L1 Capital International Fund

Quarterly Report | MARCH 2022

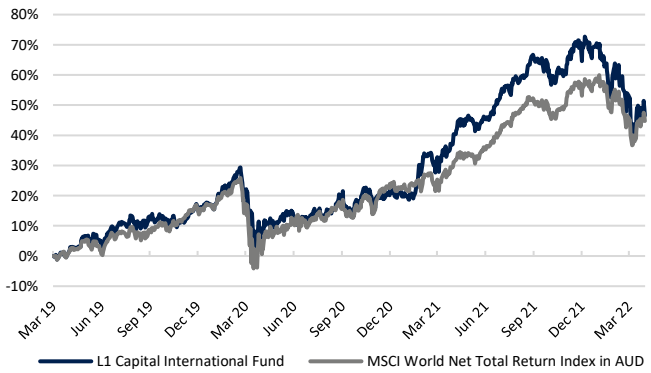
Introduction

In this March 2022 Quarterly Report, we have outlined:

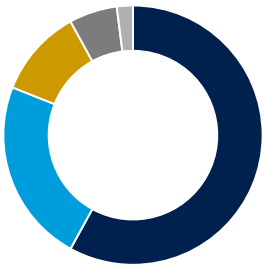
- **Our quarterly review, including key contributors and detractors to the Fund's performance.**
- **Current investment environment, with a focus on the implications of the war in Ukraine, higher inflation and interest rates.**
- **Portfolio adjustments.**
- **The importance of a longer-term investment horizon.**
- **Debates on three key drivers underpinning portfolio exposures: U.S. housing, global travel, and technology.**

Fund Performance (Net) (%)[1]	Fund	Index[2]	Alpha
3 months	-13.4	-8.2	-5.2
1 year	6.3	11.7	-5.4
3 years p.a.	13.3	12.9	+0.4
Since inception p.a.	13.2	12.7	+0.4
Since inception cumulative	46.5	44.7	+1.8

Fund (Net) Benchmark Returns Since Inception[1]



Revenue Exposure by Region[3]



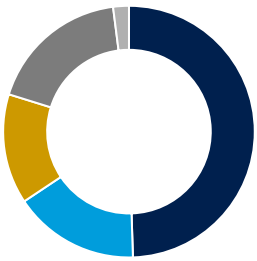
- North America 58%
- Western Europe 23%
- Asia Pacific 11%
- Rest of World 6%
- Cash 2%

Top 10 Holdings (In Alphabetical Order)	Sector
Alphabet	Internet
Amazon	Consumer Discretionary / Internet
CRH	Building Products
Eagle Materials	Building Products
Graphic Packaging International	Industrials
IQVIA	Healthcare
Louisiana Pacific	Building Products
Marsh & McLennan	Commercial Services
Mastercard	Payments
Microsoft	Software

Sector Exposure[4]

- Software 16%
- Consumer Discretionary 15%
- Commercial Services 14%
- Building Products 14%
- Internet 11%
- Industrials 10%
- Payments 9%
- Health Care 5%
- Exchanges 4%
- Cash 2%

Market Capitalisation Exposure



- $100 billion+ 49%
- $50-100 billion 16%
- $10-50 billion 14%
- <$10 billion 18%
- Cash 2%

1. Figures may not sum exactly due to rounding. Past performance should not be taken as an indicator of future performance. 2. MSCI World Net Total Return Index in AUD. Return measured from Index close on 1 March 2019. 3. Revenue by region is internally estimated on a look through basis based on the underlying revenues of the individual companies held in the portfolio. 4. Industry classification is defined by L1 International to best describe the nature of the underlying businesses.

March 2022 Quarterly Review

Performance

The L1 Capital International Fund returned -13.4% (net of fees) during the March 2022 quarter compared to the benchmark return of -8.2%. The Australian dollar appreciated 3.1% against the U.S. dollar and 4.9% against the Euro, detracting from Fund and benchmark Australian dollar reported returns.

During the quarter, the Fund recorded its three-year anniversary. Over three years to 1 March 2022, the Fund returned 14.5% p.a. (net of fees) or a total return of 49.9% (net of fees), outperforming the benchmark by 6.5% or 1.7% p.a. (net of fees). This places the Fund in the top 10% of almost 950 peer funds as assessed by Bloomberg. We are pleased with the initial returns of the Fund during this highly volatile and COVID-19 disrupted market, recognising that some of this outperformance reversed in March 2022. The L1 Capital International team looks forward to building on these initial returns in the years to come.

Key contributors and detractors

As at 31 March 2022, the portfolio consisted of 22 companies, with the top 10 holdings accounting for 59.5% of the portfolio.

At quarter end, building products accounted for 13.5% of the portfolio, of which 12.5% related to North America (principally the U.S.) and 1.0% to other international markets (principally U.K. and Western Europe). The share price of the three building products companies, **CRH**, **Eagle Materials** and **Louisiana Pacific** were each down 20% to 23% in local currency during the quarter, mainly due to concerns that the U.S. housing industry will face a cyclical downturn due to increasing mortgage rates, increased real estate prices, and reduced housing affordability.

