FORAGER

31 December 2015

# WHOLESALE VALUE FUND DECEMBER 2015

# QUARTERLY REPORT

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# LETTER FROM STEVE JOHNSON

I started the year on skis and ended it on crutches, but it wasn't all downhill in 2015. In fact, it was a good year for both Forager funds and the business.

Dear Investor,

This calendar year was a treacherous one, with a number of high profile disasters catching investors unaware and a global commodity bear market turning into an out and out rout. Combined with the ups and downs of our own small investing world, this provided the backdrop for plenty more deposits in the Forager knowledge bank. I asked the team to share a few of their own lessons from the past year and have summarised their thoughts into the following six lessons.

## THE VOLATILE NATURE OF COMMODITIES BUSINESSES

The mistake that cost you money this year – particularly if you are invested in the Forager International Shares Fund – was our assumption that oil prices would remain around $100, or potentially rise from there. Our investments in oil services stocks were belted in late 2014 and belted again in 2015, partially offsetting some excellent results elsewhere in the portfolio.

There are a few lessons here. The first, as our Americas analyst Kevin Rose points out, is that the market is highly sensitive to what we would previously have considered relatively small changes in supply and demand. "We didn't appreciate that oversupply of 2-3% could send the oil price plummeting 70%". We discussed the impact of US shale supply in depth before investing in the oil-exposed stocks but didn't anticipate how significant its impact would be on the price. The past 50 years of historical oil prices, suggest we probably should have.

Second, a few years back the price incentive needed to add additional oil resources was north of $100. We underestimated how malleable this number was. Kevin's big lesson for the year is that, when the price falls, industry participants miraculously find a way to pump oil at half the boom-time cost.

"Once demand starts to dry up, contractor capacity that had been added is suddenly superfluous, and prices begin to contract. This means that the marginal cash cost of production does not remain where it was, but falls, leading to greater production and longer down cycles than one might originally estimate."

This dynamic is playing out across the whole commodities sector and means that much-needed supply curtailment is taking longer than expected and happening at much lower prices than previously envisaged. Those cost curves aren't worth the paper they are drawn on.

The final lesson from the oil patch relates to the specific risks of investing in businesses where the main determinant of value is something as volatile as the oil price.

There's a healthy debate going on at the moment about the value of one of Australia's great businesses, ASX-listed **Woolworths** (ASX:WOW). The bulls think its dominant market position means 7% EBIT margins in Woolworths' groceries division are sustainable. The bears think low cost competition will have the same impact it has had in the UK and drive margins down to 3-4%. That wouldn't be a good outcome for shareholders, but it would still be a very profitable business.

Contrast that range of potential outcomes with our oil services investments. They were nicely profitable a few years ago and are bleeding losses now, almost exclusively because of something completely outside of management's control – the oil price. The degree of variability in these businesses is dramatic and the value of them is dependent on something which is largely unknowable. We should only be investing in them at times of outright pessimism and, even then, in very small portions.

## TOO MUCH TALKING TO MANAGEMENT IS DANGEROUS

"Not much" is my answer when asked how much time we spend talking to management. Most people seem to think we should be doing a lot of it, but 2015 reiterated the dangers of getting too close to CEOs.

Concerned about the company's viability, we had a call with the management of oil service company Dolphin Geophysical in March 2015. The share price had already fallen roughly two thirds from its peak but we were worried about it going to zero given the state of the oil market at the time.

Armed with the knowledge that the company has now filed for bankruptcy (fortunately we sold it a few months ago, but not before losing the vast majority of our investment), the notes from that call are laughable. Of course everything was going to be fine. Of course they had plenty of potential to cut costs. Of course their "asset light" business model would enable them to skilfully navigate the current market conditions.

What did we expect? Were they ever going to tell us they were going bust? It is often more nuanced than this, and getting the most out of management meetings is all about reading between the lines. But they are always going to tell you what you want to hear, and more often than not you only want to hear what reinforces your pre-existing ideas.

Management meetings can be a useful part of an investment process – particularly when you have already done a significant amount of research and are tying up loose ends – but they are a relatively small part of ours, and I expect it will stay that way.

## OUR EDGE IS SMALL COMPANIES

We've had some big wins this year. **Service Stream** (ASX:SSM) and **Coffey International** (ASX:COF) almost doubled in the Wholesale Value Fund. It's not going to surprise you that they are both relatively small companies. As European analyst Gareth Brown points out, "There's danger in extrapolating" but the year provided "further evidence that we can develop an edge most convincingly in smaller stocks and this is where we should focus our resources."

Forager is a small team of analysts competing with giants of the funds management world. Apart from loyal and long-term clients allowing us to make genuinely long-term investments, our most significant advantage is being able to invest in parts of the market where the competition can't. This year has reiterated how successful that can be.

