L1 Capital International Fund

Quarterly Report | June 2020

Introduction

In this quarterly report we have outlined:

- The key drivers of the market's performance over the past three months.
- Updated commentary on how COVID-19 is being incorporated into our Investment Philosophy.
- Recent portfolio investment decisions and performance.
- The L1 Capital International Quality rating system.
- An overview of Verisign, which is the world's largest domain name registry for .com and .net website addresses.

Fund Performance

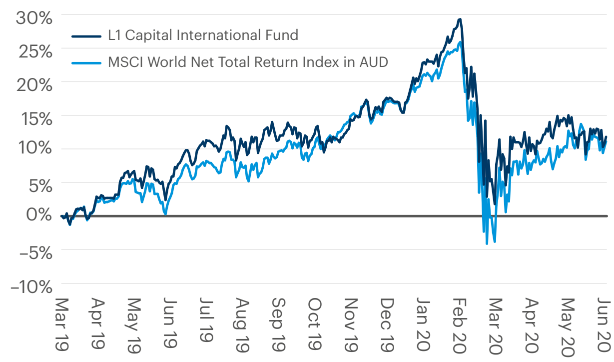
Fund Performance*	(%)	Index** (%)	Excess (%)
1 Month	–2.5	–1.0	–1.5
3 Month	3.0	6.1	–3.1
1 Year	3.2	4.8	–1.6
Since Inception – 1 March 2019	11.8	11.1	0.7

* Rounded to one decimal place. Numbers may not add due to rounding.

** MSCI World Net Total Return Index in AUD. Return measured from Index close on 1 March 2019.

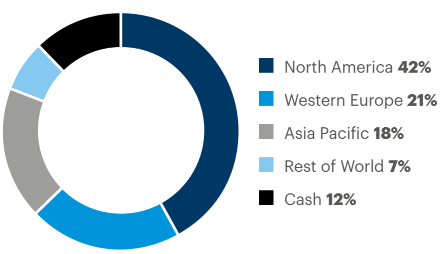
Largest 3 Contributors	Largest 3 Detractors
Facebook	CME
Mastercard	Diageo
Microsoft	Unilever

Fund Performance since Inception



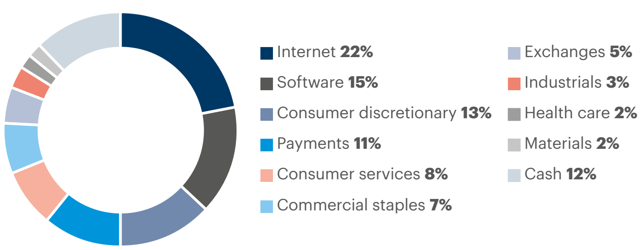
Top 10 Holdings (in alphabetical order)	Sector
Alibaba	Internet
Alphabet	Internet
Amazon	Consumer Discretionary / Internet
Aon	Commercial Services
Facebook	Internet
Fidelity National Information Services	Software
Marsh & McLennan	Commercial Services
Mastercard	Payments
Microsoft	Software
Visa	Payments

Revenue Exposure By Region*



* Revenue exposure by region is internally estimated on a look-through basis based on the underlying revenues of the individual companies held in the portfolio.

Sector Exposure**



** Industry classification is defined by L1 International to best describe the nature of the underlying businesses.

L1 Capital International Investment Philosophy – update on incorporating COVID-19

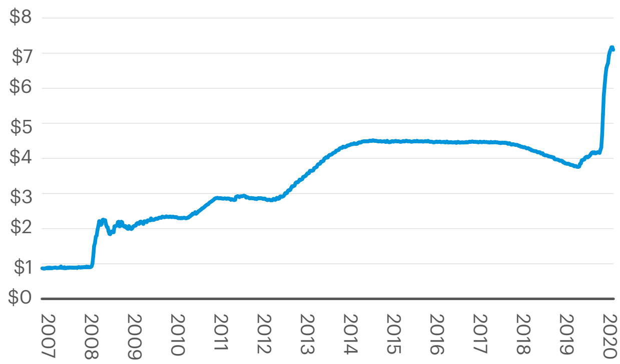
Equity markets have changed significantly since our previous quarterly update. Late March 2020 has so far proven to be the depths of the equity market's response to COVID-19. From 23 March 2020 to 30 June 2020, the MSCI World Net Total Return Index has increased 37.3% in USD (15.6% in AUD due to the appreciation AUD).

