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July 15th, 2020

Dear Investors,

During the second quarter of 2020, our portfolio was up 10.1% in Canadian dollars, net of fees. The quarter was characterised by a rapid upward re-pricing of global and european equities, falling bond yields and tightening credit spreads. Broad equity indices in Europe finished the quarter up +9% are -10% year to date[1].

Our portfolio exposure stayed roughly constant from what it was at the end of Q1. This reflects the +15% appreciation of our invested capital in the quarter plus added exposure in two positions, less the sale of half our position in another name. The table below gives you the usual summary of our exposure, performance and attribution by strategy bucket.

Gross Exposures and Attribution by Strategy	Exposure	Q2 2020 Performance	Q2 2020 Attribution	YTD Performance	YTD Attribution
Core Value Equity	61.3%	18.4%	11.3%	-5.0%	-3.2%
Special Situations Equity	8.0%	-20.2%	-1.1%	-62.7%	-6.2%
Total Equity	69.3%	15.1%	10.1%	-12.8%	-9.4%
Hedges	0.0%	0.0%	0.0%	0.0%	0.0%
Cash	30.7%	0.0%	0.0%	0.0%	0.0%
Total Portfolio	**100.0%**	**10.1%**	**10.1%**	**-9.4%**	**-9.4%**

In my last investor letter, I outlined my thoughts and approach to the Covid-19 coronavirus pandemic and its implications as a fundamental value investor with a long-term approach. In this letter, I propose to continue that dialogue by briefly updating you on how my views have evolved three months on from that point. From there, I will return to another topic from my last letter, namely Highwood's investment strategy, which I will cover in more depth. I will focus in on a portion of the strategy, the so called 'Core Value Equity' bucket, and why this is well suited to our mission, which is to compound each dollar of invested capital into five dollars over a ten-year period without taking undue risk. Finally, I will give you an update on our individual portfolio holdings, with a focus on how these businesses are being affected by the pandemic and what our management teams are doing about it.

Covid-19 Update

Mr. Market sure looks like he has drunk the Kool-Aid. The rapid rally in equity prices in the quarter has left many scratching their heads, including me. The disconnect between the fundamentals of the broad corporate economy and the valuation of those fundamentals in the equity market is probably the widest it has been in my 18 year investing career. The S&P 500 is back to where it was in December 2019, while corporate earnings are likely to be down 60% YoY in Q2[2], back to where they were 11 years ago in the

[1] MSCI Europe Index.
[2] Source: Goldman Sachs.

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depths of the 2009 financial crisis. The Covid-19 Pandemic has been slowed but seems likely to pick up steam, with a second wave of infections underway in geographies that perhaps re-opened too quickly. Central Banks around the world continue to create money and use it to buy an ever-widening collection of sovereign and corporate bonds regardless of value, and perhaps more importantly testing the trust we have in their independence. Fund flows into passive, momentum or index-hugging strategies, which are collectively forced buyers of equities and like central banks, do so regardless of value, are the vast majority of new capital flows into the global equity markets[3]. Day traders are back in force[4] and speculative behaviour, such as buying equity in known bankruptcies[5] is on the rise. In many ways, the investing environment feels much like the momentum driven bubble of 1999.

In the face of this, Highwood is sticking to its discipline and pursuing a strategy that I believe is well suited to this environment, a subject I will return to shortly. During the quarter, I added to positions having the largest gap between price and value (Standard Drilling and JZ Capital) and I reduced the position in Alimak after having doubled the position in March and benefited from strong price appreciation from those levels. I finished work on Naked Wines PLC, formerly referred to as the 'unnamed UK Mid-Cap' in my last investor letter, and did work on a handful of new names, none of which were compelling enough to put capital to work in. The portfolio was up strongly in April and May, June was weak and July has started strongly with our portfolio up a further 7% as of the date of writing.

As of the quarter end, the high-level portfolio statistics were as follows:

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-Mar-20	67%	0.44x	332	-0.9x	1.1x	10.6x
30-Jun-20	69%	0.56x	535	-0.9x	1.5x	11.9x

Highwood's Investment Strategy - The next layer down

Highwood's strategy is about as far from the momentum, 'buy everything at whatever value' strategy that is on offer by the passive, index-hugging or outright momentum strategies that seem to be dominating the buying activity at present. I believe our strategy is well suited to this environment precisely because of this fact. As a start, our returns are generated with a lower level of risk: we own good businesses with either none or very little debt finance. As opportunistic investors, we are willing and able to hold cash until businesses we know and like are priced at a level which embeds long term returns consistent with our

[3] https://www.ft.com/content/541b1acc-c521-4cfe-89a3-132f02df497b
[4] https://www.bloomberg.com/news/articles/2020-06-12/barstool-sports-dave-portnoy-is-leading-an-army-of-day-traders
[5] https://www.cnbc.com/2020/06/09/the-hot-new-thing-to-make-your-stock-pop-go-bankrupt.html

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mission. In contrast to our passive competitors, we are not forced buyers regardless of the relationship between price and value.

