# Engagement with Portfolio Companies

## Introduction

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. We also place emphasis on identifying market misperceptions and on downside valuation scenarios which we reflect in our "Conviction Score".

We incorporate information garnered from engaging with company management, board members, competitors, suppliers, customers and third-party research providers in developing both our assessment of sustainable free-cash-flow and in arriving at Conviction Scores.

We are committed to engaging with portfolio companies on a broad range of issues including ESG where relevant. Engagement activities are carried out routinely by all Merlon portfolio managers and analysts. The outcomes of the engagement are reflected in our research which has a direct relationship with portfolio positioning.

Case studies highlighting our strong engagement track record are outlined in Appendix 1.

## Effective Stewardship

Merlon recognises that investment managers play a key role in fulfilling stewardship obligations to ensure responsible management and robust corporate governance practices through engagement activities.

Shareholder stewardship is an assessment of whether a company's senior management and board have, or are likely to act, in the best interests of shareholders. This includes an analysis of historical decision making, management and board effectiveness, remuneration structures, corporate governance, culture, financial controls, the personal integrity and track records of the individuals involved, long-term alignment and culture.

The Financial Services Council introduced its Internal Governance and Asset Stewardship code in January 2018. The code is a disclosure-based standard requiring members to articulate and promote their approach to internal governance and asset stewardship. Whilst Merlon is not required to adopt this code, we recognise the importance of internal governance and asset stewardship and appreciate that as investment managers we have the privilege to engage proactively with companies.

## Management Engagement

***Merlon has a strong track record of engaging on ESG issues***

We believe that engagement (both private and public) can be an important aspect of the investing process. There is usually a distinction between board engagement and management engagement.

Engagement with ***management*** is focused on understanding the company strategy and assessing the outlook for sustainable free-cash-flow and range of outcomes, including downside scenarios. Our frequency of engagement with management is naturally higher than with boards. An important part of our process is corroborating usually positive management views with former executives, competitors, suppliers and customers through our extensive independent expert network. We believe that verifying management views, and challenging these perspectives is our obligation as managers of capital.

## Board Engagement & Voting

We aim to engage with the ***boards*** of all companies in which we have invested at least annually, in addition to those in which we might consider investing. The focus is to understand and encourage alignment and strong representation of shareholders.

A significant part of our engagement with boards occurs prior to AGMs. We research the recommendations of the proxy advisors prior to meeting. If we intend to vote against a board recommendation, we discuss this with the company prior to voting. If the board's reasoning is sound, we may consider changing our view, however the engagement and discussion with company is key to understanding their perspective.

In terms of the nature of questions we might ask at a board level, while there will always be some specific to each company, there are some core questions relevant to all as outlined in Table 1 overleaf:

**Table 1: Sample of engagement questions**

| | |
|---|---|
| ***Board composition and functioning*** | • If recently joined, what due diligence was completed prior?<br>• If long-serving, what is the view on appropriate tenure?<br>• What succession planning is in place for executives and the board?<br>• Is there appropriate challenge of the CEO and other executives? |
| ***Incentives*** | • How appropriate are the incentives to driving the correct behaviours for the long-term sustainability of the business?<br>• How are management and the board aligned to shareholders and are there minimum shareholdings?<br>• What is the board's attitude to share sales?<br>• Fatalities - is safety a gate for zero bonuses? |
| ***Accounting*** | • What is the link between accounting and incentives (use of EBITDA etc.)?<br>• Is the company doing factoring (why, how etc.)? |
| ***Capital allocation*** | • How does the board allocate capital and evaluate acquisition opportunities?<br>• What have been the board's best and worst capital allocation decisions?<br>• Is there an example of an investment that didn't go ahead due to the board? |
| ***Environmental and social risks*** | • Does the person responsible for ESG report to the board on climate change risk?<br>• Does the board have good oversight on modern slavery risks (awareness of direct suppliers etc)? |

*Source: Merlon*

**Approach to Voting**

We provide recommendations to institutional clients and to the responsible entity for pooled funds. We draw on the views of Ownership Matters and ISS when determining our voting intentions. While we are inclined to follow the proxy advisors' recommendations, on occasion our views may differ. For example, the proxy advisors recommended voting against many of the Harvey Norman 2019 AGM resolutions. Specifically, they recommended voting for a new independent director who we felt had no relevant experience to offer to the board and would have been extremely disruptive, so we voted in-line with the board recommendation.

We keep records of contentious voting issues, noting how and why we voted either against board recommendations and/or proxy advisors.

In 2019, 91.8% of our voting instructions were made in-line with board recommendations and 8.2% were against.

## Third Party Engagement

In addition to ***board*** engagement and ***management*** engagement we also engage with third parties including:

- Other shareholders and investors;
- Regulators, with an example being active lobbying of the ASX to improve its listings rules to provide greater shareholder protection for minority shareholders (A Case Study in Poor Capital Allocation: The Need for Greater Shareholder Protections) and Divestments & Shareholder Rights);
- Investment banks and other advisors, including proxy and governance firms; and
- The media by providing public commentary or background material with the purpose of influencing better corporate governance.

