30 June 2015

FORAGER

WHOLESALE VALUE FUND JUNE 2015

QUARTERLY REPORT

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MORE JITTERS PLEASE

It has been a good start to the year for the Forager Wholesale Value Fund. The risks inherent in today's extremely low interest rates are cause for concern, however there are pockets of extreme value on offer.

Dear Investor,

It has been a good start to the calendar year for the Wholesale Fund. As you'll read in the coming pages, we've received positive news in relation to a number of important investments. Being able to buy a stock for less than you think it is worth is important. Getting validation of your valuation (eventually) is more so and very welcome when it arrives.

More hopeful is that stock markets around the world have been jittery. It started in Australia, where the benchmark All Ordinaries index is now down 9% since the end of April. Then the Chinese market began to its own meltdown, with the Shenzhen Composite index falling 21% since mid-June (although it is still up 125% in the past 12 months). And in the last week of the financial year, the Greek government's decision to abandon negotiations with its European counterparts and impose capital controls sent global markets into a tizz.

It's only a minor tizz, so far. Internationally, most markets remain expensive and compelling investing opportunities are few and far between.

Investing is never easy. It's easy to say you need to be greedy when others are fearful. It is difficult to do so when there are genuine and rationale reasons for fear. Likewise we are told to be fearful when others are greedy. There are exceptions, such as the dot-com bubble of 15 years ago, but in general there is no flashing red light indicating when investors are being greedy. Take the current environment as a case in point.

The **annual report** of the **Bank of International Settlements** (BIS) was released at the end of June. The bank's annual missive became famous after its pre financial crisis warnings about the stresses building up in the global financial system. This year's version begins with a summary of the current state of affairs:

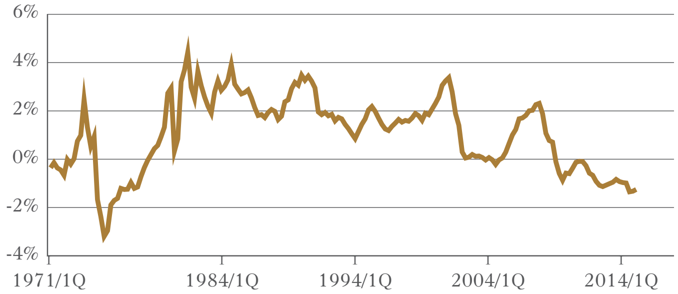
"Globally, interest rates have been extraordinarily low for an exceptionally long time, in nominal and inflation-adjusted terms, against any benchmark. Such low rates are the most remarkable symptom of a broader malaise in the global economy: the economic expansion is unbalanced, debt burdens and financial risks are still too high, productivity growth too low, and the room for manoeuvre in macroeconomic policy too limited. The unthinkable risks becoming routine and being perceived as the new normal."

That's hardly a backdrop for a bout of irrational investor exuberance, is it?

Asset prices around the world are extremely high relative to historic norms. Across all asset classes and most parts of the world, the returns on offer are measly. But most investors buying these assets are not doing so with greed as their driving emotion, rather with a sense of reluctant resignation.

Ten years into the future, we will all be experts on whether 2015 was the right time to be fearful or not. As we sit here today, it's not straight forward. Are asset prices dangerously high, or are they simply a reflection of the current interest rate environment?

Chart 1: G3 Real Policy Rates



Source: BIS

DANGEROUS ASSUMPTIONS

Perhaps both. There's no doubt you can make a logical, rational case for equities and property relative to today's interest rates. The dangerous part is the assumption that those interest rates will stay at current levels. What just a few years ago would have been "unthinkable" in the words of the BIS, has become a "routine" assumption. Their concerns are worth quoting in full:

"For monetary policy, there is a need to fully appreciate the risks to financial and hence macroeconomic stability associated with current policies … a more balanced approach would mean attaching more weight than hitherto to the risks of normalising too late and too gradually. And, where easing is called for, the same should apply to the risks of easing too aggressively and persistently.

Given where we are, normalisation is bound to be bumpy. Risk-taking in financial markets has gone on for too long. And the illusion that markets will remain liquid under stress has been too pervasive. But the likelihood of turbulence will increase further if current extraordinary conditions are spun out. The more one stretches an elastic band, the more violently it snaps back. Restoring more normal conditions will also be essential for facing the next recession, which will no doubt materialise at some point. Of what use is a gun with no bullets left?"