It is also a strategy that reflects my own circle of competence in both style and geography. It is a refinement of what I as your Portfolio Manager have been doing for the better part of two decades, either for Putnam Investments or MSD Capital in London. It focuses on two types of mispriced securities in European capital markets: 'Core Value' compounders and Net-Net 'special situations'. The Core Value bucket, where the majority of our capital is concentrated, focuses on finding businesses with strong and growing competitive advantages that allow those businesses to earn high returns on capital now and long into the future, run by owner-operator minded management teams and where those management teams have the opportunity to deploy large proportions of their excess free cash flow at high returns.

The importance of this latter quality is hard to overstate, and I think deserves explanation by way of a simple example. The table below depicts two hypothetical investments, one that is pure undervalued cash flow but with no real opportunity to deploy that free cash flow and hence, it pays the majority of it out as dividends, and another that has the same beginning free cash flow but has opportunities to deploy substantial proportions of that free cash flow at high rates of return.

The value of re-investment opportunities vs undervalued cash flow

	"Undervalued Cash Flow Corp"	"Re-investment Corp"
Current Earnings Power	$ 100	$ 100
Beginning Multiple	15x	15x
Current Valuation	$ 1,500	$ 1,500
% of Free Cash Flow (FCF) Re-invested	**40%**	**100%**
Returns on Re-invested FCF	**9%**	**25%**
Cumulative Dividends, Re-invested	$ 940	$ -
Year 10 Earnings Power	$ 142	$ 931
Year 10 Multiple	15x	15x
Year 10 Valuation	$ 2,136	$ 13,970
Multiple on Original Investment	**2.1**	**9.3**
10yr IRR	**7%**	**25%**

The former may be called 'Undervalued cash flow corp', whereas the latter may be called 'Re-investment corp'. The only difference between the two is how much of their free cash flow they can re-invest, either organically or inorganically, and what returns they can generate on that investment. Both investments are bought at 15x earnings and eventually sold at 15x earnings. By year 10, Undervalued cash flow corp has paid out $707 in dividends worth $940 when re-invested, and is earning $142 per share, which delivers a

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2.1x return on invested capital, or a 7% internal rate of return (IRR). In contrast, Re-investment corp has paid out nothing because it has the opportunity to invest 100% the free cash flow it generates in its own business at an attractive 25% return on capital. Because of this, Re-investment corp is earning $931 per share in year 10, which at 15x earnings is worth a whopping 9.3x what was paid for it 10yrs earlier. Such is the power of a business that has strong re-investment opportunities and a management team capable of seizing those opportunities. This example underscores the value of our focus on capital re-deployment and, I believe, how this aspect of Highwood's investment strategy is well suited to our mission.

The example also serves to demonstrate the importance of two other tenets of our strategy. Firstly, having a fundamental approach, which is a necessary condition for understanding the business and its re-investment opportunities, often at the level of the unit economics, and secondly, a long-term perspective. This is as important in finding such opportunities as it is in holding onto them once found. Supposing the price of 're-investment corp' appreciated from 15x earnings to 20x earnings in year 1. For many, it would be tempting to sell their interest at a +67% return, but would that be wise? Clearly not, but that decision could only be taken with skill (rather than luck) if the investment thesis established the businesses' unit economics, competitive advantage and re-investment opportunities at the outset.

To delve a little deeper, it tends to be the case, in my experience, that the companies that are most likely to pull a 're-investment corp' fall into one of a few specific categories of business model, and that is how I tend to focus my work in the 'Core Value' bucket. Chief amongst these winning models is the 'scale economies shared' business model, or what I often call the 'discount' business model. This particular model has generated some of the greatest business success, and consequently investment returns, ever: Wal-Mart, CostCo and Amazon are all examples of this model. Our investment in Protector Forsikring has aspects of this, but Ryanair and Naked Wines are probably the purest examples. In the following section I will summarize the Naked Wines thesis with a focus on its business model characteristics and re-investment opportunities to illustrate the approach in practice.

