July 10, 2015

Dear Partners,

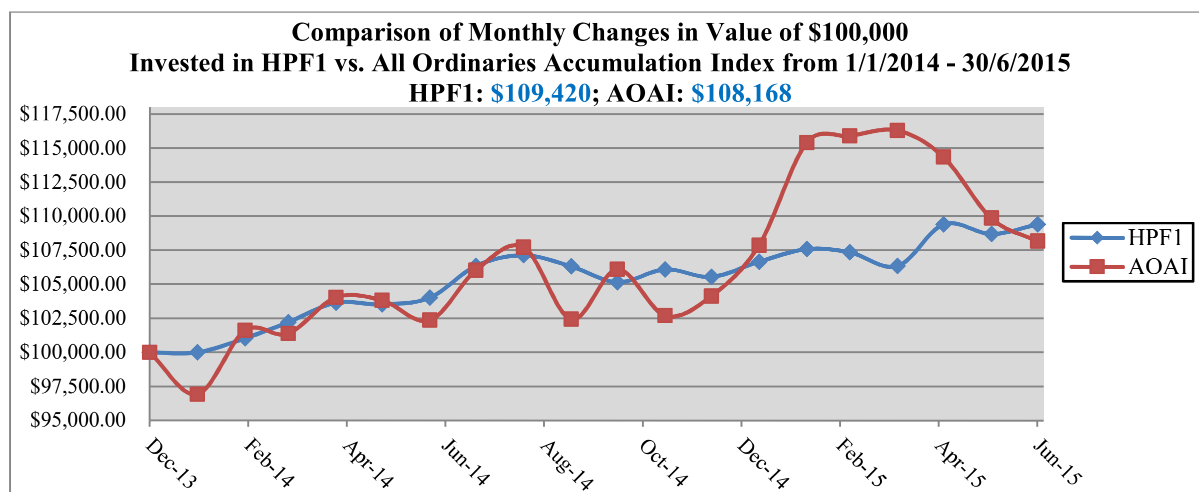
It is our privilege to present the first full financial year results for Harrington Partners Fund 1 (HPF1, the Fund). Included within this letter is a summary of the Fund's performance, a brief discussion on the market over the period, and an outline of a couple of the investments within the portfolio.

Performance Summary

Before taking into account fees and charges the unit price for HPF1 finished the Financial Year 2015 (FY15) at **$1.0939**, equating to a return for the Fund of **5.99%** over the period. As stated at the half year we do not try to match any index or benchmark but we do feel it is necessary to test our performance against an ongoing reference point. For this purpose we believe the All Ordinaries Accumulation Index (AOAI) is suitable given it provides a good comparison to what an investor could achieve in a low cost broad based index Fund. Over the past 12 months an investment in the AOAI would have returned 5.67%. Since inception, with distributions included, HPF1 has returned **9.42%**, this compares to a return for the AOAI of 8.16% over the same period. As total gross return was below our 6% hurdle rate no performance fees were paid over the period.

	HPF1 Gross Return	HPF1 Net* Return	Distribution Per Unit	AOAI Return
3/01/2014 (Inception)	-	-		
30/06/2014 (6 months)	4.01%	3.71%	$0.00494	2.36%
30/06/2015	5.99%	5.51%	$0.01693	5.67%
Compounded Annual Gain	5.00%	4.61%		4.00%
Overall Gain Since Inception	10.24%	9.42%	$0.02187	8.16%

Data source for AOAI Returns: S&P Dow Jones Indices LLC. *Net Return to investors which is less fees and charges but includes distributions.



We would like to note that the absolute returns for the Fund have been below what we set out to achieve on an annualised basis. Although not an insignificant amount of time, we don't believe much

comparable insight can be gained with any long term investment vehicle over an 18 month period. We invest with a time frame of at least 3-5 years and intend that our results will be judged over a similar timeframe.

