L1 CAPITAL

DAILY CLASS

Australian Equities Fund

Quarterly Report | September 2020

Inception Date: 23 AUGUST 2007 | Unit Price: 1.4568[1,2] | Fund NAV: $65m

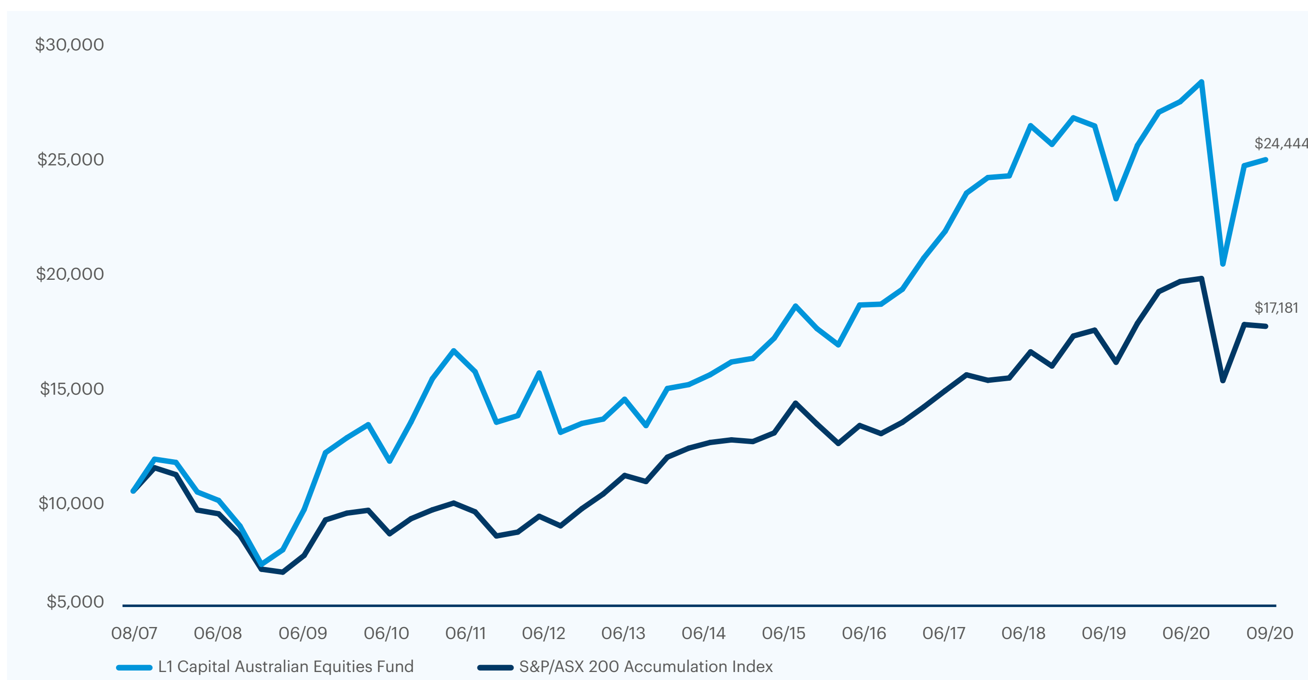
- **Over the September quarter, the Fund returned 1.1% (net), outperforming the S&P/ASX 200 Accumulation Index by 1.5%.**
- **The Fund performed strongly, primarily due to good stock selection across the portfolio during August reporting season.**
- **Since inception, the Fund has outperformed the index by 2.8% p.a. (net).**

Performance Summary (%)

	Fund (net %)	Index (%)	Alpha (net %)
One month	–3.35	–3.66	0.32
Three months	1.08	–0.44	1.52
One Year	–9.37	–10.21	0.84
Three Years (p.a.)	0.92	4.80	–3.88
Five Years (p.a.)	8.34	7.31	1.03
Ten Years (p.a.)	6.51	6.93	–0.42
Since inception (p.a.)	7.05	4.21	2.84
Since inception (cumulative)	144.44	71.81	72.63

NOTE: All performance numbers in this update are quoted after fees. All performance numbers prior to 15 September 2017 relate to the L1 Capital Australian Equities Fund wholesale class of units. The L1 Capital Australian Equities Fund PDS and RG (first issued 5 September 2017, last updated 19 March 2019) are a daily class of units. Past performance is not predictive of future returns. Index is the S&P/ASX 200 Accumulation Index.

