# Highwood
VALUE PARTNERS

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October 14th, 2021

Dear Investors,

During the third quarter of 2021, our portfolio was down 2.5% in Canadian dollars net of fees and our cash balance was 22.4% at quarter end. The broad European equity index was +0.7% and the Canadian index was +0.1%[1] in the quarter. From inception to September 30th 2021, our portfolio is up 33.2%, which is a 17.2% average annual return net of fees with 30% of the portfolio in cash on average over that time.

The table below gives you a summary of our performance and exposure by strategy bucket for the quarter and the relevant periods since inception.

| | | Exposures by Strategy Bucket | | | |
|---|---|---|---|---|---|
| **Time Period** | **Performance, Net of Fees** | **Total Equity** | **Core Value Equity** | **Special Situations Equity** | **Cash** |
| FY 2019 [1] | 1.9% | 41.0% | 36.0% | 5.0% | 59.0% |
| FY 2020 | 24.2% | 78.1% | 70.6% | 7.5% | 21.9% |
| Year to Date, 2021 | 5.1% | 76.3% | 69.1% | 7.3% | 23.7% |
| 3rd Quarter, 2021 | -2.5% | 77.6% | 72.1% | 5.5% | 22.4% |
| Average, Since Inception [1] | 17.2% | 69.8% | 62.8% | 6.9% | 30.2% |
| Total Return, Since Inception [1] | 33.2% | | | | |

1. Inception on December 9, 2019

As I mentioned in my first letter to investors nearly two years ago, Highwood aims to treat clients as I would wish to be treated. A big piece of this is a spirit of openness and transparency. To this end, I have used my recent quarterly letters to give you a detailed look at my investment process. In my last two letters, I outlined my investment process from idea origination to the buy discipline to the hold discipline, complete with live examples and investment theses. In this letter, I aim to continue this path by talking through the changes made to the portfolio in the third quarter with some additional emphasis on the 'sell discipline'. As usual, I will also update you on a position-by-position basis and give a business update at the end. As you may have noticed already, I have moved to a new office. It is just down the hall from my previous location, but it paves the way for the careful expansion of Highwood – and first on the agenda is finding the right person to sit alongside me in an operational role. Please see the business update section at the end for more information on this initiative.

Before I get onto the activity in the portfolio, a word about the performance in the quarter and the recent market drawdown in September. Highwood's portfolio was +1.6% in July, +2.0% in August and -5.9% in

[1] MSCI Europe (in CAD) and TSX respectively.

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September. The September drawdown was driven by market concerns arising from the bankruptcy of Evergrande, a large Chinese property developer and concerns about rising inflation and the knock-on impact of that into higher interest rates. While I am cognisant of the risk of sustained higher inflation, the best protection I know of is ownership of a portfolio of high-quality businesses with strong balance sheets owned at a discount to a conservative estimate of what they are worth.

Portfolio Activity in Q3

During the quarter, I initiated a new position in Sto SE & Co, a German mid-cap with a long and commendable history, added to our holding in GetBusy PLC and sold our holding in Standard Drilling. The section below details all three of these changes in detail.

Sto SE & Co.

Sto is a new investment in the Core Value bucket of our portfolio which I acquired following the equity market drawdown stemming from the Evergrande bankruptcy and macroeconomic concerns around inflation. Sto is a classic example of a great business flying below the radar of larger funds available for purchase at a discount valuation that embeds attractive prospective returns for long-term shareholders. The company was founded in 1962 and listed in 1992, from which point it has churned out a 28-year track record of steady growth with low volatility at high-teens returns on capital and has delivered a 14x return on investors capital over that time – yet it has precisely zero analyst coverage and trades at an 11% free cash flow yield on an LTM[2] basis.

Sto is a German listed international manufacturer and distributor of building coatings such as paints and renders, with a dominant market position in external wall insulation in Europe. From its roots in South Western Germany, Sto has grown from a regional brand serving Baden-Wurttemberg in the sixties to a global business with €1.5bn in revenue, 55% of which is derived outside Germany. This growth has been entirely self funded at attractive high teens returns on capital while maintaining a conservative balance sheet, which has been debt free for the past 12 years. The company earns gross margins in the mid 50's, which reflects premium pricing afforded by strong brand awareness of its products and close customer relationships through its direct distribution model in established markets. These competitive advantages have also been evident in the consistent market share gains over the past 5 years which have extended Sto's leading market position to between 30 and 40% market share in its core markets of France, Germany, Netherlands and Belgium. Unsurprisingly, this kind of a long duration track record and conservative balance sheet also reflect excellent stewardship. The company is a classic-owner operator. It is founded and controlled by the Stotmeister family, who retain 57% ownership of the company and control the board of directors.

