Castlebay Investment Partners

Quarterly investor letter March 2016

Our guiding principles:

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

Testing cash flows and dividend generation amidst a challenging market backdrop

Dear fellow shareholders,

The first quarter of 2016 saw much of the market and many of our companies report their full year results. Several cyclical sectors of the market, such as mining and oil & gas remained under pressure given weak commodity prices. Given that revenues and profits in these sectors have fallen, cash generation and therefore dividends have also declined.

Whilst the Castlebay UK equity fund is unconstrained and does not specifically target an income level, dividends are a direct reflection of the underlying cash generating capabilities of companies. It is this important factor in which we take most interest. Ultimately equity investing is about deferring the ability to use one's cash today, in the expectation that it grows into a greater amount tomorrow. Whilst a number of our more cyclically exposed companies are facing tough trading environments, it is our job to ensure that such issues are temporary in nature and not permanent. Therefore we have carried out a dividend analysis of the fund. Here we are looking not just at the current year's performance, but back through the cycle. Following this analysis we find that the cash flows generated by the companies in our fund, more than cover their current dividend payments; with the weaker cyclical companies strong enough to survive and prosper when the cycle improves.

Where companies such as Rolls Royce are going through a restructuring program, due to short-term issues, announcements such as a reduction in dividends and the preservation of capital have actually been well received by the market. This has also been the case for some of the cyclical companies such as Rio Tinto and BHP Billiton. Whilst this is an unwelcomed development from an income perspective, efficient allocation of capital and preservation of cash flows create value for shareholders over the long-term.

Offsetting such dividend declines in the fund, companies like Admiral and Croda have announced special cash returns to shareholders. This has offset the decline in income from the companies reducing their current returns to shareholders.

The fund retains its focus on owning companies which generate high returns on capital and shareholder equity. Several of these companies have produced strong full year results aided by their ability to raise prices and protect their profitability. Reckitt Benckiser is an example of just such a company. Following a general market sell-off in February, we increased our exposure to the company, at supportive valuations, the week before the company announced its full year results.

Throughout this reporting period our focus remains on analysing how effectively the companies in our fund are generating returns and allocating capital efficiently. This is one of the main reasons that we continue to produce regularly our Key Metrics table – to ensure our companies are continuing to compound returns on equity at a material premium to the market. In the current environment this has been particularly important in helping our stocks deliver full year results ahead of those of the market in aggregate. The impact of this in share price terms has allowed the net asset value of the fund to increase during the first quarter of 2016, whilst the market has fallen in value.

Company	Sector	Position
Aveva Group	Technology	5.5%
Rotork	Industrials	5.4%
Victrex	Basic Materials	5.2%
Petrofac	Energy	5.1%
Kone Corp	Industrials	4.8%
Admiral Group	Financials	4.7%
Rio Tinto	Basic Materials	4.7%
John Wood Group	Energy	4.6%
Tesco	Consumer	4.4%
Reckitt Benckiser	Consumer	4.3%
Capita	Support Services	4.2%
Rolls Royce	Industrials	3.9%
Michael Page	Industrials	3.6%
Astrazeneca	Healthcare	3.3%
InterContinental	Leisure	3.3%
Serco Group	Support Services	3.2%
Colgate Palmolive	Consumer	2.8%
British American Tobacco	Consumer	2.8%
BAE Systems	Industrials	2.8%
Unilever	Consumer	2.4%
Imperial Brands	Consumer	2.4%
BHP Billiton	Basic Materials	2.3%
Croda	Basic Materials	2.0%
Cash		12.3%
Total		100.0%

Quality Table

Key metrics	VT Castlebay UK Equity	Market
Return on Equity	34%	24%
Operating Profit Margin	20%	14%
Net debt to equity	55%	91%
Cash conversion	120%	87%
Free cash flow yield	3.60%	3.60%

During the quarter, no new holdings were purchased for the fund. Instead, exposure was increased to existing holdings. Reckitt Benckiser, Victrex, Rotork, Capita and Aveva were all bought, particularly around the first half of February following a sharp sell-off in prices. Shire was sold, in its entirety in January, following its raised bid for Baxalta Inc. Our analysis suggests that the management are overpaying for this company and that the risk is high that value is destroyed following the deal.

Once again, thank you for your support as fellow shareholders. We hope you continue to enjoy the read.

David F Holland

The value of investments can fall as well as rise and you may not get back what you invest.

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Admiral: Provider of private motor insurance; additional products; and a great place to work!

In 2015, Admiral Group was named the 5th best company to work for in the UK's Sunday Times Best Companies list. Admiral also received a special recognition award for being the only company in the list for each of the 15 years, since the competition began. What is more, CEO Henry Engelhardt won the best leader award for the second year running. It is always interesting to question the extent to which the culture of an organisation contributes to both its success and the returns for shareholders over time. However, this is a particularly salient question as the architect behind this success, Mr Engelhardt, is stepping down from the top job. Will the company's renowned culture be able to survive his departure?