Fund Performance vs S&P/ASX 200 Accumulation Index – Growth of $10,000 invested since inception (net)



The Fund delivered a net return of 1.1% (net) for the September quarter outperforming the S&P/ASX 200 Accumulation Index by 1.5%. Stock performance during reporting season proved to be a major driver of returns, with the Fund benefitting from:

- Buying the market aggressively at the March lows – these opportunities typically only come around once or twice in a decade, so we are pleased to have maintained our composure and acted decisively to take advantage of the panic.
- Stock selection – numerous examples of identifying the 'winner' across a number of sectors, e.g. Chorus in telcos, News Corp in media, Worley in energy, Mineral Resources in mining, Qantas in transportation and Peet in real estate.

Equity Market Observations

Despite a strong recovery in global equity markets since the March lows, sentiment from institutional investors continues to be cautious. The typical concerns cited are the second wave of COVID-19 cases in Europe and America, the upcoming U.S. election, the uncertainty regarding further U.S. fiscal stimulus, the risk of an economic cliff in Australia as JobKeeper and bank loan deferrals come off in Q2 2021 and a lingering concern that "the world will never go back to how it was before COVID-19".

The S&P/ASX 200 is now trading around 6000 (versus 7100 back in February), but within that there are numerous stocks that are still significantly below their February highs, largely due to the impact of COVID-19. We continue to believe equities look far more attractive than other asset classes. Cash and most investment grade bonds globally now yield less than inflation, suggesting continued scope for a rotation to equities that should gather pace as the economic outlook becomes clearer.

Furthermore, central bank actions are designed to increase asset prices which will further support equity markets going forward. This is not an unintended consequence, but rather an intended strategy of the extreme monetary stimulus we have seen (aimed at improving consumer and business confidence and generating a wealth effect to spur economic growth). We expect massive liquidity injections from the Fed and other central banks, including Australia's, to cause asset inflation, rather than goods and services inflation (at least in the short to medium term).

From a sector positioning and style perspective, we have continued to see growth and momentum stocks outperform value stocks. Since the start of the global pandemic, investors have sought refuge in stocks that have the following three attributes:

- No significant impact from COVID-19 shutdowns,
- Little impact from collapsing economic activity, and
- An under-geared balance sheet, with no risk of equity raise.

The result of this 'process of elimination' has seen investors crowd into technology, healthcare, iron ore and supermarket stocks. As investors soon realised that consumer spending would be confined to buying 'goods', given their inability to spend on 'experiences' (such as eating out, travel or entertainment), discretionary retailers became another 'COVID-19 beneficiary' sector. This has created a bifurcated market, with 'COVID-19 losers', such as travel, energy, casinos, shopping centres, financials and infrastructure stocks generally trading 20-50% lower than their February highs. Conversely, many 'COVID-19 winners' are now trading at or near record highs, often due to a large P/E re-rating rather than a significant change in their earnings outlook.

Valuations for growth and momentum stocks are now the most stretched we have ever seen. Australian high P/E stocks are trading at 45-50x (versus a long term average P/E of 24x and a P/E of 30-35x in January).

Portfolio Positioning

We remain very positive on the outlook for equities given the wave of central bank stimulus globally and our constructive view on the outlook for a COVID-19 vaccine.

Adding to our excitement is the extreme dispersion in stock valuations. This level of dispersion is likely to add considerably to returns over the next 1-2 years. While we build our portfolio 'bottom-up' from our stock research (selecting stocks that represent the best combination of value and quality), when we step back and look at the major themes and opportunity sets we see at present, they broadly fall into four key themes.

Fund – Key Themes

1) Monopoly real assets – companies such as Chorus, Atlas Arteria, Aurizon.

   These companies look incredibly attractive at present. In general, these companies own monopoly or privileged assets that cannot easily be replaced or substituted. They are expected to generate dividend yields (or free cash flow yield) of at least 6-7% p.a. in coming years with continued growth in dividends beyond that. Some also offer the potential for additional capital management given they currently have under-geared balance sheets. In a world where long-term bond yields continue trading at 0-1%, we believe these stocks represent an extremely attractive opportunity for investors seeking safe yield.

2) COVID-19-hit stocks – companies such as Star Entertainment, Scentre Group, Downer.

   These companies have had a major hit to their earnings or business models due to COVID-19 and fall into the 'COVID-19 losers' category outlined earlier. We expect many of these stocks will recover most of their losses over the next year as COVID-19 vaccine and treatment progress becomes tangible. In our forecasts, we allow for weaker earnings (and in some cases a potential capital raising) and we still see very significant upside on a 1-2 year view.

