Castlebay
Investment Partners

Quarterly investor letter March 2020

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**

Investing in unprecedented times—Covid-19 and its effects

Dear fellow shareholders,

We are certainly living and investing in unprecedented times. What started out at the beginning of December, last year, as a localised viral infection in a region of China, has turned into a global health pandemic. The World Health Organisation (WHO) named the outbreak COVID-19. This stands for **Co**rona**vi**rus **d**isease 20**19** and not as many have claimed, a **C**hinese **o**riginated **vi**ral **d**isease 20**19**. The WHO is always careful not to name outbreaks after specific regions, in an effort not to stigmatise a place or region. It is thought that by so doing it can encourage the early reporting of novel outbreaks.

In 2003 the SARS (severe acute respiratory syndrome) outbreak, a similar coronavirus to the current disease, was largely limited to Asia. There were 8,098 reported cases of SARS in 2003 and 774 associated deaths from the outbreak. That meant that the virus killed just under 10% of those infected. So SARS actually appears to have had a much higher mortality rate than COVID-19. Herein lies a paradox. The more deadly the virus the fewer people it kills. It was the same phenomenon with the recent Ebola outbreaks in Africa. Here mortality rates were even higher, ranging from between 20% to 90%! It would appear that the more deadly the virus the fewer people survive to infect others. By comparison, COVID-19 is thought to have a mortality rate of around 1%. However, the number of people who are either asymptomatic (show no symptoms) or who are contagious before symptoms manifest themselves, has led to much higher infection rates amongst the population.

There is another factor at play as well. In 2003, China had only fifteen months previously joined the World Trade Organisation (WTO). It was only in the early stages of turning its trade towards the rest of the world. Fast forward to today and Chinese travel and trade is much more global in its nature. This development in trade has propagated the spread of the disease. Globalisation has brought many benefits to the world, but this pandemic represents a tragic aspect of it.

The nature of the response to this outbreak is also unprecedented. It has effectively led to economic shutdown in many economies across the world. Most crises whether health, economic or stock market related in nature have a beginning, middle and an end. COVID-19 appears to have begun in early December 2019. It feels as if we are in the middle of the outbreak, with a rising number of cases in Europe, the Middle East and the Americas. It is difficult to say when the end will come. However, what is clear is the material impact many businesses are experiencing, as their ability to produce revenues has suddenly been ended. As companies look to survive, attention turns to their cash reserves; balance sheet strength and how long businesses can survive with little or no income being produced.

Dividend payments to shareholders have also been severely impacted. The Bank of England has forced UK Banks to cancel their final dividends, so that the expected £7.5bn of cash can instead be used to lend support to struggling UK companies. Insurance companies have largely followed suit and bowed to pressure from their regulator to pass on their payments. So far cancelled payments have totalled approximately £16bn with only 10% of FTSE 350 businesses able to commit to paying their upcoming dividends. As share prices have fallen, dividends are unable to provide the protection they would normally.

Whilst acknowledging the great human impact of the COVID-19 outbreak, we also understand well our duty to protect the wealth of our investors and clients. As such, the recent market weakness has afforded us the opportunity to invest in a number of businesses that were previously too expensively valued. For some, we have had to wait over five years before their valuations have become attractive. In investing, patience is often a virtue. **For the first time since we launched our fund back in January 2015, we are now fully invested.** We expect to own these businesses for a long time, allowing their high returns on equity capital to compound and generate value for shareholders.

For clarity, we did **not** see this outbreak coming, nor did we anticipate its severity, in terms of human or economic impact. However, to a large extent this is not the point. We have set out many times in these letters our investment approach—one of investing in Quality businesses at appropriate valuations. As our key metrics table shows, we are keen to ensure that the premium Return on Equity (ROE) our fund generates compared to the market, is not generated through excess leverage. This is why we look at the Operating Margins and the Net Debt to Equity to ensure that it is operating excellence driving returns and not too much debt. It is at times like these that such a process bears fruit. Strong business franchises and balance sheets should help protect our companies through these uncertain times. We wish you good health at this time and thank you for your ongoing support.

David F Ridland

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Investing activity increased as opportunities rise

In order to get the balance right between Quality and Value in our process, we won't overpay simply to buy a high quality business. This has meant that for the early years of our fund's life, we have held cash balances. It has required patience and discipline to resist the siren calls to be fully invested. However, following the market declines, the excess cash of the fund has now been invested.

