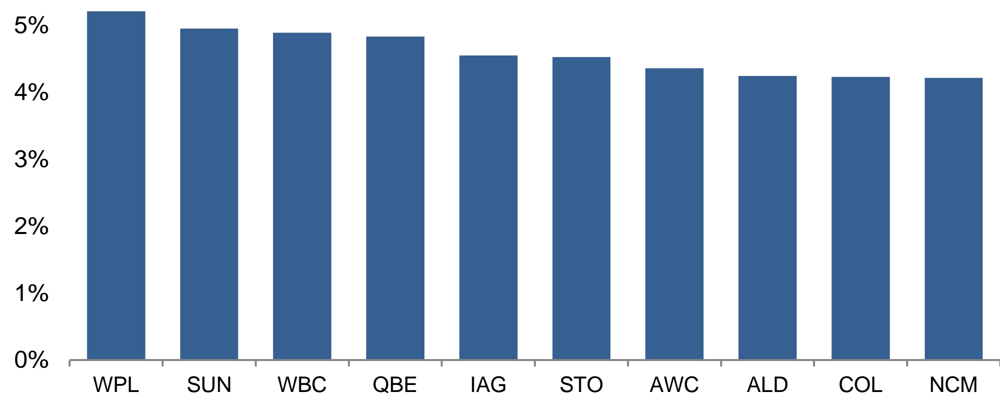
Source: Merlon

Portfolio Positioning: aligned to a 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 4: 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:

Woodside Petroleum 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 very large contingent 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 should further support prices over the medium-term, regardless of a transition to renewable energy generation. While the proposed BHP Petroleum merger is roughly neutral to our valuation and conviction, it intelligently provides access to capital to develop its Scarborough project, amidst what is an increasingly favourable contract-pricing environment.

Suncorp is a large domestic insurance and banking company. The company is undervalued relative to our valuation, as the market is concerned by shorter term earnings risks posed by the relatively high short term claims environment and business interruption charges. Yet valuing the company on the basis of a modest normalisation of insurance margins driven by higher rates, coupled with valuing the company's cashflows on an appropriate cash flow multiple sees appealing valuation upside. Further upside may be achieved via a favourable sale of the company's banking division.

Westpac is undervalued with the market assuming returns are structurally lower as a result of lower interest rates and higher operating and compliance costs. Despite having a similar business mix and track record of "underlying returns" relative to CBA, the bank continues to trade at an unusually large discount reflecting less confidence in management, persistent mortgage market share losses, a higher cost base than peers and recurring "non-recurring" items. We expect these concerns to ease over time, with investors rewarded with a 7% mid-cycle free cash flow yield in the interim.

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 and wild weather. 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.

IAG is the largest Australia and New Zealand general insurance company. The company is undervalued relative to our valuation, as the market is concerned by shorter term earnings risks posed by the relatively high short term claims environment, business interruption charges, and some loss of market share, particularly in motor. Yet valuing the company on the basis of a modest normalisation of insurance margins driven by higher rates, coupled with valuing the company's cashflows on an appropriate cash flow multiple sees appealing valuation upside.

Having merged with **Oil Search**, a company the portfolio previously owned, **Santos** is now a top-ten position in the portfolio. We voted against the merger as we assessed it as having undervalued Oil Search, a view backed by the Independent Expert's valuation. Despite this, we believe Santos is undervalued by the market, albeit less than Oil Search was, as the consolidation of PNG exposures is likely to enable a smoother path to commercialising the undeveloped Papua LNG project. We also expect the company to reassess the less compelling Alaska project, previously pursued by Oil Search. Like with Woodside, 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 should further support prices over the medium-term. As with Woodside, the pricing environment for determining new projects is strengthening.

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. The market for alumina has tightened as Noble Group's Jamalco refinery fire in August impacted the supply of alumina, while a military coup in Guinea, the world's largest supplier of bauxite (the feedstock for alumina refining), further destabilised the market.

Ampol is Australia's largest integrated oil refining, fuel distribution and marketing company, operating in a strong industry structure dominated by vertically integrated companies. Volumes have been impacted by COVID-19 related disruptions, yet the company remains in a strong position to maintain and potentially grow share as the incentive for independent, non-integrated retail suppliers to enter the market is declining in anticipation of growth in electric vehicles. Operators who own / control their sites remain in a strong position to increase their convenience offering, while extracting strong

