PALM HARBOUR
CAPITAL

Dear fellow investors and friends,

During the first quarter of 2020 the fund lost -35.47% gross of fees[1]. We have been told by our fund's administrator and our compliance that there is a new rule in which we should not be comparing ourselves to specific indices unless they are clearly stated as our benchmark in our Key Investor Information Document (KIID). As we have no stated benchmark, we will leave it up to you to decide our relative performance. We would note that to us the above number appears worse than most large cap benchmarks and in line with small and mid-cap value indices. Our fund's composition is unlike any index and we are unlikely to perform in a similar manner.

We wish you and your family the best possible health.

Optimism is the madness of insisting that all is well when we are miserable - Voltaire

It was a very tough quarter and we fear it will be a tough year. We clearly were too slow to react to the initial impact of the virus and underestimated the impact on consumer confidence and employment. We added to positions too early and we closed our hedges far too soon. But as we patiently await the end of the lockdown, it is worth noting we are, in fact, in the midst of a bull market. While it is impossible to predict the length or depth of the recession, governments have been quick to react to the economic fallout. We are optimistic that the virus will pass with time and believe it would be ill-considered to bet against the collective ingenuity of humanity's race to find a solution.

We have mixed feelings about our performance. First, it should be made clear that we believe a market price and the value of an underlying business can and will differ. That is the very essence of what we, as active and value managers hold to be a core part of our philosophy. We spend most of the day trying to assess the value of a business and compare it to the market price. We buy only when these two numbers diverge

[1] Our NAV is calculated weekly by FundPartner Solutions, a subsidiary of Pictet & Cie and does not align with monthly or quarterly reporting. The gross return stated is net of taxes and fees but before fund expenses, which are currently running at approximately 10 bps per quarter at current AUM. We project this to decline significantly as AUM grows. Please see our comment on mgmt. fees.

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significantly. We believe that buying companies trading at less than half their value, will, over time, lead to outstanding compounding. Clearly, we do not believe the intrinsic value of our portfolio declined by 35%. In fact, we believe all of our companies were trading significantly below intrinsic value on normalized earnings when we purchased them. They are therefore more attractive now. We believe declines of this nature also provide us an excellent opportunity to buy superior businesses at bargain prices. In time, things will return to normal and eventually the value of our holdings will be realized.

That said, we did make mistakes. During the quarter, we decided that our two turnaround situations, Hostelworld and Aryzta, were likely to be permanently impaired and would suffer capital loss. Both reported earnings and we were disappointed in both the results and management's strategic outlines for the businesses. Not only did Hostelworld continue to lose market share but it executed poorly - incurring serious delays in updating its systems to enable basic functions such as paying in multiple currencies. It then announced a new strategy of M&A in non-online travel agency businesses using debt. We thought this to be a terrible idea. Management should focus on rebuilding the company's market share in its main business area or selling itself to Expedia. Aryzta similarly had bad results and showed no progress on turning around North America. We believe in the business models but lost faith in the operators. After quarter end, we re-established a position in Aryzta at a significantly lower price after a new activist shareholder announced a stake and joined forces with the largest shareholder. We think this is a sign that will bode well for changes in management and possibly the breakup of the company.

The only thing that overcomes hard luck is hard work. – Harry Golden

We had some bad luck. We had a portion of the fund in companies which are most exposed to lockdowns including a hotel group, retailers, and commercial office real estate. While we do extensive scenario testing, we admit we did not stress them for potentially a year with zero revenues. If there are not rolling lockdowns, we would expect a relatively swift recovery, offering tremendous upside. By design, all but one came into the crisis with very healthy balance sheets and strong asset backing. We expect our relatively defensive companies such as a lottery ticket operator and a pawnbroker to even do quite well once reopened.

On the positive side, we have a couple of companies which are doing very well. We outline one of them later in the letter. In addition, there has been extensive insider buying throughout our portfolio especially among our top positions. We continue to work tirelessly to focus on putting capital into the best risk-reward profiles and to find more under-valued gems.

