MERLON CAPITAL PARTNERS

ESG Manager:
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ESG Integration at Merlon – Part 1 : Philosophy

At Merlon we focus on assessing the sustainability of a company's free cash flow because we believe that is the basis on which companies should be valued.

Environmental, Social and Governance (ESG) factors play a key role in determining the sustainability of a company's free cash flow and we assess every investment with ESG factors in mind. We incorporate ESG considerations in our:

- Qualitative analysis which forms the backdrop to assess sustainable cash flow that drives our central case valuation.
- Valuation range, which incorporates upside and downside cash flow scenarios.
- Conviction score, which measures how our views differ from popular opinion by referencing the valuation range and other evidence.

Companies with more ESG risks have a wider range of valuation outcomes and thus a lower conviction score if the share price does not compensate for these risks.

Merlon recognises the growing importance of ESG related matters

Dedicated ESG Capability

ESG related matters are becoming increasingly important in assessing potential and monitoring existing investments. Further, the skills required to develop a deep understanding of ESG related issues and coordinate engagement activities is becoming more specialised and resource intensive.

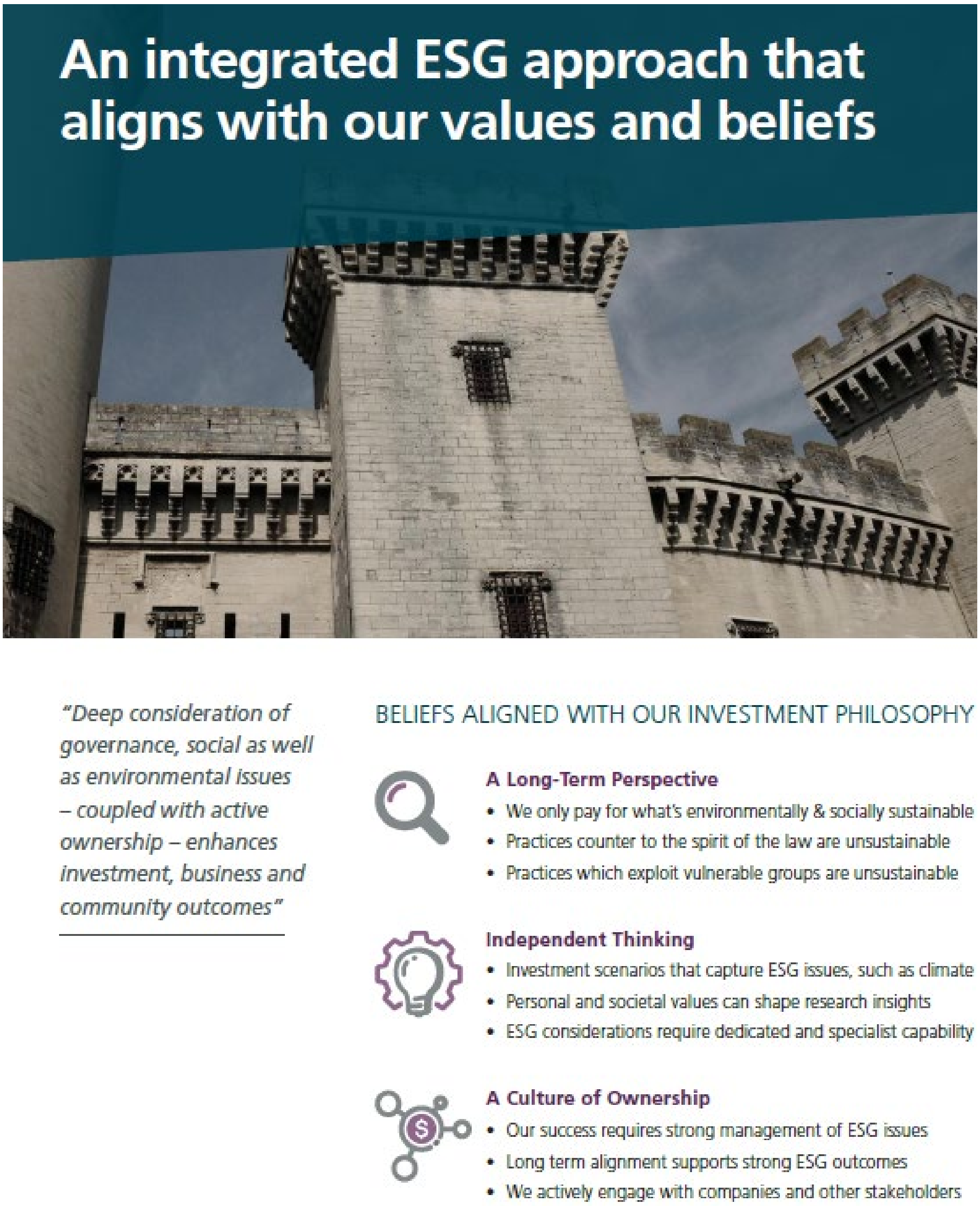
In recognition of this, Merlon expanded its in-house skill set in 2021 through hiring a dedicated ESG and Sustainability Manager to refine its ESG philosophy, further integrate the ESG process and drive proactive engagement with investee companies.

