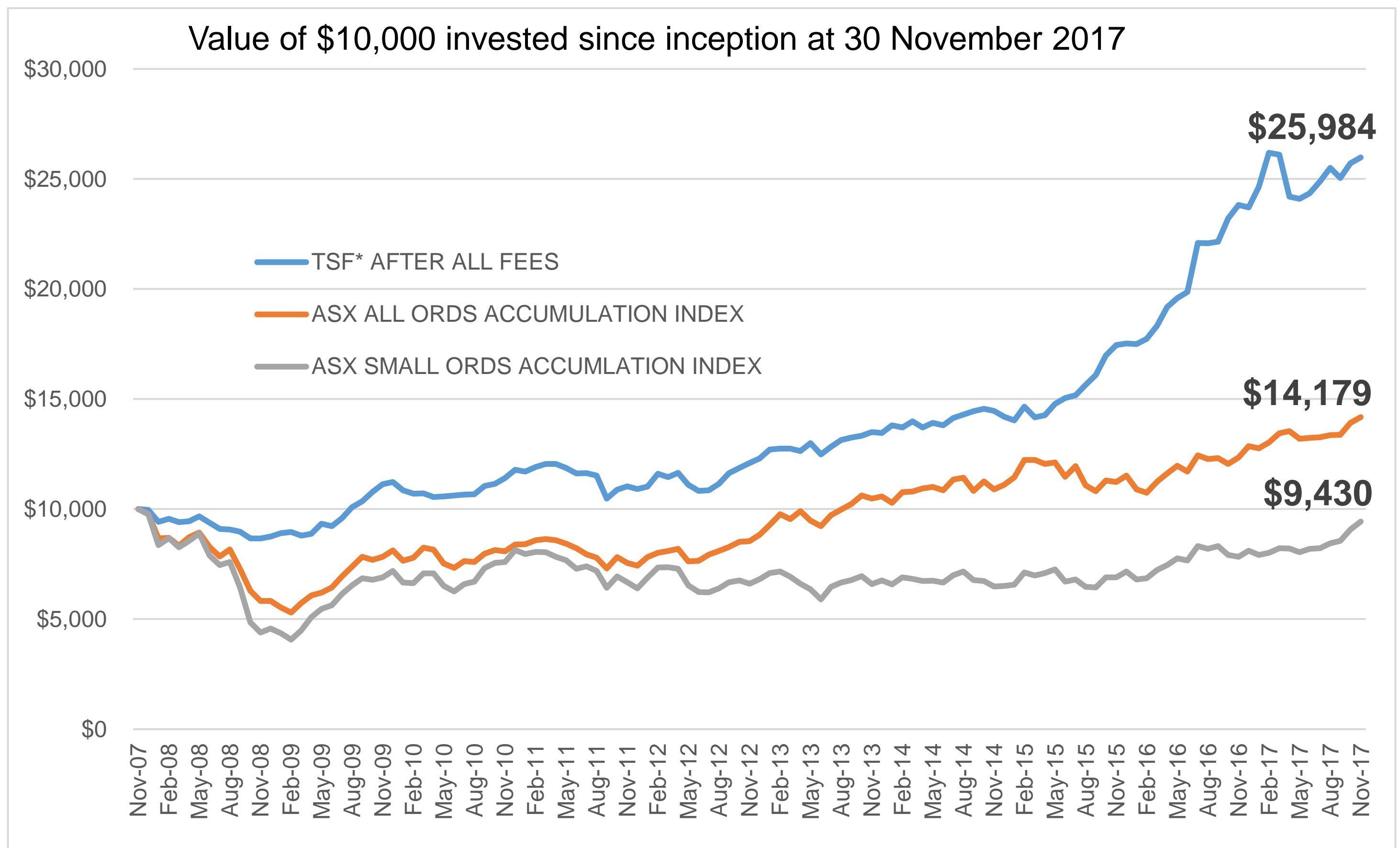
The Supervised Fund (TSF)

Monthly Report – November 2017

Performance Analysis (as at 30 November 2017)	TSF after all fees	Small Ords Accumulation	All Ords Accumulation
1 month	**1.0%**	3.3%	2.0%
12 months	**9.1%**	19.8%	14.9%
3 years p.a.	**21.6%**	13.1%	9.2%
5 years p.a.	**16.5%**	7.3%	10.7%
7 years p.a.	**12.5%**	3.1%	8.4%
10 years p.a.	**10.0%**	-0.6%	3.6%
Since inception p.a. (Dec. 2007)	**10.0%**	-0.6%	3.6%

