Third Quarter 2017 Investor Letter

23 November 2017

To our partners in the Milkwood Fund,

Cumulative net (A) returns in USD since inception. MSCI includes dividends.

To 30 September 2017:	Milkwood Fund	MSCI World
Trailing	%	%
6 months	-1.5	9.7
18 months	36.6	26.2
Two years	49.4	32.8
Three years	37.5	24.0
Compound annualised returns since launch (1/1/2014)		
Gross	11.5	6.9
Net (A)	10.5	6.9

Net Annual Performance in USD after fees (Class A):	Milkwood Fund	MSCI World
	%	%
June 2017	5.0	17.2
2016	31.0	8.8
2015	2.8	1.1
2014	3.4	2.3

In a recent meeting with a potential investor, I was teased for using "Buffett quotes" in our letters. So here is a letter with only one. The death of value investing is real!

Our message is - despite great performance in global markets, caution is warranted. The UK is possibly the one market where opportunities exist, versus an overvalued emerging market and US universe.

Take this analysis of the S&P1000 constituents. Market commentators will draw attention to the average P/E of the market being x, (pick a number between 20-26), without paying much heed to the actual opportunities available.
For example, there are (only) 39 stocks that trade below 10x earnings (out of 1000), and most of them are sporting disrupted, or worse, business models and are

uninvestable. This is borne out by their EPS declining by 20% year-to-date and poor share price performance.

85% of companies (weighted and unweighted) trade on P/E's greater than 15x. Of these, the 294 companies trading at between 20-30x generate the best performance.

P/E	Stocks	YTD performance	EPS Growth	ROIC
0-10	39	2.8%	-20.1%	5.4%
10-15	107	4.4%	2.3%	9.2%
15-20	201	7.2%	2.9%	9.5%
20-30	294	26.9%	9.1%	9.8%
30+	358	16.9%	18.4%	8.7%

Its clear momentum is driving stock performance. This is not entirely without merit. As business models get disrupted, companies can quickly become disastrous investments. This leads investors to flock, (or perhaps herd), to companies that won't "disappoint" – irrespective of valuation. As 2017 has progressed, this decision has been confirmed as being the correct one.

The more expensive the company, the better the earnings growth. And as you can't buy cheap companies, (earnings growth is poor, business models disrupted and well…they just aren't performing)…valuation discussions have become like a teen pregnancy at a convent – best not discussed. Far better to pay up for a "quality company"…or so they say.

All of this leads to the human tendency to interpret all new data as being supportive of your existing view, confirmation bias.

One of my favourite thinkers on behavioural issues is Dave Trott, the advertising guru. Here is an outstanding example:

Confirmation Bias
Confirmation bias is the tendency to interpret data as supporting your existing view.

> "In 1973, David Rosenhan was professor of psychology at Stanford University. He worried about the low standards of diagnosis across America. So he devised an experiment.
>
> He and a group of volunteers got themselves admitted to 12 psychiatric hospitals. Once inside they acted normally to see if they were correctly diagnosed as sane. The hospitals ranged from rural to urban, from

underfunded to private. Besides Rosenhan, the volunteers included psychologists and psychiatrists. To get admitted, they said they'd been having mild auditory hallucinations. Once inside they reverted to normal behaviour, to see if staff noticed they were sane. But not a single member of staff noticed they were sane. Whatever they did, the staff interpreted their behaviour as insane.

> When Rosenhan and the volunteers took notes, the staff reported it as "pathological writing behaviour". When they queued early for lunch, the staff reported them "exhibiting oral-acquisition symptoms". The staff refused to see their behaviour as sane. Eventually a team of lawyers had to step in to get the volunteers released from the hospitals.

> Even then, the staff wouldn't certify them as sane, just "in remission". <u>No matter what the evidence, they would not accept the volunteers were sane.</u>

> These findings were reported in the journal Science. Soon after, a famous teaching hospital said it would be impossible for *their* staff to be fooled. So David Rosenhan issued a challenge. They would see how many of his fake patients the hospital could spot over the next three months.

> At the end of that period the hospital had vetted 118 patients. They spotted 41 fakes, and another 42 suspects. But David Rosenhan hadn't sent a single fake patient along during that period. So the hospital was classifying genuinely ill patients as sane. Previously, the hospitals couldn't spot sane people when they were looking for insane. Now they kept spotting sane people where there weren't any.

