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Dear fellow investors and friends,

It is a great honour to be penning the first of our quarterly letters for the *Cobas Lux SICAV Palm Harbour Global Value Fund*. The journey from inception to launch this April has been long. However, patience and a long time horizon provide the ideal conditions for compounding investments, and so it is with building the foundations for a successful fund. We are very grateful to be supported and seeded by our partner Francisco García Paramés, who shares our long-term outlook.

This letter includes some commentary on the quarter and introduces five core portfolio holdings (OCI, Wabtec, RHI Magnesita, Gamenet and Elegant Hotels).

From our launch date on the 5th of April to quarter end, the fund lost 3.17% gross of fees[1]. This compares to the EuroStoxx 600 (total return reinvested) of +0.83% and the MSCI World (net return reinvested) of +0.86%. Our fund's composition is nothing like either of these indices and we do not expect to perform in a similar manner.

Equity markets rose significantly prior to our launch and lifted valuations. While market gyrations are inevitable, we focus on what is in our control, which is our philosophy and investment process. Nevertheless, there are always hidden pockets of undervalued securities and we found ample opportunities. When dealing with meaningfully undervalued companies, one never knows when or sometimes even what the catalyst might be. Often it might simply be quarterly results, which many of our companies were due to report in April and May. We prefer to be invested in our undervalued securities than attempt to time the market.

During the quarter, the majority of our companies reported positive news flow: positive earnings reports, increased dividends, share buyback programs, or announced deals. Only two of our companies had disappointing earnings reports but we believe both to be temporary in nature. Furthermore, we continued to conduct extensive

[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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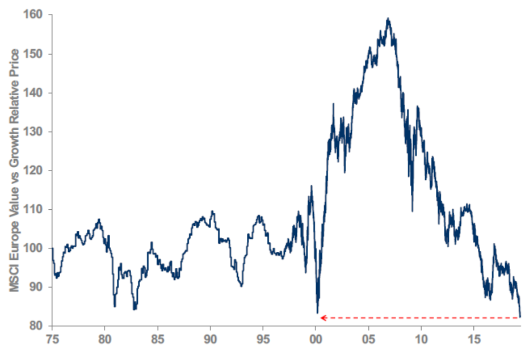
research on our positions including attending trade shows, conferences and speaking with numerous experts. Our confidence in our portfolio increased.

The Fed and ECB's capitulation to Trump and the market's mini-tantrum has further thrown central bank credibility out the window. Low interest rates continue to distort markets and cause financial repression. This gross misallocation of capital will likely end in tears. Until then, the market grinds higher with a Shiller P/E of 33.6x, which compares with a long-term average of 16.6x and is higher than any other period except the dotcom bubble. Housing continues to be unaffordable to many, destructive large-scale M&A remains in vogue, unproductive zombie companies continue on and the most speculative non-cash producing luxury items such as classic cars, artwork and wine remain ludicrously valued.

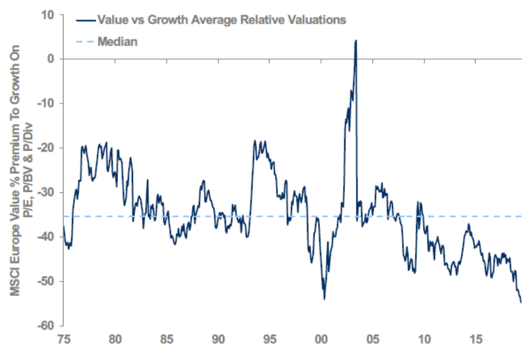
One interesting chart from Morgan Stanley shows that Value stocks are now trading at the same level relative to Growth stocks as they did during the Tech Bubble in the late 1990s. Whilst we do not describe our style of value investing in the same manner as MSCI differentiates the styles, it is nonetheless interesting. Money raised for negative earning, cash-burning companies via IPOs are also at levels comparable to the late 1990s. Food for thought.

