Castlebay
Investment Partners

Quarterly investor letter June 2015

'Price is what you pay. Value is what you get' **Warren Buffett**

Dear fellow shareholders,

In an open market, such as the stock exchange, you can pay any price for an asset as long as you spend more than the offer price. In order to be a successful investor over time though you must ensure that you are getting good value from that price. As long term investors, we are wary that many company valuations in the UK market are not offering good value at their current purchase prices. Given the uncertainty involved in investing, we aim to buy companies trading with a Margin of Safety. From a valuation perspective, this is where a given company's current valuation is trading at a discount to its historic average. Unfortunately, as the graph below illustrates, most of the companies listed in the main market of the UK are trading with a valuation Margin of Peril – ie. above their own long run average valuation ratings.

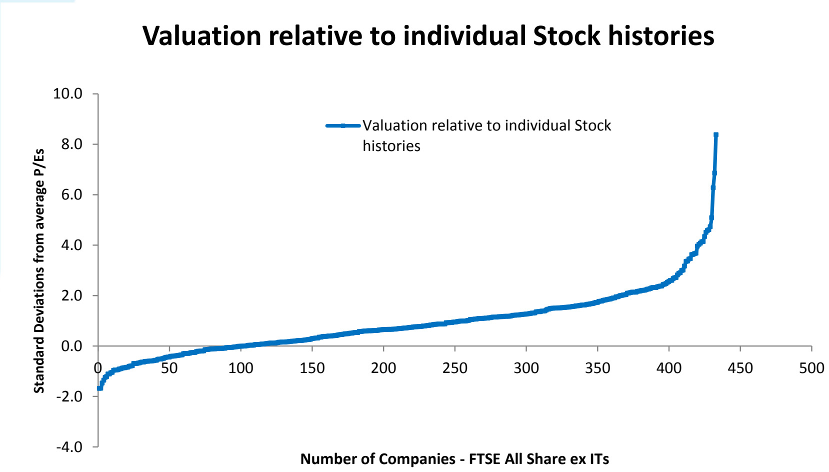
Our guiding principles:

- Transparency & alignment of best interests with our fellow shareholders
- Adherence to our investment philosophy and process—high quality & supportive valuations
- Independence of thought in order to avoid the market herd
- A focus on costs: management fees capped, low turnover of companies in the fund

The Portfolio in the second quarter 2015

There is an adage in investing that states one should 'sell in May and go away', not returning to the market until St Leger's day—at the beginning of September. Whilst markets held up in May, June saw the UK equity market fall by 6%, erasing two thirds of the market's return since the beginning of the year.

The graph below highlights why we have been wary from a valuation perspective. We emphasise we are not taking a 'top-down' or macro view. This valuation graph is an aggregation of individual stocks and how they are trading in relation to their own historic valuations. It illustrates that the vast majority of the market is trading at or above historic averages, with a material cohort in the 'very expensive' territory.



Political and Economic uncertainty with Greece and Europe, more generally, has contributed to market weakness in recent weeks. The Chinese market has also been making waves, if not front page headlines, with a decline of 32% in the last month.

In such an environment we are monitoring several companies which we believe to be of high quality, but that are currently valued expensively. Any further weakness in these companies will likely provide further investment opportunity. During the quarter no new positions were initiated in the fund but Tesco, Victrex, British American Tobacco and BAE Systems all saw further capital invested in them. All this activity reflected our belief that as our favourite assets decline in value, we want to buy more of them not less. South32, was spun-off from BHP Billiton during the quarter and listed on the UK/Australian exchanges. It doesn't share the same low cost production profile that the core parts of BHP maintains and as such the position was sold.

Company	Sector	Position
Petrofac	Energy	6.4%
Capita	Support Services	5.8%
Shire PLC	Healthcare	5.4%
Aveva Group	Technology	5.2%
Tesco	Consumer	5.1%
Rio Tinto PLC	Basic Materials	4.8%
Victrex	Basic Materials	4.8%
Admiral Group	Financials	4.7%
Wood Group	Energy	4.6%
Rolls Royce	Industrials	4.3%
Michael Page	Industrials	4.1%
Rotork	Industrials	4.0%
BHP Billiton	Basic Materials	3.8%
Serco Group	Support Services	3.2%
British American Tobacco	Consumer	2.9%
Kone Corp	Industrials	2.9%
BAE Systems	Industrials	2.9%
Croda	Basic Materials	2.6%
Astrazeneca	Healthcare	2.3%
Imperial Tobacco	Consumer	1.9%
Reckitt Benckiser	Consumer	1.9%
Cash		16.4%
Total		100.0%

Our partnership structure and approach to investment is based on our guiding principles which will feature in each of our future letters. The purpose of each quarterly letter is to update you on developments to our fund and focus on a specific theme or company. Thank you for your continued support as shareholders and we hope you 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.