Market Commentary

The Australian equity market still remains our primary focus and throughout FY15 there were a number of important events that shaped its performance. Most noticeable has been the continued weakness of the resources sector as the prices of bulk commodities (iron ore, coal, oil and gas) have substantially reduced. Just as the high prices of the past acted as a signal for investment, the current subdued prices have prompted the near cessation of new capital entering the space. Marginal producers with shaky capital structures have either exited the industry or are optimistically burning cash in hope of better times ahead. We see this as an inevitable outcome of cyclical commodities markets as the overinvestment during the good times ultimately leads to supply growth that massively outstrips current and near term demand.

This is leading to painful flow on effects to government royalty streams and private sector incomes due to Australia's reliance on the industry. There is no doubt that we are in a 'transition' period that is likely to involve significant reallocation of resources to more productive and/or profitable means whether this be domestically or overseas. Fortunately the depreciation in our currency has already done a lot of the heavy lifting towards improving our competitiveness. We still face meaningful headwinds especially as China, our biggest customer, sorts through its own economic and financial market issues. Their insatiable thirst for our exports, particularly since the GFC, has clearly been driven by overly aggressive and unsustainable government lead stimulation (as opposed to more reliable market lead demand).

Internationally, events such as start of the European Central Banks quantitative easing program and Japans extension of theirs, the re-emergence of the Greek bail out crisis (who would have thought?), and the eventual raising of interest rates by the US Federal Reserve have supplied plenty of external stimuli to keep markets in a continual state of flux.

The Reserve Bank of Australia added to the global glut of loose monetary policy by cutting the cash rate twice in early 2015 which increased the already persistent hunt for yield. Some of the most prominent affects included the 10 year Commonwealth Government bond yield which hit a record low of 2.27% in early February (yields fall when prices rise), but perhaps most noticeable for the wider population has been the unmatched performance from most classes of Australian property. Despite this, the Australian equity market measured via the All Ordinaries Index (not including dividends), finished the year at 5451 from a start of 5382, registering an appreciation of only 1.29%.

These numbers however, do not tell the full story.

When we reported to you at the half year we noted that *"[f]ortunately the volatility in recent months has resulted in certain pockets off the market shifting to a much more rational pricing environment".* Had we wrote immediately following the February rate cut we would have had to report that this favourable trend had reversed and the 'risk-on-yield-hunt' was once again good for a sharp 8%+ market rally in the third quarter of FY15. At the time we thought this one way traffic would

comparatively leave us in the dust, and as the chart of comparable returns above shows, we did not participate in the rally. Surprisingly, the second rate cut in May had the opposite effect and the market has trended lower since. The reversal contributed to providing us with the most attractive investment opportunity set to date, and during May and June we were able to invest more capital than at any other time since inception.

As always, our first preference remains to pay sensible prices for well managed businesses that have superior economics, stable cash flows, conservative balance sheets, and the ability to grow their franchise over the long term. We know of many businesses that meet this criteria but acquiring them for reasonable prices remains a difficult task. The majority pay solid dividends making them very attractive to a large investor base that, due to the low interest rate environment, has been pushed up the risk curve in search of seemingly reliable income. Fortunately, this necessity for yield has meant that many businesses that are not paying dividends are essentially being ignored by most investors. This has created some very valuable opportunities to acquire meaningful amounts of stock in what we refer to as 'deep value' or 'low risk, high uncertainty' investments.

One such area where these opportunities are prevalent is within the written off rubble that is Australia's mining services sector. We are taking advantage of the markets blanket approach to heavily discounting any business which is considered to have even a mild exposure to the industry. Just to be clear we do believe that a large part of the markets pessimism is warranted given that Australia is on the tail end of an unprecedented mining boom (as noted above). But even under our relatively strict criteria there are bargains in plain sight for any enterprising investor who is thorough, conservative and patient in their approach. As such we have been gradually adding to the number of businesses we own in this space and have established what we consider to be a requisite level of diversification. The majority of our investments have little or no debt, high net tangible asset (NTA) backing, solid free cash flow (FCF = operating cash flow LESS investing cash flow) and management whose interests are well aligned with shareholders. Our overriding thesis with these investments rests strongly on the notion of reversion to the mean, whereby the underlying value-in-use of these businesses will eventually be recognised as opposed to the below liquidation value they now command. We like the risk reward profile of these investments because the uncertainty of their future is more than compensated for by the extremely low price.