Merlon have a dedicated ESG and Sustainability specialist, Rebecca El-Khoury

To clearly articulate our ESG beliefs, the team undertook an in-depth process which included individual reflections, numerous team sessions and countless hours of debate and discussion. This process culminated in Merlon's ESG philosophy, which very closely aligns to our investment philosophy, and forms the basis of our ESG process, engagement and decision making.

This paper represents the first of a three-part series describing ESG at Merlon. In this paper, we will explore our newly established ESG Philosophy, including how it was developed and key themes arising from this. Our second and third papers will explore our refreshed approach to ESG process integration and our commitment to active ownership and engagement.

Figure 1: Merlon's ESG Philosophy



Data source: Merlon Capital. November 2021.

Alignment of ESG and Investment Philosophies

Merlon is a boutique firm and we recognise our strongest assets are our people. We are well aligned with our client's best interests, as both business owners and having coinvested a significant portion of our personal wealth in our funds.

Given this, having clear alignment across the team on important topics, including our ESG philosophy, is paramount. As such, we undertook an extensive process to clearly articulate our ESG beliefs and are proud of the outcome we have achieved.

We believe that deep consideration of governance, social as well as environmental issues – coupled with active ownership – enhances investment, business and community outcomes

We approached the development of our ESG philosophy in the same fashion we do all things: with dedication and attention to detail. The aim was to bring together, expand on and distil our ESG beliefs into a guiding document to guide future decision making, shape the integration of ESG into our investment process, underpin engagement with investee companies and communicate our beliefs to our investors.

To achieve this, we incorporated individual reflections from each team member, numerous team sessions and more than 150 cumulative hours of debate and discussion. Through these sessions, we discussed key questions, such as *What are the roles and responsibilities of directors, government, customers and employees? What are Merlon's responsibilities?* and *Is there a trade-off between investment returns and ethical responsibilities?*

Other key issues discussed included personal beliefs versus investment outcomes and whether investing in gaming stocks or weapons manufacturing provided the same level of moral dilemma as investing in coal mining stocks. We also debated the difficulties of considering different issues in isolation and the fact that a balanced and holistic assessment of key ESG issues is required for a more accurate assessment of impacts. For example, the need to decarbonise, while maintaining reliable and affordable access to energy for all.

We were very purposeful in this exercise, paying close attention to the particular words we chose and the order in which we placed them. What we have produced will not only better articulate our shared ESG beliefs and values, but also guide our decision making into the future, both in regard to the way we invest and how we run our business.

Our ESG Philosophy

At Merlon, we believe *deep consideration of governance, social as well as environmental issues – coupled with active ownership – enhances investment, business and community outcomes*.

This belief statement summarises our overarching views on ESG and what it means for the way we invest. While only 20 words, there are five key messages we want to communicate:

1. ***Good governance is essential to managing environmental and social risks***

Governance has always been a key focus in our assessment of a company. Firms that exhibit strong governance structures and practices represent less risk that those that do not, and this remains true for ESG related matters.

