Castelnau
GROUP

Quarterly Report

Castelnau Group Limited

31 December 2021

Letter from the CIO

Dear Shareholder,

Welcome to the Castelnau Group. As this is our first letter to you, I intend to set out what it is that we are trying to do and how we intend to measure our progress.

Our principal objective that drives everything we do is to generate high, risk-adjusted, long term returns on your capital and to compound those over time. By "high" we mean materially higher than the returns of passively holding all equities and by that we mean an excess return of 10% over the relevant indices before fees. We are focused on absolute returns and "high" to us means 20% per annum and above.

Returns of this magnitude are not easily achieved and writing them down might look like an act of overconfident hubris, but they are a yardstick by which we are asking you to judge us.

We care about how we make those returns and will apply the Phoenix Principles (republished below) to the way we conduct ourselves. If we do that consistently, then in time we will enhance the reputation of our assets.

Castelnau Group's 'Edge'

To achieve high returns over time requires some form of edge, some form of competitive advantage and I will try to explain what we think ours will be. Castelnau's edge is a combination of factors working together. Here are six of the more important factors.

1. **Permanent Capital.** Most investment capital is redeemable in some form or has a time horizon attached to it; ours doesn't. Should shareholders wish to move on then they can do that by selling their shares in the market to another buyer. That permanence of capital allows us to use investment strategies that many can't, where the short term may look poor and where liquidity may be low. It allows a truly business-like approach to investment.

   The board or shareholders collectively can of course still decide at any point to wind up the business and redeem the capital. Permanent capital doesn't mean perpetuity; it means that we don't have to operate under threat of a redemption event.

2. **Long Term Horizon.** We assess opportunities with a very long-term timeframe and will pursue investments that benefit from that. Most investment capital is judged over the shorter term and held in forms with some exit in mind. When you combine a very long-time horizon with permanent capital you have opportunities that many can't pursue. A long-term horizon means that the first priority always has to be survival. It also means that we can afford to be patient. It does not mean however that we don't have urgency in pursuing our goals.

3. **Standing on the Shoulders of Giants.** We don't profess genius; we are students of it. We draw upon the examples and teachings of some great investors and businesspeople. We can however substitute genius for copying. This might not seem like it should be an edge, surely everyone could do this, but such is human nature that they don't. Phoenix has been built upon the teachings of great value investors

and yet as an investment style it remains a backwater.

4. **Our People and our Network.** Our greatest edge is probably the people I have surrounded myself with. We have always taken recruitment very seriously at Phoenix and have built a highly capable team organically. We are extending that approach into our businesses and when we get that right so much of the rest takes care of itself.

   We also have the privilege of access to some great businesspeople and investors who we are connected to through their businesses or because they are investors in Phoenix. We draw upon this network in many ways, from the informal through to our partnership with Sir Peter Wood and his team at SPWOne. What we have found is that networks beget networks and good people tend to know and work with good people.

   Decades of seeking out the best companies and getting close to the best managements along with attracting business-like investors to our investment approach has gifted us a strong array of capable and knowledgeable people. John Elkann's EXOR is possibly the benchmark in this regard with its very impressive Partners Council[1].

5. **Culture.** We have a way of operating that lends itself to learning by thinking, doing and observing. A confidence to try things in a thoughtful and careful way and humility to spot and admit failures that can be utilised for incremental learnings. It is a flat, self-organising culture that you need to be inside to truly appreciate but it allows us to draw on the full breadth of capability from many diverse and able brains and experiences.

6. **The Castelnau Way & The Toolkit.** At Castelnau we seek to turn knowledge into a business craft whose output is long-term shareholder value. It is one thing to draw upon knowledge in all its forms; analysis of facts, learning from others, results of experiments, thinking and practice - but it is quite another to apply that successfully. In Castelnau, just as we do and have done for over 20 years at Phoenix, we do it by creating a framework that allows us to build a way of working that accumulates lessons and continuously improves.

   As the Nobel-Prize winning economist Daniel Kahneman and others have pointed out, for true expertise to develop there needs to be a consistency of approach, defined parameters and a good feedback loop. Engineering teaches that open-loop systems are unstable without feedback and learning. So too, in business. That is what we are cultivating inside Castelnau. The longer we do it, the more we learn from experience and the stronger this edge should become.