The key drivers of the market's recovery have principally been:

- The Federal Reserve's (and other Central Banks') actions to cut interest rates, buy financial assets and increase liquidity in financial markets.
- A desire and willingness of politicians to incur large deficits to make payments to people impacted by COVID-19 as well as open economies and reduce social distancing restrictions, leading to an improvement in economic conditions.
- An improvement in COVID-19 infection and death rates in the United States, Europe and Asia with progress made on medical treatments (although infection rates have recently been increasing in some regions).

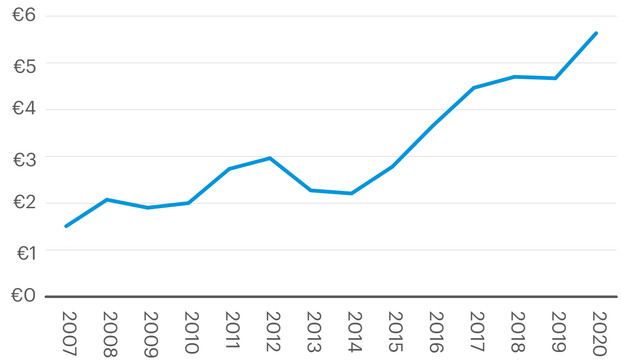
The willingness of the Federal Reserve to expand its balance sheet and cross previous red lines such as the acquisition of sub-investment grade debt has been exceptional. Other Central Banks have directionally followed the same course of action:

Fed Balance Sheet (total assets in $ trillion)



Source: Federal Reserve.

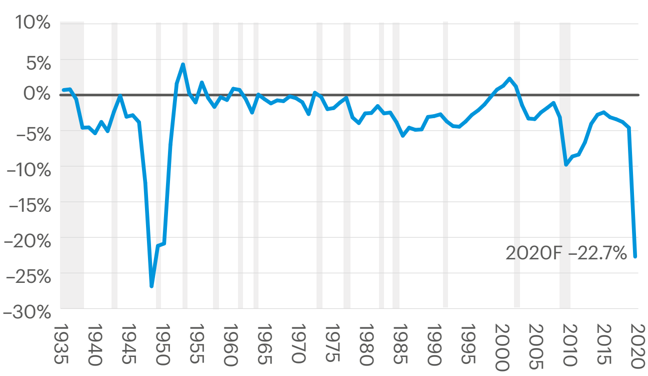
ECB Balance Sheet (total assets in € trillion)



Source: European Central Bank.

Meanwhile, Budget deficits are ballooning as Governments around the world provide increased unemployment benefits and other fiscal support to the large number of people who have lost employment or otherwise been impacted financially by COVID-19.

US Fiscal Balance as a percentage of GDP



Source: Federal Reserve. Forecast UBS Research.

* Shading indicates US recession.

At the centre of the COVID-19 pandemic is a trade-off between "wealth and health". Many academic studies have already been undertaken on societies' varied approaches to this trade off (The Centre for Economic and Policy Research (CEPR) has some interesting articles on their findings while The Organisation for Economic Co-operation and Development (OECD) has published confronting studies on the economic value of human life).

Politicians in many regions re-opened their economies to minimise economic damage at the expense of COVID-19 related health issues. It appears around the world politicians and populations are willing to accept the cost of relatively higher levels of COVID-19 related sickness and death to reduce the level of economic damage caused by prolonged, stringent shutdowns. Recent spikes in infection rates in the United States and steps by politicians to halt further re-opening stages (and in some instances wind back previous opening steps) may indicate that some jurisdictions re-opened too fast to adequately manage the health issues.

