Dear fellow investors and friends,

During the quarter the fund lost 2.65% gross of fees. From our launch date on 5th April to 30th September 2019, the fund lost 5.74% gross of fees[1]. This compares to the EuroStoxx 600 (total return reinvested) of +3.73% and the MSCI World (net return reinvested) of +5.06%. Our fund's composition is nothing like either of these indices and we do not expect to perform in a similar manner.

This letter provides commentary on the quarter and introduces two new core portfolio holdings (Ibstock & Befesa).

The quarter was once again characterized by continued volatility in equity markets, which was particularly pronounced in August with light volumes and lots of headline noise. There are a litany of macro concerns and it is not worth going through every Trump China tweet, ISM manufacturing index decline or street protest in this letter.

We do note the divergence of consumer growth and low unemployment (and relatively strong US growth) versus an industrial recession (and relatively weak German and Chinese growth). The bond markets (heavily manipulated by central banks already) signalled something was seriously wrong during the quarter, with US overnight repo rates exploding, the 3-month 10-year US treasury spread hitting minus 50 basis points and over $17 trillion worth of bonds trading at negative yields. Central banks responded by restarting quantitative easing and cutting rates. This pushed index-driven equities higher (and many to new all-time highs). How much longer engineering of financial markets can distort and misallocate capital in the real economy is unknown. All we can do is avoid the bubbles and continue to find inexpensive high-quality companies that produce strong cash flows and have sensible re-investment opportunities that do not require financial engineering to work.

[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.

Our portfolio was bifurcated with a couple of large underperformers and one large outperformer. The two largest underperformers were both relatively illiquid turnaround situations. The largest negative contributor had no significant news during the quarter, so we added to the position after a large drop in August.

The second largest negative contributor did report interim earnings. We were disappointed in management's communication and (as is almost always the case) the turnaround is taking longer than the market (and we) expected. We have been following the company for years and are also concerned the new management team is not stabilizing the business quickly enough. We still believe the business model is solid and the underlying market is growing. We decided to reduce the position size and wait for more evidence.

We had smaller negative contributors which we would label as cyclicals (real or perceived) that the market took a negative view on. We look through the business cycle to normalized cash earnings and try not to predict recessions. We are therefore happy to own these high quality, high cash flow-producing companies despite short-term market gyrations.

On the positive side, Gamenet (GAME IM), the Italian gaming concessionaire mentioned in our first letter, reported a very strong first half. Management increased their synergy target from the Goldbet acquisition, raised their EBITDA forecast for the year, and lowered their net debt forecast. They declared their intention to pay a 2020 dividend of €0.85 a share, putting the company on a >10% dividend yield. The stock, which was trading at a very depressed level, finally received some market attention.

The second largest contributor was an Italian IT equipment distributor whose results showed strong sales growth and market share gains, albeit with a slightly lower margin. It has benefitted at the expense of a larger competitor that was acquired by a Chinese conglomerate in 2016.

OCI (OCI NA) is primarily known as a nitrogen fertiliser manufacturer, but a fifth of the company's earnings come from the production of methanol. The commodity, used in building materials and for energy purposes, has fallen more than 30% over the last year after rival producers announced capacity additions, as well as slowing Chinese demand.

RHI Magnesita (RHIM LN), a producer of refractory products used in high-temperature industrial processes, reported encouraging results. Whilst its main end-market is steelmaking, we believe investors misappraise the quality and resilience of this supplier of mission-critical consumables.

Wabtec's (WAB US) second quarter results showed strong cash flows and progress on merger synergies, following which General Electric took the opportunity to sell $1.5bn worth of the stock it had received for in return for its locomotive division.

We sold completely out of one position during the quarter. Wesco Aircraft Holdings Inc (WAIR US) is a distributor and supply chain manager to the global aviation industry. The company was in the process of a multiyear turnaround. We purchased the shares for around $8.50 per share at the launch of the fund and made it approximately a 3% position. We believed the shares to be worth between $18 and $20 per share. Platinum Equity bid for the company at $11.05 per share, which was a small premium to the market price. As the largest shareholder (Carlyle Group), the founding family and management all agreed to the purchase, there was little we could do to encourage a higher bid more in line with our valuation.

At quarter-end, our portfolio had slightly over 104% upside to NAV, a weighted average P/E of 6.7x, FCF/EV yield of 18%, return on tangible capital of 26%, net debt/EBITDA of 0.5x and traded at 5.6x EV/EBIT.

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In this second letter, we have two positions to introduce.

Ibstock plc (IBST LN)

Ibstock is a UK manufacturer of clay housebuilding bricks (80% of the business) and concrete building products (20%). The company operates in an industry that doesn't exactly set the pulse racing, but it has a number of attributes that make for an attractive investment set-up.

