Castlebay Investment Partners

Quarterly investor letter December 2018

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: Part 4

Dear fellow shareholders,

Welcome to the final instalment of our series on Mastering the Moat. In our last three letters, we covered businesses with intangible assets, switching costs and network effects. In all of these moats the most important consideration is the extent to which a company's business model protects businesses and their returns from competition. Observe the first law of capitalism: that excess profits are competed away so that returns fall to the cost of capital. We are looking for businesses that can prove to be the exception to this rule. If returns can exceed the cost of making those returns, then any growth creates value for shareholders. In time, capital is attracted to these businesses as it moves away from companies which are destroying value. This is where one of the key benefits of our Investment Universe resides. By refining our investment universe based on our criteria of 'Quality', we aim to invest in businesses which create value over time.

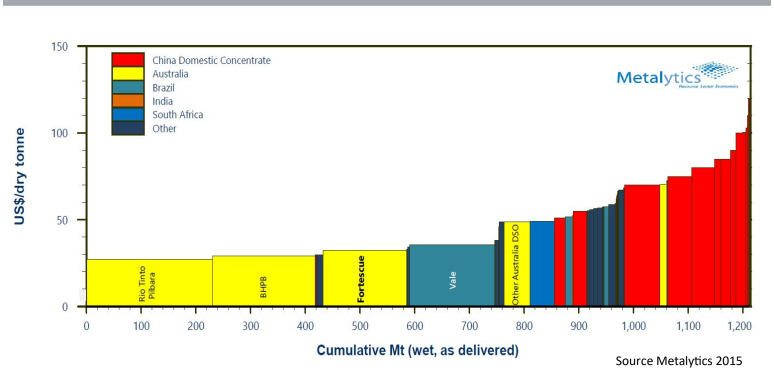
So what is the fourth moat? It is represented by **Cost Advantages.** In investigating the cost advantage moat, we are looking for businesses that can maintain materially lower costs than their competitors. The previous three moats focused on price and how 'special' products and services can command a premium price with consumers. All four divisions of Moats encompass a unifying theme. They all have the ability for a given business to do something different from its competitors and most importantly keep hold of that difference. It is this latter point that can generate significant long term benefits for our fellow shareholders.

Cost Advantages: As mentioned above, cost advantages allow a business to provide their goods or services at a lower cost than its competitors. This means that whatever price is being demanded by the customer, the lower cost producer will make superior margins relative to its competitors. This can often create a virtuous cycle which allows the low cost business to reinvest its excess capital in the business, thereby deriving further cost advantages against the competition.

Where cost is a large part of the purchase criteria of customers, 'cost advantages' are most influential. This is often the case in commodity markets where there is little or no differentiation in product between suppliers. For example, whilst grades of Iron Ore can vary, in the end it's all Iron Ore! In our Investment Universe, Rio Tinto and BHP Billiton are two good examples of such companies. Both stock positions were sold in our fund in May last year on 'through the cycle' valuation grounds. However, both illustrate well the benefits of being amongst the lowest cost, iron ore producers globally. The graph below illustrates the industry cost curve.

Rio Tinto and BHP (in yellow) are the two lowest cost producers supplying iron ore into China—the largest consumer in the world. Most of the Chinese producers (the red bars) are at the top end of the cost curve. This means that if the price of iron ore falls below \$60 per tonne, then they will lose money. This was the case during July 2018 as the price of iron ore fell below \$60/tonne. As supply reduces, when prices drop, this helps balance the market between supply and demand. Most importantly though, Rio Tinto and BHP are still happily making profits at this price. It is interesting to note that the largest producers all sit at the bottom (the left hand side) of the cost curve. As long as they maintain a collective discipline in allocating capital, they can create value for their owners through business cycles.

China's 2015 Iron Ore Supply CFR Costs (including royalties & ocean freight)



This has been evidenced over recent years by the reductions in capital expenditure budgets amongst Rio Tinto, BHP Billiton and CVRD. This has allowed Rio Tinto & BHP Billiton to reduce the debt on their balance sheets even whilst commodity markets have been weak. It is not just scale that can allow companies to maintain a cost advantage. Special or unique assets can also contribute to this. Such factors often combine to help deliver further scale benefits. In our mining example above, the mines in the Pilbara, Australia are special in both geological and practical terms. Both the prevalence and the ease with which the iron ore can be extracted makes this asset special, which when combined with scale enhances further the cost advantage. We hope you have enjoyed the short series published on 'Mastering the Moat' and that it has helped inform how we invest in our companies.

Thank you for your continued support.

David F Ridland

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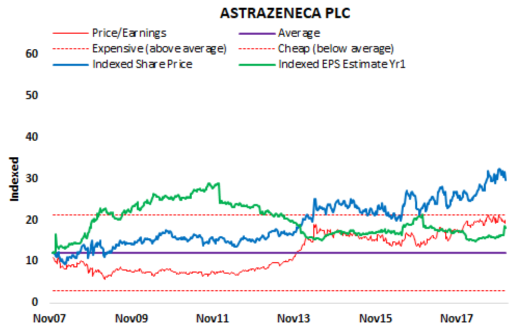
AstraZeneca: A bird in the hand or two in the bush?