The company has a market capitalisation of €1.3bn with c.€100mn Eur of net cash on the balance sheet and at our acquisition price, we own this business at 8x LTM EBIT and a free cash flow yield of 11%. Businesses with a comparable track record to this trade at significantly higher valuations and in 2019, SIKA, which is a

[2] Last Twelve Months

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competitor in Switzerland, acquired a comparable business to Sto, called Parex, for approximately double this valuation.

At 8x EBIT, we have a considerable margin of safety, and the thesis going forward is that Sto's core business is increasingly benefiting from structural tail winds. Demand for external wall insulation is driven by regulation and energy prices. Europe has put in place a series of incentives to upgrade the energy efficiency of the residential and commercial housing stock, including tax deductibility of energy-efficient retrofitting of buildings. This incentive reduces the net cost to consumers of installing external wall insulation by c.20%. On the other hand, the cost of heating a residential or commercial building in continental Europe has increased substantially – as recent headlines have made plain. This is a strong cocktail spurring increased demand for Sto's products which is starting to come through in the financials. Revenue growth in the six months to June 2021 was +17% and profits were up 56% year over year.

Sto targets EBIT of at least €210mn by 2025, which with interim cash flow, would put the business on c.3x 2025 EBIT and embeds potential returns in our base case scenario consistent with our mission, which as you know is to turn every dollar of invested capital into five dollars over ten years, without taking undue risk.

<u>GetBusy PLC – Core Value</u>

I increased our holding in GetBusy in the quarter as the price became more attractive and I gained further conviction on the investment thesis. GetBusy is our UK listed document management software business in the accountancy and tax vertical with established market positions, good unit economics and a substantial runway for growth. In the quarter, the company reported solid H1 results: Revenues were up 12% organically with 93% of this revenue from recurring subscriptions to GetBusy's products. The profits in Virtual cabinet, GetBusy's largest product, grew 6% and this cash flow is being re-deployed to acquire customers in SmartVault, the cloud-based software solution for small and medium sized accountancy and tax firms. This re-investment is being done at very attractive returns. Every dollar re-invested into acquiring subscribers of SmartVault is worth c.$4 in undiscounted gross profit contribution. My research in the quarter focused on the competitive position of the SmartVault business and that research gave me added conviction on this part of the business. What is more appealing still is that at the current valuation, I estimate we are getting the value which management are creating in this business for free. At £34mn for the whole business we get Virtual Cabinet, which generated £4mn in profits over the last year, for 10x Free Cash Flow with SmartVault and GetBusy (the consumer software product) thrown in for free. Management and the board have a large shareholding and were the company to be sold or broken-up, I estimate a fair value for the business today of more than double where it is trading today.

<u>Standard Drilling and the Sell Discpline</u>

There are three reasons to sell an investment in my view.

- Either the price has appreciated significantly such that the margin of safety and prospective return from continuing to hold it has shrunk below what I deem to be adequate to reach our long-term mission, or

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- New information or a re-appraisal of existing information leads me to believe that the investment thesis is no longer valid or finally,
- There is a higher return use of capital and the portfolio is capital constrained, in which case it becomes rational to sell a lower potential IRR to redeploy capital at a higher prospective IRR.

We sold our holding in Standard Drilling in the quarter because I believe the company is evolving in a direction that is not consistent with our thesis. I originally bought Standard Drilling at the inception of Highwood. At that time, Standard Drilling was focused on exploiting the opportunity to acquire Platform Supply Vessels (PSVs) in the private market from distressed sellers – either PSV contract operators or the lenders that had enforced their control over these assets in bankruptcy. Standard Drilling was founded specifically to target this opportunity, was 100% equity funded and backed by an intelligent capital allocator with significant skin in the game. The shares were also for sale in the equity market at a double discount. The company had acquired PSV assets at a discount to what they were worth from distressed sellers and the equity traded at a 50%+ discount to these prices, reflected by a Price / Book at our buy price of c.0.5x. The most likely end-game for Standard Drilling was, in my view, that it would either build its portfolio of assets up to a mid-sized company and sell itself to a consolidator as the oil and gas cycle turned or if not, operate a portfolio of cash generative assets that would have been re-valued in the equity market.

