Merlon Concentrated Australian Share Fund

Quarterly Report – March 2023

For queries, please call Investor Services on 13 51 53

Fund Features

Proven Investment Philosophy: We believe people are motivated by short-term outcomes, overemphasise recent information and are uncomfortable having unpopular views.

Simple Process: We invest in undervalued companies where we think market participants have become too pessimistic.

Concentrated: A portfolio of 25-35 companies constructed without regard to benchmark weights.

Proven Track Record: Merlon's investment team has a proven track record of delivering true-to-label performance since its 2010 strategy inception.

Integrated ESG Approach: We believe deep consideration of governance, social as well as environmental issues – coupled with active ownership – enhances investment, business and community outcomes.

Fund Facts

Portfolio managers	Neil Margolis
Fund inception date	1st February 2018
Merlon FUM	$1,063m
Strategy FUM	$483m
Fund FUM	$123m
Management fee	0.52% p.a
Performance fee	20% of the Fund's daily return above the benchmark.
Fund objective	The Fund aims to outperform the benchmark on a total return basis over the medium to long term.
Minimum Investment	$10,000
Suggested timeframe	At least 5 years
Buy/Sell Spread	+0.20% / -0.20%
Distribution Frequency	Quarterly
APIR Code	HOW2217AU

Top 10 Holdings (Alphabetical)

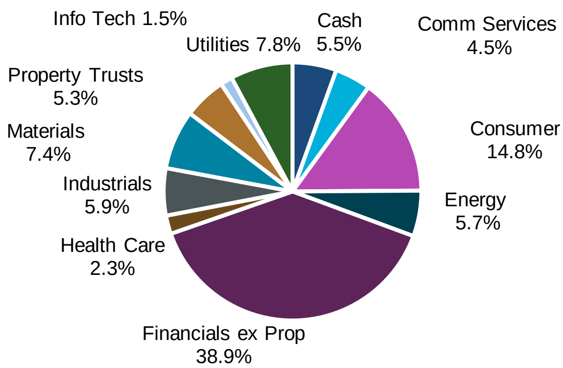
AGL Energy	Medibank
Alumina	News Corporation
AMP	QBE Insurance Group
Coles Group	Suncorp Group
Insurance Australia Group	Westpac Banking Corporation

Fund performance net of all fees and expenses

%[1]	Fund	Benchmark[2]	Excess
Since Inception (p.a)[3]	6.7	7.5	-0.9
5 Years (p.a)	8.3	8.7	-0.4
3 Years (p.a)	23.6	16.5	7.0
1 Year	7.2	0.1	7.1
FYTD	16.8	13.6	3.1
Quarter	0.2	3.5	-3.3
1 Month	-1.2	-0.2	-1.0

[1]Performance figures are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures. Past performance is not a reliable indicator of future performance.
[2] The Fund benchmark is the S&P/ASX 200 Accumulation Index.
[3]The Inception Date for the fund is 1 February 2018. Strategy Inception date is 31 May 2010.
Source: Fidante Partners Limited, 31 March 2023.

Sector Exposure



Quarterly value added relative to benchmark

Top 5	Value Added (%)
Medibank	0.6
National Australia Bank	0.5
Commonwealth Bank of Australia	0.5
Super Retail Group	0.4
Coles Group	0.3

Bottom 5	Value Added (%)
Incitec Pivot	-0.4
A2 Milk Co	-0.5
News Corporation	-0.5
Insignia Financia	-0.7
AMP	-1.1

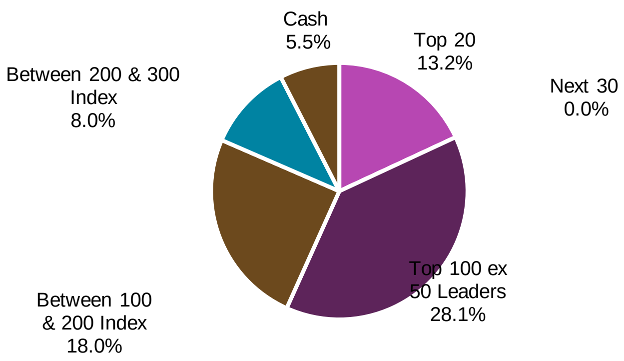
Source: Fidante Partners Limited, 31 March 2023. Benchmark is S&P/ASX 200 Accumulation Index

