L1 CAPITAL

L1 Long Short Fund Limited

Investor Letter | June 2019

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June 2019 Quarter

- **L1 Long Short Fund Limited returned 4.1% for the June quarter (after fees), taking performance in 2019 to 14.3%.**
- **The Fund is positioned to benefit from a likely normalisation of valuations between growth and value stocks.**

The Fund returned 4.1% over the quarter. While the Fund's performance has improved considerably in 2019 (+14.3% calendar year to date), we have been disappointed to observe a widening discount between the share price and the NTA. We remain focused on delivering improved returns to shareholders, including measures to help the LSF share price trade closer to the underlying value of the portfolio.

Global equity markets (excluding China) continued to perform strongly over the quarter as major central banks shifted more clearly towards an easing bias in response to an escalation of US-China trade tensions and the weak global growth outlook. Government bond yields continued to fall with the flight to safe-haven assets amplified by the dovish tone from global monetary policymakers. The ASX200 outperformed most developed country markets with gains primarily driven by:

- the relief rally in banks and healthcare stocks post the Coalition's surprise election win;
- rise in mining stocks as iron ore prices continued to surge and
- strong performance of 'bond proxies' as bond yields tightened and the RBA cut interest rates.

Despite the Fund being net short iron ore, banks and 'bond proxies', performance was strong, led primarily by a number of positive stock specific catalysts across our local and offshore positions.

Some of the best performers for the Fund over the quarter were Lynas (+55%), Boral (+12%), News Corporation (+11%), Tesla (short) (-19%), Tempur Sealy International (+18%), and HeidelbergCement (+17%).

Some of the larger detractors over the quarter were Autohome (-19%) and Downer (-10%).

In section 1 of this report, we provide an update on the extreme divergence in the performance of 'growth' vs. 'value' stocks and the opportunities we see for Fund positioning going forward.

In section 2, we provide a summary of a core long holding in the portfolio, Worley (WOR:ASX), along with a high level overview of our investment thesis.

Key Details	
ASX code	**LSF**
Share price	**$1.40**
Market capitalisation	**$934.1m**
Shares on issue	**664,839,144**
Listing date	**24 April 2018**

Net Tangible Assets Per Share (As at 30 June 2019)	
NTA pre-tax	**$1.6773**
NTA post-tax	**$1.7771**

Net Performance	
Three months	**4.1%**
Total return since inception	**(16.1%)**

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Section 1: 'Growth' versus 'Value' – Extreme Divergence = Extreme Opportunity

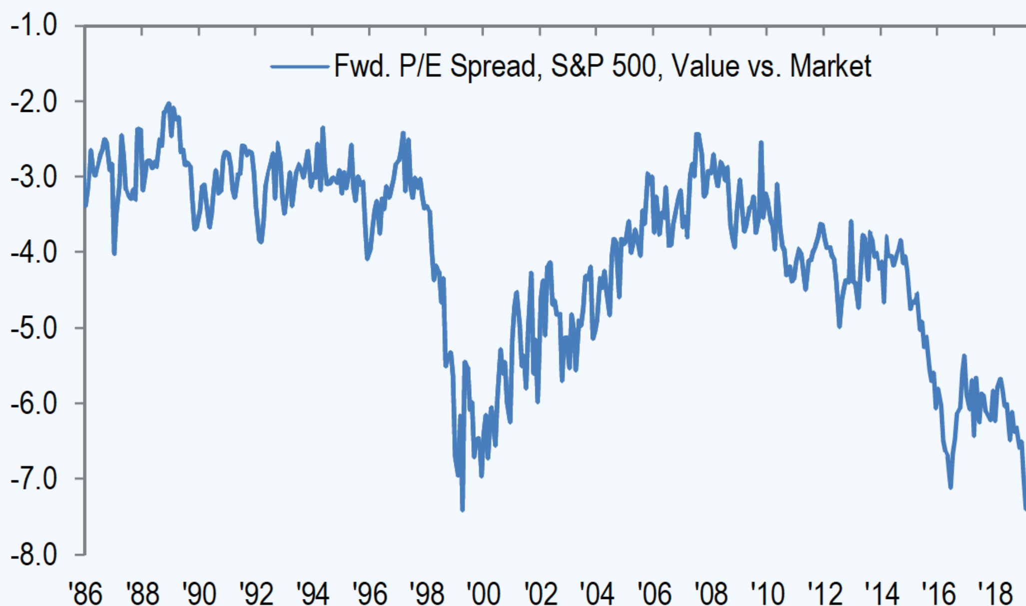
We have written previously about the extraordinary outperformance of 'growth' vs. 'value' stocks (refer September 2018 Quarterly Report). 'Growth' stocks have reached a 30 year valuation extreme across a range of valuation measures.

The quotes and associated charts below from JP Morgan's highly regarded quant & macro team perfectly capture the extent of the current valuation extreme.

"Value is currently trading at the biggest discount ever and offers the largest premium over the last 30 years. The oversold condition of Value is at par with or worse than during the 2000 TMT growth bubble. The median P/E of the cheapest portfolio relative to S&P500 is trading at ~7x discount (99%ile, Chart 1). Similarly, the relative Price/Book spread of the cheapest vs. the most expensive portfolio is at ~9x (widest ever, Chart 2). Value weakness is pervasive and persistent irrespective of its definition (P/E, P/B, P/Sales, P/FCF)."

"The degree of misalignment between Value and Momentum is at extreme levels (Chart 3) suggesting that the current dislocation is ripe for reversal."