At the end of November we sold our entire position in AstraZeneca. The investment case for AstraZeneca when we bought it at inception (JAN15), was predicated on the pipeline of drugs being discounted for nought by the market. We prefer to invest in businesses where we get a bird in the hand and the valuation and discount on the drug pipeline was attractive. In the following years, market expectations have risen and you will see from the valuation graph that AstraZeneca is now expensive relative to its own long term average valuation.

When analysing companies (in our investment universe) we attribute a cost of capital of 10% and aim for a required return of around 12% per annum. The company produces a dividend (3.4%) and so the required share price return is 8.6% p.a. To achieve this return in each of the next five years, taking into account the current valuation, the company would need to grow its earnings and cash flows at 21.5% per annum.

Astrazenca	
Share price at sale	£61.54
Dividend Yield	3.4%
Share price required return %	8.6%
Required total return %	12%
Years in the future	5
Share price in future required return (8.6%)	£92.96
Average Exit multiple (P/E)	12x
Future required EPS	£7.83
Current EPS	£2.96
Required EPS Growth	21.5%
Recent EPS Growth	-14.7%

Source: Castlebay DEC18



Source: Castlebay DEC18

Company	Sector	Position
Admiral Group	Non-life insurance	5.6%
IHG	Travel & Leisure	5.3%
Victrex	Chemicals	5.0%
Craneware	Software & Comp Serv	4.5%
Compass Group	Travel & Leisure	4.4%
RELX	Media	4.3%
Capita	Support services	4.3%
Serco Group	Support services	4.3%
BATS	Tobacco	4.1%
Imperial Brands	Tobacco	4.1%
Domino's Pizza	Travel & Leisure	4.1%
Avon Rubber	Aerospace & defence	4.0%
Reckitt Benckiser	Household Goods	4.0%
Colgate-Palmolive	Personal Goods	4.0%
Unilever	Personal Goods	3.8%
Kone	Industrial Engineering	3.5%
Dunelm Group	General Retailers	3.5%
Burberry Group	Apparel & Luxury Gds	3.0%
Novo Nordisk	Pharma & Biotech	2.7%
Croda Intl	Chemicals	2.4%
Rotork	Industrial Engineering	2.3%
Bioventix	Pharma & Biotech	2.2%
AVEVA Group	Software & Comp Serv	2.0%
Rolls-Royce	Aerospace & defence	1.9%
Pagegroup	Support services	1.4%
Cash	Cash	8.4%
Rev/Cap Accruals		1.1%
Total		**100.0%**

Source: Valu Trac 31 DEC18

The pharmaceutical industry has undergone a transformation in recent years with blockbuster drugs proving difficult to develop. In the case of Astra, the company has recognised these challenges and has shrunk its business—at a rate of 15% p.a. This has been the right thing to do. If the management had continued to push ahead with growth that was destroying shareholder value, that would have merely exacerbated the issue.

To achieve the return for which we are looking, the company is going to have to deliver new, approved drugs. Whilst its range of immune-oncology drugs appears very promising, the current valuation requires perfect execution in bringing these trial drugs to market. We are not suggesting that Astra is incapable of doing this, however, the balance of probabilities is against them at the current share price, given our required rate of return.

Victrex

We increased our existing position in Victrex in mid December following recent share price weakness at £23.14. Victrex has compounded its revenues well over the last five years, growing them at more than 8% each year on average. It continues to diversify its revenues and profits in its polymer and medical divisions, which has allowed cashflows from operations to grow over 10% annually, over the last few years. Importantly, incremental cash flow returns have exceeded the average return on equity of 23%, over both three and five years.

This is important as it shows us that Victrex is creating value for its shareholders as it grows. If, as investors, our cost of capital is set at 10%, then it is clear that Victrex is comfortably exceeding this cost by at least 13%. This positive, value creating spread, means that the more Victrex grows the more value it creates. All this whilst employing no debt! Market concerns about a slow down in growth over the short term provided us with an opportunity to invest more capital with Victrex for the long term, with a valuation margin of safety.

Cost Analysis

As we always do at the end of each year, our transactional costs are detailed in the table below. Transparency and a focus on costs are two of our guiding principles and by paying all ongoing fund costs from our management fee and detailing the transactional costs in the table below, you will see the full costs of investment in the year. The discretionary commission is our decision to buy or sell a position and the cost of these transactions amounted to 0.06% of the average fund NAV. The transaction costs include stamp duty, the PTM levy and other markets custody fees. Our turnover for the year was 12% based on purchases or sales (whichever is less) divided into the average NAV of the fund in the year.

Castlebay Fund costs	01 Jan18 -31 Dec18
Discretionary commission	£10,178
Fund Flow Commission	£8,029
Total Commission Paid	**£18,207**
Commission as % of NAV	0.06%
Transaction costs	£53,389
Total Costs of investment	**£71,596**
Total Costs as % of NAV	0.25%
Turnover 2018	**12%**

Source: Valu Trac 31 DEC18

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