Quarterly Report

Castelnau Group Limited

30 June 2023

Introduction

We apologise for the disruption to the timing of the production of this report. This was due to a price sensitive activity regarding Dignity's bonds which we cover later in the report. As Valderrama (the company through which we and Sir Peter Wood own Dignity plc) represents so much of the portfolio and is now private, we devote the write up section of this report to explaining our strategy, what you can expect to see from it and what that means in terms of value.

Although the acquisition and delisting are now complete, we still have a final step, which is making sure that Valderrama has sufficient capital to support the strategy. We expect that will conclude by the end of the year and when it is done, the temporary facility from Phoenix inside Castelnau to complete the deal will be repaid.

Castelnau owns 66% of Valderrama, that investment is valued at £191m, which represents 74% of the Castelnau equity portfolio (£258m) however, due to the temporary gearing, it works out at 85% of the current Net Assets (£224m). There are no restrictions on portfolio construction in Castelnau, which lets us do the intelligent thing, looking for the highest risk adjusted returns without risking a permanent loss of capital, and then explain it to you. We would never advocate this amount of portfolio concentration in any arm's length investment, no matter how cheap and downside protected, but we do have control here and therefore, have ways to protect and manage the downside so that Castelnau will not suffer any permanent losses of capital.

The Kelly Criterion is a formula that shows the optimal allocation of one's capital for an individual bet (it's a gambling theory construct) and it boils down to edge over odds. Given the parameters we know, even allowing for some probability of terrible things happening that we haven't thought of, the size allocation is below the levels given by the Kelly Formula. Phoenix are practitioners of what is known as a modified Kelly approach to investment sizing. If anyone would like to explore this subject with Gary (to save you from him writing an essay here) then please contact us via Maraki (maraki@pamp.co.uk).

2023 Q2 Financials

Table 1: Summary Overview

	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	QoQ Change
Net Assets £m	£155m	£142m	£138m	£138m	£142m	£224m	58%
Net Assets /share	£0.84	£0.77	£0.70	£0.75	£0.77	£0.70	-9%
Share Price	£0.95	£0.83	£0.81	£0.69	£0.75	£0.76	1%
No. of shares	184m	184m	184m	184m	184m	319m	73%
Market Cap	£175m	£153m	£148m	£127m	£138m	£241m	74%
Prem / Disc to NAV	13%	8%	15%	-8%	-3%	8%	
Assets							
Equities	£115.3m	£118.6m	£116.9m	£122.7m	£131.7m	£258.1m	96%
Loans to Subs	£5.4m	£5.2m	£6.9m	£10.1m	£14.2m	£11.8m	-17%
Cash & Equiv.	£36.3m	£20.7m	£16.2m	£7.6m	£2.2m	£8.7m	303%
Share Price							
Hornby	£0.33	£0.30	£0.29	£0.29	£0.25	£0.18	-27%
Phoenix SG (unlisted)	£2,366.00	£2,239.71	£2,261.38	£2,014.16	£2,052.78	£2,058.87	0%
Cambium (unlisted)	£1,047.06	£1,251.81	£1,250.99	£1,062.90	£1,062.16	£774.33	-27%
Ownership							
Valderrama	0%	0%	0%	0%	0%	66%	
Dignity	21%	21%	21%	21%	21%	0%	
Hornby	55%	55%	54%	54%	54%	54%	
Phoenix SG	60%	60%	63%	63%	65%	64%	
Cambium	35%	60%	60%	60%	60%	60%	
Rawnet	100%	100%	100%	100%	100%	100%	
Silverwood	0%	0%	0%	17%	1%	2%	
Ocula	77%	77%	77%	67%	49%	50%	

Source: Phoenix Asset Management Partners Ltd.
Past performance is not a reliable indicator of future performance.

Table 2 below shows a breakdown of the Castelnau Group NAV by Asset.

