L1 Capital Catalyst Fund

Quarterly Report | SEPTEMBER 2023

- **During the September quarter, the L1 Capital Catalyst Fund returned -3.0%[1] (ASX200AI -0.8%).**
- **Since inception the L1 Capital Catalyst Fund has returned 11.1%[1] p.a. (ASX200AI 2.8% p.a.).**
- **The Fund's quarterly performance was positively impacted by the sharp rise in the oil price, favourable trading updates and continued realisation of key catalysts. Performance was negatively impacted by declines in select commodity prices to which certain portfolio companies have exposure and by the increase in long-term bond yields.**

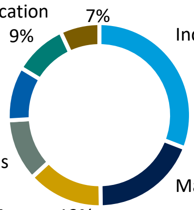
The S&P500 Index and the MSCI World Net Total Return Index returned -3.3% and -3.5% respectively, whilst the ASX200AI returned -0.8% in the September quarter.

Global equity markets started off positively in July as economic data reinforced investor expectations for a soft-landing in the U.S. However, markets declined sharply in August and September to more than offset the positive start to the quarter, impacted by the increase in long-term bond yields with 10-year bond yields moving to cycle highs throughout most developed markets (the 10-year bond yield increased to ~15-year highs).

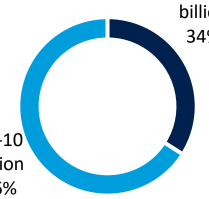
In Australia, the ASX200AI was buoyed by strength in the Energy sector, supported by a significant increase in oil prices (Brent Crude increased +27.2% during the September quarter to ~US$95 per barrel). The surge in the oil price during the September quarter was driven by a tight physical oil market. Consumer Discretionary stocks performed well, driven by better-than-expected sales, earnings and trading updates from companies relative to fairly pessimistic investor expectations.

Returns (Net)[1] (%)	Catalyst Fund	S&P/ASX 200 AI	Out-performance
3 months	(3.0)	(0.8)	(2.2)
6 months	(0.5)	0.2	(0.7)
12 months	15.4	13.5	+1.9
2 years (p.a.)	4.5	2.3	+2.2
Since inception (p.a.)	11.1	2.8	+8.3
Since inception (cum.)	26.7	6.5	+20.2

Sector exposure (%)



Market cap exposure (%)



Australian banks also outperformed as markets pivoted towards expecting fewer rate hikes and away from a 'hard landing' for the Australian economy, which, in turn, reduced expectations for loan losses. Conversely, growth sectors such as Health Care and Information Technology lagged, consistent with the rise in 10-year bond yields, as did the Consumer Staples sector. Mining stocks also underperformed, despite iron ore prices remaining elevated on Chinese stimulus optimism, led by a decline in Gold equities (on the back of rising rate expectations) and Battery Mineral commodity prices (driven by shifting supply/ demand dynamics).

The strongest sectors in the ASX200AI for the September quarter were Energy (+11.2%), Consumer Discretionary (+5.3%) and Financials (+2.4%), whilst Health Care (-8.6%), Consumer Staples (-5.9%) and Information Technology (-5.8%) lagged.

Portfolio exposures by primary catalyst as at 30 September 2023

	Strategic	Financial	Operational	Governance
Stock 1	✓			
Stock 2	✓			
Stock 3		✓		
Stock 4	✓			
Stock 5		✓		
Stock 6				✓
Stock 7			✓	
Stock 8		✓		
Stock 9	✓			
Stock 10			✓	

1. All performance numbers are quoted net of fees. Figures may not sum exactly due to rounding. Inception date: 1 Jul 2021. Past performance should not be taken as an indicator of future performance. Note: Fund returns and Australian indices are shown in A$. Returns of U.S. indices are shown in US$. Index returns are on a total return (accumulation) basis unless otherwise specified.

