L1 Capital International Fund

Quarterly Report | SEPTEMBER 2022

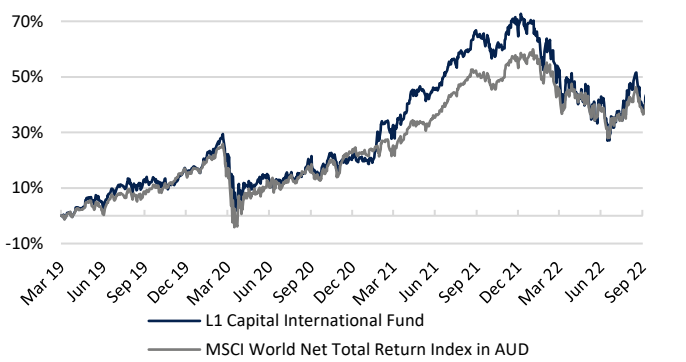
Introduction

In this September 2022 Quarterly Report, we have outlined:

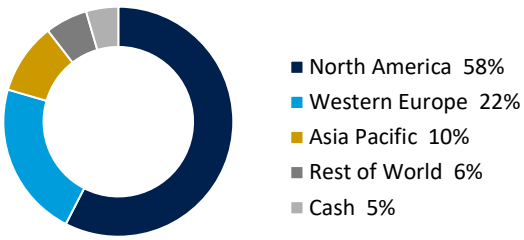
- **An update on the macroeconomic and geopolitical factors which are driving the current investment environment, with near term pressures building but investment opportunities becoming more compelling for long-term investors.**
- **Our review of the last quarter, including key contributors and detractors to the Fund's performance.**
- **Current portfolio positioning and recent adjustments.**
- **10 key takeaways from our recent travels and meetings with over 50 management teams.**

Fund Performance (Net) (%)[1]	Fund	Index[2]	Alpha
3 months	(0.4)	0.3	(0.7)
1 year	(17.7)	(9.7)	(8.0)
3 years p.a.	5.3	6.2	(1.0)
Since inception p.a.	7.9	8.3	(0.4)
Since inception cumulative	31.2	32.9	(1.7)

Fund (Net) Benchmark Returns Since Inception[1]



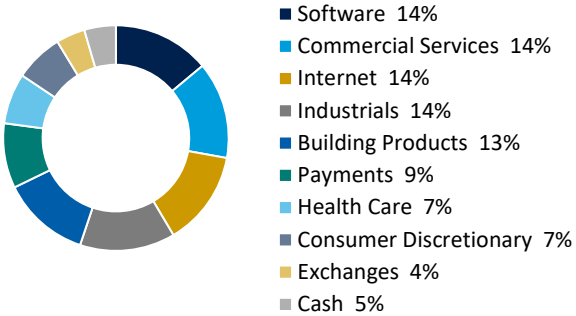
Revenue Exposure by Region[3]



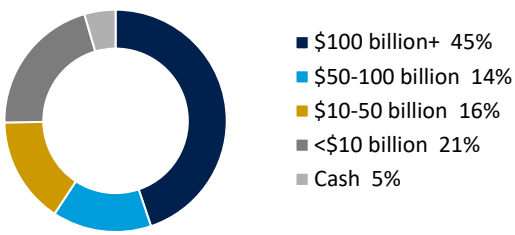
Top 10 Holdings (In Alphabetical Order)

	Sector
Alphabet	Internet
Amazon	Consumer Discretionary / Internet
Booking	Consumer Discretionary
Eagle Materials	Building Products
Graphic Packaging International	Industrials
Intercontinental Exchange	Exchanges
Intuit	Software
Marsh & McLennan	Commercial Services
Mastercard	Payments
Microsoft	Software

Sector Exposure[4]



Market Capitalisation Exposure



1. Figures may not sum exactly due to rounding. Past performance should not be taken as an indicator of future performance. 2. MSCI World Net Total Return Index in AUD. Return measured from Index close on 1 March 2019. 3. Revenue by region is internally estimated on a look through basis based on the underlying revenues of the individual companies held in the portfolio. 4. Industry classification is defined by L1 International to best describe the nature of the underlying businesses.

