Value Fund
Quarterly Update

31 MARCH 2011

Stockmarkets Sail Through Quarter of Trauma

The first three months of 2011 will be a period many people will remember for the rest of their lives. The CBD streets of one of Australia's largest cities were under water after the Brisbane River broke its banks. Cyclone Yasi hit North Queensland, leaving behind a damage bill of $5bn. An earthquake struck Christchurch in New Zealand's south and flattened much of that city before Japan's largest recorded earthquake shifted the island of Honshu 2.4 metres east and unleashed a tsunami on the island's east coast. The earthquake and tsunami crippled the Fukushima nuclear power plant and a full-blown nuclear disaster is still a possibility as engineers struggle to contain the fallout.

In the Middle East, autocratic governments were overthrown in Tunisia and »

SUMMARY OF RETURNS AS AT 31 MARCH 2011		
	IIVF	ALL ORDS. ACCUM. INDEX
1 month return	–1.49%	0.64%
3 month return	0.53%	2.92%
6 month return	8.80%	8.39%
1 year return	3.72%	4.80%
Since inception (31 Oct 2009)	2.51% p.a.	8.60% p.a.
Stocks in portfolio	13	

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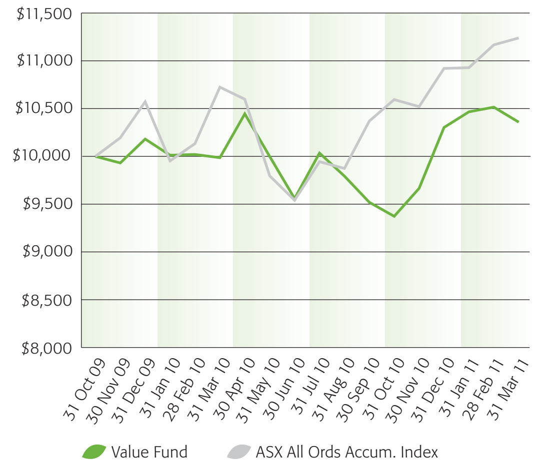
» Egypt by so-called democratic revolutions. It remains to be seen whether the new governments will be any more democratic than their predecessors. The trouble spread to Libya, Algeria, Syria, Jordan and even Saudi Arabia, home of one-fifth of the world's conventional oil reserves.

Western military forces have been drawn into the conflict in Libya, where rebel forces are attempting to overthrow the incumbent leader, Muammar Gaddafi. Oil hit two-and-a-half year highs as the crises unfolded.

In the financial world, Europe's fiscal troubles came roaring back to life. Ratings agencies downgraded Portugal's sovereign debt again. Two of the three agencies (S&P and Fitch) no longer rate the country's debt investment grade. The cost of Ireland's bank bailout is now estimated to top $100bn–$16,000 for every man, woman and child in the country. It's a sum that is going to take a generation of frugality to pay for.

> "We make our money by taking advantage of any wild and irrational downward gyrations, not predicting when they will occur."

After a few years of Ben Bernanke flood irrigation, inflation's green shoots started to poke their heads up in the US and have developed into a crop of weeds in China. Authorities in the US have been very clear that they don't intend to do anything about it and authorities in China are trying their best but clearly failing to rein in the cheap-money-induced lending boom.



And how did equity markets react to the world's troubles? The ASX All Ordinaries Accumulation Index rose 2.9%. The Aussie market underperformed its US counterpart, the S&P 500, which rose 5.9% and the Value Fund underperformed both, but still rose 0.5% for the quarter.

So much for the quarter of trauma.

As irrational as this might seem, it only confirms that attempting to predict the madness of markets is folly. We make our money by taking advantage of any wild and irrational downward gyrations, not predicting when they will occur. For now, unfortunately, it seems the only gyrations are up.

INTELLIGENT INVESTOR

Sigma added, then removed

What brief trauma there was provided an opportunity to add a couple of stocks to the portfolio. Both **Infigen Energy** and **Sigma Pharmaceuticals** have been on the watch-list for a while and, for reasons unbeknown to your fund manager, were some of the hardest hit for the few days of volatility immediately following the Japan quake.

