

Merlon Australian Share Income Fund

Delivering Sustainable Income From Australian Shares

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Sustainable Income

Paid monthly and majority franked

by focusing on capital preservation and growth

Fundamental Research

*Focused on
sustainable cash flow*

Portfolio Diversification

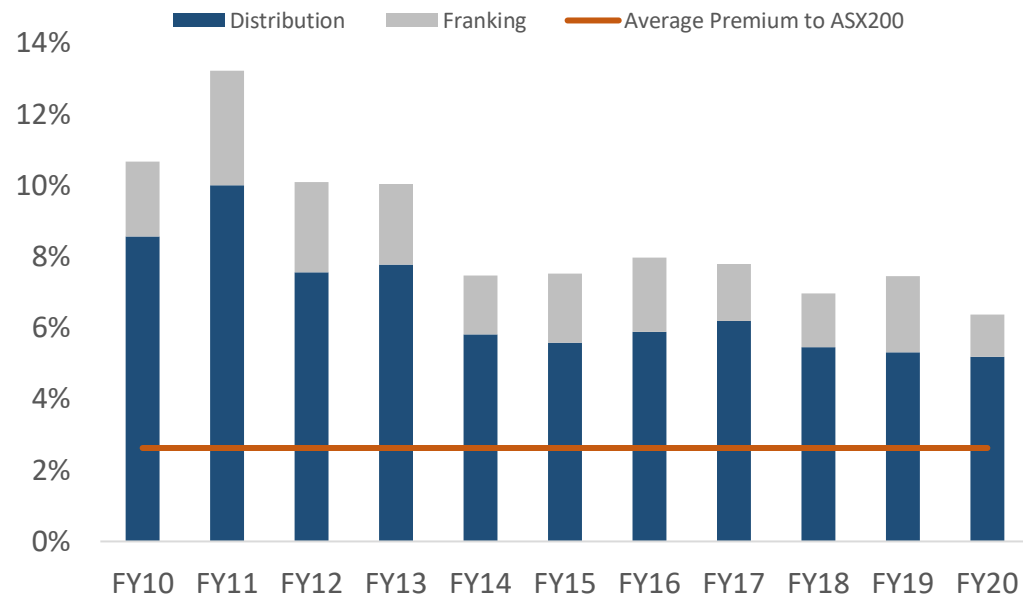
*No reference to
ASX200 weights*

Downside Protection

*Through research &
risk reduction overlay*

Above market income and franking, paid monthly

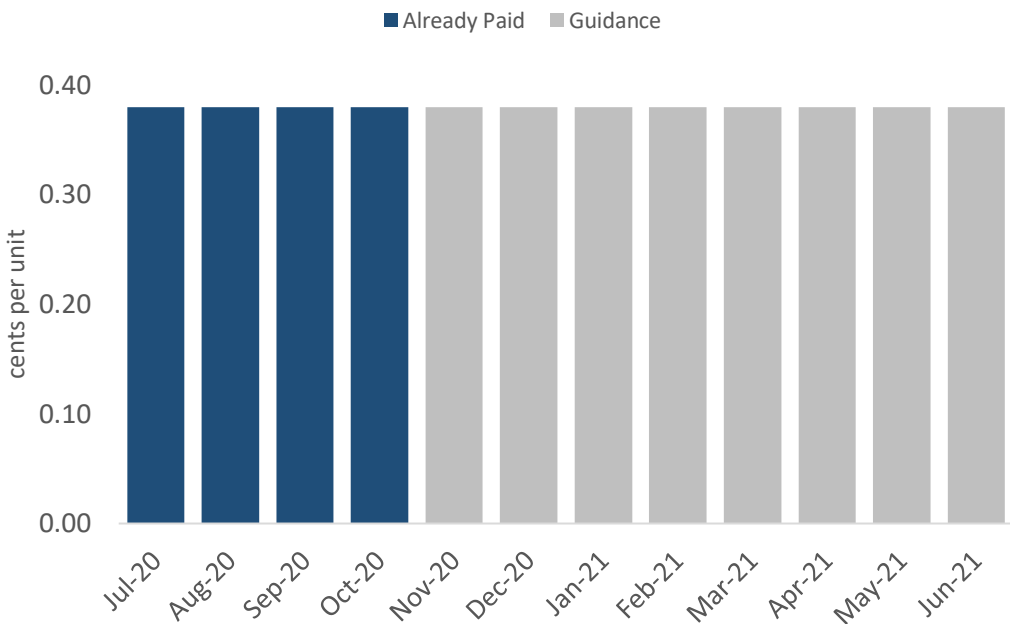
Historic distribution yield



Source: Merlon, Fidante

Average yield premium of 2.6%

Monthly cash distribution profile excluding franking credits (FY21)



