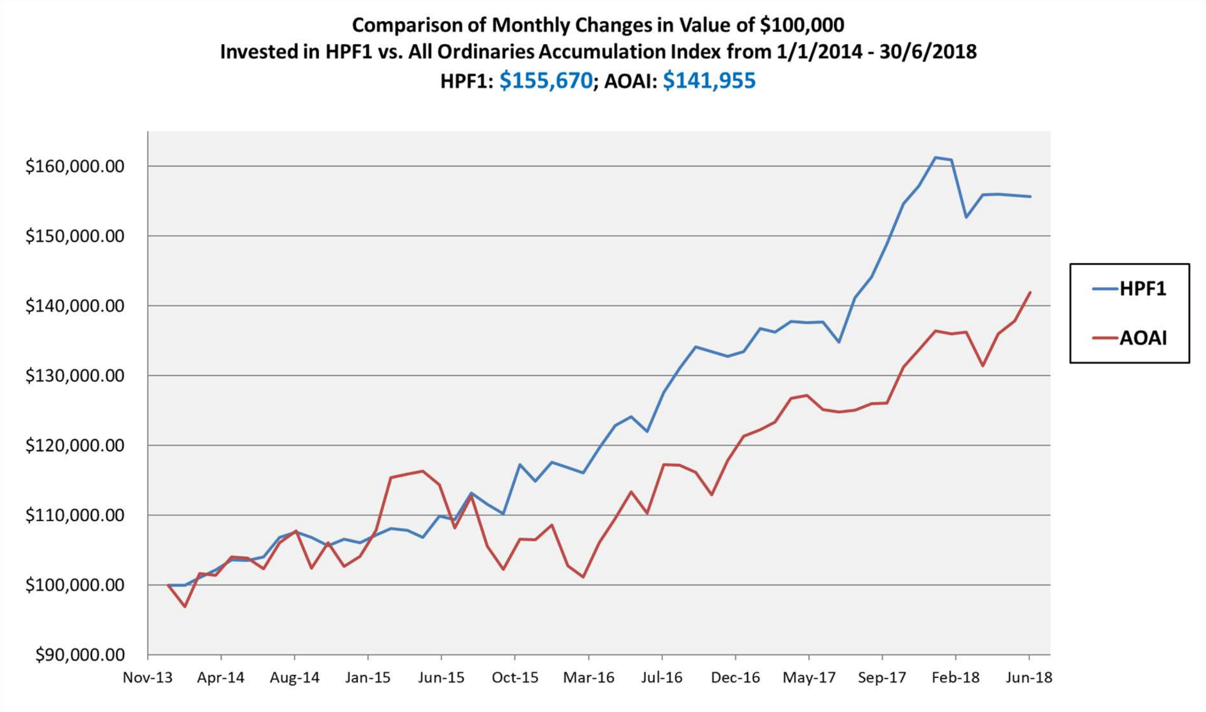
HARRINGTON PARTNERS
Investment Management

Harrington Partners Fund 1 (HPF1) – 30 June 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 powerful 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%
Annualised Performance	10.34%	8.10%	2.24%
Cumulative Performance	55.67%	41.95%	13.72%

#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.



Harrington Partners Fund 1 (HPF1, the Fund) finished the Full Year 2018 (FY18) with a unit price of **$1.4793**, equating to a gross return of **19.27%** (before accounting for fees). The Fund does not try to match an 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 an appropriate 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 13.73%. With distributions reinvested and net of all fees, HPF1 has returned **55.70%** since inception, as against a return for the AOAI of 41.95% over the same period.

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 modeling. 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	$189 million
Number of companies	22
Australian Shares	69%
International Shares	1%
Cash	30%
Concentration of top 5 holdings	64%*

*Of invested capital

The top 10 holdings as at June 30, 2018, were:

Rank	Holding	Total Equity Weighting	Total Portfolio Weighting
1	Boom Logistics (ASX:BOL)	20.93%	14.62%
2	Undisclosed	17.49%	12.22%
3	Macmahon Holdings (ASX:MAH)	14.08%	9.84%
4	Undisclosed	5.94%	4.15%
5	Undisclosed	5.92%	4.14%
6	Fleetwood Corporation (ASX:FWD)	5.21%	3.64%
7	Undisclosed	5.04%	3.52%
8	FSA Group (ASX:FSA)	3.63%	2.54%
9	United Overseas Australia (ASX:UOS)	3.16%	2.21%
10	Undisclosed	2.93%	2.04%

As at the end of FY18 HPF1 owned shares in 22 companies with 64% of the Funds invested capital concentrated in the five largest holdings. The top 10 holdings made up 59% of the total portfolio, with Cash accounting for 30% of the Funds total capital. There was a pullback in some of the Funds more substantial holdings during the second half of FY18, but overall it has been an excellent year for HPF1 and the best financial year performance since inception.

