L1 CAPITAL
INTERNATIONAL

L1 Capital International Fund

Quarterly Report | December 2019

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 **Management**. We also outline key takeaways from our recent attendance at **Money 20/20** in the United States, the pre-eminent Payments, FinTech and Financial Services Industry conference.

For the December Quarter, the Fund returned –1.4% (after fees), compared to the Benchmark Index of –0.9%, while the average cash holding has been 12%.

Since Inception, the Fund has returned 15.4% (after fees), in line with the Benchmark Index, while the average cash holding has been 11%.

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.

However, like the much-quoted adage of an iceberg, there has been substantial investment analysis activity that is not visible from the perspective of the top 10 portfolio holdings. The investment team conducted over 220 meetings and calls with management teams globally during 2019, as well as many additional diligence meetings and calls with industry consultants, analysts, suppliers, customers and competitors of the companies we reviewed.

Only a small percentage of the businesses we assess meet our high standards for both **Quality** and **Value**. In investing, it is rare that completion of diligence on a business coincides with an attractive value opportunity. This is why we have a Bench, or reserve list of potential investments. During 2019, we have added a number of high-quality businesses to our Bench and will look to invest in these companies should their share price fall to a level we consider provides an attractive risk adjusted return.

Fund Performance

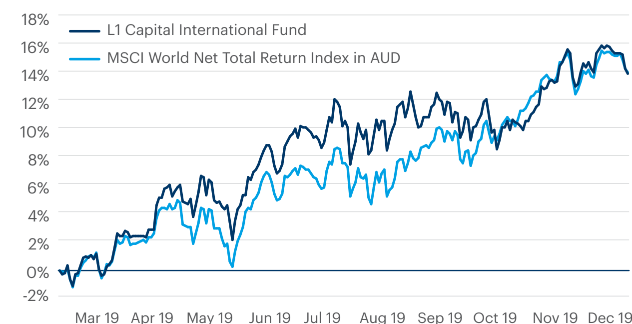
Fund Performance*	(%)	Index** (%)	Excess (%)
1 Month	–1.4	–0.9	–0.5
3 Month	2.7	4.2	–1.5
1 Year			
Since Inception – 1 March 2019	15.4	15.5	–0.1

* Rounded to one decimal place. Numbers may not add due to rounding.

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

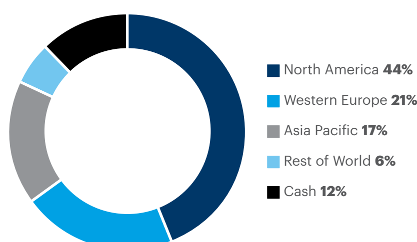
Largest 3 Contributors	Largest 3 Detractors
Alibaba	CME
Mastercard	McDonald's
St James's Place	Unilever

Fund Performance since Inception



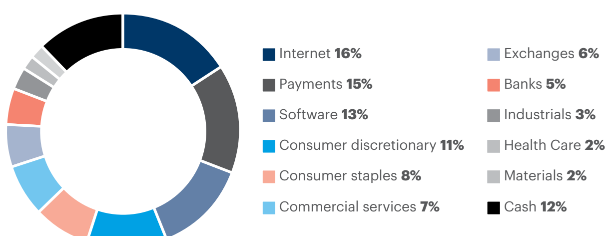
Top 10 Holdings	Sector
Alphabet	Internet
Aon	Commercial Services
Booking Holdings	Consumer Discretionary
Discover Financial Services	Banks
Facebook	Internet
Fidelity National Information Services	Software
Intuit	Software
Mastercard	Payments
Microsoft	Software
Visa	Payments

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

Our investment framework is focused on four key areas:

- Business drivers
- Industry structure
- Management
- Financial strength and business economics

Please refer to our website www.L1international.com and our prior quarterly reports for additional detail on our investment framework.

Management

Forming a view on management is a critical part of our investment process. Management drives a company's culture, business strategy, execution of that strategy and allocates capital generated by the business. Many management teams have squandered the free cashflow generated by high-quality businesses on overpriced acquisitions and dubious investments.

We do not have the ability to change management or influence the Board of Directors and therefore need to have confidence that management is driven, aligned with shareholders and act as great stewards of shareholders' capital.