Portfolio commentary

During the September quarter, the Catalyst Fund's performance relative to the ASX200AI was positively impacted by:

- **Sharp rise in the oil price:** Santos benefited from a sharp surge in the oil price. We discuss our investment thesis for Santos and our view of how the company could create significant shareholder value unlock in the 'Stock Spotlight' on pages 3 to 6.
- **Favourable portfolio company trading updates:** James Hardie's quarterly result was significantly better than consensus estimates, contributing to a 14% share price increase on the results day. The Catalyst Fund first invested in James Hardie in July 2022, when, in our view, the share price overstated near-term macroeconomic downside risks and understated the company's strong market position and attractive long-term earnings growth potential. Following the June 2023 result and given the strong recovery in the share price, we exited our position as, in our view, the company was trading close to fair value bearing in mind the continued uncertain macroeconomic outlook, including U.S. 30-year home mortgage rates increasing to above 7% when we exited.
- **Continued realisation of key catalysts:** as discussed in our **March 2023 quarterly** report, at times, the Catalyst Fund will invest in companies during a period of transition. In May 2023, we spoke to **Livewire** about our investment in Downer Group, which is currently executing an operational turnaround. During the September quarter, we were pleased to see the company announce it is on track to deliver its $100m cost-out program and re-affirm its FY25 EBITA margin target of >4.5%. We continue to view Downer as an attractive investment opportunity, even when we use a conservative risk adjusted valuation to take into account the complexity involved in executing a significant turnaround.

During the September quarter, the Catalyst Fund's performance relative to the ASX200AI was negatively impacted by:

- **Declines in select commodity prices:** Certain portfolio companies were impacted by declining prices of commodities to which they have exposure. Importantly, with regards to our commodity exposed positions, we have used conservative long-term assumptions to value companies across market cycles and we remain positive on the outlook for our commodity-exposed holdings. We believe short-term, sentiment-driven pull-backs, can provide attractive buying opportunities when framed within conservative long-term pricing assumptions.
- **Increase in long-term bond yields:** Yield-based portfolio companies were negatively impacted by the increase in long-term bond yields and the broad sentiment that interest rates may stay higher for longer. However, one portfolio company which gains from an increased rate environment is QBE Insurance, which benefits from higher interest rates through its investment income earnings. We previously detailed our investment thesis for QBE Insurance in our **March 2023 quarterly** report.

The L1 Capital Catalyst Fund continues to find value in low P/E stocks with undergeared balance sheets, strong cash flow generation and realisable near-term catalysts. We remain confident in our portfolio and are focused on identifying and enacting catalysts through active engagement with company management and Boards. We continue to believe this engagement will ultimately create better shareholder returns for investors and outcomes for the companies themselves.

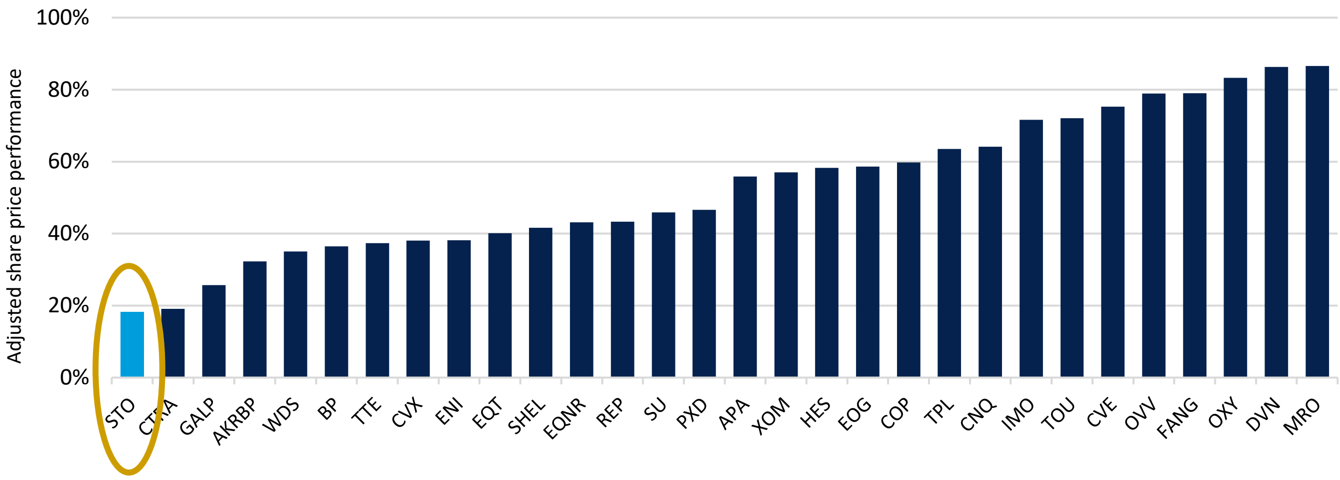
Unlocking Santos' material value potential