I don't like the BIS's chances of influencing Federal Reserve Chairman Janet Yellen and her compatriots around the world. It is not human nature to trade a short term and known risk – derailing a fragile economic recovery – for a longer term and less identifiable risk – allowing financial imbalances to accrue. But the warnings are very pertinent for investors. Negative real interest rates are not normal nor sustainable. We need to plan our investments so that they deliver our objectives in a higher interest rate world, and tread very carefully in the meantime.

"MOST INVESTORS BUYING THESE ASSETS ARE NOT DOING SO WITH GREED AS THEIR DRIVING EMOTION, RATHER WITH A SENSE OF RELUCTANT RESIGNATION."

BEST VALUE STOCKS IN AUSTRALIA

Fortunately, there are a few pockets of extreme value keeping us busy - the whole fund is looking particularly prospective. When I look across that portfolio, I couldn't give two hoots about global monetary policy or the direction of the domestic economy.

For the most part, the best investment opportunities today are not high quality businesses. As much as we would love to own them, the best businesses on the ASX are particularly expensive at the moment and the consequences of owning expensive stocks are currently being felt by investors in darlings like **Seek** (ASX:SEK) and **Flight Centre** (ASX:FLT). Relatively minor disappointments sent those two companies' share prices down 17% and 15% respectively during the quarter.

Macmahon Holdings (ASX:MAH), on the other hand, has done nothing but disappoint shareholders for the past three years. We initially bought it knowing it was a terrible business and that the external environment was going to deteriorate further. It has still managed to disappoint us (see page 8). Yet price compensates for a lot of ills. The announcement of a large contract loss in February pushed the share price down to 3.4 cents, at which point the market capitalisation was $40m.

During the June quarter Macmahon's management announced they have sold some assets in Mongolia for US$63m and settled a law suit for $19m, bringing roughly A$100m cash into the coffers. We estimate the company now has $40m of net cash, a business that should generate $30m of annual cashflow for shareholders and surplus equipment that could sell for $50m, even in today's distressed environment. Yes, it remains a horrible business, but the share price was absurd. At today's market capitalisation of $85m, it remains too cheap.

There are currently a significant number of similar opportunities listed on the ASX and we own 10 of them (see **page 9**). They are of varying quality and have varying degrees of exposure to the mining services space. The common factor is that they are cheap.

Hence we head into the new financial year with a sense of optimism about the prospective returns on offer.

STEVEN JOHNSON
Chief Investment Officer

“NEGATIVE REAL INTEREST RATES ARE NOT NORMAL NOR SUSTAINABLE. WE NEED TO PLAN OUR INVESTMENTS SO THAT THEY DELIVER OUR OBJECTIVES IN A HIGHER INTEREST RATE WORLD, AND TREAD VERY CAREFULLY IN THE MEANTIME.”

WHOLESALE VALUE FUND

FACTS

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

UNIT PRICE SUMMARY

Date	30 June 2015
Buy Price	$1.3357
Redemption Price	$1.3291
Mid Price	$1.3324
Distribution 30 June 2015	5.94cpu
Portfolio value	$21.5m

WHOLESALE VALUE FUND PERFORMANCE

Good news from a number of stocks propelled the fund to an excellent year relative to the index. The portfolio is well placed for a better year ahead.

Negative returns are nothing to crow about, but the past three months represented a better quarter for the fund than the market. The fund unit price fell 0.69%, but that was in a market where the index fell 6%. Many portfolio companies saw their share prices fall as much or more than the market – which is to be expected. But company specific news from **Service Stream** (SSM), **Macmahon** (MAH) and **Infigen** (IFN) meant that strong gains in those three stocks offset some of the falls elsewhere.