As an aside, we recently met two highly respected and internationally focused deep value Fund managers whilst on our annual US pilgrimage. Given their global perspective it was very interesting to hear that their research pointed to two prominent areas where there was maximum pessimism; Australian mining services and Greece. Greece currently sits outside our circle of competence, but Australia is well within it and we have been relishing the opportunity to buy extremely cheap assets that we understand, and nobody else wants. It's not often you get the chance to purchase written down positive cash flow assets for as low as 20c on the dollar, so when they start to appear we take note.

We look forward to reporting the progress of this basket of investments within future correspondence and hope you will find the below discussion of some earlier investments informative.

Portfolio Discussion

Although not in the mining services sector **Service Stream Limited (AU:SSM)** is another low risk, high uncertainty opportunity that we took advantage of over the period. We've been following the story of SSM since early 2013 and began buying the business in September 2014, subsequently increasing our stake in the following months to approximately 6% of the Fund, making it our largest holding.

SSM is a contractor to the telecommunications and utilities industries operating within three divisions; Fixed Communications, Mobile Communications and Energy & Water. Following their listing in 2004 they experienced rapid growth on the back of strong industry fundamentals and a debt fuelled acquisition spree. Revenue of $93.6m in FY05 rose to $558m by FY09 on strong demand for both fixed and wireless telecommunications infrastructure and utilities related services. However, it has not been smooth sailing since this time with recurrent cash flow issues and creditor concerns leading to two highly dilutive equity raisings in early FY10 and late FY14. This was caused not by the result of deteriorating customer demand but rather by some disastrous unforced errors made by the company whereby it overextended into areas where it did not have the required expertise or resource capacity.

The most notable of these errors was in 2011 when SSM tendered for National Broadband Network (NBN) construction contracts through a joint venture (JV) with Lend Lease Group (AU:LLC) known as Syntheo. The complicated logistics and lack of precedent with the schedule of works made it very difficult to submit accurately priced tenders and Syntheo subsequently lost significant amounts of money. SSM eventually walked away from the JV by cutting its losses and writing down its fixed communication division by $90m. These operational issues persisted into FY14 and were compounded by management's lack of stability with three different CEOs coming and going in the space of four years with the shortest tenure only lasting a little over six months. Understandably this continual underperformance repelled most investors and SSM was likely removed from the majority of investor's radars. But we believed that, minus their troubled assets, the remaining bulk of the operating businesses had strong underlying fundamentals and would be particularly valuable if the company could overcome its financing and management issues. In short, at the time of our purchase we were comfortable with the progress made on each of these fronts, especially the significant reduction in leverage and promotion of long term employees to the CEO and Chairman positions.

As always price was the main determinant in our decision and at our average of $0.20 we believed that no value was being given to the operations of SSM above a liquidation scenario. The business was selling at approximately six times FY14 underlying FCF with an NTA of just over $0.15 (of which $0.125 were current assets) giving us confidence in our downside protection.

The renewed financial and management stability has resulted in meaningful improvements in the underlying operations such as major contract renewals with Telstra Corp (AU:TLS), NBN Co. (ticket-of-work not heavy construction contracts), Vodafone (NASDAQ:VOD), Origin Energy (AU:ORG), and a new metering contract with Active Stream a wholly owned subsidiary of AGL Energy Limited (AU:AGL). The return to business as usual allowed management to reinstate dividends at the HY15 which we view as a strong indication of the business's improving outlook.

The result with SSM thus far is a good example of why we do not try to benchmark against any market index and why the returns of HPF1 will most likely look very different to the wider market. The main reason for this is a lot of what we invest in is driven by the market announcement feed which can be

intermittent at best. Our investments can stay 'stagnant' (in respect of price) for long periods until such time as other investors digest the news and become aware of the inherent undervaluation. For the first eight months after purchasing SSM the share price went basically nowhere, hovering around $0.18-$0.22, but after a short succession of new contract announcements (as noted above) it rallied over 50% in the space of about two weeks. SSM ended FY15 at $0.295 up 45.3% from our average purchase price.

