

# L1 Capital Long Short Fund



**L1 Capital**

## QUARTERLY REPORT

December 2016

### December 2016 Quarter

The L1 Capital Long Short Fund returned 2.65% for the quarter, taking performance over the past year to 29.61%.

The Fund has returned 118.59% since inception, with an annualised return of 39.78% (after fees).

Performance has been generated from a wide range of sectors and stocks.

The Fund has achieved outstanding risk-adjusted returns (sharpe ratio 3.9, sortino ratio 22.4, maximum drawdown 2.4%).

The Fund had a strong December quarter, despite volatility around the US election and an ongoing shift away from defensives towards cyclicals. Weakness in global equities early in the quarter reversed, with Donald Trump's election win sparking an unexpected rally in equities. Investors were encouraged by the prospect of more stimulatory U.S fiscal policy, including tax cuts and large-scale infrastructure spending.

The ASX200AI rose 5.18%, with the strongest sectors being financials, utilities and materials, offset by weakness in telecoms, consumer staples and consumer discretionary stocks. The reversal of US bond yields continued and accelerated post Trump's election win. From the July lows to the December highs, US 10-Year Treasury yields nearly doubled from 1.40% to 2.60%.

In our mind, this dramatic shift in the trajectory of bond yields is the most important change occurring in global financial markets, with profound implications for all asset classes.

Some of the fund's best performing stocks this quarter were long positions in Rio Tinto, CIMIC, BlueScope, Bank of America and AGL. One of the fund's largest holdings this year has been BlueScope, which rallied more than 100% during 2016. Later in this report, we discuss our investment thesis and why we remain positive on the stock into 2017.

In this report, we review some of the shifts in financial markets during 2016 and highlight why we believe that alpha generation will become even more important in the years ahead.

#### **The Fund is truly differentiated, having delivered:**

1. 39.8% annualised returns since inception (after fees).
2. High quality performance coming from a broad spread of sectors, geographies and themes.
3. Very strong capital preservation and risk management (largest drawdown 2.4%, sharpe ratio 3.9).
4. Positive returns in 86% of months since inception.

### Monthly Performance (Net %)

Period	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec	Year
2014									-2.42	3.03	2.85	1.61	5.07
2015	0.59	9.14	2.42	1.71	3.73	-0.86	3.30	2.06	5.51	8.49	8.11	4.61	60.52
2016	5.81	0.59	5.47	2.46	2.78	-0.89	3.22	3.92	0.46	-0.12	0.55	2.22	29.61

Note: All performance data throughout this report is quoted after fees.



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### 1. Portfolio Attribution (since inception)

#### Performance Attribution Summary

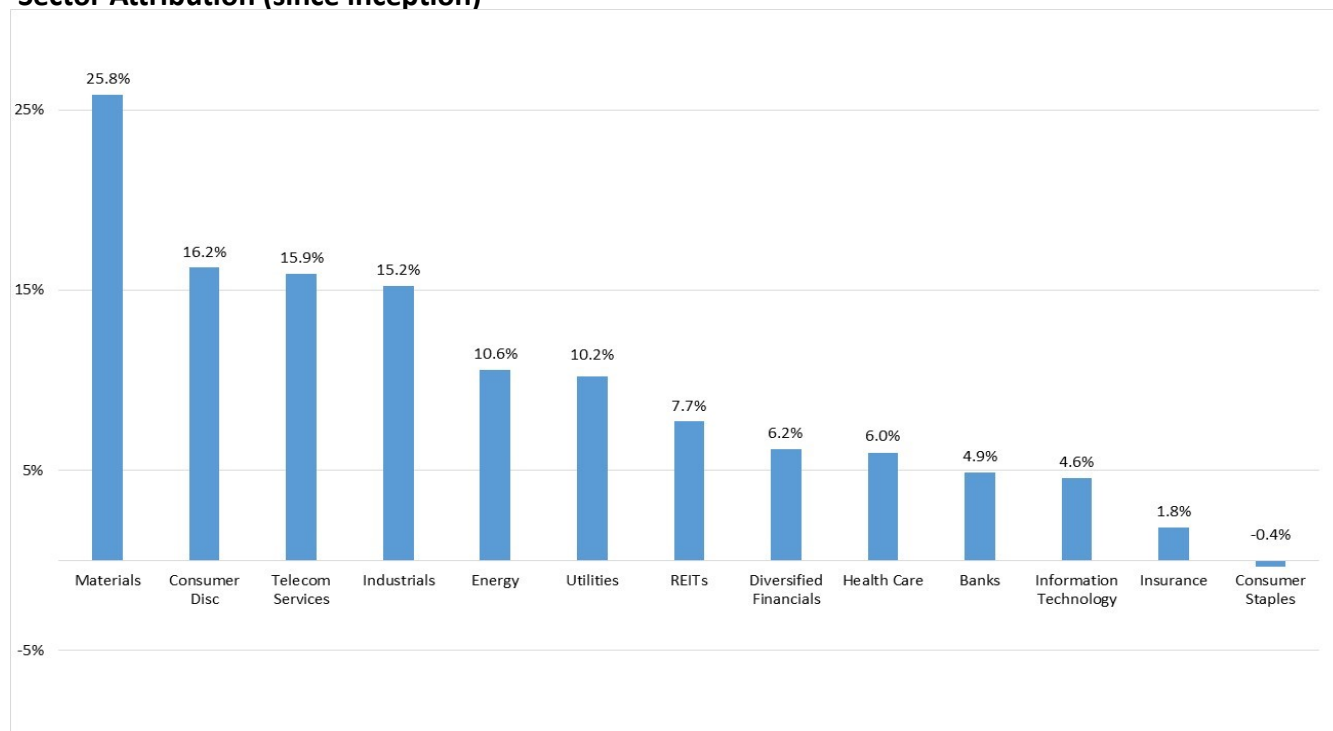
Period	Fund Return
Quarter	2.65%
Since Inception (September 2014)	118.59%

