HARRINGTON PARTNERS
Investment Management

28 January 2016

Dear Partners,

Once again, it is our privilege to report to you on the 2016 half year results for Harrington Partners Fund 1 (HPF1, the Fund). Included in this letter is a summary of the Fund's performance and an update on three specific companies within the portfolio.

Performance Summary

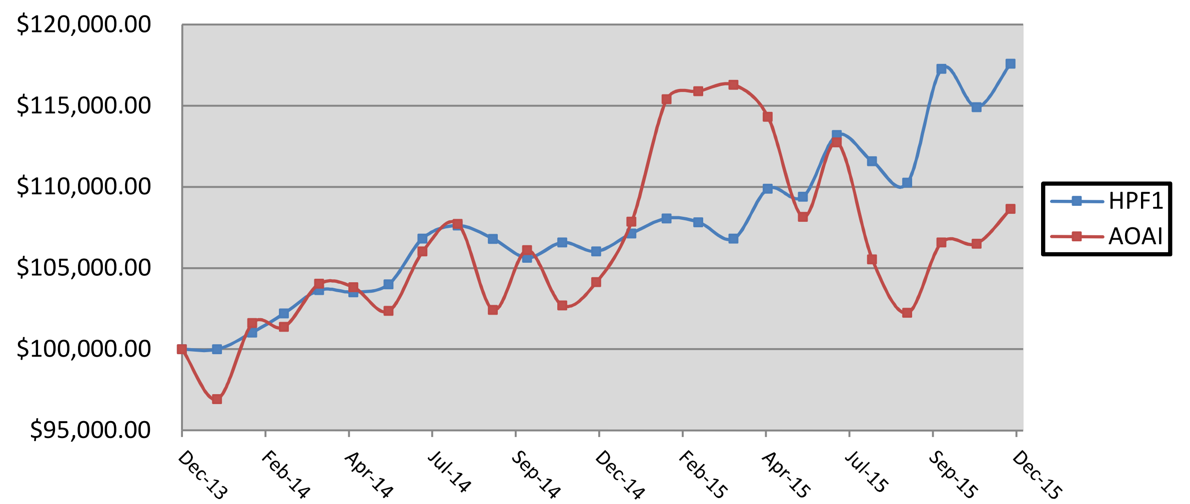
Before taking into account fees and charges, the unit price for HPF1 finished the calendar Year 2015 at **$1.1581**, equating to a gross return for the Fund of **8.02%** over the period. We do not try to match any index or benchmark, however we do feel it is necessary to test our performance against an ongoing reference point. For this purpose, we believe the All Ordinaries Accumulation Index (AOAI) is suitable given it includes reinvested dividends and provides a good comparison to what an investor could achieve in a low cost broad based index fund. Over the past 6 months an investment in the AOAI would have returned 0.45%. Since inception, with distributions reinvested and net of all fees, HPF1 has returned **17.61%**, this compares to a return for the AOAI of 8.65% over the same period.

Please note: Although the accrued performance fee has been accounted for in the net return below, no performance fee is payable (if any) until the end of financial year 2016.

	HPF1 Gross Return	HPF1 Net* Return	Distribution Per Unit	AOAI Return
3/01/2014 (Inception)	-	-		
30/06/2014 (6 months)	4.01%	3.71%	$0.00494	2.36%
30/06/2015	5.99%	5.51%	$0.01693	5.67%
31/12/2015(6 months)	8.02%	7.48%	-	0.45%
Compounded Annual Gain	9.12%	8.45%		4.24%
Overall Gain Since Inception	19.08%	17.61%	$0.02187	8.65%

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.

