L1 Capital International Fund

Quarterly Report | MARCH 2023

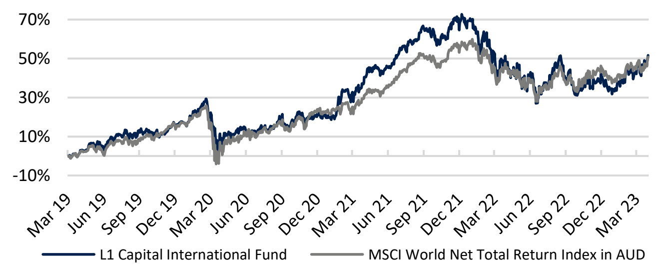
Introduction

In this March 2023 Quarterly Report, we have outlined:

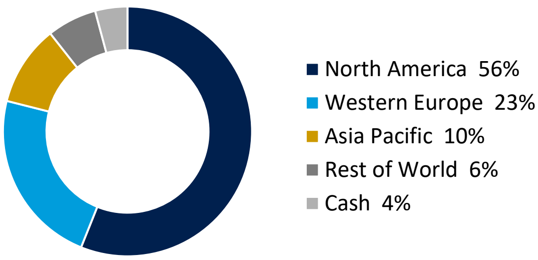
- **Our assessment of the current investment environment including:**
  - **Trends in inflation**
  - **Recent macroeconomic data**
  - **Implications of the current banking industry pressures**
  - **L1 Capital International Fund positioning**
- **Our review of the last quarter, including key contributors and detractors to the Fund's performance.**
- **Recent Portfolio adjustments.**
- **L1 Capital International Fund valuation and investment opportunities**

Fund performance (Net) (%)[1]	Fund	Index[2]	Alpha
3 months	13.7	9.1	+4.6
6 months	15.6	13.5	+2.1
1 year	3.6	4.3	(0.7)
3 years p.a.	11.8	13.0	(1.2)
Since inception p.a.	10.7	10.6	+0.1
Since inception cumulative	51.7	50.9	+0.8

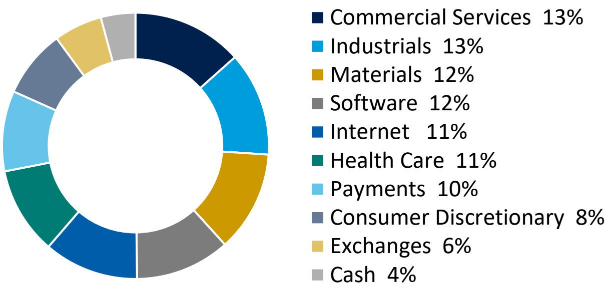
Fund (Net) and benchmark returns since inception[1]



Revenue exposure by region[3]

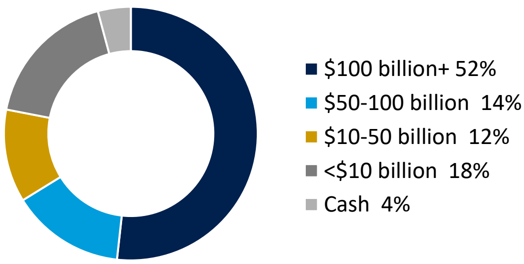


Sector exposure[4]



Top 10 holdings (in alphabetical order)	Sector
Alphabet	Internet
Amazon	Consumer Discretionary / Internet
Booking	Consumer Discretionary
CRH	Materials
Eagle Materials	Materials
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

The first quarter of 2023 commenced in the same vein as 2022 concluded, dominated by inflation, interest rate expectations and geopolitics. In March, the market's worries were compounded by the second largest U.S. bank failure in history, Silicon Valley Bank (SVB), immediately followed by the collapse of Signature Bank. Soon thereafter came the forced acquisition of Credit Suisse by UBS. Recently, macroeconomic indicators have turned downwards.

