System Capital Long Short Strategy

Quarterly Report December 2024

The investment team is very pleased to present our December 2024 newsletter. Comments and suggestions are highly welcome.

STRATEGY PERFORMANCE OVERVIEW

The strategy returned 2.3% for the quarter, bringing 1-year performance to 24.2%.

Position Type	Dec 24
Short Positions	15
Long Positions	36
Index Positions	3
Total Positions	**54**

Region	Gross Long	Gross Short	Net Long
Europe	62%	(20%)	42%
North America	41%	(21%)	19%
Asia	4%	0%	4%
Australia/NZ	21%	(4%)	17%
Total	**128%**	**(45%)**	**83%**

	Month	3M	FYTD	1 Year	2 Year p.a.	Cumulative Since Inception	Since Inception p.a.
System Capital L/S	**(1.2%)**	**2.3%**	**18.0%**	**24.2%**	**26.9%**	**60.8%**	**24.3%**
MSCI World AUD Hedged	(2.0%)	1.9%	6.5%	20.5%	21.0%	47.8%	19.6%
Stoxx 600	(0.5%)	(2.6%)	(0.1%)	8.8%	12.2%	31.6%	13.4%
ASX 200	(3.2%)	(0.8%)	6.9%	11.4%	11.9%	30.5%	13.0%

Performance is in AUD (Hedged) and is before fees. Cumulative Returns and Annualised Returns from 26th Oct 2022 to 31st Dec 2024. Returns in AUD. Gross returns before management and performance fees. MSCI World 100% Hedged to AUD Index. ASX200 Accumulation Index Stoxx 600 Net Total Return.

SIGNIFICANT CONTRIBUTORS FOR THE QUARTER INCLUDED:

- **Visa (Payment network):** Visa shares increased 15% as it reported strong revenue and earnings growth for FY24, healthy October volume trends and a strong outlook for FY25. The results of the U.S election were also positive for the stock, as the new administration's deregulatory focus may lessen regulatory risk.
- **Flutter (Gaming):** Flutter shares increased 17% on the back of 3rd quarter results which were ahead of expectations, with a particularly strong performance in the United Kingdom and Ireland (UK&I) segment.
- **Amazon (IT and E-commerce):** Amazon shares increased 18% on operational strength across the business. Retail margins improved significantly on the back of lower costs to fulfill and deliver packages, while AWS margins continued to increase due to efficiency gains.

- **Paylocity (Payroll processing):** Paylocity shares increased 21% on the back of strong quarterly operating results and an increase in next year's guidance.
- **Ferrovial (Infrastructure):** Ferrovial shares increased 7% on the back of an approximately 18% price increase on average across its 407ETR toll road. The 407ETR has a long-dated concession, attractive contractual terms and a highly strategic location within Ontario. We continue to believe that the 407ETR will continue to show healthy earnings growth for many years.

QUARTERLY MACRO REVIEW

The fourth quarter of 2024 has seen several significant macroeconomic developments, with interest rates, the US elections, trade policies and regulatory developments taking centre stage. These all have the potential to impact our portfolio.

US RATES, INFLATION AND GROWTH

The Federal Reserve maintained a cautious stance during Q4 2024. While PCE inflation remained in line with expectations, specific subcomponents showed volatility (e.g. used cars). At the December meeting, the Fed cut the policy rate by 25bps as expected, however the Fed's dot plot adjusted its projection to two rate cuts for 2025, down from four, reflecting tempered optimism. The 10-year bond yield increased from 3.8% to 4.5%, which pushed mortgage rates back above 7%. GDP growth of 2.8% in Q3, supported by a robust 3.5% increase in real consumption, highlighted the strong economic outperformance of the USA relative to other developed markets.

US ELECTIONS, TRADE & TARIFFS

The 2024 U.S. presidential election introduced significant uncertainty to the policy landscape. Key themes included the expansion of tariffs and immigration reforms, with potential impacts on GDP growth and inflation.

