DAILY CLASS

L1 Capital Australian Equities Fund

Quarterly Report | MARCH 2021

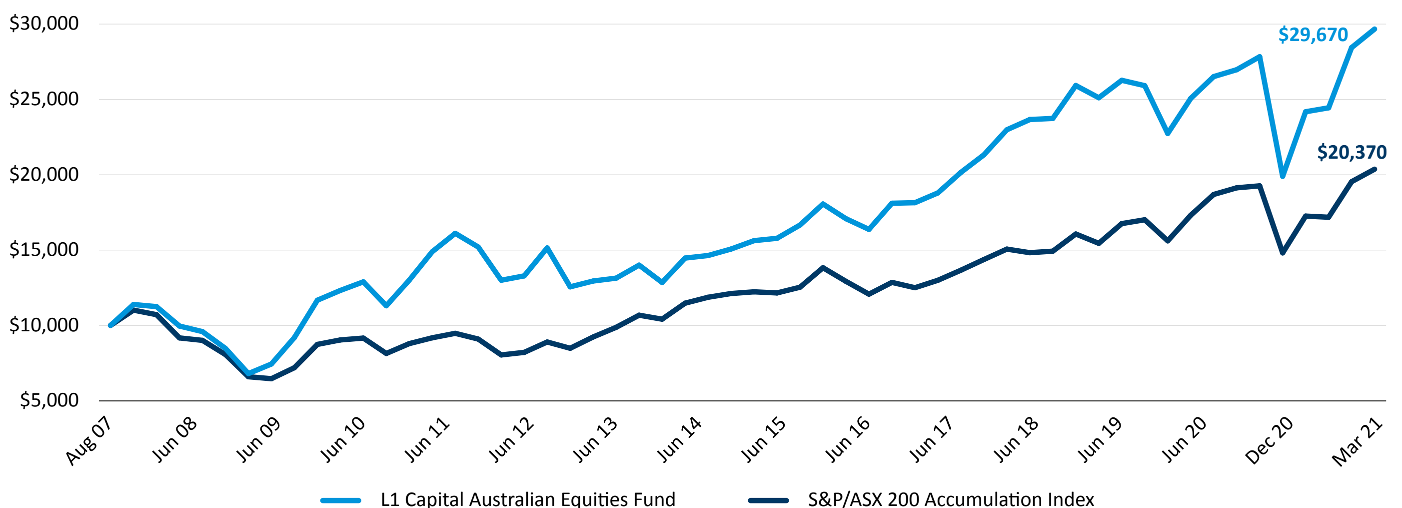
INCEPTION DATE: 23 AUGUST 2007 | UNIT PRICE: 1.7681[1,2] | FUND NAV: $76M

- **Over the March quarter, the Fund returned 4.3% (net), outperforming the S&P/ASX 200 Accumulation Index by 0.1%.**
- **Over the past year, the Fund has had a very strong period of performance, returning 49.1% (net), outperforming the index by 11.6%.**
- **We continue to be optimistic as we believe we have built a portfolio containing many mispriced stocks that have clear upcoming catalysts as well as strong valuation and balance sheet support. These companies are also likely to benefit from the potential tailwind of a rotation towards cyclical and value stocks.**
- **Since inception, the Fund has outperformed the index by 3.0% p.a. (net).**

Performance Summary (Net) (%)	Fund*	Index*	Alpha*
One month	0.2	2.4	-2.3
Three months	4.3	4.3	+0.1
One year	49.1	37.5	+11.6
Three years (p.a.)	5.7	9.7	-3.9
Five years (p.a.)	10.3	10.2	+0.1
Ten years (p.a.)	6.3	8.0	-1.7
Since inception (p.a.)	8.3	5.4	+3.0
Since inception (cumulative)	196.7	103.7	+93.0

Fund Performance vs S&P/ASX 200 Accumulation Index

Growth of $10,000 invested since inception (net of fees)



