

# Value Fund

## Quarterly Update



INTELLIGENT  
INVESTOR  
FUNDS MANAGEMENT

30 DECEMBER 2011

## The Value Fund's Quality Quarter

It was a strong quarter for the Value Fund despite substantial markdowns in some of its holdings.

The Intelligent Investor Value Fund outperformed the index in the December quarter, rising 4.8% versus a 1.9% increase in the All Ordinaries Accumulation Index. There were two announcements during the quarter that added meaningfully to both the value of our portfolio and the unit price (look for the sections relating to **Photon Group** and **ING Community Living Group**).

This good quarter left the fund down 8.5% for the year, better than the 11.4% decline in the All Ordinaries Accumulation Index but nothing to write home about. Despite pegging back some ground over the past 12 months, the Fund's performance is still marginally behind the index since inception. »

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#### SUMMARY OF RETURNS AS AT 30 DECEMBER 2011

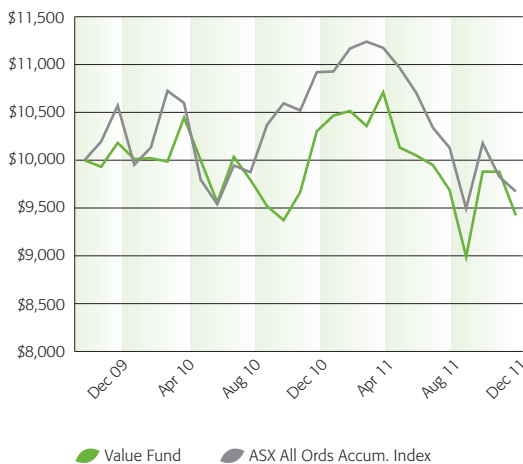
	IIVF	ALL ORDS. ACCUM. INDEX
1 month return	-4.62%	-1.57%
3 month return	4.79%	1.86%
6 month return	-6.23%	-9.63%
1 year return	-8.54%	-11.43%
2 year return	-3.80% p.a.	-4.35% p.a.
Since inception (31 Oct 2009)	-2.71% p.a.	-1.53% p.a.

## UNIT PRICE SUMMARY

DATE  
**30 December 11**  
 BUY PRICE  
**\$0.8668**  
 REDEMPTION PRICE  
**\$0.8599**  
 MID PRICE  
**\$0.8634**

» The substantial good news over the past 12 months has been offset, in terms of our performance at least, by what are, in our view, irrational markdowns of other stocks in the portfolio. To put the general level of selling into context, the Small Ordinaries Index—perhaps the best reflection of our current portfolio—fell 21.4% in 2011. That is not an excuse—we have the freedom to invest in any ASX listed stock and have chosen to invest at the smaller end of the market because we're finding the best value there—but it does explain the magnitude of the sell-off which has dragged some of our stocks down with it.

### VALUE OF \$10,000 INVESTED AT INCEPTION

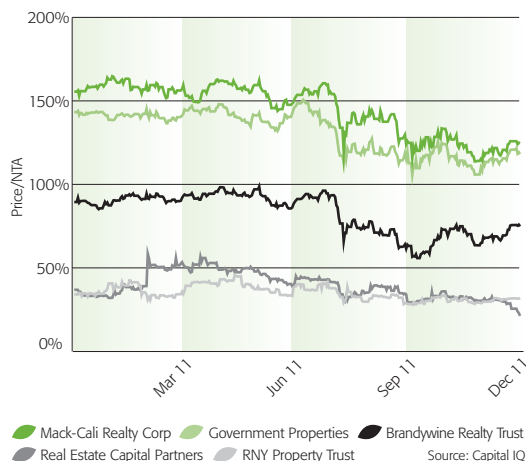


## RCU leads the falls

**Real Estate Capital Partners USA Property Trust (RCU)** led the charge with regards to small caps sold off irrationally. It wasn't that there was no bad news. This US focused Real Estate Investment Trust (REIT) announced that the distributions and earnings it promised investors at the time of its March capital raising are looking unlikely. It's just that the price fell 27% when that news is not particularly significant or surprising.

