

Merlon Australian Share Income Fund

Webinar – 6 May 2019

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How Merlon Approach is Different

Fundamental Research

*Focused on
sustainable cash flow*

Portfolio Diversification

*No reference to
ASX200 weights*

Downside Protection

*Through research &
hedge overlay*

This focus on capital preservation and growth delivers

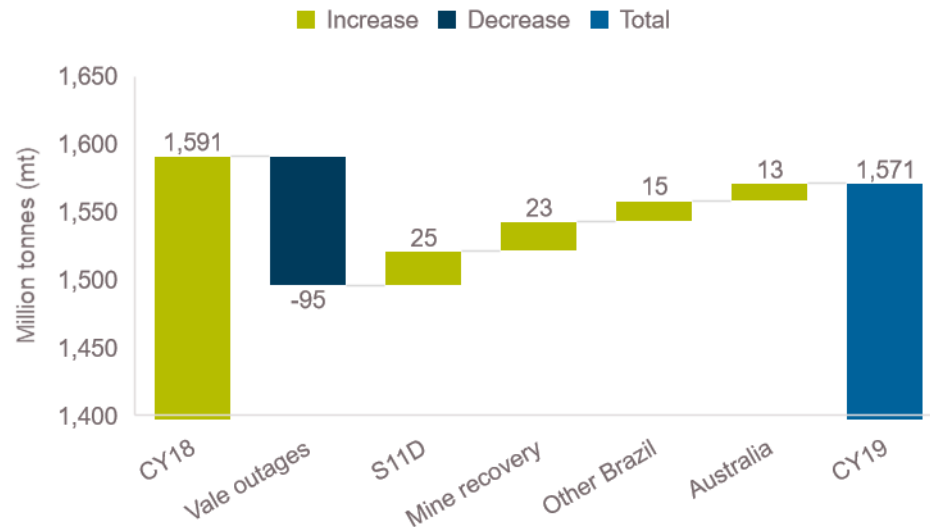
Sustainable Income

Paid monthly and majority franked

- ❑ Iron Ore: Supply Disruption is Temporary; The Transition to Recycling is Permanent
- ❑ A Case Study in Poor Capital Allocation
- ❑ Fund positioning and performance

Iron ore exports – supply path for 2019

Seaborne iron ore supply – path for 2019

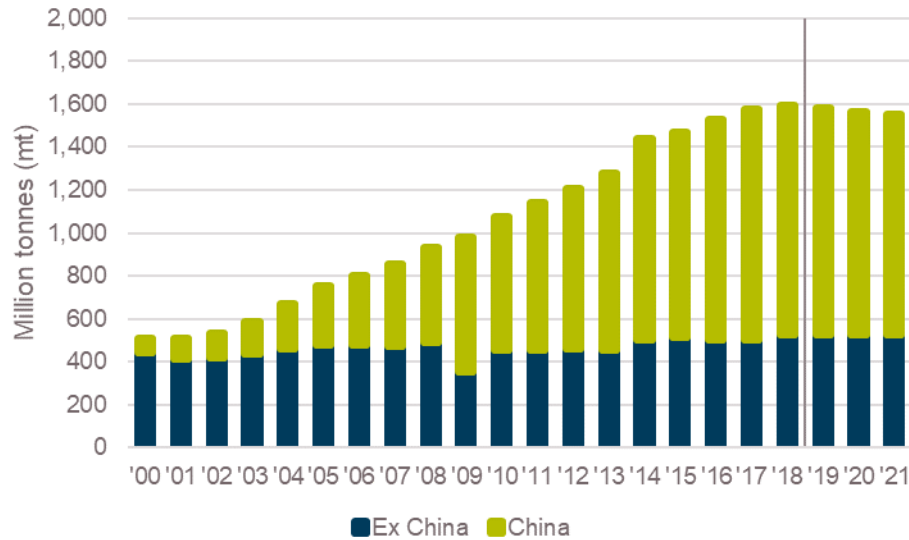


Source: Evans & Partners / forecasts: Merlon Capital Partners

- Headline outage significant
- But offset by a range of factors
- Already seeing other supply responses

Iron ore imports – China is key, but well stocked

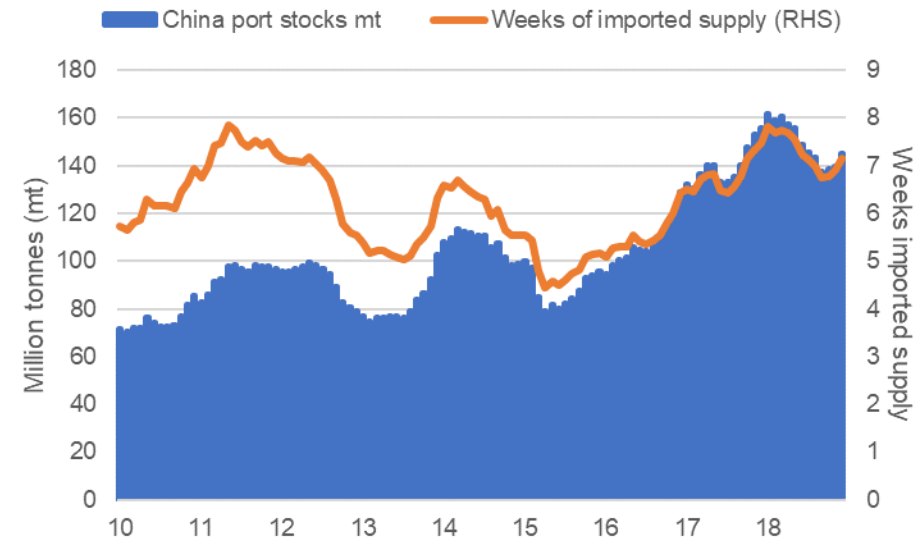
Global iron ore imports – China is key...



