L1 Capital International Fund

Quarterly Report | JUNE 2022

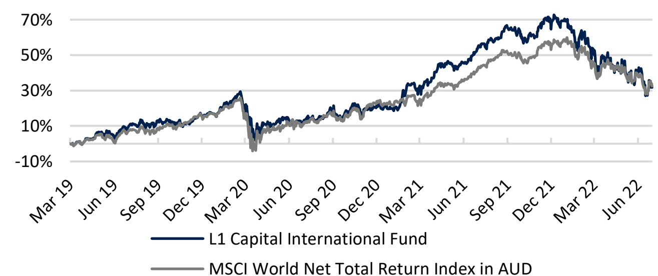
Introduction

In this June 2022 Quarterly Report, we have outlined:

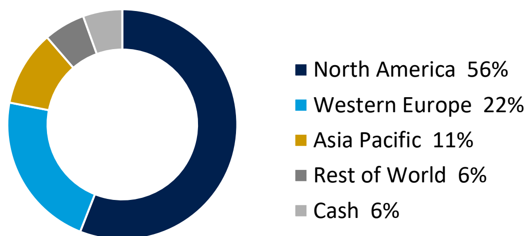
- **Perspectives on the current investment environment, which is being driven by macroeconomic factors and geopolitics rather than company-specific considerations, creating compelling investment opportunities for long-term investors. Business selection has become critically important.**
- **Our review of the last quarter, including key contributors and detractors to the Fund's performance.**
- **Current portfolio positioning and recent adjustments.**
- **The investment thesis for the top 12 Fund holdings, providing detailed transparency into our high level of conviction in the current portfolio of businesses.**

Fund Performance (Net) (%)[1]	Fund	Index[2]	Alpha
3 months	(10.1)	(8.5)	(1.6)
1 year	(14.2)	(6.5)	(7.8)
3 years p.a.	6.7	7.7	(1.0)
Since inception p.a.	8.6	8.8	(0.2)
Since inception cumulative	31.7	32.5	(0.8)

Fund (Net) Benchmark Returns Since Inception[1]



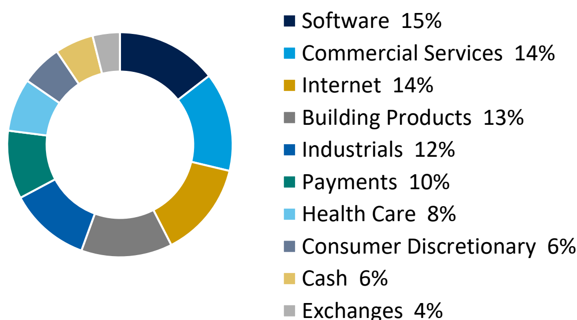
Revenue Exposure by Region[3]



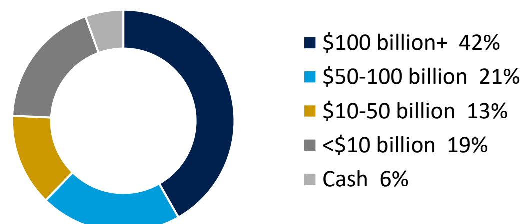
Top 10 Holdings (In Alphabetical Order)

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

Sector Exposure[4]



Market Capitalisation Exposure



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.

Current investment environment

"...the crisis won't pass in a few months" because Russia's war in Ukraine "has changed everything and supply chains are still disrupted by the pandemic."

– Germany's Chancellor Olaf Scholz on 4 July 2022 in reference to Germany's economic challenges

Macroeconomic and geopolitical environment driving capital flows, creating investment opportunities

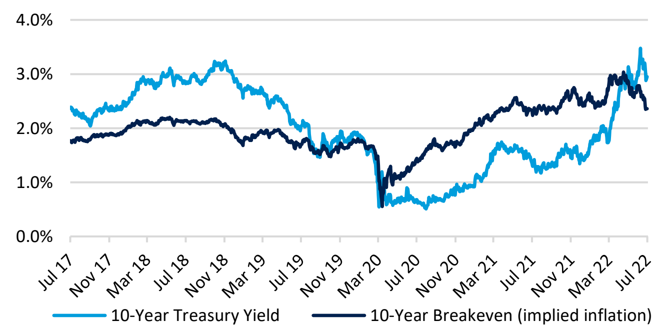
2022 has been a year driven by macroeconomic issues and geopolitics. The war in Ukraine has pressured energy and food markets, adding fire to inflationary pressures. Supply chains remain disrupted by COVID-19 ramifications, particularly in China.

While many of the inflationary pressures can be sourced to supply constraints, central banks around the world are responding to inflation the only way they can – by increasing interest rates with the blunt aim of reducing demand. Early signs are that the intended consequences are ensuing, with investor concerns switching from rampant inflation to reduced demand and expectations for a recessionary environment.

We are not brave enough to claim developed countries are at 'peak inflation', but there are many indications we are there or thereabouts. U.S. Treasury yields have fallen from recent highs and the market's implied average 10-year inflation expectation has fallen from over 3% to under 2.5% (see Figure 1). Examples where prices are already substantially below recent peaks include:

- Many metals,
- Soft commodities such as wheat and palm oil,
- Lumber and oriented strand board,
- Select semiconductor products, and
- Freight.

Figure 1: U.S. 10-year Treasury Yield and inflation expectations



Source: Bloomberg.

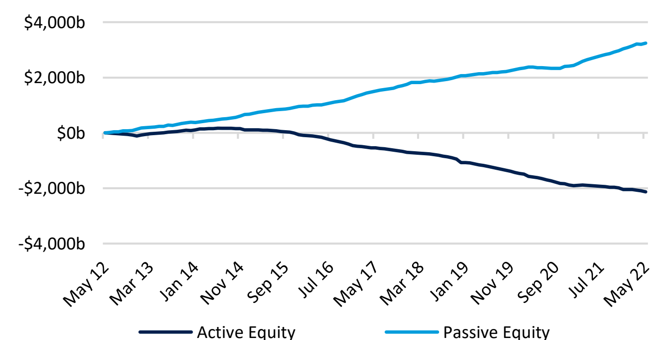
We expect pressure on automotive and U.S. house prices to increase in the short to medium term.

