L1 CAPITAL

L1 Long Short Fund Limited

Investor Letter | March 2019

March 2019 Quarter

- **L1 Long Short Fund Limited returned 9.8% for the quarter (after fees).**
- **We believe the portfolio is very well positioned to benefit from fundamentals reasserting themselves in 2019.**

Global equity markets recovered over the quarter, given the much more dovish comments from the Fed in late 2018, along with broad improvement in leading economic indicators in China and to a lesser extent Europe. The ASX200 recovered, with a surge in iron ore prices and a relief rally in banks (after the limited impact from the Royal Commission) driving the market higher. Despite the portfolio being net short iron ore and banks, performance was strong led by a number of positive catalysts during reporting season and several of our offshore positions rallying strongly after being oversold in late 2018.

Some of the best performers over the quarter were Chorus (+23%), Worley (+26%), Alibaba (+26%), HeidelbergCement (+17%) and Alacer Gold (+56%).

In section 1 of this report, we review each of these stocks, along with a high level overview of our investment thesis.

In section 2, we provide a summary of our recent offshore research trips, which have included visits to the U.S. (twice), Mainland China, Japan and Hong Kong.

In section 3, we outline our reason for being relatively upbeat about equities, given the likelihood of a surge in M&A activity in 2019.

Key Details	
ASX code	**LSF**
Share price (31 March 2019)	**$1.47**
Market capitalisation	**$977.3m**
Shares on issue	**664,839,144**
Listing date	**24 April 2018**

Net Tangible Assets Per Share (As at 31 March 2019)	
NTA pre-tax	**$1.6115**
NTA post-tax	**$1.7303**

Net Performance	
Three months	**9.8%**
Total return since inception	**(19.4%)**

Section 1: Portfolio Commentary

Chorus (CNU:ASX) – Long

Chorus remains a high conviction long position in the portfolio. Chorus owns the new monopoly high speed fibre network in New Zealand (approx. 81% of the network), along with 100% of the monopoly copper network.

Over the past year the investment community has been focused on three key risks for Chorus

1. Threat of wireless substitution from Spark's fixed wireless offer which has some early success in signing up customers and the threat of emerging 5G services over the longer term
2. Regulatory uncertainty as Chorus transitioned from being regulated under a telecommunications regime to new utility type regulation
3. Balance sheet risks as Chorus approached peak capital intensity in building the new fibre network

We have focused a lot of our investment analysis on these risks and continue to be very comfortable in our underlying thesis for the company. We believe that Chorus has a highly promising future as a regulated infrastructure provider in New Zealand and has a world class fibre network that cannot easily be overbuilt and will be completed on time and on budget. Over the last 6 months several events have validated our hypothesis and have started to be appreciated by the broader investment market.

1. Fixed wireless competition from Spark is no longer perceived to be a major competitive risk for Chorus as new customer growth has slowed. The major issue has been the fact that the speed and reliability of fixed wireless internet is inferior, especially at peak usage times, such as 7-10pm, when congestion on the network dramatically slows internet speeds. The 5G network build out from 2022 onwards remains a risk but fundamentally cannot be competitive against a next generation all fibre network.
2. New Zealand parliament passed legislation that will enable Chorus' fibre network to be regulated like other essential services, under a Regulated Asset Base. During that process, one of the senior members of our investment team presented in Parliament as part of our long-standing stakeholder engagement. The reality of Chorus's fibre investment is that Chorus is earning a negative return on its fibre investment today. The company has invested $3,245m in fibre capital expenditure since 2013, yet Chorus' earnings have declined by $114m over the same period. This is unusual for any company investing large sums of money and particularly for infrastructure companies, which usually earn more as they invest in the network. Our expectation is that once fibre is fully built Chorus can charge a regulated rate for its fibre service and earn a modest return on investment in line with other infrastructure companies. This will necessarily entail higher broadband prices but for much higher quality of internet service relative to the old copper network. The result of the legislation passing is that Chorus' earnings outlook is now more certain and they will also be able to sustain a higher level of debt

Section 1: Portfolio Commentary

Chorus (CNU:ASX) – Long

on their balance sheet (as ratings agencies view regulated assets as a lower risk proposition).