The Emperor's New Clothes – Hans Christian Andersen

Unfortunately, most countries did not enter this crisis well prepared. Not only were our hospital systems and supply chains ill prepared for a global pandemic, many hallmarks of the last crisis remain. Global central banks had bloated balance sheets and held interest rates at or near zero, governments still had near record levels of debt and public and private companies feasted on the low interest rate borrowing. To make matters worse, wide-spread inequality from these policies have inflated asset prices such as real estate, the stock market as well as speculative vehicles such as art whilst punishing savers and the young. A decade to repair the damage of the financial crisis, was effectively wasted. Myriad governments chose to support zombie companies and private equity to keep asset prices inflated to benefit certain interest groups at the expense of most. This has left many countries with little room to borrow more and drives central banks to print money in near banana republic fashion.

When will someone say, the emperor has no clothes? At some point, the market might realize that unlimited money printing leads to currency debasement and zero interest rates distorts capital allocation, leads to massive inefficiencies and anaemic growth. Our hope is these policies can be fixed in time. We can only recommend owning real assets such as companies that have pricing power no matter the mode of exchange.

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We believe that as a society we can get through this pandemic and the subsequent recession. We remain optimistic. We hope that governments and companies use the ensuing years to fix their financial houses and to better prepare for futures crises.

The market appears to be pricing in a swift recovery (or negative interest rates into perpetuity?). Under the hood there are wide distortions. Travel and leisure companies are priced for Armageddon and industrials and other cyclicals are pricing in a deep recession. We think several high-quality companies with the balance sheets to withstand the crisis are trading at favourable prices. We are slowly taking advantage of the uncertainty to build new positions, which we will discuss in subsequent letters.

We have on average lowered our target prices by around 10% and far less on a weighted average basis. The majority of a stock's intrinsic value comes from the outer years' earnings and thus one year of lower profits does not move the needle in the extreme. The largest downgrades come from those that are exposed to the virus and have either taken on additional debt, which will need to be repaid with interest

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that lowers future cash flows to equity holders or have significant cash burn in Q2 and will need to take a couple of quarters to recover it, thus making 2020 a “lost year” for earnings. We believe around 50% of the portfolio should see a low to minor impact, about 20% is impacted directly by the pandemic and about 30% is sensitive to the economic fallout. Both of the latter groups have far overshot on the downside to what we believe the impact on their earnings will ultimately be over the course of the next couple of years. Our portfolio entered the crisis with significant undervaluation to normalized earnings and that has only increased. We believe our portfolio is chock full of undervalued companies and we look forward to their future developments.

At quarter-end, our portfolio had slightly over 132% upside to NAV, a weighted average P/E of 7.4x, FCF/EV yield of 20%, return on tangible capital of 32%, net debt/EBITDA of 2.1x and traded at 6.6x EV/EBIT.

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In this fourth letter, we present two companies that despite being in the same industry have short-term divergent fortunes. The first is suffering from lockdown notwithstanding an anti-recessionary business model whilst the second is thriving due to the lockdown.

International Game Technology (IGT US)

IGT is the number one operator of lotteries worldwide, and produces and operates slot machines. Formed in 2014 by the acquisition of Nevada-based International Game Technology by Italian firm GTECH, half of its revenues come from lotteries, 30% from the production of slot machines and 20% from operating slot machines and bookmakers in Italy.

The company manages 39 of the 45 US lotteries, plus the main Italian national lottery and scratchcard concessions. Lottery contracts are typically tendered out for 7-10 years at a time, with the concessionaire paying for equipment installation upfront and receiving a 2% commission on ticket sales. Incumbents tend to enjoy an advantage in renewals because of their experience in terms of both local market knowledge and lower capex requirements should they win. Incumbency win rates are c.90%.

