HARRINGTON PARTNERS

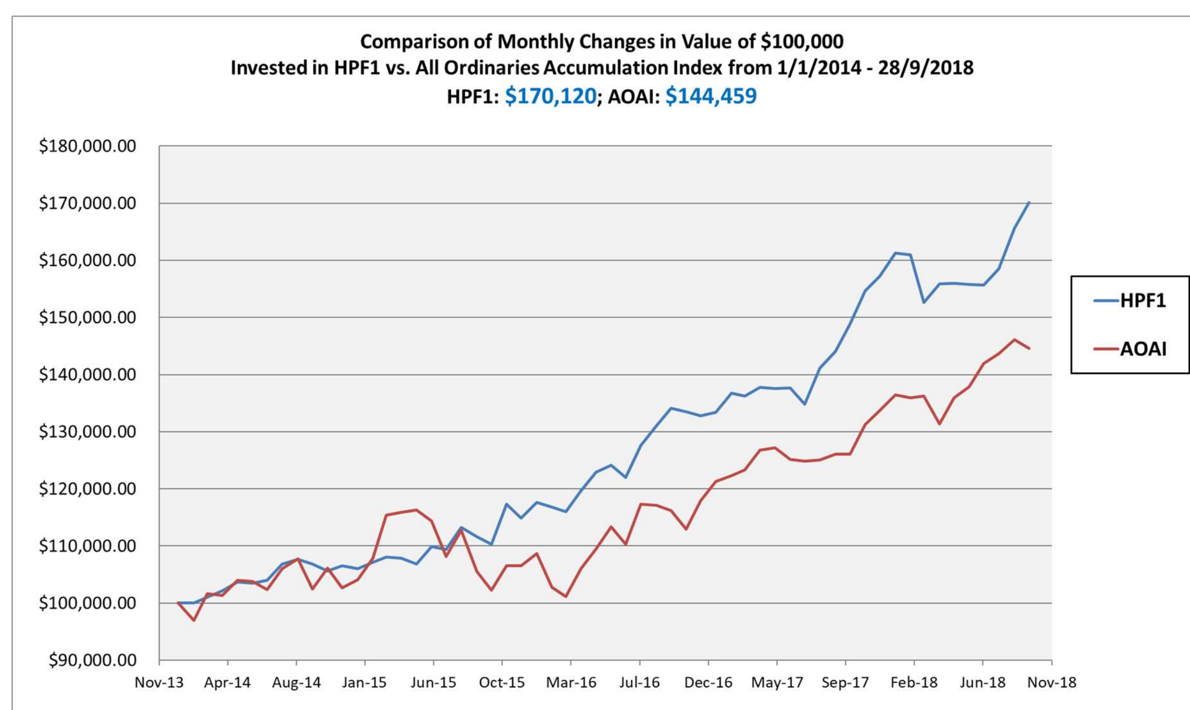
Investment Management

Harrington Partners Fund 1 (HPF1) – 28 September 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%
3 Months to 28/09/2018	9.28%	1.86%	7.42%
Annualised Performance	11.84%	8.07%	3.76%
Cumulative Performance	70.12%	44.59%	25.53%

#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 had a good start to financial year 2019 (FY19) returning 9.28% net of all fees over the first three months to September 28th, 2018, this compares to a return of 1.86% for the All Ordinaries Accumulation Index over the same period. As we start the second quarter of FY19, the completion of which will mark five years since the Fund was established, we are optimistic that we can maintain and potentially increase our current annualised relative performance of 3.76% over the AOAI. As promised, the appendix to this letter contains a brief overview of Fleetwood Corporation (ASX: FWD) which is the Fund's 5th largest holding.

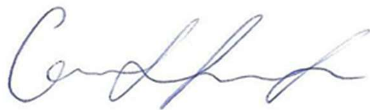
The top 10 holdings at September 28, 2018 were:

Rank	Holding	Total Equity Weighting	Total Portfolio Weighting
1	Undisclosed	17.34%	14.94%
2	Undisclosed	13.57%	11.69%
3	Boom Logistics (ASX:BOL)	13.22%	11.39%
4	Macmahon Holdings (ASX:MAH)	12.15%	10.47%
5	Fleetwood Corporation (ASX:FWD)	6.12%	5.27%
6	Undisclosed	5.41%	4.66%
7	Undisclosed	4.62%	3.98%
8	Undisclosed	4.01%	3.45%
9	Konekt (ASX:KKT)	3.79%	3.26%
10	United Overseas Australia (ASX:UOS)	3.49%	3.00%

The top ten holdings made up 72% of the total portfolio and cash allocation has decreased over the period from 30% to 14%.

