L1 Capital International Fund

Quarterly Report | September 2019

L1 CAPITAL
INTERNATIONAL

Introduction

In this quarterly report we continue to outline our Investment Philosophy. We have focused our discussion in this report on the importance we place on **Industry Structure.**

We have set out the performance of L1 Capital International Fund for the quarter to 30 September 2019 (September Quarter), as well as the period from Inception on 1 March 2019 to 30 September 2019.

For the September Quarter, the Fund has returned 3.8% (after fees), compared to the Benchmark Index return of 4.6%. The average cash holding has been 10%.

Since Inception, the Fund has returned 12.5% (after fees), outperforming the Benchmark Index by 1.6%. The average cash holding has been 10%.

We have made only modest changes to the portfolio during this quarter and continue to have strong confidence that our portfolio of businesses is well placed to build substantial shareholder value over time.

In the last section of this report we have shared our views on **Aon** which is a top 10 holding in the Fund.

If you have any questions, please feel free to contact us. We also encourage you to visit www.L1international.com for additional information on our investment philosophy and process, quarterly and monthly reports and daily fund pricing information.

Fund Performance

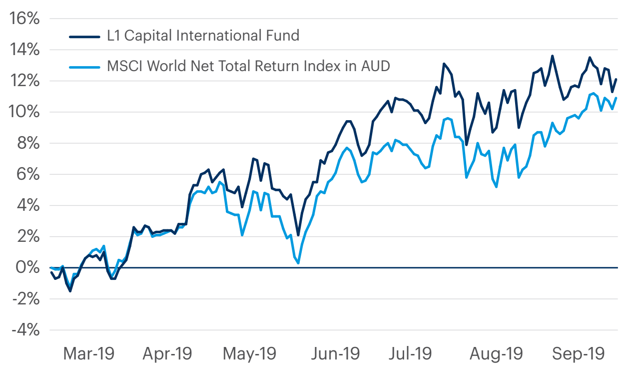
Fund Performance*	(%)	Index** (%)	Excess (%)
1 Month	–0.5	2.0	–2.5
3 Month	3.8	4.6	–0.8
1 Year			
Since Inception – 1 March 2019 (pa)	12.5	10.9	1.6

* Rounded to one decimal place

** MSCI World Net Total Return Index in AUD. Return measured from Index close on 1 March 2019

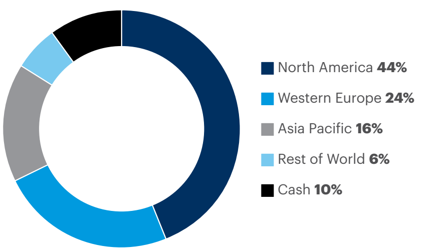
Largest 3 Contributors	Largest 3 Detractors
Alphabet	International Flavors & Fragrances
Booking Holdings	Labrador Iron Ore Royalty
Fidelity National Information Services	St James's Place

Fund Performance since Inception



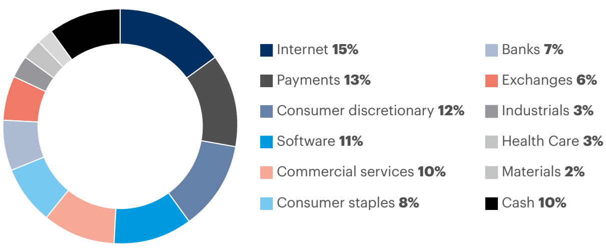
Top 10 Holdings	Sector
Alphabet	Internet
Aon	Commercial Services
Booking Holdings	Consumer Discretionary
Discover Financial Services	Banks
Fidelity National Information Services	Software
Intercontinental Exchange	Exchanges
Intuit	Software
Mastercard	Payments
Microsoft	Software
Visa	Payments

Revenue Exposure by Region*



* Revenue exposure by region is internally estimated on a look-through basis based on the underlying revenues of the individual companies held in the portfolio

Sector Exposure**



** Industry classification is defined by L1 International to best describe the nature of the underlying businesses

Investment Framework

We are often asked in introductory investor meetings how our approach to investing is differentiated. We believe that our ability to achieve attractive risk adjusted investment returns over time stems from our **disciplined** investment process. Having a **comprehensive** and **repeatable** process enables us to identify high quality businesses and assess risk in a consistent manner.

Many aspects of our framework are based on what we believe are common sense principals. Our investment approach has been refined based on practical learnings from many years of investing as well as the insights of other well-known global investors that we respect. Studying Don Bradman or Steve Smith's batting techniques is unlikely to lead to selection in the Australian cricket team, but an investment process can be shaped and improved by the wisdom of others.