3. Around a year ago, Chorus' balance sheet was perceived as "overgeared". We never believed the company was overgeared given Chorus was sitting well below its debt covenants, highly cash generative and nearing the peak of the capex cycle (2019) for the fibre build. From next year onwards, the cashflow profile of Chorus dramatically improves, significantly reducing this perceived risk. Moody's recently placed Chorus on credit rating upgrade watch, which we believe is supportive of our view.

Despite the Chorus share price more than tripling since September 2014, we believe the shares remain undervalued, offering a rare combination of extremely high quality assets, an undergeared balance sheet and the potential to significantly increase returns to shareholders over the next few years.

Chorus shareprice

Sources: Bloomberg

Section 1: Portfolio Commentary

WorleyParsons (WOR:ASX) – Long

WorleyParsons is one of the world's leading energy and chemicals engineering consulting businesses. The shares had fallen from around $19 to $11 between October and December last year due to concerns about falling demand for new energy and chemicals projects, along with indigestion from the Jacobs deal capital raising. We used the extreme sell-off to build a position and the shares have since rallied back above $14. Based on our analysis, WorleyParsons is trading on a P/E of only 11x FY21 (once the synergies from the Jacobs assets flow through). We believe the shares deserve to trade at a much higher multiple, given the structural growth in demand for their services (due to rising long term demand for resources from Asia).

WorleyParsons shareprice

Sources: Bloomberg

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Section 1: Portfolio Commentary

Alibaba Group (BABA:NYSE) - Long

In December 2018, we built a position in Alibaba, a Chinese Internet company often referred to as the "Amazon of China". Like Amazon, it dominates both e-Commerce (58% share) and public cloud services (43% share) in its home market. Unlike Amazon, it achieved its dominant position in e-Commerce through a marketplace model with free merchant listings and paid advertising. This means that Alibaba takes no inventory risk, which has allowed them to make consistently high margins (60%+) in the advertising segment. It also means that compared to global marketplace peers, Alibaba is only at the early stages of monetising the 4.8 trillion RMB in merchandise volumes that flow its platform. Today, Alibaba monetises only 3% of Gross Merchandise Value (GMV), which compares to 15%+ for Amazon's marketplace. As an example of this under-monetisation, newsfeed is one of the most popular features in Alibaba's flagship Taobao app. This is a feature where Taobao's 650m active users can browse featured product reviews and listings that are recommended to them based on their purchase history. Alibaba has only just started feed advertising this year as it has historically prioritised demonstrating attractive economics for its merchant network.

By reinvesting a portion of its eCommerce profits, the company, over the last few years, has also built up market leading businesses in logistics, food delivery, on demand video streaming and digital payments. Despite the strength of its core businesses and future growth potential, the stock was heavily sold off in Q4 2018 as the market feared a backlash from the trade war and a broader Chinese slowdown. While these factors did have a temporary negative impact, we believed that the long term structural growth story remained intact and entered the stock when it was trading at a 20x forward P/E multiple, with 25%+ EPS growth for many years to come. Since making our investment only a few months ago, the shares have rallied more than 35% and we remain optimistic about the exciting outlook for the business.

Alibaba Group shareprice

Sources: Bloomberg

Section 1: Portfolio Commentary

HeidelbergCement (HEI:DAX) – Long

HeidelbergCement is one of the world's largest construction materials businesses listed in Germany. The shares performed strongly during the quarter (+17%) on the back of improved sentiment towards global growth and the prospect of rising infrastructure spending in some of their key markets. Despite the prevailing economic weakness, we believe HEI can deliver 5-10% EPS growth p.a. and the current P/E multiple of less than 10x FY20 factors in an overly bearish outlook for the business. We believe consensus earnings expectations remain too low for the business and expect these earnings upgrades may help cause a further P/E re- rating.