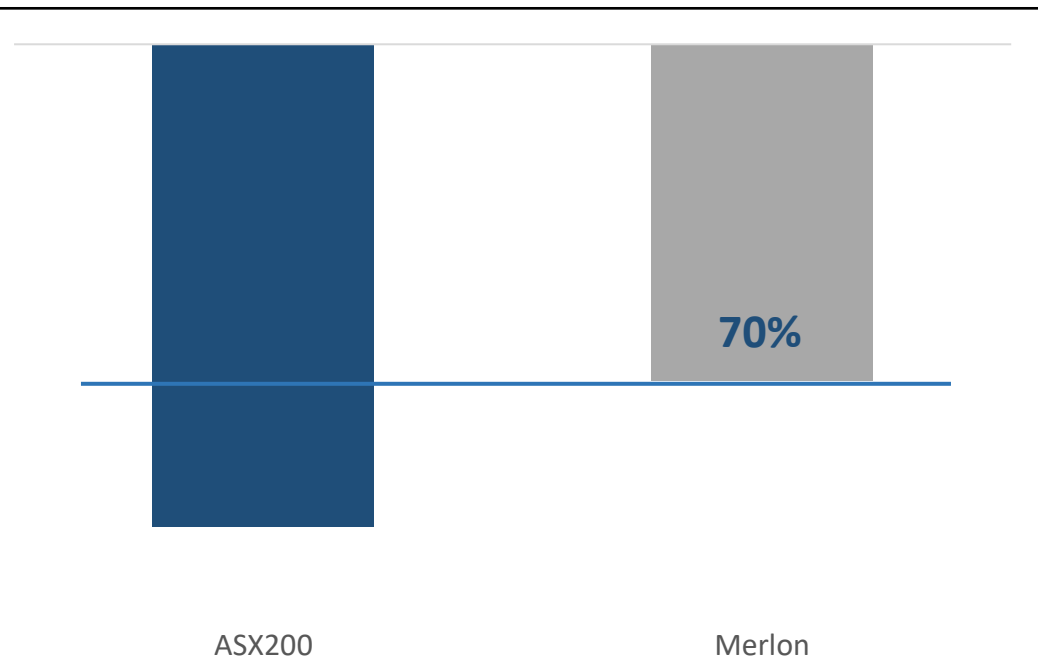
Source: Merlon, Fidante. Estimated gross yield based on monthly distribution forecasts and FY21 franking credits divided by 1 July 2020 net asset value price.

5.6% gross yield

Risk Reduction Overlay acts as a shock absorber in down markets



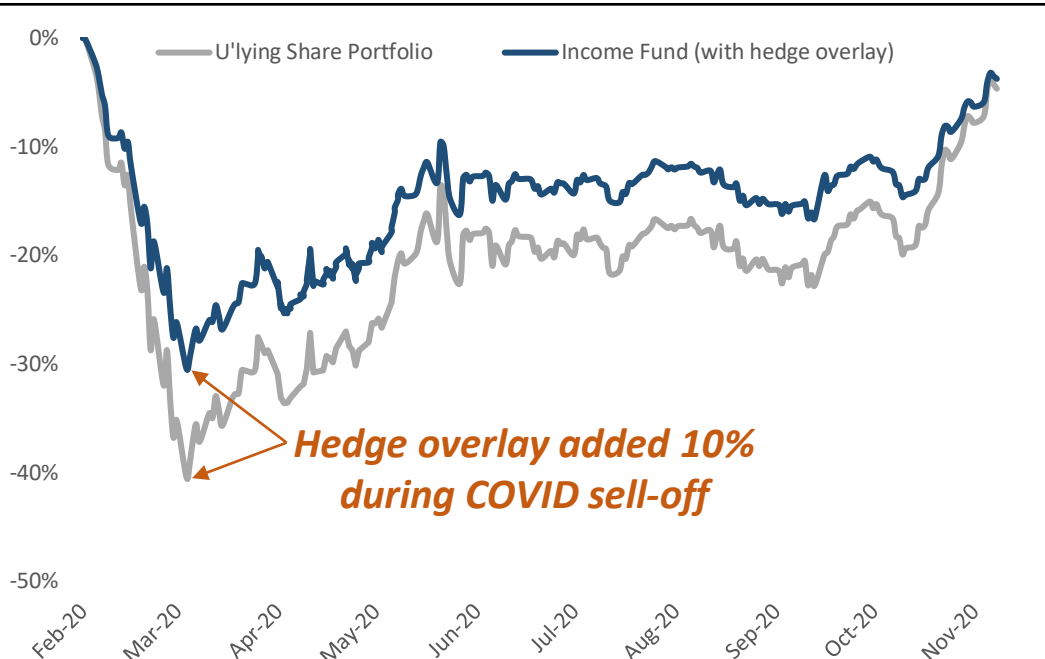
Performance in down markets



Average relative return compared to ASX200 where ASX200 monthly return is negative since June 2010.

