Merlon Concentrated Value Strategy

Quarterly Report

June 2020

Neil Margolis

The long-term dividend and free cash flow opportunity is very attractive

Long-term Dividend Opportunity the Main Game

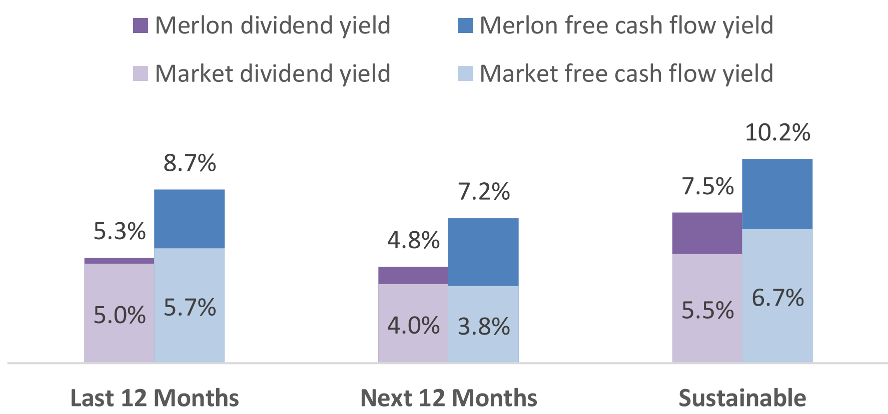
Long-term dividend prospects relative to share prices haven't looked this good for many years. With short-term dividends under pressure as a result of the COVID-19 induced economic downturn, we thought it would be a good opportunity to take stock of the near-term outlook but also present the case for taking a long-term view, focused on sustainable free cash flow. After all, dividends are merely a subset of this cash-flow. The key points are:

1. ***Free cash flow is a better measure of value than dividends***. As strange as it seems, directors often set dividends (and engage in buybacks) with little regard to the sustainable free cash flow backing the dividends, or appropriate debt levels. A company's fundamental value is best determined by focusing on sustainable free cash-flow combined with overly pessimistic market expectations.

2. The ***long-term sustainable free cash flow and dividend outlook is very attractive***, as evidenced in Figure 1 below.

3. The ***outlook for near-term dividends is weaker and difficult to predict***, particularly for macro-sensitive and highly leveraged companies such as banks, property and infrastructure stocks. Fortunately, the valuation of any business is largely insensitive to the next year's dividends and investors should not lose sight of the main game.

Figure 1: Current Value Signal From Dividends and Free Cash Flow



Source: Bloomberg, Merlon, including grossed up value of franking credits. As at 30 June 2020.

Free cash flow is a better measure of value than dividends

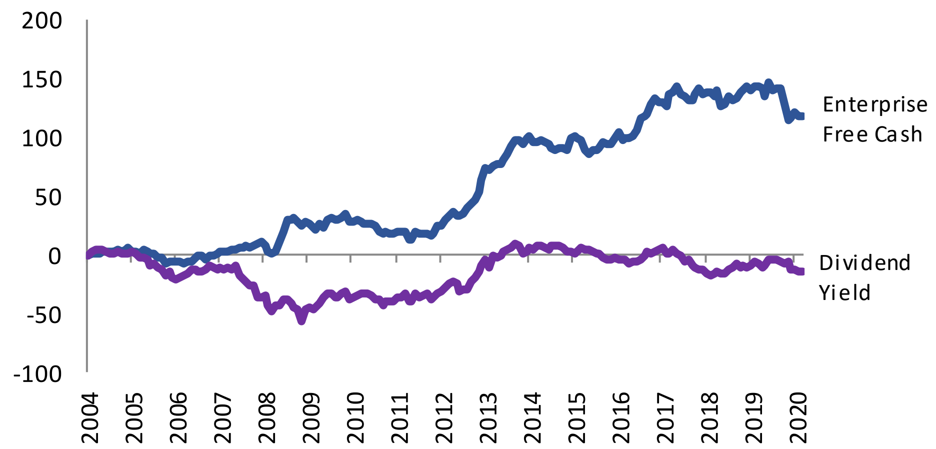
Now, more than ever, traditional classifications of value based on accounting earnings and dividends are readily manipulated by management. The recent ramp up in dividend payout ratios and the growing divergence between statutory and "underlying" earnings are examples of this.

A sensible approach to dealing with this issue is to classify stocks based on their capacity to generate cash flow above that needed to sustain and grow their businesses ("free-cash-flow"). The use of free-cash-flow rather than accounting earnings or dividends is important because the measure is less readily manipulated by management and less readily observable by the market. This creates opportunities for investors willing to invest the time to assess free cash-flow, and the degree to which it deviates from accounting-based earnings.

Value investing on the basis of free cash flow has performed well …

We wrote about the outperformance of a value strategy that classifies stocks based on free cash-flow rather than earnings or dividends in a three part series in 2017 (refer Value Investing –Part 1, Part II & Part III), with the key chart below.

Figure 2: Returns Based on Different Value Signals (Australian Data, March 2004 to June 2020)



Source: Bloomberg, Merlon. Portfolios are formed using two valuation ratios: enterprise-free-cash-flow-to-enterprise-value (EF/EV) and dividend yield (D/P). Portfolios are formed at the end of each month by sorting on one of the ratios and then computing equally-weighted returns for the following month. The "value" portfolios contain firms in the top one third of a ratio and the "glamour" portfolios contain firms in the bottom third. The analysis is based on S&P/ASX200 constituents and the raw data is from Bloomberg.

… a stark contrast to investing on the basis of dividends

Free cash flow, defined this way, also explicitly takes debt levels into account, a key consideration that is often overlooked by company directors.

Furthermore, dividends are often set by directors with respect to current operating conditions that might be inflated or depressed. Ultimately, the most relevant consideration is sustainable free cash flow and franking yield combined with overly pessimistic market expectations.

The long-term free cash-flow and dividend outlook is very attractive

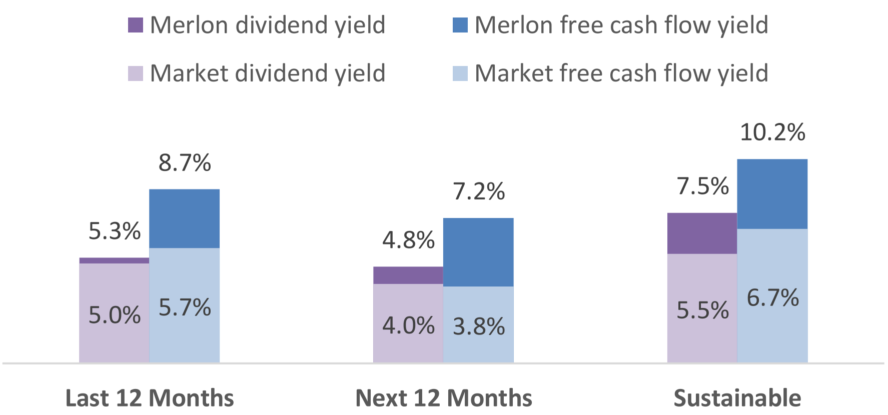
The Merlon portfolio combines a view of value determined with reference to sustainable free cash flow after deducting debt in full, with overly pessimistic market expectations.

The broad-based equity market sell-off in February and March 2020 failed to recognise the extent to which certain equity sectors were either over or under-valued leading into the crisis. While market timing is difficult, this has created an exceptional opportunity to invest in a select group of stocks that are undervalued based on their capacity to generate free cash flow and pay attractive and sustainable dividends.

The prize for staying focused on the long-term outlook is large

The companies Merlon invests have generally less debt, better cash conversion and more franking credits. This can be summarised in the below chart, highlighting the sustainable free cash flow yield of the share portfolio is 10.2% compared to the market at 6.7%.

Figure 3: Current Value Signal From Dividends and Free Cash Flow



Source: Bloomberg, Merlon, including grossed up value of franking credits

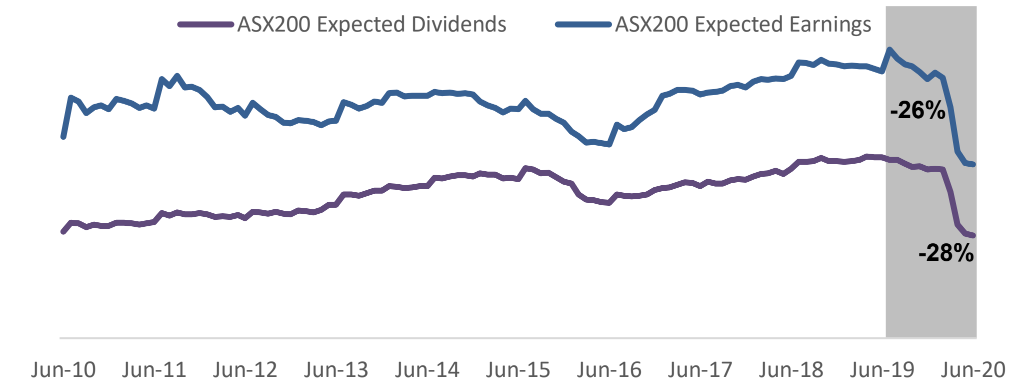
We will elaborate on the outlook for dividends in the next section but note fundamental value is largely insensitive to the next year's dividends. Rather, valuation is linked to the present value of free cash flow and franking credits, after debt has been repaid. It follows that any equity valuation is indifferent between dividends received or debt repaid, except for the time value of receiving dividends and franking credits slightly earlier.

