FORAGER

30 September 2015

WHOLESALE VALUE FUND SEPTEMBER 2015

QUARTERLY REPORT

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FOCUSING ON THE THINGS THAT MATTER

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Dear Investor,

Investors who have been with us a while are going to notice a subtle change in this quarterly report. There will be much less focus on performance.

In July we attended an investing conference where one of the speakers was a representative of the MIT Endowment Fund. While most of us were there to talk about stocks, he talked about his experience watching funds management businesses from the outside. With more than US$10bn to look after and a stated philosophy of selecting active managers to invest on the fund's behalf, he had seen his share of funds management businesses.

His speech highlighted the mistakes he had seen bring funds management businesses unstuck. One common shortcoming was a disconnect between the philosophy underlying the investment process and the communication between the fund manager and his or her investors.

Why, he asked, does a fund manager who professes to invest for the long term feel the need to explain every little rise or fall in the unit price? Why are the quarterly reports focused on which stock rose 5% and which fell 10% when the investments are supposed to be held for three to five years? And what impact does all of this short-term, performance focused reporting have on the manager's actual investing?

When I look at the format of our historical monthly and quarterly reports, we are guilty. Yes, we write plenty about long-term investing and the underlying thesis behind the investments we make on your behalf. But the first paragraph of every report we have ever written has focused on the performance over the previous month or quarter.

It is of no use to you. Apart from encouraging you to think about the wrong things, you can get the performance off the website any time you feel like it. And reporting short-term results potentially impacts our investing without us even knowing it.

So, as of this quarter, the regular quarterly reports will be about our investments, why they have been made and how they are progressing. Then, shortly following 30 June every year, we will send you an annual performance report that shows you what we have achieved over the long term and how we have done it. This performance reporting will be much more detailed than anything we have provided before, but it will only come once per year and will focus on the long-term results.

While recognising that this is going to be quite different from the industry standard, reporting consistent with our investing is the right approach for our business and Forager's investors.

TOO LATE TO PANIC ABOUT CHINA'S ECONOMY

China's economy had me puzzled back in 2011. My understanding was that the country's growth miracle was founded on exporting cheap goods and labour to the rest of the world. Presumably, that would make it highly dependent on global GDP growth.

Yet as the United States and Europe, combined some 50% of global GDP, were muddling their way through the worst recession since the 1930s, China was reporting economic growth well in excess of 10% per annum. How is it possible for an export-driven economy to grow at double digit rates when its main trading partners are shrinking?

As an Australian fund manager, I needed to answer that question. China's hectic growth was driving voracious demand for Australian resources. That, in turn, was propping up our economy and sending resources stocks to stratospheric heights.

My research uncovered all of the usual bull and bear arguments. The bulls argued that the transition of China's population from unproductive rural peasants to educated city-dwellers had many decades to run, and that China's GDP per head was still a small fraction of the US or Japan. The most common bear argument seemed to be that a communist government could never create a first-world economy.

None of this made much sense to me. If all you needed was hundreds of millions of rural workers and a large gap between your GDP and America's, then India and Indonesia should also be growing as fast as China. As for the Communist Party, they made a decent fist of it over the prior 30 years. In fact, the ability to build decent roads and airports seemed something of an advantage when compared with the dysfunctional political system in the US (or Australia, for that matter).

Then I stumbled across research by Michael Pettis, a professor at Peking University in Beijing. It was one of the more important finds of my investing career.

IT'S THE INVESTMENT, STUPID

First, Pettis outlined what was happening in China's economy. Net exports had indeed fallen, from 8% of GDP in 2008 to 4% of GDP in 2009; but even the 8% was much smaller than I had expected for an 'export-driven' economy. That went some way to explaining why the global recession was not pounding China. It turns out China's economy was (and is) an investment-driven economy, with half of its GDP comprised of spending on roads, buildings, airports and the like. The fall in net exports was more than offset by an increase in construction, fired by government stimulus and associated debt.