It is a culture, in place since the company was founded in 1993, which has produced some impressive results in a highly competitive industry. Every car owner must buy insurance, which the association of British Insurers estimates costs the average household £646 each year. However, the industry has not produced more than two consecutive years of profit over the last three decades! Profit is defined by the combined ratio—which combines a general insurer's loss ratio with its expense ratio and then compares it to premiums received. This ratio has to remain below 100% in order for a profit to be generated. Otherwise, greater amounts of costs are being paid out than are being received in sales. In 2015, Admiral's competitors, Esure and Direct Line delivered a combined ratio of 98% and 94% respectively. Admiral's ratio was 86%! Even though it was a good year all round for industry profitability, Admiral stands well above its competitors.

What is the secret behind this underwriting advantage that Admiral holds over its competitors? Admiral specialise and don't chase market share. Their relationship with re-insurers, such as Munich Re, allows them to reduce their capital requirements and generate a high level of return on shareholder equity. Their cost base is also lower, as their three UK sites and headquarters operate in Wales. This geography and the fact that their employees—all of whom are fellow owners of the business, clearly enjoy working with Admiral, also help to reduce staff turnover and the associated costs. 2015 saw another year of record results for Admiral as the business expanded not only in the UK but in its overseas markets of France, Italy, Spain and the US. Interestingly, this expansion has been at a measured pace and generated organically, not through acquisition. For a company like Admiral, this allows it to ensure that its culture remains strongly embedded in the organisation and is not diluted though the acquisition of outside companies.

So can the company's culture survive the CEO's departure? Several factors suggest that it can. Firstly, another co-founder and current Chief Operating Officer, David Stevens, is taking over from Henry Engelhardt. David Stevens has run the UK business successfully for the last seven years. Were an external CEO to be parachuted into the role, one would have far more 'cultural concerns'. We can also continue to monitor the development of the business. Any acquisitions, as opposed to organic development, would also represent a red flag for investors. Lastly, Henry Engelhardt whilst no longer CEO will still continue to lend his great expertise to the comparison websites Admiral owns. All these factors suggest that Admiral remains in good hands and will continue to deliver strong returns for its shareholders.

Rotork: An engineering company with a difference— low operational leverage and leading products create high return on capital employed

Rotork designs, manufactures and supports actuators and related products for the industrial valve industry. Actuators are devices that control the flow of fluids and gases. In an industrial context, these valves often have to operate in harsh conditions whether deep underwater or underground. Rotork, which has traded for sixty years, is regarded as one of the leaders in its field.

The company generates over half its sales from the oil and gas market, a sector that has been under pressure since the last quarter of 2014. Opec's decision to maintain its production output led to a significant fall in the oil price, which put pressure on Rotork's end customers. In this environment many engineering companies have developed their after-sales capabilities in order to protect their revenues and profits. However, Rotork's design and product functionality—i.e. the relatively simple ways in which its actuators work, have limited these after-sale opportunities. Instead, its reliance on new equipment sales led to a profit warning at the end of the third quarter last year. Deferrals of planned projects and cancellations, particularly in the downstream oil & gas markets, contributed to this shortfall in expected profits.

However, Rotork's business model protects the shareholder in other ways. Rotork has lower fixed costs than many of its other manufacturing peers. Our Rotork model highlights the low operational leverage of the business. The construction of many of its valves from outsourced parts, helps give its cost base greater flexibility. A company with high operational leverage means that changes in profitability are exaggerated as revenues rise and fall. Compare Rotork's operational leverage of 2.4x to the 4.4x of one of its peers, Weir Group. Had Rotork's figure been higher then one could have expected profits to have been even lower last year.

Rotork PLC

Sector: Industrials   Industry: Machinery   Sub-Industry: Industrial Machinery

Ratios											
For the Fiscal Period Ending	31/12/2006	31/12/2007	31/12/2008	31/12/2009	31/12/2010	31/12/2011	31/12/2012	31/12/2013	31/12/2014	31/12/2015	Average
Profitability											
Return on Capital	36.6%	40.9%	43.5%	41.2%	37.6%	37.6%	36.2%	33.1%	28.4%	16.5%	35.2%

The company also operates an asset light business model. This has generated, over the years, a very high return on capital employed (ROCE) for shareholders. This characteristic lies at the heart of the investment in Rotork. Whilst there are short term headwinds for the business, any company which can average a ROCE of 35%, over the last decade, is likely to be able to create and compound great value for its shareholders. As near term sentiment declines, the company sits on a free cash flow yield over 6%. This presents an interesting investment opportunity. Provided Rotork can maintain its leading market position and the quality of its products, it is well positioned to benefit from any recovery in its end markets.

The value of investments can fall as well as rise and you may not get back what you invest.