Funds Management Quarterly Report

March 2013

INTELLIGENT INVESTOR
FUNDS MANAGEMENT

INTELLIGENT INVESTOR VALUE FUND | INTELLIGENT INVESTOR INTERNATIONAL FUND

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Boom times for global markets

Welcome to the first combined Quarterly Report for Intelligent Investor Funds. From now on each quarterly report, combining commentary on the Value Fund and the International Fund, will be structured in three sections. First up we will provide a summary of performance and our thoughts on general investing issues or themes. That will be followed by sections specific to each of the funds, with a more detailed performance analysis and discussion of the respective investments in each.

We hope you enjoy the new format and look forward to hearing your suggestions for improvement.

The March 2013 quarter saw shares increase in price across the globe. The MSCI World Index increased 9.2%, led by the US S&P 500 increasing 10.0%. Japan's Nikkei increased 19.3%, although this was offset by the Yen's 8.2% fall against the US Dollar for anyone investing unhedged, and even Europe's markets increased over the quarter despite a resurgence of concern for the future of the Eurozone as a whole. At home the All Ordinaries Accumulation Index increased 8.0%.

PERFORMANCE

	PORTFOLIO VALUE	1 QUARTER	1 YEAR	3 YEAR	SINCE INCEPTION
VALUE FUND	$30,254,625	15.98%	31.03%	12.81% p.a	11.12% p.a
ASX ALL ORDINARIES	–	8.04%	17.80%	5.01% p.a	6.55% p.a
INTERNATIONAL FUND	$12,580,802	–0.88%	–	–	–
MSCI ACWI IMI	–	1.07%	–	–	–

Against that backdrop, we were very happy with the Value Fund's 16.0% increase in unit price (see page 5 for more details) but the strength of the global rally has made investing the International Fund's initial capital more difficult than it would have been a year ago.

The absence of bargains hasn't proven debilitating. Our focus so far has been on providing currency diversification, adding a few reasonably priced global businesses to the portfolio and waiting for opportunities to come our way. The world's major economies still look structurally unsound, and an opportunity-enriching crisis could come from any of a number of the world's trouble spots.

“Under a system of fixed exchange rates, the more productive countries end up with all the jobs and all of the money.

The inevitable Euro breakup

We maintain our view that a breakup of the Eurozone is the only long-term solution to that region's troubles.

Put simply, the Euro crisis is a relative-productivity crisis. The Northern European countries can produce goods more efficiently that the Southern European countries and that gap is widening.

Under a system of fixed exchange rates, the more productive countries end up with all the jobs and all of the money. The Spanish unemployment rate continues to rise while it falls in Germany (now 27% and 5.4% respectively).

The only fixes are politically impossible real wage decreases in Spain, politically impossible fiscal transfers from Germany or an exit from the Euro so that the exchange rate can be adjusted to bridge the gap (while this also represents a real wage decline for the Spaniards, it is much less noticeable).

In Cyprus, we have been given a glimpse of how an exit might unfold: bank closures, border controls and currency redenomination (or revaluation for Cyprus's depositors). The whole unfortunate saga could drag on for another decade, but there seems only one genuine solution.

China worries closer to home

Since Intelligent Investor Funds opened its doors in October 2009, we have not owned one mining or mining services company. True, it is not an area of deep expertise for us. But digging stuff out of the ground and putting it on a ship is not the world's most complicated business. The reason we haven't owned mining shares is because we are deeply concerned about the prospects of a significant slowdown in demand from China.

We have written a number of detailed pieces on China's problems over the past few years. It is an economy far too dependent on debt funded infrastructure spending for its growth. That infrastructure is—not surprisingly given it is being allocated by bureaucrats with vested interests—not generating enough return to service the debt that was used to build it, resulting in debt growing unsustainably faster than the overall economy.

An unsustainable growth model can be sustained a long time in a command and control economy. In 2011 we thought it could be a number of years before the consequences manifested themselves. In 2012, the Chinese economy slowed and commodity prices plummeted, only for the authorities to stimulate again using the most effective (some would say only) tool available to them—infrastructure spending.

That gave the China bulls ammunition for their argument that the Chinese government will do whatever it takes to keep economic growth high, and with that growth maintain the government's own legitimacy. But what was most surprising was how little impact the stimulus provided. GDP growth in China was 7.8% last year, one of the slowest growth rates in the past 30 years. Many economists believe the official statistic substantially overstated reality. What would it look like without a stimulus?