Summary

As outlined in our **September 2022 quarterly** report, the Catalyst Fund invested in Santos (an ASX-listed oil and gas exploration and production company with a current market capitalisation of ~A$24b and an enterprise value of ~A$30b) approximately 12 months ago. This investment was based on its portfolio of quality long-life assets and attractive valuation in the context of an elevated oil price environment, supported by long-term underinvestment in the sector.

Despite strong operational execution under CEO Kevin Gallagher, Santos' share price has lagged its global and domestic peer group, across most time periods. Over the last three years Santos' total shareholder return has been the lowest across the entire peer group (Figure 1).

Figure 1: Annualised total shareholder return of Santos and global energy peers (last three years)



Source: S&P Capital IQ as at 6 Oct 2023. Annualised share price performance from 9 Oct 2020 to 6 Oct 2023, adjusted to include cumulative dividends paid. Global energy peer group includes 29 other exploration & production companies with a market capitalisation >US$10b headquartered in Europe, Australia or North America.

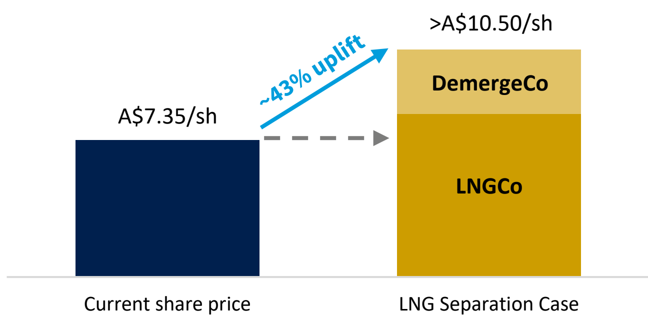
In our view, this poor relative share price performance can be attributed to multiple factors beyond regulatory overhangs (most particularly Barossa, a key growth project awaiting regulatory drilling approval), including smaller relative capital returns, a disparate growth strategy and, in particular, an under-appreciated LNG-focused equity story.

We believe a structural separation of the Company's Liquefied Natural Gas ('LNG') assets would help to unlock the inherent value of Santos' assets and ultimately present a significant value-creating outcome for shareholders.

Specifically, we propose that the Company's Australian oil and gas assets and Alaskan oil assets ('DemergeCo') should be separated via a demerger and distributed to Santos' shareholders, leaving Santos as an LNG 'pure play' company ('LNGCo'). We have recently written to Santos' Board of Directors encouraging them to initiate a strategic review to fully assess this proposal.

Our analysis suggests a sum-of-the-parts valuation of LNGCo and DemergeCo would be equivalent to >A$10.50 per share representing an uplift of ~43% above the current share price of A$7.35 (Figure 2).

