

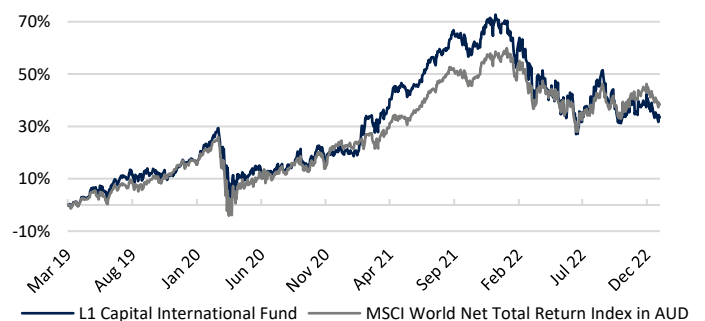
Introduction

In this December 2022 Quarterly Report, we have outlined:

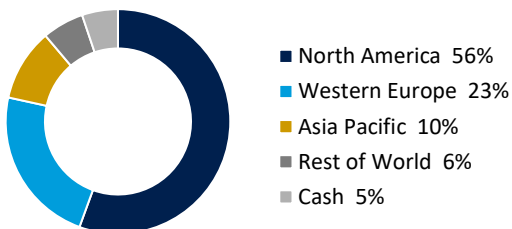
- Reflections on the 2022 macroeconomic environment and the key issues for 2023.
- Our review of the last quarter, including key contributors and detractors to the Fund's performance.
- Current portfolio positioning and recent adjustments.
- Our assessment of what is going on at Amazon.com.

Fund Performance (Net) (%) ¹	Fund	Index ²	Alpha
3 months	1.7	4.1	(2.4)
1 year	(21.1)	(12.2)	(8.9)
3 years p.a.	4.9	6.2	(1.3)
Since inception p.a.	7.8	8.8	(1.0)
Since inception cumulative	33.4	38.3	(4.9)

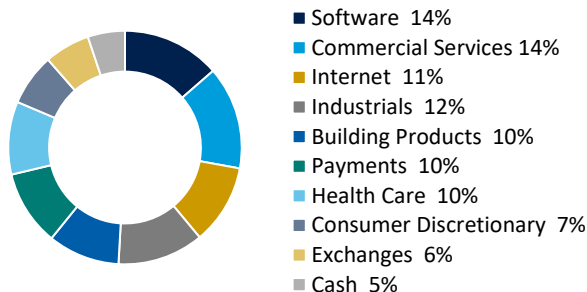
Fund (Net) Benchmark Returns Since Inception¹



Revenue Exposure by Region³



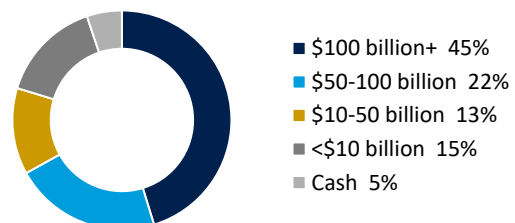
Sector Exposure⁴



Top 10 Holdings (In Alphabetical Order)

Company	Sector
Alphabet	Internet
Amazon	Consumer Discretionary / Internet
Booking	Consumer Discretionary
CRH	Building Products
Eagle Materials	Building Products
Graphic Packaging International	Industrials
Intuit	Software
Marsh & McLennan	Commercial Services
Mastercard	Payments
Microsoft	Software

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

2022 macroeconomic reflections

“History is the version of past events that people have decided to agree upon.”

– Napoleon Bonaparte

2022 was another eventful year. Russia tragically invaded Ukraine, Omicron came and went (kind of), geopolitics between China and the U.S. (and Australia) remained strained, Xi Jinping was appointed for a third 5-year term as leader of China while a lettuce outlasted Liz Truss’s U.K. Prime Ministership, politics remained in a state of flux in many countries, climate events had wide-ranging global impacts and both Queen Elizabeth II and ‘King Shane I’ passed.

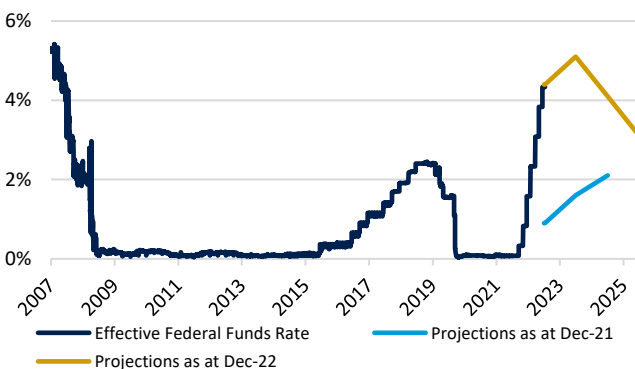
2022 **financial markets were dominated by inflation and interest rates** and **monetary policy response** by Central Banks globally. We expect **interest rates and inflation to again dominate financial markets in 2023**. While our commentary is U.S.-centric and the Fund’s greatest geographical exposure is to the U.S., most issues we discuss are prevalent in the other countries our portfolio of businesses operate in and **developed country Central Banks are all largely following the same playbook**.