Attribution	Alpha
Long	104.10%
Short	14.49%
Total	118.59%

Attribution by Market Cap	Alpha
\$1b +	84.50%
Sub \$1b	40.21%
Index Shorts (Hedging)	-6.13%

Attribution by Region	Alpha
Australia	94.98%
International	23.61%
Total	118.59%

#### Sector Attribution (since inception)



Note: Portfolio hedges (index futures and cash) detracted 6.13% in aggregate.

All performance data is presented on a net basis and is current as at 31 December 2016.



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### 2. Fund Analytics and Exposures

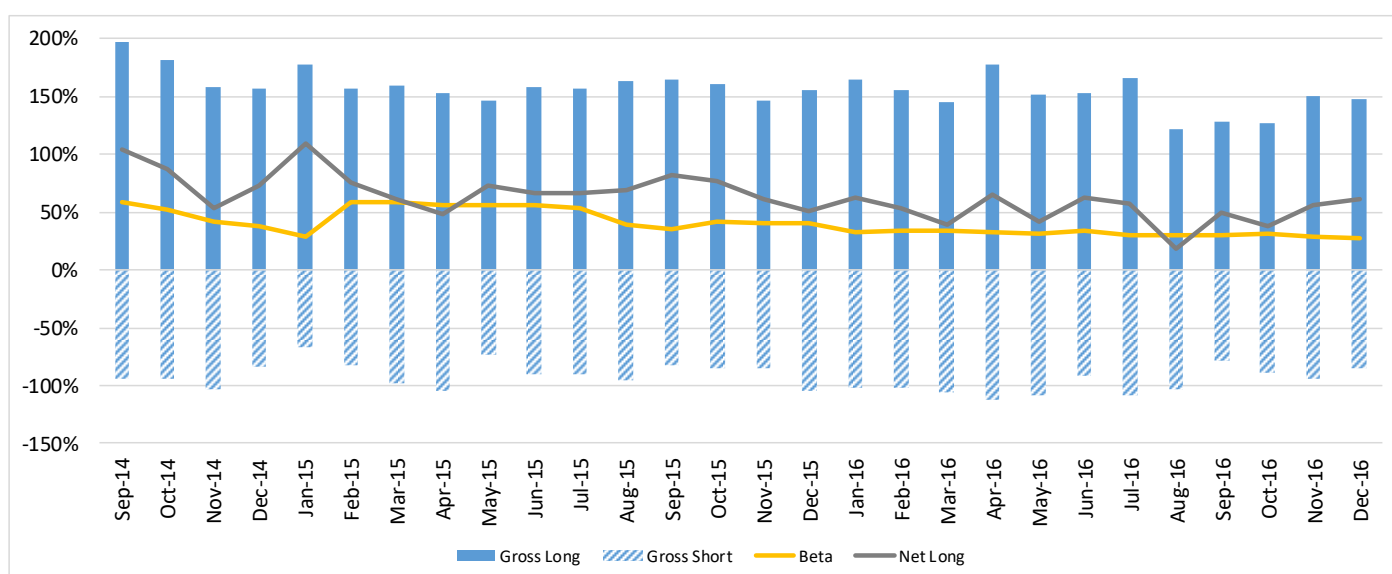
#### Fund Analytics

Annualised Returns	39.8%
Sharpe Ratio	3.9
Sortino Ratio	22.4
Annualised Volatility	9.6%
Downside Deviation	1.8%
Maximum Drawdown	-2.4%
Percentage of Positive Months	86%

#### Fund Exposures

	Current Portfolio	Average Since Inception
No. of Positions	82	69
Net Long	62%	63%
Gross Long	147%	156%
Gross Short	86%	93%
Gross Exposure	233%	250%
Beta	0.27	0.40