**Exhibit 2:** Value vs Growth just reached a new all-time price low for the first time in 19 years...




Source: MSCI, Morgan Stanley Research

**Exhibit 3:** ...and relative valuations of Value vs Growth are now at a new all-time low




Source: MSCI, Morgan Stanley Research

We endeavour to protect the capital entrusted to us and preserve it by avoiding overvalued companies and assets. This should provide downside protection when the bubbles do eventually burst. In the meantime, we buy quality cash-producing companies at low valuations, which often are undergoing some sort of significant change.

At quarter end, our portfolio had slightly over 100% upside to NAV, a weighted average P/E of 7x, FCF/EV yield of 16%, return on tangible capital of 28%, net debt/EBITDA of 1.2x and traded at 6x EV/EBIT.

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As this is our first letter, we will introduce a few of our largest positions. In the future, we will introduce more positions and discuss large portfolio movements. At the end of the quarter, we had a larger cash position (14%) than we will necessarily have going forward. This cash position had to do with establishing accounts in new countries, cash inflow timings, and concluding due diligence on several holdings.

## OCI NV

OCI (OCI NA) is the fourth largest global producer and distributor of nitrogen fertilizers and natural gas-based chemicals (primarily methanol and melamine). The founder is Egyptian billionaire Nassef Sawiris, who is credited with selling his father's cement empire to Lafarge at the top of the cycle in 2007 for outrageous multiples. He then took part of the profits and started building a fertilizer empire, first in Egypt and then adding greenfield projects in Algeria and the US and buying DSM's operations in the Netherlands.

The company is advantaged in a commodity market by being strategically located (e.g. US corn belt and North Africa with tariff-free entrance to Europe) coupled with low-cost production (modern plants with extremely low priced natural gas in the US and North Africa), which helps its profitability and cash flows. Globally, the fertilizer market has become more disciplined after years of volatility. After sanctioning many new plants in the last agricultural boom, subsequent low prices have led to few new builds recently. In addition, more stringent Chinese environmental policies have curtailed the practice of burning coal to make fertilizers for the purpose of low margin exports.

Having spent billions on capacity expansions, OCI has passed a cash flow inflection point and is rapidly deleveraging to the benefit of equity holders. The company has also recently announced a deal with Abu Dhabi to contribute its North Africa fertilizer assets to a joint venture and there are rumours that Saudi Arabia is interested in its methanol businesses. We believe that the Sawiris family, who control over 50% of the company and are known deal makers, will make economically rational decisions to maximise shareholder value. The market appears to judge the company's shares on every short-term movement of highly seasonal fertilizer prices. We prefer to take a conservative mid-term view using marginal cost curves and new-build incentive pricing as well as in-season prices in the regions into which the company is actually selling. The company is inexpensive on both a sum of the parts basis and on a free cash flow basis, using these conservative long-term fertilizer price assumptions. We see over 100% upside with a three-year view.

## Wabtec

Westinghouse Air Brake Technology Corp or Wabtec (WAB US) has historically been known as a manufacturer of train brakes as well as other rail equipment and software. The rail brake industry is a global duopoly between Wabtec and Knorr-Bremse of Germany, which listed last year. The industry is characterized by high switching costs for safety critical components which have a low value relative to the complete train. Industry volumes are low relative to the technology and R&D investment needed, a factor that discourages new entrants. Brakes have long lead times to develop and profitability comes from the aftermarket, so any new investment takes years to pay back and is driven by the installed base. Spending on servicing and spares can be triple the initial outlay on braking systems during the lifecycle of a train. In addition to needing local maintenance and customer service to maintain the aftermarket business, each country has local certifications and rules with frequently changing regulations which often involve onerous testing and extended approval processes. Wabtec bought the French company Faiveley in 2016, which added better balance between local urban transport and freight.

The opportunity to invest in this high-quality company at a discount arose due to a spin-merger with General Electrics' Transport business, a manufacturer of diesel-electric freight locomotives. This business is also a global duopoly with competitor EMD, a subsidiary of Caterpillar. In order to focus GE's portfolio, it was decided to merge the business with Wabtec and spin-off GE's ownership share to GE's shareholders. However, the deal was renegotiated to include a cash component and for GE to maintain a portion of its shareholding, so that it could sell the shares in the market. This was done due to GE's weak balance sheet and extreme need for capital. In the end, this provided an opportunity. GE's shareholders only received 1 share per 185 GE shares held - an insignificant amount, which likely led to investors selling the scraps. Furthermore, GE was contractually required to sell a portion of its stake in the first 120 days after deal completion and all its stake within three years.