RCU has been ineptly managed for years and we weren't expecting that to change the day we invested in the stock. We bought it for the value of the underlying properties and remain confident in the value and cash generating capacity of those assets. Of the trust's \$US2.03 in net tangible assets, \$US0.81 relates to a portfolio of US Government leased assets. This part of the portfolio has a 59% loan to value ratio, an average lease expiry of 6.1 years and average debt

### US COMMERCIAL PROPERTY REITS



Source: Capital IQ

## Selection of holdings

STOCK	BUSINESS	PORTFOLIO WEIGHTING
AS AT 30 DECEMBER 2011		
<b>QBE Insurance</b>	Australia's largest international general insurance and reinsurance group.	7.3%
<b>RNY Property Trust</b>	Owns 25 office properties in the New York Tri-State area of the United States.	10.1%
<b>1300 Smiles</b>	A corporate dentistry business located predominately on the east coast of Queensland. Its focus is on large regional centres.	8.5%
<b>Max Trust</b>	A leveraged bond portfolio in the process of winding up.	6.0%

maturity of 5.7 years. The US assets alone should yield the trust US7.5 cents per unit per year of operating cash, yet the 31 December closing price for the whole trust was just \$0.42.

The problems with management remain. In fact, they are worse than even we anticipated. The trust raised \$37m of new capital in March, which the manager promised would fix its problems. The US government assets were supposed to be transferred by the end of June. It happened in December. The annual accounts were lodged late with the ASX and contained a going concern notice from the auditors. It's hard to imagine how management could have been more inept.

The structure needs to be fixed, substantial amounts of non-recourse debt needs to be refinanced in 2012 and the general wisdom of having US commercial property listed on the ASX remains in doubt. That's why the stock price is where it is. But with a handful of actively engaged institutional investors controlling more than 50% of the units, we are confident of protecting and realising most of the underlying value over the next few years.

## Punters get impatient with UXC

IT services company **UXC** was the other main negative contributor to the Fund's performance in the December quarter. Like RCU, there was some justification for a share price fall but the magnitude—a 17.1% decline, adjusted for a \$0.02 capital return—seems unwarranted.

At the company's annual meeting CEO Cris Nicolli told shareholders that he was 'confident in a much improved second half'. That's a euphemism for 'profit in the first half is going to disappoint you', hence the share price decline.

We're impatient to see profit and dividends just like everyone else. But real world turnarounds take time and Nicolli has had an excellent 2011. He managed to sell the non-IT part of the business for a reasonable price, repay all of the company's debt, restructure a large number of disparate businesses into six logical business lines, grow revenue and add some much



needed fresh blood to the board.

Now he needs to increase margins and slash corporate overheads. With net cash in the bank and (in stark contrast to last year) time to focus on these issues, we are prepared to be patient.

## ILF makes something out of nothing

Just before Christmas **ING Real Estate Community Living Group (ILF)** announced that it would be writing up the value of its US assets by \$0.07 per unit in its 31 December accounts. Normally, changes in accountants' estimates of asset values are meaningless—investors should be focused on cashflow and their own valuation of those assets.

But the ILF announcement provides useful data. These US assets are up for sale and the new valuations are reflective of a number of indicative bids received by ILF. Due to the large amount of non recourse debt against these assets, the net value on ILF's balance sheet was only \$0.02 per security (versus \$0.26 of total net tangible assets). The revaluation means the board is expecting at least \$0.09 per security from the sale of these assets. For comparison, the unit price at 31 December was just \$0.16.

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The proceeds probably won't be returned to unitholders. CEO Simon Owen, who we hold in high regard, has a number of sensible incremental investment opportunities that will utilise most of the capital released from the US.

Progress is also being made on an internalisation of ILF's management and a potential solution is expected to be put to unitholders soon. With a bit of luck, by the time June comes around ILF will be paying regular distributions, have its own well-regarded management team, own a portfolio of quality Australian retirement assets and a pipeline of attractive future investment opportunities.

## Photon bruised and battered but out of the woods

With the sale of its field marketing business to private equity group Navis Capital, **Photon group** is finally out of the woods. The company now has net cash, a remarkable turnaround from the \$450m net liabilities the company had 18 months ago.