3) Resource-related stocks at a cyclical low point – companies such as Oil Search.

   We are contrarian investors and like to buy high quality cyclical stocks at a low point in their cycle. Commodities such as oil, coking coal and to a lesser extent copper have all reached an extreme cyclical low over the past few quarters and share prices are now reflecting an unsustainable situation, where a large proportion of the world's production is simply not viable at current pricing.

4) Conglomerates with high quality assets and a valuation catalyst – companies such as News Corporation and Iluka.

   When investing in conglomerates we look for three main factors before investing, namely: a selection of high quality, market leading assets, a material discount to the sum of the parts valuation of these assets and most importantly an upcoming catalyst that will result in the market better reflecting this underlying value. We believe News Corporation and Iluka each have major positive catalysts on a 12 month view:

   - News Corporation – Potential restructure/demerger of the digital real estate assets (such as REA & Move) or the Wall Street Journal, and
   - Iluka – Demerger of Mining Area C Royalty expected in late October.

Key Stock Contributors

Chorus shares rallied 14% after reporting FY20 results that demonstrated good cost control and continued take up of fibre services. Valuations for infrastructure assets continue to increase in a lower bond yield environment with Chorus benefiting from this trend, as well as from a greater appreciation for high-quality fibre assets amidst the COVID-19 pandemic. The fibre build has been consuming the majority of Chorus' cashflow for many years and has prevented the company from paying out its true underlying earnings in dividends. With the peak capex period now past, we are hopeful shareholders should finally see the returns on this 10-year investment program.

News Corp shares gained 12% over the quarter, having reported a strong FY20 result with all key divisions materially ahead of market expectations. News Corp provided additional disclosure around the Dow Jones assets (including the Wall Street Journal) bringing further visibility to the significant value of these assets as compared to listed peers such as the New York Times. If we apply the New York Times' earnings multiple to the Dow Jones assets it would imply a stand-alone valuation of ~US$7b. We continue to believe News Corp is materially undervalued with the REA interest combined with their net cash position exceeding their current market cap of ~US$8.4b. This implies the remaining media, publishing and real estate assets, including the above-mentioned Dow Jones assets, currently valued at roughly zero. News Corp management are taking progressive steps to better highlight the underlying value of the assets and simplify the corporate structure which we believe will continue to unlock value going forward.

Peet Limited shares rallied 27% over the quarter with a strategic real estate fund manager (360 Capital) becoming a substantial shareholder. Peet is a developer of master planned residential communities with a primary focus on the first home buyer. We provided a detailed note on Peet in our December 2019 quarterly report which called for a change in strategy for the company to focus on the funds management business and transition to a capital-light development model. We welcome further strategic interest in Peet and continue to believe the company is significantly undervalued. We continue to engage with the Board and see a path to a much higher share price assuming a well-executed change in strategy as we outlined in our December quarterly report.

Worley shares rose 10% after reporting resilient FY20 results that highlighted the more diversified nature of the business post the ECR acquisition. Worley proactively managed costs and staff utilisation levels to deliver second half earnings in line with the first half, along with a large improvement in cash generation, despite the impacts of the oil downturn and COVID-19 disruptions across the business. Worley initiated a $275m operational cost out program (~26% of FY20 EBITDA), with $165m of this program already delivered on a run-rate basis. While the near term outlook may be more subdued, the significant cost action taken by Worley provides a material buffer for any potential revenue weakness. Worley management have done an outstanding job of navigating the downturn, streamlining operations and positioning the business to capitalise on an improvement in the capex cycle. We continue to believe Worley is materially undervalued with the market underappreciating the flexibility of its engineering consulting business model and the diversified and resilient nature of its operations.

Qantas shares returned 7% over the quarter due to better vaccine prospects and falling COVID-19 case numbers in Victoria. This followed Qantas' announcement of a ~$1.9b capital raising in late June together with a significant restructuring and right-sizing program that should deliver $1b in ongoing cost benefits. The loyalty program continues to perform strongly and the shift away from cash towards more online transactions should produce sustained benefits going forward. We expect the competitive environment to remain rational and favour Qantas, given that Virgin has announced the closure of Tiger and has flagged reducing capacity to focus on positive cashflow and profitability. We believe Qantas can re-emerge in a stronger position post the COVID-19 disruption due to the significant cost out actions taken, the improved industry dynamics that will likely support higher market share going forward and its considerable balance sheet capacity providing flexibility to weather near-term volatility. Qantas management have also reiterated their FY23 operating targets, which we view as an affirmation of their ability to bounce back strongly as conditions allow. Alan Joyce, Qantas' well-regarded CEO, also extended his contract out to FY23, which we view as another clear positive.