The outlook for near-term dividends is weaker and difficult to predict

Near-term dividend expectations have been decimated …

Notwithstanding free cash flow being a superior approach and the long-term being a more relevant consideration, many investors are understandably anxious about the near-term outlook for dividends. Market expectations for earnings and dividends have been dramatically impacted by the COVID-19 crisis and ensuing economic fallout, with one year forward dividend estimates 28% lower than a year ago and back to absolute levels last seen in 2010.

Figure 4: Near-term Dividend Expectations Have Been Decimated



Source: Bloomberg consensus ASX200 12 month forward dividend and earnings expectations.as at 30 June 2020.

The key question is whether this outlook has already been priced in? For the optimists, the "pre-COVID" dividend yield, which assumes no permanent impact relative to the last twelve-months, is around 6% for both the broader market and the Merlon portfolio (see Figure 1). For the pessimists, the next twelve month or "COVID-affected" dividend yield, which assumes a permanent impact, reflects a much lower 4% for the market or 4.8% for the Merlon portfolio.

… but aren't useful in assessing fundamental value …

While there is some information content in these aggregate numbers, we don't consider either to be useful in assessing long-term fundamental value. Given 90% of the value of a company is dependent on cash-flows beyond the next year, the focus should be on *sustainable* free cash-flow that funds the dividends. Furthermore, value should always be considered as a range of outcomes given the difficulty in predicting the future.

The dividend forecast range for any company is a function of:

i) An assessment of the sustainability of current "advertised" accounting earnings;
ii) The conversion of these earnings into free cash-flow;
iii) Re-investment opportunities at an acceptable return on capital;
iv) The degree of financial leverage as excessive debt needs to be replaced with equity; and
v) Tax considerations such as availability of franking credits.

National Australia Bank as an example:

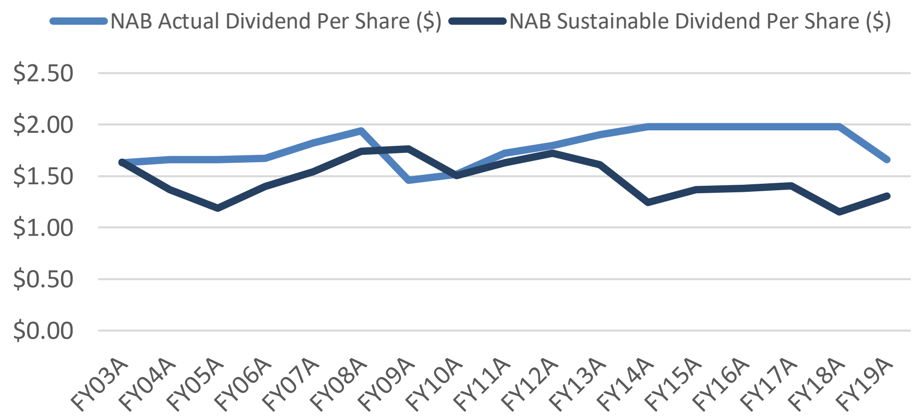
Bank dividends have propped up the market yield …

The major banks comprise a large component of the market index and an outsized component of dividends. In 2019, for example, the major banks contributed 35% of the realised yield compared to the index weight of approximately 23%. While superficially attractive, the major banks are highly leveraged which poses problems in times of economic stress.

… despite being clearly unsustainable …

NAB's "advertised" accounting earnings have been overstated in recent years as bad debts declined to unsustainably low levels and material "below-the-line charges" were booked. In addition, cash-flow was overstated due to subdued credit growth and the bank also gave up earnings from the US, UK and wealth divisions. Taking all of these adjustments into account, we estimate the sustainable dividend was on average 34% lower than the $1.98 actual dividend the directors clung to for the 2014 to 2018 period.

Figure 5: NAB Dividends Have Been Overstated For Many Years



Source: Company disclosures, Merlon, Sustainable estimate based on 0.70% bad debts to non-housing loans and 64% cash-flow to advertised accounting earnings.

.. and range between some lower number and zero in the year ahead.

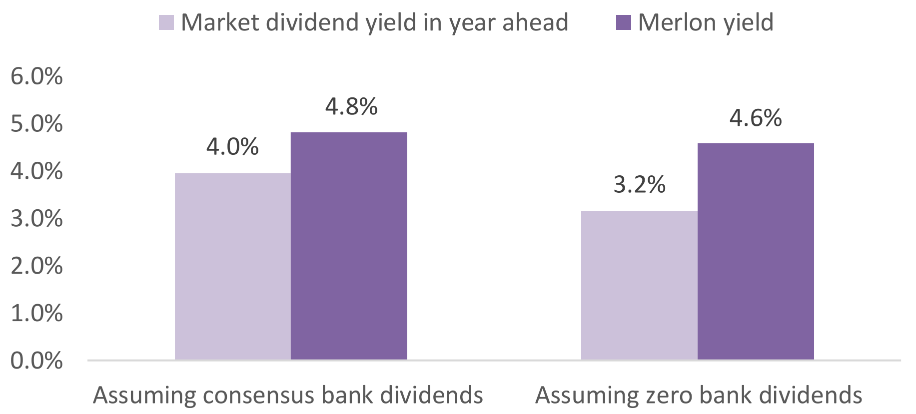
Estimating NAB's dividend in the next few years is even more difficult given the high level of financial leverage. Starting with earnings, we estimate $9b cumulative bad debts in a mid-case downturn scenario (or 10x 2019 reported bad debts) and up to $25b in a severe downside scenario based on our interpretation of APRA stress results. For reference, consensus bad debt estimates are $9b to $10b, indicating market expectations are at least somewhat appropriate.

After absorbing bad debts, directors need to shift their attention to regulatory capital before declaring a dividend. For example, NAB's own disclosures point to an equity capital shortfall of up to $8b in a severe downside scenario. Given current capital of $45b has to support a $614b loan book, it is no wonder overseas regulators and APRA are pressuring banks to limit dividend payouts until the COVID-19 economic fallout and recovery can be better understood.

High levels of debt present the greatest challenge forecasting near-term dividends and the share portfolio is significantly underweight leverage by virtue of its immaterial holdings in banks, infrastructure and property. While we assume some dividends for banks in our central case, these are below market, and a downside recession scenario of zero bank dividends for the next 12 months would reduce the market yield by 0.8% but the share portfolio's yield by only 0.2%.

… the portfolio is less exposed to cuts in bank dividends …

Figure 6: Forward Dividend Expectations Based on Bank Dividend Scenarios



Source: Bloomberg, Merlon, including grossed up value of franking credits

Telstra as an example:

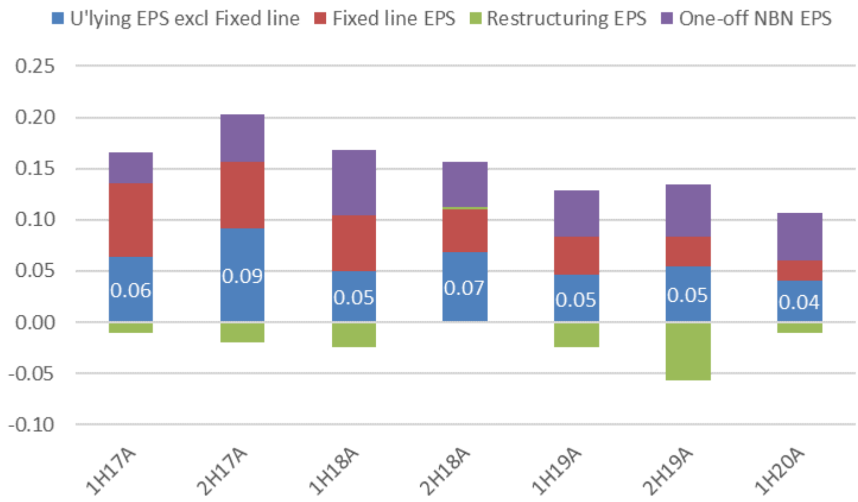
Similarly, Telstra's sustainable dividend is lower

Last year we wrote how Telstra could be worth between $1.80 and $4.50 based on a range of sustainable free cash flow scenarios, with the risk skewed towards the lower end (Telstra Investment Case). Telstra's dividend per share in the last 12 months was 16 cents which some observers use to derive a simplistic valuation of $4 (16c @ 4% yield).