Source: World Steel / Forecasts: Merlon Capital Partners.

- China iron ore imports >2x rest of world
- Imports declined in 2018

...and has ample stockpiles for temporary outages

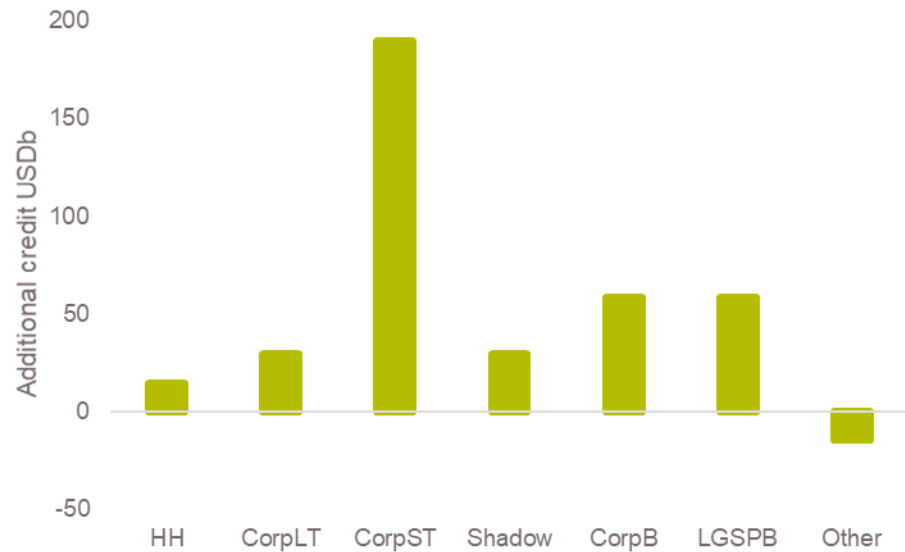


Source: Bloomberg / Calculations: Merlon Capital Partners.

- China stockpiles are elevated
- More than sufficient to cover temporary outages

China credit stimulus – key components

1Q19 credit growth vs 1Q18 (USDb)

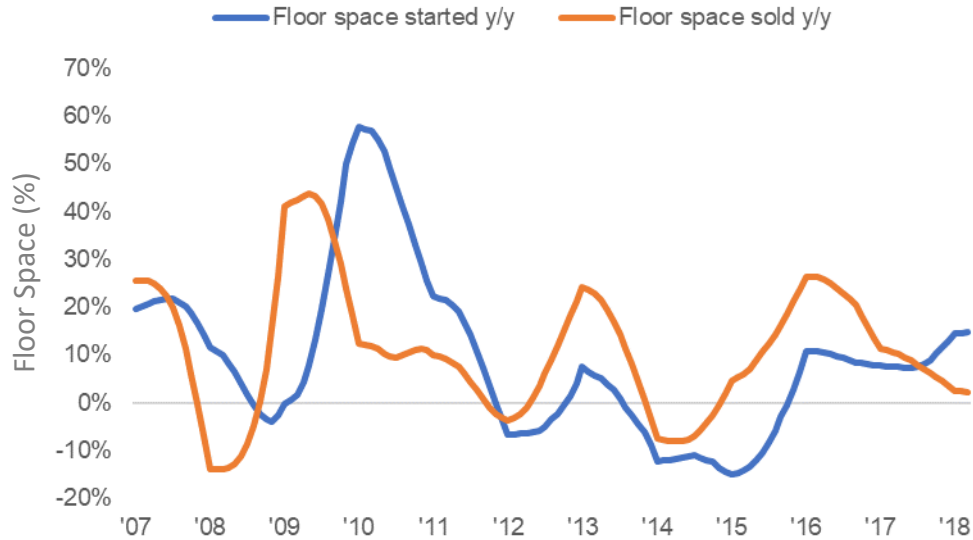


Source: Macquarie Bank.

- Majority in increase in credit short term
- Stimulus aimed at backstopping SMEs
- Not 2016-style property intensive

