

# Merlon Concentrated Australian Strategy

Quarterly Report (Strategy) – June 2024



## Strategy 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.

## Strategy Facts

Portfolio managers	Neil Margolis
Fund inception date	31 <sup>st</sup> May 2010
Merlon FUM	\$791m
Strategy FUM	\$134m

## Quarterly value added relative to benchmark

Top 5	Value Added (%)
Alumina	0.6
Insurance Australia Group	0.5
a2 Milk Co	0.5
Bendigo and Adelaide Bank	0.4
Fortescue*	0.3

Bottom 5	Value Added (%)
National Australia Bank*	-0.4
ASX	-0.4
Commonwealth Bank of Australia*	-0.6
Ramsay Health Care	-0.6
Fletcher Building	-1.2

\* Not held by fund

Source: Fidante Partners Limited, 30 June 2024. Benchmark is S&P/ASX 200 Accumulation Index

## Strategy Performance gross of mgmt. fees

% <sup>1</sup>	Strategy	Benchmark <sup>2</sup>	Excess
Since Inception (p.a) <sup>3</sup>	11.8	10.0	1.9
10 Years (p.a)	11.5	9.5	2.0
5 Years (p.a)	12.0	8.6	3.4
3 Years (p.a)	15.4	7.8	7.6
1 Year	12.1	13.4	-1.3
CYTD	11.0	4.8	6.1
Quarter	-2.4	-0.9	-1.5
1 month	1.8	1.0	0.8

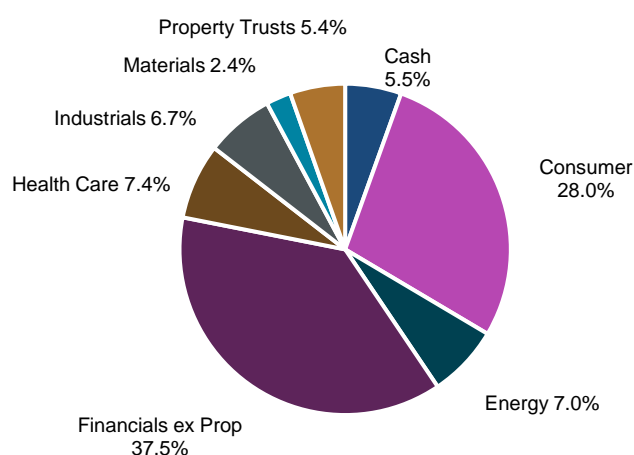
<sup>1</sup>Performance figures are calculated before fees have been deducted and assume distributions have been reinvested. All returns are grossed up to include franking credits. No allowance is made for tax when calculating these figures. Past performance is not a reliable indicator of future performance.

<sup>2</sup>The Fund benchmark is the S&P/ASX 200 Accumulation Index (inclusive of franking credits)

<sup>3</sup>The Strategy Inception date is 31 May 2010.

Source: Fidante Partners Limited, 30 June 2024.

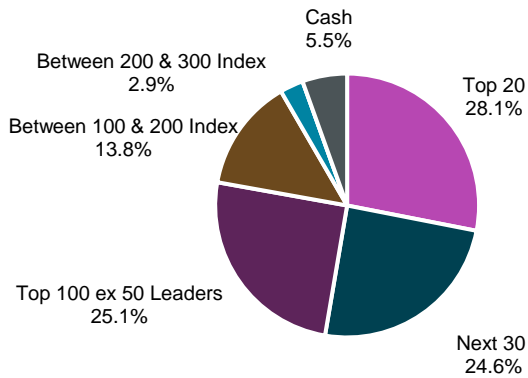
## Sector Exposure



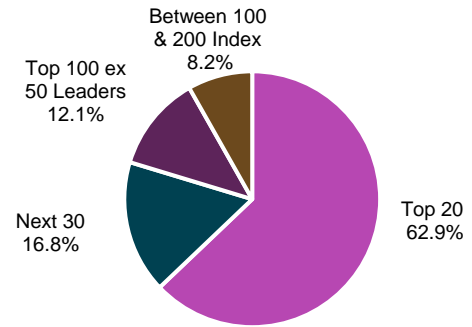
## Top 10 Holdings (Alphabetical)

a2 Milk Co	Commonwealth Bank of Australia
AMP	CSL
ASX	Insurance Australia Group
BHP Group	National Australia Bank
Coles Group	Ramsay Health Care

