L1 Capital Catalyst Fund

Quarterly Report | MARCH 2024

- **During the March quarter, the L1 Capital Catalyst Fund returned 8.1%[1] (ASX200AI 5.3%).**
- **Since inception the L1 Capital Catalyst Fund has returned 13.7%[1] p.a. (ASX200AI 7.4% p.a.).**
- **The Catalyst Fund's strong relative performance over the March quarter reflects favourable reporting from a number of portfolio companies, achieved despite having no exposure to the major Australian banks, which produced outsized returns.**

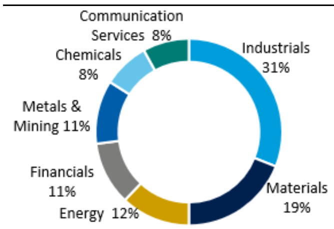
The S&P500 and the MSCI World excluding Australia returned +10.6% and +14.1%, respectively, whilst the ASX200AI returned +5.3% in the March quarter.

Equity markets moved higher as U.S. economic data continued to surprise to the upside relative to market expectations. The strength of the economic data more than offset a hawkish repricing of monetary policy expectations. At the start of this year the market was expecting seven 25bps interest cuts, with the first cut expected in March 2024. This has subsequently shifted to two ~25bps interest rate cuts, starting in the back half of 2024. This compares to the three cuts projected by the median Fed forecast.

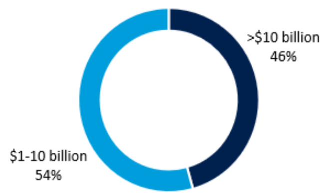
In Australia, the strength of recent macroeconomic data has been mixed. Real GDP growth remains only marginally positive, with December 2023 quarter real GDP per capita declining for the third consecutive quarter. The level of private investment has slowed and retail sales growth remains weak.

Returns (Net)[1] (%)	Catalyst Fund	S&P/ASX 200 AI	Out-performance
3 months	8.1	5.3	+2.8
6 months	12.4	14.2	(1.8)
12 months	11.8	14.4	(2.6)
2 years (p.a.)	8.2	7.0	+1.2
Since inception (p.a.)	13.7	7.4	+6.3
Since inception (cum.)	42.4	21.6	+20.8

Sector exposure (%)



Market cap exposure (%)



Meanwhile, the Australian unemployment rate declined from 4.1% to 3.7% from January to February 2024, while capital city house prices continue to rise. The annual movement in the monthly CPI indicator remained at 3.4% in February, only marginally above the RBA's target inflation band. While additional increases in the RBA's cash rate now appear unlikely in this cycle, the market now expects the first rate cut to be deferred to late 2024.

The strongest sectors in the ASX200AI for the March quarter were Information Technology (+24.4%), Property (+16.8%) and Consumer Discretionary (+12.9%) while Materials (-6.2%), Communication Services (1.1%) and Consumer Staples (+2.0%) lagged.

Portfolio exposures by primary catalyst as at 31 March 2024

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

- **Favourable portfolio company trading updates:** A number of portfolio companies provided positive trading updates during the February reporting season. One of the best performing stocks was QBE. The company's share price rose ~22% during the March quarter after reporting solid FY23 results, with earnings double the prior year. Importantly, QBE's insurance profits were consistent with company guidance, demonstrating the considerable progress it has made in delivering stronger and more consistent earnings. We see QBE as well positioned to deliver ahead of expectations with conservative guidance and market consensus estimates reflecting very little improvement in insurance margins going forward.
- **Continued realisation of catalysts:** Individual stock catalysts continued to play out during the March quarter. One example of this was Downer, where the share price rallied 16%. The company announced it was increasing its targeted cost-out program by $75m p.a. to a revised total of $175m p.a. to be achieved by FY25. In addition, Downer reported that its utilities division successfully returned to profitability during H1 2024. Together with the expanded cost-out program, this reaffirmed that it remains on track to achieve target EBITA margins of at least 4.5% in FY25. We provide more insight into our investment in Downer from page 4 of this report.