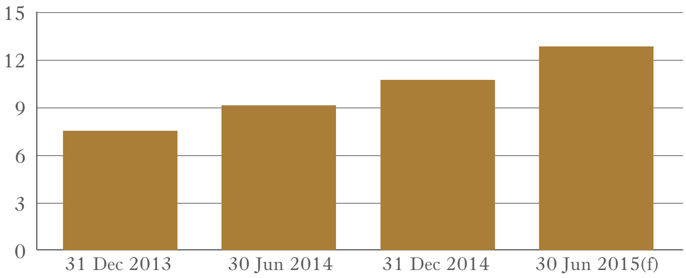
Table 1: Summary of returns as at 30 June 2015

	Wholesale Value Fund	ASX All Ords Accum. Index
1 month return	–2.63%	–5.40%
3 month return	–0.69%	–6.25%
6 month return	4.59%	3.32%
1 year return	10.21%	5.67%
2 year return (pa)	12.03%	11.50%
3 year return (pa)	20.18%	14.47%
Since inception* (pa)	7.38%	8.49%

*Inception 2 Sep 2004

It has been almost 18 months since we significantly increased the fund's investment in Service Stream, participating in the company's capital raising in January last year. The share price hardly moved over the ensuing period, while the management team quietly went about increasing profitability and stabilising the company's revenue. Progress was obvious in the results for the year to 30 June 14 and the half year to 31 December, but investors took no notice.

Chart 1: Service Stream's EBITDA



Source: Service Stream

For whatever reason – perhaps the progress became too obvious to miss – that changed with a market update provided in May.

The company – which provides installation and maintenance services to telecommunications and utilities clients – now forecasts full year earnings before interest and tax of $24m for 2015. That should translate to profit after tax of $10m and represents healthy growth relative to recent periods (see Chart 1). Our estimate of the current run rate is $14m of net profit next year without any significant growth. Relative to a $115m market capitalisation, that looks cheap despite the 40% price increase during the quarter.

INFIGEN FINALLY STARTS TO BLOW WIND

Waiting a couple of years for something to happen with Service Stream is nothing compared to our investment in Infigen. The Fund has owned securities in this wind farm owner since 2010. It hasn't paid a dividend and the unit price has spent most of that time trading between $0.20 and $0.30, a meaningful drag on the average annual return.

That *could* be changing, thanks to a few events during the past six months. First, the Federal parliament has published an amendment to Australia's renewable energy policy, reducing the 2020 target for renewable energy from 43,000 Gwh to 33,000 Gwh.

Chart 2: Infigen share price

Source: S&P Capital IQ

Despite being a significant reduction, that's good news for Infigen. There was a significant risk that the target was abolished altogether and the new target still requires plenty of new windfarms in the next four years. Infigen has a large portfolio of approved but undeveloped projects which should now proceed (hopefully with someone else's money) and its existing assets can be re-contracted to utilities that need to increase their renewable energy purchases.

Second, late in June Infigen announced that it has sold its US Solar business for US$37m, plus up to US$30m more if certain post-sale targets are met. We hadn't attributed any value to this part of the business until they sold a couple of projects for US$15m during 2014, so it's an unexpected windfall. It also sits outside the assets over which the company's lenders have security, so shouldn't be confiscated by the banks.

There are a few more pieces of the puzzle that need to be put in place before Infigen's value will become obvious to the wider market. It currently has its US wind portfolio up for sale and a

> "WAITING A COUPLE OF YEARS FOR SOMETHING TO HAPPEN WITH SERVICE STREAM IS NOTHING COMPARED TO OUR INVESTMENT IN INFIGEN."

price in excess of US$350m is essential if Infigen is to refinance its debt. Even then, we anticipate a rights issue will be required, but that is all looking increasingly likely. If achieved, Infigen could be paying significant distributions by this time next year and will look appealing to yield-seeking investors prepared to pay us a much higher price. Its closing price was up 5% on the 31 March price.

RARE VALUE IN MEDIOCRITY

The fund first ventured in to mining services in 2013, and the results since have been poor. Shares in mining contractor Macmahon were selling for a third of our original purchase price by February. **Hughes Drilling** (HDX), which provides production drilling for coal-miners, saw its share price fall nearly by 70% after our first purchase. It has since doubled but, even after buying more shares at lower prices, we are still slightly under water.

With the exception of some healthy fully franked dividends from Brierty, there aren't any counterbalancing big winners in the sector as yet, either. We've asked ourselves whether continuing investment is justified and have done a full review of our investments and the wider sector, including some miners. The answer is a resounding yes.

On average, mining is a tough business. In terms of the sheer extent of value destruction, the junior miners are the worst of the bunch. Management act like poker machine addicts—the next big jackpot is always just around the corner, so cash rarely stays in the bank for long and almost never gets paid out as dividends. It is gambled on mainly losing bets.