Comparison of Monthly Changes in Value of $100,000
Invested in HPF1 vs. All Ordinaries Accumulation Index from 1/1/2014 - 31/12/2015
HPF1: $117,609; AOAI: $108,653



Portfolio Discussion

Like all great things, we believe that constructing a high quality investment portfolio at reasonable prices requires a lot of time and patience. Our first preference is to deploy the majority of our capital at sensible prices into sound operating businesses run by competent and honest management teams. Over the longer term these types of investments will be the engine room that provides HPF1 with the overwhelming majority of its growth. Effectively identifying, analysing, tracking, and managing a portfolio of these investments is the primary objective of our day-to-day actions.

Relatively high cash holdings continue to remain a prominent characteristic of the Fund. The cash portion we currently hold in excess of our prudent minimum of 5-10% of assets is not designed as a directional position based on our view of its relative value versus equity valuations. Rather, the cash component of the Fund is simply a by-product of our investment process that accrues when we cannot find sufficient suitable investments to own and reduces when such opportunities are abound.

Fortunately, we are starting to add more of our desired 'engine room' businesses to the portfolio as the Australian investment landscape has become more accommodating to our approach. In our view the portfolio in its current form is meaningfully undervalued and we are optimistic that it will create significant value for the Fund over time. In addition, we are very excited about the likelihood of further improving the investment quality of the portfolio as our ongoing preparation meets with the inevitable opportunities that will be provided in 2016 and beyond.

In our FY15 letter we first discussed our loosely defined 'mining services' basket, which remains a small part of the portfolio and has been performing in line with expectations. Each individual investment within the group has met our risk assessment criteria and was bought at a price we believed would deliver above average returns over the medium term. Specific characteristics we required were financial stability, robust cash flow, meaningful discounts to productive tangible assets and shareholder aligned management. However, despite these positive characteristics it was necessary to adopt an added layer of diversification by owning a 'basket' of such investments in order to minimise the risks posed by their inherent unpredictability.

The individual results of these businesses have been mixed, with some reporting positive or more stabilised operating performance much sooner than anticipated, whilst others continue to struggle with the underlying issues that first prompted their unpopularity. For example, shortly after our initial purchases the outlook for two of these businesses (one of which we will detail herein) quickly turned optimistic. The first was as a result of a takeover offer and the second was due to the combination of asset sales, contract dispute resolutions and debt reduction.

In contrast, the underlying performance of other members within the basket continues to provide plenty of fuel for uncertainty, which the wider market despises. This is especially true of those whose future is perceived to be wholly reliant on the health of the resources and/or energy sectors, both being areas that are under immense pressure. Overall we remain very confident in the risk/reward profile of this basket and believe the probabilities are set in our favour. We do not expect to see any meaningful changes for at least 12-18 months from these businesses and look forward to keeping you posted on their progress.

We first began purchasing shares of **Coffey International Limited (AU: COF)** as part of our 'mining services' basket in July 2015 and continued to build our position in the business to around 2.75% of the Fund's total assets. On the 14th of October a US firm **Tetra Tech (NASDAQ: TTEK)** made a full cash takeover offer for the business at $0.425 per share. The COF board unanimously endorsed the offer and subsequently commissioned an independent experts report which concluded that the offer was 'fair and reasonable'. On the 15th of January 2016 TTEK declared the offer unconditional and on the 18th exercised their compulsory acquisition rights after receiving shareholder acceptance from over 90% of the issued shares in COF. With an average purchase price of $0.145 and the cash payout on schedule to occur before the end of February, it's expected the Fund will realise just over a 190% return on its investment over approximately 8 months.

The way in which this investment has played out was unexpected and is indeed a rare occurrence upon which 'luck' has played a significant part. At the time we first bought COF, we believed it had a very conservative fair value of at least twice the market appraisal and expected to wait for 2-3 years for this value to be realised. The fact that our value and time expectations were proven inaccurate is a strong reminder that the most important element of successful long term investing is focusing on minimising the downside, because the upside generally takes care of itself.