Chart 1: Forward P/E Spread – Value at a ~7x discount to market



Source: J.P. Morgan US Equity Strategy and Quantitative Research

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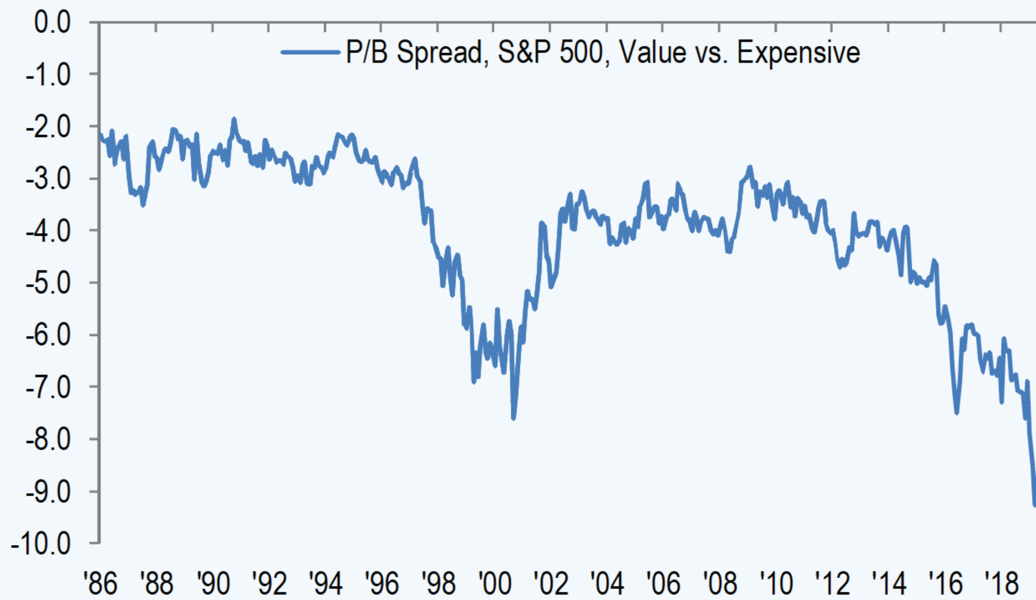
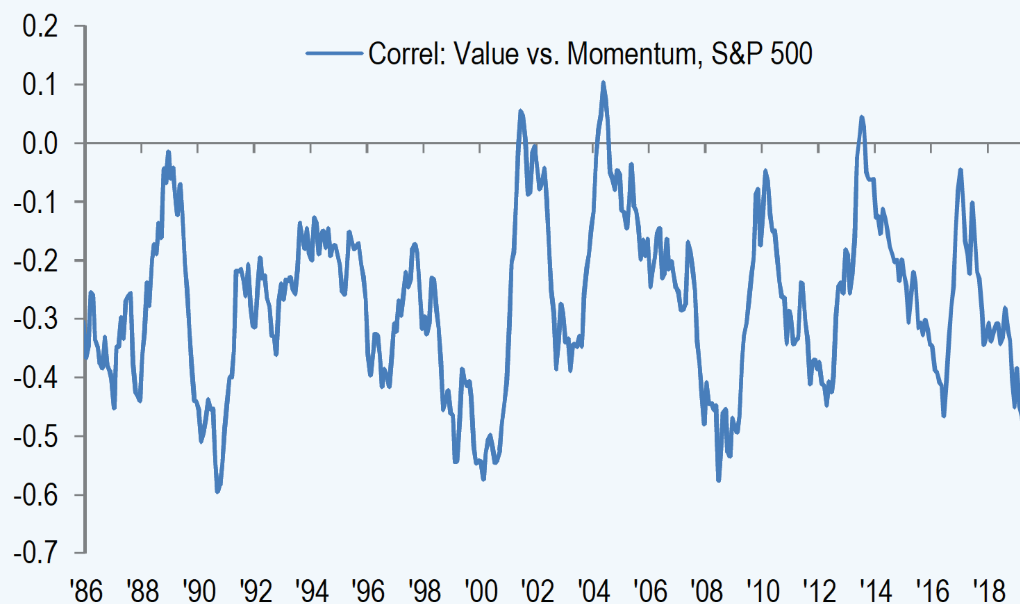
Section 1: 'Growth' versus 'Value' – Extreme Divergence = Extreme Opportunity