The wildcard is energy, which will be driven by geopolitics as well as economics. Deteriorating economic conditions are normally negative for oil and metal demand, and their prices. The copper price is responding normally (down). However, we are not in normal times, and we cannot rule out a major oil and or gas price spike, even from current elevated levels. While the portfolio has limited energy intensive exposure, further spikes in energy (and/or restrictions on the availability of energy) would be materially negative for most companies and equity markets in general.

Rent, a key component of the Consumer Price Index (inflation), is also less predictable, particularly based on the way it is assessed for Government reporting purposes, which could add to near term reported inflation.

Passive equity flows continue to dominate markets (see Figure 2). These flows in and out of the market have no regard to individual business issues or valuation considerations. While not a new phenomenon, we believe the increased prevalence of passive capital flows, particularly when the market is in a state of flux caused by volatile macroeconomic and geopolitical considerations, is leading to shares of high-quality businesses being sold solely due to passive/index flows, creating compelling investment opportunities for longer-term, fundamentals-based investors.

Figure 2: Cumulative U.S. Net Inflows



Source: BofA Global Research, L1 Capital International.

Challenging market conditions will lead to divergence of business performance

"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets." **— Peter Lynch**

"… none of us here are trying to forecast macro... As a percentage of GDP, tech spend is, on a secular basis, by the end of the decade, going to double. We just want to keep driving usage, driving share and be competitive. So that's kind of how we view what we are doing, and that's where our confidence comes from in terms of our outlays, whether it's OpEx [operating expenditure] or CapEx [capital expenditure]."

– Satya Nadella (Microsoft Chairman and CEO), 26 April 2022

The current market correction has not occurred in a vacuum and without reason:

- Operating conditions are more challenging for almost all businesses.
- Inflation, whether or not it has peaked, remains high.
- Monetary policy globally is less supportive of growth and asset values.
- Consumers are under financial pressure and sentiment has deteriorated.

Unfortunately, there is no end in sight to the Ukraine war and the economic fall-out is broadening. COVID-19 has not gone away, which has economic implications that extend beyond China's hard lockdown approach to containment.

There have been multiple examples of increased taxation on companies around the world. We expect this trend to continue – Governments need revenue to pay for some of the fiscal stimulus provided to offset the damage caused by COVID-19, and now face economies that are under pressure and potentially contracting.

Market expectations for company profits at a holistic level, remain too high. We have written extensively how we **expect company margins to come under pressure, and only a select group of high-quality businesses will have sufficient pricing power** to offset inflationary pressures, maintain margins and market share**.**

We have already seen a number of companies report revenue in line with expectations but deliver disappointing margins and profitability. We anticipate this is just the start, and most companies are going to reduce earnings guidance, with market earnings forecasts needing to reset materially lower. We therefore caution placing too much reliance on commentators referencing 'market multiples' and concluding 'the market' is appropriately valued or a buying opportunity. Rather, **business selection is going to be of critical importance**.

Outlook

No business is immune to macroeconomic conditions and the effects of the dramatic shift in monetary policy globally. However, quality management teams do not try to predict the macroeconomic environment and manage their business based on this forecast. Rather they respond and adjust to the macroeconomic environment. **The businesses in our portfolio benefit from long-term growth drivers, operating in well-structured industries, holding leading market positions with rational competitors and high barriers to increased competition, experienced and aligned management, robust earnings, cashflow and balance sheets, high returns on capital and favourable ESG policies and trends.** They are well positioned to manage the current challenges and deliver strong investment returns to shareholders over our investment horizon.

June 2022 Quarterly Review

Performance

The L1 Capital International Fund returned -10.1% (net of fees) during the June 2022 quarter compared to the benchmark return of -8.5%. The Australian dollar depreciated 8.2% against the U.S. dollar and 1.9% against the Euro, adding to Fund and benchmark Australian dollar reported returns.

Key contributors and detractors

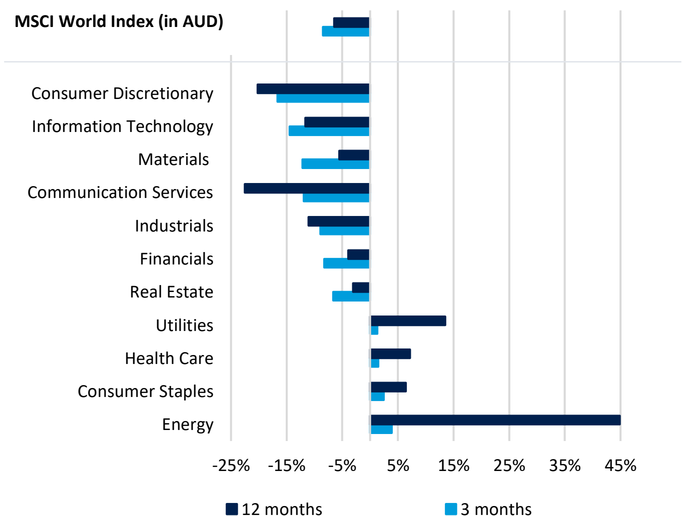
As at 30 June 2022, the portfolio consisted of 20 companies, with the top 10 holdings accounting for 61.1% of the portfolio.

During 2022, equity markets have rapidly shifted from TINA (There Is No Alternative) or indiscriminate buying of companies with limited regard to valuation, to a 'risk-off' environment where shares in companies are sold, again with limited regard to valuation.

Only energy-related companies (until recently) have performed strongly due to the disruption to oil and gas markets and a spike in prices caused by Russia's invasion of Ukraine, while Consumer Staples and Utilities also provided safety in uncertain times, albeit at the cost of relatively high valuations (see Figure 3). The Fund's lack of exposure to these sectors contributed to our short term negative relative performance compared to the Fund's benchmark.

In terms of short-term performance, the Fund had a difficult quarter. However, with a couple of exceptions, the businesses in our portfolio continue to perform broadly in line with our base case expectations. The businesses we have invested in are not immune to the deteriorating macroeconomic environment, and rising interest rates are negative not only for asset values but also, in some instances, operational performance (e.g., new residential construction and capital markets exposed businesses in the portfolio). **We strongly believe share prices are overly reflecting near-term challenges and our portfolio of companies are now meaningfully undervalued.**

Figure 3: MSCI World Index (in AUD) – Sector Performance



Source: Bloomberg.

During the quarter, eight companies detracted more than 0.5% from the Fund's performance in Australian dollars. Five companies made a positive contribution to the Fund's quarterly performance in Australian dollars, with **Graphic Packaging** positively contributing more than 0.5%.