Looking back to our [December 2021 Quarterly Report](#) we correctly noted “the central market debate has moved on from COVID-19 and is now firmly focused on inflation and interest rates”. We also noted “...we were surprised in 2021 by the degree of inflation, and **inflation in 2022 and beyond could also be more widespread and exceed our expectations**”. Unfortunately, these words proved to be both **correct and understated**.

One year ago, the Federal Reserve had already clearly communicated that U.S. interest rates would increase in 2022. However, we, along with the Federal Open Market Committee (FOMC) and most investors were **surprised by the rate at which interest rates increased** due to concerns about widespread, elevated and potentially persistent inflation.

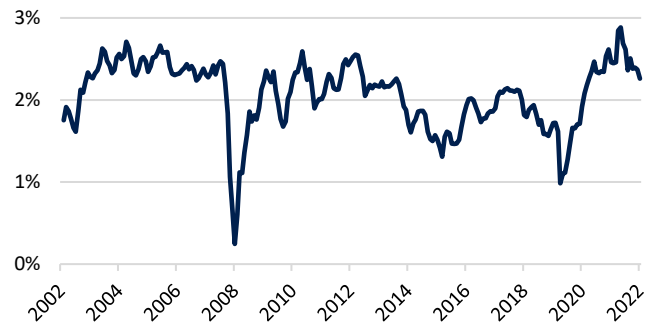
Back in December 2021, the FOMC was predicting that the Federal Reserve Funds Rate would increase to 2% in 2024. By December 2022 the Federal Reserve Fund Rate was 4.25% to 4.50% and the FOMC was predicting the Federal Reserve Funds Rate would peak at over 5% in 2023 (see Figure 1). Despite the dramatic shift in short term interest rates, and the U.S. average 10-year bond yield increasing from 1.5% to 3.9% during 2022, **market expectations for average U.S. inflation remain in the Federal Reserve targeted 2%ish range**, increasing modestly from 2.0% at the end of 2021 to 2.3% by the end of 2022 (see Figure 2).

Figure 1: Federal Reserve Funds Rate and Federal Open Market Committee rate projections



Source: St. Louis Federal Reserve Bank.

Figure 2: Market expectations remain for a sustainable 2-3% average U.S. inflation rate over the next 10 years



Source: St. Louis Federal Reserve Bank.

2023 macroeconomic outlook

So how do we reconcile a massive and unexpected increase in short term interest rates with consistent and muted long term inflation expectations? Because investors are expecting the **Federal Reserve will do what it takes** to tame inflation through tightening monetary policy and achieve its inflation policy objectives.

So why were equity markets, particularly in the U.S. and particularly for higher growth companies, under so much pressure in 2022? Because investors are expecting lower inflation is going to come at the cost of an economic recession.

The U.S. Federal Reserve and its Chair, Jay Powell, can readily be criticised for being late to recognise the inflationary environment building in 2021 as well as being late to reverse Quantitative Easing and increase interest rates. Yet Powell's communication of the Federal Reserve's thinking is clear. We recommend reading Powell's speech [Inflation and the Labor Market](#) given at the Brookings Institution on 30 November 2022. **This speech succinctly outlines the Federal Reserve's current inflation and macroeconomic expectations, and monetary policy intentions.**

Key takeaways from this speech include:

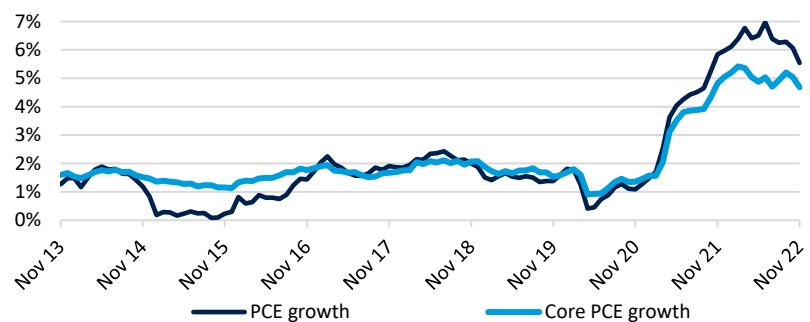
1. Powell commented "Price stability is the responsibility of the Federal Reserve and serves as the bedrock of our economy...By any standard, **inflation remains much too high...The truth is that the path ahead for inflation remains highly uncertain...ongoing increases [in interest rates] will be appropriate**...It is likely that restoring price stability will require holding policy at a restrictive level for some time. History cautions strongly against prematurely loosening policy. We will stay the cause until the job is done."

It is abundantly clear the Federal Reserve will further increase U.S. interest rates and maintain tighter monetary policy until they have confidence that inflation is heading meaningfully lower. Powell explicitly noted this will require "a **sustained period of below-trend growth**". The key debate is how much will interest rates still increase, to what extent will growth be impacted, how deep and how long will be a potential recession, and what macroeconomic environment is already reflected in the share prices.

2. Powell noted that **core PCE inflation** (which excludes food and energy-related components) "gives a more accurate indicator of where overall inflation is headed". We agree, but energy is directly and indirectly used in most products and services and energy price volatility will still be an important issue for the world going forward, particularly following Russia's invasion of Ukraine.