On average 30% downside protection

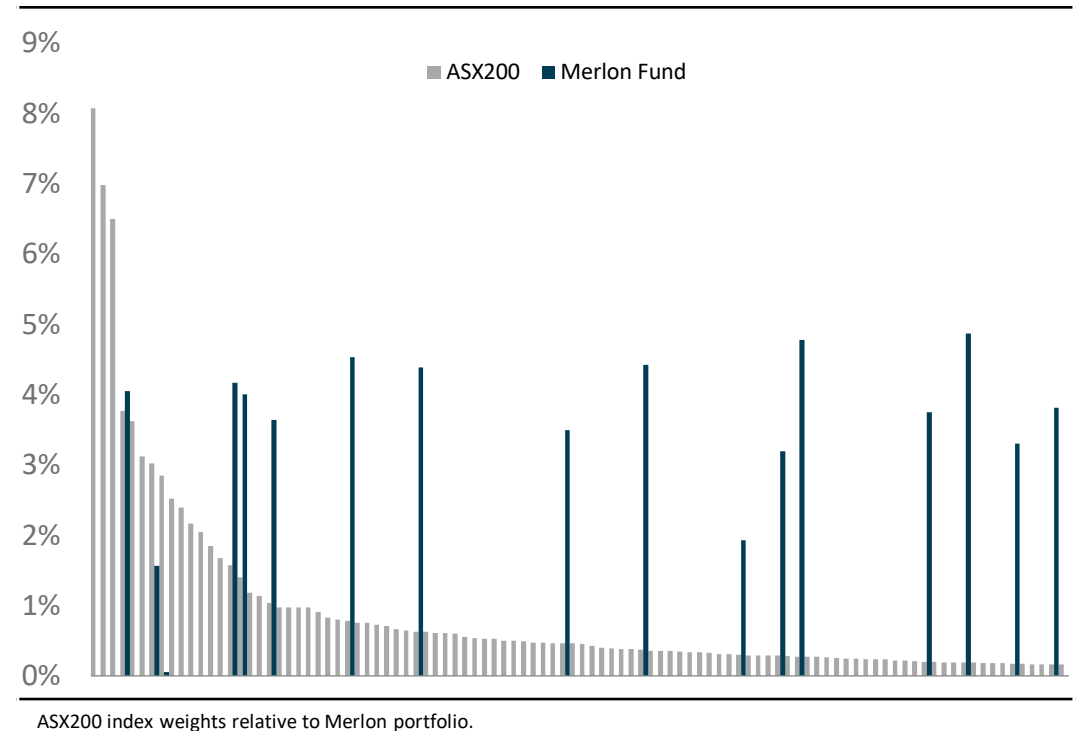
Performance since 20 February 2020



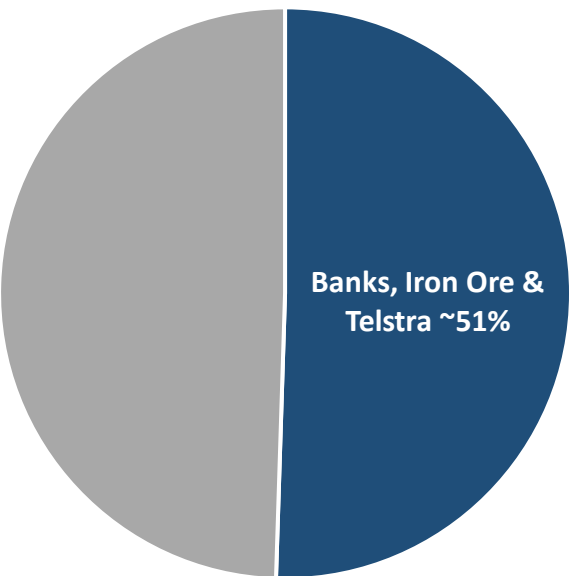
Merlon Australian Share Income Fund compared to the underlying share portfolio over the period 20th February to 27th November 2020.

Non-benchmark portfolio provides diversification

The ASX200 is skewed to ultra-large companies



ASX200 dividends have heavily relied on the banks, iron ore & Telstra



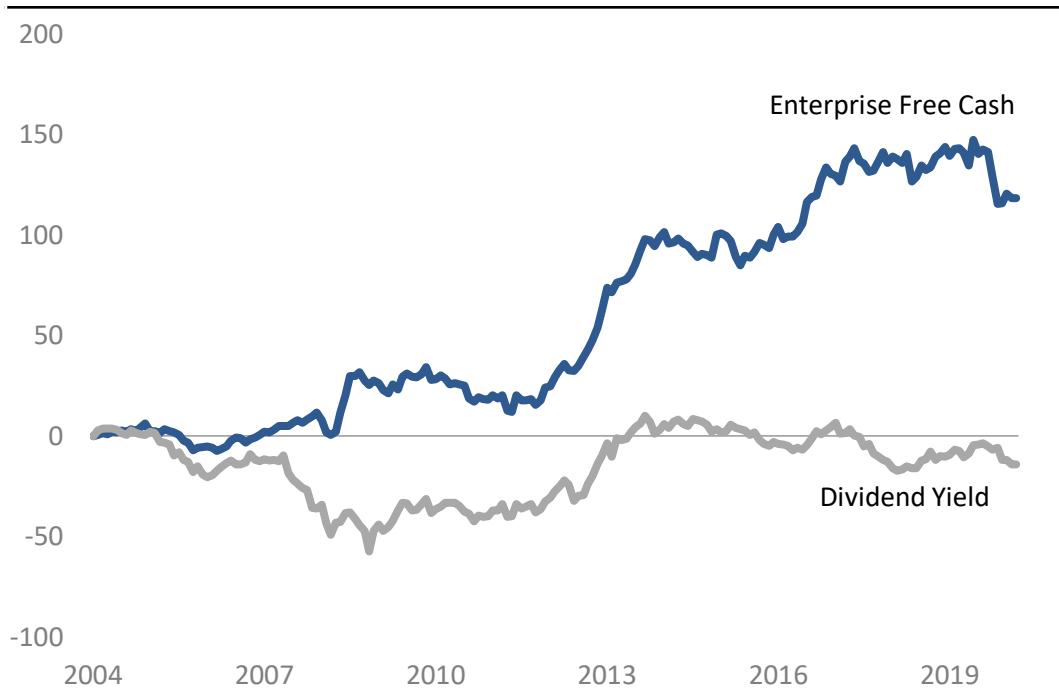
Source: Bloomberg, average contribution to ASX200 gross yield over the last five fiscal years.