Merlon Concentrated Australian Share Fund

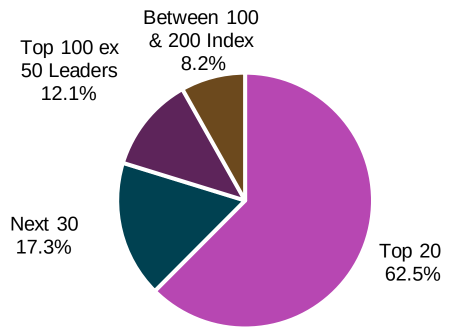
Quarterly Report – March 2023

For queries, please call Investor Services on 13 51 53

Market Cap Bands - Fund



Market Cap Bands – ASX 200



Market Review (March 2023 quarter) – financial sector risks

Having peaked at 4.25 per cent in the December 2022 quarter, US 10 Year Treasury Bonds spent much of the March 2023 quarter drifting lower, ending at levels below 3.50 per cent. Bank instability became more tangible during the quarter as the rapid rise in rates exposed mark-to-market losses on assets and raised concerns on recoverability of deposits. The largely unknown Silicon Valley Bank declared bankruptcy due to the impact of higher interest rates on its bond portfolio, while the far more well-known Credit Suisse, under pressure from client outflows, coupled with an unwillingness from capital providers to continue funding the bank, was merged with the other Swiss banking giant, UBS.

Following its leading role in beginning to slow its level of rate hikes, early April saw the RBA ultimately pause rate hikes altogether, albeit noting its data-driven approach. In pausing, the RBA noted a wage inflation figure of 3.3 per cent as within its 4 per cent upper tolerance limit. Also weighing on the decision were the 880,000 fixed rate mortgages written during the zero-rate COVID property market peak which are due to reset over coming months. Yet should we see the impact of continued rental rate increases and rising electricity prices flow through to elevated inflation data, rates may ultimately need to keep rising.

In these conditions, we saw the local equity market rally by 3.5 per cent. While the **Bank** sector, affected by concerns over the stability of the global banking system, declined by 4.4 per cent, the rally in risk assets, buoyed by declining risk-free yields, more than offset losses in banks. Leading the market, we saw 10-plus per cent returns from the **Communications** and the **Consumer Discretionary** sectors, and 8-plus per cent returns from the **Consumer Staples** and **Information Technology** sectors, all of which were beneficiaries of the potential rate rise pause. The **Materials** sector also recorded an 8-plus per cent return during the quarter, benefiting from lockdowns easing ahead of Chinese New Year.

Also worth noting was the flat return registered by the Australian **Energy** sector. China's mobility resumption should be a boon for Australian energy producers, both in terms of oil and gas demand. Yet continued (and ill-advised) domestic government regulatory intervention (most notably the risk that LNG export volumes may be forced to be made available for the lower priced domestic market) impacted the sector.

Also weighing on returns was the combination of softening post-winter Northern Hemisphere gas pricing, and softening oil prices, driven lower by growing expectations of weakening ex-China oil demand as rate rises flow through to reduced activity levels. The OPEC+ cartel responded in early April with an 'out of cycle' production cut. While providing what looks to be a USD80 per barrel support to pricing, it does risk higher than otherwise central bank rates.

Merlon Concentrated Australian Share Fund

Quarterly Report – March 2023

For queries, please call Investor Services on 13 51 53

MERLON CAPITAL PARTNERS

Portfolio Review (March 2023 quarter)

The Merlon concentrated portfolio returned 0.9% in the quarter, under-performing the S&P/ASX200, which returned 4.0%. This relative performance should be viewed in the context of a three-year outperformance of 8.6% per annum. From the depths of the market downturn at the onset of the global COVID-19 pandemic, which at the time we published our 'Covid Roadmap', the portfolio has returned 102%, a figure our internally portfolio construction framework (PCF) calculated at the time. This compares to a 64% return for the ASX200.

Stock-level summary: Positively contributing stock exposures during the quarter included overweight positions in **Medibank Private**, **Super Retail Group**, and **Coles Group**, as well as underweight positions in **National Australia Bank** and **Commonwealth Bank**. These positive contributors were, however, more than outweighed by negative contributions by overweight positions in **AMP**, **Insignia Financial** (previously IOOF), and **News Corporation**.