HeidelbergCement shareprice

Sources: Bloomberg

Section 1: Portfolio Commentary

Alacer Gold (AQG:ASX) – Long

Alacer Gold is an intermediate-sized gold producer that is dual listed in Australia and Canada. Its most important asset is an 80% interest in the Copler mine in Turkey. While Copler has a long proven history as a successful oxide operation, the larger sulfide deposit has only recently come into production with the commissioning of the 1.9mt sulfide plant in December 2018. We expect Alacer's 80% share of production to deliver around 280k ounces in 2019 at a very low all-in cost of around USD$700 per ounce. This operating cost compares favourably to most mid-cap Australian gold peers. A more significant differentiator is the 20 year mine life for the sulphide project, which also has the benefit of being particularly cash generative because of the low ongoing capex requirements. Despite the strong share price performance last quarter (+56%), we believe the best is yet to come for Alacer as it de-risks the sulfide production over the coming months. Further unpriced upside includes the potential for the company to exceed nameplate production with the sulphide plant and continued growth of the Ardich oxide deposit (which has the potential to maintain production of around 100k ounces p.a. for many years to come). Using the midpoint of Alacer's guidance, the company is trading on a free cashflow yield of around 20% in 2019, with further cash flow growth to come in 2020. Alacer stands out among its peer group, given its very low operating cost, long mine life, considerable growth options and superior cash flow profile.

Alacer Group shareprice

Sources: Bloomberg

Section 2: Global Research Trips

During the March quarter, our team conducted a number of extensive research trips overseas. In total, we made 5 separate offshore visits focused on specific opportunities that we believe are exciting.

Below we have included a brief summary of each of the trips and some of the interesting insights we discovered.

(1) U.S. Research Trip – Housing / Repair & Restoration Market

During the quarter, we spent close to two weeks in the US with a focus on the US housing and repair and renovation ("R&R") market as well as a number of portfolio company specific visits. Some of the more interesting points from the research trip are set out below.

US housing market

We carried out meetings from both a "top-down", macroeconomic perspective as well as a "bottom-up" fundamental basis in order to develop a more complete and timely view of market dynamics.

From a "top-down" perspective, we met with a number of prominent research institutes and associations, including:

- the Harvard Joint Center for Housing Studies – a widely referenced research institute focused on the assessment of the housing, remodelling and rental markets;
- the National Association of Home Builders – ~140,000 members that represent ~80% of new homes built across the US;
- the Federal National Mortgage Association or "Fannie Mae" as it is more commonly known – one of the largest purchasers of mortgages in the secondary market and the largest funder of 30-year US fixed rate mortgages; and
- Hanley Wood – the industry's largest residential data provider.

From a "bottom-up" perspective, we met or had calls with the three largest homebuilders in the US – Lennar, DR Horton and Pulte Group and visited a selection of their housing communities across the US.

Our meetings reaffirmed our more constructive outlook on US housing, with our base expectations of continued modest growth in housing starts in 2019 and 2020.

While there was a material slow-down in demand in Q4 2018, primarily due to the increase in mortgage rates, the demand profile has improved in 2019 as mortgage rates have stabilised on the back of a more dovish tone from the Federal Reserve.

This feedback is reflected in the uptick in US mortgage applications on a year to date basis (refer to the Mortgage Bankers Association Purchase Index* below) and was echoed by our visits to the homebuilders and building communities, who consistently noted an improving trend from January to March this year. The large homebuilders remain positive on the outlook heading into the peak US spring "selling season" which runs from late February to May 2019.