That gave me a much better understanding of China's growth model. What Pettis explained next, however, was the crucial part. He explained that there was nothing unique about China's 'miracle economy'. In fact, every other economy that had grown in a similar fashion had eventually come unstuck:

'In all previous cases of countries following similar growth models, the dangerous combination of repressed pricing signals, distorted investment incentives, and excessive reliance on accelerating investment to generate growth has always eventually pushed growth past the point where it is sustainable, leading always to capital misallocation and waste. At this point – which China may have reached a decade ago – debt begins to rise unsustainably.

> “STOCK PRICES DO NOT WAIT FOR CURRENT DATA, THEY MOVE AS SOON AS EXPECTATIONS CHANGE ABOUT THE FUTURE. YES, CHINA’S ECONOMY IS DETERIORATING, BUT I CAN ASSURE YOU TODAY’S BUYER OF RIO TINTO IS ALREADY AWARE OF THAT FACT.”

China’s problem now is that the authorities can continue to get rapid growth only at the expense of ever-riskier increases in debt. Eventually either they will choose sharply to curtail investment, or excessive debt will force them to do so. Either way we should expect many years of growth well below even the most pessimistic current forecasts. But not yet. High, investment-driven growth is likely to continue for at least another two years.’

You may have read or seen some of the exposés of China’s ghost cities, but Pettis explained in 2011 why and how the entire economy’s growth was unsustainable. We have been preparing for a China crisis for a long time.

IF YOU ARE GOING TO PANIC, PANIC EARLY

Today China’s economic problems are on the front page of newspapers around the world. Every week we see a new factory output statistic or Purchasing Managers Index that tells us the slowdown might be more of the hard variety than the soft. That would not surprise me one iota. But today’s investors face a dilemma.

Sure, you can sell your Rio Tinto shares because the China dream is over. But you will be selling them for $50 each, not the $85 they were changing hands for in 2011. You can sell your BHP Billiton shares, but you will be banking $24 a pop instead of the $45 you could have received four years ago.

The stock market looks through the front windscreen, not the rear. Stock prices do not wait for current data, they move as soon as expectations change about the future. Yes, China’s economy is deteriorating, but I can assure you today’s buyer of Rio Tinto is already aware of that fact.

Indeed, Forager has added its first ever mining stock to its portfolios in the past few months. BHP Billiton spinoff South 32 owns a world class collection of mining assets in alumina, manganese, coal, silver, nickel and lead.

It is among the world’s most efficient producers in each commodity class, which means that a majority of competing mines will be bleeding red ink while South 32 remains profitable. The balance sheet is robust, and the early indications are that the managers are top notch (and have been buying shares with their own money).

Today’s share price suggests the company is only worth half the replacement cost of its assets. We expect things to remain ugly for a few years yet, but I find it hard to envisage a world where these assets produce such lowly returns over the long term.

I remain bearish on China’s prospects and their impact on the Australian economy. Domestic interest rates will fall further and could potentially wind up at zero. But it is too late to sell your mining stocks now. The time to panic was four years ago.

Yours sincerely,

STEVEN JOHNSON
Chief Investment Officer

“WHILE RECOGNISING THAT THIS IS GOING TO BE QUITE DIFFERENT FROM THE INDUSTRY STANDARD, REPORTING CONSISTENT WITH OUR INVESTING IS THE RIGHT APPROACH FOR OUR BUSINESS AND FORAGER’S INVESTORS.”

WHOLESALE VALUE FUND

FACTS

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

UNIT PRICE SUMMARY

Date	30 September 2015
Buy Price	$1.3358
Redemption Price	$1.3292
Mid Price	$1.3325
Distribution 30 September 15	2.50cpu
Portfolio value	21.2m

RETURNS AND PROMISE FOR THE WHOLESALE FUND

The ASX All Ordinaries definitely has a case of the jitters, but for all the fuss finished the quarter only 6% lower, or about 15% below its April high. Volatility is a benefit to long-term investors.