Current investment environment

"We didn't start the fire.

It was always burning, since the world's been turning."

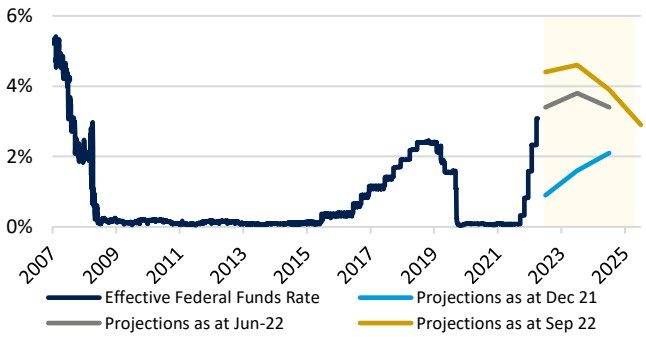
– Billy Joel

Macroeconomic and the geopolitical environment continue to drive the investment environment

Red China…North Korea, Ayatollah's in Iran, Russians in Afghanistan…as we know history doesn't repeat, but it often rhymes, and while Afghanistan has been replaced by Ukraine, Billy Joel was almost prophetic over 30 years ago when he rhymed 'vaccine' with 'England's got a new Queen'. The Richter Scales' 2007 parody "Here Comes Another Bubble" is not lost on us either and is worth looking up for a laugh, particularly after this sombre quarterly update.

Unfortunately, macroeconomics and geopolitics continue to dominate the 2022 investment environment. The Federal Reserve's response to broadening inflationary pressures has hardened, with the Federal Funds rate being increased by a further 1.5% during the September 2022 quarter, taking the total increase to 3.0% since March 2022. While the Federal Open Market Committee's interest rate projections have lacked the foresight of Billy Joel, their forward interest rate expectations have increased dramatically during 2022, from an expected peak of around 2% in 2025 to current expectations of a 4.5%+ peak in 2023.

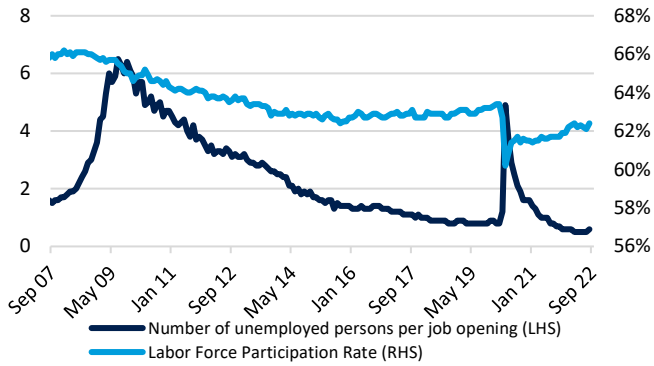
Figure 1: Federal Reserve Funds rate and Federal Open Market Committee rate projections



Source: St. Louis Federal Reserve Bank, Federal Reserve Bank of Atlanta, Bureau of Labor Statistics.

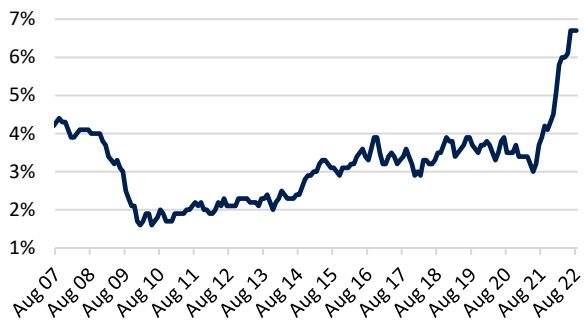
The war in Ukraine and associated energy insecurity in Europe remains unabated, and OPEC production cuts are not assisting. Supply chains, while slowly improving, remain disrupted, partly due to China's COVID-19 lockdown restrictions. These disruptions continue to cause inefficiencies, elevated costs and limit a supply response to dampen inflationary pressures. Despite what we expect will be meaningful house price pressure in the U.S., rental growth currently remains strong, reflecting robust demand and limited housing supply. The Federal Reserve is particularly concerned about the tight labour market causing significant wages inflation and the potential for a wages-inflation spiral.

