Castlebay Investment Partners

Quarterly investor letter September 2018

Our guiding principles:

- **Transparency & alignment of best interests with our fellow shareholders**
- **Independence of thought in order to avoid the market herd**
- **Adherence to our investment philosophy and process**
- **Focus on costs: management fees capped, low stock turnover**

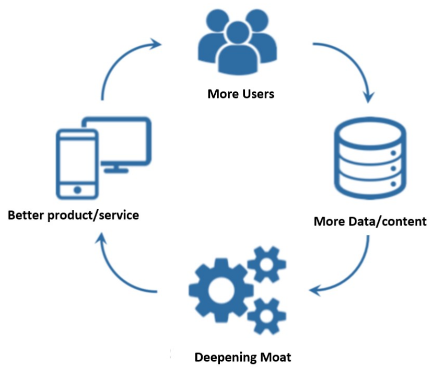
Mastering the Moat—Part 3

Dear fellow shareholders,

Welcome to the third instalment of our series on Mastering the Moat. In our previous two letters, we covered businesses with intangible assets and switching costs. Having covered the intangible heritage brand of Burberry and the high switching costs from the products of Croda and Victrex, we turn now to the **Network Effect.** Whilst the network effect is a less common phenomenon than the previous two moats, this partly explains its power. Indeed, some of the most successful companies of recent years have captured the tenets of the Network effect. Pareto's Law—the 80/20 Principle, explains some of its power, which has led to great share price returns as well as the creation of much shareholder wealth.

The Network Effect:

So what is the Network Effect? Well, imagine you could create a company which required very little money to grow its business. A company whose own customers help to construct the barriers protecting your business and encouraged others to join in—helping to widen the company's business moat. The Network Effect delivers all these things. The most critical aspect of Networks is that the value of the product or service increases as the number of users rises. As you can imagine these Network businesses can grow quickly as their size confers greater advantages to the consumers or businesses accessing their Network.



As such, industries in which the Network effect exist, tend to be either monopolies or oligopolies with dominant market share positions.

As readers will know, these are the types of industry structures we particularly like as investors, as they often bestow many advantages to the patient investor. However, there is a potential dichotomy between companies that have proven themselves—having been around for a long time, compared to newer companies in 'knowledge and information' businesses. For the latter, where it is often easier to build up the network effect, there is less time over which their business models have been tested. So the 80/20 principle describes how 20% of market participants come to dominate 80% of the market. In some networks this ratio is even more extreme!

Companies that have had time to prove their business models, through several business cycles, reduce investment risk. However, one must take a balanced approach in this regard. First mover advantage is often critical within fast changing markets, in which network effects are often developed. However, one's investment risk is greatly reduced once the incumbent has become well established. Then, customers and businesses will think twice about moving elsewhere because of the benefits the network brings to them. As customer preferences become 'more fully formed', it becomes more and more difficult for a challenger to disrupt the market.

Some real life examples of businesses, which reside in our investment universe, should help move from theory to the real world! RELX, which we own in the fund, the old Reed Elsevier, is one such company that has morphed into a modern business by 'digitalising' its content. It is a global provider of information and business analytics. Importantly, this has allowed it to enhance its 'network effect', as its publications become the de facto leaders in their respective sectors. As more and more customers use Lexis Nexis, the Legal Research and Intelligence solutions division of RELX, for example, the more likely future customers are to use Lexis Nexis. Effectively, it becomes the default provider of this data and service.

Microsoft is one of the overseas companies in our Investment Universe. Microsoft's network effect is quite easy to understand. Nearly everyone uses Word, Excel and Powerpoint. Many IT experts agree that there have been better software suites over time, but the fact that the corporate world and many consumers use Windows based computers, means it represents a common language. Changing from Windows to a competitor would result in high switching costs and all the risks that working against this dominant network entail.

We hope you have enjoyed reading our quarterly letter. The next publication will conclude our study of business moats when we look at 'cost advantages'. Once again we would like to thank you for your continued support.

Kind regards

David F Ridland

The value of investments can fall as well as rise & you may not get back what you invest.
Past performance cannot be relied upon as a guide to future returns. This newsletter should not be construed as investment advice.

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Portfolio Activity:

Our position in Aveva, which had become one of our largest positions was reduced at the end of August. This occurred following the Schneider acquisition and the return of capital to Aveva shareholders. Integration appears to be going well as evidenced by their recent capital markets day. Given the nature of the reverse takeover, goodwill on the balance sheet impacts the subsequent returns profile of the business. That said, this is a cost that has been incurred in completing the deal and so must be reflected in our returns analysis.