Remember that 'fixed asset investment', or infrastructure spend, represents approximately half of GDP in China. Even to maintain spending in 2013, they need to build the same extraordinary number of roads, airports, ghost cities and train lines. And that would represent zero growth for that huge component of GDP. Even if consumption grew at 15% for the year, overall growth would still be less than 5%.

"More than ever I am convinced that if China is to rebalance its economy towards a more sustainable growth model ... its GDP growth rate will drop sharply with its average annual growth over the next decade unlikely to exceed 3–4%.

An adjustment that will take place

Everyone from new President Xi Jinping down knows that the economy needs to rebalance away from its dependence on debt-funded infrastructure and towards consumption, but no one has yet explained how that can happen without a dramatic slowdown in growth. Michael Pettis, Finance Professor at Guanghua School of Management at Peking University, reckons the overall growth rate will be 4% or less for the next decade as this rebalancing takes place:

> *"More than ever I am convinced that if China is to rebalance its economy towards a more sustainable growth model—and rebalance it must if it is to avoid a financial crisis—its GDP growth rate will drop sharply with its average annual growth over the next decade unlikely to exceed 3–4%. My forecast is still an outlier, but over the past six months even the optimists no longer see it as unthinkable and more and more analysts are drawing their own projections closer to mine."*

As Pettis points out, he is no longer a lone wolf suggesting a dramatic slowdown in the Chinese economy. And as anyone who owns commodity or mining services stocks will tell you, the thesis is becoming something of a consensus view amongst stock market participants. But the penny still doesn't seem to have dropped on the wider implications for the Australian economy.

While commodity-related shares have fallen significantly, CBA, Australia's largest bank, is trading at an all time high and has returned 44% in the past 12 months (including dividends). CBA is the country's best managed bank, and banking is a wonderful business in this oligopoly-friendly country, but it seems incongruous that Mr Market is worried about a dramatic slowdown in China and not worried about highly leveraged residential property lenders in Australia, one of China's most dependent trading partners.

You could argue we were too early with our negativity on China. You could even argue it is too early today. But while some like to play the game of standing atop an active volcano forecasting that it won't erupt for another 18 months, that's not our game. We like living on volcano-free islands, or sifting through the ashes of those that have already erupted.

We've been able to make perfectly good money over the past three years without any exposure to China, and don't see any reason why that won't continue to be the case. When the volcano erupts, our aim is to be as far away as possible.

Intelligent Investor Value Fund

The Value Fund had an excellent March quarter returning 16.0% compared to the ASX All Ordinaries Accumulation Index which returned 8.0%.

We benefitted from rising share prices in most of the companies we own during the quarter, with **Vision Eye Institute** (VEI), **RNY Property Trust** (RNY) and **Rubik Financial** (RFL) the most prolific contributors. Pleasingly the Fund has now produced an annualised return of 11.1% since inception, well in excess of the benchmark return of 6.6%.

Portfolio concentration and risk

Today's Value Fund portfolio is very different from the portfolio we held six months ago and it is very important that you are aware of the difference. The portfolio six months ago was almost fully invested (less than 10% cash) and pregnant with opportunity. We owned more than five stocks that we thought were trading at less than half their value and had a reasonably even spread of exposure to each of them.

Today's portfolio is nearly 15% cash and contains only three stocks that are, in our view, exceptionally attractively priced—RNY Property Trust, Vision Eye Institute and Enero Group. We expect to do well out of the rest, but please temper any expectation of a repeat performance over the next year.

Most importantly, for the reasons provided below, RNY is now the largest individual position we have ever held. At a 17% weighting in a portfolio that is only 80% invested, it is likely to be the main driver of performance, good or bad, over the next 12 months.

We are keenly aware of the risk inherent in this position, to both your investment and our reputation, but we are also conscious that it is our job to run a concentrated portfolio of our best ideas and make you money. And when it comes to making money, it is actual risk, and not perceived risk, that counts.

The portfolio 12 months ago had a lower exposure to RNY, but a 21% exposure to US commercial property as an asset class. Granted, that exposure was split between two stocks, RNY and RCU, which provided some diversification benefits. But RCU was appallingly managed, short of capital and was owned by a group of unitholders spending most of their time fighting with each other. Do we really have less risk today with 17% of the portfolio invested in the wonderfully managed RNY and no exposure to RCU?