The value of what's left is difficult to ascertain with any degree of clarity. Even more so now that the architect of Photon's turnaround, CEO Jeremy Philips, has tendered his resignation. Even on extremely conservative assumptions, however, the stock remains cheap.

The sale of the field marketing businesses generated \$146.5m for Photon, enabling it to repay all of its outstanding debt and retain \$21.5m of cash surplus to operating requirements.

It's now left with 14 businesses that generated \$210m of revenue in the 12 months to 30 September. Six of those contribute 90% of the company's earnings (the big six are Australian marketing agencies BMF

and BMW, international agencies Naked and the Leading Edge and UK public relations companies Frank and Hotwire).

If the remaining businesses generate \$200m of revenue and earn margins of 15%, Photon will produce \$30m of operating cashflow. Subtract depreciation and tax and shareholders will be left with approximately \$20m of post-tax cashflow per year. That would represent a 20% return on the current market capitalisation of about \$100m.

The revenue should be higher. And the margins should be significantly higher (see the graph below for a comparison with Photon's historical averages and some comparable listed companies).

There are still plenty of problems. The board doesn't seem to have a replacement CEO to start with. And the company can't pay dividends for another five years due to contractual arrangements with vendors related

to contingent earnout payments (Photon will only have to make the payments if operating earnings are 80% higher than the \$30m estimated above). But despite the share price rising 77% during the quarter, it's hard to see a disastrous outcome from here.

Rumours of further corporate action abound, including the potential for a takeover offer from global marketing giant WPP, or a merger with fellow ASX-listed marketing company **STW Communications**. The later would make particular sense, given Photon has the international exposure and growth potential STW doesn't have, and STW has the infrastructure and management Photon doesn't have. With Photon's future assured though, shareholders are in a position to make sure any deal is a good one.

## Retailing in Australia

The past year was horrible for the Australian retail sector. The S&P ASX 200 Retailing Index fell 37% in 2011. Former darling stocks **JB Hi-Fi** and **The Reject Shop** fell 37% and 25% respectively and stalwart **Harvey Norman** fell 38%. For the most part the price drops have not been random market panic, but the result of disappointing results and dire predictions about future profitability.

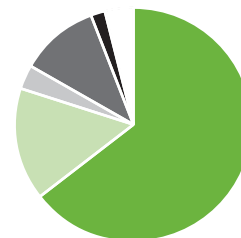
That's all taken place despite a relatively benign economic backdrop and 5% unemployment. Imagine where the sector would be with 10% unemployment and a housing crash.

We have been concerned about these businesses for years and haven't owned one retail stock in the Fund. We are sifting through the sector, though. One would think, amidst the carnage, there must be some value.

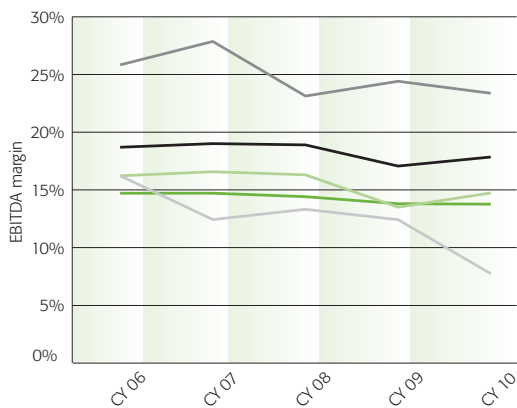
There are three main issues facing Australian retailers. Firstly, the sector has too much capacity.

### PORTFOLIO DISTRIBUTION (by market capitalisation)

- Less than \$100m **64.8%**
- \$100m–\$200m **15.3%**
- \$200m–\$1bn **3.3%**
- Over \$1bn **11.1%**
- Cash **1.9%**
- Unlisted **3.6%**



### ADVERTISING COMPETITORS



■ Omnicom    ■ WPP    ■ Publicis    ■ STW Communications  
■ Photon Group    CY = Calendar year Source: Capital IQ

- » The industry expanded rapidly while retail sales grew faster than disposable incomes. Thanks to five-year interest free periods, credit card debt and mortgage drawdowns used to fund retail consumption, the retail sector now has a level of infrastructure that is not justified based on a sustainable level of spending.