Yet despite the uncertainty and challenging economic outlook, the **MSCI World Index increased by 9.1%** (in Australian dollars) during the March 2023 Quarter. The **L1 Capital International Fund outperformed the Index by 4.7%, returning 13.7%,** (in Australian dollars). At times like these we are reminded of the oft-quoted statement by Peter Lynch:

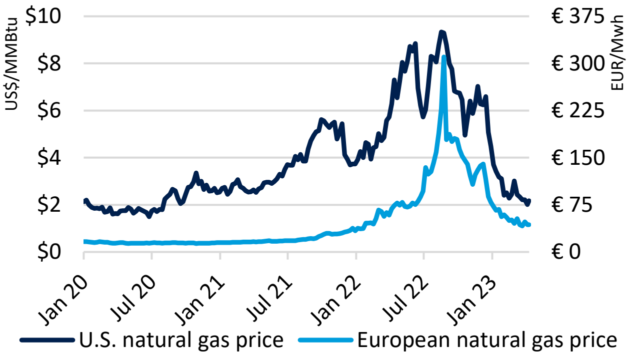
"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

Peter Lynch

Inflation

There are many indicators that inflation has likely peaked:

Figure 1: U.S. natural gas prices are below levels pre-Russia's invasion of Ukraine, while European gas prices are well below peak levels

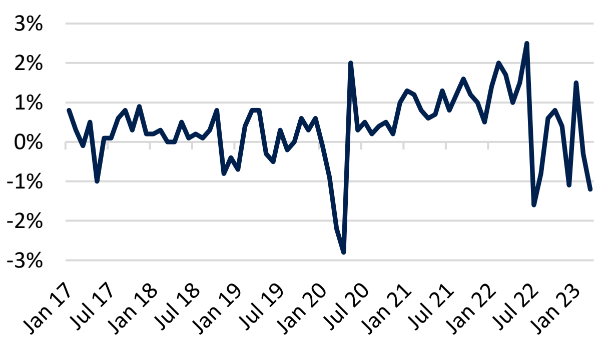


Source: Bloomberg.

Figure 2: Container freight rates are back to normal after a COVID-induced spike

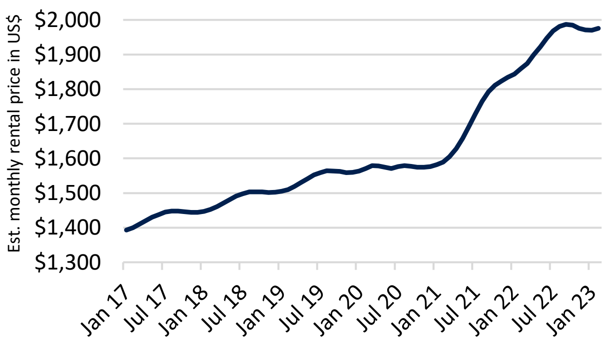
Source: Bloomberg.

Figure 3: U.S. Producer Price growth has turned negative



Source: Bureau of Labor Statistics, Bloomberg.

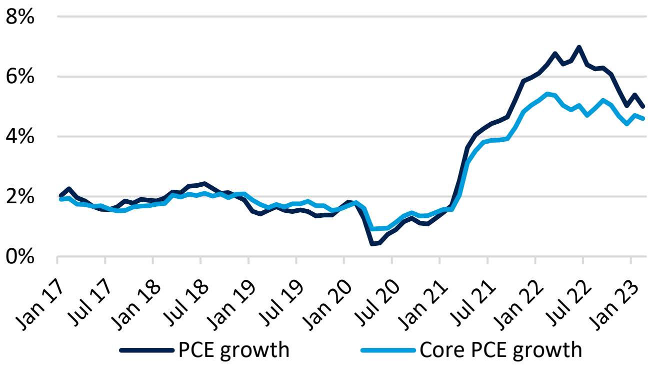
Figure 4: U.S. housing rent has stabilised, but is a lagging indicator and new rents are falling



Source: U.S. Zillow Rent Index, Bloomberg.