U.S. core PCE inflation has recently stabilised at around 5%, well above the Federal Reserve's targeted levels of around 2%.

Figure 3: Total and Core PCE inflation



Source: St. Louis Federal Reserve Bank.

3. The Federal Reserve is focused on **three key component categories of core inflation** when assessing appropriate monetary policy:

- i. **Core goods inflation** accounts for around 30% of core PCE inflation. The focus on goods inflation was the genesis of the Federal Reserve's (and our) expectation that a significant portion of the past inflation pressures would be **transitory**. We have written extensively about how goods inflation was driven by abnormal demand and supply chain disruptions caused by COVID-19. While core goods inflation peaked at higher levels (nearly 8%) and has lasted longer than expected, the supply and price growth of many goods is normalising and this component of inflation is likely in a **sustained downward trend**.

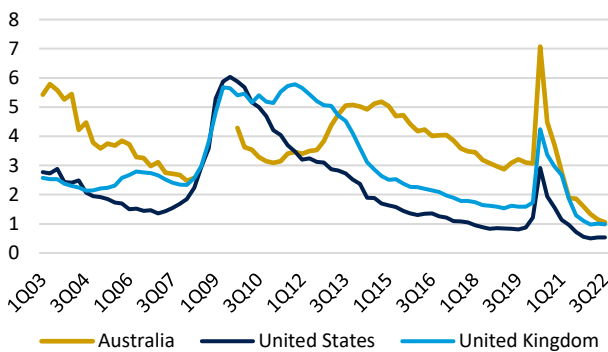
- ii. **Housing services inflation** (which measures the rise in price of rents and the rise in the rental-equivalent cost of owner-occupied housing) accounts for around 20% of core PCE inflation. This is a tricky issue to summarise briefly and its outlook depends on a range of housing-related factors. Due to the average duration of leases it tends to lag changes in other inflation price points. New leases peaked at 20% growth during the COVID-19 pandemic and have recently been trending down into the high single digits. While we don't expect rent or rental-equivalent costs to crash, the rate of growth should slow over time and contribute to lower core inflation, a view also held by the Federal Reserve.

iii. **Core services excluding housing** accounts for slightly more than 50% of core PCE inflation and is driven by **wages growth**. **We believe trends in the labour market and associated wages growth will be the key determinant of monetary policy in 2023, and therefore be a key driver of equity markets.** Reflecting its importance, half of Powell’s speech was devoted to this issue.

Anyone who has spent too long waiting hungry and grumpy at a short-staffed restaurant will not be surprised to hear that labour market conditions are tight. Redundancy programs have begun in earnest at high profile technology companies such as Amazon, Carvana, Lyft, Meta, Peloton, Salesforce, Twitter and Zillow to name a few but the technology sector only accounts for a small minority of the U.S. workforce. These job losses generally reflect over-hiring during recent boom times or the fallout of questionable business models. **Real-world companies are still struggling to attract and retain employees.** In the U.S. there are only 0.6 unemployed persons for each job opening, the lowest levels in the past two decades. Similar trends have been observed globally, even in countries such as the U.K. and Germany which are under greater macroeconomic pressures.

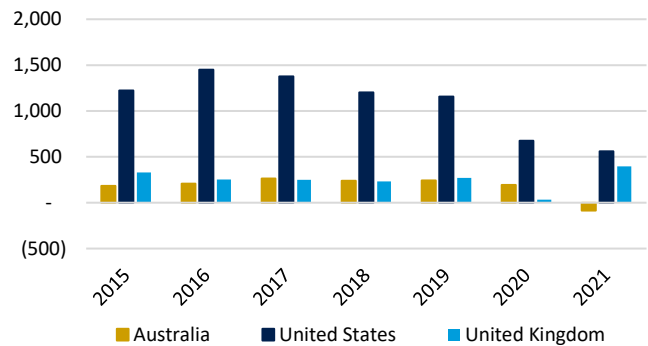
Federal Reserve economists estimate that there is a labour force shortfall of 3.5 million in the U.S.. There are a range of factors that have likely contributed to tight labour markets – lower labour force participation, higher death rates and lower population growth, earlier retirements, lower immigration, onshoring of manufacturing and supply chain contingencies.

Figure 4: Unemployed persons to job vacancies



Source: ABS, Bureau of Labor Statistics, Office of National Statistics.

Figure 5: Net migration (000's)

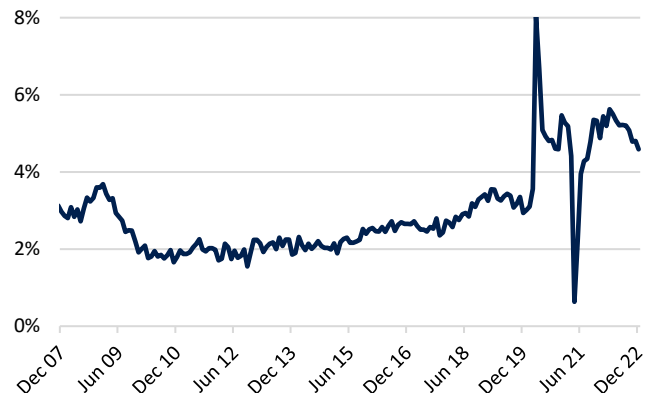


Source: ABS, World Bank, U.K. House of Commons Library.

