L1 Capital International Fund

Quarterly Report | JUNE 2023

Introduction

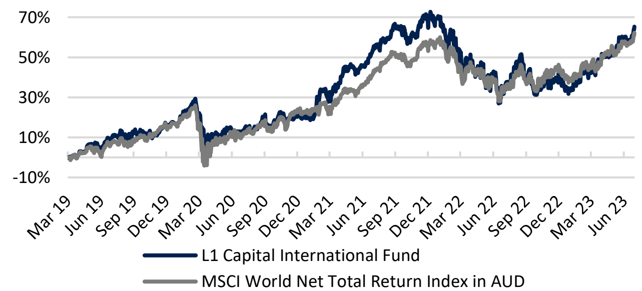
In this June 2023 Quarterly Report, we have outlined:

- **Our assessment of the current investment environment including:**
  - **Lessons to be learned from the 1994 to 1995 interest rate tightening cycle and why rising rates do not necessarily mean the world is heading for a sharp recession**
  - **Current perspectives, including normalisation trends post COVID-19**
  - **Why an economic 'hard landing' is looking increasingly less likely**
  - **L1 Capital International Fund positioning**
- **Our review of the last quarter, including key contributors and detractors to the Fund's performance.**
- **Recent Portfolio adjustments.**
- **An overview of United Healthcare, the leading U.S. diversified healthcare business.**

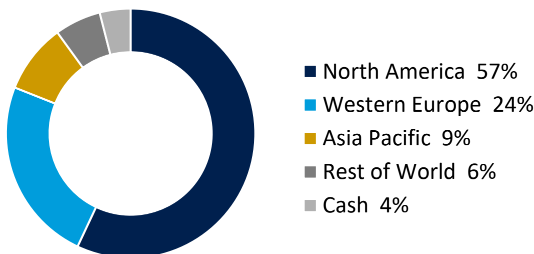
Fund performance (Net) (%)[1]

	Fund	Index[2]	Alpha
3 months	9.0	7.5	+1.5
6 months	23.9	17.2	+6.7
1 year	25.5	22.4	+3.1
3 years p.a.	13.9	13.4	+0.5
Since inception p.a.	12.3	11.8	+0.5
Since inception cumulative	65.3	62.2	+3.1

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



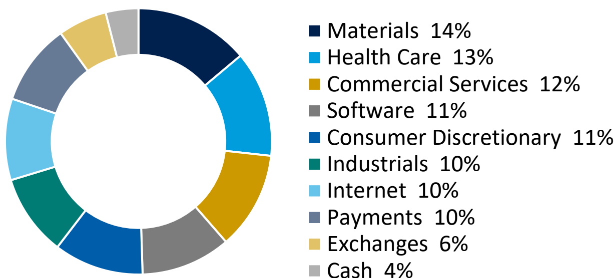
Revenue exposure by region[3]



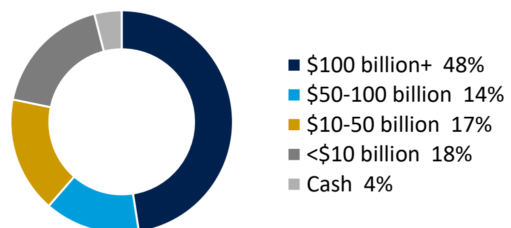
Top 10 holdings *(In alphabetical order)*

	Sector
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
United Healthcare	Health Care

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.

L1 CAPITAL INTERNATIONAL

L1 Capital International Fund

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Current investment environment

"Just as a cautious businessman avoids investing all his capital in one concern, so wisdom would probably admonish us also not to anticipate all our happiness from one quarter alone."

Sigmund Freud

The markets concerns highlighted in our **March 2023 Quarterly Report** – inflation, interest rates, tightening financial conditions, macroeconomic pressures and geopolitical tensions, have not dissipated. Yet, despite the uncertainty and economic outlook, share markets performed strongly with the **MSCI World Total Return Index increasing by 7.5%** (in Australian dollars) during the **June 2023 Quarter**. **The L1 Capital International Fund outperformed the Index by 1.5%, returning 9.0%** (in Australian dollars). This strong performance compounded returns achieved in the March 2023 Quarter, with the **L1 Capital International Fund returning 25.5% for the year ended 30 June 2023, 3.1% ahead of the Index.**

Why is the share market and L1 Capital International Fund performing so strongly despite a massive increase in interest rates by Central Banks around the world and significant economic uncertainty?

Historical Perspective

In **1995** Barings Bank collapsed, Russia was at war in Chechnya and Europe was at war in Bosnia, the U.S. Government stopped funding The National Science Foundation Network enabling the Internet to become fully privatised, Microsoft launched Windows 95, Sony launched the first PlayStation, Bill Gates was announced by *Forbes Magazine* to be the richest man in the world with a quaint net worth of US$12.9 billion, O.J. Simpson was found not guilty, Yitzhak Rabin was assassinated, *Toy Story* was the first full-length film to be created entirely using computer animation and Mississippi ratified the abolition of slavery (yes really! In fact, the Secretary of State then 'forgot' to send a copy to the office of the Federal register, which was only done in 2013, officially enabling a declaration that Mississippi had ratified the 13th Amendment to the U.S. Constitution).

Besides the somewhat loose parallels with today's world events, **what has 1995 got to do with the current investment environment**?

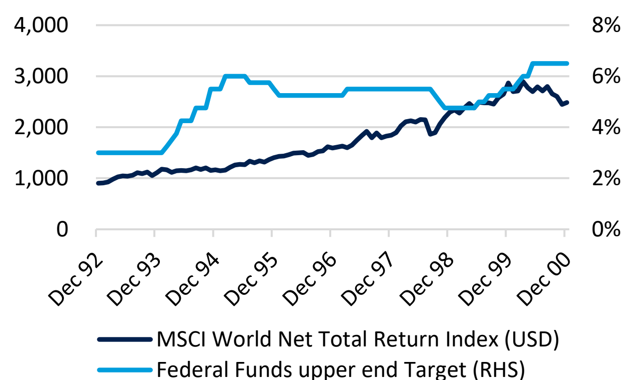
It is well established that humans have a **recency cognitive bias**. We have all just been through the COVID-19 pandemic which caused extreme economic dislocation alongside tragic health consequences. Most of us are also scarred by the Global Financial Crisis (GFC) or Great Recession of late 2007 to 2009. Countless articles and investor quarterly reports have been written predicting dire economic outcomes or that an economic 'hard landing' is about to befall the world. We get it – we are by nature 'glass half-empty' people too. However, despite James Morrison singing "*The future's uncertain and the end is always near*", currently the world does not look that bleak to us, or Mr Market.