Chart 2: P/B Spread – 'Value' at a 9x discount to the most expensive portfolio



Source: J.P. Morgan US Equity Strategy and Quantitative Research

Chart 3: Value-momentum correlation – extreme and at cycle lows



Source: J.P. Morgan US Equity Strategy and Quantitative Research

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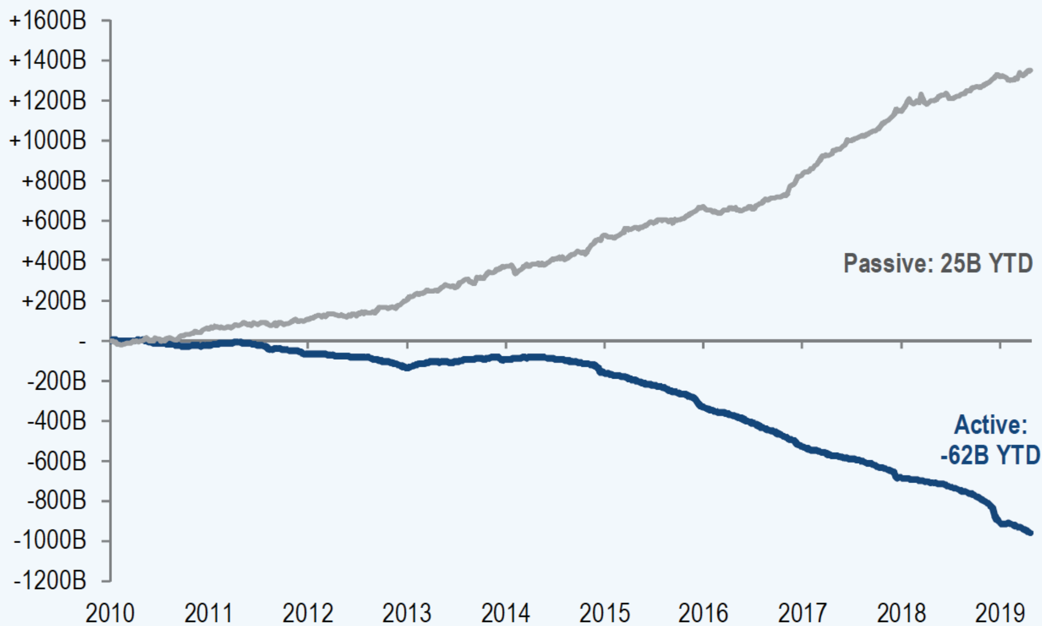
We believe indexation and the rise of stock correlations have strongly contributed to the above anomaly with the exponential rise in demand for passive products (Chart 4). JP Morgan estimates that ~60% of equity AUM in the US is now made up of passive products.

Declining global rates:

the other structural shift we have seen in the last quarter has been the continued decline in global rates which has driven institutional holders such as pensions funds and insurance companies into equity 'bond proxies' in the form of low volatility stocks. This has led to low volatility stocks trading at their most expensive level in the last 30 years.

Chart 4: Indexation and passive fund flows continues to rise



Source: JPM US Equity Strategy & Quantitative Research

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Section 1: 'Growth' versus 'Value' – Extreme Divergence = Extreme Opportunity

When looking at the domestic market, the above themes are even more extreme in Australia. Based on Goldman Sachs analysis, Australia has the most expensive 'High Growth' stocks globally.

ASX names that are expected to deliver more than 20% EPS CAGR over the next two years are up ~62% on average over the past 12 months, pushing their forward P/E to 38.9x (Chart 5 and Chart 6). This is 65% above the global average and 25% above the 2nd most expensive market for 'growth', the US.

Chart 5: 12 month forward P/E of stocks forecast to grow EPS by >20% p.a. over FY1 to FY3

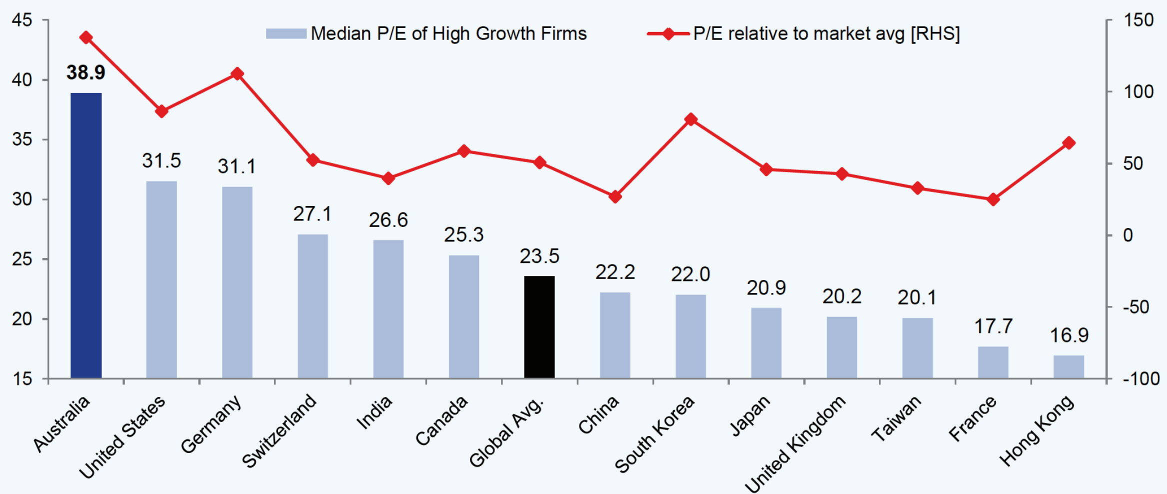
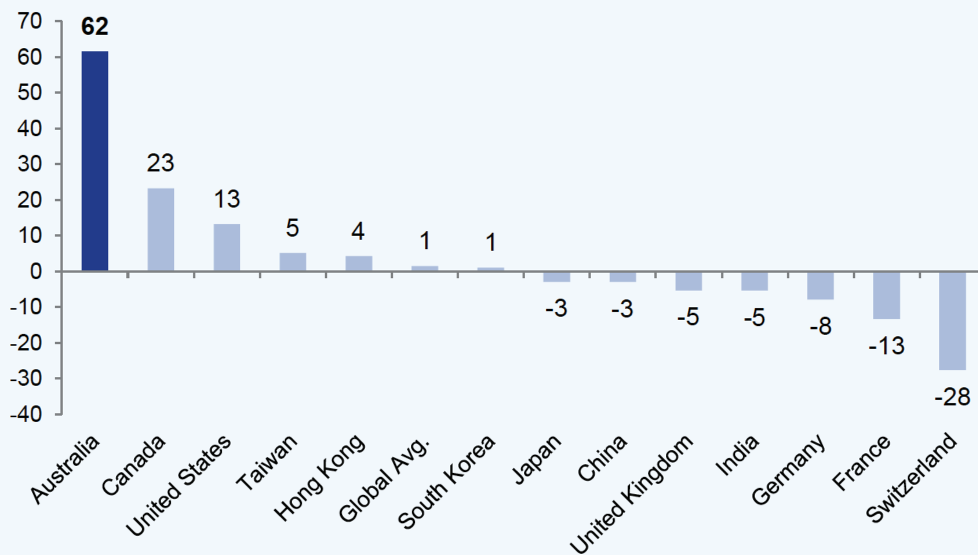