Tightness in the labour market has translated into rapid wage growth which, as the largest cost involved in delivering core services, has buttressed inflationary pressures. **U.S. services inflation remained elevated at over 7%.**

Many of these factors are COVID-19-related but are unlikely to be resolved quickly or easily. Powell commented “the persistent labour supply shortfall...[is] unlikely to fully close anytime soon.” The Federal Reserve and other Central Banks are worried about a wages/inflation spiral. Central Banks are limited in what they can do to address labour markets. Monetary policy is a blunt tool which aims to reduce labour demand. Policies around immigration and encouraging labour force participation are likely to have a more targeted impact on labour markets but are restricted by political quagmire. **Some kind of U.S. recession is the consensus view of most investors and economists.** The latest Federal Reserve [Survey of Professional Forecasters](#) forecast a 50% probability of a contraction in real GDP in any of the four quarters in 2023 (we provided a link to the actual survey but we could have provided a link to a betting platform instead).

Figure 6: U.S. wages inflation



Source: Bureau of Labor Statistics, St Louis Federal Reserve.

The market is forward looking, and investors are intensely focused on pre-empting a shift in monetary policy. U.S. equity markets recently rallied when December 2022 U.S. wage growth moderated to 4.6% year on year (the lowest levels since August 2021) even though the unemployment rate remained low at 3.5%. **We expect data around the level of wages growth to be a key driver of investment sentiment during 2023.**

December 2022 quarterly review

Performance

In the December 2022 Quarter, the Fund returned 1.7% compared to the Benchmark return of 4.4%. The Australian dollar appreciated 5.7% against the U.S. dollar and depreciated 2.8% against the Euro, which, on a net basis, reduced the Fund and Benchmark Australian dollar reported returns.

Key contributors and detractors

Performance by sector continued to diverge during the December 2022 quarter, with Energy continuing to outperform and Technology and Consumer Discretionary continuing to underperform. The oil price has now fallen almost 40% since its mid-2022 peak and it remains to be seen if Energy companies continue to perform well, but for the December 2022 quarter and 2022 in general the Fund's lack of exposure to the Energy sector was a material contributor to the Fund's negative performance relative to its Benchmark. We believe investors' flight to safety has led to many companies in the Consumer Staples and Utilities sectors becoming expensive, particularly relative to the Fund's holdings.

There is no doubt there are many clouds in the macroeconomic sky and the macroeconomic environment will remain uncertain for a while to come. **We noted in the September 2022 Quarterly Report that a myopic focus of many investors was creating compelling investment opportunities for longer-term investors focused on the fundamental value of a business, not the near-term direction of a share price.**

During the December 2022 Quarter **over 50% of the Fund's holdings' share prices increased by more than 10%** in local currency with a number of them increasing by more than 20%.

Five companies positively contributed over 0.5% (in AUD) to the Fund's returns for the quarter (in alphabetical order **Booking Holdings** (Booking), **CRH**, **Eagle Materials**, **Graphic Packaging** and **Mastercard**).

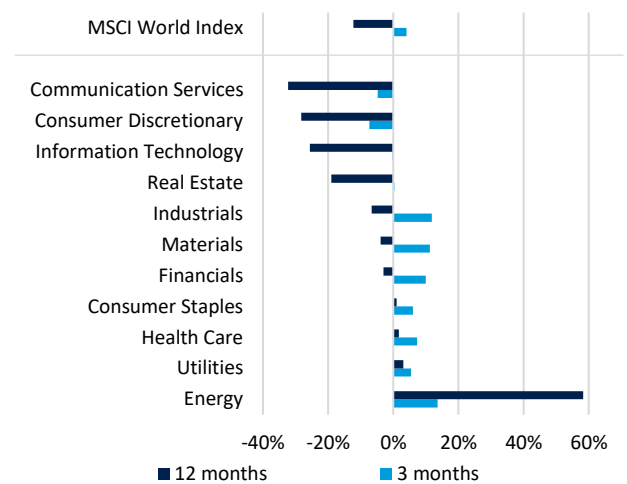
We added to our investment in Booking prior to Q3 2022 results due to the share price overly discounting concerns about near term travel activity. **Booking's quarterly results were a standout**, with the recovery in the travel industry following COVID-19 disruptions running well ahead of our expectations. Booking's share price subsequently increased 23% in the December 2022 Quarter and has increased a further 14% so far in 2023 (in USD). The share price of our building materials companies, **CRH and Eagle Materials, also recovered from oversold levels in the December 2022 quarter**, increasing 23% and 24% respectively (in USD), with further increases in early 2023. Mastercard's share price also increased over 20% in the December 2022 Quarter.

These companies span a range of industries and size by market capitalisation and include both 'Growth' and cyclical 'Value' businesses. All meet the L1 Capital International unique definition of Quality.

Two companies, **Amazon.com (Amazon)** and **Alphabet**, detracted more than 0.5% (in AUD) from the Fund's returns. Both companies reported Q3 2022 quarterly results that were modestly below our expectations.