We discuss our views on the U.S. housing market in detail in this report (see page 5). New residential housing only accounts for around 4% of the fund's total building materials exposure, with the much less cyclical repair and renovation sector accounting for a similar percentage, and the robust infrastructure sector and steady commercial/industrial sectors each accounting for over 2% of the building materials exposure. While we expect the U.S. new residential housing cycle will be impacted by rising interest rates and house prices, the fall in share prices of the companies in our portfolio is an over-reaction compared to their long-term value. The relative stability of the repair and renovation, infrastructure and industrial/commercial exposure of these companies has also been underappreciated. We note that Eagle Materials and Louisiana Pacific were each both significant positive contributors to the portfolio's performance during the December 2021 quarter demonstrating that, whether good or bad, three months is an inappropriately short time period to assess the performance of any investment.

These three companies each negatively contributed over 1% to the portfolio's total return, as did **IQVIA** and **Netflix**. One holding, **Activision,** which is subject to a takeover offer by **Microsoft**, positively contributed more than 0.5% to the Fund's quarterly performance in Australian dollars. The appreciation of the Australian dollar during the quarter detracted from local currency return of all companies in the portfolio.

Share prices of many technology companies were under pressure during the March 2022 quarter, particularly 'unprofitable growth' technology companies, a segment of the industry which L1 Capital International has no exposure. All the technology companies in our portfolio are leaders in their industry, generating strong earnings and cashflow. During the quarter share prices for many of the technology companies we own fell from around the top end of our view of fair value, to the bottom end or below our fair value range. The share price falls were more than the benchmark average, contributing to the portfolio's negative relative return. As discussed on page 5, we took advantage of the opportunity and selectively added to our investment in a number of these highest quality businesses at very attractive prices.

The Fund has no exposure to commodity businesses in the energy sector, which was the only sector to perform strongly during the March 2022 quarter, and which also contributed to the Fund's negative relative performance.

The Fund was almost fully invested throughout the March 2022 quarter, ending with cash levels of around 2%. **We believe our portfolio of high-quality businesses will continue to perform strongly under a range of operating conditions and we view current valuations as attractive, and in some instances compelling.**

Current Investment Environment

"There is always something to worry about… Sell a stock because the company's fundamentals deteriorate, not because the sky is falling."

Peter Lynch

Currently there are many issues to worry about.

Ukraine war

Talking about the economic and portfolio implications of Russia's invasion of Ukraine seems insensitive compared to the unimaginable humanitarian suffering caused by this senseless war. We can only hope that the majority of the world's support for Ukraine leads to a peaceful resolution as soon as possible. Nevertheless, our role as stewards of the Fund's capital mandates that we consider the broader economic implications of Russia's actions and specifically how the businesses we have invested in or consider for investment will be impacted. We have assessed the impact of the war on our portfolio at three levels:

Estimating the **first order impacts** of the Ukraine War on our portfolio of businesses is relatively straightforward. We do not invest directly in Russia or Ukraine, but we do invest in global businesses which operate in this region. Across the portfolio, we estimate total portfolio exposure to Russia/Ukraine to be around 2%, ranging from nil for purely domestic U.S. businesses, to 6% for **Mastercard**.

Second order impacts, though harder to estimate, are also expected to be relatively minor. Within this category, we include the effect of higher energy and other commodities, the potential for energy rationing in Europe and supply chain disruptions.

Because most of our companies are capital light, people-based businesses, we have limited exposure to commodity price increases. And while our building products businesses are consumers of energy, they are principally operating in the U.S. where price increases have been more modest. Our investment in **CRH** is our primary exposure to European energy prices – and even here, it is only around 20% of the business.

Third order impacts of the war are harder to quantify. The war and associated sanctions on Russia have disrupted supply of commodities and supply chains, adding to inflation and dampening consumer sentiment. Higher petrol, heating and other costs will be broadly felt around the world – look no further than the cost of filling your own car's petrol tank – pressuring consumer discretionary spending. The longer the war and associated sanctions, and how Russia responds, will heavily influence the acuteness of the third order impacts for the world's economy and our portfolio of businesses.

We do not invest in commodities such as oil and gas, and therefore no companies in our portfolio have benefited from the spike in energy prices. The rays of economic positivity from the Ukraine war for our portfolio are few and far between. **Intercontinental Exchange** has benefited from the volatility in energy and other commodity prices, and from the volatility in interest rates.

In summary, the war in Ukraine is a clear negative for world economic growth, adding to inflationary pressures while negatively impacting demand. We consider the direct impact on our portfolio of businesses to be limited and readily manageable, but the war is a new and meaningful issue to worry about and could have ongoing negative implications for the world's economy.

Inflation and interest rates

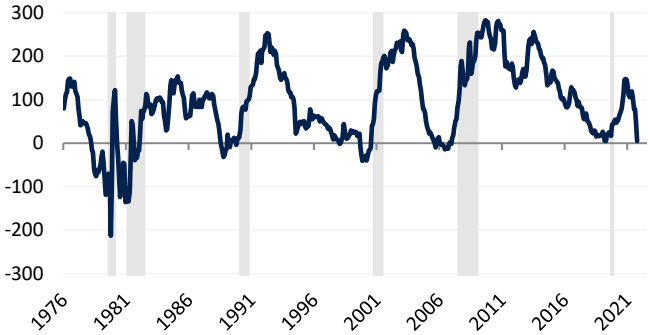
Much has been written about global inflationary pressures, interest rate implications and the impact on investment markets, including more than a few pages by us.

Higher for longer inflation expectations have become more widespread. The Ukraine war has added to inflationary pressures, particularly energy and commodities, and is placing further pressure on supply chains already strained by COVID-19 inefficiencies.