Negative share price performance in the portfolio was widespread across industry sectors, size and quality ranking of the business. This correlates with our view that recent equity market performance has been driven by macroeconomic and geopolitical factors and large passive flows, rather than bottom-up, company-specific business considerations.

Amazon.com (Amazon) was the largest negative contributor to the Fund during the quarter. Q1 2022 results and Q2 2022 profit guidance were below market expectations. Amazon has been operating in an extraordinary environment since the start of the COVID-19 pandemic. Lockdowns led to an exceptionally rapid shift in retail activity online and Amazon benefitted from a dramatic increase in revenue. Management responded by doubling fulfilment and logistics capacities over a 2-year period – a response which has proven to be somewhat excessive.

Too much capacity, combined with elevated shipping and logistics costs, employee inefficiencies and a resetting of higher share-based compensation have pressured near-term profitability of Amazon's retail (non-Amazon Web Services) operations. Management changes have exacerbated market uncertainty. We consider these issues to be real and negative to valuation, but somewhat transitory and more than reflected in Amazon's current share price. Meanwhile Amazon Web Services (AWS) continues to deliver strong, profitable growth, ahead of our base case. **In our view, AWS now accounts for the majority of Amazon's share price. Amazon offers compelling value at today's share price, with our investment thesis discussed in more detail on page 8.**

While it seems an eternity ago, in April **Netflix** reported Q1 2022 results and gave forward guidance which flashed many red flags. Not only were subscription numbers (and forward guidance) well below expectations, but management also gave new disclosure on the massive extent of password sharing which raises concerns that Netflix is much more mature than we had previously considered, constraining future growth. Management also haphazardly announced it will introduce an advertising-supported subscription tier, albeit currently lacking the necessary capabilities to do so. Despite continuing to produce world-leading content, we have lost confidence in management's ability to respond to increased competition and a more challenging operating environment. We sold our entire investment in Netflix immediately post Q1 2022 results. Currently we do not consider Netflix to meet our stringent quality criteria to be considered as a potential investment in the Fund.

Portfolio adjustments

"Buy low sell high, not buy lowest sell highest."

– L1 Capital International

At times like this most fund managers or financial advisors pull out the classic investing adages such as "it is not about timing the market, but time in the market" and the importance of a **long-term investment horizon**. We are no different and consider the increasing short-term focus of many market participants creates opportunities for genuine longer-term investors.

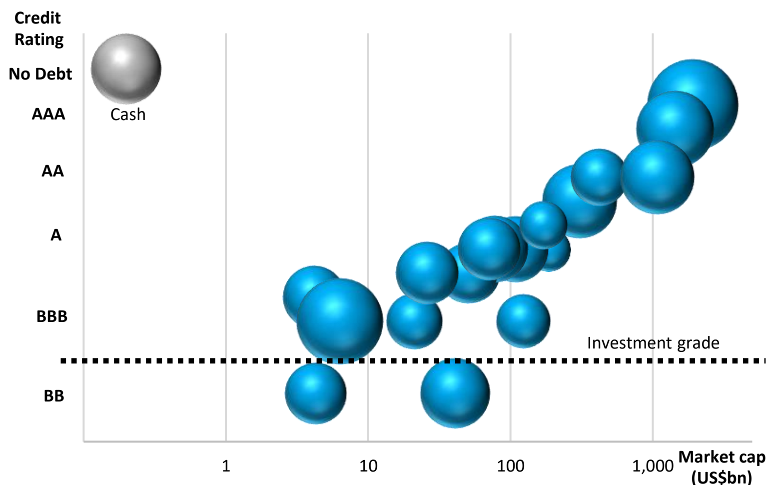
However, **time is not the answer to all problems**. If you are mortally wounded, time is not going to lead to your salvation. As Warren Buffett said over 30 years ago, "**Time is the friend of the wonderful business, the enemy of the mediocre**". The bursting of the 'TINA bubble' has exposed many weak business models. The companies may not die, but the prospects of their share price recovering to prior highs are slim at best.

We believe our **portfolio of high-quality businesses is well positioned over the medium to long term**. **Therefore, adjustments to the portfolio during the quarter were relatively modest.** That does not mean we have been inactive in our assessment of our businesses, nor have we concluded the operating environment is unaffected – for most companies it has deteriorated, sometimes meaningfully.

We have reassessed every company against our quality criteria and in light of a more challenging macroeconomic and higher interest rate environment. In most instances we have modestly lowered our base case valuation range. For some businesses like Graphic Packaging, there have been no adjustments. Overall, we have consolidated the portfolio into our 20 highest conviction investments.

We continue to place high importance on businesses with modest financial leverage and robust, dependable cashflows. The vast majority of the companies in our portfolio have an investment grade debt rating and the portfolio includes some of the financially strongest businesses in the world (see Figure 4).

Figure 4: Credit rating (size of bubble = portfolio weight)



Source: L1 Capital International as at 30 Jun 2022. Note: One portfolio investment has modest debt, no net debt (cash greater than debt outstanding) and does not have a credit rating.

Within the top holdings we trimmed our investment in **Louisiana Pacific** at a share price much higher than today's. We retain high confidence in the long-term potential of Louisiana Pacific's Smartside business (see page 10) but trimmed the holding to reduce the portfolio's exposure to U.S. new residential construction. Louisiana Pacific remains a mid-sized position just outside the top 10 and we consider the current share price offers compelling value.

We selectively added to a few mid-sized positions, particularly **Intuit** and **Booking** at prices we consider to be well below fair value. Intuit entered the top 10 holdings and Booking is just outside. The investment thesis for each company is summarised briefly on page 11 and page 8, respectively, of this report.