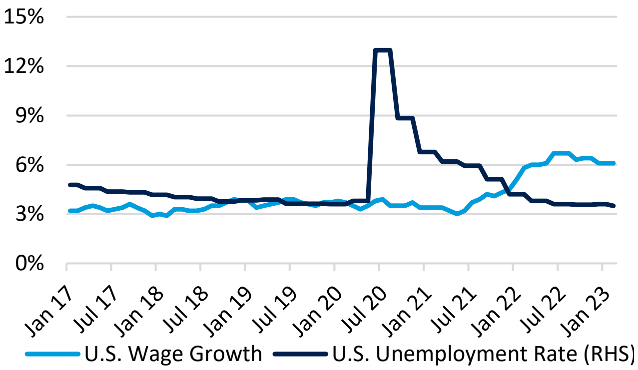
However, while likely to have peaked, U.S. core PCE inflation remains well above the Federal Reserve's target of around 2%, U.S. unemployment remains low and wages growth is still robust:

Figure 5: Growth in total and core PCE inflation



Source: St Louis Federal Reserve.

Figure 6: U.S. wage growth remains elevated at around 6% and remains a key focus for the Federal Reserve. Unemployment is low

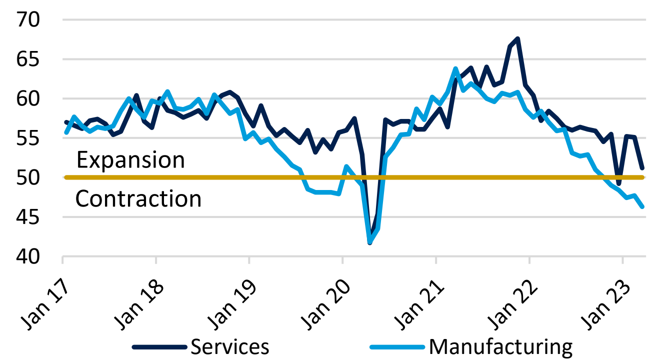


Source: Bloomberg.

Macroeconomic data is deteriorating, as is consumer sentiment

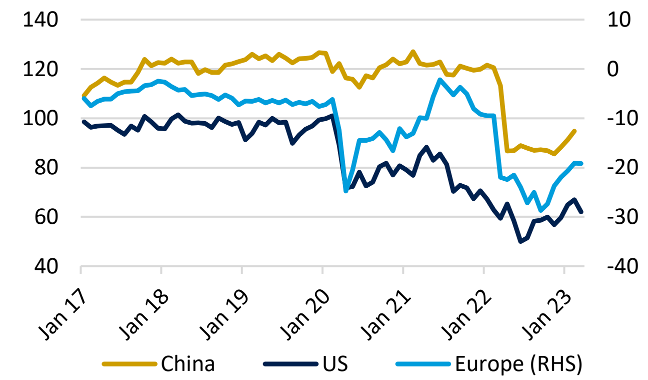
Central Banks around the world have undertaken a rapid tightening of Monetary Policy with the objective of reducing inflation. Unsurprisingly, these actions are starting to impact consumer and business confidence:

Figure 7: U.S. business conditions are deteriorating, particularly for Manufacturing



Source: Institute for Supply Management, Bloomberg.

Figure 8: Consumer confidence has deteriorated around the world



Source: European Commission, National Bureau of Statistics of China, University of Michigan, Bloomberg.

Implications of the current banking industry pressures

We have written extensively about why we are cautious and selective when considering an investment in any bank. No bank can be rated higher than a Category 3 under L1 Capital International's proprietary qualitative ranking system. This is the lowest quality ranking we consider for investments in the Fund. In addition to being a highly competitive industry, this is because all banks have inherent weaknesses:

- Highly levered, with low levels of equity capital relative to assets and liabilities,
- A duration mismatch with funding, principally deposits, at call or short-term compared to the duration of many assets, either loans to borrowers or investments in securities such as bonds, and
- The potential for a 'bank-run', where deposits are withdrawn quickly *en masse*, breaking the bank's liquidity.

