HARRINGTON PARTNERS

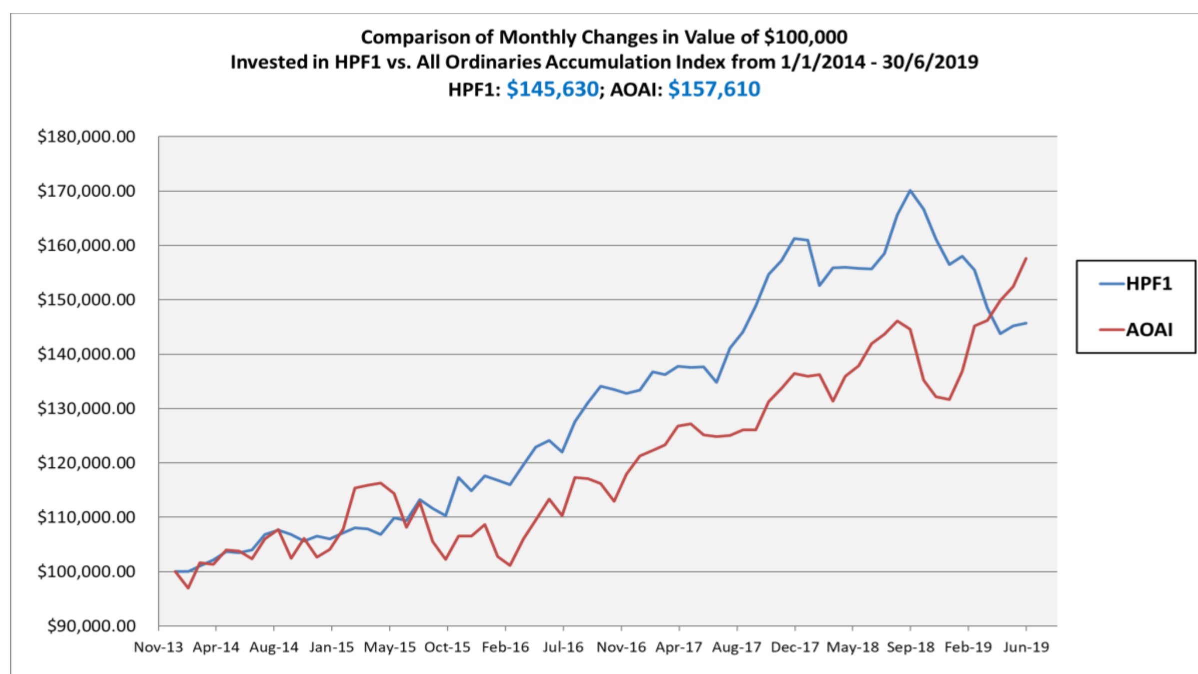
Investment Management

Harrington Partners Fund 1 (HPF1) – 30 June 2019

Harrington Partners primary goal is to protect investors capital and outperform the Australian All Ordinaries Accumulation Index (AOAI) by 3-5% annually as measured over rolling 5-year periods. The Fund managers have the majority of their investable assets in the Fund, this creates a very strong alignment of interests between the managers and investors with a concentration on achieving the highest possible risk adjusted returns.

	HPF1 Net Return*	AOAI Return#	Relative Performance
6 Months to 30/06/2014	**3.71%**	2.36%	1.35%
30/06/2015	**5.51%**	5.67%	-0.16%
30/06/2016	**11.50%**	2.01%	9.49%
30/06/2017	**10.48%**	13.12%	-2.64%
30/06/2018	**15.49%**	13.73%	1.76%
30/06/2019	**-6.45%**	11.04%	-17.49%
Annualised Performance	**7.07%**	8.63%	-1.55%
Cumulative Performance	**45.63%**	57.62%	-11.99%

#Data source for AOAI Returns: S & P Dow Jones Indices LLC. *Net Return to investors which is less fees and charges but includes reinvested distributions. Past returns are not a good indication of future returns.



HPF1 finished financial year 2019 (FY19) returning a net loss of 6.45%. This is the first year of negative performance since the establishment of the Fund and is relatively disappointing given the stellar showing of the AOAI which rallied over 18% in the second half and closed at near record levels. It is inevitable that we will experience periods of negative performance and underperformance given the concentrated nature of the Fund, this in no way shifts our focus from continually stacking the deck in HPF1s favour for achieving the stated long-term goal. We continue to concentrate on the underlying performance of the businesses we own, not their share prices. In our view, the current portfolio is as prospective as ever and primed to generate favourable performance in years to come.