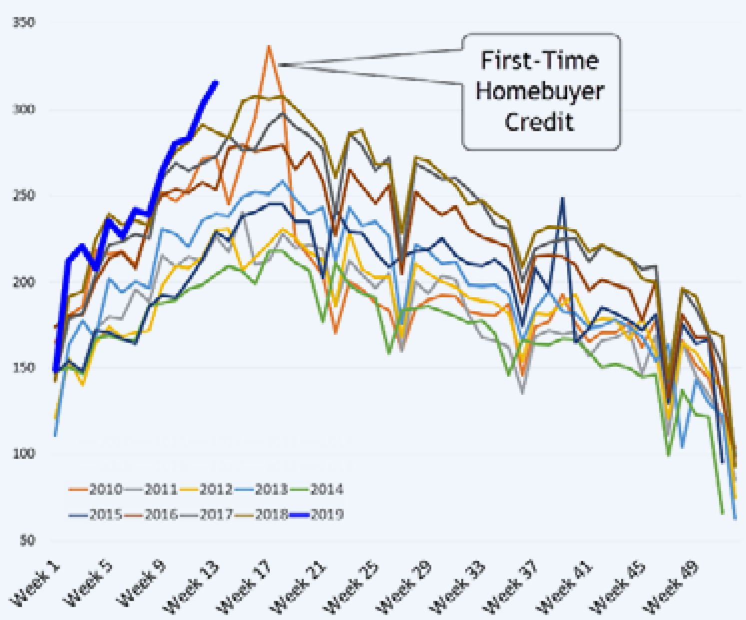
Section 2: Global Research Trips

On a medium term basis, while total US housing starts are tracking at ~1.2m p.a. they remain well below the mid-cycle average of ~1.5m p.a. starts. Despite this, there are supply and demand side restrictions that are likely to temper growth to low-to-mid-single digits going forward. These restrictions are anecdotally referred to as the "5L's":

- Land – lack of land lots available from land developers which have struggled to get financing post the 2008/2009 recession;
- Labour – tight labour availability with unemployment at historic low levels and a more restrictive US immigration stance limiting foreign workers;
- Lumber – rising costs of lumber driven by tariffs and increased transportation costs;
- Legal – increased regulatory costs, greater restrictions and time delays in obtaining land development permits from councils;
- Lending – affordability concerns in certain areas given the significant increase in home prices.

Due to the above restrictions, the current US housing cycle is expected to have a lower growth, more elongated upcycle going forward, relative to the more accelerated "boom-bust" progression that was the case in prior cycles. Importantly, there are currently no indications of material overbuilding or excessive lending that were the hallmarks of the prior downturn.

Mortgage Bankers Association Purchase Index



Source: Mortgage Bankers Association, WSJ.
*The MBA Purchase Index is The Mortgage Bankers Association's weekly measurement of nationwide home loan applications based on a sample of about 75 percent of U.S. mortgage activity.

Section 2: Global Research Trips

Company specific insights

Boral (BLD:ASX) - Long

Boral remains a core long position for the Fund . The improvement expected in the US housing market is supportive of Boral's North American business, which we believe has a number of earnings tailwinds over the next 2-3 years (fly ash volume and pricing growth, Headwaters synergies, ongoing improvement in industry conditions).

Furthermore, our meetings with Boral's US management team and key industry players reinforced our views on the strength of the key fly ash and roofing divisions:

- Boral's has ~50% market share in fly ash (a cement substitute that has superior structural properties) with the potential to grow this further through storage and optimization of its existing supply and further growth as it secures new domestic contracts on the back of its extensive network and experience.
- Boral's roofing business operates in regions such as Florida and Texas where housing demand remains robust, with near-term volume growth further supported by the completion of re-roofing work post Hurricane Irma.

Much like in Australia, Boral's U.S. business endured an earnings headwind in late 2018 due to harsh weather conditions that interrupted its operations. We expect improved earnings trends into FY20 assuming a return to more normal weather patterns.