#### Historical Portfolio Gross & Net Exposure





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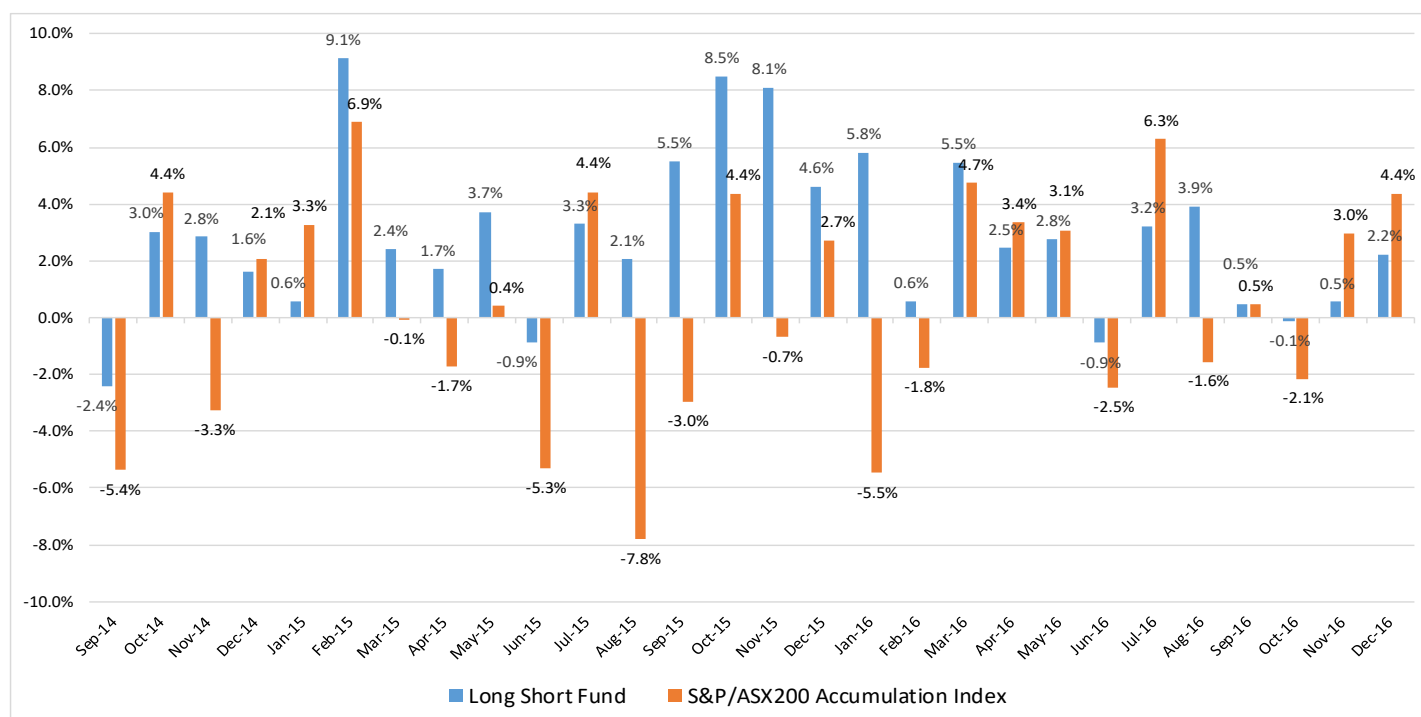
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### 3. Performance Summary

	Fund (net)	ASX200AI	MSCI World Index	HFRX Global Hedge Fund Index
Since Inception	118.6%	11.9%	-0.1%	-3.7%

Monthly Fund Returns v ASX200 Accumulation Index



- Over 100% outperformance above ASX200AI (post fees)
- Low correlation with global equity markets (true alpha generation)
- Extremely strong capital preservation (stronger returns than market in every market sell-off)
- ASX200AI fell more than 1% in 11 individual months versus only 1 month for the Fund

Note: MSCI World Index returns are quoted on a USD basis as at 31 December 2016.  
HFRX Global Hedge Fund Index represents the average return of all hedge funds globally as tracked by HFR.

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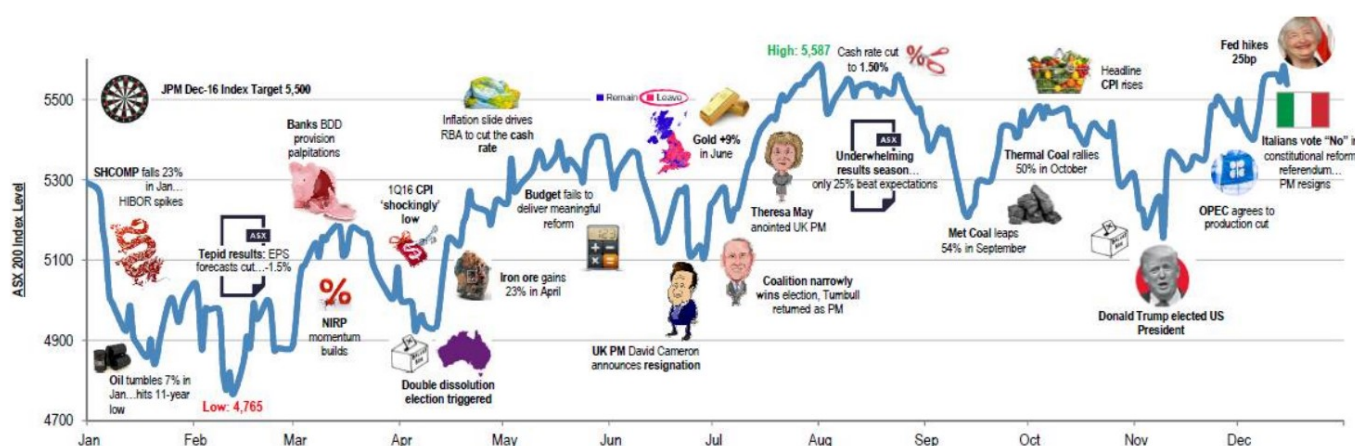
December 2016

