January 2020

L1 Long Short Fund Limited

(ASX Code: LSF)

Key Details

ASX code	LSF
Share price	$1.49
Market capitalisation	$990.6m
Shares on issue	664,839,144
Listing date	24 April 2018

Net Performance*	NTA pre-tax
One month	(7.75%)
Three months	(5.52%)
Six months	0.63%
One Year	11.00%
Total return since inception	(15.06%)

The L1 Long Short Fund returned -7.8% in January.

After a strong year of performance in 2019 (+26.2%), the portfolio had a weak January. The portfolio is positioned for improved global growth, given the backdrop of central bank stimulus, the resolution of the trade war and the removal of tail risk from a hard Brexit. Leading economic indicators had been showing consistent improvement towards the end of 2019 and we believed higher bond yields would lead to a rotation towards more cyclical companies. While we continue to believe that this positioning will deliver attractive returns over the medium term, we fully accept that this has been wrong given the sudden risk-off environment that developed in January (primarily due to the Coronavirus outbreak causing an economic shock in China).

From a top-down perspective, the portfolio has a bias towards cyclical stocks more so than defensives (we would say 'expensive defensives'). We believe that this positioning is sensible as valuations for cyclicals are far more compelling than the defensive stocks that are trading at multi-decade extremes. The impact from the Coronavirus outbreak has been severe and unexpected - oil prices have fallen 20% in only a few weeks, copper is down 12% and 10-year bond yields in Australia collapsed from around 1.4% to 0.9%. Our long positions in the energy and materials sectors have typically fallen 10-30% in a short space of time. Even at these much lower oil/commodity prices our stocks look extremely attractive (most still trade on single digit P/Es, generate 10-30% of their market cap in free cash flow p.a. and have strong balance sheets).

Please note, we position the portfolio with a medium term view and we cannot rationalise buying defensives with little earnings growth on 25-30x P/E, when we can buy leading cyclicals at a low point in the cycle that are trading on less than half of that multiple.

The market rally in January was heavily skewed to Healthcare (+12%), Technology (+11%) and Staples (+8%). There was no company news of note to justify these moves other than a fall in bond yields. Each of these sectors are trading far above their 10-year average P/E and all are at the very top of their 10-year history.

Some of the key stock detractors in January were:

Teck Resources (long -26%) is one of the world's highest quality mining companies with very low-cost operations in coking coal, copper and zinc. The shares sold off in January due to falling commodity prices. Even at today's depressed commodity prices, Teck trades on a P/E of only 6.8x (consensus earnings) and 3.5x EV/EBITDA, with a large cost out program still to come over the next few years. All of Teck's main assets are situated in low risk jurisdictions, such as Canada, U.S. and Chile. Teck is currently building one of the world's largest copper mines (QB2) at a time when the world is becoming short copper due to ongoing grade declines at the world's largest mines. Copper demand continues to enjoy secular growth due to rising living standards across Asia. We believe the medium-term outlook for copper and coking coal is very attractive, given spot prices are close to marginal cash cost for many mines and incremental supply has proven difficult to bring on in a timely manner.

Downer (long -9%) downgraded earnings guidance for FY20 as a result of some one-off loss making construction projects in its EC&M division. The construction business within the EC&M division contributes well below 5% of Downer's earnings, yet has been the cause of operational issues for the company in recent years. Downer's business is predominantly low risk, maintenance style work and this further misstep in the construction division has resulted in management announcing an aggressive exit from this activity over the coming months. We believe that the downsizing of construction, along with the expected divestment of the mining services division will lead to a re-rating of Downer as a capital-light (and lower risk) services business exposed to growing, annuity-style contracts. Downer trades on a P/E of 14x FY21 (consensus) with exposure to the structural growth in infrastructure maintenance across Australia and New Zealand.

MEG Energy (long -8%) is an oil sands producer with long life and low cost operations in Canada. The shares have performed strongly since we initiated a position in Q2 2019 (at ~$5.30). While we trimmed over a third of our position at $7.70 in early January, MEG shares fell on the back of a 20% fall in the oil price from its recent highs. Even at today's depressed oil price, MEG will generate around 30% of its market cap in free cash flow p.a. going forward. The company has previously received a takeover bid at $11/share (64% higher than today's $6.71 share price) which the company turned down as the board believed that it significantly undervalued the business.

The Company had been short **Tesla** through most of 2019. Tesla shares initially collapsed by 50% in the first half of 2019 and then surged towards the end of 2019 (Tesla shares rose 26% in total for calendar year 2019). Due to the rising share price, we had been methodically reducing our short position to manage portfolio risk and we have since closed the entire position. While we remain sceptical about the outlook for Tesla's cashflows and valuation, we believed the combination of frenzied retail buying, ETF buying and hedge funds closing short positions meant that the share price had the potential to further detach from fundamentals.

We believe the stock opportunities available at the moment are exceptional and that the market's obsession with concept stocks and yield stocks is presenting incredible opportunities elsewhere in the market. We (Mark Landau and Rafi Lamm) have been aggressively adding to our personal investment in the Company over the past 6 months - we have purchased another $25m of LSF shares and are continuing to buy on market. While we appreciate the short-term volatility caused by the outbreak of the Coronavirus can be unsettling for our investors, these events have historically had a relatively short-term impact on share prices and these market distortions typically present fantastic buying & shorting opportunities.

*Source: Link Fund Solutions. Net performance is defined as the movement in NTA pre-tax. Performance is shown after all applicable fees and charges.

Portfolio Exposures (month end)

Number of positions	91
Number of long positions	57
Number of short positions	34
Gross long exposure (%)	157%
Gross short exposure (%)	93%
Gross exposure (%)	250%
Net exposure (%)	64%

Board of Directors

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

Investment Guidelines

Typical number of positions	50-100 securities
Geographic exposures	Max 30% gross outside of Aust/NZ
Net exposure limits	Max 150% of NAV; typically 30-90%
Gross exposure limits	Max 300% of NAV; typically 150%-300%

Key Contacts

Company secretary	Mark Licciardo
Investor relations	Wayne Murray WMurray@L1.com.au
Manager	L1 Capital Pty Ltd +61 3 9286 7000 info@L1LongShort.com
Registry	Link Market Services Limited 1300 554 474 registrars@linkmarketservices.com.au

Net Tangible Assets Per Share (as at 31 January 2020)

NTA pre-tax	$1.6988
NTA post-tax	$1.7977

Source: Link Fund Solutions. The NTA pre-tax is calculated before the provision for deferred tax on unrealised gains and losses on the investment portfolio. The NTA post-tax is calculated after all taxes.

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.