

# Merlon Australian Share Income Fund

Teleconference – October 2017

Hamish Carlisle and Adrian Lemme

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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*

# Outline

- ☐ Telstra

- ☐ Fund positioning and performance

## Case Study: US Railroad Industry



- ❑ In mid-1950s US railroad industry was hit with equivalent of NBN – interstate highways
- ❑ At the same time airlines were taking almost all long haul passengers off the tracks
- ❑ The industry entered into a prolonged period of structural decline
- ❑ BUT: Since 1957 railroad stocks have beaten the S&P 500, airlines and trucking industries
- ❑ LESSON: An industry in decline can offer good returns if expectations are low enough

# Telstra: Gauging Market Expectations

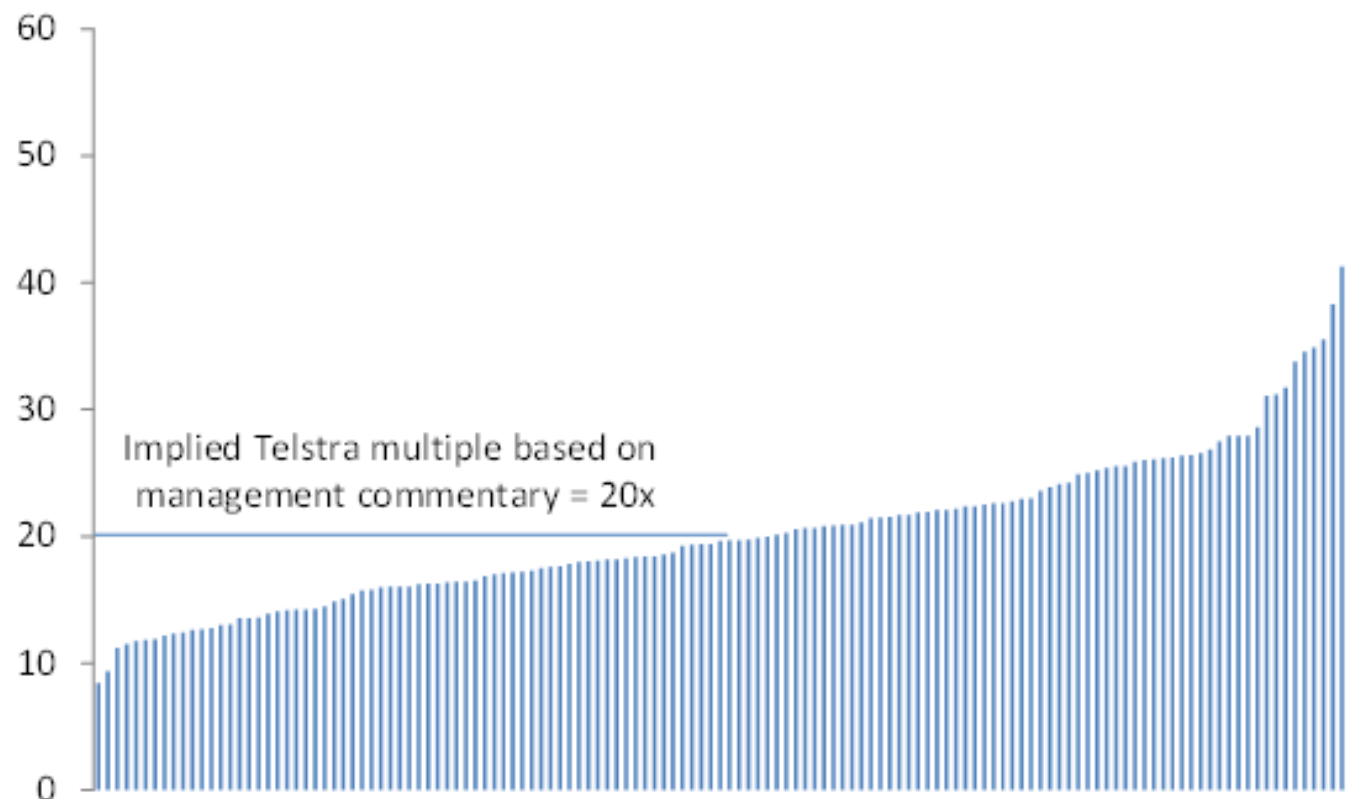
**Figure 1: Implied Management Expectations for Telstra's Sustainable Free-Cash-Flow**