It is important to note that the end of the 2018 calendar year will mark the Funds first 5 years in operation. As you know, we have reiterated that 3-5 years is what we deem to be the minimum period over which one can start to objectively judge the effectiveness of an investment approach like that of HPF1. The easiest, albeit far from perfect, way to make this judgement is to compare performance against a pre-determined and relevant reference point, for which we chose the AOAI all those years ago. The Fund has thus far delivered a 2.24% annualised advantage against the AOAI over 4.5 years which is reasonable, but below our initial and ongoing expectation of 3-5% superiority as measured over rolling 5-year periods.

We are confident that we can significantly improve our all-important absolute performance above the current annualised figure of 10.34% and at the same time expand our relative advantage to the AOAI. That said, the Fund has not experienced a negative year since inception (nor has the AOAI) and, while we are confident our performance will improve over time, we do not expect this to occur in a smooth linear fashion. Instead, we expect performance to be lumpy especially given that the equity portfolio is becoming larger and increasingly concentrated with cash now accounting for a much smaller percentage of total capital than the average since inception.

We look forward to reporting on HPF1s first five years in operation in the upcoming half year letter.

Portfolio Discussion

In the appendix to this letter we discuss the following portfolio holdings in more detail; **Boom Logistics [ASX: BOL]**, **Macmahon Holdings [ASX: MAH]**, and **Fleetwood Corporation [ASX: FWD].** Each of these businesses shares similar economic and industry characteristics, in the sense that they are all capital intensive and have concentrated exposures to the mining sector. The Fund has owned each of these Company's for well over three years, and they form part of a portfolio 'vintage' that was established during the 2014-16 period when we were focused on the then highly unpopular mining services sector. The cornerstone of our investment approach during this period was the search for businesses where the market was excessively discounting our determination of productive net tangible asset (NTA) value [total tangible assets less all liabilities]. Our key advantage with these types of investments was behavioural, more specifically, our research gave us the conviction to buy what most people were selling, and the ability to be patient while these company's and the industry worked through a cyclical downturn.

The outcome from this approach has been reasonably good as many of these investments have contributed significantly to the cumulative return of HPF1 and, as you will read herein, we think there is more upside as they remain core portfolio positions. Each of these businesses is now entering a phase of the cycle where improved asset utilisation and productivity is resulting in much healthier operating margins given their fixed cost leverage. Importantly, they all have strong balance sheets, with two of the three being in a net cash position, and the board's/management teams have thus far been conservative regarding new capital investment despite the cyclical upturn. However, the investment landscape is continually changing and is very different today than during the 2014-16 period. While opportunities still exist in the mining services space; we are finding the risk-reward profiles to be less attractive primarily because the industry is back in vogue based on bulging order books and valuations now implying solid profitability for some years. We remain cautiously optimistic given the inherent cyclicality, contract risks, and margin volatility of the industry, especially during periods of aggressive tendering activity, and are being selective with both the exposures we maintain and any new opportunities we consider.

Fortunately, there are many alternative areas of the market where we have been finding great opportunities, and more recently we have renewed our concentration on niche-focused, and owner-operator run businesses within the small capitalisation sector of the market. At this point, we believe this is the area where we can most effectively leverage our competitive edge given the amount of investable capital and research resources available to the Fund. Several of the Funds' more recent investments do not have the capital intensity characteristics of BOL, MAH, and FWD. Instead, they are comparatively capital light and can broadly be described as focused contractors who are market leaders within their niche industries. The core value of these businesses is intangible and exists within the cumulative experience, skill, relationships, and reputation of their people. We expect these businesses will generate significantly better returns on capital than many of the Funds past investments and look forward to discussing them as they develop over time.