Amazon was by far the largest negative contributor during the December quarter. In addition to a general shift away from higher growth technology businesses, the market has concerns with a slowing in the growth of Amazon Web Services, general macroeconomic pressures on consumer ecommerce spending and elevated costs impacting both Amazon's ecommerce business and Amazon Web Services.

Figure 7: MSCI World Index (in A\$) – Sector Performance



Source: Bloomberg.

While we consider these issues to be real and some pressure on Amazon's valuation justified, Amazon has been oversold. **Growth in Amazon's long term business drivers, cloud computing and ecommerce, remains intact.** Amazon continues to be the leader in these two industries, both in the United States and many international markets, with increasing barriers to additional competition. Some cost pressures, like fuel and other shipping costs, are likely to reduce over time, while Amazon's management is taking proactive steps to reduce headcount and investments with questionable economics, slow logistics infrastructure rollout and improve efficiencies. Investors are currently overly emphasising short-term pressures and under-valuing the longer-term potential of Amazon's businesses. **We discuss some of these issues in more detail on page 7 of this Quarterly Report.**

Alphabet's share price was impacted by concerns that macroeconomic pressures will impact advertising spend, increased commentary that Alphabet's core search business could be disrupted by open artificial intelligence technologies, particularly from OpenAI's ChatGPT chatbot (Microsoft is rumoured to be investing \$10 billion in OpenAI with the aim of incorporating the technology into Bing, Word and email). Alphabet's growth in employee numbers is also expected to pressure profitability in a more subdued economic environment.

We have allowed for a softening in advertising in our base case expectations and believe **Alphabet's management will be under increasing pressure to take action to manage its cost base**, as many other technology businesses have already done, including Amazon. **Disruption to search remains an issue to monitor.** However, we consider **Alphabet to be at the forefront of developments in artificial intelligence and well placed to defend its core franchise.**

We are not contrarian for the sake of it but, reflecting our longer-term investment horizon, often find opportunities to invest in high quality businesses at attractive valuations when the near-term outlook is subdued. Recently, travel and building materials companies represented oversold opportunities due to short term clouds in the operating outlook. The share prices of our investments in these companies subsequently recovered. Today, sentiment towards many high-quality technology and ecommerce-related businesses like Amazon and Alphabet is negative. Capital flows and an over-emphasis on short-term challenges is driving share prices well below fair value, providing **compelling investment opportunities for longer term investors.**

Portfolio adjustments

Little changed over the past three months from our investment perspective. The macroeconomic and geopolitical environment remains uncertain. Our portfolio of businesses continues to be managed well to deliver long-term value to shareholders. However, share prices can be volatile and presented opportunities to make relatively modest adjustments to the Fund's holdings.

During the December 2022 Quarter we took advantage of a strong recovery in share prices to further reduce our exposure to the U.S. housing market. We remain confident in the longer-term outlook for the building products companies we have invested in. That said, the rapid and substantial increase in mortgage rates will inevitably have a meaningfully negative impact on U.S. housing activity. Commercial activity remains robust and Infrastructure activity is expected to strengthen off a high base in 2023. We have therefore been selective in which sector investments we have retained, divesting **Louisiana Pacific** while continuing our investments in **Eagle Materials** and **CRH**.

We made initial investments in two high quality Bench companies. In one instance we have **patiently waited over 2 years** for the share price to fall back to level we consider attractive to make an investment.

Portfolio adjustments over the past 12 months have been very deliberate. The interest rate environment has dramatically changed and the outlook for some industries is materially different. While wages growth remains high and unemployment low, **consumers are under pressure from inflation and cost of living increases**, particularly people with lower socioeconomic means.

Over the past 12 months there have been three changes to the Fund's top 10 holdings. The Fund's exposure to Consumer Discretionary businesses has reduced from 17% to 7%, with this exposure concentrated in our investment in Booking. Building Products exposure has decreased from 15% to 10%, reducing housing exposure without lowering the Fund's exposure to the robust infrastructure sub-sector. Selectively we have increased our exposure to Healthcare businesses from 5% to 10%. Cash (in U.S. dollars) has increased modestly to 5%. **The portfolio of businesses has never been stronger from a quality perspective and the Fund is well-placed to deliver compelling returns to investors over our investment horizon.**

We look forward to providing a further update once most of the companies in the Fund report final 2022 results and provide outlook commentary for 2023.

Amazon.com – so what is going on?

“You shouldn’t own common stocks if a 50% decrease in their value in a short period of time would cause you acute distress.”

– Warren Buffett

Easier said than done, Mr. Buffett! The share price of Berkshire Hathaway (Buffett’s investment group) has fallen 50% multiple times. So Amazon’s 50% share price decrease in 2022 has laudable historical company. Nor is this the first time Amazon’s share price has fallen over 50% since its public listing. It doesn’t make the situation feel any better.

So, what is going on? Why has Amazon’s share price halved over the past 12 months and under-performed weak equity markets?

As outlined on page 5, investors are concerned with four key issues:

- Macroeconomic pressures on consumer ecommerce spending,
- Elevated costs impacting both Amazon’s ecommerce business and Amazon Web Services,
- Slowing in the growth of Amazon Web Services (AWS), and
- Shift away from higher growth technology businesses.

