Quarterly investor letter March 2018

Castlebay Investment Partners

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

Dear fellow shareholders,

We have mentioned in previous quarterly letters our way of investing: invest in good companies, making high returns on their capital; don't overpay for the privilege and then be patient—allowing for the power of compounding returns to take effect. In this letter we turn our attention to the 'good companies' part of the equation and develop our thinking on this important investing tenet. We have often stated a desire to analyse the fundamentals of the businesses in which we invest and reduce the amount of time spent forecasting cash flows. Maintaining false confidence in forecasted business cash flows can be a dangerous occupation.

Instead we analyse the returns businesses have produced and determine how likely those returns will be maintained in the future. In short, we look for businesses that are mastering the Moat. That is to say, companies whose business moats protect their superior returns from the threat of competition—much like the moats that protected medieval castles and their occupants. After all, the first law of capitalism states that excess profits are competed away as competition reduces returns towards the cost of making those returns. If a business can protect itself, then superior returns can be maintained, creating material value for the owners of these businesses. There are four broad categories used when defining a company's moat—Intangible Assets, Switching Costs, Network effect and Cost advantage. We shall look at them in turn over the coming quarterly letters due to their importance and see how our companies fit into these different categories. For this letter we shall focus on Intangible assets.

Intangible assets:

A good example of an intangible asset is a ***brand.*** By definition as it is not a tangible thing, it is not reflected on the balance sheet. This in part gives a clue as to how it can help companies to maintain their competitive advantages over time. It often makes it difficult to replicate the value of these brands, helping the brand owners preserve superior returns. However, having strong brands is not enough in itself to protect a business or create value for shareholders. The brands have to confer an advantage that is reflected in higher prices relative to the competition; higher returns on capital or superior cash flows. Sony, for example, is one of the world's top 100 brands and has been for some time. However, for many years the company has struggled to convert this brand power into cash/returns. Last year Sony made a return on its equity of only 3%! So a key question to ask is what benefit does the brand provide the consumer or client?

In the luxury retail sector, brands can often create a type of positional value. The utility of a Patek Philippe watch in terms of telling the time is largely the same as its cheaper rivals. However, it confers a position of tradition and luxury for the owner. As the advertising campaign declares, "you never actually own a *Patek Philippe,* you merely look after it for the next generation." Colgate, one of our holdings, sells its brand products based on trust and not just directly with the consumer. When a trusted practitioner like one's dentist recommends Colgate toothpaste, that reinforces the brand value and allows Colgate to charge a higher price. This has been translated into high margins and returns for the company. However, management are not complacent. This highlights an important point. In order for brands to maintain their position there needs to be a constant reinvestment in the brand. Companies like Colgate, Reckitt Benckiser (RB) and Unilever (ULVR) continually reinvest in their businesses and brands through innovation. It is much easier to sell a higher priced Colgate toothpaste, Nurofen painkiller (RB) or Dove moisturiser (ULVR), when it is a new and improved product with extra features.

Patents represent another intangible asset that can create much shareholder value. AstraZeneca invests billions in developing its drug pipeline. Patents protect their drugs, for a finite period of time, once they have passed regulatory approval. This process protects their licensed drugs from generic competition that could merely copy and sell AstraZeneca's drugs for a fraction of the cost and price. If this were to happen there would be little incentive for companies to invest their capital, only to see future returns melt quickly away. So for a time, returns are both protected and visible. This does not of course remove the risk that future investment in its new drug pipeline is unsuccessful. It is one reason we have a larger position in Craneware, an AIM listed UK software provider, than we do in AstraZeneca. Craneware is currently in 1 in 4 US hospitals, helping these institutions to save money and improve patient outcomes. However, Craneware is more relevant for a discussion on the effects of **switching costs,** so we'll leave that for a subsequent letter, as noted above.

Licenses/regulation can represent another category of intangible assets. When they are in place it can often make it virtually impossible for competitors to enter the market. As regulation has increased in the Tobacco sector over recent years it has effectively increased the size of the moat surrounding the big five companies. They operate in an oligopoly structure. How can a new tobacco manufacturer disrupt this sector when there are such restrictions in advertising in many developed markets? The disruptive challenge for the tobacco industry comes more from next generation products (NGP), such a e-cigarettes and heat not burn technology. However, being wise to this rising threat, as cigarette volumes decline in developed markets, the major players are investing in this alternative technology to help protect their business models.

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IN FOCUS

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Concluding thoughts for part 1 of our Mastering the Moat series:
Should businesses try to develop multiple moats? Generally, it is better to maximise the value of a single MOAT, than to try to develop several. As we live in a dynamic world, it is also best to seek companies who are growing their moats and not standing still. The attacking armies of competitors will find a way to bridge any moat unless businesses are constantly striving to widen and develop protection for their business models. We should see evidence of a growing moat, by rising profitability and higher incremental returns on capital. As investors it is our job to think about ways in which our companies' moats could come under threat, whilst trying to understand just how sustainable the advantages are that they confer.