We remain happy with the current management's strategy and believe there is significant potential for improvement in margins from the current revenue base. The demand for its services also remains very strong with all the major telecommunications companies investing heavily in high speed broadband capacity as their own customers are demanding greater volumes and access to data. Furthermore, there are favourable trends for SSM occurring within the utilities sector, such as the ongoing roll-out of smart meters and at-home energy generation systems. SSM should be able to participate profitably as their customers continue to invest and we still see a lot of upside for the business.

RNY Property Trust (AU:RNY); is the second largest holding within the portfolio and at present accounts for approximately 4% of total funds. RNY is an ASX listed, US based, real estate investment trust (REIT) that currently owns twenty office properties within four submarket areas of the New York Tri-State region including; Long Island (New York), Westchester County (New York), Fairfield County (Connecticut), and Northern New Jersey. The responsible entity of the trust is incorporated in Australia, but importantly the property manager, known as RXR Realty (RXR), is based in New York.

The trust was listed in 2005 after an initial public offering that raised $263.4 million. The equity proceeds along with additional debt, were used to acquire a 75% interest in a portfolio of twenty-five suburban office properties for approximately US$422 million from Reckson Associates Realty Corporation (Reckson). Reckson retained the remaining 25% interest in the property portfolio.

Timing for the float of RNY was great for those who chose to cash out but terrible for longer term owners. Within two years the US property market experienced its biggest decline since the great depression and the unit price of RNY suffered a large fall from a high of $1.25 in 2007 to a low of $0.04 in 2009. During the pre-GFC interim Reckson was subsequently merged with SL Green Realty Corporation (a whopping US$6bn deal), but Recksons 25% interest in RNY was not part of the transaction. Instead it was sold to RXR (the current property manager) which was created by the former controlling members of Reckson as their new corporate holding structure. One of the most important characteristics of RNY is that in aggregate, the three main US based executives (the CEO, CFO and Vice President/Corporate Council) continue to own 40% of RNY's portfolio. This strong alignment with shareholders is a critical aspect of the investment especially given the foreign location of the assets. [On this point we have not performed any 'on the ground' investigation work on the property assets but we have been able to access sufficient insight that we trust from RNY's second largest shareholder (also an Australian based fund manager) as to the credibility of RNY's disclosure.]

Since the GFC RXR has guided the portfolio through an extended period of depressed property values and rental demand which was coupled with a very difficult credit environment. This has involved numerous asset sales and debt restructurings along with significant lease incentives designed to maximise occupancy and underlying cash flows. Up until 2012 it was not a pleasant ride for unit holders with an absence of distributions since FY08 and no meaningful unit price appreciation from a

trading range of $0.10-$0.12. The unit price started to appreciate after 2012 primarily due to a recovery in the NTA backing following partial debt forgiveness, a valuable deal made possible due to the credibility and experience of the RXR management team. The CEO Scott Rechler is a life time veteran of the Manhattan and New York tri-state property market and he leads a first class team of talented owner operators of whom we are very happy to be partnering with. We believe their strategy for realising significant value for all unit holders is sound, and are prepared to give them the necessary time to execute it.

RNY's value revolves around a catalyst from upcoming debt refinancing of two restrictive and expensive loans which expire in January 2016 and early 2017. These loans are limited recourse and secured against separate property 'pools' within the overall portfolio. The debt is restrictive because properties within each pool cannot be sold off individually without triggering prohibitive creditor charges and it's expensive because it was contracted in a much tighter credit environment than exists today.

The pools could be sold as complete packages with the current loans attached, but management has made it clear, and we agree with them, that this is not the best way to maximise present value. In the meantime management is maintaining a continued focus on improving portfolio occupancy, allocating capital prudently and 'riding out' the business cycle as the US economy continues its recovery. All cash flows are being retained and invested back into the portfolio in an attempt to maximise the attractiveness of the assets from both a refinancing and sales perspective.