Industry Structure

In our initial June 2019 Quarterly Report (available to download at www.L1international.com/reports) we outlined that our investment framework is focused on four key areas:

- Business drivers
- Industry structure
- Management
- Financial

We discussed the importance we place on return on invested capital and return on incremental invested capital generated by the businesses in which we invest. In our view, a well-structured industry is critical to sustainable value creation by the companies operating within that industry. We define sustainable value creation as the company's return on invested capital remaining higher than its cost of capital.

Forming a view on the industry structure is a critical step of our investment process, often formed over many years of observation.

Empirical studies of investment returns (Economist Michael Porter has done a lot of work in this area) have concluded that over the long term, industry factors are more important than macroeconomic conditions and business issues.

Industry Assessment

Porter's Five Forces (threat of new entrants, bargaining power of buyers, bargaining power of suppliers, threat of substitutes, and rivalry amongst existing firms) is one of the most well-known frameworks for assessing industry structures. We incorporate similar concepts to these as well as a broader list of considerations in our detailed assessment of the industry structure for all prospective investments.

Supply vs Demand

Many investment managers will justify owning a company on the basis of a robust and/or improving demand outlook. A growing addressable market, an emerging middle class, premiumisation, or a secular growth opportunity are just some descriptors we often hear.

While demand growth is essential, when assessing an industry we require much more than just growth in demand. Often industries that are growing strongly can be poorly structured and the businesses operating in that industry are destined for mediocrity at best.

At L1 Capital International, we pay equal (if not more) attention to understanding the supply side of an industry. In our opinion, it is generally easier to form a view and have conviction on supply than it is on demand. Demand is often more difficult to predict, particularly over a shorter time horizon, usually because there are many more buyers (consumers) than there are suppliers/producers. We know all the material suppliers in an industry and can track industry capacity more accurately. Supply changes are based on an assessment of demand over longer term horizons, resulting in changes in supply tending to be more consistent and rational.

Forming a view on potential new entrants causing an increase in supply (or a better substitute) is also critical. This is why we favour industries with very high barriers to new competition and low risk of substitution or technology risk displacing the incumbents.

We believe that the benefits of investing in an industry with disciplined supply (i.e. a well-structured industry) is often underappreciated.

For example, it is well documented that there are more families with two working parents, increasing demand for childcare services. Having had first-hand experience managing childcare centre businesses in the past, increased demand for childcare services is not enough to make this industry attractive from an investment perspective. The childcare industry is plagued by lack of supply discipline, fragmentation, competition from not-for-profit service providers and low barriers to new entrants. Notwithstanding the strong demand environment, increased supply of childcare centres coupled with dependence on Government funding, increasing regulatory burdens, diseconomies of scale, excessive operational leverage and a transient customer base (children grow up) inevitably results in poor investment returns for large childcare service providers.

Concentration – Noah's Ark

The Herfindahl-Hirschman Index (HHI) and concentration ratios (the market share of the largest firms in an industry) are the most common metrics cited to estimate the level of concentration within an industry.

We keep things simple and colloquially refer to our favourite industry structure as 'Noah's Ark', one that is analogous to the animal pairs, ideally with a tail of weaker competitors who missed the boat and forfeit market share over time. We tend to prefer a rational duopoly where there are two very strong competitors over an industry which is dominated by a single company, since the latter are either regulated or risk inviting regulation.

We have found that the Noah's Ark industry structure tends to result in the most attractive combination of growth, margins and returns. Many of our portfolio investments exhibit this industry structure, and we often invest in both of the dominant industry leaders e.g.

- **Visa** and **Mastercard** (payment networks)
- **Diageo** and **Pernod Ricard** (alcoholic spirits)
- **Aon** and **Marsh & McLennan** (insurance broking and risk management)
- **CME** and **Intercontinental Exchange** (US derivatives exchanges)

You don't need to be a payments industry expert to recognise that **Visa** and **Mastercard** are the dominant payments networks globally (ex-China) in comparison to the card issuers (banks) which operate in a highly fragmented and competitive industry.

Stability

Stable, well-structured industries give us greater confidence that existing industry leaders will be able to sustain a high return over their cost of capital for longer periods, making them less risky and more valuable businesses.