Key Stock Detractors

CIMIC fell 23% after reporting weaker than expected first half CY20 revenue and cash flows, primarily due to COVID-19 impacts and temporary delays to project awards. The majority of CIMIC's construction work is government related and while there have been near term delays as governments deal with more immediate priorities, the medium to long term infrastructure pipeline remains substantial. As part of its recent results, CIMIC noted an order book of $70b for award in CY20 and ~$470b from CY21 onwards. We expect this pipeline will increase as governments look to boost infrastructure spending to help stimulate economies post COVID-19. We continue to believe CIMIC is materially undervalued, trading on a normalised P/E of only ~9x despite this significant addressable pipeline and its industry leading positions in construction and mining services. In addition to the above, we believe several catalysts may drive further valuation upside. CIMIC has announced an intention to sell a 50% interest in its mining services business (Thiess) to a joint venture partner in the coming days, which should enable the balance sheet to return to a net cash position.

Oil Search shares fell 17% due to a ~6% decline in crude oil prices and the broader transition away from energy stocks over the quarter. Oil Search is one of the highest quality energy stocks listed in Australia, given 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 PNG and Alaska and, as oil prices recover, we believe the market will likely reincorporate meaningful value for these projects in group valuations. Furthermore, we believe the more difficult economic backdrop in PNG is likely to incentivise the PNG Government to resolve their differences with the joint venture and enable this project to proceed (subject to market conditions). While we expect continued share price volatility in the near term, we believe that Oil Search is extremely well placed over the medium to long term to benefit from a recovery in oil prices.

Resolute Mining shares fell 18% during the quarter due to strike action at its flagship Syama gold mine located in Mali. The company resolved the strike action quickly, with a conciliation agreement signed less than three weeks after the strike action was first reported and only a 3% production cut was noted at the mid-point of the revised full year production guidance. Resolute has a valuable portfolio of assets with low costs of production, long resource life and growth optionality. The company is trading at a substantial discount to most ASX and Canadian listed peers. We believe the shares will re-rate substantially as Syama fully ramps up in the coming months and as the company rolls off adverse gold hedges that will enable much stronger cashflow generation.

Encouraging Outlook for COVID-19 Treatments and Vaccines

As we have written previously, COVID-19 research has a been a huge focus for us throughout 2020. We have conducted an enormous amount of detailed research including more than 100 meetings/calls with leading clinicians, along with the leading major vaccine and therapeutics players. We have been more optimistic than consensus around the likelihood and timing of a safe and effective vaccine, as well as the interim benefits that treatments (such as monoclonal antibody drugs from companies such as Regeneron & Eli Lilly) can be a helpful bridge until the vaccine is commercialised and rolled out globally.

Over the quarter, we have seen rapid and substantial progress:

1) Vaccine trial data to date has been overwhelmingly positive. This provides us with continued confidence that at least one phase 3 trial will succeed in delivering a safe and effective vaccine.

   There are currently nine companies globally in Phase 3 trials – five in the western world (Pfizer, Moderna, J&J, AstraZeneca and Novovax), three in China (Sinovac, Sinopharm and Cansino) and one in Russia (Gamaleya Research Institute). We expect positive data to be released from at least one of the western world Phase 3 candidates over the next few months (Pfizer is expected to read out interim data in the next month and Moderna around December). We continue to find many investors who do not believe that a vaccine will emerge or that it will be rolled out within the next year. Our confidence is based on the fact that:

   - there are more than 160 vaccines that have commenced trials globally,
   - nine trials are likely to complete their final (phase 3) trial in the next 3 months, using a range of different approaches (eg. mRNA, adenovirus, inactivated virus) providing numerous 'shots on goal', and
   - we have seen an unprecedented and co-ordinated effort from big pharma, biotechs, regulators, governments and trial candidates, which we believe will achieve commercialisation of an effective vaccine only 12 months after first identifying the virus.

2) Initial trial data indicates antibody-based treatments could reduce hospitalisation rates by more than 70%.