<b>2017 EBITDA</b>	<b>\$10.7b</b>	
One-off nbn receipts	(\$1.8b)	❑ One-off NBN receipts
nbn cost to connect & other expenses	\$0.5b	
Restructuring & impairment	\$0.5b	
New business	\$0.2b	
<b>Company defined 2017 "recurring core" EBITDA</b>	<b>\$10.1b</b>	
Recurring impact from nbn	(\$2.5b)	❑ Network payments
<b>Sustainable 2017 EBITDA</b>	<b>\$7.6b</b>	
Capex at 14% of sales (management 2020 target)	(\$3.9b)	
Tax at 30%	(\$1.1b)	
<b>Implied sustainable free cash flow</b>	<b>\$2.5b</b>	
Market capitalisation at \$3.50 per share	\$41.6b	
Net debt	\$16.3b	❑ Don't forget the debt
Anticipated one-off nbn receipts (undiscounted)	(\$9.0b)	
<b>Enterprise value</b>	<b>\$49.0b</b>	
<b>Enterprise value / sustainable free cash flow</b>	<b>20x</b>	❑ No bargains here

Source: Company 2017 full year result presentation, Merlon Capital Partners

# Telstra: Relative Value

**Figure 2: Enterprise Valuations / Sustainable Free Cash Flow**  
(Merlon Coverage Universe, data as at 22 September 2017)



Source: Bloomberg, Merlon Capital Partners

# Telstra: Ignore the cash flow statement at your peril

**Figure 4: Telstra – Merlon Defined Free Cash Flow (2017 Full Year)**

Gross Operating Cash Flow	\$9.5b
Payments for property, plant & equipment	(\$3.7b)
Payments for intangible assets	(\$1.6b)
Proceeds from sale of property, plant & equipment	\$0.7b
<b>Free cash flow before tax</b>	<b>\$4.9b</b>
Tax paid	(\$1.8b)
Tax shield on net interest	(\$0.2b)
<b>Free cash flow</b>	<b>\$2.9b</b>
nbn receipts (after tax)	(\$1.2b)
Recurring impact from nbn (after tax)	(\$1.8b)
<b>Recurring free cash flow</b>	<b>(\$0.1b)</b>

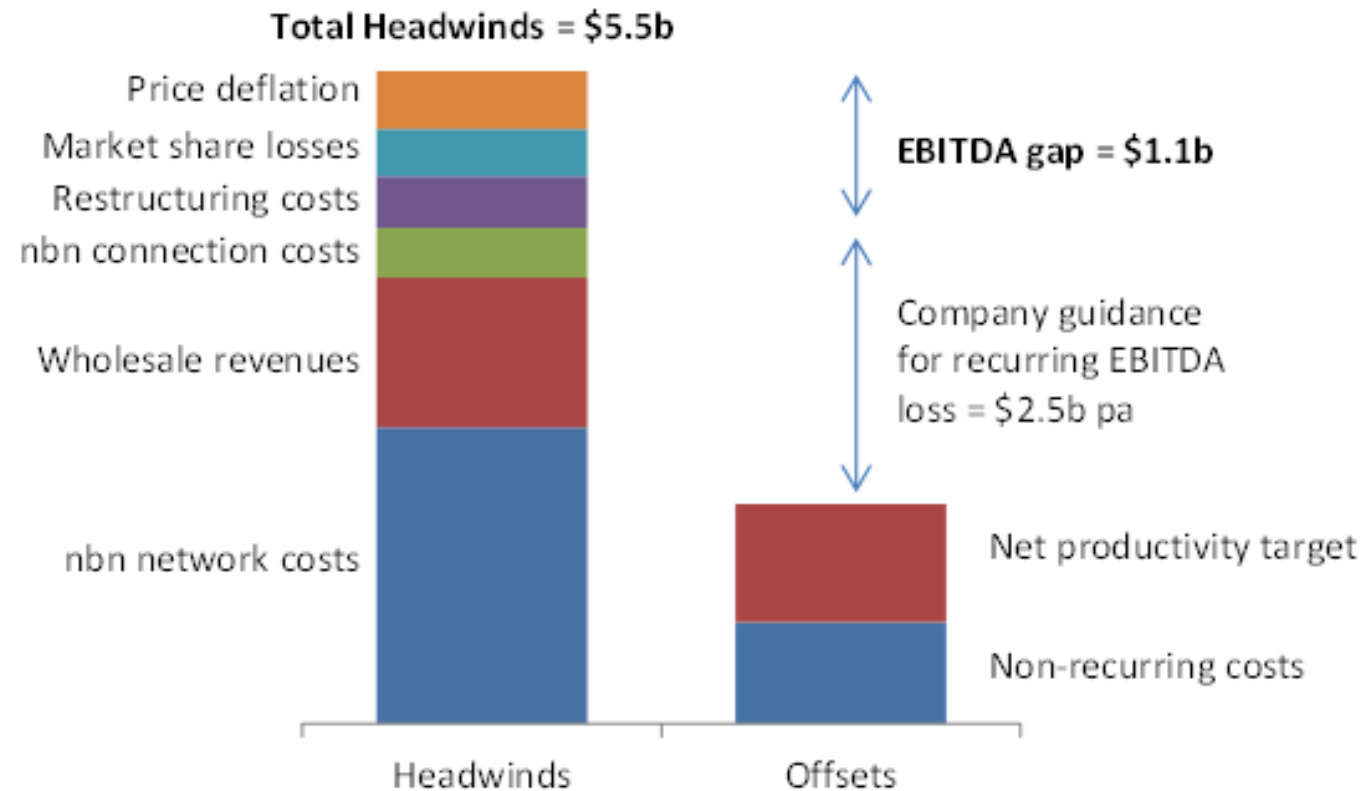
Source: Company 2017 full year result presentation, Merlon Capital Partners