Sigma Pharmaceuticals is one of three 'full line' pharmaceutical wholesalers in Australia. This status obliges them to distribute the full list of drugs on the Federal Government's pharmaceutical benefits scheme (PBS) and entitles them to related government subsidies via the community service obligation (CSO) pool.

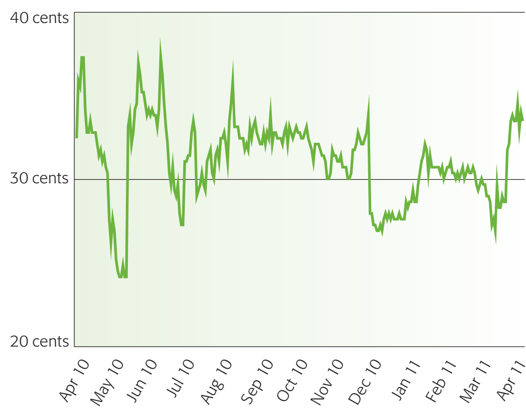
Once market darlings, the two ASX-listed participants (Sigma and API) now trade at substantial discounts to their net asset backing (the third, Symbion, is foreign owned). Unlike most other businesses, where most of the assets are property, plant and equipment, almost all of the assets owned by Sigma and API are inventories and receivables—liquid assets which should be converted to cash in fairly short order.

The shares are trading at a discount to net asset backing because management haven't been able to earn a decent profit relative to the asset base, firstly because the government has been reducing the price it is prepared to pay for Sigma's products and, secondly, because Sigma has been extending overly generous payment terms to its customers. (We understand that the rollout of Chemist Warehouse, for example, has been funded with 180 day credit from Sigma. That's six months Sigma has to wait to get paid, when it typically pays its own bills within 45 days).

New management, led by former Paperlinx CFO Mark Hooper, seem wholly focused on increasing the company's profitability to acceptable levels, even suggesting that they can perform their return on capital calculations on a pharmacy-by-pharmacy basis. Those pharmacies that are prepared to pay higher prices can have extended trading terms. Those that want discounts will have to pay their bills promptly. Either way, Sigma needs to earn an acceptable return. »

> **"We had been waiting for an attractive entry price and, when the share price dipped below $0.40, we were granted our wish."**

SIP SHARE PRICE



» It can't happen immediately without sending a number of pharmacies down the gurgler, but we expect that with working capital improvements Sigma will be able to generate something closer to 10% return on equity within the next few years. That would be a substantial improvement on the current levels of profitability and justify a market price commensurate with its book value.

> **If REC prices return to $100, Infigen's wind farms will be worth as much as $700m more than its $1.3bn in debt.**

That's the thesis. We had been waiting for an attractive entry price and, when the share price dipped below $0.40, we were granted our wish. We have since sold for a gain of 19% but have a good understanding of this stock and will be watching both the price and management's progress closely should further opportunities arise[1].

Infigen: Alinta's big brother

Infigen Energy shares some similarities with Sigma. It's trading at a substantial discount to our estimate of the value of its wind farms and is at the behest of government policy, in this case with regards to renewable energy. The opportunity, however, has more in common with our successful Alinta Energy investment than it does with Sigma.

The key to both investments lies in their somewhat complicated structures. Both have a lot of debt but that debt lies at a subsidiary level and is non-recourse to the parent companies. In Alinta Energy's case, cash and other assets at the parent level more than justified the security price at the time of purchase, meaning that if the subsidiary went bust, securityholders would still have been left with substantial value that the banks couldn't touch.

In Infigen's case, cash and other assets at the parent level equal about $200m. The current market capitalisation is $280m, so you need the debt-laden subsidiary to be worth something to do well out of the investment. Our view is that this is much more likely in Infigen's case than it was for Alinta.

Most of the value resides in Infigen's Australian portfolio of wind farms (the US wind farms are worth more but are financed in conjunction with US tax investors which leaves less equity for Infigen). And most of the reasons for the share price slump are also attributable to these assets.

Approximately 60% of the electricity generated by Infigen's Australian portfolio is sold under long-term contracts, some out as far as 2030. The remainder is sold at market prices, a combination of the base electricity price in whatever state it is produced, and the revenue from selling its associated renewable energy certificates (RECs).