China property – a key steel market

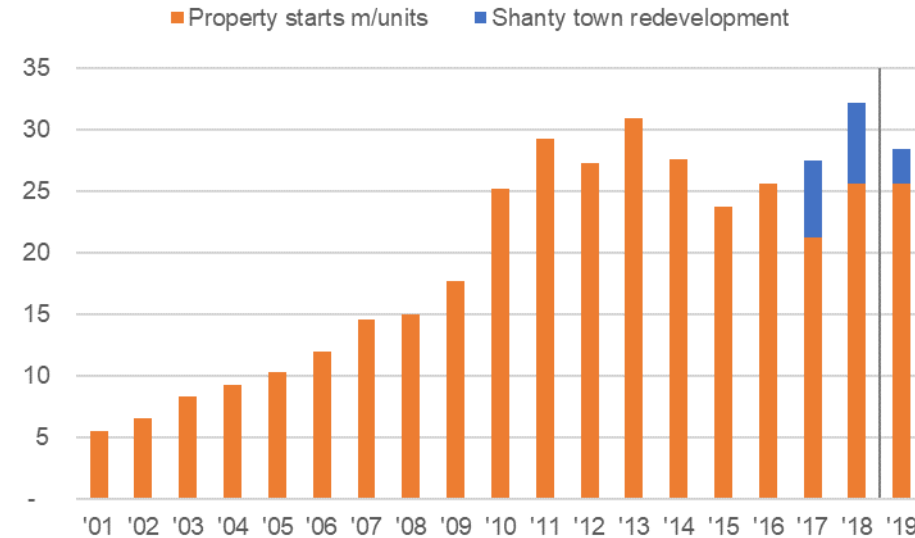
Property activity already elevated...



Source: Bloomberg / Calculations: Merlon Capital Partners

- Majority in increase in credit short term
- Stimulus aimed at backstopping SMEs
- Not 2016-style property intensive

...and supported by policy

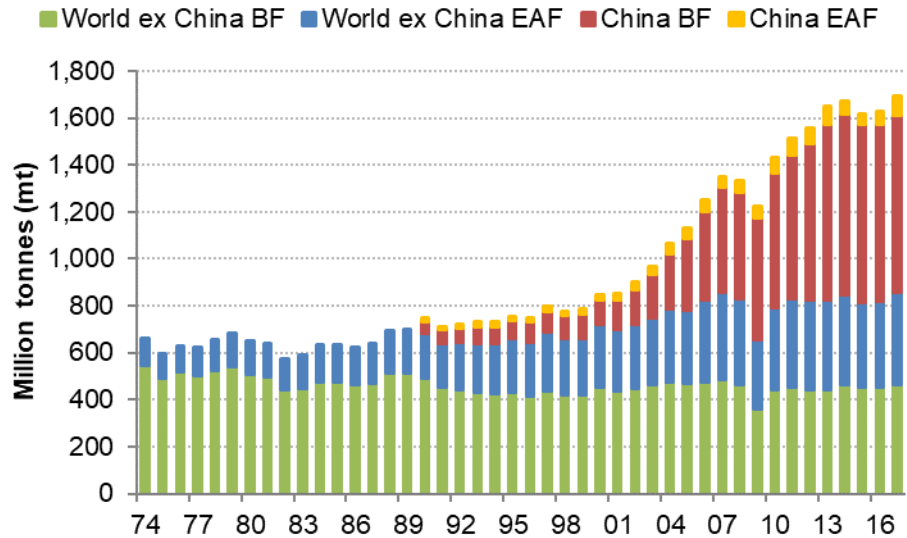


Source: Capital Economics / Calculations & Estimates: Merlon Capital

- Property purchase restrictions remain tight
- Policy support downgraded
- 'Property for living, not speculating'

Steel recycling – key risk for iron ore

China 'under-recycling'

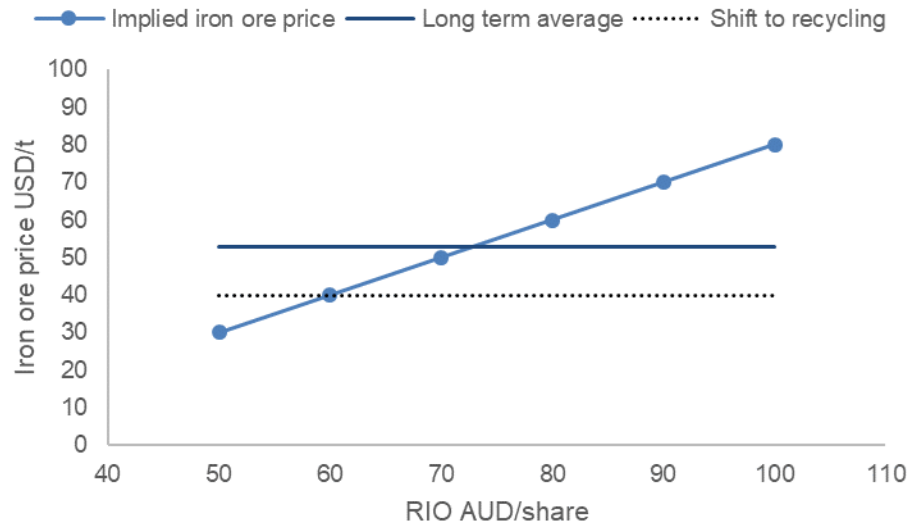


Source: World Steel

- China has a pollution problem
- Is seeking to address via capacity swap policy
- Significant room to displace iron ore

Equity implications

Iron ore equities factoring in temporary factors



Source: Merlon Capital Partners.