Figure 2: U.S. Labour market conditions are tight



Source: U.S. Bureau of Labor Statistics.

Figure 3: U.S. wages inflation is rapidly accelerating



Source: Federal Reserve Bank of Atlanta.

Fiscal policy globally generally lacks the vision and/or political capital to address many of the world's issues, and in some instances (not mentioning anyone specifically but, hint, her name rhymes with an English double-decker bus) is making a bad situation worse. Acknowledging the U.K. (temporary) aberration, we expect tax rates to increase, both at the individual and corporate level. There is a limit to helicopter money and unchecked fiscal deficits.

We outlined in the **June 2022 quarterly report** that there were already signs of inflation nearing a peak, with the price of many commodities, technology products (such as semiconductors) and freight rates falling significantly. To this list we can now add not only hiring freezes, particularly in the technology sector, but also the start of redundancies.

U.S. dollar strength may assist to dampen U.S. inflationary pressures, but it will exacerbate inflation internationally and reduce reported international earnings for U.S. companies.

Energy remains unpredictable, but 'unexplained' Nord Stream pipeline explosions and OPEC production cuts are not conducive to a rapid reduction in energy prices.

Central Banks have responded the only way they can – by increasing interest rates to constrain the economy and reduce demand.

The **mainstream debate has shifted** from will this tightening cause a recession (in the U.S. and most countries) **to how deep will the recession be and how long will it last.**

At a microeconomic or business level, we are already seeing more than one canary in the coalmine indicating operating conditions are rapidly slowing. FedEx, one of the world's largest global transportation companies, recently noted "Global volumes declined as macroeconomic trends significantly worsened later in the quarter, both internationally and in the U.S.". Nike, led by one of the most optimistic CEOs in the world, noted macroeconomic uncertainty and reported lower revenue and margins and higher inventory levels compared to market expectations. Housing markets are rapidly softening globally and some technology segment such as PCs have also deteriorated more rapidly and to a greater extent than previous market expectations.

Despite some recent near-term resetting, **market expectations for company profits at a holistic level remain too high.** We caution relying on commentators who base their views on an assessment of 'market multiples' without scrutinising the underlying over-optimistic earnings expectations.

The rapidly deteriorating economic cycle has been reflected in a challenging investment environment, with the MSCI World Index falling 25% in U.S. dollars and 16% in Australian dollars since the start of 2022.

Outlook

The market is forward looking, and investors are searching for a bottom. Share prices have already significantly fallen. In July, expectations started to build that inflation was peaking and interest rate rises were nearing an end. This led to a strong bounce in equity markets. However, this early optimism was crushed by higher than expected monthly inflation numbers and the market rapidly sold off in August and September. Early October initially saw the market gravitate to bad news is good news – if there are signs of a deteriorating economy it will give the Fed reason to slow or pause tightening, hence positive for equities. We believe this 'bad is good' sentiment should be treated with caution. In addition, employment related data remains relatively robust, and the **only certainty is that the macroeconomic environment will remain uncertain for a while to come**.

The current economic environment continues to deteriorate, and the near-term outlook is challenging. However, humans, and particularly humans participating in financial markets, have a **strong bias to over-extrapolate the present**. Inflationary pressures, rising interest rates, deteriorating economic conditions…sell, sell, sell.

Yet this herd mentality, combined with indiscriminate passive capital flows, can and is leading to **share prices diverging from fair value for high quality businesses, creating compelling investment opportunities for longer-term investors focused on the fundamental value of a business, not the near-term direction of a share price**.