   The Castelnau Way is the approach we are adopting to achieving our goals, the modus operandi we are developing and evolving through practice and experience. By contrast the Castelnau Toolkit, as its name implies, is a very specific set of tools and capabilities that we have been building and adding to.

These are "edges" which we believe we possess and will apply to the goal of compounding your capital at high risk-adjusted rates. The primary way in which we will do that is by deploying your capital in businesses that themselves have an edge: a moat, a defensible competitive advantage that allows them to earn a high return on their capital and to re-invest at high marginal rates. Such businesses, when their attributes are obvious to all, are usually

[1] https://www.exor.com/pages/exor/governance/exor-partners-council

not available at prices that will generate high returns on your capital. So, our primary strategy is to gain control and influence businesses that have *the potential* to be great and then to help them to realise that greatness. We want to *Build and Keep Great Companies*.

In this overall context we believe Castelnau to be quite a unique investment vehicle.

The Shoulders of Giants

Phoenix investors are familiar with our longstanding admiration of and learnings from Messrs Buffett, Templeton and Keynes, amongst others. Our inspiration for the Castelnau group structure was in no small part inspired by these investing greats but also from highly successful operators of businesses. Henry Singleton's **Teledyne** is probably our preferred source of inspiration for Castelnau. Teledyne's business system and Singleton's track record is well documented: his was an unwavering focus on exceptional operational excellence combined with genius capital allocation that confounded conventional wisdom and was decades ahead of its time.

We reference three more inspirational business systems below. All three used systematic continuous improvement methods and stringent capital allocation, but interestingly did so in quite diverse end markets. None of these businesses are comparable businesses to Castelnau's holdings per se, but all offer direct learnings that we can tap in to and apply. All four remind us that it is not just moats, nor learnings in isolation that count, but *each* of these combined with consistent and systematic execution.

The Rales Brothers (and **Danaher Business System**)
Steven and Mitchell Rales set the benchmark for how to apply operating learnings systematically to great effect in their Danaher conglomerate of industrial manufacturing businesses. Inspired by the Japanese Kaizen system for continuous improvement, the Rales systemised an approach (dubbed the Danaher Business System) which led to astonishing compounding of profits and shareholder value over three decades and still going strong. Larry Culp (Danaher CEO 2001-14) later described Danaher's secret sauce as "*common-sense, vigorously applied*" which resonates greatly with us.

David Barber[2] (**Halma plc**)
Closer to home, Halma plc in the 1970s was set out from day one by founder David Barber as a business with a long-term mindset and unrelenting focus on building a sustainable moat. Barber outlined the simple (but not easy) process of achieving long-term growth in shareholder value as: "*First establish the mathematical model which meets your needs. Then, steadily and systematically change the group until it gradually comes to conform with your model*". Barber was also unapologetic in establishing (and later achieving) what he admitted were at the time "enormously ambitious" goals including 40% ROC targets.

Mark Leonard (**Constellation Software**)
Further afield, Canadian vertical software business Constellation might be the least well known to our UK investors but offers another source of common-sense inspiration from within a far more contemporary business. Constellation is yet another business roll-up but also like the others above, has an extremely rigorous business system for sourcing, acquiring and integrating software businesses. Above all, it is systematic in how it manages and develops

[2] (David Barber sadly passed away last month. Under his tenure as CEO and later as Chairman the Halma share price compounded at 21% per annum. His legacy is assured).

its people internally, has a strong corporate governance regime and excels at capital allocation.

Ingredients of Great Companies

There are some key common ingredients of Great Companies and a large part of our work at Castelnau will be in helping our businesses attain and utilise them.

- **Culture of Learning.** This element is the hardest part of what we will be attempting to do, takes the longest to achieve but ultimately will have the highest long-term value. Continuous learning (vigorously applied) leads to continuous improvement. A learning organisation that is focused on its customers will adapt to its marketplace faster than its competitors thus protecting its moat.

- **A sustainable competitive advantage.** This is what Warren Buffett refers to as a moat. Every moat protecting a valuable castle will be under continual threat and so it needs to be paired with a strategy that is constantly seeking to widen the moat by improving its proposition to its customers. Henry Ford put it well: *"a business absolutely devoted to service will only have one worry about profits. They will be embarrassingly large."*

- **An ultimately high return on capital business model.** To state the obvious: the only way that shareholders will reap high long-term returns is if at some point the returns of the business become high in absolute *and* marginal terms.

