Capricorn Diversified Investment Fund

Fundamentally Speaking

ISSUE 9 DECEMBER 2019

The purpose of The Fund

The purpose of the Capricorn Diversified Investment Fund (CDIF) has not changed since its formation in January 2008. The Fund's key objectives are to generate regular income distributions similar to those of the broad Australian share market but with lower relative year-to-year volatility in asset value. The Fund's continuing tilt is toward recurring income rather than capital gains. A benefit to the investor is a more consistent performance compared with sometimes volatile market segments such as shares. These objectives were being achieved on a consistent basis until the disappointing result of one asset over the course of this year.

CDIF provides indirect access to investments outside the reach of most individual investors, due to the minimum investment and wholesale investor designations required for participation in many deals. The benefit to the investor is a more diversified portfolio than they could otherwise hold themselves.

Greetings

Welcome to Edition 9 of the Capricorn Diversified Investment Fund's (CDIF) newsletter – Fundamentally Speaking. We have made slight changes to the investments in the portfolio and are working towards re-opening the Fund to applications and redemptions. We are currently facilitating the sale of a troubled asset that we expect will allow us to resume providing stable returns after what has been a challenging year. Please contact us if you have any comments or queries.

Summary

The Fund's value (net of debt) on the 31st of October was $12,523,232 compared with $13,916,672 the previous year.

The largest investment change in the last 12 months was the sale of 5 per cent of our holdings in Eighth Gate Residences Fund No.6 for $317,054.

Debt secured by the Suncorp House asset reduced by $157,500 during the year to end October 2019. Loan repayments are made monthly.

All tenancies of Suncorp House are now under lease agreements.

We established a $1 million overdraft facility with the National Australia Bank for additional flexibility when investment opportunities present themselves.

CDIF was holding $590,000 in cash across its various entities as at the end of October 2019. This is higher than usual following the 5 per cent sale of our Eighth Gate investment.

In May 2018, Jetgo Australia Holding (Australia) Pty Ltd was found to be in breach of the terms of a finance lease that supported the purchase of an Embraer 135KL aircraft. This resulted in CDIF repossessing the aircraft, which in addition to directors' guarantees and other measures, comprised the primary security for the loan. After a prolonged and unsuccessful maintenance program and numerous attempts to sell the aircraft at its perceived market value, we have agreed to sell the aircraft at its salvage value.

CDIF's unit price was revalued down from 82 cents to 72 cents to reflect the write down of the aircraft's carrying value. This is the largest monthly reduction in unit price since the Fund's inception.

Suncorp House

Suncorp House in downtown Rockhampton is a significant asset of CDIF. The Suncorp Group, The Investment Collective and The Barbeque Box are the current tenants.

In anticipation of continuing business growth, The Investment Collective took back office space it formerly occupied on the ground floor and is now leasing both Tenancies 1b and 4. This agreement was on properly commercial terms, with the result that all the Suncorp House office space is now leased.

The ground floor, street-based space has been set up for use in the hospitality industry. In April 2019, a three-year lease agreement was signed to the operators of a Korean restaurant, The Barbeque Box. All tenancies are now under lease agreements.

Suncorp vacated its branch office located in Tenancy 1a in early October. The agreement for the space expires on the 1st of December 2020 so Suncorp is contractually obliged to honour lease payments until a new tenant is found. We are actively searching for an appropriate replacement. Suncorp will retain the corporate office in Tenancy 3 on level 1.

Eighth Gate Residences Fund No.6

We introduced Federation Villages (more formally known as Eighth Gate Residences Fund No.6) to the CDIF portfolio in 2015. This investment makes quarterly distributions. The forecast yield for the 2019 financial year was 6.27 per cent. The actual yield was 4.01 per cent with quarterly yields varying from a low of 2.98 per cent (Q1) to a high of 4.60 per cent (Q3).

The main reason for the variation in income from this asset relates to the portion deriving from deferred management fees (DMF). About one-third of the yield is generated from this source, received when units are sold following the departure of a resident. This category of fee varies from quarter to quarter and is somewhat dependent on the housing market. The soft housing market throughout FY19 delayed sales of existing residences, and therefore settlements at Eighth Gate. As a matter of interest, companies with operations similar to Federation accrue this DMF income, regardless of when it is actually received, based on life expectancy tables and the like. This means earnings are often reported at a lower level than they would be if the company was listed, regardless that the underlying business is very similar.

In August, the security holders of the Eighth Gate Residences Fund No. 6 voted to approve the terms of Ingenia Communities' (ASX: INA) proposed acquisition of Eighth Gate's funds management business. As part of the proposal, INA offered to purchase up to 5 per cent of existing unitholders' securities for $1.10 per unit. We allocated 5 per cent of our holdings and received $317,054 in cash, reducing our holding to $6.02 million.

Eighth Gate's management structure is currently integrating into Ingenia. We expect Ingenia's management disciplines and processes will result in increased returns to unitholders through increased unit sales, the refinancing of existing debt facilities, and increased pricing power in negotiations with the developers of the greenfield Ballarat site.