As illustrated in Figure 7, Telstra's earnings per share can be decomposed into four categories:

i) One-off NBN disconnection receipts (9.7c per share as disclosed by Telstra)
ii) Restructuring charges and impairments (-6.8c per share as disclosed by Telstra)
iii) Fixed line EPS, trending down (4.8c estimated by Merlon)
iv) Underlying EPS ex fixed line (9.5c, the residual)

Figure 7: Decomposing Telstra Earnings Per Share



Source: Company accounts, Merlon, assumes 30% tax rate and 20% depreciation/ EBITDA for fixed line

To the company's credit, Telstra does disclose 6c of the 16c dividend as an unsustainable special dividend, representing one-off NBN disconnection payments net of NBN cost to connect charges.

However, even if investors give management the benefit of the doubt and assume NBN cost to connect won't be recurring and ignore persistent restructuring charges, they are left with somewhere between 9.5 and 14.4 cents earnings per share depending on their view on the ultimate profitability of fixed line EPS (reselling commoditised NBN replacing current "copper earnings"). Applying a 70% payout ratio would yield a dividend per share range of 7 to 10 cents per share (or simplistic valuation range of $1.70 to $2.50 capitalised at 4%).

With Telstra's 16 cent dividend per share contributing a not insignificant 4% of the market's next twelve-month dividend yield, this is an important debate for investors to have.

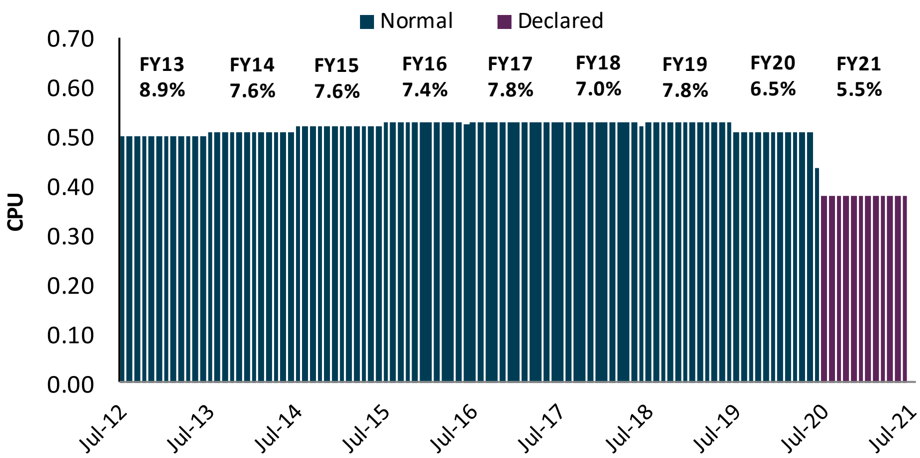
Merlon Australian Share Income Fund Distribution Outlook:

In addition to long-term capital growth above inflation and lower risk than the market, the Merlon Australian Share Income Fund (**Fund**) targets a higher distribution yield than the market. As Figure 8 highlights, this yield has also been consistently distributed on a monthly basis since 2012.

The Income Strategy's distributions will be lower this year …

While the COVID-19 crisis will pass and Australia appears to be in a relatively strong position, predicting near-term dividends given the economic dislocation is difficult. As a result, we have adopted a conservative approach and reflected this economic event by reducing the monthly income guidance to 0.38 cents per unit, a 25% reduction relative to the past 12 months and slightly better than the 28% reduction for the broader market (Figure 4). The new guidance represents a premium distribution yield of 4.7% at the 30 June 2020 unit price, or 5.5% including the grossed up value of franking credits.

Figure 8: Merlon Australian Share Income Fund Monthly Distributions



Source: Merlon, FY21 estimate, FY Yield based on monthly distribution plus franking credits divided by opening unit price, excludes bonus income in FY13 and FY14. Any forecasts are based on assumptions which we believe are reasonable, but are subject to change and should not be relied upon.

… but the yield is less vulnerable to unsustainable dividends …

This yield is above market and importantly, is less exposed to the highly leveraged banking sector, Telstra's unsustainable fixed line earnings and the macro sensitive iron ore miners.

As evidenced in Harvey Norman and Nick Scali's recent reinstatement of their dividends, there is upside to the yield in the event of a "V shaped" economic recovery. In a more protracted downturn scenario, there is downside risk to the dividends but this could be offset by additional income from the downside protection overlay.

… and the long-term opportunity is very attractive.

Importantly, the sustainable grossed up dividend yield of over 7% and free cash flow yield over 10% (see Figure 1) underscores the long-term opportunity for capital growth and higher dividends which the Fund is exposed to, with a 30% lower risk profile than the market.

Conclusion:

As highlighted through 16 years of data (Figure 2) and demonstrated with the National Australia Bank and Telstra examples, investors cannot rely on last reported dividends to value companies as these dividends might not be sustainable. Also, it is very challenging forecasting the next year's dividends during economic downturns, particularly for highly leveraged companies.

However, while the outlook for near-term dividends is weak and difficult to predict, investors should not lose sight of the main game. The long-term opportunity for capital growth and sustainable franked dividends from a contrarian cash-flow based investment strategy, such as the one employed at Merlon, is as attractive as it has been for some time. Patient investors could be rewarded along the way with above-market, majority-franked distributions and 30% downside protection from the hedge overlay.

Analyst:
Ben Goodwin

Oil – Pricing in More Realistic Recovery

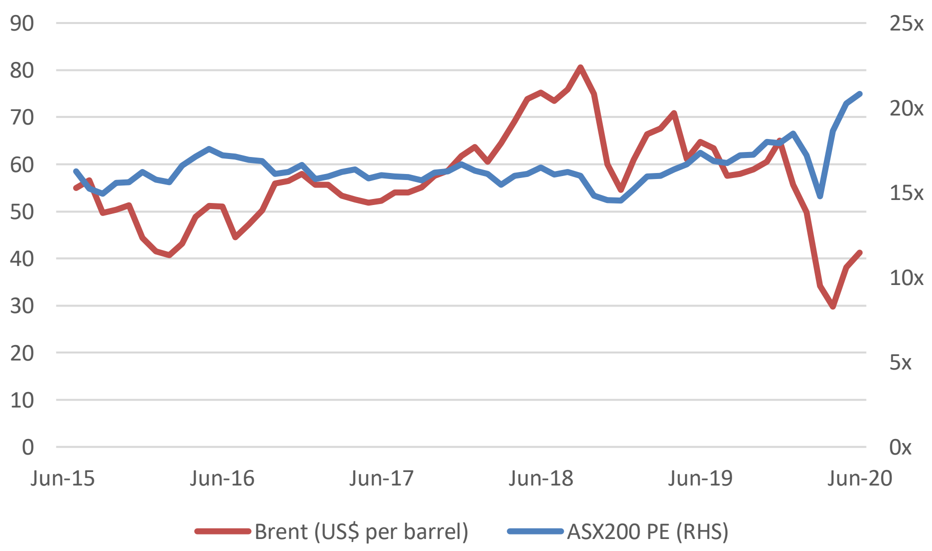
Even with the bounce of more than 100% from March lows to USD43/bbl, oil prices reflect a more realistic view of the difficulty restoring economic activity to pre-COVID levels than the broader equity market and other key commodities (see below). For this reason, oil equities have a better risk-reward skew than the broader market, whether lockdowns are reinstated, or a V-shaped recovery transpires. In addition, medium-term supply/demand dynamics result in an upside risk bias.

We explore the outlook for oil and related equities in this paper, with the key points being:

1. The recovery in oil demand is underway, albeit at a slower pace than initially anticipated.
2. US Shale supply is at a tipping point. Capital had become more disciplined and rigs had been declining pre-COVID. Weaker near-term demand should see this continue but at the same time, any price spikes are likely to see US supply at least partly restored.
3. Years of underinvestment in conventional oil underwrite higher oil prices long-term.
4. There is a disconnect between low oil prices and the broader equity market, with the former implying a protracted recovery and the latter a V-shaped recovery. Investing in oil equities therefore provides downside protection should the recovery be more drawn out,
5. For similar reasons, oil also has a superior risk reward skew to iron ore in our view.

Investing in oil equities offers more downside protection than the broader market

Figure 9: Oil Pricing Reflects More Cautious Recovery Than Equity Market



Source: Bloomberg, Calculations: Merlon Capital as at 30 June 2020.