The first debt pool is set to expire in January 2016 and accounts for approximately US$40 million (US$0.15 per unit) in equity at which point RNY will have options in terms of either recapitalising, refinancing or selling some assets. However, the biggest catalyst will be the expiry of the most onerous 2017 debt facility and we do not expect full value to be realised until this time. Without the likelihood of distributions RNY is not attractive to the bulk of REIT investors and its current form is more that of a distressed asset turnaround. It is an investment which requires considerable patience for which we believe investors will be duly rewarded.

From a quantitative perspective we were attracted to RNY because it was selling for a large discount to an already written down NTA value and the potential for a significant improvement in cash flows. We also liked the USD exposure and at the time of our original purchase the AUD was buying closer to US$0.90 giving us an additional margin of safety to an expected USD appreciation. As at 30 Dec 2014 RNY's NTA per unit was US$0.444 and at the time of writing one Australian dollar is buying about US$0.74, this gives RNY a current NTA per unit of approximately AU$0.60 whereas our average purchase price was just above AU$0.29 per unit. With the potential for further USD appreciation, and a debt refinancing catalyst getting closer every day, we are confident that the AUD NTA is likely to remain reasonably solid.

We anticipate waiting until 2017 for any real value creation with RNY although we believe the upside is substantial. The assets do not really belong on the ASX but in our mind there is no need to rush in terms of trying to realise the value, being patient will yield the best results. RNY is again another investment that is unlikely to have any correlation to the market as a whole.

Now, as promised in previous correspondence, we will discuss our mistakes (of which there will be many) and a business we invested in and subsequently sold out for a loss was **Oroton Limited (ORL).**

ORL is a retailer whose main asset is its namesake Oroton brand. The Company was founded in 1938 by Boyd Lane, a Sydney textile merchant, and has grown to include around seventy domestic and eleven international stores primarily in South East Asia. In addition, they have the Australian franchise rights for GAP clothing (6 stores) and a 51% share in Brooks Brothers Australia (14 stores), a joint venture with the brands American parent company.

ORL was one of the first businesses owned by the Fund with our initial attraction being spiked by a significant fall in the share price following the loss of their lucrative Ralph Lauren Australian franchise. At the time we thought the sell-off was overdone and our optimistic valuation rested on the belief that the Oroton brand had franchise value and would continue to produce strong free cash flow, and more importantly, allow management to return significant surplus capital to shareholders (as they had alluded to doing). Unfortunately both these presumptions were proven to be incorrect. ORL had damaged the Oroton brand after an extended period of discounting and it quickly became clear that a large investment in the 'aspirational quality' of the brand was required such that it could maintain its luxury positioning. We supported this approach and saw it as worthy long term investment in the pricing power of the brand. However, we didn't anticipate (or support) the capital intensity necessary to acquire and finance the aggressive rollout (funded by the aforementioned surplus capital) of the GAP franchise and Brooks Brothers JV. Over time it became increasingly clear that management had a different view to us as to which direction the business should proceed, and that the investment value of our ownership was not as solid as first thought.

In the interim, we did voice our concerns over the expansion plans through a detailed letter to management. We sought to emphasise our belief that the best use of capital was investment behind the Oroton brand with any surplus free cash flow being returned to shareholders (with a preference for share buybacks). The reply we received countered that the current strategy was a prudent approach designed to *'fill the revenue gap'*, leverage the Group's *'retail skills and infrastructure'* whilst adding *'market risk diversification'*. Our perspective was that shareholders money should be applied to organic growth only, and that the balance sheet needed to be shrunk. This was clearly not shared by management and should have given us a much bigger wakeup call than it did. We mistakenly remained confident, despite our concerns, that they could maintain their financial strength on the back of cash flows from the core brand and that the fair value of their portfolio of assets would eventually be recognised. To the detriment of our partners this proved to be a damaging exercise in over-optimistic-thumb-sucking as the financial results continued their decent.

