31 March 2015

FORAGER

WHOLESALE VALUE FUND MARCH 2014

QUARTERLY REPORT

CONTENTS

RBA SENDS 2015 OFF WITH A BANG	3
Iron Ore: How Low Can it Go?	3
What next for Australia?	3
Fessing up about our mistakes	4
WHOLESALE FUND PERFORMANCE	7
Software Superb	8
Hughes Making the Hard Yards	8
Service Stream's One Solid Performance	9

RBA SENDS 2015 OFF WITH A BANG

An interest rate cut and the prospect of more to come put a rocket under the Australian market in the first three months of the year. Steve Johnson explains that it's the economy you need to be worried about.

Dear Investor,

The first quarter of 2015 was kind to global sharemarkets and the Forager Wholesale Value Fund. Domestically, the Reserve Bank of Australia has been late to the global low-interest rate party but a cut in February had the same impact as similar actions by central banks around the world in recent years: prices for property and shares headed sharply higher and the local currency fell against the US dollar.

There are more rate cuts to come for Australia and that could mean even higher prices for stocks, particularly those paying high dividends. It seems simple – just buy a stock with a reasonable yield and watch it rise – but thoughtless investing is always risky. I'm unsure whether this global monetary experiment ends in inflation, deflation or the world sails through just fine. But I know that equities are not bank deposits.

Regardless of how reliable an historical dividend has been, shares are not low-risk investments and should not be bought on the basis of yield alone. Australian dividend payout ratios are high – far too high in my opinion – and the underlying profitability of any business can change dramatically.

The good news is that Australian investors' obsession with yield is also creating opportunity. There's very little interest in those stocks not paying dividends and not perceived as 'reliable'. That's led to some cheap investments for the Fund. Despite plenty of nervousness about the domestic economy (see below), we're optimistic about the prospects for this portfolio.

IRON ORE: HOW LOW CAN IT GO?

In the first few days of April this year, the benchmark iron ore price slipped below US$50 a tonne. That's down 50% in the past year alone and more than two thirds from its peak in 2011.

How much further can it fall?

No one has any idea. Particularly in the short-term. But the question is irrelevant in any case.

Prices for iron ore are falling because the market is dramatically oversupplied.

Demand is unlikely to increase rapidly enough to fix the problem. In fact, while most observers have finally woken up to the fact that China's construction boom is unsustainable, analysts are still forecasting somewhere between slow and no growth for Chinese iron ore demand.

Even to maintain the same level of demand – that's zero growth – China would have to build the same number of roads, railways and airports as last year, adding significantly more infrastructure and debt to an economy that is plagued by too much of both.

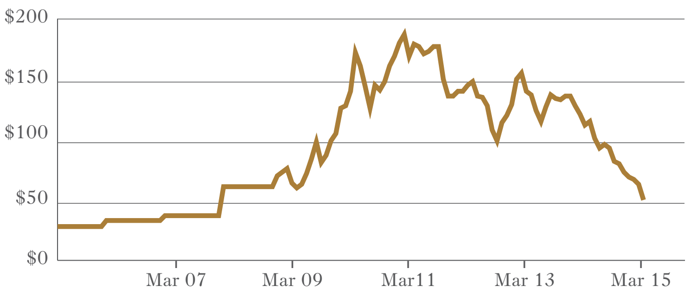
It seems perfectly reasonable to expect the demand for iron ore to fall. Perhaps dramatically.

Meanwhile, **BHP Billiton** plans on increasing its iron ore production by 65 million tonnes per annum (mtpa) over the next few years. **Rio Tinto**'s plans include an additional 50mtpa. And Gina Rinehart's new Roy Hill mine will add 55mpta to the market in 2016. Combined, these three players plan on adding roughly 20% to the supply of internationally traded iron ore.

If demand is, at best, growing only slowly, it's clear that supply needs to be removed from the market somewhere. Iron ore mines need to close.