The Harrington Partners Approach

Harrington Partners' primary objective is to protect partners' capital while achieving performance that is superior to the market average over the medium to long term. We are patient value orientated investors with a fundamental approach that is thorough, creative and flexible. Our investment universe is not pre-determined by size, industry, or geography, providing us with the ability to operate in areas that are out of favour or not as widely researched by the broader investment community.

We do not follow any rigid formulas or complex rules and avoid the need for overly optimistic long-term predictions, complex financial products, or elaborate modelling. We do not trade price movement, trends, or macroeconomic theories.

Our process has a core emphasis on minimising error. We proactively work to mitigate the possible impacts of psychological and cognitive biases in our decision making and have intentionally built an operating structure that supports this.

We see ourselves as business owners and focus intently on both the tangible and intangible qualitative elements which are necessary for a successful investment. We view the management teams of the businesses in which we invest as our partners and therefore demand high levels of integrity, skill, ambition, and alignment with shareholder interests.

Our first preference is to pay sensible prices for well-managed businesses that are conservatively financed, possess durable competitive advantages and can grow their franchise over time. Opportunities to buy these businesses at prices below our appraised intrinsic value are rare. When we do find opportunities that meet these criteria, we are willing to own them indefinitely, providing the fundamental investment hypothesis remains sound.

If we cannot meet our first preference, we are confident to scour the market in search of situations where the probabilities of achieving superior returns are in our favour.

Resources are concentrated on our best investment ideas; this has the potential to lead to volatility relative to the market average. We do not consider this type of volatility to be a relevant measure of risk for the long-term investor. Our primary determinant of risk is the probability of permanent loss of capital. Ultimately, if we are unable to find opportunities that meet our investment criteria, then we hold cash.

We only get paid for positive performance, and the majority of our investable net worth is in the Fund, this ensures a powerful alignment of interests with partners. Investing is our passion, and we continually strive for improvement, both professionally and personally.

Our goal is to establish mutually beneficial long-term relationships with partners who align with this philosophy and appreciate that meaningful wealth creation requires time and persistence. Achieving our economic objectives is crucial to HPF1s enduring success, however, building a business that all partners are proud to be part of, and appreciating the journey, are equally important.

The Portfolio

Portfolio Average Market Capitalisation	$165 million
Number of companies	13
Australian Shares	70%
International Shares	1%
Cash	29%
Concentration of top 5 holdings*	66%

*Of invested capital.

The top 10 holdings at June 30, 2019 were:

Rank	Holding	Total Equity Weighting	Total Portfolio Weighting
1	Enevis Limited [ASX: ENE]	20.03%	14.45%
2	Locality Planning Energy [ASX: LPE]	13.23%	9.54%
3	EVZ Limited [ASX: EVZ]	11.21%	8.09%
4	Legend Corporation [ASX: LGD]	11.11%	8.01%
5	Boom Logistics [ASX: BOL]	10.71%	7.73%
6	Kangaroo Plantations [ASX: KPT]	8.12%	5.86%
7	Fleetwood Corporation [ASX: FWD]	7.86%	5.67%
8	United Overseas Australia [ASX: UOS]	7.00%	5.05%
9	FSA Group [ASX: FSA]	3.54%	2.55%
10	Blackwall Limited [ASX: BWF]	3.43%	2.47%

The top ten holdings made up **69%** of the total portfolio and cash allocation is **29%.**

The share price appreciation of Enevis Limited [ASX: ENE] and EVZ Group [ASX: EVZ], which are two of the Funds largest holdings, made a significant positive contribution over the first quarter of the financial year, although both have traded lower over the last nine months which has accounted for -9.4% of the Funds' performance since September 30 2018. Operationally, these businesses are performing very well, and we have outlined their attractive underlying potential within the Appendix to this letter.

The Fund has had a small position in Locality Planning Energy [ASX: LPE] since May 2018, this was substantially increased during April and has quickly become the second largest position after benefiting from strong share price growth shortly thereafter. We have met with the founders and joint CEOs Damien Glanville and Ben Chester at the headquarters in Maroochydore and were impressed by their somewhat unorthodox approach towards the traditional retail electricity market. We will include a detailed thesis on LPE in the coming September update, but suffice to say that we believe the business has bright prospects and a long runway of growth ahead.

