Officium Special Situations Fund

SECTOR FUNDS

Quarterly Report March 2011

OFFICIUM CAPITAL

Stockmarkets Sail Through Quarter Of Trauma

Performance Data as at	31/03/2011
1 month	2.55%
3 months	6.06%
6 months	8.02%
1 year	4.14%
2 years (p.a.)	21.87%
3 years (p.a.)	0.05%
5 years (p.a.)	1.35%
Since 30/09/2004	2.33%
Net Asset Value ($)	0.9294
Fund Size ($ million)	39.10

Top 10 Portfolio Holdings	%
Oceania Capital Partners Ltd.	17.99%
CASH	12.76%
Spark Infrastructure Group	8.75%
Photon Group Limited	7.35%
QBE Insurance Group Limited	6.99%
UXC Limited	6.59%
Transfield Services Infrastructure	5.86%
Resolute Mining Ltd.	5.33%
Map Group	4.77%
Reckson New York Property Trust	4.51%
Other holdings	19.10%
TOTAL	100.00%

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 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 were 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 again downgraded Portugal's sovereign debt. 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 US$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.

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 are failing to rein in the cheap-money-induced lending boom.

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%. The Officium Special Situations Fund outperformed both, rising 6.1% for the quarter.

So much for the quarter of trauma. As irrational as this might seem, it only confirms that attempting to predict market fluctuations is folly.

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OCP Sells Signature Security

There were a number of contributors to the Fund's positive performance for the quarter. Oceania Capital Partners (OCP) announced that it had reached agreement to sell its Signature Security business to Tyco International.

The price, in line with OCP's carrying value, wasn't extraordinary. But with OCP trading at a large discount to its asset backing, the transaction was viewed favourably by the market and the price rose 21% for the quarter. Thanks to a takeover offer for its largest investment, healthcare IT company iSOFT, OCP's price has risen another 46% since the end of the quarter but we will write about that next quarter.

Another infrastructure fund draws foreign takeover

In late February and early March, the Fund established a position in Transfield Services Infrastructure Fund (TSI). On the last day of the quarter, TSI announced it had received a takeover offer from Thai power company Ratchaburi. The $0.85 Ratchiburi is offering represents a 49% premium to our average purchase price and looks fair.

A higher bidder looks unlikely but, unless the Manager needs the funds for other investments, OSSF will likely hold until the proceeds are received (expected to be prior to 30 June 2011).TSI joins Alinta Energy and Prime Infrastructure on OSSF's list of successful infrastructure investments during the past year and, while the list of potential investments is dwindling, the Manager still sees it as a fertile section of the market.

Sigma adds another short-term success

Japan's troubles did provide a few days of trauma and the Manager took the opportunity to add a couple of new stocks to the Portfolio. Both Infigen Energy (IFN) and Sigma Pharmaceuticals (SIP) have been on the watch-list for a while and, for reasons beyond the Manager's comprehension, were some of the hardest hit during the few days of volatility 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. (For example, the Manager understands that the rollout of Chemist Warehouse has been funded with 180 day credit from Sigma.)

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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.

It can't happen immediately without sending a number of pharmacies broke, but the expectation is 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.

That's the thesis; the Manager had just been waiting for an entry point that offered a large enough margin of safety. When the share price dipped below $0.40, the gap between price and value looked appropriate.

The shares have since been sold for a gain of 19% following the half-year results and the announcement of a 15-cent fully franked dividend. Such a quick buy and sell is not typical but this is a unique situation. It was very clear that the company had excess cash from the sale of its manufacturing business to Aspen Pharmaceuticals and that it intended to return that cash to shareholders with franking credits attached.

Excluding the $0.15 dividend from the value and from the share price, the remaining business is now 33% more expensive than it was when OSSF bought it, effectively erasing the margin of safety.

The Manager has a good understanding of this stock and will be watching both the price and management's progress closely should further opportunities arise.