### 4. The Year in Review - Expect the Unexpected

The past year has provided another powerful reminder of the market's ability to surprise and why keeping an open mind remains one of the most important behavioural traits for all investors. During 2016, we witnessed:

- a doubling in the oil price – from its lows around US\$28 to US\$56/barrel by year end
- UK voters choosing 'Brexit' and the subsequent collapse of the Pound
- a surprise election win by Donald Trump
- an initial fall and then massive intra-day reversal in equity futures after Trump's victory speech
- an 80% rally in the iron ore price – from around US\$43/t to US\$78/t by year end
- the possible end of a 35 year secular bull market in bonds

We enjoyed this picture from JP Morgan which shows the main events of 2016 set against the ASX200 price chart.



As we review the best and worst sectors of 2016, we note that the best sectors were dominated by sectors that investors were most negative on at the start of the year, such as mining & mining services, retail and capital goods. On the other hand, the glamour sectors that had built up the highest expectations and traded on the highest P/Es were the weakest performers. Telcos, healthcare and technology, had a perception of defensiveness and strong earnings growth, yet many of these stocks delivered weak earnings outlooks that were at odds with their lofty multiples (see chart 1).

As you can see in chart 2 below, most sectors are now trading around one standard deviation above their 15 year average. This is justified given a much lower interest rate environment versus history. Most sectors are now trading between 14-18x P/E, while utilities, cyclicals and healthcare continue to attract a premium rating (21-24x).