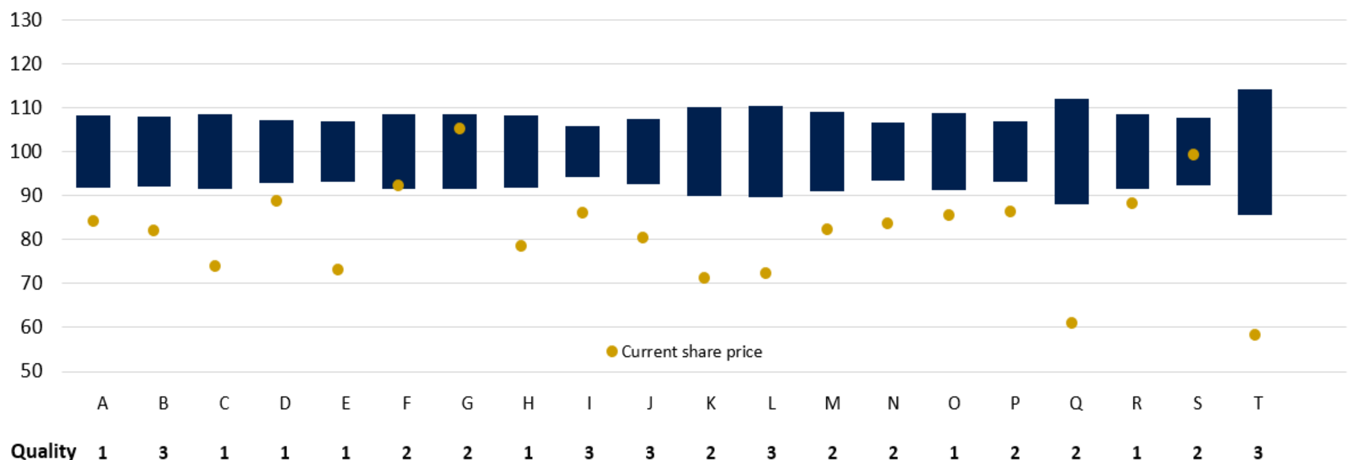
Our technology investments are in some of the largest, most financially strong companies globally. We have watched from the side lines as the share prices of many 'Growth' companies reached levels that could not be supported by any rational valuation analysis. This valuation bubble, particularly for unprofitable technology companies, has well and truly popped. However, alongside this justified resetting of expectations, the share prices of the companies in the Fund have fallen well below fair value. While many technology companies are reducing headcount and costs, our companies are continuing to invest in their business and attract and retain the best employees by increasing compensation. **Bigger does not always equal better, but simplistically in the case of Alphabet, Amazon and Microsoft it does**. While not at the same scale, **Adobe** and **Intuit** dominate their markets, continue to have very favourable growth prospects and are now trading at much more attractive valuations.

Given the deteriorating macroeconomic environment, we deliberately **reduced the Fund's exposure to consumer discretionary businesses**, with total exposure to this sector reducing from 15% (31 March 2021) to 6% (30 June 2022). This included the divestment of Netflix and the increased investment in Booking. While travel is discretionary, we believe people's desire to travel again will more than offset economic pressures. **We have increased exposure to the more defensive Health Care sector** to 8% from 5% during the quarter. The recent market correction has created the opportunity to make an initial investment in a high-quality health care related business at around the bottom end of our assessed fair value range. This investment highlights the importance of our ready to go 'Bench' of potential investments.

Cash increased to 6% from 2% during the quarter. This should not be interpreted as a desire to increase the Fund's cash weighting, but rather reflects modest portfolio changes towards the end of the quarter. We see compelling value in our portfolio of businesses and several companies on our Bench are approaching our initial buy price.

Everybody knows the **oldest adage in investing – "buy low, sell high"**. Yet most people do not follow this simple advice. They interpret it as "buy lowest, sell highest". **Usually this results in actual investment behaviour of not buying low and not selling high**. **We cannot say the market has bottomed – no-one can. However, in our view we can say that current share prices for our portfolio of businesses are low and are below fair value, offering very favourable risk adjusted returns** (see Figure 5).

Figure 5: L1 Capital International assessed valuation range vs current share price (in order of position size)



Source: L1 Capital International as at 30 June 2022.

Current portfolio investments

At L1 Capital International we fundamentally believe in transparency and alignment. Our personal capital is invested alongside yours and that of your clients. In these times of adverse equity market conditions and falling share prices we believe it is of even greater importance to clearly outline why we believe **our detailed investment process has ensured we have invested in high quality businesses with strong medium to long term businesses prospects in a range of macroeconomic and operating environments**.

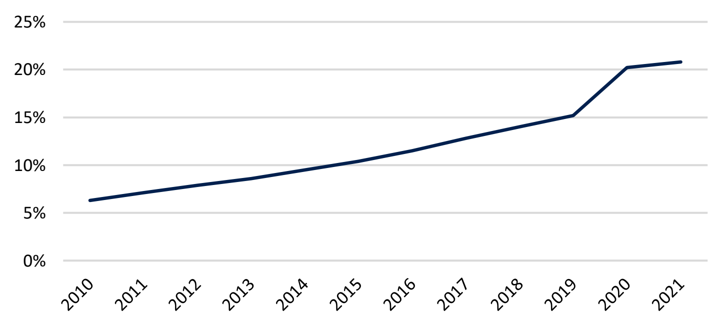
In this section we have briefly outlined the investment thesis and our valuation perspectives for the 12 largest holdings (in alphabetical order), representing 70% of the total portfolio. **Having conviction in a business does not mean everything is perfect all the time.** Some of our investments have near term challenges. However, we believe all these companies offer attractive risk adjusted returns at current share prices and in some instances provide a compelling investment opportunity.

Alphabet (Google)

Alphabet is by far the largest online advertising business globally, dominating Search outside of China and other protected markets. Online advertising is driven by eCommerce – not just buying online, but also omnichannel (for example, searching for a product online and then buying it instore).

Retail sales have consistently shifted online. Historically, eCommerce has increased its penetration of adjusted total U.S. retail sales by around 1% per annum. However, due to COVID-19 and associated lockdowns, eCommerce penetration stepped up by 5% in 2020 and now accounts for over 20% of adjusted retail sales (excluding food services, automotive and gas stations), up from 6% in 2010 (see Figure 6).

Figure 6: eCommerce penetration of adjusted U.S. retail sales



Source: U.S. Department of Commerce, J.P. Morgan Equities Research.

Alphabet has been a major beneficiary of COVID-19, with its advertising revenue increasing 43% to nearly US$210 billion in 2021. Naturally this level of growth is unsustainable particularly in a worsening macroeconomic environment and some retail activity is shifting back offline as people are less restricted by COVID-19. However, the established trend of increasing eCommerce penetration will not reverse, and we expect Alphabet's advertising revenue to continue to increase, albeit after a period of muted growth in 2022 and 2023. There are also bright spots for Alphabet such as travel advertising, which is recovering strongly post COVID-19.