And here is the point…

> What we would call Confirmation Bias had taken over from the ability to think. Confirmation Bias is when we can't evaluate results objectively. We can only use those results to confirm whatever findings we're looking for.

And that is the issue with so many companies we look at. Rather than question what might go wrong, the market has become accustomed to asking – and believing – what might go right.

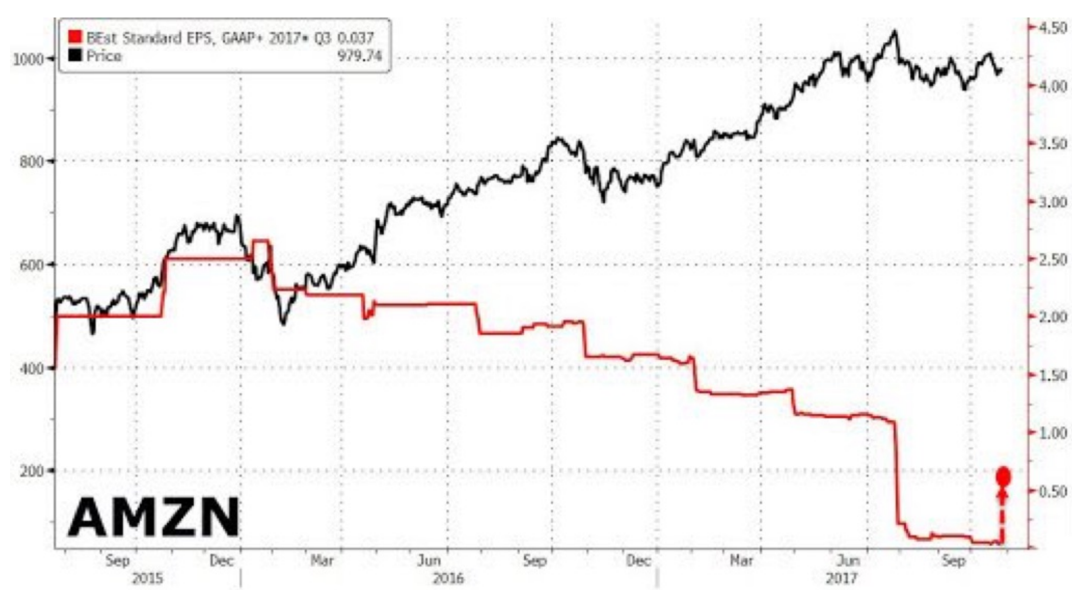
Amazon is a good example. Despite what long-term investors in Amazon might say, no one could have predicted the performance of AWS back in 1995 when Amazon listed. But, somehow, Amazon has been in the right place and executed. As an 87 year-old, sitting in Omaha, Nebraska said earlier this year:

He (Jeff Bezos) has been the CEO almost simultaneously of two businesses starting from scratch. Andy Grove at Intel used to say "if you had a silver bullet and you could shoot it and get rid of one of your competitors who would it be"? I think that both in the cloud and in retail, there are a lot of people who would aim the silver bullet at Jeff … And we missed it entirely. We never owned a share of Amazon… I was too dumb to realize what was going to happen. I admired Jeff, but I did not think he'd succeed on the scale that he has, and I didn't even think of the possibility that he'd do the things with the cloud services. I never even considered buying Amazon.

We shouldn't be surprised when concepts like "Margin of Safety" and valuation discipline are replaced with a messianic belief that future endeavours will be successful.

What about taking the opposing view? Eradicate the confirmation bias and question what might go wrong. We see very little of that in today's world.

Here is a recent example from Amazon's 3Q 2017 results. Amazon's expected earnings a year ago were US$2. Over time, consensus earnings fell to US$1.50, and then all the way to US$0.05. The reported earnings came in at US$0.50, contributing to a 13% rise in the stock price on the day following results, (I stress "contributing" because Amazon is not an earnings story really, it's a revenue growth one. Of course, that will at some point need to change, and the bigger they get, the more investment dollars will be wasted - or utilised - as their hit rate will eventually fall).



