The Cavendish Partnership

January 2022

Dear Partners,

Our portfolio rose 15% in 2021, based on our current investments in 9 businesses: 6 in North America, 2 in Europe, and 1 in Australasia.

Although this represents an adequate first year for the partnership, we remain convinced that our competitive advantage comes primarily from the long-term mindset of our partners. We can therefore step away from chasing the short-term performance of others and seek out valuable insights that are more consistent with our multi-year holding period. This approach is best judged over at least five years, where we target double digit annualised returns, whilst minimising the risk of permanent capital loss.

We are currently holding 19% of the portfolio in cash. This represents a drag on our short-term performance that we find acceptable only because of the optionality it provides, allowing us to steadily build a portfolio of between 10 and 20 investments.

Our best ideas continue to be found among transformational businesses, a concept that we briefly discussed in our last letter. These companies have unexceptional past performance but represent the rare case where a management team recognises historic mistakes and forces the business in a shareholder friendly direction. We like to see sweeping changes, including shutting down or selling off unprofitable businesses. Ideally, these changes also include material adjustments to capital allocation policy, such as refocusing investment on the highest quality business segments or returning capital to shareholders through dividends or buy-backs.

In smaller and more illiquid companies, generally overlooked by most professional analysts, these positive signs are sometimes ignored or underappreciated for many months or even years. This represents an opportunity for us to invest at bargain prices that are based on the mediocre history of the company and disregard the potential value created by the transformation.

Our simple framework for researching these ideas focuses on five questions:

- ***Is there <u>hidden value</u>?***
- ***Is there a <u>good business</u>?***
- ***Is management <u>shareholder friendly</u>?***
- ***Is there <u>resilience</u>?***
- ***Is the <u>price reasonable</u>?***

The first three help us to understand the opportunity, and the last two are concerned with protecting our capital. Each is highly subjective, containing many layers, but a suitable investment will clearly and positively answer all five questions.

In our current portfolio, Currency Exchange International and Kiland represent two examples that help explain our approach:

Currency Exchange International. Re-investing from a mature and shrinking business into a fast-growing and quality one. An area where we have historically found hidden value is companies with two or more business lines. The primary business is an unexciting and low growth enterprise, but the second is smaller, better quality, and faster growing. The idea becomes interesting when a low valuation reflects the mature (and unexciting business) whilst ignoring the smaller and better-quality enterprise.

We think Currency Exchange International fits this mould. It was listed on the Canadian Stock Exchange in 2013 and is led by Randoph Pinna, an owner-operator CEO who remains the largest shareholder.

The primary business operates in North America providing foreign banknotes (physical cash) to wholesale customers, mainly small and mid-sized banks, and to retail customers at airports and at travel hubs (like Travelex in the UK). The banknotes industry is mature, consolidated, and steadily shrinking due to the reducing use of physical cash as a payment mechanism.

The secondary business provides international payment services (wire transfers) to smaller banks and businesses across North America. To participate in this highly regulated activity required over five years of investment and the creation of a dedicated Foreign Exchange bank based in Canada. Sales were first reported in 2017 and have been growing organically at over 20% per year, today accounting for a quarter of total revenue. Alongside faster growth, the economics are much better than the banknotes business. It is essentially a software service with higher operating leverage, lower capital requirements, and the potential for better free cash flow generation.

The banknotes business may take years to recover to pre-pandemic profitability after being hit hard by the current drop in international travel. However, if the payments segment continues to rapidly grow, as we expect, Currency Exchange International will slowly transform into a much higher quality payments business. An investment the partnership would happily hold onto for the long term.

Kiland. A failed timberland company that is transforming into an agricultural land business. Kiland has had a chequered past, having already been through multiple transformations. The first in 2005 when it was restructured out of bankruptcy and listed on the Australian Stock Exchange. The new company, called *RuralAus Investments* used the listing proceeds to purchase 11,000 hectors of timberland in Southern Australia.

The second transformation started in 2013, when the company narrowed its geographical focus to a single island called Kangaroo Island, located off the coast of Adelaide. It rebranded as *Kangaroo Island Plantation Timbers* and bought land on the island totalling 25,000 hectors. Three quarters became timberland plantations, requiring a decade long growing cycle before being cut, transported off the island, and sold.

It took until 2019 for the trees to mature and the transportation options to be properly considered. But in a tragic turn of events, bush fires raged across Southern Australia, eventually spreading to the island, and damaging 95% of the company's timber. Suddenly, the current timberland strategy based on sustainable cashflows appeared irrational, requiring replanting and another decade spent waiting for the timber to regrow. It looked even more irrational, when the company announced it was possible to convert all the timberland back into agricultural land. This option would take months instead of years and had recognisable value since agriculture was already the island's main economic activity.

Following the fire damage, many investors were selling, which caused the market price to plummet. This new market price implied that the company's land was now worth just 400 Australian Dollars per hector (after adjusting for insurance receivables and cash on hand), far below the island's average agricultural land price, and even below an independent valuation of swamp land on the island! We saw an opportunity and an excellent margin of safety, so we started buying.

The third transformation into an agricultural land business was officially announced in August 2021. The management team was replaced, the largest shareholder was appointed to the board, and the company rebranded as *Kiland Ltd*. There was more positive news as the new management team recognised the low market price and proceeded to buy back nearly a fifth of all shares outstanding. This is a recent transformation, so we are remaining patient and waiting for further hidden value to be realised as part of the new agricultural strategy.

We aim to include 1-2 investment writeups in each of our letters until we have covered the entire portfolio. Up to now, we have written about four of the nine businesses we own, including Permanent TSB and Park Aerospace from our previous letter.

As we conclude our first year, we are ready to welcome new partners on our journey. Mindful that we will only attract those few individuals with a long-term outlook who are willing to commit their capital for many years. To find suitable people, we will not be engaging in clever marketing techniques to quickly drive up our assets, but we do appreciate word of mouth recommendations. If you know of anyone who is interested in our uncommon approach to investment management, we would love to talk to them.

Thank you for your continued trust and I look forward to our conversations over the year.

With all good wishes,

Adrian

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Partnership Snapshot

Portfolio Breakdown, 31st December 2021 (%)

Cash	19.4
Kiland	17.4
Permanent TSB	14.2
Aimia	10.2
Schmitt Industries	9.5
Park Aerospace	8.5
Trecora Resources	7.8
Currency Exchange International	6.5
Rubicon Technology	5.7
Pressure Technologies	0.9

World Allocation, 31st December 2021 (%)

United States	31.4
UK	20.3
Australia	17.4
Canada	16.7
Ireland	14.2

Portfolio Turnover (%)

2021	14

Rounded to the nearest % and calculated by taking the lesser of purchases or sales and dividing by average net assets

Track Record of Investment Advisor (%)

2017	13	£ 1,129
2018	2	£ 1,151
2019	2	£ 1,174
2020	23	£ 1,442
2021	15	£ 1,653
Annualised	**12**	

Source: Inception 23rd May 2017. Adrian Ford's 'unaudited managed accounts' represented using a notional £1000 investment. Results are rounded to the nearest % and net of all fees and transaction costs.

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