MILKWOOD
CAPITAL

Q1, 2017 Letter 16 April 2017

To our partners in the Milkwood Fund,

To 31 March 2017 (US$):	**Milkwood Fund**	**MSCI ACWI**
Trailing (<u>Gross</u> of fees)	%	%
1Q, 2017	7.3	6.9
Compound annualised returns since inception		
Gross	14.1%	5.0%
Net (Class A)[1]	12.9%	

Net Annual Performance after all fees (Class A in US$):	Milkwood Fund %	MSCI ACWI %
2016	31.0	7.9
2015	2.8	-2.4
2014	3.4	4.2

The Milkwood Fund generated gross returns of 7.3% in Q1 2017. So far, so good. For Class A, our largest share class, this was a net return of 6.5%. Class D returned 6.3%.

Quarterly returns are meaningless, but it's worth highlighting that this performance came despite my best efforts to destroy value – we have been short or market neutral for most of the year, believing that US large company valuations are excessive and it was appropriate to limit our risk. This mistake (so far) on my part has cost us about 2%.

1 Please refer to your relevant statements for performances by share class. Includes voluntary fee refund in 2014.

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Three investments are worth talking about:

- John Menzies PLC – our largest holding
- Locamerica – an investment we have almost exited, and
- Constellation Healthcare – a special situation.

John Menzies PLC

Menzies remains our largest investment. Fortunately, it continues to perform both operationally and structurally ahead of our expectations.

Operationally, it's most recent results indicated strong progress in the existing aviation services business (growing 9%). The new ASIG acquisition provides further reason for optimism – so far its integration is going better than expected, although it's early days.

Menzies remains undervalued. Here is a world-class company in aviation services, with a valuation of c. 11x FY18 earnings. Margins are low overall (just 3.9% in aviation services), but what is lost in this number is the major impact of some low/no margin business in the UK and South Africa. As the new management and board gain confidence, these margins should comfortably reach over 5% – driving profitability further.

And now to the structure….This is also being addressed ahead of schedule. The appointment of a new Chairman in 2016 – Dermot Smurfit – has injected some common sense into the Menzies boardroom. At the end of March 2017, it was announced that two key issues are being positively addressed. 1) the pension fund and 2) the potential merger of Menzies Distribution with DX, a listed entity. I feel confident that this will result in the true value of Menzies Aviation being unlocked.

Menzies continues to justify its position as the largest investment for Milkwood.

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Constellation Healthcare

In November 2016, an offer was made to acquire Constellation Healthcare (CHT) – a company listed in the UK, but with operations mostly in the US. The then shareholding of CHT was mostly the company founder and management, plus some UK institutions. The offer price in total was US$3.36 per share. So far, so good.

Absurdly, the share price of Constellation Heathcare did rally on the news but then proceeded to hover at around £2.10, or about US$2.65. The deal had very little chance of failure, as management wanted it voted through and they were the largest shareholders.

So why the gap?

You see, the offer price would be paid in two parts – a cash amount of US$2.93 per share, and a promissory note yielding 5% and maturing in 7 years, which made up another US$0.43 of the offer. As most UK institutions could not own the promissory note (because of their portfolio restrictions), there were very few buyers of CHT, besides Milkwood.

For us, buying CHT at a discount to the cash we would receive was a mental hurdle we could comfortably step over. Subsequently, we received the cash as well as the promissory note (which we have discounted at a fair rate in our portfolio valuation to reflect the tenor and credit risk). This deal contributed about 2% of performance in Q1 2017.

We are constantly on the look-out for special situations to deploy our capital, and when general market opportunities are few, they can make a meaningful contribution to performance. Our fund can take advantage of these mispricings because:

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1) Milkwood will be around in some form in 7 years
2) Milkwood is small, so what is just a rounding error for an institution can be a material investment for us
3) we make decisions quickly, without institutional baggage.

Locamerica

In our September 2015 letter, I wrote:

"Locamerica released strong results in August, but could not escape the pressure from a fund being forced to sell it after it suffered from redemptions and margin calls. Brazil is currently a hotbed for all kinds of indiscriminate selling."

The letter continued:

"In earlier letters we made the case for the company to grow at the expense of weaker competitors in a high rates environment, and this has so far played out. Locamerica is trading on a p 6 P/E, with a tangible – and increasing – asset based worth nearly double its market value. We say increasing because its tangible value is made up of vehicles, which appreciate in Brazilian real as the currency depreciates."

Perhaps more than any other investment we have made, Locamerica ticked all the boxes – extreme undervaluation, forced sellers, while the company was benefiting from its (tough) operating environment. From time to time a company is completely mispriced, where an unthinking seller is not concerned about the company's fundamental value. Buying into such scenarios requires clear thinking (what might we be missing?) and guts, but the rewards are commensurate. As we wrote in 2015, purely based on the value of the fleet, Locamerica was worth double of what the market was pricing it at. We took advantage and have now mostly exited this investment with well over a 100% return, in USD.

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Of course, not all our investments will have such a wonderful outcome. The ride is often uncomfortable. In fact, if it's too comfortable, I start to worry. Furthermore, I am sure that right now our portfolio has investments which will turn out to be mistakes. I can only hope that these are limited and that our winners will continue to more than compensate for our losers. As partners in the fund, please note this is a hope, not a guarantee.

The performance of markets as a whole is masking many issues which are currently not being priced appropriately. While this makes investing extremely tricky, we continue to focus our time on company fundamentals and we are finding interesting investment ideas, mostly in the UK.

As always, if you would like to discuss any aspect of the fund or our investments, please give me a call or pop in to visit us in Windsor.

Cordially,

Rhys

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