Chart 6: 12 month return of stocks in the current list of 'High Growth' firms



Sources: Goldman Sachs Global Investment Research, Bloomberg

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Section 1: 'Growth' versus 'Value' – Extreme Divergence = Extreme Opportunity

The trends above are similar when looking at stocks in the top quartile of forecast EPS growth in the ASX 200. On average these stocks trade at an average forward P/E of ~29.2x, which is 52% above their 20-year average (Charts 7 and 8). These P/E multiples have only ever been seen once before in 1999-2000.

Chart 7: Forward P/E for ASX 200 stocks in the top quartile of forecast EPS growth (FY3/FY1)

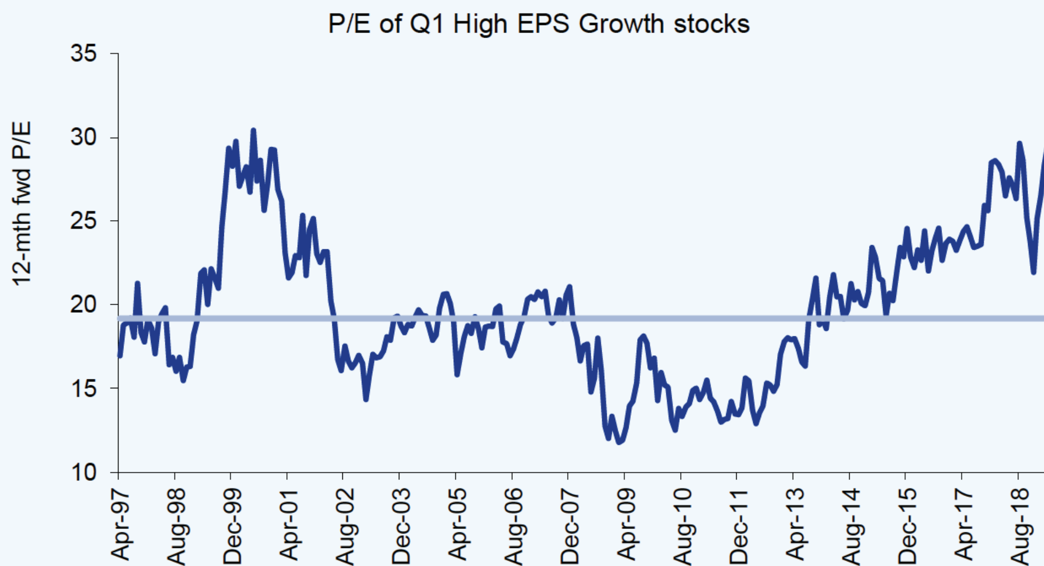
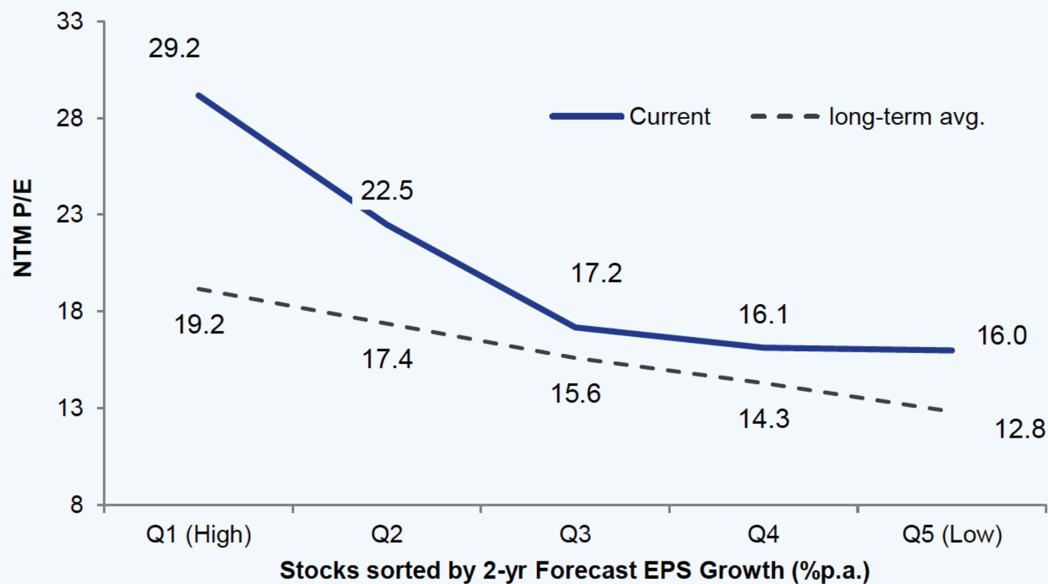


Chart 8: Forward P/E vs. 20 year average



Sources: Goldman Sachs Global Investment Research, Bloomberg

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Section 1: 'Growth' versus 'Value' – Extreme Divergence = Extreme Opportunity

Common themes that have been used to justify the enormous re-rating of 'growth' are a) falling interest rate expectations or b) the increasing scarcity of 'growth' names.