These weaknesses cannot be avoided, but they can be managed. Unfortunately, SVB's management appear to have gone to too many venture capital parties rather than attend Bank Management 101. We consider the rapid demise of SVB (and to a similar extent Signature Bank) was largely due to idiosyncratic issues, including:

- Concentrated customer base centred around the closely connected, herd-centric venture capital community,
- Rapid growth, particularly of uninsured deposits, which pressured net interest margin in an inverted yield curve environment,
- Excessive investment in longer duration securities, and
- Naïve management, at best.

The demise of Credit Suisse was less swift. In fact, it was a train wreck in slow motion, with a litany of operational and financial mistakes apparent to even the most casual observer.

While the demise of SVB and Signature Bank were material enough for the Federal Deposit Insurance Corporation to intervene under the **'systemic risk exception'**, and the acquisition of Credit Suisse by UBS is a significant development in the European banking industry, **we do not consider these events to be signs of systemic weaknesses in either the U.S. or European bank industries**. This does not mean the current pressures on the banking industry are over, nor would we be surprised if other banks fail.

However, banks are central to the supply of credit and economic activity. **The bigger issue is whether pre-emptive defensive actions by management of banks as well as regulatory responses to the weaknesses in the banking system will further pressure economic growth**.

Federal Reserve Chairman, Jerome Powell, explicitly addressed this issue following the collapse of SVB when he commented at the March 2023 press conference after increasing U.S. interest rates by a further 0.25%:

"Financial conditions appear to have tightened, and probably more than the traditional indexes say…The question for us though is how significant will that be – what will be the extent of it, and what will be the duration of it…We'll be looking to see how serious is this and does it look like it's going to be sustained. And if it is, it could easily have a significant macroeconomic effect, and we would factor that into our policy decisions."

Jerome Powell, Federal Reserve Chair

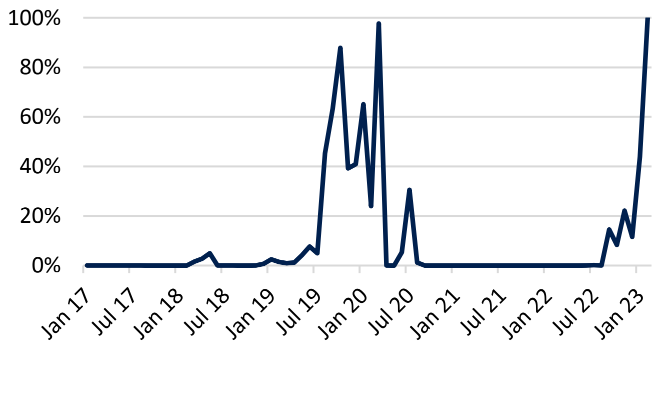
Powell recognises the uncertainty of the implications of these developments,

"…we don't really know yet…people are publishing estimates, but it's very kind of rule-of-thumb guesswork almost at this stage."

The market has been more decisive in its interpretation of the macroeconomic data and implications of the banking industry developments. **Bloomberg Economics is forecasting the probability of a U.S. recession in the next 6 months at 99.9%. Federal Reserve staff economists have also outlined their base case view is a mild U.S. recession commencing in 2023.**

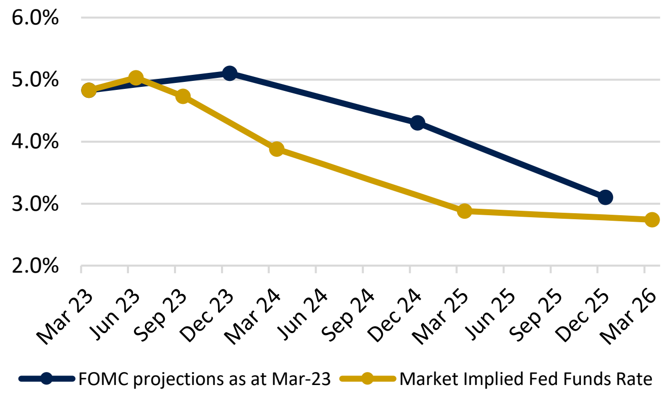
Market interest rates imply U.S. rate cuts before the end of 2023.

Figure 9: Bloomberg Economics probability estimate of a U.S. recession in the next 6 months



Source: Bloomberg.