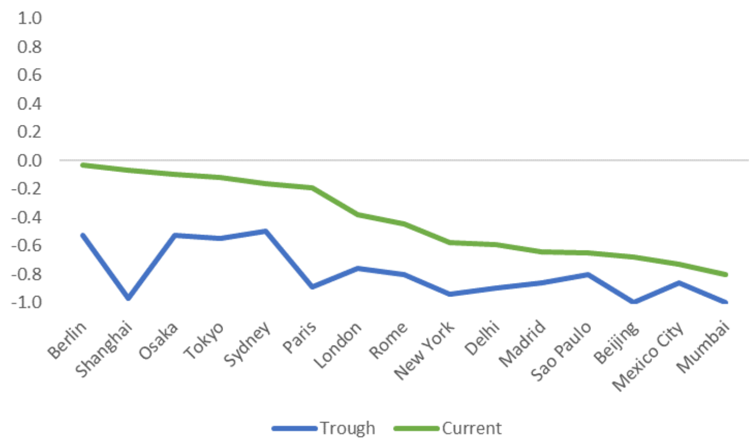
Demand recovery is underway, albeit slower than expected

Demand recovers to 10% below normal

Initial estimates on the impact of the pandemic were for oil demand to trough in April, following the globally co-ordinated social distancing measures introduced. Demand was estimated to trough 15% below baseline levels of 100mbpd and recover to be only 5% lower in 2020 as lockdown measures were eased. With cases yet to peak in emerging economies and parts of the US, current estimates now have demand 7.5% lower in 2020, with recovery pushed out into 2021.

Analysing available data on traffic congestion levels in major cities does provide some indication of the shape of the recovery to date. From real-time TomTom data, we can see that global congestion levels have recovered roughly half of the activity lost at the peak of lockdowns. The question now is how disrupted the path to recovery from here will be given the effects of relaxing social distancing measures. Medium term recovery will likely depend on achievement of herd immunity and / or vaccine(s) development.

Figure 10: Congestion Data vs a year ago – Major Cities



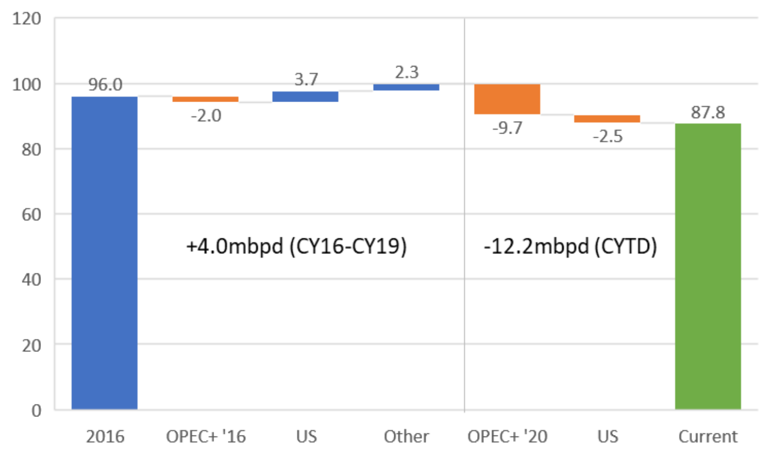
Data source: TomTom. Calculations: Merlon Capital.as at 24 June 2020.

Supply

During the 2014-2016 crisis in oil markets, oil prices touched USD27/bbl, and a newly expanded OPEC+ cartel reached a previously-unthinkable agreement to reduce production by 1.6mbpd. By 2020 this agreement had evolved into an even larger cut of 2.0mbpd, or 2% of global oil production. This collective action, despite a volatile phase as the agreement rolled off in March, was enacted once again, with the OPEC+ group agreeing to cut by 9.7mbpd in response to the rapid impact of COVID-19 on demand, as can be seen below.

Figure 11: Oil Production Evolution – 2016 Crisis Response to COVID-19

OPEC+ came to the party but unlikely to cede further gains to US Shale



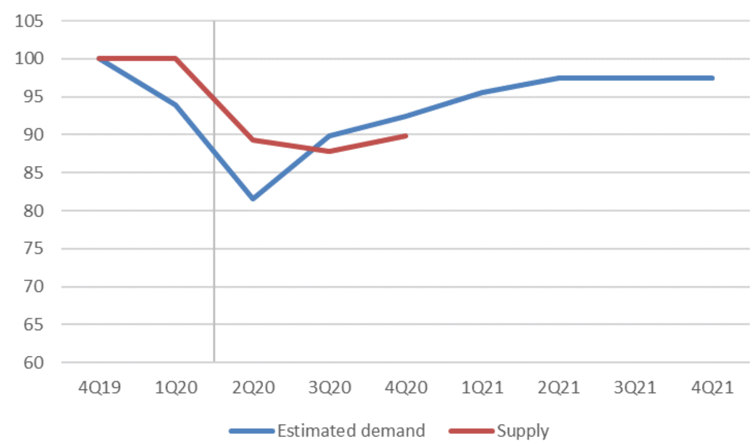
Source: EIA / OPEC+ announcements. Calculations: Merlon Capital.

The question from here, is how successful these cuts in supply are in addressing the declines in demand. The chart below is an estimate of the path of demand over the course of 2020 and beyond. Should demand recover as currently modelled, then global oil markets should be moving into a deficit in the second half of 2020.

High inventories may cap prices in the short-term

The objective, once the market has been stabilised, will then be to work off inventory build over the first half of the year. OPEC has estimated an inventory build to date of 1.3b barrels, more than three-times the 2014-16 level. Given this, it is likely that the OPEC+ production agreement will be extended, notwithstanding any rebound in US onshore volumes.

Figure 12: Oil Supply and Demand Estimates

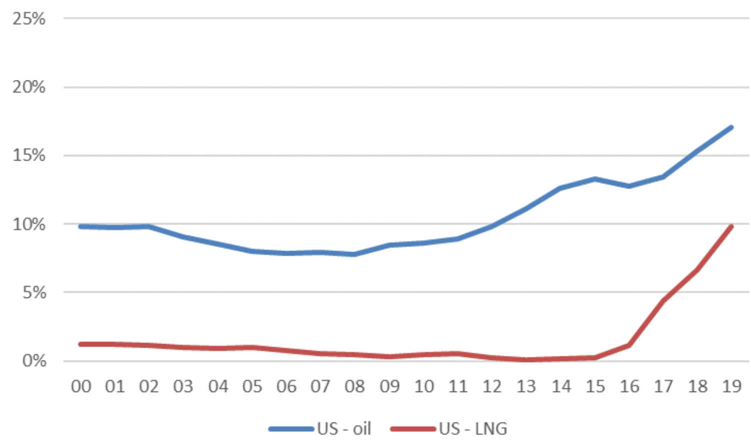


Data source: Rystad Energy / EAI / OPEC+. Calculations: Merlon Capital

The future of shale

Given the scale of the impact on global oil markets, it is worth assessing the effects on the US unconventional oil and gas industry. Over the past decade, the rapid growth in unconventional oil and gas production has seen the US as a key disruptor of global oil and gas markets.

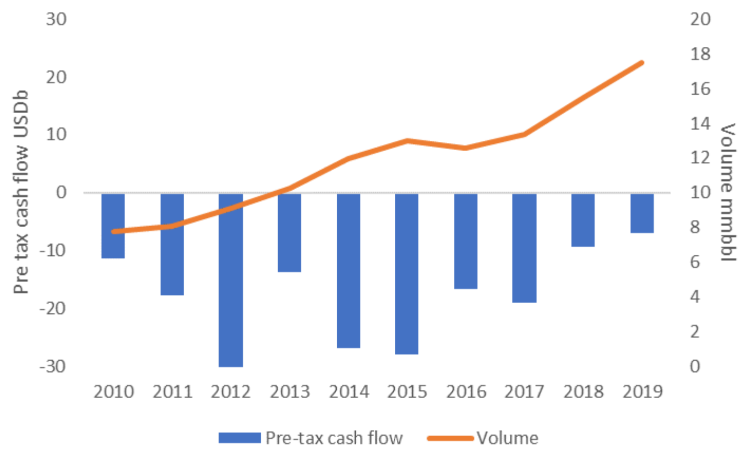
Figure 13: US Hydrocarbon Market Share



Data source: BP. Calculations: Merlon Capital.

Yet it was estimated that roughly half of US onshore shale was already cash loss-making before COVID-19 (see chart below). This was before factoring in the need to drill 12,000 new wells required to maintain production, at a cost of USD85b. With this expenditure premised on oil prices above USD50/bbl, and capital markets drying up, this budget will be slashed.

