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 2

Dear fellow shareholders,

Welcome to the second part of our series on Mastering the Moat. In our previous letter to shareholders we covered businesses with intangible assets. In these companies, returns are more easily protected from competition as it is often difficult to replicate the company/customer relationship. Heritage brands, such as **Burberry's**, are good examples of this. New entrants to the market find it difficult to displace the positional value of the brand in the consumer's mind. Part of the Moat is the tradition and brand value built up over decades, sometimes centuries!

Switching Costs

We would now like to turn to the second main area of business Moats: **Switching costs**. These costs tend to influence customer behaviour when the benefit of switching to another company's products is less than the cost of doing so. For example, say a rival software program can be bought for £100 fewer per year than an incumbent's product, but the cost of making the switch is £300. This cost obviously represents 3 years of cost-savings and in year one the customer will see a £200 outflow in cash. This cost may be enough to dissuade them from changing to the rival's program. So when switching costs are high for a company or consumer, they are less likely to move to another supplier of the goods or services in question. Suppliers can therefore charge higher prices if they know that their customers are 'sticky'. Interestingly, this phenomenon can be both real and imagined. For example, when was the last time that you switched bank? Banks prosper from this inertia by making a spread between the interest we as depositors are paid and the interest rates they make from turning these deposits into loans to customers. As consumers we should change banks more often, but there is the perception associated with such a move—what if the transfer takes longer than expected; what if it is botched and I miss payments on all the direct debits I have in place? Such thoughts dissuade many from seeking out better returns on their deposits, even in such a low interest rate environment. As the challenger banks in the UK develop, it will be interesting to see if bank account transfers rise. Switching costs can also manifest themselves in the time it takes to learn how to use a new IT or software tool and can put off consumers from changing software provider. A recent example at Castlebay is Bloomberg and their ability to increase prices because they have confidence that once they have a user onboard, it is unlikely they will choose to move to a competitor, even if they are cheaper!

High switching costs are often present in the supply chain manufacturing process. Several of our companies make products or deliver services which are integral to the finished goods of their customers. Ideally, in the supply chain, we like to see our companies' products representing a small overall cost to the end customer, whilst fulfilling a vital role or part in the end product or service. **Croda International**, is a good example of this. It creates the active ingredients used by L'Oreal and Christian Dior in some of their personal products. These active ingredients often provide the very essence of the product and so are often a small but vital ingredient in the process. If L'Oreal is looking to cut its overall operating costs, Croda is likely to be far down the list. After all, L'Oreal doesn't want to risk alienating its loyal customer base and tarnishing its brand by altering the proven formulations to which Croda's active ingredients contribute. **Victrex** is another of our companies where the switching costs to its customers are high. It manufactures a thermo-dynamic plastic called **PEEK** (**P**oly**e**ther**e**ther**k**etone). Over the years, Victrex has developed highly integrated relationships with many of its customers. These customers often come to Victrex and ask them how PEEK can be used further in their product lines. So it is clear that these customers trust Victrex and the benefits that PEEK brings to their products. It is easy to see how difficult it may be for a competitor to try and disrupt this relationship, especially as price is not the main motivating factor for many of Victrex's customers. Switching costs are high in the minds of Victrex's customers as quality and reliability of supply are more important considerations than price. This in turn gives an investor confidence that Victrex's strong returns can be maintained in the future as the business model is protected by this 'switching cost moat'. There are numerous other examples of the switching costs for the companies in which we are invested for the long term. In isolation these costs may not fully protect a company's moat, however in tandem with the three other categories of: intangible assets, network effect and cost advantage they play an important part of a company's competitive advantage. In the following two letters of 2018 we will discuss the network effect and cost advantage in more detail.

Portfolio Activity: Given that we tend to own the companies (as shareholders) in our fund for the long term, activity has been higher of late. In April, RELX was purchased for our fund. The old Reed Elsevier publishing business, it is a stock we have watched for several years, but its valuation precluded us from owning it. Finally, a de-rating of the valuation offered an opportunity to invest in this high returning business, whose business moat includes strong brands and a network effect—the latter of which we shall discuss in the next quarterly letter. The last day of April also saw the sale of Tesco. We have talked about Tesco previously, recognising it as a mistake. I misjudged its industry leading market share and operating margin premium relative to its peers as conferring a sustainable competitive advantage. Interestingly, it wasn't the changing structure of the industry that led to Tesco's issues. This has remained pretty constant over recent decades, including the presence of the discounters. It was Tesco itself that was largely the architect of its own downfall. This aspect, along with a sensible turnaround plan set in place by Dave Lewis, the CEO, gave us confidence that Tesco could effect a successful turnaround.

We averaged down our book cost which meant that when we sold our position we made a positive return on the shares. The creation of our investment universe was partly a response to our Tesco investment. It allows us to invest in high returning businesses whilst avoiding being lured into cheap but lower quality companies which could be value traps and impair capital.