We view a key aspect of a board's responsibility is to ensure that material ESG issues the company may face, or is currently facing, are well considered and have appropriate strategies and risk management practices in place. This includes the ability to identify and respond to ESG related risks and opportunities, for example climate change and shifting social expectations.

For example, when Rio Tinto destroyed the 46,000-year-old Juukan Gorge rock shelters, an ancient Aboriginal sacred site in 2020, a parliamentary report concluded that poor governance was a key factor. There was clear lack of oversight and enabling of a poor culture which was not conducive to considering and raising concerns, such as the significance of the rock shelters. While this event raised clear environmental and social issues, it was ultimately a failing in proper governance in identifying and managing these risks. Poor governance also leads to poor culture, which can have a greater impact than simple policies and procedures. As such, it is important for board directors and management to truly believe in the direction they are setting for the company, as opposed to window dressing to appease investors.

Further, we believe that strong alignment of a company's directors and key management with shareholder's interests supports strong ESG outcomes. We believe remuneration frameworks which are weighted towards share holdings and longer-term outcomes, including ESG related factors, will lead to better ESG and shareholder outcomes. To reflect this, our business is both employee-owned and we have significant co-investment in our funds. This provides a high degree of long-term alignment to our business success including the role of strong ESG management for our business, as well as the companies we invest in.

2. ***Consideration of key ESG issues improves investment decision making.***

As long-term investors, we focus on at least a three-year investment horizon and consider all investments across a range of outcomes. This allows us to factor in all relevant and material investment issues, which sometimes includes key ESG issues, into our central case valuation as well as both downside and upside scenarios.

To explore this in practice, we have summarised a case study example of Australian Pipeline Trust (APA) below which demonstrates how we think about key ESG risks facing our portfolio and potential portfolio companies, and how we capture them into our valuations.

Australian Pipeline Trust (APA) is Australia's largest natural gas infrastructure business with over 15,000 kilometres of natural gas pipelines, connecting sources of supply and markets across mainland Australia.

The company screened as undervalued, with the markets concerned about decarbonisation and electrification trends, resulting in an overly pessimistic view on the duration of cashflows from APA's portfolio of assets. The market was also highly concerned about the prospect of poor capital allocation, initially associated with US expansion plans and more recently stemming from the proposed Ausnet acquisition.

We initiated our position in APA when the share price was trading close to our downside scenario, which incorporates key ESG issues including decarbonisation and climate change transition risk. Under our central case, long term demand for gas distribution network remains stable through to 2050, eventually falling towards almost zero by 2070. While, under our bear case, revenue declines by 75% between 2040 and 2050, and gas only exists until 2050. We also considered capital allocation risk in our bear case, including incorporation of a $1.5 billion haircut for undisciplined and destructive M&A activity.

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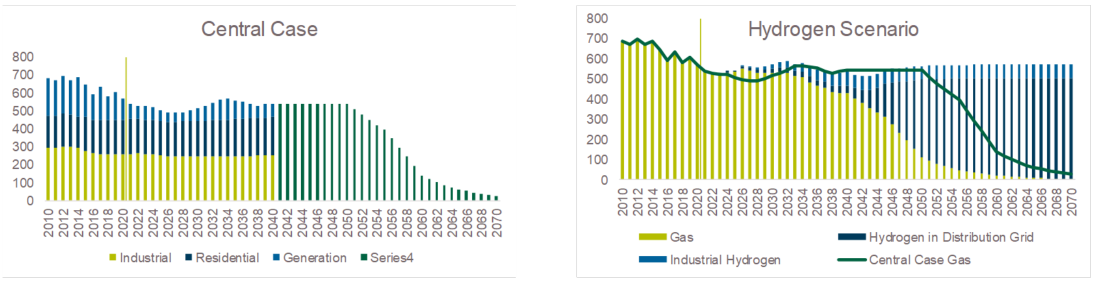

Active ownership is preferred over divestment

3. We believe 'active ownership' is the preferred method for addressing ESG risks.

As responsible investors, Merlon recognises that we have responsibilities outside of delivering investment returns for our clients, such as engagement and responsible voting. Further, we believe society is better off with responsible and active investors to enhance both investment and societal outcomes. As such, engagement with our investee companies is an important part of our overall ESG strategy.