- Factoring in USD80/t iron ore
- 60% above long-term average (see chart)
- Downside risk from transition to recycling

Outline

- ❑ Iron Ore: Supply Disruption is Temporary; The Transition to Recycling is Permanent

- ❑ A Case Study in Poor Capital Allocation

- ❑ Fund positioning and performance

Warren Buffett on Capital Allocation



*"The first law of capital allocation—whether the money is slated for acquisitions or share repurchases—is that **what is smart at one price is dumb at another**" **

*"**Managers tend to be reluctant to look at the results of the capital projects** or the acquisitions that they proposed with great detail only a year or two earlier to a board. And they don't want to actually stick the figures up there as to how the reality worked out relative to the projections. **That's human nature.**" ^*

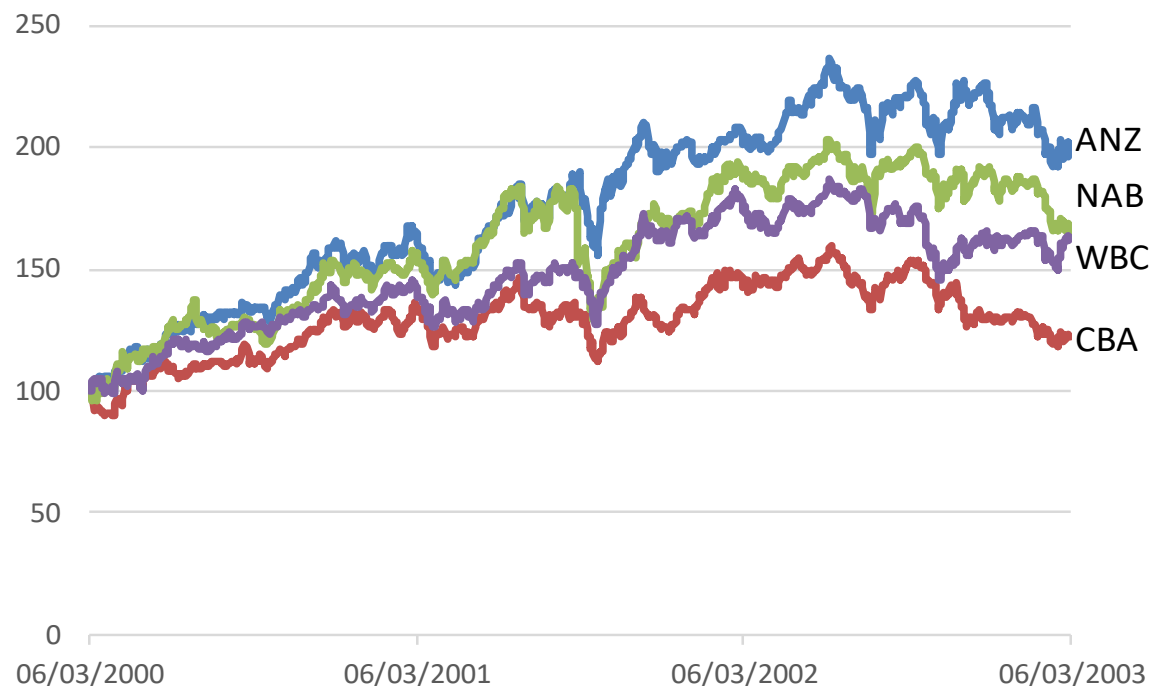
* Source: Berkshire Hathaway Investor Letter (2011)

^ Source: Berkshire Hathaway Annual meeting (3 May 1999)