Table 2: NAV Breakdown

Asset	2023 Q1 £m	2023 Q2 £m	Q2 % of NAV
Dignity	54.9	0.0	0.0%
Valderrama	0.0	191.0	85.4%
Hornby	22.6	16.6	7.4%
Phoenix SG	20.3	20.6	9.2%
Showpiece	0.0	0.0	0.0%
Cambium	20.5	14.9	6.7%
Silverwood	1.9	3.4	1.5%
Rawnet	6.6	6.6	3.0%
Ocula	4.9	4.9	2.2%
Total Equities	131.7	258.1	115.4%
CGSL	0.1	0.1	0.0%
Prepaid Fees	0.0	0.0	0.0%
Loans to enabling companies	14.2	11.8	5.3%
Cash	2.2	8.7	3.9%
Short Term Bonds	0.0	0.0	0.0%
GAV	148.2	278.7	
Accrued Liabilities	-6.5	-55.0	-24.6%
NAV	141.7	223.7	

Source: Phoenix Asset Management Partners Ltd.
Past performance is not a reliable indicator of future performance.

Table 3: Castelnau Q2 2023 'Look-Through'

Q2 2023	Pro-Rata Castelnau "Look-Through" ↓	Listed stakes		Unlisted stakes					
		Hornby	Silverwood	Valderrama (Dignity)	Phoenix SG	Cambium	Rawnet	Ocula	Showpiece
Castelnau (CGL) Ownership stake		54%	1.8%	66%	64%	60%	100%	50%	80%
Employees (approx.)	2,693	210	79	3,559	46	161	68	24	7
Sales annual 'run-rate'	**£255.4m**	£53.7m	nm	£304.0m	£11.1m	£20.6m	£4.3m	£0.7m	0
per CGL share	£0.8								
underlying Pre-tax profit *run-rate*	**£25.4m**	**-£0.5m**	**nm**	**£42.0m***		**-£4.3m***	**£0.3m**	0	0
per CGL share	£0.08								
# CGL shares	319m								
CGL Share price (latest)	**£0.76**								
CGL Market Capitalisation	£241m								
CGL NAV 30/06/2023	£223.7m	£16.6m	£3.4m	£191.0m	£20.6m	£14.9m	£6.6m	£4.9m	£0.m
CGL NAV per share	**£0.70**								
Premium	7.5%								

*EBITDA

Source: Phoenix Asset Management Partners Ltd.

Past performance is not a reliable indicator of future performance.

Dignity – now owned by Valderrama

Now that we have secured full ownership of Dignity and taken it private we can talk about what it is we are doing to turn it into a much more valuable business. That understates the scope of the ambition, but this report is about the investment and ultimately the judgement of its success in that regard will be on the investment returns it delivers.

Capital Structure

Before we get into the business side let's first talk about the capital structure. It's dull and arcane so if you just want to get into the business discussion then just skip this section, save it for bedtime. This report was delayed because we have been seeking an agreement with the bondholders of Dignity which has now been reached and announced. There will be a formal vote on the 4th of September 2023. We negotiated with bond holders representing more than 75% of the outstanding Series A bonds. In summary, the agreement if approved extends last year's deal until the end of 2024.

The need for an agreement arose because the deal we reached with bondholders a year ago is due to expire at the end of September 2023. That deal gave us certain waivers from the covenant test whilst we sell 7 of our crematoria to pay down some of the debt and reduce leverage. The 7 were chosen as the freeholds sat outside the securitisation but the businesses sat within.

Once the leverage is reduced, a number of other consents kick in which loosen the restrictions on the business that come from the whole business securitisation structure that most of Dignity sits in.

Our expectation was that the natural buyers for those crematoria would be Dignity's funeral plan trusts, because of the alignment between their long term returns and the long-term liabilities in the trusts.

The trusts have been going through a complicated process of their own due to the start of FCA regulation of the sector. That required Dignity to set up an entirely new trust which was FCA compliant and then merge all of the past trusts into it. The trustees were advised that the merger process required the consent of the court which then got delayed and derailed by a very slow and unhelpful response from HMRC. The process to fix this is underway and a solution has been found, however, in the absence of a merger the sale of the crematoria to the combined new trust was not doable in the original timeframe.