The U.S. Federal Reserve increased interest rates by 0.25%, the first increase since 2018, with the market expecting progressive and substantial increases in short term interest rates during 2022 and into 2023. Federal Reserve Chair, Jerome Powell, made it clear that the Federal Reserve "…will take the necessary steps to ensure a return to price stability" including increasing the Federal Funds rate as required, reinforcing expectations for a more rapid and pronounced increase in interest rates, particularly in the U.S. Quantitative tightening, or a shrinking of the Federal Reserve's balance sheet, will add to the impact of tightening monetary policy.

At times like these it seems every economist and market commentator starts talking about the shape of the yield curve, and in particular the 2-year interest rate compared to the 10 -year interest rate. Historically, when the 2-year/10-year interest rate relationship has inverted (2-year interest rate is higher than the 10-year interest rate) it has been a strong signal that tighter monetary policy will slow growth, leading to an economic recession (see Figure 1).

Figure 1: 10-year – 2-year spread vs. Recessions (shaded)



Source: Haver, Jefferies Economics, L1 Capital International

We find this kind of headline-seeking analysis simplistic. It is a data point to be considered, but only that. Historically there have been false positive and false negative signals from the 2-year/10-year spread. The interest rate yield curve reflects consensus expectations for interest rates at that point in time, but like share prices, expectations for future interest rates change. Expectations for near term interest rates have increased meaningfully, quickly and not without reason. However, we caution that there are many globally important issues currently which lack high degrees of predictability.

Very few people predicted an extensive invasion of Ukraine by Russia. Even fewer predicted an elongated war once conflict commenced or the scope of sanctions against Russia. Worldwide economic and military responses continue to evolve, including responses by OPEC. Anyone offering a view on how the conflict will be resolved, when, and with what ongoing implications is merely speculating.

COVID-19, which dominated investment markets for much of 2020 and 2021 today barely rates a mention. Yet as we complete this report, Shanghai is in lockdown and globally supply chains remain disrupted by the ongoing effects of COVID-19, including shortages of labour, inventory and logistics.

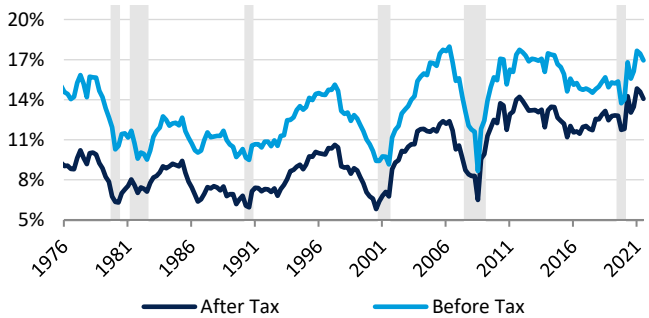
Market implications

Much of the market's recent price movements are easy to explain and reflect bias to near term information and trends. Higher energy and commodity prices have led to investors chasing exposure to these sectors, extrapolating that the recent increases in prices will continue. Businesses with no competitive advantages or barriers to competition that are dependent on a commodity price they do not control or even influence do not meet our definition of quality, and therefore fall outside our investment universe.

Expectations for higher interest rates has pressured longer duration asset values – whether they be longer term fixed income securities or higher-growth companies which depend on an assessment of longer-term earnings and cashflow potential. This has particularly impacted '**unprofitable technology**' companies which may generate revenue today but will only generate earnings and cashflow in future years if strong growth is maintained. Many of these businesses were trading at share prices which reflected unrealistic expectations for the future. Valuation support was lacking and their share prices will struggle to recover.

The share price of companies operating in industries which are negatively impacted by rising interest rates have also fallen, including the housing sector. The L1 Capital International Fund does not have exposure to any home builder (which have significant operating and financial leverage and generally weaker building models) but does have meaningful exposure to companies which manufacture building products which are in part used in residential home construction. This portfolio exposure is discussed in detail on page 7.

Figure 2: US Corporate Profit Margins vs Recessions



Source: Haver, Jefferies Economics, L1 Capital International

Currently corporate profit margins are elevated. Inflationary cost pressures, not just commodities, but also transportation, labour costs and the cost of financing, will challenge the sustainability of these margins for many businesses. A key recurring comment in our recent quarterly reports is that in this environment, investing in companies with **pricing power** is of paramount importance. We expect a wide dispersion in the performance of businesses over the coming reporting periods, with businesses with genuine pricing power able to maintain and expand operating margins, while companies **which lack genuine barriers to competition reporting reduced margins and profitability**.

Portfolio adjustments

Adjustments to the portfolio were relatively modest. Within the top 10 holdings, **TSMC** was progressively divested during the quarter, and we added to our investment in **Alphabet** which re-entered the top 10. Divesting TSMC was a difficult decision. The business is extremely well-positioned over the medium to long term as a global leader in manufacturing semi-conductors, particularly for the most demanding, leading-edge technology applications. TSMC has exceeded our expectations from a financial perspective, and we believe the current share price is below fair value. However, Russia's invasion of Ukraine has **highlighted that geopolitical risk is real** and we expect TSMC will continue to trade at a substantial discount to fair value due to Taiwan's geopolitical situation. We utilised the TSMC proceeds to increase our investment in several existing investments including **Alphabet**, **Booking Holdings**, **Intuit, Moody's** and **Nike**.