We think not, but you should be aware that it has the potential to result in even more volatility in our unit price than usual. We have also provided a detailed analysis of the trust below to enhance your understanding.

Price and Value Rise at RNY

The Value Fund first bought units in RNY at the beginning of 2010. At the time this ASX listed trust owned a 75% interest in 25 office buildings in the New York Tri State area. The December 2009 book value (on a 100% basis) was US$500m, against which there was some US$364m of debt—a loan-to-value ratio (LVR) of 73%. While the market cap of $31m looked interesting relative to RNY's $100m share of the equity, what made the investment case compelling was the structure of the debt. The 25 properties were split into four pools, each with their own limited recourse debt. Of the US$145m of equity, US$104m was in two relatively conservatively financed tranches (LVRs of 50-60%) and cash.

Yes, we were likely to lose the properties in the two highly leveraged pools but the remainder was worth more than double the unit price at the time. And there were some interesting options on the upside. The highly geared properties were still controlled by RNY. The book values themselves—arrived at using an average capitalisation rate of 8.2%—looked attractive in a low interest rate environment. And the USD exposure looked appealing to us Australian investors worried about our local currency's exposure to an unbalanced China.

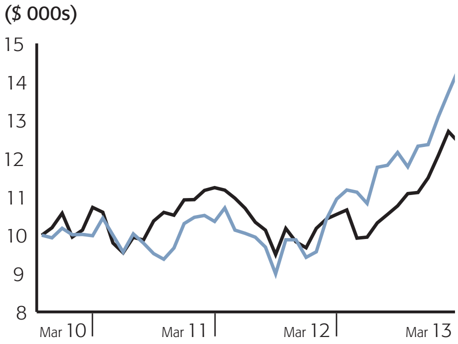
All options that could be worth nothing, of course. But a free option is a good option.

Fast forward three years and the investment opportunity is perhaps more attractive than it was. Granted the unit price has doubled ($0.24 at the end of the March quarter), but one of those options has turned out to be very valuable and the other two are looking increasingly important.

TABLE 1: SUMMARY OF RETURNS

	INTELLIGENT INVESTOR VALUE FUND	S&P ALL ORDS. ACCUM. INDEX
1 MONTH RETURN	4.51%	–2.24%
3 MONTH RETURN	15.98%	8.04%
6 MONTH RETURN	17.93%	15.37%
1 YEAR RETURN	31.03%	17.80%
2 YEAR RETURN (P.A)	17.65%	5.12%
RETURN SINCE INCEPTION (31 OCT 2009) (P.A)	11.12%	6.55%
$10,000 SINCE INCEPTION	$14,336.00	$12,418.97
PORTFOLIO VALUE		**$30.3m**

CHART 1: COMPARISON OF $10,000 INVESTED IN VALUE FUND VS ASX ALL ORDS INDEX

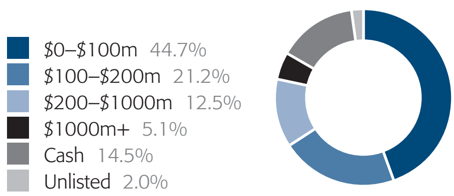


Source: Capital IQ

TABLE 2: UNIT PRICE SUMMARY

DATE AS AT	31 Mar 13
BUY PRICE	$1.2947
REDEMPTION PRICE	$1.2844
MID PRICE	$1.2895

CHART 2: PORTFOLIO DISTRIBUTION ACCORDING TO MARKET CAP



In April last year, management announced that they had been able to refinance one of the highly leveraged pools of property—the largest of the four. The new debt facilities are for five years and total US$159m versus US$196m owed under the old loan. The 'haircut' taken by lenders added US$28m to RNY's equity value and means we get to keep the properties for at least another five years.

Today management are in the 'final stages of documentation' for a similar deal on the much smaller remaining overdue loan. It should add something like US$12m to RNY's net asset backing and means that we still own every single property and building that the trust owned entering the financial crisis in 2007. Which brings us to the option over an increase in the values of these assets.