We do not believe these explanations are valid - the statistics do not support these arguments. Goldman Sachs conducted a detailed analysis of Australia's growth stocks and compared their multiples, sales/earnings growth rates and interest rates with global peers and found that not only are growth stocks globally incredibly expensive by historical standards, but that Australia's growth stocks are the most expensive globally.

"The fall in long-term interest rates has contributed to a large expansion in P/E multiples for Australia's long-duration 'growth' stocks. That said, it is hard to reconcile these moves globally. Despite falling to all-time record lows, Australia's 10-yr bond yields are still relatively high when compared globally (below only China and the US). Even in countries where long-term interest rates are negative, the valuation premium attached to structural 'growth' stocks is significantly lower than it is in Australia (Chart 9)."

"Similarly, while the scarcity of 'growth' in Australia is certainly a factor, 'High Growth' stocks are just as rare in some other markets where the growth premium is much more modest (Chart 10)."

Chart 9: Median P/E of 'High Growth' firms relative to bond yields

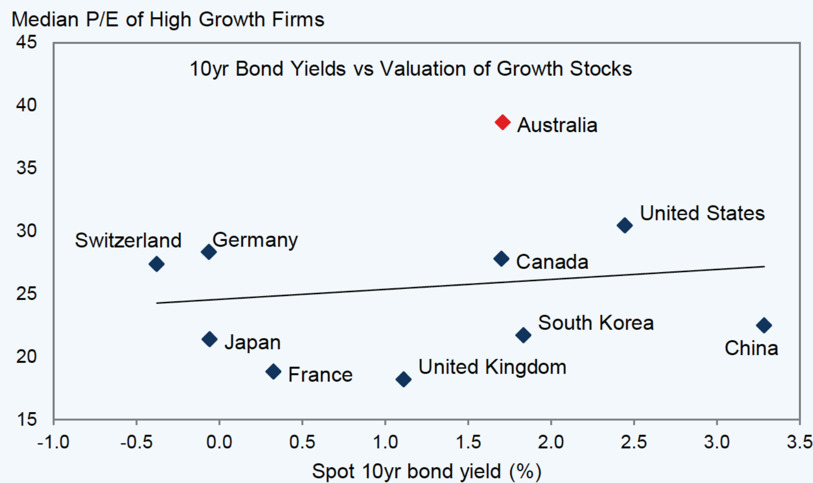
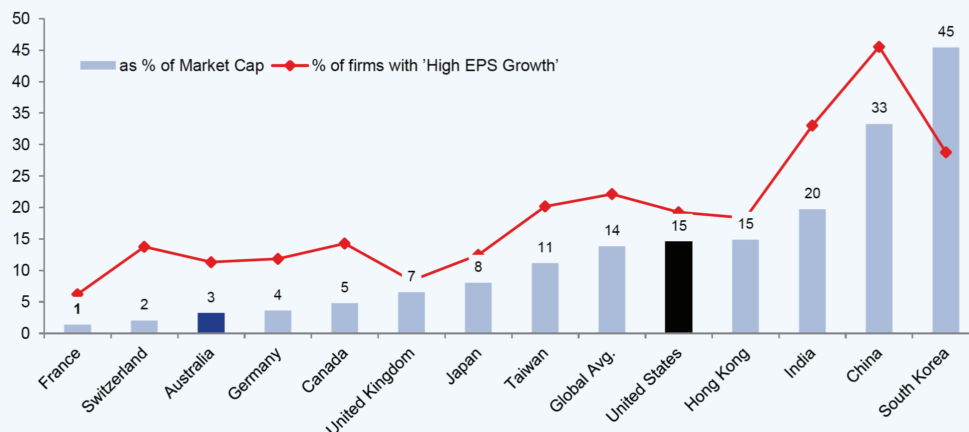


Chart 10: 'High Growth' stocks as a percentage of each country, split by number and market cap



Sources: Goldman Sachs Global Investment Research, Bloomberg

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Section 1: 'Growth' versus 'Value' – Extreme Divergence = Extreme Opportunity

Momentum and yield factors have dominated this year's market rally, which has proved to be a significant headwind for our portfolio (given that we tend to have had a value and contrarian bias). Given the extreme point we are at in the relative valuations of 'growth' versus 'value' stocks, we believe it is both prudent and appropriate to have a more pronounced 'value' bias than usual, in order to be positioned for a likely period of reversion.

However, given how stretched current valuations are for both 'growth' stocks and 'yield' stocks, we believe that there is an elevated risk that a reversal could be abrupt and very costly to adjust for after an inflection point has become apparent. There are some important points that we believe get overlooked in today's market commentary:

1. Current valuations require 'growth' stocks to execute almost perfectly and maintain extremely high levels of growth for a very extended period, just to justify today's share prices, let alone deliver further gains. Often the 'law of large numbers' makes these growth assumptions unrealistic to achieve. (ie. it is far easier to grow $300m of revenue at 40% p.a. for a few years than it is to grow $3b of revenue at those rates).

2. The management team of many growth companies quote a massive 'TAM' (Total Addressable Market) to give the impression that their sales growth could persist for decades. Often these TAMs are hugely overstated to inflate the stock's valuation and give the impression that a much longer growth horizon is realistic. One recent high profile example is that Uber stated a TAM of US$12 trillion(!) in its IPO filings. For context, that would amount to around 60% of U.S. GDP. Given that Uber provides taxi services and takeaway food delivery, it's hard to imagine it could possibly account for 60% of U.S. GDP. Unfortunately, little critical analysis is done by investors to question if these stated TAMs are realistic and sensible.

