Dear fellow investors and friends,

During the fourth quarter of 2019 the fund gained +11.47% gross of fees. This compares to the Stoxx 600 (total return reinvested) of +6.16% and the MSCI World (net return reinvested) of +5.43%. From our launch date on the 5th April to the 31st December 2019, the fund gained +5.07% gross of fees[1]. This compares to the EuroStoxx 600 (total return reinvested) of +10.13% and the MSCI World (net return reinvested) of +11.53%. Our fund's composition is unlike either of these indices and we are unlikely to perform in a similar manner.

This letter provides commentary on the quarter and introduces four portfolio holdings (Esprinet, Jost Werke, CIR and Aryzta).

The fourth quarter has broken the trend of the previous two quarters. The fund performed well in each month as did most major indices. The market lapped up the Fed's stimulus and then cheered as China signalled a willingness to sign a phase one trade deal. We added several new positions to the portfolio, which we hope to detail in future letters.

The largest contributor in the fourth quarter was Elegant Hotels, which was described in our Q2 letter and was a top five holding. The company was purchased by Marriott International for 110p, which was a 55% premium to our entry price. While not quite at the valuation level we would have wanted (we thought it was worth 180-190p), we are not surprised with the outcome, as we suspected a larger hotel chain would see the value, although admittedly we thought Melia more likely than Marriott.

The second largest contributor was Ibstock, the UK manufacturer of bricks highlighted in our Q3 letter, which in October recovered from its August decline as the market revised its expectation of an imminent UK recession. In December it further benefited from the UK election outcome.

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[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.

Palm Harbour Capital LLP
12 Hammersmith Grove
First Floor 117
London, W6 7AP, UK
info@palmharbourcapital.com

The third significant contributor was Esprinet SpA (PRT IM), an Italian distributor of electrical products, which we mentioned without naming last quarter. We will describe it later in this letter in more detail. The company had strong Q3 results, but this was likely overshadowed by its larger US competitor Tech Data being bought by Apollo at a multiple significantly higher than Esprinet's. Warren Buffet said on CNBC that Berkshire Hathaway had bid higher than Apollo for Tech Data during the "go shop" period but declined to enter into a bidding war when Apollo raised its bid. We think this speaks to the quality of the business model of Esprinet, which had been trading at very depressed levels, below net working capital, when we initially purchased the shares. Applying the Tech Data earnings multiple of only 11.5x to Esprinet would give us over 100% upside. We believe Apollo got a good deal and could have paid even more.

The fourth largest contributor was JOST Werke AG (JST GY), a supplier to the truck and trailer market, which we will detail later in this letter. It has been perceived by the market as highly cyclical given its end market. While it is true that its sales could decline significantly, the company is asset light with a flexible cost base. Add to this a large maintenance component, and the underlying cash flows are much stronger than the market has given them credit for. They have low net debt and an extremely low valuation. Through the cycle the company is a bargain. The market began to realize this after their Q3 results, and the shares started to re-rate. In December, they then bought a company, which the market has taken quite favourably. We would have preferred a share buyback as we told management on several occasions, but at least they are using their balance sheet more productively than previously. The company went from a perceived "cyclical detractor" in Q3 to a large contributor in Q4.

The fifth significant contributor was Aryzta AG, one of the turnaround situations mentioned as a detractor in the Q3 letter and which we will describe later in this letter. The company reported muted full year numbers this quarter, with ongoing weakness in the key US market. Management has promised this will change in the spring and summer quarters, but it is most definitely a "show me" case as management has a reputation for disappointments, overpromising and underdelivering. Clearly this is not exactly what the market is looking for in a turnaround. However, at the Annual General Meeting, the Chairman made several positive comments, and this was enough to boost the depressed share price significantly.

The final large contributor was again Gamenet SpA (mentioned as a top five position in our Q2 letter and as top contributor in Q3). After purchasing 29% from a vehicle owned by the PE fund Trilantic and the Chiarva family and 20% from the very distressed Intralot, Apollo made an offer at €12.50. However, the stock was trading above €14 the day before. Apollo then threatened to call an EGM and take the company private, and those shareholders who did not tender would have to keep an illiquid non-listed company. The shares traded down but still above the €12.50 offer and we hoped enough hedge funds would get involved to vote against Apollo. However, Apollo then organized a reverse bookbuild and offered to purchase shares at up to €13 from the market. They received enough shares to gain a majority at an EGM given normal turnout levels. We found the manner, threats, and level of the bid insulting but nevertheless will tender our shares as they have secured a dominant majority. We valued the shares at between €22-25, so whilst €13 was 46% above our average price of €8.88, Apollo again got a great deal.