Tariffs and Trade Policy

The anticipation of expanded tariffs, particularly targeting imports from key trade partners, heightened concerns over supply chain disruptions and increased input costs. Tariff adjustments are expected to exert upward pressure on consumer prices, complicating the Federal Reserve's inflation management. Furthermore, retaliatory measures from affected nations could amplify trade tensions and weigh on global growth prospects.

Immigration Reforms

Tighter immigration policies were flagged as a cornerstone of the new administration's platform. These reforms are likely to slow labour force growth, contributing to tighter labour market conditions. While this may initially support wage growth, it risks creating bottlenecks in sectors heavily reliant on immigrant labour, potentially fuelling wage-driven inflation over time.

Fiscal Stimulus and Infrastructure Spending

The new administration signalled interest in fiscal expansion, particularly in modernising critical infrastructure, promoting fossil fuels (and repealing clean energy legislation) and supporting domestic manufacturing. While these policies could provide a short-term boost to GDP growth, they also raise concerns about fiscal sustainability and their potential to exacerbate inflationary pressures in an already constrained supply environment.

EUROPEAN RATES AND INFLATION

In December, the ECB cut rates, marking a continuation of its dovish trajectory as inflation trended downward. Euro area growth faced headwinds from tighter fiscal policies, subdued exports, and monetary policy lags. PMIs rebounded in December after a weak November, yet 4Q growth remained sluggish at an estimated 0.1% quarter-over-quarter.

GLOBAL REGULATORY DEVELOPMENTS

The outcome of the US election during the quarter catalysed a sentiment shift regarding US regulatory risk. As mentioned in the prior quarterly, the Biden administration had become increasingly aggressive in regulatory and antitrust actions, while the Trump administration has an explicit focus on deregulation.

With the change of administration, there will most likely be leadership changes at both the DOJ and CFPB. Any changes to the DOJ may benefit Visa (currently subject to DOJ lawsuit) and Google (embroiled in multiple litigations with US regulators). Furthermore, changes to the CFPB may also benefit FICO and EFX who are among a range of companies under scrutiny from the CFPB for their pricing actions.

The DOJ antitrust case against Google in the US District Court continued as both Google and Apple responded to the DOJ's remedies submission with their own milder remedies. The case is currently waiting for the judge to rule on remedies, which will likely be followed by a Google appeal to the initial antitrust ruling.

The quarter also included regulatory updates across the gaming industry. In the US, there was a successful vote in Missouri to legalise online sports betting. In the UK, the gambling white paper recommendations were implemented across our portfolio companies. Finally, the enactment of a Brazilian licence regime for online betting, with both Entain and Flutter in compliance, moved the jurisdiction to a more restrictive stance against illegal gaming – a positive move for legitimate operators.

We continue to closely monitor regulatory developments and risks relevant to our portfolio companies and the broader industry they operate in.

STOCK REVIEWS: PAYCOM AND PAYLOCITY (PAYC/PCTY)