To date many companies have been able to increase prices in an inflationary environment. However, **inflation can disguise genuine pricing power**. It is much easier to raise prices when demand is robust compared to a weakening demand environment. Over coming months and quarters we expect most companies are going to report margin pressure, and only a **select group of high-quality businesses will have sufficient pricing power** to continue to offset inflationary pressures, maintain margins and market share**.**

The market has rapidly shifted from 'a rising tide lifting all boats', to 'stormy seas'. Business selection is increasingly critical. As outlined on page 5, we have made relatively limited changes to our portfolio during the quarter. Despite near term macroeconomic pressures, the L1 Capital International portfolio continues to benefit from **long-term growth drivers, operating in well-structured industries, holding leading market positions with rational competitors and high barriers to increased competition, experienced and aligned management, robust earnings, cashflow and balance sheets, high returns on capital and favourable ESG policies and trends.** They are well positioned to manage the current challenges and deliver strong investment returns to shareholders over our investment horizon, despite clear near-term macroeconomic pressures.

September 2022 Quarterly Review

Performance

The L1 Capital International Fund returned -0.4% (net of fees) during the September 2022 quarter compared to the benchmark return of +0.3%. The Australian dollar depreciated 6.7% against the U.S. dollar and 0.7% against the Euro, adding to Fund and benchmark Australian dollar reported returns.

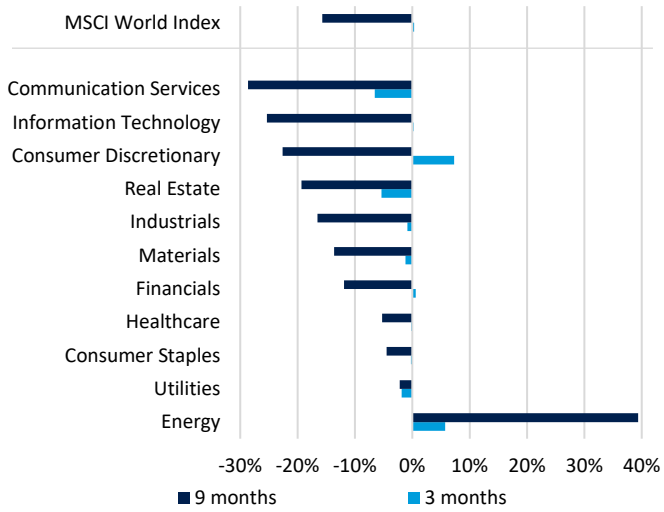
Key contributors and detractors

As of 30 September 2022, the portfolio consisted of 21 companies, with the top 10 holdings accounting for approximately 60% of the portfolio.

During 2022, equity markets have rapidly shifted from TINA (There Is No Alternative) or indiscriminate buying of companies with little regard to valuation, to a 'risk-off' environment where shares in companies are sold, again with little regard to valuation.

Energy-related companies continue to perform relatively strongly due to the disruption to oil and gas markets caused by Russia's invasion of Ukraine and announcements of production cuts by OPEC. Defensive sectors such as Utilities and Consumer Staples have outperformed during 2022 as investors look for safe havens, but companies in these sectors generally do not offer good value in our view, with investors willing to pay a premium for safety in uncertain times (see Figure 4). The Fund's lack of exposure to these sectors has contributed to short term negative relative performance compared to the Fund's benchmark.

Figure 4: MSCI World Index (in A$) – Sector Performance



Source: Bloomberg.

In terms of the September quarter, the share price performance of our portfolio of businesses can best be described as subdued and mixed. There was no sector or driver which stood out over this short time period.

Quarterly results (mostly reported in late July and early August) were generally in line with our expectations. Solid company execution was subsequently swamped by increases in interest rates and hawkish Federal Reserve commentary. During the quarter, only one company (**Amazon.com**) made a positive contribution of more than 0.5% in Australian dollars. Amazon was the largest negative contributor in the June 2022 quarter, with the share price recovering modestly but it is still well below our view of fair value. No company detracted more than 0.5% from the Fund's performance in Australian dollars, although the depreciation of the Australian dollar obfuscates some meaningful share price falls in U.S. dollars.

