Castlebay Investment Partners

Quarterly investor letter September 2017

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**

Our acid test and the most important table in finance?

Dear fellow shareholders,
Readers of our quarterly investor letters will know that we keep to a simple investment strategy: invest in high quality companies whilst not paying too much for the privilege. As we are investing this way over the long term, there can often be movements in share prices in the short term that don't reflect the underlying value creation of businesses. Market sentiment can quickly change and prices fall. It is on such occasions when we can take advantage, invest or add to a position in a company that will create value over the long term, but in which the market has temporarily lost faith.

To put it another way, all our companies must pass the acid test — 'when the prices of our favoured assets fall, whilst the investment cases remain intact, we must be able to buy more'. If the investment case has changed and we can't buy more, the company has failed the acid test and should be sold. If, for example, a stock falls by 50%, the share price subsequently has to double in order to make back what has been lost on paper. Following our acid test enables us to invest more, thereby reducing the average cost price of a stock. This means that if the company does return back to its initial share price, not only has the initial loss been recovered but a positive return (albeit unrealised) has been made. Inaction, following a significant share price decline, is therefore generally not the best option.

We recently carried out a review of how we invest. Looking at how we deliver our investment process. It is always useful to analyse the way in which we have been making decisions, in order to improve how we do things. As part of this process we set out to define an investment mistake. This was distilled down into four main areas: 1) deviation from our investment process; 2) a company which passes our quality test but shouldn't have; 3) doing nothing if the share price falls substantially (if investment case remains unchanged we should buy, if it has deteriorated then we should sell) and 4) inaction once the investment thesis changes or red flags are raised.

During the last quarter Petrofac failed our acid test when the embattled Chief Executive Officer, Ayman Asfari, was prosecuted by Italian authorities for insider dealing. As this followed the Serious Fraud Office's investigation, we could not invest further capital in the company, even at depressed levels and so we sold the shares. It is always difficult realising a loss in any stock. However, if it fails the acid test it should be sold.

So where did my mistake lie with Petrofac and what has been learned? Petrofac passed our quality test with a consistent track record of generating high returns even during periods of weak oil prices. The management were invested in the long term success of the company with large equity ownership and had been honest about past mistakes. However, Petrofac fell into the second category of error, where I made the mistake of underestimating the quality of the business. There are several components to our view of quality. One aspect of quality is the ability of a management team to monitor business activity and ensure that it is being carried out in a responsible manner. This, of course, is potentially difficult to assess, as we are not privy to all such information.

One aspect of my mistake was in not recognising the potentially greater risks present in a business like Petrofac, for which big turn-key projects and contracts are being bid. Large multi-billion dollar contracts can result in a misalignment of incentives for those responsible for securing these contracts. This in turn may result in a blurring of the lines between proper and corrupt behaviour. The SFO has not yet passed its determination on Petrofac. The company may yet be proved innocent. Either way though my mistake will remain - in underestimating the risks of such a business.

Aveva bid
Is this third time lucky for Schneider Electric's reverse takeover of one of our holdings, Aveva? Aveva is a developer of engineering software used primarily in the oil and gas, power and marine industries. In both 2015 and 2016 Schneider tabled a bid but negotiations broke down. This time £10.14 of cash is being proposed to be returned to Aveva shareholders. Whilst this will come mainly from Schneider Electric there will also be £100m coming from the balance sheet of Aveva, to be given back to shareholders.

The strategic fit has always been present between the two companies, as it will help diversify and open up markets for Aveva, spreading demand risk away from Aveva's oil focused end users. So will the deal be finalised? This time Schneider Electric has reorganised its own operating structure, which should make the marriage easier to effect. This time it could be the gift that keeps on giving, as cash is returned to Aveva shareholders to produce a stronger UK listed company, in which ownership can be maintained.

As ever, we hope you enjoy this quarterly letter and that it continues to illustrate some of the practical applications of our investment philosophy and process.

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.

Profitability vs Growth: what is more important?

		Profitability (Return on Capital)								
		0.0%	2.5%	5.0%	7.5%	10.0%	12.5%	15.0%	17.5%	20.0%
Growth	0.0%	-10.00	-7.50	-5.00	-2.50	0.0	2.50	5.00	7.50	10.00
	2.5%	-10.25	-7.69	-5.13	-2.56	0.0	2.56	5.12	7.69	10.25
	5.0%	-10.50	-7.88	-5.25	-2.63	0.0	2.62	5.25	7.87	10.50
	7.5%	-10.75	-8.06	-5.38	-2.69	0.0	2.69	5.37	8.06	10.75
	10.0%	-11.00	-8.25	-5.50	-2.75	0.0	2.75	5.50	8.25	11.00
	12.5%	-11.25	-8.44	-5.63	-2.81	0.0	2.81	5.62	8.44	11.25
	15.0%	-11.50	-8.63	-5.75	-2.88	0.0	2.87	5.75	8.63	11.50
	17.5%	-11.75	-8.81	-5.88	-2.94	0.0	2.94	5.88	8.81	11.75
	20.0%	-12.00	-9.00	-6.00	-3.00	0.0	3.00	6.00	9.00	12.00