Legend Corporation [ASX: LGD] is another relatively new investment which regrettably is set to be short lived as the business has accepted a takeover offer from a private equity firm. While the return

on our investment has been great, it would have been better to own LGD for a much longer period, and we think the new owner will realise a lot of upside in years to come.

During the final days of FY19 we opted to sell the entire position in Macmahon Holdings [ASX: MAH] after the abrupt and unexplained resignation of their Chairman and a non-executive director on the same day. This development left minority shareholders (like us) in a somewhat precarious position given the remaining board dynamics, while the way in which the departures were handled suggested they had some deeper corporate governance issues. At an operational level the business continues to trade well, has a massive growth pipeline, and is being led by a top-class CEO. However, the board level instability was enough of a negative catalyst to prompt our early exit from this cyclical and capital-intensive business. Overall MAH has been a very good investment for the Fund since we made our first purchase in March 2015.

Finally, we sold the remainder of the Funds investment in Konekt Limited [ASX: KKT] which has proven to be a mistake on our part and contributed -3.4% towards HPF1s loss for FY19. This action came about after some thorough reflection and we encourage you to read the rationale behind our decision as detailed in the Appendix.

In our perspective the portfolio holds a significant amount of unrecognised value and we are optimistic of this potential being realised in periods to come. Most importantly, the last twelve months has again provided several valuable lessons which have aided our pursuit towards making higher quality investment decisions.

We are privileged that you have chosen to partner with us on this journey and look forward to sharing many great years ahead. We welcome any feedback and if you have any questions, comments or investment ideas please do not hesitate to contact us.

Yours Sincerely,

Cameron Harrington
Executive Director
Harrington Partners Pty Ltd
Email: cameron@harringtonpartners.net.au

Brendan Harrington
Executive Director
Harrington Partners Pty Ltd
Email: brendan@harringtonpartners.net.au

Appendix (Business Discussion)

Enevis Limited [ASX: ENE] is the Funds largest position accounting for 14.4% of the total portfolio. Enevis consists of three complementary operating divisions being SKS Technologies, Urban Lighting Group, and Enegrow, all of which are detailed herein. The company first came to our attention in early 2018 as part of our ongoing search for competent owner-operator management teams running quality businesses. At the time ENE was raising capital to retire debt and expand working capital while also issuing shares to acquire an energy-efficient LED lighting business known as Lumex®. Our due diligence suggested the company had the people, reputation, and operating systems necessary to achieve their ambitious medium-term objective of growing annual revenues to at least $50 million. At this level of turnover, we expected ENE would be generating good returns on their capital, that the equity raising would be sufficient to see them through to this stage, and that further growth was likely. Based on this overall dynamic we deemed the then valuation to be attractive and as such made a significant investment.

Revenue for FY19 revenue is on track to be around $40 million, or 48% growth over FY18. Our base case thesis for FY20 assumes that ENE will generate revenue of at least $50 million and pre-tax profits of $2.5 million. This represents a 23% pre-tax earnings yield against the current market capitalisation of only $11 million (pre-tax multiple of 4.4 times), and the company has substantial carry-forward tax losses. We are optimistic that ENE can generate performance considerably better than this given that each operating division has its own highly prospective growth potential as outlined below.

The first being within the traditional audio-visual (AV) contracting space, the second within the energy-efficient LED lighting retrofit market, and lastly the potentially game-changing opportunities supplying grow lights to the nascent protected cropping industry. Most importantly, these strategies are being spearheaded by competent and aligned management teams who have spent their entire professional lives in these industries and also have significant experience running much larger organisations. That said, the company's cash flow has remained very tight during this high growth phase and it appears likely that sustaining the current trajectory may require additional equity or perhaps the sale of non-core assets to improve liquidity. Further, the current share price weakness has been a significant contributor to the underperformance of the HPF1 this year and this has reminded us to be patient when building our initial investments. All in all, we believe ENE will grow into a substantially larger business over the medium to long-term and could prove to be a fantastic investment for the Fund.

SKS Technologies (SKS) is the groups largest division and provides audiovisual (AV) products and solutions, along with electrical and communications cabling to the commercial, retail, health, defence and education markets. SKS is the brainchild of brothers Peter and Greg Jinks, who respectively occupy the positions of executive chairman and executive director of ENE. In 1981 the Jinks founded an electrical contracting business called KLM Group (KLM) and over the ensuing 28 years built this business into a leading national electrical, data, and communications provider with over 700 employees and revenue of $161 million before it was taken over by Programmed Maintenance in 2010. At the time of the sale the AV division was reportedly the largest in the country and also the fastest-growing segment of KLM, accounting for ~$27 million of revenue. In the absence of a sale KLM's strategy was to significantly expand AV solutions given the market was growing rapidly and the fact that there are several inherent advantages over traditional electrical contracting. For example, AV contracting is generally higher-margin, has lower customer concentration risk due to a higher aggregation of projects, is far less exposed to potential weather issues, and has a rough material to labour split of 80/20 compared to 20/80 for electrical contracting.