Attributes of a high-quality management team

Given the importance of management, it is critical we are backing the right management teams. We like to think that the management teams we are backing share similar attributes to the way we approach investing. We have an acknowledged bias to businesses that are founder-led, or multi-generational family-controlled businesses as they tend to have many of these attributes:

- Culture – To be a sustainably successful business, management needs to engender a culture throughout the organisation that extends beyond financial results, and is built on doing right for customers, employees and other stakeholders. This is a subjective assessment and often difficult to gauge from outside a business and relies on judgement formed over many years of investing. Satya Nadella, CEO of Microsoft, recently named Financial Times' Person of the Year, is a great example of the change to culture that can be delivered from the top, with around $1 trillion of market capitalisation added by Microsoft during his current six-year tenure.
- Passionate – Does management live and breathe the business and industry they operate in? Managers who are passionate can usually speak at length and in detail about any aspect of their industry and have often chosen to spend most of their career in one industry, building a business for the long term.
- Consistency – We maintain a regular dialogue with our management teams. Quite often this is to check their communication is consistent and that they are following through on what they said they would do. We favour management teams who refer to operational and financial targets and publicly measure their performance against stated objectives.
- Long term thinking – We prefer management teams to manage the business on a sustainable basis, rather than focus on the next quarter's financial results. Do they have a strong view about where their industry is headed over the next 5 to 10 years, or are they redirecting the conversation back to short term 'equity story'? We look for investments to make the business stronger in the future even though there may be an impact on short term profitability.
- Ownership mentality – We look for management that behave like owners of a business rather than just an employee. For example, we like to visit company headquarters to observe how lavish or basic they are. Does management spend frugally as if it were their own money?
- Skin in the game – An extension of an ownership mentality is having a direct equity interest in the business. We like management teams that have a meaningful amount of their personal wealth invested in the business. We also like owner operated businesses where the original founder or family descendants have invested much of their working life into building up the business over many decades.
- Track record – The track record of business managers is usually a reliable indicator of future performance. We spend significant time assessing how management has allocated capital historically, and whether these decisions have enhanced shareholder returns. Usually we are assessing capital allocation by the management team at the current business, and we will also look at how they allocated capital as managers of prior businesses.

The importance of Capital Allocation

Capital allocation refers to how the cashflow generated by a business is spent. Management essentially has four options:

1. Re-invest into the business – Examples include increased R&D/marketing or investing in a new production plant. The key issue is whether the reinvested capital will generate attractive incremental returns (see our first quarterly for more on this topic www.L1international.com/reports/). Currently Booking Holdings, led by Glenn Fogel is investing in product experience and capabilities to the detriment of short-term margins, but in our view to the benefit of long-term shareholder value creation.
2. M&A – Sometimes it makes sense for a business to acquire an asset or skillset rather than build this capability organically, particularly when there are genuine synergies. The success or otherwise of an acquisition can take years to become evident, but some management teams have been able to build a successful acquisition track record. Within our portfolio:
   - Intercontinental Exchange (ICE), led by Jeff Sprecher, illustrates the value that can be created by a well thought out and executed acquisition strategy. ICE was founded in 2000 as a new venue for trading energy derivatives and has been transformed into a diversified group of financial exchanges and proprietary information with an enterprise value of US$60 billion. ICE has expanded through organic investments and acquisitions including New York Board of Trade, Creditex, Climate Exchange, New York Stock Exchange, SuperDerivatives, Interactive Data Corporation, Virtu BondPoint, MERSCORP and Simplifile.
   - Fidelity National Information Services, currently led by Gary Norcross, is another example of value creation through M&A, having completed a series of acquisitions over its 50 year operating history, most recently the acquisitions of SunGuard and Worldpay.
3. Pay down debt – We generally do not invest in businesses with a high degree of financial leverage. The amount of financial leverage a business can comfortably support varies depending on the business model. In the current world of very low interest rates, financial debt seems cheap and readily serviceable. However, the sky may not always be as blue as it appears today. We favour management teams to set clear financial leverage targets, and then use free cashflow to repay debt to prudent levels before embarking on further acquisitions. Fidelity National Information Services, following its acquisition of WorldPay in the aforementioned example, is currently pursuing a strategy of debt reduction.
4. Return capital to shareholders – We do not want management to rely on excessive financial leverage to generate returns, but this does not mean we favour management teams who allow excess capital to build. We prefer excess capital to be returned to shareholders through a combination of dividends and buybacks. Discover Financial Services generates far more capital than can be invested prudently in expansion of its consumer loan book. Rather than pursue growth for growth's sake, the management team led by Roger Hothschild and before him David Nelms, has consistently bought back shares below our view of fair value, while also growing dividends. Since 2010, Discover Financial Services' outstanding share count has reduced by 42%, while dividends per share have increased from $0.08 to $1.68 per share.

