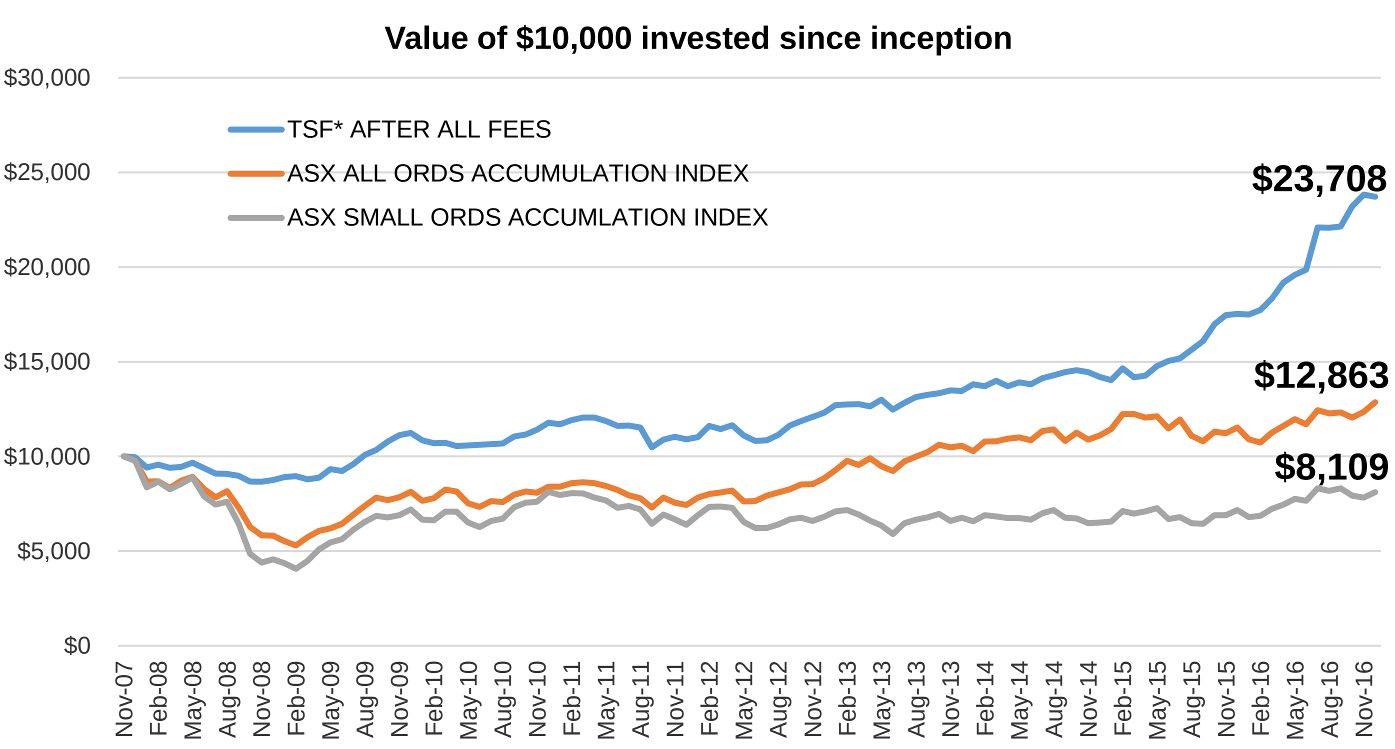
The Supervised Fund (TSF)

Monthly Report – December 2016

PERFORMANCE ANALYSIS	TSF AFTER ALL FEES	BENCHMARK	ALL ORDS ACCUM
Month ending 31 December 2016	**-0.49%**	0.42%	4.17%
6 months	**19.38%**	2.50%	9.94%
1 year	**35.29%**	5.00%	11.65%
3 years p.a.	**20.76%**	5.00%	6.76%
Since inception p.a. (since 1 Dec 2007)	**9.97%**	5.00%	2.81%



*Please note TSF returns assume reinvestment of all distributions (as do the indices).

At 31 December the portfolio was composed as follows:[1]

Top 15 Positions	% of NAV
Kangaroo Island Plantation Timbers Ltd	32.0%
Cash	7.7%
HGL Limited	9.5%
Bell Financial Group Limited	6.1%
Gale Pacific Limited	5.9%
Samuel Terry Absolute Return Fund	4.5%
Po Valley Energy Limited	3.5%
Hillgrove Resources Limited	3.0%
Base Resources Limited	2.9%
Osprey Medical Inc - CDI	2.9%
ETFS Physical Gold (AUD)	2.8%
NZME Limited	2.6%
APN News and Media Limited	1.8%
Sirtex Medical Limited	1.7%
Beadell Resources Limited	1.4%

- 0.1% of capital is invested in (put) options over stock market indices.
- 0.6% of capital is invested in non-ASX listed investments (excluding cash).
- 0% of capital is invested in ASX200 companies.
- 10% of capital is invested in oil, gas and resources companies (excluding gold).
- 9% of capital is invested in gold mining companies. A further 2.7% of capital is invested in physical gold.
- 51% of capital is invested in companies with a market capitalisation of less than $150m.