Positive contributors:

- **Medibank** benefited from a stronger than anticipated first-half financial report, specifically noting growth in policy holders, a positive recovery following October 2022's data hacking event. This result, albeit short-term, justified our belief that the market had over-reacted relative to a reasonable estimate of the impact.
- **Super Retail Group** benefited from a record December quarter sales update flagged in January, and a subsequent strong earnings report in February.
- **National Australia Bank** and **Commonwealth Bank** were both impacted by global credit events, notably the collapse of Silicon Valley Bank and the subsequent fall of Credit Suisse, which was ultimately forced into the hands of compatriot UBS.

Negative contributors:

- **AMP** saw the December quarter's strong performance, driven by the prospect of more meaningful capital returns, reverse as the market reacted to a larger than expected decline in underlying net profit result declared in February. The market continues to focus on current earnings over the fact the company has $4 billion in cash backing against a market capitalisation of $3.3b.
- Similarly, **Insignia Financial** reported a lower than market-anticipated decline in earnings as reported in February, as the company continues to shape its suite of acquired and existing assets into a more sustainable business model.
- **News Corporation** reported its December quarter earnings, with a decline in revenues and an associated flagging of a 5% headcount reduction as the company seeks to reset its business for a tougher operating environment. Pleasingly, however, the company's streaming initiatives in the form of Binge and Kayo continue to show subscriber growth.

Portfolio Activity

During the quarter, we added to existing investments in **Coles Group**, **Healius**, and **Insurance Australia Group**. To fund these additions, we exited the residual position in **G8 Education**, and reduced investments in **Qantas Airways**, **A2 Milk Company**, **Origin Energy**, **Super Retail Group**, and **Woodside Energy**, all of which outperformed and therefore had less valuation upside..

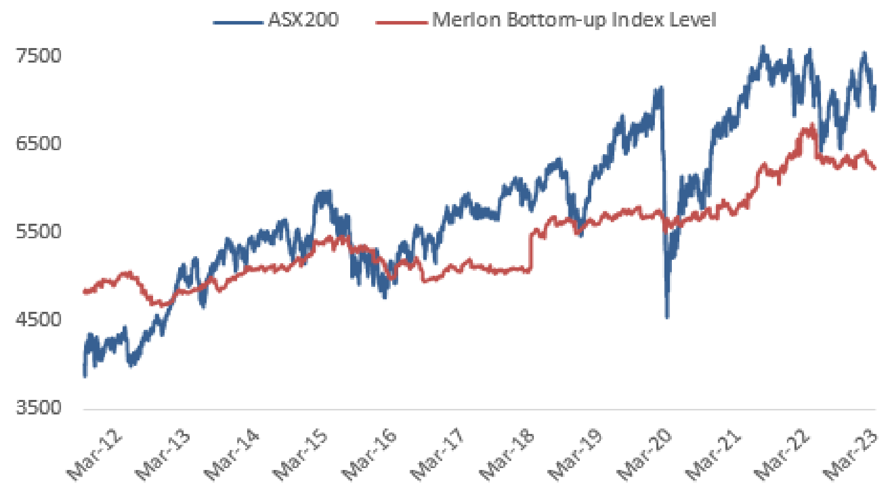
Despite having outperformed through the quarter, **Coles Group** continues to offer valuation upside within a relatively narrow range, reflecting its defensive nature. We expect continued mobility normalisation and inflation to benefit revenues, while COVID costs are also expected to unwind.

The reduction in energy-related positions such as **Origin Energy** and **Woodside** continued to reflect outperformance relative to our valuation range, based on long-term Brent oil price of US$60-100/barrel. We had maintained the position in Origin, as it had lagged the broader sector and the oil price and hence continued to present upside, a view vindicated in the form of the Brookfield/EIG acquisition.

Portfolio Outlook

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. While not as overvalued as the end of 2021, the market was 12% overvalued at the end of the March 2023 quarter.

