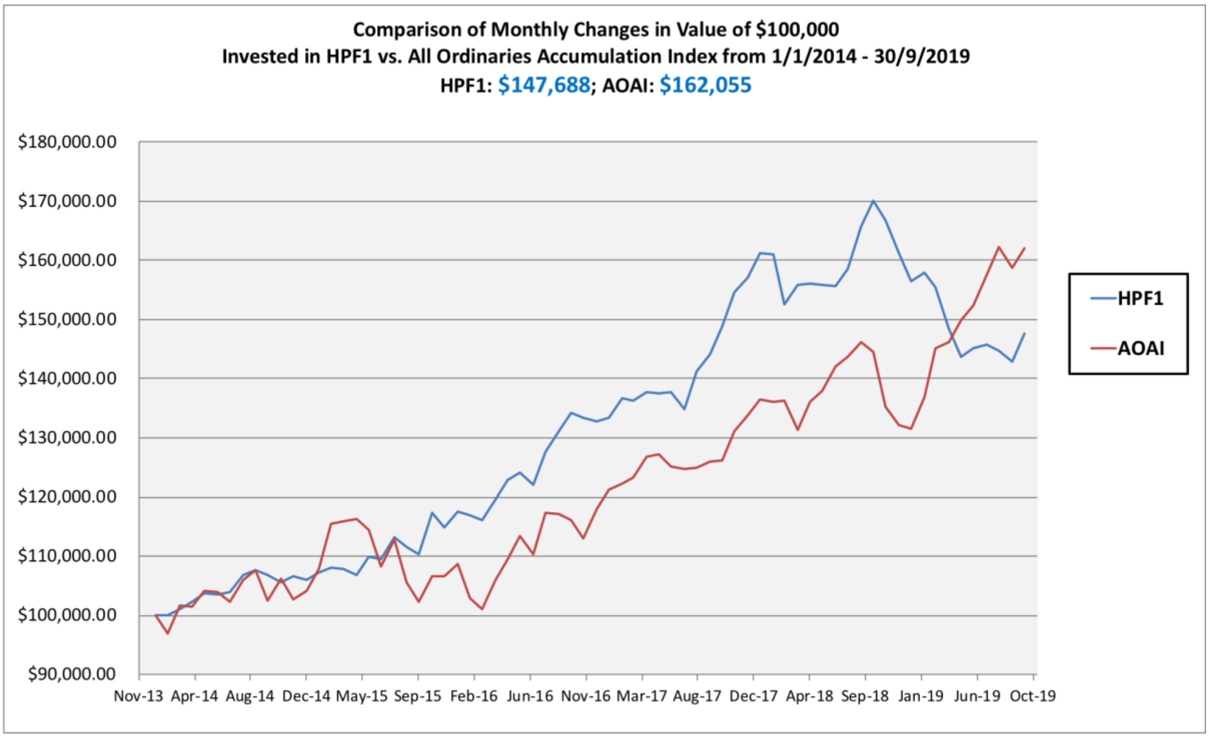
HARRINGTON PARTNERS
Investment Management

Harrington Partners Fund 1 (HPF1) – 30 September 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%
30/6/15	5.51%	5.67%	-0.16%
30/6/16	11.50%	2.01%	9.49%
30/6/17	10.48%	13.12%	-2.64%
30/6/18	15.49%	13.73%	1.76%
30/6/19	-6.45%	11.04%	-17.49%
3 Months to 30/09/2019	1.39%	2.82%	-1.43%
Annualised Performance	7.01%	8.76%	-1.75%
Cumulative Performance	47.66%	62.07%	-14.41%

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.



The Fund returned 1.39% net to investors during the first three months of Financial Year 2020 (FY20), this compares to a return of 2.82% for the All Ordinaries Accumulation Index over the same period. The core investments performed in line with expectations during the quarter as we continued to progressively transition the portfolio towards our aim of having a greater concentration within businesses that have above-average economics, defensible competitive positions, and competent owner-operator management teams.

To this end we have reduced the number of investments from 22 as of Dec 30, 2019 to a total of 14 at present and we believe this has significantly improved the inherent potential of future returns. The most prominent changes in recent periods were the inclusion of **Blackwall Limited [ASX: BWR]** and **Gowings Brothers Limited [ASX: GOW]**, along with the complete sale of our holding in **Boom Logistics [ASX: BOL]**, which the Fund has owned since 2014.

