L1 CAPITAL

L1 Long Short Fund Limited

Investor Letter | September 2018

September 2018 Quarter

- **The L1 Long Short Fund Limited returned -6.3% for the quarter.**
- **Performance was negatively impacted by a number of unexpected stock specific events, along with the strong performance of growth/momentum stocks.**

The Fund has performed poorly over the past six months, largely due to four factors:

1. High P/E stocks have dramatically outperformed low P/E stocks. The Fund typically has a modest value bias, but that bias has been more pronounced in 2018 given that growth stocks are trading at 20 year extremes versus value stocks.
2. 'Momentum' has been the strongest performing factor in the market, with a huge mid-year surge. The Fund typically has a contrarian bias (the opposite of momentum), which has been a huge headwind this year.
3. Over the past six months, the Portfolio has had more of its net exposure in Europe and Hong Kong rather than the U.S. While the allocation to Europe/Hong Kong has been modest, the performance differential between the U.S. versus Europe/Hong Kong has been extreme (>20% performance difference in only six months).
4. The Portfolio was impacted by a number of truly left-field stock events.

These four factors account for the bulk of the weak performance over the past six months. We have also made some mistakes where either a company's operating performance has been weaker than expected or a short position rallied in advance of our catalyst arriving.

While recent performance has been disappointing, we remain excited about the positions in the portfolio. Recently, we have both significantly increased our personal investment in the Long Short Strategy by buying shares on market in the LIC (Listed Investment Company). We have both continued buying post quarter end. We feel a tremendous responsibility to our new investors (who have not enjoyed the strong performance of the strategy from prior years) and we are working hard to deliver for you going forward. We sincerely appreciate all the support we have received over the past few months.

Key Details

ASX code	**LSF**
Share price	**$1.65**
Market capitalisation	**$1.10b**
Shares on issue	**664,839,144**
Listing date	**24 April 2018**

Net Tangible Assets Per Share (As at 30 Sept 2018)

NTA pre-tax	**$1.6679**
NTA post-tax	**$1.7648**

Net Performance

Total return since inception	**(16.6%)**

Portfolio Commentary

PORTFOLIO CONTRIBUTORS

Chorus (Long: +19%) – Shares continued to perform strongly after an upbeat operational update in August. We believe the outlook for the company is exceptional, with Chorus set to finally enjoy the benefits of their 10-year, $6b investment in its monopoly fibre network. We expect the company can deliver a high and fast-growing dividend profile in the years ahead.

Downer (Long: +19%) – Shares recovered from oversold levels in June. The market has become increasingly comfortable with the Spotless acquisition, with management providing upbeat commentary on the synergies and earnings outlook for both Spotless and the core Downer business. Downer trades on a 1-year forward P/E of only 12.7x and is well positioned to benefit from the continued growth in infrastructure maintenance and outsourced services.

Boral (Long: +9%) – Solid results and upbeat commentary at the Q4 result caused the stock to catch up some of the underperformance after its weaker Q3 result. We expect Boral to deliver much higher EPS in a few years time, due to rising infrastructure spending in Australia, higher prices and volumes in its U.S fly ash business and further synergies from the Headwaters acquisition. Boral is the dominant construction materials supplier for Australian East Coast road projects with strong volume and price leverage to rising demand. In the very short term, Boral may be affected by unfavourable weather in Sydney and some parts of the U.S, however this impact is transitory, and we believe the current share price represents exceptional value. Boral trades on a 1 year forward P/E of 12.2x, despite our expectations of strong earnings growth p.a. over the next few years.

Tesla (Short: -21%) – Tesla shares collapsed after the CEO's privatisation plan turned out to be fake. An SEC investigation resulted in Elon Musk and Tesla being fined and Musk being forced to stand down as chairman of the company. Operationally, Tesla continues to struggle, with production issues and high levels of senior executive departures. We believe the near-term earnings for Tesla may improve, however, the medium-term risk from rising competition, falling subsidies and higher tariffs will crimp demand and gross margins. After quarter end, we closed our short position given the shares had fallen dramatically since August.

Mineral Resources (Long: +2%) – Shares recovered around 10% from their August lows. Management are looking to sell a 49% stake in its Wodgina lithium asset (the world's largest hard rock lithium mine) by the end of this year. We believe the market is underestimating the value of Wodgina, given it is a genuine tier-one asset, with a low operating cost and long mine life. We believe Mineral Resources' other assets are worth close to the current market cap of $2.8b, with Wodgina implicitly being valued at close to zero. We believe a look-through value for 100% of that asset could be a significant proportion of the entire market cap given comparable transactions and the likely cashflow profile using conservative lithium price assumptions. The appeal of the asset has only increased in recent times, as some mines overseas are struggling to expand due to operating issues or difficulty attaining permits because of environmental issues associated with lithium brine mines (which require vast amounts of water). In another positive sign, the CEO recently bought more than $5m of stock on market.