Our main detractor was again OCI, a major nitrogen and methanol producer discussed in our Q2 letter. The company reported a weak Q3 on extensive maintenance downtime and turnarounds in their nitrogen business and an unplanned shutdown in their methanol JV coupled with weak methanol prices. Although it was below our expectations, we expect the results to recover in 2020 given insurance payments and less downtime.

We run a portfolio that looks absolutely nothing like any index and we do not expect to perform like any index. As our performance inception-to-date has shown, our results can be lumpy given our 30 positions or fewer. Often the market has a negative perception of our companies, which can lead to temporary paper losses. We cannot predict when the market (or an acquirer) will realize the value that we see in our companies. Ultimately, strong cash flows and low valuations will be recognized.

At quarter-end, our portfolio had slightly over 101% upside to NAV, a weighted average P/E of 7.7x, FCF/EV yield of 20%, return on tangible capital of 28%, net debt/EBITDA of 0.75x and traded at 6.5x EV/EBIT.

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In this third letter, we introduce four positions.

Esprinet SpA (PRT IM)

Esprinet is a distributor of IT products in Italy, Spain and Portugal. It is listed in Italy, from where it derives two thirds of its sales and is the number one player, with 24% market share. Its Iberian operations, acquired piecemeal over the years, make up the other third of sales, and it also holds the number one position there.

A distributor sits between original equipment manufacturers (OEMs) and end-users, processing huge quantities of sales and earning a slim margin. This may not sound like a great business model, but a good distributor performs a valuable service and can make decent returns on capital.

The IT equipment manufacturing industry is fragmented, and OEMs can produce thousands of separate products. They typically want to sell them in a wide range of retail stores as well as to many thousands of corporations small, medium and large. A distributor specialises in selling to these customers, providing a 'one-stop shop' for the OEMs to get their products to market. Esprinet has some 36,000 customers, to whom it markets 75,000 products from 700 OEMs. Most of those customers are small businesses (including resellers), but a sizeable minority of sales goes to retailers such as MediaWorld and Unieuro.

Reported operating margins look perilously thin, at less than 1% - but they are not what they seem. Esprinet books as revenue the entire value of each item it sells, subtracting the price it paid for the item as cost of goods sold. If, instead, we consider the company's revenue to be the commission it earned (rather than the value of goods distributed) its operating margin is more like 20%.

One potential concern with distributors is that they might end up with piles of unsold inventory if a certain product doesn't sell in line with expectations. Industry convention, however, generally sees OEMs taking back poorly-selling stock rather than forcing the distributor keep it, as they are dependent upon one another over the long run and don't want to encourage fire-sale pricing. Customer risk is mitigated as a significant chunk of their sales are factored (meaning they sell the invoice to a bank for an almost immediate payment, less a fee), or credit-insured. For in a business with such a high rate of asset turnover, tight working capital management is crucial. After-tax ROCE is about 8%, which the CEO targets to increase to 12% through working capital initiatives (rival Tech Data manages 14%).

We believe the reasons for Esprinet's low valuation include its low liquidity and listing in Italy, as a well as misconceptions about distribution as a business model. There have also been some industry-specific clouds, which we think are clearing. Europe's two largest IT distributors are the American firms Tech Data and Ingram Micro. Ingram Micro was bought out in 2016 by spendthrift Chinese conglomerate HNA Group. Under new ownership, Ingram Micro upset the market, bidding aggressively low for new contracts and generally depressing industry margins. With HNA now looking to pay down debt by putting assets up for sale, we understand Ingram Micro has returned to rationality. Apollo's recent acquisition of Tech Data might be seen as an endorsement of this view.

On our estimate of €45m in 2020 normalised free cashflow, even after a more than 60% rally, Esprinet trades at an 18% FCF yield.

Palm Harbour Capital LLP
12 Hammersmith Grove
First Floor 117
London, W6 7AP, UK
info@palmharbourcapital.com

JOST Werke AG (JST GY)

Jost is a German manufacturer of components for trucks, trailers and agricultural vehicles. Jost's main products are fifth wheels (the metal disc on the back of a truck's tractor unit that the trailer slots into) and landing legs (retractable legs that support a trailer when not attached to a tractor unit). Jost has over 50% global market share in fifth wheels and landing legs and competes with only one or two rivals in most regions.

These are not particularly pricy or sophisticated pieces of equipment, but their reliability is foremost in the mind of the buyer. The fifth wheel is what keeps the 5 ton tractor and its 35 ton trailer hitched together. At 60 mph a failure could have dire consequences. The price of a fifth wheel (€500) or landing leg (€200) is low compared to the price of a truck-trailer (€100,000) and even compared to the cost in time wasted replacing a failed component.