After the deal was announced Wabtec's shares rose above $110. Since then the shares have fallen as low as the $60s, with GE selling 13.2% at $73.50. We believe the market expects GE to sell the remaining 11.8% after its lock-up ends, which we think partially explains why the stock is depressed.

Worries surround Precision Scheduled Railroading (PSR) as well as the general health of the US freight market due to the trade wars and economy. About the former, we have done a lot of analysis and have spoken to experts. We believe the market is overreacting to these threats. If locomotive sales decline due to PSR (which isn't guaranteed and is not in major railroad capital expenditure plans at the moment), then this will lead to increased maintenance and modernization rebuilds from running the current fleet harder. Maintenance and rebuilds are more profitable than new builds. In any case, we reckon a drop in new builds by 50 per year might lead to $175 million less of revenue out of around $9 billion. On the latter issue of the economy, we normalize numbers through the cycle and make our investment decisions on this as opposed to trying to time recessions (as they have been predicted every year since the last one). The combined order backlog is $23 billion and aftermarket services is 61% of sales, which gives some cushion in a downturn.

The sell-side seems completely focused on 2019 EPS estimates, which are meaningless in our view and includes several one-off transaction expenses, only 10 months of GET, and minimal synergies. All discussions on conference calls and sell-side notes refer to 2019. Management in the merger documents laid out long-term guidance including their market forecasts and synergies, which calls for $6 billion of free cash flow between 2019 and 2022 or $1.5 billion a year. The sell-side have only $350 million this year, which is their focus. On our numbers in 2021 we reach $1.3 billion. We believe with a reasonable multiple on this number we have 100% upside in the shares. If you use management guidance there is even more. Looking at it another way, on adjusted EPS for 2020, WAB trades at an 11x PE ratio. Knorr-Bremse trades at 20x PE. We feel consensus 2020 EPS is likely too low as well.

## RHI-Magnesita

RHI Magnesita (RHIM LN) is a producer of refractory products, materials that can withstand extreme heat used in the manufacture of steel, cement and glass. As a result of a 2017 merger between the second and third largest players in the industry, it is now the global market leader in a consumable product that plays a critically important role in its customers' processes and has no known substitutes. Refractories in steel mills are replaced on a weekly basis and constitute just 1-2% of the total cost of a ton of steel but an operator cannot afford to scrimp on them as a bad batch can cause a plant to shut down. Because refractories are consumed whether a furnace is profitable or not, RHIM's earnings are significantly less volatile than those of its customers and since it operates its own mines, it is substantially self-sufficient in raw materials too. These traits show up, unsurprisingly, in its return on capital employed, which is in the region of 20%. For such a company addressing end markets that should see long-term growth (for example, electric arc furnaces – which China is just beginning to transition toward – consume four times the level of refractories as blast furnaces) a free cash flow yield of more than 10% is highly attractive. The market prices the stock as if it were a price-taking steel producer and not an essential volume-linked service provider.

## Gamenet

Gamenet (GAME IM) is a gambling concessionaire and betting machine operator in Italy. It was formerly owned by Intralot in Greece which sold a partial stake of the company to the private equity firm Trilantic. The PE fund IPO'd the business in December 2017 and now controls 30% with Intralot controlling 20%. Gamenet acquired bookmaker Goldbet in October 2018, which added 1,600 betting shops and a gave it a stronger online brand.

The Italian gambling market is mature and is expected to grow at a low- to mid-single digit rate. However, spending is largely unaffected by the economic cycle and consolidation of the industry is leading to higher profitability.

The greatest risks come from regulation and taxation. This was recently highlighted when the new Italian government raised taxes on payouts. However, we expect mitigation through the lowering of payout rates on games, which in the past has caused minimal user attrition. Clearly such a tactic has its limits, but we think at some point the Italian government will do what is best to maximise its revenues and not to kill the golden goose. The other major regulatory change is an advertising ban in Italy. Counter intuitively, we think it will benefit incumbents with a physical branch network (a form of legal advertising) at the expense of online-only competitors who can no longer promote their brand.