### Market Cap Bands - Fund



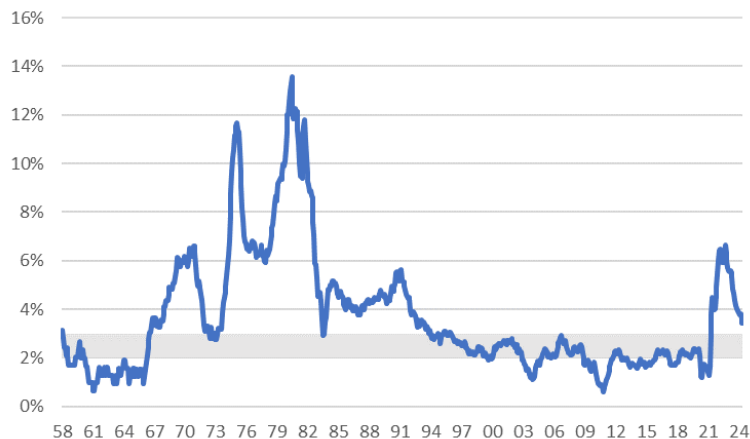
### Market Cap Bands – ASX 200



## Macro Review

Much of the market's focus throughout the financial year has been following the rate of inflation decline. While markets were initially quick to price in a corresponding decline in official interest rates, a slowing in the pace of disinflation has seen these optimistic expectations moderate. In line with stickier than hoped inflation, US 10-year treasury yields rose by more than 50 basis points to finish the year at 4.36%, while inflation settled at an above-target 3.4%.

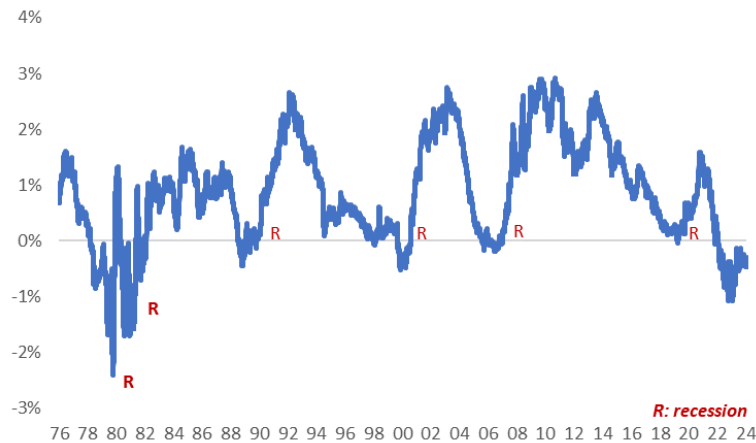
**Figure 1: US core inflation rate**



Source: Bureau of Labour Statistics. Calculations / Charting: Merlon Capital Partners.

Australian inflation has also disappointed, with a May print of 4.1%, leading markets to price in an even chance of a rate rise being the RBA's next policy move. As long noted in our reporting, it is likely to take longer than hoped for inflation to return to the 2-3% target rate. This is primarily due to the inflationary pulses that occur, with wage inflation currently catching up to goods and services inflation. It is yet to be determined whether this results in a second round of price hikes by businesses looking to manage margins, or whether labour is laid off. Demand strength will ultimately be the determinant of the path from here. The US, as an indicator, is not out of the woods if bond investors are to be believed, with the yield curve remaining in negative territory.

