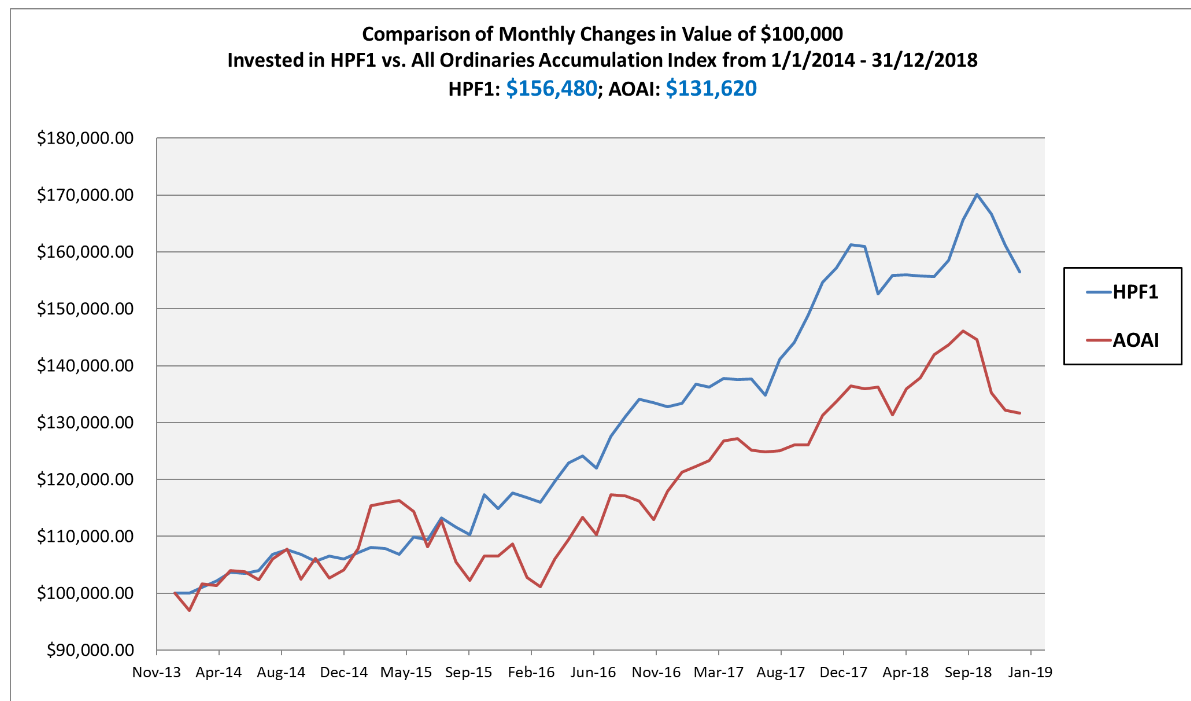
HARRINGTON PARTNERS
Investment Management

Harrington Partners Fund 1 (HPF1) – 31 December 2018

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%
29/06/2018	**15.49%**	13.73%	1.76%
6 Months to 31/12/2018	**0.52%**	-7.28%	7.80%
Annualised Performance	**9.37%**	5.65%	3.72%
Cumulative Performance	**56.48%**	31.62%	24.87%

#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 has returned 0.52% over the first half of Financial Year 2019 (FY19), this compares to a return of -7.28% for the All Ordinaries Accumulation Index over the same period. The strong start in Q1 FY19 reversed over the past three months with many of the core portfolio holdings experiencing significant price declines. Fortunately, most of these businesses are generating excellent trading performance, have healthy balance sheets, and expanding pipelines of new work.

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 Weighted Average Market Capitalisation	$105 million
Number of companies	22
Australian Shares	83%
International Shares	1%
Cash	16%
Concentration of top 5 holdings	61%*

*Of invested capital

The Fund owns shares in 22 companies with 61% of capital invested concentrated in the 5 largest holdings. The top 10 holdings made up 71% of the total portfolio and cash weighting is 16%.