Stability can be measured in many ways. Attributes we consider include:

- **Longevity** – It is well documented that many businesses do not survive their early years – survival of the fittest. An industry where the main players have been around for a very long time (many decades) is a good sign that the business economics are strong for the industry leaders.
- **Family ownership** – An industry where one of the leading businesses is controlled by a founding family (particularly one that spans multiple generations) tends to be a good indication that the industry has attractive, enduring business economics (usually growth has been funded organically). The presence of a family often coincides with competitive dynamics and capital allocation within that industry being more rational and longer term in nature. **Pernod Ricard** (alcohol spirits) is an example of this dynamic.
- **Market share** – We focus on whether market share has remained relatively stable over time (indicating relatively predictable and rational competition) or whether market share shifts meaningfully from one year to the next (indicating intense competition or the prevalence of fads and fashion risks). We also look to see if an industry continually attracts new entrants (which usually suggests that barriers to entry are low).
- **Consistency of demand** – Increasing demand is important, but so is consistency of demand. An industry with relatively consistent demand is often more rational. If demand fluctuates significantly, a business with relatively high fixed costs might be incentivised to chase demand at all costs (to the detriment of the entire industry's economics).
- **Technology** – We consider whether technology can be leveraged to drive efficiencies as well as the prospect for it to disrupt existing business models and spawn new competition.
- **Regulation** – Consistent regulation is often useful in setting 'the rules' of business and can sometimes act as a deterrent to competition.

Dynamism

Stability should not be confused with stagnation. We favour investing in industries which are dynamic. Stagnant, low growth industries often drive competitors to focus on lowering costs and prices to gain or maintain market share. Dynamic, growing industries often provide opportunities for industry participants to cooperate as well as compete. Travel is a growing industry globally. Within this industry, **Booking** is the largest online travel agent. Booking is one of Google's largest customers (we have also invested in **Alphabet** which owns Google) and both Booking and Google are targeting prospective travellers with their competing travel services. In the dynamic, growing travel industry we believe there is room for both Booking and Google to grow strongly and profitably. Please reference last quarter's report for our overview of Booking Holdings (which owns Booking).

Summary

Critical assessment of an industry's structure is central to our investment process as part of our quality assessment of a business (along with business drivers, management and the business financials).

Many of the industries we invest in are well established, growing but relatively mature, duopolistic or oligopolistic, are often global with benefits of economies of scale, are dynamic but have low disruption risk and have network characteristics creating strong barriers to increased competition.

Commodity orientated industries or capital-intensive industries which are fragmented or highly regulated are generally not conducive to delivering strong sustainable returns in excess of their cost of capital.

It is important not to over-simplify – there can be niches within a broader industry which are well structured and provide the opportunity for a business to deliver sustainable risk adjusted returns. Part of our assessment process is to identify and deeply understand some of these niches.

There are always industry attributes we find favourable as well as negative issues to consider. However, if there are critical negative issues such as material regulatory uncertainty or lack of strong barriers to competition, we will exclude the industry from our investment universe.

In an investment world increasingly focused on quarterly or shorter investment time horizons, we believe the enduring stability provided by well-structured industries is a foundational element for a business to be able to sustainably deliver high returns on invested capital and to continue to compound shareholder value over many years.

Portfolio Investment - Aon plc

Aon is a leading global professional services firm providing a broad range of risk, retirement and health solutions. The company has over 50,000 employees in over 120 countries around the world.

Following on from our earlier discussion about **Industry Structure**, Aon is a great example of a high-quality business operating within what we regard to be a 'Noah's Ark' structured industry. At an industry level, Aon and **Marsh & McLennan** (which we also own) and to a lesser extent Willis Towers Watson dominate the most sophisticated clients. There is a long tail of smaller (generally local) competitors, their customer base (predominantly companies) is very diversified and their supplier base (insurers) is highly fragmented.

Clients (companies)
(many/diversified – e.g. Fortune 500)

Insurance Brokers
(Aon + Marsh & McLennan+ Willis)
i.e. Oligopoly

Insurers
(fragmented – Top 10 < 40% share)

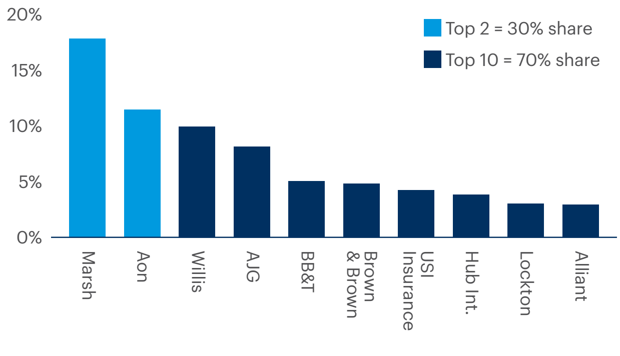
Other reasons why we like Aon (the industry factors also apply to Marsh & McLennan) and their segment of the risk management industry:

- **Stability and predictability** – Insurance is a non-discretionary expense for businesses providing consistency of demand for risk management services and high recurring revenues to Aon. Retirement and Healthcare solutions are also non-discretionary business requirements.
- **Demand growth** – At an industry level, revenues tend to grow at least with GDP (insured asset values increase with the economy) with additional growth opportunities as new risks such as cybersecurity and intellectual property are managed.
- **Supply of risk management services** – Aon (and Marsh & McLennan) continue to consolidate the industry through acquisitions while the requirements for substantial investment in data and analytics becomes a competitive advantage and barrier to new competition. Aon is able to use its scale and information advantages to gain favourable pricing from insurers for their clients.
- **No insurance risk** – Aon doesn't assume any underwriting risk, revenue is earned through commissions and fees for service.
- **Solves a complex pain point** – Finding the right insurance cover is complex and requires specialist knowledge in different jurisdictions with differences in rules and regulations. Aon knows all the insurance offerings and products on the market and help clients navigate the claims process.
- **Brokers own the client relationship** – Brokers own the end client relationship (not the insurers). They understand their clients' risk profile and history. Underwriters rely on that data and knowledge to underwrite that business.
- **Better use of data and analytics and technology** – Aon and Marsh & McLennan, as the industry leaders, have the resources to invest in sophisticated data and analytics and apply technology to proprietary data to assess their clients' risk and structure appropriate cover as well as cross-sell group capabilities. New revenue streams in selling data and analytical services are also being developed. Management needs to stay ahead of the fintech curve which is seeking to make aspects of their industry more efficient. Overall, we consider Aon is able to leverage technological developments to drive improved margins and gain market share over time.
- **"Aon United"**– In 2017, Aon sold its lower quality outsourcing business and embarked on a significant restructure and streamlining of the group. Separate brands were consolidated, divisions were more tightly integrated and management and incentivisation structures were adjusted. Management attributes the acceleration in revenue growth to this program which has allowed the business to not only become more cost efficient but also serve their clients in a more holistic manner.
- **Pricing power** – Corporate insurance is a customised product with idiosyncratic risk management requirements with opaque pricing.

- **Favourable business economics** – Aon requires limited incremental capital to support growth and generate high returns on invested capital.
- **Improving cash conversion** – Current cash conversion is suppressed by restructuring. The comprehensive Aon United restructuring is largely complete and cash conversion should improve significantly in the near term.
- **Experienced and aligned management** – Management is not driven by growth for growth's sake, and has sold businesses to improve the overall quality of the group. Capital has been invested in organic growth opportunities as well as returned to shareholders through increasing dividends and buybacks.
- **Overlooked** – Aon tends to be covered by insurance analysts and to some extent is overlooked as an 'insurance' company, despite Aon's business and financial attributes being completely different.
- **Long successful history** – Aon and Marsh & McLennan have been operating for a very long time and seen many economic cycles. The precursor company to Aon was originally established in 1918, while Marsh & McLennan was founded in 1905. Experience and longevity is an advantage in this industry.

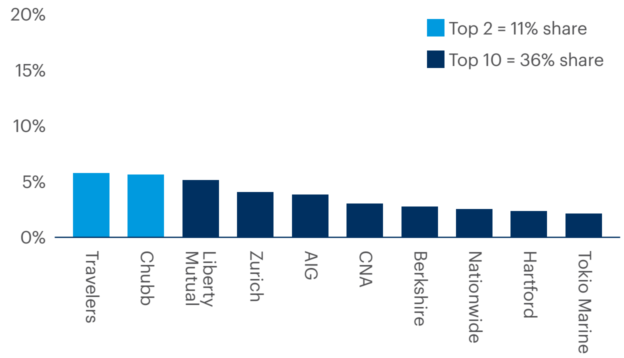
Aon and Marsh & McLennan operate in a well-structured industry...