US Repair and Restoration Market

Ferguson Plc (FERG:LON) and Lowe's (LOW:NYSE) - Longs

We took advantage of the market sell-off in the December quarter of 2018 to build new positions in Ferguson and Lowe's which we view as quality companies with a strong earnings outlook. Our constructive view of the U.S. housing and R&R market provided a point of difference to much of the investment community who had become very negative on the U.S. housing sector.

Ferguson Plc is the leading specialist distributor of plumbing and heating products in America. Whilst the business is listed in the UK, ~90% of revenue is generated from the US across its branch network of ~1,500 stores and 10 distribution centres. Ferguson can be viewed as a business similar to Reece in Australia but with a larger untapped opportunity to consolidate the market. Ferguson, however, trades on a forward PE multiple of around 13x, compared to Reece at ~21x and US peer Watsco at 22x. Interestingly, all three companies are expected to deliver a similar earnings growth trajectory on consensus estimates. Our US visit included a number of store visits to Ferguson branches and discussions with the ex CFO of the Ferguson US business, a 25 year veteran with the company. We have also had several calls with senior management, who we believe are capable, passionate about the business and shareholder friendly.

The trip reinforced our positive views on the investment story and we believe Ferguson can reduce the valuation gap to peers over time as it continues to drive top-line performance through share gains and market growth.

Lowe's is the second largest home improvement retailer in the US behind Home Depot, with US$70bn in annual sales generated primarily from its 2,000 store US footprint. Lowe's has underperformed its key peer Home Depot over several years with average same store sales growth of ~3% p.a. relative to Home Depot at ~5% which has contributed to a ~500bps difference in Lowe's EBIT margins of ~9% vs. Home Depot at ~14%.

Our interest in the stock was piqued when Lowe's appointed Marvin Ellison as CEO in July 2018 to lead an operational turnaround. Marvin is a former senior executive at Home Depot who was in charge of their US store operations from 2002 to 2014 and is therefore

Section 2: Global Research Trips

exceptionally well placed to close the performance gap. He followed his appointment by poaching a number of other senior Home Depot staff and has set upon an operational improvement program that targets a 12% EBIT margin within a 3-5 year timeframe.

We initiated our position in Lowe's when the company de-rated to a forward PE of ~16x, relative to its longer term average of ~18x, on the view that the market was pricing in a more bearish scenario on US housing / R&R spending than would be likely and that the potential upside from closing the performance gap to Home Depot was not being reflected in the share price. Our US trip included a number of Lowe's and Home Depot store visits as well as meetings with Home Depot where we were able to see tangible signs of improvement across the Lowe's network and reaffirm our base case R&R growth forecasts. Lowe's has subsequently rallied ~25% on a YTD basis to a multiple in line with its longer-term average, as housing concerns have abated. While we have trimmed our position into this rally, we believe the progress being made by management is very encouraging. Pleasingly, much of the operational upside is low risk (reducing inefficiencies, improving product range, etc) and within management's control.

(2) U.S Research Trip – Healthcare & Technology

We spent a week in San Francisco attending the JP Morgan Healthcare Conference (widely regarded as the best healthcare conference in the world), followed by visits to a wide range of technology companies in Silicon Valley. One of many highlights was a meeting with Uber management. Under new CEO, Dara Khosrowshahi, Uber is focusing on driving core ride sharing markets to profitability while rapidly expanding the footprint of their home delivery business (UberEats). While we remain unsure of the long-term economics of food delivery, UberEats has already significantly altered food consumption behaviour in many markets and disrupted businesses across the entire retail food supply chain. For example, US competitor Grubhub has already seen heavy market share losses in areas UberEats has become available (Grubhub shares are down 25% over the past quarter).