The top 10 holdings at December 31, 2018 were:

Rank	Holding	Total Equity Weighting	Total Portfolio Weighting
1	Undisclosed	19.30%	16.27%
2	Undisclosed	14.16%	11.94%
3	Macmahon Holdings (ASX:MAH)	11.18%	9.43%
4	Boom Logistics (ASX:BOL)	10.37%	8.74%
5	Undisclosed	5.83%	4.92%
6	Fleetwood Corporation (ASX:FWD)	5.74%	4.84%
7	Undisclosed	5.14%	4.34%
8	Undisclosed	4.46%	3.76%
9	United Overseas Australia (ASX:UOS)	3.85%	3.25%
10	Konekt (ASX:KKT)	3.69%	3.11%

We are optimistic of the portfolio's latent upside potential given several key holdings continue to improve their operating and financial performance and are nearing the point where we expect an increase in the amount of capital returned to shareholders. However, the portfolio is heavily exposed to cyclical and capital-intensive businesses and we are mindful of the fact that underlying activity levels appear to be closer to a cyclical peak than a trough. We are advocates for a strategy of pragmatic growth in this environment, and more specifically, growth that can be achieved without the need to assume significant financial or operational leverage. Hubris can easily creep in on the back of linear demand projections and we are vigilant of whether any of our investee companies are becoming fragile were an unexpected negative catalyst to strike. We believe that HPF1s primary protection against such hubris comes from partnering with businesses where the key decision makers own meaningful levels of equity, as this provides a strong incentive to make prudent medium to long-term decisions.

The First 5 Years

December 2018 marks five years since the establishment of Harrington Partners Fund 1. Our primary objective from the start was to protect investors capital and outperform the Australian All Ordinaries Accumulation Index (AOAI) by 3-5% annually as measured over rolling 5-year periods. Fortunately, the Fund has achieved this objective by generating net returns to investors of cumulative 56.48% and a 3.72% annualised outperformance of the AOAI over the period. Our objective for the next five years

and beyond remains the same given our philosophy rests on the belief that capital preservation combined with superiority to the AOAI, as measured over rolling 5-year periods, is the most sustainable approach for generating wealth through the stock market.

As we have stated in the past, we do not expect the ongoing pursuit of this objective to be a linear and consistent trajectory, rather there is likely to be years when the Fund does not generate a positive return and underperforms the AOAI. However, we expect the outcomes over rolling 5-year periods will continue to be favourable and the AOAI will remain a suitably relevant long-term proxy against which to measure performance.

No Points for Difficulty

One of our most important lessons from the journey thus far has been that there are no points for difficulty in investing. In the beginning it was hard for us to overcome the misguided fear of looking incompetent by saying "I don't know" and passing on most opportunities. We now understand how crucial a clear awareness of your competence boundary is for minimising overconfidence and complacency. Being comfortable saying "I don't know" also provides the equally important benefit of reducing cognitive overwhelm and thereby creating the space necessary for making sound decisions within areas we know well. This realisation has also allowed us to become more patient and willing to do nothing when there is nothing worthwhile to do.

The willingness to endure long periods of little to no activity, while still searching persistently, is one of the hardest things to do as an active investor. This task becomes decisively more difficult at times when both the investor's performance is sub-par and other market participants are seemingly achieving investment success with ease. HPF1 will inevitably go through such periods and we are committed, as both managing partners and significant investors in the Fund, to maintaining our investment discipline during such times. As is often the case, it seems necessary to credit Warren Buffett who succinctly encapsulated the above notion by saying:

> "The stock market is a device for transferring money from the impatient to the patient"

The product of this approach has been that HPF1 is, and will continue to be, a relatively concentrated investment portfolio built upon a primary focus on paying sensible prices for businesses that:

1. Generate superior returns on capital and have good reinvestment prospects.
2. Are run by competent, honest, and appropriately incentivised owner-managers.
3. Have entrenched competitive positions that make them leaders in their niche markets.

The aim is to have the bulk of the Funds capital invested in such enterprises for long periods, while at the same time being opportunistic when favourable conditions arise. The current portfolio does not represent a glowing example of this objective, primarily due to the exposure to several businesses that are likely to generate average returns on capital. As such, there is likely to be a period of transition as we progressively improve the overall portfolios alignment with the above aim.

Business Discussion

The appendix to this letter contains an extended discussion on **Konekt Limited [ASX: KKT]** which is the Funds 10th largest position accounting for 3.11% of total capital. We made several analysis and valuation mistakes as part of the initial KKT investment in late 2017. The experience thus far has provided many valuable lessons, not least the challenge of critically testing our rationale against more objective facts and reasoning as our understanding of the business improves. We encourage you to read this section as we hope that it provides valuable insight into how we think about investing.

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If you know of any family, friends, or associates you think may benefit from becoming a part of HPF1, we ask that you please forward on our details or send theirs to us. Your recommendation is the type of authentic endorsement we strive for.

