Value Fund
Quarterly Update

30 JUNE 2010

Defence reigns in June quarter

'The reasons why investors were told that toll roads, airports, pipeline and power stations were an essential part of any investor's portfolio remain in place. Many of these assets are natural monopolies. The cashflows are predictable. And they are relatively immune to the economic cycle'.

That was one of the last things I wrote for *The Intelligent Investor* newsletter almost a year ago, in a special report titled *Opportunities in Infrastructure*. We included some of the stocks from that report in the initial Value Fund portfolio and have carried the defensive theme through almost every purchase we've made since. I'm pessimistic about the prospects for global economic growth and have mostly stuck with economically resilient businesses.

I want to expand on this a little as I've had two weeks holiday in June and, as usual, time away from the office has done wonders for my clarity of thought. Paul Krugman (Nobel Prize winning economist and *New York Times* journalist) is right. The Greek Crisis has spurred a wave of fiscal austerity measures that are downright dangerous. As Krugman put it in a recent piece 'while long-term fiscal responsibility is important, slashing spending in the midst of a depression, which deepens that depression and paves the way for deflation, is actually self-defeating'.

Pulling the rug from under these economies now will usher in what Krugman is already calling 'The Third Depression'.

The other side of the argument, perhaps put best in this *Financial Times* piece by Nouriel Roubini (31/5/10), is that the debt-fueled level of consumption that Krugman wants his government to maintain is clearly unsustainable. Substituting private debts with public ones is not a long-term solution. 'Public debt is ultimately a private burden', Roubini writes, 'governments subsist by taxing

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	IIVF	ALL ORDS. ACCUM. INDEX
SUMMARY OF RETURNS		
1 month return	–4.40%	–2.60%
3 month return	–4.28%	–11.04%
Return since inception (2 November 2009)	–4.41%	–4.59%
Number of stocks in portfolio	17	

PORTFOLIO DISTRIBUTION (according to market capitalisation)

- Less than $100m **26%**
- $100m–$200m **33%**
- $200m–$1bn **14%**
- Over $1bn **24%**
- Cash **3%**

private income and wealth, or through the ultimate capital levy of inflation or outright default. Eventually governments must deleverage too, or else public debt will explode, precipitating further, deeper public and private-sector crises.'

My moment of clarity was to realise that both Krugman and Roubini are right. Now is not the time for fiscal austerity. But neither is government spending a panacea. The US, the UK and Europe need to run short-term deficits but they also need long-term policy that is a genuine solution to the structural problems at hand: labour market inefficiencies, unsustainable pension and health care systems and a general standard of living not justified by current productive capacity.

What this means for Australia, with its exposure to Asia, strong government balance sheet and overleveraged consumers, I'm still unsure (perhaps a few more weeks holiday would help). But I remain extremely cautious and am reluctant to venture from the defensive end of the spectrum given the relative value on offer at the moment.

Owning defensive businesses doesn't always mean you are protected against falling share prices. But in the past quarter, when the prospects of another recession (the so-called 'double dip') have come to the fore, our portfolio has held up relatively well.

The Value Fund unit price is down a comparatively modest 4.3%, while the All Ordinaries Accumulation Index has retreated 11.0% since the end of March. That only brings us back into line with the index since inception, however, and we certainly aren't crowing about performance just yet.

Stock commentary

Yin and yang of the underlying portfolio

We own a number of stocks, including **MAp Group** and **1300 Smiles** (see page 5) that represent businesses with excellent underlying economics run by top-class management. If everything goes to plan, we buy them, hold on to them for a long time and let the profits build.

The Value Fund also contains a few businesses that fit into a different category. We've invested despite issues with the underlying business, the management, the capital structure or some combination thereof.

Buying these types of businesses individually is fraught with danger. But we can manage the risk of any one business failing by, firstly, adjusting our portfolio weightings depending on the risk of failure and, secondly, by diversifying into a number of uncorrelated stocks so that, over time, the losers will be more than offset by the winners.

Obviously there is no clear line designating which stocks are risky and which aren't. We're yet to come across the perfect business, so it's all a matter of degree. As a rough guide, however, we aim to keep our total exposure to the riskier businesses, such as the two we're about to discuss, to less than one third of the portfolio.

Photon calls for more while UXC sells itself

The first is **Photon Group**. Photon hasn't traded since 7 June and, when it starts trading again, investors look like they're in for a massive capital raising. The company owes banks $271m and owes a further $176m in deferred consideration in relation to previous business purchases, and it's not generating enough cash to meet those obligations.