Almost three and a half years later the Jinks brothers reignited this AV growth strategy with the establishment of SKS Technologies. The ongoing pitch is that *'we have been there before and can get there again although this requires a significant upfront investment in people, facilities, and equipment'*. Thus far this has proven accurate with SKS on track to generate revenue of ~$28 million in FY19 which is only the fifth full year of operation. The growth has been achieved through building a team of experienced AV industry experts, that now stands at around 50 people, with a large number of them joining as a result of their previous association with the Jinks during the KLM days. This is very important, as success within the relatively small Australian AV industry is heavily reliant on the quality of your reputation, relationships, and tangible track record of completed projects. However, the rapid progression of SKS has not been without some meaningful growing pains, and the division is still consuming more cash than it is producing.

Urban Lighting Group (ULG) specialises in the engineering, design, installation, and support to customers within the commercial, industrial and public lighting markets. ULG includes the recently acquired Lumex® business which focuses on the large retrofit market for energy-efficient LED lighting within commercial and industrial buildings. Improving lighting efficiency within established structures remains one of the quickest and most effective means of reducing operating costs and environmental impact. We believe this market is still maturing and, despite the intense competition, Lumex has a favourable position given their proprietary products, full-service offering, and established relationships with several project financiers. In our view, one of the most beneficial elements of the Lumex acquisition was the establishment of a partnership with the vendor Erik Scholz. Erik brings decades of valuable experience and relationships within the Australian electrical and lighting industry, and he has a strong incentive to leverage his skills and network towards helping ENE thrive as he is now one of the largest shareholders.

Enegrow was recently established after ENE signed an exclusive distribution deal with US-based Lumigrow to distribute their products in Australian and New Zealand. Lumigrow is a world leader in the design and manufacture of LED grow lighting for the rapidly developing protected cropping industry. Although early days, our research on Lumigrow has led us to believe that their product is market-leading and that the long-term potential of the broader protected cropping market is substantial. Australia has several major protected cropping projects in the planning and application phase and Enegrow is ideally positioned with superior grow light technology that itself is core to the overall economics of these projects. If Enegrow were able to secure *any* of these projects, then they would be significant for ENE. Fortunately, the capital requirements of this endeavour are low at this stage and primarily consist of marketing overhead until a substantial project is secured.

****

During the period we sold the Funds' remaining holding in **Konekt Limited [ASX: KKT]**. This action followed our evaluation of the recently announced changes to the federal government's jobactive program, which accounts for approximately 46% of KKTs revenue. The program is set to be progressively migrated to a centralised digital platform by June 30, 2022 enabling the majority of job seekers and providers to 'self-service', thereby reducing the demand for traditional retail shopfront service delivery. The primary point of connection for most job seekers and employers will shift from the physical branch network of incumbent employment service providers, such as KKT and their competitors, to the new centralised digital platform. This dynamic is akin to shifting banking from the traditional branch model to the dominant online service delivery that exists today, with the critical

difference being that the digital employment platform will act as a monopolistic conduit for the industry's entire volumes and not just company-specific volumes.

To the best of our knowledge, the backbone of the new platform will be algorithms that synthesise questionnaire inputs to effectively match job seekers to the most suitable jobs employers have available. Both parties will then have digital access to the necessary resources that facilitate a smooth face to face connection, i.e. the job seeker can turn up on-site 'work ready', while ensuring both parties meet their compliance requirements. As a result, an overwhelming majority of the matching services will occur without the need for third-party participation from traditional employment agents. It is likely that specific services and certain individual circumstances will always necessitate the involvement of third-party employment agents. However, the difficulty is determining what level of demand will persist and, more importantly, whether there will be sufficient volumes to provide an acceptable return on the capital that KKT has already invested into an established branch network and trained workforce.