Many directors are sitting around boardroom tables wasting their time pontificating about where the iron ore price will bottom out. The simple fact is that if your mine is in the least efficient quintile of global production, the price is going to fall to a level that puts you out of businesses.

Chart 1: 10 year iron ore price (USD)



Source: S&P Capital IQ

Australia's high cost operators like **BC Iron**, **Atlas Iron** and **Mineral Resources**'s Minara mine will close first. But they're only small players. It's going to take something significant, either **Fortescue Metals** going under or Rio or BHP Billiton curtailing expansion plans before the market is going to be anything like balanced.

However painful, and however low the iron price needs to fall to make it happen, this is the only way the market can return to balance.

WHAT NEXT FOR AUSTRALIA?

We're what the asset consultants would describe as 'bottom up' investors. That is, we value companies and we buy them when we think they're cheap. Macro, or 'top down' investors look at the big picture first. Armed with a theme, they then find stocks that will help them profit if the world plays out the way they expect.

Obviously a top down investor still puts a lot of work into the individual stocks they end up buying. And a bottom up investor should – indeed must – put a lot of time and effort into understanding the macro environment a company operates in and how that environment is expected to impact a company's future profitability.

Hence, while picking individual stocks for the past five years, our concerns about a China slowdown have influenced our portfolio allocation in three distinct ways. One, we obviously don't want to own resources stocks. Two, we prefer exposure to foreign currencies. Three, we are wary of exposure to discretionary spending and the domestic Australian economy.

China's growth has slowed dramatically and the first two pennies have dropped. Mining stocks have been smashed and

"REGARDLESS OF HOW RELIABLE AN HISTORICAL DIVIDEND HAS BEEN, SHARES ARE NOT LOW-RISK INVESTMENTS AND SHOULD NOT BE BOUGHT ON THE BASIS OF YIELD ALONE"

the Aussie dollar has fallen. Yet the third concern – the flow-on effect of a commodities meltdown on the wider Australian economy – is yet to be reflected in stock prices. Sure, the unemployment rate has crept up, but bank share prices are hitting all-time highs.

Obviously the more iterations between China's economic growth and the company you are looking at, the less direct will be the impact. It's hard to imagine how China's economic growth slows dramatically without impacting commodity prices. It's less certain, but still likely, that this will cause the Aussie dollar to fall. When it comes to the wider Australian economy, there are a lot of other factors at play.

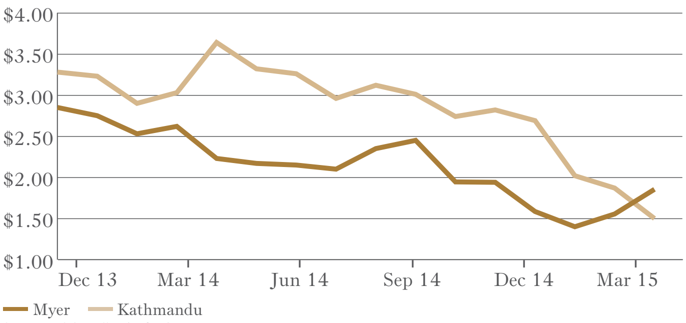
We are more likely to be wrong the further we extrapolate from the epicentre. But it is fairly clear that the Australian economy is about to go through a very difficult adjustment period as the commodities boom ends.

Our view and stance hasn't changed much over the past few years. The only change is that the slowdown, or potential recession, is now upon us.

We demand an even greater margin of safety when looking at discretionary retail stocks, as well as Australian financials, housing and anything else dependent on Australian consumers. We will buy them, if they are cheap enough, but we require a higher-than-usual expected return, because we think the risk is higher than usual at the moment.

Take retailer **Myer Group** for example. There's a pretty straight forward case for this stock being cheap. It trades at roughly 10 times downgraded earnings, yields 9.3% on last year's dividends and, in our opinion, is probably making less profit than it should. The margins, at 2.4%, are very low relative to the competition and its own historical averages.

