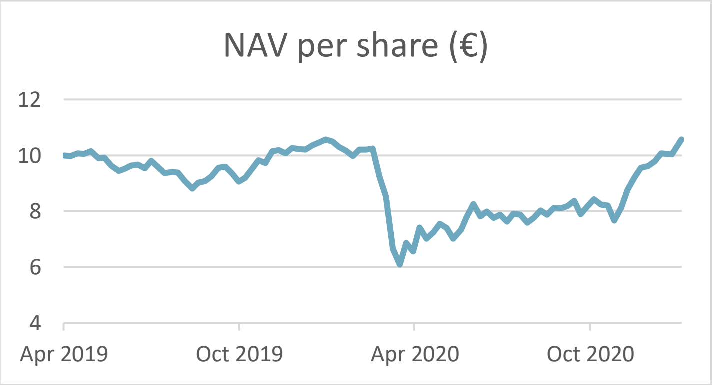
PALM HARBOUR CAPITAL

Dear fellow investors and friends,

During the fourth quarter of 2020 the fund gained 23% gross of fees[1]. We do not have a stated benchmark in our Key Investor Information Document (KIID) and therefore cannot comment on relative performance. We leave it up to you to decide. We would note that to us the above number appears much better than European and global benchmarks. However, while the Palm Harbour Global Value Fund posted a good quarter, this performance was not enough to make up for the first quarter's results and we ended the year down 2.9%. Our fund's composition is unlike any index and we are unlikely to perform in a similar manner.



What a difference a quarter makes! Or at least a handful of days within a quarter. We wrote in our last letter that we were optimistic in the mid-term that human ingenuity would bring a vaccine or other solution, but that we were likely to see some dark days this winter. We found the October sell-off somewhat odd (the fund was -5.96% for the month), as we had assumed winter would naturally see an increase in cases and thought that was well known. But just as despair set in, the holy grail was apparently found. Ben Graham's Mr Market surely is a manic depressive.

[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.

The popular market narrative confuses us and appears to now be: the currently suffering economy will improve greatly in the second half of 2021 and see "global synchronized growth". Therefore, it is obvious and imperative that lots of stimulus is needed now to make things better more quickly. Stimulus is defined as politicians (and central bankers) handing out as much cash as they want, to whomever they wish, sans any obligation for repayment. Expectations of stimulus and in many areas increased taxes and regulation, will stoke inflation. This is, in turn, somehow good, not only for the economy but *drum roll* also value stocks. We haven't heard commentators say much positive about value stocks in years and find it amusing what they now seem to think is positive for them. Interest rates, however, should remain low despite it all. This all combines in an idyllic goldilocks scenario where valuations just don't matter, especially for <insert name of your favourite retail heavy, call option traded, fad stock here>. The narrative continues: buy every IPO and SPAC you can find (especially those run by fraudsters and charlatans) because they are asymmetrical bets.

That is a lot of get your head around. It sounds like many diametrically opposing forces combining to become magically bullish for equities. But hey, stimulus checks will go into Robinhood accounts and push the garbage higher, right?

We thought we were seeing the start of the bubble bursting in revenue-less and profitless companies and increased interest in undervalued and overlooked names in the fourth quarter. This seems to have been short-lived as growth-at-any-valuation and retail investors push absurd fad stocks even higher. Whilst we cannot predict when the day of reckoning will come for the current valuation bubble, one thing we can agree on is that this should be a good year for value stocks[2] and our portfolio. Despite a fear of eventual impacts of high levels of debt, asset bubbles and financial repression on the markets and our society, we remain confident that a portfolio of high-quality companies trading at low multiples to robust cashflows will generate strong returns through the cycle.

Whilst the vaccine news was the overriding theme in the portfolio during the quarter, there were other idiosyncratic events and encouraging earnings reports as well.

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The largest contributor during the quarter was RHI Magnesita, the refractory company introduced in our second quarter 2019 letter, which gained 43.6%. The recent strong

[2] We remind our readers that our definition of value stocks is not the same as index providers. We do not simply mean low multiples of earnings or book value but rather high-quality companies trading at low valuations to their cashflows relative to their growth expectations.

trading update, reinstated interim dividend and share buyback have led to a bounce. We look forward to the next couple of quarters where we expect a further re-rating of the shares as restocking takes place and demand returns to their end-markets. RHI ended the year with a small loss for the fund and remains the fund's largest position.

