To: **Investor Partners of Castlereagh Equity Pty Ltd**

From: **Peter Phan**

Date: **30 September 2018**

Re: **Monthly Update**

	Castlereagh Equity	ASX All Ordinaries	Relative Performance	CE Net Asset Value
1 November 2013 to 30 Sept 2018	66.3%	16.7%	49.6%	141.3 cents*
1 November 2013 to 31 January 2015	6.2%	2.4%	3.8%	106.2 cents
1 February 2015 to 29 January 2016	19.4%	-9.2%	28.6%	126.8 cents
1 February 2016 to 31 January 2017	19.7%	12.5%	7.2%	151.8 cents
1 February 2017 to 31 Jan 2018	9%	8.3%	0.7%	146 cents
1 February 2018 to 30 Sept 2018	1.6%	2.9%	-1.3%	141.3 cents

To aid in understanding the tables above:

1. CE commenced on 1 November 2013 with shares issued at $1 per share, backed by $1 of cash per share.
2. The first row of the table above provides a summary of CE's performance since its commencement on 1 November 2013 until the date of this memorandum. It also compares CE's performance with the benchmark All Ordinaries index over the same period.
3. The second row of the table provides a summary of CE's performance for its first reporting period (15 months period from 1 November 2013 to 31 January 2015).
4. The third row of the table provides a summary of CE's performance for its second reporting period (12 months period from 1 February 2015 to 29 January 2016).
5. The fourth row of the table provides a summary of CE's performance for its third reporting period (12 months period from 1 February 2016 to 31 January 2017).
6. The fifth row of the table provides a summary of CE's performance for its fourth and current reporting period (period commencing 1 February 2017 to the date of this memorandum).
7. *CE NAV is after payment of dividend and director fees in Feb 2017 and Feb 2018. These payments "reset" the NAV from 1.52 to 1.34 in Feb 2017 and from 1.46 to 1.39 in Feb 2018.

The XAO started at 5420 on 1 November 2013 and ended at 6324 on 28 September 2018. In percentage terms, the XAO gained 18.6% for the 58 months period since the start of the CE fund. CE's performance over the same 58 months period is 66.3%.

For the month of September 2018, the XAO dropped by 1.6%. The CE portfolio was slightly up by 0.8% for the month.

The cash component of the CE fund is just under 20%. During the month, we have exited our holdings in Clydesdale Bank (CYB) and the proceeds were redirected towards a new opportunity in a non-sexy sector of the market. The share price of this opportunity has declined by some 80% from its high. Management made some bad decisions a few years back and they have now taken decisive steps to rectify the error. In my opinion, the core business remains unharmed and it is a relatively good and stable business with non-insignificant competitive advantages, a tailwind and a long runway ahead of it, with the owner founder returning to the helm and buying up stock at current depressed prices. I see this opportunity as an example of what Charlie Munger terms as "cancer surgery". There are risks involved, but I believe we are well compensated for it at current price. I will explain more in due course.

Euphoric prices continue in the hot technology sector of the market. Overall, the market is behaving in its usual topsy turvy manner. In the meantime, the CE portfolio performed as expected and is slowly and surely clawing back its recent underperformance against the market. Against a backdrop of continuing selling pressure, the businesses that we hold are starting to report positive developments, both expected and unexpected.

I will now explain a little bit more about Clydesdale Bank (CYB).

CE purchased shares in CYB in about March 2016. Clydesdale Bank was spun off from NAB in February 2016. With an imputed price of $4 for CGT purposes, the shares promptly dived on listing to a low of around $3.60, investors presumably rattled by news in January 2016 of increased PPI provisions by the major banks in the UK. At the time of the spin-off, NAB's market capitalisation was AUD$75b, and CYB at $4 was capitalised at $3.2b. This is barely 5% the size of the parent. The CYB share parcels handed out to shareholders would have created problems. For institutional investors, they may either lack a mandate to invest due to 1) CYB being non-Australian 2) CYB not included in any index 3) CYB being below minimal size of holdings required 4) CYB not having a yield or franking. For retail investors, the share parcel is 5% of their NAB holding, making it a small inconvenient nuisance holding, no franking credits, in a sector not currently covered by their brokers. As tax loss selling season approaches, investors will look at this as free money, since they get cash from the sale, and they book a capital loss at the same time.