Infigen: Alinta's big brother

Infigen Energy shares some similarities with Sigma. It's trading at a substantial discount to the Manager's estimate of 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 the successful Alinta Energy purchase, which resulted in a doubling of OSSF's small 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, security holders 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, which means the debt-laden subsidiary needs to be worth something to do well out of the investment. The 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).

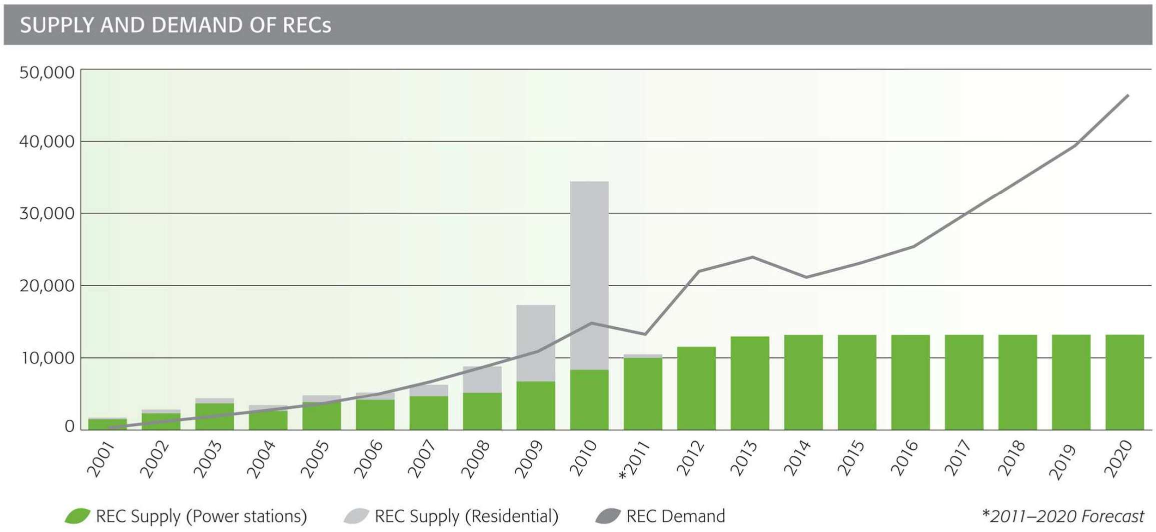
Qualified renewable energy producers earn one REC for each megawatt hour (MWh) of electricity they generate (approximately enough electricity to power your home for two months). Electricity retailers must purchase enough of these RECs to cover stipulated percentages of their electricity sales, which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



Source: Green Energy Markets

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 Officium Special Situations Fund, RNY Property Trust (RNY) and Real Estate Capital Partners USA Property Trust (RCU), still trade at less than half NTA. There are some good reasons for discounts, including onerous management contracts, high listing costs relative to their market capitalisations and unresolved debt issues. With almost 10% of the Fund invested in this asset class, though, the Manager is confident the gap will narrow.

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REIT	Assets	Exchange	Price/Book Value
Boston Properties (BXP)	Class A offices in Boston, Manhattan, Washington, D.C., San Francisco and Princeton.	NYSE	3.07
Brandywine Realty (BDN)	Class A suburban offices throughout U.S.	NYSE	0.89
Mack-Cali Realty (CLI)	Class A office buildings in North Eastern U.S.	NYSE	1.53
RNY Property Trust (RNY)	Class A office buildings in the New York Tri-State area	ASX	0.4
Real Estate Capital Partners USA Property Trust (RCU)	Various class A and government-leased properties across the U.S.	ASX	0.49

Source: Yahoo Finance

Other quarterly action

It has been a year of transition for OSSF as the portfolio has been progressively handed over to Intelligent Investor Funds. The Fund sold the last of its Resolute Mining (RSG) shares in early April and, with OCP looking like it could return most of its value to shareholders in the relatively short term, the transition should be complete by 30 June 2011.

We look forward to that point and to growing your investment thereafter. Quarterly reports like this one will be a regular feature of the Fund from now on and, as always, feel free to contact us should you have any questions about your investment.

Kind regards,

Steve Johnson
Chief Investment Officer
Intelligent Investor Funds