Mosaic Special Situations Fund

Quarterly Report December 2011

The Mosaic Special Situations Fund outperformed the index in the December quarter, rising 3.9% versus a 1.9% increase in the S&P/ASX All Ordinaries Accumulation Index. There were two announcements during the quarter that added meaningfully to both the value of the Portfolio and the unit price (look for the sections relating to **Photon Group** and **ING Community Living Group**).

The solid December quarter capped off a good year for the Special Situations Fund, with an overall return of 10.0% compared to the S&P/ASX All Ordinaries Accumulation Index decline of 11.4%. This outperformance is largely attributable to the oversized weighting to **Oceania Capital Partners**, discussed below, up 120% over the previous 12 months (inclusive of the upcoming $0.30 capital return).

Oceania Capital Partners (OCP)

At OCP's resumed Annual General Meeting, shareholders overwhelmingly voted in favour of the revised 'continuation offer'. All shareholders will now receive $0.30 per share cash and have the option to sell at least 90% of their shares to OCP at $2.15 each in early February.

The Manager views this as a sensible outcome for all shareholders involved, albeit still at an 8.5% discount to the last reported net asset value, and the buy-back will allow the Special Situations Fund to substantially reduce its position size in OCP. The Manager will form a view as to whether to retain a smaller position in OCP closer to the buy-back date.

Punters get impatient with UXC

IT services company UXC was the main negative contributor to the Special Situations Fund performance in the December quarter. There was some justification for a share price fall but the magnitude—a 17.1% decline, adjusted for a $0.02 capital return—seems unwarranted.

At the company's annual meeting CEO Cris Nicolli told shareholders that he was 'confident in a much improved second half'. That's a euphemism for 'profit in the first half is going to disappoint you', hence the share price decline.

The Manager is impatient to see profit and dividends just like everyone else. But real world turnarounds take time and Nicolli has had an excellent 2011. He managed to sell the non-IT part of the business for a reasonable price, repay all of the company's debt, restructure a large number of disparate businesses into six logical business lines, grow revenue and add some much needed fresh blood to the board.

Now he needs to increase margins and slash corporate overheads. With net cash in the bank and (in stark contrast to last year) time to focus on these issues, the Manager is prepared to be patient.

Performance Data as at	31/12/2011
1 month	-1.05%
3 months	3.93%
6 months	-2.23%
1 year	10.01%
2 years (p.a.)	3.63%
3 years (p.a.)	28.79%
5 years (p.a.)	-0.05%
Since Inception (p.a.)*	2.59%
Net Asset Value ($)	0.9353
Fund Size ($ million)	34.75

* Inception date of Fund 30/09/2004

Top 10 Portfolio Holdings	%
Oceania Capital Partners Ltd.	28.99%
Cash	9.75%
Infigen Energy	8.97%
QBE Insurance Group Ltd	7.30%
Photon Group Limited	7.28%
UXC Limited	5.69%
ING Real Estate Community Living	5.13%
1300 Smiles Limited	4.93%
Reckson New York Property Trust	4.56%
Tassal Group Limited	3.52%
Other holdings	13.87%
TOTAL	100.00%

NOTE: Due to the high concentration of Oceania Capital Partners Limited (OCP) in this Fund, any purchase of new units in the Fund is effectively equivalent to investing circa 29% of your funds in OCP as at 31 December 2011. Please be mindful of this when considering a new investment into the Mosaic Special Situations Fund or purchasing additional units in the Fund.

ILF makes something out of nothing

Just before Christmas ING Real Estate Community Living Group (ILF) announced that it would be writing up the value of its US assets by $0.07 per unit in its 31 December accounts. Normally, changes in accountants' estimates of asset values are meaningless—investors should be focused on cashflow and their own valuation of those assets.

But the ILF announcement provides useful information. These US assets are up for sale and the new valuations are reflective of a number of indicative bids received by ILF. Due to the large amount of non-recourse debt against these assets, the net value on ILF's balance sheet was only $0.02 per security (versus $0.26 of total net tangible assets). The revaluation means the board is expecting at least $0.09 per security from the sale of these assets. For comparison, the unit price at 31 December was just $0.16.

The proceeds probably won't be returned to unitholders. CEO Simon Owen, held in high regard by the Manager and other shareholders, has a number of sensible incremental investment opportunities that will utilise most of the capital released from the US.

Progress is also being made on an internalisation of ILF's management and a potential solution is expected to be put to unitholders soon. With a bit of luck, by the time June comes around ILF will be paying regular distributions, have its own well-regarded management team, own a portfolio of good quality Australian retirement assets and a pipeline of attractive future investment opportunities. The stock price rose 23% during the quarter.

Photon bruised and battered but out of the woods

With the sale of its field marketing business to private equity group Navis Capital, Photon Group is finally out of the woods. The company now has net cash, a remarkable turnaround from the $450m net liabilities the company had 18 months ago.