However, it became increasingly obvious to me in the last quarter that the plan had evolved away from this focused strategy to something else. The company hired two investment managers and re-deployed the proceeds from the sale of three of the PSV ships (which were sold at or above book value), to acquire public equities. It is clear this is the future strategic direction of the group, rather than a diversion. This may be a fine strategy, but it is not why I owned the shares in the first place.

So, I will stick to my discipline and move on. Our investment in Standard Drilling delivered 1.16x money and an 8% IRR over the 1.8 yrs we owned it.

**Portfolio Updates**

The combination of the trades described above and lower prices for some of our securities means our portfolio is better positioned now than 3 months ago. This is partly reflected in some of the portfolio statistics below, notably the Median Price / Estimated Intrinsic Value and the Median P/E.

| Highwood Value Partners Portfolio | | | | | | |
|---|---|---|---|---|---|---|
| As of Date | % Invested | Median Price / Est. Intrinsic Value | Median Market Cap, in Mns of USD | Median Net Debt (Cash) / EBITDA | Median EV / Sales | Median P/E |
| 31-Dec-19 | 41% | 0.54x | 550 | -0.8x | 1.6x | 15.1x |
| 31-Dec-20 | 78% | 0.69x | 713 | -0.3x | 2.2x | 13.1x |
| 31-Mar-21 | 75% | 0.67x | 863 | -0.6x | 2.0x | 13.5x |
| 30-Jun-21 | 76% | 0.69x | 807 | -0.6x | 2.0x | 13.8x |
| **30-Sep-21** | **78%** | **0.64x** | **820** | **-0.5x** | **1.9x** | **12.5x** |

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Below are the updates on our portfolio holdings in the quarter in alphabetical order, excluding Sto and GetBusy which I have already commented on.

*Alimak – Core Value*

Alimak is our mid-cap, Swedish industrial business which operates an attractive installed base business model. Alimak reported results to the end of June in the quarter, which showed the business continues to recover from the pandemic and make progress on the building blocks that will drive the business toward its mid-term ambitions of mid single digit organic growth at 15% margins. Revenue remains c.20% below pre-pandemic levels, and despite this, the group has made considerable progress on cost initiatives such that operating margins improved to 13.2% in the quarter. This is a capital light business – capex is 10-20% of cash from operations, which frees up capital for acquisitions and growth investment along the vectors of new products, geographic expansion and targeted acquisitions. Over the past year, the company has generated 580mn SEK (80mn CAD) in available free cash flow. Despite the progress in the business, the share price has been treading water. As of the end of the quarter, we now own this business at 12x free cash flow, or an 8% cash on cash yield on an LTM basis.

*JZ Capital Partners – Special Situation*

JZ Capital is our small cap, UK listed closed end private equity fund in liquidation. The company continued to make progress toward the end goal of liquidation in the quarter by redeeming its convertible unsecured loan stock with the proceeds from asset sales. Once all the debt has been repaid, we as shareholders can look forward to distributions directly to us of the cash generated from remaining asset sales. As of August 31st, the fund had assets of $461mn in a diversified portfolio of private equity interests, liabilities of $144mn which makes for net assets of $316mn – and this is available today for a price of $127mn or a 60% discount to Net Asset Value. I continue to believe we have an attractive return embedded in this investment, and it is up to us to have the patience that others may not to capture this return.

*Naked Wines – Core Value*

Naked wines is our UK listed online direct-to-consumer subscription wine business. The price of the shares declined 14% in the quarter despite there being very little change in the prospects for the company, which remain bright in my view. Naked won a record set of awards at the Decanter World Wine Awards – in total the company's exclusive wines received two platinum, seven gold, 48 silver and 105 bronze medals. This is important because it is a strong independent endorsement of the quality of the wines on the Naked Wines platform and gives potential customers greater transparency between price and value. The new chairman, Darryl Rawlings, formally started in the job during the third quarter and promptly bought $175,000 worth of shares. For a more in-depth view of the thesis on this investment, please see the presentation I did to the CFA society of Toronto in June of this year. The password is HIGHWOOD.