3. Low growth 'yield' stocks are now trading at extreme P/E multiples to reflect their appeal vis-à-vis bonds. The justification has been that falling bond yields have warranted a re-rating of these stocks. While that is true, given that long term bond yields are now 0-2% (or even negative) in all major developed markets, the likelihood of a further significant re-rating appears low. While these stocks may in fact be attractive versus a bond that yields nothing, we believe they remain overvalued and unattractive compared to most other stocks. Put simply, once the steady state yield stabilises, the total return for a 'yield' stock would equal its dividend yield (say 4%), plus 0-2% earnings growth, delivering a total return of 4-6% (assuming no change in P/E multiple). This compares to the total return of a typical stock in our portfolio that trades on a P/E of 13x, has a 5% div yield and grows earnings at 5-10% = total return of 10-15% (ie. 5% div + 5-10% growth). Over time, it is far more likely that a growing company on a lower multiple will re-rate than a low growth, yield stock on a higher multiple.

4. Furthermore, a number of these hot 'yield' stocks face serious structural challenges that mean their current dividend yield may not in fact be sustainable. Interestingly, the threat of disruption is typically most acute for 'yield' stocks that are mature businesses and face serious threats from the internet (eg. shopping centres), new business models (eg. banking), new competitors (eg. supermarkets) or government policy (eg. coal-fired electricity generators).

In summary, we question why a rational investor would feel more comfortable owning a 'growth' stock at an extreme valuation or a 'yield' stock with minimal growth on 20-25x P/E that is allocating all available free cash flow to dividends (and therefore not reinvesting at all in its business for longer term growth) as opposed to another company that is trading on 10-15x P/E that is growing nicely and may only be allocating half of its cash flow to dividends. Over time, we have no doubt that the 2nd company will prove to be the far better investment, given its lower earnings multiple, better growth outlook and fewer structural tail risks.

An example of such a company we are invested in, is Worley, which has become a core long holding in the portfolio. An overview of the company and our summary investment thesis is further outlined in section 2.

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Section 2: Worley (WOR:ASX) – Long Position

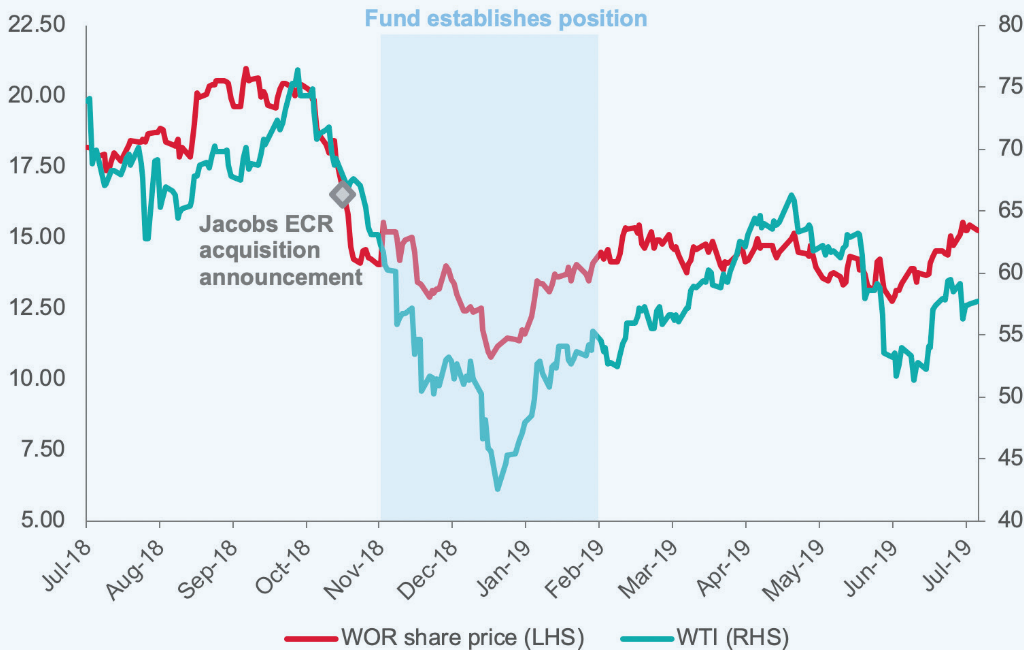
Worley is a global engineering, advisory and project management services company with a focus predominantly across the hydrocarbons, chemicals, minerals & metals and infrastructure sectors.

The company announced the acquisition of Jacob's Energy, Chemicals and Resources ("ECR") division on 22 October 2018 for an Enterprise Value (EV) of US$3.3bn, implying a June FY18 EV/EBITDA multiple of 11.5x pre-synergies (8.5x post synergies). The ECR acquisition nearly doubles both revenue and earnings for Worley going forward and results in a combined headcount of ~57,000. As a reference point for the scale of the combined business, this headcount is greater than Rio Tinto or any of the big four Australian banks.

As illustrated in Chart 11 below, the Fund established a position in Worley at the back end of 2018 & early 2019 at around ~$13 per share, after what we regarded as an extreme sell-off driven by two primary events:

1. Concerns about falling demand for new energy projects linked to a sudden 40% fall in the oil price (from $75 to $45/barrel); and
2. Some indigestion from the capital raising associated with the Jacobs ECR acquisition.