   Eli Lilly and Regeneron have both reported clinical trials with antibody-based treatments which showed a significant reduction in the symptoms and duration of disease in mild to moderate cases of COVID-19. While these treatments still need to complete their larger phase 3 trials, we are optimistic on their potential to significantly improve COVID-19 outcomes. We note that President Trump was recently administered Regeneron's antibodies (along with steroids and other medications) after he tested positive for the virus and was able to recover quickly and be discharged from hospital after 3 days.

3) The roll-out of rapid COVID-19 antigen testing will facilitate mass screening and contact tracing.

   Since the start of the pandemic, public health bodies globally have rolled out polymerase chain reaction (PCR) based tests for COVID-19. These tests are very accurate but require specialised personnel and need to be centrally processed at a laboratory, which increases costs and report times, sometimes up to a few days. High prevalence countries, like the U.S., simply could not meet the volume of PCR testing and rapid turnaround time needed to stay on top of the outbreak. In late August, the FDA approved Abbott's Rapid Antigen Test, which is cheaper, can be processed at the point of delivery and provides a result within 5 minutes. These tests have begun to be rolled out across the U.S. and we expect that it will significantly improve the detection and containment of COVID-19, as they are ideal for symptomatic detection, mass screening and contact tracing.

We believe the outlook for COVID-19 will improve significantly over the next year as improvements in testing and antibody based treatments reduce the severity of the virus spread. Our discussions with these vaccine companies (and their outsourced manufacturers and suppliers) suggests that we will have widespread vaccine availability by Q2 2021 in the U.S. and Q3 for most of the developed world. We believe the market continues to ignore the fact that Pfizer and Moderna (via Lonza) have already commenced large scale manufacturing ahead of their potential approvals, which will enable a very fast vaccine roll out for high risk populations (such as front line healthcare workers, aged care residents and workers, etc). We expect Pfizer will have more than 100m doses available for supply by December, with clear plans to deliver at least 1.3b doses in 2021. While there is still uncertainty as to the exact percentage efficacy that will be achieved (and the durability of any vaccine), we believe it will be enough to enable people to resume near-normal activities, such as visiting a shopping centre, going to a café, working from the office, taking a flight, etc.

Share prices of many COVID-19 impacted stocks are still suggesting a large and permanent negative impact on earnings and cashflows, because of the fear and uncertainty that the normal (pre-COVID-19) way of living may never return. We believe this set-up has created one of the greatest investment opportunities of our careers, with stocks in sectors such as Travel, Energy, Gaming, Industrials, Property and Infrastructure remaining very oversold and implying a much more bearish outlook for COVID-19 than we believe is likely over the coming 1-2 years.

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Worley (WOR)

Worley is a leading global provider of professional project and asset services in the energy, chemicals and resources sectors. Worley has a worldwide team of ~50,000 consultants, engineers, construction workers and data scientists that are focused on solving complex problems for a range of multi-national clients.

Worley shares are trading ~30% below pre-COVID-19 levels due to the significant fall in the oil price earlier this year and concerns over COVID-19 restrictions leading to a subdued recovery in oil demand. We believe Worley is an attractive investment as the market incorrectly perceives the company as a direct exposure to the oil and gas industry, while greatly underappreciating the flexibility of its engineering consultancy led business model and the diversified nature of its operations. Worley is trading on only 13x consensus FY21 earnings which is a substantial discount to its 3-year average multiple of ~18x and is on a depressed earnings base impacted by COVID-19.