PORTFOLIO DETRACTORS

The portfolio has been negatively impacted by several unexpected stock specific events:

Venator Materials (Long: -44%) – Venator shocked the market after revealing that a fire at its main plant in Europe (two years ago) would cost far more than previously flagged to remediate and rebuild and that this large incremental cost would not be covered by insurance. Given the cost blowout, management have now decided not to rebuild the plant. This shock news has changed the risk profile of our position, which caused us to sell down our position during the quarter. When we bought Venator it was trading on a forward P/E of 7x, with an under-geared balance sheet and solid earnings growth.

Portfolio Commentary (continued)

Lynas (Long: -32%) – The newly-elected Malaysian government announced a review into the environmental impact of Lynas' LAMP processing facility. This decision was a surprise, given the company has passed numerous independent reviews previously (including by the IAEA), has widespread local community support and has never had an adverse breach. During the quarter, a long-time opponent of Lynas was appointed to chair the review committee, which resulted in a further fall in the share price. After quarter end, the Government decided to remove this person from the committee given their perceived lack of independence. The timing of this review is frustrating, given Lynas controls one of the only large-scale rare earths assets outside of China and it is well positioned to benefit from rising rare earths prices (as supply is now being curtailed in China due to a renewed focus on environmental damage from some of China's facilities). During the quarter, we travelled to China and met with several of our contacts in the industry who corroborated our positive medium-term pricing outlook for the industry.

Nufarm (Long: -24%) – An unexpected court case ruling against Monsanto in California resulted in a judge in Brazil electing to implement a temporary ban on glyphosate sales in Brazil (glyphosate is the generic name for Roundup, the world's most popular herbicide). The company was already facing weaker earnings due to severe drought in Australia and a later than usual season in Europe. The combined effect of these issues made the board decide to raise $300m of equity. We believe this raising was unnecessary given the company was unlikely to breach covenants and the earnings will recover strongly going forward given the contribution of their newly acquired European assets. We believe the shares are compelling at these prices, with no value being ascribed to their revolutionary Omega 3 asset.

Other stocks detracting from returns included:

Alcoa (Long: -12%) – Aluminium prices fell after Norsk Hydro announced plans to cancel the shutdown of the remaining 50% capacity of its Alunorte alumina refinery in Brazil (Alunorte is the world's largest aluminium refinery). Despite the restart, we believe Alcoa is an exciting opportunity for the Fund. It operates one of the best, low-cost alumina & aluminium portfolio globally. Current commodity prices are sustainable and enable the company to generate around 15% of its market capitalisation in free cash flow each year. Furthermore, the assets are substantially undervalued – to build this portfolio of assets from scratch would cost around US$100 per share, versus today's share price of around US$33. Now that the company has been de-geared, we expect management will soon be able to commence ongoing share buybacks that will be both earnings and value accretive.

News Corp (Long: -12%) – Shares in News Corp fell after the company flagged ongoing reinvestment in Foxtel. We struggle to reconcile the move in the share price, given Foxtel (plus the additional investment) is an immaterial part of the News Corp valuation. The current market capitalisation of circa $10b only recognises the value of NWS' stake in REA and Realtor.com (the #2 digital real estate portal in the U.S. behind Zillow), along with the $2b of net cash on balance sheet. NWS also owns 12 other major media assets that we believe are conservatively worth between $6-8b, which equates to around 70% upside to the current share price. The Wall Street Journal alone is worth approximately A$4-5b based on comparable asset values for slower growing peers (e.g. Financial Times, New York Times). A likely catalyst for improved future share price performance is a potential asset restructure or deployment of the balance sheet on acquisitions or capital management.

Momentum versus Value – The headwind became a hurricane

As illustrated in Chart 1 below, momentum stocks have strongly outperformed value stocks over the past 5 years, by an average of 1.3% per month (or 17% p.a.). While this has proven to be a headwind for our portfolio (given that we tend to have a modest value and contrarian bias), we have still been able to deliver strong returns from the strategy by generating enough stock specific alpha to offset that impact. However, so far in the 2018 calendar year, that headwind became a hurricane, with outperformance of momentum stocks versus value stocks almost tripling. In the month of August alone, the gap was 8%. Interestingly, this phenomenon has been global, with the Morgan Stanley Momentum Stocks ETF in the U.S. outperforming the Morgan Stanley Value Stocks ETF by 32% so far this year*.

