<u>Samuel Terry Absolute Return Fund</u> – April 2009 monthly report

The Fund's performance, and those of the Australian All Ordinaries Accumulation Index and the MSCI World Equities Index, are as follows:

To 30 April 2009	STAR	All Ords	MSCI ($A)
1 month	2.08%	6.07%	7.64%
3 months	5.81%	9.73%	-5.67%
1 year	-21.81%	-30.36%	-21.10%
3 years (%p.a.)	-8.73%	-6.47%	-10.18%
Since inception on 1 November 2003 (%p.a.)	0.35%	6.81%	0.11%

World markets continued their recovery but we were hurt by the first bankruptcy[1] of one of our investments, **Timbercorp**, an Australian agri-business manager.

The effect of the bankruptcy was to wipe 4.4% off the Fund this month. Fortunately, only 1.9% of this loss can be regarded as permanent; the other 2.5% is likely to be recovered in time. The Timbercorp saga is a complex one and on the following pages I describe what happened and what I expect to happen next.

Elsewhere, most of our shares went up. The standout was **Willmott Forests preference shares** (8.9% of the Fund) up 36% because of an encouraging trading statement. Other big gainers were investment bank **Macquarie Group** (5.2% of the Fund) up 24% and fund manager **Hunter Hall** (5.4% of the Fund) up 17%. Both these companies rose with their peer groups in Australia and overseas.

The Fund's net asset value per unit was $A 0.7516 at the end of April. 3.3% of the Fund was in $A cash. The Fund owned securities issued by 22 companies.

Fred Woollard
15 May 2009

[1] To be precise, Timbercorp appointed voluntary administrators, but bankruptcy is the more widely used term for what happened.

Timbercorp Ltd

What is Timbercorp? The company is a fund manager specialising in timber and other agricultural products such as grapes, almonds and oranges. The company owns real estate, which it leases to passive investors ("growers") for a defined period, typically 13-25 years. The main attraction to growers is the ability to defer taxable income for many years into the future, as well as to invest in agricultural and timber assets, which generally have low correlations to the returns from other assets.

Timbercorp manages the assets and collects rents and management fees from its clients. Timbercorp was the second largest company in its market and had a diverse mix of clients and assets. As at 30 September 2008, it had $1.5bn of assets and $830m of debt.

What do we own? At the end of March, 1.9% of the Fund was in Timbercorp preference shares and junior debt. These securities are now worthless, but there is a remote chance that we could recover some value..

At the end of March, a further 5.1% of the Fund was in debentures issued by Timbercorp Orchards Trust ("**TOT**"), which were then trading at 60% of face value. As the price of Timbercorp securities collapsed during April, the Fund bought some more TOT debentures and some debentures issued directly by Timbercorp, both at around 27-30% of face value. **By the time of the bankruptcy on 24 April, 2.8% of the Fund was in TOT debentures and 1.2% in Timbercorp debentures.**

Why did we buy this stuff? The attraction of both debentures is that they are protected by first mortgages secured over real estate and water rights said to be worth at least 150% of face value. Timbercorp has never disclosed the list of assets protecting its own debentures, but TOT has disclosed its properties. These properties are all leased to Timbercorp for 25 years, and sub-leased by Timbercorp to the growers.

TOT has $55m of debentures on issue. According to TOT's accounts, its assets, mostly properties and water rights are worth $100m. This is based on capitalising the $10m of net rental income that TOT received from Timbercorp, its tenant. Timbercorp is due to pay rent quarterly in advance and the administrators have not yet told TOT if they will continue paying rent, or if they will make the next payment due on July 1.

I expect that Timbercorp will continue paying rent, not just because it has a contractual obligation to do so, but more importantly because Timbercorp receives several million dollars more rent from the growers than it pays to TOT. If Timbercorp stops paying rent to TOT, then Timbercorp's head-lease drops out and the growers have to start paying TOT directly.

From our point of view it would be better if Timbercorp continues paying rent, because it would ensure that we will continue to be paid interest and we would have a good chance of being repaid in December 2010, without all the potential complexities of changing from one tenant to hundreds of tenants, even if they pay a few million dollars more rent.

Last year I visited the properties and was impressed with what I saw, particularly the orange grove at Renmark, which is one of the largest in Australia. Based on comparable sales figures, I estimated that the properties were worth at least $40m, or 73% of face value, assuming that neither the growers nor Timbercorp were paying any rent. Most of this value is in the form of water rights that alone are worth over $30m, assuming the land and the trees are worthless.

With this as our downside protection, and believing that Timbercorp was likely to survive, the Fund bought TOT debentures at various times over the last two years, originally as a yield play, then in the last few days before Timbercorp's bankruptcy I decided to buy more at 30% of face value, believing we would recover a lot more than 30% from the bankruptcy.

Until recently, the Fund did not buy any Timbercorp debentures because of the company's refusal to disclose the properties mortgaged to the debenture holders. In Timbercorp's final days, I bought some at 27% of face value in the belief that we had a large margin of safety between the price paid and the value of the land and water rights supposedly worth 150% of face value[2]. If it turns out that these assets actually have little or no value, then the debenture trustee (a large and reputable firm)[3] might be hearing from some class action lawyers.