The optimal mix of capital allocation will depend on how capital intensive the business is, as well as organic and inorganic growth opportunities. We favour businesses that have opportunities to reinvest at high incremental returns, as well as capital light businesses that generate strong returns on invested capital and excess free cashflow. In all instances, how management allocates capital to enhance shareholder returns is critical to our investment approach.

L1 CAPITAL
INTERNATIONAL

L1 Capital International Fund

Quarterly Report | December 2019

Management Incentives

In addition to assessing management's track record, we look at their financial incentives as (most) managers will act rationally and in line with human nature and try to maximise their compensation.

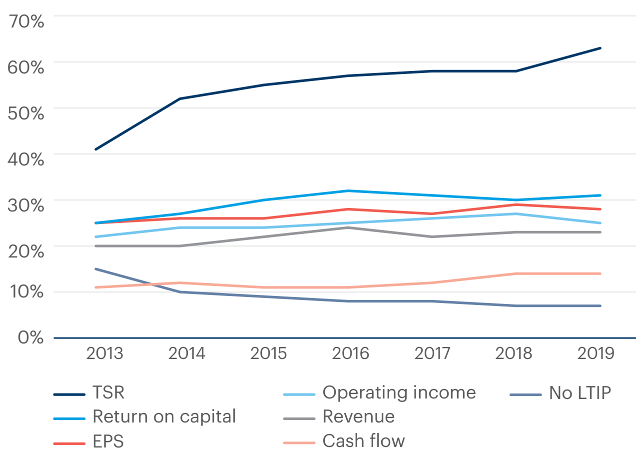
"Show me the incentives and I will show you the outcome"… "If you have a dumb incentive system, you get dumb outcomes." – Charlie Munger

Reading a company's proxy statement is therefore one of the first things we do when analysing a company.

According to a recent report by Goldman Sachs, the most common Long Term Incentive Plan (LTIP) metric for companies in the S&P500 (excluding financials and real estate) is Total Shareholder Return (TSR) – used in over 60% of companies. TSR is a reasonable metric to complement a long-term incentive plan as it provides a degree of alignment with shareholders, but TSR is not sufficient in isolation. The downside to using TSR includes:

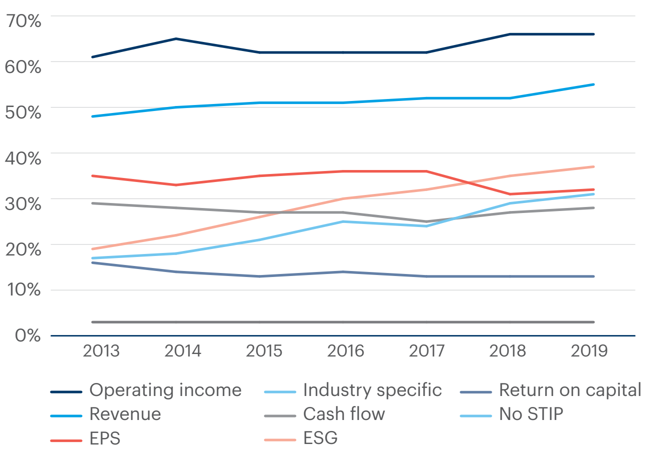
- It is an outcome of management's actions, rather than something that is directly controllable as it is influenced by either the overall performance of the market or in the case of TSR relative to a peer group – the share price of peer companies. This is further complicated by peer group selection e.g. should management get paid just because a highly regarded CEO of large competitor resigned and their share price subsequently underperformed?
- It embeds expectations of future performance (as opposed to what management has delivered);
- It can lead to an undue focus on the share price – which can be 'manipulated' through short-term focused actions as opposed to long term value creation; and
- It depends on the starting and ending measurement points.