Following several years of steadily rising markets, 2015 has seen a pronounced increase in share price volatility. In contrast with the typical up-and-down market, the share prices of Australia's larger companies have been bumpier than those of their smaller brethren. Even when we have seen attractive prices at the small end of the market, poor liquidity has prohibited us from making any meaningful investments.

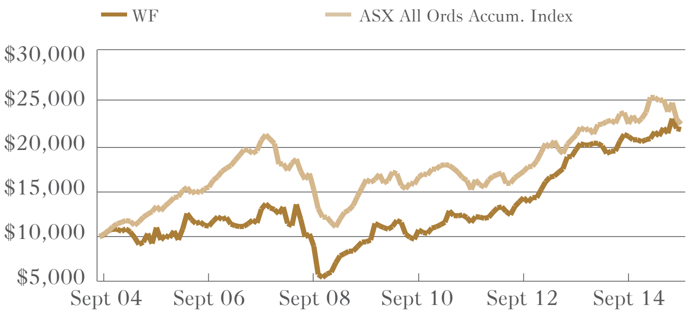
While we have one larger new idea (detailed below), we have spent most of the period digesting recent full-year results from our portfolio companies and assessing their progress against our investing theses. The news has not been as encouraging as in previous years, though we do have one standout performer.

Table 1: Summary of returns as at 30 Sept 2015

	Wholesale Value Fund	ASX All Ords Accum. Index
1 month return	–0.58%	–2.50%
3 month return	1.89%	–5.79%
6 month return	1.18%	–11.68%
1 year return	3.65%	–0.16%
2 year return (pa)	5.50%	2.82%
3 year return (pa)	15.28%	9.31%
Since inception* (pa)	7.39%	7.65%

*Inception 2 Sep 2004

Chart 1: Comparison of $10,000 invested in the Wholesale Fund and ASX All Ords Index



Inception 2 Sep 2004

SERVICE STREAM BACK ONLINE

Service Stream (SSM), which provides blue-collar services to telecommunication companies and utilities, produced an excellent full-year result reporting operating profit of $19m before tax. That more than doubled last year's effort and exceeded management's own guidance.

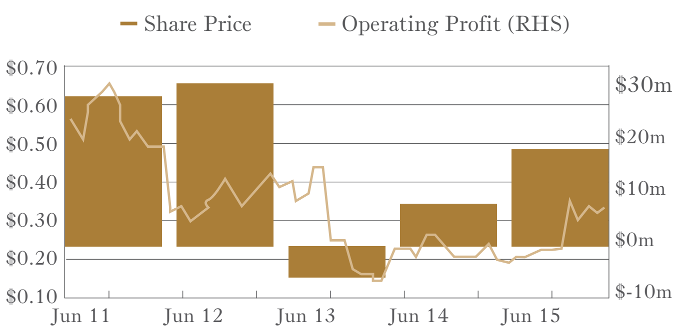
Now the Wholesale Fund's largest investment, the company has redeemed itself after a disastrous period in 2013 where it was forced to relinquish contracts with the National Broadband Network (NBN), wind up the joint-venture with Lend Lease (LLC), and suspend trading in its shares while it restructured debt.

With the debt now repaid, the company has a more promising future. If the company can grow modestly while maintaining margins, full-year profit after tax could be around $16m or 4.3 cents per share this year. Service Stream could easily be worth $0.50 per share, which is why we have not rushed to sell despite sitting on some nice profits from purchases at an average price of $0.19.

There is also a possibility it could do even better. Service Stream's Fixed Communications division, for several years the problem child, is performing well and should grow handsomely as the NBN rollout ramps up. In 2015, around 400,000 homes were connected to the NBN. But with some 10 million homes still to be connected, there is plenty of work for a decade to come.The company has now run out of franking credits and will not be paying taxes any time soon due to its available tax losses. Not having to pay tax is great; and as we did with **Watpac** (WTP) in the same circumstance, we have indicated to Service Stream we would rather it not pay unfranked dividends for this period.

Shareholders pay full income tax on unfranked dividends, which spoils the whole benefit of the company's tax losses. A capital return or share buy-back would make much more sense. Hopefully common sense (rather than dividend fixation) prevails, and the dividend is cut.