TTEK is still getting a very good deal despite the large premium it is paying over the average traded prices of COF shortly before the offer. COF is worth more to TTEK than as a standalone company because they are (were) direct competitors in international development consultancy, and, the takeover will allow TTEK to significantly strengthen its competitive position in this area. By purchasing a developed and respected operating business, TTEK can more quickly achieve their Asia-Pacific growth ambitions as opposed to taking a purely organic approach. Further, they receive a readymade platform on which to further expand their world leading water, solid waste, and environmental management expertise within the region. It is reasonable to conclude that in the parlance of an investment banker, TTEK will benefit from 'synergies' and it should be noted that recent depreciation of the AUD against the USD provided a helpful tailwind for their actions.

There is a lot more detail to the COF/TTEK story than outlined above, most of which is beyond the scope of this letter, although there is one particularly disappointing aspect of the deal that relates to the utilisation of franking credits which we think deserves further discussion. First, however, we will provide some history on COF together with our rationale for making the initial investment.

COF is a specialist professional services consultant with three main operating divisions; Geoservices (GEO), International Development (ID) and Project Management (PM). Through these divisions the company has exposure to sectors such as infrastructure, oil and gas, mining, and international development (primarily foreign aid). COF was established in 1959 by David Coffey after he identified the potential for geotechnical engineering services in the Australian market and in 1990 the company listed on the ASX. They had a major growth spurt in the early-to-mid 2000's after leveraging strong underlying economic activity and buoyant capital markets to precariously debt fund multiple acquisitions, however by the tail end of the decade they were in trouble.

Operating margins dropped by over 25% between FY09-FY11 resulting in insufficient cash flows to support COF's excessive operational and financial leverage. The result was a string of significant non-cash write-downs, cash restructuring charges, cessation of dividends, divestment/closure of multiple businesses, and ultimately a $37m dilutive equity raising in 2012. Along the way these events predictably ushered in new management who attempted to stem the losses through cutting costs and improving margins.

When we first commenced researching COF in 2014, it had reported losses for each of the FY11-13 years and only mild profitability in FY14, however free cash flow had remained relatively strong since FY12. The key attraction was the ID division which was solidly profitable and objectively worth more than the entire market capitalisation of the company at the time. ID is a steady business that has delivered reliable work and consistent margins from a quality client base that includes the US, UK and Australian governments through their respective foreign aid programs.

Despite this, a continuation of large write-downs in its GEO division (due to its significant exposure to deteriorating resources and energy markets) overshadowed the performance of ID when recorded on a consolidated basis. At first we could not satisfy our required margin of safety at the then share price of $0.30 and instead simply tracked the business over the course of the next 12 months. In FY15, despite continued pressure in GEO, the fundamental dynamics of the company began shifting as strong growth in ID meant it became the biggest revenue contributor for the group.

More importantly to the story (and our investment case) was that by this time the share price had halved and we became convinced that the ID division on its own solidly underpinned the investment value in COF. In addition, the upside was significant if GEO simply returned to break even performance, something we were confident it could achieve given management's focus on cost control and also the potential for improvements in government infrastructure spending in Australia. Based on this position we expected that our investment in COF would have achieved a similar absolute return to that of the TTEK takeover however over a much longer period of time.

Although it is always welcomed to have an investment materialise in a shorter time frame than predicted, as it gives us the opportunity to reinvest the capital, there is one major benefit to owning businesses for at least 12months. If as we had expected, that a comparable outcome was achieved over a longer period, it would have allowed the Fund to pass on the investment returns with a valuable embedded capital gains discount. This is not possible under the current scenario given HPF1 has not owned COF for over 12 months.

Maximising after-tax returns should be an important focus of any sound investment approach, particularly in a long-term vehicle like equities where tax efficiency can have a massive effect on any ultimate wealth creation. One particularly beneficial aspect of Australia's investment regime, as it relates to after-tax returns, is the ability for companies to avoid double-taxation on dividends paid to shareholders. They can achieve this through disbursing tax credits, known as franking credits, for tax already paid on the income that is distributed as dividends. The value of franking is directly relevant to the COF story and the source of our previously mentioned disappointment with how the TTEK deal has been structured.