Figure 1: Expected return based on Merlon valuations



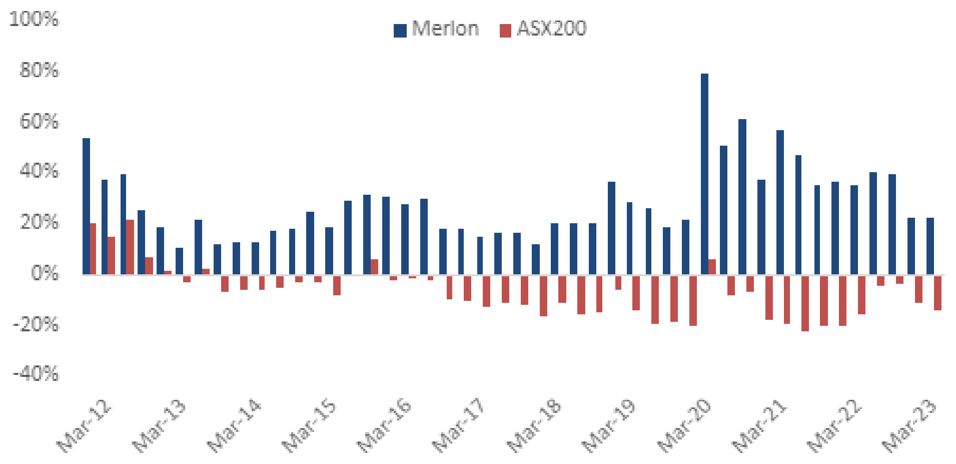
Source: Merlon Capital Partners

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.

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 and where investors have become overly pessimistic about long term prospects on account of weaker short-term performance. We assess the degree of pessimism by considering the company's market value in relation to a sensible valuation range with particular focus on the downside risk scenario. 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.

As can be seen in Figure 2, the Merlon portfolio continues to offer attractive upside as it has over the past 12 years, with the key being the expected return spread over the market. This gives us confidence we can continue to outperform over the medium-term.

Figure 2: Expected return based on Merlon valuations



Source: Merlon Capital Partners

Inflation and rate expectations appear to have peaked but this is now a consensus view. Downside economic risk and associated company earnings downgrades from the extent and pace of rate hikes is similarly a consensus view and most likely priced into current equity prices. We observe however that inflation, while having peaked, remains too high and markets are not priced for persistently high inflation in our view. A pause in central bank rhetoric runs the risk of a reacceleration of inflation and the longer inflation remains elevated the greater the risk of wage-price spirals. It is also unclear the extent of economic (and earnings) pain required to return inflation to central bank target levels. Furthermore, we have only recently ended 14 years of unconventional monetary policy that has suppressed discount rates and inflated most asset values.

Our portfolio is well positioned, at least in a relative sense, if inflation proves more persistent as we focus on under-appreciated cashflow rather than longer dated growth potential at low discount rates and have consistently factored in higher (3%) real bond yields. These higher yields are consistent with history which extends beyond the period of central bank meddling with bond purchases and reflects a risk premium for inflation volatility.

Our portfolio is also well positioned, again at least in a relative sense, for an economic and earnings downturn. We are materially underweight late-cycle banks which are not pricing in the inevitable turn in the credit cycle, and are now underweight commodity-exposed stocks (principally iron ore and now energy too) which will not be immune from the lagged global economic slowdown triggered by rapidly-higher interest rates. As we wrote about in our Covid Roadmap in 2020, leverage is the enemy in downturns and there are no more leveraged stocks than the banks, property and infrastructure stocks.

As it did in the most recent quarter and during the 2017 to 2019 period, our portfolio might lag a strong market if central banks do an about-turn and engineer more record stimulus to push real bond yields back towards zero or below. Investors might consider this a risk worth taking in exchange for a portfolio of companies with absolute upside through a focus on cash generation, conservative approach to leverage and overly pessimistic market expectations, without needing assistance from lower real interest rates.

Figure 3: Portfolio Analytics

	Portfolio	ASX200
Number of Equity Positions	32	200
Active Share	82%	0%
Merlon Valuation Upside	29%	-14%
Mid-cycle Free Cash Flow Yield	6.9%	5.0%
EV / EBITDA (year ahead)	12.6x	14.6x
Price / Earnings Ratio (year ahead)	14.9x	16.8x
Price / Book Ratio (year ahead)	1.9x	3.5x

Source: Merlon Capital Partners

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.