More diverse sources of income and growth

A focus on free cash flow provides long term downside protection



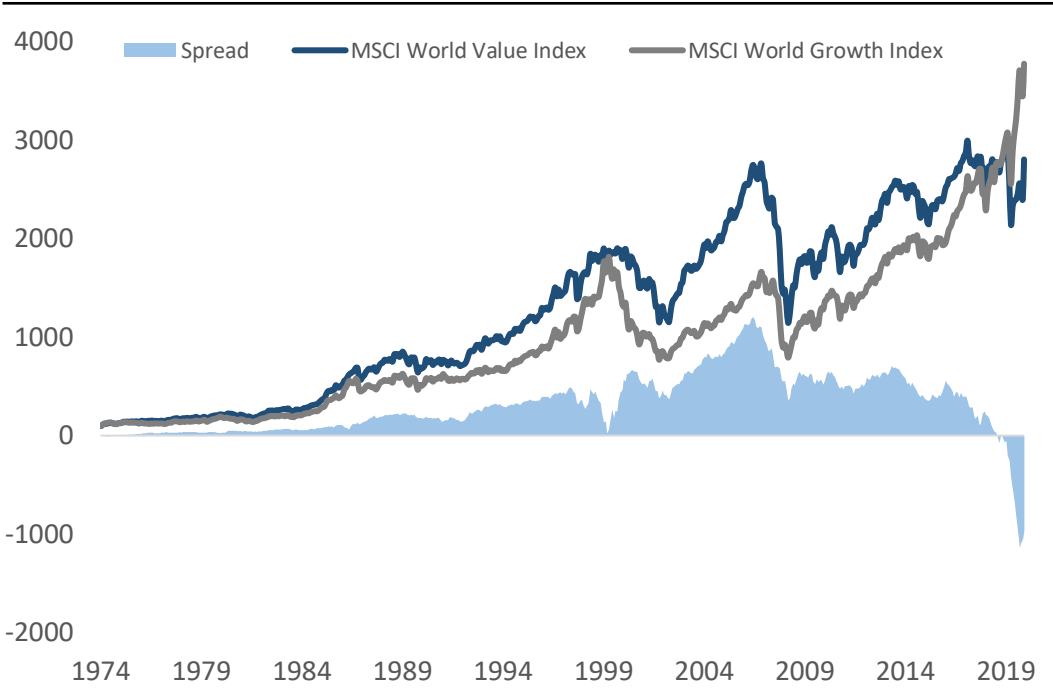
Free cash flow a better measure than dividends



Portfolios are formed using enterprise-free-cash-flow-to-enterprise-value (EF/EV) and dividend yield. 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. Risk is defined as annualised standard deviation of monthly returns.

Free cash flow ultimately funds dividends

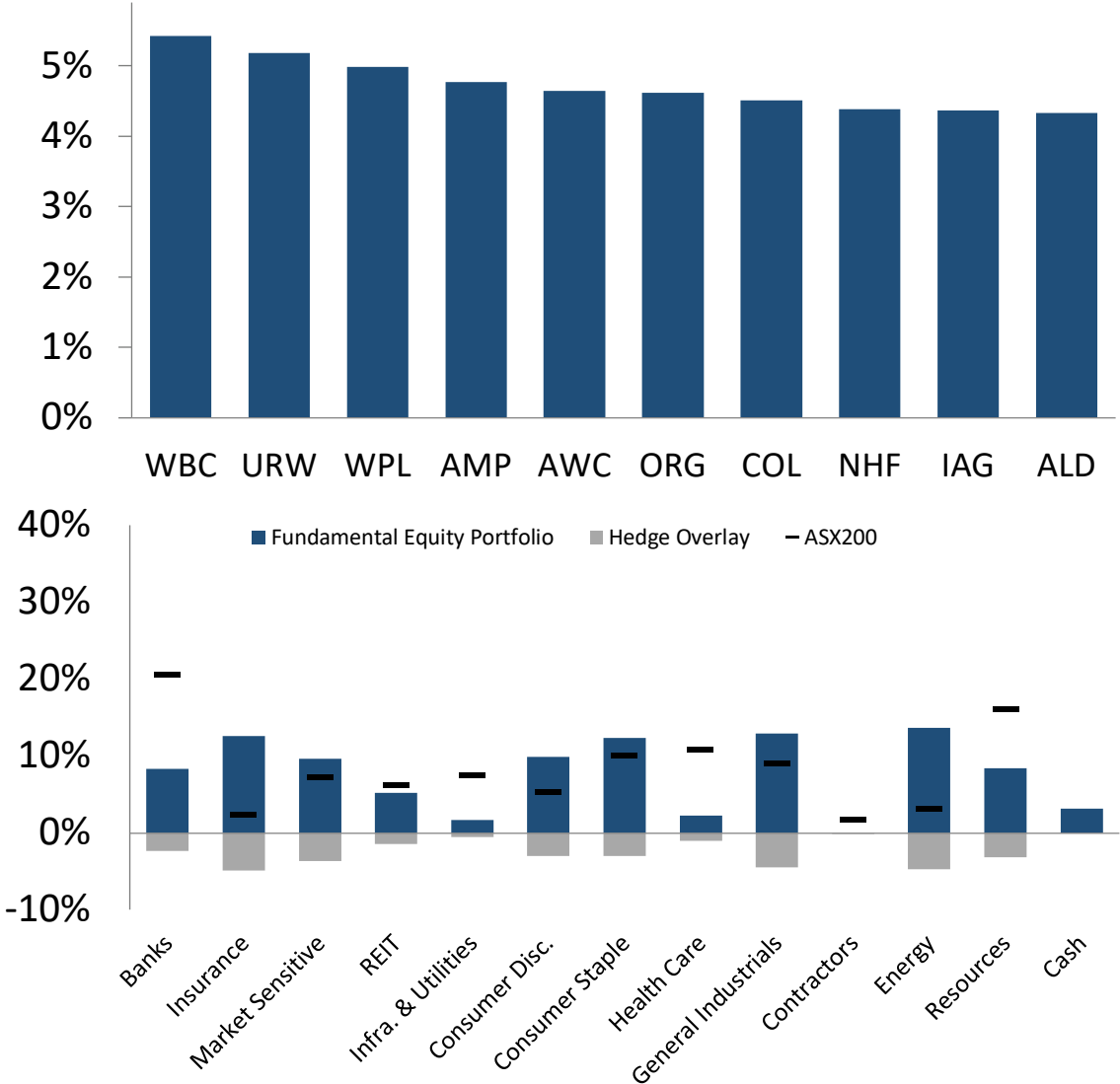
“Growth” vs “Value” - a longer term perspective