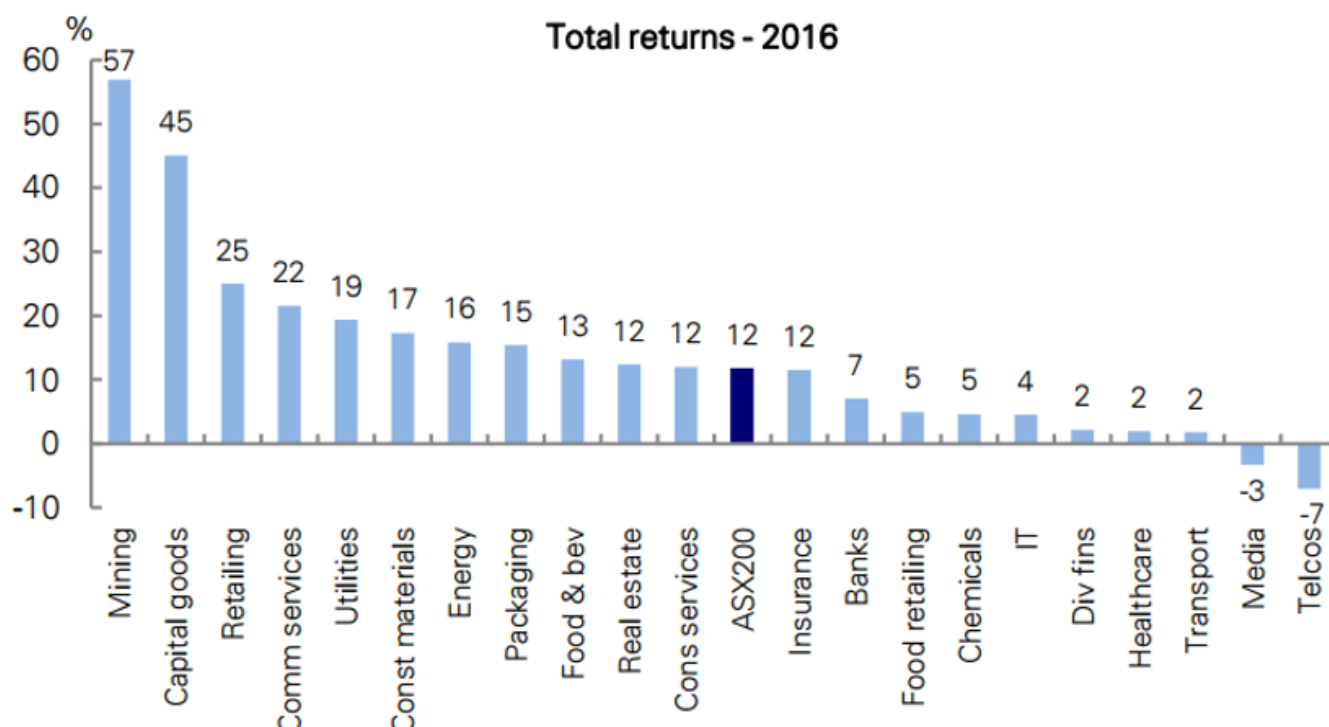
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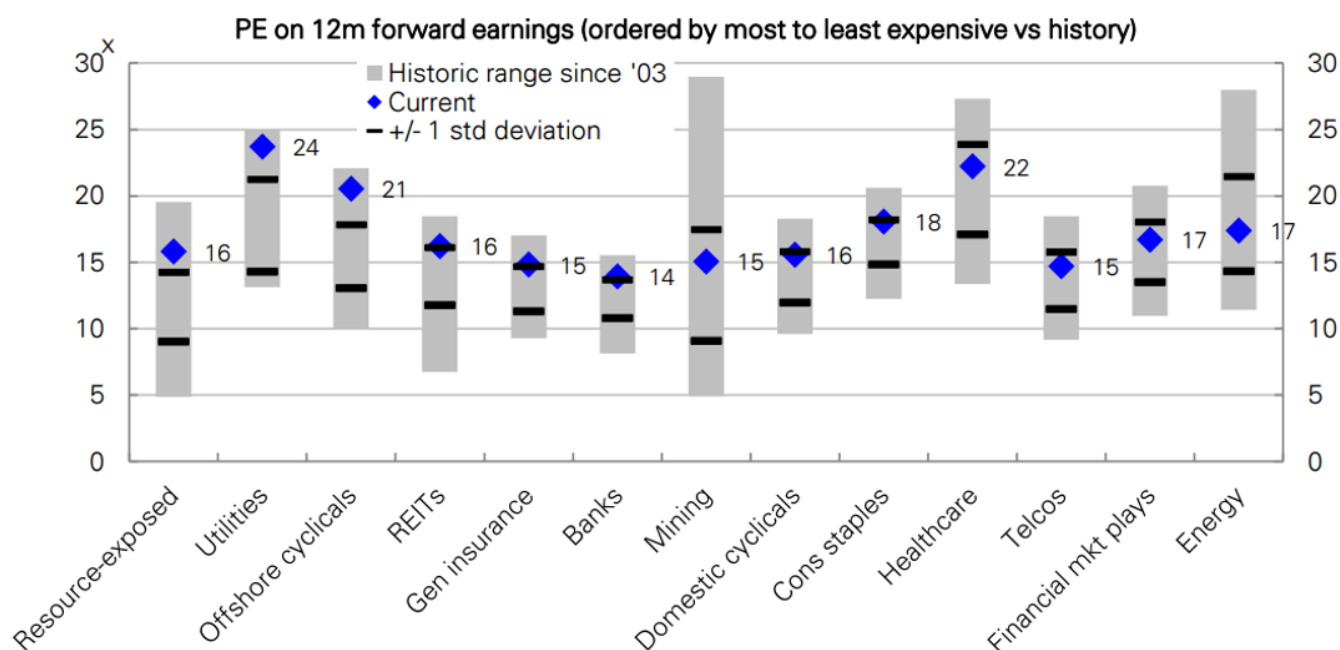
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Chart 1: Total returns by sector in 2016