❑ Poor conversion of “EBITDA”

❑ A company burning cash



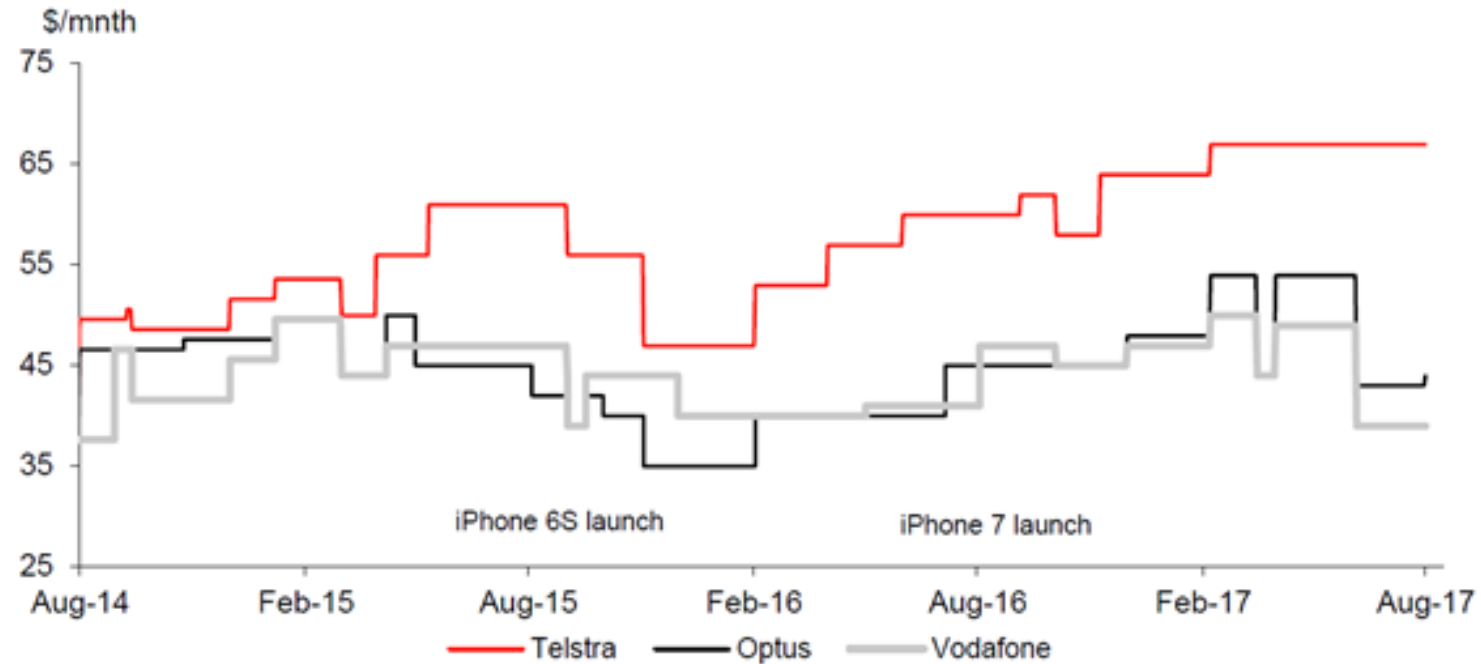
# Telstra: Is \$2.5b pa a reasonable estimate for NBN earnings loss?