Source: Bloomberg, MSCI World Growth and Value index returns. 30 November 2020.

Value investing due for a comeback

Current Fund Positioning



Portfolio Analytics (31 December)

	Portfolio	ASX200
Number of Equity Positions	36	200
Net Market Exposure	65%	100%
Active Share	80%	0%
Valuation Upside ¹	56%	-16%
Mid-cycle Free Cash Yield	7.5%	3.4%
Gross Distribution Yield	5.4%	4.1%
Price / Earnings Ratio	16.5x	20.7x

Portfolio as at 31 January 2021. ¹Valuation Upside based on Merlon proprietary valuations.

Overview

- ☐ Regulated monopoly in QLD coal network
- ☐ Core customers are ultra low-cost miners
- ☐ Low balance sheet gearing

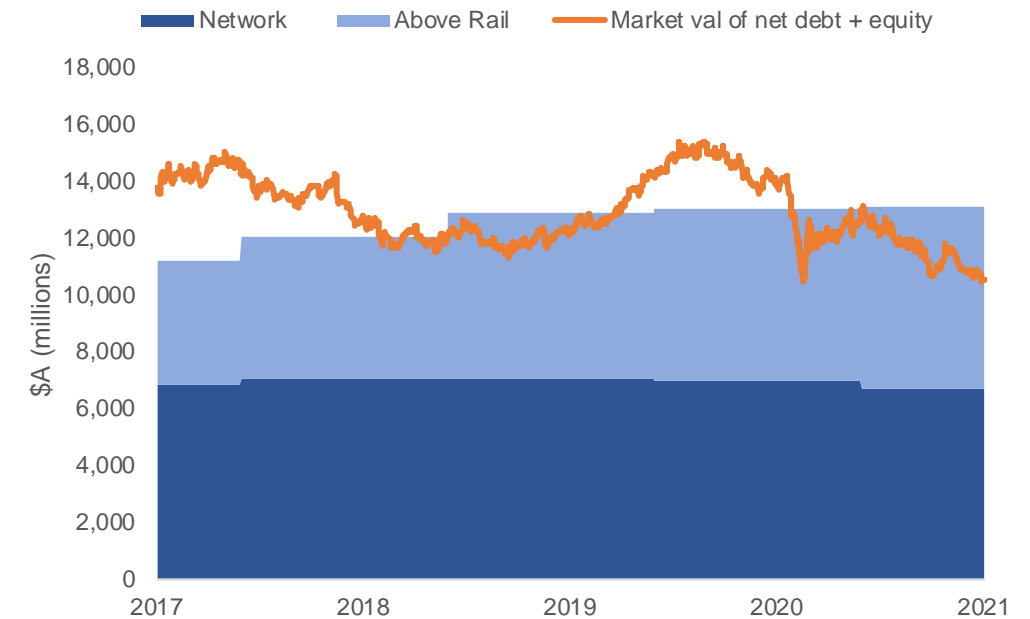
Market View

- ☐ Limited growth from sunset industry
- ☐ Short-term China coal import risk
- ☐ Record relative PE discount

Merlon View

- ☐ Mid-cycle free cash-flow yield 6% + franking
- ☐ Majority of earnings from met coal & bulk
- ☐ Downside covered by track & rolling stock assets

Aurizon Premium / Discount to Merlon cashflow approach



Source: Bloomberg, Company Accounts Calculations: Merlon Capital Partners February 2021

Incitec Pivot Limited



Overview

- ❑ Top-two global explosives player
- ❑ Leading position in Australian fertilisers
- ❑ Pursuing capital-light growth strategies