Chart 2: Service Stream Share Price and Operating profit



Source: Capital IQ

CONTRACTOR WOES

We touched in the recent monthly report on the disappointing results from **Boom Logistics** (BOL), **Brierty** (BYL), **Coffey International** (COF) and **Hughes Drilling** (HDX), all reporting higher than expected debt.

Two of those companies, Brierty and Hughes Drilling, continued their inglorious runs in September. Unable to resolve a $9m dispute with Main Roads Western Australia,

“IN 2015, AROUND 400,000 HOMES WERE CONNECTED TO THE NBN. BUT WITH SOME 10 MILLION HOMES STILL TO BE CONNECTED, THERE IS PLENTY OF WORK FOR A DECADE TO COME.”

Brierty saw a decline in profit and tripped a bank covenant. That is a serious event, and the inability to resolve a claim with a major customer does not inspire confidence. This may prove to be just a hiccup for this civil contractor, but our suspicions are aroused that there may be deeper problems.

Hughes Drilling, which does exactly what its name suggests, found itself suspended from the ASX after failing to lodge its audited accounts on time.

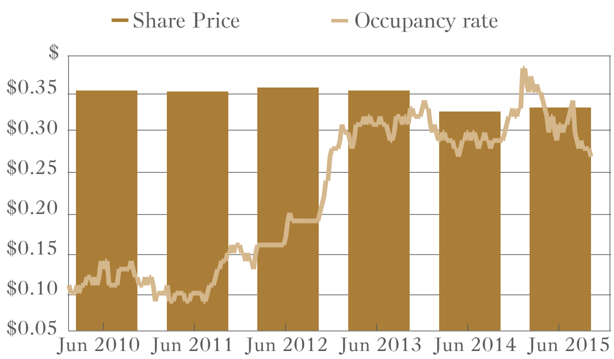
It is hard to know how to interpret this. Despite its impressive operational performance, the company has a management team as deep as Lake Eyre and could have simply missed the deadline. Or the delay could be due to issues the auditor might have raised.

We will not know until the accounts are published. These are unimpressive developments for both companies, but without a few trepidations their shares would not trade at such depressed prices. Time will tell whether we have assessed the value and risk correctly, but we are keeping the portfolio weightings small just in case.

STILL WAITING FOR RNY

The Wholesale Fund first purchased units of **RNY Property Trust** (RNY) in 2010. An owner of suburban office property near New York City, RNY had been decimated by the global financial crisis and ensuing recession. It was overleveraged and looked unlikely to be able to refinance large chunks of its expiring debt.

Chart 3: RNY Occupancy rate and Share Price



Source: Capital IQ

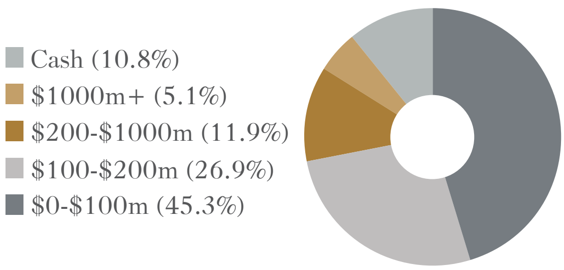
We reasoned that even if a few properties were repossessed by lenders, the other assets were worth far more than the unit price of $0.12. That has proved to be a good call, and the unit price has since more than doubled to $0.27. Net asset value per unit, aided by a stronger US dollar, has climbed from a low of $0.28 in 2011 to around $0.63 at today’s exchange rate.

However, the process to value realisation has dragged out longer than we envisaged. Activity in the suburban office market remains anaemic with very few properties changing hands. Occupancy has declined from greater than 90% to less than 80% as management has struggled to retain tenants and replace those who leave.

This is partly because the recovery has been slow to spread to small and medium businesses. But there has also been a structural shift away from suburban office parks towards downtown office space close to public transport (living in New York City and “reverse commuting” to the suburbs has become increasingly popular).