* *The Index is the S&P/ASX 200 Accumulation Index. Fund performance and alpha are quoted net of fees. All performance numbers prior to 15 Oct 2017 relate to the L1 Capital Australian Equities Fund wholesale class of units which is subject to a different fee structure. The L1 Capital Australian Equities Fund PDS and RG (first issued 5 Oct 2017, last updated 19 Mar 2019) are a daily class of units. Numbers may not net exactly due to rounding. Past performance is not predictive of future returns.*

Equity Market Observations

Global markets have recovered strongly over the past twelve months as investors gained comfort on the progress and efficacy of vaccines and the concurrent recovery path through COVID-19. Despite this strong improvement, we continue to believe the equity market will remain supported, with numerous compelling stock-specific opportunities.

We have started to see the early signs of a major market rotation that we previously flagged would accompany a strong rebound in economic activity. We believe this is likely to extend further, with an acceleration in global GDP growth likely through 2021 leading to a rotation from:

1. **Bonds and cash into equities –** Equities continue to look far more attractive than other asset classes, with cash and most investment grade bonds currently yielding less than inflation. We expect tailwinds for equities from monetary and fiscal stimulus, strong corporate earnings, rising M&A activity and the vaccine rollout (which will unleash enormous pent-up demand for a range of services).
2. **Defensive stocks into cyclical stocks –** Investor positioning remains skewed towards defensive sectors (such as technology, healthcare and supermarket stocks) that have been largely unaffected by COVID-19 shutdowns. With a recovery in global GDP growth and our positive outlook on the path to a "COVID normal" environment, we believe there will be a further shift towards hard hit "COVID losers" as their operating metrics begin to show tangible improvement in the second half of 2021.
3. **Growth stocks into value stocks –** Value stocks have endured the largest and longest period of underperformance on record as bond yields have collapsed to historic lows, supporting the outperformance of long duration equities. COVID-19 exacerbated this trend, with a further melt-up in high P/E stocks as investors sought safety in "COVID winners". As Figure 1 illustrates, the recovery in value and cyclical stocks has been modest relative to history. Growth stocks continue to trade at the widest premium to value stocks since the dot-com bubble of the late 1990s (refer Figure 2). This supports our view that there is still further to go to see conditions revert to a more balanced "equilibrium". We believe the catalyst will be the combination of accelerating operating metrics for many cyclical stocks, along with a rise in long term bond yields, particularly in the U.S. and Australia.

Figure 1: Growth vs. Value – Relative performance

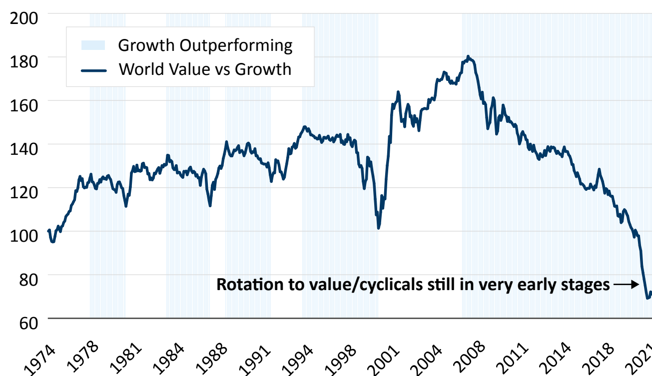
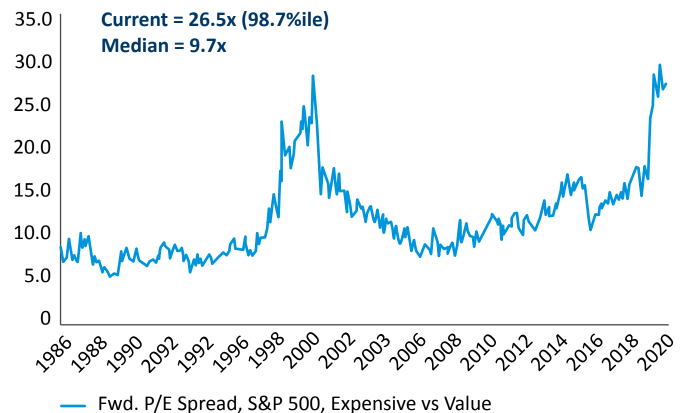