Figure 10: Federal Reserve vs. Market U.S. interest rate expectations



Source: Federal Reserve, Bloomberg, L1 Capital International.

L1 Capital International's expectations and Portfolio positioning

We caution listening to any market commentator who expresses high conviction in forecasting macroeconomic developments. Broken clocks correctly tell the time twice daily. There are too many unknowable variables, and the potential for game changing developments at any time.

That said, **it is clear from our macroeconomic observations, and our continuous investment diligence that there has been a progressive slowdown in economic activity associated with tightening monetary policy, inflationary pressures, geopolitical uncertainties and now likely tighter credit conditions.**

This does not mean the sky is falling in. The debate remains focused on the **sharpness and longevity** of any global softening of economic activity. There are **still many relative bright spots** to point to:

- **Consumers are generally in a strong financial position**, particularly more affluent consumers.
- **Unemployment remains very low in most developed countries, workers are receiving wage increases** to at least partially offset inflation, and savings levels remain relatively high. Homeowners have benefited from rising asset prices, and at least in the U.S. are protected from rising mortgage rates through the industry standard 30-year fixed mortgage.

Mortgage borrowers in other countries like Australia are less protected from rising interest rates and the economic implications of tighter Monetary Policy are likely to be more pronounced and why we expect interest rates to increase less in Australia compared to the U.S.

There has been a divergence in Central Bank policy, with New Zealand's Central Bank and the European Central Bank most recent decision to increase interest rates by 0.5%, while the U.S. Federal Reserve, Bank of England and Reserve Bank of Australia each increased rates by 0.25%. The central banks in Canada, Japan and South Korea kept interest rates steady.

E**quity markets have been responding favourably to bad economic news** with the expectation that indicators of lower economic growth will cause central banks to pause rate increases, and potentially bring forward rate cuts, supporting a more muted economic downturn and faster recovery.

We are approaching expectations for interest rate cuts as early as late 2023 with caution. As outlined, we believe inflation has peaked and will reduce over time, but we also expect some contributors to core inflation such as wages growth, which feeds into the price of most services and goods over time, to remain sticky. **We believe the market is starting to get ahead of itself, and that interest rate cuts during 2023 are unlikely unless consumer demand and wages growth softens meaningfully.**

There is also always the potential for adverse inflationary shocks. OPEC has played their hand, recently announced a surprise oil production cut and strongly indicated they will take action to support relatively high oil prices. Geopolitical tensions and associated risks have not gone away either.

Portfolio changes are discussed on page 7. **Our central objective is to invest in quality companies that have experienced management and enduring competitive advantages to deliver shareholder value over time, regardless of fluctuations in economic conditions. That said, we have continued to make modest portfolio changes to increase our investment in businesses that are less sensitive to a macroeconomic downturn, and trim investments in more cyclical businesses where the share price has recovered strongly over recent months.**

March 2023 quarterly review

Performance

In the March 2023 Quarter, the Fund returned 13.7% (net of fees), outperforming the Benchmark return of 9.1% by 4.6% (all in Australian dollars). The Australian dollar depreciated 1.2% against the U.S. dollar and depreciated 3.2% against the Euro increasing the Fund and Benchmark Australian dollar reported returns.

Key contributors and detractors

Pleasingly, the Fund's strong performance for the March 2023 Quarter was once again broad based. Over 50% of the Fund's holdings' share prices increased by more than 10% in local currency with the share price of four of these holdings increasing by more than 20%. **AMD**'s share price increased more than 50% after being heavily oversold on negative sentiment to the PC cycle.

Position size is often given cursory attention but is critical to overall fund performance. The L1 Capital International Fund is relatively concentrated, with the top 10 holdings accounting for 60% of the Portfolio. **During the March 2023 quarter some of the companies with the strongest share price performance were also some of the largest holdings in the Fund**. Ten companies positively contributed over 0.5% (in Australian dollars) to the Fund's returns for the quarter, with 7 of these companies contributing over 1.0%. Only 4 companies made a negative contribution to the Fund's returns (in Australian dollars), with none of these detractors material.