CBA Acquisition of Colonial Limited - Shareholder Value

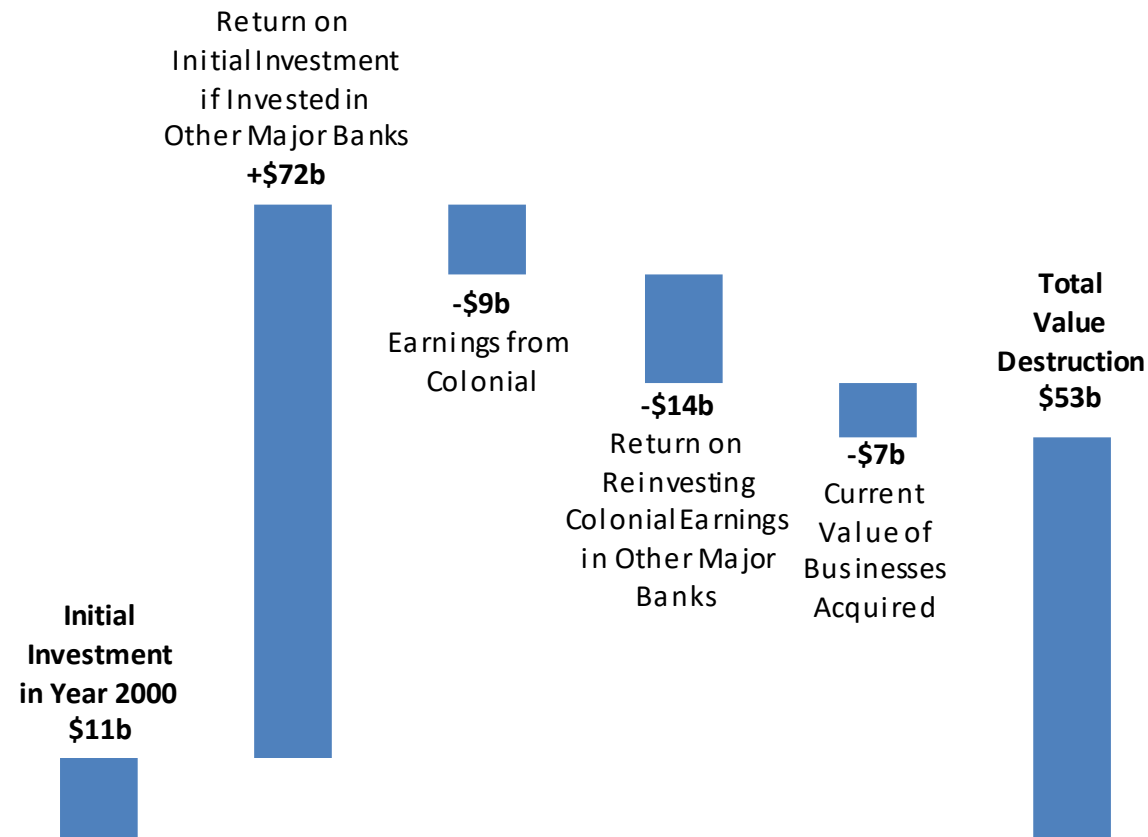


Total Shareholder Return (Indexed to 100)



Source: Bloomberg

Calculated Value Destruction From Colonial Acquisition



Source: Colonial Ltd's Company Accounts, Merlon Analysis

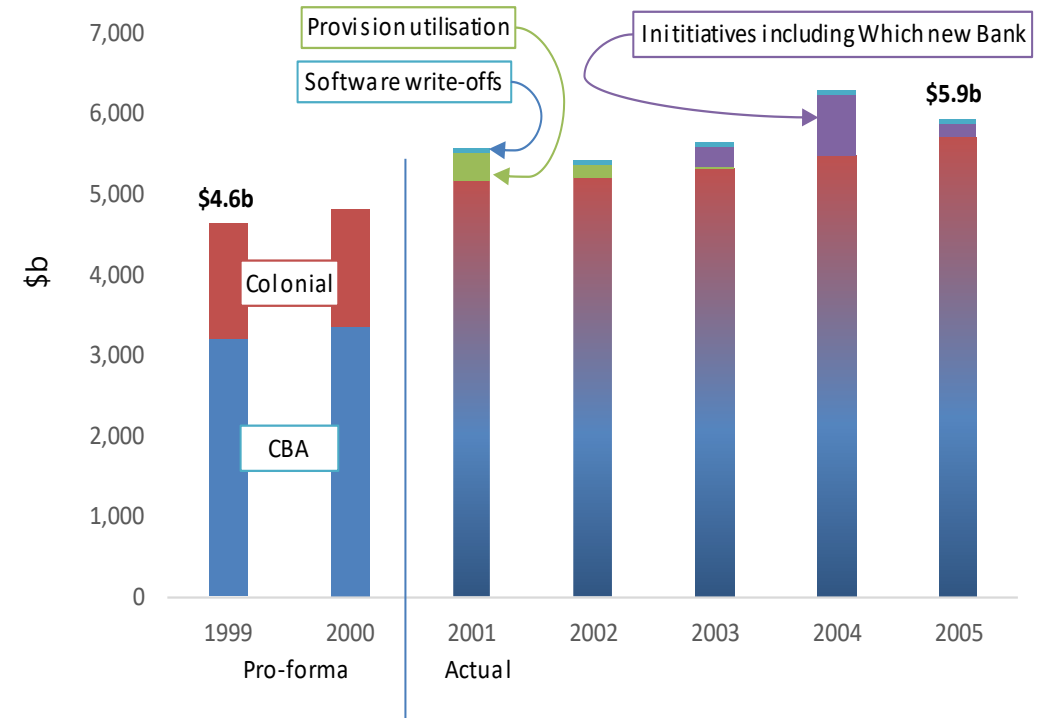
CBA Acquisition of Colonial Limited - Operating Results



CBA Banking Market Share



Consolidated Cost Base



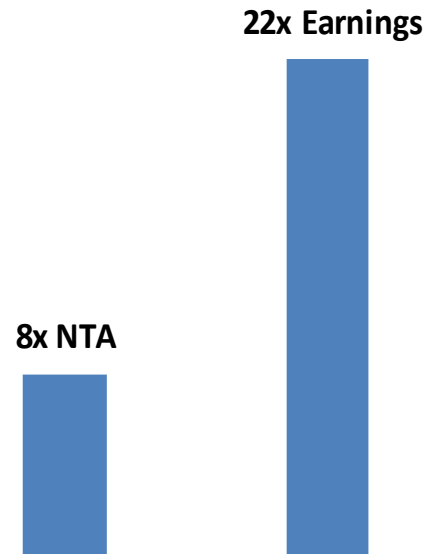
Source: APRA monthly banking statistics, average market share of mortgages and deposits