Qualified renewable energy producers earn one REC for each megawatt hour (MWh) of electricity they generate (approximately enough electricity to power your home for two months). Electricity retailers must purchase enough of these RECs to cover stipulated percentages of their electricity sales, which creates a market and a market price for the certificates.

Businesses like Infigen need a price of somewhere between $100 and $120 per REC to justify building a new wind farm. The price for the last few years has averaged $45 and, accordingly, Infigen's wind

[1] *We don't usually buy and sell in a 19% range but this was a somewhat unique situation in that $0.15 of the value was about to be returned to shareholders as a dividend. Excluding that from the value and the share price, the ongoing business is now 33% more expensive than it was when we bought it, effectively erasing our margin of safety.*

farms that don't have long-term contracts have been generating substandard returns.

The low prices are unlikely to remain beyond the next 18 months at most. As can be seen in the graph below, the market has been swamped with RECs for the past two years thanks to misguided government policy on residential solar installations. The policy has been rectified, with retailers now needing to obtain 90% of their renewable energy requirements from large-scale providers, but the glut has not.

As the mandated targets ramp up over the next few years, though, it is quite clear that more capacity needs to be built. For this to happen, REC prices need to move back to levels that provide an adequate return on the cost of construction. There are enough surplus RECs in the market to last as long as three years but, with a typical lead time of more than four years to build a wind farm, retailers will need to commit to higher REC prices much sooner than that if they are to meet their requirements.

If REC prices return to $100, Infigen's wind farms will be worth as much as $700m more than its $1.3bn in debt. If they don't and Infigen fails to meet its debt obligations, securityholders will be left with the backstop of $170m in cash and the Woodlawn wind farm. There's no guarantee management don't fritter away the rest of the value too but, at today's prices, it looks an attractive trade-off.

UNIT PRICE SUMMARY

DATE
31 Mar 11

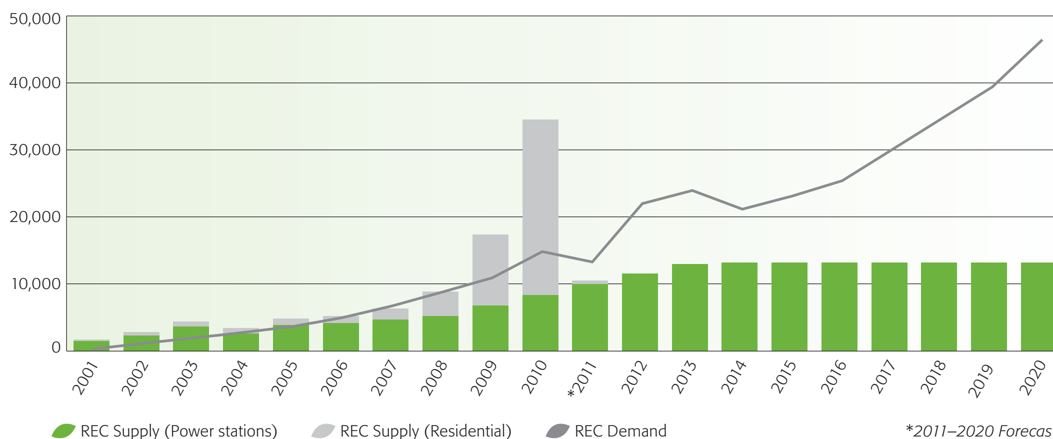
BUY PRICE
$1.0200

REDEMPTION PRICE
$1.0119

MID PRICE
$1.0160

"The low prices are unlikely to remain beyond the next 18 months at most."

SUPPLY AND DEMAND OF RECs



Source: Green Energy Markets

Kinghorn Kicks the Hornets' Nest

RHG's founder, chairman and largest shareholder John Kinghorn has finally done enough to upset his institutional investors, almost four years after he first upset retail investors with what the *New York Times* called the worst float of all time (the company, known as Rams Homeloans at the time, was funded out of the US and listed two weeks before the credit crisis hit).

At the company's AGM in November last year, Kinghorn announced that the company would be undertaking an optional, off-market buyback at $0.88 per share. While the deal substantially undervalued the company, it was a step in the right direction for a company that hadn't distributed one cent out of its rapidly growing pile of cash.