- **Great management.** None of the above is possible and sustainable without great management. Culture filters down from the top and great management inverts the organisation to be in touch with its customers.

Capital Allocation. Building Great Companies (and keeping them) gives us a great capital allocation opportunity by virtue of the retention of some of the returns they generate to fund future growth. Every time we, as investors, make a capital allocation decision it contains an array of expected returns and risks, one of which is the risk of a mistake in the assessment assumptions. One reason why we see great value in having money permanently deployed in businesses that have some need for retained capital to grow is that the probability of error in those capital allocation decisions is much lower, provided it is for something they already do or have the expertise in. Deploying capital within a circle of competence in a thoughtful and structured framework lends itself to high probabilities of success and is a valuable feedback loop. Surplus capital can be deployed outside of these businesses. Ideally into new, potentially great companies, or a number of other areas where we expect to earn high returns and usually to further the overall objective of building a portfolio of great businesses.

Enabling Companies. These are companies we use to assist us in Building Great Companies. We own them where that creates a distinct advantage that we couldn't achieve by just working with them. We invest in them with the same expectations of high returns and achieving greatness. We let them serve external customers who don't compete with our group companies and to create long-term value that might get realised through external investment.

Opportunistic Investments. It is the nature of the way we work that sometimes great opportunities that don't fit our usual pattern come our way. We don't feel bound by convention *not* to consider them. Of course, such opportunities still need to pass our tests of being something we can understand well, are the best uses of our capital at that time, involve people that we trust and generate the high returns we seek.

The Castelnau Starting Line-Up

We own four principal businesses where we see the potential for greatness, but which need the application of our tools and techniques and the assistance of our enabling companies. They are all in different stages of that process and as 3 of them are public companies we will have to be sensitive about what we say so as not to disclose any price sensitive information.

General Attributes

All four businesses serve an emotional need of their customers and are threatened by the changes brought about by the internet and digital communication. Our businesses in weddings (The Cambium Group) and funerals (Dignity plc) deal with life events whereas the other two deal with hobbies and play (Hornby and Stanley Gibbons). Technology is changing the way that their customers inform themselves and make their choices. We believe all of them can create value by embracing and fully utilising technology and digital communication. For each company we thus bring fresh perspective.

Cambium

Cambium was a small failing company when we first took control in 2015. Our experiences here are the basis of what we call The Castelnau Way and the Toolkit.

Since the restrictions on weddings ended in July 2021, Cambium has surged back to life. Even with less than half a year of trading in 2021, 'product pledge' revenue was a third higher than the whole of 2019, the prior peak. This surge in growth which, again, had a run rate over double the prior peak combined with a workforce that had been reduced during the Covid restructuring in 2020, has caused significant challenges for the company. To add to that the supply chain problems experienced by suppliers are causing them to disappoint lots of customers. This latter point is deeply distressing to an organisation whose culture is focused on delighting couples. It is a real test of the strength of the culture.

The run rate of new registrations and the pipeline of activity for 2022 looks on course for very strong growth again; the business is targeting 70% growth on 2019. By all measures it looks like Cambium with its portfolio of brands has grown its leadership position in wedding gift lists.

The business model for the core gift list business involves negative working capital, minimal stock and no discounting. By merging with Prezola in 2019 and combining the fulfilment operations of all three businesses they own, Cambium has now built the scale to operate profitably.

Cambium is preparing a launch this year into a new space which is an extension of what it does, and we will report that when it happens.

As of the end the of December, the current valuation we have for the equity of the Cambium business is £20.8m, of which you currently own 19.2% (ie your share at the end of December was worth £3.99m, an increase of +5.6% In value from when we floated). We expect that your share of the equity will increase in the near future.

Dignity

Our biggest holding is Dignity plc where I am also currently CEO and have been now for 9 months. We have been implementing the strategy I set out at the AGM to invert the organisation, empower a customer focus and make a virtue of being a confederation of local businesses that are part of a national network.

We have spent six months employing a key part of our Castelnau approach; that is, embedding a learning culture within. Using an approach from the Toolkit Dignity have been running an exercise to develop company principles which are about to be published. When they are in the public domain, we will share them with you. That marks the beginning of a process that never ends to make these principles intrinsic to the way Dignity works so that ultimately, they become its culture.

The commercial elements of our strategy will have to await Dignity's own announcements, but we are very much applying all that I have mentioned previously to set Dignity on the path to being a great business. The early years are the toughest when you are making such wholesale changes and so we expect them to be here.