Source: Datastream

Chart 2. Current & Historical 1 Year Forward P/E Multiples by Sector



Source: IRESS, IBES, Datastream



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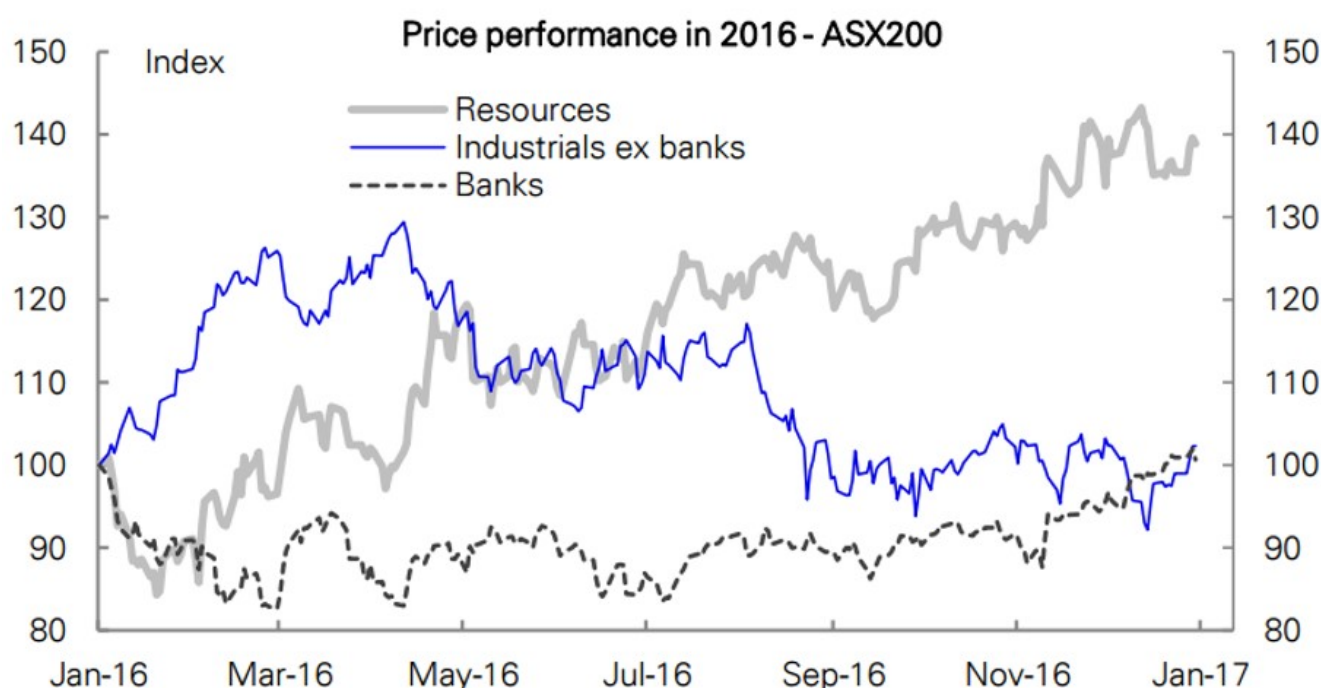
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Bank and industrial shares were broadly flat for 2016, while resources rallied 40%. The reports of the market having a strong year (+12%), hide the painful truth that most investors were not exposed meaningfully to resources (given the resource sector's horrible prior 5 years) and that is the real reason why many fund managers struggled to generate strong returns in 2016.

The hidden benefit of being underweight or short resources has been a large and consistent tailwind for many funds over the past 5 years. Our portfolio continues to be very diversified and does not rely on a specific macro backdrop to perform well.

**Chart 3: Resources was the standout performer in 2016**



Source: Datastream, Deutsche Bank

### Lower Beta = Greater Need for Alpha

Pleasingly, we have been able to generate strong returns in each of the past three years, despite a market that has swung wildly towards defensives and then more recently to cyclicals (see chart 4 on the next page). The Fund's performance has come almost exclusively from alpha generation (ie. value add beyond the market's return). Furthermore, the alpha has come predominantly from stock-picking rather than macro positioning. We believe this is more sustainable and repeatable given the vagaries of macro forecasting.

As we have stated previously, we believe the value of alpha generation will become even more important as we enter a lower return environment. In a world where almost all asset classes are likely to generate a lower real return than