Chart 11: Worley share price vs oil



Sources: CapIQ

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Section 2: Worley (WOR:ASX) – Long Position

In addition to several meetings with Worley management, we have carried out a number of sector meetings/calls across the engineering and global oil and gas space in order to formulate our views on Worley. These meetings/calls included engineering peers (Wood Group and Fluor), US and European Oil majors (Exxon, BP, Royal Dutch Shell and Total), Canadian oil sands players (Cenovus, Suncor, CNRL, MEG, Imperial Oil) and US shale players (Encana and EOG Resources).

Our research indicates the events that drove the sell-off are transitory, with Worley having a number of positive catalysts, further outlined below:

1. **Consensus earnings expectations over the next few years remain too low.** Worley has not updated the market on Jacobs ECR pro-forma financial performance post June FY18, with disclosed numbers therefore outdated. We believe forward EPS estimates are too low, with the upcoming FY19 results providing an opportunity for analysts to re-calibrate estimates as ECR performance is updated and MergeCo accounting policies are clarified, providing consistent treatment across the market.

2. **ECR diversification and synergy benefits are underappreciated.** The ECR acquisition gives Worley three key benefits going forward:

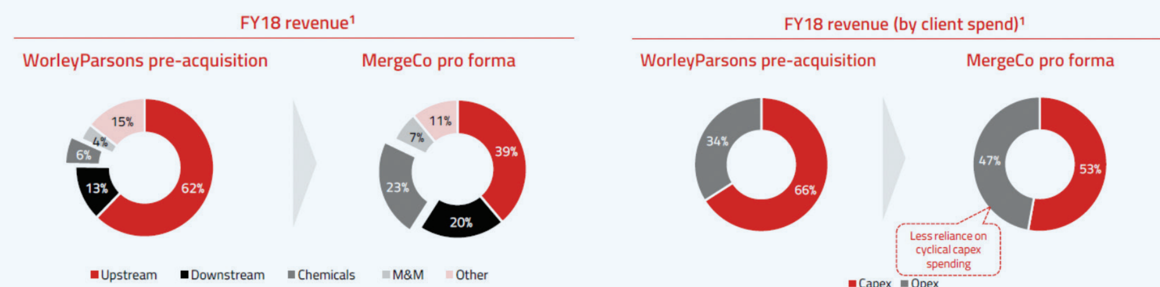
   i. Global sector leadership across Hydrocarbons by combining ECR's downstream expertise with Worley's upstream expertise;

   ii. Earnings diversification and greater through the cycle stability with ECR reducing MergeCo's upstream exposure from 62% to 39% of revenue and increasing opex related revenues from 34% to 47% (Chart 12); and

   iii. Cost and revenue synergies that should underpin material EPS accretion and shareholder returns.

Worley upgraded cost synergies from $130m to $150m only ~6 weeks post closing the ECR deal and signalled greater optimism from the revenue opportunities emerging from their combined capabilities going forward at its Investor Day last month. Importantly, Worley has assumed no revenue synergies from the deal, despite the fact that there appears to be a number of areas where cross-selling opportunities exist.

Chart 12: Pre and post-merger revenue breakdown



Sources: Company Reports

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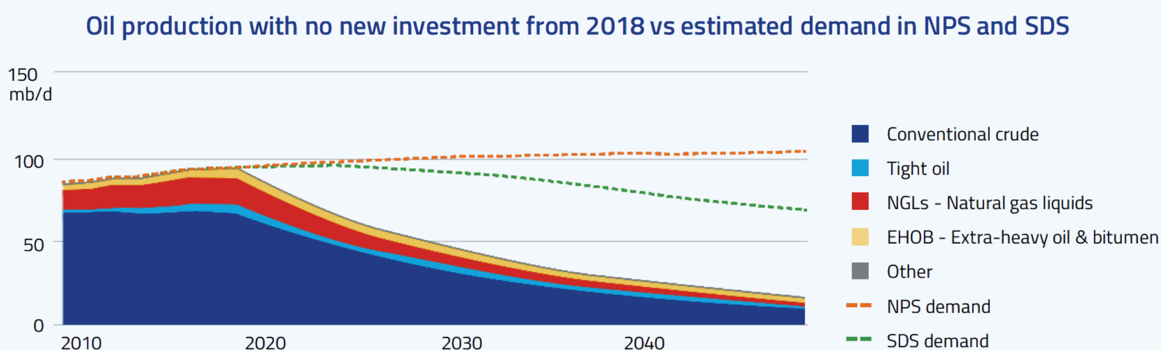
Section 2: Worley (WOR:ASX) – Long Position

3. **Lean operating model provides meaningful margin upside going forward.** 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 overhead cost base by ~33% or ~$500m primarily through optimising its footprint, pooling resources and improving staff utilisation. These measures have set Worley up as a much leaner operation, providing greater operating leverage into an increasing capex cycle and supporting an increase in EBIT margins going forward towards double digits from 5.6% in 2018.

4. **Key executives and management team are well-regarded with strong alignment to shareholders.** The current management team have a track record of delivery, having led the above-mentioned cost out program and recovery of Worley through a very challenging period. Furthermore, there is strong alignment of interests with shareholders, with the Chairman holding ~$500m worth of Worley stock and the CEO holding ~$21m worth of stock (excluding performance rights). The Chairman and founder of Worley, John Grill AO, took up $100m of his entitlements as part of the ECR capital raising.