Hornby
Hornby has recently announced that it is looking for a new CEO and we see that as an essential step before the work on forming company principles and applying them to a cultural transformation.

Our data science company, Ocula Technologies, started to apply its proprietary technology to the Scalextric website with favourable results. Rawnet (our Digital Marketing company) is involved in the website development and digital marketing.

Stanley Gibbons
We created a new business called Showpiece in the quarter, which partnered with Stanley Gibbons to buy and sell off the world's most valuable asset by weight, the 1c Magenta, in fractional virtual form. Having launched that successfully within two months of purchase, Showpiece has now lined up its next asset which is a valuable rare coin. These efforts are an attempt to bring the traditional worlds of stamp and coin collecting into the modern era of digital virtual collecting and vice versa. We plan to launch a platform to allow a secondary market in these assets and to continue to bring new launches.

Ocula also started to apply its technology to the Stanley Gibbons website with favourable results. Rawnet is also involved in the website development and digital marketing.

Measurement

In the Berkshire Hathaway Owner's Manual, Warren Buffett reminds us that *"noble intentions should be checked periodically against results".* We agree. In order for you to measure what we do and track our progress at Castelnau, we propose to use some quantitative and qualitative approaches.

We can present the Castelnau Group in a number of ways.

At the most simplistic level, we can list the assets and their current value, aggregate them as a portfolio, calculate a net asset value and track the performance of that. This is the traditional way to judge a fund and the figures are shown here.

Asset	31/12/2021 £m	% of NAV
Dignity	60.5	35%
Hornby	37.9	22%
Phoenix Stanley Gibbons	18.2	11%
Showpiece	0.0	0%
Cambium Group	4.0	2%
Rawnet	6.1	4%
Ocula	0.0	0%
Total Equities	**126.7**	**74%**
Loans to group companies	3.4	2%
Cash	44.5	26%
Short Term Bonds	0.0	0%
GAV	174.5	
Accrued Liabilities	-2.4	
NAV	172.1	

Source: Castelnau Group. Past performance is not a reliable indicator of future performance

Looked at differently, you might also consider that your ownership in Castelnau confers a partial stake in a portfolio of businesses and therefore have a partial interest in the assets and profitability of those businesses. Again, here we can be led by Warren Buffett: *"The goal of each investor should be to create a portfolio (in effect, a "company") that will deliver him or her the highest possible look-through earnings a decade or so from now. "*

So, in that light, we present a look-through version of what Castelnau Group might look like as a company with the pro-rata ownership of its underlying assets. Notionally, Castelnau can thus be thought of today as a business with c.905 employees, £101m in Revenue and £18.6m in pre-tax profit. Or said differently, one Castelnau share has a pro-rata pre-tax profit run-rate of £0.10 per share. Tracking how these figures move through time offers a business perspective to how we are performing.

	Pro-Rata Castelnau "Look-Through"		listed stakes			unlisted stakes			
			Dignity	Hornby	SG plc	Cambium	Rawnet	Ocula	Showpiece
Castelnau (CGL) Ownership stake			21%	55%	32%	19%	100%	77%	100%
Employees	905		3,341	193	66	150	50	15	3
Sales annual run-rate	**£101.0m**		£338.4m	£43.6m	£4.5m	£19.3m	£2.7m	0	0
per CGL share	£0.55								
Pre-tax profit run-rate	**£18.6m**		£101.0m	-£1.5m	-£2.6m	-£2.4m	0	0	0
per CGL share	£0.101								
# CGL shares (m)	184								
CGL Share price (31/1/2022)	**£1.06**								
CGL Market Capitalisation	£195m								
CGL NAV (31/12/2021)	£172m	=	£60.5m	£37.9m	£18.2m	£4.m	£6.1m	0	0
CGL NAV per share	**£.94**								

Source: Castelnau Group. Past performance is not a reliable indicator of future performance.

Ultimately, the true measure of our efforts is the aggregate intrinsic value of our underlying businesses. For that we would need to estimate all their future cash generation and discount it to a present value. As most of our value is in public companies where we are insiders it is not permissible for us to do that. What we can do is guide you to the factors that drive those estimations. As we currently stand, none of the holdings are delivering obvious high returns which we can point you to. All of them are able to move to business models that will generate high returns and that is what we are assisting them with. If we succeed, then their potential value will become more apparent, but we have to get there first.