We believe KKT and its competitors are likely to experience operational deleverage as in-person caseloads fall dramatically and this margin erosion may force painful restructuring charges such as redundancies, and the write-off of PP&E[1], leases, and intangible contract assets. In addition, announced changes to the payment structure, along with the introduction of a licensing requirement and "tough" new performance regime, will make many sub-scale operators unviable. Under this scenario it seems inevitable that the pace of industry consolidation will increase rapidly with only the most financially stable players being able to profitably adapt by pivoting their business models to focus on higher value-add services and less on transactional volumes. MAX Solutions and APM Group are the clear market share leaders in the industry, and they have nationwide networks and more robust financial resources than KKT. We think these companies will remain relevant to the future industry landscape while mid-market competitors will struggle.

The proposed model appears considerably more transparent while substantially reducing the potential for undesirable human bias, inconsistency, and unscrupulous conduct. Overall, this a prudent initiative which should provide meaningful benefits given the societal benefits of an efficient employment market and the fact that welfare is the governments' second-biggest procurement outlay after defence[2].

The KKT return to work division suffered a similar fate 18 months ago when their largest customer, the NSW workers compensation scheme, known as *icare*, developed a service delivery model that redirected all policy claimants to a central platform. This change ultimately resulted in a significant caseload reduction for KKT. In hindsight, this development should have sparked a realisation that KKTs employment division had a high likelihood of suffering a similar fate given the comparable industry dynamics and business models. We have learned to be more alert to automation risk that exists for many traditional service industries which have repetitive and generic processes that can be effectively codified.

We continue to believe that KKT is a decent investment given the likelihood of a slow transition to the new jobactive model and the presence of some attractive near-term growth opportunities. However, the abovementioned changes to the employment industry have significantly reduced the predictability of KKTs longer-term cash flow potential, and we believe there are better opportunities for the Fund. To conclude, KKT contributed -3.4% to the Fund in FY19, and our position size was too large given the risk-reward dynamic. The experience has been valuable and a catalyst for implementing several improvements to our investment process.

---

[1] Property, plant, and equipment

[2] https://ministers.employment.gov.au/odwyer/jobactive-ceo-forum-melbourne-20-march-2019

****

EVZ Limited [ASX: EVZ] is the parent company of two primary operating divisions; Brockman Engineering and Syfon Systems, each of which is detailed individually in later sections. We first came across EVZ around 2015 when we were researching one of their competitors and at the time, believed they were unlikely to stay solvent much longer given their unsustainable debt load. However, they were able to trade through this challenging period and achieve a significant recapitalisation and debt forgiveness package in early 2017, which is when we became genuinely interested. We extensively tracked their progress through this significant change and were impressed with what appeared to be a competent and 'battle-hardened' management team who, despite financial difficulties which they primarily inherited, had successfully maintained the expertise and capacity of the group. Most importantly, they had meaningful amounts of their own money on the line and took up their full entitlements in the equity recapitalisation.

Our previous research on the broader industry dynamics had confirmed that the underlying operating divisions were capable of generating attractive returns on capital and had good growth prospects. We came to believe that EVZ was fundamentally a decent business with significant potential that had been marred by an unsustainable amount of legacy debt. Our investment thesis was simply that financial performance would improve substantially now that the company had been liberated from a highly restrictive balance sheet. Key to our perspective was that, to the best of our knowledge, prospective customers were satisfied with the quality of their work but had been rightly dubious about awarding large packages of work to EVZ given their shaky financial position. This thesis has somewhat played out with work in hand (WIH) and revenue increasing 73% and 49% respectively since June 2017, unfortunately profitability has not been at the levels anticipated while the amount of capital required to achieve this growth has been more than we expected.

More specifically, while revenue for FY19 is likely to be a record of around $77m[3], operating income will be comparatively weak at a forecast $1.6m or a margin of only 2%. We believe EVZ is capable of generating operating margins well above 5% at these revenue levels and the management team has the ability necessary to see a considerable improvement in FY20 and beyond. The business has started FY20 with a very well capitalised balance sheet and low debt levels, a near-record WIH, and an attractive pipeline of growth opportunities. We expect EVZ will generate at least 3.2 cents per share of net profit in FY20 which is an attractive earnings yield at the current share price of $0.17.