Source: Company reports, Merlon Capital Partners

# Telstra: Is mobile pricing sustainable?

**Figure 6: Telstra Post Paid Mobiles Implied Monthly Service Fee**



Source: Macquarie Equities Research

## Telstra: Some Observations

- ❑ Market expectations appear to reflect management commentary
- ❑ Management commentary implies:
  - ❑ A significant reversal in recurring free-cash-flow from 2017 position of cash-burn
  - ❑ A potentially optimistic interpretation of ongoing NBN impact
  - ❑ Potentially optimistic outlook for mobile pricing

# Outline

- ❑ Telstra

- ❑ Fund positioning and performance



# Current Fund Positioning



Portfolio as at 30 September 2017, Valuation Upside based on Merlon proprietary valuations.

Fundamental Research

Non-Benchmark

Downside Protection

Sustainable Income

Portfolio Analytics	Portfolio	ASX200
Number of Equity Positions	27	200
Net Market Exposure	68%	100%
Active Share	74%	0%
Valuation Upside	+17%	-11%
Trailing Fee Cash Yield	5.7%	5.1%
Gross Distribution Yield	7.3%	5.9%
Price / Earnings Ratio	15.0x	16.8x

# Outcomes

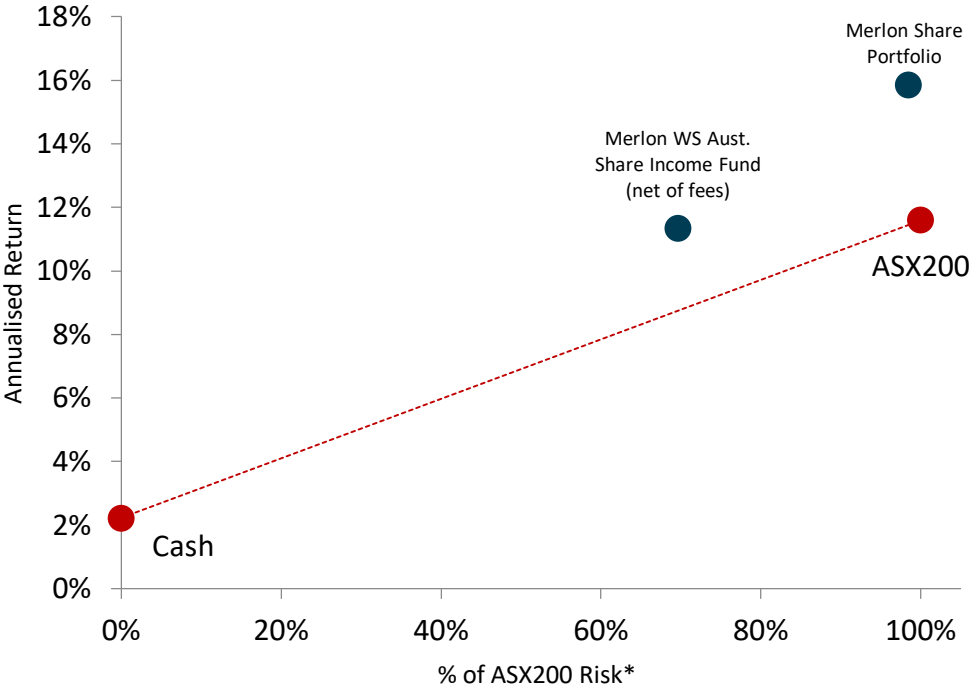
Fundamental Research

Non-Benchmark

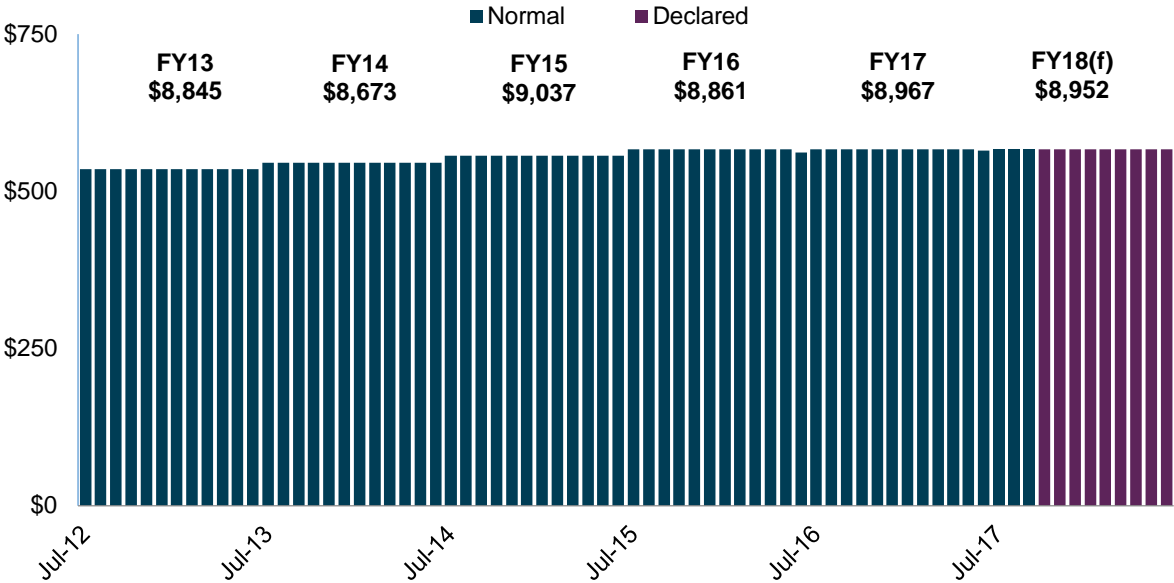
Downside Protection

Sustainable Income

Total Return vs Risk (5 Years)



Monthly Income from \$100,000 invested on 1 July 2012