Slot machine manufacturing is a business facing structural pressure as a once-cosy oligopoly has given way to intense competition in recent years. We don’t rate this segment highly, and consider it probable that GTECH grossly overpaid for IGT at the time of the acquisition. The operation of gaming machines in Italy, however, we know from our earlier investment in Gamenet (see 2Q19 letter) to be a decent business. The government has capped the number of machines that may be installed, entrenching the incumbents as they continue to earn healthy returns despite a number of tax hikes.

The effect of coronavirus on IGT however has been significant. Locked-down citizens have been unable to gamble on slot machines, whether in Italy or Las Vegas, and it has become harder (though not impossible) to buy lottery tickets. Lottery sales volumes are down in the order of 30% since the virus struck the US, and whilst costs can be managed down the business overall still has fixed cost.

IGT went into this crisis with above average balance sheet leverage as they had just renewed several concessions, paying upfront for the long-term contracts, despite having recession-resistant characteristics which allowed them to grow in previous recessions, they were not built to withstand a lockdown crisis. We expect them to have some tough quarters ahead, but they have received covenant waivers at favourable terms and we believe they will emerge from the crisis in a stronger competitive position.

Gamesys (GYS LN)

Gamesys Group plc is an online bingo operator. Two-thirds of its revenues come from the UK, where its best-known brand Jackpotjoy is market leader. Across the group the Jackpotjoy brand accounts for 30% of revenues, with other brands including Virgin Games, Vera&John and Heart Bingo. Formerly known as Jackpoyjoy plc, the company listed in London in 2017, and for most of the period since had suffered in investors' eyes from its reliance for its core gaming platform on a license from a third party, named Gamesys. In summer last year Jackpotjoy announced it would acquire Gamesys, and subsequently renamed itself after the acquiree. We welcomed the deal, as it removed the company's Damoclean Sword of potentially losing its platform provider.

Online bingo is a better business than might at first appear. In contrast to most other areas of gambling, the typical online bingo player is a woman over the age of 35. For them, the social element of the game is important, so Gamesys employs 'chat hosts' whose job is to encourage engagement and to engender customer loyalty. This allows the company to spend less on marketing than the typical online casino, whose churn rates can be shockingly high, providing it with something of a moat that keeps rivals from poaching its players. Bingo websites do not actually make most of their money from bingo. Whilst waiting for the numbers to be called out, players are offered casino-style side games such as slots. These casino games contribute 80% of the typical bingo site's revenue, so it is more helpful to think of the concept as 'social bingo-led slots' than just bingo.

Gamesys Group has proven resilient so far to Covid-19 given it is 100% online and has announced 19% growth in pro-forma revenues in the first quarter of 2020. It has seen notable growth in Asia over the past year, whilst the UK performance was described as 'solid', with trends in the first three weeks of April in line with those of Q1.

We have always liked Gamesys as a strong free cashflow generator, on track to produce almost £150m this year on an EV of £1.3bn. Management are shareholder-friendly, and have been clear that when leverage falls below 2.75x (it was 2.8x at year-end) they consider buybacks to be an attractive proposition.

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As stated in our previous letter, we are currently not charging a management fee until the fund reaches a larger size. The founder's class management fee will then be only 1% of assets under management.

Our focus is and remains the portfolio, but we do need to grow our assets to a sustainable level. Our fund can be invested through both European international central securities depositories: Euroclear and its FundSettle clearing platform and Clearstream through the Vestima fund clearing platform. Our fund is registered for distribution in the UK, Spain and Luxembourg including for retail distribution. Currently the following financial institutions in Spain are distributors: BBVA, Renta 4, Lombard Odier, Banco Alcala as well as many other institutions working through the main platforms in which the fund is available upon request: Allfunds Bank and Inversis. In the UK we are offered on the AJ Bell low-cost platform Youinvest.co.uk and can be part of an ISA or pension. If you have any issues finding our fund, please contact us at IR@palmharbourcapital.com

We can confirm that all systems and work from home contingencies are performing flawlessly in lockdown. The only minor hiccup is when Peter's 18-month-old son occasionally steals his phone during a conference call and runs away pressing random buttons.

We appreciate your support over the past year.

Yours faithfully,

Palm Harbour Capital