EVZ Limited	FY20f
Revenue ($m)	80.0
EBIT* @ 5% ($m)	4.0
Earnings per share (cents)	3.2

* Earnings before interest & tax

Brockman Engineering was established in the North Shore area of Geelong in 1921 and over the ensuing decades provided specialised engineering services to a thriving hub of industrial prosperity that once included primary operations of such companies as Ford, Shell, Phosphate Cooperative of Australia, International Harvester, Pilkington Glass Works, the Corio Distillery, and the Alcoa smelter at Point Henry.[4] However, during the early 1970s manufacturing and heavy industry in the area began a long-term structural decline, and today only the Shell refinery survives under new owners Viva

[3] For the combined Brockman, Syfon, and TFS Maintenance divisions
[4] https://www.geelongaustralia.com.au/geelong/article/item/8d0779e8d5e7ee6.aspx

Energy [ASX: VEA]. The demand for specialised engineering services suffered a similar fate which ultimately resulted in many firms significantly downsizing, closing their doors, or merging with competitors to survive.

Today Brockman is one of only a small group of firms that provides a single-source solution for the design, fabrication, construction, and maintenance of bulk liquid storage tanks and pressure piping to the fuel, chemical, and water industries. Most of their activity revolves around the development and maintenance of downstream oil & fuel infrastructure which includes refineries, storage terminals, and pipelines. This infrastructure requires significant annual maintenance due to high levels of corrosion. Our analysis suggests that the domestic demand for tank and piping expertise fluctuates between $80m-$120m annually, with the majority of variability due to the timing of large tank projects. Overall, the market is relatively niche, requires specialised skillsets, and most importantly, a reputation for quality work given the inherent sensitivity around environmental and public safety issues.

This industry dynamic has manifested in a relatively concentrated competitive landscape consisting of Brockman and two primary rivals. The first of these is the local division of McDermott International [NYSE: MDR], and the second is a Newcastle based firm called Saunders International [ASX: SND]. It is our view that each of these competitors is in a period of internally compelled transition which overall, is likely to deliver an increasingly favourable competitive landscape for Brockman as outlined below. External competitive threats also appear relatively tame in the near-term given the overall health of engineering and construction work available within the broader infrastructure and resources markets. In recent years several general engineering firms did enter the market and outbid Brockman on several large tank projects, however their results were generally dismal both from a financial and reputational perspective.

McDermott International (MDR) is a global behemoth set to generate revenue of $9.5 billion in 2019 following a merger with Chicago Bridge and Iron (CB&I) in May last year. The merger was designed to create a vertically integrated business by bringing together the 'onshore' energy expertise of CB&I with 'offshore' energy expertise of MDR. As part of the merger MDR is currently trying to sell the global onshore tank and piping division which it inherited from CB&I and is no longer considered as a 'core' asset. The sale includes the Australian tank and pipe operations that Brockmans competes against which, for MDR overall, has been a relatively inconsequential contributor outside their work on mega Australian LNG projects. We believe this corporate level paper shuffling, combined with the relatively insignificant nature of the domestic tank and pipe business, will be to the benefit of a nimble and focused operator like Brockman. That said, we are cognizant of potential adverse outcomes for Brockman, such as MDR 'pumping the books' to attract buyers and that the eventual purchaser may prove to be a fiercer rival.

Meanwhile, Saunders International (SND) have recently closed their proprietary steel fabrication workshop and moved entirely to a third-party supply model. We believe this is a significant change to the competitive landscape as a proprietary fabrication workshop is a crucial component of being cost-competitive, maintaining quality standards, and delivering projects on time. Further, the industry necessitates short turnaround times on repairs and maintenance as it becomes costly when these massive pieces of infrastructure sit idle. Work performed under such circumstances generally has the most attractive margins given customers become far more *time*-sensitive than *price*-sensitive. The one critical caveat to maintaining a successful fabrication workshop is that you must have sufficient work volumes to cover your fixed overheads. If this is not the case, and circumstances are unlikely to improve in the foreseeable future, then the rational thing to do is to close the workshop. We believe

this is the unfortunate dynamic Saunders faced, and their decision aligns with a sweeping national trend whereby the supply of specialist manufacturing, engineering, and fabrication skills, has been diminishing. While the demand in many industries can be entirely satisfied by importation, such as cars, electrical goods, and clothing, the same is not valid for the downstream oil and fuel industry where the majority of work is bespoke and requires domestic expertise. Fortunately for Brockman the workshop is busy with a record volume of work in hand (WIH), and the business has an attractive medium-term pipeline of growth opportunities.