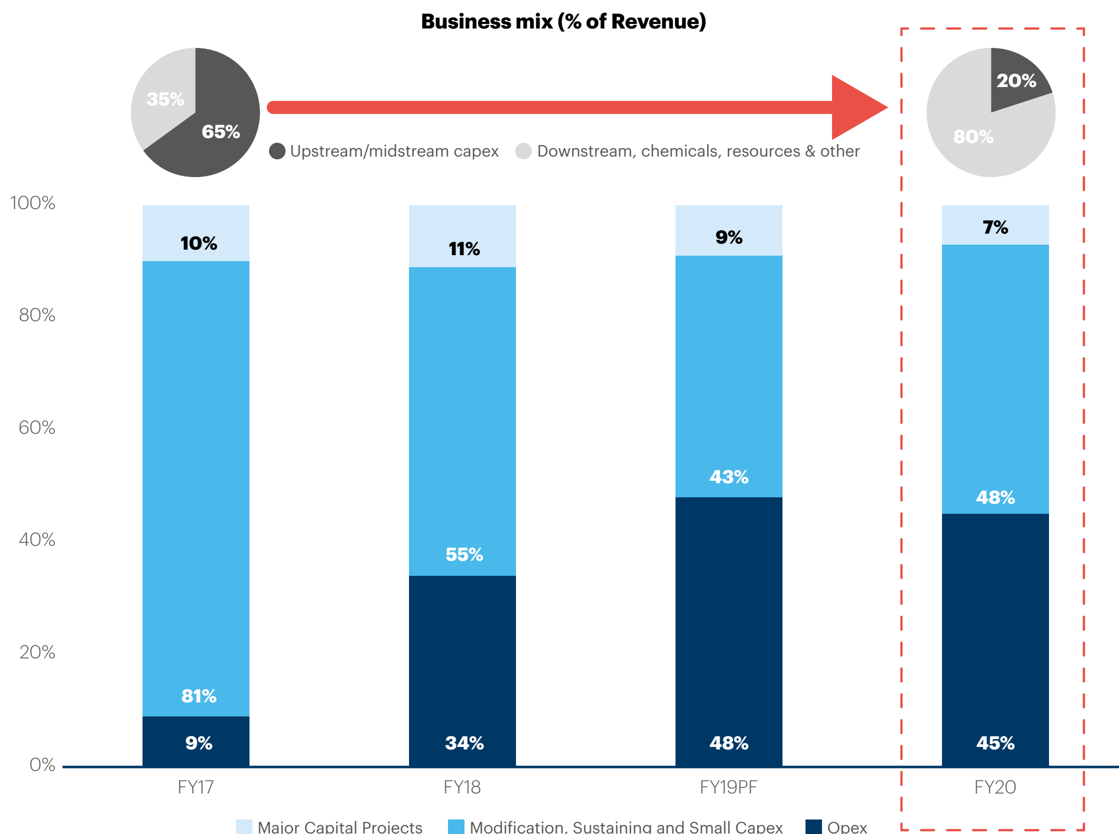
We have been adding to our position at attractive levels over the past few months and believe Worley is incredibly well positioned to deliver margins ahead of consensus expectations and to take advantage of an improvement in the capex cycle as global growth recovers.

There are five key aspects we believe are underappreciated by the market:

1) Worley is a much more diversified business post the ECR acquisition and much better placed to weather the downturn in upstream oil and gas capex relative to prior cycles.

Worley announced the acquisition of Jacob's Energy, Chemicals and Resources ("ECR") division on 22 October 2018, nearly doubling the proforma revenue of the company. The ECR acquisition resulted in a significant shift in Worley's revenue exposure towards more opex related activities and away from predominantly upstream and midstream capex exposure. As illustrated in Chart 1, upstream/midstream capex comprised ~65% of Worley's revenue in FY17, with this dropping to ~20% in FY20. Furthermore, opex related expenditure, which is typically much more stable, has increased from <10% of revenue in FY17 to ~45% of revenue in FY20. The fundamental shift in business mix has resulted in a much more resilient and diversified business model going forward.

Chart 1: Worley revenue exposure

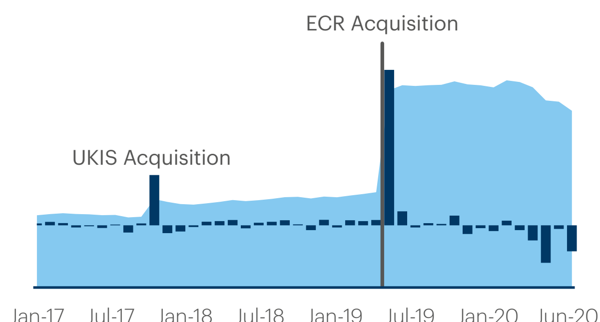


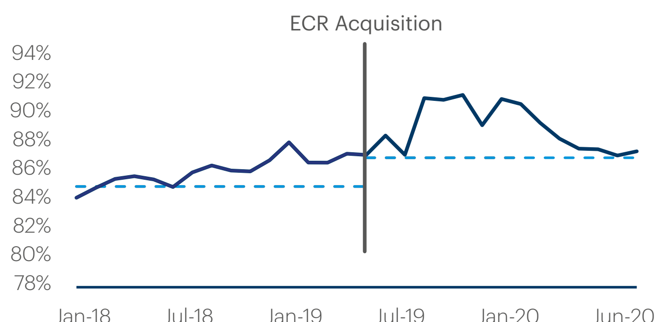
Source: L1 Capital Analysis, Worley FY20 investor presentation.

2) Worley has a flexible, reimbursable led business model that can be scaled up or down to match market demand, unlike lump-sum focused peers.