CDIF Solar

CDIF Solar holds a Retail 8 exemption from the Australian Energy Regulator. This exemption allows us to provide solar electricity systems to commercial customers under power purchase agreements (PPAs). Currently, there are systems servicing the tenants of Suncorp House in Rockhampton, another system servicing a fruit processing plant in Yeppoon and two new systems servicing a customer with a caravan park in Yeppoon and a commercial property in North Rockhampton.

The addition of the new systems brings our total portfolio to 164 Kw across four properties.

Embraer ERJ 135KL Aircraft

In August 2017, the CDIF Investment Committee approved to provide Jetgo Australia with a $2 million loan to finance the balloon payment of an Embraer ERJ 135KL aircraft. The agreement took the form of a finance lease whereby CDIF purchased the aircraft and leased it to Jetgo at a fixed interest rate of 8.5 per cent for 60 months. This agreement was beneficial to both parties for seven months. However, owing to, amongst other things, its primary funding source failing to contribute funds as agreed, Jetgo encountered serious financial distress and was forced to enter voluntary administration in June 2018. Fortunately, we were able to identify Jetgo's issues before administrators were appointed, which allowed us to repossess the aircraft.

The aircraft was completing a large and expensive scheduled heavy maintenance project in Cairns that was originally the responsibility of Jetgo. Approximately $200,000 had to be paid to the maintenance, repair and overhaul (MRO) business for work already completed (to release the aircraft). In order to give unitholders the best possible return, we committed to completing the maintenance program to work towards selling the aircraft at its market price rather than its salvage value. This meant the cash position of CDIF had to be carefully managed.

An independent valuer estimated the fair market value of the aircraft at approximately $3 million in mid-2018. This was somewhat higher than the carrying value in the books of CDIF, and was not significantly different to the recovery estimates, including the cost of the maintenance program. In addition, we were advised by a number of industry professionals to complete the maintenance program in order to maximise the potential return. To that end, we engaged the services of an aircraft engineer to oversee the project.

In February 2019, corrosion damage was discovered on one of the aircraft's engines. Again, we sought professional advice and decided the highly valuable components of the engine meant it was worth sending it to the United States for repair. Unfortunately, in June the severity of the damage was discovered upon stripping the engine. The damage exceeded original expectations and the engine was deemed "beyond economical repair". This development severely limited our ability to sell the aircraft outright.

We began negotiating with a business that was interested in purchasing and installing a new engine and an air stairs door to lease our aircraft for luxury air charters in Australia. The negotiations developed to a point where a heads of agreement was being finalised. Disappointingly, in October the business subsequently withdrew its interest in response to our requirement to provide directors' guarantees.

The final option available was to sell the airframe, auxiliary power unit (APU) and purchased parts to C&L Aerospace for a consideration of US$504,000 (A$741,000). We also intend to utilise C&L's network to sell our serviceable engine for an expected US$350,000 (A$515,000). CDIF's Investment Committee approved this option and we received the deposit in early December.

In anticipation of impending audits, we compiled a memorandum in August to ascertain an appropriate carrying value of the aircraft. We assumed a "base case" value of A$1 million could reasonably be collected. This value resulted in the unit price of CDIF dropping from $0.82 in April to $0.72 in May. While this is a disappointing result, we are hopeful to deploy the proceeds in investment opportunities that can generate stable returns for unitholders.

Since inception, the Fund has made over 20 investments and this is the first to ever lose capital for unitholders. We are very disappointed to have to report a loss, and we understand the frustration caused.

Distributions

The Fund has paid $2.7 million in distributions since 2012, at the rate of 1 cent per quarter. Management has decided to suspend distributions until the aircraft sale is completed.