Chart 2: KMD and MYR chart



Source: S&P Capital IQ

There are plenty of things to worry about. The internet and foreign retailers are encroaching on Myer's space. The stores look tired. And Westfield is stealing the profit (almost all of the margin deterioration in recent years has been due to increasing rents). None of these issues are easily fixed.

In a normal economic environment, however, I'd say the potential rewards outweigh the risks at this price. The time to buy retailers is when the margins are low. And at these prices a private equity bid is surely on the cards. The same case could be made for **Kathmandu** (see the Chart 2).

But is now the time to be wading into the consumer discretionary sector?

Not unless the stock is cheap enough to sail through a recession and still look cheap. And neither of these stocks meet that criteria.

FESSING UP ABOUT OUR MISTAKES

December's quarterly report caused concern to some of our newer investors. The discussion of 2014's mistakes made some people, understandably, question why they'd invested with a fund manager who keeps stuffing up.

Yet it was nothing new to investors who've been with us for years. We regularly discuss our mistakes and there wasn't anything special about 2014. We aim to get fewer wrong each year but there will always be errors.

That's not only true of us, because all fund managers make mistakes. The difference is that we are open about them with you, our investors. And for good reason.

As a result of our confessionals and general transparency, most of our investors understand that we are human, that we get things wrong from time to time and that our returns are likely to be lumpy and often differ markedly from the index.

That understanding and the resulting long-term nature of the investments our clients place with us as a result, are our main advantage over the competition. In the short-term, we probably attract less money. In the long-term, we have a much more sustainable business and our investors, we hope, superior returns.

So come the end of this year, you'll once again be reading about the things that we got wrong in 2015.

STEVEN JOHNSON
Chief Investment Officer

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WHOLESALE VALUE FUND

FACTS

Fund commenced	2 September 2004
Minimum investment	$10,000
Income distribution	Quarterly
Applications/Redemption	Weekly

UNIT PRICE SUMMARY

Date	31 March 2015
Buy Price	$1.4052
Redemption Price	$1.3982
Mid Price	$1.4017
Portfolio value	$23.34m

WHOLESALE FUND PERFORMANCE

A strong contribution from the Fund's investments in software businesses made a good start to the year, but not quite enough to beat the benchmark. High prices make the search for value harder but there are opportunities around.

The benchmark ASX All Ordinaries Accumulation Index returned a booming 10% in the March quarter while the Fund produced a 5% return for the same period.

Table 1: Summary of returns as at 31 March 2015

	Forager Wholesale Fund	ASX All Ords Accum. Index
1 month return	3.61%	–0.03%
3 month return	5.32%	10.21%
6 month return	2.44%	13.04%
1 year return	7.90%	13.25%
2 year return (p.a.)	14.30%	13.22%
3 year return (p.a.)	18.08%	14.72%
Since inception* (p.a.)	7.63%	9.30%

*Inception 2 Sep 2004

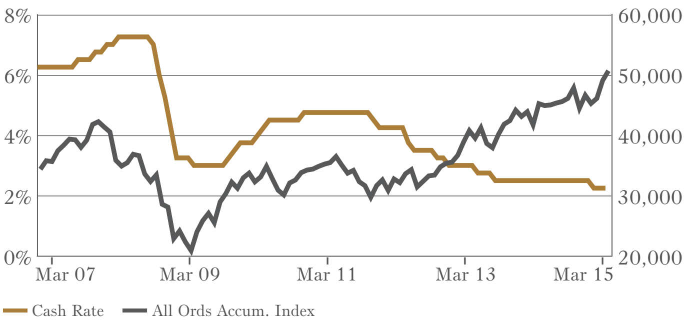
Chart 1: Comparison of $10,000 invested in Forager Wholesale Fund vs ASX All Ordinaries Accum Index

The rising market is being fueled by increased conviction that interest rates in this country will be low for a long time, and that's emboldening investors to bid up the price of blue-chip shares as well as bonds, property and anything else that generates reliable (or sort-of-reliable) cash flow. Since the global financial crisis the Australian market has rallied from 11 to 17 times earnings, and it's starting to look overstimulated.

