Semgroup

Semgroup, one of the fund's holdings, was subject to a take-over offer in late October. Below we have provided some background to our position in the company.

We started working seriously on Semgroup in early 2011 and established a position around mid-year which we continued to add to during weakness. It is currently a 4.5% position in the fund.

Semgroup is a US based company with an event filled last few years, culminating with its bankruptcy in 2008.

There are a lot of reasons why we could have shied away from Semgroup post its bankruptcy restructuring. However, as a distant observer of its unravelling up to 2008, I was aware that they had some attractive assets – the issue was their business model. The opportunity we saw was the bankruptcy process had obscured some valuable assets which had significant value under a fee based (rather than marketing / trading) business model.

Semgroup's assets consist of an eclectic range of oil storage and pipeline assets in and around Cushing, and gas processing assets in Canada and the Mississippi area. They also have an oil storage facility in the United Kingdom and a small Mexican asphalt business. Some of the assets are new or recently refurbished.

Prior to bankruptcy, many of Semgroup's assets were organised primary as a trading business seeking to capitalise on directional bets primarily on the oil price. This contrasts to a tolling business model providing fee based pipeline, storage and processing services to third parties based on throughput / usage.

In 2008 Semgroup came unstuck as it seems to have been on the wrong side of the strong rally in the oil price. This resulted in significant losses and a bankruptcy filing in July 2008. Creditors took severe losses, overall in the vicinity of 50%.

Semgroup emerged from bankruptcy and re-listed on the NYSE during November 2010, owned by its creditors. Importantly, it emerged with:

- new management headed by a CEO with a long track record and reputation for good operational expertise;
- new tolling business model focused on providing fee based oil and gas pipeline, storage and processing services to third parties; and
- new balance sheet, with a low level of debt.

We accumulated our position at a price implying a 9% ungeared pre tax cash coupon. Moreover, we consider the cash coupon to be materially understated given the earnings uplift from recently completed projects, significant improvement in some under-utilised assets, and one off cost items associated with the final stages of the bankruptcy proceedings. In addition, the geographic location

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of the assets provides the opportunity for a range of expansion projects which should generate favourable incremental returns.

Our October 2011 trip to the US provided the opportunity to meet management and further test our Semgroup investment tenet. Prior to this we had held conference calls with the company and undertaken an extensive review of bankruptcy, regulatory and re-listing filings.

On 24 October 2011, Plains All American (a US listed MLP) made an unsolicited offer of $24.00 per share for Semgroup, which is 5-10% higher than our cost base. Semgroup is currently trading around $28.00.

While we have a direct interest in Semgroup, we are also interested in the changing oil and natural gas supply dynamics in the US and the opportunities these present for infrastructure companies – particularly, in relation to the opening of new oil and natural gas liquids rich regions and the opportunities / threats this has for existing and new infrastructure assets. This was one area of focus on our recent trip to the US where we met with a range of infrastructure and related companies exposed to these dynamics. We also visited Cushing over the weekend to view the impressive collection of oil storage tanks and extensive new build. We continue our work on these opportunities.

Finally, Semgroup is not the only company in our portfolio which has emerged from bankruptcy – there are two others which exited, albeit earlier than Semgroup (around 4 years ago). While former bankrupt companies is not an area we set out seeking opportunities, to date it has shown to be prospective and rewarding.

2 November 2011

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