Source: Colonial Ltd's Company Accounts, Merlon Analysis

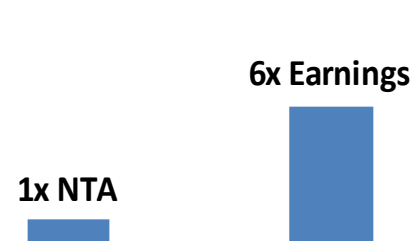
Pro-cyclical Behaviour

Comparative Deal Multiples

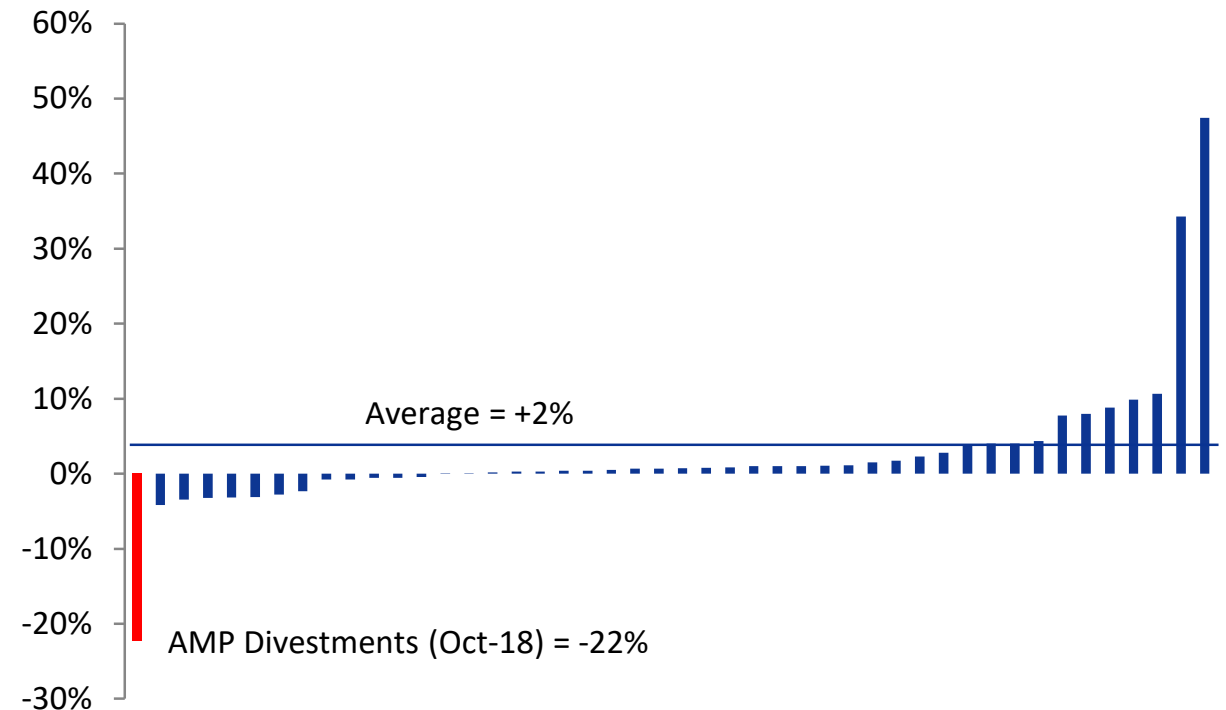
Colonial Acquisition Multiples



AMP Divestment Multiples



Divestment Announcements – Market Reaction



Source: Colonial Ltd's Company Accounts, Merlon Analysis

Share Price Reaction on Day of Divestment Announcement (ASX100 Companies, 2000 to Today, Proceeds > 10% of Enterprise Value)

Source: Bloomberg, share price reaction relative to All Ordinaries Accumulation index

The Merlon Process



- ❑ ***Assessing the risks*** through qualitative scorecard
- ❑ ***Valuations*** that reflect qualitative considerations
- ❑ ***Conviction*** around whether our views are more or less pessimistic than the market
- ❑ ***Disciplined portfolio management*** that flags exit opportunities and avoids fire sales

The Need for Greater Shareholder Protections

Shareholder Approval Thresholds

Exchange	Threshold
ASX	<u>Not required</u> for rights issue or scrip deal
NYSE	<u>Approval required</u> for any deal resulting in <u>20%</u> increase in shares
LSE	<u>Approval required</u> for any deal more than <u>25%</u> of company value, assets, revenue or earnings
HKEx	<u>Approval required</u> for any deal resulting in <u>25%</u> increase in shares
SGX	<u>Approval required</u> for any deal resulting in <u>20%</u> increase in shares
TSX	<u>Approval required</u> for any deal resulting in <u>25%</u> increase in shares