**Figure 2: US yield curve**

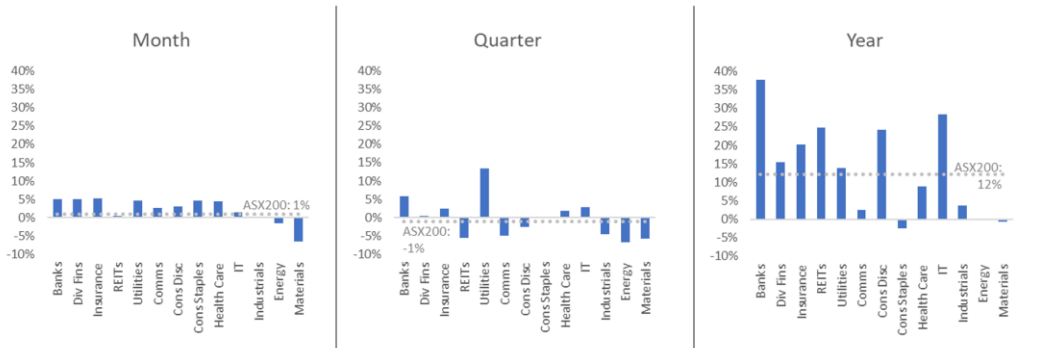


Source: Federal Reserve Bank of St. Louis. Calculations / Charting: Merlon Capital Partners.

### Market review

The ASX200 rose by 1.0% during the month, finishing the month off its highs following a higher inflation reading and a corresponding sell-off as the market moved to increase its expectations of another rate rise. Despite the positive month, the June quarter finished down 0.8%, with broader expectations of lower yields impacting returns. The full financial year, however, delivered a strong return of 12%, in line with the strength seen in global markets.

**Figure 3: sector returns**

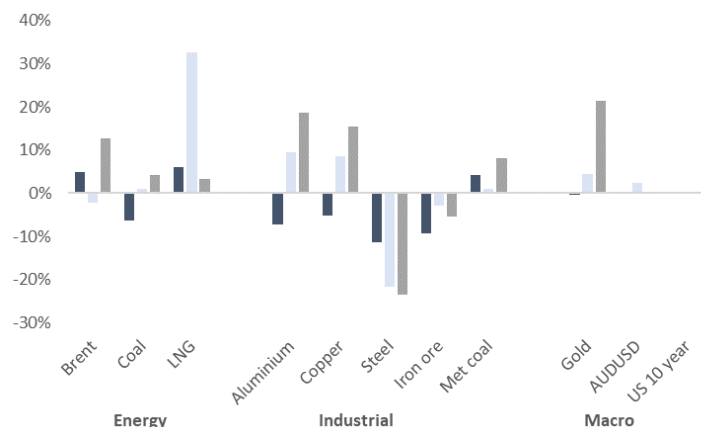


Source: Merlon Capital Partners, Bloomberg.

At a sector level, **Banks** performed best, driven largely by **Commonwealth Bank (CBA)**, while the Information Technology sector was strong, partly tracking the strength seen in US technology counterparts. Other positive sectors included **Consumer Discretionary**, reflecting low earnings expectations, **Insurance**, tracking lower claims and higher rates, and **REITs**, driven primarily by **Goodman Group (GPG)** on growing expectations of data centre warehouse demand.

The worst performing sectors over the year were **Materials**, led lower by weak iron ore and lithium prices, outweighing the positive gold sector. **Consumer Staples**, and **Healthcare**, all partly reflecting high premiums paid for defensiveness amidst a market starting to consider growth rather than defensiveness. And the **Energy** sector, underperformed the 13% return from oil, a commodity in tune with continually positive demand growth.

**Figure 4: commodity and macro returns**



Source: Merlon Capital Partners, Bloomberg.

## Portfolio Review

**MONTH:** The Fund **outperformed the ASX200 by 0.8%** (before fees and franking credits).

### Positive contributors:

- **IAG (overweight):** continued to perform strongly on a late month confirmation of a large reinsurance agreement.
- **BHP (underweight):** continuing Chinese property weakness flowed through to lower demand for steel and iron ore.
- **FMG (underweight):** continuing Chinese property weakness flowed through to lower demand for steel and iron ore.

### Negative contributors:

- **CBA (underweight):** continued its year-long rally and in turn, screens very expensive relative to domestic and global peers.
- **URW (overweight):** impacted by rate rise expectations as well as growing political instability in France.
- **NAB (underweight):** rallied throughout the year alongside CBA (above), albeit to a lesser degree.