The second largest contributor was Befesa, the steel dust recycling company introduced in our third quarter 2019 letter (+51.8% during the quarter). The company was able to maintain guidance and pay the remainder of the full year dividend as steel dust volumes remained robust due to limited downtime at the electric arc furnaces it serves. The company further benefited by locking in high zinc prices with hedges into the first quarter of 2023, providing decent visibility. It looks likely that 2020's abnormally high zinc treatment charges, which Befesa pays to smelters, will fall in the 2021 contract negotiations as spot prices remain significantly below the current contract value. If you add to these factors its ESG credentials and the progress made in its Chinese greenfield growth projects, Befesa is finally beginning to rerate as it is perceived as less cyclical, growing and more environmentally friendly. It ended 2020 as the sixth largest positive contributor and fourth largest position of the fund.

The third largest contributor was OCI NV, the nitrogen fertilizer and methanol producer, introduced in our second quarter 2019 letter (+43.3%). Nitrogen fertilizer prices remained strong during the quarter. Demand was aided by large Indian tenders and a strong Brazilian market whilst supply was muted due to high costs for marginal Chinese exports and a robust Chinese domestic market. Healthy crop prices should fuel continued demand heading into the 2021 planting season. Methanol prices also rebounded sharply on curtailed supply and strong industrial demand. We believe these trends should continue allowing OCI to de-lever quickly, which will greatly benefit the equity. While it was the sixth largest detractor in 2020, we believe it is likely to be a large contributor in 2021. OCI ended the year as the second largest position.

The fourth largest contributor was Esprinet, the Italian electronics distributor introduced in our fourth quarter 2019 letter and been mentioned as a top contributor in our second and third quarter 2020 letters. The stock was up another 42.6% following robust third quarter results with revenues up 24% and adjusted EBITDA up 76% over 2019. It also made two small acquisitions and settled an outstanding legal dispute. Esprinet gained 108% for the fund in 2020 and 230% since inception of the fund in 2019. When we first purchased the stock it traded below net working capital and was off the radar for most investors – even in European small caps. CEO Alessandro Cattani has done a tremendous job in refocusing the company to deliver profitable growth with a focus on return on capital, working capital management, lowering debt and shareholder returns. Esprinet ended the year as our top contributor and third largest position.

Fifth is International Game Technology, the lottery operator and slot machine manufacturer introduced in the first quarter of 2020, up 45% in euro terms (more in dollars). The company divested its Italian gaming and betting business to Gamenet SpA for €950 million. Long-time readers might recall that the fund owned Gamenet (introduced in our second quarter 2019 letter as a core holding) prior to it being bought by the private equity firm Apollo. The deal will likely lead to a higher multiple for IGT as it lowers perceived Italian government risk, lowers B2C (including retail shop) risks and focuses the business more on lotteries and back-end software solutions. IGT ended the year as the sixth largest position and sixth top contributor to the fund.

Sixth is MTU Aero Engines, the aircraft engine manufacturer introduced in our second quarter 2020 letter, up 50% during the quarter. Whilst the company hosted a capital markets day and reported third quarter earnings, the main driver was clearly the vaccine news and the hope to a return to "normal" flying patterns in the years to come. MTU ended the year as the 11th largest holding and second largest contributor to the fund.

Seventh is Avid Technology, which we will introduce later in this letter, up 77% during the quarter. The company benefited not only from the vaccine news but also progress on its business model transition and positive cashflows. Although the company was unfortunately never a significant position, the 102% return since purchase in the third quarter led it to be a top 10 contributor in the year.

In addition, the fund gained during the quarter due to its exposure to UK bricks, oil and gas, hotels, trucking and rail supplies.

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The only significant detractor was Bayer AG down 9.7% in the quarter. We mentioned in our previous letter that the shares had performed well in the second quarter on the back of a potential settlement in glyphosate litigation. The shares then sold off during the third quarter as the judge asked the parties to renegotiate certain points. The stock then sold off again early in the fourth quarter as it issued a profit warning for the Crop Science division for 2021.

We pointed out in our previous letter the incongruity in Bayer issuing a profit warning due to crop prices at a point when corn and soybean prices were rallying. That trend has continued apace, with prices reaching their highest levels since 2014, driven by constrained supply and by strong demand from China as it rebuilds its herds following a devastating bout of swine flu. This should leave US farmers flush with cash, encouraging them to plant more acres of Bayer's seeds (and lay down more of OCI's fertilisers and buy more of Jost's tractor parts). As mentioned on the other two factors for the early 2021 profit warning, Brazilian farmers are similarly flush with dollars and local input pricing will adjust for the real depreciation. The EPA approved dicamba for another five years in October and while we are uncertain how markets will play out in the 2021 soybean season; we are confident Bayer should be able to hold its own.