As stewards of the L1 Capital International Fund's capital, our role is not to judge whether the political decisions regarding COVID-19 and changes to social and economic restrictions are morally correct, but rather form a view on how politicians' and societies' response to COVID-19 may impact the range of operating environments for the companies in our universe.

In our March 2020 quarterly report we outlined that **capital preservation** over the investment horizon is central to our investment philosophy. Given the uncertainties caused by COVID-19 and the potential for materially adverse economic outcomes, we have been erring on the side of caution, acknowledging that our approach may subsequently prove to be too conservative. We also noted that the COVID-19 crisis would not last forever and that markets will prioritise the recovery well before infection rates reduce to low levels or a vaccine is available.

Over the past 3 months available data indicates the impact of **COVID-19 is likely to be less severe than the downside scenarios we envisaged in March 2020**. We are not surprised that equity markets have recovered from their lows, but the strength and speed of the recovery has exceeded our expectations. However, recent increases in infection rates in parts of the United States, continued elevated infection rates in South and Central America, India, the Middle East and the potential for secondary outbreaks are still reasons to **remain cautious**. At the time of finalising this report, reported global daily new infection rates have reached a record high, including in the United States.

Strength of the economic recovery

There has been a clear improvement in economic conditions since late March 2020, although the debate continues whether the recovery will be V, W, U, L shaped – or another letter in the alphabet.

The economic improvement is reflected in spending data provided by Mastercard and Visa. In the United States aggregate spending on cards is now broadly flat with the same time last year. Aggregate spending on debit cards is now up year on year, likely reflecting elevated Government payments to the unemployed. Spending on credit cards in the United States remains heavily impacted, down around 20% y/y at the end of May indicating consumers remain cautious. Outside the United States, aggregate spending was down around 5% at the end of June, while total cross-border volume was down over 40% due to the impact of COVID-19 on international travel (international spending on Visa and Mastercard in person is still down over 70%).

MASTERCARD								
	DEC-19 QUARTER	MAR-20 QUARTER	MARCH FIRST 2 WEEKS	WEEK ENDING 21-MAR	28-MAR	28-APR	28-MAY	21-JUN
Switched volume (total)	12%	8%	8%	–5%	–25%	–17%	–8%	–1%
United States	9%	4%	5%	–6%	–26%	–12%	–1%	5%
Rest of World	14%	11%	11%	–3%	–24%	–22%	–13%	–5%
Switched transactions	19%	13%	18%	2%	–20%	–16%	–7%	1%
Cross-border volume	14%	–1%	–8%	–32%	–48%	–49%	–44%	–41%

Source: Mastercard.

VISA								
			WEEK ENDING[1]					
	DEC-19 QUARTER	MAR-20 QUARTER	10-MAR	17-MAR	24-MAR	31-MAR	APRIL	MAY
US payments volume	7%	5%	8%	7%	–16%	–28%	–18%	–5%
Credit	7%	4%	7%	2%	–20%	–32%	–30%	–21%
Debit	8%	6%	10%	9%	–13%	–22%	–5%	12%
Processed transactions	11%	7%	13%	8%	–14%	–30%	–24%	–12%
Cross-border volume[2]	9%	–2%	–6%	–12%	–32%	–42%	–43%	–35%

1. Estimated based on graphical disclosure.
2. Constant dollar, includes intra Europe transactions which have declined less than other cross-border transactions.

Cross-border volumes excluding intra-Europe transaction decreased 51% in April and 45% in May.

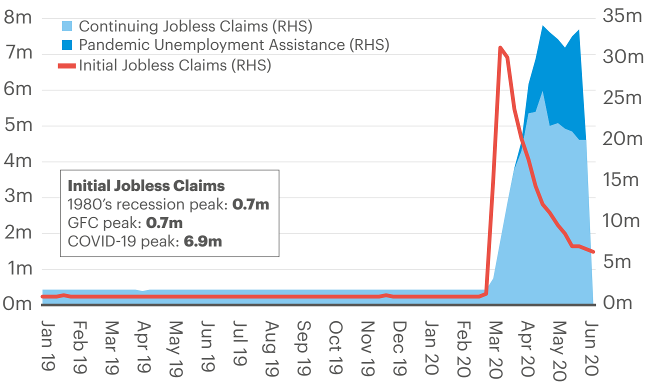
Source: Visa.