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)

The Fund first started buying **Fleetwood Corporation [ASX: FWD]** in May 2015 when the Company was best described as a mini-conglomerate with operations spanning manufacturing and distribution of caravans, caravan parts and accessories, aluminium tray and fibreglass canopy's, portable accommodation, and finally the construction, ownership, and management of transient workers accommodation (TWA) villages. At the time FWD was working through a difficult multi-year period of revenue contraction which had seen their earnings per share drop from $0.865 in FY12 to only $0.074 in FY15 (-91%). Not surprisingly the share price had taken a similar tumble of around 90% from a high of over $13.50 in 2011 to around $1.40 when we started buying. Our investment thesis resided on the belief that on a 'sum of the parts' basis FWD was worth closer to $3, and crucial to this was the expectation that the performance of their troubled caravan manufacturing business would improve. As it stands today, we still believe we appraised the first part of this dynamic reasonably accurately although events have proven we were wrong on the latter as we briefly outline herein.

At a parent Company level, the period from the early 2000's through 2013 were golden years as FWD successfully rode the wave of sustained growth within core exposures to the recreation, retirement, and resources sectors, despite highly variable results amongst the operating divisions. Their businesses focused on the broader caravan industry and retirement sectors, known as the Recreational Vehicles (RV) division, grew consistently fuelled by the demographic tailwind of an ageing population which increasingly had the financial capacity and time available to engage in recreational pursuits. However, RV experienced significant revenue contraction immediately following the GFC, and the subsequent operational deleverage resulted in a 57% decline in pre-tax earnings. Fortunately, this was more than offset by strong performance from their then Manufactured Accommodation (MA) division which itself was being fuelled by the Western Australian centred mega-mining-boom.

The mining-boom opportunity proved so significant for the MA operations that management focus and capital investment on the RV division waned. As a result, the design, build, and fit-out quality of their caravans became significantly inferior at the same time competition was becoming increasingly fierce. The most damaging flow-on effect was that members of their national sole-dealership network progressively started to abandon RVs well known Windsor and Coromal brands which, despite a brief volume recovery in FY10 & FY11, ultimately resulted in significant unit sales declines to the point where manufacturing volumes were insufficient to cover fixed overheads. The fatal decision for RV occurred in 2012 when all manufacturing operations were transferred to WA thereby creating a significant competitive *disadvantage* due to the cost of transporting completed goods from the West to the East where the majority of customers resided. Despite this monumental competitive headwind, FWD elected to invest heavily in restoring the fortunes of the division and were successful at improving caravan quality and re-establishing a strong sole dealership network. Unfortunately, financial losses continued to mount, which ultimately resulted in the recent decision to sell the brands and shut down the factory, with the transition process forecast to be completed in early 2019.

A lot of money and management focus has been expended trying to unsuccessfully turnaround the RV division and the fact that FWD persisted for so long appears to be a product of a heavy sentimental attachment to caravan manufacturing under the previous board, which was to be expected.

Fortunately, we believe this ordeal has positioned FWD to be in its best health since our initial investment as it is now comparatively less complex and more focused from a strategic, structural, and managerial perspective. Today FWD is a composite of independently and consistently profitable

operating businesses across three distinct divisions; Parts and Accessories (P&A), Villages, and Fleetwood Australia (FA).