Alphabet is also one of the global leaders in artificial intelligence, machine learning, autonomous vehicles and the third largest Cloud business outside of China. Alphabet has been investing billions of dollars every year in its **Other Bets** for many years – an investment we are effectively valuing at cost yet could be the start of the **next big investment opportunity**.

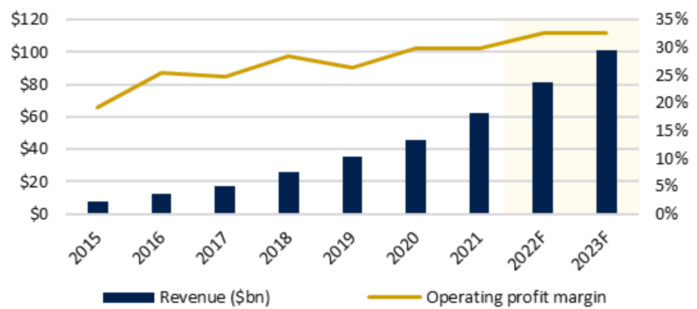
We expect to see continued revenue and earnings downgrades by market participants as expectations for Alphabet's financial performance adjust to a more challenging economic environment. However, the share price of Alphabet has already more than compensated for the near-term challenges and an irrational focus on slowing near term growth, now trading on a forward PE of around 20x and a free cashflow yield of around 4.5%, excluding the investment in Alphabet's 'Other Bets'.

We consider these valuation metrics to be exceptionally attractive for a business with Alphabet's dominant market position, minimal competition, long-term growth prospects and a balance sheet with well over US$100 billion of net cash.

Amazon.com (Amazon)

To describe our perspectives on Amazon we are reminded of the opening line in *A Tale of Two Cities* by Charles Dickens – "***It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness***...". In our tale, one city is **Amazon Web Services (AWS)**, while the other is everything else, which we will refer to as **Retail and Other**.

Figure 7: AWS Revenue and Operating Profit margin

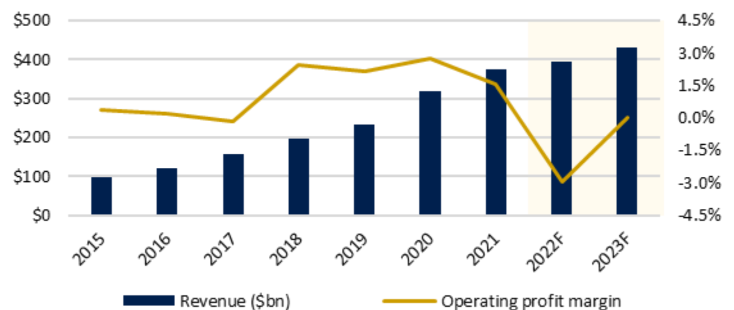


Source: Company reports and L1 Capital International.

Times are good for AWS. The clear leader in the provision of cloud services outside of China, with only one substantive non-Chinese competitor, Microsoft. It is hard to fault AWS's historical performance, with revenue increasing from US$8 billion in 2015 to an expected US$80 billion plus in 2022, while expanding operating profit margins to well over 30% (see Figure 7). AWS provides an extremely rare combination of a global leader in a well-structured industry with immense long-term growth potential, strong profitability and an opportunity to invest large amounts of capital organically at high rates of incremental returns. **Put simply, we view AWS as one of the very best, highest-quality businesses globally.**

The investment considerations for Amazon's Retail and Other operations are more complex. As outlined earlier, despite astonishing growth in revenue, the profitability of Amazon's retail operations has been impacted by increased costs and inefficiencies (see Figure 8). We expect costs to remain elevated while revenue growth slows dramatically as Amazon cycles the exceptional COVID-19 period.

Figure 8: Retail and Other Revenue and Operating Profit margin



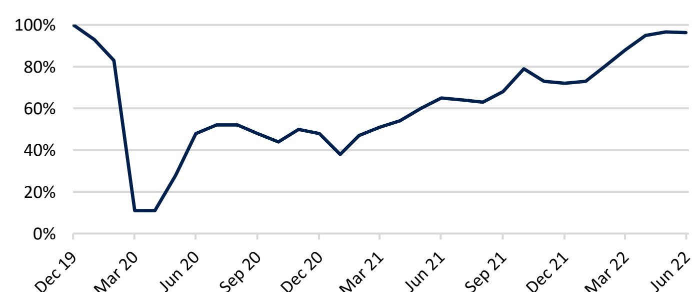
Source: Company reports and L1 Capital International.

Yet if one steps back to look at the business with a broader perspective, Amazon's Retail and Other operations consist of a retail business which accounts for over 40% of eCommerce sales in the U.S. and the leader in many international markets outside of China, an unrivalled fulfilment network, a shipping network which now challenges industry pure play businesses, a Prime subscription business with around 100 million members generating around US$35 billion of subscription revenue, and the third largest online advertising business outside of China generating advertising revenue also of around US$35 billion. Major shipping and logistics businesses such as Fedex and UPS are soundly profitable, major retailers such as Walmart and Target are profitable (albeit also under pressure), the leading online advertising businesses, Alphabet and Meta, are exceptionally profitable – yet taken as a whole, Amazon's Retail and Other operations are loss-making. **We do not expect this situation to persist, although a strong increase in reported profitability for Retail and Other will take time.**

Booking Holdings (Booking)

We have been increasing our investment in Booking which now lies on the edge of the top 10 holdings. The investment thesis for Booking, **the world's largest online travel agent (OTA)**, was outlined in our inaugural **June 2019 Quarterly Report**. Back then, no-one could have envisaged the subsequent disruption to the travel industry caused by COVID-19. Today the world, outside of China, has adjusted to COVID-19 and life has largely returned to normal. Travel is rapidly normalising with domestic travel ahead of 2019 levels and international travel recovering strongly (see Figure 9).

Figure 9: Global hotel reservations volumes vs. 2019 levels



Source: Siteminder.

Yet Booking's share price is lower than where it was trading post the onslaught of COVID-19 and pre the widespread approval of vaccines. Yes, travel is discretionary, and yes more challenging economic conditions and higher fuel costs will have a negative impact on the travel industry. However, **we consider travel activity recovering to prior trend levels is a question of when, not if.** Consumers will adapt to economic circumstances – travelling to cheaper destinations, going on holiday for a shorter period or staying at a lower cost hotel, but we still expect travel activity to rapidly recover.

