L1 Capital International Fund

Quarterly Report | September 2020

Introduction

In this quarterly report we have outlined:

- Our perspectives on the “Main Street” vs “Wall Street” debate.
- The current investment environment.
- Recent portfolio investment decisions and performance.
- The importance of consistency, predictability and longevity of growth for a business.
- An overview of Intuit, the global leader in accounting software for small and medium-sized businesses (QuickBooks) as well as the leading provider of software for preparation of US tax returns (TurboTax).

Fund Performance

Fund Performance*	(%)	Index** (%)	Excess (%)
1 Month	−0.3	−0.4	0.1
3 Month	5.1	3.7	1.4
1 Year	4.5	3.9	0.6
Since Inception – 1 March 2019	17.5	15.2	2.3

* 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.

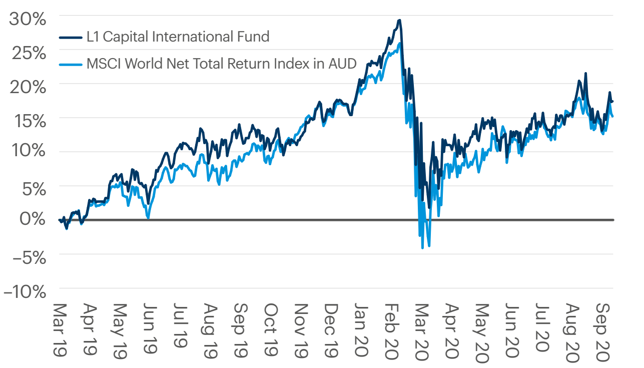
Largest 3 Contributors*	Largest 3 Detractors*
Alibaba	Microsoft
Mastercard	nVent Electric
Nike	Verisign

* In alphabetical order.

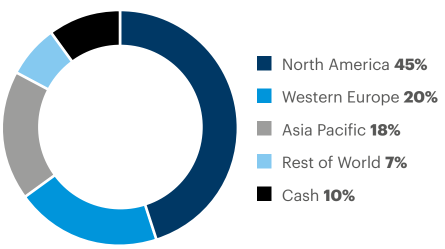
Top 10 Holdings*	Sector
Alibaba	Internet
Alphabet	Internet
Amazon	Consumer Discretionary / Internet
Aon	Commercial Services
Facebook	Internet
Fidelity National Information Services	Software
Marsh & McLennan	Commercial Services
Mastercard	Payments
Microsoft	Software
Visa	Payments

* In alphabetical order.

Fund Performance since Inception

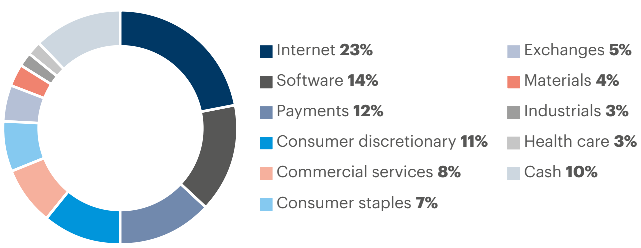


Revenue Exposure By Region*



* 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.

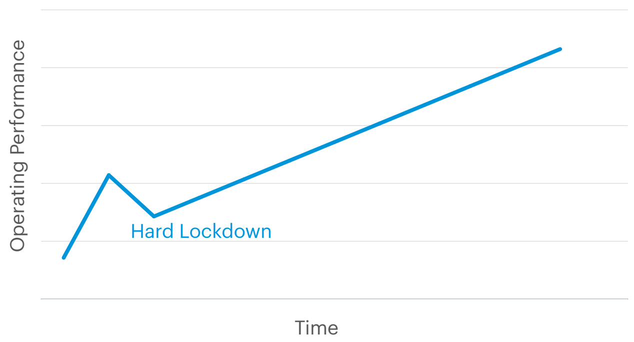
Investment environment – uneven impact of COVID-19 to date

Many commentators have noted the apparent disconnect between "Main Street" and "Wall Street", or the equity market's strength compared to real economic weakness due to COVID-19. A GDP decline of 9.5% for the US economy in the June 2020 quarter is a truly staggering number, as is the sharp increase in unemployment around the world. Yes, GDP and employment are recovering, but global equity markets have increased despite elevated COVID-19 infection levels, second waves of infections, new lockdowns, political uncertainties and ongoing social unrest.

The impact of COVID-19 has unevenly impacted regions, industries, businesses, as well as people. Equally, not every share price has performed strongly. The equity market's performance is clearer and more rational when the analysis is deeper and more specific than generalist commentary on the overall change in the fortunes of Main Street and Wall Street.