US Insurance Brokerage market share (2017)



Source: Business Insurance

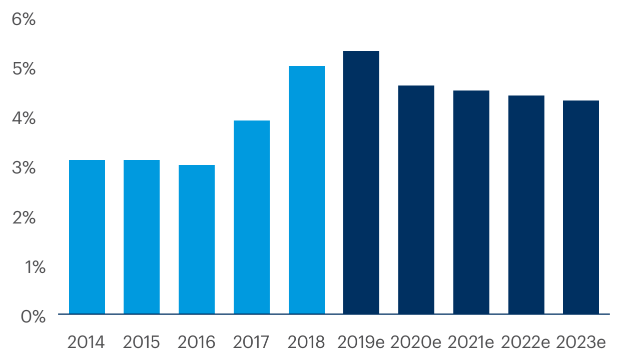
US Commercial Insurance market share (2017)



Source: A.M. Best, SNL, Morgan Stanley

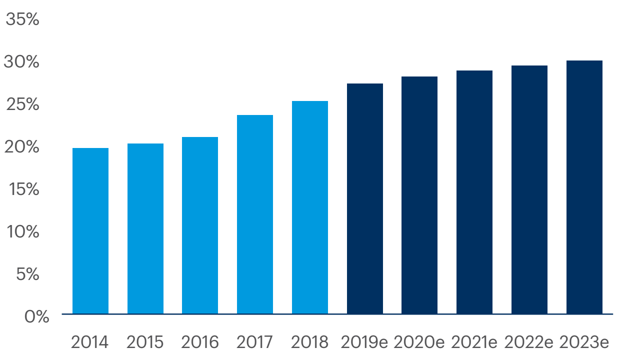
Consistent organic revenue growth coupled with operating efficiencies driving operating margin expansion...

Organic revenue growth



Source: Company data. L1 Capital International estimates

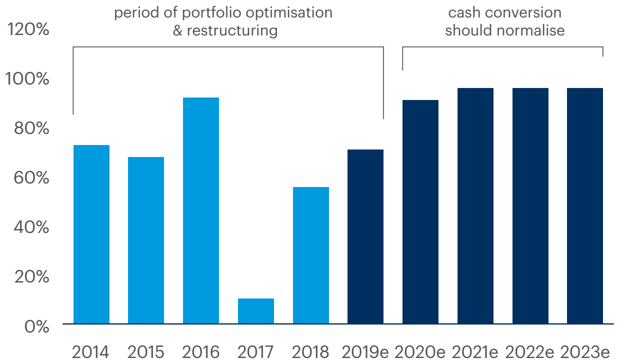
Operating margins (adjusted)



Source: Company data. L1 Capital International estimates

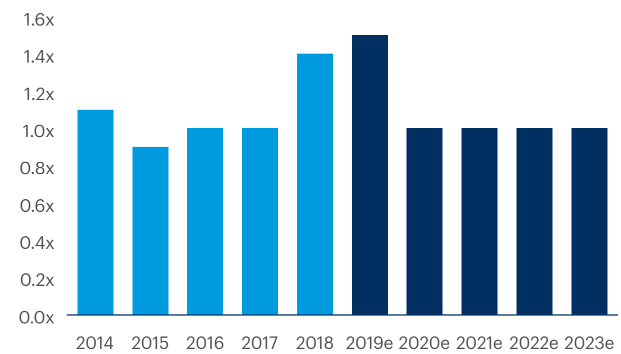
Free cashflow (FCF) conversion improves as restructuring, portfolio optimisation and capex normalises...

FCF conversion



Source: Company data. L1 Capital International estimates

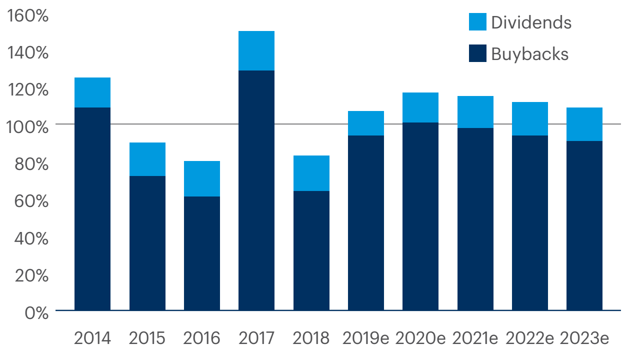
Capex to Depreciation



Source: Company data. L1 Capital International estimates

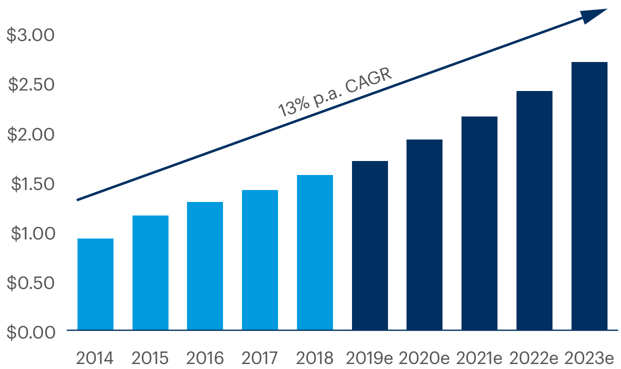
Returning capital back to shareholders...