We believe Worley is much more comparable to a global engineering consultancy business than a lump-sum contractor. Worley derives ~81% of its revenue on a reimbursable basis and tightly manages headcount to maintain utilisation above target levels as illustrated in Chart 2 below. Labour costs are Worley's largest expense and comprise ~70% of FY20 direct overheads. Worley is therefore able to materially scale its cost base up or down in response to the demand environment. For the second half of June FY20, Worley delivered a 70bps improvement in EBITDA margins on a year on year basis through the delivery of synergies from the ECR acquisition and its proactive management of utilisation levels. Worley's key European and U.S. peers including Wood Group, Tecnicas Reunidas, Petrofac, Saipem, Aker Solutions, Hunting, Subsea 7, Technip FMC and Schlumberger all had varying levels of margin decline over the same period.

Chart 2: Global headcount and staff utilisation levels



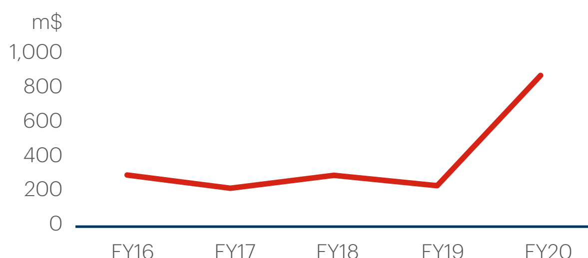


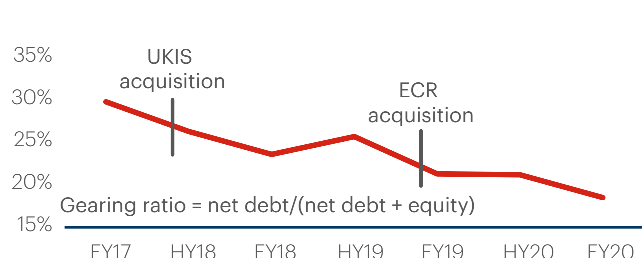
Source: Worley FY20 investor presentation.

3) Worley has continued to demonstrate improving cash generation and lower gearing despite macro headwinds.

A common issue with contractors is the inability to deliver consistent free cash flow due to project related issues and/or working capital delays. A number of Worley's peers such as Fluor and McDermott have had significant issues with fixed price contracts that have either led to bankruptcy filings (in the case of McDermott) or significant share price declines and SEC investigations (in the case of Fluor). Worley does not take on material lump-sum contracts and therefore has a very different risk profile to these peers and a much more consistent cash generation profile. Furthermore, as illustrated in Chart 3 below, Worley management have substantially improved working capital and cash conversion over the period to drive a significant improvement in operating cash generation in FY20 despite the impacts of the oil downturn and COVID-19.

Chart 3: Operating cash flow generation and gearing





* Net debt, gearing ratio and leverage ratio are calculated on the debt covenant definition. HY19 excludes the impact of proceeds from capital raising. FY20 excludes the impact of AASB 16 *Leases*.

Source: Worley FY20 investor presentation.

4) Worley has initiated a significant cost out program, with a history of strong delivery on prior cost-out initiatives.

Worley management have implemented a ~$275m cost out program (~26% of FY20 EBITDA) to streamline and simplify the business in response to the oil downturn. Worley has already delivered ~$165m of the $275m program on a run-rate basis through their actions in the FY20 period. This will be further supplemented by an upgrade to synergies from the ECR acquisition from ~$175m to ~$190m.

The management team have a strong history of delivery on prior cost out programs. From 2013 to 2016, Worley faced a very challenging macro backdrop as international oil majors and national oil companies cut oil and gas capex spending. In response, Worley reduced its overheads by ~33% or ~$500m primarily through optimising its footprint, pooling resources and improving staff utilisation.

While the near term revenue outlook may be more subdued, we believe the significant cost out program and streamlining of operations positions the company well to deliver margins ahead of consensus expectations in FY21 and to take advantage of an improvement in the capex cycle as global growth recovers post COVID-19.