5. **Favourable positioning for an increase in the upstream oil and gas capex cycle.** According to the International Energy Agency, approvals of new conventional oil and gas projects fall materially short of what would be needed to meet continued robust demand growth (Chart 13). The current shortfall has been driven in part by the focus of oil majors on repairing balance sheets and delivering free cash flow to shareholders, which led to a trough in oil and gas capex in 2017. However, oil majors will need to increase capex spending within the next few years to catch up on prior underinvestment and replace utilised reserves. As illustrated in Chart 14 below, 2018 has shown early signs of recovery in the capex cycle, with this trend expected to increase steadily going forward based on consensus estimates. Worley revenue (ex ECR) is highly correlated to capex spending, positioning the company well for an upturn in the cycle.

Chart 13: Oil and gas demand vs. supply considerations



NPS – New Policies Scenario (includes policies/targets announced by governments), SDS – Sustainable Development Scenario (accelerated clean energy transition)
Source: International Energy Agency (IEA), World Energy Investment 2019

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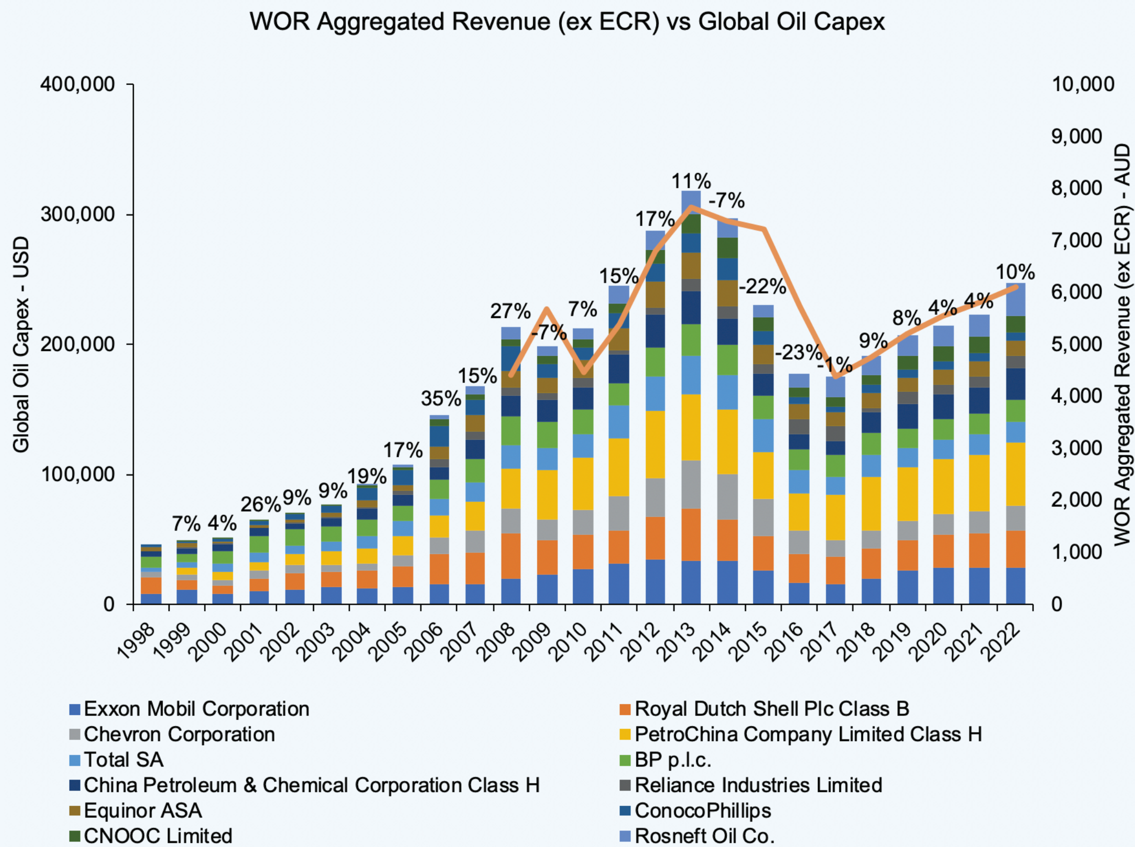
Section 2: Worley (WOR:ASX) – Long Position

Chart 14: Global oil majors project capex (1998-2022)



Source:Macquarie Research estimates, Factset

Valuation:

On our forecasts, Worley is trading on a P/E of only ~12x FY21 EPS (once the majority of the synergies of the ECR acquisition flow through). This is a material discount to its historical average P/E of 17.5x and its P/E pre the ECR deal announcement of around 20x.

We believe the shares deserve to trade at a much higher multiple, given the positioning of MergeCo as the global leader in a sector primed for growth, the diversification and synergy benefits from the ECR acquisition supporting shareholder returns, and a well-regarded and focused management team driving execution. We have used this recent period of weakness in the share price to significantly increase our position and it is now one of the largest positions in the portfolio.

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L1 Capital Overview

L1 Capital is a global investment manager with offices in Melbourne, Sydney, New York and London. The business was established in 2007 is 100% owned by its senior staff, led by founders Raphael Lamm & 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, insurance companies, financial planning groups, 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 its flagship L1 Capital Australian Equities Fund in August 2007. Since inception, the L1 Capital Australian Equities Fund has been one of the best performing large cap, long only funds in Australia, outperforming the S&P / ASX200 Accumulation Index by 3.1% p.a. (after fees).

Investment Guidelines

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

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

Service Providers

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

Level 28, 101 Collins Street
Melbourne VIC 3000 Australia
www.L1LongShort.com

Phone +61 3 9286 7000
Fax +61 3 9286 7099
Email info@L1LongShort.com

Information contained in this publication

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

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