Booking Holdings (Booking) was the largest positive contributor to the March 2023 quarterly performance. We meaningfully added to our investment in Booking in the middle of 2022 when the market was overly focused on disruptions to travel in Europe caused by airport understaffing and other COVID-19 induced inefficiencies, as well as concerns that an economic downturn would materially reduce discretionary travel. Since then, **the travel environment has continued to normalise**, with China being the last major market to open travel borders post COVID-19. People the world over have demonstrated their ongoing desire to travel, an industry that has historically grown significantly faster than GDP growth. Management has continued to execute a well-planned strategy to increase connections with customers booking accommodation, including offering flights, on ground transport, activities and payment options. **After increasing over 20% in the December 2022 quarter, Booking's share price increased a further 30%+ during the March 2023 quarter. Booking is now trading within our assessed view of fair value**. We retain confidence that management will continue to deliver returns to shareholders and Booking remains one of the Fund's largest holdings.

We commented in the **December 2022 Quarterly Report** "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".** In that report we outlined in detail why Amazon's share price has been oversold and offered compelling value.

During the March 2023 quarter the share price of many large capitalisation technology companies increased significantly. The Fund has investments in **Alphabet**, **Amazon** and **Microsoft** and their share prices increased 17%, 23% and 20% (in U.S. dollars), respectively. While we continue to see value in these privileged, high-quality businesses, share prices are no longer trading at materially oversold levels and we have selectively started to trim some of the Fund's exposure.

Anyone who has followed L1 Capital International will know we have a healthy disdain for the investment nomenclature of fund managers being either 'Growth' investors or 'Value' investors. For a more detailed discussed please refer back to our **March 2021 Quarterly Report** (seems like a lot longer than 2 years since that quarterly review), but the short version is **Growth is just one factor to consider when assessing a business. Investing at attractive risk-adjusted valuations is fundamentally important to all our decisions.**

There are times when equity market favours higher growth companies over lower growth companies, and during 2021 valuation didn't appear to be a primary concern for many investors. **L1 Capital International's unique definition of Quality** supports our objective to **structure a portfolio which performs well over time during a range of economic and share market conditions**.

The share price of many higher growth companies rebounded during the March 2023 quarter and this shift in market sentiment contributed to the Fund's strong performance. However, **the Fund's returns were also supported by our highly selective investment in cyclical businesses** which would be characterised by most investors as 'Value' investments. To us, while cyclical, they meet our definition of Quality.

CRH, an Irish domiciled but North American-centric building products and solutions provider performed strongly in the quarter, with the share price increasing over 25% (in Euro). **The market had under-estimated CRH's pricing power and the benefit of providing integrated solutions to its customers, not just vanilla commodity building product**s. Investors were also pleased that CRH is considering moving its primary listing to the U.S., although we consider this action to be of limited materiality. We took advantage of an over-enthusiastic response to this announcement to trim our investment.

We were particularly pleased by management announcing an increase in CRH's buyback to US$3.0b over the next 12 months, compared to US$1.2b in 2022. **We have been engaged with management stressing that it would be beneficial to take advantage of the company's strong financial position and undervalued share price to increase buyback activity.** While we are not taking credit for the increased buyback, it is pleasing that the Board and management has once again demonstrated strong alignment with shareholders. Even after the strong price increase, CRH is currently trading on ~12x 2023F P/E, 7.5% free cashflow yield, a dividend yield of 3% and at the current share price will buy back over 8% of its outstanding shares over the next 12 months, all while maintaining very conservative financial leverage.

Some of the smaller market capitalisation companies in the Portfolio also performed strongly. **Flexibility in the size of companies by market capitalisation is another advantage of the Fund** – we see no reason to handicap potential investment selection by limiting investments to companies with a market capitalisation above or below an arbitrary limit.

The share price of Portfolio stalwart, **Graphic Packaging International**, increased 15% during the March 2023 quarter, reaching an **all-time high**. We continue to view the current share price is meaningfully undervaluing this low profile but high-quality business. Graphic Packaging International is currently trading on ~9x 2023F P/E while investing in a new highly efficient, environmentally beneficial manufacturing plant as well as reducing financial leverage.