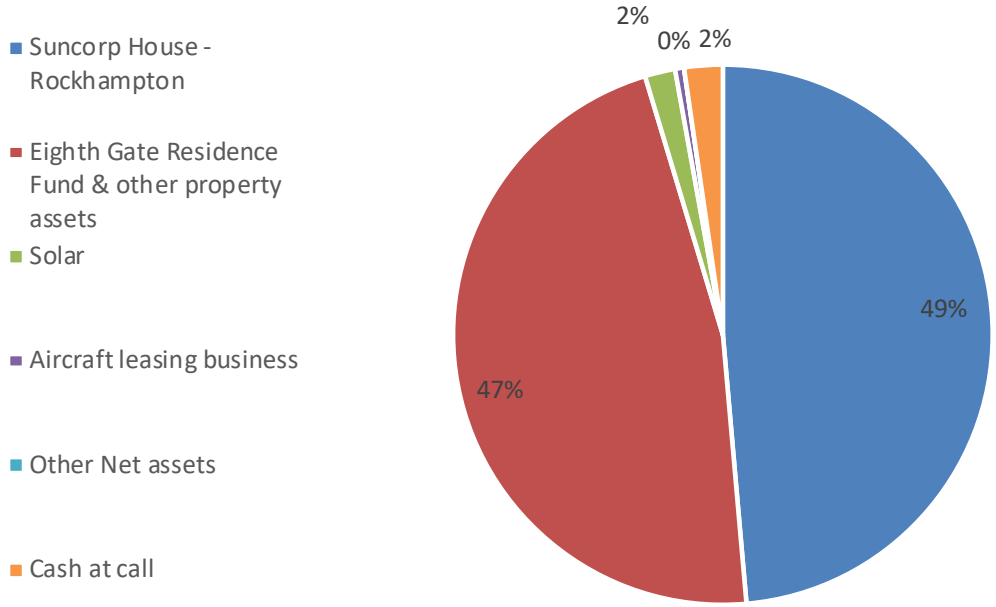
Redemptions

CDIF is an open-ended and unlisted managed fund that aims to provide investors with returns that are uncorrelated with equity markets. This mandate leads CDIF to invest in diversified assets that are often illiquid. As a result, redemption requests are met subject to availability of liquidity and quarterly redemption caps in order to ensure the Fund's unit price is maintained at a level that protects the remaining investors.

All redemptions are approved by the CIP Licensing Board of Directors. If approved, under an internal policy document, a maximum of 1.25 per cent of the Fund's net assets can be redeemed to unit holders per quarter. Since inception, a total of $1.9 million has been redeemed from the Fund.

As previously discussed, the maintenance program for the aircraft was an expensive and somewhat unpredictable task. To ensure the Fund had adequate capital to complete the project we decided to withhold distributions and redemptions until the completion of the aircraft sale. If you have any further questions, please contact your adviser.

Asset allocation & Property Lease Profile (October 2019)



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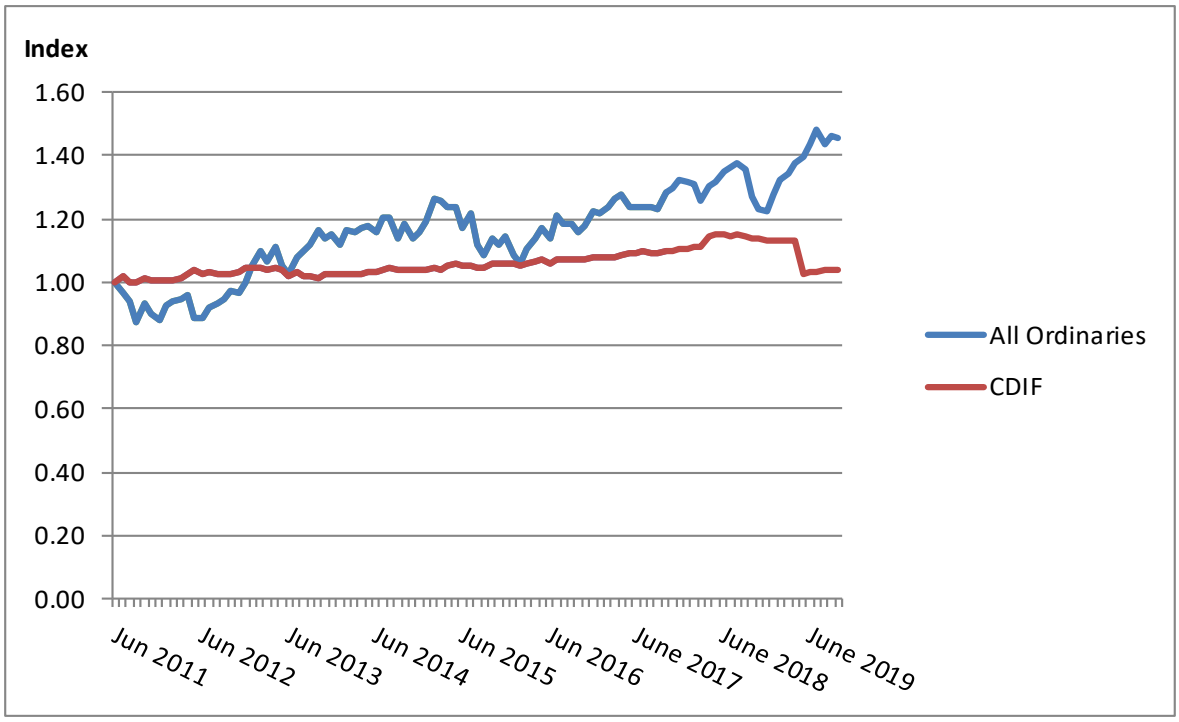
The combination of capital value and distributions was showing an upward trend before the write down of the aircraft. We expect the trend to return to its previous trajectory with the potential to accelerate as the Fund increases in size:



Historical relative volatility is low versus the All Ordinaries (XAO):

- Excluding the effects of aircraft write-down, the largest monthly negative shock to CDIF's performance was 2 per cent vs 10 per cent (August 2015) and 9 per cent (October 2018) for XAO.
- Average monthly negative drawdown for CDIF since inception is 0.1 per cent vs 3.3 per cent for XAO.