Figure 2: Growth-Value P/E spread



Source: Datastream, Goldman Sachs Global Investment Research, J.P. Morgan U.S. Equity Strategy & Global Quantitative Research

From a COVID-19 perspective, we continue to be positive on the ability for vaccines to control the pandemic. The contrarian view we expressed from July 2020 onward regarding the higher probability of vaccine success and accelerated timetable for the vaccine rollout has largely played out as we had expected. Our continued confidence in vaccine success is based on three key reasons:

1. Most vaccines have been proven to have significant efficacy against the identified mutant strains;
2. Vaccines will provide some protection against non-mutated parts of the viral spike protein; and
3. Both the U.S. Food and Drug Administration and the European Medicines Agency have signalled that they will consider expedited approvals of minor modifications to better target mutations, which can be rolled out in weeks.

Our positive views on the recovery path are supported by data in countries that are at the forefront of the vaccination roll-out. Israel is the most advanced country globally, with ~60% of its population having received at least one dose of the vaccine. Since the vaccine rollout began in Israel, COVID-19 cases are down 98%, critically ill down 93%, deaths down 87% (Figure 3). The U.S. and U.K. have significantly stepped up their vaccine roll-out over the quarter and expect to have half of their populations vaccinated by the end of June this year. As the U.S. has stepped up its vaccination drive, which began in mid-January (it is currently administering around 3m doses per day), the death rate from COVID-19 has fallen by 70% (refer Figure 4 below) and is now at levels not seen since October.

Figure 3: Israel COVID-19 vaccinations and death rates

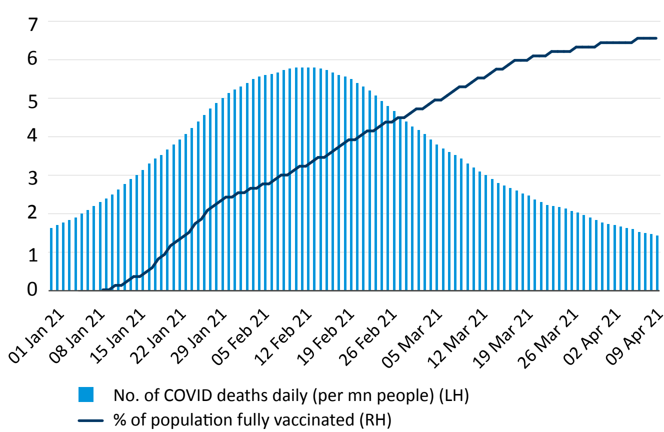
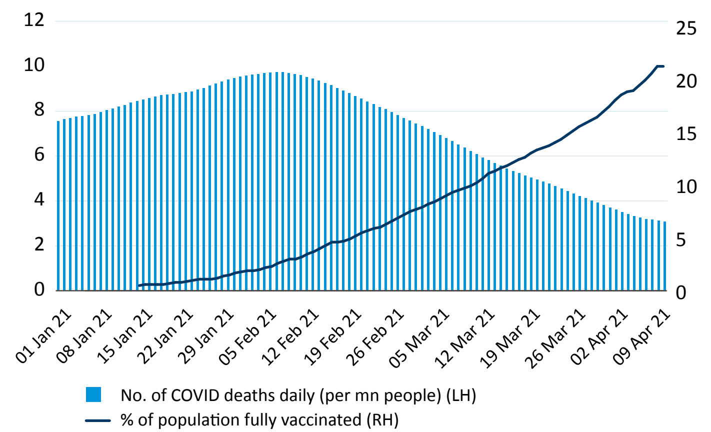