Mistakes

The most damaging contribution to FY18 performance came from our investment in **Konekt Limited [ASX: KKT]**, whose share price ended the period 35% below our average purchase price. Shortly after establishing our desired position the business released its HY18 results which illustrated a deterioration in the core operations and lower than expected returns from a recent large acquisition. We expected some variability around the acquisition integration, although the poor results in their core operations were a surprise and prompted us to freshly revisit our research and more thoroughly test the rationale for long-term ownership. With hindsight, it became evident that our original research, although extensive, significantly underestimated the risk posed by their heavy reliance on a concentrated customer and contract revenue profile. In particular, we assumed that their traditional operations would continue to provide steady operating results which has proven to be misguided. As a result, we reduced our intrinsic value expectations and scaled back the portfolio exposure to what we now consider to be a more prudent level by selling a portion of the initial investment. The realised loss was around 0.75% of the Funds capital.

We look forward to providing a more detailed overview of KKTs operations and an update on the business's performance within the upcoming half year FY19 letter. We remain confident that the company will be able to execute on an attractive longer-term strategy and is likely to produce very good returns on capital along the way. KKT is efficiently run by an experienced and driven CEO, who owns 15% of the company and participated heavily in a recent capital raising. That said, our improved understanding of the industry and KKTs business model gives us concern that the inherent contract rollover risk has a high likelihood of producing significant earnings volatility. Also, the recent acquisition has significantly expanded the operating structure and this, along with the enlarged management team, is yet to be tested through difficult market conditions.

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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 FY19. 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)

Boom Logistics [ASX: BOL] remains the Funds biggest position. The business is performing well on the back of synchronised growth within their core resources, infrastructure, and wind farm markets. As we noted in the HY18 letter, our original thesis was based on the belief that the share market's appraisal of BOLs productive tangible assets would revert closer to what a private business owner would deem reasonable. This thesis has predominantly run its course, and in many cases, this would be a trigger for us to sell a significant proportion of our initial investment. However, our understanding of the business, which has accumulated since first investing over four years ago, gives us the confidence that BOL continues to be an excellent opportunity with attractive risk/reward characteristics.

The most recent performance update in June reported that revenue is growing strongly, and there is sound evidence to support the viewpoint that this trend will continue in the near-term. More importantly, gross debt has been reduced to around $40m which, when combined with stabilised asset values and the return to operating profitability, means the board is now able to implement share buybacks and dividends. At this stage, we will be advocating for buybacks given that the share price continues to trade at a significant discount to NTA, their ability to utilise tax-losses to shield cash flow, and the likely absence of sufficient imputation credits to distribute fully franked dividends. We believe BOL should be able to support strong revenue growth *and* return capital to shareholders using flexible and low-risk financing of their working capital and operating assets. BOL is currently able to access attractive operating leases on new equipment which allows the business to upgrade the crane fleet and therefore competently service revenue growth opportunities without the need to assume the balance sheet risk of purchasing assets outright. This flexible financing approach will likely dilute operating margin potential but has the key advantage of somewhat limiting the detrimental effects of operating and financial leverage experienced during periods of much lower asset utilisation.

The market for new and used cranes in Australia has improved substantially given that the general construction, infrastructure, and resources sectors are all firing simultaneously, with the bargains seen during the downturn no longer available. Ideally, we would have preferred BOL to be a countercyclical buyer of high-quality assets during the downturn, but their excessive leverage accumulated during the last boom meant they did not have the financial firepower, and they were, in fact, a heavy seller of assets. From a competitive standpoint, we are not aware of any public or private crane/construction companies who made a significant coordinated effort to invest countercyclically. If this were the case, then these competitors would likely have far lower debt and depreciation expenses which, in theory, should enable them to tender for jobs at sharper rates than BOL. Fortunately, we believe the majority of the cranes and ancillary equipment that BOL did sell were older, commodity-style, low tonnage capacity assets. The fleet they have maintained is relatively new and consists of a higher proportion of heavy-tonnage capacity cranes that are more suitable for higher-margin technical lifting work. We are cognisant of the fact that improving industry fundamentals makes it increasingly likely that BOLs depreciation expense may start to under account for the real cost of maintaining their relative operating capacity and competitive position, especially given the fact that their incumbent fleet has been heavily written down.