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

- **Sector positioning:** The major Australian banks have continued their strong share price performance. They have been the single largest driver of index returns for the ASX200, contributing ~45% of the ASX200 index return year-to-date despite representing only ~20% of the index weight. The portfolio has no exposure to the major banks. We find it difficult to justify this rally and current valuations, given bank earnings have shown very little leverage to rising interest rates so far and there continue to be economic risks from cost-of-living pressures that could impact bad debt levels going forward (off a near zero base).
- **Declines in select commodity prices:** Certain portfolio companies were impacted by their exposure to declining prices of commodities. Importantly, we have used conservative long-term assumptions to value these companies across market cycles and we remain positive on the outlook for our commodity-exposed holdings. We believe short-term, sentiment-driven pullbacks can provide attractive buying opportunities when framed within conservative long-term pricing assumptions. We took advantage of the situation during the quarter by adding to some of our positions.

We continue 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.

Santos update

We previously outlined our investment in Santos (ASX:STO), and why we viewed a structural separation of the company's Liquefied Natural Gas ('LNG') assets as the optimal approach to unlock value for shareholders (refer **September 2023 Quarterly Report**).

Since the time of our report, energy market fundamentals have remained robust. We have also had the opportunity to actively engage with the company and key stakeholders. This has included numerous meetings with the senior management team, Chair and other major institutional shareholders. Following this intensive campaign, we believe there is wider support from the broader Santos investor base for a fulsome review to evaluate structural solutions to realise the company's full value potential.

We have also been encouraged by communications from the company that they continue to examine a range of options, including constructive comments from CEO, Kevin Gallagher during the FY 2023 conference call.

> ***"We welcome shareholder feedback and opportunities or ideas to unlock or to create shareholder value…. we'll continue working with our advisers to evaluate, develop and negotiate or implement any of those opportunities or ideas as we go forward"***
>
> *Kevin Gallagher, CEO (21 Feb 2024)*

Furthermore, there have been several positive developments over the last six months which have increased our conviction in the upside potential for the company and the rationale of a structural solution, which we discuss below.

1. Resolution of Barossa legal challenges

Santos' Barossa LNG project has been subject to numerous challenges by environmental activist bodies. In January 2024, the two material outstanding challenges to progress the project were overcome, including a decisive win for Santos in the Federal court challenging pipe-laying activities due to claims of risk to Indigenous culture heritage.

Santos' Barossa LNG project is now ~70% complete and is expected to be completed with only a very minor delay to the initial schedule and a minor capital increase, a strong outcome given the extent of legal delays. We see the derisking of the Barossa project as enhancing the viability and attractiveness of a standalone Santos LNG equity story.

> ***"The cultural mapping exercise and the related opinions … are so lacking in integrity that no weight can be placed on them."***
>
> *Justice Charlesworth*

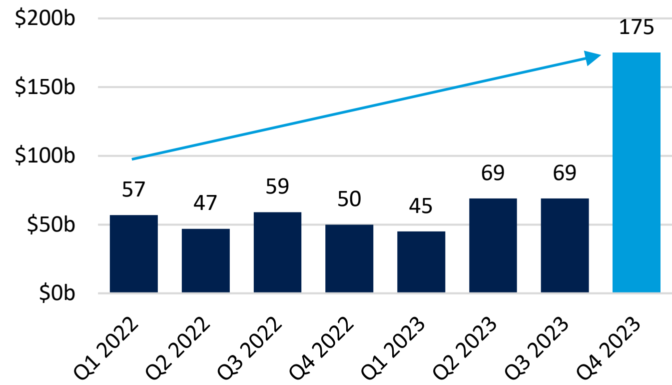
2. Significant sector M&A activity

We have observed a significant recent increase in M&A activity within the oil and gas space globally (Figure 1). Notable deals include Chevron's US$53b acquisition of Hess, Exxon's US$60b acquisition of Pioneer and Chesapeake's US$7.4b acquisition of Southwestern Energy.

We believe the trend of consolidation will continue, driven by several key themes:

- It is more capital efficient to buy growth than to build greenfield projects;
- Consolidation allows for greater efficiency of capital allocation in a capital starved sector;
- Complexity associated with navigating the energy transition can be assisted with scale (e.g. new technologies, influence public policy); and
- Potential for regional synergies.