To measure how well we are doing in transforming our businesses we have developed a simple scoring system against the four key ingredients we mentioned above of great businesses: culture, competitive advantage, high ROC and management. We won't publish the details because we believe that will be unhelpful, but we will share the aggregate scoring as a percentage where 100% reflects full marks on all of those metrics.

Dignity	35%
Hornby	25%
Stanley Gibbons	30%
Cambium	55%

We won't be succeeding until those numbers reach 75% and above but to paraphrase David Einhorn, great things happen when a low ROC business transforms itself into a good ROC business. To be clear, our ambition is that these become better than good (ie great) ROC businesses.

Outlook

We are, however, making progress with all our businesses. We see significant potential for greatness in them and we believe we know what it will require to realise it. We are very engaged; seven of the investment team have operational roles within our companies. We are in the process of adding to our resourcing in Castelnau to give us capabilities that we will deploy in group companies. Rawnet and Ocula are working on and adding value to all our businesses as well as for outside customers. The team at SPWOne are helping us across the portfolio and so are a number of other people from our network.

We promise you as much openness and transparency as we are permitted, and which is in your interest. We take our duty as stewards of your capital extremely seriously. We still hold c. £43m of cash and short-term bonds (as of the end of January) and will invest that when we have an opportunity that satisfies all the criteria above.

What started in 2015 in a small way with Cambium and which has been escalating since has culminated in the formation of Castelnau.

Steve Jobs, the former head of one of the most innovative companies ever, once said that "the best innovation is sometimes the company, the way you organise a company". In Castelnau we are bringing a new innovative organisational structure to a portfolio of diversified companies of great potential. This structure and the culture that we seek to instil in the group, we think, can be extremely rewarding for all involved – customers, employees and shareholders.

Gary Channon
1st February 2022

Phoenix Company Principles

- Strive for excellence in investment management
- Treat our investors as partners and strive for excellence in our dealings with them
- We invest our own money alongside our investors
- Be conscious of and positively contribute to our local community
- Operate profitably and be frugal with our costs
- Treat success with humility and failings with honesty
- Conduct ourselves at all times with integrity and fairness

Phoenix Investment Principles

- Apply an intelligent, valuation-based approach to long-term investing
- Strive for excellence in primary research
- Focus: we diversify only to the point of necessity to protect us from our mistakes
- Avoid permanent losses of capital
- Be aware of the extent of our knowledge base and only operate within it
- Avoid leverage
- Learn from our mistakes
- Keep learning from the wisdom of others

This document is issued by Phoenix Asset Management Partners Limited (PAMP), registered office 64-66 Glentham Road London SW13 9JJ, Company number 03514660. Authorised and regulated in the UK by the Financial Conduct Authority. This advertisement is directed only at persons in the UK who are (i) investment professionals as defined in Article 19 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 or (ii) are persons of a kind described in Article 49(2) of the Promotion Order or (iii) are persons to whom this presentation may otherwise lawfully be issued or passed on.

Castelnau Group Limited ("CGL") is a Guernsey closed-ended company listed on the Specialist Fund Segment of the London Stock Exchange. Shares traded on a stock market will fluctuate in accordance with supply and demand and may not reflect the underlying net asset value of the shares. The value of investments and any income from them may go down as well as up and investors may not get back the amount invested. There can be no assurance that CGL's investment objective will be achieved, and investment results may vary substantially over time. Past performance is not a reliable indicator of future performance. This advertisement is for information purposes only and does not constitute an offer or invitation to purchase shares in CGL.

The information contained within this document has been obtained from sources believed to be reliable and accurate at the time of issue. Prospective investors should not rely upon this document for tax, accounting or legal advice and should consult their own advisors prior to making any investment. The Prospectus and other regulatory documents can be found at can be found at: www.castelnaugroup.com

Contact Details

Castelnau Group Limited
www.castelnaugroup.com

Investment Manager
Phoenix Asset Management Partners Ltd
64-66 Glentham Road
London
SW13 9JJ
Tel: +44 (0)20 8600 0100
Email: Info@castelnaugroup.com

Phoenix is authorised and regulated by the Financial Conduct Authority
Registered as an Investment Adviser with the Securities and Exchange Commission

Administrator
Northern Trust International Fund Administration Services (Guernsey)
Les Banques, Trafalgar Court
St Peter Port
GY1 3QL