COF has approximately $0.054 per share in franking credits available that could have been paid out to shareholders as part of the deal, these credits are worthless to Tetra Tech because it is a US domiciled corporation. The rationale provided by the board for not pursuing a payout of these credits was that the additional time it may have taken would work against the short completion timetable desired by TTEK, as well as the belief that the $0.425 takeover price acted as a *'catch all'* for this inherent value.

We believe that the value of the franking credits relative to the takeover price was sufficient enough to warrant the additional effort required from the board to ensure they were included in the TTEK deal.

Whilst it is true that franking credits do not benefit all shareholders in each given scenario, the all-cash nature of the TTEK offer provided the COF board with a unique opportunity to provide a universal benefit to its shareholder base. Attaching franking credits as part of the acquisition would likely have resulted in the pre-takeover trading of COF to occur at a premium price to the value of the all-cash component however at a discount to the all-cash plus franking credit value.

The reason for this is shareholders who can utilise the franking credits can benefit even if they pay a premium to the all-cash component because they will also realise the value of the franking credit. Likewise, shareholders that cannot utilise the franking credits can benefit through selling their shares at a premium to the all-cash offer. All shareholders could have realised added value at no extra cost to either TTEK or COF and it is disappointing to see this potential value foregone.

Service Stream Limited (AU: SSM) is continuing its strong improvement in operational and financial performance thanks to a combination of solid underlying industry fundamentals and competent leadership by its first class management team. During 2015, the business was successful in renewing the majority of its key recurring contracts, whilst in some cases also extended the volume and scope of these works. SSM also won several new contracts with the most significant being those with the National Broadband Network Limited (nbn). Equally important has been management's diligent work around diversifying the customer base through securing a number of smaller contracts.

These dynamics will likely result in meaningful revenue growth for SSM over the coming periods and, when combined with management's current focus on cost control and productivity, we are confident that profit growth can exceed revenue growth as a result of margin improvement. At present, SSM remains the largest holding in the portfolio.

SSM has compounded our belief that a business, despite its inherent economics, can generate superior absolute results provided it is run prudently by people that are competent and possess high integrity. In our FY15 letter we noted the significance of the promotion of long-term employees to the CEO and Chairman positions as critical elements in our initial purchase decision. Both these individuals had demonstrated solid credentials through their previous management of one of SSMs most steadily profitable divisions. Given their proven track record we thought it was highly probable that they would apply their owner mentality to the remaining operations.

Subsequently we have been impressed by their and the wider management team's attention to detail in critical areas such as safety, employee recruitment, training and engagement, customer retention and relationships, and overall operational productivity. SSM exists within an industry that is built on the strength of one's reputation and relationships and it does not possess any meaningful structural competitive advantages. Therefore, the quality of customer engagement, contract performance, and operational efficiency are all critical elements for achieving above-average results. As investors we are broadly looking for businesses that profitably add value for its customers and society as a whole, which in-turn allows the business to do well and by extension the shareholders also. We believe SSM continues to add significant value for all stakeholders and, under the current management team, is likely to be able to continue doing this in a very profitable way for the foreseeable future.

We were pleased to receive rapt attention towards our perspectives from the management team during the October annual general meeting, and although we always try to guard against being unintentionally influenced, we came away confident that SSM's interests continue to be sufficiently aligned with the interests of the Fund. However, SSM's current consideration on whether or not to pay unfranked dividends has the potential to become a frustrating point of disagreement.

As you would be aware, we like a management team who makes use of every opportunity to add long-term value, as opposed to taking actions that are seemingly designed to 'please' owners with a short term orientation. More specifically, SSM has sufficient carry-forward tax losses to avoid paying tax for about the next 2 years and have also exhausted their franking account balance. This means the SSM board has to decide whether to pay unfranked dividends, which would pass on an unnecessary tax liability to shareholders, or cease dividends until sufficient franking credits have accrued.