The impact of UberEats is global and pervasive, with Steven Cain (the CEO of Coles) admitting on their latest earnings call that the industry's slowing sales growth trend has in part been a function of consumers shifting eating habits to food aggregators like UberEats. The convenience and range of options on UberEats is exceptional, which provides a daunting long-term competitive threat for supermarkets who have historically struggled in Australia to offer fresh, interesting meal solutions (given the complexity of transforming the supermarket's supply chain processes and meeting local taste preferences). Given our expectation that UberEats is only just starting to gain awareness and popularity, we believe the impact on supermarkets has only just begun to be felt.

(3) Japan Research Trip

We then travelled to Japan and met with Japanese companies across a variety of sectors, including manufacturing, gaming, telecom and pharmaceuticals. One of the most interesting meetings was with Takeda, a US$80 billion (EV) pharmaceuticals company, which has recently become CSL's largest competitor (after its takeover of Shire). Unlike most Japanese companies, it has an entirely Western management and has embarked on a string of ambitious acquisitions. In our discussions, Takeda's CFO laid out their strategy for re-establishing their lead in the immunoglobulin market through new product launches and expansion of their fractionation/ plasma collection facilities. This has given us valuable insights into the outlook for the plasma industry, the relative opportunities and threats for CSL and areas of risk in this opaque industry. CSL remains the best managed plasma operator globally and in the short term, we believe CSL continues to perform well.

Section 2: Global Research Trips

(4) China Research Trip

Our most recent trip started in Hong Kong where we held a series of 1-on-1 meetings with mainland Chinese companies across the telco, gaming, retail and technology sectors and also attended Credit Suisse's Asia Investment Conference. We also had an opportunity to meet a number of unlisted companies, in artificial intelligence, real estate and resources.

After HK, we then proceeded onto Mainland China. One specific focus of the trip was meeting with some of the biggest rare earths miners in China. China produces around 90% of the world's rare earths, which is a critical input into electric vehicle batteries, wind farms and numerous other technology appliances. The key commodity exposure for Lynas is Neodymium/Praseodymium (NdPr). After a sharp price spike in early 2018, NdPr oxide prices have gradually been declining. Our on the ground research has strengthened our conviction that this is a temporary phenomenon caused by a slower than expected Chinese economy in 2018 and a one-off impact from the withdrawal of electric vehicle (EV) subsidies. Some of the tailwinds we see in the coming year include:

- Continued reduction of China domestic NdPr output as the government renews environmental crackdowns on illicit mines;
- Resurgence of demand as EV adoption continues to climb in China;
- OEMs increasingly prefer permanent magnets (with high NdPr use) over induction magnets in EV powertrains due to its superior energy efficiency and cost

Given that Lynas remains the only significant producer of rare earths outside of China, we believe the market is significantly undervaluing the strategic importance of the business and the earnings upside as China's supply rationalisation takes hold. Wesfarmers' surprise takeover bid no doubt reflects their view that the outlook for battery minerals, such as lithium and rare earths, remains very positive. Media articles suggested that Wesfarmers was also the underbidder on Mineral Resources selldown of Wodgina, the world's largest hard rock lithium mine (The Australian, 28 March 2019).

Section 3 – The Upcoming M&A Frenzy

There are numerous risks for Australian equities investors:

- Valuations are stretched by historical standards
- Declining earnings growth – most companies are now only growing earnings 2-4%.
- Quality of earnings deteriorating – cash conversion has been declining recently
- Likely change of Federal Government – many sectors face policy risk

There are also numerous macro uncertainties that give us reason for caution over the year ahead:

- Global trade war
- Brexit
- Chinese economic imbalances
- European banking system
- Breakup of the European Union (eg. Italy)
- Australia's housing downturn
- Rising populism and anti-business sentiment globally

Each of these risks individually has the potential to derail equities and in each case the timing and magnitude of any issue is difficult to predict.

Yet, despite these risks we remain constructive on the outlook for equities for 2019. Asset allocators face few alternatives, given the paltry yields from bonds, deteriorating property market and minimal returns offered from cash.