The **P&A** division houses two operating business known as Camec and Northern RV. Camec is Australia's largest wholesaler/retailer of caravan appliances, parts & accessories with four company run Australian stores and one in Auckland NZ, along with a successful online store and an extensive national network of third-party retailers. The performance of Camec has been improving rapidly over recent years despite flat overall industry volumes and this is a testament to the quality of the incumbent executive team who have been able to both expand pre-tax earnings and reduce the amount of capital employed. Achieving high levels of efficiency in this business requires a persistently sharp focus on working capital management and FWD is fortunate to have a highly competent CEO in Manny Larre who does just that. Northern RV (NRV) was acquired in July this year and is a single workshop business based in Campbellfield Victoria that focuses on plumbing, gas fitting, and electrical parts & accessory supply, installation, and certification to the caravan industry. NRV supplies plumbing kits and certification to 27% of the caravans manufactured in Australia and has a large market share in the plumbing and electrical certification of the growing import market. There is strong strategic and financial rationale for combining the operational skillsets of Camec and NRV, but also significant key-man risk given NRV is essentially being 'corporatised' from what has been a family run business.

The **Village** division owns the Searipple transient worker's accommodation (TWA) village in Karratha WA along with a 10-year contract with the West Australian government for the management of an affordable housing village in South Hedland WA. FWD has freehold ownership over half of the 15-acre site which houses Searipple, this land was purchased as a caravan park around three decades ago and is held at cost. The attractiveness of this asset lies in the substantial operating leverage when high rates of occupancy are achieved, although occupancy in recent years has been running well below 50% due to an oversupply of TWA rooms in the region. The majority of Searipple's current tenants are workers who perform maintenance and shutdown operations which tends to deliver multiple short-term demand spikes throughout the year as opposed to more consistent medium-term demand from mine construction and production workers. Despite this variable demand profile, the village generated pre-tax margins above 30% during FY18 and we expect further improvements are likely in FY19 as the volume of shutdown and maintenance demand continues to expand.

From an optimistic perspective, there is a reasonable probability that *sustained* levels of high occupancy may be achieved over the coming 2-3 years given the combination of large capital investment intentions in the area from the likes of Woodside Petroleum, Rio Tinto, and BHP, and the fact that the number of TWA rooms in Karratha has reduced from 7,000 in 2013 to around 3,200 today (Searipple's market share has doubled since 2013 as they have only removed negligible rooms). However, the big resources companies are pre-empting their own demand to avoid being faced with a chronic undersupply of TWA options, by applying with the local council to construct their own TWA villages. Even under this increase supply scenario it is likely that Searipple will experience much higher occupancy given the sheer volume of TWA rooms that would be required were the announced projects to proceed as planned. Under the right conditions, Searipple profitability has the potential to double, although we are not factoring any growth into our intrinsic valuation and are happy to own this asset which even under current conditions is generating great free cash flow (FCF).

Fleetwood Australia (FA) is the country's largest vertically integrated pre-fabricated (prefab) construction business and provides manufactured buildings to the education, government, commercial sectors, and, to a much lesser extent, the residential housing market. The business has a national network of manufacturing facilities and on-site installation teams based in Victoria, NSW, Queensland, and Western Australia, and are one of only a handful in the industry that has an in-house

architectural design, drafting, and rendering capabilities. The division is led by a highly competent CEO in Jarrod Waring, who is eager to grow the business through leveraging FAs reputation for delivering quality projects on time and within budget. Importantly, this market-leading operating infrastructure is backed by a very healthy parent company balance sheet which enables the subsidiary to support the large current and anticipated future production volumes required by their long-term government clients. The near-term growth potential for FA is attractive given the VIC, NSW, and QLD governments are all in the early stages of multi-year multi-billion-dollar school infrastructure investment programs to accommodate for a boom in school-aged children, specifically within their respective capital cities where Australia's rapid population growth has been concentrated.

It is easy to see some of the tangible first-order effects of our Country's population trend, particularly within Melbourne and Sydney, where there has been an enormous amount of high-density and freestanding residential and commercial construction to meet housing and office demand, while governments are investing record levels on civil infrastructure projects to cope with skyrocketing road and public transport congestion. The inevitable flow-on capacity demand to other forms of crucial social infrastructure is also occurring, such as schools, universities, hospitals, and prisons. While we are always wary of the sometimes-fleeting nature of politically charged investment programs, the current circumstances appear to us to be the result of unavoidable 'catch-up' following several years of underinvestment which has been exacerbated by population growth well above expectations. We also believe school infrastructure spending in particular, which is FAs primary focus, is less vulnerable to budgetary and bipartisan political risks. That said, we do not expect the announced school spending spree will provide long-term recurring revenue, but rather a very healthy medium-term spike given the social/political pressure to build capacity in short time frames.