The top 10 holdings at September 30, 2019 were:

Rank	Holding	Total Equity Weighting	Total Portfolio Weighting
1	Enevis Limited (ASX:ENE)	16.25%	10.08%
2	EVZ Limited (ASX:EVZ)	15.88%	9.85%
3	Locality Planning Energy (ASX:LPE)	13.98%	8.67%
4	Kangaroo Plantations (ASX:KPT)	10.59%	6.57%
5	Fleetwood Corporation (ASX:FWD)	10.35%	6.42%
6	United Overseas Australia (ASX:UOS)	8.27%	5.13%
7	Blackwall Limited (ASX:BWF)	6.10%	3.79%
8	Gowings Limited (ASX:GOW)	5.14%	3.19%
9	FSA Group (ASX:FSA)	3.97%	2.46%
10	Excelsior Limited (ASX:ECL)	2.85%	1.76%

The top ten holdings made up **58%** of the total portfolio and cash allocation is **38%.**

The Appendix to this update includes our thesis on **Locality Planning Energy [ASX: LPE]**. LPE is a rapidly growing electricity retailer authorised with the Australian Energy Regulator (AER) that focuses on strata communities within southeast Queensland. The company has inherently defensible economics, an owner-operator culture, and significant growth potential.

We are privileged that you have chosen to partner with us on this journey. As always, we welcome any feedback, and if you have any questions, comments or investment ideas, please do not hesitate to contact us.

Yours Sincerely,

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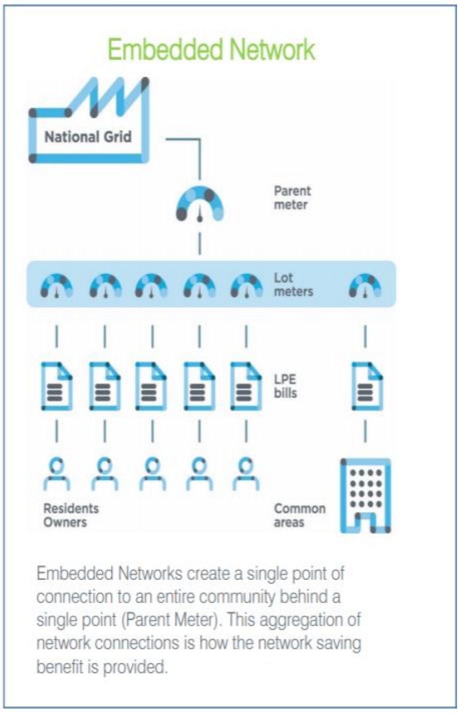
Appendix (Business Discussion)

Locality Planning Energy [ASX: LPE] is an electricity retailer focused on servicing established strata communities across southeast Queensland via three mechanisms of supply: Embedded Electricity Networks (EEN), Solar, and Direct Market Consumer (DMC). The Company is headquartered in Maroochydore where it was founded in 2012 by the current joint Managing Directors (MD), Damien Glanville and Ben Chester, whom each owns around 17% of the business. LPE aims to build long-term trust with customers and differentiate themselves through a transparent pricing structure and an Australian based customer service centre. Their motto is 'Honest Energy' within an industry notorious for lack of transparency, complicated pricing structures, and often frustrating customer service.

LPE's core product offering is known as an **Embedded Electricity Network (EEN)** which is a parent electricity meter installed in front of individual consumer meters suitable for strata communities of at least 50 lots such as apartment blocks, retirement villages, and shopping centres. The EEN creates a single point of connection to the National Electricity Market (NEM) instead of individual lot connections. As a result of this aggregation, only one NEM access fee is charged creating an average saving of 25-35% across the community which is shared amongst lot owners.



The EEN model has a relatively long sales cycle due to the body corporate voting approval process, and once approved, the network conversion takes on average 16 weeks. LPE funds the supply, installation, and commissioning of the EEN with the body corporate repaying this financing over an initial contract term of 5 to 10-years. Under the contract, LPE gains the right to be the default electricity retailer to the entire strata community for the duration of the initial term. That said, individual lots always retain the right to opt for a different retailer but in most cases, they lose the cost advantage received under the EEN. In essence, LPE creates a financing mechanism for the strata communities to lock-in the certainty of longer-term electricity rates significantly below standard retail prices. In return, LPE receives the right to the recurring income stream from managing electricity supply and billing.