Late in the quarter, one of our smallest positions, **Adobe**, reported quarterly results and gave guidance which was modestly below our expectations. The share price fell substantially, not because of current financial performance and outlook, but principally because of the announced **acquisition of Figma for $20b** in cash and shares, plus additional retention payments to Figma employees. Figma, founded in 2012, has pioneered the development of software for collaborative product design on the web. The acquisition is a mix of offence and defence by Adobe management. Strategically the acquisition makes a lot of sense, with Figma complementary to Adobe's suite of software and it is the clear leader in a fast-growing market. We also believe Adobe was acting defensively, fearing Figma could develop into a strong direct competitor over time. **The acquisition price was extremely high**, with annual recurring revenue estimated to be $400m by the end of 2022.

The share price of **Advanced Micro Devices (AMD)** was weak during the quarter and weakened further in early October when the pre-announced revenue was significantly below prior guidance, reflecting an acute slowdown in the PC market. Data centre related revenue grew strongly, albeit below our expectations, while gaming and embedded revenue was in line with our base case.

Geopolitical risks have increased for the semiconductor sector, with the U.S. Government announcing restrictions on the sale of certain technologies to China. Despite near term headwinds, AMD is well positioned for the medium term, with a technology lead over Intel in servers for data centres and rapidly gaining share in the PC/notebook sectors. Its gaming and embedded applications continue to grow strongly. AMD is a very capital light business, with manufacturing outsourced. After expending nearly $5b on research and development, AMD generates around $5b of free cashflow. With a net cash balance sheet, we expect management will accelerate buyback activity at a share price well below fair value.

The share price of our more cyclical businesses, in particularly the building products companies which have exposure to the U.S. residential, repair and renovation and infrastructure sectors, were broadly flat for the quarter. Rapidly escalating mortgage rates and rapidly reducing affordability will have a pronounced negative effect on near term new residential construction activity. We believe these cyclical pressures are well understood and are more than reflected in current share prices. Overall, we **strongly believe share prices are overly reflecting near-term challenges and our portfolio of companies are now meaningfully undervalued.**

Portfolio adjustments

"In many ways, the stock market is like the weather in that if you don't like the current conditions all you have to do is wait a while."

– Lou Simpson

U.S. macroeconomic data remains robust, particularly tight employment conditions leading to wages growth and inflationary pressures. This is driving Federal Reserve commentary.

"Restoring price stability will likely require maintaining a restrictive policy stance for some time. The historical record cautions strongly against prematurely loosening policy."

– Jerome Powell, September 2022

Economic conditions have been too hot, with the heat fanned by exceptionally low interest rates, quantitative easing, supply constraints and more recently energy prices. Yet the winds of economic change can already clearly be felt, and **recession clouds are intensifying**.

Short term it is highly likely it is going to rain, but the intensity and duration of the storm remain unknowable. The current investment climate is adverse. However, trying to dodge the raincloud or **time the market** is rarely successful, particularly on a repeated basis.

Despite an expected near term economic downturn, we remain extremely comfortable with the business prospects of our portfolio of companies over a **longer-term investment horizon**. The short-term focus of many market participants has led to a substantial correction in share prices and created attractive opportunities for genuine longer-term investors.

To paraphrase Lou Simpson (former investment manager in Warren Buffett's Berkshire Hathaway group of businesses), we don't like the current weather, but we are prepared to wait a while, knowing that our portfolio of businesses is built to withstand the adverse conditions and will be in a stronger position when the outlook is more favourable.

Accordingly**, adjustments to the portfolio during the quarter were relatively modest.**

During the quarter we made an initial investment in one new business, added to our investment in **Booking Holdings (Booking)**, and reduced our investment in **IQVIA**, using the proceeds to increase our investment in **Danaher**.

The investment thesis for Booking, **the world's largest online travel agent (OTA)**, was outlined in our inaugural **June 2019 Quarterly Report** and our current thoughts were outlined in the **June 2022 Quarterly Report**. Booking's share price is the same as it was five years ago and the same as it was following the onslaught of COVID-19, but pre the FDA approval of vaccines.