Figure 2: Potential value unlock from LNG separation

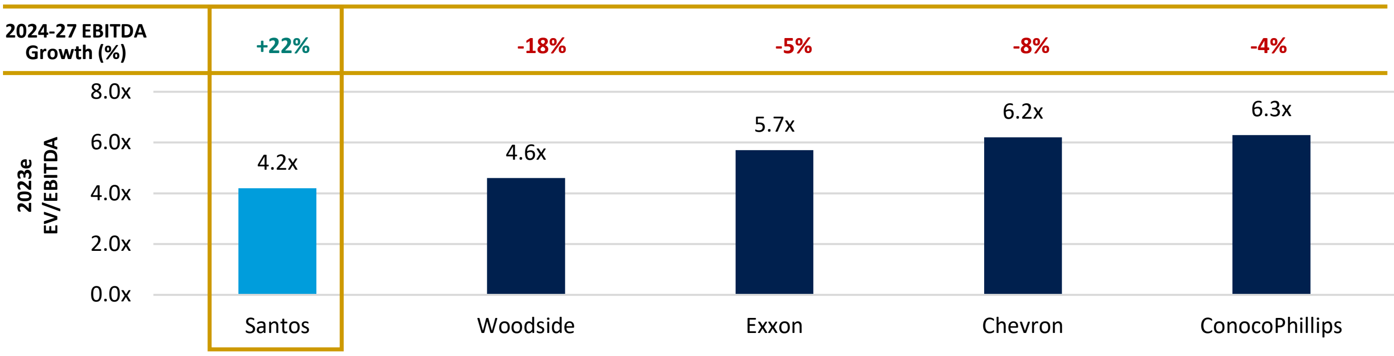


Source: L1 Capital and S&P Capital IQ as at 6 Oct 2023

Substantial valuation discount

As a result of sustained relative share price underperformance, Santos trades at a significantly discounted valuation to its key peers (Figure 3), despite its strong EBITDA growth outlook.

Figure 3: Santos' valuation relative to Woodside and U.S. peers (EV/Adjusted 2023e EBITDA)



Source: Visible Alpha as at 6 Oct 2023. Santos' 2023e EV/EBITDA multiple has been adjusted to remove from the enterprise value the sunk capital into the Pikka (18% complete) and Barossa (60% complete) projects which are not incorporated into the CY2023 EBITDA figures.

This valuation discount to its peers is despite:

- **A high-quality growth profile:** Specifically, Santos' Pikka project in Alaska is expected to deliver strong returns and the Barossa project will bring near-term LNG volumes to an increasingly tight market, and
- **Strong operational execution:** Operating costs across the portfolio have decreased over time despite broad inflationary pressures. For example, the Pikka project remains on-time and on-budget (as per the Company's disclosure), which has become a rarity for developments within Australia and North America.

We believe Santos' share price is trading materially below its intrinsic value and is disconnected from peer valuations in the sector due to the following key reasons:

1. **Market providing inadequate credit for the LNG equity story:** Investors seeking LNG exposure have often chosen alternative stocks to do so, with Santos' LNG equity story (including increasing proportion of spot-linked volumes) underappreciated in our view relative to its peers.
2. **Smaller relative capital returns and balance sheet capacity:** Santos' recent capital returns have lagged Woodside (its most comparable domestic peer) and its key U.S. peers, with Santos having used more of its balance sheet capacity to fund growth projects compared to these peers.
3. **Portfolio complexity, growth strategy and project execution:** We believe that the market is attributing close to zero value to Santos' upstream project pipeline (which includes Barossa and Pikka, as well as the Narrabri, Papua and Dorado projects), despite the fundamental quality of these projects, substantial capital invested to date and Santos' track record of execution. This partly reflects the relatively disparate range of growth projects across geographies and products (oil, domestic gas and LNG).

A separation of Santos' LNG business

We believe a structural separation of Santos' LNG assets will present the best long-term outcome for shareholders for the following key reasons:

1. **Unlock Santos' valuation discount**: We estimate that the valuation of LNGCo on a standalone basis would exceed more than the entire market capitalisation of Santos today, especially considering the scarcity value of such assets within the current macroeconomic backdrop.
2. **Greater management focus:** Standalone management teams and governance structures would further improve project execution and market sentiment towards each company's prospects. In particular, DemergeCo's assets would benefit from enhanced management focus to ensure their longevity and backfill plans materialise.
3. **Tailored capital allocation:** LNGCo and DemergeCo would be established with capital allocation frameworks and balance sheet positions better tailored towards the different asset characteristics and shareholder bases that LNGCo and DemergeCo will attract.
4. **Strong standalone equity stories that will appeal to different investor bases:** In particular, we believe that LNGCo will be highly attractive to a global shareholder base (with a longer-term outlook and greater appreciation of the LNG assets' strategic value) that may not invest in Santos today due to the shorter-life domestic market profile of DemergeCo's assets.
5. **Significant strategic appeal for LNGCo:** We believe the highly attractive group of assets within LNGCo will create a floor to support a favourable trading valuation. This was observed with BG group (a formerly LSE-listed LNG-focused oil and gas business), which consistently traded at a premium to global oil majors prior to ultimately being acquired by Shell in 2016.
6. **Attractive demerger structure:** A demerger would likely receive 'rollover relief' for Santos shareholders with no tax leakage, and both DemergeCo and LNGCo should qualify for ASX 100 index inclusion.