Given active ownership over divestment is our preference, Merlon engages with the management teams and boards of companies to seek further clarification and provide feedback on ESG issues and help them understand how we think about ESG in our investment process. Our aim is to positively impact future decisions made by our portfolio companies, as well as optimise our investment decisions by further enriching our research.

At the same time, we also recognise that time and resources are finite, and as such, we focus on what is material and engage where we believe we can make a difference.

For example, Merlon has owned coal mining companies which are currently facing climate change and decarbonisation risks. For these companies, we remain conservative in how we value them, ensuring we factor in relevant ESG risks by focusing on existing 2P reserves, discounting new projects which do not align to a net zero 2050 future and fully deducting site restoration costs. This ensures we factor in the relevant ESG issues facing these companies. We also actively engaged with these companies, including via formal written communications to company boards urging them to not pursue growth projects that do not align with decarbonisation trends.

4. Personal views and values are relevant.

Personal views and beliefs are important

Our employee-owned business is small and focused, with seven employees. We have a flat structure allowing individual views to easily permeate across the group. This has allowed us to explore the role of personal and societal values when investing.

In developing our ESG philosophy, we concluded personal views can often be relevant considerations to an investment case, and should be reflected in our valuations, investment decisions and company engagements.

Personal views, which are often formed through either personal experience or upbringing, can uncover practices which may be considered unsustainable. For example, a person may view a gaming company as exploitative and therefore unappetising from investment perspective. This is considered relevant to the investment thesis as revenue streams which relate to vulnerable groups (e.g. problem gamblers) as unsustainable, and should be discounted in our valuations.

Personal views also form part of broader societal beliefs and values, which will impact investment outcomes overtime, particularly if law and regulation catch up. For example, legislation regarding gaming companies and problem gamblers could become more stringent in response to changing societal values and increased community pressure on governments. This would lead to increased regulatory costs and a corresponding reduction in margins for gaming companies, which would reduce their investment appeal. As such, Merlon reflects relevant and material personal beliefs and societal values into our valuations, valuation range and engagement agenda.

Further, we recognise that by incorporating personal views, we improve our own culture, team engagement and ability to attract and retain talent. Ultimately, we expect this to result in better investment performance and business outcomes.

5. We must act in a way consistent with expectations for investee companies

At Merlon, we pride ourselves on being authentic and true to label. This means that our beliefs not only apply to our investment approach but also to the way we conduct ourselves as a business. We recognise that Merlon's success requires strong management of ESG issues. Against this backdrop, we also expect to hold one another accountable to our values and beliefs, as articulated in our investment philosophy and our ESG philosophy.

We must live our values

As mentioned above, we both own our business and co-invest in our funds to ensure we are aligned to the long-term interest of our clients. In addition to this, we have strong processes including board involvement and oversight of our ESG efforts and approach. Our ESG philosophy and engagement approach has been unanimously approved by the Merlon Board. We have also recognised the importance of ESG in our structure, including the recruitment of a senior and dedicated ESG and sustainability resource.

Concluding Remarks

At Merlon, we assess every investment with ESG factors in mind. We achieve this by incorporating ESG considerations in our qualitative analysis, valuation range and conviction score. We only invest in companies if the share price adequately compensates for ESG and other investment risks and opportunities.

We recognise the growing importance of ESG related matters and expanded our in-house skill set to include a dedicated and specialised ESG and Sustainability Manager.

We established our own ESG philosophy, aligned with our investment philosophy, to clearly articulate our beliefs. We believe that deep consideration of governance, social as well as environmental issues – coupled with active ownership – enhances investment, business and community outcomes.

In future papers, we will explore our refreshed approach to ESG process integration and highlight our commitment to active ownership and engagement.