In short, Tesco in its restructured state with a 4% operating margin target and a deleveraged balance sheet is, we believe, unlikely to generate returns in excess of 20%. This is important as that is our hurdle rate when we screen the market for factors such as Return on Equity and Return on Capital Employed. So with this sale, Tesco drops out of our investment universe.

Our two mining stocks Rio Tinto and BHP Billiton were also sold in mid-May. As their earnings and cashflows are cyclical in nature we look at valuations through their cycles. In Q1 2016 we doubled our weighting to Rio Tinto when the stock and sector were out of favour. Price/earnings valuations were high at the time as earnings were very low due to weak commodity prices in the past three and a half years. Free cash flow yield valuations however, were more supportive. Rio Tinto was on an 8% free cash flow yield and a 7% dividend yield. Even after these weak commodity markets, Rio Tinto was managing to deleverage its balance sheet. By May this year things had changed. The share prices of Rio Tinto and BHP Billiton have more than doubled and their earnings had trebled. However, their through the cycle free cash flow yields had fallen to below 5%. For cyclical businesses with greater uncertainty of future cash-flows this is at the more expensive end of the valuation range. Given the much improved capital allocation decisions being taken by management in the Mining sector, BHP Billiton and Rio Tinto both remain in our investment universe.

Company	Sector	Position
Victrex	Chemicals	5.3%
Aveva Group	Software & Comp Serv	5.2%
Admiral Group	Non-life insurance	4.8%
Intercontinental Hotels	Travel & Leisure	4.8%
Domino's Pizza Group	Travel & Leisure	4.6%
Colgate Palmolive Co	Personal Goods	4.2%
Craneware	Software & Comp Serv	4.2%
Capita	Support services	3.9%
Reckitt Benckiser	Household Goods	3.9%
Compass Group	Travel & Leisure	3.9%
Imperial Brands	Tobacco	3.9%
Serco Group	Support services	3.7%
Unilever	Personal Goods	3.6%
BATs	Tobacco	3.6%
Avon Rubber	Aerospace & defence	3.4%
Burberry Group	Personal Goods	3.3%
Rotork	Industrial Egineering	3.2%
Dunelm Group	General Retailers	3.1%
Kone Oyj	Industrial Engineering	2.7%
Croda International	Chemicals	2.5%
Relx	Media	2.4%
Rolls-Royce	Aerospace & defence	2.4%
Novo Nordisk	Pharma & Biotech	2.2%
Bioventix	Pharma & Biotech	2.1%
AstraZeneca	Pharma & Biotech	1.8%
Page Group	Support services	1.8%
Cash	Cash	9.7%
Total		**100.0%**

Source: Valu Trac 30JUN18

bioventix

Bioventix is an AIM listed company that develops, produces and markets Sheep Monoclonal Antibodies (SMAs). These are used in the blood testing process for the diagnosis of diseases and conditions. The investment case centres on persistency of revenues and exposure to a global diagnostics market which is growing at around 5-10% each year. Growth comes from the adoption of new antibodies as the diagnostics market develops. There are 60,000 things that can go wrong with the human body and we currently only have 6,000 drugs to treat these ailments! Whilst treatments by drugs and therapies are rapidly changing, diagnostics is likely to remain centred on blood testing, the market on which Bioventix is focused. The antibodies, which Bioventix produces, facilitate the Testing companies to lower diagnostic search costs at hospitals.

It takes approximately a year to develop an antibody for testing. Then the regulators have to approve its use through the testing phase, which takes another 2-3 years. This means that once Bioventix's SMAs are being used in the reagent packs, which go into the blood testing machines, persistency is very high. In the context of the 'business model moats' we were discussing earlier, it is clear that 'switching costs' are therefore high in this business. What is the evidence to support this assertion? Bioventix's antibodies have never been replaced once they are being used in a specific, regulated blood test! In many ways, like Craneware, Bioventix is selling the spades for the gold rush in its industry. The business has good cost flexibility, no debt and a rising net cash position. They can afford to be patient and so can we as investors.

Bioventix's Return on Equity (ROE) currently is 44%, with an operating margin of 71% driving returns. In comparison with our Key Metrics Table, it is clear that the addition of Bioventix to the fund is helping to elevate further the fund's overall ROE. Strong growth in cash-flows and an owner earnings' yield of c4%, support the stock from a valuation perspective.

Key Metrics Table	VT Castlebay UK Equity Fund	Market
Return on Equity	38%	25%
Operating Profit Margin	22%	14%
Net debt to equity	42%	89%
Cash conversion (free cash/ net profit)	108%	99%
Free Cash Flow Yield	3.6%	3.5%

Source: Bloomberg as at 30JUN18

We appreciate your ongoing 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. This newsletter should not be construed as investment advice.