Low interest rates certainly increase the present value of fixed-interest investments like bonds, but the relationship between interest rates and the value of shares is not clear cut – low interest rates often signal of a poor environment for corporate earnings. The Reserve Bank has not, of course, sent interest rates to emergency lows without reason, it is concerned the Australian economy is in a frail state.

Investors should take heed too. A huge cycle of investment in resources is coming to an end with the completion of the major gas liquefaction plants. The iron ore price has tumbled, weakening a key revenue earner for the country. If the country's other key export, coal, is any guide, iron ore has a long period of structural adjustment ahead. It could be a deep depression of endless cost-cutting and oversupply.

Chart 2: RBA cash rate versus All Ordinaries



Source: S&P Capital IQ, Reserve Bank of Australia

A lower Australian dollar should rekindle demand for our non-resource exports but can cushion the blow only a little. Ideally investment in infrastructure would pick up some of the slack, but as portfolio holdings **Coffey International** (COF) and **Infigen Energy** (IFN) can attest, political uncertainty has gridlocked decision making. With important projects being delayed and cancelled, the expected help could come too little, too late.

For now the impact seems contained to the energy and mining sectors, but second and third order effects will surely flow to other sectors. As tax receipts and employment fall in the resource states of Queensland and Western Australia, spending must be trimmed elsewhere too. This impacts demand, which hurts not only discretionary consumer sectors like retail, but also housing, finance and white-collar services. The logical outcome should be weak revenues and earnings across the economy, which could be a nasty spectacle with the sharemarket so highly priced.

Balanced against this, low interest rates could drive the market higher still in the interim. So how should investors respond to these circumstances? We're not willing to speculate on ever-tightening dividend yields and intend, as we have always done, to steer clear of the high-priced blue chips. This might make the market hard to outperform in the short-term.

That's actually how it should be. Our job is to find long-term value which means we must steer clear of today's glamour stocks and focus on what is disliked, overlooked or misunderstood.

Misunderstood might be the key term, because where something is disliked but well understood then it is no bargain. Indeed there are resource companies whose shares have fallen 90% that are much *better* understood now than they were previously. Where things are both disliked and misunderstood there is great opportunity but the market only affords us this severe pessimism occasionally. Pockets of mining services today or in infrastructure five years ago, for example.

"IN THE UK, GBST HAD THE SUPER-CHARGED COMBINATION OF HIGH SWITCHING COSTS AND AN *OVERWHELMING DRIVER FOR CHANGE*"

But when the sharemarket is high, like today, there aren't that many disliked things just lying around. So it's not easy to buy super cheap. To generate returns through a bull cycle, we need to identify things that aren't obviously cheap so much as misunderstood, their true value not apparent straight away. These opportunities occur in all markets rather than just depressed ones.

SOFTWARE SUPERB

Samples of these misunderstood opportunities can be found in **GBST** and **Hansen**, by far the best performers in the Wholesale Value Fund over the last year, where the value on offer was far greater than it appeared on the surface. In the case of GBST it was much greater than we originally understood also.

When we first came across GBST, a provider of software to the finance industry, it traded at 26 times statutory earnings and had a bit of a scruffy history. Its Australian operations were profitable and stable, but it had acquired an international capital markets business called Syn which was a disaster and was losing money. Offsetting this, the expansion of GBST's wealth management platform Composer into the UK looked to have some potential.

We deduced that underlying profitability was being hidden by the loss making Syn, and by amortization charges being made in addition to heavy research and development expenses. Stripping those negative amounts out, and GBST traded around 6 times pre-tax earnings, a cheap price we thought for a business with fairly stable customers and revenue, certainly much cheaper than peers like **Iress** (IRE). Potentially the Australian business was also suffering from low trading volumes in capital markets which could recover, boosting earnings.