PETROFAC LTD

We endeavour to buy good quality companies, great ones if we can, whilst trying not to pay too much for the privilege. This often requires patience as only occasionally do such companies sell at very attractive valuations. In the normal run of events there are often no obvious entry points. However, a number of factors conspired towards the end of last year, sending down Petrofac's shares and valuation. Opec's decision to maintain their oil output at 30 million barrels per day, led to a sharp fall in the oil price. Petrofac serves the oil and gas sector as it provides engineering, construction, operational and maintenance services. As such, its share price fell along with the oil price, following Opec's announcement.

Pertrofac also made mistakes. Sometimes even companies earning high rates of return can falter. Petrofac took on construction risk for its work on the Laggan Tormore oil and gas project north west of Shetland. This led it to incur higher costs than expected. All these factors led to a sharp downturn in sentiment towards the stock. However, as long as our analysis supported the long term viability of the company, we viewed this share price weakness as an investment opportunity.

Petrofac Ltd

Sector: Energy Industry: Energy Equipment & Services Sub-Industry: Oil & Gas Equipment & Services

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
Profitability									
Return on Assets	10.1%	12.0%	13.2%	12.0%	15.5%	12.7%	12.4%	10.3%	1.5%
Return on Capital	33.3%	35.7%	39.9%	41.6%	59.6%	52.8%	40.9%	25.5%	5.8%
Incremental ROC 1 year									
Return on Equity	45.3%	43.4%	48.5%	48.7%	66.8%	57.2%	47.5%	36.7%	6.2%

We create a financial model for each company in our fund. It helps us to analyse how the business has developed over recent times, the returns it has generated and the likelihood that these elements can continue in the future. The excerpt above, from our Petrofac model, shows the consistently high returns on capital and equity that the company has earned over recent years. It is only in the last year, due in part to the issues mentioned, that returns have been materially lower. However, the company has shown that it can deliver strong returns in the past and we believe that it can do so again. Combined with a large valuation margin of safety, this led us to increase our position in Petrofac in the first quarter of the year.

RECKITT BENCKISER

Reckitt Benckiser is a leading manufacturer of consumer goods. Its products are used across a variety of market segments such as Home, Personal Hygiene and Health. Over many years it has earned a high rate of return on its capital and its equity base. Due to the nature of its business model, as well as the fact that its customers pay it before it has to pay its suppliers, it is highly cash generative. Over the last five years alone it has compounded its growth in cash flows at 15% per annum. So what is the secret that lies behind this performance? Reckitt Benckiser owns a collection of what it calls its 19 'Power brands.'

One of the first lessons given in any course in economics describes the difference between perfect competition and consumer monopolies. In the first of these, companies operating within perfect competition see any short term excess profits competed away as new competition comes into their market. However, with consumer monopolies where there is often a dominant player, high returns can often be maintained for long periods. Over the last ten years, for example, Reckitt's gross margin has risen steadily from 53% to 59%. This is general evidence that the company has what is called 'pricing power' - namely the ability to increase prices whilst maintaining sales volumes. Essentially it is these power brands that, through a process of continual innovation, allow it to increase its prices in relation to its cost base whilst growing its business.

Key investment themes:

- Reckitt Benckiser is well placed to take advantage of the growing demand for its products in emerging and developed markets. Its continued focus on cost reduction, innovation and brand development should allow it to maintain its strong margin profile.
- Whilst it is currently trading on a valuation 'Margin of Peril' from a price/earnings ratio perspective, its strong and growing cash flows support its valuation and current position in the fund.
- An attractive free cash flow yield of 4.9% also supports the valuation.

Key Metrics Table	Petrofac	RB Group
Return on equity	43%	32%
Operating profit margin	11%	24%
Net debt to equity	29%	28%
Cash conversion	140%	100%
Interest coverage	6x	75x
Free Cash Flow Yield	4.3%	4.9%

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