The strength and timing of the economic recovery remains highly uncertain and structurally uneven. For example, spending in the United States on airlines is still down around 90%, spending on restaurants is down 20% to 30%, conversely spending on online electronics is up over 100%[3].

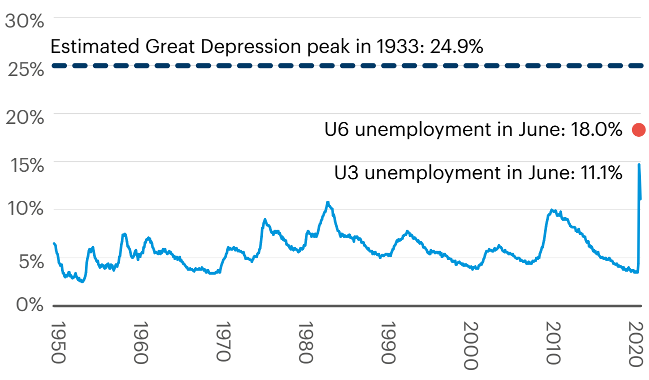
3. Bank of America card data as at June 2020.

US jobless claims continue at a unprecedented levels and while continuing jobless claims may have peaked and some job recovery is occurring, these levels of claims are still deeply concerning.

Employment conditions went from great to terrible in a month



Source: Bloomberg.



Source: Bloomberg.

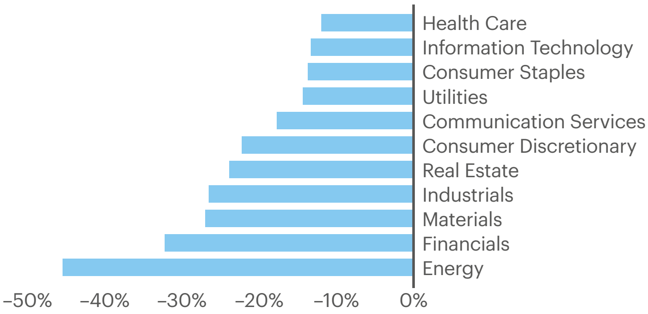
The **global economic environment remains stressed and is far from normal**. However, our view is the **tail risk of a deeply depressed economic environment has reduced**. Increases in COVID-19 related sickness and ongoing or reinstated social distancing restrictions may well occur, but it is likely people and economies will be able to adapt without the extreme social distancing restrictions enforced in March and April 2020.

Our objective is not trying to predict the exact timing and strength of the economic recovery, or to try to "time the market". We focus on making sure the businesses we invest in have long term positive business drivers, the financial strength to successfully navigate a stressed operating environment and have management teams driven to improve their competitive position and build shareholder value over time through a range of operating conditions.

Recent equity market performance by sector

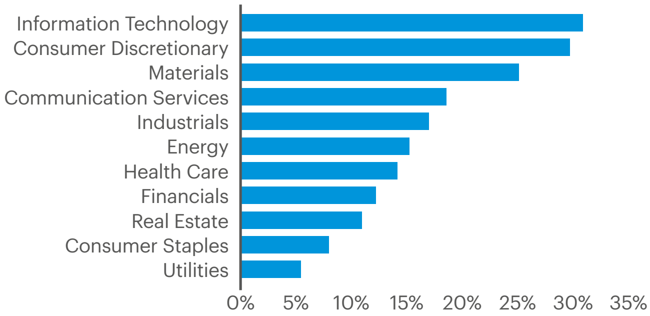
The share prices of more cyclical and highly levered companies which were under significant pressure in Q1 2020 have generally bounced back strongly in Q2 2020:

MSCI World Returns by sector (3 months to 31 March 2020)



Source: Bloomberg.