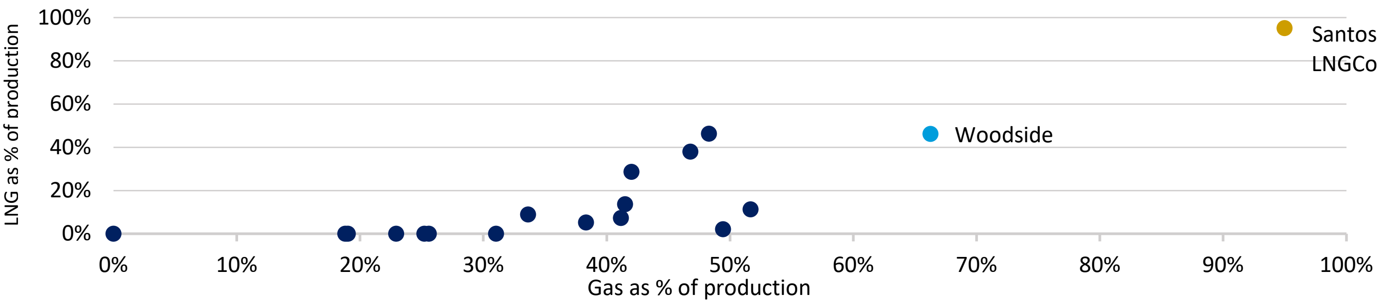
Figure 4: Overview of LNGCo and DemergeCo

	LNGCo	DemergeCo
Assets	PNG LNG GLNG DLNG Papua Barossa Energy Solutions (Bayu-Undan CCS)	Australian Domestic West Coast Australian Domestic East Coast Dorado Narrabri Pikka Energy Solutions (Moomba CCS, WA CCS)
Run-rate production	~72 mmboe p.a.	~50 mmboe p.a.
2P Reserves Life	~17 years	~8 years
Estimated enterprise value	~US$21b	~US$5.5b
Potential investor base	▪ Global investors seeking LNG exposure ▪ ESG-focused funds in the context of gas' role in the energy transition ▪ Significant capital returns potential post-2025	▪ Australian domestic-focused investors ▪ Investors seeking high cash flow yield, underpinned by contracted CPI-linked cash flows
ASX 100 index inclusion?	✓	✓

LNGCo equity story: A leading global LNG pure-play

- **The leading global LNG pure-play exposure:** LNGCo will have the most concentrated exposure to LNG of its global peer group, which should make it the preferred exposure among investors (Figure 5).
- **Portfolio of tier-one, large, low-cost and long-life assets:** LNGCo is set to generate substantial cash flow, with high-quality projects, tier-one partners, low operating costs and long reserve lives.
- **Attractive LNG market fundamentals:** A tight current global market dynamic and expected long-term growth in demand is likely to result in sustained high LNG prices.
- **Strong targeted portfolio growth profile:** Growth (via the Barossa and Papua assets) in existing operating jurisdictions and leveraging existing infrastructure (backfill for DLNG and PNG LNG, respectively). The proportion of uncontracted LNG volumes is also expected to increase from this year, as PNG LNG contracts roll off and Barossa volumes come online.
- **Robust balance sheet and shareholder return capacity**: We expect LNGCo to have improved access to debt financing and greater relative debt capacity, compared with Santos today. The business could even support the entire existing debt of Santos if required and be able to commence material shareholder returns from 2025.

