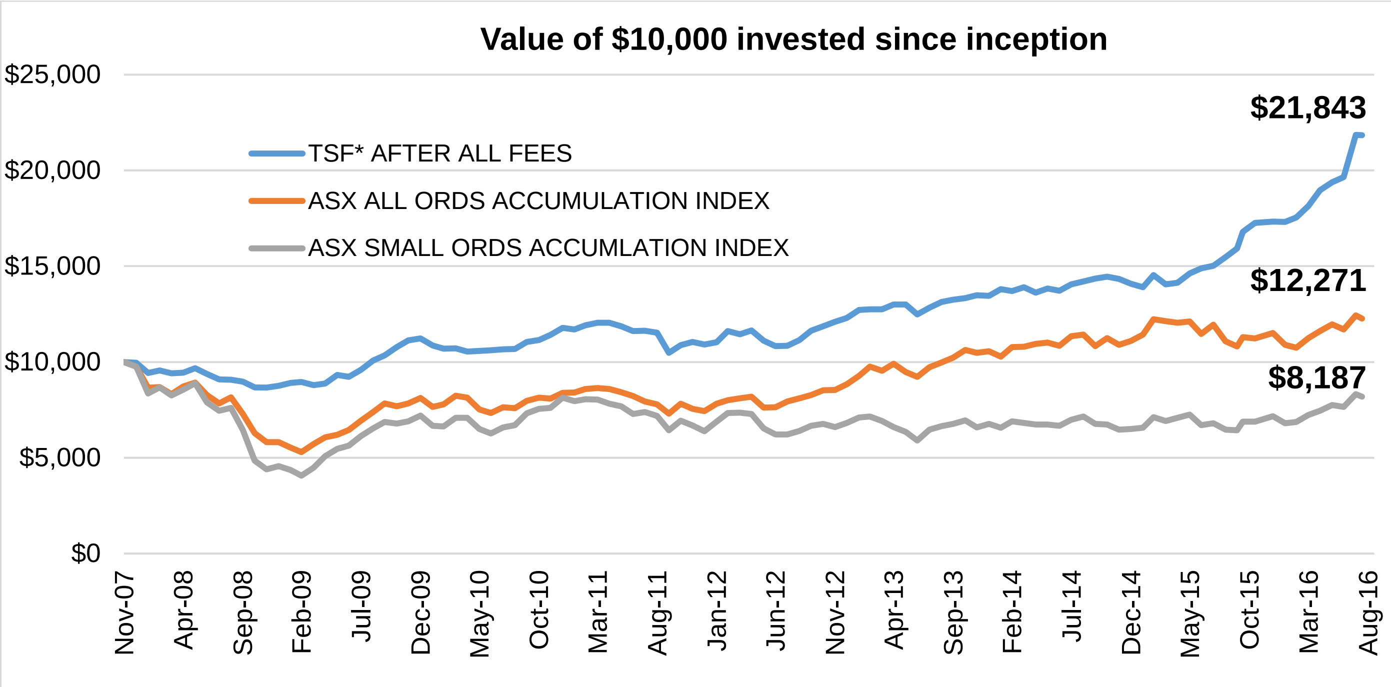
The Supervised Fund (TSF)

Monthly Report – August 2016

The Fund's performance compared with the All Ords Accumulation Index is set out as follows:

	TSF AFTER ALL FEES	ALL ORDS ACCUM	TSF OUTPERFORMANCE
Month ending 31 August 2016	-0.07%	-1.33%	1.26%
6 Months	24.49%	14.25%	10.25%
1 year	41.16%	10.72%	30.45%
3 years p.a	18.46%	7.12%	11.34%
Since inception p.a (since 1 Dec 2007)	9.43%	2.39%	7.04%



*Please note TSF returns assume reinvestment of all distributions.

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

Top 15 Positions	% of NAV
Kangaroo Island Plantation Timbers Ltd	30%
HGL Limited	9%
Bell Financial Group Limited	7%
Cash	7%
Gale Pacific Limited	6%
Australian Vintage Limited	5%
Samuel Terry Absolute Return Fund	4%
Hunter Hall International Limited	4%
Po Valley Energy Limited	3%
Sirtex Medical Limited	3%
IMF Bentham Limited	2%
Base Resources Limited	2%
Osprey Medical Inc – CDI	2%
Beadell Resources Limited	2%
Ramelius Resources Limited	1%

- 0.5% of capital is invested in (put) options over stock market indices.
- 2% of capital is invested in non-ASX listed investments (excluding cash).
- 5% of capital is invested in ASX200 members.
- 6% of capital is invested in oil, gas and resources companies (excluding gold).
- 7% of capital is invested in gold mining companies.
- 74% 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 August, most ASX listed companies announce annual results and provide an opportunity for investors to meet with management. We met with the leaders of most of our holdings and were on the whole impressed with their progress and prospects. Bell Financial Group Limited was our best performer during the month and returned 34% on the back of a solid half-year result and promising outlook. Other positive contributors included Hunter Hall International Limited (up 4%), IMF Bentham Limited (up 10%), and Sirtex Medical Limited (up 7%). APN News and Media Limited (down 8%) and our portfolio of gold stocks (down 8%) were the worst performers during the month.

