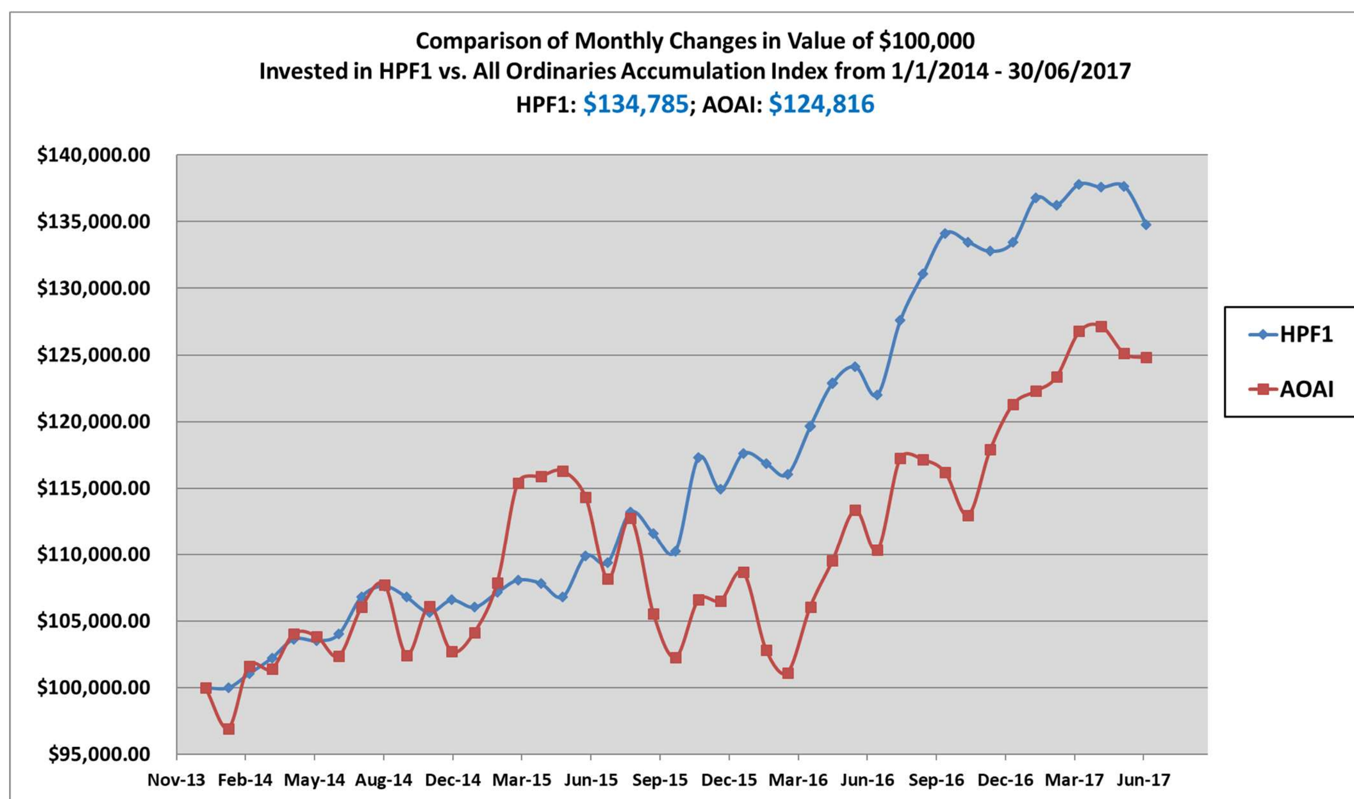
11 August 2017

Dear Partners,

Harrington Partners Fund 1 (HPF1, the Fund) finished the Financial Year 2017 (FY17) with a unit price of **$1.2429**, equating to a gross return of **12.15%** (before accounting for fees). The Fund does not try to match any index or benchmark; however, it is necessary to test performance against a pre-determined and relevant reference point. For this purpose, the All Ordinaries Accumulation Index (AOAI) is suitable given it includes reinvested dividends and provides a relevant comparison to what an investor could achieve in a low-cost broad-based index fund. Over the past 12 months an investment in the AOAI would have returned 13.12%. With distributions reinvested and net of all fees, HPF1 has returned **34.79%** since inception, as against a return for the AOAI of **24.81%** over the same period.

	HPF1 Net* Return	Distribution Per Unit	AOAI Return#	Relative Performance
6 Months to 30/06/2014	**3.71%**	**$0.00494**	**2.36%**	**1.35%**
30/06/2015	**5.51%**	**$0.01693**	**5.67%**	**-0.16%**
30/06/2016	**11.50%**	**$0.09448**	**2.01%**	**9.49%**
30/06/2017	**10.48%**	**-**	**13.12%**	**-2.64%**
CAGR	**8.91%**		**6.54%**	
Cumulative Performance	**34.79%**	**$0.11635**	**24.81%**	**9.98%**

#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.