Utilisation of common LTIP metrics in S&P 500 (excluding Financials and Real Estate)



Source: Goldman Sachs Global Investment Research

Utilisation of common STIP metrics in S&P 500 (excluding Financials and Real Estate)



Source: Goldman Sachs Global Investment Research

There is no "one-size fits all" approach when it comes to structuring incentives. The incentive metrics should be clear, appropriate to the business and deliver fair compensation to the management team if they increase the economic value of the business. We prefer compensation to be weighted to longer term incentive plans, with short-term incentive structures designed to reward annual performance, but not overly influence strategic and capital allocation decisions.

An ideal set of financial KPIs for longer term incentive compensation should reflect some combination of organic revenue growth, EPS, cashflow generation and return on capital, measured over a sufficiently long enough time frame (usually 3 years), as well as TSR thresholds for some or all of the compensation to vest.

Money 20/20

Money 20/20 is the key industry conference for the global Payments, Fintech and Financial Services industry. There are 500 companies presenting and exhibiting and over 5,000 attendees, predominantly representatives from companies in the industry with limited attendance by the investing community.

The conference has been running annually since 2012 and we have attended multiple times. The range of companies presenting has continued to broaden as the focus of the conference has shifted from being purely focused on Payments and Fintech to a broader agenda that encompasses commerce and a range of financial services.

We like to attend industry conferences as they often provide different perspectives on portfolio companies or businesses we are assessing for potential future investment. Investment conferences can be useful, but management are trained in the art of presenting their business and financial results in the best possible light. In contrast, industry conferences are aimed at a different audience and give insights into how management is focusing on their customers, how companies view their competitors and work with other businesses in their industry. We often learn more talking to suppliers and competitors of the business we are focused on than from directly speaking to the representatives of the business itself. We also hope to find hidden gems amongst the many companies attending.

We have outlined our key takeaways and investing implications from our attendance at Money 20/20.

Evolution of disruption

Over the years, Money 20/20 has evolved from being a venue where technology geeks get excited about how they are going to use the latest cutting edge technology to disrupt everything in the payments and financial services industry, to a realisation that Fintech is only part of the equation. Gone is the notion that everyone's banking will be done through a payment enabled toaster, or that your car will double as your bank branch.

While technology and the impact of change remains central to all discussions, outright disruption has generally been replaced by an acknowledgement and behavioural trend for entrepreneurial technology to partner with existing industry leaders.

The more innovative industry leaders are also openly disrupting their own legacy businesses through internally generated technical capabilities and partnerships.

Artificial Intelligence and mobility are central to almost every company's strategy

What was innovative a few years ago is "table stakes" and mainstream today. Artificial Intelligence (AI) is increasingly being adopted in core applications. AI is widely being adopted in a range of financial risk management applications which should lower fraud and compliance costs. For example, currently in the US, banks spend $25 billion on anti-money laundering compliance alone. AI should enable the reduction of these costs with increased accuracy.

Voice will be a key driver of commerce

People on average type 40 words a minute, but they speak over 150 words per minute. Patrick Gauthier, head of Amazon Payments, outlined a 20-year journey of making devices "more normal" as the mode of control shifts from typing to a combination of AI and voice-enabled technology. We believe Alphabet (one of the fund's largest investments) and Amazon are the clear leaders in voice-enabled consumer devices and will strengthen the lead of their ecosystem as these devices gain greater prominence in both financial services and commerce.

In December 2019, Discover Financial Services announced that cardmembers can access their credit card accounts through voice instructions to Amazon Alexa. Alexa can provide information on recent transactions, available credit, current balance, rewards and payment due date – simple and early examples of this inevitable technology trend.

Data, data, data

The word "data" was used more than any other during the conference presentations, with analysis and application of proprietary data central to many innovations in lending.

Privacy and control of data is becoming increasingly topical, and we expect this trend to continue. We expect consumers will become more aware of the value of their data and will receive financial benefits for the use of their data over time.

Visa and Mastercard's competitive positions are strengthening

Visa and **Mastercard** are two of the largest investments in L1 Capital International Fund. We view both companies as exceptionally high quality, with management teams that are taking their business to the next level. There is so much more to Visa and Mastercard than just the traditional network for debit and credit card acceptance. Both companies have built and continue to build new networks using blockchain and other technologies to facilitate payments globally in existing and new applications.