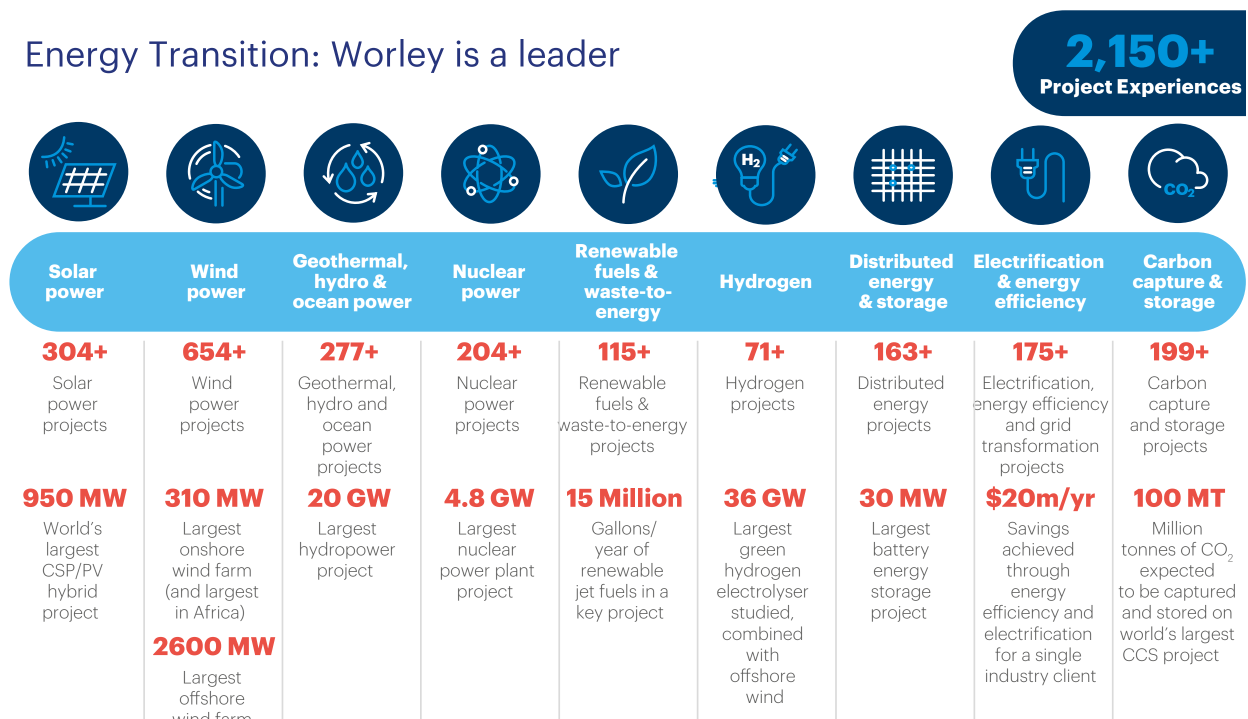
5) Worley is well positioned to benefit from increased spend on energy transition technologies.

Worley is often viewed as a direct exposure to oil and gas expenditure rather than as an engineering and project delivery specialist across the energy, resources and chemicals sectors. We believe the transition to cleaner forms of energy and the global focus on reducing emissions is an opportunity for Worley rather than a threat. Worley's deep bench of engineers can pivot towards solving energy transition related opportunities such as the installation of offshore wind turbines and substations or development of carbon capture technologies to reduce emissions for global oil and gas companies. Chart 4 illustrates Worley's leadership position in executing projects across the energy transition landscape.

We believe investment in hydrocarbons will continue as oil and gas remains a fundamental part of the energy mix going forward and Worley is well placed to benefit here as global oil demand recovers. However, we also believe the shift to cleaner forms of energy will be tailwind to further highlight Worley's energy transition credentials and drive additional growth potential.

In summary, we believe Worley is a compelling long term investment for the Fund and exhibits all the key attributes we look for in a stock – a large discount to valuation, a strong position in their industry and a proven management team with a track record of delivering on their objectives. We believe that over time the market will re-rate the stock as investors recognise the leadership position they have established, along with the resilience and quality of their business.

Chart 4: Worley's energy transition experience



Source: Worley FY20 Investor Day presentation.

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L1 Capital Overview

L1 Capital is a global investment manager with offices in Melbourne, Sydney, New York, 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, endowment funds, private banks, insurance companies, 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 and has produced strong risk adjusted net returns of 16.6% p.a. since inception.

Fund Information

Name	L1 Capital Australian Equities Fund
Class of Units	Daily
Structure	Unit Trust
Domicile/Currency	Australia/AUD
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/ASX 200 Acc Index*
High Watermark	Yes
APIR/ISIN	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	JP Morgan
Legal Advisor	Hall & Wilcox

There have been no changes since the last quarterly report.

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Information contained in this publication

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