## DON'T LET RISING PRICES KILL GOOD IDEAS

Both Gareth and junior analyst Alvise Peggion listed some of their biggest mistakes of 2015 as "errors of omission". Gareth's most significant was German car-wash manufacturer

> “WE TEND TO BE PRETTY GOOD AT IGNORING THE PESSIMISM WHEN A STOCK IS TRADING AT OR NEAR ITS LOWS, BUT THIS SAME BENT FOR A BARGAIN SOMETIMES STOPS US BUYING A STOCK SIMPLY BECAUSE ITS PRICE HAS RISEN.”

**Washtec:** (DB:WSU) “I came across it around the same time I was studying Kapsch, so it took a temporary back seat. By the time I returned, it had risen 25% which, irrationally, put me off. It has subsequently doubled.”

Junior Analyst Alvise Peggion went one better than that with ASX-listed honey company **Capilano Honey** (ASX:CZZ):

“When we started analysing the stock in 2014, the company was trading on a pre-tax earnings multiple of about eight times (adjusted for insurance reimbursements). That looked low for a company with a strong competitive position and one set to benefit significantly from strong Asian demand and a lower Australian dollar.”

However, the stock was illiquid and the price had jumped 40% by January to about $7. Despite signs that the investment thesis was looking better than originally envisaged, we decided to wait for the price to fall.

“Well it didn’t – today the share price is $22”.

Value investors find it easy to ignore the pessimism when a stock is trading at or near its lows, but this same bent for a bargain sometimes stops us buying a stock simply because its price has risen. As Alvise puts it, “the lesson here is that the market can underreact to new positive information, just like it can overreact to new negative information”. We tend to be pretty good at factoring the new information in when we already own a stock. Over the past year we have added to our largest holdings in both portfolios as good news didn’t move the share price as much as it should have. We need to get better at doing the same for stocks we don’t yet own.

## GOOD IDEAS ARE SIMPLE

The best investment ideas are very rarely immediately obvious. Except in times of extreme distress, we shouldn’t expect fellow investors to leave $100 notes lying around on the pavement. Looking back at our best investments from the past year, none of them would have looked cheap on the basis of superficial ratios (each of the successes mentioned above would have been trading at large multiples of both earnings and assets at the start of the year).

We generally need an insight into the business or the opportunity that other investors haven’t had. Regarding Betfair, that was the competitive advantage and scalability of its business model. For Coffey, it was that one division was worth more than the entire value implied by the share price. These key insights might require a lot of work and some creative thinking but, once you have the insight, the idea itself should be very easy to explain.

Simplicity is often a key indicator of a bargain. Take Kapsch TrafficCom for example. This Austrian tolling technology company has its complications. The company has two main divisions, one of which is lossmaking, and dozens of new business opportunities that haven’t yet been executed on. The idea was simple, though, because the share price was low enough to ignore the complexity.

As Gareth puts it, “at a price of €20 per share, you were buying the whole business for less than the value of Kapsch’s reliable, predictable truck tolling division of the business”. If the rest turned out to be worth anything positive, “the stock would turn out to be a bargain”. At a higher price, you need to start putting a value on all of those options and that’s where the idea gets complicated.

And generally, the more complicated an idea, the more things that can go wrong. Our investment in oil-services company **Subsea 7** (OB:SUBC) was dependent on the oil price, the relative competitiveness of offshore oil versus other sources like shale, management execution and the political environment in Brazil. The more factors an idea is dependent on, the more there is that can go wrong.

## THERE’S NOTHING LOST ABOUT THE PAST DECADE

The media (and apparently some fund managers) is calling the 10 years to the end of 2015 the “lost decade” for Australian shares. At the time the article was written, was a “miserly 5.4%”.

First, that doesn’t include dividends. In a country where the tax system encourages particularly high payout ratios, dividends should and do represent the bulk of investor returns. Incorporating dividends, the total return has been a much more acceptable 68%.

More importantly, though, it has been a great decade for stock pickers. We’ve had numerous market panics provide opportunities to invest widely and almost every year has provided enough volatility to find individual opportunities. The past year has been no exception.

Kevin, talking about his biggest successes for the year, notes the **Google** (NASDAQ:GOOG) share price volatility as providing a great opportunity: “Continuing to follow Google after we had sold the stock enabled me to spot a change in its attitude towards capital allocation and costs”. But it was August’s mini meltdown that allowed us to execute on this rediscovered optimism. “Across two trading days in August, the share price of one of the world’s largest businesses traded between $565 and $640, allowing us to pick up shares for $585 each”. Now called **Alphabet**, today it trades at around $775 per share.

There have been hundreds of episodes of market madness that have made the past decade a great one in which to be an active investor. As long as we keep building on our list of investable opportunities, I have no doubt that the coming decade will offer up the same.