Figure 4: U.S. COVID-19 vaccinations and death rates

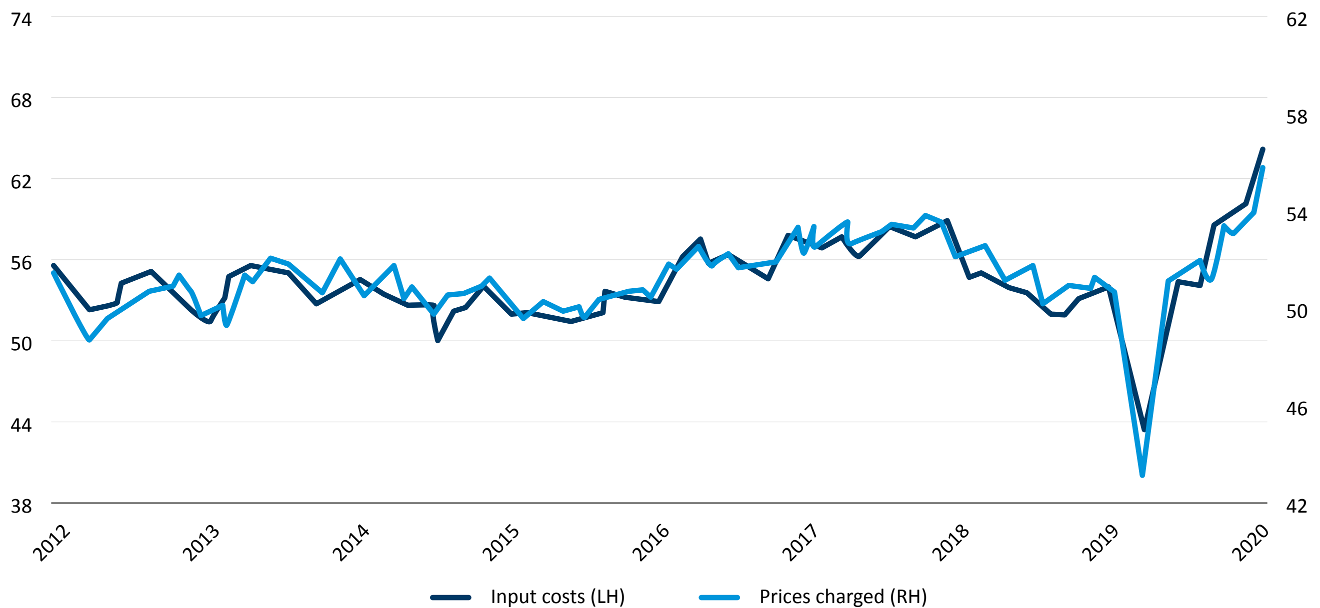


Source: Our World in Data, Segal Lab (Weizmann Institute)

While we remain positive on our outlook for equities in general, a key risk that we have been monitoring for several months now is inflation, where our analysis suggests rising inflationary pressures in 2021, as companies face a surge in input prices. The ISM Prices Paid Index is at record levels and the Producer Prices Index (PPI) registered its largest gain in ~10 years (4.4% YoY in March). From the dozens of company meetings we have held in recent months across many sectors, we have observed countless anecdotes of rising input costs for companies – retailers are grappling with freight costs that have surged 100-500%, copper prices are up ~50%, steel prices have nearly doubled, U.S. lumber costs are up ~200% and numerous soft commodities (e.g. corn, wheat, soy beans, cotton and palm oil) have risen between 30-50% since June 2020. In Figure 5, we note the surge in both 'Input Prices' and 'Prices Charged' in the U.S. Services PMI. Price increases in general have been driven by a stronger than expected rebound in consumer demand and bottlenecks and shortages in supply due to COVID-19 disruptions.