The extension of the deal with the bondholders allows us the time to implement the right deleveraging transaction, whilst shielding us from the risk of a covenant breach at a time when the profitability is most depressed. This is essential. The reason why it is an investment principle of Phoenix to avoid leverage is not only due to the damage done when gearing works against you, but also because of the damage when breaches of covenant give power to bondholders to assert themselves at the expense of the equity.

Value Creation

Which should be subtitled: *'the work to take Dignity from what it was to the UK's truly leading end of life business, generating high and enduring returns on its capital whilst being a force for good in the society it serves.'*

The building blocks of Value Creation are:

1. A leading funeral plan business that expands market penetration
2. A network of leading community-based end of life businesses operating with the benefits of national scale
3. A national network of community focused crematoria and cemeteries

Organising the business in a way that benefits from scale, vertical integration and a dynamic, customer-focused culture is what will make it a commercial success.

On top of those three main areas there are also complementary and meaningful opportunities for us in memorialisation, coffin manufacturing and adding other related services.

Funeral Plans

The number of funeral plans we will sell is a function of the population size, our share of the market and the proportion of the population who have one. The introduction of regulation by the FCA this time last year has removed more than half the competitors (by number), making market share growth easier. The population of those who might think about taking a funeral plan is also growing, and so our most difficult challenge will be growing product penetration.

We have set about this goal firstly by creating a product that is best in class, that is innovative and that we will continually improve upon. It is the top recommendation of Martin Lewis of MoneySavingExpert.

The next challenge is properly launching that from a marketing perspective in a way that reaches a much wider audience in order to expand the market. The work on that is underway and announcements will come when ready.

Yet we can see that even without promotion, even though we have gradually rolled out the product through the branch network making sure we had all the new FCA based training and competency in place and still don't have it yet in all branches, the product is being well received and is selling much better than the previous products. We have already sold over 15,000 plans since launch, and on top of that, we have offered the product to plan holders in schemes that didn't make it into regulation and have sold more than 60,000 plans to those customers.

Value creation in funeral plans happens in three ways.

i.) From any excess return received on monies held over and above the assumptions used when the plans were sold. In essence this amounts to the investment return over inflation if there is one. The investment strategy has a goal of exceeding funeral price inflation by 3% per annum. The size of the float of capital held in our funeral plan trusts will be a function of how much we can grow the market and our share in it. At 10% penetration (versus 7% currently) the float reaches c.£1.7bn and 3% equates to over £50m per annum. 10% is our first objective, if we achieve 12.5% penetration then assets would be £2.3bn, and so on.

ii.) We build up a store of future funerals on which we will make our margin. As we improve the efficiencies in our funeral businesses and grow volumes our unit cost will fall which will increase the value of a future funeral. Currently the average life expectancy of a plan purchaser is 15 years. We aim to build margins to 30% in funerals. Against that return is the cost of acquiring a plan which in the past was at a similar level. We believe once we have ourselves properly launched, growing volumes will mean that our cost of acquisition (CPA) will decline and will be much lower than the margin on a funeral.

iii.) We start a relationship with a customer to whom we wish to offer other relevant products and services. The value for this will grow as we build out our overall end of life offering.

Funeral Homes

We have inherited the results of decades of a strategy that undermined the businesses that were acquired by making it uncompetitive, by not investing enough in it, by taking away local decision making and by failing to adapt and innovate.

Dignity has not previously delivered any benefits of scale; the cost structure of our funeral businesses was higher after integration into the group than it was before they were acquired. We believe we can change that through improved ways of operating, introduction of better technology and the effect of growth on operating costs per funeral.

Throughout 2022 the funeral division went through a restructuring that removed the management layer and organised all the branches into local businesses run by a Business Leader. This is a newly created role and had to be interviewed for even though most of the candidates were internal. The end result was 168 businesses and 46 crematoria all also run by a business leader.