Activision was fully divested following a takeover offer by **Microsoft**. There is significant uncertainty whether the acquisition will receive regulatory approval and if so on what terms. We therefore elected to realise the profit on this investment rather than wait for an uncertain and elongated regulatory process to conclude.

The vast majority of companies in the portfolio reported quarterly results and gave forward-looking guidance that met or exceeded our base case expectations. **Netflix** and **Adobe** both reported quarterly results which were in line with our expectations but gave guidance that was a little below our (and the market's) expectations. In our view the share price of both companies overly reacted to the lower growth guidance, and we added to our investment in both companies, albeit they remain smaller positions in the portfolio.

During the quarter we divested **Texas Instruments** and invested in **AMD**. While both companies operate in the semiconductor industry, they have meaningfully different industry exposures and business models. Texas Instruments manufactures analog semiconductors for industrial and auto industries whereas AMD designs (and outsources manufacturing) semiconductors for the gaming, data centre and personal computer markets. We believe the step-change in the competitiveness of AMD's technology, particularly following the $40 billion plus acquisition of Xilinx is greatly under-appreciated and AMD will gain market share ahead of expectations. Texas Instruments is a high-quality business and remains on our bench of potential investments.

Portfolio debates

Longer-term investment horizon creates opportunities

A core tenet of the L1 Capital International's investment philosophy is **having a longer-term investment horizon creates opportunities. We aim to benefit from the short-term focus of the market.** Many investors are focused on the short-term absolute and relative performance of their investments. Yet **sustainably successful businesses are not managed quarter to quarter**. Our investment philosophy is not centred on being contrarian. L1 Capital International invests in high-quality businesses which have sustainable tailwinds to support growth, but that does not mean operating conditions will always be optimal. We recognise some high-quality businesses in well-structured industries are cyclical. We do not ignore macroeconomic conditions, but **rather than try to predict the unpredictable**, we **focus on businesses** managed by boards and management teams that adapt to their operating environment, invest in their business and **strengthen their competitive and financial position during more challenging times**.

We have outlined three key drivers underpinning portfolio exposures where we believe excessive focus on short-term operating conditions rather than longer-term sustainable, albeit cyclical, competitive advantages and growth is creating compelling investment opportunities: U.S. housing, global travel and technology.

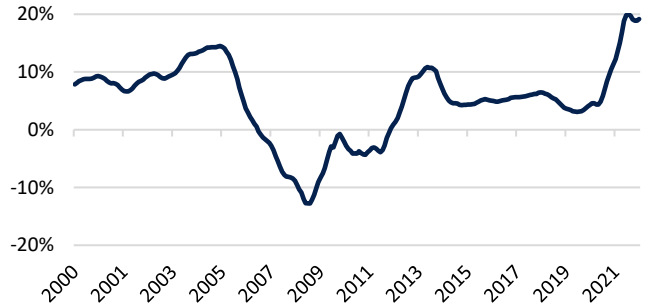
U.S. housing

Housing is a notoriously cyclical industry. Activity levels do not just compound upwards over time, but rather fluctuate significantly depending on economic conditions.

John Maynard Keynes is usually attributed with the quote: ***"When the facts change, I change my mind. What do you do, sir?"***

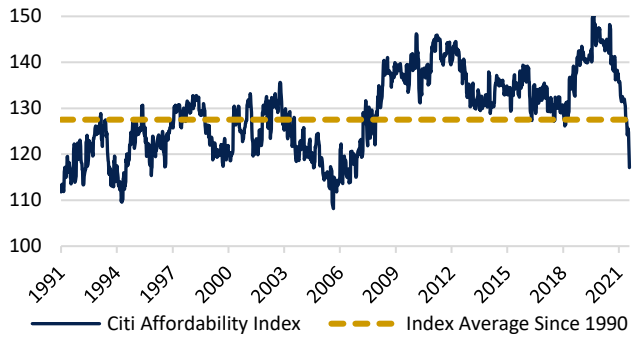
Recently the facts changed, significantly. House prices have increased almost 20% over the past 12 months, average 30-year mortgage rates have increased from 3.3% to 4.8% over the past three months, and housing affordability has fallen and will likely fall further. Accordingly, there is **justified concern** that the sustained recovery in new housing construction activity will falter.

Figure 3: U.S. House Prices, year on year (% change)



Source: S&P Corelogic Case Shiller, Bloomberg, L1 Capital International

Figure 4: Housing Affordability Index

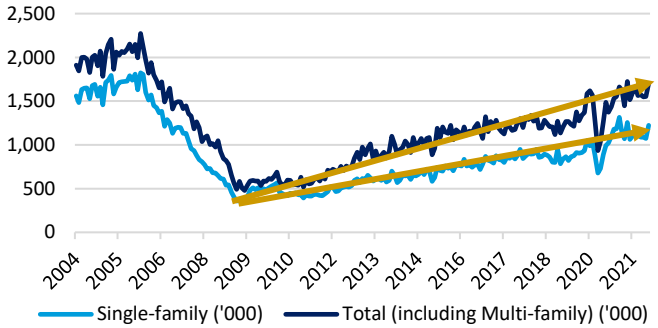


Source: Citi Research, L1 Capital International

Figure 5: U.S. average 30-year mortgage rate

Source: MBA, Bloomberg, L1 Capital International

Figure 6: U.S. single-family and multi-family house construction (number of units ('000))



Source: U.S. Census Bureau, L1 Capital International

So with the facts changing, why do we still retain exposure to the US housing sector? The short answer is while we agree the operating environment for the housing sector is not as favourable as it was only a few months ago, the debate on future housing activity is more nuanced and there are many factors that will assist to support demand (see Figure 7).