Fifth wheels and landing legs take a lot of abuse and, while tough, need to be replaced periodically. Jost has developed a global distribution network so that its well-recognised brands are available at any truck parts dealer a driver may find himself at following a breakdown. Aftermarket sales are significantly higher margin than sales to OEMs (Jost's fifth wheels are the default choice on trucks built by every major OEM but Navistar). Market share gains at the OEM level in recent years are flowing through into an increasing proportion of aftermarket revenues, which stand at around 25% today. Asia is still a smaller region in terms of sales than Europe and North America, but recent safety-focused regulatory changes in China have boosted demand for Jost's products.

The company's operating leverage is low for a manufacturer, as it buys in its metalwork pre-forged and simply performs the assembly and distribution itself. This provides resilience in tough times: in the financial crisis its adjusted EBITDA margins (10 year average: 13.7%) did not drop below 13%. This makes us relatively relaxed about the impending truck production slump: OEMs forecast an average volume decline of 30% in North America and 10% in Europe in 2020. With mostly variable costs Jost is able to be quite responsive to demand declines, although it will be less affected than the OEMs because of its aftermarket exposure. We may see revenues decline this year but margins will almost certainly rise, and the working capital release would be expected to benefit free cashflow.

In December Jost announced the acquisition of a manufacturer of agricultural front-loaders, increasing the group's revenues by a quarter. It seems like a reasonable business to us but we have some concerns over the price paid of 10x EBITDA and the danger of 'diworsification' of the product portfolio. Nevertheless with the company trading at a 12% FCF yield on our normalised 2020 forecasts, we remain comfortable owners.

Compagnie Industriali Riunite SpA (CIR IM)

CIR is controlled via Cofide (COF IM) by the de Benedetti family. The company was founded in 1976 by Carlo de Benedetti and is a holding company which owns three companies: the unlisted KOS, and the listed GEDI and Sogefi. It should be noted that the company has a history of building businesses and selling them - such as Finanza e Futuro (now part of Deutsche Bank), Omnitel (now part of Vodafone Italia) and Infostrada (now part of Wind Group). One notable failure is that of Sorgenia, a utility that was written off in 2014 when Italy was in recession. Post-merger it will be owned 29.8% by Fratelli de Benedetti SpA, which is owned by Carlo's three sons: Rodolfo (CIR/Cofide's Chairman), Marco (GEDI's Chairman) and Edoardo (not involved in management).

The company is currently undergoing a merger between CIR and COFIDE, which should reduce costs, increase liquidity and increase visibility in the market. We believe that the merger might increase sell-side coverage and prompt brokers to assign healthcare focused analysts instead of auto analysts. It should also increase the weighting of CIR in various indices, which could help given the passive money flowing about.

In addition to this change, one of the three major assets, the listed newspaper/media company GEDI (GEDI IM) is being purchased by EXOR (EXOR IM) at a fairly decent price. This reduces the holding company to two companies as well as a large pile of cash/funds/real estate. We think the holding discount can be eventually eliminated if the other listed asset is merged or disposed of.

Their largest holding is a 59.5% stake in KOS, an Italian nursing home, rehabilitation centre and hospital management company. The remaining 40.5% is owned by a fund of the Italian private equity group F2i.

KOS makes most of its money from the operation of care homes and rehabilitation clinics for the elderly and psychiatric patients, with the remainder coming from clinical outsourcing and the management of a public hospital near Mantua. It operates over 8,000 beds at 86 facilities in Italy, making it the largest player in the sector. With an aging population and the longest life expectancy in Europe, Italy's demographics provide a tailwind to care home operators. Italy has only half as many elderly care home beds per capita as the EU average. Whilst cultural factors go some way to explaining this, we feel comfortable this market is not at a near-term risk of oversupply.

In summer 2019 KOS announced the purchase of Charleston Holding – a 47 care home chain with 4,050 beds in Germany. The deal, representing its first foray abroad, was a major acquisition for KOS, increasing the number of beds in the group by 50%.

Sogefi (SOG IM), 56.7% owned by CIR, is a supplier of car parts with a focus on suspension, filtration and cooling applications. Sogefi has a diversified range of carmaker clients and is in the process of relocation production plants to lower-cost jurisdictions.

GEDI, which is 45.7% owned by CIR, is an Italian newspaper company whose main publication is *La Repubblica*. GEDI has long been the most structurally challenged part of CIR, so it was well-received when in December EXOR agreed to buy all but 5% of CIR's stake for a net cash-in to CIR of c.€90m.