That analysis was fair enough, but the true value of the UK business wasn't completely apparent to us. It was set to be immense. Changes to regulations were forcing the retirement industry, which traditionally had offered annuity-type pension products, to offer a far greater range of investment options, more like the superannuation system in Australia. The incumbents of the UK retirement industry had legacy software platforms unable to offer multiple investment products and were compelled to upgrade.

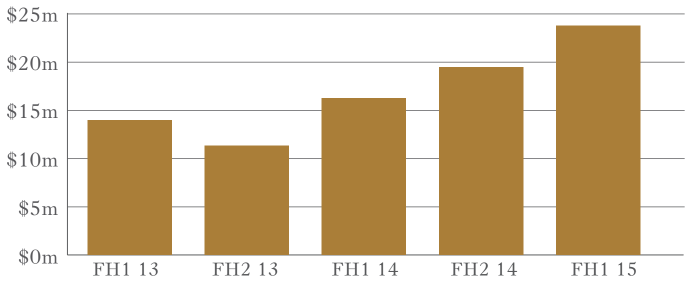
Like Hansen does in billing and invoicing, GBST runs a business where customers encounter very high costs to switch providers. This means revenue is rather 'sticky' – when customers join they often stick around for decades. That permits healthy profit margins. In the UK, GBST had the super-charged combination of high switching costs and an *overwhelming driver for change*. That pointed to a dramatic and permanent expansion in activities and huge value creation. Customers were forced to upgrade to remain in business and each one who signed-up potentially earns revenue for 20 years.

Along with rival Bravura, GBST had stepped on the proverbial gold mine. You can see the results to date in the table below.

That's growth every six months, not annualised, and will continue for years yet.

In early 2013, GBST was a bargain at twice the price. You had something like the opportunity that the market sees in front of accounting software provider **Xero** (XRO): enormous scale growth from which defensive revenues and high margins will flourish long-term. But unlike Xero, the market hadn't understood the opportunity well, and GBST didn't trade at 30 times revenue.

Chart 3: GBST International wealth management revenue



Source: GBST

Value investors must always demand a discount to fair value, but it's important to be aware that for some businesses fair value can be a high multiple of today's earnings (conversely for others it can be a very low one). The business model of a software company is nothing at all like a supermarket or an asset intensive property trust where the capital gains on offer are either capped or incremental. Dramatic growth potential at high margin has a lot of value, as is becoming apparent. GBST shares finished the quarter 58% higher at $5.98. Hansen shares were 27% higher at $2.32.

The lesson is to watch closely and be alert for hidden earnings power. A business trading at 15 times earnings can offer as much value as another trading at half tangible assets. These misunderstood opportunities are out there today.

HUGHES MAKING THE HARD YARDS

Moving back to the 'disliked' part of our investing activities, mining service providers have been rudely dropped from most investor portfolios as gloom envelopes commodity markets. To an extent the pessimism is justified, mining services companies tend to feature a nasty dual-combination of flakey business models and cyclical industry exposure. We've argued there's value in the sector but so far are poorer for the experience.

Good companies have an uncanny way of making hard yards through tough times however, setting themselves up for brighter results when conditions eventually turn. That seems to be the case with **Hughes Drilling** (HDX), which reported an impressive interim result against the general tide. The company provides – you guessed it – drilling services to the mining sector, reported a big jump in profit from its west coast

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operations. That led to overall underlying profit 38% higher than the six months prior.

Margins in the east coast, the historic profit engine of the business, remain suppressed due to the dire state of the coal market, but Hughes continues to gain new contracts nonetheless. It seems to be through the worst of it now. Utilisation should improve and full year profit is likely to be stronger than the first half.