Figure 7: Housing cycle considerations

Glass half full

- Demographics support household formation and home ownership
- Structural underbuilding over the past 10-plus years
- Robust labour market leading to wage growth
- Shortage of existing homes/record low time to sell an existing home
- Lumber-related building products prices likely to fall considerably
- Affordability still reasonable in geographic areas most important to new residential construction
- Ageing housing inventory
- Increased consumer savings during COVID-19
- High housing equity for existing homeowners looking to trade up or renovate
- Supportive mortgage availability, low real (net of inflation) interest rates, mortgage tax deductibility
- Rising rents increasing the relative financial advantages of home ownership

Glass half empty

- Increasing mortgage interest rates
- Increased home prices
- Reduced affordability
- Supply chain disruptions leading to elevated costs and delays in construction
- Inflationary pressures elsewhere pressuring household budgets
- Falling consumer confidence

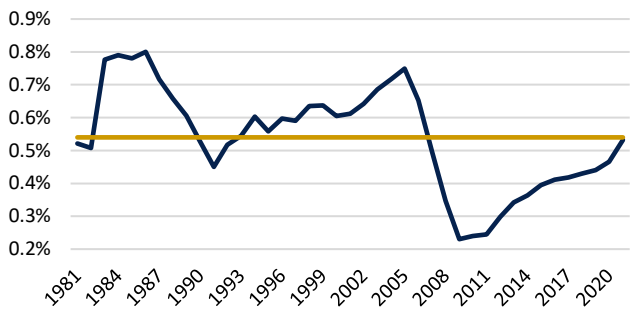
Source: L1 Capital International.

For any cyclical industry, it is common sense to consider where we are in the cycle. Even though new residential construction activity has been steadily recovering since the 2009 crash, activity levels are now only around mid-cycle, particularly when you adjust for population growth (see Figure 8).

Focusing on broad national averages is too simplistic. Financial commentators shout headlines of record home prices and increased unaffordability, and for many people unfortunately that is reality. However, consider:

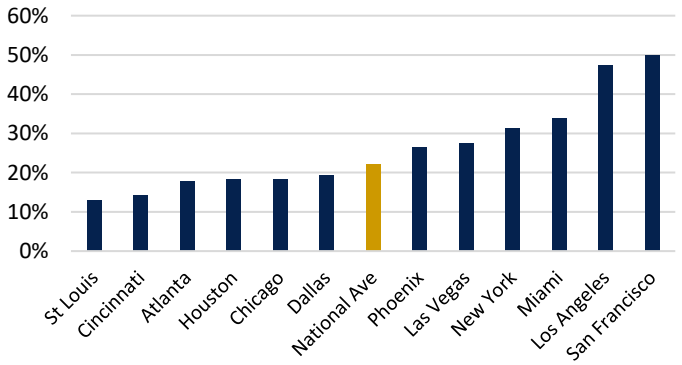
- Over the past 10 years the number of U.S. people in the prime first home buyer age group of 30 to 39 years old has increased from 40 million to 45 million, significantly increasing how many people are looking to enter the housing market.
- The average household income for a homeowner in the U.S. is US$82,300 compared to US$46,100 for a household which rents. New residential construction demand is driven by more affluent households, not the national average.
- Housing affordability is relative. Affordability varies greatly by market within the U.S., and recent reductions in U.S. affordability are tame compared to Canada and Australia.

Figure 8: Total family housing starts / U.S. population



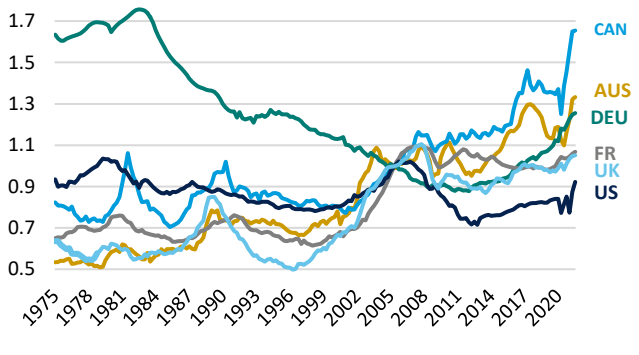
Source: U.S. Census Bureau, L1 Capital International

Figure 9: Mortgage payment as a percentage of household income for existing homes



Source: Census Bureau, RBC, L1 Capital International

Figure 10: House price to personal disposable income



Source: Macrobond, Macquarie, L1 Capital International

Portfolio implications

CRH, Eagle Materials and Louisiana Pacific meet our definition of a high-quality business, albeit operating in a cyclical industry. Each company has a unique investment case with enduring advantages – strong regional market positions with barriers to competition, strategic raw materials reserves, production cost advantages, as well as leading industry brand names. These attributes support pricing power and the ability to maintain higher profitability than their competitors over operating cycles.