This time-constrained dynamic is highly favourable for the prefabricated industry overall given the primary advantage over traditional onsite methods is speed. Projects which utilise prefabricated structures can progress at much faster rates because factory-based construction and on-site preparation works can take place simultaneously. The predictable factory environment has the advantage of being able to better control economic, risk, and environmental factors such as build quality/consistency, safety, security, weather, raw material consumption, waste/recycling, and energy usage. Prefabricated construction is also much safer and less intrusive for communities surrounding the end project because it requires less site movements (construction equipment, workers, building supplies, waste removal, etc) which generally cause lots of disruption especially within highly sensitive and densely populated areas. For example, FA has completed the installation phase of smaller projects during long-weekends with minimal site movements, greatly reducing the disturbance to both local communities and student's education schedule. Prefab structures can be more easily remodelled, reconfigured, or removed and redeployed to accommodate changing capacity or usage requirements. And finally, prefab reduces the problems posed by skilled labour shortages especially in regional areas because structures can be delivered to site virtually complete with minimal fit off requirements allowing qualified installation teams to commission projects on very short timeframes.

State government education departments have been pioneers in supporting the modernisation of prefab structures to the point where they are now being adopted as permanent multi-decade solutions to fluctuating school capacity requirements. The aesthetic potential of prefab buildings is today arguably on par with traditional construction methods and this is helping break the stigma that has long surrounded what are unlovingly known as 'demountable' classrooms. Broader industry penetration is still very low; however, momentum is building, and prefab is starting to be adopted more consistently in an extensive range of applications such as motels, retirement living, affordable housing, universities, and large residential projects. The upfront investment required to support this

growth is not onerous, with FA able to establish suitable prefab factory's for around $1 million in the space of 3-6 months given Australia has a good stock of appropriate vacant manufacturing facilities. In general, beyond the necessity for a location that is easily accessible to large articulated vehicles, all that is required is sufficient underroof floor space serviced by a capable gantry crane, and concreted 'hardstand' space (unroofed outdoor area for storage and transport logistics). The expansion risk predominantly lies in the lease term and how well this can be matched to reliable underlying contract demand. This dynamic tends to suit operators with multi-year contracts who can efficiently manage their overheads through optimising factory utilisation and work flow of onsite installation teams.

The development of the Australian prefab industry is not without its challenges, and like any industry in its infancy, it will no doubt take longer than expected for the necessary system-wide adaptation to occur that will ultimately enable prefab to advance from what is still considered a marginal and inferior solution towards mainstream popularity. That said, we believe the advantages over traditional construction are just too significant to ignore, particularly for the applications discussed above. Further, FA is ideally positioned to play a significant future role given the business's sound industry reputation, market-leading operating scale, and superior financial capacity. We encourage you to watch the several videos produced by FA on their Vimeo site here to better understand the scale, quality, and potential of their operations and prefab more broadly.

Our investment thesis is predicated on the belief that the FA division alone has the potential to be worth more than FWDs current enterprise value with pre-tax earnings (net of recent acquisitions) likely to experience a rapid expansion around calendar year 2019 as the wave of State government education demand manifests. We expect FWD will begin distributing a healthy fully-franked dividend stream beginning in the second half of FY19 once they have cycled through the closure of the caravan manufacturing operations along with the integration of recent acquisitions.

Despite our optimism, one of our ongoing points of uneasiness with FWD is the low insider ownership by the board and senior executive, with the Managing Director only recently investing what appears to be a meaningful amount of his own money into the Company. Our preference is to invest alongside management who have meaningful ownership established with their own money (not through $0 priced options or rights) who are also investing at the same time we are. The insider ownership dynamic of FWD has resulted in the Fund having a smaller portfolio allocation than would otherwise be the case, we would like to see broad-based insider buying at FWD as this, in majority of cases, provides a very strong signal of value. Fortunately, the remaining characteristics of the investment are very attractive; robust balance sheet with no net debt and a solid tangible asset backing, strong industry tailwinds, comparatively minor near-term capital requirements, $23m of franking credits, and what we believe is a 'low expectation' valuation.

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