That process impacted over 3,000 people in the business and was completed at the beginning of 2023. Although the removal of so many management roles was expected to reduce headcount and cost, the result has been the opposite. This was probably due to a combination of what was a highly disruptive process at a time of an elevated death rate creating short term need for help. So, in 2023 even as revenues have grown strongly, costs rose even further.

Since acquisition there has been a team of people, drawn from good practitioners in Dignity, working with analysts from Phoenix and SPWOne reviewing every business in numbers and in the field. From that work; good operating models will be applied, best in class practices shared, and unviable marginal activities and operations will be ended. The whole portfolio of funeral businesses will then be invested in for growth. You should expect the business and branch numbers initially to reduce along with the headcount. Currently there are 100 less branches than we started with in 2021.

To give an idea of the magnitude of the effect, our top quartile branches make a contribution of a £1,000 a funeral more than those in the bottom quartile and it is largely a result of the cost side of the equation. The current work has been identifying the reasons and the solutions and we will soon move into execution mode.

We have been trialling the new strategy in Bristol now for 2 years and have had a person from Phoenix embedded there throughout. That business has grown from doing an average of 24 funerals a week across 10 branches to 30 and has grown from 14% to 17%. Some of those funerals come from pre-sold funeral plans, so to really appreciate the movement in local performance, you need to look at At Need volumes and share. At that level the growth is 40%, going from 8.5% to 12% market share.

Whilst growing the business, it also improved the operating efficiencies and therefore contributes profits at well over 30%.

The business introduced its own products using alternative venues that has increased volumes at our crematorium in Weston-Super-Mare.

You should expect to see the profitability of our funeral business to grow significantly in 2024 as these changes take place.

One of the key skills we need to possess for this model to work is an understanding of what it takes to be a good business leader in this end of life space; how to recruit, retain and develop such talent, and what kind of operating framework we need to provide so that we get the best of empowered customer focused entrepreneurial decision making close to customers combined with the benefits of operating at a national scale which requires some standardisation.

Once we have refined our own estate, we will be ready to consider expansion knowing what value we bring and what kind of expansion makes sense for us, i.e. new openings, acquisitions, partnerships and franchise.

We see our funeral homes as more than arrangers of funerals; we want them to provide a full end of life service in the communities they serve. So, as well as funeral plans we expect to introduce more products and services. We see our branches becoming a place where you can drop by to discuss any aspect connected to preparing for end of life and for us to be able to help you.

Value creation comes as our focused portfolio of businesses builds good margins, grows volumes and local share and we start to grow the portfolio in a number of ways. At 100,000 funerals (Our 2025 objective), which would be 15.5% of the market, we would expect the funeral division to contribute over £60m per annum after capex. At a 20% share by 2032 we would be handling 140,000 funerals a year, double our current numbers as the ONS estimates the annual death rate by then will have reached 700,000.

We don't know what our ultimate market share potential is, we will earn our right to grow by winning and earning the trust of families and retaining it. In the Barnes postcodes, where

Castelnau is based, we have an over 50% share. That happens in communities where we have good performing operations, and in Barnes, there is still so much potential. Although the branch is very well positioned, it is underwhelming visually and seems designed to avoid having anyone drop in and yet there is a whole community here ready to be engaged and without any alternative aside from the internet.

Crematoria

We see great potential in our portfolio of crematoria to make them individually better, to make a lot more of memorialisation both through the crematoria and our funeral homes, and to take advantage of the national footprint to build our direct cremation business. We also have a pipeline of 7 more to build.

We see a lot of scope to do more memorialisation by offering choice, innovation and through closer working with our funeral businesses.

Unlike the revolution in the funeral business, the work in the crematoria division is more evolutionary. Exchanging best practice and making incremental improvements is the goal. Every crematorium will have a new website and ways of engaging with the local communities digitally as well as physically. We have some wonderful establishments, but you wouldn't know without visiting them. We want to make them easier for all funeral directors to use and reserve.