Post COVID-19, Booking is a stronger business. Many competitors, particularly small travel agents, have not survived the downturn. Hotels are increasingly reliant on Booking to source customers, and Booking has continued to invest, expanding its range of products and services and breadth of accommodation options, leading to **market share gains**.

Booking is another example of a company in our portfolio with leading market share in a well-structured, growing industry, strongly profitable with net cash on its balance sheet.

Short term earnings are hard to predict given the volatility in travel market conditions and some near term softening of travel intentions is expected. We assess Booking to be trading on well under 20x the EPS earnings power of the business, or over a 5% free cashflow yield, well below levels we consider to be fair value for this high quality, well-managed business.

Building Materials – CRH, Eagle Materials and Louisiana Pacific

We have written extensively on the Fund's building products exposure, most recently in the **March 2022 Quarterly Report**. We have invested in three businesses, CRH, Eagle Materials and Louisiana Pacific, collectively accounting for a 13% weight in the Fund. Approximately 12% of this exposure is to the North American region and 1% to Europe. Within North America, new residential construction accounts for around 4% exposure, with the balance split between repair and renovation, and infrastructure construction, and a smaller exposure to commercial construction.

The share price for all three companies has fallen materially recently on concerns that the U.S. housing cycle is about to crash due to rising interest rates, higher housing prices and reduced affordability. **We agree that new residential construction will be under pressure and near-term headlines are likely to be ugly, but we expect both home buyers and the industry will adapt fairly quickly and the impact on our businesses will be manageable, particularly given the diversified nature of their operations.**

Short term, we expect home builders will focus on completing a record backlog of orders and limit new housing starts, while buyers will take time to adjust to higher mortgage rates, save for their deposit and await lower housing prices and mortgage rate stabilisation. Medium term we do expect new house prices to fall – builders, currently achieving exceptionally high profitability, will provide greater incentives to new buyers. The price of lumber and oriented strand board (wood product used in construction) has already crashed, singlehandedly lowering the building materials cost of a new home by over 5%.

30-year mortgage rates have increased at an unprecedented rate, from around 3.25% to 6.0%, but have since softened slightly around 5.4%. Mortgage spreads (the difference between mortgage rates and 10-year or 30-year Treasury bonds) are currently elevated and we would not be surprised to see these spreads contract over coming months and quarters. Demand for new housing in the U.S. remains strong, supported by favourable demographics and 15 years of structural underbuilding. **Prior to the current mortgage rate increases, the industry could not meet demand** and activity was only at mid cycle-levels**.** Credit availability has been relatively tight. The current situation is nothing like the environment which led to the housing market crash during the Global Financial Crisis.

Much has been written about the rapid fall in affordability of new homes and the headlines are largely true. However, as illustrated in Figure 10 a 10% fall in new home prices combined with a modest pullback in mortgage rates and some wages growth goes a long way to offsetting affordability pressures.

Figure 10: Home prices and mortgage rates

Home price	$500,000	$450,000
Deposit	$100,000	$100,000
30-year mortgage rate	3.25%	5.00%
Monthly repayment	$2,135	$2,240

Source: Bankrate and L1 Capital International.

CRH

CRH was outlined in detail in our **December 2021 Quarterly Report**. Since then, the tragic war in Ukraine commenced with no signs of resolution. This war and associated sanctions on Russia have led to major disruptions to European energy markets. CRH is a relatively energy intensive business and around 20% of the Group's operations are in Europe. We expect they will be negatively impacted by higher energy prices and reduced economic activity. Around 75% of CRH's operations are in North America and will be less impacted compared to the European operations.

We have followed and analysed the global building products industry for nearly 25 years and **the current share price of CRH presents an investment opportunity that rarely arises**. CRH recently sold a business for US$3.8 billion, equating to almost 15x EBIT. In comparison, the remainder of CRH which consists of many businesses which are higher quality than the divested operation, is trading on around 9x EBIT, 11x PE, 9% free cashflow, 4% dividend yield and CRH is buying back around 3% of its shares annually. **CRH has delivered shareholders a 15% return per annum, compounded over 50 years. The current share price provides compelling value for investors with a longer-term horizon.**

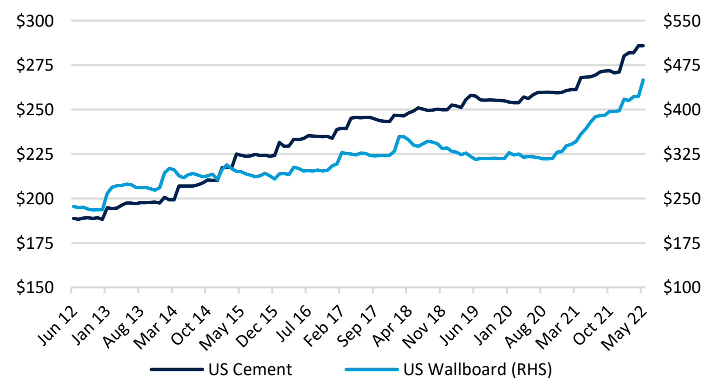
Eagle Materials

The investment thesis for Eagle Materials was featured in our **December 2020 Quarterly Report**. Since then, the business has met our expectations. Eagle Materials is a low-cost regional producer of cement and wallboard. The U.S. cement industry is sold out, with imports required to meet demand levels. Eagle Materials operates in the centre of the U.S. where imports from the coast are prohibitively expensive. These sold-out conditions are before an expected increase in demand in 2023 and beyond as the U.S. implements its **US$1 trillion infrastructure spending program.**

Eagle Materials' wallboard operations also have a cost advantage over its competitors, predominantly using natural gypsum located next to its manufacturing facilities, rather than relying on more expensive synthetic gypsum derived from the waste generate by coal power plants or imported natural gypsum.