We believe the past performance of SND provides useful insight into the potential economics of Brockman in a favourable competitive environment. More specifically, over the ten years from FY07 through to FY16, SND generated an average return on equity of around 25% with zero debt while distributing 85% of their reported earnings in fully franked dividends. The main downside, perhaps, was that their profits were lumpy. In comparison, Brockman's performance over the period was weak, and it appears that this was in large part the result of a much lower average revenue as shown in the table below. During this time, SND was solely focused on servicing the oil and fuel infrastructure industry and commanded a clear market share leadership especially within the area of refinery maintenance contracts. However, in April 2017 SND acquired a civil infrastructure business as part of a broader 'diversification strategy' and started to branch out into non-core maintenance work. Coincidentally, Brockman has been able to significantly increase revenue within the core oil and fuel industry since SND made these changes in FY17, as the table below illustrates. We believe these fundamental shifts by a critical competitor will be to the ongoing benefit of Brockman and increases the likelihood that operating margins and returns on their capital will improve.

Revenue $m	10 year average FY07-FY16	FY17	FY18	FY19f
Brockman	27.9	25.6	37.8	51.8
Saunders	51.2	20.0	38.2	25.8

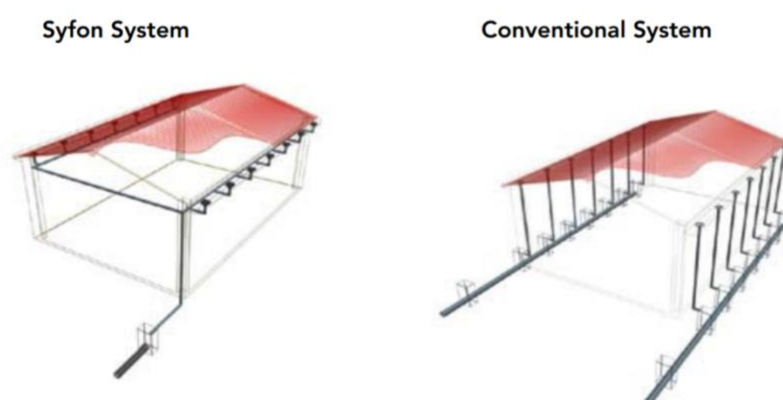
At a broader level, the Australian fuel supply landscape has undergone a meaningful change in the last decade following the closure of three oil refineries which were all converted to storage terminals. Four domestic refineries remain although they are finding it increasingly difficult to compete with the economies of scale achieved by 'mega' refineries based in other parts of Asia. The decline of refining capacity has reduced the need for intensive maintenance services but provided the impetus for ongoing investment in a more robust storage network as imports have replaced lower production volumes. Meanwhile, demand for liquid fuel continues to grow, predominantly driven by diesel and jet fuel, despite the substantial increase in efficiency of internal combustion engines and the introduction of hybrid and electric vehicle technology. Further, Australia's vulnerability to a fuel shortage continues to be a hot topic given we are the only member of the International Energy Agency that does not meet the minimum requirements for stockholdings of crude oil or liquid fuel. This issue is currently front of mind as the federal government is in the midst of a recently fast-tracked liquid fuel security review that in our perspective has a high probability of being the catalyst for the potential investment into additional storage capacity.

Syfon Systems was formed in 1992 in Melbourne and expanded into Malaysia in 1997. The business provides a single contractor total turnkey solution for the design, manufacture, installation, testing and warranty for large syphonic roof drainage projects. The firm has been a leading pioneer of syphonic roof drainage in the Asia Pacific region and has successfully established themselves as a clear market leader with an estimated 80% share across both the Australian and Malaysian markets.

Notable projects completed in Australia include Federation Square, Southern Cross Station, Eureka Tower, Chadstone Shopping Centre, the MCG and SCG, Metricon Stadium, and ANZ Stadium. Asian projects include the Marina Bay Sands, Kuala Lumpur Convention Centre and International Airport, Sunway Velocity Mall, City of Dreams Casino (Macau and Manilla). The Malaysian operations also recently signed a contract for the Tun Razak Exchange in Kuala Lumpur, which will be their most significant project on record.

Syphonic roof drainage is an alternative to conventional roof drainage for buildings over 4.5 metres in height that removes higher volumes of water, across longer distances, with significantly less piping. The technology is especially beneficial for large roof and podium surfaces in areas that are subject to extreme recurrent and one-off rainfall events. Conventional roof drainage is highly inefficient during massive rainfall events because water spirals into downpipes creating a vortex effect that traps large volumes of air, which generally limits overall water flow to only 25% of pipe diameter. Accommodating for this inefficiency necessitates the use of bigger gutters, stronger bracing, larger diameter downpipes, and a higher number of discharge points, all of which adds significantly to overall materials and construction costs. In contrast, syphonic technology restricts the flow of air into the downpipes thereby utilising 100% of pipe capacity which, when combined with syphonic suction effects, enables water to be drained over ten times faster.