Hughes shares can be purchased today at half book value, despite having rallied 52% to $0.16 in the March quarter, which makes it interesting but far from the cheapest thing in the sector. In the table below we've lined Hughes up against equipment hire business **Emeco Holdings** (EHL). You can see that Emeco trades at a much bigger discount to its book value.

	Emeco	Hughes
Price / tangible book value	0.2 x	0.5 x
Return on equity	(6%)	19%
Debt / EBITDA	4.5 x	1.7 x

But you can also see why Hughes might be the better investment idea. Emeco is losing money and has too much debt, which puts shareholders in a precarious situation unless conditions improve quickly. If losses were to continue like this for another 3 years before returning to a more 'normal' return on equity, investors today need to demand something like a 40% discount to book value to make a reasonable return, factoring nothing in for the cost of distress.

The market discount is bigger than that and Emeco may prove a decent investment for the brave-hearted. But Hughes, with a more workable debt load and an excellent return on equity, is plausibly worth twice book value if it can just maintain current revenue and margins.

It's likely to do better on both counts. The company is run by a passionate owner manager in Bob Hughes, who possesses a wealth of drilling experience and knows how to run a lean ship. Hughes also has its own in-house drill manufacturing capabilities through Reichdrill which is delivering new equipment cheaper and quicker than competitors can manage. That has afforded Hughes a big cost advantage in a price sensitive market.

Hughes sells for the princely sum of 3 times earnings (astute readers might have noticed the nice combination of a big discount to book value and high return on equity) and, as you'd expect for a company so cheap, it's not all roses and petals. The industry is volatile and the debt, though not as high as Emeco's, is higher than we would like. Hughes has only recently become public and is still a maturing business, the corporate team is slim and the business is basically being run in the Managing Director's head. There is plenty of key man risk and it's plausible the cost advantage is lost if competitors step-up their game.

But the cheap price compensates us well for these risks and Hughes is a very interesting investment proposition.

Mid-tier construction **Watpac** (WTP) also has a mining services division, which, just like **Macmahon** (MAH), is watching revenue evaporate. **BC Iron** (BCI) recently announced the early termination of Watpac's services at the Nullagine Joint Venture mine in Western Australia's Pilbara region. That contract accounted for around $100m per year in revenue and will be hard to replace.

There's still value in that mining segment however, and with a strong balance sheet and conditions improving in Watpac's east coast construction market, the company has plenty of flexibility as to how to manage these difficulties. On top of this management has begun to make noises about using its excess cash for capital management purposes (usually this means a share buyback or capital return). Today's share price of $0.80 doesn't reflect the value of the excess capital on top of the construction and mining segments.

SERVICE STREAM'S ONE SOLID PERFORMANCE

Chairman Peter Dempsey announced 'another solid performance' from **Service Stream** (SSM), a significant Wholesale Value Fund investment.

In all the recent turmoil we must have missed the other 'solid' performances from this telecommunication services business over the past few years.

Nevertheless, the half year results were pleasing. The Fixed Communication segment, the cause of all yesterday's headaches, continues its regeneration, reporting a 29% growth in revenue and 23% higher earnings before interest, tax, depreciation and amortization than six months ago.

The National Broadband Network rollout is yet to ramp-up in earnest. But it is already an important revenue contributor for Service Stream and can be a major source of value for the next 10 years, assuming the management team can avoid some of the execution disasters of the past.

While the first half results suggest that's looking more likely, the market hasn't changed its view. Service Stream shares finished the quarter 16% higher at $0.22 but were basically unchanged after the results were announced.

The dividend was reinstated with a 0.5c interim payment. At a market capitalisation of $80m, Service Stream trades at around 10 times earnings based on the half year results. That's on thin margins – the multiple of revenue is only 0.2 times – and we expect revenue can grow too. Debt is now under control and the associated risk has dropped a long way since we initially ventured in to this. Let's hope for more solid results to come.

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