Being able to buy these assets for half net tangible assets (NTA), assuming the current refinance is successful, is what makes this our favourite ASX investment right now. But, subject to portfolio weightings and the like, we wouldn't be selling RNY even if it was trading at NTA. The asset class itself looks attractive, and we envisage the prospect of meaningful gains in the market value of RNY's assets.

> *"We wouldn't be selling RNY even if it was trading at NTA. The asset class itself looks attractive, and we envisage the prospect of meaningful gains in the market value of RNY's assets.*

For asset values to rise, one or both of two things needs to happen. Either the income the properties generate needs to increase due to increasing occupancy and higher rents or the required return demanded by investors needs to fall. In our view, the later looks likely and the former increasingly possible.

The required return used to value property assets is known as a capitalisation or 'cap' rate. The average rate used to value RNY's portfolio of suburban office buildings is currently 8.2%. Prestige Manhattan office buildings have been changing hands at cap rates of 5-6%. There is always a gap between the required return on prime A-grade office buildings and the dowdy suburban versions that RNY owns, but the gap between the two, and the gap between the return on these and government bond rates, has never been higher.

This spread could narrow quickly. The strong rally in A-grade prices over the past 18 months has been driven by sovereign wealth funds, like Norway's Oil Fund, and lenders with extremely narrow mandates to lend against 'prime assets with long term leases from high quality tenants'. But the rally is starting to spread. Large private equity groups KKR and Blackstone have recently raised money for investment in commercial property and are specifically looking for higher yielding options. More importantly, the Commercial Mortgage Backed Security (CMBS) market has recently come to life. After bottoming at $3bn in 2009, news issuances of CMBS rebounded to $48bn in 2012. In 2013 $12bn has been issued in January and February alone. The lenders supporting the run up in A-grade property prices—typically insurance companies and banks prepared to justify lending with their own balance sheet—aren't about to start financing $10m office buildings in Westchester County. The CMBS market, however, is ideal for bundling up a number of these assets and pooling them together into a loan where the attractiveness or otherwise of any one particular asset becomes less important.

TABLE 3: RNY'S UPSIDE POTENTIAL

	CURRENT	REFI POOL B	CAP RATE CONTRACTION	10% OCCUPANCY INCREASE
CAP RATE (%)	8.20	8.20	6.50	6.50
PROPERTY REVENUE (US$000s)	68,226	68,226	68,226	75,049
PROPERTY EXPENSES AND TAXES (US$000s)	31,999	31,999	31,999	35,199
NET OPERATING INCOME (US$000s)	36,227	36,227	36,227	39,850
PROPERTY ASSETS (US$000s)	459,600	459,600	557,338	613,072
CASH (US$000s)	13,900	13,900	13,900	13,900
DEBT (US$000s)	323,169	308,169	308,169	308,169
NET ASSET BACKING (US$000s)	150,331	165,331	263,069	318,803
NET ASSET BACKING PER UNIT (75% OWNERSHIP)	0.43	0.47	0.75	0.91

Dormant for the past five years, the market for suburban office properties could be about to come to life. A cap rate of 6.5% applied to RNY's assets—a margin over A-grade assets more in line with historical averages, would imply a net asset value for RNY of roughly US$0.75 per unit.

And then there's the income side of the equation. Only 81% occupied at the moment, RNY's portfolio of offices has plenty of space in which to fit new or expanding tenants. Management tells us that demand is still weak but that the 'velocity' of enquiries has picked up substantially. Lease rates are not increasing, but the level of incentives offered to prospective tenants has reduced. A sustained improvement is needed in the US employment market for any upside to arise here but, given our five year window of opportunity until the debt facilities mature, the prospects would seem reasonable that the cashflow generated can increase from today's levels. A 90% occupancy rate, assuming the same average lease rate as today, would imply a 10% increase in net operating income and a commensurate increase in valuations.

None of this is a fait accompli. Interest rates can, believe it or not, go up. And the world economy is hardly firing on all cylinders. Europe and China are the US's two most important trading partners. Meltdowns in either economy threaten the US's tepid recovery.

RNY also has its own problems. Leases expiring this calendar year equate to 15% of floor space and 21% of income. Arrow Electronics, the Trust's largest tenant, has already indicated it will not be renewing its lease when the 31 December expiry rolls around (although the Arrow property is in the pool currently being restructured, which will limit its impact on the overall valuation). And sprucing up unoccupied office space so it can be leased is an exercise that requires capital—something RNY does not have in abundance.