MSCI World Returns by sector (3 months to 30 June 2020)

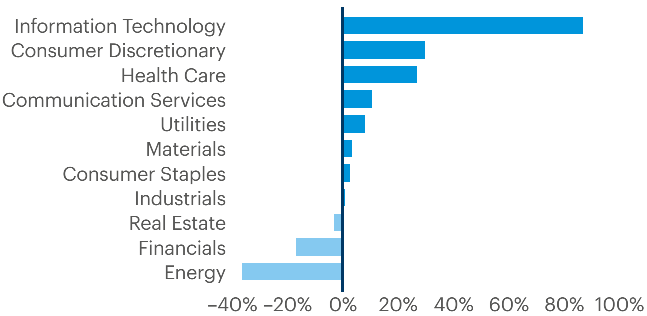


Source: Bloomberg.

The L1 Capital International Fund remains selectively overweight high-quality businesses in sectors that have sustainable, long-term tailwinds driving outperformance such as information technology and consumer discretionary. The Fund currently has no exposure to sectors we consider to be commodity orientated with secular challenges such as the energy and financial sectors.

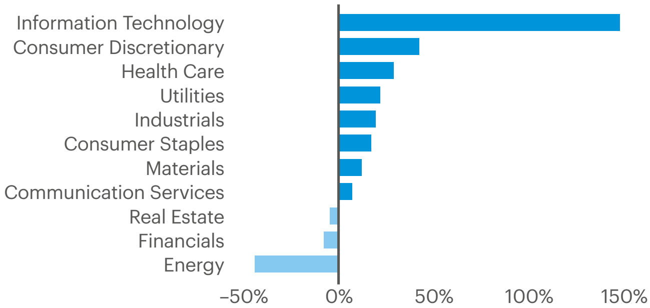
Superior risk adjusted investment returns from investing in advantaged businesses in favourable industries is more evident over a longer-term investment horizon:

MSCI World Returns by sector (3 years to 30 June 2020)



Source: Bloomberg.

MSCI World Returns by sector (5 years to 30 June 2020)



Source: Bloomberg.

June 2020 Quarter performance and changes to the Portfolio

During the June 2020 quarter, the Fund returned 3.0% (net of fees), compared to the Benchmark return of 6.1%. In USD, the Fund returned 15.8% with the appreciation of the Australian dollar by 12.6% against the USD during the quarter reducing reported returns for both the Portfolio and the Benchmark.

As at 31 March 2020 the Portfolio consisted of 24 investments and 17.7% cash (held in USD). During April 2020, cash increased to a peak of around 21% as position sizes were reduced to reflect our view of a highly uncertain operating environment.

As our assessment of economic tail risks associated with COVID-19 reduced, we added to existing Portfolio investments and also made 3 new investments in our Bench companies. As at 30 June 2020, the Portfolio consisted of 27 investments, and cash (in USD) was 12.2%.

The performance of the Fund in AUD was affected by the USD cash position held and by the appreciation of the Australian dollar. During the June 2020 quarter the Portfolio's average cash balance (in USD) was 18.3%. With the Benchmark increasing by 19.8% in USD, **holding a significant USD cash balance accounted for the Fund's underperformance compared to the Benchmark**.

The improvement in the health environment, combined with unprecedented stimulus by the Federal Reserve, other Central Banks, and governments around the world has been well received by financial markets, resulting in a material expansion of near-term valuation multiples.

While the worst of COVID-19 and associated economic tail risks may be behind us, we **remain cautious about the strength and timing of a full economic recovery** and expect the ongoing improvement in economic conditions to be uneven and for some sectors, elongated.

As we see opportunities for improved risk adjusted returns we will look to make further investments in the Portfolio, leveraging our deep Bench of prospective investments.