Both the cement and gypsum industry have increased prices to offset cost inflation (see Figure 11). Eagle Materials has benefitted from these price increases and expanded margins due to its low-cost position in the industry. While we expect some softening in the wallboard industry due to reduced new residential **construction, we consider Eagle Materials is currently materially undervalued, trading on 11x EV/EBIT, 12x PE and a 10% free cashflow yield.**

Figure 11: U.S. cement and wallboard prices



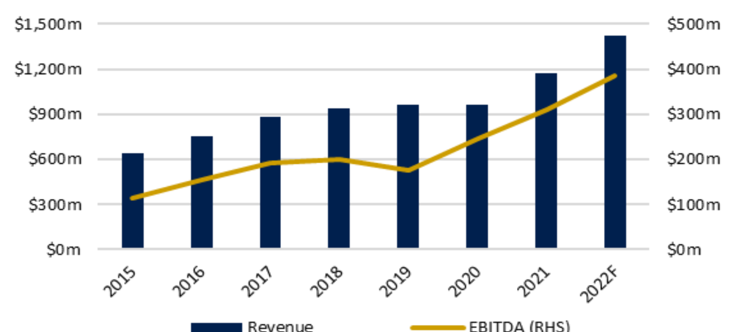
Source: ***U.S. Bureau of Labor Statistics.***

Louisiana Pacific

We have invested in Louisiana Pacific due to its Smartside siding business. Smartside has consistently increased its share of the siding market in the U.S., not just new residential construction but repair and renovation, shed and other markets. **Louisiana Pacific has not been able to keep up with demand for Smartside and is sold out to the end of 2022**. New capacity is being added currently which will support future growth.

Between 2015 to 2022, Smartside EBITDA increased from around US$100 million to a run-rate approaching US$400 million. We believe Smartside has many years of strongly profitable growth to come (see Figure 12).

Figure 12: Smartside Revenue and EBITDA



Source: Louisiana Pacific and L1 Capital International.

Imagine being offered to buy a business. This business is breakeven in a down year, makes an operating profit of a few hundred million dollars in a normal year, and in an exceptional period in 2021 made around US$1.5 billion profit. **The person offers to sell you the business for nothing. This is the current investment opportunity for Louisiana Pacific**. In addition to owning Smartside, it also owns the second largest oriented strand board business in North America and a successful woods product business in South America. The price of OSB is exceptionally volatile, but has recently delivered super-normal profits to Louisiana Pacific, enabling management to buy back 45% of shares on issue while maintaining net cash. **At Louisiana Pacific's current share price, we are paying the bottom end of fair value for Smartside and getting the OSB business practically for nothing.**

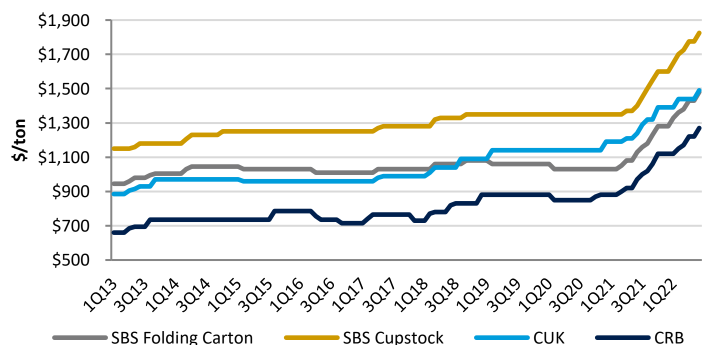
Graphic Packaging

The investment thesis for Graphic Packaging was outlined in detail in the **June 2021 Quarterly Report**. Since then, the performance of the business has been in line with or ahead of our base case, and the share price has performed well in challenging equity market conditions. Demand for Graphic Packaging's products remains steady, low single digits growth supported by a **consistent environmentally driven shift to paperboard-based packaging and away from plastic packaging**.

Even though Graphic Packaging is relatively low growth, it still meets all our criteria for a high-quality business – long term positive business drivers, leader in a well-structured industry with rational competitors and barriers to increased competition, experienced and aligned management and favourable financial metrics. Financial leverage is relatively high but is reducing as strong free cashflow is allocated to debt repayment. One of the central criteria we look for in the businesses we invest in is **pricing power**. **Graphic Packaging has demonstrated the ability to increase the price for its products to offset cost pressures, without reducing demand or losing market share** (see Figure 13).

Despite strong absolute and relative share price performance, **Graphic Packaging still only trades on a forward PE of 10x and 9% free cashflow yield**, highly attractive given the dependability and low macroeconomic sensitivity of this business.

Figure 13: Price of Graphic Packaging's key paperboard products



Source: RISI, Jefferies Equity Research.

Intuit

Intuit was featured in the **September 2020 Quarterly Report**. Subsequently, Intuit acquired Credit Karma (uses consumers' financial information on a consent basis to provide improved financial outcomes) which has proven to be a home run acquisition, as well as Mailchimp (marketing solutions) which is still in its early days of integration. The core Quickbooks (small business accounting software and associated ecosystem) and TurboTax (software to self-file tax returns) businesses have exceeded our base case.

The U.S. small business accounting software market opportunity is over 10x the size of the Australian market yet is around one third as penetrated, providing and immensely long runway for future growth for Quickbooks, a business with around 90% market share in the U.S. and limited credible competition. TurboTax accounts for around 30% of all tax filings in the U.S. but less than 15% of total industry revenue, supporting double digit revenue growth potential for many years to come.

The Intuit share price has been on a volatile journey, rapidly increasing from the low US$300s to more than US$700. On the way up we reduced our investment at prices above what we considered fair value. With hindsight we should have sold completely. Intuit's share price subsequently crashed along with all other technology businesses. **While some reduction in the share price is justified, Intuit has become meaningfully oversold.**

While not immune from the macroeconomic environment, the business is relatively macro-insensitive, providing essential software and services and benefitting from a high degree of recurring subscription revenue. **Intuit grew during the Global Financial Crisis and is a much stronger, more diversified business today.**

Low earnings and cashflow trading multiples do not mean a business is cheap and high multiples do not mean a business is expensive. Within our portfolio, Intuit is a higher growth, higher valuation multiple business. Not only are we extremely comfortable with the quality of Intuit's businesses, but we also believe **the duration of Intuit's growth horizon is currently undervalued**, and we have been adding to the investment with Intuit becoming a top 10 holding of the Fund.

IQVIA

IQVIA is the leading global provider of advanced analytics, technology solutions and clinical research services to the life sciences industry. Behind many of the breakthroughs in the treatment of COVID-19 you will find IQVIA. It is the largest contract research organisation (CRO) globally, planning and managing clinical trials as well as reporting on safety and efficacy in the real world following regulatory approval. **IQVIA is not the life science industry gold miner, but rather provides the 'picks and shovels' to support others discover life sciences industry gold.**

Few companies can compete with IQVIA – a proprietary database of over 1.2 billion non-identified patient records, a global healthcare IT network that receives and processes 100 billion healthcare records annually while ensuring privacy and security, combined with unique technology, data analytics and logistical capabilities managed by 80,000 employees in over 100 countries. IQVIA delivers information and insights on over 85% of the world's pharmaceuticals, as measured by global sales. Disruption risk to this highly specialised but comprehensive network is limited.