New residential construction activity only accounts for part of their sector exposure and the diversity of their business exposure is under-appreciated. That said, all three businesses are subject to cyclical demand conditions which is why we rate all of them a '3' (Good) on our business quality assessment scale. **Each company is trading materially below our view of fair value** – CRH and Eagle Materials are trading on around 10-11x 2022 operating profit, 12x 2022 PE and an 8% free cashflow yield, provide a secure, increasing dividend, have balance sheet flexibility and are actively buying back shares at current prices which is increasing long-term shareholder value. Louisiana Pacific has no net debt and is trading on a 2022 PE ratio of under 5x (yes after-tax earnings, not revenue), albeit current profitability is unsustainably high.

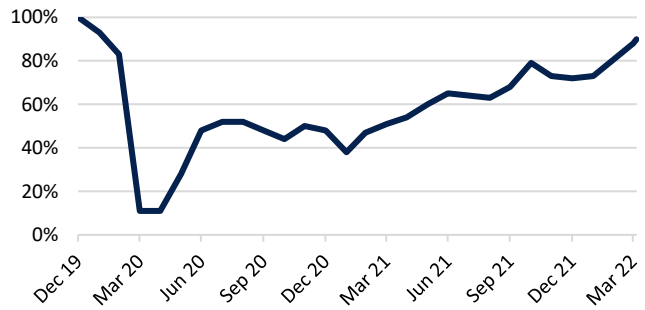
In summary, while the facts have changed and we have lowered our base case expectations for housing activity to account for higher interest rates, reduced affordability and cyclical pressures, current share prices overly reflect sentiment rather than the fundamental value of CRH, Eagle Materials and Louisiana Pacific. We believe our longer-term investment horizon will lead to strong returns from these investments, and the short-term focus of many market participants is leading to compelling valuations today.

Global travel

The travel industry has demonstrated long-term sustainable growth, but activity was severely disrupted by COVID-19. The travel recovery has progressed substantially since the onset of COVID-19 although in fits and starts due to new variants and more recently, the potential impact from Russia's invasion of Ukraine. Despite ongoing high COVID-19 infection rates, travel frictions and geopolitical uncertainties, global hotel reservation volumes have recovered to 90% of 2019 levels based on data from Siteminder, a global hotel booking management platform. Current data also suggests that hotel bookings in the major European travel destinations (France, Germany, Italy, U.K. and Spain) have been relatively unaffected by the conflict in Ukraine.

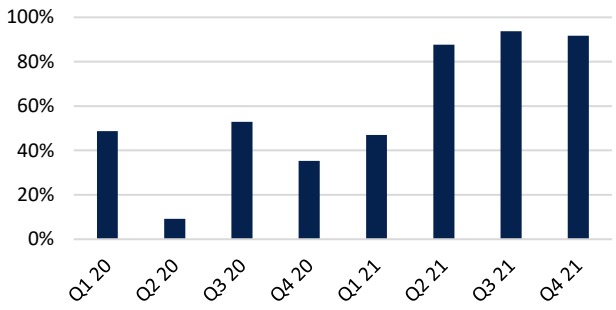
Gross bookings, reported by **Booking Holdings** (Booking), had recovered to within 6% of 2019 levels in the third quarter of 2021 before slowing slightly to 8% below 2019 levels in the fourth quarter due to the outbreak of the Omicron variant which disrupted the important Christmas travel period. In early March, bookings had improved to being flat on 2019 levels throughout February 2022, although following Russia's invasion of Ukraine this had deteriorated to 10% below.

Figure 11: Global hotel reservation volumes relative to 2019 levels



Source: Siteminder as at 5 April 2022.

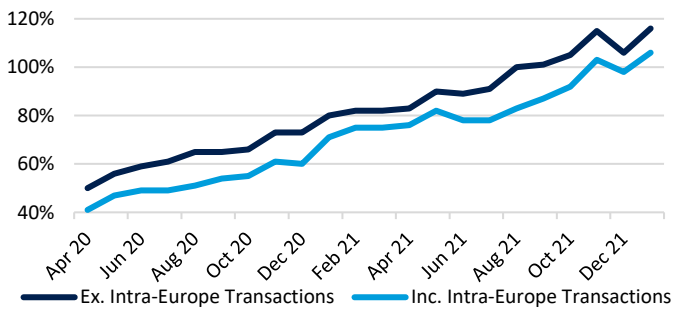
Figure 12: Booking Holdings – Gross Bookings (% of 2019 levels)



Source: Booking Holdings.

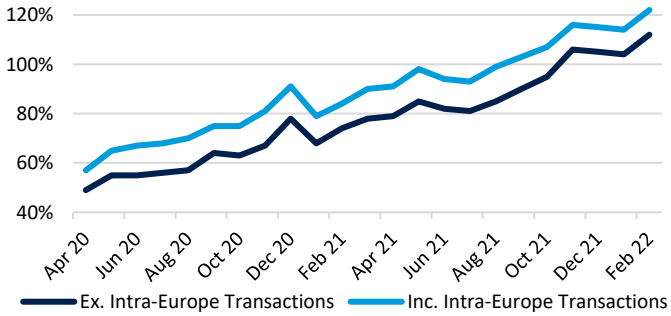
Cross border revenues for **Mastercard** and **Visa**, which accounted for 22% and 27% of total revenues respectively in 2019, have also substantially recovered. Total cross border transaction volumes, which include e-commerce as well as travel, has recovered to well above 2019 levels. Cross border travel transaction volumes, excluding intra-Europe travel, has returned to around 80% of 2019 levels for each of Mastercard and Visa (see Figures 12 and 13).

Figure 12: Mastercard – Cross border volumes relative to 2019



Source: Company reports and L1 Capital International.