[1] Please note we treat our investment in the Samuel Terry Absolute Return Fund as an allocation to non-ASX200 equities.

Commentary

During December, global stock markets rallied as market participants increased their expectations regarding US growth, corporate activity and regulatory reform. TSF does not have material exposure to large cap or high beta stocks and accordingly did not participate in this so called *Trumponomics* rally. The largest positive contributors during December were **Hillgrove Resources Limited** (up 80%), **Gale Pacific Limited** (up 9%) and **Po Valley Energy Limited** (up 25%). These gains were offset by an 8% decline in **Kangaroo Island Plantation Timbers Limited,** which fell for no apparent reason, as well as a 5% decline in our **gold allocation**.

Towards the end of the month, **Hunter Hall International Limited's** CEO, founder and 'key-man' abruptly announced his departure from the business and sold 20% of the stock at a 67% discount to the market price. We sold the majority of our Hunter Hall shares over the past few months and were not materially affected by the shock decision. Hunter Hall has been a successful investment for TSF. For the majority of our holding, we realised a return in excess of 80% in less than 2 years. At the day of writing, the stock has fallen 20% since the news. TSF has a 1% allocation, down from 4% several months ago. The recent events are a stark reminder of the key man risk sometimes present in small companies.

Hillgrove Resources Limited

During December we invested 2% of unitholder capital in secured convertible notes issued by Hillgrove Resources Limited (HGO). The notes carry a 6% interest rate and convert to ordinary equity at a 30% discount to the share price. Furthermore, the notes came with a free 9–month call option,[2] effectively bestowing the right but not obligation to invest 4% of unitholder capital in the equity at a 30% discount, whilst maintaining a secured claim ahead of potentially onerous trade creditor debts.

These terms were agreed in September last year, when copper was at a seven-year low. Since then, the AUD copper price has increased 20%, which has dramatically increased the future prospects of the equity's value. We continued to buy the notes on-market during January. The notes, options and stock have all continued to rally.

HGO is an ASX listed pure play copper mining company whose sole operating asset is located in Kanmantoo, 55km south east of Adelaide. The Kanmantoo project has been a monumental failure; HGO's market cap declined from $230m in 2010 to $10m in 2016, despite raising new equity of $150m over those seven years. Although some of the value destruction is resultant from a declining AUD copper price, the bulk of the losses were owing to lower than anticipated feed grade, misalignment of employee and contractor incentives, and significantly higher CAPEX than originally expected.

18 months ago a seasoned mining operator was appointed CEO. He has significantly improved operating efficiencies and aligned the interests of key stakeholders. The company has undertaken a series of debt restructurings in order to simplify the capital structure. The current capital structure is as follows:

- $6m equity market cap at note conversion price[3]
- $30m trade creditors
- **$5m secured convertible notes** (junior to senior secured debt)
- $15m senior secured debt by way of direct debt and environmental bonds with the government of South Australia.

[2] Exercisable at the same discount to market price.
[3] Prior to the exercise of options and conversion of notes. The market cap would be $18m if notes were converted and options exercised and the company would have an additional $5m in cash.

At present Hillgrove is a marginal copper producer because of its very high strip ratio. For the past ~18 months the company has been undertaking a giant cutback to access more ore from the historically attractive Kavanagh Pit (in plain English below).

The Kavanagh Pit

The ore at the bottom of the Kavanagh Pit was most recently mined in 2014. At this time the pit yielded ~$70m cash flow over an 18-month period (there was more debt back then!). The copper rich ore continues at-depth and to each side. In order to access this ore HGO has been undertaking a giant cutback, effectively expanding or ‘cutting back’ one wall of the pit by moving vast quantities of earth. To this end, the cutback is 90% complete and HGO has spent over $60m on earth movement – the recent raising provides the final capital needed.

From June 2017 until late 2019, the company should be mining the higher grade copper ore and will operate in the bottom quartile of the cost curve. At current AUD copper prices this would generate in excess of $100m in free cash flow - cash backing would be more than 5x the conversion price. As always, there is minerology risk associated with this thesis. Because we are not geologists we are forced to trust the company’s mine plan. To this end we are comforted by the fact that the orebody was mined as recently as 2014.

If AUD copper prices fall 40% or more (to all-time lows), the mine-plan would not yield positive cash-flow and the equity would likely be worthless. In this scenario there is still a fair chance we receive our principal back because the company has plant and equipment, with salvage value near $20m. We hope the management will mitigate this risk by entering price hedging activities.

The major shareholder is a well-known activist investor. We expect their presence will ensure the company utilises its $20m franking account balance and returns excess cash as dividends. While there are many obstacles still to overcome, we believe the outlook for Hillgrove Resources has finally improved and are comfortable with the risk/reward characteristics of the convertible notes.

Mitch Taylor - 17 January 2017.

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