LPEs **Solar** product was introduced in June 2018 to service smaller strata communities where an EEN is unviable but who want to access the benefit of lower electricity prices from onsite renewable generation. Similar to EEN, the Solar product has a relatively long sales cycle and requires a significant upfront investment which is funded in full by LPE in return for 10-year energy management rights. The solar systems are primarily designed to service the electricity requirements of the common areas with individual lot owners having the ability to tap into the system if they also become a customer of LPE.

Direct Market Customers (DMC) is the standard mechanism of electricity supply to individual consumers within the Australian market and involves a very short sales cycle and negligible upfront capital costs. LPE created the DMC product to service 70% of Australian strata communities where an EEN or Solar is not viable and to provide current customers with the ability to keep their account if they relocate. The DMC product significantly increases the number and density of customers within each sales territory and has the potential to dramatically improve LPE's fixed cost leverage over time. Both the acquisition costs to LPE and switching costs for the consumer are very low which suggests price competition will be intense and customer churn much higher than the EEN and Solar products. LPE's strategy is to only offer plans with a competitive and straightforward flat rate per kWh, whereas most competitors primarily offer plans that adopt an inflated headline price with the lure of concessions such as time-based usage and pay on time discounts. The complexity of traditional offers often results in 'disengaged' consumers who have an insufficient understanding of their retail electricity agreement and this often leads to higher costs than under a flat rate per kWh. Management reports that the DMC offering is proving very popular because consumers value the contract simplicity and expense certainty, along with the ability to contact an Australian based customer service team.

Economics and Competitive Position

LPE is an established player within a niche and high growth area of electricity retailing. This is an industry where defensible recurring revenue streams are the norm given the non-discretionary nature of residential consumption. Their primary focus on servicing established strata communities provides a massive growth runway, especially for the Solar product which is resonating well with this target market. At this stage LPE is primarily focused on Queensland which accounts for around 18% of the total strata lots within Australia but they have recently developed a presence in NSW (Sydney) which accounts for approximately 34% of total strata lots[1]. Management reports that annual electricity sales to the entire national strata market are around $2.6 billion[2], so given LPE's geographic coverage a very rough estimation is that their addressable market may be in the range of 40-50% of this, or around $1-1.3 billion. This compares to the LPEs forecast FY20 electricity sales of about $50 million.

LPE's competitive edge has emerged from its focus on servicing entire strata communities which are perceived as a more complex market than individual customers. The 'decision by committee' nature of initiating change on a community-wide basis results in a significantly longer sales cycle when compared to individual customers. For example, the process of putting forward a motion to install an EEN or Solar at a body corporate committee meeting, to the point where LPE can bill for electricity consumption, generally takes several months. LPE also provides financing for both the EEN and Solar products whilst assuming the ongoing responsibility for the often-complicated administrative task of accurately billing multiple lots from a centralised meter (EEN) or common source of generation (Solar). This overall approach requires a more sophisticated and patient sales and administrative function which many competitors deem to be 'too hard' or not worth the investment when compared to the quicker and lower cost method of selling to individual customers.

Fortunately, the end benefit of LPE's business model is a much stickier customer base and therefore more reliable long-term revenue streams. Given these economics we are more than happy for management to aggressively invest in customer growth for as long as the present value of each new customer remains attractive. LPE is executing on the classic long-term thinking we seek from management teams whereby they are focused on the overall lifetime value of each customer as opposed to the financial return in the current period alone. In our view this is the rational approach

[1] https://apo.org.au/sites/default/files/resource-files/2018/05/apo-nid174131-1184756.pdf
[2] http://www.aspecthuntley.com.au/asxdata/20190626/pdf/02117634.pdf#search=%22%22

and the type of behaviour that can lead to substantial wealth creation given the fact that businesses built upon a long-term horizon often face far less competition.