With personal savings rates at records highs and highly accommodative fiscal and monetary policy, we expect consumption to remain very strong in the second half of the year, which will place further upward pressure on inflation and may lead to an overshoot relative to central bank expectations. The significant step up in bond yields we saw over the quarter with a ~84% increase in the Australian 10 year (from 0.97% to 1.79%) and ~90% increase in the U.S. 10 year (from 0.92% to 1.74%) reflects the market placing a much higher probability on both real GDP growth and inflation. While most of the factors driving inflation appear transitory, we are monitoring wage rates, energy markets and capacity utilisation to determine how persistent any rise will be. We are positioned to mitigate some of the risks from an increase in inflation with our bias towards short duration (value and cyclical) stocks, as well as our positions in energy, gold and financials.

Figure 5: U.S. input costs and selling prices



Source: PMI, IHS Markit and JP Morgan

Portfolio Positioning

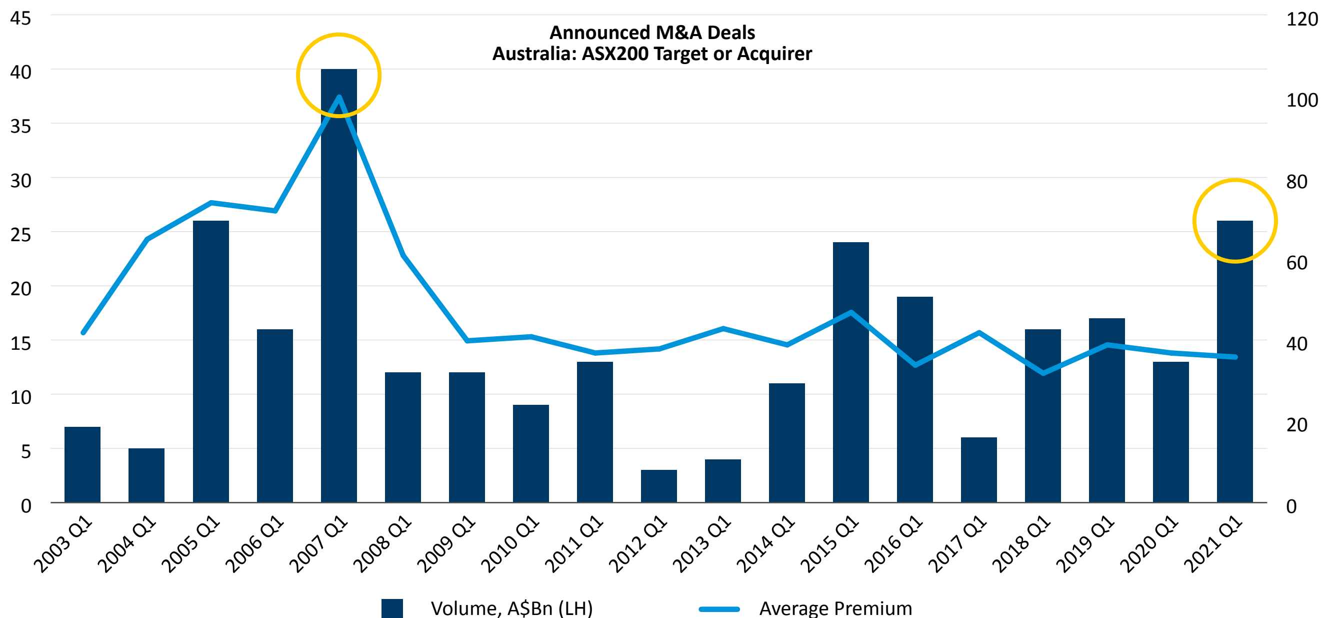
While we are monitoring a number of potential market risks, we continue to be optimistic as we believe we have built a portfolio of many mispriced stocks, with clear upcoming catalysts and strong valuation and balance sheet support. We expect that those factors, together with a strong environment for corporate activity, should provide the portfolio with strong upside potential.