ABOUT THE COMPANIES

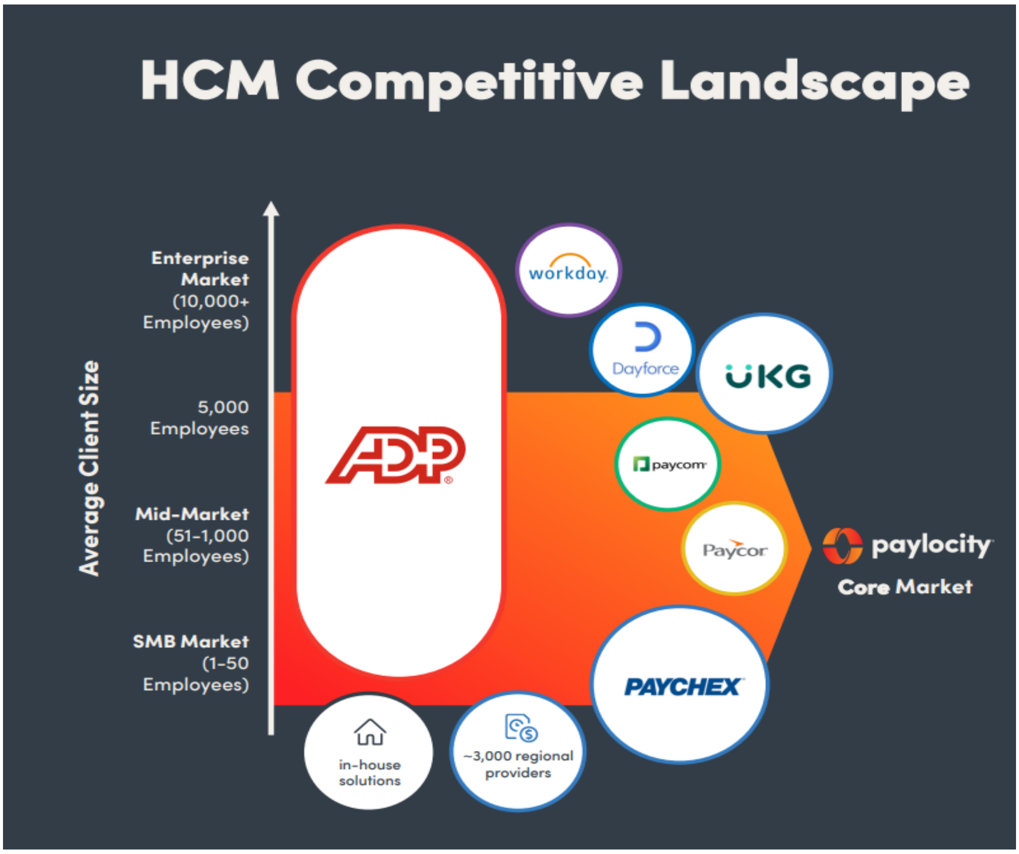
Paycom and Paylocity are new positions for the portfolio. Our investment followed an in-depth review of the Human Capital Management (HCM) sector.

HCM vendors provide a wide range of services to employers. These include:

- Payroll processing and tax
- Talent management (recruitment, on boarding, training, performance management),
- Benefits administration (401K pension benefits, insurance)
- Workforce analytics (leave management, predictive hiring models, workforce productivity modelling).

Globally, 70% of employers outsource some or all of their HCM needs, with payroll and time and attendance being the most typical functions to be outsourced.

The HCM industry is highly competitive. HCM providers vary greatly in their capabilities and service offerings, from small accounting firms providing payroll and tax, to large outsourcing firms which largely replace the HR function, through to software vendors offering powerful HCM capabilities to HR and corporate office teams. Large players include ADP and Paychex, which offer a fully outsourced payroll solution, software vendors like UKG and WorkDay which cater to very large corporates and Paycom and Paylocity which cater to small and medium businesses (SMB's).



Source: Paylocity 1Q2025 Presentation

Paycom and Paylocity have similar corporate histories.

Paylocity was started in 1997 with the vision of allowing small and medium businesses to outsource their HCM needs while having access to cutting edge technology only previously available to large corporates. The business transitioned to a SaaS model from 2004 onwards and IPO'd in 2014. Paylocity has a strong founder led culture, with a significant history of product innovation, and accretive M&A, strong management incentives linked to shareholder value creation. The Founder has retained a significant shareholding in the business. Paylocity caters to businesses with a typical employee base of 150 people although it can scale to larger enterprises. Paylocity is US listed with a $11bn market cap.

Paycom was started in 1998 by Chad Richardson who remains the CEO of the business. Chad has had a strong focus on offering a unified outsourcing HCM software solution, with a focus on growing organically through leveraging the core payroll database to build new products. The business was a similarly early adopter of SaaS and also IPO'd in 2014. Paycom typically caters to businesses with more than 300 employees and has been scaling to larger corporates. The current CEO and Founder maintains a significant shareholding in the business, and similarly to Paylocity has strong incentives linked to shareholder value creation. Paycom is US listed with a $11bn market cap.