There is also one major reason to be positive on equities. We believe we are on the cusp of a huge M&A cycle – something we haven't seen since 2007. A number of events have coincided to create a perfect backdrop for M&A:

1. Private equity has enjoyed a strong period of returns and has now raised massive amounts of FUM that will be deployed into takeovers. The money is highly likely be deployed, as private equity managers only earn fees once funds are invested.

   According to Preqin, there is now approximately US$2 trillion of unlisted private capital available for deals. Of that, around US$360b is focused on Asia. These figures only denote the equity component (and does not incorporate the large proportion of debt that is often loaded on top)

2. Debt markets are now very conducive to M&A – debt is cheap and covenant-lite with extreme gearing levels often available. A typical Australian corporate will have a balance sheet with 1-2x net debt to EBITDA. In some of the recently announced private equity deals, the capital structure of the takeover was extraordinary:

   - MYOB was acquired using 11x net debt to EBITDA (Australian Financial Review, 27 February 2019);
   - Trade Me was acquired using 8x net debt to EBITDA (The Australian, 13 December 2018);
   - Healthscope – property assets expected to be spun into a highly geared REIT structure (Australian Financial Review, 31 January 2019).

Section 3 – The Upcoming M&A Frenzy

3. This extreme gearing is a symptom of very low government bond yields. Debt investors (such as pension & endowment funds) are looking for a yield pick-up and are prepared to deploy money into riskier vehicles on the proviso the underlying business has relatively stable cashflows and they can attain a yield of closer to 5-6% than 1-2% from government bonds. Interestingly, the initial batch of takeovers has focused on well-liked sectors, such as healthcare, technology and education, however the target has been a company that has struggled or is facing competitive headwinds.
4. Another powerful force driving more takeover activity is the rise of industry funds, which have become much larger and taking a more active role in takeovers. Many of the large funds in Australia now control $50-150b of assets, which means owning "only" a 10% stake of a $2b company is no longer enough to move the dial for these investors.
5. The weaker Australian Dollar makes domestic assets attractive to overseas acquirers.
6. Last, but not least, corporates are also getting more desperate to do deals to prop up their own slowing organic growth profile.

The best analogy we can think of for how this M&A cycle will play out is putting popcorn into the microwave. Initially, it seems like nothing is happening. Then you hear a few pops go off (that's the first few deals) and then there is a full blown frenzy of activity (that's what we expect to happen over the next 12 months)

Just in the last few months we have seen bids by private equity for Navitas, Greencross, Healthscope, Trade Me and MYOB. More recently, Nippon Paints launched a bid for Dulux. Unfortunately, the fund was not long any of these stocks.

Overall, we are encouraged by the Fund's improved performance so far in 2019 and believe the portfolio is full of attractive asymmetric opportunities that should deliver further gains into the future.

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Overview and Investment Philosophy

L1 Long Short Fund Limited has been established to invest in a portfolio of predominantly Australian and New Zealand securities, with up to 30% invested in global securities. The Company has the ability to both buy and short-sell securities, which provides a flexible strategy to deal with changing stock market conditions. The objective is to deliver strong, positive, risk-adjusted returns to investors over the long term. The portfolio is managed by L1 Capital Pty Ltd, which has established a reputation for offering clients best of breed investment products. L1 Capital manages money for a range of clients including large superannuation funds, endowment funds, financial planning groups, asset consultants, family offices, high net worth individuals and retail investors.

Investment Guidelines

Andrew Larke	Independent Chair
John Macfarlane	Independent Director
Harry Kingsley	Independent Director
Raphael Lamm	Non-Independent Director
Mark Landau	Non-Independent Director

Service Providers

Manager	L1 Capital Pty Ltd
Prime Broker	Morgan Stanley, Credit Suisse (Europe)
Administrator	Link Fund Solutions
Auditor	EY
Legal Advisor	Kardos Scanlan

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Information contained in this publication

All performance numbers are quoted after fees. Past performance is not predictive of future returns.

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