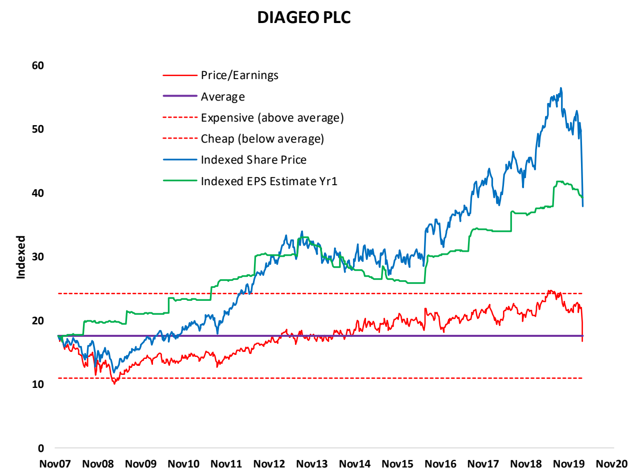
In short, many more of the companies in our investment universe, that were previously too expensively valued, are now much more attractively priced. This has led to a rise in 'competition for capital' amongst the stocks in our universe, fighting for a position in our fund. When a fund is running cash balances a new investment is normally competing against cash. When a fund becomes fully invested companies compete solely against each other. Consequently, we believe that with the recent falls in prices, an opportunity has arisen to increase further the quality and predictability of the businesses in our fund.

We sold our position in Rolls Royce on 12th February 2020, due to the rising operational and financial risks of the business. Over recent times the business has not had its issues to seek. The problems with its Trent 1000 fleet have been well documented. Whilst the CEO Warren East has progressed well with the ongoing restructuring of the business, the cost of repairing the rotor blades and associated issues with the Trent 1000 engines, could cost up to £3bn. It is also worth noting that the newer suite of Trent 7000 engines have a 95% technological overlap with its older Trent 1000 cousin. Could there be future associated issues and costs here? Either way, the current remedial work required has put a strain on the balance sheet of Rolls Royce, which in turn increases the investment risk to the company. For all our businesses, in which we invest, we have to weigh up the investment opportunities and risks. Our central case is that Rolls Royce is likely to continue to lead the production of turbines for wide-bodied aircraft globally. However, the balance sheet and operational risks have increased to the extent that we believe the risks now outweigh the investment opportunity. We sold our entire position in mid February at a price of £6.97. As of writing the price is now trading materially below this exit price. We only mention this to highlight the element of good fortune attached to the timing of the sale; coming as it did before the full impact of the general market sell-off took hold.

A 2% position was purchased in Nichols PLC in mid February. The maker of Vimto - the original 'Vim & Vigour' tonic, it also licenses Sunkist as well selling flavoured waters. Sales per share growth has compounded well over the last five years, growing at a 6% annualised rate. Operating margins have risen over recent years to the mid-20 percentages and retained earnings have compounded well at 17% and 22% over the last five and ten years, respectively. The balance sheet is strong with the business carrying a net cash position (effectively no debt) and retained earnings making up 94% of gross equity. Valuations have become more attractive since news of a sales tax in the Middle East broke. However, this is a relatively small part of the business. Nichols' main UK market grew at a double digit percentage rate last year. More recently, it has grown strongly in the UK stills market whilst the market overall has declined slightly.

We purchased a 2% position in Edwards LifeSciences in mid February. It is the global leader in patient-focused medical innovations for structural heart disease and critical care monitoring. It designs, develops, manufactures, and markets products and services to treat late-stage cardiovascular disease. The Company offers products such as tissue replacement heart valves, heart valve repair, hemodynamic monitoring devices and angioscopy equipment. Edwards Lifesciences supplies its products worldwide. Edwards has a conservatively managed balance sheet with net cash and yet it still delivers a return on average gross equity of 29%. Whilst the business does not pay out a dividend, the reinvestment of earnings at high incremental rates of return, has generated strong growth in retained earnings at an annualised rate of 15%, over the last decade.

Due to very weak global markets following the outbreak of the COVID-19 virus, Diageo's share price fell 35% from its September 2019 highs of £36 to below £24. We have followed the maker of Johnnie Walker and Guinness for over 5 years. During this time its valuation has been too expensive for us to purchase the shares, whilst maintaining our valuation discipline. We have had to look too far into the future as the shares were several years expensive, in relation to the compounding rate of return on its shareholders' equity. The recent price weakness has now allowed us to purchase a **4% position** in the fund. The shares were purchased following a material de-rating of the valuation (the red line). As Diageo has a dividend yield of c3%, the required growth in earnings and cashflow is in line with historic growth rates—to generate our required investment return. Whilst on-trade sales will undoubtedly have been affected by the shut-down of pubs and restaurants, off-trade sales will help in part to offset this decline in revenues. Longer term, its well-known brands and strong distribution networks will serve the business well.