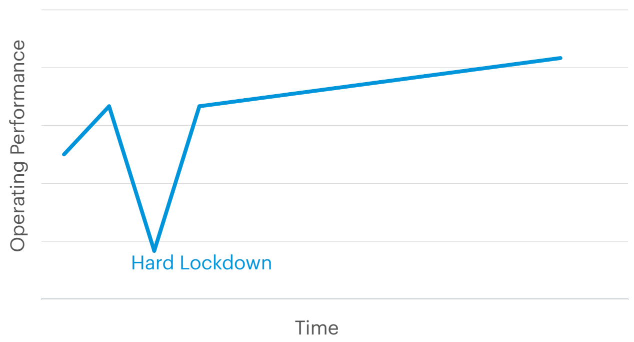
We have simplified the impact of COVID-19 **to date** into 4 key business categories. Directionally, the share price of companies in each category has mirrored the impact of COVID-19 on their operating performance:

Category 1: Strong beneficiaries of the current operating environment



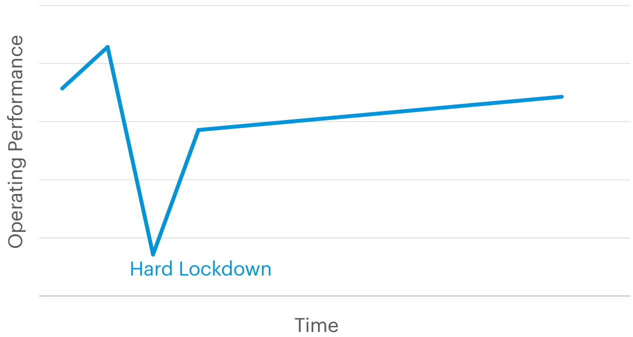
- Examples include companies focused on eCommerce, work from home and spend at home.
- L1 Capital International has exposure to businesses which have benefitted from the current operating environment e.g. **Amazon**, however we generally consider the share prices of many direct COVID-19 beneficiaries are at elevated levels and do not provide sufficiently attractive risk-adjusted investment opportunities.
- We have sold investments in businesses when the share price exceeded the sustainability of the favourable operating environment e.g. one of the leading video gaming businesses, **Activision Blizzard**.

Category 2: Resilient businesses able to perform strongly in a range of operating environments, including current conditions

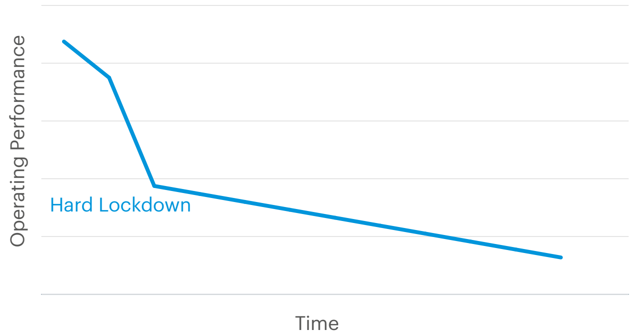


- The L1 Capital International Fund predominantly invests in businesses which fall into this category.
- Businesses such as **Marsh & McLennan** and **Aon** which provide essential insurance brokerage and risk management services are not immune to economic pressures, but are highly resilient.
- Companies such as **Alphabet** and **Facebook** continue to benefit from the secular shift in advertising dollars to their ecosystems, even though some discretionary spending may reduce due to pressures on some customers.
- The impact of COVID-19 on other businesses in the portfolio has been more nuanced. **Thermo Fisher** has benefitted from the provision of equipment and services to the companies providing COVID-19 testing and working on vaccines which has more than offset reduced activity in other life science sectors.
- Payments companies, **Mastercard**, **Visa** and **Fidelity National Information Services** have benefited from a shift away from cash and to eCommerce payments, offset by reduced international travel payments.

Category 3: Businesses meaningfully impacted by COVID-19, but will likely recover strongly over time



Category 4: Businesses that will have enduring headwinds, exacerbated by COVID-19



- The L1 Capital International Fund has retained smaller sized investments in several businesses which have been materially impacted by COVID-19 in the near term, but where we expect limited permanent change to medium term demand, strengthened competitive position, and where we expect the share price to recover over time.
- **Pernod Ricard** and **Diageo**, the global leaders in the alcoholic spirits industry, have had reduced sales through pubs, clubs, events and restaurants, with only a partial offset from increased at home consumption.
- We are confident that people's alcoholic consumption behaviour has not permanently changed due to COVID-19, and that sales will recover as socialising returns to normal. Recently, Diageo announced a positive trading update with the overall recovery in performance exceeding expectations.
- **Booking Holdings** owns the world's largest online travel agent (OTA), Booking.com. Travel has been upended by COVID-19. Increased domestic travel will partially offset reduced international travel but it will take time before the travel sector returns to a more normal environment. Booking continues to invest in growth initiatives while adjusting its cost base to current demand and we are confident Booking's position will strengthen relative to its much more challenged competitors.
- The share price of companies in this category have only partially recovered from their March 2020 lows and still present attractive investment opportunities, albeit requiring a longer-term investment horizon.