MILKWOOD
CAPITAL

Portfolio Update

Barclays

One of our longest held investments has been Barclays. Our investment in Barclays has been a great example of "watering the weeds and cutting the flowers", to quote Peter Lynch. It's a flattering way of saying my decision to invest in it has been wrong.

The reason we have owned Barclays for so long is that it always seems to offer outstanding value. Right now, it is over 10% of our portfolio.

A series of own-goals, (appointing a US investment banker as the CEO is one), has resulted in Barclay's share price not following consistently improving fundamentals. Of course, we think the reasons for the poor share price performance are not valid, but rather a reflection of a market in love with confirmation bias and momentum – and clearly out of love with Barclays. But that changes.

The nub of the issue is summarised in the exchange between analyst and CEO on the 3Q17 results conference call. Here is the dialogue.

Analyst:

> *Well, I guess – I mean, if you look at Barclays, not just recently, but over sort of a number of years, I think it's fair to say that the sort of discount to book value is usually put down to too much capital being invested in a business where there's volatile earnings. And typically, you don't make your cost of equity through the cycle, in other words, too much equity invested in the Investment Bank.*
>
> *And I just wonder, firstly, do you agree with that assessment? And if you don't, you don't. But if you do, maybe you could sort of talk about where the market is wrong now? Is it failing to understand the opportunity that you're putting forward to boost returns by these various balance sheet optimization that you discussed or something else? I'm just trying to understand what your thought process is around the sort of overall CIB strategy, I guess. Thank you.*

Jes Staley (CEO Barclays):

> *In terms of the CIB in how one trades, what I would say, if you look at the U.S. universal banks there are the five largest banks now, they are all trading well north of book value. And, in most cases, they have investment banks that I would argue if you carve them out are generating high single-digit returns and account for a very significant percentage of their revenues and earnings.*

In fact, so people like Morgan Stanley [are] more levered into their investment banking platform than Barclays is, by quite some measure. And so, they are not being penalized to the degree of business that they've got. Quite the contrary, I think the market has gotten quite comfortable that the volatility of the U.S. banks is down significantly and, therefore, they are trading well north of book value.

<u>The main difference is they are, right now, returning 100% of their earnings in stock buybacks and dividends. And I think it's that return of excess capital that has very much driven a drop in their cost of capital and, correspondingly, where their stocks trade vis-à-vis book</u>. (Underlining added)

This is my final point. What's important about Barclays, I think, is to recognize where are we in the recovery of this bank post the financial crisis. This bank went into the financial crisis in 2006 with the second largest balance sheet in all of finance. And the restructuring, given the size of that balance sheet and the level of capital we had, has taken a very long time. And we only completed the restructuring of this bank a couple of months ago. <u>So, there is a difference in timing as to where the U.S. banks are versus where we are. I don't think it's a business model issue. I think it's a timing issue of the recovery. We've closed Non-Core. Now, we're focused on driving earnings and we have all the instruments at our hands to deliver the same level of earnings that you see coming out of the U.S. banks, and that's what we're going to do</u>. (Underlining added)

Explanation

Barclays investment bank generates low returns but sucks most of the capital. Here are the numbers.

- Barclays total tangible capital is GPB 49bn. Remember, we are paying GBP 32bn for it, (as it trades at 185p).
- Barclays' UK bank, (plain vanilla bank), generates a return of 18% on a capital base of GBP 9.4bn, (theoretically, this should justify a value of GPB 17bn).
- The investment bank generates a 5.4% return currently, but on a capital base of GBP 28.9bn. (This 5.4% return is influenced negatively by low volatility in markets, resulting in a decline in revenues of 30%. A recovery will increase returns to c.7.6%).

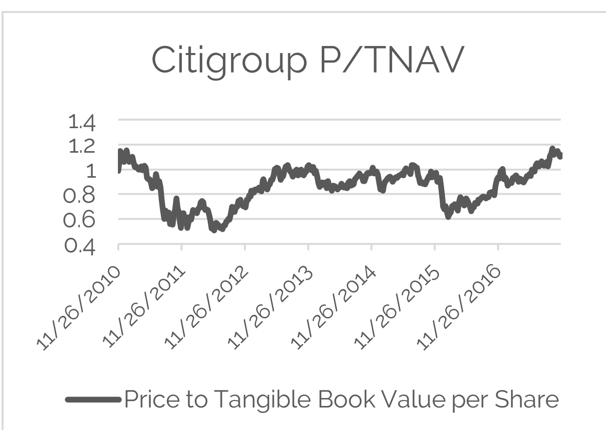
So what changes for Barclays?