One percent of miners hit the jackpot, the rest run out of cash and return to shareholders for more money regularly. We continue to keep an eye out for value, but other than **BHP Billiton** (BHP) spin-off **South32** (S32) at the larger end of the market, we haven't found much to invest in.

The service providers too are a mediocre bunch. In favourable circumstances they can mimic good companies, but when conditions deteriorate they are usually shown to be cyclical beasts. As investors in **United Group** (UGL) and **Forge Group** (FGE) would know, profit is often earned by taking on risks that aren't apparent until the company is battered by them.

Our experience to date, particularly with Macmahon, gives us further reason to be wary. The first purchase of shares in the company was two years ago, just prior to it reporting $1.3bn in revenue for the 2013 financial year. It was obviously going to shrink, but we had pencilled in $700m per annum as a sustainable amount of revenue. That number turned out to be wildly optimistic: for the coming 2016 financial year it could be less than $300m. The company has failed to renew every contract that has expired, hasn't been able to land one new win and had an important long-term contract with Fortescue cancelled.

But from our review we've concluded, despite the mediocrity, there's remarkable value in the service providers. A few of them are better quality then they look. But for the most part it's because, as the commodities boom has faltered, share prices have plummeted. These businesses are average, but not *this* average.

They are also less risky than they were two years ago. Having closely watched the sector for two years now, we are beginning to see the operating results of companies progressing through the difficult business conditions. The results aren't pretty, but they aren't catastrophic either, and our conviction is strengthening that the value here is real and hugely mispriced.

Chart 3: Comparison of $10,000 invested in Forager Wholesale Fund vs ASX All Ordinaries Accum Index

Even our friends at Macmahon have managed to pull a rabbit out of the hat. Its Mongolian business – on care and maintenance since the Mongolian government stopped paying the bills in August last year – has been sold for net proceeds of US$63m, or approximately 6.5 cents per share (compared that with a pre-announcement share price of 4.6 cents). We need to make sure the rabbit doesn't run off into the bushes (the CFO seemed reluctant to discuss the best way of returning this cash to shareholders) but from its newfound position of being net debt free and with cash in the bank, it is hard to see it ending in disaster.

The story is similar across the sector. At these prices, many service providers in the fund will likely produce more cash flow in a just a few years than their current market capitalisation. Others trade at a fraction of their liquidating asset value. Some have both huge earning yields and sell at a discount to tangible assets, increasing the protection.

Having swept the sector, here's a summary of our best picks and the opportunity as we see it. Any one of these businesses could have a tough run, and it's highly likely one or two will. But together the combined earning power, cash generation and asset backing for each dollar invested is very impressive. It's as exciting a bucket of stocks as we've ever had in the portfolio.

> “THE COMPANY HAS FAILED TO RENEW EVERY CONTRACT THAT HAS EXPIRED, HASN’T BEEN ABLE TO LAND ONE NEW WIN AND HAD AN IMPORTANT LONG-TERM CONTRACT WITH FORTESCUE CANCELLED.”

Warren Buffett once said: ‘Opportunities come infrequently. When it rains gold, put out the bucket, not the thimble’. The Australian Fund has topped up in the best on offer, and our bucket is out and ready to collect.

Despite the drag from mining services, the past 12 months have been good for the Fund, with an investment returning 10% versus the 6% return from the index. Pregnant with opportunity at the moment, we are hopeful of even better to come.

Company	Description	Opportunity
Hughes Drilling	Production drilling	Price / earnings < 5 x
Boom Logistics	Crane hire	Price / net tangible assets = 0.25 x
Logicamms	Engineering services	45% cash backed, price / earnings = 6 x
Brierty	Civil and contract mining	Price / earnings < 5 x
Mining and Civil Australia	Civil and contract mining	EV / EBITDA = 1 x
Macmahon	Contract mining	EV / EBITDA = 1 x
Watpac	Construction, civil, mining	EV / EBITDA = 2 x
Coffey	Geosciences	EV / revenue = 0.2 x
MMA Offshore	Offshore oil and gas vessels	Price / net tangible assets = 0.24 x
South32	Diversified miner	Price / net tangible assets = 0.6 x

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