Macroeconomic environment

There is no denying the macroeconomic environment has deteriorated during 2022 and Amazon faces more challenging operating conditions, as do most businesses. Amazon is the leading ecommerce business in the U.S. and many international markets, excluding China, generating well over \$400 billion of revenue, excluding AWS. A slowing in consumer (and business) spending will naturally flow through to Amazon. Amazon is also cycling elevated activity caused by COVID-19. As the world continues to normalise, consumers are returning to physical shops and ecommerce penetration of retail sales is adjusting back to historical trends at a faster rate than expected. Amazon’s growth rates will also slow because of the law of large numbers. We have allowed for realistic growth in our base case and see upside if the economic environment improves.

Elevated costs

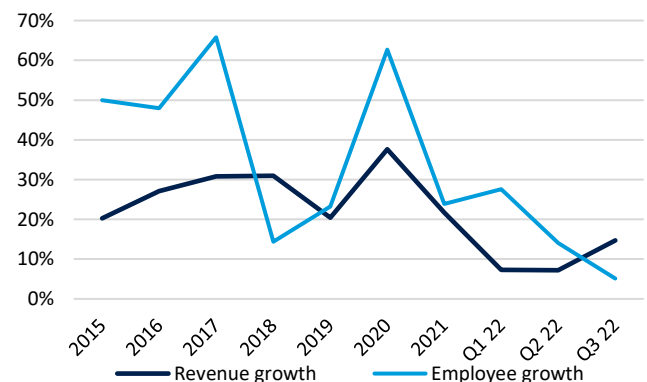
Anyone who has run a business will tell you it is usually better to have a costs problem than a revenue problem. From our perspective, Amazon’s revenue growth has not been particularly disappointing, but the growth in costs and resultant pressure on margins has been greater than our expectations. Cost pressures are evident at many levels – higher cost of goods impacting gross margins, increased fuel and energy costs, infrastructure inefficiencies following a period of rapid expansion and increasing labour costs which impacts all aspects of Amazon’s integrated operations.

Employees and employee costs

Over the past 7 years, Amazon’s total revenue has increased from around \$100 billion to around \$500 billion, a staggering 25% cumulative average rate of growth (CAGR) for some very large numbers. Employee numbers have increased even faster, from 230,000 to over 1.5 million, equating to a 31% CAGR (see Figure 8).

Amazon added 500,000 employees in 2020 and a further 300,000 employees in 2021 as it scaled up to meet rapid growth during the pandemic and to support international expansion. In recent times Amazon’s revenue growth has slowed off a very high base, with revenue from sale of goods online essentially flat. In short, Amazon over-hired and is progressively adjusting its employee base to increase productivity. Recently, Amazon confirmed 18,000 redundancies concentrated in its Amazon Stores and People, Experience and Technology divisions.

Figure 8: Changes to Amazon’s minimum wages



Source: Amazon and L1 Capital International.

While we do not expect redundancies in the people-intensive warehouse and transportation areas, we do expect thoughtful replacement of natural attrition and ongoing productivity efficiencies. There are already early signs of tangible action with total employee numbers drifting down in 2022.

Amazon's labour practices are far from perfect. That said, Amazon has been at the forefront of increasing minimum wages in the U.S. As illustrated in Figure 9, Amazon has supported a minimum starting salary of \$15/hour since 2018, and its current average starting salary for warehouse and transportation workers is around \$19/hour. The U.S. Federal Minimum Wage is still stuck at 2009 levels of \$7.25/hour.

Figure 9: Changes to Amazon's minimum wages

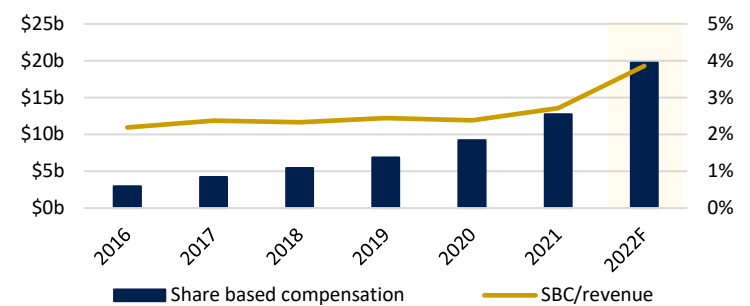
Date	Action
Oct 18	Announces minimum \$15/hr starting salary – benefitting 250,000 permanent and 100,000 temporary employees.
May 21	Average starting salary \$17/hr, sign on bonuses and intends to hire an additional 75,000 warehouse and transportation workers.
Sep 21	Average starting salary increases to \$18/hr and intends to hire an additional 125,000 warehouse and transportation workers.
Sep 22	Average starting salary increases to \$19/hr. \$1 billion investment in additional frontline employee benefits.

Source: Amazon.

Share-based compensation

The growth in Amazon's share-based compensation has materially exceeded our expectations and has been a major disappointment, meaningfully lowering our valuation of Amazon. We recognise Amazon needs to pay competitively to attract and retain the best talent, particularly in the Amazon Web Services division, and that Amazon's share-based compensation structure had some particular quirks which led to adjustments in 2022. However, the increase in share-based compensation by an estimated \$7 billion in 2022, rising to around 4% of total revenue compared to the low 2s in the past substantially lowered our near-term earnings expectations for Amazon and our valuation of the business (see Figure 10). With almost daily announcements of layoffs by technology companies, including Amazon, it is highly likely we are past the immediate peak in technology employment costs. We do not expect Amazon's SBC expense to reverse, but we do expect stability going forward.