Getting back to our history lesson, in 1994 the Federal Reserve, under the leadership of Alan Greenspan, increased interest rates from 3.0% to 5.5%, with the monetary policy tightening cycle peaking at 6.0% in early 1995. In comparison, today's Jay Powell-led Federal Reserve has increased interest rates from 0.25% in early 2022 to a current upper target level of 5.25%, with further tightening likely.

How did the share market respond? In 1994 the MSCI World Total Return Index in USD (Index) increased by 5% following a 23% increase in 1993. 1995 was another strong year for equity markets, with the Index increasing 21%. Each of the years 1996 to 1999 were all good years for share market returns. The Index increased by almost 200% from the end of 1993 to late 2000 despite the Federal Reserve increasing interest rates from 3% to 6% with rates then staying between 4.75% and 6% over this period.

If you assure us the next 5 years will be as strong for share market returns as the mid to late 1990s, we will gladly take it. We are not making such bold projections and have often written repeatedly that trying to time the market is impossible. What we are saying is that **just because monetary policy has materially tightened does not mean the economic world is about to end**.

Figure 1: MSCI World Net Total Return Index (in USD) compared to the Federal Funds Upper Target Rate



Source: Bloomberg, L1 Capital International

There are other parallels with the mid-1990s financial period. **1994** was also the year of the '**bond market crisis**' or a period when bond market prices fell sharply and suddenly across the developed world. The causes and implications of the bond market's volatility then, and the impact of rising interest rates on the financial system and failing of Silicon Valley Bank, Signature Bank, First Republic Bank and Credit Suisse in 2023 differ, but are still related. **The rapid rise in interest rates causes stresses, particularly to weak financial institutions**. *Fortune Magazine* featured a review of the '***The Great Bond Market Massacre***' in October 1994. The article notes "1994 became the year of the worst bond market loss in history" with 30-year Treasury rates increasing from 6.2% at the start of the year to 7.75% by mid-September 1994. Unsurprisingly, leverage was the magnifier of many bond investors losses.

This article makes the important observation that "**Stocks always turn out to be what economists and mathematicians call a positive-sum or negative-sum gain**. When stock prices rise, investors get wealthier; when they fall, investors get poorer [L1 Capital International note: let's ignore our equities short selling friends]. **The bond market, in contrast, is a zero-sum game**. That's because someone – namely, the borrower or issuer – is effectively short every bond that investors own. Thus, when bond prices fall, the losses born by the bondholders are matched by equal gains on the part of the issuers, who have the choice of buying the bonds back for less than they sold them for or, alternatively, of sitting back and enjoying paying what now is a lower-than-market interest rate. The biggest winners of all of this year are the folks who bought new homes last year or refinanced with new fixed-rate mortgages… in effect they were the brilliant timers who shorted the bond market at its peak." Hopefully the dots are starting to join to the current investment environment (subtle nerdy Federal Reserve dots pun intended), but we will expand on these points shortly.

Alan Blinder, former Vice Chair of the Federal Reserve Board of Governors, wrote an ***easy-to-read article in September 2022*** outlining how the **Federal Reserve had a reasonably good historical track record of engineering an economic 'soft landing'** particularly when there were **no external shocks** to the world economic system.

Written from the perspective of obviously biased rosy glasses, Blinder concludes that the period following the 1994 interest rate increases produced "fabulous results" and led to a "perfect soft landing", coincidentally corresponding to the period he was Vice Chair. The article has obvious limitations, but it does succinctly highlight that **tightening monetary policy of itself does not by necessity lead to a deep recession**. The article also makes the obvious point that "**external shocks can ruin the best-laid plans**".

Current Perspective

So enough of the nostalgia. **What can we learn from the past to profit in the present?**

Firstly, if COVID-19 isn't an 'external shock' we don't know what is. The world is made for economic cycles, and well-structured and implemented fiscal and monetary policy can help manage and mitigate economic cycles. The COVID-19 global pandemic simply broke the world.

Source: iStock

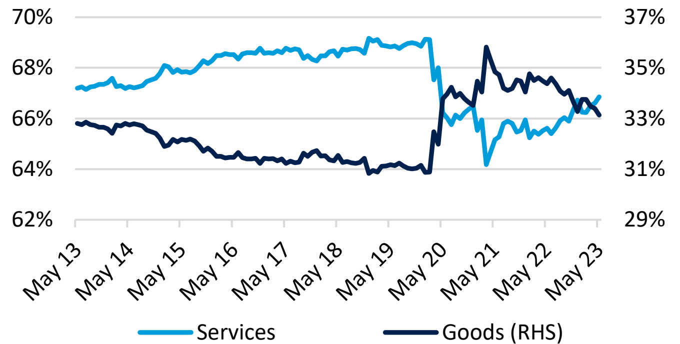
Life, both at the macro and micro level, was not normal during the COVID-19 pandemic. At a macro level, a near instantaneous halting of the global economy was met by a **torrent of fiscal stimulus** that resulted in many people having the same or more disposable income than they had pre pandemic.

Interest rates around the world were cut to zero (or below) and Central Banks **flooded the financial system with liquidity**. At the micro level, hand sanitiser became the most sought-after alcohol, we stayed at home, saved more, spent less, and the money we did spend was disproportionately spent online rather than instore and allocated to goods such as Peloton bikes and Weber BBQs at the expense of holidays, eating out and other services. Distorted demand as well as distorted labour and logistics markets strained supply chains and the capacity for businesses to adapt. Geopolitical tensions and Government restrictions didn't help.

Google says there is a Chinese proverb 'the wise adapt themselves to circumstances, as water moulds itself to the pitcher'. This is somewhat ironic as China had the highest barriers to the proverbial water finding its natural level. Humanity adapted to the COVID-19 pandemic quickly, but fortunately the pandemic is largely behind us. The world is getting back to normal. **In most respects behaviours, economic and personal, are largely returning to pre COVID-19 days.**

The Federal Reserve Bank of San Francisco recently published research on ***The Rise and Fall of Pandemic Excess Savings*** which found that **U.S. households accumulated US$2.1 trillion of excess savings during the pandemic, of which US$1.6 billion has been drawn down.**

Figure 2: The proportion of U.S. personal consumption expenditure spent on goods and services is gradually reverting to pre pandemic trends