Capital returns as % of Net Income



Source: Company data. L1 Capital International estimates

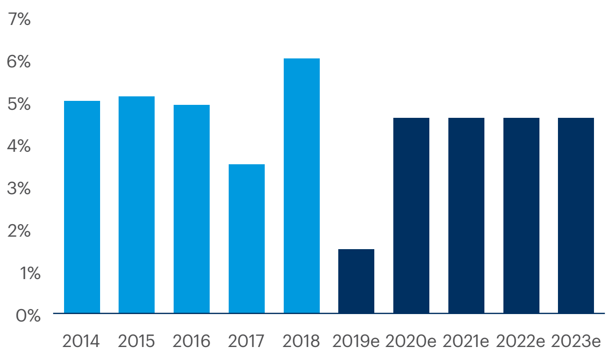
Dividend per share



Source: Company data. L1 Capital International estimates

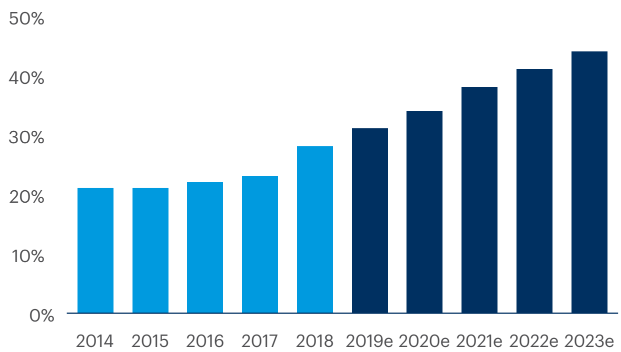
...which is driving a lower share count and a higher return on invested capital over time

Share count reduction



Source: Company data. L1 Capital International estimates

Return on Invested Capital



Source: Company data. L1 Capital International estimates

Valuation

We value Aon at $180 to $210 per share compared to the current share price of $190. We believe the current share price provides an attractive risk adjusted return in our base case scenario while offering upside optionality through successful implementation of management’s growth initiatives.

L1 Capital International Fund

Quarterly Report | September 2019

L1 Capital International Overview

L1 Capital International is an independent active manager of global equities established as a joint venture with L1 Capital. We apply a detailed investment process built on a fundamental assessment of quality and value. We aim to deliver attractive risk-adjusted returns by investing in high quality companies that have favourable cashflow-based valuations in well-structured industries that we understand. Capital preservation over the investment horizon is central to our investment philosophy and process. We view risk as the potential for a permanent loss of capital as opposed to volatility in share prices.

Additional information on L1 Capital International is available at **www.L1international.com**

L1 Capital is a global investment manager established in 2007 with offices in Melbourne, Sydney, New York and London. L1 Capital manages money for a range of clients including large superannuation funds, endowment funds, pension funds, financial planning groups, asset consultants, family offices, high net worth individuals and retail investors.

Additional information on L1 Capital is available at **www.L1.com.au**

Fund Information

Name	L1 Capital International Fund
Portfolio Management	David Steinthal (Chief Investment Officer) David Khaw (Portfolio Manager)
Types of investments	Listed securities globally, developed market focus. No shorting, no leverage
Number of investments	20 to 40, typical position size 3% to 6%
Cash weighting	0% to 25%
Minimum initial investment	$25,000
Hedging	Unhedged
Structure	Unit Trust
Domicile / Currency	Australia / AUD
Inception	1 March 2019
Management Fee	1.2% p.a inclusive of GST and RITC
Expenses	Nil (included in Management Fee)
Benchmark	MSCI World Net Total Return Index in AUD
Performance Fee	15% over Benchmark, subject to any underperformance being recouped. There must be positive absolute performance (adjusted for distributions) in the performance period*
High Watermark	Yes
APIR	ETL1954AU

* Otherwise positive relative performance is carried forward to the next Performance Period

Service Providers

Responsible Entity	Equity Trustees
Fund Administrator	Mainstream Fund Services
Fund Auditor	EY
Fund Custodian	Mainstream Fund Services
Legal Advisor	Hall & Wilcox

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