Figure 5: LNG exposure across key global and Australian oil and gas companies

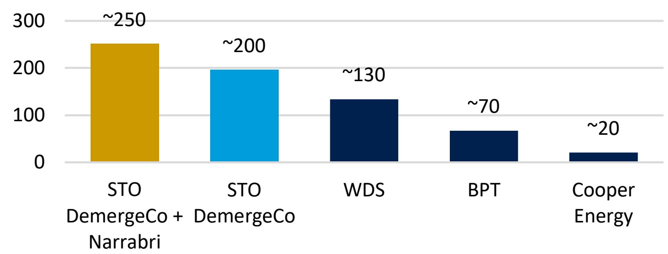


Source: Credit Suisse. Global peers include Saudi Arabian Oil Co, ExxonMobil, Chevron, Shell, Total Energies, ConocoPhillips, Equinor, BP, Petrobras, EOG, CNR, Occidental, ENI, Suncor, Impex.

DemergeCo: An Australian domestic gas champion with strong liquid growth opportunities

- **Exposure to tightening Australian domestic gas markets:** The Australian domestic gas market is undersupplied and is expected to tighten over the medium-term, with declining production rates from existing sources and limited new supply.
- **Domestic gas champion:** We see an opportunity for an Australian champion in the domestic market as larger players (including Woodside and offshore players) outgrow and exit certain positions. Narrabri represents a critical source of gas for NSW with the ability to supply up to 10% of the current east coast domestic demand, offsetting supply declines (Figure 6).

Figure 6: Australian domestic gas market supply (PJ p.a.)



Source: Company reports (last full year volumes reported by each company)

- **Attractive free cash flow yield, underwritten by CPI-linked contracts:** Once the Pikka project starts production in 2026, we believe DemergeCo has the ability to generate a free cash flow yield of ~15% at our base case valuation, making it an attractive value proposition for yield-focused investors.
- **Cohesive growth strategy which is underpriced in Santos today:** DemergeCo has a strong volume growth outlook, which we think is currently underappreciated by investors today. In particular, Dorado is the largest oil discovery in Australia since 2003 and Pikka has significant optionality to grow beyond its phase 1.
- **Conservative balance sheet and funding options for growth:** There is potential for DemergeCo to initially take on a conservative quantum of debt, positioning it to provide sustainable and attractive returns to shareholders. Given the Australian domestic gas business' revenues are largely based on CPI-linked contracts, we also believe that DemergeCo has strong debt capacity to support the funding of its growth projects. In addition, we believe the development of Dorado in Western Australia could be part funded via a partial sell-down of 80% stake currently held by Santos.

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Quarterly Report | SEPTEMBER 2023

Fund information

Fund/Class Name	L1 Capital Catalyst Fund – Retail Class
Currency	AUD
Investment approach	The Investment Manager seeks to deliver private equity-style returns with listed market liquidity by taking a hands-on 'owner's mindset' to each investment in a tightly focused portfolio of up to 10 companies.
Investment objective	To deliver strong positive risk adjusted returns over the long term.
Benchmark	S&P/ASX 200 Accumulation Index
Minimum investment	$25,000
Management fee	1.28% p.a. inclusive of GST and net of RITC
Performance fees	20.5% (inclusive of GST and net of RITC) over benchmark, subject to any underperformance being recouped
Vehicle	Australian Unit Trust
Launch date	1 July 2021
Platform availability	Australian Money Market, BT Panorama, CFS FirstWrap, HSBC, Hub24, Macquarie Wrap, Mason Stevens, MLC, Netwealth, North*, Powerwrap, Praemium

Research house ratings

Zenith Rating[2]

Zenith notes: *"Zenith's conviction in the Fund is underpinned by the high calibre of the investment team and the attractiveness of the underlying investment philosophy and process. Despite the Fund's relatively recent inception, we draw confidence from the impressive performance track record of L1's other strategies."*

Zenith
HIGHLY RECOMMENDED

Lonsec Rating[3]

Lonsec notes: *"The Fund seeks to deliver private equity-style returns with listed market liquidity by taking a hands-on 'owners mind-set' approach to each investment. The owners mind-set is anchored in constructive engagement with companies, driving the realisation of positive change by bringing strategic options, new ideas and thinking to company Boards and management."*