## Private vs Public Engagement

***We engage privately but are prepared to go public if necessary***

Our engagement will almost always be held privately, through emails, letters, face-to-face meetings, teleconferences etc. However, there are instances where we publicly express concerns if we feel it is in the best interests of shareholders and hence our investors. This has typically been in relation to critical issues (e.g. divestments, takeover approaches etc.) where we felt our concerns were not being adequately addressed and / or where we would like to garner the support of other investors.

Case studies highlighting our strong engagement track record are outlined in Appendix 2.

## Engagement and ESG

We have a strong commitment to engaging on ESG issues. We seek to engage regularly with the management teams and boards of companies with the objective of better understanding their position and share ours on key ESG issues. We also believe it is important to assist them in understanding how we think about ESG in our investment process and how this can drive the sustainability of cashflow and mitigate downside scenarios into the future.

We incorporate environmental, social and governance (ESG) considerations into our assessment of sustainable free-cash-flow and in arriving at Conviction Scores. This means we are less likely to invest in companies if the market is complacent about ESG risks that we see as significant.

As part of this process and where relevant, we engage with management teams and boards of companies to understand their positions on key ESG issues and to influence or change their view where ours differs. We also believe it is important to assist companies in understanding how we think about the linkages between ESG related matters, sustainable free-cash-flow and the resultant the valuation of their businesses.

As part of our commitment to active ownership, Merlon is a signatory to the Principles for Responsible Investment (PRI). The PRI is the overarching framework of our ESG approach and we commit to the following:

- We will incorporate ESG issues into our investment analysis and decision-making processes;
- We will be active owners and incorporate ESG issues into our ownership policies and practices;
- We will seek appropriate disclosure on ESG issues from entitles in which we invest;
- We will promote acceptance and implementation of the PRI within the investment industry;
- We will work to enhance our effectiveness in implementing the PRI; and
- We will report on our activities and progress towards implementing the PRI.

***We engage with companies on a broad spectrum of key issues***

Our commitment to the PRI Principle to be active owners is demonstrated through our engagement activities across our portfolio of investee companies. A sample of the specific ESG issues we might raise with companies is outlined in Table 2:

**Table 2: Sample of specific ESG issues that may be raised with companies**

| | |
|---|---|
| ***Environmental*** | • Impact of climate change including physical and transition risks<br>• Recycling<br>• Packaging<br>• Water<br>• Site remediation |
| ***Social*** | • Modern Slavery<br>• Workplace health and safety<br>• Supply chain management<br>• Human rights<br>• Employee recruitment and retention<br>• Treatment of customers<br>• Treatment of staff<br>• Customer satisfaction |
| ***Governance*** | • Board structure<br>• Capital allocation<br>• Related party transactions<br>• Remuneration structure<br>• Accounting practices<br>• Alignment with shareholders |

*Source: Merlon*

## Responsibility for Engagement

Within the investment team, we have a senior investment professional with overall responsibility for coordinating engagement activities and ensuring a consistent approach. The senior portfolio managers have ultimate responsibility for voting decisions. However, our general approach is to provide a high degree of autonomy, accountability and responsibility to responsible analysts.

As an owner-managed firm with significant co-investment alongside our clients, the investment team have a strong alignment with clients on engagement matters.

## Tracking Engagement Activity

We keep a notes and records of company and other engagements and draw on these for future engagements and monitoring. We maintain proprietary qualitative scores, financial models and Conviction Scores on companies in our investible universe including scores specific to management and governance. These scores and models may be influenced by our engagement activities which in turn impact portfolio investment decisions.

Engagement activities are tracked and reported to our investors and the PRI annually. We have a weekly investment meeting to coordinate our engagement activity and resolve contentious issues.

## Conflicts of Interest

In accordance with regulatory requirements, Merlon maintains a conflict of interest policy to ensure that any actual, potential and/or perceived conflict of interest that may arise both between itself and its clients, a staff member and a client and between clients are identified, prevented or managed and disclosed in the best interests of clients.

All Merlon staff are required to complete annual conflicts of interest training to ensure they have the appropriate understanding to identify and report conflicts of interest which can then be prevented or managed pursuant to its conflicts of interest framework.