Figure 14: US Onshore Oil & Gas Producer Cash-Flows



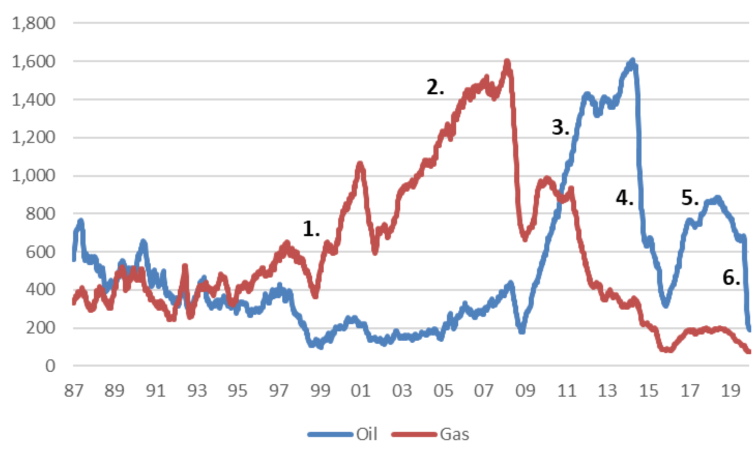
Data source: Rystad Energy. Calculations: Merlon Capital.

COVID has intensified pressures already felt by US Shale

Should this growth reverse, either due to persistence of capital discipline seen throughout 2019, or through the effects of COVID-19 low oil prices, we could see oil markets tighten. And in the case of LNG markets, declining volumes would see increasing contract negotiating power for incumbents ahead of sanctioning new projects. The ultimate conclusion will largely depend on the willingness of capital to re-enter and support a strong recovery of drilling.

Capital discipline in shale oil is expected to moderate supply

Figure 15: US Oil & Gas Rig Activity

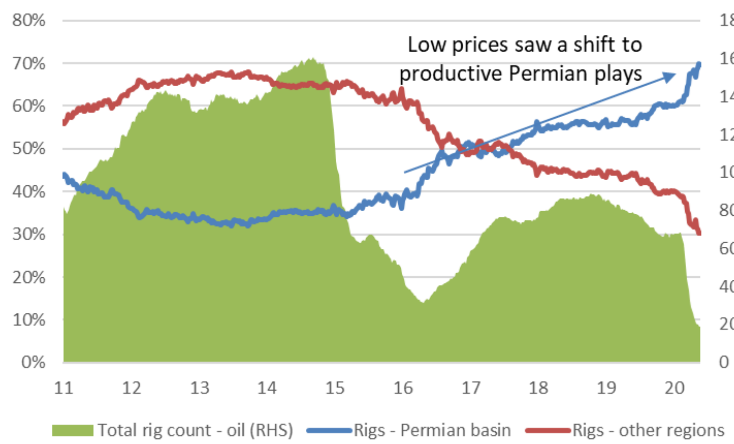


A brief history of unconventional oil & gas in the US: 1. Technology-enabled exploitation of shale gas reserves. 2. Gas glut and declining prices. 3. Rigs refocused on oil. 4. Oil glut and price declines. 5. Rigs refocused on most productive plays. 6. COVID-19

Data source: Baker Hughes. Calculations: Merlon Capital.

The precarious (or destructive) relationship between capital and returns has been exposed with the high-profile bankruptcies of Whiting Petroleum and Chesapeake Energy. The fact that Chesapeake has filed for bankruptcy, even after oil's rally back above USD40/bbl, coupled with the more recent focus on more productive geology (see chart below), highlights the stress unconventional producers may be under. It is possible capital may permanently exit the US unconventional space given rig counts are close to historic lows, rig activity has already shifted to more productive plays (effectively high grading production) and OPEC+ is unlikely to allow second grab of market share.

Figure 16: High Grading

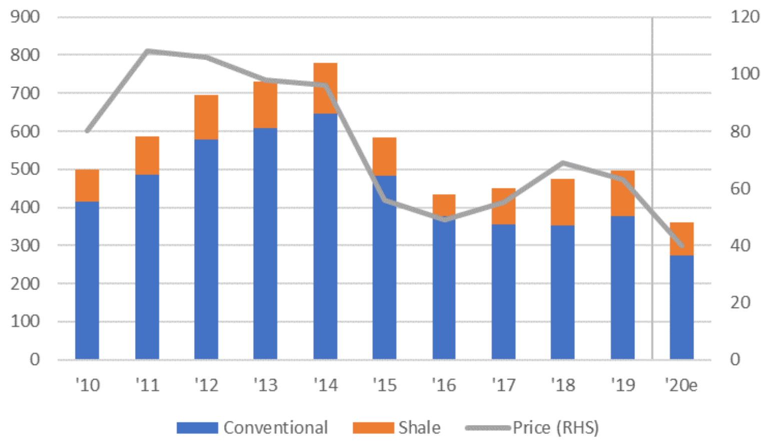


Data source: Baker Hughes. Calculations: Merlon Capital.

The future of conventional oil

With the US unconventional oil industry under pressure, where to for conventional players? With the US having accounted for the majority of supply growth over the past decade, the focus is investing at a level sufficient to offset the natural 3-5% conventional field decline rates inherent in oil reservoirs. Prices have been too low since 2015 to incentivise any meaningful recovery in investment, with capital expenditure roughly 40% below peak levels, before factoring in 2020 cuts to spending. This underinvestment will be exposed if there is any sustained decline in US shale output.

Figure 17: Oil Industry Capital Expenditure

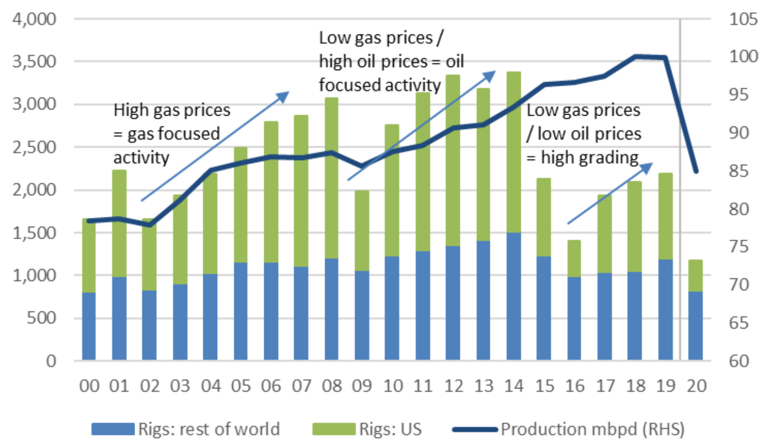


Data source: IEA / Bloomberg. Calculations: Merlon Capital.

On the basis of a return to pre-COVID-19 levels of demand, the combined effects of a crowding out of conventional investment, which have not recovered since the downturn in 2016, and the investment cuts expected throughout 2020 across the industry, are likely to result in a tightening of global oil markets over the medium term.

This underinvestment is visible in the number of active rigs outside of the US declining from 1,500 to around 1,000. This serves to indicate the relative importance of US activity in sustaining a normalised 100mbpd of oil demand.

Figure 18: Global Rig Count



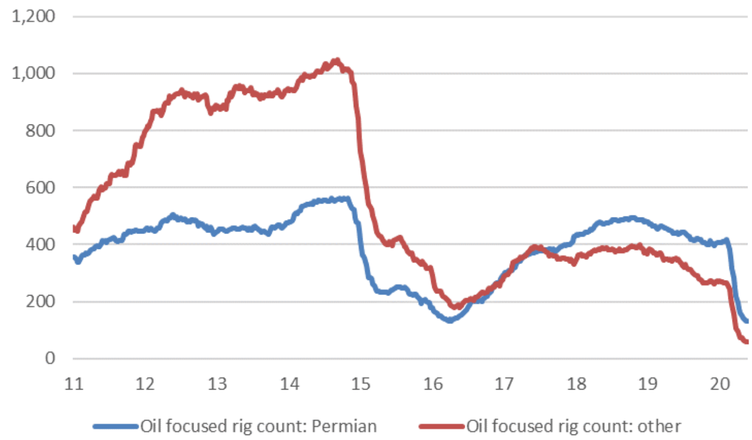
Data source: Baker Hughes / BP. Calculations: Merlon Capital.

While "easy money" presents a risk, US rig activity is ultimately driven by oil prices rather than access to capital

And, in conclusion then, we return to the US, and the more recent concentration of activity in the productive Permian basin, which has, in turn, become the key support of US oil production. The geology and productivity of this Texas-based field has enabled production growth, even with lower oil prices, and using fewer rigs.

While it is possible that the abundant liquidity unleashed by the Federal Reserve results in a flow of new capital into drilling, rig activity was already elevated in the US well before the initial flood of capital from unconventional monetary policy following the GFC. ***In short, activity has been driven by prices, whether gas or oil, more so than cost and availability of capital.*** If enthusiasm for directing capital into drilling these fields does not return to drive a recovery in drilling in this key oil patch (see chart below), then US unconventional oil may have already peaked, and a growing reliance on an under-invested conventional oil industry may result in higher long-term prices.