We forecast Booking will make about as much net profit in 2022 as it did in 2017 (over $3b), so superficially you may conclude that it is reasonable for the share price to be at a similar level in 2022 as it was in 2017. However, this would miss 5 years of sustained operational investment, improved products and services, and a strengthened competitive position. In addition, travel has not fully recovered from COVID-19 in 2022. Many markets remain disrupted, particularly outbound travel from China. While 2023 may be impacted by economic conditions, we believe Booking's growth outlook over the medium to long term remains robust.

In addition, over the past 5 years, Booking has bought back around 20% of shares on issue while retaining the same small amount of net debt. This means **the total enterprise value of Booking is around 20% lower than it was 5 years ago**. The total enterprise value of Booking today is the same as it was near the depths of the COVID-19 crash, or back in 2015 when the earnings power of Booking was around half of what it is today. We consider the current share price offers **compelling value.** Management agrees, recently commenting that they expect to accelerate their buyback activity, **intending to complete around $10b of repurchases over 2 years, importantly without increasing financial leverage**.

IQVIA and Danaher have overlapping drivers, with both companies being **'picks and shovels' businesses servicing the life sciences industry**. We remain comfortable with both businesses and determined it was more appropriate to make the position size in each company more comparable. We would consider making our investment in both companies larger if valuations become even more compelling.

Technology companies continue to be under pressure, with the **technology centric NASDAQ index now down nearly 35% from its November 2021 peak**, and recently reaching a 2 year low. During 2020 and 2021 we witnessed a bubble building in many high growth, 'flavour of the moment' technology companies, many of which were and are unprofitable. This bubble has burst, with many companies now trading at a fraction of their peak share price, with little prospects of a full recovery. We did not participate in the '**unprofitable tech bubble**', but **our portfolio does have significant exposure to some of the largest, highly profitable and incredibly financially strong technology companies** which dominate their markets and have outstanding medium to long term growth prospects - including **Alphabet**, **Amazon**, **Intuit** and **Microsoft**. The share price of these companies has now fallen to levels we now consider provide very attractive valuations for long term investors.

Cash (in U.S. dollars) was maintained at around 5% during the September quarter.

In summary, not that much has changed since our June 2022 quarterly report. Inflation remains broad-based and high, monetary policy has tightened further, and interest rates are likely to continue to increase. Macroeconomic conditions are worsening, and geopolitical tensions remain intense. Investors are cautious and the market is in a 'risk-off' mode.

We cannot say the market has bottomed – no-one can. However, in our view we can say that current share prices for our portfolio of businesses are now below fair value, offering very favourable risk adjusted returns over our investment horizon.

U.S. travel takeaways

During the September 2022 quarter we returned to physical travel, our first trip to the U.S. since COVID-19. We had the opportunity to meet with management teams of over 50 companies across a range of industries – principally technology, consumer and industrial. We have outlined **10 key takeaways** from these meetings:

1. CEOs don't have a crystal ball either

Many of the CEOs we met with openly acknowledged the current economic uncertainties but **did not profess to know how the economic environment would unfold**. The most clear-cut comments about already seeing weakness were centred on lower socio-economic consumers and from a geographical perspective, Europe. More industrial and commercially orientated businesses, particularly those exposed predominantly to the U.S., noted that in general they had not seen weakness in demand, yet.

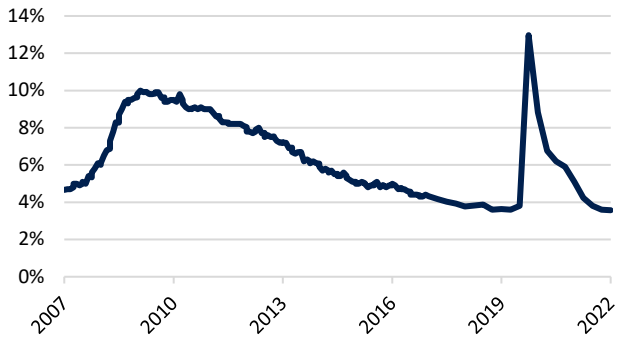
2. Supply chains improving, albeit slowly and slightly

COVID-19 has had long-lasting impacts on supply chains. China remains in varying stages of lock-down and the flow of goods globally has not fully returned to normal. We heard countless references to the **'golden screw'**, or a critical small part that held up the production of the finalised product. The golden screw is no longer a hold up for most companies – companies have made major changes to diversify their suppliers and adjust production to accommodate selective shortages. However, **inefficiencies remain**. We expect these inefficiencies to gradually normalise, helping some companies partly overcome inflationary pressures and increased supply to reduce price pressures in supply constrained sectors like the automotive industry.