Preliminary returns for the Fund and ASX200 grossed up for accrued franking credits and the Fund return is stated after fees as at 30 September 2017.  
Merlon Wholesale Australian Share Income Fund franking 1.8% p.a., ASX200 franking 1.5% p.a.  
\* % of ASX200 Risk represents the Fund's statistical beta relative to the ASX200

# Fund Performance

Fundamental  
Research

Non-  
Benchmark

Downside  
Protection

Sustainable Income

	FY18TD (%)	FY2017 (%)	FY2016 (%)	FY2015 (%)	FY2014 (%)	FY2013 (%)	FY2012 (%)	Year (%)	3 Years (% pa)	5 Years (% pa)
Portfolio Return (net of fees)	0.1	16.8	5.1	6.8	11.8	25.5	-1.7	8.5	8.6	11.5
ASX200 Return	1.2	15.5	2.2	7.2	18.9	24.3	-5.1	10.7	8.6	11.6
Excess Return (net of fees)	-1.1	1.3	2.9	-0.4	-7.2	1.2	3.4	-2.3	0.0	-0.1
Share Portfolio Excess Return (before fees)	-0.8	8.0	4.8	2.3	-2.7	11.7	1.7	1.3	3.3	4.4
Excess Yield	-	1.7	1.7	1.5	0.9	3.0	4.1	0.8	1.4	1.6
Average Daily Market Exposure	67%	68%	70%	70%	69%	69%	69%	68%	69%	69%

Preliminary returns for the Fund and ASX200 grossed up for accrued franking credits and the Fund return is stated after fees as at 30 September 2017.



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## 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, Buckridge, Young and National Australia Bank. Hamish holds a MBA with honours from The Wharton School, University of Pennsylvania.



**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.

*Thank you*