In our view the risk of technological developments fundamentally disrupting Visa and Mastercard has reduced over the past few years. This reflects both Visa and Mastercard investing in technical capabilities organically and through acquisitions, as well as potential disruptors partnering with the Visa and Mastercard to gain immediate global distribution and ecosystem relevance.

There was much discussion of the evolution of "real time payment" networks globally. There is no doubt these developments are positive for businesses and consumers and will reduce overall friction in the payments industry. However, our view is that these networks will generally operate in conjunction and alongside other networks, and do not equate to the end of existing debit franchises.

Visa and Mastercard, along with several innovative payments companies like Adyen and Stripe, are focused on being "infrastructure partners" in payments, providing application programming interface (API) tools to other industry participants to cement their role in a broader range of transactions. This is consistent with our focus on investing in companies which provide the "tools to the trade" or the "picks and shovels to the gold miners".

We believe the longevity of Visa and Mastercard's growth remains under-appreciated, in part due to a lack of awareness of the ways the management teams of these companies have expanded their total addressable market.

Facebook Libra – compliments rarer than socks on Millennial Fintech founders' feet

Facebook's Libra blockchain digital currency was at best described by many as "a solution seeking a problem", and at worst "dead on arrival". While we have invested in Facebook, given the many regulatory and commercial challenges this initiative faces, we do not have high expectations for Libra making a meaningful positive contribution to Facebook.

Traditional banking – not dead, but under sustained pressure

Technology is lowering the cost of the provision of a wide range of financial services, but access to low cost funding, distribution and the ability to meet regulatory requirements are still critical to success and create meaningful barriers to competition.

Credit conditions in most market segments remains exceptionally benign. The management of most financial institutions are cautious and are planning their strategies on the assumption that the US economy is in late cycle, including gradually tightening their lending standards.

Fintech and technology centric competitors are likely to focus on niches as well as partner with traditional banks. Many credit-centric new industry participants are yet to operate in a period of meaningfully deteriorating credit, and their ability to provide sound risk adjusted credit is yet to be tested.

Underbanked and poorer Americans

Money 20/20 always has a social inclusion theme running through several presentations and this year was no exception. A staggering 60% of Americans have less than $1,000 in savings and most people are intimidated by personal finances.

Intuit, which owns QuickBooks and TurboTax and is a top 10 Fund investment, showcased a number of new applications designed to assist people manage their tax refund which is often their largest "paycheck" for the year. These services combine capabilities in TurboTax as well Mint, Intuit's personal finance franchise. We believe the synergies between QuickBooks, TurboTax and Mint are under-appreciated as Intuit continues to build out its ecosystem for small businesses and individuals.

L1 Capital International Fund

Quarterly Report | December 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

Level 13, 139 Macquarie Street
Sydney NSW 2000 Australia

Phone +61 2 8067 7090
Email info@L1international.com

www.L1international.com

Information contained in this publication

The opinions, advice, recommendations and other information contained in this publication, whether express or implied, are published or made by L1 Capital International Pty Limited (ACN 628 068 717), (an authorised representative (no. 1273764) of L1 Capital Pty Ltd (ACN 125 378 145) AFSL (314 302)) and its officers and employees (collectively "L1 International") in good faith in relation to the facts known to it at the time of preparation.

L1 International has prepared this publication without consideration of the investment objectives, financial situation or particular needs of any individual investor, and you should not rely on the opinions, advice, recommendations and other information contained in this publication alone. This publication contains general financial product advice only. Equity Trustees Limited ('EQT') (ABN 46 004 031 298) AFSL 240975 is the Responsible Entity for the L1 Capital International Fund ARSN 631 094 141. This publication has been prepared to provide you with general information only. It is not intended to take the place of professional advice and you should not take action on specific issues in reliance on information in this publication.

L1 International does not express any view about the accuracy or completeness of information that is not prepared by it and no liability is accepted for any errors it may contain. Past performance should not be taken as an indicator of future performance. You should obtain a copy of the PDS (available at L1international.com) before making a decision about whether to invest in this product. To the maximum extent permitted by law, L1 International, EQT and their related parties, directors and representatives will not be liable in any way for any loss or damage suffered by you through use or reliance on information in this publication. Copyright in this publication is owned by L1 International.