Portfolio adjustments

For a while now we have been noting that the macroeconomic outlook is cloudy, with the weather worsening during the past quarter. Uncertainty abounds – it has been decades since the world faced such a rapid tightening of monetary policy, distortions from COVID-19 continue to unwind and geopolitical tensions remain acute.

Investor sentiment has become increasingly volatile and myopic, with the herd mentality rapidly shifting from 'risk-on' to 'risk-off' and back again.

We are not traders, but we do seek to take advantage of volatility in share prices to adjust investment holdings when share prices do not reflect our view of the fundamental fair value of a business.

During the March 2023 quarter, while share prices changed, the change was largely in one direction, up, for companies in our Portfolio and on our Bench. We did take advantage of improving sentiment to higher growth technology companies and the share price of more defensive companies drifting down to divest our investment in **Adobe** and increase the Fund's investment in **United Health**. United Health's share price was also under moderate pressure due to regulatory announcements being very slightly adverse. We believe the market over-reacted to these announcements and the share price has recovered strongly over recent weeks.

We modestly trimmed investment in CRH and Eagle Materials. These businesses continue to perform in line or ahead of our base case expectations, but following significant share price increases the risk adjusted returns in our base case scenarios were less favourable. Microsoft was also trimmed due to share price performance and position size.

Two additional businesses were added to the Portfolio, including one business on our Bench which had previously been a Portfolio investment and was sold following a substantial increase in the share price, and more recently fell back to our initial investment price.

While less apparent to external investors, we believe our process of having a genuine 'ready to go' Bench of potential investments is critical to longer term performance of the Fund. We analyse and diligence these companies as if we had made an investment and wait for the opportunity to invest at more attractive prices. **Being patient and being ready to take action — often during short investment windows — is a key element of our investment process**. During the quarter we added a couple of high-quality businesses to the Bench, **providing both depth and diversity to our potential investments**.

Current Portfolio valuation and investment opportunities

We pride ourselves on transparency to current and prospective investors. Figure 11 outlines the base case valuation range for each company in the L1 Capital International Portfolio relative to its current share price.

Figure 11: L1 Capital International Fund base case valuation range compared to the current share price

Source: L1 Capital International.

The Portfolio investments are listed in size, with A being the largest holding and V being the smallest. The L1 Capital International Quality Rating is listed below each holding – 1 is the highest quality rating and 3 is the low-quality threshold for being included in the Portfolio. **Most Portfolio investments are trading at or around fair value, with a few companies trading meaningfully below our view of fair value. At current prices, base case risk adjusted returns are still attractive, and the Fund is almost fully invested, as it usually will be.**

Previously we have called out sectors which have been clearly undervalued, such as large capitalisation technology businesses last quarter, or the high-quality building products companies we have invested in when the market was overly focused on a downturn in the housing sector.

Today, **we do not see such obvious broad-based dislocations between fair value and share prices for our high-quality universe**. This should not be interpreted as believing valuations are full – we are simply noting the share price of many companies in our Portfolio have increased substantially over the past few months and now reflect around fair value, while some companies in the Portfolio remain meaningfully undervalued.

Our Bench of potential investments continues to strengthen, with a number of companies trading around our initial potential investment price. This provides a healthy tension between existing investments and prospective new Portfolio holdings.

Our Portfolio of businesses has never been stronger from a quality perspective and the Fund is well-placed to continue to deliver attractive returns to investors over our investment horizon.

We look forward to providing a further update following the upcoming quarterly results season.

L1 Capital International Fund

Quarterly Report | MARCH 2023

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 net of RITC
Expenses	Nil (included in Management Fee)
Benchmark	MSCI World Net Total Return Index in AUD
Performance fee	15.38% over Benchmark inclusive of GST and net of RITC*
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

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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 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.

* Fees calculated as % of the net asset value of the Fund (including GST and RITC) subject to any underperformance being recouped. There must be positive absolute performance (adjusted for distributions) in the performance period. Otherwise, positive relative performance carries forward to next Period.