Recommended
Lonsec Research

2. The Zenith Investment Partners (ABN 27 103 132 672, AFS Licence 226872) (Zenith) rating assigned to L1 Capital Catalyst Fund (Jun 23) referred to in this document is limited to General Advice (s766B Corporations Act 2001) for Wholesale clients only. This advice has been prepared without taking into account the objectives, financial situation or needs of any individual, including target markets of financial products, where applicable, and is subject to change at any time without prior notice. It is not a specific recommendation to purchase, sell or hold the relevant product(s). Investors should seek independent financial advice before making an investment decision and should consider the appropriateness of this advice in light of their own objectives, financial situation and needs. Investors should obtain a copy of and consider the PDS or offer document before making any decision and refer to the full Zenith Product Assessment available on the Zenith website. Past performance is not an indication of future performance. Zenith usually charges the product issuer, fund manager or related party to conduct Product Assessments. Full details regarding Zenith methodology, ratings definitions and regulatory compliance are available on our Product Assessments and at http://www.zenithpartners.com.au/RegulatoryGuidelines

3. The rating issued for L1 Capital Catalyst Fund (Oct 23) is published by Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL 421 445 (Lonsec). Ratings are general advice only and have been prepared without taking account of your objectives, financial situation or needs. Consider your personal circumstances, read the product disclosure statement and seek independent financial advice before investing. The rating is not a recommendation to purchase, sell or hold any product. Past performance information is not indicative of future performance. Ratings are subject to change without notice and Lonsec assumes no obligation to update. Lonsec uses objective criteria and receives a fee from the Fund Manager. Visit lonsec.com.au for ratings information and to access the full report.

* Managed account holders only.

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L1 Capital | Overview

L1 Capital is a global investment manager with offices in Melbourne, Sydney, Miami and London. The business was established in 2007 and is owned by its senior staff, led by founders Raphael Lamm and Mark Landau. The team is committed to offering clients best of breed investment products through strategies that include long short Australian equities, international equities, activist equities, a global multi-strategy hedge fund and U.K. residential property. The firm has built a reputation for investment excellence, with all L1 Capital's strategies delivering strong returns since inception. The team remains dedicated to delivering on that strong reputation through providing market-leading performance via differentiated investment approaches with outstanding client service, transparency and integrity. L1 Capital's clients include large superannuation funds, pension funds, asset consultants, private wealth firms, financial planning groups, family offices, high net worth investors and retail investors.

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Key service providers for the Fund are: Responsible Entity – Equity Trustees Limited, Fund Administrator and Fund Custodian – Apex Funds Services (formerly Mainstream Funds Services), Fund Auditor – EY, Legal Advisor – Hall & Wilcox. There have been no changes to key service providers since the last report.

Information contained in this publication

Equity Trustees Limited ("Equity Trustees") (ABN 46 004 031 298), AFSL 240975, is the Responsible Entity for the L1 Capital Catalyst Fund ARSN 650 484 263. Equity Trustees is a subsidiary of EQT Holdings Limited (ABN 22 607 797 615), a publicly listed company on the Australian Securities Exchange (ASX: EQT).

This publication has been prepared by L1 Capital Strategic Equity Management Pty Limited (ACN 648 751 928), (an authorised representative (no. 1286013) of L1 Capital Pty Ltd (ACN 125 378 145, AFSL 314 302)) and its officers and employees (collectively "L1 Strategic"), to provide you with general information only. In preparing it, we did not take into account the investment objectives, financial situation or particular needs of any particular person. It is not intended to take the place of professional advice and you should not take action on specific issues in reliance on this information. Neither L1 Strategic, Equity Trustees nor any of its related parties, their employees or directors, provide any warranty of accuracy or reliability in relation to such information or accepts any liability to any person who relies on it. All performance numbers are quoted after fees. Past performance should not be taken as an indicator of future performance. You should obtain a copy of the Product Disclosure Statement before making a decision about whether to invest in this product.