Figure 10: Share-based compensation and SBC as a % of revenue

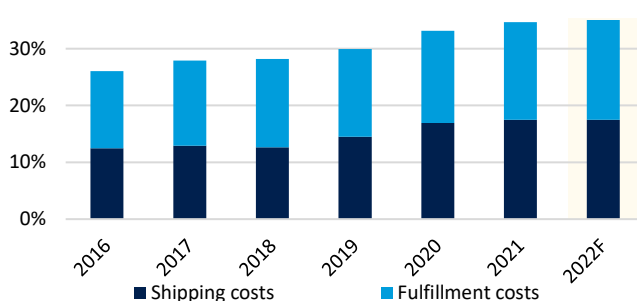


Source: Amazon and L1 Capital International.

Shipping and fulfilment costs

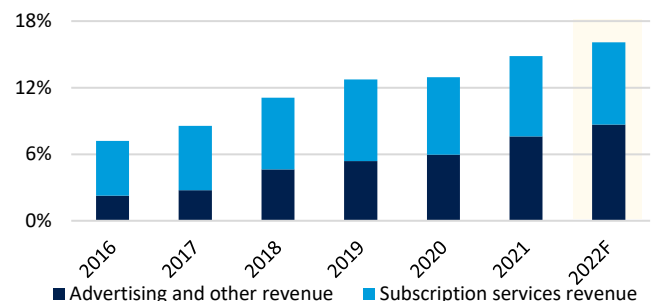
Higher fuel, freight and employee costs, operating efficiencies and increasing service levels have been reflected in an increase in Amazon's shipping and fulfilment costs. **These costs as a percentage of Amazon's total revenue, excluding AWS, have increased from around 26% of revenue to 35% of revenue over the past few years**, despite sustained outsized growth in advertising and subscription revenue which have no shipping or fulfilment costs (see Figure 11 and 12).

Figure 11: Shipping and fulfilment costs as a % of total Amazon revenue, ex AWS



Source: Amazon and L1 Capital International.

Figure 12: Subscription services (including Prime), advertising and other revenue as a % of total Amazon revenue, ex AWS



Source: Amazon and L1 Capital International.

We estimate Amazon’s cost to fulfil and ship an online unit has increased over 40%, despite a nearly five-fold increase in volume of units fulfilled over this period. **We expect a gradual improvement in operating efficiencies as Amazon beds down the massive expansion in its fulfillment and logistics network over the past few years.**

Specifically, Amazon management has commented that 2022 capital investments are expected to be around \$60 billion, similar to 2021. This allows for a reduction in fulfillment and transportation capital investments of approximately \$10 billion compared to 2021 to better align expansion projects with demand, offset by an approximately \$10 billion year-over-year increase in technology infrastructure, primarily to support the growth of AWS.

Amazon Web Services (AWS)

AWS is one of the highest quality businesses in the world. In less than 10 years, AWS has developed into a business generating revenue of \$80 billion and operating profit of around \$23 billion. Outside of China, only Microsoft through Azure, and to a lesser extent Alphabet’s Google Cloud Platform are the only credible competitors. **Technology, scale and capital requirements are strengthening barriers to competition, while cloud computing has an extensive runway for further growth.**

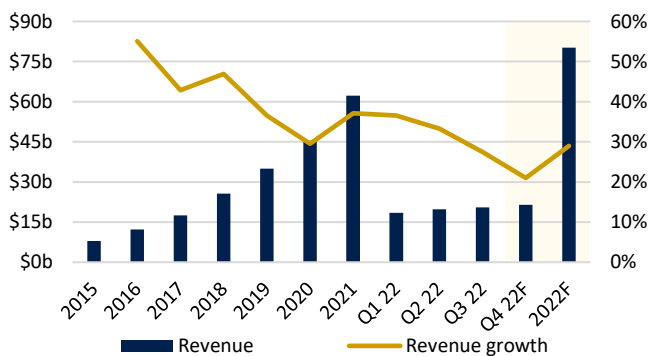
2021 was an exceptional year of growth for AWS. Despite an ever-increasing base, AWS increased revenue by \$17 billion or 37% to \$62 billion, and maintained operating margins at around 30%.

We still expect robust growth by AWS, but the business is not macro immune and will also be impacted by a slowdown from customers in the technology sector, particularly less established businesses. Amazon is likely to exit 2022 with a growth rate around 20%, still exceptional, but a slowdown from recent levels and a further tapering of growth rates is likely over time.

Operating margins are a more complicated discussion. Amazon (along with its peers) has increased the useful life of equipment in its data centres, lowering depreciation and increasing operating profit. This contributed to operating margins spiking to 35% in Q1 2022. Subsequently Amazon increased share-based compensation, which was particularly targeted at AWS, reducing operating margins below 30%. Q3 2022 operating margins were further impacted by a softening in operating conditions and increased energy costs. We expect AWS’s operating margins to gradually increase from current levels, which is moderately below our prior expectations.