In previous quarters we have written that we think we are on the cusp of a major increase in mergers and acquisitions (M&A) and corporate restructuring activity which will further bolster market performance. We expect five key factors to drive the upturn in activity:

1. **Surging business confidence** – Strong earnings and economic growth forecasts and increasing confidence of a post-pandemic recovery have reinforced the appetite of senior executives to explore strategic deals.
2. **Acceleration in corporate transformation/consolidation** – COVID-19 has pressured some sectors and re-shaped the way they operate, bringing forward decisions on corporate strategy and industry consolidation.
3. **Massive capital pool** – Private equity fund raisings and the listing of numerous SPACs (Special Purpose Acquisition Companies) in the U.S. have created a massive pool of money which must be deployed in the near term. Industry super funds have also become much larger and are taking a more direct role in takeovers, thereby adding to the pool of potential acquirers.
4. **Significant pent-up demand** – We had started to see the early signs of M&A accelerating in 2019, however, the pandemic interrupted the cycle and paused many deals. We expect a catch-up of these transactions over the next 12-18 months.
5. **Favourable debt and equity markets** – Interest rates remain at very low levels with credit terms loosening towards pre-COVID levels and covenant-lite loans on offer once again. Equity markets remain easily accessible.

M&A activity in Australia has already surged so far in 2021 and is on track for the strongest year since 2007 in terms of deal volumes (Figure 6). Even with this strong start, Australia continues to lag the U.S. and Europe, where deal volumes in Q1 have been tracking at a much faster pace fuelled to a greater degree by SPAC and private equity activity.

Figure 6: 1Q 2021 M&A activity in Australia is on track to reach a decade-high



Source: Bloomberg and Goldman Sachs Global Investment Research.

The portfolio is well positioned to benefit from rising M&A and restructuring activity, given our skew to undervalued companies with strategic appeal. Some of the stock specific positions that may benefit from this tailwind are outlined below:

- **Telstra** is in the process of implementing a corporate restructure to separate its core telecom infrastructure assets from the rest of the company. Globally, mobile towers portfolios and fixed network assets have recently transacted at multiples north of 20x EV/EBITDA, reflecting the attractive cashflow profile and demand outlook in increasingly digital economies. With Telstra currently trading on an EV/EBITDA multiple of only 7.5x, we see strong upside potential as the share price adjusts to better reflect the true value of its high-quality infrastructure assets.
- **News Corporation** has pursued a number of initiatives recently to help unlock latent value within its portfolio of assets. During 2020, the break-out of the Dow Jones segment financials has helped highlight the value of that asset to investors, although we remain of the view that the implied US$8b+ valuation for Dow Jones is not being fully recognised in the current share price. In addition, News Corp has been active in its restructuring efforts, by exiting unprofitable operations and through strategic acquisitions, including HMH Books for US$349m, Investor's Business Daily for US$275m as well as REA's proposed US$244m takeover offer for Mortgage Choice. Given the latent value of the portfolio, we believe News Corp could realise further value for shareholders through additional restructuring initiatives and value-accretive M&A going forward.
- **Tabcorp** received two indicative bids for its wagering business with the Board having commenced a strategic review to determine the optimal path forward. The review is set to conclude by June 2021. We believe a sale or demerger of this business will unlock significant value for shareholders as it will both catalyse interest in the wagering business and enable a re-rating for the lotteries business, which we think is well-deserved given its high-quality, infrastructure like characteristics.

In addition to the above, we have several portfolio positions across the oil & gas, industrials, consumer discretionary and resources segments which we regard as potential takeover targets. While this is not the central part of our investment thesis, the supportive M&A and restructuring environment provides free upside optionality across the portfolio.