We are privileged that you have chosen to partner with us on this journey and wish yourself and your loved ones a happy, healthy and prosperous 2019. 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)

Konekt Limited [ASX: KKT] consists of two primary operating divisions; Konekt Employment and Konekt Workcare. Konekt Employment (formerly Mission Providence Australia) was acquired in September 2017 and assists individuals to find and maintain employment under the Federal Governments Jobactive program while also providing services under the New Enterprise Incentive Scheme (NEIS) and more recently the Disability Employment Services (DES) program. Konekt Workcare offers services to large government, corporate, and insurance clients to help them minimise the costs of physical and psychological employee injuries and illness. The combined business has over 800 staff and 115 locations across Australia.

Both divisions are characterised by a concentrated customer base with revenue profiles that are heavily reliant on a small number of significant contracts and as a result KKT faces recurrent high-risk periods during contract tender applications. This creates an unfavourable competitive dynamic whereby customers have superior bargaining power during contract negotiations given there are invariably multiple well-qualified competitors vying for the work. Price becomes a significant determinant of perceived value in this situation. Scale is also becoming a competitive necessity as customers opt for more concentrated volume allocations with the expectation that forecast productivity benefits will be shared through service providers charging lower prices.

Within the FY18 letter we briefly outlined our mistakes in relation to the initial investment in KKT. In hindsight, we paid too much for what was an unfavourable risk-reward dynamic and have learned to be more discerning when considering an investment in the type of economics KKT exhibits. More specifically, we noted that we had *"…significantly underestimated the risk posed by their heavy reliance on a concentrated customer and contract revenue profile."* This reality played out adversely during the period when the Company announced that their second biggest contract, which represented approximately 12% of acquisition adjusted FY18 revenue, will not be renewed past June 30, 2019. The full impact of this development is yet unknown as management is presently working through the transition process and attempting to reallocate staff internally, however significant revenue contraction and corresponding margin dilution are inevitable.

The challenge management now face is how to effectively navigate this operational deleverage and specifically whether to endure financial underperformance, due to lower employee utilisation, in the expectation of near-term recovery in contract volumes. It is essential that management is pragmatic and avoids taking actions that could lead to a destructive loss of accumulated workforce skills or a meaningful deterioration to employee morale, loyalty, and company culture. The cliché that *'people are the most important asset'* is no more accurate than in a business like KKT as it is the quality of their workforce that will ultimately determine the extent to which future opportunities can be exploited. This is an ongoing challenge for KKT as the business must accurately resource itself such that it can competently deliver on large incumbent contracts and be able to scale up capability on short notice, while always being cautious of not creating a rigid cost base which is unable to be rationalised when contracts are lost. Effectively managing these ongoing productivity pressures under a fluctuating and unpredictable demand profile requires a pro-active and hands-on style of leadership. Fortunately, we think this is a challenge the CEO, Damian Banks, is both capable and

appropriately incentivised to take on.

While our appraisal of KKT has reduced significantly since our initial investment, the market price has dropped far more, and we believe the business is conservatively worth $50m against a current enterprise value of only $35m. This valuation is predicated on the belief that FY20 will represent a low point in profitability and be indicative of a sustainable free cash flow (FCF) yield from which financial performance will gradually improve. The most critical component (and risk) to our valuation is the belief that the Jobactive contract with the Federal government will be extended beyond June 2020 in a form that is comparably favourable for KKT as exists today. However, there is a non-trivial probability that this may not occur given the next Federal election is on the horizon and the tendency for newly elected governments to adjust welfare policy as a matter of due course. That said, we estimate KKT to be in a strong position and likely to continue as a crucial provider of employment services at scale under future Government programs.

KKT	FY20 ($m)
Revenue	85.0
EBITDA^ @ ~ 9%	7.5
Capex	1.5
Interest	1.0
Earnings Before Tax	**5.0**
Tax @ 15%*	0.8
Free Cash Flow	**4.3**

^ EBITDA = Earnings Before Interest Tax Depreciation and Amortisation.
* Tax rate of 15% due to the utilisation of significant carry forward tax losses.

As the table above illustrates, our FY20 FCF forecast of $4.3m represents a 12% yield on the current $35m enterprise value which we think is adequate, albeit not compelling, given the circumstances. Our base case expectation from this point is mild revenue growth on the back of increased Jobactive caseloads and DES volumes, along with continued strong performance from their workplace psychological health division. We think FCF, will improve closer to $5m or $0.045 per share, as interest charges decline and productivity improves in line with lower volatility in contract volumes, with the majority of this going towards debt reduction over the coming 24 months. However, once the debt is at more conservative levels, we anticipate that KKT will significantly increase fully franked dividends through leveraging a beneficial combination of low capital investment requirements, considerable tax losses, and accumulated franking credits. Overall, with an average buy price of $0.475 it is unlikely that Fund will generate an acceptable return on investment and may not even recoup the capital invested. However, we anticipate a much smaller overall loss than the current market valuation implies.

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