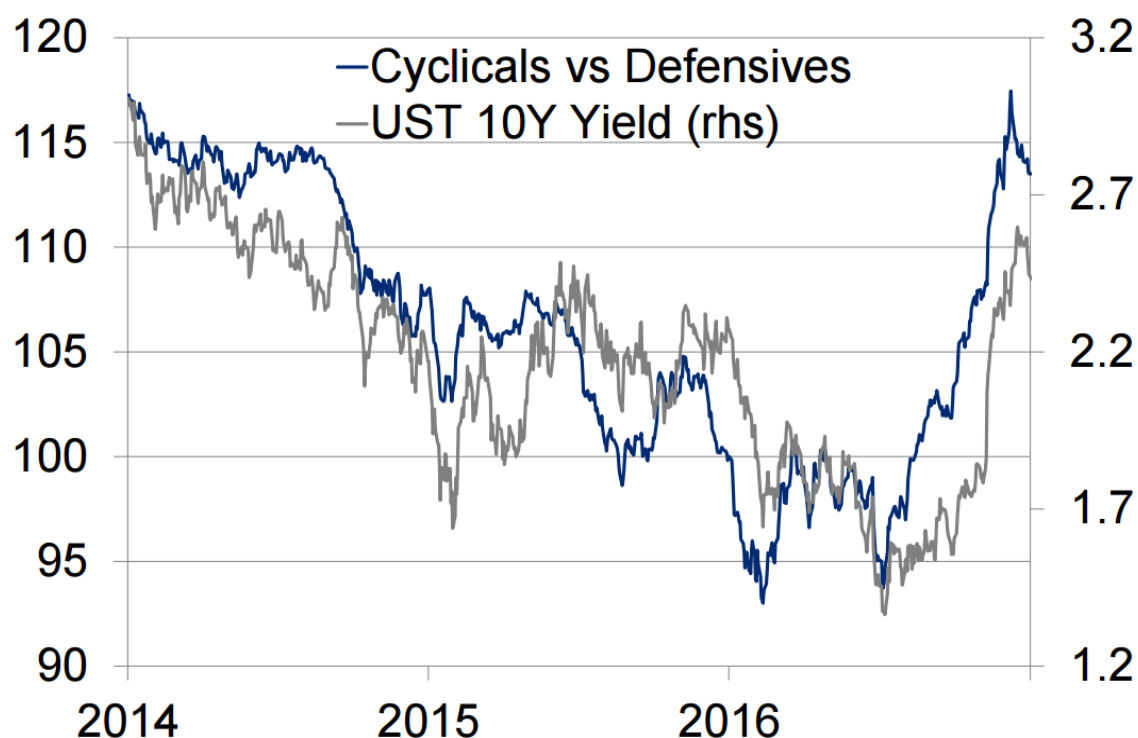




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Chart 4: Global Cyclical vs Defensives



**Source:** Citi Research, Datastream, MSCI. Defensives = Consumer Staples, Health Care, Telecoms, Utilities. Cyclical = Energy, Materials, Industrials, Cons Disc, Financials, IT





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### **5. Stock Review – BlueScope Steel**

The Fund bought BlueScope Steel in August 2015 when the shares were trading around \$4.30. We had a far more positive view of the earnings outlook for the business, along with the ability of management to sustainably improve margins and returns on capital. Since our initial buying, the shares have rallied more than 100% and it has been one of the best performing stocks in the ASX100.

Over the past five years, Paul O'Malley (CEO) and his team have successfully completed a number of important structural improvements:

- Recognising that Australia is a high cost jurisdiction to produce & export HRC (Hot Rolled Coil), management closed roughly half their Port Kembla steel-making capacity.
- Management introduced Nippon Steel as a JV partner in the Asian coated products business for an EV of US\$1.36b.
- Co-ordinated a massive cost out program across the group, which generated around \$300m of savings

**Earnings expectations:** At its recent AGM, BlueScope modestly upgraded first half EBIT guidance to “at least \$510m” from prior guidance of “around” \$510m. Consensus full year EBIT expectation is for \$883m, which implies second half EBIT of around \$370m. While Q3 will show some compression in HRC spreads in Australia and North America, these have now recovered and BlueScope is likely to have a very strong Q4. We believe BlueScope is likely to comfortably exceed FY17 consensus EPS, with further significant EPS upgrades likely for FY18. It should also be noted that BlueScope has substantial tax losses in Australia and is unlikely to pay any cash tax in Australia for the next 7+ years. The result is that cashflow will substantially exceed reported earnings for many years to come.

**Balance Sheet:** After a period of significant balance sheet repair, BlueScope made its first major new investment when it purchased the other 50% of its North Star JV in North America for USD\$720m. While BlueScope made some quick progress in reducing debt during FY16, some of the reductions in working capital are likely unsustainable. Nevertheless, with strong operating cashflow, we estimate BlueScope will finish FY17 with around \$200m net debt or a ratio of below 0.2x Net Debt/EBITDA. Going forward, management will either make some substantial investments (such as Arrium's east coast assets) or alternatively, commence a major capital management program with an emphasis on buybacks.

**Valuation:** BlueScope is trading on a FY17 PE of 11.4x consensus earnings and 5.3x EV/EBITDA, making it one of the cheapest steel stocks globally, with almost all peers trading on significantly higher multiples (see chart over the page). Notably, BlueScope's Asian JV partner, Nippon Steel, is trading on a premium EBITDA multiple of around 10x, highlighting the future potential for an accretive sale of the other half of this JV.

The key sources of potential medium term earnings and valuation upside versus market are:

- North Star – Rising fixed asset investment by U.S. corporates and Trump's infrastructure spending should boost steel demand, while supply should remain constrained as existing and potentially further anti-dumping measures constrain the supply of imported steel. The combined supply and demand changes are likely to result in an HRC spread (difference between the HRC price and the scrap price) of well above \$300 per tonne on BlueScope's 2.3mt of annual production.
- Australian Steel Products should benefit from stronger Asian HRC prices and spreads as China curtails loss making steel production, Asian economies strengthen and anti-dumping measures become more entrenched. Now that coking coal prices have started to fall (from over US\$300/t to US\$200/t), steel spreads have improved from around \$140/t at their trough to around \$250/t more recently. This shift will generate a huge boost to BlueScope's commodity steel sales.