Value creation comes through that growth in numbers, volumes, and memorial revenues. A contribution this year which, after capex is likely to be around £45m, we see doubling in 6 years as a result of those forces above.

Central Costs

Dignity became bloated at the centre as a result of the Transformation Plan started in 2018. In 2021 they reached £40m. The work of reducing it started last year (2022 = £33m) and now that the company is private, we have been making further changes. Some efficiencies require investment in technology and better processes which take more time. We expect to get down to the right cost level by the end of 2024 which we believe will be no more than £25m and then that ratio to sales (c.6%) will be maintained as the business grows.

New Services

Our desire to be a true full-service end of life provider means that we will introduce new products and services, and partner with complimentary organisations to achieve that. These are commercially sensitive and so we will discuss them as they happen.

Other Areas of Value Creation

We believe our manufacturing operation and our large portfolio of freehold commercial and residential property offers considerable scope for value creation, and that work is already underway.

Profitability

As with 2022, we expect profitability to be depressed in 2023 as we restructure the business. We expect 2023 to show some improvement on 2022 depending on the death rate for the rest of the year, but it is from next year onwards that we expect to see profitability rise more significantly. As the restructuring reduces the core cost base and improves efficiencies, margins will rise on increasing revenues. In two to three years, we expect to be making over £100m before tax. With all of the forces of vertical integration working, more funeral plan sales drives more funerals, which in turn means more cremations and a growth in profitability. On our plans it takes 7 years to get that pre-tax profitability to £200m. Things may and probably will unfold differently, faster or slower, depending on a number of things both within our control and beyond it, but once we have the business model in the right shape, it will be generating high returns on capital and marginal growth will also come at high returns and we will have a very valuable business.

Using the Phoenix intrinsic value methodology, and even allowing for dilution for the equity being raised at the Valderrama level, we get a value of c.£30 per share on our central case plan. That doesn't mean we will be able to achieve that value in a float, but it is a guide to the amount of potential value, and we will update that figure using the same methodology so you will be able to see the extent to which the plan is working.

People

The most important determinant of our success will be our people. A new ExCo has been assembled post-acquisition. Kate Davidson remains as Chief Executive and a new Chief Financial Officer has been appointed (he was previously the CFO and acting CEO of eSure where he worked with Sir Peter Wood) and we have also appointed a Chief Marketing Officer, Director of Operations, Chief Transformation Officer, Chief Commercial Officer and Chief Risk Officer. This sounds like a lot of chiefs, but these are all high quality, driven people who are incentivised to deliver the value discussed above. SPWOne and Phoenix are also utilising the full breadth of their network to bring resource and expertise into this exercise. The work of crafting a great company out of such a complex starting situation is now about executing and building the right culture.

Summarising the Value Creation Formula

What turns this into a great investment are three forces; i.) the price we paid in relation to the value purchased, ii.) the value that comes from reorganising the capital structure and having the capital being intelligently allocated and then iii.) the value that comes from building a growing and commercially successful end of life business. The first two turbo charge the third. Currently the holding is valued at the price of the acquisition. As the results of strategy execution come through, that valuation will change.

The Rest of the Portfolio

We have focused on the Dignity acquisition because it is so material to the value of Castelnau Group and this is the first time we have been able to talk about it. Future reports will return to covering all the businesses.

Around the rest of the group there have been any further material developments beyond what was covered in the monthly factsheets. From a trading perspective Cambium is dealing with a much weaker wedding market this year as the post pandemic surge ends and so it is having to improve efficiency to be able to be profitable in a smaller market than anticipated. There has also been a rise the proportion of couples asking for cash which doesn't contribute margin. To reflect these changes the valuation has been adjusted downward from trading, assumptions and discount rate.