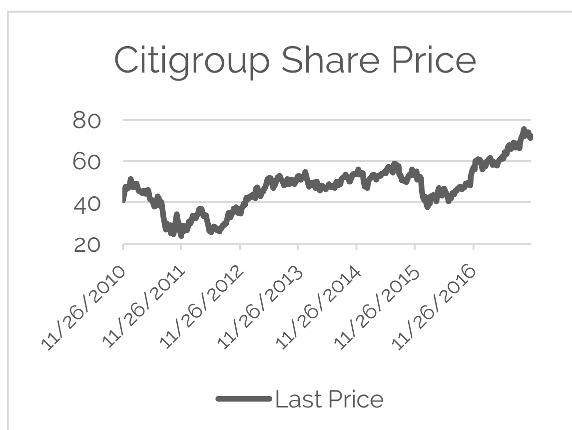
A year ago, we predicted that Barclays would sell its African subsidiary – Barclays Africa. This would strengthen its balance sheet – at that point the big worry for investors. It happened. The result is that now Barclays has excess capital at 13.6%, vs a stated goal of 13%. In other words, future capital generation is not needed to be retained by the bank.

We agree with Jes Staley. There are parallels between the US banks and their UK 2nd cousin Barclays. The big US banks operate across similar lines as Barclays - retail, commercial and investment banking. Although the nature of these "universal banks" are similar to Barclays, the capital returns are not. While US universal banks have been returning excess capital to shareholders via buy backs and dividends, Barclays has cut its dividend while it dealt with legacy issues, or the "bad bank".

We believe that is now over. In March 2018 Barclays will update the market on its capital return policy. It will most likely be a bank with excess capital and a return in 2020 of 10% of capital, which we think ends up back in the hands of shareholders. On a share price of 185p, that's a 15% yield.

Citigroup is a good example, (in which we participated). Below we show its re-rating to a premium to book value. This happened when Citi was allowed, (following a successful stress test outcome), to return 10% of its capital each year, via buybacks and dividends. Note the rerating from 0.5x to 1.1 p/book. A similar re-rating in Barclays would result in a share price of 280p, upside of 54%.





John Menzies PLC

We met with the management of John Menzies at its analyst day, held in London on 10 November 2017. The focus was the aviation division, which continues to execute well. Recall that in June 2017 Menzies walked away from a high-revenue-no-profit contract with Easyjet, operating out of Gatwick. This appears to have sent the right message - low margin contracts will not be renewed and don't make sense to service. We like this focus. And the strategy appears to be working. Recently, Menzies has won new contracts in the UK and Europe, with double digit escalations, resulting in higher margins.

In addition, the acquisition of ASIG, (the fuel stations for planes business), has gone smoothly. Anticipated synergies of GBP10.5m for FY17 will be exceeded. Further acquisitions can be made in consolidating the market. ASIG's revenue is very sticky – think of it as being similar to filling up at the gas station with only one option available to you.

However, since June 2017, Menzies share price has declined slightly. This is because of the failure to execute on the de-merger of the distribution division with DX. This weakness is an opportunity. Most likely, the distribution division will be sold or spun off during the early part of FY18.

The valuation remains compelling to at least GBP 10.50 per share (current price is GBP6.80). This is how I get to it.

- Aviation is worth at least GBP 1bn. FY18 EBITDA = GBP 91m on 11x (peers have been acquired by private equity at above 14x)
- Distribution is likely to be sold for at least GBP 100m (3x EBITDA). If I had the money I'd buy it at that valuation.
- Combined enterprise value of GPB 1.1bn
- Debt of GBP 220m
- Equity value = GBP 880m or GBP 10.48 per share, versus a current share price of GBP 6.80.

Menzies remains our largest investment.

Greencore

We continued to build our investment in Greencore at attractive prices. Firstly, there was a rumour that Greencore lost the contract with Starbucks in the US. This was untrue, but like all lies, those with a bit of truth in them seem to stick. The bit of truth was that Greencore stopped the supply of frozen products to Starbucks.