Figure 19: US Oil-Focused Rig Count – Importance of the Permian



Data source: Baker Hughes. Calculations: Merlon Capital.

The Merlon process and commodity stocks

Commodity stocks are a good illustration of Merlon's process …

At Merlon, we believe people are generally motivated by short-term outcomes, overemphasise recent information and are uncomfortable having unpopular views. Our process is aimed at ensuring we minimise our exposure to these behavioural biases and exploit misperceptions about risk and future growth prospects.

The first step in our process is determining sustainable free cash-flow, with reference to qualitative considerations, macro and cyclical considerations and financial returns with as long-term an historic context as possible.

Commodity exposed stocks generally fare poorly in terms of undifferentiated product, high capital intensity and pro-cyclical capital allocation track record. In 2018, we argued a quick resolution to the trade war was unlikely, but the more important driver was unfavourable long-term supply / demand dynamics in our most critical export, iron ore.

The second step is to determine an unbiased and consistent measure of value based on sustainable free cash flow and franking, net of debt. This allows us to determine whether there is some chance other investors have become too concerned (or complacent) about risks and growth.

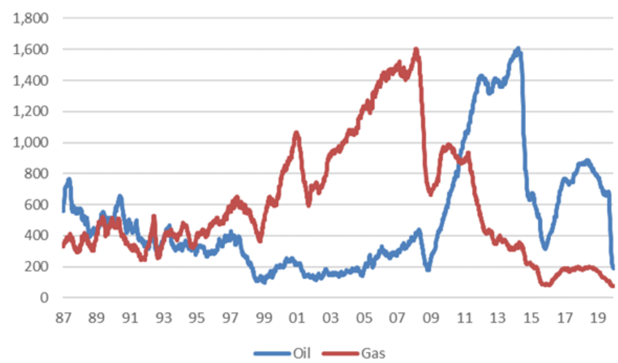
We then shift our focus to conviction, which recognises that to be a good investment, we need evidence the market's concerns are either priced in or invalid. One way we determine whether the market is overly pessimistic is to produce valuation scenarios focused on the risk of permanent capital loss relative to the best case or upside scenario. Again, commodity exposed stocks are well catered for in our process given the undifferentiated product and the long-term historical context available to assess a range of plausible valuation outcomes.

Merlon positioning summary

LNG (Overweight): The positions in **Woodside Petroleum**, **Origin Energy** and more recently, **Oil Search**, were established on the basis of an expected tightening of global oil markets over the medium term. Having been the primary driver of excess oil supply over the past decade, the current extreme price pressure is pressuring the US unconventional business model, resulting in US oil and gas rig activity declining to record low levels. Over the medium term we expect this to support prices and reduce the volume of US LNG exports. Over the longer term, we expect the underinvestment in conventional oil and gas assets, driven by the flow of capital towards unconventional assets, to reveal the effects of 3-5%pa natural decline rates. We have high conviction in this view because the market is overly focused on short-term demand disruption. As a result, even if we are wrong on the timing of the demand recovery, this is at least partly priced in relative to other commodities and equities.

Oil is pricing in a more subdued recovery, offering downside protection relative to the broader market

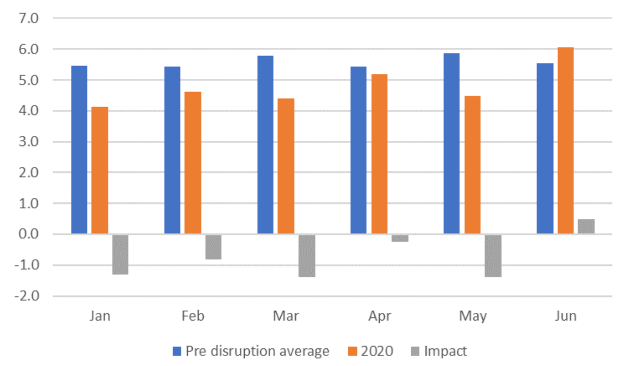
Figure 20: US Rig Activity



Data source: Baker Hughes. Calculations: Merlon Capital.

Iron ore (Underweight): Continued supply disruptions saw Brazilian exports down nearly 20% from average levels, supporting iron ore prices. Recent export data is showing signs of supply normalisation, which should see a looser market. Over the longer term, we also expect to see iron ore displaced as Chinese steel recycling rates increase – a well-accepted path in maturing steel industries. Given these risks, we do not hold iron ore producers.

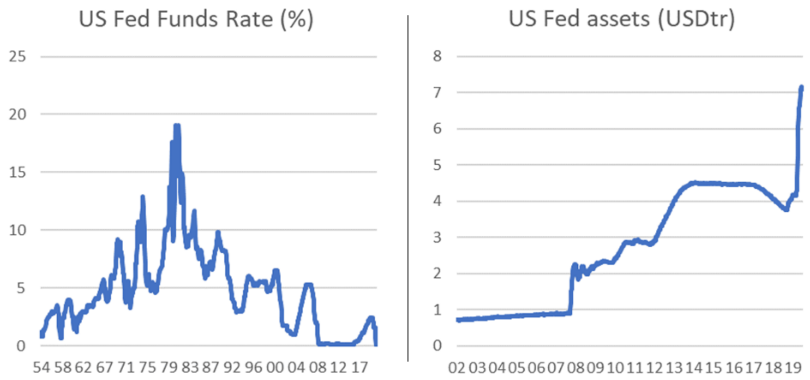
Figure 21: Brazil Iron Ore Exports



Data source: UBS. Calculations: Merlon Capital.

Gold (Overweight): The position in gold, via **Newcrest Mining**, has been increased throughout CY20 as the ability of the US Federal Reserve to meaningfully increase ultra-low interest rates and reduce its balance sheet has become increasingly limited. While these unconventional policies were designed to be temporary, the ability to unwind in the context of growing geopolitical tensions between the US and China, and continued growth in debt levels restricts the ability to normalise.

Figure 22: US Monetary Policy



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

Other: We also have smaller positions in copper, coal and more recently, alumina:

- **Copper: Sandfire Resources (SFR)** is a small, yet highly cash-generative copper producer, undervalued due to the market's concern over its ability to extend its production beyond its core WA-based asset. The small scale of the company enables it to maintain productivity via exploiting high quality, but small scale ore-bodies globally which are of less interest to larger peers, who are struggling to find suitable projects to fulfil anticipated growth in demand.

- **Coal: New Hope Coal (NHC)** is undervalued by the market due to the perceived unattractiveness of coal-assets, coupled with the lack of investment in growth projects across the industry, in contrast with continued investment in thermal coal fired generation capacity. This dynamic is expected to manifest in tighter coal market over the medium term, with New Hope benefiting from the shift towards higher calorific-value coals as produced by Australia.

- **Alumina**: **Alumina Limited (AWC)** is a recent investment, having been sold down to attractive levels due to the effects of COVID-19 on the transport sector (particularly aviation). AWC is the largest supplier of alumina in export markets and occupies the bottom quartile of the global alumina cost curve.

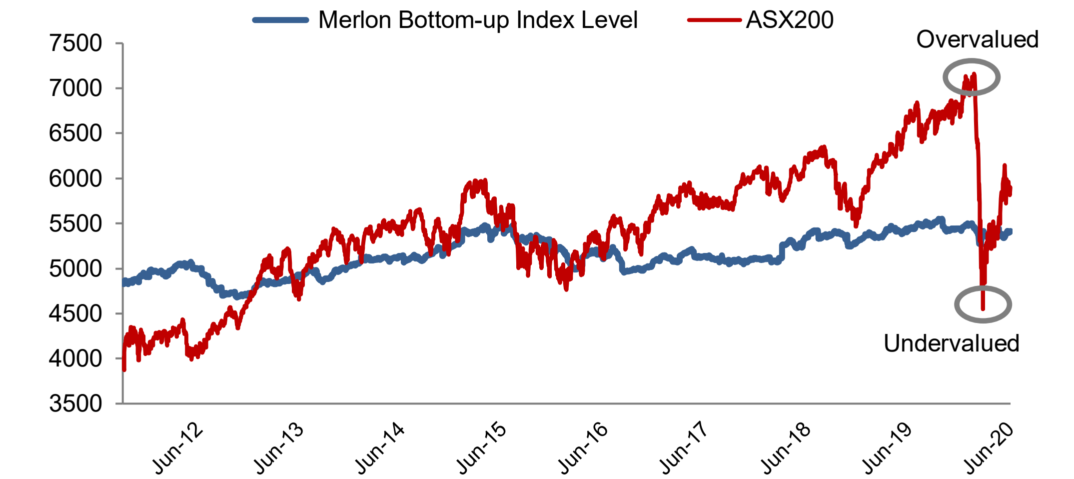
Market Outlook and Portfolio Positioning

Neil Margolis

Market approximately 8% 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 154 stocks we actively cover. On this basis the market appears approximately 8% overvalued after rallying 16% during the quarter and 30% off the 23 March lows.