Key Stock Contributors for the Quarter

News Corp shares continued their strong momentum, rising 36% in the quarter supported by the release of the company's second quarter results, which were materially ahead of market expectations. A key driver of the result was the Dow Jones division, which grew subscriptions by over 18% versus the prior year. Digital-only subscriptions at the Wall Street Journal grew by over 29% and now comprise over 76% of total Wall Street Journal subscriptions, demonstrating the significant transformation of the business. Even following the recent increase in the News Corp share price, we believe the Dow Jones asset remains significantly undervalued by investors. Applying the same valuation multiple to the Dow Jones segment as is being ascribed to the New York Times would imply a value for the Dow Jones asset alone in excess of ~US$8b, which equates to over half the current News Corp market capitalisation. Furthermore, the recent proposed sale of Simon & Schuster (a key competitor to News Corp's book publishing business) for ~15x EV/EBITDA to Penguin Random House should draw more attention to the value embedded in the company's publishing assets. News Corp management is taking progressive steps to better highlight the underlying value of its assets and to simplify its corporate structure, which we expect will continue to unlock value going forward.

Tabcorp shares rallied 20% based on a combination of very strong half-yearly results showing both lotteries and wagering ahead of consensus estimates, as well as corporate interest in its wagering business. Tabcorp provides gambling and entertainment services through a range of brands across three segments: lotteries & keno, wagering & media, and gaming services. Lotteries had a particularly strong period with an uplift in digital sales, a significant increase in keno (reflecting excellent operational execution) and higher long term margins. In the second half of the financial year, lotteries are expected to benefit from a more normal jackpot sequence and a change in lottery game design, while wagering should benefit from retail venues reopening and the launch of new wagering products. Following multiple approaches from a range of corporate and financial buyers, the Board is currently considering the future of the wagering business with the review hopefully concluding by June 2021. We have actively engaged with the Board and management to highlight the benefits of pursuing a demerger and will continue to advocate for unlocking the hidden value in Tabcorp's asset base.

Telstra shares rose 14% during the March quarter with investors responding positively to its 2021 first half results release as well as the update late in the quarter that the corporate restructuring and the monetisation process for its towers portfolio remains on track. At the 1H result, Telstra re-affirmed guidance for the current year, but also provided an earnings pathway towards its FY23 EBITDA target by flagging that it expects FY22 EBITDA will grow by mid-to-high single digit percentage levels. We see this outlook being underpinned by growth in the mobile segment, where competitive intensity has eased over the last 12 months as operators reverse prior years' pricing strategies that had significantly eroded sector returns. The business should also benefit from declining NBN headwinds and ongoing measures to reduce costs. On the restructuring side, Telstra reaffirmed the process was on track, including plans to monetise its portfolio of over 8,000 towers during calendar year 2021. A number of market transactions continue to reinforce the under-appreciated value of these assets, most recently with the IPO of Vodafone Group's European towers portfolio on an EV/EBITDA multiple of 20x. In addition to the towers process, the corporate restructuring will allow Telstra to unlock further value across infrastructure assets, such as ducts and fibre over time.

Oil Search shares rose by 11% over the quarter driven by a continued recovery in oil prices as global inventories normalise based on OPEC and its allies' supply discipline and growing demand. Oil Search is one of the highest quality energy stocks listed in Australia, with its low cost of production, long life assets, attractive growth options and partnership with a high quality operator (Exxon Mobil). Oil Search has a large stake in two very substantial growth projects in Papua New Guinea (PNG) and Alaska. Recent Papua LNG discussions with the PNG Government indicate a far more positive relationship and an increasing likelihood of a project sanction in the coming 1-2 years. Oil Search management is targeting late in the calendar year 2021 for a partial sell-down of the company's Alaskan stake to enable funding and approval for the first stage of PNG development. Furthermore, we expect broader consolidation in the oil and gas industry as a response to the difficult macroeconomic conditions, with Oil Search a likely target given its high quality asset base. While we expect continued share price volatility in the near term, we believe that Oil Search is very well placed over the medium to long term to benefit from a continued recovery in oil prices.