- In some instances COVID-19 will lead to sustained changes in consumer and business behaviour, often accelerating previous trends.
- By necessity, many people have shifted their purchasing activities online from physical retail stores. We believe the trend for eCommerce to increase its share of total retail sales will continue, accelerated by COVID-19, while traditional retail businesses will be increasingly challenged.
- The portfolio has no investments in businesses with structural headwinds.

Investment Environment – What next?

The question everyone is trying to answer is what happens next? In our view it is unhelpful to place too much emphasis on the unknowable. History reflects only one possible outcome. We remain **cautious and highly selective**, and continue to focus the portfolio on businesses which:

- Have sustainable positive drivers which support growth in a range of economic climates;
- Operate in well-structured industries where competition is rational;
- Are led by experienced management teams capable of responding to challenging operating conditions; and
- Are financially strong and have the capacity to invest in their employees and the business.

Hindsight is easier than foresight. We now have around 9 months of history to see how COVID-19 has impacted the world and to form a view on its ongoing impact.

We have seen a wide range of government policy and social responses to COVID-10. Victoria, Australia and New Zealand implemented hard lockdowns to manage relatively low COVID-19 infection levels. The United States has taken a very light-handed approach to restrictions and India has effectively given up on serious containment strategies.

The humanitarian costs have been substantial with officially over 30 million confirmed COVID-19 cases and around 1 million confirmed deaths.

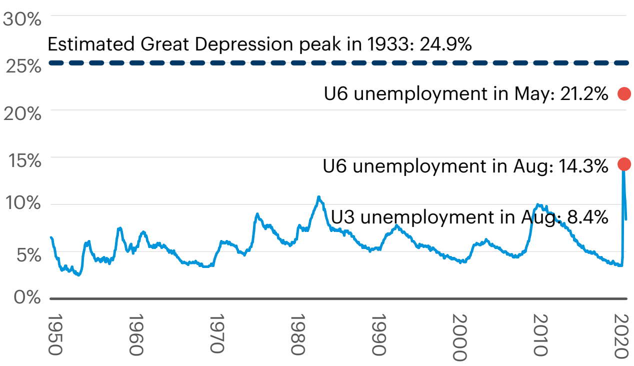
The management of one of the companies in our portfolio succinctly set out three cases for the economic impact of COVID-19 on their business: Severe, Moderate and Mild.

So far, the impact on their business is between the Mild and Moderate category, and while the impact varies significantly by business and industry, we believe this summarises the general economic impact of COVID-19 to date. There is now extensive economic and company specific data to support the view that economic and operating conditions have improved significantly over the past 6 months, although the rate of improvement is slowing.

In our June 2020 Quarterly Report, we said that the economic environment remains stressed and is far from normal, but the tail risk of a deeply depressed economic environment has reduced. This deep recession/depression scenario has not eventuated, and we believe it is unlikely. This is due to a combination of very accommodative monetary policy, unprecedented fiscal support, a less acute health outcome and a willingness of people and Governments to accept a relatively high degree of sickness and death to preserve employment and economic health.

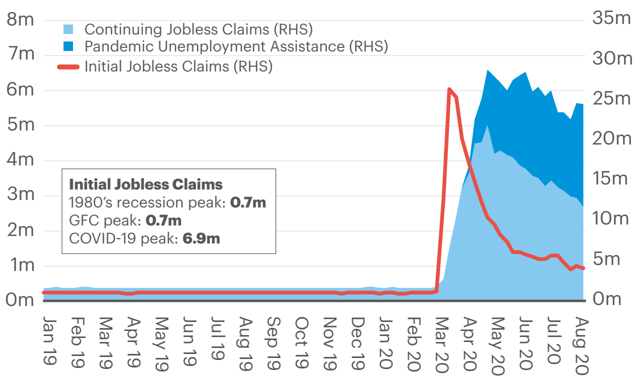
Significant risks remain and while there is hope for a vaccine in the near term, timing and efficacy are uncertain. Employment levels are improving but unemployment remain elevated. Geopolitical tensions remain high, the US election and subsequent policy has the potential to destabilise markets and fiscal stimulus is waning.