There is downside to the current book values, but we think it much less likely than upside. And, in any case, the discount to book value implied by today's unit price gives us a significant margin of safety. As reflected in the largest weighting we have ever had to one stock, it is our favourite opportunity at the moment by a significant margin.

> *"As reflected in the largest weighting we have ever had to one stock, it is our favourite opportunity at the moment by a significant margin.*

Finding Redemption in RCU

Continuing the good news this quarter, we managed to recover our investment from **Real Estate Capital Partners** USA Property Trust (RCU) at a meaningful premium to recent market prices.

RCU sold its remaining valuable US office property assets in January and has been a cash box since. Interests associated with fellow unitholders Greg Woolley and Joshua Liberman blocked an initial proposal to distribute the cash to unitholders and by February were pushing for a change of strategic direction for the trust. The changes included replacing the Responsible Entity, appointing Woolley to the board of the new responsible entity, changing the investment strategy to include concentrated private equity style investments, capital raisings and no prospect of distributions. An unappealing prospect for the rest of us to say the least.

We found a clause in the Trust's constitution that implied unitholders could request redemption of their units and that the RCU Board should consider redemption requests if the trust was liquid. The day after the distribution was voted down we submitted our redemption request, and proposed to the Board that all unitholders not wanting to follow Woolley and Liberman should be permitted to exit while the trust held cash.

It became a race against time once the RCU board agreed, subject to obtaining a court ruling, that the redemption was legal and permitted by the ASX listing rules. The judge's decision, arrived at after some vociferous opposition from the Woolley lawyers, was handed down just a few days prior to a unitholder meeting that was almost certain to result in a new board—one dramatically less sympathetic to our cause—being appointed.

After 18 months of scrapping, legal fees, value destruction and fee leakage, our final investment losses on RCU are shown in the Table 4. It is an unfortunate outcome, especially given the portfolio was up 33% during the same period, but one that could have been a lot worse had it not been for our unitholder activism.

TABLE 4: RCU PERFORMANCE SUMMARY

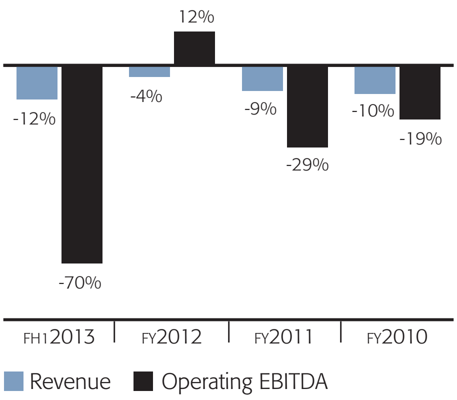
AVERAGE PURCHASE PRICE	$0.6288
REDEMPTION PRICE	$0.5685
LOSS	(9.6%)

Enero Needs More Than a New Name

Regular readers of our reports will know we've had an investment for some time in marketing and advertising business **Enero Group** (previously Photon Group) which has been a serial disappointment. In February Enero reported another lousy set of results, again showing a serious decline in like-for-like sales from the prior period.

Operating earnings before interest and tax (EBITDA) was even worse, down 70% on the prior period. This caps off an unenviable four year record of declining results shown in the Chart 3. The only positive thing to be said is that Enero managed to retain most of its cash balance.

CHART 3: ENERO'S DECLINING RESULTS (% CHANGE VERSUS PCP)



Source: Company reports

If Naked and BMF can be returned to their former glory, the share price will be multiples of what it is today.

So where to from here? Enero is a business that is conceptually simple but difficult to value with confidence. The business model is straight forward; the major expense is staff wages and Enero simply needs to book them out at a margin above wages and overheads. If we can estimate sustainable revenue and margins then we can value the business without much fuss.

Unfortunately this is challenging where the revenue is eroding badly and the margins are anaemic. After years of decline we need to decide whether the business will continue to decay, or whether it might revert or at least stabilise.

The signs superficially aren't great. Enero has been through a huge restructure which saps morale. Many key bread-winners have taken a hit to their earn-out payments and others have left taking their earning potential with them. This business has pro-cyclical tendencies and bad news can compound quickly.