**STEVEN JOHNSON**
**Chief Investment Officer**

“FORAGER IS A SMALL TEAM OF ANALYSTS COMPETING WITH GIANTS OF THE FUNDS MANAGEMENT WORLD. APART FROM LOYAL AND LONG-TERM CLIENTS ALLOWING US TO MAKE GENUINELY LONG-TERM INVESTMENTS, OUR MOST SIGNIFICANT ADVANTAGE IS BEING ABLE TO INVEST IN PARTS OF THE MARKET WHERE THE COMPETITION CAN’T.”

# WHOLESALE
# VALUE FUND

## FACTS

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

## UNIT PRICE SUMMARY

| | |
|---|---|
| **Date** | 31 December 2015 |
| **Buy Price** | $1.4390 |
| **Redemption Price** | $1.4318 |
| **Mid Price** | $1.4354 |
| **Portfolio value** | 22.8m |

# FORAGER WHOLESALE VALUE FUND REVIEW

The big miners and banks have been the main drivers of ASX market returns for more than a decade. That came to a dramatic end in 2015.

**Table 1: Summary of Returns as at 31 December 2015**

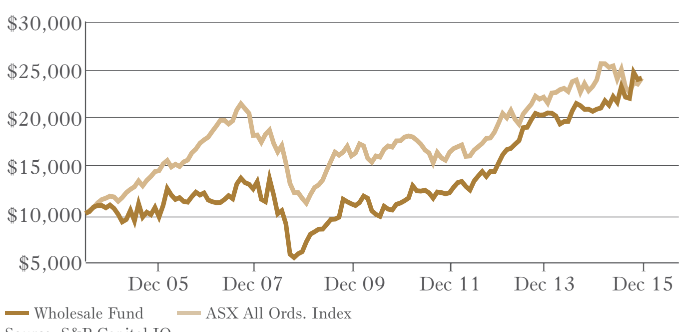
| | Wholesale Value Fund | ASX All Ords Accum. Index |
|---|---|---|
| 1 month return | 0.61% | 2.65% |
| 3 month return | 9.60% | 6.62% |
| 6 month return | 11.67% | 0.45% |
| 1 year return | 16.79% | 3.78% |
| 2 year return (pa) | 9.09% | 4.40% |
| 3 year return (pa) | 18.85% | 9.26% |
| Since inception* (pa) | 8.08% | 8.08% |

*Inception 2 Sep 2004

## YEAR IN REFLECTION

To give an idea of the magnitude of the declines, shares in miner **BHP Billiton** (ASX:BHP) fell 39% during the year, knocking $60 billion Australian dollars off its market capitalisation. Shares in peer **Rio Tinto** (ASX:RIO) fell 23%, shedding $24 billion of value.

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




Source: S&P Capital IQ

Inception 2 Sep 2004

The four big banks lost a further $19bn in appraised value, and if you throw in another $25bn, or 31%, lost by the ASX 200 Energy Index thanks to a collapsing oil price, a total of $128bn has been wiped from the big end of town.

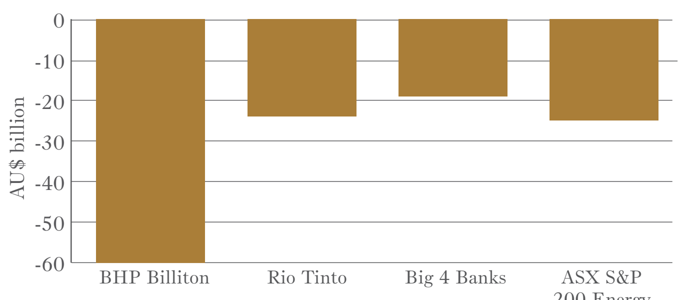
That's more than 8% of the $1.5 trillion ASX All Ordinaries Index, a significant movement to say the least. And for boutique fund managers, like Forager, who tend to ply their share picking skills in smaller industrial companies, it has been a boon to relative returns not to be invested in this part of the market.

In our case it was as a deliberate decision to invest elsewhere. And the Wholesale Value Fund has suffered in previous years against a benchmark propelled by the appreciation of these blue chip companies.

But it does show how arbitrary short-term performance comparisons are, and how difficult it actually is to distinguish between skill and luck in investing. To quote Daniel Kahneman, whose studies found virtually zero correlation in the returns of practitioners in the investment industry from year to year, "the illusion of skill is not only an individual aberration, it is deeply ingrained in the culture of the industry".

That's even more the case in Australia where the index is dominated by a small number of large companies. So don't give too much credence to fund managers, including us, reporting nice relative performance for the past 12 months. Anyone who doesn't own the index is doing well.