Markets that are dominated to such an extent by momentum will always prove difficult for us, given our focus on valuations and our tendency to have more of a contrarian bias. While frustrating in the short term, we remain confident given that our investment approach has proven successful over a long period of time. As Warren Buffett's mentor, Ben Graham, famously said "In the short run, the stockmarket is a voting machine, but in the long run it is a weighing machine". We believe that over time the weight of cashflows from our longs (and the distinct lack of cashflows from many of our shorts) will deliver stronger returns going forward.

Using consensus broker forecasts, our long portfolio today trades on an average P/E of just over 14x P/E (FY19), compared to 31x P/E (FY19) on average for our shorts. Despite this huge disparity in earnings multiples, both our longs and shorts are expected to deliver the same earnings growth over the coming year (based on consensus broker forecasts). Overall, our longs are trading at vastly lower multiples, have far better industry structures and have far safer and less geared balance sheets. We are not buying structurally impaired or low growth companies.

Chart 1: Relative performance of value vs momentum factors for ASX200 to 30 September 2018

TYPE	FACTOR NAME	CYTD 2018	5-YEARS
Value	Value Composite - per month	-1.4%	-0.3%
Momentum	Price Momentum (12 Month) - per month	2.0%	1.0%
Difference	Price Momentum less Value Composite - per month	3.4%	1.3%
	Price Momentum less Value Composite - annualised	**49.5%**	**17.2%**

Source: Factset, UBS.

Chart 2: Financial metrics of long and short portfolio positions

PORTFOLIO METRICS (FY19)	LONG POSITIONS	SHORT POSITIONS
EV / EBITDA	**5.9x**	**13.3x**
Free Cash Flow Yield	**8%**	**3%**
Price to Book	**1.2x**	**4.2x**
EPS Growth	**8%**	**8%**

All metrics quoted are based on Bloomberg broker consensus data

*The Morgan Stanley Momentum Index has risen 11.0%, versus -20.8% for the Morgan Stanley Value Index year-to-date to 31 August 2018.

Growth versus Value – 30 Year Perspective

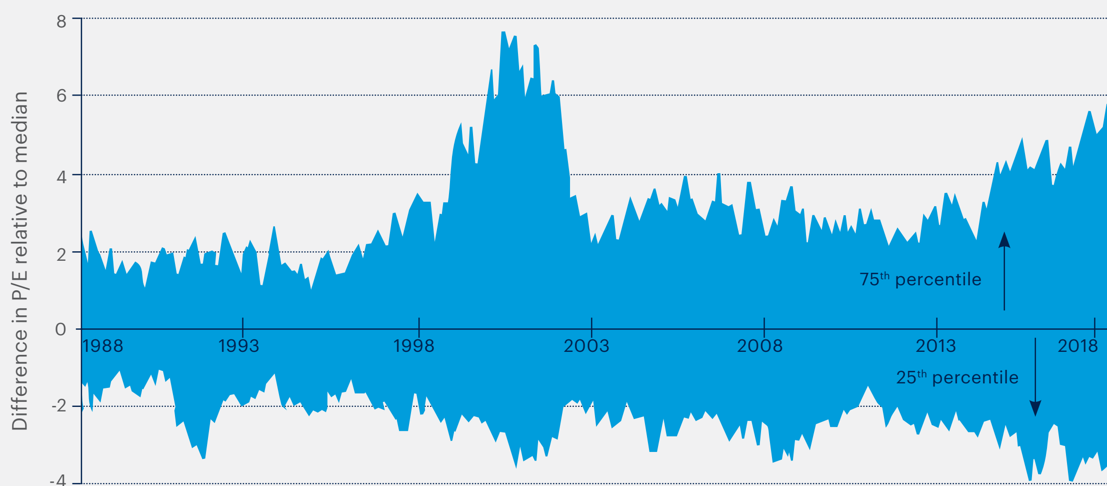
One of the most interesting observations about the current market can be seen in Chart 3 below. This chart shows the P/E premium for growth stocks and the P/E discount for value stocks in the ASX200 over the past 30 years. As you can see, the relative valuations for growth versus value stocks has been very stable for most of the past 30 years. The only period of significant distortion came during the peak of the dot com boom. Currently, the stock market is exhibiting the same distortion in relative valuations that has only been seen once before in 30 years. Growth stocks today have never been more expensive relative to the market, apart from at the peak of the dot com boom. Value stocks have almost never traded cheaper versus the market at any time in the last 30 years.