US Unemployment



Source: Bloomberg

US Jobless Claims



Source: Bloomberg

As evidenced by Mastercard data, spending levels improved dramatically since late March/April, but the improvement has stagnated recently, potentially reflecting the reduction in fiscal stimulus such as unemployment payments:

MASTERCARD SWITCHED VOLUME*	QUARTER		MONTH			WEEK ENDING	
	DEC-19	MAR-20	APR-20	MAY-20	JUN-20	28-JUL	28-AUG
Switched volume (total)	12%	8%	–23%	–9%	–3%	2%	3%
United States	9%	4%	–18%	–2%	2%	5%	4%
Rest of World	14%	11%	–27%	–15%	–7%	–1%	1%

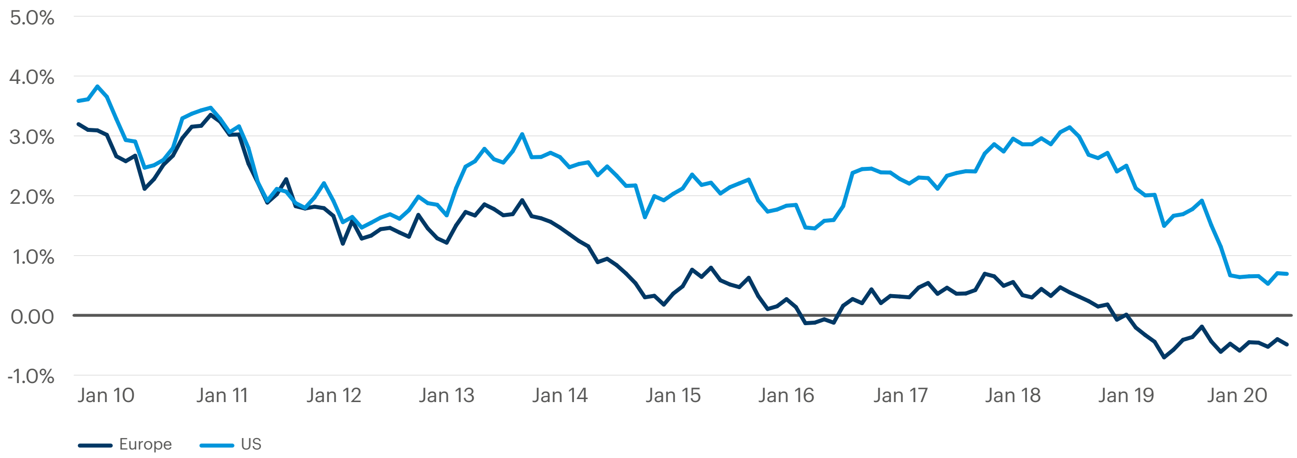
* Volume authorised, cleared and settled by Mastercard.

There is also room for selective economic optimism – as outlined below demand for new housing in the US has recovered strongly and we expect activity to remain robust.

Interest rates

Globally, interest rates remain exceptionally low.

10 Year Bond Yield



Source: Bloomberg

Our view remains that **interest rates in key developed markets are likely to stay very low for an extended time horizon**, and this will assist to **support valuations for high quality businesses**. Very low interest rates drives "there is no alternative" sentiment, but the sustainably low interest rate environment is also lowering the cost of capital for businesses and the effect of lower discount rates makes the value of a future dollar worth more in today's terms, **increasing the value of companies with sustainable and dependable growth**.

September 2020 Quarter performance and changes to the Portfolio

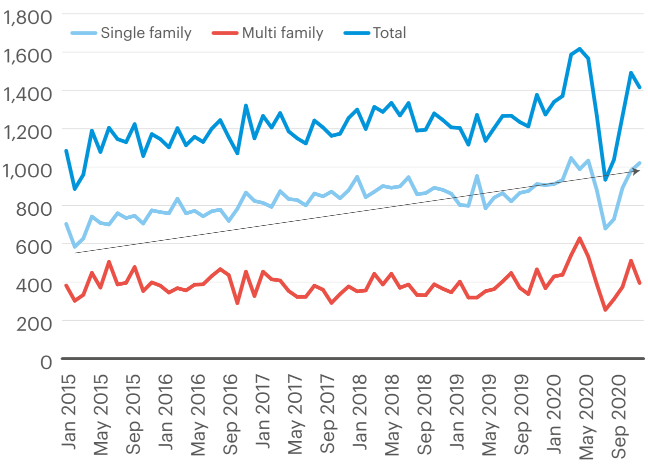
During the September 2020 quarter, equity markets increasingly reflected the continued economic rebound as economies continued to reopen.