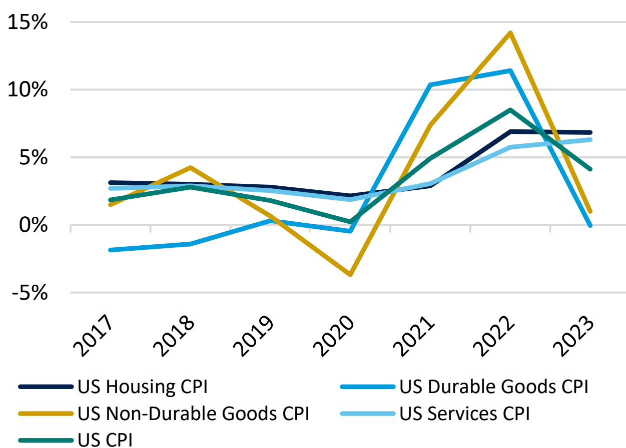
Source: Federal Reserve, L1 Capital International

Forward Perspective

While things are getting back to normal, the **impacts of COVID-19 were so profound and so widespread it is not surprising there were meaningful implications for our finely tuned world that is not structured to withstand such a shock**. **We were writing about inflation more than two years ago and we still are. Monetary policy has been the key driver of markets for quite a while.**

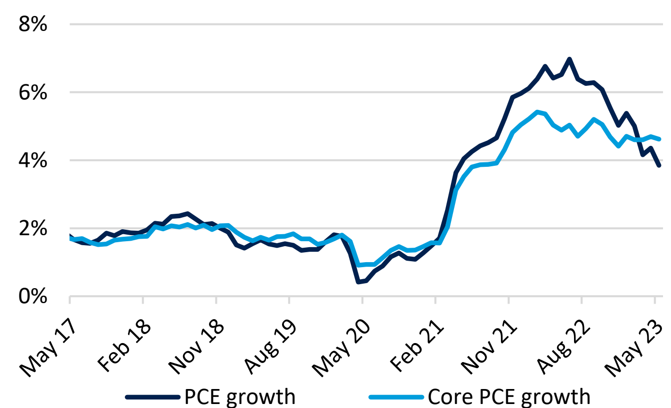
We were wrong in our initial expectation that higher inflation would be relatively narrow and reasonably temporary. Inflation spiked, initially goods but then spread to labour, housing and services. 'Temporary' became a dirty word, but most things in life are temporary – they do not last forever. **The degree, depth and longevity of inflation has certainly been higher, broader and longer than we expected, but there are clear signs inflation has peaked and is falling**. Goods inflation was the most distorted and is falling the most rapidly, while housing and services inflation (driven by a tight labour market) will take longer to fall. We speak to many businesses in our daily endeavours, and anecdotally broadly speaking the heat is coming out of the labour market (albeit wages are still increasing) and housing rents are beginning to turn down, particularly apartments.

Figure 3: Goods are leading the downturn in inflation



Source: Federal Reserve, Bloomberg, L1 Capital International

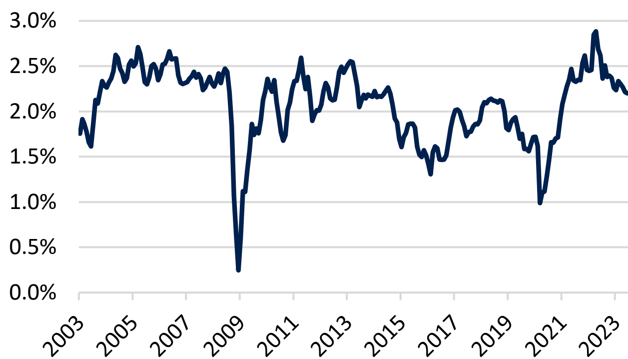
Figure 4: Total and Core PCE has likely peaked



Source: Federal Reserve, Bloomberg, L1 Capital International

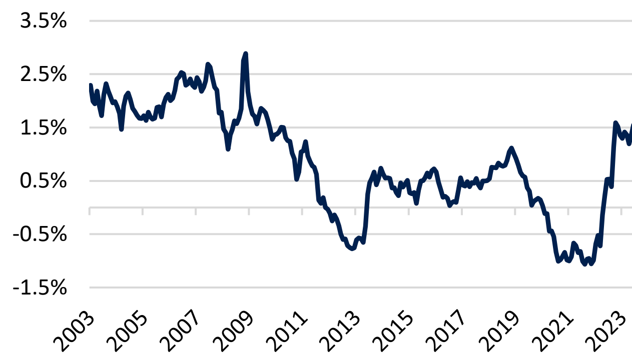
Some things have been changed by COVID-19. Labour participation by older people has not rebounded to pre-pandemic levels, labour markets are potentially tightening at a structural level and 'work from home' has been relatively enduring, straining sectors such as office property and CBD shopping, particularly in some regions such as San Francisco. **Critically, longer-term inflation expectations have not increased significantly, despite near term high inflation**. Balanced inflation expectations support longer term economic growth and asset valuations:

Figure 5: Market expectations remain for U.S. inflation to average in the low 2s over the next 10 years



Source: Federal Reserve, L1 Capital International

Figure 6: Yields on 10-year Treasury Inflation Protected Securities are no longer at distorted negative yields, but remain at historically 'normal' levels



Source: Federal Reserve, L1 Capital International

So far, by our standards, this update and outlook commentary has been outright bullish. However, **we don't want to give the impression that everything is good or that we have lost our conservative, 'worry about everything' nature**:

- Even though inflation has likely peaked, core inflation remains well above levels targeted by Central Banks.
- Interest rates have increased substantially and sharply around the world.
- Consumer confidence is down and consumer budgets are being strained (particularly for less affluent people).
- U.S. student loan repayments are likely to resume.
- Some components of inflation, particularly related to wages and housing, are likely to be sticky.
- The Federal Reserve, Reserve Bank of Australia and other Central Banks have paused rate increases recently but maintain a tightening bias.
- Market expectations for rate cuts in 2023 look premature to us and are only likely if economic conditions weaken meaningfully.
- Business margins are under pressure.
- Credit conditions and bank regulations are tightening.
- Fiscal budgets have materially worsened after emergency COVID-19 measures.
- Tax rates are likely to increase.
- China's rebound after hard lockdowns has underwhelmed.
- The war in Ukraine continues.
- OPEC remains unpredictable but has a clear bias to keeping oil prices relatively high.
- Global geopolitics remain strained.
- COVID-19 (or whatever comes next) could still surprise.

The litany of worries above is enough for anyone to find a rock to hide under. A slowing of economic activity is inevitable. We may or may not get a technical recession in the U.S., Australia and other developed countries in late 2023 or 2024. We do have confidence, however, that **a 'hard landing' is looking increasingly less likely**. Hopefully the preceding pages highlight **that rising interest rates of themselves do not automatically mean the world is heading for a sharp recession and that share markets will by necessity fall. To further walk back from the cliff edge**, fiscal stimulus, while not at pandemic-induced levels, remains high and immigration, a key driver of long-term growth, has resumed. Returning to the 1994 *Fortune Magazine* article on the 'bond market crisis' U.S. homeowners who fixed their loans for 30 years at ultra-low rates are insulated from recent central bank actions. This is a key reason why we believe interest rates will peak at higher levels in the U.S. than in Australia. Home prices globally have remained firm, delivering significant wealth to many people. Unemployment remains low in most regions, and employees are receiving salary increases to offset cost of living pressures. Savers and self-funded retirees are finally getting an economic return for their prudence. Fossil fuel bubbles caused by geopolitics do not last forever.