But Enero's consolidated results mask the fact that some agencies are loss making and others performing quite well. Whilst the company doesn't provide results for specific agencies, we're almost certain that global marketing agency Naked Communications is losing money and advertising consultancy BMF is also clearly struggling. The other major agencies—public relation firms Hotwire and Frank PR and research house The Leading Edge—are performing quite well. Any of these three businesses could be worth more than the current $32m market capitalisation on their own. Then there's $7.5m of excess cash, website owner Dark Blue Sea (once listed on the ASX itself) and a collection of smaller, less valuable businesses.

We're confident that if Enero were to be broken up and sold, shareholders would realise substantially more than the current share price. We're not pushing management to consider that path just yet. If Naked and BMF can be returned to their former glory, the share price will be multiples of what it is today. Yes, that's a big if. But it's another of those free options we like, and for that we're prepared to give them some time.

TABLE 5: A SELECTION OF STOCK HOLDINGS

RNY PROPERTY TRUST (RNY)	Owns 25 office properties in the New York tri-state area of the United States.
VISION EYE INSTITUTE (VEI)	Ophthalmology clinics around Australia recovering from historical debt burden.
ENERO GROUP (EGG)	A collection of advertising and marketing research agencies

Intelligent Investor International Fund

At six weeks old, it is very early days for the International Fund. Our main priority has been to ensure the Fund is providing investors with the foreign currency exposure promised in the Product Disclosure Statement and to begin investing in some reasonably priced world class businesses. We wrote about **Google**, **Tesco**, **AIG** and **Sheng Siong** in the first monthly report, and below we provide a more detailed insight into two other holdings, global credit card company **American Express** and German home improvement business **Hornbach**.

The unit price is down a little thanks to the strong Australian dollar but there is little news of note to report from the underlying portfolio.

All Aboard the American Express

Finding value amidst the freight train that is the US stock market has become a challenging endeavor. Equity prices continue to climb as Ben Bernanke prints money as if it was going out of fashion. But maybe money—or more precisely—paper money is going out of fashion? We here at Intelligent Investor Funds certainly hope so. American Express Co. (AXP) represents one of our initial investments, and it is primed to gain as people across the globe continue to realise the many benefits of electronic payments.

Over the last sixty years, Amex, Visa and MasterCard have built businesses that span millions of cardholders, merchants and issuing banks. Few industries that we have looked at encompass such compelling structural advantages.

Typically an investor must "pay up" for such high quality businesses, and that is certainly the case with Visa and MasterCard (trading at multiples of 23 and 21 times earnings, respectively). But shares in Amex traded at a measly 12.5 times at the time of our purchase. Why the discrepancy? Whereas Visa and MasterCard simply facilitate payments on behalf of banks and merchants, Amex doubles as a bank in its own right, extending credit directly to many of its customers. This requires capital and is subject to a broader set of risks, making Amex's overall business slightly less sexy relative to its payment network brethren. Still, Amex has built one of the great global brands by persuading millions of members to use its cards. 'Membership has its privileges,' and its customers agree: average spend per card is five times that of Visa. As a result, Amex has averaged a 25% return on equity over the last ten years. Not too shabby.

But Investors question whether or not Amex can continue to generate these same returns in the future. We like the opportunity set ahead of it. Of all global retail transactions, 85% are still made with cash. Yet cash is less convenient, less secure and more costly from a handling perspective. As a reference point, in the US, cash is used in only 50% of all retail transactions. Amex's fastest growing unit, Global Network Services, has been partnering with overseas banks in order to grow their cardholder base abroad. We expect that the rest of the world will continue to shift to electronic payments providing a long-term tailwind for growth.

A number of new initiatives are gathering steam. Bluebird, an online prepaid banking platform aimed at the under-banked population in the US, has been very successful at bringing in customers that would ordinarily shy away from Amex's more richly priced cards. Serve is a digital wallet offering that competes with PayPal, Google Wallet and other mobile payment systems. Bluebird and Serve generate high growth, high margin revenue streams that require little invested capital—attributes we like.

Meanwhile, management plans to return virtually all of its cash flow back to shareholders via buybacks and dividends. We are betting that Amex's highly regarded management team will find the right mix of execution and cash management to deliver attractive returns on our capital.