*Protector Forsikring – Core Value*

Protector is our mid-cap, Norwegian P&C insurer with a large and growing float. The company reported Q2 results to the end of June during the quarter. The results were strong: the insurance side of the business delivered an 84% combined ratio and premium growth of 22% in local currencies. This meant an

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insurance (or technical) result of 190mn NOK, which was a record for the company. Together with a solid investment result in the quarter, the company delivered earnings per share of 3.2 NOK, and given the strong financial position, announced a second special dividend of 1.7 NOK which was paid out to us on July 21st. So far this year, Protector has generated 10 NOK/share in earnings (an 11% yield on the current price) and paid out 3 NOK/share in dividends (a 4% yield). In simple terms, our return from holding this security over the long term will be approximated by the dividends we receive plus the book value per share growth. We are halfway through 2020, and already the business has delivered book value per share growth of 15% and a dividend yield of 4% - or 19% in total as of H1.

*Ryanair – Core Value*

Ryanair is Europe's largest short-haul airline and a fine example of the discount business model I so like. It is able to price its fares at a 30% discount to the costs of competing airlines and still be the most profitable major airline in the Europe. The company is finally seeing the benefits of a return to short-haul air travel in Europe. Passenger numbers increased rapidly through the summer from near zero last winter to 5mn in June and 11mn in September. This is still c.80% of what would be 'normal' at this time of year, but at this level, the company is back to generating positive cash flow. The other major news in the quarter was that Ryanair finalized a deal with Boeing to buy 210 new 737 aircraft (after first calling off the negotiations), and upgraded its forecast for the number of passengers it expects to carry by March 2026 from 200mn to 225mn. This is 12% upgrade in the longer run earnings power of the business and amounts to a 50% increase in passengers carried compared to its pre-Covid traffic of 150mn passengers per year. This is all market share gain which is the result of a superior competitive position, a strong balance sheet and great management. Michael O'Leary, the CEO of Ryanair, went so far as to say that he has never seen, in his 30yr career, as much growth opportunity in front of Ryanair as what he sees right now as the industry emerges from the Covid-19 pandemic.

*Vestas – Core Value*

Vestas is the Danish listed, global market leader in wind turbine manufacture and service. The company has an attractive installed base business model with a highly profitable and competitively advantaged service business and a net cash balance sheet. Vestas reported Q2 results in the quarter which I would describe as mixed. Order intake remained strong, but revenue was flat year over year, which reflects a degree of lumpiness in customer orders and fulfillment due in large part to logistical challenges and supply chain bottlenecks. Vestas, like many industrial OEMs, has a complex supply chain across multiple borders which means it is only as strong as its weakest link. However, the long-term thesis remains very much on track in my view. As the recent International Energy Association (IEA) World Energy Outlook makes clear, the transition to renewable energy sources is just getting started. For example, on the basis of all member government's stated energy policies, the IEA estimates wind power generation capacity is likely to grow 4.1x over the next 30 years. However, on the basis of what the IEA estimates is required for net zero emissions by 2050, wind capacity must grow by 11.2x over the next 30yrs. As the industry leader and only pure play in the sector, Vestas is well placed to take advantage of this transition. And, given the attractive business model, we as shareholders are in a good position to benefit.

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**Business Update**

Highwood has moved office to a new and larger office with a view of the mountains. The next step will be to hire someone to take on more of the operational aspects of the firm, which will free up more of my time to stay focused on finding great bargains for our portfolio. If you know of someone who shares our values, has operational experience, and would like to be part of a growing firm in the beautiful coast mountains of BC, please have them get in touch.

As always, I value your support and welcome your questions and comments.

Sincerely,

Desmond Kingsford

**Appendices**

Underlying Currency Exposure Split

This is not a breakdown of the listing currency of our holdings. It is the split of the currencies our portfolio companies earn their revenues in. As such, it is the underlying exposure to currencies you have through your partial ownership of these businesses. As investors can choose whether to have their account in USD or CAD and hence their cash balance may be in either USD or CAD, I have expressed the currency exposure as a percent of invested capital.