Figure 23: 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.

We always maintain a long-term view. In that respect, as we indicated in our last quarterly update, we remain optimistic that at some point there will be a vaccine, herd immunity will develop, and ordinary life will bounce back. The market has rallied hard in the last quarter at least in-part reflecting this situation.

The global economy is unlikely to operate anywhere near pre-crisis levels for some time…

But we continue to think that a vaccine and/or herd immunity is at least 12 months away and in the interim it is difficult to envisage the global economy will operate at anywhere near pre-crisis levels. The politics of the crisis are emerging as a potentially more powerful force than the virus itself.

The risks directly associated with the Covid-19 crisis are being manifested by secondary impacts such as political tensions with China, the US electoral cycle and the potential for social unrest. All these issues were bubbling below the surface prior to the crisis but have become more pertinent in recent months. None of these are good for global economic growth and all point to further fiscal and monetary stimulus as well as a more volatile and more extended recovery path.

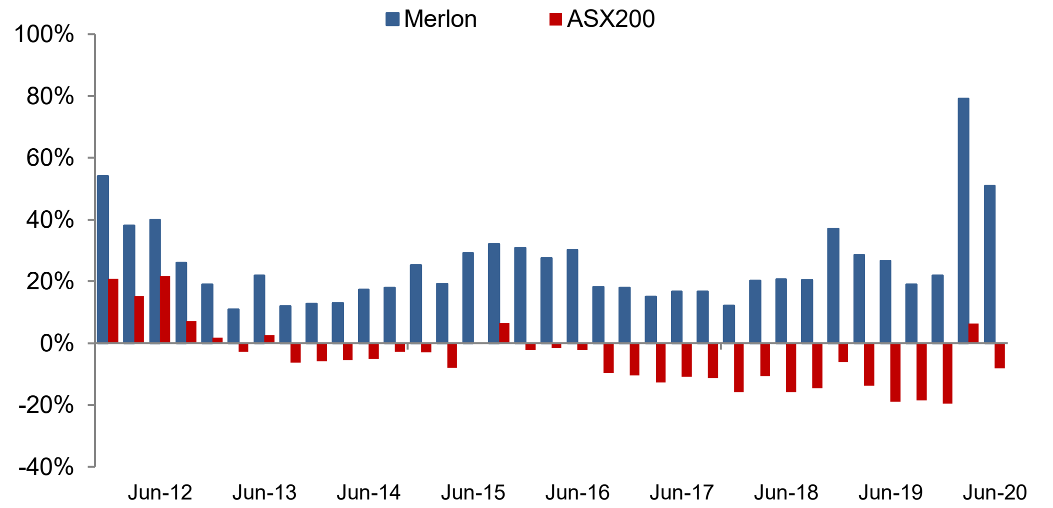
We continue to stress test all our investments against this backdrop. Some companies will face severe balance sheet strain for extended periods of time (for example the travel related businesses, cafes & restaurants and banks) while others face the prospect of permanent changes in the way they operate (for example real estate owners).

The risk of permanent loss is mitigated by owning undervalued assets…

Our view is that the risk of permanent loss through the current crisis is mitigated by owning undervalued assets. This is not to say that undervalued assets cannot fall more than expensive assets over short periods of time. Rather, our emphasis is stress testing our investments to ensure we deliver good returns relative to the risk of permanent loss.

The Merlon portfolio continues to offer truly exceptional expected returns…

Figure 24: Expected return based on Merlon valuations



Source: Merlon

The short-term outlook is difficult to predict…

Our expectation of a volatile and more extended recovery path than initially envisaged, combined with the rapid pace of the market recovery has led us to reposition the portfolio towards affected industries and cyclical businesses a little more slowly than might have otherwise been the case.

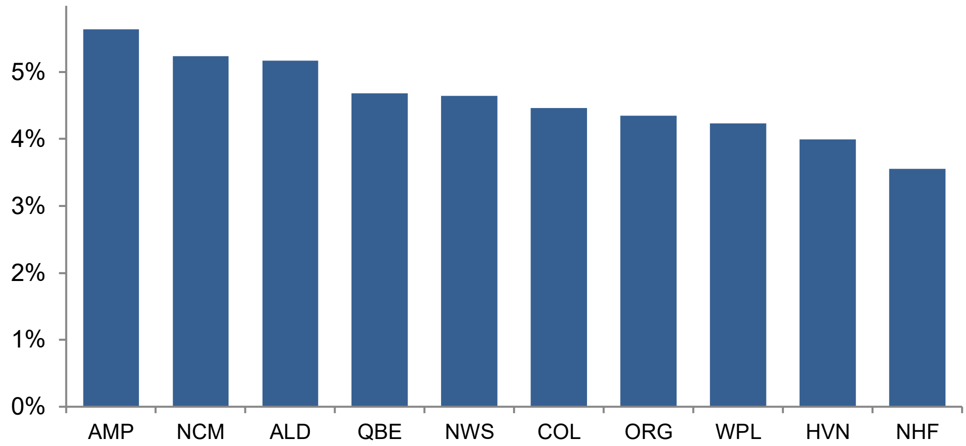
We expect the environment over the next year or so will continue to present wonderful investment opportunities for investors with long-term horizons, who are prepared to look through short term noise and who are comfortable having unpopular views.

The portfolio comprises undervalued businesses based on sensible interest rate and risk margin assumptions…

Portfolio Aligned to Value Philosophy and Fundamental Research

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 25: Top ten holdings (gross weights)



Source: Merlon

While we are not macro investors, as discussed above there are clearly some macro themes built into 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.

AMP continues to feature in our portfolio notwithstanding continued concerns about the fallout of the Royal Commission on the company's financial advice businesses. We believe our investment in the company is more than underwritten by value outside the financial advice businesses consisting net asset backing (estimated $1.20 per share after life insurance sale recently completed), AMP Bank and AMP Capital Investors (The AMP Valuation Case).

Newcrest Mining now features as a significant position in our portfolio. Newcrest 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 firmly to the upside. Newcrest continues to generate strong cash flow in the interim.

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.

QBE Insurance Group has seen a significant retracement of unrealised investment losses incurred during the early part of the Covid-19 Crisis leaving the business extraordinarily well capitalised coming into an environment of historically strong premium inflation in its core markets.

Newscorp remains a significant position in the fund. This is a stock plagued with concerns around governance, the structural decline in print media and competition in the subscription video market from Netflix, Stan and Amazon (among others). All these concerns are valid in our view but need to be weighed up against a share price that assigns no value to any of the affected businesses.

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 generating margins below historic levels.

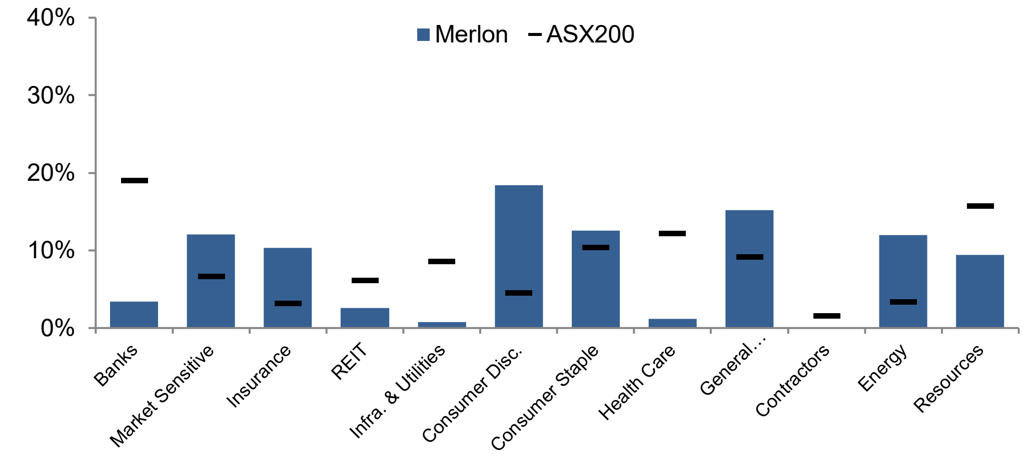
Origin Energy and **Woodside Petroleum** are both exposed to robust LNG portfolios being underappreciated by the market, and an oil price that is not reflecting the likely decline of non-cash generating unconventional US oil production, coupled with the underinvestment in conventional fields. They are both low cost operations with lower risk balance sheets (relative to peers) that make them more resilient to depressed oil prices while offering significant upside when demand recovers.

Harvey Norman has benefitted from the recent lock-down as stimulus enriched consumers sought to deploy spending outside traditional services parts of the economy (tourism, cafes & restaurants, etc) and small businesses sought to take advantage of tax perks. It is unlikely the business will sustain the type of sales growth experienced in recent times but against this market expectations remain very low.