WHAT ATTRACTED US TO IT

Given the high level of competition and seeming low barriers to entry, HCM software vendors are not typically the types of companies that we would consider for a long position, given System Capital's focus on businesses having strong competitive advantages which improve over time.

However, there are some aspects of the HCM software industry, and Paycom and Paylocity in particular, that we believe make these business interesting stocks for our portfolio. We review these below:

High and growing switching costs: There is incredible complexity around payroll, insurance and tax and there are significant reputational, legal and financial costs for an employer to get these things wrong during a transition to another vendor. As the number of services sold by a HCM vendor increases, these switching costs continue to grow. As a result, switching largely occurs because of system failure, a significant fall in service standards or the need for a core new capability that isn't addressed by a vendor.

Significant learning effects limit competition from new entrants: HCM software is inherently complex. Paylocity and Paycom have the best onboarding tools for new clients and a large number of reference customers, which is important for an HR manager for whom a botched transition can be career limiting. Importantly, Paylocity and Paycom also benefit from having a large group of existing HR professionals who have used their software at their current or previous employer. Given the mission critical nature of HCM software and the high reluctance to learn new workflows, this tends to reward existing leaders in the space who already have significant market penetration over new entrants.

Significant runway for market share penetration driven by increasing complexity: As complexity grows and talent acquisition, training and workforce optimisation become more critical for SMB's, market share continues to shift from inhouse solutions and accountancy firms to HCM software solutions. Additionally, as the leading HCM technology vendors, Paycom and Paylocity continue to take share from legacy outsource providers like ADP and Paychex. System Capital estimates Paylocity and Paycom have a 6% share of the combined market, highlighting the runway ahead.

Cost per employee is modest relative to the value provided: Both Paycom and Paylocity charge $200-$300 per employee per year for the core payroll and tax modules. Additional modules available for recruitment, training, employee benefits, leave management and analytics take the maximum cost to $500-$700 per employee. System Capital believes that this is a modest part of total employee costs but is critical for staff productivity, retention and training for SMB's that do not have large central offices to run these programs at the same level of efficiency. In many cases, the new modules introduced by these vendors replace much more expensive outsourced solutions, further adding to value provided.

Pricing power: At an average revenue per employee of $250-$300 across both companies, both companies have a long runway of pricing growth as employer adopt more of the modules and more features are introduced. This is on top of regular 3-4% price increases passed through regularly by HCM vendors across the industry.

HOW IT'S PLAYED OUT AND WHAT WE ARE LOOKING FOR

Both Paycom and Paylocity have traditionally commanded high valuations since IPO given their strong execution in a growing market. Paylocity has traded at a circa 40-70x FCF multiple from FY19-FY23 and Paycom has traded in a similar range. This reflects the average 31% revenue growth for Paycom and 30% for Paylocity since IPO.

However, in June 2024, concerns about future employment growth, slowing market share gains and a tough business environment for SMB's led to a material derating of the multiple for both businesses.

At the time of our entry, Paylocity traded at a 25x 2025 free cash multiple (FCF) while Paycom traded at a 20x multiple. At these multiples we believed 10% FCF growth per share in the next 5-7 years together with a structurally stronger business at exit would underwrite a strong return for the strategy.

Our modelling suggested that this level of FCF growth only required a very modest growth in market share, CPI pricing, and a modest uptick in penetration of new products into the existing customer base. These estimates are all significantly lower than what these businesses have achieved historically. In addition, both businesses had net cash on the balance sheet, a strong history of prudent capital allocation and strong management incentive structures.

We first bought shares in Paycom and Paylocity in June 2024 and the shares have appreciated by 41% and 47% respectively. We have trimmed our position given the strong appreciation in 2024 but continue to hold the shares in the Strategy.

Important Information