Figure 1: M&A in the global oil & gas industry – 2022 & 2023 (by deal value in US$b)



Source: GlobalData Oil & Gas Intelligence Center

We believe Santos' LNG portfolio would be a highly attractive M&A target in a consolidating industry. We favour a structural solution that enables this strategic value to be better reflected in market prices.

3. Proposed transaction with Woodside

In December 2023, Woodside and Santos announced that they were having discussions regarding a potential merger (the entities together would be worth ~A$85b). Shortly thereafter, in February 2024, the companies announced they had ceased discussions without a transaction materialising, however Woodside noted that it “considers that the global LNG sector provides significant potential for value creation”, further evidencing the strategic value of Santos’ LNG assets.

We see Woodside’s interest as a positive. We believe that a low-premium merger would have been a sub-optimal outcome for Santos’ shareholders with the company having more favourable alternative options available, including a structural separation of its existing LNG assets.

Summary

We believe Santos remains a highly compelling investment, with a number of operational and structural catalysts that can drive material shareholder value over the medium-term. Our analysis continues to suggest substantial upside to the current share price on a sum-of-the-parts valuation basis.

Downer: Significant progress achieved on an ongoing turnaround story

Downer (ASX:DOW) is an Australian and New Zealand contracting business focused on transport (roads and rail management services), facilities (health, education, defence facilities management) and utilities (water, telecommunications and power servicing) end markets. The company was a strong contributor to Catalyst portfolio performance in the March quarter with its shares rising 15.9%, as Downer continues to execute on its turnaround strategy.

Downer’s share price had declined significantly throughout the course of 2022 (down 38%), on the back of difficult trading conditions and the emergence, in late 2022, of onerous contracts in the utilities business. As a result, the company’s entire utilities division became loss-making. Shortly after, in February 2023, Downer downgraded its FY23 profit guidance and reported a collapse in cash conversion, resulting in a further share price decline of 24%. The Catalyst Fund established an initial small position in early 2023 and proceeded to buy the majority of its position after the February 2023 profit downgrade.

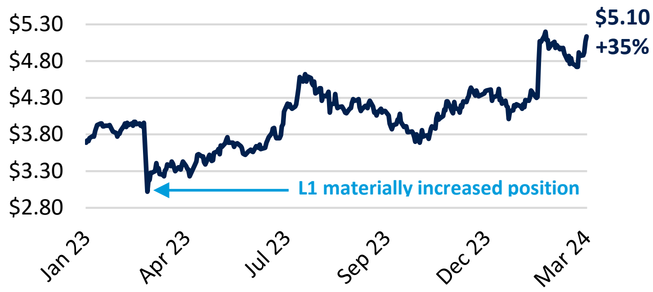
Since then, Downer’s shares have increased more than 65%, primarily as a new, focused and energised management team has continued to reiterate a target of improving profitability to 4.5%+ EBITA margins by FY25 (from 2.6% in H1 24) and restore cash conversion levels (~88% H1 24 vs. 8.5% in H1 23). Consensus numbers continue to upgrade forecasts towards those margins as the company has gradually provided greater line-of-site over its continued turn-around.

Figure 2: Downer capitalisation

Market cap (31 March 2024)	$3.7b
Last reported net debt (incl. leases)	$0.7b
Enterprise Value (EV)	$4.4b
FY25F EBITA	$478m
FY25F EV/EBITA	9.1x
FY25F P/E	14.0x

Source: Based on consensus estimates. Company financial year-end is 30 June. Market cap is diluted for ROADs instruments.

Figure 3: Downer last 18 month share price



Source: IRESS

Investment case

Our investment thesis was premised on the opportunity for both cyclical and operational improvement at Downer. We believed the core business was high quality, benefitting from various structural trends, and we fundamentally viewed new management targets as highly achievable. In addition, our intrinsic valuation of the business at our entry point allowed a significant margin of error below these management targets.

Summary

With substantial progress achieved to date, we remain positive on the ability for the company to continue its momentum and organisational transformation into FY25.

Quality

While Downer's business had faced significant pressure during the year preceding our investment, we believed the market had lost sight of an underlying core business that had many favourable characteristics. These included ~90% government contracts, defensive positioning to economic conditions, CPI-linked contracts in a high inflationary environment, material market share and improved pricing power in a tighter contracting market, among others.