At this point in the cycle, we are very wary of management teams who become overly optimistic about the quantum and tenure of expected growth. We are especially cognisant when businesses opt to double down based on optimistic projections through significantly increasing operational *and* financial leverage. It is often relatively quick, easy and enjoyable to leverage your operating and financial capacity during good times as everyone is optimistic and capital flows freely, however, the necessity to deleverage can be a very long, challenging, and painful task. Fortunately, up until this point, the board has acted conservatively in their management of operational and financial leverage, despite the high growth environment. Based on our discussions with them, we are confident that their 'institutional memory' carried over from the last industry bust reduces the likelihood that hubris will develop. Also, we think it is of crucial significance that in June 2017 Jean-Pierre Buijtels was appointed to the board as a representative for Gran Fondo Capital, which is the largest shareholder of Boom at just over 14%. Jean-Pierre has reportedly ushered in a strong focus on capital allocation discipline and a fresh perspective on how Boom can competently maintain its commitments to employees, customers, and shareholders throughout the cycle.

To conclude, our base rate expectation when owning a capital-intensive business like BOL over the cycle is that it will produce below average returns on capital and therefore the only way to generate acceptable investment performance is to buy opportunistically when the capital employed is being sold for a significant discount. We have seen many private business owners shrewdly build their wealth in this patient low-risk way and we try to apply a similar approach to publically listed investments. As it stands, we have executed reasonably well as patient countercyclical buyers and believe that the coming 18-24 months should provide the ultimate determinant as to whether we have invested shrewdly overall.

Macmahon Holdings [ASX: MAH] is a mining services contractor with surface and underground projects spanning across Australia, Indonesia, and Malaysia. The Fund first purchased MAH in early 2015 at a time when the business was in turmoil due to the abrupt canceling of its largest project which resulted in a 'material contract' condition breach under their then banking facility. At its lowest point, the market capitalisation of MAH reached $63m (they did have net debt of $36m) against statutory net tangible assets (NTA) of $322m and our conservative valuation of their productive NTA of $210m. From our perspective, this 50% discount was based on mindless selling driven by an environment of broad-based investor disgust for anything mining related, and not on a comprehensive analysis of fundamental value. While we did not expect the irrationality of this undervaluation to so quickly become apparent, it fortunately did, when shortly after our initial purchase MAH received net cash inflows of around $100m following two contract dispute settlements and ultimately finished FY15 with net cash of $74m.

Since this time Macmahon's operating and financial performance, while not all smooth sailing, has drastically improved in line with the broader mining industry recovery and we think there is still lots of upside potential to manifest. As such, we have been progressively increasing the Funds exposure to MAH to the point where it has become the third largest holding. Like Boom Logistics, our thesis on MAH has evolved from expecting significant upside directly from a reversion to rationality, to that where we now think the business is well positioned to produce stable FCF in the medium to longer-term. However, continuing to own the business beyond this point has required us to extend the coverage of our research and build a more thorough understanding of the industry, operating economics, and management team. This process has confirmed the attractiveness of MAHs operating leverage, conservative financial position, and competent management at a time when revenues are expanding rapidly, and the broader competitive strength of mining services firms during contract negotiations is relatively robust.

Today MAH is very well positioned to succeed as it still has a net cash balance sheet and wholly owns most of its substantial fleet of mining equipment. Further, their fleet utilisation rates are already high and improving as they go about executing on their record order book which stands at well over $5 billion. Most importantly, the effective execution of this work pipeline is being overseen by a first-class management team who are supported by an experienced board we hold in high regard. We were encouraged that the board opted to elevate Michael Finnegan, the highly experienced general manager of surface mining, to the CEO position instead of hiring externally as all too often occurs. Michael started his career in the industry as an on-site project manager/engineer after graduating from the Western Australian School of Mining and has worked his way up patiently over 24 years including long stints in South East Asia. He has a robust combination of safety, people, technical, management, and capital allocation skills which combine to make him an ideal CEO, although his low share ownership is a concern. We intend to write about Macmahon in more detail in the HY19 letter as we expect that the next 6-12 months of operations will provide compelling evidence that the business is significantly undervalued.

We had planned to include detailed commentary on **Fleetwood Corporation [ASX: FWD]** which as of the end of FY18 was the Funds 6th largest position representing 3.64% of the total capital. However, the Company sold its severely loss-making division in June and is currently finalising a $60m equity raising to finance two significant acquisitions made in July. HPF1 took up its full capacity and applied for additional shares as part of this equity raising, as such FWD will become the Funds 5th largest position. Suffice to say; we are reasonably confident that FWD has a bright future and we will provide a comprehensive discussion on our investment thesis within the September quarterly update.

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