Bricks must be produced at kilns near clay deposits, and in the UK almost all of the viable clay deposits are owned by incumbents. There are not many of these, as the market is consolidated, with three major players controlling over 90% of UK capacity. Ibstock is the number one, with over 40%.

Because bricks have a very low value-to-weight ratio they are uneconomical to transport long distances. It costs about 6 pence to transport a brick across the Channel, and the same again for every 100 miles it travels on a truck. With an average selling price of 30 pence per brick, you can see how much location matters. Ibstock's production sites are clustered in the Midlands and the South of England, within reach of the major population centres (and of course, where the clay is found).

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This keeps the island of Great Britain well insulated from foreign imports, which make up around 5% of total brick used in the UK. Whilst egregious price gouging would invite a flood of imported bricks, the incumbents do not push their position too aggressively. For this reason, most imports result not from pricing arbitrage but merely because certain brick types architects sometimes desire are simply not available in the UK.

We were pleased when Ibstock announced the sale in November 2018 of its struggling US brick business Glen-Gery. The group received a multiple of over 8x EBITDA for a business that had made only a 12% margin over the prior four years, compared to the group's 27% in the UK.

The company's concrete division is of lower quality than the brick division. Cement can be shipped longer distances and concrete mixed almost anywhere. Ibstock (which was formerly part of building materials firm CRH) makes concrete products under a number of brands that seem reasonable to us, but it is not why we own this stock.

Over the last few years we have seen Ibstock's share price jump around on Brexit-related news as if its earnings were highly sensitive to the outcome of trade negotiations or the value of the pound. In reality this is a steady, domestic-facing business serving a housebuilding industry addressing decades of pent-up demand. The company's returns on capital are in the region of 20%, and it is even able to plough some of its free cash flow back into growth as it upgrades its facilities and increases capacity by 13% with a new brick plant in Leicester.

With the cash received from the US sale, Ibstock paid down debt to below 1x leverage, so we are comfortable with its ability to pay a healthy dividend whilst maintaining the quality of its plants and investing in selective growth.

We see the company making around £100 million in operating profits and normalised free cash flow of around £90m a year. With an enterprise value of £1.1 billion, that gives the company a free cash flow yield of 8% this year, rising above 10% in 2021 as capacity is added via plant upgrades. We believe the majority of this cash can be returned to shareholders.

Befesa SA (BFSA GR)

Befesa is a German-Spanish company which collects and recycles steel dust and aluminium residues. It charges a collection fee to steel mills and aluminium smelters to remove hazardous waste, which it then turns into valuable zinc (in the form of Waelz oxide) and aluminium. With long-term contracts in place and difficulties transporting hazardous waste long distances, their plants are generally located close to their customers and could be considered local monopolies as a rational rival would not build a plant nearby to gain only modest utilization.

In developed markets growth is driven by steel volumes - particularly those produced by electric arc furnaces (EAFs), which use scrap steel as an input. Steel produced from scrap tends to have a high zinc content in the waste dust, which Befesa can turn into Waelz oxide and sell to zinc smelters. Developed markets are highly regulated and also use more EAFs as there is more available scrap. However, another form of growth is geographical expansion as unregulated emerging markets begin to regulate these dangerous hazardous materials. Befesa has expanded into South Korea and Turkey and is now breaking ground on two plants in China. China is dominated by blast furnaces which consume little scrap. However, there is now a movement toward EAFs as they are more environmentally friendly and after years of strong steel production there is an ever-increasing quantity of scrap steel available. Befesa is trying to be first mover in regions where they see new EAFs being built.

Besides steel volumes, the primary risks to Befesa's earnings are the mid-to-long term zinc price and zinc treatment charges levied by smelters. On the latter, zinc treatment charges tend to move inversely to zinc prices over the mid-term (though can take a full year or two to resync) – which acts as a natural hedge for Befesa. On the former, the company hedges 70% of its zinc exposure out to three years. We use a conservative long-term zinc estimate based on the cash cost curve of producers. In addition, as its clients are required by law to dispose of this waste in an environmentally friendly way, Befesa could raise its collection fees if zinc prices were weak for a prolonged period of time.

Befesa earns over 30% returns on tangible capital and trades at a 10% normalised free cash flow yield, which we find highly attractive.

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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.

While we will always focus on our portfolio, we do need to grow our assets to a sustainable level. We are on Allfunds, which allows most private wealth advisors, professional investors and platforms easy access. 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. In Spain, we are on Inversis and Allfunds and through those platforms it should be possible to invest using all major banks and platforms. 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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This summer we welcomed a new intern, Bharath Nagaraj, who is working with us as he finishes the value investing course at London Business School.

Peter's son started crawling, causing some mayhem but also great delight.

Yours faithfully,

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