L1 Capital International Quality Rating System – Importance of Quality in uncertain times

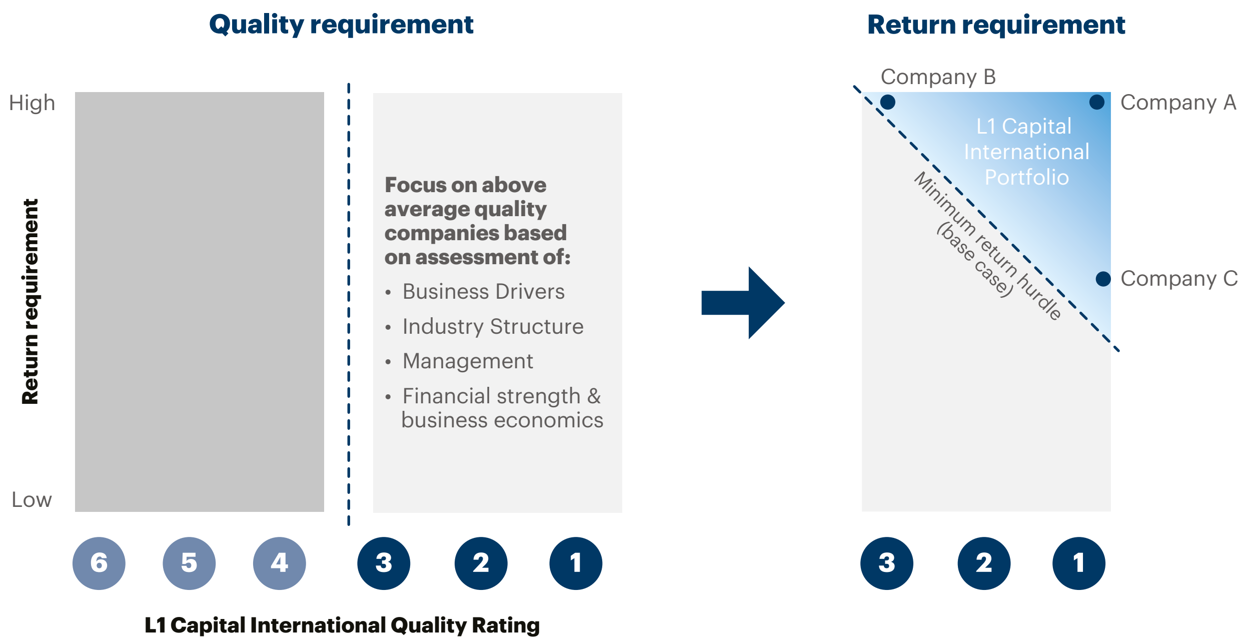
In our view, the Portfolio is the highest quality since inception of the Fund. We have intentionally invested in higher quality businesses during the current uncertain economic environment. In prior quarterly reports we have outlined that our investment philosophy is based on investing in high quality companies that have favourable cashflow-based valuations in well-structured industries. In assessing quality our investment framework focuses on four key areas:

- Business drivers
- Industry structure
- Management
- Financial strength and business economics.

Having assessed these four key areas, we rate a business based on an internal L1 Capital International rating system.

- Category 1 is reserved for what we consider the highest quality businesses in the world.
- Category 2 is allocated to very high quality businesses.
- Category 3 applies to businesses where the quality is assessed to be well above average.

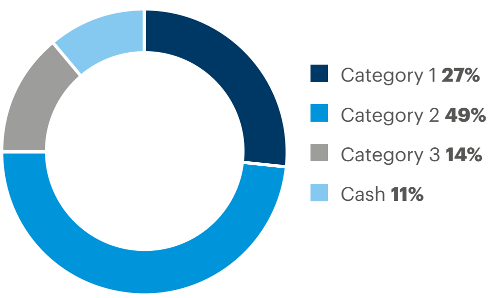
Businesses we assess to be average from a quality perspective are assigned a Category 4 rating, while secularly challenged, declining businesses are rated lower and dismissed. We will only invest in businesses with a quality rating of 3 or higher. Businesses rated 3 must provide a significantly higher forecasted return and will usually be smaller positions in the Portfolio.