A total addressable market assessed at over US$200 billion growing mid to high single digits per annum across IQVIA's range of services ensures IQVIA has an extensive runway for growth.

IQVIA's CRO revenue backlog is over US$25 billion, while its technology and data solutions provide defensive, recurring revenue. This supports predictable and consistent growth in IQVIA's earnings and cashflow.

Biopharma budgets may come under some pressure in a more difficult economic environment, but we expect IQVIA's diverse operations will deliver **consistent, compounding growth over the long term**.

Marsh & McLennan

Marsh & McLennan is another of our **steady, compounding, 'picks and shovels' type businesses**, this time to the global insurance, reinsurance, retirement, and health benefits industries. Marsh & McLennan does not assume any insurance risk itself, but rather provides analytical and consulting services to help clients manage their risk, acting as the middle person between the client and the insurance provider.

The essential, non-discretionary nature of most of Marsh and McLennan's services means financial performance is likely to be robust in the face of challenging economic conditions. Revenue increased in 2020 despite the pressures of COVID-19 and we expect Marsh & McLennan will continue to deliver on average mid-single digit organic revenue growth in the years to come.

Marsh & McLennan operates in our favourite, 'Noah's Ark' industry structure, with only one genuine global competitor, AON. However, outside of these two global leaders (and to a lesser extent Willis Towers Watson), there remains a large tail of small regional competitors, providing opportunities for consistent market share gains, both organically and through acquisitions.

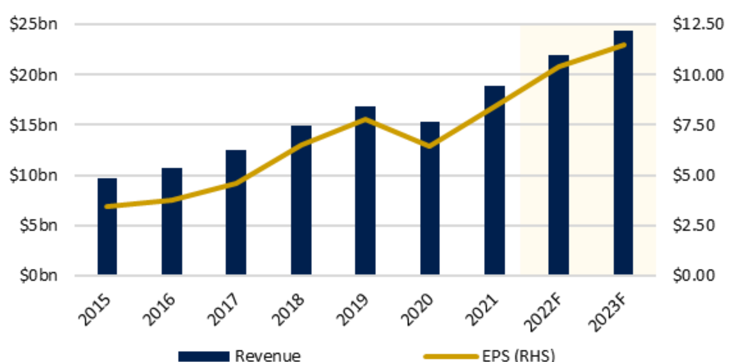
The defensive nature of Marsh & McLennan's business is recognised by other investors, with Marsh & McLennan's share price materially outperforming during the recent market correction. Most of the businesses in our portfolio are trading well below our assessed fair value range. Marsh & McLennan is trading within our fair value range but still provides a sound base case investment return given the lower risk, more defensive nature of the business.

Mastercard

Growth in electronic payments, the continued shift away from cash and cheques, and the provision of additional services such as fraud identification and prevention continue to power Mastercard's growth (Figure 14). In person cross-border transactions are recovering alongside normalisation of travel.

Mastercard and Visa (we have invested in both) continue to dominate the electronic payments industry outside of China, utilising their own multi-faceted networks as well as Government and third-party payments infrastructure to facilitate transactions. Another perfect example of a 'Noah's Ark' industry structure.

Figure 14: Mastercard revenue and EPS



Source: Company Reports and L1 Capital International.

Regulation, technological disruption and disintermediation, and geopolitical constraints are perennial issues for consideration, but Mastercard (and Visa) management have repeatedly demonstrated their ability to manage these issues.

While not inflation proof, Mastercard (and Visa) **'clip the ticket' of personal consumption expenditure**, and therefore to some extent benefit from higher prices. A challenging macroeconomic environment will lower Mastercard's growth, but **over the medium to long term it is a question of 'by how much' will Mastercard grow, rather than 'if' Mastercard will grow**.

Over the past decade, Mastercard has compounded revenue at an average growth rate of 11% and EPS has compounded at an average growth rate of 16%, while paying out almost all earnings generated over this period to shareholders through dividends and buybacks. **We view Mastercard as one of the highest quality businesses in the world**. At the current share price, we consider Mastercard remains a highly attractive opportunity for long term investors.

Microsoft

Saving the best for last, **Microsoft is the most advantageously positioned business globally for long term success**. Powered by sustained growth drivers including cloud computing, security, data analytics, collaboration, artificial intelligence, automation, business productivity, low-code programming and gaming, amongst others.

No company is 'macro immune' as Microsoft's management has recently explicitly noted, but the business is defensive.

"…I don't hear of businesses looking to their IT budgets or digital transformation projects as the place for cuts. If anything, some of these projects are the way they're going to accelerate their transformation or, for that matter, automation, for example.

I have not seen this level of demand for automation technology to improve productivity because in an inflationary environment, the only deflationary force is software."

– Satya Nadella (Microsoft Chairman and CEO), 26 April 2022

Despite its immense size, Microsoft has more than doubled revenue over the past 5 years and will approach US$200 billion in financial year 2022, while EPS will have compounded at over 20% over this period. To be clear we do not expect this rate of growth to continue, but we do expect Microsoft to deliver healthy growth in revenue, earnings and cashflow despite challenging economic conditions. Meanwhile **Microsoft retains a AAA-rated balance sheet, one of only two companies globally to hold the highest credit rating**. We expect dividends and buybacks to consistently increase as Microsoft has limited other sensible ways to deploy its excess cashflow, particularly in an environment where proposed acquisitions will be under intense regulatory scrutiny.

Having a longer-term investment horizon is an advantage when assessing a business such as Microsoft. We read far too much commentary on whether Microsoft will 'beat or miss' quarterly market expectations – referencing a few hundred million dollars in the context of a company with a US$2 trillion market valuation. Rather, from our perspective, Microsoft has so many sustained, long-term growth drivers and operational and financial competitive advantages that **further shareholder value creation is all but assured, particularly from the current share price.**

Microsoft is not a 'get rich quickly' business, but it is a genuine 'get richer over time' business.

L1 Capital International Fund

Quarterly Report | JUNE 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	Asgard, BT Panorama, Hub24, Macquarie Wrap, Mason Stevens, MLC, Netwealth, 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 report.

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

Information contained in this publication

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