NIB Holdings is a relatively new addition to the portfolio and is a private health insurance operator servicing Australian residents, New Zealand residents and international students residing in Australia. NIB Holdings also operates a small travel insurance business. NIB has fallen out of favour in recent times due to its exposure to the foreign student market and international travel activity. We believe these short-term headwinds will be offset by low claims activity in its core business. Further, NIB is attractively priced both in absolute terms and particularly compared to its larger listed peer Medibank Private.

We are a non-benchmark investor and unlike many other managers we are under no compulsion to own the **major banks** simply because they represent a large part of major share market indices. While they appear undervalued in a rapid economic recovery scenario, the upside in less leveraged industrials is similar without the tail risk that comes with a protracted economic downturn.

Figure 26: Portfolio exposures by sector (gross weights)



Source: Merlon

Figure 27: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	39	202
Active Share	84%	0%
Merlon Valuation Upside	51%	-8%
EV / EBITDA	9.1x	14.7x
Price / Earnings Ratio	18.2x	21.0x
Price / Book Ratio	2.0x	4.4x
Trailing Free Cash Flow Yield	7.5%	4.4%

Source: Merlon

June Quarter Portfolio Activity

During the quarter, we invested in Oil Search and Alumina Limited …

During the quarter we introduced two new investments. We invested in **Oil Search**, a key participant in the ExxonMobil-operated PNG LNG project with attractive growth options when the oil price recovers. Market concerns relating to the collapsed oil price and financial leverage provided an opportunity to acquire the company close to our bear case scenario, which factors in a long-term oil price well below the level required to sustain most US onshore production.

We invested in **Alumina Limited**, which holds a 40% interest in Alcoa Worldwide Alumina, the world's largest alumina producer operating at a very attractive cost of production. Market concerns have related to the declining alumina price due to curtailed supply coming back online and COVID-19 related demand destruction. Low prices are unlikely to be sustained, however, with almost half the industry loss-making. Alumina Limited's low cost of production and net cash backing means the risk of permanent loss is low and upside is significant when demand recovers.

… and topped up undervalued industrials with limited downside risk …

We continued to invest in existing positions in high quality industrials with hard-asset backing, such as **Star Entertainment Group**, **Harvey Norman**, **Boral** and **Unibail-Rodamco-Westfield**. We slightly increased our holding in **Westpac**, the only major bank held in the portfolio, with a much more attractive risk/reward skew than the other banks under a range of economic scenarios. At the same time we increased existing investments in undervalued companies that would perform well in a severe economic downside scenario, such as health insurer, **NIB Holdings** (funded by exiting our investment in **Medibank Private**), and **Newcrest Mining.**

… funded by exiting Flight Centre and reducing some holdings that had outperformed.

We funded these investments by exiting **Flight Centre**, which recovered strongly post capital raising, and **Spark Infrastructure**, while reducing but still retaining investments in defensives **Asaleo Care** and **Woolworths**; discretionary consumer holdings **Southern Cross Media** and **Super Retail**, and fund managers **Pendal** and **Platinum**.

Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	10 Years (p.a.)
Portfolio Return (inc. franking)	2.2	24.7	-9.3	-9.3	1.8	6.9	9.8
ASX200 Return (inc. franking)	2.6	16.5	-6.5	-6.5	6.6	7.4	9.3
Excess Return*	**-0.5**	**8.1**	**-2.8**	**-2.8**	**-4.8**	**-0.5**	**0.5**

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

June Quarter Market & Portfolio Review

The ASX200 had its best quarter in 11 years…

In another reminder how difficult market timing is, markets backed up the worst quarter since 1987 with the best since 2009, returning 16.5% (including franking). The market closed the financial year down only 6.5% (including franking), despite forward earnings estimates declining 26% over the same period.

This extraordinary PE multiple expansion (+3 points to 19x) reflects investor reaction to unprecedented monetary and fiscal stimulus fuelling the recovery as the economy emerges from hibernation. Ballooning central bank balance sheets led to gold gaining 13% over the quarter (26% over FY 2020). Remarkably, the currency only declined 1c over the financial year after rallying 13% in the final quarter. Bond investors remain less convinced, with Australian 10 year bond yields only rising 0.12% in the quarter and closing the financial year 0.45% lower. The contrast is even starker in the US, with 10 year bond yields closing at 0.66%, broadly flat over the quarter and 1.35% lower over the 12 months. Oil rebounded 57% over the quarter but remains 35% lower than the same time a year ago. Iron Ore remains volatile after Vale's dam incident in 2019, rising 28%t over the quarter, albeit 15% lower over the year.

The best performing equity sectors over the quarter were Technology, Consumer Discretionary and Energy and Materials, while defensive sectors such as Healthcare, Utilities and Consumer Staples lagged. For the 2020 financial year, Healthcare (+26%) and Technology (+12%) performed best and Financials, mainly the major banks, Energy and Property Trusts detracted the most. Lower rates disproportionately benefitted the multiples of growth stocks, although value stocks re-rated too as earnings were materially cut.

… with the portfolio outperforming by 8.1% over the quarter …

Against this backdrop the portfolio increased 24.7% in the quarter (including franking), outperforming the market by 8.1%. In contrast to the March quarter, being non-benchmark assisted performance (principally not owning CSL), with the average company outperforming the cap weighted index. Pleasingly, after CSL, the next 9 largest contributors were stocks held, including consumer exposed names, **Super Retail**, **Southern Cross Media** and **Nick Scali**, as well as domestic exposed industrials **Boral** and **Ampol** (formerly Caltex), copper miner **Sandfire**, **Origin Energy** as oil recovered, and non-bank financials **AMP** and **Pendal**. The largest detractors in the quarter were **Metcash**, following a surprising capital raising on a working capital blow-out, **QBE Insurance**, on widening credit spreads and a capital raising,

Unibail-Rodamco-Westfield on offshore mall exposure and debt concerns and not owning **Afterpay**, **Macquarie Bank** and the iron ore miners, **BHP** and **Fortescue Metals**.

… underperforming by 2.8% over the financial year …

For the 2020 financial year, the portfolio underperformed by 2.8%. Best performing holdings included supermarkets **Coles** and **Woolworths**, fuel retailer **Ampol**, auto and sports retailer, **Super Retail Group**, **A2 Milk**, being underweight the major banks, principally **ANZ**, and investing in **Oil Search** and **Star Entertainment Group** during the COVID sell-off. Notably, **AMP** crept into the top 10 following the late closure of the life sale transaction on 30 June.

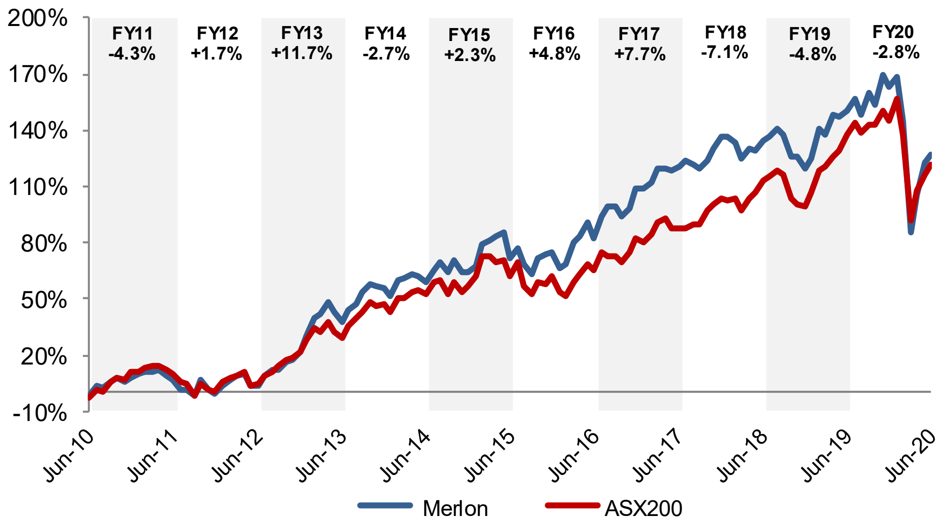
The largest detractors over the 2020 financial year were not owning Healthcare stocks, principally **CSL** (which detracted 2.4% from relative performance), **Southern Cross Media**, which was over-leveraged for a cyclical media company, **QBE**, **Unibail-Rodamco-Westfield**, and not owning **Wesfarmers** or the iron ore miners, **BHP** and **Fortescue Metals**.

… while remaining true-to-label and well positioned going forward.

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 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.

Over the past ten years, the portfolio has outperformed by 0.5% per annum, below our target but with most of the underperformance in the past 3 years for the reasons outlined above.

Figure 29: Cumulative Returns since inception



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

Strategy FUM	Merlon FUM
$937m	$940m

About Merlon

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