Cambium are running an exercise using automation and AI to make significant productivity gains and we are using it as a learning exercise for the group. The market for wedding gift lists is still too small a subset of weddings and so to change that cultural psyche that is holding back penetration the group is going to be using its wedding planning business, Rock My Wedding, to educate and inspire.

New CEOs at Stanley Gibbons and Hornby are pressing ahead with building the visions and strategies for those businesses, which we will talk more of in future reports. They have both, through modest acquisitions, added to their offerings, with wargaming at Hornby and Entertainment/Popular Culture at Stanley Gibbons, and soon, Sports Memorabilia. Both businesses need to increase their profitability and are taking steps to do that.

Ocula and Rawnet have continued to add external clients beyond Castelnau Group companies. For Ocula this is especially important because, as we head into the end of the year, it needs to be preparing for its next round of external funding, what is known as a Series A round.

Intrinsic Value

We estimate that Intrinsic Value per share using the methodology Phoenix applies to its investments in its funds, is £4.30 per share (£1.4bn). That represents an upside of 515% from the period end NAV. This calculation does not allow for any performance fee that might accrue. In our view this measurement, applied consistently over time, is the best guide to future returns. Now we need to deliver it.

Thought Piece:

Culture

As Jeff Bezos puts it, a company's culture can be a source of advantage or disadvantage. Ergo, what matters is having the right culture.

> *A word about corporate cultures: for better or for worse, they are enduring, stable, hard to change. They can be a source of advantage or disadvantage. You can write down your corporate culture, but when you do so, you're discovering it, uncovering it—not creating it. It is created slowly over time by the people and by events—by the stories of past success and failure that become a deep part of the company lore. If it's a distinctive culture, it will fit certain people like a custom-made glove. The reason cultures are so stable in time is because people self-select. Someone energized by competitive zeal may select and be happy in one culture, while someone who loves to pioneer and invent may choose another. The world, thankfully, is full of many high-performing, highly distinctive corporate cultures. We never claim that our approach is the right one—just that it's ours—and over the last two decades, we've collected a large group of like-minded people. Folks who find our approach energizing and meaningful.* - J Bezos

In our inaugural Castelnau quarterly report to you, we cited Culture and our way of operating as one of six 'edges' possessed by the Castelnau Group.

At that time, we wrote:

> *(re:) 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* - Castelnau Q4 2021 report

We realise that such a statement from such a youthful business might seem a tad grandiose or even hubristic. Indeed, every annual corporate report we read these days seems to have some variation of the "we are fostering a culture of innovation and entrepreneurship" blurb.

So, what then gives us the right to suggest that our Culture is an edge for Castelnau Group?

In short, we believe it is because we have studied and stand on the proverbial 'Shoulders of Giants'. In other words, we have identified and observed the best business cultures and humbly seek to emulate the best ones that suit our chosen way of operating. Starting with a clean slate also allows us to begin with clear intent from the ground up. Indeed, perhaps that aforementioned (organisational) youth of ours is an advantage in creating a culture that can be an edge. Of course, only time will tell - cultures take years not quarters to manifest. We believe ours will be a source of advantage.

In the following, we try to show some substance underlying our learnings on culture. We examine how the Giants built great cultures and how that applies to what we are doing at Castelnau.

i) Learning from the giants

Culture is especially interesting because it is just so hard to replicate. Would an unlimited budget allow one to replicate Amazon's culture?

A simple Google Ngram search shows the deluge of writing and pontificating about corporate culture that has taken place in recent decades. Culture is indeed a complex topic to define, never mind to identify or indeed, to create. We choose to take our lead from the Giants, the men (and women) in the arena.

Whilst all agree on its importance, brilliant CEOs of brilliant businesses do vary in their expression of what culture means to them. Reed Hastings of Netflix, believes culture reflects "what behaviour is rewarded" within an organisation. Simon Wolfson says NEXT's culture is "about what we expect from one another". Jim Tisch of Loews said that Culture "is the glue that holds people in the firm together and it also provides the vision for all the people in the firm to know just what they're driving to". None of these are contradictory statements.