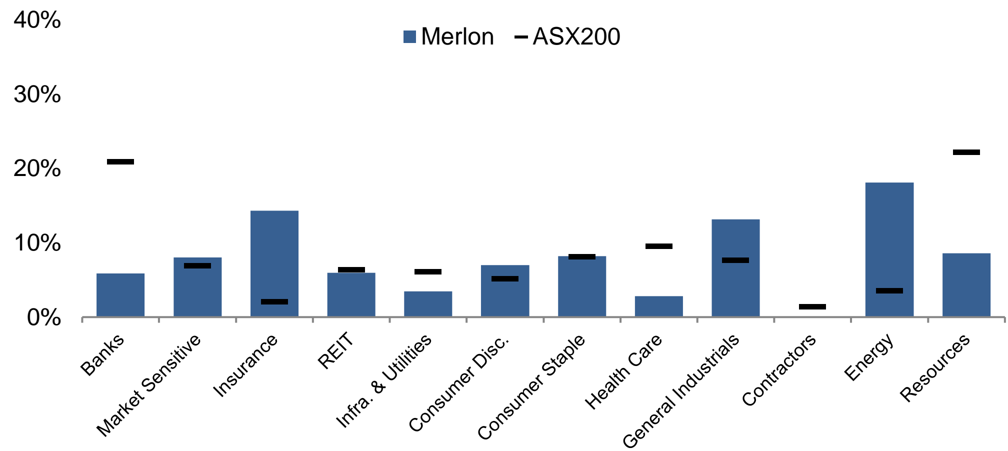
conventional fuel margins given the long term need for supply of fuels to non-EV drivers. While the market continues to value the company's refining business as a high-risk asset, the Government's underwriting of refining margins has significantly reduced this risk. Ampol's counter-cyclical, cashflow-accretive takeover of Z Energy (ZEL), increases the company's regional market share - and hence buying power – and supply chain infrastructure utilisation.

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, provide long term inflation protection, have minimal debt and are still generating margins below historic levels despite the COVID demand boost.

Newcrest Mining 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 positive. While we expect the US Federal Reserve to attempt to taper its Quantitative Easing programme, a negative for gold in the context of higher real yields, we believe the extent to which it can do so will be limited by 1. The potential global wealth effects of asset price declines and 2. Extensive debt levels globally. In this context, we expect Newcrest to generate strong cash flows, benefiting from its position of far longer dated reserves than those presented by peers.

MERLON CAPITAL PARTNERS

Figure 5: Portfolio exposures by sector (gross weights)



Source: Merlon

Figure 6: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	30	200
Active Share	83%	0%
Merlon Valuation Upside	37%	-15%
Mid-cycle Free Cash Flow Yield	7.4%	5.1%
EV / EBITDA (year ahead)	12.5x	16.0x
Price / Earnings Ratio (year ahead)	12.9x	18.5x
Price / Book Ratio (year ahead)	1.9x	3.8x

Source: Merlon

March Quarter Portfolio Activity

There was one new investment and two complete exits during the quarter

During the quarter, we established a new position in **Scentre Group**, and exited positions in **APA Group** and **Lend Lease**. Across existing positions, we increased exposures to **Suncorp**, **A2 Milk**, **IAG Group** and **Qantas**, and reduced positions in outperforming companies including **Woodside**, **Virtus Group**, **Santos**, **Whitehaven**, **New Hope Coal**, and **Origin Energy.**

Scentre Group is a large Australia and New Zealand shopping centre group, operating under the Westfield brand. Scentre Group's leading geographic footprint enables it to offer landlords a high-quality national exposure. The company remains undervalued when assuming a continued normalisation of operating conditions as the nation emerges from COVID-restricted environment, leading to an expected $1.0billion-plus free cashflow generation per annum, even after factoring in an estimated 10% impact from the switch to online shopping.

The Australian equity market rose during the quarter, ahead of global markets, a function of the Australian market's commodity-heavy weightings…

Performance summary

Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	10 Years (p.a.)
Portfolio*	5.0	10.4	15.0	20.2	11.7	9.2	12.7
ASX200*	7.0	2.8	7.4	16.4	11.8	10.6	11.6
Excess Return**	**-2.0**	**7.6**	**7.5**	**3.8**	**-0.1**	**-1.4**	**1.1**