In the September 2020 quarter the L1 Capital International Fund increased by 5.1%, while holding an average USD cash balance of 10.4%. The Fund outperformed the MSCI World Net Total Return Index by 1.4% which increased by 3.7% in AUD and 7.9% in USD (due to the appreciation of the AUD).

We made modest changes to the portfolio:

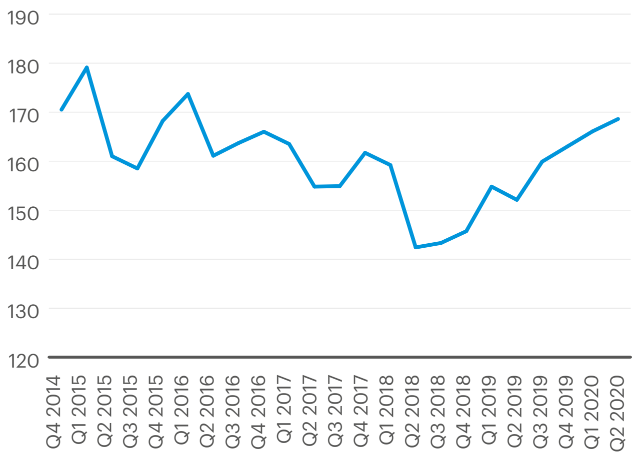
- **Activision Blizzard**, one of the global leaders in video gaming, was divested as the share price exceeded our assessment of fair value. We will look to reinvest in this business should the share price fall back to a more attractive investment level.
- Several investments in the technology sector were trimmed on valuation grounds with the proceeds used to increase our investment in **Amazon**. Amazon's successful flywheel business model and Amazon Web Services are well known. However, we believe the current share price under-appreciates:
  - The consistency and longevity of Amazon's growth potential in its key businesses;
  - The importance of additional revenue streams such as advertising which are high margin and growing rapidly; and
  - The strengthening barriers to competition and competitive advantages arising from Amazon's stepped-up investment in logistics and other infrastructure.
- We reduced our investment in **Nike**. Nike is performing extremely strongly in a challenging operating environment, gaining share and exceeding our expectations. However, the market has recognised Nike's strong performance and after a substantial increase in the share price we consider the risk adjusted return potential only warrants a minimum position size.
- Selectively, we have increased our exposure to businesses which will benefit from the recovery in the US housing sector. US single-family housing, was showing a strong recovery pre COVID-19 and has demonstrated a V-shaped recovery to over 1 million starts after an initial downturn due to hard lockdowns. We believe the underlying drivers for US single family housing are strong reflecting a period of under-building and increasing affordability. We have made investments in two businesses which we believe are well managed and have strong market positions in their well-structured industry segments.

US Seasonally Adjusted Housing Starts ('000)



Source: US Census

US Housing Affordability Index



Source: National Association of Realtors

L1 Capital International Investment Philosophy – The importance of consistency, predictability and longevity

In prior quarterly reports https://l1international.com/reports/ we have outlined aspects of the L1 Capital International Investment Philosophy and Process, designed to invest in businesses that will continue to strengthen over a medium to long term investment horizon.

One aspect of **quality businesses** we believe is often under-valued is the **consistency, predictability and longevity of its growth profile**. Too much emphasis is often placed on near term absolute growth expectations and whether a company will "beat" or "miss" short-term market expectations for financial performance. This, in part, reflects the **short-term investment horizon of many investors**.

A business which can perform well in a difficult economic environment is particularly under-appreciated. We all know the simple maths that if a share price falls by 50% it needs to double from the bottom to get back to the starting value. We focus on earnings and cashflow rather than share prices. A business which can maintain forward momentum and growth when competitors are falling backwards will have an even stronger competitive position on the other side of the economic challenges.

Longevity makes Albert Einstein's eighth wonder of the world, compound interest, possible (although Einstein probably was not thinking of today's low or negative interest rate world – compounding doesn't provide much help for holders of long duration negative yield bonds).

Longevity is reflected in the multiple of near-term earnings and cashflow, or more theoretically in a discounted cashflow based valuation. The higher the growth and longer the growth rate is expected to last, the higher the multiple of near-term earnings and cashflow, particularly in a very low interest rate environment. Any future prediction about a business is inherently uncertain. However, some businesses are more **consistent** and **predictable** than others. Consistency and predictability of earnings flow from **consistent and predictable business drivers**.