**QUARTER:** The Fund **underperformed the ASX200 by 1.5%** (before fees and franking credits).

### Positive contributors:

- **AWC (overweight):** Alcoa announced its intention to acquire AWC's 40% stake in Alcoa Worldwide Alumina and Chemicals.
- **IAG (overweight):** performed strongly, tracking lower claims rates and higher bond yields.
- **A2M (overweight):** delivered a strong first half result, upgraded full year sales guidance, and noted a stabilising formula market.

### Negative contributors:

- **FBU (overweight):** impacted by the cyclical and product related issues, coupled with management and board turnover.
- **RHC (overweight):** cost-driven margin weakness across the sector, albeit subject to increasing risk of rationalisation.
- **CBA (underweight):** continued its year-long rally and in turn, screens very expensive relative to domestic and global peers.

**YEAR:** The Fund **underperformed the ASX200 by 0.9%** (before fees and franking credits).

### Positive contributors:

- **CSR (overweight):** rallied strongly on the takeover by French company Saint-Gobain at the upper end of our valuation range.
- **URW (overweight):** rallied as the company delivered better than market expectations on portfolio rental income.
- **A2M (overweight):** delivered a strong first half result, upgraded full year sales guidance, and noted a stabilising formula market.

### Negative contributors:

- **FBU (overweight):** impacted by the cyclical and product related issues, coupled with management and board turnover.
- **SGR (overweight):** was impacted by a combination of regulatory challenges, cyclical issues, and management turnover.
- **CBA (underweight):** rallied throughout the financial year, despite screening expensive relative to domestic and global peers.

**LONG TERM:** before fees and franking credits, **the Fund has outperformed by +7.7% p.a. over three years, +3.6% p.a. over five years, +1.9% p.a. over ten years and +1.5% p.a. since the strategy's inception in 2010.**

Contributions over this period have come from a variety of sectors including Energy, Consumer, Health, Insurance and Utilities, demonstrating the flexibility of our approach, coupled with its disciplined implementation during more difficult periods.

## Portfolio Activity (quarter)

### Positions established / increased:

- **Orora Group:** a position was established as the company underperformed, increasing the valuation appeal in what is a high-quality company, with the market likely too pessimistic about what we expect are transitory cyclical factors.
- Existing positions in **Bendigo Bank, Ramsay Health Care, Woolworths, Insurance Australia Group, and Fletcher Building,** were increased on growing valuation appeal.

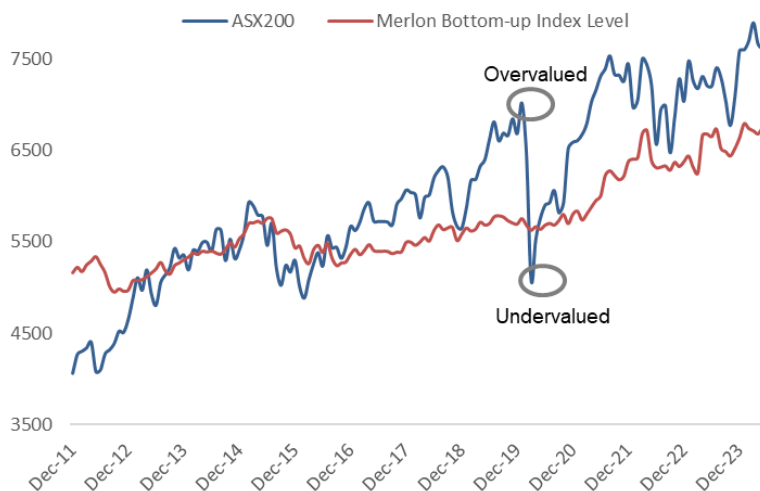
### Positions exited / reduced:

- **CSR:** the position was exited following the takeover by French company Saint-Gobain at the upper end of our valuation range.
- Positions in **AWC** and **URW** were reduced following strong periods of strong performance.