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

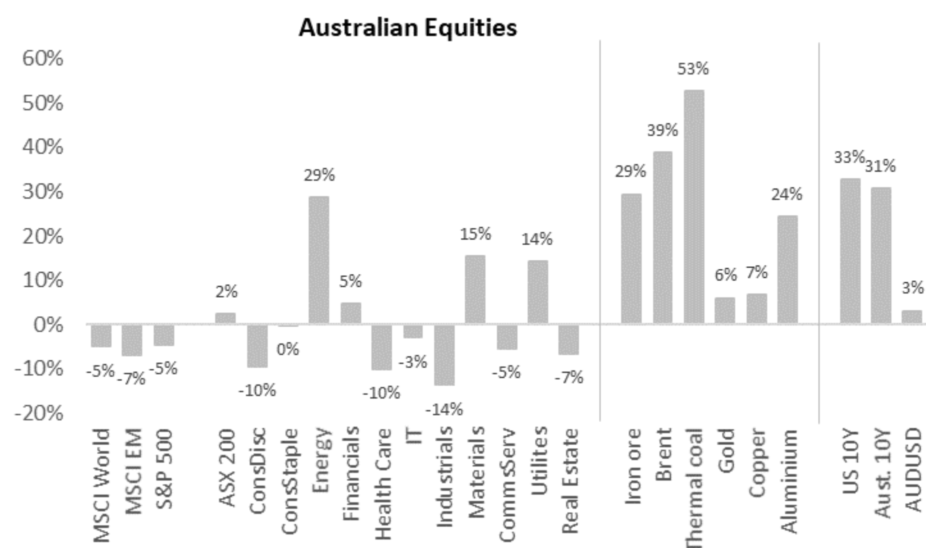
Market Review

The Australian market returned 2.8% for the quarter, well ahead of global markets which lost 5%. The relatively strong quarter by the Australian market was driven by the Energy sector, following Russia's invasion of Ukraine, and subsequent announcements of sanctions of Russia's energy-heavy export sector. Strong returns were also seen in the Materials and Utilities sectors.

The oil price rallied more than 50% in 2021 yet the domestic Energy sector recorded a -2% return over the same period. Pleasingly, it in part made of up for this commodity-relative underperformance with a 29% return in the first quarter of the 2022 calendar year. This has seen the large valuation discount noted in our last quarterly report (see article) narrow somewhat.

US treasury yields rallied alongside implied long-term inflation rates, ensuring real yields remained at negative levels. Real yields ended the quarter at -0.51%, albeit above the -1% level where they ended 2021. As noted, in our prior report, the Fed has indicated that it is to begin tapering. History has shown this to be difficult, so we watch this attempt with interest.

Figure 7: Overview of key markets



Data source: Bloomberg, Merlon Capital. Inflation measured as the 10-year break even rate.

Portfolio review

The portfolio outperformed this quarter and financial year to date…

Energy prices continued to rally during the quarter, a function of underinvested supply chains, in conjunction with Russia's invasion of Ukraine risking supply further. Russia is a key global supplier of oil, gas and thermal coal. The portfolio's energy exposures rallied alongside these commodity price movements, driving much of the portfolio's outperformance.

Last quarter we noted the apparent valuation discount across Australian energy companies. This quarter saw some of that valuation gap closed as investors began to see the tightness evident in these commodities.

...which saw the prior quarter's Omicron-driven underperformance more than outweighed by Russia's invasion of Ukraine.

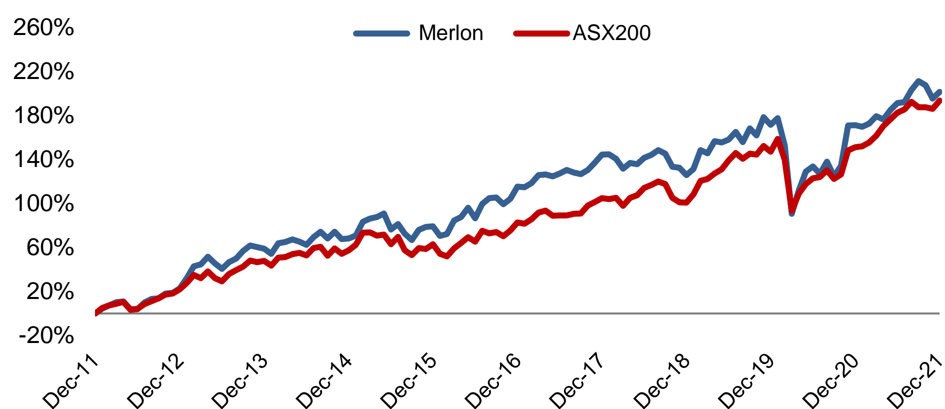
At a stock level, the key contributors to the portfolio during the **quarter** were **Woodside Petroleum**, **New Hope Coal**, **Whitehaven Coal**, **Santos**, and **Origin Energy**. Partly offsetting these contributions were underweight positions in **BHP**, **NAB**, **CBA** and **Rio Tinto**, and an overweight position in **Super Cheap Retail**.

Over the **financial year to date**, the Portfolio also outperformed, driven by many of the same energy exposed names as well as **Incitec Pivot**, which has benefited from its exposure to lower gas prices in regional specific markets. Partly offsetting these returns were underweight positions in **BHP** and **NAB**, and overweight positions in **AMP**, **Unibail** and **IAG**.

And over the rolling **twelve-month** period, the portfolio was also ahead of the market, again due to energy names including **Whitehaven Coal**, **New Hope Coal**, **Woodside Petroleum**, and **Origin Energy**. Key detractors over the year were overweight positions in **AMP**, **Unibail Group** and **Super Retail Group**, and underweight exposures to **BHP Group** and the **Commonwealth Bank** of **Australia**.

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

Figure 8: Rolling ten-year returns



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

MERLON
CAPITAL PARTNERS

Strategy FUM	Merlon FUM
$1,081m	$1,086m

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

Running on Empty
Forecasting with Humility
Who's Got the Energy
Australian Private Health Insurance
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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