After including liquid assets of €214m as well as €67m of private equity, hedge funds and real estate and subtracting holding costs, we have a post-merger SOTP of 1.05 for c. 105% upside.

Aryzta (ARYN VX)

"If you ever run into an investor who is shocked at the slow and choppy rehabilitation of a business's problem child, congratulate them on their first week on the job."
(*BANOR SICAV – North America Long Short fund, 1Q18 report*)

Aryzta is the global market leader in par bakery, a technique whereby fresh bread is cooked 80% of the way and then deep-frozen to be finished/reheated at the premises of a restaurant or supermarket. Think Subway sandwich bread or any large retailer that claims to have freshly baked goods in store. They are a leader in supplying McDonald's fresh buns in Europe and the US and have a catalogue business aimed at restaurants called Food Solutions. They specialize in breads, buns, cookies, donuts, breakfast sweets and breads, and laminated dough. They serve large quick service restaurants (QSRs, 29%), food retailers (33%), convenience stores (10%) and other foodservice (28%). Their sales are 50% Europe, 41% North America and 8% rest of world with over 50 bakeries.

In theory, this should be a good business. While bread appears to be a commodity, quality, innovative product and excellent distribution are not. Scale in manufacturing and strong regional distribution is key. No mom or pop shop can supply Tesco or Kroger nationwide. Bakeries have high fixed costs and capacity utilization makes or breaks profitability. It makes little sense to build a new large-scale par bakery unless you have the contracts in the region to fill it. Of course, getting the contracts without a facility is tough. Very few players can reliably deliver high quality product to demanding clients such as McDonald's day-in and day-out from dedicated plants with exact specifications with extremely high food regulations and health and safety protocols.

The company historically had high and stable margins, able to pass through raw material inflation, with subsequent strong returns on tangible capital and cash flows. The market growth in bread was low at GDP levels of 1-2% but within that par baking was taking share from fresh baked.

Given the stable nature of the business (and poor incentives), prior management went on a debt-fuelled M&A binge and bought anything that resembled a bakery (and some things that didn't). This cumulated in the purchase of Picard, a French frozen foods retailer, which put them in competition with customers. They doubled down on this strategy by trying to launch B2C products, despite their customer base being entirely B2B – putting them at odds with their client base. To top things off, they did a major SAP implementation (which in the history of the world has never gone to plan), an SKU rationalization plan and a major capex plan. They consequently dropped the ball completely on operations and lost their focus on clients - many of whom were upset as they found themselves sole-sourcing from Aryzta. As contracts came up for renewal, they began to lose a few. A couple of their clients built bakeries in response, to insource. From our understanding, in-sourcing for these clients may make a bit of sense for very specific reasons but generally doesn't go well as retailers are not manufacturers and they run up across a plethora of problems.

After the share price tanked, a new Chairman with a reputation of dealing with crises came in and fired management. However, there was a vacuum for almost a year before a new team came into place during which employee morale tanked further. As the new team formed, the company was hit with a perfect storm of problems. One of their bakeries in the US was found to have hired illegal immigrants indirectly through an agency just as Trump became president. Shortly after, that same plant served clients who were quite upset that Aryzta was entering the B2C market and pulled their business. This was followed by a spike in butter and grain prices and then, for the first time in a long-time, wage inflation in the US, especially among truckers and blue-collar staff.

While any one of these issues was likely surmountable, all of them within the space of a few months was toxic to a company with a large debt pile and grumpy customers.

The company refused to explore strategic options and instead forced through a large equity raise against major shareholders' wishes. After wiping out shareholders, management launched a turn-around plan to rebuild their lost margins and attempt

Palm Harbour Capital LLP
12 Hammersmith Grove
First Floor 117
London, W6 7AP, UK
info@palmharbourcapital.com

to re-enter growth mode. We are now in the fourth(?) inning of that turnaround plan. It has not been straight forward. Management's credibility is low given their track-record of overpromising and under-delivering (despite repeatedly saying they were doing the opposite).

This is a classic turn-around situation. If the company can stabilize the top-line and return margins to industry averages, there is significant upside of 150%. If the company can grow the top-line and return to historical margins similar to that of other regional leaders, the upside is more than 300%.

Of course, the company still has debt, it hasn't shown it can stabilize the top-line, especially in North America, food trends might be against carbs and sweet baked products and it will likely take time to fill excess capacity and make their clients feel valued again.

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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 found worldwide by any financial institution 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.

We appreciate your support over the past year.

Yours faithfully,

Palm Harbour Capital

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