Total Capital £100

Formula: (Total Capital Invested * Growth* ROCE) - (Total Capital Invested * Growth * Cost of Capital)

This table illustrates the critical trade-off between Return On Capital (ROC or profitability) and Growth. As such, we think it conveys one of the most important concepts in finance. Investing £100 of capital, the table highlights the incremental value created or destroyed, as ROC and Growth rise and fall. The assumed cost of making those returns (i.e. the cost of capital) is set conservatively at 10%. That is why when the return made equals the cost of making that return, no incremental value is created, irrespective of the growth rate. Thus, the '10%' Return on Capital column is full of zeros. An incremental £2.50 of value is created when ROC increases from 12.5% to 15% at zero growth, i.e. £2.50 to £5.00. When ROC is kept at 12.5% and growth this time increases by 2.5%, only another 6 pence of value is created, i.e. £2.50 to £2.56!

It is our belief that many business managers and investors look at this table the wrong way round! There is strong empirical evidence to suggest that a focus on 'growth' is consistently prioritised over increasing returns in relation to the cost of capital. We observe many acquisitions, into which managers enter, to 'grow' their businesses. However, if the price paid for this growth is too high and synergies are not forthcoming, returns can often fall. If they fall below their cost of capital, whatever it may be, then management is destroying value through acquisitions. Mitie Group illustrated the point through its own acquisition strategy, which we covered in our first quarterly letter of March 2015. Ultimately, capital flows away from value destruction towards value creation. This may happen when, under financial stress, a proposed rights issue is not fully supported or the rights issue has to be more heavily discounted to offset the lower returns being made. More generally, shares in the secondary market are sold when value is destroyed and the business experiences a valuation de-rating.

Company	Sector	Position
Victrex PLC	Basic Materials	6.0%
Domino's Pizza Group	Consumer	5.8%
Aveva Group	Technology	5.5%
Intercontinental Hotels	Leisure	5.2%
Serco Group	Support Services	5.1%
Admiral Group	Financials	5.0%
Capita	Support Services	4.5%
Dunelm Group	Consumer	4.5%
Kone Oyj	Industrials	4.3%
Rotork	Industrials	4.0%
Tesco PLC	Consumer	3.8%
Imperial Brands	Consumer	3.4%
Rolls-Royce	Industrials	3.4%
Craneware PLC	Technology	3.2%
AstraZeneca PLC	Healthcare	2.7%
Pagegroup	Industrials	2.6%
Reckitt Benckiser	Consumer	2.4%
Burberry Group	Consumer	2.3%
Unilever PLC	Consumer	2.1%
BATs	Consumer	2.1%
Colgate Palmolive Co	Consumer	2.1%
Novo Nordisk	Healthcare	2.0%
Rio Tinto PLC	Basic Materials	2.0%
BHP Billiton	Basic Materials	2.0%
Avon Rubber	Industrials	1.9%
Croda International	Basic Materials	1.6%
Cash	Cash	10.6%
Total		**100.0%**

Source: Valu-Trac End SEP17

Key Metrics Table	VT Castlebay	Market
Return on Equity	36%	26%
Operating Profit Margin	21%	12%
Net debt to equity	46%	79%
Cash conversion	119%	94%
Free cash flow yield	3.4%	3.6%

Source: Bloomberg End Sep17

We are encouraged that we can point to many companies in both our Investment Universe and our Fund, where the management team clearly understand the ROC v Growth table. Admiral is a good example of this. Its whole business model is designed around prioritising returns over unprofitable growth, as evidenced by its average return on equity (ROE) of over 50% during the last five years. It has a capital light business model as it passes risk off its own balance sheet to a variety of re-insurers, such as Munich Re. In turn Munich Re pay back stock commissions to Admiral only when Admiral writes insurance profitably. This incentive has led Admiral to maintain amongst the very best combined ratio (percentage claims ratio + percentage expense ratio = combined ratio) in the industry. Subsequently, it means that Admiral's management prioritise returns over growth. Often the market will sell down the shares when Admiral's revenues are weaker than expected. However, this normally occurs when Admiral is not chasing unprofitable growth in the car and home insurance markets. As the premium cycle recovers more business can be written, all whilst returns are kept in focus. David Stevens the present CEO and Henry Engelhardt, a co-founder before him, both understand the ROC v Growth table. This wisdom has created a lot of value for shareholders over recent years.

The following companies, in our fund, are all good examples of businesses and their managers focusing on the Profitability v Growth table in the right way: Colgate maintains its focus on increasing its gross profit margins, as it has done over the last decade; InterContinental Hotels Group sold off its hotel assets to move to a franchise/managed business model; and Domino's Pizza Group continues to develop its own cash generative, franchise business. In simple terms, our investment process seeks to increase exposure to businesses that 'understand the table', selling companies which either don't 'get it' or lose sight of it in the pursuit of short term growth.