Why did we buy the preference shares, and why are they now worthless?

The Fund originally bought the preference shares when they were issued in 2004. At that time, I perceived Timbercorp to be a growing business with a solid balance sheet. The business was profitable and cash generative. The assets were mostly real estate, water rights and loans to growers. Although there was considerable debt, it was locked in for long maturities; assets were more than twice debt, and profits covered interest more than twice. I particularly liked the fact that even if Timbercorp were to completely exit the business of selling new schemes, the annuity revenue from existing schemes was enough to keep paying interest, and the annuity income would continue rising even if no new schemes were sold. The first harvest of old schemes starting now, would enable debt repayment over several years if the banks wanted debt repayment.

The preference shares paid a 6.75% fully franked coupon and were convertible into ordinary shares, giving us the potential to make money if the ordinary shares continued to rise, which they did for a while. The danger in the preference shares was that they can be repaid in ordinary shares, but provided Timbercorp shares retained some value, that was not a problem.

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[2] Under the Trust Deed that governs the Timbercorp Debentures, the Trustee must hold a first mortgage over land and water rights worth at least 150% of the face value of the debentures.

[3] Permanent Trustee, a subsidiary of Trust Company of Australia

In November 2008, Timbercorp announced that its profit had fallen below the level required under its bank covenants. This was because it had planted the wrong kind of grapes on one of its properties, and needed to replant them, at a cost of $20m. To put that into context, Timbercorp still generated $140m of EBIT, amply covering its $78m interest expense.

Timbercorp's bank lenders[4] then demanded that the company repay $200m by immediately selling part of Timbercorp's land. Unsurprisingly, given that world financial markets were then in panic, and banks had stopped lending, Timbercorp failed to find buyers at anywhere near book value.

My reason for continuing to hold the preference shares, and for buying a small position in the junior debt in March and April, was a belief that, while Timbercorp's situation was obviously fragile, the banks were much more likely to recover their loans by keeping the company alive than by killing it. I reasoned that a bankruptcy was likely to destroy huge amounts of value for the banks, by selling off assets in a fire sale. On the other hand, if they kept Timbercorp alive, they would recover 100 cents in the dollar (and presumably a lot of fees and penalty interest) over several years. Obviously, the banks had a different agenda.

Had it survived, the preference shares and junior debt had potentially large upside because they were, in effect, an entry to the shares at less than 10% of net asset value. Putting it another way, I believed that Timbercorp had a greater than 50% chance of survival, and that if it survived, these securities stood to rise at least five-ten fold, possibly a lot more. *Assuming that my estimate of the odds were correct* (something that is impossible to prove or disprove), then the investment made sense, even if there was a high probability of bankruptcy.

Although it does go against my usual preference for low-risk securities, I am not afraid to invest a small part of the Fund in mis-priced speculative securities, such as Timbercorp junior debt in April, or oil shale shares (2.0% of the Fund). 1% of the Fund has recently been invested in shares of a leveraged property company. This company has assets more than twice its debts, is capable of repaying its debts over time, and its shares trade at around 2% of net asset value. I think it more likely than not that this company will survive, and if it does survive, then we will make many times our money.

Where do we go from here?

Both TOT and Timbercorp debentures are suspended from trading pending the release of further information. TOT is not in bankruptcy, and has a good chance of being able to repay us a large part, if not all of what we are owed.

The fate of the Timbercorp debentures is less clear, but the asset value ought to protect us, provided the trustee behaves sensibly.

[4] I have been told, but cannot verify, that the banks' decision to demand repayment was led by Bank of Scotland, which was acting under orders from the UK government, its new controlling shareholder, to repatriate loans from overseas to fund lending in the UK.

In both cases, I have sought a copy of the list of other debenture holders, and am prepared to engage in some activist activity to ensure that debenture holders are looked after. I believe that with a small amount of effort I can help to make a significant difference to the amount we recover.

Conclusion Although bankruptcy is an occupational hazard for investors, it is something I generally try to avoid, except when I consciously invest in speculative securities. When the Fund originally bought Timbercorp, I did not regard it as being in that class of investment.

One conclusion from this situation is that in a tougher credit environment, a company only has a truly safe capital structure if it could repay its bank lenders at short notice, even in a fire sale scenario. Fortunately, about half the Fund is in companies that have more cash than debt and about 30% is in companies that satisfy that test.

On the other hand, it is important not to become too risk averse, particularly at a time when many others have become much more risk averse. Today, the spreads between “risky” and “safe” securities have blown out to levels that sometimes mean that the “riskier” securities are sometimes safer and offer better returns than “safe” securities. I believe that, for the reasons described above, the Timbercorp debentures now fit into that category, and if I could buy more of them at an appropriate price, I would do so.

For us, the Timbercorp saga is far from over. I regret the losses we have incurred in Timbercorp, and am determined to do all I can to recoup the monies lost.

Fred Woollard
15 May 2009