Source: Respective Exchange Listing Rules of ASX, NYSE, LSE, HKEx, SGX and TSX

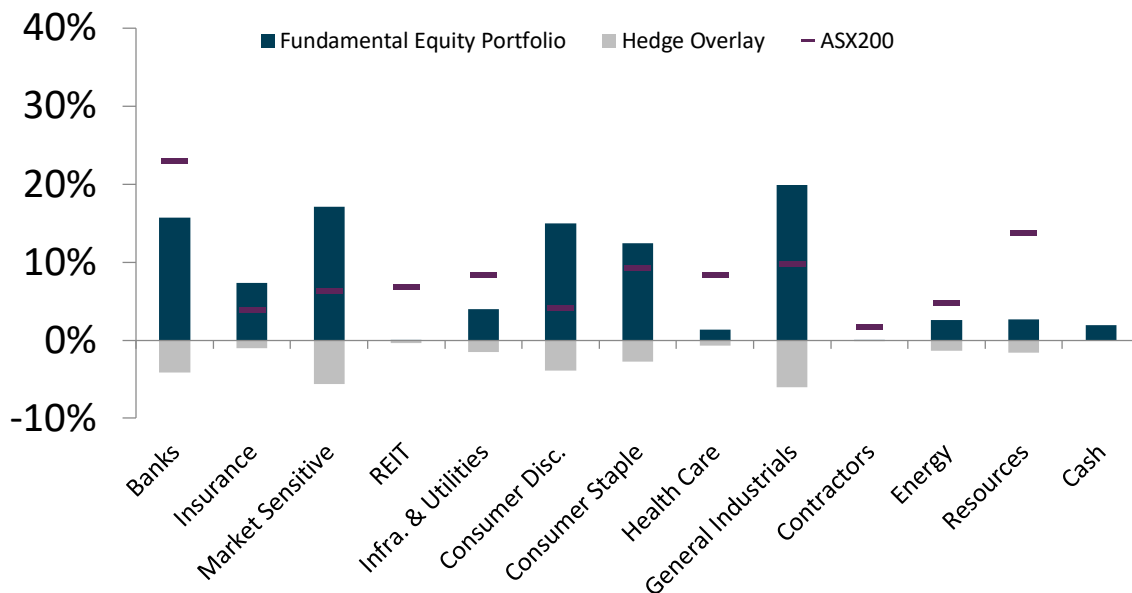
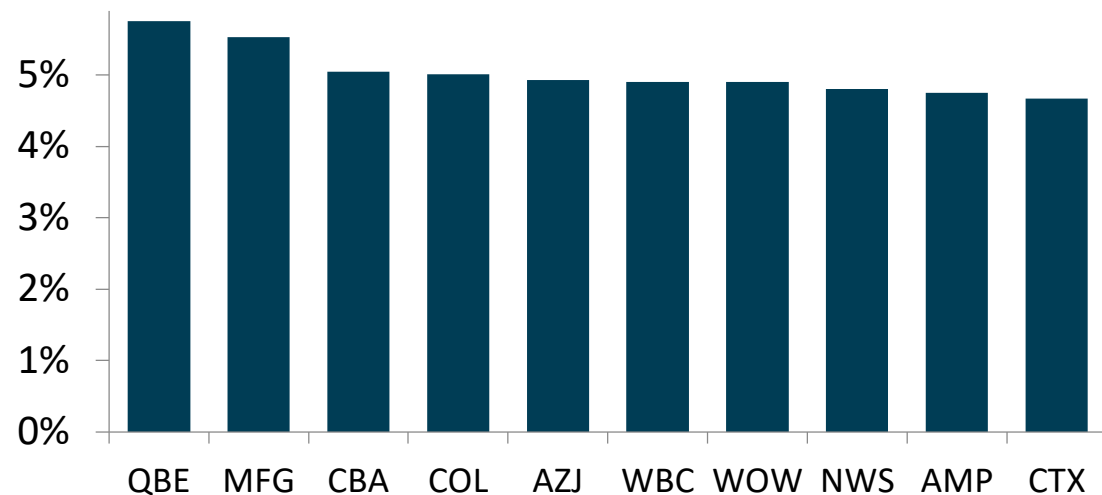
- ❑ **Large transactions have broad ramifications**
CBA & BHP represent c15% of index
- ❑ **Shareholder approved deals are better received**
Average +2% vs -2% for unapproved deals*
- ❑ **Australia is out-of-sync with rest of world**

* Source: Equity issuances and agency costs: The telling story of shareholder approval around the world, Journal of Financial Economics, September 2018

Outline

- ❑ Iron Ore: Supply Disruption is Temporary; The Transition to Recycling is Permanent
- ❑ A Case Study in Poor Capital Allocation
- ❑ Fund positioning and performance

Merlon Australian Share Income Fund - Current Fund Positioning



Portfolio Analytics – 30 April

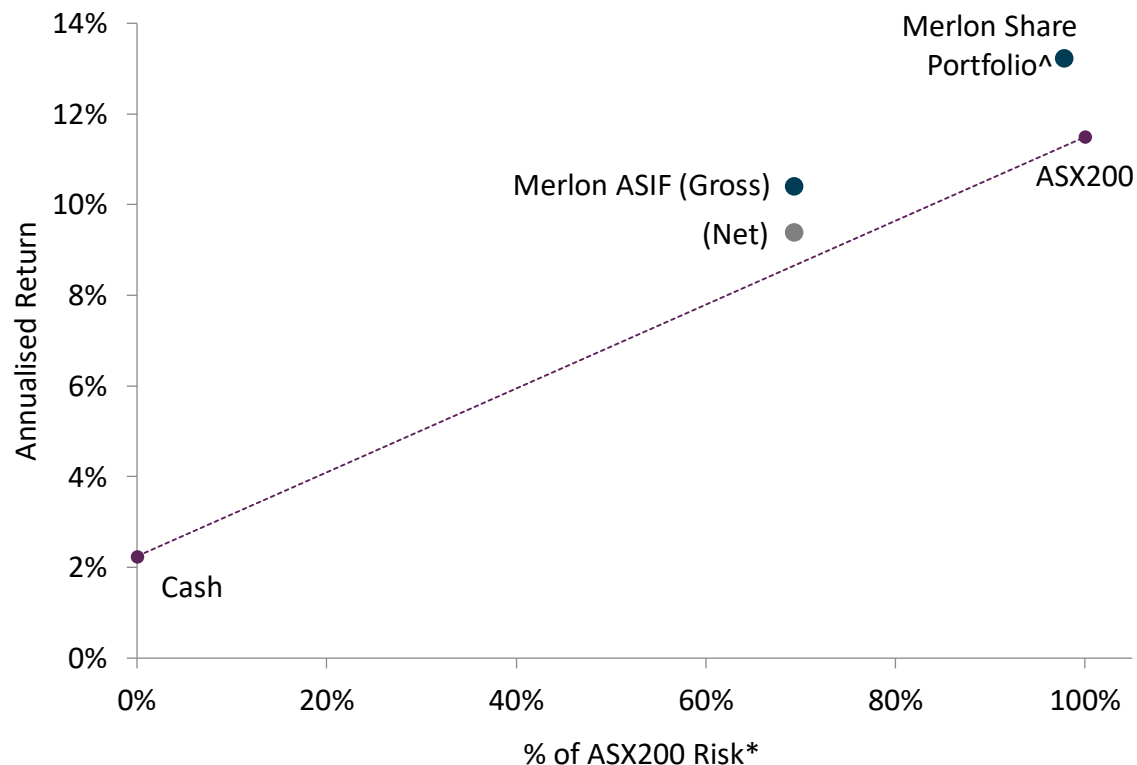
	Portfolio	ASX200
Number of Equity Positions	36	200
Net Market Exposure	69%	100%
Active Share	75%	0%
Valuation Upside ¹	+24%	-15%
Trailing Free Cash Yield	5.6%	4.6%
Gross Distribution Yield	7.2%	5.7%
Price / Earnings Ratio	15.3x	17.3x