Company A: Excellent company (rated 1) at an outstanding valuation (rare)
Company B: Good company (rated 3) require a higher base case return
Company C: Excellent company (rated 1) still needs to exceed our minimum base case return hurdle

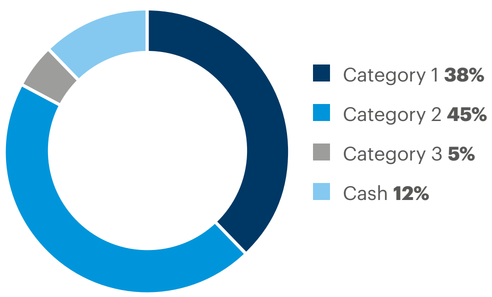
The charts below illustrate the transition of the Portfolio since Inception by quality category, with over 95% of the Portfolio invested as Category 1, Category 2 or held in cash.

Inception (1 March 2019)



Source: L1 Capital International estimates.

Today (30 June 2020)



Source: L1 Capital International estimates.

Portfolio Investment – Verisign

We took advantage of the market sell off in March to initiate a position in **Verisign** – a high quality company that we have analysed and followed for several years. The company operates the largest domain name registry in the world. It has a monopoly to manage the internet's premier top-level domain names – Verisign receives a payment from every website in the world that ends with .com or .net.

Revenues are highly recurring since a domain name is a very low cost, non-discretionary expense (.com costs only $7.85/year). Since customers cannot purchase and own a domain outright, they effectively rent it with Verisign acting as the monopoly registry. Verisign's high certainty over these recurring revenues (domain names can be registered for any period between 1 and 10 years), means that the business has the predictability of a regulated utility but without the burden of high capital intensity.

While Verisign's business is not based on industry leading technology that many of our other portfolio businesses possess, Verisign has unrivalled scale and does not have any direct competition. Verisign also has an exemplary track record in running this service over multiple decades, maintaining 100% operational accuracy and stability.

Unlike other licenced businesses, there are no payments required on renewal, it just needs to maintain service levels and the relationship with its regulators.

Verisign recently regained pricing power having been restricted from raising prices on .com registrations since 2012. The company is now authorised to increase prices by +7% in each of the final four years of a rolling 6-year term, which translates to the equivalent +4.5% per annum. In order to support individuals and small businesses affected by COVID-19, Verisign has committed to not raising registry prices until the end of 2020. We do not expect Verisign to delay price increases for an extended time, recognising the price increase only amounts to around $0.55 per year.

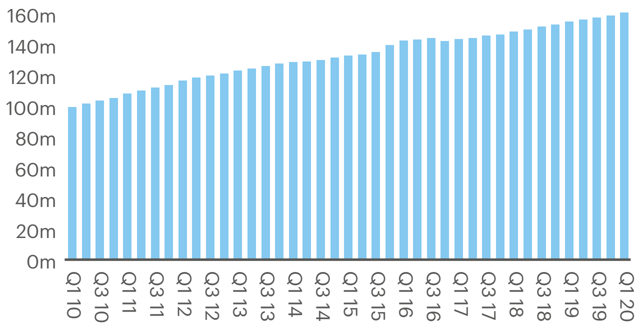
In addition, Verisign has a financial profile that would be the envy of many companies. This includes:

- **Very high margins** – gross margins in the 80's and operating margins in the 60's – which is a reflection of Verisign's scale and relatively simple business. There are very few companies in the world with margins this high.
- **Even higher incremental margins** – most costs are relatively fixed and so there is natural operating leverage in the business.
- **Very high cash conversion** – a function of being paid upfront resulting in negative working capital.
- **Low capital intensity** – low single digit capital expenditure to sales.
- **High returns on invested capital** – book capital is actually negative as balance sheet equity has been reduced below zero due to continuous share buybacks.
- **Sound leverage** – Verisign has always operated with a prudently levered balance sheet.

Verisign has a very long standing and stable management team in place. The current CEO James Bidzos, who is also the founder of the company, has proven to be an excellent capital allocator and has also managed the company's relationship with the various regulatory bodies (ICANN and the NTIA) very well. All excess free cash flow has been returned to shareholders (share count has halved over time) with no value destroying acquisitions.