Kangaroo Island Plantation Timbers Limited (KPT)

KPT traded as high as $27 during the month before closing at $24.50 on very low volume. For the August NAV, we again instructed our fund administrator to value KPT at the bid price, which decreased $0.50 month-on-month to $19.50. Given the size of the position and its inherent illiquidity, we deemed it appropriate to adopt a conservative valuation.

The upside to our KPT position is contingent on the existence of a deep water wharf on Kangaroo Island. KPT's biological assets (planted timber which is mostly ready to be harvested) can only be turned into cash if there is a means to transport the timber to an end consumer. If there were a deep water wharf, we estimate KPT would operate in the bottom quartile of all timber producers in the world (on a cost basis). With this in mind we were encouraged to read the following in the company's Annual Report (p40):

> *The Company now considers the development of wharf infrastructure that allows exploitation of the substantial standing timber resource to be virtually inevitable. What is not yet certain is the form and location of the wharf and the terms on which the company may be able to obtain access.*

Given the present condition of the South Australian economy, the state and local governments are presumably supportive of a wharf development and its associated employment opportunities. We expect government involvement in conjunction with the fact KPT owns one of the two proposed development sites will ensure access to any wharf on desirable terms. The board are seemingly bullish and continue to prefer to be paid in shares. We are looking forward to an update at the AGM early next month.

Namoi Cotton Co-Operative Limited capital units (NAM)

We recently invested approximately 1% of unitholder capital in NAM, whose primary business is owning and operating cotton gins. A cotton gin separates cotton fibres from seeds and converts harvested cotton into a finished format. In addition NAM has a 51% stake in a joint venture marketing business which purchases and distributes ginned cotton into Asia all the while hedging price risk by way of cotton futures in the US.

Several years ago this marketing business nearly bankrupted the co-operative as the difference between the price of cotton in Asia and the US (the basis) ballooned. The firm was effectively unhedged and booked significant cash losses. NAM subsequently sold a 49% interest in the marketing business to global trading house Louis Dreyfus. By doing so, NAM mitigated the risk of future collapses as the new partner has an ability if need be to deliver physical cotton to the US exchange.

The majority of EBITDA is generated from the ginning business. NAM owns 13 gins and is the biggest player in Australia with an estimated 30% market share. Cotton ginning requires significant fixed assets and has equally significant operating leverage. Although NAM's co-operative roots might suggest the pricing structure is generous towards the grower 'owners', in reality the industry is competitive and NAM is forced to meet the market price.

Ginning EBITDA is largely a function of throughput. Given NAM's competitive position, throughput is driven by the size of the cotton crop which is in turn reactive to the availability of irrigated water in the Northern NSW and Southern QLD farming regions[2]. Accordingly, NAM's EBITDA can be volatile - although the firm has made a profit from ginning in each of the last 10 years.

The near collapse of the marketing business and a series of poor cotton crops has starved the business of cash. The gins need capital investment in the order of $15- $20m to improve efficiencies, capacity utilisation and return earnings margins to historical averages. In the present form we estimate the co-operative would generate a return on tangible equity[3] of only 5% in an average cotton year. The current market valuation of ~$40m or 35% of the net tangible asset value suggests this cannot be improved. We have inspected the sites and believe modest capital works could more than double this return on tangible equity and increase average utilisation to 70%.

The capital units do not presently carry sufficient voting entitlement. In order to source new funds, the inefficient co-operative needs to be converted to a modern company. To this end, the Board has appointed a corporate advisor and is in the process of negotiating with both stakeholders. We believe it is in all parties' interest to follow through with the proposal. We don't believe the co-operative model is appropriate for the 21st century and expect the grower members would benefit from a faster service without a corresponding increase in price. The capital holders will benefit from increased voting power and earnings from operational efficiencies expected from new investment. We also think a modern company structure could facilitate a reduction in corporate overheads, which look high from the outside.

Our conservative estimate implies the current market price represents a 50% discount to the post conversion net tangible assets per share, or a normalised P/E ratio of 6-8x in an average cotton crop. We like the business' high barriers to entry, significant tangible asset backing and industry exposure. We are intrigued by the situation and will consider allocating more capital if and when we have a better understanding of the future corporate structure.

Market Outlook

During company reporting season our practice is to participate in as many company meetings and teleconferences as possible. Meetings discussing sectors and stocks we don't like are often just as valuable as those with the management teams with which we have invested. We discovered corporate managers are generally optimistic about the economic environment and are forecasting earnings growth from increased revenues rather than cost cuts. Managers are not overly concerned with risks pertaining to international pressures. We observed continued investor interest in the 'growth' sector over the larger cap stocks. Perhaps most interestingly we came to the view that retail investors are rotating out of cash into equities while the institutional managers are doing the opposite. We continue to consider the consequences and seek to create a portfolio which would be expected to perform under a multitude of market scenarios.

Mitch Taylor – 20 September 2016.

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[2] Cotton is generally the highest yielding crop to farmers, however it is very 'thirsty' and requires more water than alternatives. History suggests farmers will plant cotton if they believe access to affordable water can be obtained. Please note the availability of water in these regions has not been jeopardised by an emergence of extra 'thirsty' exotic crops like almonds, as has been the case in the lower and central NSW farming regions. The regions where NAM is exposed are mostly dry and are not expected to see these sort of water price pressures - at least in the medium term.

[3] The majority of tangible assets are cotton gins which are held at 'fair value' as determined by Colliers International.

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