We had two very small detractors during the quarter. One was Gamesys, a Covid-19 beneficiary that we have held since launch. We still consider the online bingo operator to be inexpensive, and capable of growing even without the assistance of lockdowns. The other was our euro cash position, which earns a negative interest rate.

Outside of stock performance, we had some substantial foreign exchange movements. The fund lost mark-to-market 0.67% in the fourth quarter and 2.43% during the year, primarily due to the strength of the fund’s base currency, the Euro versus the dollar.

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Treasure ASA is a Norwegian-listed investment vehicle controlled by Wilh. Wilhelmsen Holding ASA (WWI NO). Its sole investment is a minority stake in Korean-listed Hyundai Glovis (086280 KS), a car shipping and logistics firm. During the quarter, the shares of Hyundai Glovis were up 38% in USD terms on the back of perceived improvement in demand for cars produced by Hyundai Motor and Kia Motors and a mothballing of industry shipping capacity on the supply side. Hyundai appears poised to benefit from the coming boom in EVs, particularly with a leading position in Fuel Cell EVs and rumours of a potential partnership with Apple. The Hyundai group will likely clean up its convoluted ownership structure and Hyundai Glovis is one of the few companies in the group that the controlling family actually has a significant stake in. We think this might be beneficial to how the group is structured in the future. Treasure took the opportunity of the share price run-up to sell 1.04% of its stake (taking it from 12.04% to 11%) for approximately US$62.5 million, which will likely be paid out to Treasure shareholders. Treasure ended the year trading at a 38% discount to its stake in Hyundai Glovis, with over 13% of its market cap in cash.

Aryzta, the distressed bakery company introduced in the fourth quarter of 2019, had a busy quarter. After its EGM in September that replaced the board leadership, December saw the rumoured bid from Elliot Advisors at CHF0.80 materialize and an AGM, which saw further board changes. The new board swiftly rejected Elliot’s bid and announced a new strategic direction, with a focus on turning around the European business whilst making the North American unit available for sale. The company also announced the sale of its North American pizza business and its remaining stake in French frozen food retailer Picard. The fund owns junior debt in Aryzta, which was up 13%, and equity, which was up 12% during the quarter. The fund’s combined stake was roughly 2.9% at the end of the year.

As mentioned in our previous letter, we had a small position in a company active in the sports rights management business. The controlling shareholder proposed to take the company private. We felt that the offer drastically undervalued the business and that they were taking advantage of the Covid-19 situation to buy the shares on the cheap. We wrote to the independent members of the board laying out our qualms and hoped to receive an improved offer. The independent board did follow some of our suggestions, and we were even mentioned in SEC filings:

“the Independent Board Committee discussed with its advisors, among other things, certain shareholder inquiry letter that they had received regarding the Proposed Transaction and instructed Houlihan Lokey to review the inquiry letter and take into consideration any reasonable suggestions from the shareholder when conducting its financial analysis on the Company.”

The “independent” advisor hired to value the company, Houlihan Lokey, surprisingly ended up with some of the financial projections we did. We had very similar free cashflow and enterprise value calculations. They even pointed out that other Covid-affected stocks were all up significantly since the offer was made. However, despite this, they still recommended the offer as fair – apparently buying a growing business for 6x free cashflow from minority investors is reasonable. We wish they would offer to sell us competitively advantaged growing businesses for 6x free cashflow. In the end, the offer was improved by a measly 5 cents and we sold with a small loss and moved on with lessons learned.

During the quarter, we exited two small positions, including the above-mentioned company and added two small positions, Melco and a German property company invested in offices and hotels.

At year-end, our portfolio had 104% upside to NAV, a weighted average
P/E of 9x, FCF/EV yield of 14%, return on tangible capital of 28%, net debt/EBITDA of 1.3x and traded at 9x EV/EBIT.

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Avid Technologies (AVID US)

Avid Technology (‘Avid’) is a software company that develops and sells tools for long-form video editing and music production. If you watched a Hollywood movie or even a TV show over Christmas, chances are it was produced using Avid’s video editing suite. Avid is a technology company undergoing a transition from hardware and software sales to software-as-a-service (SaaS). Its decades-old model of selling editing control panels and servers bundled with perpetual software licences had begun to look increasingly outdated. In common with many other software companies, Avid began a couple of years ago to encourage its users to switch from buying perpetual software licences to paying a monthly or annual subscription fee for a product that is constantly updated. The SaaS approach can yield stickier, more predictable cashflows but only works if a product is indispensable to the customer. Avid's 'non-linear editing' software checks this box, being considered the gold-standard by generations of TV and movie editors in Hollywood and around the globe. They are trained on it from the start of their careers, become familiar with its layout and functions, and particularly value its capabilities in allowing numerous editors to work on a project simultaneously. The value lies in the ingrained habits of the video editors, who typically specifies to a producer the editing tools he wants to use. In this era of increased remote working, that has boosted the product's appeal further versus its main rival, a product of Adobe's.