Steve Jobs' favourite saying was apparently an Aristotle line: "We are what we repeatedly do. Excellence, then not an act but a habit". To paraphrase Jobs, culture might be the habits of a company.

Culture is clearly not strategy (it eats that for breakfast), and it seems harder to implement. So, what do the Giants teach us about how to create a culture?

Here might be one way of decoding the art of building corporate Culture:

a. Deciding on HOW things get done (deciding on the direction)
b. Having utmost DISCIPLINE in repeatedly doing it that way (giving it strength)
c. Constantly REINFORCING via communication and stories (keeping it on course)

a. Deciding HOW things get done

The chosen strategy of a business will no doubt, influence how things get done. Here are some different examples of strong business cultures from a disparate group of great businesses with disparate business models. Importantly, each business has created a very durable competitive advantage thanks in small part to the underlying Culture. Each culture has its own nuance, appropriate for the chosen business model.

For example:
Berkshire and **Capital Cities** developed a culture of de-centralised decision making, high integrity behaviour and shareholder centricity. The culture was centred around the hiring of ultra-high-integrity people, having extreme clarity of purpose and then getting out of the way of the operational managers.

From its rebirth under Michael O' Leary in 1994, **Ryanair** focussed on absolute lowest cost air travel and its entire culture was centred around 'the how' in which this would be realised. The culture required to achieve this was a no-nonsense, open and often cut-throat culture which still thrives nearly 30 years later.

IKEA founder Ingvar Kamprad fostered a culture of low cost, simplicity and (interestingly) fostering what he called a safe place "to practice making decisions" while not fearing failure.

Amazon and **Costco** developed a culture ensuring that all decisions (sometime big bets, but also small incremental changes) were made through a customer obsession lens. The culture was about unwavering commitment to the customer in all facets of business without pandering to short-term gains or (again) fear of failure.

The founders of **JD Wetherspoon** and **Sports Direct** instilled a culture of experimentation, adaptation and continuous learning throughout their organisations. The culture led to deeply embedded entrepreneurial and hard-nosed 'ways of doing things' that eschewed traditional retail practices.

Howden Joinery, Games Workshop and **Richer Sounds** all created a culture of clarity of purpose, empowered employees and insistence on a level of customer service beyond the normal call of duty of a retailer. All had founder managers who were deeply involved in day-to-day operations and constantly reinforced the culture.

Other great conglomerates like **Halma** and **Teledyne** instilled a culture of astute capital allocation with a disciplined focus on return on capital.

b. DISCIPLINE of repeatedly doing it

Once the direction of travel is established, then the need for discipline comes into play. That is, our Giants always seem to be making sure that the way of doing things does not fade, get diluted or superseded by short term demands on the business. Charlie Munger says one of the most valuable tasks a director can ever perform is guarding against the drift in the culture.

Here is Jim Collins (reporting back from his business lab!)

> *It all starts with disciplined people. The transition begins not by trying to discipline the wrong people into the right behaviours, but by getting self-disciplined people on the bus in the first place. Next, we have disciplined thought. You need the discipline to confront the brutal facts of reality, while retaining resolute faith that you can and will create a path to greatness. Most importantly, you need the discipline to persist in the search for understanding until you get your Hedgehog Concept. Finally, we have disciplined action, the primary subject of this chapter. This order is important. The comparison companies often tried to jump right to disciplined action. But disciplined action without self-disciplined people is impossible to sustain, and disciplined action without disciplined thought is a recipe for disaster.* - Jim Collins, Good to Great

c. REINFORCING via communication

Perhaps a less well appreciated aspect of strong culture is the importance of constant reinforcement. All of the strongest cultures overseen by our Giants have exceptional communication habits for reinforcement of the cultural practices.