When the paperwork came out for the buyback, however, there were a few conditions that weren't included in the AGM announcement. After the buyback the company would continue its policy of not paying a dividend and, wait for it, delist.

In other words, shareholders can take the lowball buyback offer or end up owning an unlisted, John-Kinghorn-controlled entity that doesn't pay any dividends.

For us, this gun-to-the-head approach is probably the best thing Kinghorn has done. It has galvanised a disparate bunch of shareholders—some who wanted the buyback, some who didn't, some who wanted dividends, some who didn't—behind a push to reconstitute the board.

In 2009, we tried and failed to get board representation on behalf of Intelligent Investor members. This time around, Wilson Asset Management and Cadence Capital are requisitioning a meeting. The proposed board members are far more credible and the other institutional investors seemingly in the same camp. It seems there is a genuine chance of removing Kinghorn's control over the company and establishing a board committed to maximising value for all shareholders.

RHG has been one of our best performing stocks since the Value Fund began but it is still worth a lot more than the current price. Our estimate of the cash value is $1.40–$1.50 per share and there will be another $0.45–$0.50 in franking credits that can be distributed.

For the first time ever, the chances look reasonable that all shareholders will get the benefit of it.

IFN SHARE PRICE

PORTFOLIO DISTRIBUTION (by market capitalisation)

- Less than $100m **35.6%**
- $100m–$200m **16.5%**
- $200m–$1bn **24.0%**
- Over $1bn **11.3%**
- Cash **12.6%**

INTELLIGENT INVESTOR

US Commercial Property REITs

REIT	ASSETS	EXCHANGE	PRICE/BOOK VALUE
Boston Properties (BXP)	Class A offices in Boston, Manhattan, Washington DC, San Francisco and Princeton	NYSE	3.07
Brandywine Realty (BDN)	Class A surburban offices throughout US	NYSE	0.89
Mack-Cali Realty (CLI)	Class A office buildings in North Eastern US	NYSE	1.53
RNY Property Trust (RNY)	Class A office buildings in the New York Tri-State area	ASX	0.40
Real Estate Capital Partners USA Property Trust (RCU)	Various class A and government-leased properties across the US	ASX	0.49

US Commercial Property Opportunities

In 2010, a gulf emerged between the best and the rest in the US commercial property market. The prices for the best properties, with long-term leases and high quality tenants in prime locations like Manhattan and Washington, have almost returned to 2007 levels, up 35% from their lows at the height of the financial crisis. Outside this 'prime' market, prices have barely budged.

In the first quarter of 2011, the first signs emerged that the optimism is spreading. According to a report by Cassidy Turley, capitalisation rates have dropped 1.5% from their 2009 peak. More importantly, average asking rents increased 5% in the March quarter and, for the first time since 2007, net absorption (space leased less space vacated) was positive.

The reason things are improving is that the US economy is finally creating a meaningful number of jobs. In recent months a large number of the more than 200,000 per month have been office jobs and, with construction at a standstill for the last three years, existing office properties are well placed to benefit.

In US stockmarkets, office property trusts (REITs) are currently trading at a premium to their underlying net tangible assets (NTA), reflecting this improvement in the underlying market that hasn't yet been reflected in the trusts' NTA. Here in Australia, the two US REITs owned by the value fund, RNY and RCU, still trade at less than half NTA. There are some good reasons for the discounts, including onerous management contracts, high listing costs relative to their market capitalisations and unresolved debt issues. With more than 20% of the Fund invested in this asset class, though, we're confident the gap will narrow.

We'll report back on this, RHG action and the rest of what looks to be an interesting June quarter early in July. As always, please contact us if you have questions about any aspects of your investment.

Steve Johnson

Access your investment on the web

We're putting the finishing touches to an investor login section at www.iifunds.com.au. Once finished, you'll be able to view your investments, download tax statements and see the current value of your investment. We'll send out access details once it's complete.

Monthly Investing Option in the Value Fund

No initial $10,000 investment required.

Grow your investment over time*
with monthly contributions from $100 minimum.

Open to new and current investors.

Details online at www.iifunds.com.au/how-to-invest

Or call 02 9011 5206

*Recommended time frame is 3–5 years

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