Key Stock Detractors for the Quarter

Resolute Mining shares fell 45% in the March quarter due to general weakness in the gold price, compounded by an announcement that the Ghanaian government is terminating their mining lease at the Bibiani gold mine (this decision was reversed in April). While Resolute has had the mine on "care and maintenance" for many years, they announced a conditional sale of the mine to a Chinese corporate for US$105m in December 2020. Given the decision by the Ghanaian government, that transaction has been terminated. Resolute confirmed the Bibiani sale is not required to meet its debt obligations and reaffirmed 2021 guidance with its two operating assets expected to produce solid results for the period. Resolute shares remain dramatically undervalued and we believe the shares will begin performing as it delivers on its 2021 outlook, with further benefits from any potential stabilisation or recovery in the gold price.

Chorus shares declined 14% in the March quarter. The stock has been impacted by a punitive determination by the New Zealand Commerce Commission on the allowed rate of return for Chorus's fibre assets. The very low allowed rate of return severely underestimates the real risks investors have taken on in building and operating the fibre network. We are hopeful this will be corrected through a much more commercial approach to the assumptions underlying the asset base and a re-examination of other assumptions through the rest of this year. Failure to do so would send a strong signal that there is huge risk in entering into long term public private partnerships with the New Zealand government and that New Zealand is not a reliable destination for investing in regulated assets. In terms of company fundamentals, Chorus's fibre build has been consuming the majority of cashflow for many years, preventing the company from paying out its true underlying earnings in dividends. With the peak capex period now past, we are hopeful that shareholders will finally begin to see the returns on this 10-year investment program.

Atlas Arteria shares fell 9% during the quarter on the back of continuing restrictions on travel in France as well as the recent rise in bond yields. Atlas Arteria is part owner of one of France's best quality tollroad networks, the 2,318km APRR. While the company continues to be impacted by pandemic-related traffic declines and the slow roll out of the COVID-19 vaccine in France, this temporary impact does not materially change our medium term valuation view. Atlas Arteria raised ~$495m to strengthen the balance sheet in 2020 and remains well funded to weather near term COVID-19 related volatility. We still see substantial upside in the company as dividends return in 2022 towards our previous expectations.

DAILY CLASS

L1 Capital Australian Equities Fund

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L1 Capital Overview

L1 Capital is a global investment manager with offices in Melbourne, Sydney, Miami and London. The business was established in 2007 and is 100% owned by its senior staff, led by founders Raphael Lamm and Mark Landau. The team is committed to offering clients best of breed investment products. L1 Capital manages money for a range of clients including large superannuation funds, pension funds, financial planning groups, asset consultants, family offices, high net worth individuals and retail investors. L1 Capital uses a fundamental, bottom-up research process to identify investments with the potential to provide attractive risk-adjusted returns. The L1 Capital investment approach is largely style-neutral with modest value and contrarian characteristics. The firm launched the L1 Capital Long Short Fund in September 2014. The Fund has returned an average of 22.1% p.a. (net of fees) since inception.

Fund Information – Daily Class

Name	L1 Capital Australian Equities Fund
Class of Units	Daily
Structure	Unit Trust
Domicile/Currency	Australia/AUD
Class Inception	23 August 2007
Management Fee	0.77% p.a. inclusive of GST and RITC
Expenses	Maximum of 0.20% p.a.
Performance Fee	15.38% above S&P/ASX200 Acc Index*
High Watermark	Yes
APIR/ARSN	LCP0001AU/621 183 195
Minimum Investment	A$25,000
Subscription Frequency	Daily
Redemption Frequency	Daily

Service Providers

Responsible Entity	Equity Trustees Limited
Fund Administrator	Mainstream Fund Services
Fund Auditor	EY
Fund Custodian	Mainstream Fund Services
Legal Advisor	Hall & Wilcox

Level 28, 101 Collins Street
Melbourne VIC 3000 Australia
Phone +61 3 9286 7000
Fax +61 3 9286 7099
Email **info@L1.com.au**
www.L1.com.au

* The performance fee is equal to the stated percentage of the amount by which the Fund's performance exceeds the S&P ASX 200 Accumulation Index (after management expenses but before performance fees) in a Performance Period.

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Information contained in this publication
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