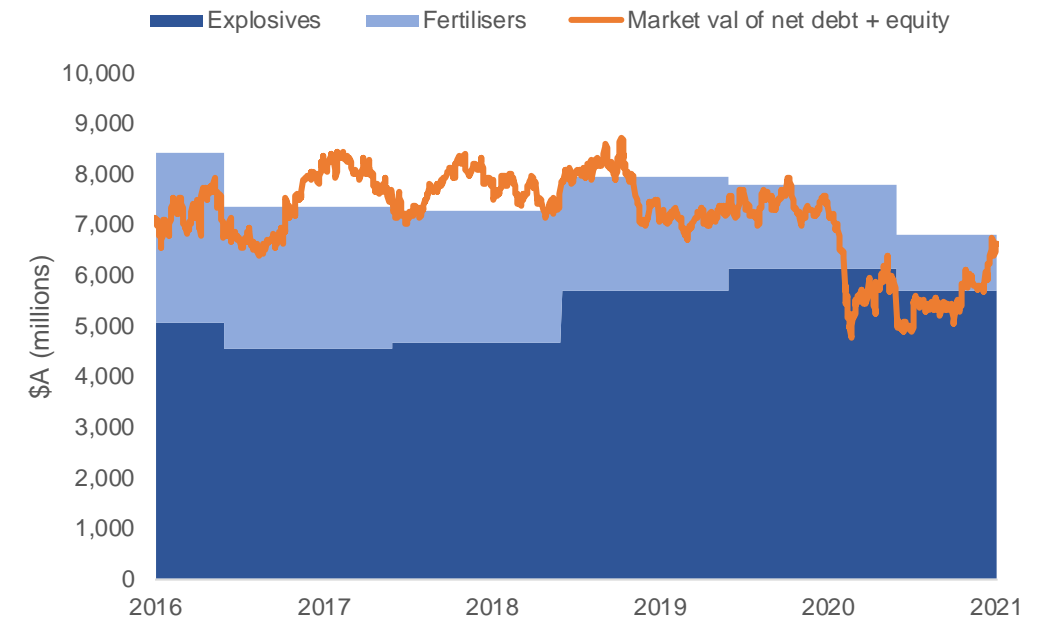
Market View

- ❑ Fertilisers impacted by drought
- ❑ US coal 16% of revenue
- ❑ Trading on low multiple vs history

Merlon View

- ❑ Mid-cycle free cash-flow yield 6% + franking
- ❑ Fertilisers under-earning with improving trends
- ❑ Fertilisers was being ascribed zero value by market

Incitec Pivot Premium / Discount to Merlon cashflow approach



Source: Bloomberg, Company Accounts Calculations: Merlon Capital Partners February 2021

Overview

- ☐ Leading furniture retailer in fragmented industry
- ☐ Revenue grew 11% pa to 2020 and 50% in 1H21
- ☐ Strong founder alignment

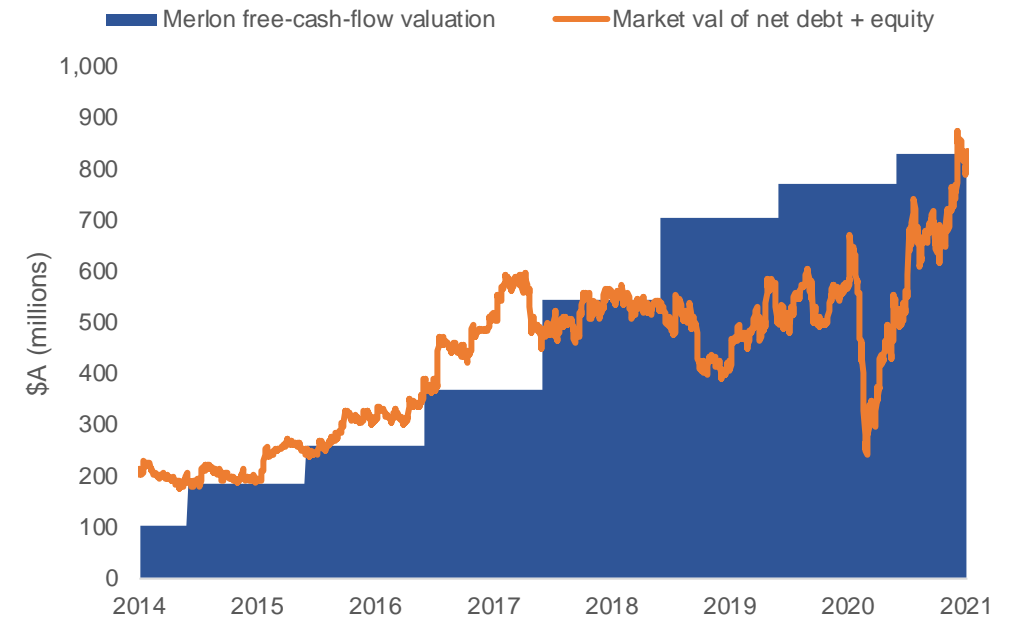
Market View

- ☐ Market concerned about housing cycle & COVID
- ☐ Sales have surprised on stimulus & stay-at-home
- ☐ Traded at 3x pre-tax earnings in March 2020

Merlon View

- ☐ Mid-cycle free cash-flow yield 6% + franking
- ☐ Less risky than perceived (property, stock & cash)
- ☐ Recently reduced holding as no longer cheap

Nick Scali Premium / Discount to Merlon cashflow approach



Source: Bloomberg, Company Accounts Calculations: Merlon Capital Partners February 2021

Overview

- ☐ Favorable industry structure
- ☐ Business mix weighted to retail
- ☐ Yet current returns 9% vs 20% historically