TABLE 1: SUMMARY OF RETURNS

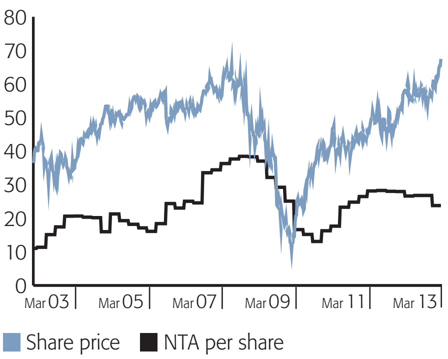
	INTELLIGENT INVESTOR INTL FUND	MSCI ACWI IMI
1 MONTH RETURN	–0.62%	0.15%
RETURN SINCE INCEPTION (8 FEB 2013) (P.A)	–0.88%	1.07%
$10,000 SINCE INCEPTION	$9,912.00	$10,106.89
PORTFOLIO VALUE		**$12,580,802**

TABLE 2: UNIT PRICE SUMMARY

DATE AS AT	31 Mar 2013
BUY PRICE	$0.9952
REDEMPTION PRICE	$0.9873
MID PRICE	$0.9912

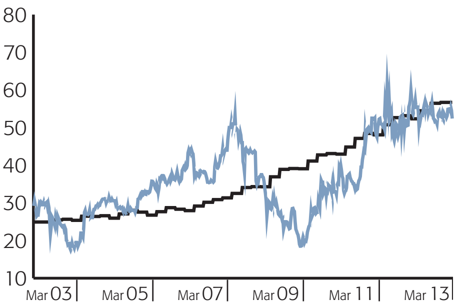
> *"Amex has averaged a 25% return on equity over the last ten years. Not too shabby.*

CHART 1: AMEX'S WONDERFUL RETURNS



Source: Capital IQ

CHART 2: HORNBACH'S GROWING VALUE (CENTS PER SHARE)



Source: Capital IQ

> *If market consolidation continues and industry EBIT margins rise closer to developed world averages, then today's stock price will prove very cheap.*

Can Hornbach Holdings be Germany's Bunnings?

'There's always something to do' is the name of a book about Canadian investing legend Peter Cundill. It's also the direct translation of the tagline for German DIY hardware store group Hornbach. The group operates 137 DIY megastores in Europe—91 In Germany and 46 elsewhere in Europe (approximately half western and half eastern). There are two listed entities—Hornbach Baumarkt is the operating business and also directly owns around one-quarter of the real estate on which the group operates. Parent company Hornbach Holdings owns 76.5% of the outstanding shares of the operating business, a smaller business focused on trade professionals in south west Germany, and an additional 29% of the property on which the DIY stores operate in return for rental payments (the remaining 45% of sites are leased). The Hornbach family firmly controls the holding company and, by default, the operating business.

Germany's DIY market is a stark contrast to Australian eyes—the market is fragmented and there is no dominant Bunnings equivalent. The largest player, OBI, controls less than 20% of the market. Hornbach recently sped past a financially-struggling competitor to become the third largest player in the German market (and fifth largest in Europe overall). Hornbach's point of difference is its large and homogenous store size (averaging 11,600m^2) and a focus on 'project customers' doing, for example, a complete bathroom renovation. The company uses an everyday low prices strategy and has a reputation for value (acutely important in the German market). Last year's *Kundenmonitor Deutschland* survey of customer satisfaction awarded Hornbach the highest 'overall satisfaction' mark ever for a DIY brand. The company was ranked first in 16 of 33 individual categories.

But the competition is plentiful and fierce. In the year just finished, Hornbach generated EBIT margins of 3.3%, down from 4.0–4.5% in recent years. Although most of its competitors are unlisted, we believe this was among the industry's highest margins and some of its competitors are bleeding red ink. It compares with high single-digit margins for big American equivalents like Lowe's and Home Depot and more than 10% for Bunnings (whether it's banking, groceries or hardware, Australians are being ripped off).

The DIY market in Europe turned down sharply in the last half of 2012, and Hornbach Baumarkt reported negative same-store sales results for the past two quarters. But it's a market-wide issue, and the company still picked up market share over the year—to 9.3% today (up from 8.3% five years ago, and 6.3% a decade ago). Hornbach isn't the biggest player but it has a strong hand and some of its competitors are foundering. Further consolidation is part of our upside thesis.

Plenty of Value, but which Hornbach?