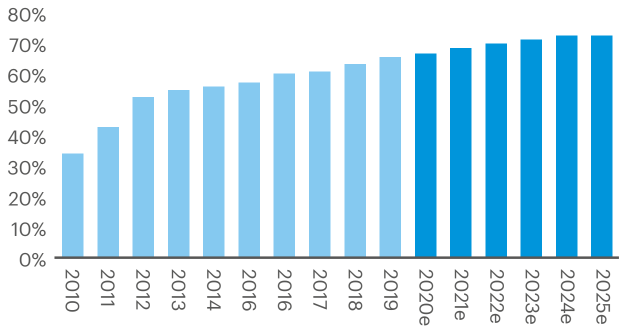
Verisign is trading on a mid 3% free cashflow yield which we believe fairly reflects the underlying predictability, quality and growth profile of the business.

Steady growth in domain names over time



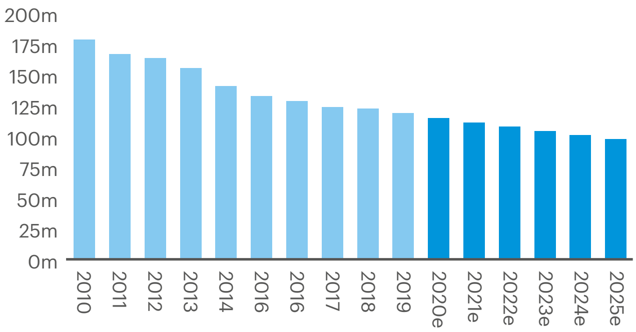
Source: Company data.

High and expanding operating profit margins



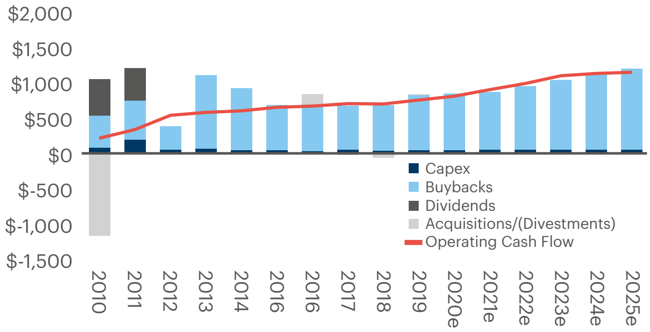
Source: Company data. L1 Capital International estimates.

Falling share count over time



Source: Company data. L1 Capital International estimates.

Management have sensibly allocated capital



Source: Company data. L1 Capital International estimates.

L1 Capital International Fund

Quarterly Report | June 2020

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 that we understand. 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 established in 2007 with offices in Melbourne, Sydney, New York and London. L1 Capital manages money for a range of clients including large superannuation funds, endowment funds, pension funds, financial planning groups, asset consultants, family offices, high net worth individuals and retail investors.

Additional information on L1 Capital is available at www.L1.com.au

Fund Information

Name	L1 Capital International Fund
Portfolio Management	David Steinthal (Chief Investment Officer) David Khaw (Portfolio Manager)
Types of investments	Listed securities globally, developed market focus. No shorting, no leverage
Number of investments	20 to 40, typical position size 3% to 6%
Cash weighting	0% to 25%
Minimum initial investment	$25,000
Hedging	Unhedged
Structure	Unit Trust
Domicile/Currency	Australia/AUD
Inception	1 March 2019
Management Fee	1.2% p.a inclusive of GST and RITC
Expenses	Nil (included in Management Fee)
Benchmark	MSCI World Net Total Return Index in AUD
Performance Fee	15% over Benchmark, subject to any underperformance being recouped. There must be positive absolute performance (adjusted for distributions) in the performance period*
High Watermark	Yes
APIR	ETL1954AU

* Otherwise positive relative performance is carried forward to the next Performance Period.

Service Providers

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

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Information contained in this publication

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