3. Labour remains tight, particularly in the U.S.

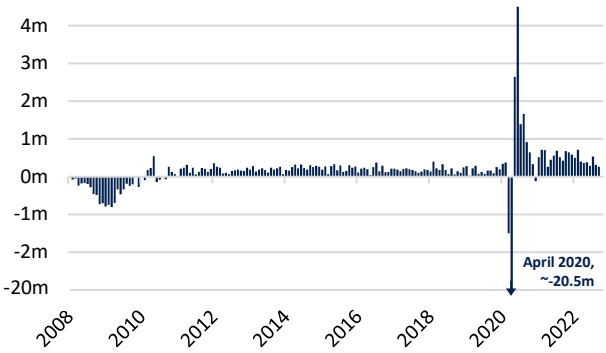
Companies are still struggling to attract workers, particularly in the U.S. Unemployment remains very low, and jobs continue to be created, albeit there are early signs of a slowdown. We believe **employment conditions are at or near peak levels**, and hiring freezes followed by redundancies will increasingly make headlines. However, the **employment starting position is extremely tight** including a lower participation rate post COVID-19 and therefore it will likely take a while until pressure for increased wages eases.

Figure 5: U.S. unemployment rate



Source: Bureau of Labor Statistics.

Figure 6: U.S. monthly change in non-farm payroll



Source: Bureau of Labor Statistics.

4. Inflationary pressures remain acute

In our discussions, management teams highlighted **continuing inflationary pressures**. Yes, some commodities and costs such as freight had fallen, but in addition to labour there continued to be inflationary pressures from suppliers, energy costs, insurance and other key areas. Companies continue to try to take price to offset these pressures. **Over the near term it is going to be increasingly apparent which companies have increased prices in an inflationary environment, and which companies have genuine pricing power. The former will face increasingly margin pressure** as future price increases become more challenging, particularly if the demand environment deteriorates**.**

5. COVID-19 is essentially yesterday's problem

For most companies, their **world has moved on from COVID-19**. Some supply chains remain impacted and operational risks need to be managed, but COVID-19 is no longer a constraining issue for most businesses. Without diminishing the humanitarian and economic cost of the pandemic, it does show how quickly the world adapts, and that too much emphasis is often placed on today's issues.

6. Consumers under pressure, demand for COVID-19 beneficiaries has fallen acutely

The **canary in the coal mine** for an economic slowdown appears to be the **lower income consumer** who more acutely feels the pressure of inflation on cost of living expenses. A number of companies referred to consumers starting to trade down or look for less expensive options in a given spending category. Demand for COVID-19 beneficiaries has fallen acutely – if you want a new BBQ for a new outdoor deck next to your new pool, you will surely get a good deal.

7. Industrial and commercial markets remain robust

As noted in commentary by CEOs earlier**, industrial and commercial markets**, particularly **in the U.S.**, had **not noticeably slowed down**. Companies still reported healthy backlogs and low inventories, commenting that managing their supply chains was still more of a focus than worrying about demand. We caution that circumstances can change quickly, and **today's backlog can be tomorrow's double-ordering**.

8. Clear regional differences

The further East you go, the more pressure and uncertainty. The U.S. was stronger than Western Europe which was stronger than Eastern Europe. China remained mixed and uncertain, but most companies were not reporting major disruptions from lockdowns.