Portfolio positioning

Followers of the Fund will be aware we **caution listening to any market commentator who expresses high conviction in forecasting macroeconomic developments**. There are too many unknowable variables, and there is potential for game changing developments at any time. It is easy to espouse a bearish or bullish view, but the world is complicated and nuanced. **Predicting the market's response to macroeconomic developments is also challenging. Recently the market has reverted to going down when macroeconomic data is good due to concerns a strong economy will lead to even higher interest rates and a sharper future downturn**. Bubbles are often easy to identify but can expand and last longer than expected. Better to avoid bubbles than to participate and to try and dodge the inevitable pop.

In our view business selection is becoming increasingly critical and in a world of positive real interest rates **fundamental valuation analysis once again matters** (thankfully).

Our central objective is to invest at sensible valuations in quality companies that have experienced management and enduring competitive advantages to deliver shareholder returns over time, regardless of fluctuations in economic conditions. We believe our **unique definition of quality, prudently and cautiously applied, results in a portfolio of businesses that can deliver strong risk-adjusted returns across business cycles**.

Share prices often fluctuate wildly, driven by sentiment and other factors, presenting opportunities to make portfolio adjustments in a well-defined investment universe. Recent portfolio changes are discussed on page 9.

June 2023 quarterly review

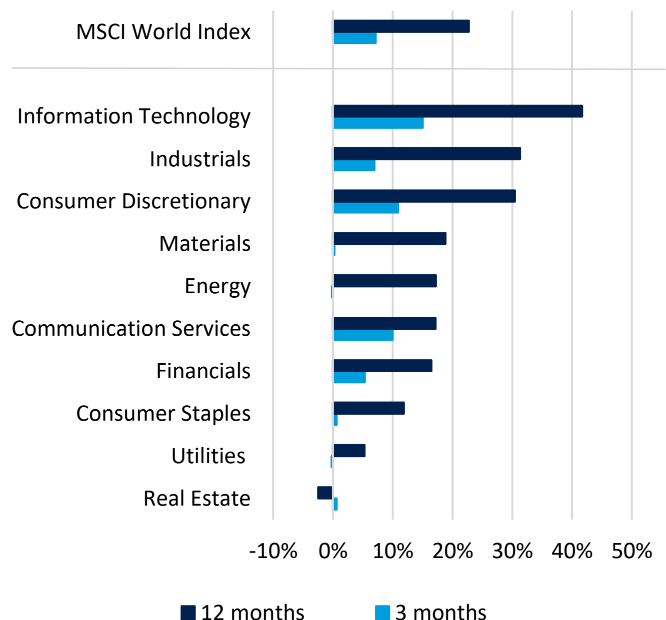
Performance

In the June 2023 Quarter, the Fund returned 9.0% (net of fees), outperforming the Benchmark return of 7.5% by 1.5% (all in Australian dollars). The Australian dollar depreciated 1.0% against the U.S. dollar and depreciated 0.9% against the Euro increasing the Fund and Benchmark Australian dollar reported quarterly returns.

Key contributors and detractors

Much has been written about how a small number of large capitalisation predominantly technology companies have driven U.S. equity indices higher in 2023. While this is undoubtedly true, many of these companies were also key detractors from index performance in 2022. Big, strong, well-run companies are likely to get bigger and stronger over time (despite Lina Khan's best efforts). However, when looking at contributors to the performance of the MSCI World Total Return Index over the past 12 months, contribution at the sector level has been relatively broad. In addition, there has been significant divergence in company performance within sectors. **Individual business selection is becoming increasingly important to deliver strong risk adjusted returns.**

Figure 7: MSCI World Net Total Return Index (in A$) – Sector Performance



Source: Bloomberg, L1 Capital International

The Fund's performance in the June 2023 Quarter benefited from our investments in large capitalisation technology companies **Alphabet**, **Amazon** and **Microsoft**. However, **contributions to the Fund's performance continued to be broad-based**, with seven companies positively contributing over 0.5% (in Australian dollars) to the Fund's returns for the quarter, and another five companies almost reaching this level of positive contribution. Only four companies made a negative contribution to the Fund's returns (in Australian dollars), with none of these detractors being material. **Graphic Packaging International** (discussed below) came close to the -0.5% detraction level with the share price drifting down, albeit from record high levels.

For the year ended 30 June 2023, the Fund returned 25.5% (net of fees), outperforming the Benchmark return of 22.4% by 3.1% (all in Australian dollars). Twelve companies positively contributed over 1.0% (in Australian dollars) to the Fund's performance. The five largest contributors to the Fund's performance over the past year (in alphabetical order) were **Booking Holdings**, **CRH**, **Eagle Materials**, **Graphic Packaging International** and **Microsoft**.

These companies cover a wide spectrum of industry exposure, market capitalisation and growth profile, reflecting L1 Capital International's unique definition of high quality and 'all-weather' portfolio construction.

Over the past year no company detracted 1.0% or more from the Fund's performance (nothing came close). **Thinking about downside risks and protecting capital are key tenets of our investment philosophy**. Even though we had the positive tailwind of a broadly rising share market it was still very satisfying that there were no businesses that meaningfully underperformed our expectations over the past 12 months.

Artificial Intelligence (AI) has become the market's latest obsession. We will expand on our thoughts on AI another day, but in short, our view is that **AI is a step-change in technology and will have broad ranging adoption and implications**. It is too early to pick winners and losers beyond superficial observations and near-term obvious winners such as Nvidia. Quantifying the implications of AI on businesses at this stage is not much more than guesswork. We can say with confidence that expectations, or in our language "**what you need to believe**" to justify current share prices for some companies such as Nvidia are very high.

Microsoft is a clear and substantial beneficiary of AI – not only through its investment in OpenAI/ChatGPT but through the incorporation of AI into core Microsoft products and services, and increasingly through Azure (Microsoft's cloud computing business) providing '**AI-as-a-service**'. At this stage we don't know what the long-term financial benefits of AI will be to Microsoft, but we have confidence that it will be meaningful, that barriers to competition are increasing and that Microsoft is worth more today than it was 12 months ago. That said, Microsoft's share price has increased 33% (in U.S. dollars) over the past year, and we no longer consider the company to be undervalued in our central base case. We have started to trim our investment in Microsoft, although it remains one of the Fund's largest positions.