Past performance is no indication of future performance



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

Portfolio at 30 November 2017

Top 10 Positions	% of NAV
Kangaroo Island Plantation Timbers Ltd	26%
Cash	16%
Hillgrove Resources Limited (equity & notes)	10%
HGL Limited	9%
Po Valley Energy Limited	7%
Bisalloy Steel Group Limited	4%
ETFS Physical Gold	4%
Engenco Limited	4%
Base Resources Limited	2%
Bell Financial Group Limited	2%

- 0.4% of capital is invested in (put) options over stock market indices.
- 1% of capital is invested in non-ASX listed investments (excluding cash).
- 22% of capital is invested in oil, gas and resources companies (excluding gold).
- 5% of capital is invested in physical gold and gold mining companies.
- 71% of capital is invested in companies with a market capitalisation of less than $150m.

Commentary

The Supervised Fund's November return of 1% was driven by Creso Pharma Limited (up 96%), Engenco Limited (up 32%), and Kangaroo Island Plantation Timbers Limited (up 3%). Our investment in Creso Pharma, which is developing medical cannabis therapeutic products, was a short-term position. We bought in at the end of October at 54c and sold out three weeks later at $1.06. This rapid share price appreciation is characteristic of the current fervour in the medical cannabis market, in which a multitude of mergers and acquisitions are occurring as the Australian government moves closer to legalising the plant for medicinal purposes. Engenco's share price increased as the company released a market update announcing that the positive momentum of the second half of FY2017 is continuing into FY2018, with a material improvement in profit expected. Engenco will be discussed in further detail below. KPT shares rose after the company announced that Mitsui had agreed to purchase up to 500,000 green metric tonnes per annum of woodchip for at least the first five years of harvesting. On the second last day of November, KPT went into a trading halt to conduct a $20m placement at $2 per share, a 21% discount to the last traded price of $2.41. We felt a more accurate price for valuation purposes was $2.35, the last bid price as at 30 November. At the time of writing, the share price is $2.27.

The main detractors during November were Namoi Cotton Limited (down 17%), Hillgrove Resources Limited convertible notes (down 10%), and Gale Pacific Limited (down 4%). Namoi shares decreased in price for no apparent reason, following a 43% rise during the previous month. Hillgrove notes similarly fell on no news, with just 576 securities traded during the month at a total value of $1,451.50. Trading in these securities has almost completely ceased since the company issued an early redemption notice. The notes will be repaid on 22 December 2017 if not converted into shares at 3c beforehand. It is likely the majority of noteholders will convert, since the last share price of Hillgrove was 8c. This should be a positive step for the company as it will reduce debt by $5m. We are currently in the process of converting our notes. The price of Gale Pacific shares also declined on no news.

November was a significant milestone for The Supervised Fund, which has now been operating in its current Australian vehicle for ten years. We are pleased to report that since its inception on 1 December 2007, the fund has returned 10% compound per annum after all fees, compared to the ASX Small Ordinaries Accumulation's -0.6%.

Engenco Limited

Over March to November 2017, we invested 2.5% of unitholder capital into Engenco Limited, an industrials company specialising in diesel engine and locomotive maintenance and parts supply. The company, which listed in December 2006, had a spectacular fall from a high of $17.65 in July 2007 to a low of 6c in January 2016. This was due to high net debt levels, peaking at $147m in mid-2009 (when the company's market cap was $25m), coupled with the downturn in the resources sector from mid-2011, which led to the company's revenue decreasing by 33% from FY2011 to FY2016 (around half of the company's revenue is derived from the resources sector). In addition, Engenco had four consecutive years of net losses, from FY2012 to FY2015. When we first started looking at the company in early 2017, after it came up on our proprietary Supervised System screen, it was trading at a 20% discount to its tangible book value per share and on an EV to EBITDA multiple of 4x. It had recently, in August 2016, posted its first full year profit in five years and had moved into a net cash position for the first time since listing. Therefore, it had all the typical attributes of a turnaround company that had fallen out of favour with shareholders after years of sub-zero returns and worrying debt levels, with negative sentiment resulting in overselling and a share price that undervalued future earnings.