Examples of these consistent and relatively predictable drivers underpinning some of the portfolio's investments include:

- Replacement of cash and cheque payments with electronic methods;
- Movement in commerce from physical stores to eCommerce;
- Advertising on social media and other online platforms replacing traditional media advertising;
- IT spending moving from on-premises to the cloud;
- Transfer of financial markets trading from unregulated bilateral trading to centrally cleared, regulated exchanges;
- Transition of provision of services from offline to online e.g. travel agencies (**Booking Holdings**), small business accounting software and tax preparation (**Intuit**); and
- Essential non-discretionary services e.g. insurance and risk management brokerage (**Marsh & McLennan**, **Aon**), website registration (**Verisign**).

Portfolio Investment – Intuit

Intuit epitomises the consistency, predictability and longevity of growth we seek in high quality businesses.

Intuit currently operates through 2 main divisions:

intuit quickbooks

- Software for financial and business management as well as integrated payroll solutions, merchant payment processing solutions, and financing for small businesses in the US and key global markets; and

intuit turbotax

- Do-it-yourself and assisted income tax preparation software products and services sold in the U.S. and Canada.

Intuit also provides personal financial software and services through its Mint and Turbo products and has announced the acquisition of Credit Karma for US$7.1 billion which will significantly expand its personal finance capabilities, creating a third leg to Intuit's growth stool.

Intuit's tax capabilities also include software and services for professional accountants in the United States and Canada.

Intuit has made 5 "big bets" which extend across its divisions and drive its operating strategy and growth profile:

- Utilisation of **Artificial Intelligence** (AI) and customer insight (based on **unique data**) to make products simpler and to increase the speed of product enhancements – many of Intuit's products are "do it for myself" applications and AI can facilitate self-help and ease of use.
- **Connecting people to experts** – QuickBooks Live, TurboTax Live and Mint Live enable customers to speak to independent experts to solve their issues, increasing the number of customers, engagement levels, and revenue per customer.
- Facilitating "**smart money decisions**" by connecting customers with financial offerings that save them money – there are now 22 million registered users of Turbo and this division will be significantly expanded through Credit Karma's over 100 million members (37 million monthly active users) once the acquisition completes.
- Becoming "**the source of truth for a business**", not just "the source of truth for your books" – Intuit aims to assist small business customers get paid fast, manage capital, pay employees and grow in an omnichannel world. Intuit has unique capabilities through the integrated QuickBooks software, Payroll, Payments and QuickBooks Cash bank account, facilitating payments ($65 billion charge volume) and optimising cashflow management.
- **Disrupt the market for accounting software for businesses with 10 to 100 employees** – QuickBooks' traditional strength lies with smaller businesses but QuickBooks Advanced expands the product's capabilities to fully service larger businesses at a very competitive price point, albeit multiples of the standard QuickBooks price.

These "big bets" support consistent, predictable growth in all of Intuit's key businesses:

- QuickBooks Online (QBO) dominates the United States small business accounting software industry. **QuickBooks has a total of 4.6 million US customers, compared to Xero which only has 241,000 customers** across the United States and Canada combined. Businesses in the United States are well behind Australian businesses in adoption of online accounting software. Intuit estimates there are 48 million small businesses and self-employed potential customers in the United States. International opportunities are also immense with QBO having over 1.2 million customers in the United Kingdom, Canada and Australia compared to over 10 million serviceable small businesses. Flags have also been planted in other markets with significant long-term potential such as France and Brazil. Management aims to grow **QBO ecosystem** (including associated services) **revenue by 30% per annum** and has **exceeded this target for the past 4 years**. QBO ecosystem accounted for 6% of Intuit's group revenue in FY2012, 28% in FY2020 and we expect will account for around 50% of Intuit's total revenue by FY2025.
- TurboTax is driving the transition of tax preparation to online, self-service and assisted channels away from traditional tax preparation stores. TurboTax makes the necessity of filing tax returns quicker, cheaper, and facilitates maximising tax refunds. **TurboTax already supports the filing of 30% of all tax returns in the United States, yet only accounts for around 13% of revenue spent on filing tax returns.** We expect TurboTax's share of total returns to continue to increase. Over the **past 6 years TurboTax's revenue has increased at a 10% average annual growth rate**. Through the development of TurboTax Live and other products Intuit will be able to generate increased revenue per average filing, supporting its medium-term target of 8% to 12% revenue growth for this division.

We believe the best is yet to come for Intuit, requiring a vision of future potential that is only just beginning to be realised. Through QuickBooks, Intuit has unique, comprehensive customer data, and can be the "source of truth" for small businesses. Intuit can assist its customers use their data to save money improve cashflows, such as optimising working capital, financing terms and business requirements such as insurance.