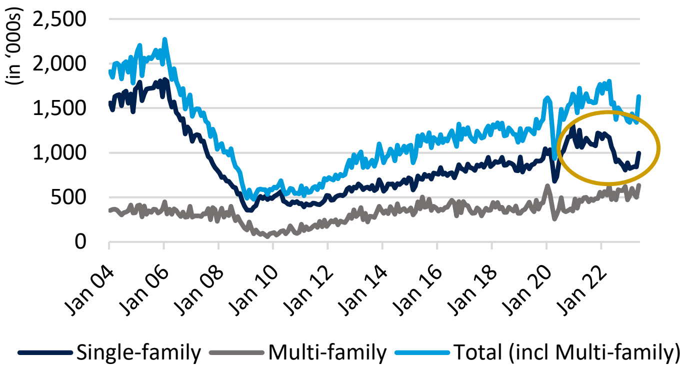
CRH and Eagle Materials, the Fund's two building materials investments, continued to contribute strongly to the Fund's performance. Both companies have diversified exposure to residential (new and repair and renovation), commercial, and infrastructure construction. Eagle Materials is a purely US domestic business, while CRH generates around 75% of its earnings in North America and the vast majority of the remainder in Europe (if you step on a concrete manhole cover in Australia it was probably manufactured by CRH).

In this quarterly report we have spent several pages outlining our assessment of the current macroeconomic environment. **We have also repeatedly stated that in our view, no-one can consistently predict the macroeconomic outlook and how share markets will respond. There are too many variables and uncertainties.**

Assessing industries and individual businesses is not easy, but it is easier. In the case of CRH and Eagle Materials, their business drivers and industry considerations are at the more straight-forward end of the spectrum, but it has taken around 25 years of closely following the building materials industry to express this degree of confidence. We have written extensively on CRH and Eagle Materials in the past (please refer to our **December 2021** and **December 2020** quarterly reports for company overviews). Below is a brief update on U.S. new residential construction and what is going on in the U.S. cement industry.

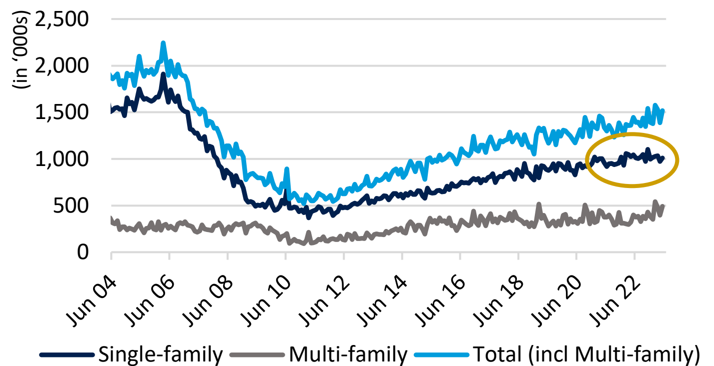
The **U.S. new residential construction** industry has structurally under-built new homes since the excesses preceding the GFC. Construction activity was consistently recovering from post-GFC lows, and then COVID-19 hit. A combination of exceptionally low mortgage rates (driven by the Federal Reserve cutting interest rates to zero) and a desire for people to live in single-family homes led to a spike in new residential housing starts. However, due to a shortage of labour and materials, housing completions flat-lined and led to a build-up in houses started but not completed. In 2022 and early 2023 housing starts fell more than 20% due to rising interest rates and higher house prices combining to constrain affordability. House completions held steady. Recently there has been an uptick in housing starts as builders adapt to current conditions by building smaller, cheaper homes and provide financial assistance to prospective buyers, and consumers accept and adapt to higher mortgage rates. Multi-family construction (apartments) has remained robust throughout this period. People need to live somewhere, and rents have also been increasing (until recently). Repair and renovation activity has dipped, but from very high levels (when everyone was stuck at home during COVID-19 lockdowns and spent money repairing and renovating their home).

Figure 8: U.S. housing starts



Source: U.S. Census, L1 Capital International

Figure 9: U.S. housing completions



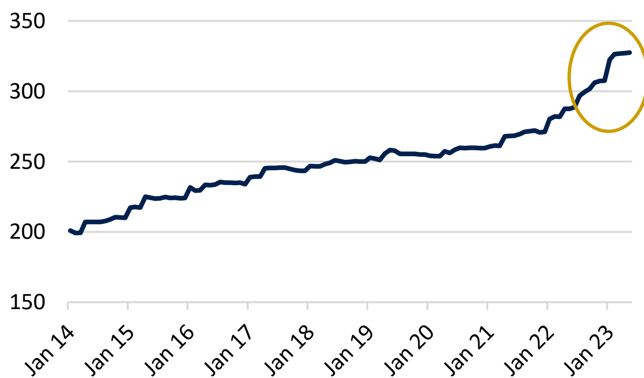
Source: U.S. Census, L1 Capital International

The net effect of all this detail is that CRH's businesses exposed to new residential construction have only been under modest pressure. Eagle's exposure is more late cycle (completions rather than starts) and therefore never felt the dip.

Both CRH and Eagle Materials have significant U.S. cement businesses. The **dynamics in the U.S. cement industry are highly favourable** and easy to understand. It simply **comes down to demand and supply**. Demand is high because of stimulus spending on roads, bridges and other infrastructure at the Federal and State levels. Commercial demand is reasonably robust driven by mega projects such as semiconductor chip manufacturing facilities. Residential demand has remained reasonably robust. Supply is constrained, particularly in the regional areas in which Eagle Materials operates, away from coastal import competition. Costs of production, particularly energy and freight, have fallen. The resultant formula is simple:

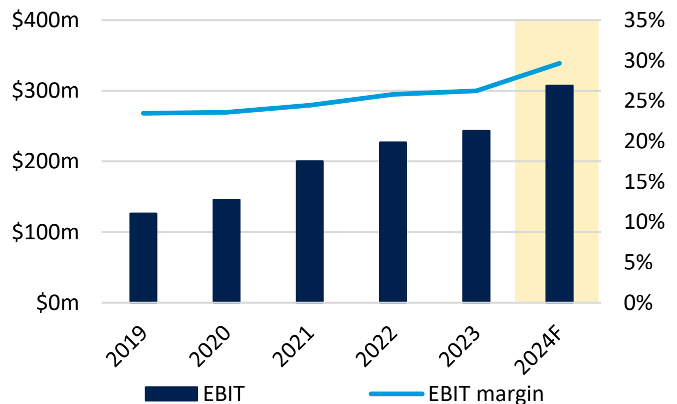
Increasing demand + constrained supply + decreasing costs + increasing prices = more profits:

Figure 10: U.S. cement prices



Source: Bureau of Labor Statistics, L1 Capital International

Figure 11: Eagle Materials cement division's earnings



Source: Eagle Materials, L1 Capital International

Both CRH and Eagle are trading near record high share prices, yet still reflect good value. We also believe CRH will benefit from shifting its primary exchange listing from Ireland/U.K. to the U.S., although this may cause near-term volatility in the share price. If so, we look forward to the opportunity to increase our existing investment.