The Harrington Partners Approach

Harrington Partners' primary objective is to protect partners' capital whilst 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 modeling. We do not trade price movement, trends, or macro-economic theories.

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

We see ourselves as business owners and although the bulk of what we do is numbers driven, we 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 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 have the ability to 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, provided that the fundamental investment hypothesis remains sound.

If our first preference cannot be met, we are committed to scouring 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. Rather, 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.

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.

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

Portfolio Weighted Average Market Capitalisation	$133 million
Number of companies	15
Australian Shares	41%
International Shares	1%
Cash	58%
Concentration of top 5 holdings	67%*

*Of invested capital.

The Fund owns shares in 15 businesses with nearly 70% of the capital invested concentrated in the 5 biggest holdings. The weighted average market capitalisation is a clear indication of the Funds focus on under researched 'small capitalisation' and 'micro capitalisation' businesses where we can best leverage our competitive edge. The cash allocation remains well above our long-term intentions and we expect this to reduce significantly over time.

The most relevant components of HPF1s cumulative performance since establishment have been that;

1. The opportunities that most comprehensively met our investment criteria have generally been the best performers whilst, not surprisingly;

2. The bulk of our mistakes have come from opportunities that, from the outset, *struggled* to comprehensively meet our criteria checklist, and;

3. We have carried a relatively large cash position.

We reflected on similar characteristics 12 months ago in our FY16 letter and briefly outlined our key focus areas for improvement, namely; investing more time, energy, and capital in our most strongly held convictions and invest much less into opportunities that display lower probability of acceptable returns. Operationally this has meant saying '*no*' earlier to those seemingly attractive opportunity's that do not comfortably meet our risk/return requirements and allocating the additional resources towards improving our understanding and potential investment in those opportunities that do. More specifically we noted that:

> *"We believe that we have not yet fully leveraged the benefits of concentrating our time, energy and capital to anywhere near its potential and we know we can significantly improve in this area."*

We have built significant momentum in this pursuit during FY17, both professionally and personally, and a big part of financial year 2018 (FY18) is about pro-actively continuing this journey. We expect that our persistent focus on quality over quantity will result in the combination of lower cash weightings over time combined with a reduced likelihood of capital loss. We are prioritising areas where we can identify exploitable competitive advantages and are intently focused on leveraging our differentiated approach and operating structure to add superior value.

Further, we continue to improve the Funds' systems, processes, and daily operations to create the necessary psychological and physical 'space' in preparation for significant growth. We are already seeing the tangible benefits of this discipline with an increase in the number of worthy investment ideas. As our knowledge and good habits compound, so does our potential, and we are in the best position yet, to capitalise on this positive momentum.

Business Discussion

The appendix to this letter contains an extended discussion of three investments that are now 'complete' - one success and two mistakes. We encourage you to read this section carefully as we hope that our commitment to writing it provides valuable insight for all partners.

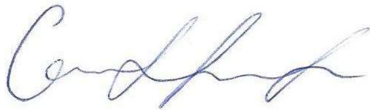
Outlook

We are as prepared as ever and it is our expectation that FY18 will be a good year for HPF1. Our view is that there is a significant amount of unrealised value within the current portfolio and we have identified some great opportunities to allocate increasing amounts of capital. The Fund has started FY18 strongly being up 4.1% at the time of writing.

We are privileged that you have chosen to partner with us on this journey and wish yourself and your loved ones a healthy, happy, and safe FY18.

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

Yours Sincerely,



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APPENDIX 1:

Business Discussion

The Fund recently sold its entire position it held in **Scantech Limited (not listed)** and realised a compound annual return of 12.4% on its investment during the 2-year holding period. Whilst the return was not overly spectacular, the investment provides a good illustration of an important element of the Harrington Partners Approach – the search for low-risk investments with attractive upside potential.

Scantech is a world leader in the niche market of manufacture, installation, and servicing of on-belt analysers to the bulk materials industry (coal, cement, iron ore, phosphate, etc). Their products are all about improving productivity as they provide real time analysis of bulk material quality in the mining, refining, production, and feedstock stages of the resource lifecycle. Both producers and consumers of bulk materials experience significant efficiency benefits from the use of Scantech products which helps to optimise the productivity, longevity, and profitability of their assets. Scantech even offers money back performance guarantees and reports that most customers experience full payback on the initial analyser investment in well under 12 months.

Scantech's competitive advantage lies primarily in their reputation for superior quality and reliability within their niche market. They have a large established base of operating analysers which require ongoing maintenance, this revenue stream is high margin and has valuable annuity characteristics. Further, their customers are not overly price sensitive given the crucial role analysers play in the overall production cycle and the small relative cost of analysers compared to the overall infrastructure investment. We attended the annual general meeting in November 2015, held at their headquarters in Adelaide, and were impressed with the professionalism and enthusiasm of the personnel at all levels. The workshop was clean, well maintained and efficiently run.