The same opportunity exists in **helping individuals optimise their financial position**, combining tax return information with Turbo, Mint and, in time, Credit Karma, to not only enhance tax refunds, but also lower borrowing costs, increase savings rates and reduce expenses.

All these opportunities do not come cheaply. In FY2020 Intuit generated revenue of US$7.7 billion across the group and **fully expensed US$1.2 billion or 16% of revenue on research and development activities**. In comparison, in FY2020 Xero had total revenue of around US$0.5 billion and spent around US$160 million on product design and development costs (of which 45% was capitalised). We believe **Intuit's dominant market position will continue to strengthen** due to its much greater size and scope of activities, and ongoing investment in its business.

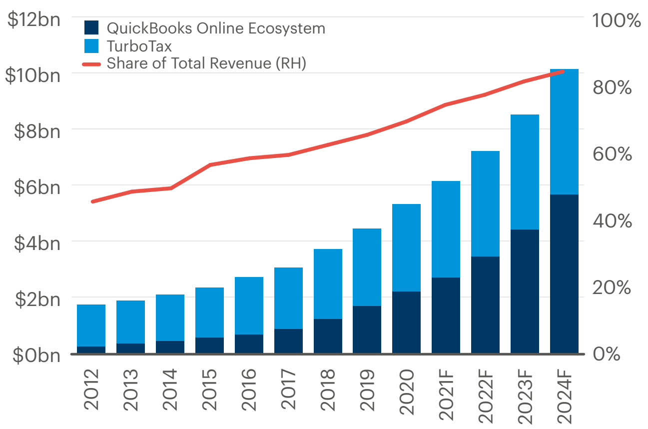
Intuit's financial profile is exceptionally attractive:

- **Consistent, sustainable revenue growth** – annual revenue growth has ranged between 11% and 16% over the past 5 years and we expect Intuit to continue to generate double digit revenue growth over the medium term, with growth increasing as QBO becomes an increasing share of total revenue;
- **High margins** – operating margins are approximately 30% and management targets increasing operating profit at a faster rate than revenue growth. We expect sustained operating leverage in conjunction with increasing ongoing investment in growth initiatives;
- **Very high cash conversion** – reflecting being paid upfront and negative working capital;
- **Limited capital requirements to support organic growth** – growth has been organically funded, with Intuit last raising equity capital over 20 years ago. Capital expenditure is less than 2% of revenue;
- **High returns on invested capital** – book capital is minimal and returns on invested capital are exceptionally high; and
- **Strong financial position** – Intuit has US$3.7 billion net cash. Net cash will be approximately nil after completion of the US$7.1 billion acquisition of Credit Karma (funded 50% cash, 50% equity). Intuit generated operating profit of over US$2.2 billion in FY2020 and has the financial strength to withstand a challenging operating environment for small businesses caused by COVID-19.

Management is led by Sasan Goodarzi who has held senior management positions at Intuit for the past 14 years. Scott Cook co-founded Intuit in 1983 and remains a Board member and significant shareholder.

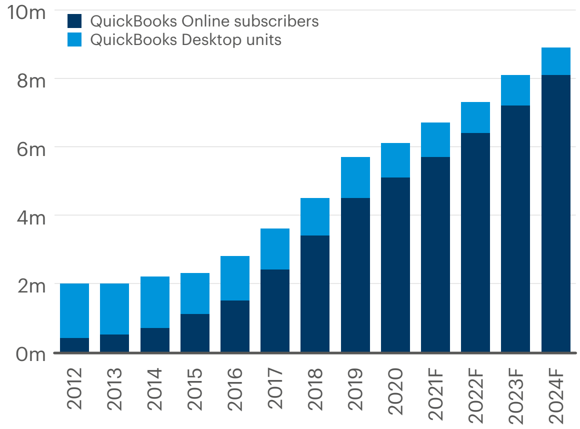
Intuit is trading on around 30x FY2021 EBITA, 42x FY 2021 PE, 2.5% free cashflow yield and provides a dividend yield of around 1%. While the near-term earnings and cashflow multiples optically are relatively high, we believe they fairly reflect Intuit's attractive business, industry, management and financial attributes, including its **consistent, predictable and long-term growth profile**. Intuit will continue to deliver strong value to shareholders for many years to come, with our **base case implying a double-digit annual return** for this investment.