That has meant the trust is not producing any cash flow and RNY investors are not being paid while we wait for value to be realised. So is it time to take our gains and move on? Or to press management to sell the properties and wind-up the trust?

Chart 4: Portfolio distribution according to market cap



We do not think so. For starters, at today’s unit price there is a 130% return available for an investor who eventually manages to realise RNY’s net asset value. Of course there are no guarantees the assets will actually be realised for net asset value, but that is a large and attractive gap. Secondly, to maximise the value these assets can be sold for, an orderly process is essential. If the properties are taken to market too quickly, with poor occupancy, too many upcoming lease expirations, or without clean financing, they will not attract a good sale price.

So we will continue to wait. It requires patience, but that is what long-term investing is all about—delaying gratification today for better rewards tomorrow. In the meantime, management has plenty of work to do.

RNY is starved of the cash it needs to invest to attract tenants. A couple of assets could be sold in the next six months, and one tranche of debt expires in January. It is likely that more money can be borrowed through a refinancing of this facility, which will release cash the company can put to use.

There is no telling the exact finish date for realising our investment in RNY. Most of the remaining debt expires in 2017, so it is not likely to be earlier than that. But as we look ahead over the next six months, we are optimistic we will see the first signs of progress.

“WITH MINIMAL DEBT AND LOW-COST MINES, SOUTH32 IS WELL POSITIONED TO CUT COSTS AND WAIT THIS PERIOD OUT. MANY PEERS DO NOT HAVE THE SAME LUXURY.”

SOUTH32 SPINS-OFF, SLIDES-DOWN

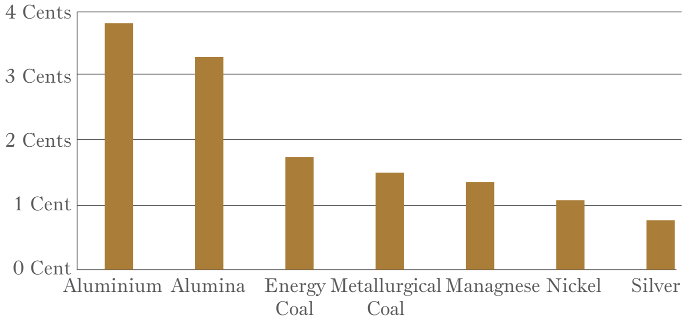
One new addition to the portfolio we are excited about is **South32** (S32), formerly part of diversified miner **BHP Billiton** (BHP). The new spinoff owns a range of mines in the southern equator including assets in Australia, South Africa and South America—hence the ‘South’ part of its new name.

Most of the mines are high quality and low cost. But the commodities involved—aluminium, coal, nickel and manganese—are all in a deep slump, and South Africa and South America are not the easiest places to do business. Labour strikes and power outages are everyday operating risks.

Amidst the ongoing rout in mining shares, the company’s stock price has slid 44% from $2.45 to $1.37. We sense opportunity. The malaise in commodity prices is cushioned quite a bit by weaker local currencies in the regions in which South32 operates, lowering costs in US dollars. We do not expect a rebound in commodity prices any time soon, but with minimal debt and low-cost mines, South32 is well positioned to cut costs and wait this period out. Many peers do not have the same luxury.

Return on invested capital is currently a miserable 6.2%, but quality assets like these should earn better returns over the commodity cycle. We doubt all of South32’s depressed commodities will remain so forever, and South32’s shares are selling at just 52% of their US$2 tangible book value.

Chart 5: Impact of 10% change in commodity price to South32’s earnings per share



* = assume 30% tax rate and 1 AUD = 0.70 USD
Source: South 32, Forager

Speaking after the results were released, chief executive Graham Kerr was very upbeat on the potential for improved cost efficiency now that South32 had been cut loose from BHP. If other spinoffs are a guide, the savings will be significant. Management seems to have its head screwed on properly in respect of capital management (extraordinary for a miner); and with modest capital expenditure requirements, there is a chance it could do something clever such as a share buy-back.

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