It is generating enough profit to justify the last traded price—$1.02 implies a market capitalisation of $191m and, despite the current troubles, the business is still expected to generate an underlying profit of $28m after tax this year. Yet it's going to need cash to get through the next few years of deferred payments and debt obligations. We expect this business to survive but it's going to be a much rockier road than was expected when we first invested six months ago. At the time the expected profit was higher and the deferred consideration payments lower (it seems somewhat ironic that the business is suffering because of payments that only have to be made when businesses they have bought perform better than expected).

On the other side of the ledger we also have a large investment in IT Services business **UXC**. Again, we bought the shares in the full knowledge that all was not well. The company has been caught up in a very expensive dalliance with the government's aborted environmental stimulus programs, and the board has been trying to con shareholders into thinking they are getting a dividend when they are not (in lieu of a half-yearly dividend, the company issued all shareholders with one bonus share for each 10 they already own, which is equivalent to cutting a starving man's slice of bread into two pieces and trying to convince him he is well fed).

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Despite all this, we've made a significant investment in the business because it looks exceptionally cheap. The part of the business that provides traditional IT consulting services (advising on and managing large scale IT projects for corporate businesses) continues to grow and will, in the 2010 year, generate more in earnings before interest, tax, depreciation and amortisation than listed competitor **SMS Management and Technology**. SMS is attributed a current value of $370m versus only $210m for UXC, and the comparable part of UXC's business only generates two thirds of the revenue.

Suitors in the due diligence room

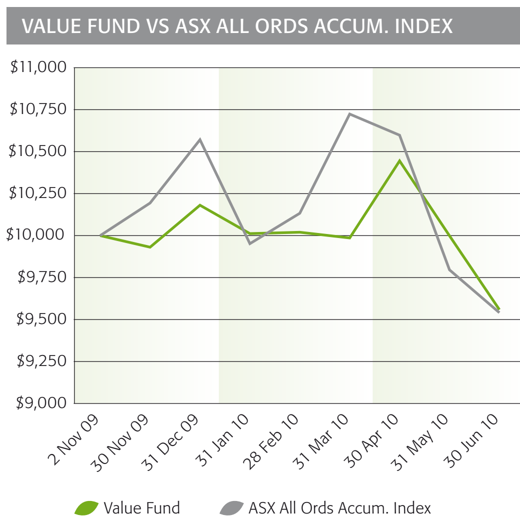
Where Photon is headed for the rehab clinic, UXC looks like it could be headed for the discharge ward. The directors put the company up for sale after announcing the disappointing half year results in the environmental division, offering parts or all of the business to potential suitors. This was welcome news for us. We expect to do well despite the existing management team—the loss-making businesses have already been discontinued and we would expect a healthy profit in 2011—but the business could be worth substantially more in someone else's hands or as part of another business. Both SMS and fellow competitor **Oakton** »

earn double the margins UXC does on their IT services revenue, which highlights the potential for a substantial uplift in earnings.

In the first week of July, UXC announced that it had several parties interested in the business and that the board had decided to enter into a period of 'exclusive due diligence' with one of them. This suggests someone sees the value we do and that they're talking a price the board is interested in. Hopefully it is one that is satisfactory to us as well.

Prime kneecapped by NGPL

One stock that is causing problems but shouldn't be is **Prime Infrastructure**. This stock was Babcock and Brown Infrastructure until it was recapitalised with a life-saving injection of more than $1bn of new capital, much of which came from astute Canadian investor Brookfield Asset Management. The underlying assets were sound, or so the theory went, and all we had to do now that there were no refinancing issues was sit back and collect our distributions; 30 cents per security this year and expected to grow.



Unfortunately, its largest asset, Natural Gas Pipeline Company of America, has been slammed by the US energy regulator and forced to agree to new tariffs that could cut Prime's expected cashflow from the asset by half. Prime owns a number of other high quality assets, including Dalrymple Bay Coal Terminal and Westnet Rail, but NGPL was the most significant and this one decision will cut the total distributable cash by up to 20% (from $0.38 per security this financial year). We also anticipate NGPL will require further capital to keep its lenders happy. Prime probably has enough cash to fund its share but a capital raising is not out of the question.

The 14% stock price reduction since the announcement fully reflects the reduction in underlying value but these troubles with Prime's largest asset means we may not get the returns we originally hoped for.