Figure 13: Visa – Cross border volumes relative to 2019



Source: Company reports and L1 Capital International.

While the exact timing of a full recovery is uncertain, we believe it is a matter of "when", not "if".

- **Border restrictions continue to ease:** There has also been a significant easing of border restrictions in recent months. Major European travel destinations including the U.K. and Sweden have dropped all border restrictions, allowing entry without vaccination, testing or quarantine requirements.
- **Latent financial capacity and demand for travel exists:** Europeans saved nearly 50% more than normal during the pandemic in 2020 and 2021, leading to an estimated €907 billion in surplus savings[5] as a result of both furlough schemes supporting incomes as well as families staying at home. The IMF estimates that almost 80% of the total spending drop stemmed from declines in the hospitality and transportation sectors. Moody's also estimates that consumers globally have stockpiled an extra US$5.4 trillion of savings since the pandemic began[6].

Portfolio Implications

Visa and Mastercard both meaningfully outperformed the market correction in the March 2022 quarter, and we expect ongoing recovery in their business, including cross border travel related revenues. We have taken advantage of Booking's share price volatility to add to our position in early March, shortly following the Russian invasion. Booking is highly competitively-advantaged and will benefit from the long term structural growth in the demand for tourism and shift in hotel bookings from offline to online channels. Many offline travel agencies have closed or reduced their store footprint due to the subdued demand through the pandemic while Booking has continued to invest in improving its customer experience, bolstering capabilities in flights, payments, alternative accommodation and building its 'connected trip' vision. We expect Booking will be well placed to resume growth post the current COVID-19 induced disruptions.

Technology

"History may not repeat itself. But it rhymes." – Mark Twain

"… mounting concerns about the pace of growth spurred fresh declines in stocks around world …, wiping out gains for the S&P 500 and Dow Jones Industrial Average.

What started as a selloff in shares of highflying technology companies bled into other corners of the financial markets, as investors drove down prices for everything …

The latest bout of selling left investors grappling anew with concerns that the nearly 10-year bull market could be running out of steam, even as ongoing growth in U.S. jobs, manufacturing, and corporate earnings signal to many that a recession isn't imminent.

Traders described a hectic opening for stock trading, with some companies swinging in the first several minutes on higher-than-usual trading volumes. Amazon.com dropped 6% shortly after the open …"

Wall Street Journal, November 2018

The above excerpt is from a **November 2018** *Wall Street Journal* article. At the time there was increasing geopolitical uncertainly and rising interest rates. The U.S. 10-year interest rate had increased around 100 bps from a year earlier.

Between August 2018 and December 2018, the Nasdaq Index fell nearly 25%. "How can you possibly own technology stocks when you KNOW interest rates are going up?" was a common refrain back then – the same as it is today. A deft hand, and one indifferent to tax consequences, might have been able to time markets perfectly and avoid this correction, but we haven't met a person who can repeatedly time markets yet.

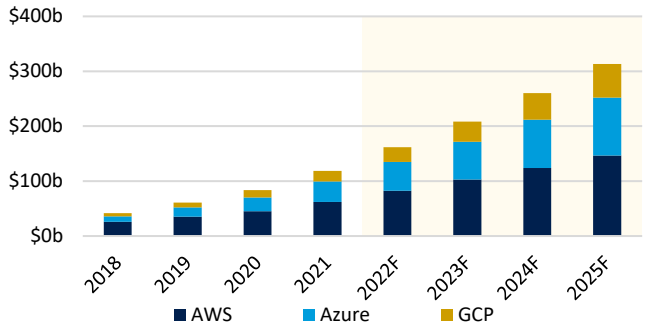
Notably, after this 2018 drawdown, the technology heavy Nasdaq Index has delivered a total return of 130%, compared to around 100% for the S&P 500 Index (including the recent drawdowns), despite the COVID-19 pandemic and many other reasons to worry. We acknowledge this market performance was in an environment of pandemic-induced, exceptionally low interest rates, and the share price of many technology companies increased to over-valued territory. However, rather than focus on simplistic headlines and be influenced by market sentiment, we focus on the key drivers, the underlying investment thesis for each company and our fundamentally driven longer-term valuation assessment.

5. IMF. 6. Financial Times.

Cloud

Three of our largest investments are **Amazon**, **Microsoft**, and **Alphabet** – and for these companies, their Amazon Web Services (AWS), Azure and Google Cloud Platform (GCP) businesses, respectively, are very significant components of the underlying investment thesis (more so for Amazon and Microsoft). Collectively, these businesses have dominant share in the global public cloud market (excluding China). While the law of large numbers is slowing absolute growth rates, they are still expected to increase revenue at a mid 20s percent compound growth rate, while generating strong margins (GCP is still investing heavily in growth constraining near term margins) and generating extremely attractive returns on existing capital invested in their business, and additional capital expenditure to support this growth.

Figure 14: Cloud revenue of AWS, Azure and GCP



Source: Company reports and L1 Capital International.

Nothing about the recent market volatility suggests to us that the **long-term drive to the cloud** will reverse. Nor do we believe that the increasing prevalence of digital technologies and the advantage that the cloud offers in terms of superior analytics and security, faster and more flexible deployments and lower maintenance will suddenly come to an end because interest rates have increased to more normal levels.