> *Yeah, well I think culture has to come from the top, it has to be consistent, it has to be part of written communications, it has to be — you know, has to be lived, and it has to be rewarded when followed, and punished when not.* - W Buffett

In a great interview with Outsider Tom Murphy, Murphy describes the culture that he famously was instrumental in creating at Capital Cities. Intentionally or not, in the interview how Murphy describes culture as a series of communications is really interesting. In a sense, Murphy was demonstrating the virtuous cycle of repeatedly telling employees about their culture. Murphy understood the need for constant reinforcement.

> *In terms of culture, we told our employees that we hire the smartest people we can find and that we have no more of them around than necessary. We also told them that we would be highly decentralized and give them a lot of responsibility. For most employees, we'd give them a ticket on the horse race, which means we'd give them options. We also told employees that we were in a business that was fun to be in. In fact, very few people ever left the company voluntarily.*
>
> *We told employees that the one thing they could not do was anything that would embarrass the company. They could not do anything that was improper or unethical because there would be no second chance. That's how we operated and that's how the leadership ran the company. We thought we had a responsibility to the communities that we served, and we figured that if we did a good job serving the community and our employees, then our stockholders would do fine. Of course, we were lucky, too, that we happened to be in a wonderful business.* - Tom Murphy, Interview Dec 2000 (emphasis ours)

We have noticed that many of the great business leaders create employee handbooks or communications missives to keep culture on track.

For example:

- Berkshire's owner's manual from 1999 (post the Gen Re acquisition) and of course Warren Buffett's annual shareholder letter are best in class examples of shareholder - and employee - communication
- Tom Kirby's (of Games Workshop) Little Black Book (and the sequel - The Little Red Book!) is a fascinating (and really enjoyable) handbook when tells you all you need to know about the fantastic culture that Kirby nurtured at this fantastic business
- IKEA - The Testament of a Furniture Dealer by its founder Ingvar Kamprad is full of deep social principles and common sense
- Jeff Bezos annual shareholder letters
- Simon Wolfson's letters and presentations (which it is clear are intended equally for both an internal and external audience)
- And as a sign of 21st century excellence Stripe's operating principles offer a fascinating guide on "how we interact with each other and our users, translating our values and beliefs into concrete actions."

Here is Warren Buffett describing his routine to keep his 70 CEOs on task.

My job is to have those 70 CEOs sending out the right message. Every two years, I write them a very simple letter. It's a page-and-a-half. I don't believe in 200-page manuals because if you put out a 200-page manual, everybody's looking for loopholes basically - W Buffett

ii) Applying all this to Castelnau

As we recently outlined, our ambition with Castelnau is to create a Culture suitable for a winning strategy. Our ambition is very high in this regard though we recognise that this is a marathon not a sprint.

We are seeking to build a culture that is:

- customer centric
- with devolved empowerment
- that embraces continuous improvement
- is a safe place to fail
- with dynamic execution
- acts with integrity and openness
- is aligned to reward for success
- and finally is an attractive, even magnetic place, for good people

To give some specifics, at our controlled companies we think we are on the right track in beginning to build out the broader culture. For example:

Dignity

Principles implemented as of June 2022

Hornby

New principles being formed

Cambium

Principles in place since 2015

Stanley Gibbons

Rebuilding the business' reputation

Above all, we believe we are attracting the right people and the self-selection that Jeff Bezos referred to above is in evidence in the new hires across our group companies.

Conclusion

Baruch Lev (once dubbed "the world's most exciting accountant"!) is a NYU professor who has written extensively about the deficiency of accounting to capture the real value within modern companies - its intangible assets. Whilst Lev spends most of his time thinking about how to treat R&D and goodwill, it seems to us that Culture is the key intangible asset that he should be assessing.

In no small way, Culture, your company's way of operating, is its ultimate intangible asset. We provide a NAV monthly to you, our shareholders. But the more useful metric is of course Intrinsic value. The difference between NAV and IV is to a large extent determined by the intangible assets - the strong culture - that we are building.

"Culture – and that includes your attraction for great people – is the only alpha." David Krakauer, President Santa Fe Institute

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