<u>Naked Wines PLC</u>

Naked Wines is a UK listed on-line only subscription-based wine business. The company emerged out of Majestic Wines PLC, which was a traditional wine retailer, but late last year management took the rational but difficult decision to divest itself of the much larger retail portion of the business and focus all its resources on the on-line only subscription business.

In my framework, the business is a classic manifestation of the 'discount' business model because the key aspect of its competitive advantage is its ability to sell a product or service at a substantial discount to competition, while still earning high returns on capital for shareholders. In this case, the product is wine. Naked Wines is a regulated winery, owns its own brands and sells direct to consumer (DtC), rather than through the usual 3-tiered system (winery to distributor, distributor to retailer, retailer to consumer). Typically, out of the retail cost of a bottle of wine, 2/3rds of the cost of that bottle of wine is margin to the wholesale distributor and retailer. In the case of a $30 bottle of wine, that is c.$20. Naked Wines cuts this out, which means it can sell the same $10 of wine for $20, which thereby delivers a 50% gross margin while still pricing at 2/3rds of the cost of comparable wines. This discount to the market generates volume market share gains – and Naked Wines has been a consistent market share gainer with organic revenue

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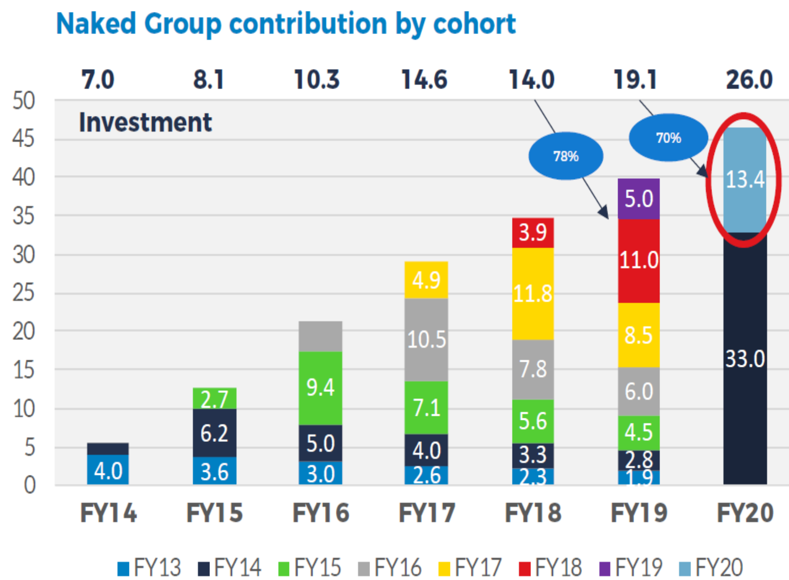
growth of c.15% per annum historically. The product – a bottle of wine, delivered to your door – has significant unit costs that decline with scale, and as the company sells more units, it is able to either negotiate lower costs per bottle (eg corks, bottles, labels) or benefit from declining fixed unit costs (such as distribution center overheads). In either case, the company plows those unit cost gains back into lower prices for the consumer. This creates a self-reinforcing loop of lower prices to the consumer, which stimulates more volume, which creates more scale, lower unit costs and lower prices. This kind of competitive advantage becomes very difficult to attack as any new entrant cannot provide the same customer proposition without running at a loss for a long period of time.

The business model and competitive advantage mean the company is well placed to generate lots of free cash flow from its existing subscribers well into the future – they are getting a good deal, and the company is earning high margins at the same time. Consistent with our stylized example earlier, it also has the opportunity to deploy large amounts of the free cash flow it generates at high rates of return. How much and at what rate? At this point, 100% of free cash flow at a rate of over 80%. The company groups its customers into 'cohorts', depending on when the customer became a subscriber as outlined in the following chart:



See slide 51 in the Appendix for the calculation of Stand still EBIT and Pro Forma method. Any forward looking and / or pro forma financial information is for purely illustrative purposes, reflecting assumptions based on historical data and guidance. It should not be interpreted as a forecast of future performance.