At the time of purchase, CYB along with all major UK banks were trading at roughly 0.5x to 0.6x book value. The market cap of CYB then was just below GBP$2b at prevailing exchange rates pre-Brexit. Apart from this general pessimistic pricing for the whole sector, CYB also possessed several interesting features:

1. It has a very strong balance sheet. CYB made heavy provisions for PPI liabilities, and if these liabilities do not eventuate, there was a potential for a significant amount of capital to be freed up for shareholders. Apart from this, there was also a further potential GBP$500m of excess capital that could be freed up in respect of its regulatory capital adequacy requirements relating to its mortgage book.

2. CYB's cost to income ratio (CIR) was in excess of 75%, which was significantly higher than its peers. With revenue running at nearly GBP$1b, every percentage decrease in the CIR ratio means GBP$10m pre-tax straight to the bottom line. Management set out a plan to reduce the CIR from 75% to 55% (=an extra GBP$200m pretax without any growth) within 4 years, and the CEO together with his team had already done a similar exercise in the past with an Irish bank.

3. CYB's catchment area is in the industrial heartland of Scotland and parts of England (this is very important in terms of making a judgment on the quality of its loan book- a bit too long to discuss here). CYB is 90% depositor funded, and housing mortgages made up a significant portion of its book. The absence of reliance on wholesale funding is another significant risk mitigating factor.

4. CYB had a new technology platform which was unencumbered by legacy systems. Apart from aiding the cost reduction exercise, this would be an important tool in gaining market share.

5. The UK market as a whole was projected to grow in the low to mid single digits. CYB just needs to keep pace with system growth.

6. At that time, I did not predict that Brexit would take place, but my thinking was that even if Brexit eventuated, the impact on CYB's operations would not be significant, and whilst there would be a currency impact, this would even itself out over a long holding period of say 5 to 10 years.

All in all, I worked out that even on conservative assumptions, CYB was worth $8 within 4 years if management could execute their plan. Frankly the probability of success was high. Cost cutting at a bank is not exactly rocket science or a trade secret. And neither is growing the loan book in line with the market.

In the nutshell, the thesis was pretty simple- cost reductions, steady growth, low price to book value, and 2 separate upside optionality from the balance sheet, together with a takeover possibility.

Shortly after the purchase of the first parcel at average prices of $4, CYB shares went on a quick run to $5.75 before the Brexit event took place. The shares were duly sold down to below $4 again, and I took the chance to load up to a full 8% position. In hindsight (a wonderful thing that is), the loading should have been 10% to 15%. This was an error of judgment on my part.

I took the decision to exit CYB this year firstly because the proposed takeover of Virgin Money in the UK has changed the investment thesis. I did not feel that I have a good grasp of the salient issues both within Virgin and the overall merged entity to make an informed judgment to invest. Secondly, the price has already appreciated past $6 which was close to book value (in GBP terms), and given my lack of conviction and knowledge of the environment post-Virgin, I could not confidently estimate an intrinsic fair value.

CE made 50% return on capital invested in just over 2 years from CYB. Management executed on its CIR program whilst growing the loan book and keeping arrears and defaults steady, whilst dealing with the PPI issue which is now forecasted to cost more than eventually anticipated. Overall, the quality of CYB's business has increased significantly over the last 2 years since the spin-off, which is reflected in the rerate to book value. We made less in Australian dollars due primarily to the drop in the UK pound post Brexit.

More importantly, we took relatively low risks to achieve our returns. The possibility of CYB ending up worse in terms of business quality after such a long period of NAB (mis)management was pretty remote at the time of purchase of the shares, given the pristine state of its balance sheet, its technology platform and a motivated management.

The CYB investment is an example of a risk-adjusted returns approach which I have written and talked about extensively. How we make our money is just as important as how much we make. As the Chinese saying goes, if you keep going into the hills, you will eventually meet the tiger. In the context of a long period of investing, it is unnecessary and dangerous to take too much risks.

Thank you for your trust and confidence in us.

Regards
Peter Phan
Director, Castlereagh Equity Pty Ltd