We believe investors are well compensated for these risks at a 20-25% FCF yield (after taking into account the cost of concession renewals), with the company using free cash to simultaneously pay down debt, pay a hefty dividend and buy back shares.

Whilst many value investors would not invest in a recent IPO, especially one owned by private equity (the asymmetric information fear), we find they sometimes present interesting opportunities. PE makes most of its return from levering up quality businesses with strong cash flows. We, too, like to own businesses with strong cash flows - we just prefer lower debt and well-invested assets. Since PE funds have a limited lifetime, it is often possible to buy toward the end of a fund's life cycle - when the fund can be thought of as something of a forced seller. This can lead to interesting valuations for potential buyers. PE can rarely sell its entire stake in the IPO and thus has an interest in the share price not collapsing soon after it. The IPO proceeds are often used to pay down debt and as the financials under PE ownership often look unappealing, few quant funds or other statistical investors tend to be interested. The management teams often have sizable stakes, which we like and gives us some comfort they will invest properly in the business. PE also has reputational risks and may not want to taint their next deal. We feel these can be interesting special situations.

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## Elegant Hotels

Elegant Hotels (EHG LN) is a London-listed hotel company which owns seven freehold hotels and a restaurant on the island of Barbados. The hotels are a high-end mixture of luxury, adult-only and family-oriented hotels. The properties are located on around 23 acres of land with 2,600 feet of prime platinum beachfront property. The shares IPO'd in 2015 and suffered drastically after the Brexit vote and Sterling devaluation as over 70% of the company's room-nights were sold to British tourists yet its costs are mostly dollar-denominated. Furthermore, this hit to tourism exacerbated an overextended Barbadian national budget which led to a new government and a debt restructuring, followed by a change in taxation on the hospitality industry. Another concern may be the appearance of high leverage at 3.3x trailing net debt to EBITDA.

Over the past two years, Barbados has seen increased airlift from the US and Canada to balance the drop from the UK. The UK itself did not drop as much as feared as those holidaymakers going to high-end Caribbean resorts were less sensitive to sterling weakness than the market had anticipated. In addition to several new US routes, a new route will open from Frankfurt starting this October. The mix of inbound tourism is now much more balanced, even though UK tourists tend to be higher value as they stay longer than US or Canadian tourists.

On taxes, while there were increases in some taxes, they were offset in other places. The end result was virtually no impact, perhaps even slightly beneficial with the tax regime now covering Airbnb and other such hotel-like services for the first time.

On the debt front, while 3.3x net debt-to-EBITDA may seem high to some, we consider a 28% loan-to-value ratio on the freehold hotel portfolio as conservative.

On our calculations Elegant is trading at a 12% FCF to enterprise value and 17% to equity. It is also trading at more than a 50% discount to the net value of its prime beach front property.

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We have been asked why we do not charge a performance fee. We decided to keep the fee structure simple and to follow what our partner has done at Cobas Asset Management. We also find some performance fees can be asymmetrical and lead to excessive risk taking. In an ideal world, we would charge a fee based on our outperformance for a sufficiently long period of time. However, that system would be very complex. Hence, we are sticking with a plain vanilla fee structure. Currently, our founder's class management fee is only 1% of assets under management.

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That said, we are currently not charging a management fee until October. We may choose to extend this offer until the fund reaches a suitable size.

While we will always focus on our portfolio, we do need to grow our assets to a sustainable level. In the UK we are offered currently on the AJ Bell low cost platform Youinvest.co.uk and can be part of an ISA or pension. In Spain, we are on Inversis and Allfunds and through those platforms it should be possible to invest using all major banks and platforms. Allfunds should also allow most private wealth advisors, professional investors and platforms easy access. If you have any issues finding our fund, please contact IR@palmharbourcapital.com and we will try to find a solution. We appreciate all the support shown us over the past year.

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During the quarter, Tom was lucky enough to marry his fiancé on a beautiful sunny day in Cornwall. Congratulations to the couple! They are looking forward to a well-deserved holiday in the US and Canada in August.

Yours faithfully,

Palm Harbour Capital