Stock in Focus

Healius (HLS) is one of the three large pathology providers operating in Australia, a relatively concentrated industry structure. The business provides pathology services across more than 2,000 sites, diagnostic imaging at nearly 150 sites, and operate 11 day hospitals.

To be a good investment, we need to understand the concerns that are driving a company to be undervalued by the market, and either prove these concerns are not valid or that the worst-case outcome is more than factored into the share price. With Healius, the market is concerned about the company's ability to reset its cost-base following the normalisation of COVID-19 testing volumes. While testing volumes have rapidly declined as COVID has become endemic within the population, Healius' operating model has lagged. While these concerns are valid, we believe they are transitory and have been more than discounted into the share price.

In addition to deep fundamental research and rigorous peer review, we have a formal engagement programme with the board of directors around the time of initial investment. We write a letter with the purpose of introducing Merlon, outlining our investment thesis, summarising key Environmental, Social and Governance (ESG) issues and ultimately engaging directly with the company. In the case of Healius, we value the company between $2.90 and $5.70 per share based on a range of long-term margin assumptions and segment valuations. An extract of the Healius letter follows, outlining our valuation range and investment thesis as delivered to the company.

Figure 4: Extract of letter to HLS Board

Members of the Board of Directors
Healius Limited
Level 22, 161 Castlereagh Street
Sydney NSW 2000

Re: Introduction to Merlon Capital Partners

Ladies and Gentlemen:

For your information, Merlon Capital Partners ("Merlon") owns [redacted] shares in Healius Limited ("HLS") on behalf of our clients, being retail and institutional investors. The purpose of this letter is to i) introduce Merlon to the board of directors; ii) outline our HLS investment thesis; iii) provide an overview of our approach to Environmental, Social and Governance (ESG) matters; and iv) summarise key ESG issues identified to date in relation to HLS.

Key ESG Issues in Relation to Healius

Merlon actively engages with market participants including other fund managers, proxy advisors, brokers and external rating agencies as well as other relevant stakeholders to identify market views and concerns regarding a company's ESG exposure and performance. In such discussions, key ESG issues identified in relation to HLS include:

1. Governance and management: some proxy advisors and sell-side analysts have raised concerns regarding board and management composition, following the recent departures of both the Chair and Chief

Investment Approach & Healius Investment Thesis

Our investment approach is to invest in undervalued companies where we think market participants have become too pessimistic. In the case of HLS, we value the company at between $2.90 and $5.70 per security based on a range of long-term margin assumptions. Our valuation is summarised below:

Segment	Low	High	Key Assumptions
Pathology	$1.6b	$2.8b	10-18% EBITDA margin
Imaging	$0.4b	$0.5b	15-22% EBITDA margin
Day hospitals	$0.1b	$0.1b	Sale price
Agilex	Nil	$0.2b	$0-16m EBITDA
Debt	($0.6b)	($0.6b)	Book value
Franking Credits	$0.1b	$0.1b	70% of face value
Equity value*	**$1.6b**	**$3.3b**	
Equity value per share	**$2.90**	**$5.70**	

*Numbers may not add up due to rounding

We believe the market is extrapolating historically low margins too far into the future, particularly in light of Sonic Healthcare's substantially higher margin performance and Australian Clinical Labs marginal profitability.

Source: Merlon Capital Partners

Prior to establishing our position in late-2022, we viewed the market as extrapolating historically low margins too far into the future, particularly considering competitors Sonic Healthcare's substantially higher margin outcomes and Australian Clinical Labs marginal profitability.

Since establishing an initial position, competitor Australian Clinical Labs (ACL) announced its intention to make a takeover offer for Healius. We sought board engagement with Healius, outlining our views as follows:

1. We viewed the deal as 'marginally dilutive' relative to our own valuation of the company,

2. That the assumptions underpinning the valuation range relied on successful strategy execution, and there was some credence to ACL's noting of the target's 'unsuccessful track record', and

3. That we believed the Healius board should seek to engage constructively with ACL in order to tighten offer conditions and simultaneously initiate a process to solicit alternative proposals that might unlock further value.

In response, we received a letter from the Healius Chair, and we are continuing to engage with board directors on the contents of our letter, including our own valuation, the ESG issues we have identified, and to better understand the takeover offer.

Links to Previous Research

- Energy system stability: risks, opportunities & the decarbonised future
- ESG Integration - Philosophy
- 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