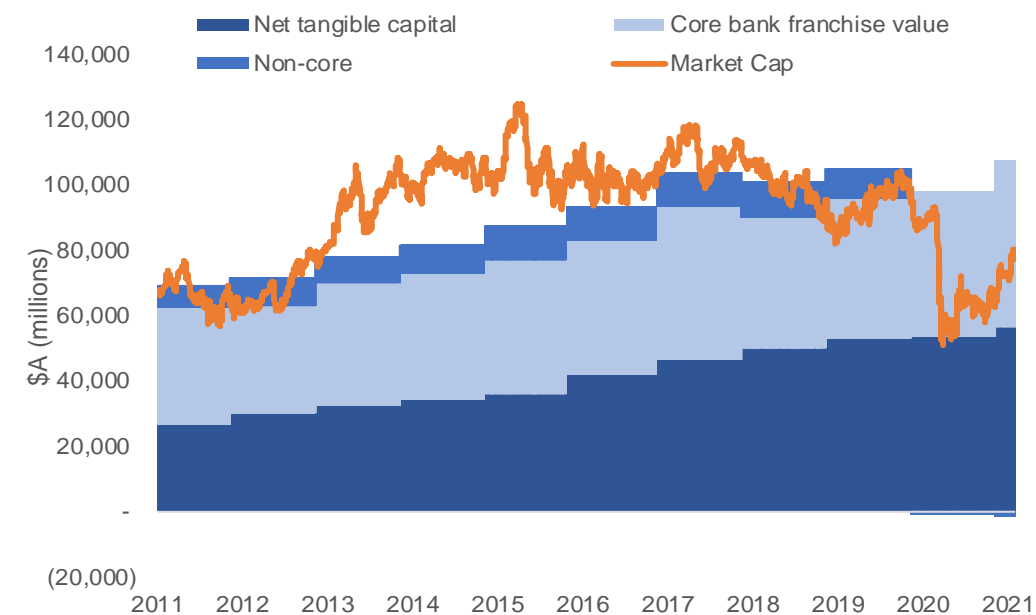
Market View

- ☐ Low rate, bad debt & management concerns
- ☐ Low earnings expectations
- ☐ Shares recently traded at tangible capital

Merlon View

- ☐ Mid-cycle free cash-flow yield 7% + franking
- ☐ Operating environment increasingly favourable
- ☐ More similar to CBA than perceived

Westpac Premium / Discount to Merlon cashflow approach

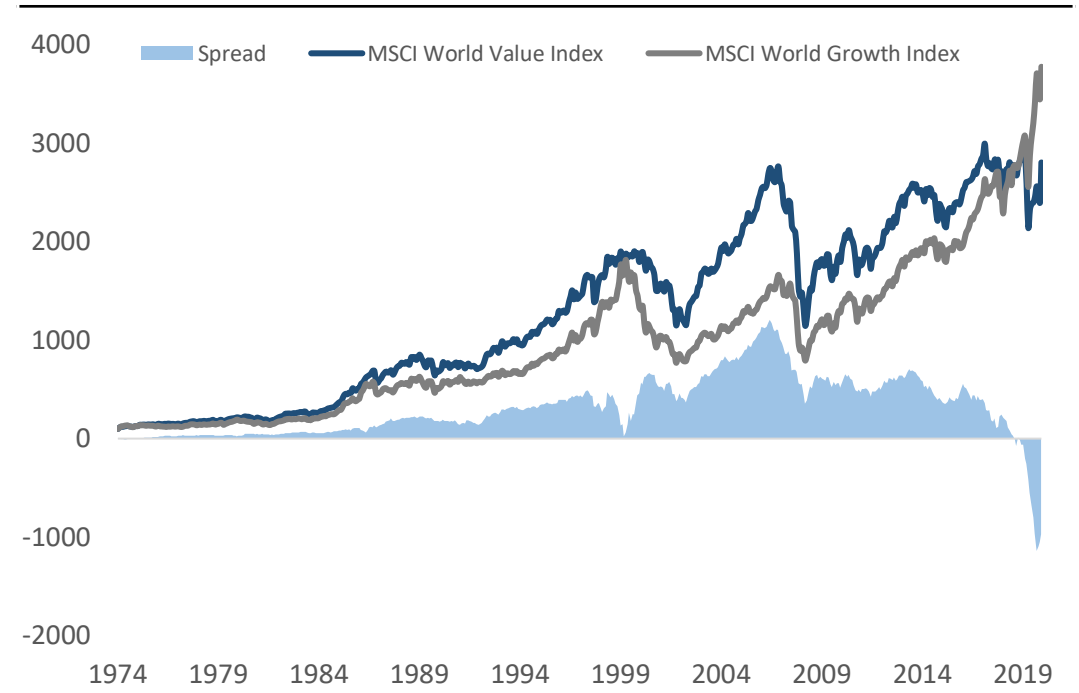


Source: Bloomberg, Company Accounts Calculations: Merlon Capital Partners February 2021

Reinventing Value Investing

- ❑ Markets are mostly efficient
- ❑ Value a signal of over-pessimism / optimism
- ❑ Accounting measures of value flawed
- ❑ Cash over “advertised” earnings
- ❑ Cash-flow focused on “sustainable” over “current”
- ❑ Risk management is “margin of safety”
- ❑ No reference to index & appropriately diversified