### 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. Following the rally this year, the market could be up to 15% overvalued based on long-term discount rates.

**Figure 4: Expected return based on Merlon valuations**



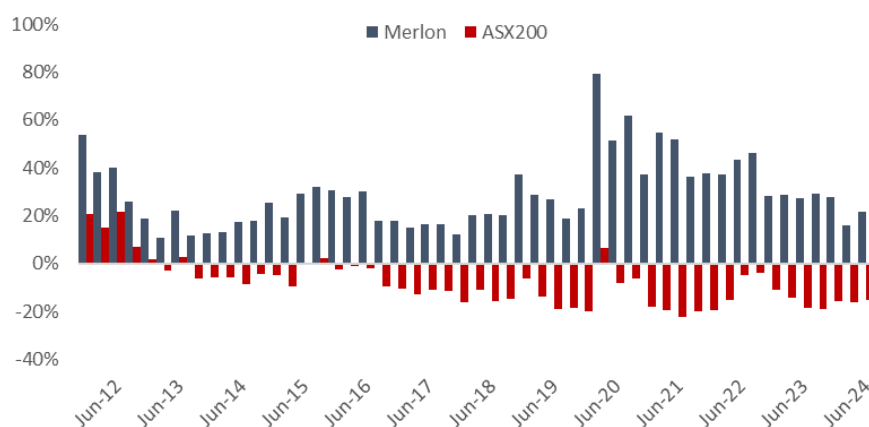
Source: Merlon Capital Partners

The portfolio reflects our best bottom-up fundamental views rather than macro or sector-specific themes. These are usually companies 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 or unbalanced risks. We seek to manage any such risks 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 a 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 some “margin of safety” in the event conditions deteriorate.

The Merlon portfolio continues to offer attractive upside as it has over the past 14 years, with the key being the expected return spread over the market. This gives us confidence we can continue to outperform over the medium and longer term.

**Figure 5: Expected return based on Merlon valuations**



Source: Merlon Capital Partners

From a short-term perspective, inflation has decelerated and inflation expectations have rapidly moderated, however markets may not be adequately priced for persistently high and volatile inflation in our view. A pause in central bank rhetoric runs the risk of a reacceleration of inflation, with the longer inflation remains elevated comes 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 interest rate policy that has suppressed discount rates and inflated most asset values.

We believe 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 December 2023 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 6: Portfolio Analytics**

	Portfolio	ASX200
Number of Equity Positions	32	200
Active Share	78%	0%
Merlon Valuation Upside	22%	-15%
Price / Earnings Ratio (year ahead)	16.5x	18.7x

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



**Woolworths (WOW)** is Australia's largest supermarket operator, with 1,400 stores across Australia and New Zealand, and operating in a highly concentrated industry structure.

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.

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 achieving direct engagement with the company.

We value WOW at between \$30/share and \$42/share based on long-term assumptions and segment valuations. While government and media scrutiny surrounding the industry structure has continued since our initial investment, we believe the company will recognise the importance of a sustainable business model, and act accordingly. Having sought board engagement (see excerpt of letter below) and gained a fuller appreciation of the acquired business, we have continued to increase our position.

Our view is that the market is too pessimistic about the long-term impact of increased government scrutiny on supermarket pricing, over-emphasising the short-term earnings impact of high wage inflation and over-weighting the problems facing Woolworths New Zealand and Big W in the context of their minor contribution to the group's valuation.

In forming our view, we actively engage with market participants including other fund managers, proxy advisers, investment banking analysts and external ratings agencies as well as other relevant stakeholders to identify market views and concerns. In this way we seek to address the most important issues affecting each company with their board and drive deeper engagements.