After in-depth research, including visiting Engenco's headquarters in Melbourne, we concluded that the company was an attractive investment. The management team was impressive and clearly dedicated to the business. The CEO, Kevin Pallas, had begun his role in February 2015, when the company began to turn around. He was reducing excess costs and to our particular liking was keen on maintaining low debt levels. We were happy with the position of the 65%-owner of the company, Elphinstone Group, which is an original equipment manufacturer of Caterpillar in Australia, with annual revenues in excess of $1 billion. The Group's founder, Dale Elphinstone, is a non-executive director of Engenco. We also felt the company was operating market-leading, specialised businesses in industries experiencing considerable growth: mining services and infrastructure.

Although Engenco has five subsidiaries, two of them, Drivetrain and Gemco Rail, consistently account for over 70% of revenue. Drivetrain provides parts sales and maintenance for heavy duty vehicle powertrains (comprising the engine, transmission, drive shafts, and differentials) and power generation equipment. Since over 50% of revenue comes from the resources sector, Drivetrain had a difficult few years, with EBITDA declining by 91% between FY2011 and FY2015. It has since shown signs of recovery, with earnings increasing over the last two years. Gemco is a supplier of rolling stock products and maintenance services. It is the third largest player in the Australian rail industry after Downer and UGL. It operates in a unique position, as Downer and UGL compete for the biggest contracts, leaving Gemco with its own market space comprised of medium-sized railway carriers looking for more flexible services. With only 30% of its revenue derived from the resources sector, Gemco's revenue and earnings have been growing since FY2015. Two of Engenco's other three subsidiaries are service providers in the rail industry and are accordingly complementary to Gemco. The remaining subsidiary designs and maintains aluminium pneumatic tankers for the transport of bulk dry goods by road and rail. It is less complementary, has struggled to break even in the last two years, and we see it is a divestment opportunity.

After the company released their FY2017 half-yearly results in February, it was apparent that there had been a significant upturn in its core businesses. Underlying EBITDA was up nearly three times on the second half of FY2016, with Gemco's earnings up 130% and Drivetrain's up 9%. We were comfortable these businesses could maintain or even surpass first half earnings in the second half, which would mean significant full year growth in FY2017. The basis for our confidence was the increasing government spending on infrastructure, which was fuelling heightened activity in the railway industry, and the equipment maintenance cycle and upturn in commodity prices, both of which were driving increased capital expenditure amongst mining companies.

In late July, Engenco announced to the market that conditions had in fact improved in the second half of FY2017. When the full year result was released at the end of August, EBITDA for the full year was up by 97% on FY2016. Gemco grew earnings by another 15% on the first half and corporate costs were cut by 5%. The company also declared its first dividend (albeit at a 2% yield) since FY2008. This was a particularly positive indicator to investors, since the board repeatedly asserted they would only consider a dividend once they comfortably foresaw sustained earnings in future years. The market received the news positively, with the share price rising by nearly 50% over July and August. We maintain our confidence in Engenco's prospects. If they can continue their second half run-rate through the new year, FY2018 EBITDA should see a further 14% increase. The chance of this outcome was elevated when the company released a market update in November stating that the board "anticipates material improvement" in FY2018 profit compared to FY2017. We look forward to continuing our association with Engenco and will update unitholders on the company's progress.

David Constable, Portfolio Manager

20 December 2017

	TSF after all fees	Small Ords Accumulation	All Ords Accumulation
Since inception p.a. (Dec 2007)	10.0%	-0.6%	3.6%
Financial year to date	6.7%	14.4%	7.2%
Calendar year to date	9.6%	15.6%	10.3%
FY17	22.6%	7.0%	13.1%
FY16	32.0%	14.4%	2.0%
FY15	9.0%	0.4%	5.7%
FY14	10.6%	13.1%	17.6%
FY13	15.3%	-5.3%	20.7%
FY12	-6.8%	-14.6%	-7.0%
FY11	9.4%	16.4%	12.2%
FY10	15.1%	11.2%	13.8%
FY09	-1.7%	-28.6%	-22.1%

The Fund's benchmark is 5% per annum. Small Ords Accumulation and All Ords Accumulation are included for the sake of comparison to the predominant Australian equity indices.

DISCLAIMER

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