Portfolio as at 30 April 2019. ¹Valuation Upside based on Merlon proprietary valuations.

Outcomes



Total Return vs Risk (7 Years)



Monthly Distribution Detail: Cents per Unit

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Total	Franking
FY2013	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.29	6.79	2.26
FY2014	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.52	6.13	1.98
FY2015	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	6.24	2.20
FY2016	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.52	6.35	1.92
FY2017	0.53	0.53	0.53	0.53	0.53	0.3	0.53	0.53	0.53	0.53	0.53	0.53	6.36	2.02
FY2018	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.52	6.35	1.84
FY2019	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	6.36	1.90

Highlighted data are estimates at the date of this presentation. Information is predictive in nature, may be affected by inaccurate assumptions or known or unknown risks and uncertainties, and may differ materially from results ultimately achieved.

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 30 April 2019.

Merlon Australian Share Income Fund franking 1.9% p.a., ASX200 franking 1.5% p.a.

*% of ASX200 Risk represents the Fund's statistical beta relative to the ASX200. Past performance is not an indication of future performance.

^Underlying portfolio returns before hedge overlay

Merlon Australian Share Income Fund Performance



	FY19TD (%)	FY2018 (%)	FY2017 (%)	FY2016 (%)	FY2015 (%)	FY2014 (%)	FY2013 (%)	FY2012 (%)	3 Years (% pa)	5 Years (% pa)	7 Years (% pa)
ASX200 Return	7.2	14.5	15.5	2.2	7.2	18.9	24.3	-5.1	12.6	9.0	11.6
Share Portfolio Excess Return	0.3	-6.9	8.0	4.8	2.3	-2.7	11.7	1.7	-0.2	1.1	2.2
Hedge Overlay	-0.6	-2.4	-5.6	-0.9	-1.7	-3.5	-9.3	2.6	-2.7	-1.8	-2.9
Portfolio Return (before fees)	6.9	5.1	17.9	6.1	7.8	12.8	26.7	-0.8	9.7	8.3	10.9
Portfolio Return (net of fees)	6.1	4.2	16.8	5.1	6.8	11.8	25.5	-1.7	8.7	7.3	9.8
Gross Yield	6.7	7.0	7.8	7.5	7.6	7.6	9.8	10.1	7.5	7.6	8.1
Average Daily Market Exposure	69%	68%	68%	70%	70%	69%	69%	69%	69%	69%	69%

Returns for the Fund and ASX200 grossed up for accrued franking credits and the Fund return is stated as at 30 April 2019. Past performance is not a reliable indicator of future performance. Gross Distribution Yield represents the income return of the fund inclusive of franking credits (before fees).

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This focus on capital preservation and growth delivers

Sustainable Income

Paid monthly and majority franked

A bit more about your presenters



Hamish Carlisle
Analyst/Portfolio Manager

Hamish joined Merlon Capital Partners as a Principal in July 2010. Hamish was previously Head of Research, Asia Pacific Equities at AMP Capital Investors. Prior to AMP, Hamish was a Senior Director and Head of Australian Banks Research at Merrill Lynch Equities. He has also held positions at Burdett, Buckeridge, Young and National Australia Bank. Hamish holds a MBA with honours from The Wharton School, University of Pennsylvania. Hamish holds a B.Comm (Hons) and an MBA (Hons).



Ben Goodwin
Analyst/Portfolio Manager

Ben joined Merlon Capital Partners as a Principal upon its inception in May 2010. Prior to joining Merlon, Ben was Head of Research and Information at Challenger Limited, managing the risk and quantitative research processes across all portfolios, as well as conducting tailored fundamental research, macro and commodity based research. Ben has held similar roles at First State Investments (UK), Colonial First State (Australia), and BT Funds Management. Ben holds a B.Ec (Hons).



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