### Figure 7: Extract of letter to WOW Board

<p>22 April 2024</p> <p>Members of the Board of Directors Woolworths Group Limited 1 Woolworths Way Bella Vista, NSW, 2153</p> <p>Re: <u>Introduction to Merlon Capital Partners</u></p> <p>Ladies and Gentlemen:</p> <p>For your records, Merlon Capital Partners ("Merlon" or "we") owns ████████ shares in Woolworths Group Limited ("WOW") 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 WOW 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 WOW.</p> <p><u>Introduction to Merlon</u></p> <p>Merlon is a high conviction fund manager. Subject to continued due diligence, when we initiate an investment position in a company our intent is to build the position into a significant proportion of our portfolios, which in turn also represents a significant proportion of our own personal wealth. In addition to direct alignment with our clients through co-investment, our firm is majority owned by our staff and we recognise investment performance over the long-term is critical to its success.</p>		<p><u>Investment Approach &amp; Woolworths Group Investment Thesis</u></p> <p>Our investment approach is to invest in undervalued companies where we think market participants have become too pessimistic. We value all companies by capitalising our assessment of sustainable earnings at multiples aligned with free-cash-flow generation. In the case of WOW, we value the company at between \$30 and \$42 per security based on a range of long-term margin assumptions. Our valuation is summarised below:</p> <table border="1"> <thead> <tr> <th>Segments</th> <th>Low</th> <th>High</th> <th>Key Assumptions</th> </tr> </thead> <tbody> <tr> <td>Australian Food</td> <td>\$35.2b</td> <td>\$45.6b</td> <td>9.5 - 11.5% EBITDAR margin</td> </tr> <tr> <td>Australian B2B</td> <td>\$0.7b</td> <td>\$1.2b</td> <td>4.0 - 7.0% EBITDA margin</td> </tr> <tr> <td>New Zealand Food</td> <td>\$2.9b</td> <td>\$4.1b</td> <td>8.0 - 11.0% EBITDAR margin</td> </tr> <tr> <td>Big W</td> <td>NIL</td> <td>\$1.7b</td> <td>6.0 - 10.0% EBITDAR margin</td> </tr> <tr> <td>PetStock</td> <td>\$0.5b</td> <td>\$0.5b</td> <td>Acquisition price</td> </tr> <tr> <td>Unallocated</td> <td>(\$0.2b)</td> <td>NIL</td> <td>Quantum, MyDeal &amp; overheads excl EDV</td> </tr> <tr> <td>Endeavour investment</td> <td>\$0.9b</td> <td>\$0.9b</td> <td>Market value</td> </tr> <tr> <td>Net Debt</td> <td>(\$3.0b)</td> <td>(\$3.0b)</td> <td>Book value</td> </tr> <tr> <td>Franking Credits</td> <td>Nil</td> <td>\$0.9b</td> <td>0 - 70% of face value</td> </tr> <tr> <td><b>Equity value*</b></td> <td><b>\$37.1b</b></td> <td><b>\$51.7b</b></td> <td></td> </tr> <tr> <td><b>Equity value per share</b></td> <td><b>\$30</b></td> <td><b>\$42</b></td> <td></td> </tr> </tbody> </table> <p><small>*Numbers may not add up due to rounding</small></p>		Segments	Low	High	Key Assumptions	Australian Food	\$35.2b	\$45.6b	9.5 - 11.5% EBITDAR margin	Australian B2B	\$0.7b	\$1.2b	4.0 - 7.0% EBITDA margin	New Zealand Food	\$2.9b	\$4.1b	8.0 - 11.0% EBITDAR margin	Big W	NIL	\$1.7b	6.0 - 10.0% EBITDAR margin	PetStock	\$0.5b	\$0.5b	Acquisition price	Unallocated	(\$0.2b)	NIL	Quantum, MyDeal & overheads excl EDV	Endeavour investment	\$0.9b	\$0.9b	Market value	Net Debt	(\$3.0b)	(\$3.0b)	Book value	Franking Credits	Nil	\$0.9b	0 - 70% of face value	<b>Equity value*</b>	<b>\$37.1b</b>	<b>\$51.7b</b>		<b>Equity value per share</b>	<b>\$30</b>	<b>\$42</b>	
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Source: Merlon Capital Partners.



### Links to Previous Research

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[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](#)

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[Value Investing - An Australian Perspective: Part III](#)

[Value Investing - An Australian Perspective: Part II](#)

[Value Investing - An Australian Perspective: Part I](#)

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[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](#)

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