As a child, I am sure you tossed a coin and called out "Heads I win, tails you lose!" – seemed witty at the time. At today's share price we believe **Graphic Packaging International** presents almost as good an investment opportunity – more like "**Heads we win, tails we don't lose**!" We outlined the investment case for Graphic Packaging International in our **June 2021 Quarterly Report** and the substance of our views then remain current today. Right now the market is concerned about weakness in demand for paperboard packaging and medium-term increases in supply of paperboard. Both concerns are valid, but in our view are overly reflected in Graphic Packaging International's share price.

Graphic Packaging International supplies the boxes used by food, beverages, household and personal care companies. Normally demand growth is modest but relatively stable, supported by a continuous environmentally driven shift away from plastic packaging, but it is not macro immune. Recently a number of consumer staples companies have reported weakening demand, as well as some destocking by retailers who are looking to better match demand with their inventory levels. These issues will **impact Graphic Packaging International, but to a modest extent and only for a temporary period**. Graphic Packaging International also benefits from supplying packaging for house brand products which are benefitting from trade-down by cost conscious consumers.

Supply of paperboard is increasing, both in Europe (where Graphic Packaging International converts paperboard into packaging but does not manufacture) and in the U.S. in the near term. Increased supply does have the potential to lower prices, but we again expect the impact on Graphic Packaging International to be manageable. Graphic Packaging international is largely integrated, meaning it provides complete packaging solutions to its customers rather than rolls of paperboard which require converting into packaging. It also has the **industry's newest, lowest cost and most environmentally efficient facilities**. Management is highly seasoned and will adapt the business to changes in market conditions.

Our forecasts for Graphic Packaging International's revenue, earnings and cashflow have modestly reduced over recent months. With the company **trading on a forward PE multiple of 8x and a prospective free cashflow yield in the teens once expansionary capital expenditure is complete, we believe the current share price offers compelling valuation**. In our base case we make strong investment returns and in a realistic downside we do not lose capital **– heads we win, tails we don't lose**.

Portfolio adjustments

Over the past year there were only 27 companies that were held in the Fund at any point in time – we are not traders, and we genuinely invest with a medium- to long-term investment horizon. That said, **buy and hold forever is usually too simplistic**. 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, both too high and too low.

During the June 2023 quarter the AI bubble continued to inflate. **AMD,** as a key challenger to Nvidia, will benefit from increased demand for its next generation semiconductor chips. AMD's share price is reflecting very bullish sentiment and the share price has run ahead of a reasonable base case valuation. Accordingly, we divested our entire position and moved AMD to our Bench.

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".** The share price of many of these companies continued to recover in the June 2023 quarter, building on earlier gains in the year**. We no longer consider these high-quality mega-cap technology companies to be under-valued. Nor do we they are currently over-valued**. Given portfolio exposures and competing investment alternatives, we have **selectively trimmed** some of these holdings.

Currently, we do not see broad sectors or industries which are materially over or under-valued. Pockets of irrational exuberance are generally idiosyncratic. Areas of deep stress are also largely isolated, although we note that when assets such as the Westfield San Francisco shopping mall are being handed back to lenders by owners Unibail-Rodamco-Westfield and Brookfield, there is potential for weakness in certain categories of commercial real estate, particularly retail and office, to spread **–** another reason to avoid banks for now.

Close observers of the Fund will note the increased exposure to healthcare, currently 13% of the portfolio. **Healthcare is generally less macro-sensitive** than some other sectors. In a reversal of market sentiment compared to 2022, the healthcare sector has been under modest pressure due to what we consider to be some short-term transitory issues, while technology, particularly anything to do with AI, has become the market's dish *du jour*. We have been selectively increasing our investment in a few very high-quality healthcare businesses at prices we consider to be fair. **UnitedHealth Group** is now a top 10 holding, and our investment thesis is outlined in this report (starting on page 10).

In addition to other incremental adjustments, two new starting investments were made during the quarter, reflecting the benefits of having a well-researched, genuine, 'ready to go' Bench of potential investments. These businesses add depth and diversity to the portfolio and both have the potential to be larger investments over time.

Cash holdings (in U.S. dollars) remain below 5%.

Our portfolio of high-quality businesses is well-placed to continue to deliver attractive returns to investors over our investment horizon despite the uncertain macroeconomic environment and likely global slowdown.

Portfolio investment – UnitedHealth Group

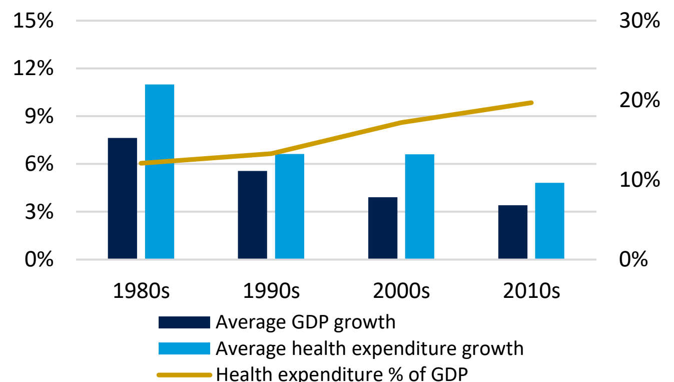
Introduction

It is said that nothing in life is certain except death and taxes.

We have **previously written** on our exposure to taxes through our investment in Intuit and its market leading TurboTax franchise (Intuit also owns the QuickBooks small business accounting franchise, Credit Karma and Mailchimp). **UnitedHealth Group** (UnitedHealth) is leading the charge to postpone the inevitable, while lowering overall healthcare system costs.

U.S. health spending has outpaced GDP growth for decades, with spending on healthcare increasing from around 12% of GDP in the 1980s to nearly 20% today, driven by advancements in healthcare capabilities and an ageing population with increased life expectancy.

Figure 12: Health care expenditure vs. GDP growth



Source: U.S. Bureau of the Census, U.S. Department of Commerce, U.S. Bureau of Economic Analysis

Set against this backdrop, UnitedHealth is exceptionally well positioned as the leading scale player with unrivalled depth and breadth of capabilities across many of the most important areas of healthcare.