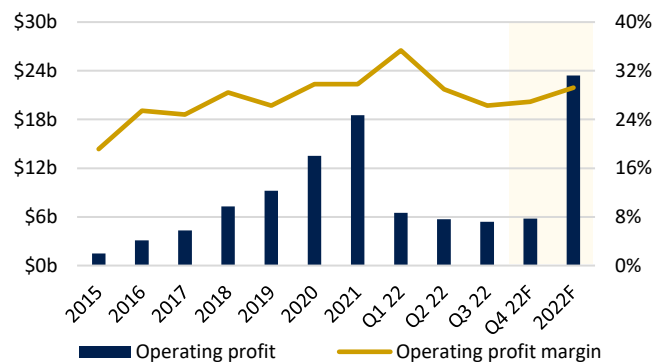
While AWS’s operating performance is only modestly below our prior expectations, some analysts and investors had, in our view, unrealistically high expectations. Negative revisions to expectations have contributed to negative sentiment impacting Amazon’s share price.

Figure 13: AWS revenue and revenue growth



Source: Amazon and L1 Capital International.

Figure 14: AWS operating profit and operating profit margins



Source: Amazon and L1 Capital International.



L1 CAPITAL
INTERNATIONAL

L1 Capital International Fund

Quarterly Report | DECEMBER 2022

Missing profitability

Excluding AWS, Amazon will report an operating loss in 2022. Notwithstanding the cost pressures outlined and likely substantial losses in less mature international operations, **our analysis suggests Amazon is making significant losses on initiatives that are not core to Amazon's existing operations** – initiatives like Project Kuiper (satellites), Zoox (autonomous vehicles), Health, Alexa-related AI projects and video games. Experimentation and side developments are core to Amazon's culture and have led to AWS and other significant businesses. **However, we believe investors would benefit from Amazon disclosing the size of investments in these initiatives and increasing cost discipline**, a process that has likely already commenced.

Summary

Amazon is an immense and complicated group of integrated businesses, generating around \$500 billion of revenue and employing over 1.5 million people. Yet, **fundamentally, it is powered by two key drivers – ecommerce and cloud computing**. Amazon and AWS are both global leaders in ecommerce and cloud computing, respectively, and are increasing their barriers to competition. Amazon is facing cost pressures and the macroeconomic environment has worsened. Interest rates have increased dramatically which does lower the value of future earnings. **Accordingly, we have reduced our valuation assessment of Amazon in 2022, but not enough to justify a 50% fall in Amazon's share price.**

We do not expect any silver bullet or quick fix to drive a rapid recovery in Amazon's profitability, and future expectations need to be set at realistic levels. We remain confident in Amazon's management and note meaningful actions have already been taken to improve operating efficiencies and enhance longer term shareholder value. In our view, **Amazon's share price has been oversold and offers compelling value. So far in January 2023, at the time of finalising this report, Amazon's share price has increased by 17%.** There is substantial further upside before Amazon's share price approaches fair value.



L1 Capital International Fund

Quarterly Report | DECEMBER 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, Australian Money Market, BT Panorama, Hub24, Macquarie Wrap, Mason Stevens, MLC, Netwealth, North, Powerwrap, Praemium

Contact us

Head of Distribution	Chris Clayton cclayton@L1.com.au +61 3 9286 7021
Researchers	Aman Kashyap akashyap@L1.com.au +61 477 341 403
Advisors	Alexander Ordon aordon@L1.com.au +61 413 615 224 Alejandro Espina aespina@L1.com.au +61 423 111 531
Private Clients	Edward Vine evine@L1.com.au +61 412 525 390



**L1 CAPITAL
INTERNATIONAL**

Level 32, 1 Farrer Place
Governor Phillip Tower
Sydney, NSW 2000

Email info@L1international.com

www.L1International.com

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 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 – Apex Group, 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

Equity Trustees Limited ('Equity Trustees') (ABN 46 004 031 298), AFSL 240975, is the Responsible Entity for the L1 Capital International Fund ARSN 631 094 141. Equity Trustees is a subsidiary of EQT Holdings Limited (ABN 22 607 797 615), a publicly listed company on the Australian Securities Exchange (ASX: EQT). This publication has been prepared by L1 Capital International Pty Limited (ACN 628 068 717), (an authorised representative (no. 1273764) of L1 Capital Pty Ltd (ACN 125 378 145, AFSL 314 302) and its officers and employees (collectively 'L1 International'), to provide you with general information only. In preparing it, we did not take into account the investment objectives, financial situation, or particular needs of any particular person. It is not intended to take the place of professional advice and you should not take action on specific issues in reliance on this information. Neither L1 International, Equity Trustees nor any of its related parties, their employees or directors, provide any warranty of accuracy or reliability in relation to such information or accepts any liability to any person who relies on it. All performance numbers are quoted after fees. Past performance should not be taken as an indicator of future performance. You should obtain a copy of the Product Disclosure Statement before making a decision about whether to invest in this product.

Copyright

Copyright in this publication is owned by L1 International. You may use this information in this publication for your own personal use, but you must not (without L1 International's consent) alter, reproduce or distribute any part of this publication, transmit it to any other person or incorporate the information into any other document.