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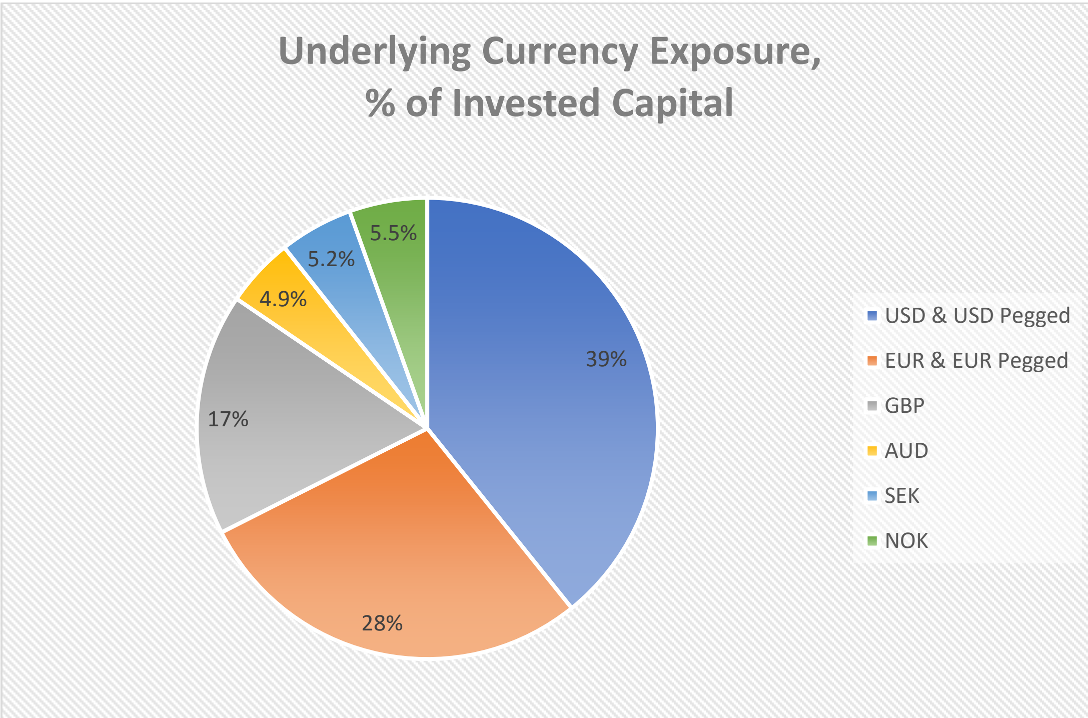


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Certain statements contained in this Letter may be considered "forward-looking information" and "forward-looking statements" (collectively "forward-looking statements") within the meaning of applicable Canadian securities legislation. All statements, other than statements of historical fact included herein, without limitation, statements relating to the Firm's future financial performance and investment returns, are forward-looking statements.

Forward-looking statements are frequently, but not always, identified by words such as "expects", "anticipates", "believes", "intends", "estimates", "potential", "possible", and similar expressions, or statements that events, conditions, or results "will", "may", "could", or "should" occur or be achieved. Forward-looking statements in this Letter include, among other things, statements relating to: the desire to generate outstanding investment results with low risk; the proposed timeline for the Firm's investment horizon and Mr. Kingsford's career; the benefits of operating the Firm out of Whistler, British Columbia as opposed to a more traditional investment market; Mr. Kingsford's beliefs regarding the necessary components to investment success; the future operating or financial performance of the Firm and the assets managed by the Firm; the intention to prioritize long-term investment return over short-term results; the intention to take on more capital only where the Firm believes it will not dilute investor returns; the intention to maintain a fee structure that incentivizes manager performance over asset gathering; the intention to maintain the Firm's current strategy and vision as it grows; the potential to provide a fund structure in addition to the SMA approach in the future; the Firm's mission to compound each dollar of invested capital into five dollars over a ten-year period without taking undue risk; the belief that a short term quarterly or annual results focus is harmful to long-term returns; the Firm's beliefs with respect to how risk is properly defined and mitigated; the Firm's beliefs as to how returns may actualize; the beliefs of the Firm and Mr. Kingsford regarding the prospective results of specific investments of the Firm; the theories and beliefs disclosed regarding what makes an investment strategy successful; and the expectation and plans for growth . Actual future results may differ materially. There can be no assurance that such statements will prove to be accurate, and actual results and future events could differ materially from those anticipated in such statements. Forward-looking statements reflect the beliefs, opinions and projections on the date of this Letter and are based upon a number of assumptions and estimates that, while considered reasonable by the Firm and Mr. Kingsford, are inherently subject to significant business, economic, competitive, political and social uncertainties, many of which are beyond the control of management. Many factors, both known and unknown, could cause actual results, performance or achievements to be materially different from the results, performance or achievements that are or may be expressed or implied by such forward-looking statements and management of the Firm have made assumptions and estimates based on or related to many of these factors. Readers should not place undue reliance on the forward-looking statements and information contained in this Letter concerning these assumptions.

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