9. Preparing for an economic downturn, but not taking significant action yet

The more open management teams recognised that an economic downturn was more likely than not and were already **preparing their plans to respond** as necessary. We saw how quickly companies respond to changes in market conditions with unemployment rapidly spiking at the start of COVID-19. Many technology companies have already announced hiring freezes and some redundancies. For some companies we follow we have already noticed announcements of extended plant maintenance periods, and in some select instances, plant closures. Importantly, in contrast to the period preceding the Global Financial Crisis, **most industries have not added significant capacity in recent years due to COVID-19 constraints**, and therefore there is less likely to be widespread excessive supply capacity, at least on a relative basis.

10. Balanced approach to capital allocation

The companies we invest in and consider for investment are in a strong financial position. They are not faced with excessive debt burdens. Rather, they are well positioned to continue to allocate their capital through a balance of organic investment, acquisitions, debt repayment, dividends and buybacks. **Several of our portfolio companies have recently commented that they expect to accelerate buyback activity as in their view their share price is well below their assessment of fair value**. **Not every company is in the enviable position of being able to take advantage of an undervalued share price and ramp up buybacks**. During Q2 2022 buybacks for S&P 500 companies totalled $220b, down 22% from the Q1 2022 record high, and a number of high-profile companies such as JP Morgan and Citigroup have suspended buybacks to build up capital reserves. Nearly half of the total Q2 2022 buyback activity was undertaken by the top 20 companies, led by Apple, Alphabet and Microsoft which bought back nearly $50b of shares outstanding in Q2 2022 on a combined basis. We do not expect buyback taxes to have a material impact on buyback activity. We do expect Governments to continue to target the largest and financially strongest businesses to raise fiscal revenue.

L1 Capital International Fund

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Fund Information

Name	L1 Capital International Fund
Portfolio Management	David Steinthal, Chief Investment Officer
Types of investments	Listed securities globally. Developed market focus. No shorting, no leverage
Number of investments	20 to 40
Cash weighting	0% to 25%
Minimum initial investment	$25,000
Hedging	Unhedged
Structure	Unit Trust
Domicile/Currency	Australia/AUD
Inception	1 March 2019
Management Fee	1.2% p.a. inclusive of GST and RITC
Expenses	Nil (included in Management Fee)
Benchmark	MSCI World Net Total Return Index in AUD
Performance Fee	15% over Benchmark, subject to any underperformance being recouped*
High Watermark	Yes
APIR / ISIN	ETL1954AU / AU60ETL19543
Platform Availability	Asgard, Australian Money Market, BT Panorama, Hub24, Macquarie Wrap, Mason Stevens, MLC, Netwealth, North, Powerwrap, Praemium

Contact us

Head of Distribution

Chris Clayton | cclayton@L1.com.au | +61 3 9286 7021

Researchers

Aman Kashyap | akashyap@L1.com.au | +61 477 341 403

Advisors

Alexander Ordon | aordon@L1.com.au | +61 413 615 224

Alejandro Espina | aespina@L1.com.au | +61 423 111 531

Matthew Leung | mleung@L1.com.au | +61 431 747 929

Private Clients

Edward Vine | evine@L1.com.au | +61 412 525 390

L1 CAPITAL INTERNATIONAL

Level 13, 139 Macquarie Street
Sydney NSW 2000 Australia

Email **info@L1international.com**

www.L1International.com

L1 Capital International overview

L1 Capital International is an independent active manager of global equities established as a joint venture with L1 Capital. We apply a detailed investment process built on a fundamental assessment of quality and value. We aim to deliver attractive risk-adjusted returns by investing in high quality companies that have favourable cashflow-based valuations in well-structured industries. Capital preservation over the investment horizon is central to our investment philosophy and process. We view risk as the potential for a permanent loss of capital as opposed to volatility in share prices. Additional information on L1 Capital International is available at **www.L1International.com**.

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. L1 Capital's clients include large superannuation funds, pension funds, asset consultants, financial planning groups, family offices, high net worth individuals and retail investors. Additional information on L1 Capital is available at **www.L1.com.au**.

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

* There must be positive absolute performance (adjusted for distributions) in the performance period. Otherwise, positive relative performance carries forward to next Period.

Information contained in this publication

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