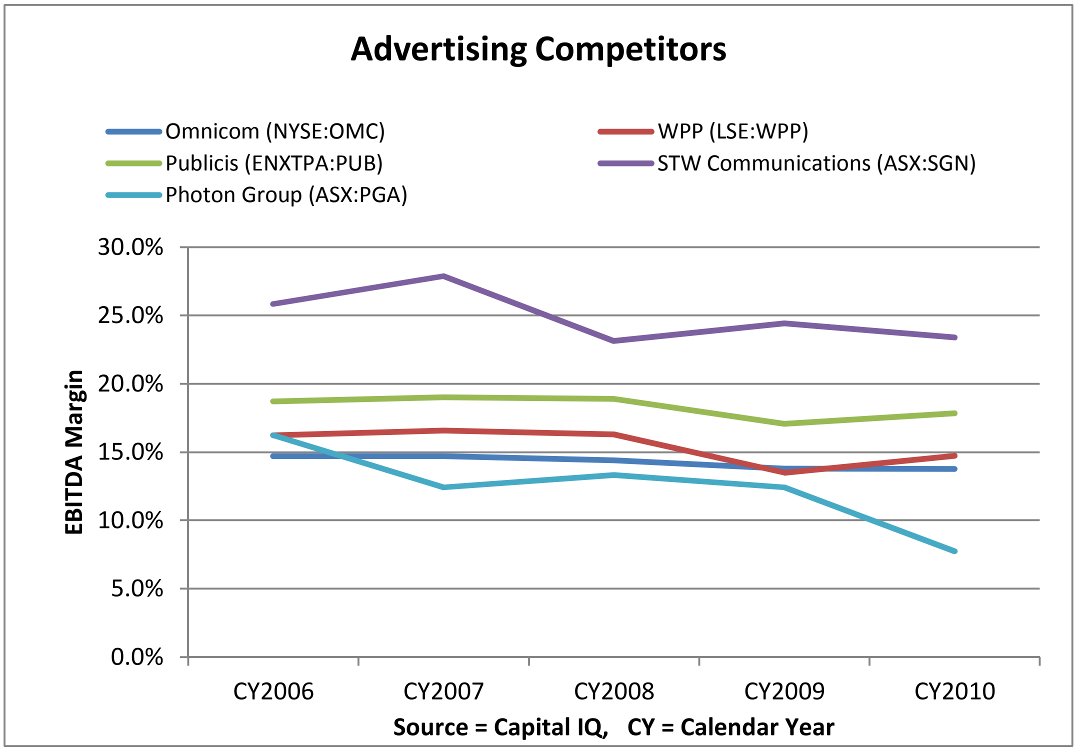
The value of what's left is difficult to ascertain with any degree of clarity. Even more so now that the architect of Photon's turnaround, CEO Jeremy Philips, has tendered his resignation. Even on extremely conservative assumptions, however, the Manager believes that the stock remains cheap.

The sale of the field marketing businesses generated $146.5m for Photon, enabling it to repay all of its outstanding debt and retain $21.5m of cash surplus to requirements.

It's now left with 14 businesses that generated $210m of revenue in the 12 months to 30 September. Six of those contribute 90% of the company's earnings (the big six are Australian marketing agencies BMF and BWM, international agencies Naked and the Leading Edge and UK public relations companies Frank and Hotwire).

If the remaining businesses generate $200m of revenue and earn margins of 15%, Photon will produce $30m of operating cashflow. Subtract depreciation and tax and shareholders will be left with approximately $20m of post-tax cashflow per year. That would represent a 20% return on the current market capitalisation of approximately $100m.

The Manager believes that the revenue should be higher, and that the margins should be significantly higher (see the graph below for a comparison with Photon's historical averages and some comparable listed companies).



There are still plenty of problems. The board doesn't seem to have a replacement CEO to start with. And the company can't pay dividends for another five years due to contractual arrangements with vendors related to contingent earnout payments (Photon will only have to make the payments if operating earnings are 80% higher than the $30m estimated above). But despite the share price rising 77% during the quarter, the Manager believes that it's hard to see a disastrous outcome from here.

Rumours of further corporate action abound, including the potential for a takeover offer from global marketing giant WPP, or a merger with fellow ASX-listed marketing company **STW Communications**. The later would make particular sense, given Photon has the international exposure and growth potential STW doesn't have, and STW has the infrastructure and management Photon doesn't have. With Photon's future assured though, shareholders are in a position to make sure any deal is a good one.