QuickBooks Online and TurboTax are driving revenue growth, already accounting for around 70% of total revenue



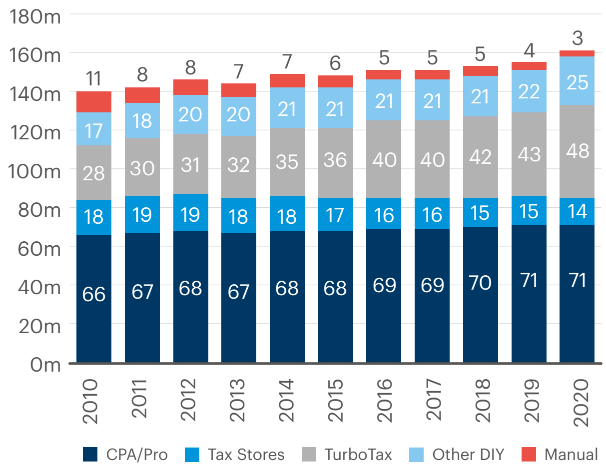
Source: Intuit and L1 Capital International

Long runway for growth – 5.1m QuickBooks Online subscribers and 1.0m desktop units compared to 48m small business and self-employed entities in the US and 30m in core markets outside the US



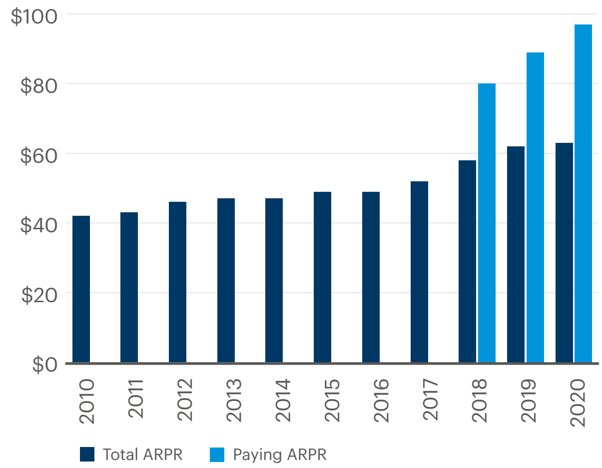
Source: Intuit and L1 Capital International

TurboTax units have increased 5.4% CAGR over 10 years in a US Tax industry growing 1.3% as TurboTax gains share in DIY and from offline channels



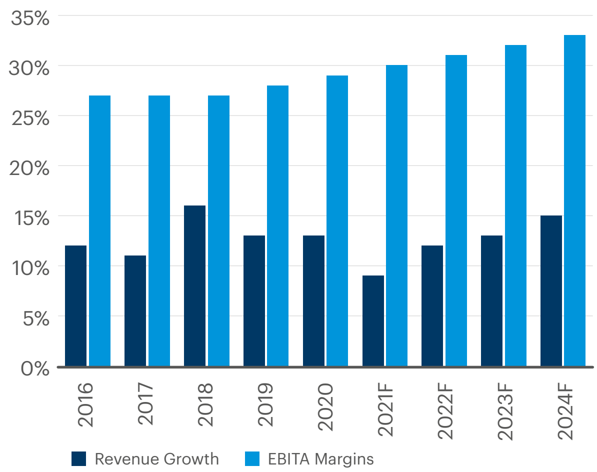
Source: Intuit

TurboTax has consistently increased its average revenue per return as additional capabilities are added



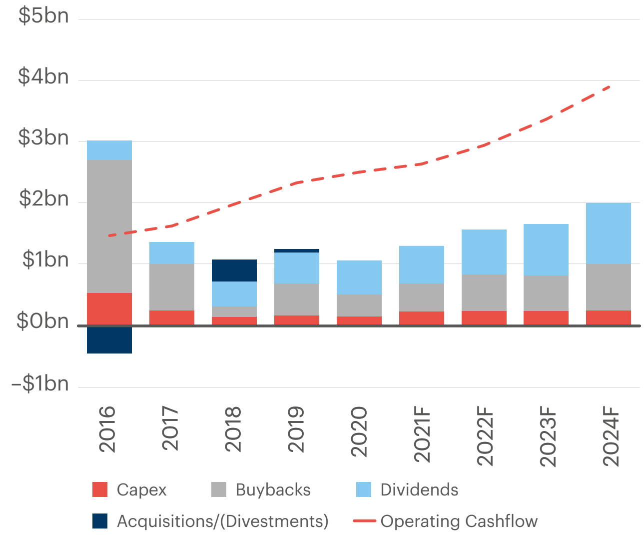
Source: Intuit

Intuit delivers consistent double-digit revenue growth, operating margins are high and expanding



Source: Intuit and L1 Capital International

Strong growth in operating cashflow, limited capital requirements beyond R&D (expensed), management sensibly allocates capital, fortress balance sheet (net cash)



Source: Intuit and L1 Capital International, not including Credit Karma (to be completed)

L1 Capital International Fund

Quarterly Report | September 2020

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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