Previous management had disappointed investors continuously with a number of accounting restatements and earnings misses. The current CEO, however, has begun to earn the market's respect. Under his tenure, which began in the first quarter of 2018, the company has focused on its SaaS transition and has boosted recurring revenues from 50% of total revenue to 71% in the most recent quarter.

After Avid's third quarter results, released in late October, the market began to give credit to the turnaround, which manifested itself in improving gross margins and strong free cashflow. Up to 60% of the cost cuts taken in 2020 are expected to continue into 2021, putting EBITDA margins into the 20s. This improvement has allowed deleveraging from above 3x net debt to EBITDA to 2.7x at the 30th September balance sheet date. At the start of the new year the company refinanced its debts, taking out an expensive credit facility with a much cheaper term loan and reducing its effective interest rate by 450 basis points from 7.75% to 3.25%. This equates to a saving of about $10 million a year, increasing our estimate of normalised free cashflow by 20%.

We purchased a starter position in the company's stock during the third quarter at around $7.66 only to see it quickly rerate. It ended the year at $15.87.

Melco International Development Limited (200 HK)

Melco International (200 HK) is a Hong Kong-listed holding company whose main asset is a 54% stake in New York-listed casino operator Melco Resorts & Entertainment (MLCO US), 'Melco'. Melco's operations are focused on Macau, where it is one of just six companies with a concession to operate casinos. Melco has three casinos and earns 87% of its EBITDA in Macau, which is the only place in China where gambling is permitted. Given the limited supply of rooms in the city-state and a huge number of potential customers, hotels there typically operate at 100% occupancy year-round. Two of Melco's Macau casinos account for the bulk of its EBITDA, with the 2,170-room City of Dreams resort generating over US$920 million in 2019 and the 1,600-room Studio City resort a further US$415 million. Studio City is in the process of adding a further 900 rooms at a cost of US$1.3bn. The other significant casino in the group is a resort in Manila, which provided Melco US$150 million of EBITDA in 2019.

Melco has a new project under construction in Cyprus, which is set to be Europe's largest casino resort. Costing US$600 million to build, the casino has a 30-year concession and for the first 15 years of that will hold a casino monopoly. We estimate the resort could generate $90 million of EBITDA by 2023.

We started looking at Melco back in 2019 when the debate was focused on the uncertainties of concession renewal in 2022 and the protests in nearby Hong Kong. It is still not known what terms Macau's government will seek to impose on concessionaires, but the impact of Covid-19 has made a simple extension of the status quo for several years look like the most likely outcome today.

We did not invest at the time, but we returned to the stock in 2020 following the almost complete travel ban imposed by the Chinese government in response to Covid-19. Gross gambling revenue, or GGR (the industry's favoured top-line metric, which consists of the net amount of wagers kept by the casino after customer wins are paid out), fell almost 80% in 2020 as a whole. Some improvement was seen through the year, with December's GGR being down 65% year-over-year, but any recovery is entirely dependent upon China's willingness to permit its citizens to travel to Macau.

Melco Resorts' net debt of US$3.6 billon stands at 2.4x its 2019 EBITDA, and it is not currently burning significant cash. The company said in November it expects to breakeven at the EBITDA level when the GGR run-rate is in the mid-to-high twenties per cent of pre-Covid levels. Macau's government reported December GGR at 34% of prior year levels.

We are confident that Macau will retain its allure to Chinese gamblers, and that as soon as they are allowed to return, they will. We are talking about a market of almost a billion eligible adults in China, not to mention those from other countries in the region curious to experience the thrills of Asia's Las Vegas. Our projections indicate Melco Resorts can earn US$1.4 billion in normalized free cashflow for 2023. On today's market cap of US$7.9 billon this represents a 16% free cashflow yield. But that's not all. Buying via Melco International, which trades at a 20% discount to the value of its stake in Melco (adjusted for holding company net debt), gives us a comfortable margin of safety.

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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

Our fund is being offered as part of a Spanish pension value-orientated fund of funds. If interested in investing through a Spanish pension scheme, please contact us.

We appreciate your support over the past year.

Yours faithfully,

Palm Harbour Capital

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