The Fund bought several parcels of Scantech shares starting in mid-2015. The average purchase price was $0.51 and at the time the business had a net tangible asset (NTA) backing of $0.62, net current assets of $0.60, and cash per share of $0.44. We liked the combination of their cash rich balance sheet, an operating business with good earnings prospects, and a management team who owned over 35% of the company. We expected Scantech to deliver reasonable returns for bearing a low level of risk and, therefore, offered an attractive opportunity to invest a significant amount of the Funds capital.

Unfortunately, there were few shares on offer, and we were only able to build an ownership position that was approximately 0.5% of the company. The process of building our ownership position was made more difficult when the company elected to delist from the ASX in October 2015 and transferred to what is known as a 'low volume financial market' for the trading of its shares. To our knowledge no trade has yet been made under this structure and this lack of liquidity was a key factor in our decision to tender all the Funds shares in a recent company initiated buyback.

Whilst we still believe Scantech has a bright future, we decided that selling into the buyback at a reasonable NTA premium and reallocating the capital was the best option for the Fund.

RNY Property Trust [ASX: RNY] – The Fund realised an overall 69% *loss* on investment when it sold the remainder of its holding in RNY during FY17. The catalyst for our decision was the announcement that bids received for the bulk of their assets with the greatest equity component, were 13.3% below the 30 June 2016 carrying value. Their significant leverage meant that this potential discount had a precipitous effect on NTA per share falling from $0.27 to a predicted $0.04-$0.10. We saw this as the start of a dangerous negative spiral and concluded that the equity had an unacceptably high risk of being worthless.

When we first invested in RNY in mid-2015 we were aware of the inherent risks posed by their unhealthy balance sheet. Despite this, we incorrectly judged that the market valuation was excessively pessimistic of their ability to monetise the underlying property assets over a 2-3year period. As such, we thought RNY presented a good opportunity for patient investors. However, we underestimated the rate at which their asset values would deplete due to a generational shift in demand for office property away from the suburbs and into connected city centres (part of the 'urbanisation' trend). We expected the value of these assets to follow their traditional path of fluctuating in line with underlying economic and employment activity. However, the significance of this longer-term trend is causing a large proportion of these assets to become stranded. This is especially true of the 'B-grade' suburban office property's that RNY predominantly owns.

Overall, whilst we had partnered with good management and thought we had a great price, we underestimated the overwhelming negative effects of their depleting asset value and overleveraged capital structure. We have learnt that the significance of a few individual risks, especially leverage, can easily outweigh a long list of positive attributes. Secondly, it has reminded us that the best form of risk minimisation is to always conduct yourself like a prudent business owner in *thoroughly knowing what you own*. RNY properties are all US based and we did not perform sufficient 'on-the-ground' research to test our hypothesis that they indeed had intrinsic value significantly above the market price.

Hughes Drilling [ASX: HDX] – was a mineral production drilling contractor that went into voluntary administration in September 2016 and is now owned by Action Drill and Blast. HDX is our largest mistake to date, we invested just under 1% of the Fund's total capital into the business, and this has been written down to zero.

We were initially attracted to HDX because of its strong market share in east coast coal production drilling, large insider ownership, vertical integration (through the ownership of Reichdrill a US based drill manufacturer), and the extremely low market valuation relative to our analysis of distributable cash flow and tangible asset backing. The Fund's average purchase price for HDX was $0.106 per share which represented a 63% discount to NTA of $0.29 and only 1.2 times FY15 operating cashflow.

We wrongly assumed that, despite their highly leveraged capital structure, complete failure of the business was unlikely due to the solid underlying cash flow being generated by long term drilling contracts with a diverse range of 'blue-chip' mine owners. We were confident that the founder/chairman, who had 35% of his own skin in the game, would not allow catastrophic unforced errors to occur. It was our view management could have easily halted capital expenditure on new projects and used the consistent operating cashflow to pay down debt to a more manageable level. This could have been done in a relatively short period of time and although Hughes would have lost

market share in the short term, the company would have had a much higher probability of continuing as a going concern and providing significant value to equity holders.

Unfortunately, despite management proclaiming that debt reduction was a primary focus, they were unable to refuse work and subsequently used operating cash flow and additional debt to chase growth. The pressure of this unsustainable approach ultimately led to Hughes losing the confidence of its bankers. As it now stands, whilst secured creditors will likely recoup a portion of their investment, the equity is worthless.

In hindsight, we should have been focused intently on *what management were doing* and less on *what they were saying*. We were aware that there was a very real possibility that the company could go bankrupt but incorrectly concluded that the probabilities of survival were higher and that if this was the case the return on investment would have been substantial.

Action Drill and Blast [ADB] have reported that the legacy east coast business continues to trade very profitably, has maintained market share, and has a strong order book. The ASX listed parent of ADB, NRW Holdings, paid cash for Hughes and at a consolidated level adopts a conservative leverage profile. NRW paid a bargain price for a fundamentally good business that was mismanaged and overleveraged, they are likely to do very well from the transaction.

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