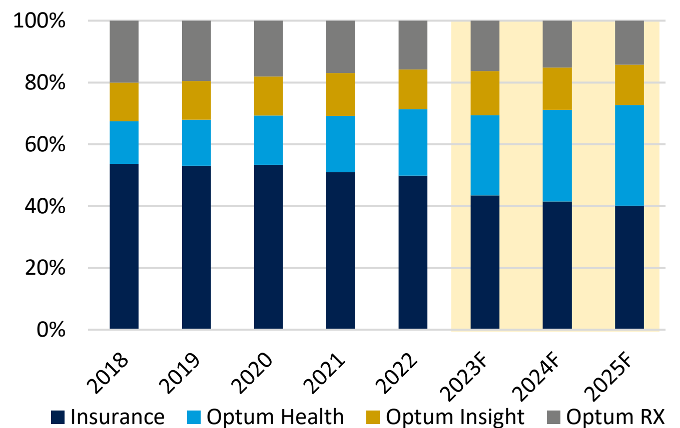
Overview

UnitedHealth operates in two major segments:

- The **Optum** division includes multiple business lines including physician practices (**Optum Health**), a pharmacy benefit management (PBM) group (**Optum RX**), as well as the largest healthcare IT and consulting business in the world (**Optum Insight**); and
- The **United Healthcare** division provides commercial, private and government funded healthcare insurance coverage and benefits.

Currently, UnitedHealth's earnings are approximately equally derived from each division. However, we expect the faster growing Optum businesses to account for an increasing proportion of UnitedHealth's earnings over time.

Figure 13: UnitedHealthcare Group – EBIT business mix



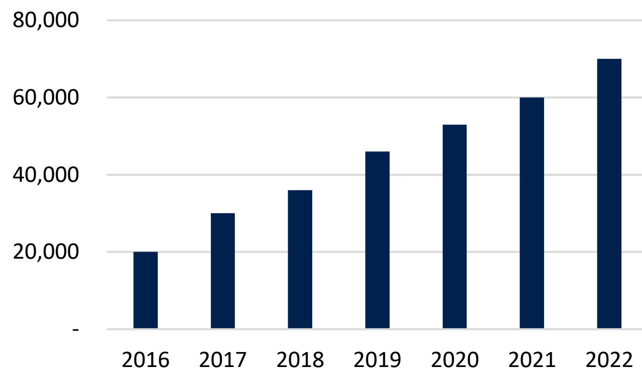
Source: UnitedHealth Group, L1 Capital International.

Optum Health

Because it is 'hidden' within such a large and complex organisation, the Optum Health business is often under-appreciated. However, if it were a standalone practice, Optum Health would be one of the largest physician networks in the U.S. with around 70,000 doctors, 7% of licensed physicians.

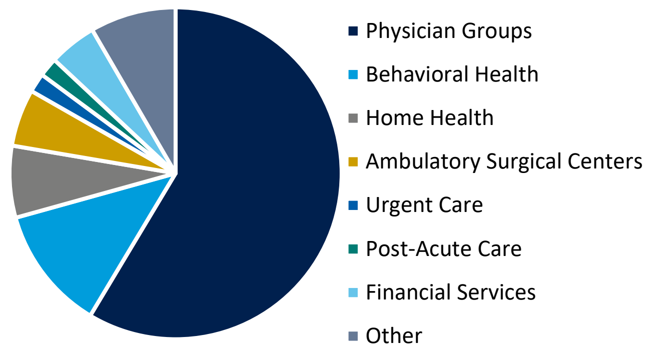
Roughly two thirds of Optum Health's revenue is from its physician groups. Another 10% to 15% is from behavioural health practices. The balance of revenue is from ambulatory surgical centres, urgent care, post-acute, in-home and virtual care, as well as some financial services.

Figure 14: United Health employed physicians



Source: UnitedHealth Group

Figure 15: Option Health revenue mix



Source: UnitedHealth Group, Bank of America Global Research, L1 Capital International

Optum Health is at the forefront of what is called '**value-based care**.' Under this framework, instead of receiving a fee every time a doctor sees a patient (**fee for service**), the physician network is incentivised to properly diagnose and treat the patient – as they receive financial incentives depending on patient outcomes – not simply on utilisation. Studies show this can have excellent results both for patient outcomes and for lowering total healthcare system costs. However, many health organisations are not equipped to practice value-based medicine because it requires tight integration and communication across every aspect of a patient's treatment and care.

Optum Health is also rapidly expanding its **in-home care** capabilities through a series of acquisitions as well as organic investment. In-home care, in conjunction with Optum Health's other capabilities, will be another increasingly important way to improve healthcare outcomes at lower cost than traditional hospital and other external treatment settings.

Optum Health is UnitedHealth's fastest growing business and is an increasingly important driver of improved healthcare outcomes, lower healthcare system costs, and UnitedHealth's profitability.

Optum Insight

If Optum Insight were a standalone business, it would be the **largest healthcare IT company in the world**. Optum Insight provides data, analytics, research, consulting, technology, and managed solutions to physicians, hospitals, health plans, government organisations, and life science organisations.

The organisation has four primary goals: to reduce administrative costs, to help companies achieve regulatory compliance and requirements, to improve clinical outcomes, and to help change/transform organisational operations.

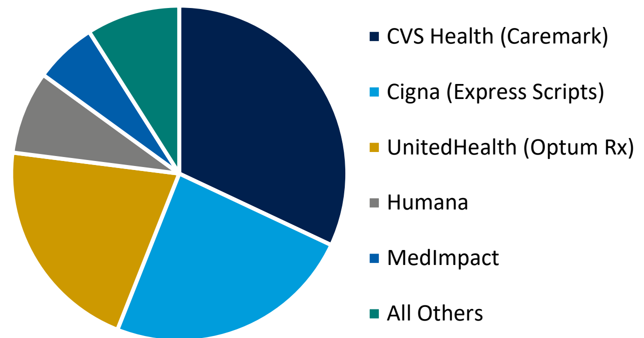
Optum Insight has averaged double digit revenue growth for the last five years and we expect similar growth for the foreseeable future.

OptumRx

OptumRx is UnitedHealth's pharmacy benefit manager (PBM). PBMs manage prescription drug benefits on behalf of healthcare insurers and various government programs. They provide formulary management, price and rebate negotiating services, mail order delivery, generic drug substitution recommendations and various specific drug services, as well as processing pharmacy claims and help with patient adherence.

The industry is highly consolidated with UnitedHealth (Optum Rx), Cigna (Express Scripts) and CVS (Caremark) having a combined market share of approximately 80% and benefitting from significant economies of scale.

Figure 16: PBM market share



Source: Company filings, Bank of America Global Research, L1 Capital International.