The operating company (Hornbach Baumarkt) trades at a small discount to net tangible book value. But the property it owns is on the books at historic cost (less accumulated depreciation). Some of those properties have been held for a long time and are worth significantly more today. If one reconsiders the balance sheet using conservative market valuations for property, the stock is trading at a discount of more than 20% to NTA. You'd never get Bunnings so cheaply.

When the company reports its full results for the year to 28 February 2013 in a few weeks, we expect to see profitability that translates to a price-earning ratio of about 15. That doesn't sound initially cheap on an earnings basis, but there are a few things worth noting. Firstly is the aforementioned downturn. The stock is trading at more like 10 times the prior year's earnings. Europe might get worse before it gets better, but the pain won't last forever.

Secondly, the company is inefficiently financed (and we don't use that term the way an investment banker might). It has a small net cash position, but that's made up of €450m of cash and €425m of debt. It pays much more interest on its debt than it receives on its cash. A recent bond refinancing at lower interest rates will make some headway, and if the company chose to retire debts with some of its remaining cash then earnings would rise and the PER would sink further. Lastly, over the past few years the company has been spending heavily on an online/home delivery offering to try and lead that market in Germany. This level of expense, punishing short-term earnings, won't be ever-present. Such pain today, gain tomorrow activity is to be applauded.

So Hornbach Baumarkt is trading at perhaps 10 times 'normalised' earnings, with downside protection afforded by substantial asset backing—the stock is trading around or perhaps even below liquidation value. With a focus on Germany and 'rich' Europe, we don't think that even a Euro breakup would cause irreparable damage. And if market consolidation continues and industry EBIT margins rise closer to developed world averages, then today's stock price will prove very cheap.

While the above focus has been on the operating business as a necessary explanation, we've invested your money in the holding company, Hornbach Holdings. On a 'look through' basis, that means an investment in the operating business on the terms described above, plus some additional property assets at well below current market valuations. Investing alongside the controlling family brings an additional measure of protection, in case the family ever decides to emulate the Lowys and gouge on inter-company property leases (not that we expect them to).

We like the upside/downside dynamics of our first continental European investment.

Holding companies are an area of initial focus for our European office. Family or owner-manager controlled holding companies are very common all over Europe, and have often been in existence for generations. They range from diversified listed investment companies to strategic stakeholders to singular operating business (like Hornbach Holdings). Some of them are cheap. We expect there will be at least one more in the portfolio by the time we report next month.

Benjamin Graham lives on in Japan

Perhaps most famous for his tutelage of the world's most famous value investor, Warren Buffett, Benjamin Graham was a very successful investor in his own right. Some of his favourite investments were what he defined as 'net-nets'. These were stocks that could be bought for less than two thirds of their net working capital (cash, inventory and receivables less all liabilities). Graham's argument was that you were getting a discount on the working capital and all of the business's fixed capital—property, equipment and the like—for free.

While the method has proved sound over the ensuing eight decades, unfortunately, genuine net-nets are few and far between in the modern world. Except in Japan.

We've been able to put together a portfolio of 25 Japanese stocks that meet criteria slightly more stringent than Graham's (less than 60% of net working capital rather than Graham's two thirds). As you can imagine, they are not the most wonderful businesses you will ever find, but they are all real businesses, mostly profitable and all but one are paying dividends.

You need a large enough basket of these types of stocks to minimise the risk of any one blow-up impacting the portfolio, and we intend on reporting on this basket of stocks in one line in our monthly and quarterly reports (you will see Japanese net-nets alongside other individual names like American Express and Google).

Being able to find 25 is an excellent outcome and we have allocated 9% of the portfolio to what we expect will be a very productive space.

"Graham's argument was that you were getting a discount on the working capital and all of the businesses fixed capital—property, equipment and the like—for free.

TABLE 3: INTERNATIONAL FUND PORTFOLIO

COMPANY	COUNTRY	WEIGHTING
JAPANESE NET NETS	Japan	8.5%
GOOGLE	US	4.8%
AMERICAN INTERNATIONAL GROUP	US	4.1%
TESCO	UK	3.5%
AMERICAN EXPRESS	US	3.0%
COACH	US	2.7%
HORNBACH	Germany	3.0%
SHENG SIONG	Singapore	1.4%
USD CASH		**25.1%**
AUD CASH		**22.7%**
EUR CASH		**16.5%**