Retailing in Australia

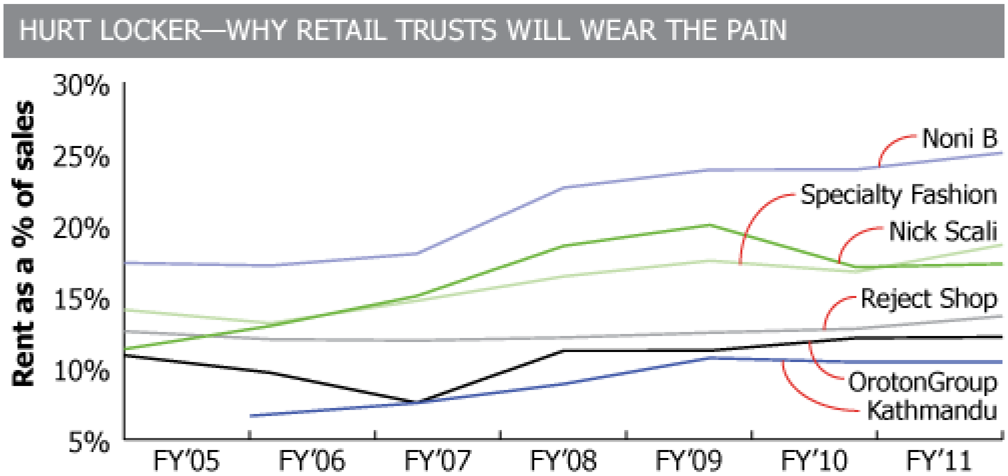
The past year was horrible for the Australian retail sector. The S&P ASX 200 Retailing Index fell 37% in 2011. Former darling stocks **JB Hi-Fi** and **The Reject Shop** fell 37% and 25% respectively and stalwart **Harvey Norman** fell 38%. For the most part the price drops have not been random market panic, but the result of disappointing results and dire predictions about future profitability.

That's all taken place despite a relatively benign economic backdrop and 5% unemployment. Imagine where the sector would be with 10% unemployment and a housing crash.

The Manager has been concerned about these businesses for years One would think, however, that there might now be some value amidst the carnage.

There are three main issues facing Australian retailers. Firstly, the sector has too much capacity. The industry expanded rapidly while retail sales grew faster than disposable incomes. Thanks to five-year interest free periods, credit card debt and mortgage drawdowns used to fund retail consumption, the retail sector now has a level of infrastructure that is not justified based on a sustainable level of spending.

The second issue facing the sector is that retail property trusts – **Westfield Group** in particular – have been increasing their portion of the pie. The graph below shows the ratio of rent to revenue for a number of ASX-listed discretionary retailers. On average, an additional 4% revenue from these retailers is being handed over to the landlords. In most cases, the retailers are making more gross margin than they were five years ago. They are marking up the sale price of their goods by more, yet making less profit because the additional margin (and then some) is being confiscated by the landlords.



Source: Capital IQ and Intelligent Investor Funds

Finally, the issue that brings the former two to the fore is that today's customer has an alternative to bricks and mortar retailers. From a competitive perspective, it doesn't matter if your rent is high as long as everyone else's rents are the same. Now that customers can purchase online, rent and high Australian staffing costs place the traditional retail sector at a competitive disadvantage. Even those that don't shop online are usually doing online price checks and know what price they should be paying.

There is no doubt there will be a bricks and mortar retail sector 20 years hence. A shuffle through Sydney's Pitt St Mall in the lead-up to Christmas indicates 'shopping as an experience' is alive and well. So, there will always be physical shops and, in many cases, physical stores should still have a cost advantage. Online grocery shopping will never be a lower cost business model than establishing local warehouses and letting your customers do the local distribution for you. The cost of delivering groceries ordered online is higher than the cost of warehousing (**Woolworths'** rent is less than 3% of sales and they would incur some of these costs running a pure online business).

The question is not whether there will be bricks and mortar retailers. There will. The question is how the industry transitions from today's excess capacity and high costs to one that is smaller, paying lower rents and focusing on the sectors in which physical stores have a competitive advantage.

The Manager doesn't have an answer to that question. Perhaps the strong, relatively low cost players like JB Hi-Fi will take even more market share from rivals and manage to grow despite industry-wide difficulties. Perhaps the property trusts will wear the bulk of the pain. They are the ones that have been generating the excess profits to date. Perhaps new businesses and business models will emerge and annihilate the existing players. Despite the carnage in the sector, stock prices still aren't at a level where the Manager believes that investors are being compensated for the uncertainty.

Action aplenty in 2012

Between the **RHG** corporate saga, the **Centrebet** takeover and Photon's dramas, it was an action-packed year in 2011.

With proceeds from the OCP share buy-back to be received in February, the Manager is working hard on new investment opportunities, so expect to see new additions to the Portfolio soon. No doubt another action-packed year ahead is in store for 2012.

As always, please get in touch via email (steve.johnson@iifunds.com.au) or call (02) 8305 6050 if you have any queries about your investment.

Kind regards,

Steve Johnson
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