## Appendix 1: Engagement Case Studies

### Case Study 1: AMP's Life Insurance Sale

***Governance issue: Poor capital allocation***

On 25 October 2018, AMP announced the sale of its Australian and New Zealand wealth protection and mature businesses (AMP Life) for A$3.3b to Resolution Life. We believed the sale represented a destruction of shareholder value, as evidenced by the 28% decline in the share price in the two days following the announcement. Our engagement with the company was as follows:

**Table 3: AMP engagement**

| Dates | Actions |
|---|---|
| 25 October 2018 | • Initial discussions with management<br>• Discussions with other shareholders |
| 27 October 2018 | • Letter to the board on detailing our position and concerns |
| October 2018 to April 2019 | • Contribution to various media articles in The Australian and Australian Financial Review as well as appearing on ABC Business several times |
| 31 October 2018 | • AMP releases additional information in relation to the AMP portfolio review to respond to Merlon requests |
| 1 November 2018 | • Follow-up letter to board in response to additional information released |
| 15 November 2018 | • We highlight AMP experienced the worst share price reaction of all top 100 company divestments since 2000 and that never before has a top 100 company sought to divest so much of its operations without shareholder approval (Divestments & Shareholder Rights) |
| 31 March 2019 | • We highlighted the need for greater shareholder protections on 31 March 2019 (A Case Study in Poor Capital Allocation: The Need for Greater Shareholders Protections) |
| 12 April 2019 | • We actively campaign for the removal of AMP chair for governance failings ahead of the AGM (ABC Business) and meet with all key proxy advisors to share our views. |
| 30 July 2019 | • We further detail the value of AMP on 30 July 2019 (The AMP valuation case) |
| 1 July 2020 | • AMP announces the completion of the sale on 1 July 2020 and return of capital to shareholders |

*Source: Merlon*

## Case Study 2: Boral's acquisition of Headwaters

***Governance issue: Poor capital allocation***

On 21 November 2016, Boral announced the acquisition of Headwaters Incorporated – a US listed company - for US$24.25 per share or A$3.7b in total. The acquisition was funded by a mixture of debt and a $2.1b capital raising.

**Table 4: Boral engagement**

| Dates | Actions |
|---|---|
| 1 December 2016 | • Met with management and expressed concerns over price paid |
| 31 December 2016 | • We released a report detailing our views (Boral's High Price Acquisition of Headwaters Incorporated). We considered Boral to have overpaid by between 10% and 40% |
| 2 August 2017 | • Met with members of the board to understand the process for making the acquisition including due diligence done |
| June 2017 to September 2017 | • Exited investment after holding for four years once the stock recovered to ~$7 |
| December 2018 to June 2019 | • Reacquired a position when the stock represented better value |
| 27 August 2019 | • Meeting with management following FY19 result. Sought an understanding from management regarding the underlying organic growth of the North American business. The base business had been deteriorating, reflecting too much emphasis on deal synergies |
| 1 November 2019 | • Sought accountability from the Chairman Kathryn Fagg in pre-AGM call |
| 10 February 2020 | • Boral announces retirement of CEO Mike Kane |
| 15 June 2020 | • Boral announces new CEO Zlatko Todorcevski. |
| 28 August 2020 | • Headwaters deal failings are detailed in the FY20 result presentation. The company writes down the value of their investment in Headwaters by $1.1b |
| 28 September 2020 | • Boral announces significant board renewal. Only the Chairman and one other director remain from the time of the Headwaters deal |
| 13 October 2020 | • Pre-AGM call with the Chairman Kathrynn Fagg and retiring Director John Marlay |
| 15 October 2020 | • Chairman indicates she will retire in 2021 |

*Source: Merlon*

## Case Study 3: Caltex's takeover approach

***Governance issue: Not acting in shareholder's interests***

On 28 November 2019, Caltex announced the receipt of a non-binding, indicative and conditional proposal from Alimentation Couche-Tard for $34.50 per share in cash. This followed an earlier proposal in October for $32 per share that was not disclosed. On 3 December 2019, Caltex announced that the Board had concluded that the proposal undervalued the company but offered to provide Alimentation Couche-Tard with selected non-public information to allow it to submit a revised proposal.

**Table 5: Caltex engagement**

| Dates | Actions |
|---|---|
| 28 November 2019 | • Initial discussions with management once the takeover approach had been confirmed |
| 4 December 2019 | • Formal letter and presentation sent to the board detailing our views. We disagreed with the board's view that the offer undervalued Caltex |
| 5 December 2019 | • Meeting with Chairman |
| 6 December 2019 | • Merlon issues clarification regarding our position on 6 December 2019 (Merlon Clarifies its Position Regarding Couche-Tard Offer for Caltex Australia) |
| December 2019 | • Contribution to various media articles in The Australian and Australian Financial Review |
| 17 December 2019 | • Follow-up letter on 17 December to the board with follow-ups from prior meeting |
| 13 February 2020 | • Alimentation Couche-Tard boosts offer |
| 20 April 2020 | • Alimentation Couche-Tard walks away from bid |

*Source: Merlon*

### Some other examples

Some other examples include formally engaging with the chair of Wotif in July 2014 and iINet in March 2015 to express our disappointment and urge the rejection of the low takeover offers from Expedia and TPG Telecom respectively; the chair of Seven West Media in April 2015 in relation to convertible preference shares that diluted the value of ordinary shares; and more recently publicly shared our disapproval of the Amaysim board's support of the low takeover offer from Optus (The Strategic Value of Amaysim).