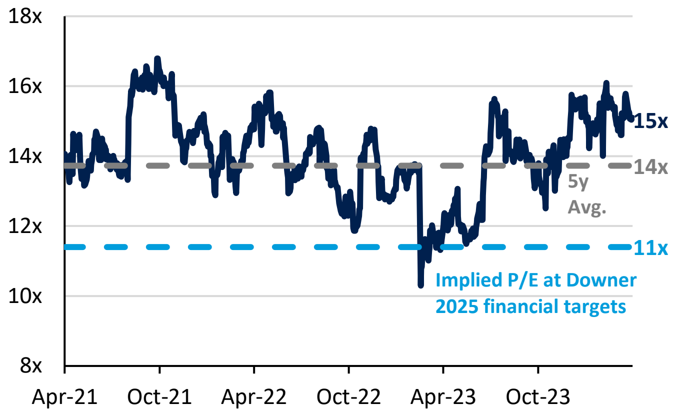
We anticipated a business recovery based on:

- **Cyclical pressures were leading to an under-estimation of Downer's earnings power:** At the time of investment, La Niña weather disruptions impacted roads maintenance, the business' largest segment, where rainfall led to >40% in lost shifts of asphalt laying for major cities. In addition, the impact of COVID-19 and resulting shortage and high turnover of labour, the firm's largest expense, resulted in an increased reliance on external contractors (typically >15% more expensive). While detrimental to near-term earnings, as the business cycle normalises these pressures on the business should ultimately alleviate. This is already becoming apparent with the transition from La Niña to El Niño and improved immigration dynamics for Australia easing some labour tightness.
- **Internal factors could be addressed with appropriate actions:** In our view, some of the problems and inefficiencies historically encountered by Downer were related to an ineffective organisational structural including duplicative functions, limited accountability, ineffective board oversight, accounting system failures and ineffectual incentive systems which rewarded contract wins over contract profitability. We saw that opportunities existed to achieve significant cost reduction and margin improvement, as evidenced by benchmarking to domestic and international peers. In short, relatively standard organisational changes could translate to drastically improved business performance and quality.

Value

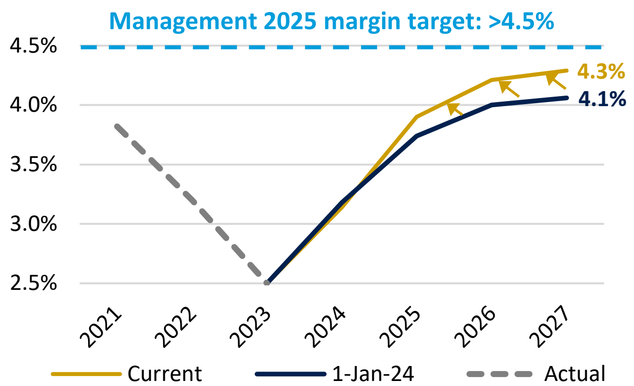
When we entered our position in Downer, the company's share price was trading at similar levels to where it did 20 years earlier. We continue to see significant value potential in Downer today, as we believe the market still only partially prices in management achieving its EBITA margin target of 4.5%+. At these EBITA target margins, which we maintain are conservative relative to global and domestic peers, Downer would trade at 11x P/E, compared to a historical average of 14x P/E.

Figure 4: Downer next 12 months P/E



Source: Bloomberg and L1 Capital

Figure 5: Consensus downer EBITA margin projections (%)



Source: Visible Alpha broker consensus forecasts, company filings

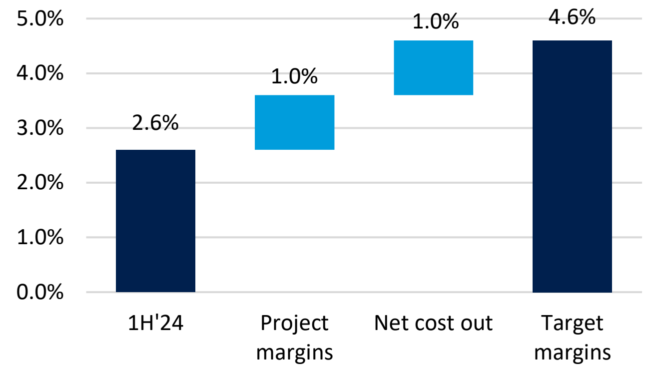
Catalysts

We note the significant transformation that has taken place in the business recently, which we expect to continue into FY25. These include:

1. **Cost-out program:** In 2023, the incoming CEO Peter Tompkins identified cost-out opportunities of ~$100m, primarily from collapsing duplicative functions, merging the Australian and New Zealand divisions, and property and systems optimisations. To date, $80m of cost-outs have been achieved and 400 FTE headcount has been removed from the organisation. During the recently released H1 24 results, the company committed to an additional $75m cost-out by FY25 (for a total of $175m), driven by a further evaluation of the operating model layers and IT system consolidation. Altogether, the $175m of targeted cost-out is expected to benefit EBITA margins by ~1%, comprising half of the bridge to management's 4.5%+ FY25 EBITA margin target.
2. **Disciplined bidding:** The company has new tendering governance in place with improved focus on both risk and margins. This is evident with its decision to avoid tendering for large scale transmission contracts, which had large contract values but an unattractive risk-reward proposition. A key success of Downer's disciplined but competitive bidding model has been the award of the multi-billion Queensland Train Manufacturing Program, where, importantly, Downer was able to subordinate construction risk to subcontractors with back-to-back security provisions and to focus on its core maintenance work.
3. **Asset sales and portfolio alignment:** Downer has sold a number of assets (six during H1 24) that the company feels are either a) high-quality, sub-scale assets which are undervalued in the current portfolio (e.g. 'Repurpose It', a minority stake in a recycling business which the company sold for $85m), or b) lower-quality assets that have undesirable risk exposure and low margin potential (e.g. the Australian Projects Business, which the company sold for $212m) This represented the majority of its large scale construction contract exposure, a business generally considered to be higher risk than its maintenance contracts.

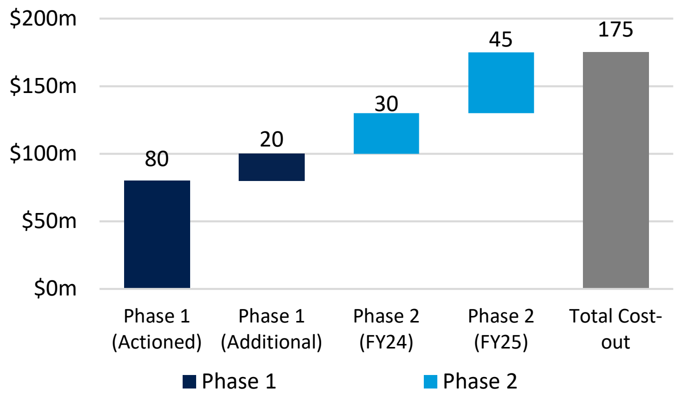
   We see potential for the company to continue on this path and have identified a further 2-3 significant assets we believe are logical divestments.
4. **Governance and leadership reset:** Since the beginning of 2023 the company considerably overhauled its Board and senior management team with the Chairman, CEO and CFO all leaving the business, and three new directors added to the Board. The new Chairman (ex-Lendlease), CEO (ex-Downer COO with risk focus) and CFO (ex-CIMIC) all have significant industry experience. The company has also revamped its risk frameworks, reporting lines, remuneration structures and oversight committees. Management's target of 4.5%+ EBITA margin is reflected in the Group's LTI scorecard (>4.5% average across FY25 and FY26).

Figure 6: Management target EBITA margins of 4.5%+



Source: Downer Investor Presentation

Figure 7: Build-up of $175m cost-out program ($m)



Source: Downer Investor Presentation

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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
Fund identifiers	ISIN: AU60ETL12936, APIR: ETL1293AU
Launch date	1 July 2021
Platform availability	Australian Money Market, BT Panorama, CFS FirstChoice, CFS FirstWrap, HSBC, Hub24, Macquarie Wrap, Mason Stevens, Netwealth, North*, Powerwrap and 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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