The second issue facing the sector is that retail property trusts—**Westfield Group** in particular—have been increasing their portion of the pie. The graph below shows the ratio of rent to revenue for a number of ASX-listed discretionary retailers.

On average, the percentage of revenue these retailers pay to landlords has increased from 12.1% in 2005 to 16.2% in 2011. In most cases, the retailers are making more gross margin than they were five years ago. They are marking up the sale price of their goods by more, yet making less profit because the additional margin (and then some) is being confiscated by the landlords.

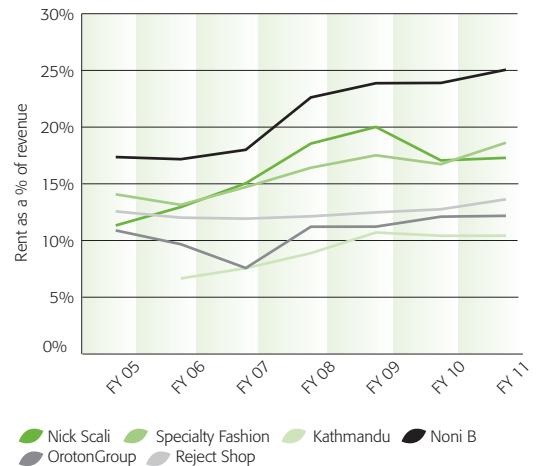
Finally, the issue that brings the former two to the fore is that today's customer has an alternative to bricks and mortar retailers. From a competitive perspective, it doesn't matter if your rent is high as long as everyone else's rents are the same. Now that customers can purchase online, rent and high Australian staffing costs place the traditional retail sector at a competitive disadvantage. Even those that don't shop online are usually doing online price checks and know what price they should be paying. There is no doubt there will be a bricks and mortar retail sector 20 years hence. A shuffle through Sydney's Pitt St Mall in the lead-up to Christmas indicates 'shopping as an experience' is alive and well. So, there will always be physical shops and, in many cases, physical stores should still have a cost advantage. Online grocery shopping will never be a lower cost business model than establishing

local warehouses and letting your customers do the local distribution for you. The cost of delivering groceries ordered online is higher than the cost of warehousing (**Woolworths'** rent is less than 3% of sales and they would incur some of these costs running a pure online business).

The question is not whether there will be bricks and mortar retailers. There will. The question is how the industry transitions from today's excess capacity and high costs to one that is smaller, paying lower rents and focusing on the sectors in which physical stores have a competitive advantage.

We don't have an answer to that question. Perhaps the strong, relatively low cost players like **JB Hi-Fi** will take even more market share from rivals and manage to grow despite industry-wide difficulties. Perhaps the property trusts will wear the bulk of the pain. They are the ones that have been generating the excess profits to date. Perhaps new businesses and

**HURT LOCKER—WHY RETAIL TRUSTS WILL WEAR THE PAIN**



business models will emerge and annihilate the existing players. We don't know and, despite the carnage in the sector, stock prices still aren't at a level where we're being compensated for the uncertainty.

For now, we'll stick to buying US commercial property at less than replacement cost.

## Action aplenty in 2012

It was an action-packed year in 2011. Between RHG shenanigans, the Centrebet takeover and Photon's dramas, we've been stuck on the edge of our seats.

With the current portfolio heavily pregnant with opportunity it will, no doubt, be another action-packed year ahead. We'll keep you updated as events

transpire. Don't forget we also publish a shorter monthly update which you can download within a week or so of the end of each non-quarterly month.

Kind regards,



Steve Johnson

PS. If you aren't getting emails from us with the monthly and quarterly updates attached, make sure we have your email address. Email [admin@iifunds.com.au](mailto:admin@iifunds.com.au) or call Kate on (02) 8305 6050 to let us know. Please remember to include your investor number.

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## Intelligent Investor Value Fund

*Value investing the easy way*

The Value Fund is a managed fund that offers you access to:

- an expert management team
- investment opportunities in the small cap market
- a long term option for building your wealth

There are no exit or entry costs and fees are kept to a low 1.1%p.a. before performance fees.

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