CAPITA The investment case for Capita is predicated on it being a market leader in the outsourcing sector with a 29% share of a growing market and the ability to generate consistently high cash returns with clear visibility due to the long term nature of their contracts.

In recent times however, Capita has not had its issues to seek. Jonathan Lewis, the new CEO appointed in late 2017 promptly announced a rights issue and a desire to continue to sell off non-core businesses following declining corporate profitability. We identified similar issues previously at Mitie Group, by focusing on their declining incremental returns on capital. My mistake with Capita was not identifying a similar trend, or rather being blinded to their issues by focusing on other more positive aspects of the business. To be clear, we believe that Capita is a good company going through a tough time, whose issues have been severely punished by an unforgiving market. It is not, be believe comparable to that of Carillion which went into administration a month or so ago.

Turnaround Checklist
Whenever one of our businesses is going through a period of restructuring we draw up a checklist of actions we want the management team to undertake. Capita's business is split into 5 main divisions: Public Services Partnerships; Private Partnerships; Professional Services; Digital & Software Solutions and IT services. The Public Services Partnerships division has caused the greatest issues for Capita recently. This division provides services such as the Transport for London congestion charge, defence infrastructure organisation and local government services, amongst others. Whilst recent revenues generated have exceeded £1bn, operating profit has barely been positive.

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Turnaround Checklist	
Capita Plc	✓
1. Strengthen Balance Sheet	
• Sale of non-core assets. – already underway with Capita Asset Services sale for £888m. • £700M rights issue to raise capital to support further the balance sheet.	✓
2. Focus on what Capita does best	
• Highest margins are generated in non-Government contracts and account for 50% of the business.	
3. Future Growth	
• Greater discipline when tendering for future contracts - not bidding for growth at any cost • Develop digital & software solutions division which has an operating margin in excess of 32% • Future acquisition discipline measured by rising incremental return on capital.	

It is an area that we would expect Jonathan Lewis to be looking to address. Interestingly, if this division were to be stripped out of the equation entirely and the margin calculated for the rest of the business, Capita's Operating profit margin would be a more respectable 13%. It would be overly simplistic to identify this division as Capita's only problem, but it is certainly a large contributor to its ills.

Company	Sector	Position
Victrex PLC	Basic Materials	5.9%
Domino's Pizza Group	Consumer	5.5%
Intercontinental Hotels	Leisure	5.5%
Admiral Group PLC	Financials	5.1%
Aveva Group	Technology	4.1%
BATs	Consumer	4.1%
Craneware PLC	Technology	4.0%
Reckitt Benckiser	Consumer	4.1%
Unilever PLC	Consumer	3.9%
Serco Group PLC	Support Services	3.8%
Tesco PLC	Consumer	3.7%
Compass Group PLC	Comsumer	3.7%
Imperial Brands PLC	Consumer	3.6%
Avon Rubber	Industrials	3.6%
Colgate Palmolive Co	Consumer	3.6%
Rotork	Industrials	3.5%
Dunelm Group PLC	Consumer	3.3%
Kone Oyj	Industrials	3.1%
Novo Nordisk	Healthcare	2.8%
Burberry Group	Consumer	2.8%
Rolls-Royce	Industrials	2.6%
Page Group	Industrials	2.1%
AstraZeneca PLC	Healthcare	2.1%
Croda International	Basic Materials	1.9%
BHP Billiton PLC	Basic Materials	1.7%
Rio Tinto PLC	Basic Materials	1.6%
Capita PLC	Support Services	1.3%
Cash	Cash	7.0%
Total		**100.0%**

Source: Valu Trac 31MAR18

The already announced rights issue and sale of the Asset Management servicing division will shore up and allay any balance sheet concerns. Going forward we also expect management to exercise discipline when allocating capital to acquisitions and when tendering for new contracts.

The company and indeed sector are both very much out of favour and the recent woes experienced by the likes of Carillion and Brexit uncertainty have only served to amplify the market's negativity towards outsourcers. The sector has experienced woes in the past and whilst the issues now being faced are more severe, we remain of the view that Capita is still a good business and will be able to survive this latest bump in the road. Patience will however be required!

Our full portfolio is listed above and we have taken the opportunity during the recent market weakness to add to our positions in Aveva Group, BATs, Colgate, Compass Group, Imperial Brands, Novo Nordisk, Reckitt Benckiser and Unilever. You will see that our cash balances are now at their lowest levels since launch, at 7%. The premium on the ROE versus the market is at its highest since we launched just over three years ago. Our valuation on a free cash flow yield remains similar to the market at 4% and the dividend yield following the recent reinvestment is just under 3%.

Key Metrics Table	VT Castlebay UK Equity Fund	Market
Return on Equity	**38%**	**25%**
Operating Profit Margin	**21%**	**14%**
Net debt to equity	**48%**	**79%**
Cash conversion (free cash/ net profit)	**110%**	**86%**
Free Cash Flow Yield	**4.0%**	**4.2%**

Source: Bloomberg 31MAR18

We thank you for your continued support over the first three years of the fund's life.
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.