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Investing activity increased as opportunities rise

Capita was sold for both operational/capital reasons and also due to 'competition for capital' amongst other businesses in our investment universe. Their shares had been very weak since their results, where revenues and profits had been delivered in line with expectations. However, cashflows of only £160m were generated against expectations of £200m. In short, the restructuring of Capita requires more cash than CEO Jon Lewis had initially expected. This also led to debt increasing by £300m during the year. At a time of market dislocation, following the Covid-19 outbreak, it is unclear if the management team will have sufficient time and opportunity to deliver a successful business recovery. However, there is another reason for the sale— **competition for capital**. The market sell off has presented to us, through our Investment Universe, several higher quality businesses at cheaper valuations. Further, our confidence in the future business prospects of companies like Diageo, Intertek, Accenture and Estée Lauder, is greater than for both Capita and Serco. It is not just the headline Return on Equity figure, as shown in the Quality Table below, we must consider. It is also the likelihood of any business continuing to prosper. Sadly, we have had to realise a permanent impairment of capital in this sale of Capita. It is only the second time we have had to do this since we launched the fund. However, we believe it is the right thing to do, not least because of the benefit of reinvesting the proceeds into the companies mentioned below.

Serco is further down the restructuring road than Capita, but it was sold for similar reasons. Mainly, that other higher quality businesses were now more attractively valued and offered a better Quality/Value balance than Serco. Whilst Serco's margin profile is improving, it is still some way from hitting its 5-6% Operating Profit Margin target. This target was set out by Rupert Soames when he took over the CEO role some six years ago.

Having watched several high quality businesses in our Investment Universe for quite a while, the COVID-19 sell off has presented a once in a decade opportunity to invest in these businesses with much more supportive valuations. The investment case for Accenture, the provider of management and technology consulting services and solutions, centres on its 29% return on equity, strong cash conversion and strong historic value-creating growth. A flexible cost structure also supports the investment case in these uncertain times.

Similar to the Accenture purchase, Estée Lauder's valuation had declined materially as markets sold off. EL is one of the world's leading makers of cosmetics, fragrances, skin and hair products. Its global brand value is strong, which is reflected in its strong pricing power and near 80% gross profit margin. The business also generates a strong conversion of operating profits into cashflows. Having made returns on equity in excess of 35% with a retention ratio of 66%, Estée Lauder has a Retained Return on Equity of 23%.

Intertek Group offers product inspection services. It tests everything from textiles, toys and electronics to building materials and agricultural products. Its shares have fallen recently from over £60 to below £45, leading to a much more supportive valuation. Profitability has been rising over recent years as Intertek's operating profit margin has increased from 13% to 16%. Conversion of profits into cash is excellent and it has generated high incremental rates of return on its reinvested capital.

In summarising our recent purchases, part of our activity has been generated due to competition for capital—higher quality businesses replacing Capita and Serco. However, other purchases have been made with the cash available in the fund, so that now we are fully invested in high quality businesses at attractive valuations.

Quality Table

Our quality table continues to highlight the superior quality characteristics of the companies in which we are invested, compared to the wider market. Our operating margin is twice that of the market. There are also two points to make about the free cash flow yield (FCF yield). Firstly, our fund's FCF yield has risen, as expected, following the sell off. It compares very favourably with the 0.3% yield of the UK Government's 10 year gilt. Secondly, the market's FCF yield is now at 5.9%. Should one buy the market because of this valuation yield?

Quality Table	Castlebay Fund	Market
Return on Equity	39%	23%
Operating profit margin	24%	12%
Net debt to equity	49%	75%
Cash conversion	86%	75%
Free Cash Flow yield	4.5%	5.9%

Source: Bloomberg as at 31/03/2020

Consider BP, for example, which is on a free cash flow yield of 15%. Remember that this refers to its historic free cash flow of £10.3bn divided by a market capitalisation of £67bn. What is the probability of BP making anything near £10bn of free cash flow this year? When one considers the impact of coronavirus and the fact that the oil price has fallen 50% since beginning of the year, it seems very unlikely. Oil & Gas remains the largest sector of the market and there are many other cyclical companies that will be in a similar position to the oil majors. So the market's 5.9% free cash flow yield is very unlikely to remain at these elevated levels, as earnings and cashflows decline over coming months.

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