Take the 2015 cohort for example. In that year, the company invested £8.1mn to acquire customers that subsequently bought c. £38mn worth of wine at a 25% contribution margin (after all but central costs) in 2016, which delivered £9.4mn of profit or a 116% return in year one. While some customers cancel their subscription or spend less, this cohort on average has continued to deliver profits of £7.1mn in 2017, £5.6mn in 2018 and £4.5mn in 2019. All told, to this point the 2015 cohort has delivered £33.4mn of

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profits for an investment of 8.1mn, or 5.7x the invested capital over 5 years. 2015 was an exceptional vintage, but 2014, 2016, 2017, 2018 and 2019 have all been in a similar ball-park or are on track to be similar. With a single digit market share of the markets it operates in, I believe the company has many more years ahead of it investing at these rates.

Consistent with the rest of our portfolio holdings, Naked Wines has a very strong balance sheet with c. £55mn of net cash, or c.1/3rd of the market cap at the time of our purchase of the shares. We acquired our stake in the business at 0.5x revenue and 9x EBIT after the necessary re-investment to maintain the existing cash flow (ie pre-growth).

Now, as an on-line only, delivery to your door business, Naked has been a strong beneficiary of the Covid-19 lock-downs. Revenue has accelerated from c.15% per annum to +81% in the months of April and May, which has put the company on the radar screens of more investors, and seen the share price double from where we purchased our initial position in March.

Portfolio Updates

Below are the updates on the rest of our portfolio holdings in the quarter.

Ryanair – Core Value

The thesis on Ryanair is broadly playing out as expected, with some nuances around the impact of government bailouts of competing airlines. During Q2, Ryanair reported full year results to the end of March, which saw profits +13%, a strong balance sheet and a widening gap on their unit cost advantages vs competition. The company has been able to cut costs aggressively to reduce cash burn and continues to have the powerful cocktail of the lowest costs in the industry and the strongest balance sheet, which sets it up for market share gains as competitors go bust or re-trench. On the other hand, the under-capitalised, high-cost flag carriers such as Lufthansa and Air France-KLM are receiving bail-outs from their domestic governments to keep them from going insolvent at the risk of thousands of job losses. These bail-outs do not solve the problem for the flag carriers, nor do they alter the long-term thesis on Ryanair. In my opinion, they just give the flag carriers more rope to hang themselves with and slow their market share losses from what they would have been under an insolvency. For example, Lufthansa has received a €9bn bail-out from the German government, which is a mix of straight equity, a preference equity like instrument and €3bn of straight debt. With a current cash burn rate of €1.1bn per month, this gives Lufthansa a little more breathing room, but it adds to the company's indebtedness, increases fixed costs and reduces the company's flexibility. Further, as part of the deal, Lufthansa is forced to give up some of its most profitable slots at hub airports, which will be taken on by those that can operate them more profitably. The most likely scenario is that Lufthansa will be forced to re-trench by cutting its least profitable routes, which opens up additional market share potential for Ryanair.

Standard Drilling – Special Situations

Despite the share price being largely unchanged in the quarter, the thesis on Standard Drilling is also on track. Through the equity of Standard Drilling, we own a portfolio of PSV ships at c.$3mn per ship where the market value of those same ships today is between $10mn and $15mn each, plus cash and a profitable

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JV interest. My conversations with the management team over the quarter continues to support the view that we are partnered with a no-nonsense operator motivated to maximise shareholder value.

Protector Forsikring – Core Value

Protector reported strong Q1 results that saw the shares advance 11% on the day and the shares have continued to re-price upward since then. The C-19 crisis has had a relatively small impact on the business, partly due to decisive action by the investment team: the small investment losses the company incurred on a mark to market basis are more than offset by the running yield the investment team was able to deploy capital at during the C-19 drawdown. On the insurance side, the company is seeing steady improvement in its combined ratio as it re-prices some of its less profitable business.

Alimak – Core Value

Alimak reported Q1 results to the end of March that were more mixed in my opinion. Revenue and profits were down 21% and 48% respectively, but in contrast to previous recessions, the aftermarket profits were down due to customers limiting access to their sites for all 3rd party contractors to conduct routine maintenance on the installed base. This is an understandable and transient dynamic, and management have elected not to cut engineer numbers in the aftermarket business as they expect demand here to come back strongly. I added to the position in March as the share price became detached from fair value and as the shares came back strongly in April and May, I reduced that additional exposure.