The post deal return on equity falls from a mid 20s to a mid-single digit percentage. So the risk profile of the business has changed. There is an increased valuation risk from a market P/E perspective as well as a free cash flow yield perspective. Optically things look expensive with a margin of peril of 28% to the historic average valuation of 21x. The market is assuming that the risk profile of the business is somewhat reduced given end market diversification. However, this aspect is also reflected in a lower free cash flow yield. Adjusting for the acquisition is one thing, but this remains a cyclical business (albeit with a flexible charging structure). Thus, in conclusion, Aveva has been a strong investment since initial purchase. Whilst the deal with Schneider is likely to bring mid and long term benefits both in end market growth/diversification and lower revenue uncertainty, deal execution and cyclical end market risks remain and we sold half of our position in the company.

Company	Sector	Position
Craneware	Software & Comp Serv	5.8%
Victrex	Chemicals	5.3%
Admiral Group	Non-life insurance	5.2%
InterContinental Hotels	Travel & Leisure	5.1%
Compass Group	Travel & Leisure	4.2%
Reckitt Benckiser Group	Household Goods	4.2%
Serco Group	Support services	4.1%
Capita	Support services	4.0%
Avon Rubber	Aerospace & defence	3.9%
Colgate-Palmolive	Personal Goods	4.0%
Domino's Pizza Group	Travel & Leisure	3.8%
Imperial Brands	Tobacco	3.6%
Unilever	Personal Goods	3.6%
British American Tob	Tobacco	3.4%
Dunelm Group	General Retailers	3.3%
RELX	Media	3.2%
Burberry Group	Apparel & Luxury Goods	2.9%
Rotork	Industrial Engineering	2.8%
Kone Oyj	Industrial Engineering	2.6%
Novo Nordisk	Pharma & Biotech	2.5%
Croda International	Chemicals	2.4%
AVEVA Group	Software & Comp Serv	2.2%
Bioventix	Pharma & Biotech	2.1%
Rolls-Royce Holdings	Aerospace & defence	2.1%
AstraZeneca	Pharma & Biotech	1.8%
Pagegroup	Support services	1.6%
Cash	Cash	9.1%
Rev/Cap Accruals		1.1%
Total		**100.0%**

Source: Valu Trac 30SEP18

COMPASS GROUP

Compass Group is a global leader in the fragmented food catering market. It operates in 50 countries; in over 50,000 client locations; employing over half a million employees and serving over 5.5 billion meals each year!

The Company offers services to offices, factories, hospitals and care homes, schools and universities, sports venues, military facilities, and other remote locations. Compass Group serves customers worldwide, with over half its revenues coming from the lucrative North American market. The global food service market, of which Compass is the leader, will likely continue to consolidate in coming years. Compass has constructed a dominant position over the last decade through both acquisitions and organic growth.

In the US market, Compass has twice the market share relative to its nearest competitor (Aramark). Their economies of scale have allowed them to achieve superior purchasing power, which in turn supports industry leading margins of over 7%. In comparison, the global number 2 in food service, Sodexo, has an operating profit margin that is more than 1% lower. Compass Group also sweats its assets hard, with an asset turnover of 2.1x. This results in a return on equity in excess of 50%, as well as a strong return on capital employed.

The valuation is also supportive with a recent de-rating moving the Price earnings valuation back towards its historic average. The free cash flow yield of 5% further supports the valuation, a factor caused by a business that generates cash as it grows. The steady growth in earnings, as well as cash flows over time, gives testament to the quality and predictability of the business.

Our quality table to the end of September reflects the key metrics we assess of the companies in which we are invested. It is interesting to note that the Return on Equity measure is the highest it has been since we launched our fund in January 2015 at 41%. Approximately half of the return is retained by the businesses to reinvest at these high rates of return. We have had to be patient to invest in companies like Relx, Compass Group, Craneware etc and we are now starting to see the compounding effect of investing in quality companies at the right valuation. The table also highlights that our companies in aggregate are of higher quality then the market (excluding financials) but on a free cash flow basis more attractively valued.

Key Metrics Table	VT Castlebay UK Equity Fund	Market
Return on Equity	41%	25%
Operating Profit Margin	22%	14%
Net debt to equity	42%	89%
Cash conversion (free cash/ net profit)	110%	99%
Free Cash Flow Yield	3.6%	3.4%

Source: Bloomberg as at 30SEP18

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