Ultimately, we sold our entire position earlier this year after witnessing a stark eighteen month deterioration in their capital structure from around $23m in net cash (no debt) to $5.6m in net debt, a 115% increase in operating lease commitments (over twelve months), and a halving in profit on a constant currency basis. Our uneasiness with the changed landscape was not so much to do with the profit decline but rather with the alarming increase in liabilities (both on and off balance sheet) and a sharp swing to negative operating cash flow as they continued to fill the growing GAP and Brooks Brothers store network with fresh inventory.

It became clear that management may have underestimated the level of cash outflow necessary to see the new brands through their establishment phase, whilst the continued heavy investment had unintentionally put the company under concerning financial pressure. We were no longer comfortable

with the fundamental risk/return profile of the investment and think that, in the least, a tactical and perhaps strategic, change is necessary. We believe that the operations need to be rationalised by either selling their GAP or Brooks Brothers interests (or both) thereby delivering the core Oroton brand the requisite level of management focus and capital investment that it deserves. This would still involve a potentially expensive 'transition period', but in our opinion it would deliver owners of the company the most value over the long term.

Looking back on our initial appraisal it is clear that we were attracted to their demonstrated history of high returns on invested capital, solid free cash flow generation, conservative use of debt, and management who were (and still are) meaningful owners of the business. For many years they had benefited from improving gross margins and operational leverage as their sales grew faster than their total cost of doing business, which ultimately resulted in strong earnings and dividend per share growth. It appeared as though the Oroton brand maintained a valuable franchise within its *'affordable luxury'* niche and this did not appear tangibly on the balance sheet. Despite this, we were naive in believing that the aspirational quality of the brand could overcome a wider retail market slump and that it had sufficient pricing power to offset part of the foreign currency headwinds.

In retrospect the rear view mirror may have passed the test, but we should have been able to foresee that the future economics of the company were likely to be dramatically different, especially after the purchase of GAP and Brooks Brothers. When we broke the mistake down to its simplest components it was clear to us that we did not incorporate a large enough margin of safety sufficient to protect our capital against both the foreseen and unforseen risks inherent in the investment.

Our average price paid on the ORL investment was $3.40 and we sold our entire stake for $2.51. The realised loss accounted for approximately -0.5% to the performance of the Fund over the period. Looking at ORL in isolation, for every dollar invested we only received roughly $0.74 back (a 26% reduction), therefore, in order to restore our original capital we would now need to generate 35% on the lower starting base ($0.74 * 1.35 = $1). This asymmetric return requirement illustrates why avoiding loss of capital is so important. As painful as any loss is, when investing they are inevitable and you should rest assured that the many valuable lessons learned and post mortem analysis from this experience stretch many more pages than this discussion. More importantly, these lessons have been seared prominently into our ever developing investing repertoire.

The Year Ahead

Despite the fact that over the shorter term we are not overly optimistic on the Australian economy, we are very comfortable with where the portfolio currently sits and excited by the quality of investment opportunities that are materialising. Forecasting markets is not our game, and with the current unprecedented level of artificial stimulation from global central banks it is even more precarious. When the United States Federal Reserve begins to raise interest rates it will have an effect on asset prices. When this will happen and what will be the consequences is anyone's guess.

We will continue to be patient and only allocate capital in well understood opportunities where probabilities are strongly in our favour. We currently maintain a significant cash balance and we

remain poised and ready to take advantage of any unjustified market pessimism that may eventuate. We will enthusiastically welcome any pullback in the market as a potential opportunity to acquire quality assets at a discount to their intrinsic value. We agree with Warren Buffett when he said "*Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down"*.

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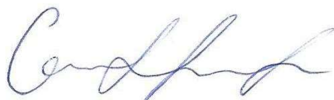
Congratulations if you have read this far; we know these letters can be quite long and that our writing still requires some polishing. Our main objective is to use this correspondence to deliver sufficient detail so that you, as our business partner, can be comfortable with how your investment is being managed.

We are both very excited about the year ahead and wish you and your family a happy, safe and productive FY16. We are extremely grateful for your continued patience and support especially during these early years and look forward to building a prosperous partnership with you over many years to come.

Be sure to contact us if you have any questions or comments.

Yours Sincerely,



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