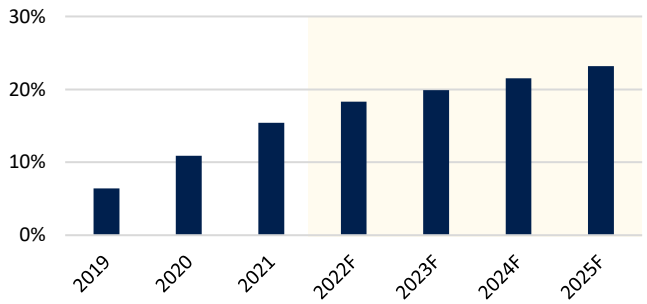
Semiconductors

Consistent with our view that the cloud will be a long-term, secular grower, we took the opportunity to transition our investment in **Texas Instruments** to **Advanced Micro Devices** (AMD). We also used some of the proceeds from the sale of TSMC to take advantage of the market volatility, adding to the AMD position at attractive prices.

AMD is an increasingly strong number two player in several very attractive oligopolies, its key market being the cloud data centres. The company also has significant exposure to the gaming markets through its graphics processing units (GPU) and to the laptop and desktop markets through its central processing units (CPU). The share price has been weak the last few months as a result of the general decrease in the market's valuation of higher growth technology companies and more recently as a result of fresh concerns that the personal computer (PC) market may decline moderately this year and next.

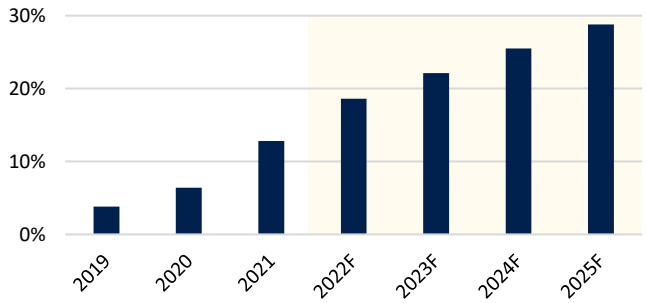
Our base case assumes the PC market (laptops and desktops) does decline moderately over the next 2 years following elevated demand during the COVID-19 period. However, the AMD thesis is not built upon timing the PC cycle. It is built upon AMD's continued innovation and resultant share gain as well as its exposure to other large and growing markets. AMD's strength in the **datacentre** is compounding concurrent with the datacentre market rapidly expanding.

Figure 15: AMD Notebook Market Share



Source: Company reports and L1 Capital International.

Figure 16: AMD Datacentre Market Share



Source: Company reports and L1 Capital International.

And as regards the **gaming** markets, AMD is the sole-source provider of the GPU and CPU to both the Playstation 5 and Xbox Series X, both of which have been consistently sold out. AMD's gaming business is supply constrained, not demand limited.

We also like that AMD management is focused on the long-term success of the business while taking advantage of near-term opportunities. Just in the last two months, the company has closed on the transformative acquisition of Xilinx and announced the tuck-in acquisition of Pensando. The former gives AMD the leading position in FPGAs globally – technology critical to datacentre, automotive and industrial markets – the latter completes AMD's portfolio of solutions in the datacentre, giving it a truly world-class and unmatched set of go-to-market capabilities.

Like us, management also sees the current share price as undervaluing the business and has begun using their accelerating free cash flow generation to purchase more of their own shares, as indicated by their recently announced $8 billion share repurchase plan – double the authorisation announced less than one year ago.

Other portfolio implications

The technology companies in our portfolio are some of the best and most important companies in the world and we expect they will compound shareholder value for many years to come. From small and medium businesses, to individuals, to large and global enterprises, our companies are digitising the world and ushering in productivity and efficiency on a scale previously unimaginable.

They are doing this while generating consistent growth, free cash flow and high returns on invested capital. We have judiciously added to portfolio investments in **Intuit** and **Adobe**, taking advantage of the recent derating of the sector, and in the case of Adobe, an over-reaction to a genuine but modest softening in growth expectations.

Outlook

Despite recent negative share price performance for some portfolio holdings, we are particularly positive about the current valuations of, and longer-term outlook for, the businesses in our portfolio. Even with the worries we have highlighted, we remain confident and excited about the opportunities for the Fund.

L1 Capital International Fund

Quarterly Report | MARCH 2022

Fund Information

Name	L1 Capital International Fund
Portfolio Management	David Steinthal, Chief Investment Officer
Types of investments	Listed securities globally. Developed market focus. No shorting, no leverage
Number of investments	20 to 40
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*
High Watermark	Yes
APIR / ISIN	ETL1954AU / AU60ETL19543
Platform Availability	Hub24, Macquarie Wrap, Mason Stevens, Netwealth, AMP North, Powerwrap, Praemium

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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. 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 with offices in Melbourne, Sydney, Miami and London. The business was established in 2007 and is 100% owned by its senior staff, led by founders Raphael Lamm and Mark Landau. L1 Capital's clients include large superannuation funds, pension funds, asset consultants, financial planning groups, family offices, high net worth individuals and retail investors. Additional information on L1 Capital is available at **www.L1.com.au**.

Key service providers for the Fund are: Responsible Entity – Equity Trustees Limited, Fund Administrator and Fund Custodian – Mainstream Fund Services, Fund Auditor – EY, Legal Advisor – Hall & Wilcox. There have been no changes to key service providers since the last quarterly report.

* There must be positive absolute performance (adjusted for distributions) in the performance period. Otherwise, positive relative performance carries forward to next Period.