“Growth” vs “Value” - a longer term perspective



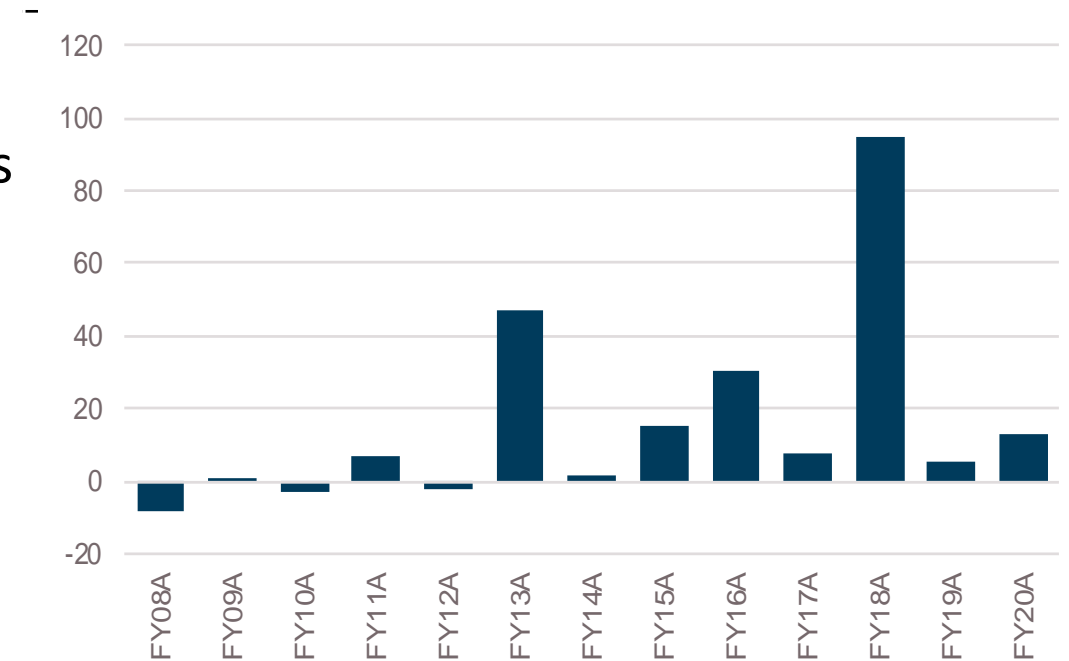
Source: Bloomberg, MSCI World Growth and Value index returns. 30 November 2020.

Merlon Approach to Corporate Governance



- ❑ Highly integrated in investment process
- ❑ Free cash flow can identify governance concerns
- ❑ Companies not screened out on governance
- ❑ Having different view to market more relevant
- ❑ Strong track record of engagement

Harvey Norman loans to JV's and related/unrelated parties (\$m)



Source: Annual reports, Merlon. Positive values denotes cash outflows and negative values indicate cash inflows

Fund Performance



	FY21TD (%)	FY2020 (%)	FY2019 (%)	FY2018 (%)	FY2017 (%)	FY2016 (%)	FY2015 (%)	FY2014 (%)	FY2013 (%)	FY2012 (%)	5 Years (% pa)	10 Years (% pa)
ASX200 Return	14.0	-6.5	13.2	14.5	15.5	2.2	7.2	18.9	24.3	-5.1	11.4	9.3
Share Portfolio Excess Return	2.8	-2.8	-4.8	-6.9	8.0	4.8	2.3	-2.7	11.7	1.7	-0.5	0.9
Hedge Overlay	-5.4	3.9	-0.9	-2.4	-5.6	-0.9	-1.7	-3.5	-9.3	2.6	-2.3	-1.9
Portfolio Return (before fees)	11.4	-5.4	7.5	5.1	17.9	6.1	7.8	12.8	26.7	-0.8	8.6	8.3
Portfolio Return (net of fees)	10.8	-6.3	6.5	4.2	16.8	5.1	6.8	11.8	25.5	-1.7	7.6	7.3
Gross Yield	3.6	6.4	7.9	7.0	7.8	7.5	7.6	7.6	9.8	10.1	7.3	8.4
Average Daily Market Exposure	65%	67%	69%	68%	68%	70%	70%	69%	69%	69%	68%	69%

Returns for the Fund and ASX200 grossed up for accrued franking credits and the Fund return is stated net or gross of fees (as applicable) as at 31 January 2021.
Past performance is not a reliable indicator of future performance. Gross Distribution Yield represents the income return of the fund inclusive of franking credits (after fees).

Sustainable Income

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by focusing on capital preservation and growth

Fundamental Research

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Portfolio Diversification

*No reference to
ASX200 weights*

Downside Protection

*Through research &
Risk reduction overlay*

A bit more about your presenters



Neil Margolis
Lead Portfolio Manager

Neil Margolis founded Merlon Capital Partners in May 2010. Prior to Merlon, Neil was Portfolio Manager of Challenger Limited's Australian Share Income Fund, having established the strategy in 2005. Neil joined Challenger in 2004 as a Senior Industrials Analyst from Alliance Capital Management where he held the position of Senior Equities Analyst. Neil was with Alliance for three years, and prior to that worked for JP Morgan Investment Bank.

Neil holds a B.BusSc (Hons), CA and CFA.



Adrian Lemme
Analyst/Portfolio Manager

Adrian joined Merlon Capital Partners as a Principal in May 2012 from AMP Capital where he was a Portfolio Manager/Analyst, responsible for investments in retail, food and beverage, transport and chemical sectors. Having commenced his career with Commonwealth Bank in 2003, Adrian was the lead transport analyst with CBA Equities Research prior to joining AMP Capital in 2010.

Adrian holds a BMathFin (Hons) and CFA.

Thank you