It is our position that the business ought to make full use of its current tax losses and abstain from paying unfranked dividends, until such time as a sufficient franking account balance has been restored. In late 2015 we wrote a letter to the board of SSM, proposing a number of potential actions we believe would deliver a beneficial outcome for the majority of shareholders. We look forward to reporting the outcome of this matter along with the businesses progression following the HY16 results announcement in February.

RNY Property Trust (AU: RNY) is an Australian listed, US based, real estate investment trust that owns a portfolio of office properties in the New York Tri-State area (excluding Manhattan). The most significant development for RNY occurred outside the HY16 period when, in early January 2016, it announced the refinancing of its Citibank debt pool into a new three-year facility. In the FY15 letter we referred to this upcoming event as the first of two important refinancing catalysts. We expected the event to result in meaningful traction around assets sales and/or improved financing costs. Unfortunately, the initial event did not deliver either predicted outcome, although the new facility does have two very important characteristics that are likely to be highly beneficial for RNY.

The first important element is a US$15.3 million unrestricted cash component being made available as a means to fund capital expenditures, tenant incentives and leasing commissions. When combined with US$5.6 million already held, RNY will have over US$20 million available for these purposes. This is significant because it provides management with the ability to improve the attractiveness of RNY's portfolio to tenants, subsequently improving occupancy and yield, and therefore the attractiveness to potential buyers. This critical aspect of operating flexibility has been severely restricted up until now, and was emphasised by the CEO, Mr Scott Rechler, in the 2014 annual report stating:

> *"...one of our primary challenges is sourcing the additional capital required to execute our business plan related to leasing. Management will explore and analyse all options to provide such additional liquidity to fund and stabilise these assets"*

The second important element is the ability of RNY to prepay the debt provided that the contracted income received by the lender during the first 18 months is unaffected. This acts as a penalty for early repayment and therefore RNY has little incentive to reduce the loan on income producing properties until mid-2017. Fortunately, the non-penalised repayment period commences mid-way through the total loan term. As a result, management can use the initial 18-month penalty period to apply the unrestricted cash towards improving the portfolio's occupancy and subsequently look to more favourably refinance or sell the assets after the penalty period is over.

As a final observation, RNY's new financing facility is not with a bank. Instead, it is with a private real estate lending firm known as ACORE Capital which funds its deals from its own balance sheet. This is a change in circumstance, the significance of which we are yet to fully digest, however our first impression is that the relatively unconstrained nature of ACORE's investment mandate provides a better lending platform through which to service the intricacies of RNY.

Looking ahead RNY has a significant amount of leased space expiring in 2016 and we remain focused on its performance in relation to renewal rates, operating cash flows, asset sales and debt reduction. The financial year for RNY is January 1 - December 30 and we eagerly await the opportunity to dig deeper into its full year accounts, at which time we may provide a further update on the business within our FY16 letter.

In the event the coming 6 months does not bring anything of significance we do not intend to provide unnecessary commentary, and take this opportunity to reiterate the following excerpt from our FY15 letter:

> *"[RNY] is an investment which requires considerable patience for which we think investors will be duly rewarded...We anticipate waiting until 2017 for any real value realisation with RNY although we believe the upside is substantial".*

Overall, we remain confident in the management team's judgement and its ability to execute a business strategy that will ultimately result in meaningful appreciation on the Fund's investment. Maximising the value of RNY's assets requires the combination of deep local market knowledge, healthy relationships with key local stakeholders, specialist on-the-ground management and most importantly patience. We can capably provide the last attribute and believe that we have partnered with a management team who can competently to do the rest.

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We are extremely grateful for your continued patience and support especially during these early years and would like to wish you and your loved ones a happy, healthy and prosperous 2016.

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

Yours Sincerely,

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