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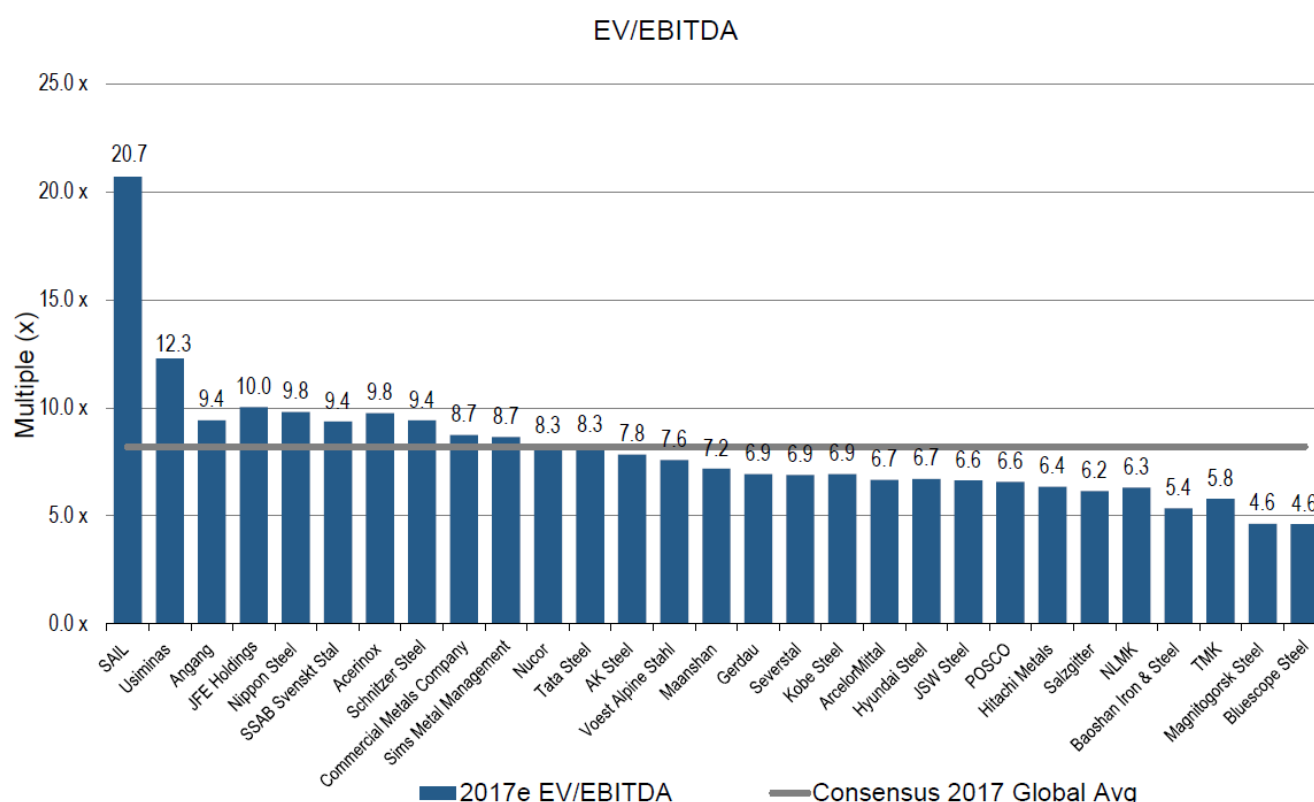
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- Substantial turnaround in the NZ business driven by higher steel prices, large cost reduction program, initial contribution from the billet caster (\$40m annualised EBIT) and higher realised iron ore prices for their low-grade iron sands exports (around 3.5mt pa).

Key downside risks for BlueScope include a higher AUD, lower domestic housing activity and lower global steel demand (particularly in North America). While none of these factors are individually material for BlueScope, cumulatively they pose a meaningful risk. Despite its recent rally, we believe BlueScope has transformed its business mix, cost competitiveness and balance sheet in a manner that is still underappreciated by the market.

**Chart 5: Global peers trade on ~8x consensus FY17 EV/EBITDA. BlueScope remains the cheapest of the peer group**



Source: IBES, Credit Suisse estimates

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FUND INFORMATION			
Name	L1 Capital Long Short Fund	Minimum Investment	A\$500,000
Class of Units	Wholesale	Subscription Frequency	Monthly
Structure	Unit Trust	Redemption Frequency	Monthly
Domicile / Currency	Australia / AUD	Responsible Entity	Equity Trustees Limited
Inception	1 September 2014	Administrator	White Outsourcing
Management Fee	1.281%	Auditor	Ernst & Young
Performance Fee	20.50%	Custodian	HSBC
High Watermark	Yes	Prime Brokers	Credit Suisse (Europe) Morgan Stanley
APIR/ ISIN	ETL4912AU / AU60ETL49128	Legal Advisor	Hall & Wilcox
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### L1 Capital Overview

L1 Capital is a boutique fund manager based in Melbourne committed to offering best in class investment products. The firm invests for wholesale clients, primarily superannuation funds, large institutions and high net worth investors and has been one of Australia's top performing Australian equity fund managers since its inception in 2007. L1 Capital has two investment funds:

- **L1 Capital Australian Equities Fund** offers investors the opportunity to hold a concentrated portfolio of Australian stocks, primarily from the S&P/ASX200 Accumulation Index.
- **L1 Capital Long Short Fund** offers investors the opportunity to profit from a diversified range of long and short positions using the investment team's fundamental bottom-up research process.

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