JZ Capital Partners – Special Situation

The shares in JZ were weak again in the quarter and now trade at a very considerable margin to my appraised liquidation value. On top of that, the liquidation event looks to be moving closer. The company announced an EGM to gain shareholder approval for the revised investment policy that aims to curtail any new investments, maximise value from the portfolio in a sale process and return capital to shareholders. The most recently published NAV is $6.14/share, or £4.91 at current exchange rates vs a share price of £0.90, or circa 18 cents on the dollar of NAV. My own assessment of fair value is below this, but still gives us both a margin of safety and the potential for a substantial return on our investment from current levels. From my conversations with the management team, I am confident we are on the same page as to the path to value realisation from here and given they collectively own 26% of the shares, our interests are well aligned.

Vestas – Core Value

Vestas' business continued to chug along in the quarter. The company had some disruption from the C-19 crisis at its main factories, but has re-opened production quickly with the necessary safety protocols. The company continues to win new orders, both on-shore and increasingly off-shore through its JV with Mitsubishi, typically with attractive long-term aftermarket service contracts. As innovation, scale benefits reduce the unit costs of generating wind power, the industry is eating up investment that used to go to conventional oil and gas. As an example, over the last decade, offshore oil and gas development spend in the US was c.$154bn, while offshore wind developments received close to zero investment. Based on known projects over the next decade, Offshore oil and gas investment spend is expected to decline to $82bn

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while offshore wind investment is expected to grow to $78bn, or roughly half the total from zero in one decade[6]. Vestas is the leader in a consolidated industry providing the 'picks and shovels' for this build out, and importantly retains a dominant share of the highly profitable aftermarket service business on the installed base of turbines.

Business Update

Highwood Value Partners continued to grow and take on additional mandates in the quarter. Thank you for your trust and I look forward to continuing our mission with well aligned, thoughtful partners.

Travel restrictions permitting, I will be visiting Vancouver, Calgary and Toronto in September. Please contact me if you would like to meet to discuss the strategy or investing generally.

Also, I will be posting past investment letters to my website. The purpose of this is to further transparency and openness with you and with potential new investors.

As always, I value your support and welcome your 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.

[6] Source: Wood Mackenzie.

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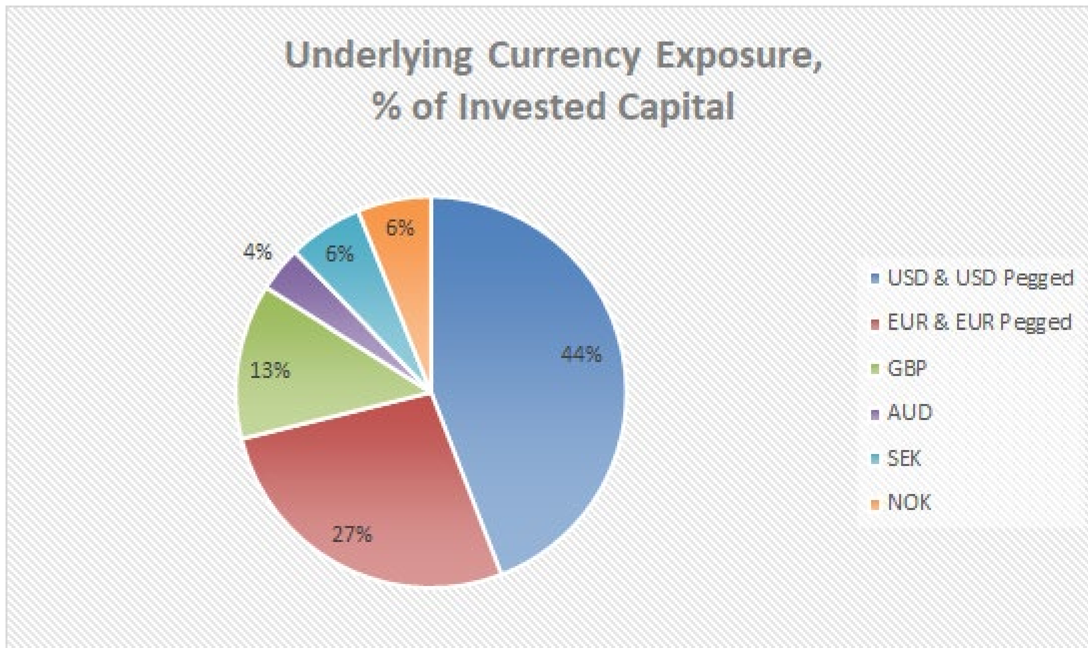

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Certain statements contained in this Letter may be considered "forward-looking information" and "forward-looking statements" (collectively "forward-looking statements") within the meaning of applicable Canadian securities legislation. All statements, 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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