We believe the primary reason for this extreme divergence is excessive central bank stimulus, in the form of negative real interest rates and quantitative easing (over US$1 trillion of asset purchases a year, which has continued far longer than we believe was necessary to help lift the world out of the 2008 recession). By flooding the world with cheap money and depressing bond yields, investors have been forced into growth equities to meet their return objectives. Also, the lower risk-free rate has been used to rationalise the valuation of long duration stocks (like some highly priced growth stocks), where the cashflows in outer years are discounted back using an artificially low risk-free rate (usually the 10-year bond yield). The parallels with the dot com boom are clear:

- monetary policy settings that are far too stimulatory versus the economic 'requirement' (the fact that the U.S. still has negative real interest rates, despite having the lowest unemployment rate in the last 50 years seems non-sensical to us);
- hot sectors/themes that capture investors' imagination and are bid up to extreme levels (small/mid cap technology stocks, cannabis, cryptocurrencies, etc) often with a large component of retail investor participation;
- new valuation measures that are invented to justify historically extreme valuations. Today's usage of price to sales (instead of price to earnings/ cashflow) is one obvious example.

In the Reserve Bank's latest Financial Stability Report they noted "With the price of risk so low, there is a heightened possibility than an increase in expected or realised inflation or a negative growth shock could result in a significant and widespread rise in volatility and repricing in financial assets. An adverse shock could result in a broad fall in asset prices, exposing vulnerabilities that have built up in the low interest rate, low volatility environment". We strongly agree with this sentiment.

Chart 3: 12 Month Fwd PEs for Industrials (25th percentile & 75th percentile vs median)



Source: Thomson Reuters, Macquarie Research, September 2018

Growth versus Value – 30 Year Perspective (continued)

We are trying to safeguard the portfolio from the looming risks we see, such as the unwinding of massive central bank stimulus (i.e. the removal of the central bank 'put' that has prevailed for the past 9 years), rising U.S. inflation, rising trade and geopolitical tensions and a likely change of Government in Australia. We believe each of these risks is not being priced adequately by the market.

Within the portfolio today, we have some short positions against a subset of U.S. technology stocks that we believe are vastly overvalued and at risk of a large fall. These companies are now being valued by the investment community on a 'price to revenue' basis (generally because they are loss-making or trade on massive P/E multiples). This part of our short book is trading with median metrics of almost 200x P/E and around 8x price to revenue.

Given those metrics, we thought this quote from the former CEO of Sun Microsystems back in 2002 (immediately after the dot com crash) perfectly captures the insanity of this valuation approach.

"But two years ago we were selling at 10 times revenues when we were at $64. At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realise how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"

China/U.S. Relations – Trade War or Cold War?

During this quarter, we spent two weeks in China, visiting companies across a wide range of industries including infrastructure, manufacturing, travel, technology, resources, consumer products and healthcare. While many companies will have an investor relations team that can take meetings in English, many of the management teams in China speak only Mandarin. We are fortunate to have added Andrew Lin to our investment team earlier this year who was born in China and is fluent in Mandarin. This enabled better management access and less stilted meetings that typically require a translator.

At present we are reflecting the new information from the trip into the portfolio and will provide an overview of this research trip in our December quarterly report.

On October 4, U.S. Vice President Mike Pence gave a speech outlining the Administration's policy towards China. We believe this speech marked a monumental change in the U.S. Government's relationship with China and marked a clear shift towards a more confrontational and nationalistic policy stance. The issues identified in the speech are far broader and fundamental than simply tariffs and trade. They include intellectual property rights, military positioning, personal freedoms and China's alleged interference in U.S. domestic policies and politics.

The catalogue of issues outlined in the speech (and the direct riposte to China's position on these issues) make us believe the China/U.S. economic relations will not thaw quickly. We encourage you to read the transcript of the speech (we have attached a link here).

While it is still possible that the U.S. and China find some common ground and agree to some sort of trade deal, it seems the broader issues identified are far more entrenched and risk moving the U.S. and China towards Thucydides Trap*.

Up until now, China has had a 'wait and see' approach to the Trump administration's rising trade tensions. Given the weakening Chinese economy and the prospect of tariffs increasing from 10% to 25% imminently, we believe there is now greater pressure on President Xi than before. In the past few weeks, we have seen the Government and the PBOC reverse their restraint on lending and fixed asset investments. It has become clearer how serious the U.S. is regarding this course and how far they have been willing to follow through and exceed the responses from China.

Up until now, Australia has sought to maintain strong trade and diplomatic ties with both the U.S and China, whilst clearly aligning itself militarily with the U.S. Given that Australia's largest trading partner is China (China buys 5 times more goods from Australia than the U.S. buys from Australia), this fracturing in the U.S./China relationship will become increasingly difficult for Australia to navigate as Australia becomes pressured to pick sides on several divisive issues.

Some companies that could be adversely impacted by the strained relationship with China include a2 Milk, Bellamy's, Treasury Wine Estates and Blackmores.

*'Thucydides Trap' refers to the situation where a rising power causes fear in an established power, which escalates towards war. It was coined by Harvard political scientist Graham Allison, after reflecting on the 30-year Peloponnesian War in Greece.

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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

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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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