MILKWOOD
CAPITAL

Next, there was a listeria food scare, prompting a recall of egg sandwiches, (they taste awful at the best of times, no matter who makes them), and a 7% decline in the share price. At this rate, 14 more food scares and we can buy Greencore for 0p. We took advantage of the weakness and increased our holding in Greencore to 6% of the fund.

Connect Group

We acquired a stake in Connect Group. Connect is a logistics player in the UK, owning Tuffnells, (parcel delivery business), and a distribution business. The numbers are simply stunning. When we acquired Connect, it had a market value of GBP250m. It generates FCF of c. 50m annually, but we don't anticipate much growth, (although Connect management does). It pays out GBP25m of this FCF as a dividend – a yield of 10% (the dividend was recently confirmed in its latest results and a subsequent meeting with management suggests it's got legs to run for at least another 3 years).

What we find fascinating is that it has a debt facility of GBP175m, at a rate of 4%. This means that Connect could buyback its stock, effectively financing the repurchase 2.5x over with the dividend.

We have encouraged the company to think along these lines. In the interim, we are enjoying the 10% yield.

Santova

We have owned Santova since Day 1 of the fund, watching the market discover the value in a capital-light global logistics company. It ended up becoming a 3-bagger for us. Recently I made the decision to exit our investment as we have more attractive options available, with a different risk/reward profile.

Argent

In the table below, you will notice that the investment with the greatest upside (according to me anyway) is Argent. For now, you will have to take my word for it, but as soon as we have completed building our investment in the group, I promise to discuss my thinking and plans to execute, (quite literally, perhaps), on this investment.

Conclusion

We continue to own companies which are in absolute and relative terms - undervalued. In absolute terms, the valuations can all be justified based on old-fashioned thinking - such as earnings, cash flow, and assets.

Undervalued, by how much?

MILKWOOD CAPITAL

My valuation, (and although I can preface this by saying its conservative, it's open to biases I cannot control), suggests the portfolio is at the biggest discount to my, (again, biased), fair value since December 2015.

Below are our largest investments and my estimate of fair value for each - today and in 3 years.

		Estimated Fair Value		Upside	
	Current Price	Low	High	Low	High
Menzies	6.68	10.50	12.00	57%	80%
Barclays	189.25	280.00	400.00	48%	111%
Greencore	195.00	300.00	400.00	54%	105%
Argent	3.85	8.50	11.00	121%	186%

Keep score on how close we get to reaching these values. And feel free to debate them with me. We welcome the dialogue and look forward to discussions with our investors.

As always, thank you for your support, loyalty and patience. I feel extremely privileged, (and responsible), to manage your money along with mine and look forward to the value in our portfolio being reflected in market prices in future.

Cordially,

Rhys Summerton

MILKWOOD
CAPITAL

This letter is issued by Milkwood Capital Ltd, advisor to The Milkwood Fund (the "Fund"). The Fund is an unregulated collective investment scheme ("UCIS") and the promotion of the Fund either within the UK or from the UK is severely restricted by statute. Consequently, access to this letter is only made available to professional clients and eligible counterparties as defined by the Financial Conduct Authority. Shares in the Fund should only be purchased by persons with professional experience of participating in unregulated schemes and any other person should not act upon the content of this website. This letter and the information contained herein does not constitute an offer or a solicitation, or a recommendation to purchase or sell any investment instruments, to effect any transactions, or to conclude any legal act of any kind whatsoever. The information contained in this letter is issued for information only and is not intended to constitute financial, legal, tax, investment or other professional advice and should not be relied upon as such. Applications to invest in the Fund can only be made based on the information contained within the Funds offering memorandum and prospective investors should consult with their own professional advisors and read the offering memorandum in its entirety prior to making a decision to invest. The investments described herein are not publicly distributed. The content of this letter is confidential and for the use of only those persons to whom it is lawfully transmitted. Information herein may not be reproduced nor passed to non-qualifying persons or to a non-professional audience. If you are in any doubt about your status, please seek advice from your own professional advisers.

Milkwood Capital is authorised and regulated by the Financial Conduct Authority FRN 607356.

Address:
12 Park Street
Windsor
Berkshire
United Kingdom
SL4 1LU