The PBM industry is essential to the U.S. healthcare system but is a relatively mature business. This year, we expect OptumRx to fill approximately 1.5 billion scripts and earn around US$3 profit per script filled. Revenue growth is around mid-single digits, driven by growth in both the number of scripts filled, and revenue per script.

Insurance (United Healthcare)

United Healthcare is the largest customer of the Optum division and underpins the Optum business. The U.S. healthcare insurance sector is highly complex, but, in summary, United Healthcare has leading market positions in almost every sector, both commercial and Medicare Advantage and Medicaid Government funded programs.

In total, United Healthcare covers the healthcare insurance of 47.6 million people in the U.S. and an additional 5.3 million people through commercial programs in international markets.

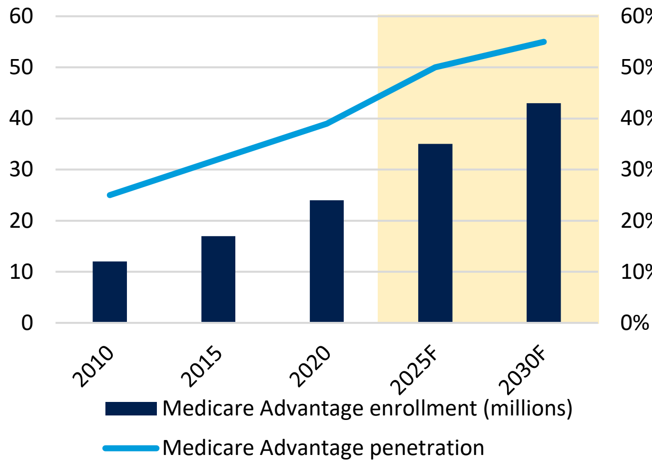
Commercial health care insurance is provided under both **risk-based** and **fee-based** models. Under a risk-based model United Healthcare assumes the risk of both medical and administrative costs in return for an insurance premium which is typically a fixed rate per individual served for a one-year period. For customers who elect to self-fund the health care costs of their employees and dependents (typically very large corporations that can afford to self-insure), United Healthcare receives a fixed monthly fee per individual served. The customer retains the risks associated with the health care coverage, while United Healthcare provides services such as the coordination and fulfilment of medical services and well as manages the associated administration.

The commercial healthcare insurance business is mature, driven by worker participation growth and the degree of healthcare expense coverage provided by employers. We expect consistent moderate growth for this business.

Government spending on Medicaid (for people with limited income and resources and some special health populations) and Medicare (for people 65 or older, and some people under 65 with certain disabilities or conditions) will continue to increase, reflecting an ageing population, improved healthcare services (albeit at higher costs) and increased life expectancy.

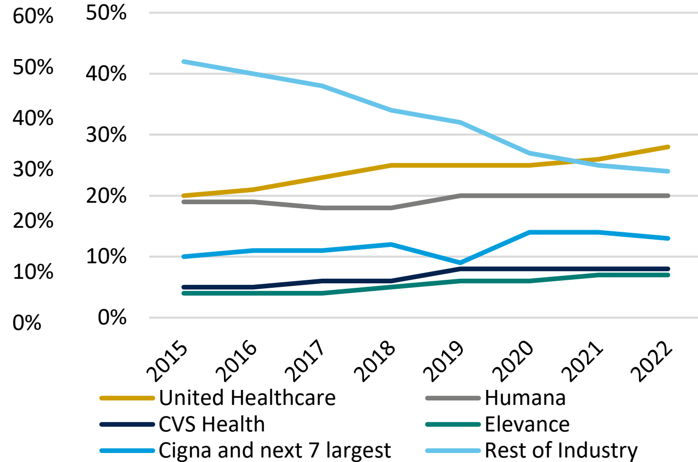
Some people elect to maintain healthcare coverage under government-provided Medicare, while others are electing to switch to **Medicare Advantage**. The latter is provided by private health insurance companies such as United Healthcare and is structured more like traditional health insurance that most people are familiar with. Comparing these programs is complex and depends on the individual's health position and preferences. However, in summary, Medicare Advantage continues to gain share of the total Medicare market. United Healthcare is the leading provider of Medicare Advantage coverage, serving over 7.5 million people. Medicare Advantage will be a key driver of United Healthcare's future growth in revenue and earnings.

Figure 17: Medicare Advantage share of the Medicare market



Source: CBO, Bank of America Global Research, Company filings, L1 Capital International

Figure 18: Medicare Advantage market share



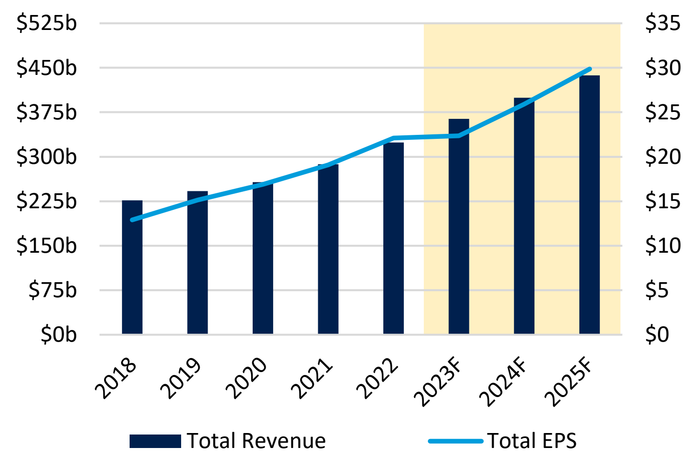
Source: CMS, Company filings, L1 Capital International

Summary

UnitedHealth is a collection of world-class, market-leading healthcare businesses performing vital functions in a cost-effective manner. With scale benefits across insurance, physician practices, pharmacy benefits and technology as well as growing expertise in value-based care. UnitedHealth is ideally positioned to profitably grow its market position as provider of choice while also bringing down overall costs to the U.S. healthcare system.

UnitedHealth has massive scale with a market capitalisation of US$440 billion. Despite (or maybe because of) this scale, over the past five years, UnitedHealth has increased revenue at a compound rate of 10% p.a. and increased EPS at a compound rate of 14%. Over the long-term, UnitedHealth targets low to mid-teens EPS growth p.a. and a return on equity of 20% or higher. Our base case expectations are consistent with these targets.

Figure 19: UnitedHealth revenue and EPS



Source: UnitedHealth Group, L1 Capital International

UnitedHealth is currently trading at around 19x forward PE. We believe we have paid a fair price for a very high-quality healthcare business with strong growth prospects in a range of macroeconomic environments.

L1 Capital International Fund

Quarterly Report | JUNE 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, CFS Firstwrap, 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.

Information contained in this publication
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