MAp earnings set for liftoff

Our other large infrastructure investment, airport fund **MAp Group**, has been delivering a constant stream of excellent news. Traffic growth has averaged in excess of 8% at Sydney Airport and, combined with new retail facilities at the international airport, this has meant growth in operating earnings well in excess of 10% (EBITDA for the first quarter of the calendar year was 13% higher than the year before). MAp owners should do even better than that, however, as the financial leverage employed at all three airports means that distributable cash will grow faster than operating earnings. The opposite impact applies if earnings fall, of course, but this year looks like generating an increase in earnings per stapled security in the »

Selection of holdings

STOCK	BUSINESS	PORTFOLIO WEIGHTING
AS AT 30 JUNE 2010		
RNY Property Trust	Owns 25 office properties in the New York Tri-State area of the United States.	12%
Prime Infrastructure Holdings	A diversified infrastructure fund. The main investments are Natural Gas Pipeline Company of America, Queensland's Dalrymple Bay Coal Terminal and WestNet Rail – a rail network in Western Australia.	10%
MAp Group	Owns a majority stake in Sydney Airport and several other smaller airport investments including stakes in Brussels and Copenhagen Airports.	9%
1300 Smiles	A corporate dentistry business located predominately on the east coast of Queensland. Its focus is on large regional centres.	9%

These stocks are not necessarily the largest holdings in the Value Fund.

» order of 20%, assuming traffic continues to grow at similar rates for the rest of the year.

Long-term investment in 1300 Smiles

In March 2005, a small Townsville dentistry business listed on the ASX. In the financial year before listing, the business had made a $1m profit from 13 dentists in 7 dental practices, six of which were in and around Townsville and one in Cairns.

Today **1300 Smiles** (ASX code ONT) has 20 practices, mostly down the eastern side of Queensland, and will generate a profit for the year ended 30 June 2010 in excess of $4m, four times what it generated 6 years ago. The growth has been achieved with minimal use of debt, a negligible increase in the number of shares on issue and a healthy dividend payout ratio. Managing Director and founder Daryl Holmes still owns 70% of the company and says all the right things (from our perspective, at least) in his letters to shareholders. His focus is clearly on growing earnings per share, not growing the empire, which augurs well for a business with abundant growth opportunities ahead of it.

Holmes is not the first person to attempt to build a corporate dentistry business, nor will he be the last. **Capitol Health** listed on the ASX in 2006 and almost went bust not long after. Capitol has since switched its focus from dental practices to medical imaging and diagnostics but the current share price of 3 cents, versus a listing price of 20 cents, says it all.

In contrast to Capitol's experience, Holmes has been able to make it work. The basic business model is to offer dentists a service which allows them to outsource all the administration and procedural work to 1300 Smiles. All the dentist needs to do is dentistry, 1300 looks after the rest. The dentist keeps 40% of the revenue and 1300

UNIT PRICE SUMMARY

DATE
30 Jun 10

BUY PRICE
$0.9598

REDEMPTION PRICE
$0.9521

MID PRICE
$0.9559

2010 Distributions

You should receive your 2010 distribution from the Value Fund before the end of July. This year's distribution is 1.8240 cents per unit and will be paid directly to your bank account or, if you elected to reinvest some or all of your distributions, added to the number of units you own in the fund.

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uses the rest for staff, marketing, equipment and to generate a profit for shareholders.

For now Holmes, a dentist himself, is focused on large regional centres where there aren't enough dentists to meet demand. (One regional centre had a three month waiting list before 1300 opened in the town. That's now been cut to two months.) The 20 practices successfully operating today represent about 0.5% of the Australian market for dental services, so there's plenty of room to grow if Holmes can keep finding attractively priced practices to buy or attractive locations on which to build new practices from scratch.

The transition from a small one man business to a successful large corporate is never easy and we don't expect this to be any different. Holmes is going to need to find high quality support as the business grows and he's going to need to pay them substantially more than the $80k salary he pays himself. But we're quite excited about the prospects for this business and very happy that we've been able to establish a fairly large position for the fund in what is a very illiquid stock. The downside is that selling such an illiquid position would be difficult, but this is a business we hope to be involved with for a long, long time.

Action aplenty in September quarter

The next three months are going to be extremely busy. Most of our businesses will report their annual results in August and we have a number of companies, including UXC (see page 3), due to announce potentially company-changing news. We'll have plenty to write about at the end of September, so keep your eye on the mailbox in the first weeks of October.

As always, if you have any questions please don't hesitate to contact me via email at steve.johnson@iifunds.com.au.

Kind regards

Steve Johnson

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