The superior flow rates and suction action enable the syphonic drainage system to have considerably fewer and smaller diameter downpipes, while collector pipes do not require 'grade' (pipe slope to harness gravity) and can therefore span very long distances horizontally. These characteristics make syphonic technology very attractive because it significantly reduces the need to excavate for stormwater drains while also allowing for higher yields on under roof floorspace within traditional structures (as shown in the illustrations below). As a result, customers can often achieve lower overall capital costs, shorter construction times, reduced risk of flash flooding, and improved system longevity.



However, the potential market for syphonic drainage is very small relative to conventional methods, and the technology has remained a niche industry with specialised expertise. This characteristic has generally been to Syfon's advantage as they have been able to maintain a very high market share and consistently generate returns on equity above 20% with low annual capital expenditure to revenue requirements of roughly 3%. The core of Syfon's value-add and competitive edge exists within their specialised design and engineering services which are delivered on a project by project basis as they do not have any proprietary componentry that is unique to syphonic systems. They predominantly rely on their reputation for quality work and broad industry relationships with building designers, architects, and engineers who ultimately specify drainage systems very early in a project's conception.

Fortunately, the founder and current general manager, Adam Bellgrove, along with Malaysian general manager, Alvin Sia, are both highly competent leaders with in-depth industry knowledge and relationships developed over their respective 25 and 17 years with the business.

Syfon's Australian revenue has compounded at just over 3% during the previous decade and, given the developed nature of the local industry and their dominant market share, further growth is unlikely to be above broader economic expansion in the near-term. However, the potential in southeast Asia is significant, where the combination of high rates of population and economic growth, rapid urbanisation, and extreme rainfall climates provide the ideal market for syphonic drainage. Syfon's performance in Malaysia offers an insightful case study for what may lay ahead with revenue in that region compounding at 15% annually from $1.8m in FY08 to $7.4m in FY18. Since establishing an operation in Malaysia around two decades ago, the business has ridden a powerful wave of economic development that has predominantly concentrated around significant urban locations. For example, in 1997 Malaysia had an estimated population of 21.5 million and an urbanisation rate (percentage of people living in urban areas) of 58%, whereas today's population is 32.5 million with an urbanisation rate of 76%[5].

While Malaysia continues to grow strongly, the most substantial opportunity for Syfon is within neighbouring countries with large populations and low rates of urbanisation. For example, Thailand with a population of 69 million and an urbanisation rate of 50%, Vietnam with a population of 95.5 million and an urbanisation rate of 36%, and the Philippines with a population of 106 million and an urbanisation rate of 47%[6]. The challenge for the management of Syfon is to successfully introduce and educate these local markets about the benefits of syphonic drainage given the current default choice is conventional drainage. However, as the Malaysian experience has shown, the inevitable increase in structural density that occurs as part of the urbanisation trend results in considerable growth of large non-permeable roof and podium surfaces where conventional drainage will be inadequate and syphonic can provide a ready solution.

[5] https://data.worldbank.org/indicator/SP.URB.TOTL.IN.ZS?locations=MY

[6] https://data.worldbank.org/

DISCLOSURES:

Past performance is not indicative of future returns. The information contained in this document is of a general nature only and does not take into account your particular objectives, financial situation or needs. Accordingly, the information should not be used, relied upon or treated as a substitute for specific financial advice. These letters/updates are not an invitation to subscribe to Harrington Partners Fund 1 and should not be taken as such. Whilst all care has been taken in the preparation of this material, no warranty is given in respect of the information provided.

The opinions and estimates offered constitute our judgment and are subject to change without notice. Under no circumstances does the information contained within represent a recommendation to buy, hold or sell any security, and it should not be assumed that the securities transactions or holdings discussed were or will prove to be profitable. There are risks associated with purchasing and selling securities, including the risk that you could lose money. Harrington Partners Pty Ltd and Harrington Partners Fund 1 Pty Ltd nor its employees or agents shall be liable on any ground whatsoever with respect to decisions or actions taken as a result of you acting upon such information.

The All Ordinaries Accumulation Index represents an unmanaged, broad-based basket of stocks. Index returns assume that dividends are reinvested and do not include the effect of management fees or expenses. You cannot invest directly in an index.

No part of this material may be copied, photocopied, or duplicated in any form, by any means, or redistributed without Harrington Partners' prior written consent.