The competitive response from the incumbent 'big four' (AGL, Origin, Energy Australia, and ERM Power) to the rapid rise of several smaller players such as LPE has been relatively muted thus far. This seems to be a result of the fact that they are focused on the overall residential electricity sales pie, which is around $18 billion annually, and $37 billion when you include industrial electricity sales[3]. However, LPEs continued growth will not go unnoticed and we presume the big four will begin engaging more aggressively with comparable products marketed to the established strata industry. We are less concerned about the shorter-term behaviour of smaller direct competitors as we think there is adequate room for collective growth, whilst LPE is one of the few smaller players with the full trifecta of competitive strength, namely:

a) Retailer authorisation with the Australian Energy Regulator (AER);
b) Access to an ample amount of reasonably priced capital, and;
c) Established and scaleable sales and administrative systems.

Valuation

At this stage LPE is not producing free cash flow as they are investing heavily in customer growth of which management is forecasting to nearly double during the financial year 2020 (FY20). The rationale for this rapid customer expansion is based on past experience of the number of new customers generated daily by each salesperson and starting FY20 with 32 trained and deployed salespeople. More specifically, management reports that each salesperson signs up on average 3 new customers per day which, based on 32 staff working a 42 week / 210-day year, equates to customer growth of around 20,160 over twelve months. Management expects that at the end of FY20 LPE will have around 41,500 customers which would equate to ~92% growth on the 21,555 of customers they had at the end of financial year (FY19). One of the critical components of this forecast is the expectation that small and medium enterprise (SME) customers will come to account for 25% of the FY20 end total, relative to their current representation of around 6%. The average annual revenue of an SME customer is around eight times that of residential customers although this is traded off against much lower gross margins.

Table 1 below illustrates LPE's revenue and gross profit potential on a run-rate basis as at the end of FY20 when the above expectations around customer growth and changes in the relative customer 'mix' are applied to their historic average revenue and gross margin per customer.

Table 1: End of FY20 Annual Run-Rate Forecast

Customer Type	Number of Customers	Average Revenue per Customer	Average Gross Margin %	Revenue (Net of GST)	Gross Profit
Residential	30,500	$1,300	23%	$36,045,455	$8,290,455
SME	11,000	$10,500	13%	$105,000,000	$13,650,000
Total	**41,500**	**NA**	**15.56%**	**$141,045,455**	**$21,940,455**

[3] ibid

Taking this projection further, Table 2 below includes the above revenue and gross profit assumptions and incorporates our expectations for LPE's operating overhead to arrive at a potential run-rate net profit at the end of FY20. As Table 2 illustrates, this translates into an implied run-rate earnings yield of around 19% at the current share price of $0.75.

Table 2: End of FY20 Annual Run-Rate Figures
Assuming LPE Meets FY20 Forecast

	$	Notes
Revenue	141,045,455	Forecast
Gross Profit	21,940,455	Forecast growth margin of 15.56%
Employee cost	8,000,000	Annualised Q2 Management Estimate*
Admin & Corporate Costs	4,500,000	Annualised Q2 Management Estimate*
Interest	2,200,000	$22M of debt drawn at 10% annual interest
Net Profit	**7,240,455**	
Shares Outstanding	50,210,000	
Earnings Per Share	$0.144	
Sep 30 Share Price	$0.75	
Earnings Yield	**19.23%**	

*See Appendix 4C Dated 31 October 2019 - https://www.asx.com.au/asxpdf/20191031/pdf/44b434kgppcq92.pdf

This is by no means a definitive expectation, although LPE's trajectory up until the time of writing suggests the assumed customer growth and per customer economics remain on track. From our perspective substantial customer growth appears inevitable and we are not overly concerned with the exact numbers or timing of this variable. Our primary focus is on the sustainability of their margins and specifically the possibility for detrimental effects due to declining wholesale electricity rates or a blowout in their operating costs. LPE's capital structure is also of key importance and fortunately they have minimal need to raise equity capital in the near term, given their debt facility has ample undrawn capacity and just under three years of breathing room until renegotiation.

To conclude, we believe LPE provides compelling value based on the near-term growth trajectory and has robust downside protection constituted by the defensible nature of their incumbent customer profile, which in aggregate has an average remaining contract term of around seven years. Beyond this, if they can sustain comparable growth rates and per customer economics for the coming 2-3 years, then the upside is likely to be several multiples of the downside risk.

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