**Chart 2: The Big Losers of 2015**




## MAINSTREAM HITS THE BOARDS

A new company, **MainstreamBPO** (ASX:MAI), was added to the Wholesale Value Fund portfolio in late 2015. The shares were bought through an initial public offering, which is something we tend to avoid. But a few factors swayed us to participate here.

Firstly, the sellers were founders rather than private equity. Secondly, the money raised is being used within the business rather than cashing the vendors out. Thirdly, the opportunity was enticing and, due to the company's small size, it was the only way to buy a meaningful amount of shares.

Mainstream provides administration services to the funds management and superannuation industries, helping to take care of day to day activities such as unit pricing, investor communication, and the processing of investor applications and redemptions. The role that Macro performs for the Wholesale Fund. Mainstream performs for other funds management companies, including industry giant **Magellan Financial Group** (ASX:MFG).

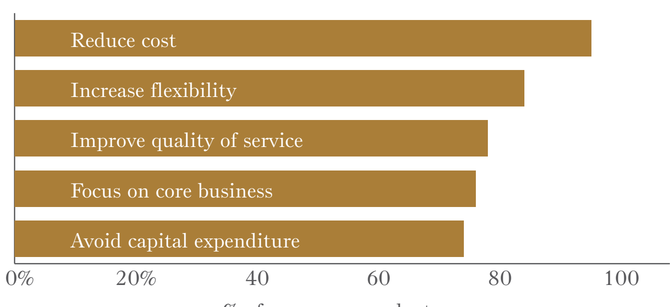
It has also branched out into compliance, performance reporting, and call centre services. This isn't the world's most exciting business but Mainstream takes care of the fiddly little tasks that clients don't want to worry about.

It can be a good business, with reliable revenues and reasonable margins. Importantly, Mainstream has some scale in a business where size matters. Being large delivers big cost savings in this line of work as it allows greater fixed investment in automation and technology, which lower costs and improves service. There

> "IT DOES SHOW HOW ARBITRARY SHORT-TERM PERFORMANCE COMPARISONS ARE, AND HOW DIFFICULT IT IS TO DISTINGUISH BETWEEN SKILL AND LUCK IN INVESTING."

is therefore a strong incentive for clients to outsource (that's the 'O' in 'BPO') administration services rather than do it themselves.

**Chart 4: Top 5 Motivations for Outsourcing Funds Management Operations**




Source: Mainstream BPO prospectus, Accenture Capital Markets White Paper: Outsourcing opportunities and strategies, Global fund manager survey February 2011

Yet, despite the compelling reasons to do so, the industry has been painfully slow to embrace progress. Much work is performed manually that could be automated, and the service provided to investors is often less than what it could be. Many fund management businesses still perform administration in-house, or have outsourced to subscale businesses running outdated software or operating from spreadsheets. That's partly because of switching costs, the effort and risk involved in changing administration providers, but also from lethargy.

The trend is increasingly towards outsourcing, though, as technology pervasively improves and investors demand better service. This, and potential consolidation among service providers, presents good growth opportunities for Mainstream at high incremental returns.

The business isn't bullet-proof. Mainstream's top two clients account for 36% of revenue, which is a little uncomfortable, and there's also the risk that a sharemarket crash could see many of its fund manager clients become unviable. Still, on balance, it's a better business model than most we see.

The Fund's shares were purchased at $0.40, equating to roughly 10 times forecast operating profit before tax. Though it pays to be wary of prospectus forecasts, and we'll be more confident if the forecast results are achieved, that's a nice price for a stable business with potential. The share price has since jumped 48% to $0.59, closer to our estimate of fair value, but liquidity is limited so we'll be holding this investment until it becomes more mature and more shares trade.

**Table 2: Top 5 Investments**

| | |
|---|---|
| Service Stream | 14.3% |
| RNY Property Trust | 8.3% |
| Macmahon Holdings | 7.2% |
| Coffey International | 7.1% |
| GBST Holdings | 5.8% |

## COFFEY SHOWS INCENTIVES NOT RIGHT

If you need convincing that executives only ever give you an extremely biased narrative about a company's prospects (see page 3), just wait for a board sanctioned takeover offer.

We have been concerned about **Coffey International's** (ASX:COF) debt levels since we first bought the stock in June 2014. At meetings prior and subsequent to our investment, both CFO Urs Meyerhans and Managing Director John Douglas were adamant that the relationship with lenders was rock solid and that there was nothing to worry about. The most recent of these meetings was in August 2015.

It's amazing how much can change in less than six months. Apparently, were we not to accept a takeover offer from US company **Tetra Tech** (Nasdaq:TTEK), the Coffey's "overgeared" balance sheet would leave it in a "precarious position".

The truth, of course, is that nothing much has changed. Meyerhans and Douglas changed their tune because they wanted us to accept the bid (sweetened for them thanks to 4.2 million "performance" rights they received at the 2015 AGM, two days after the bid was announced).

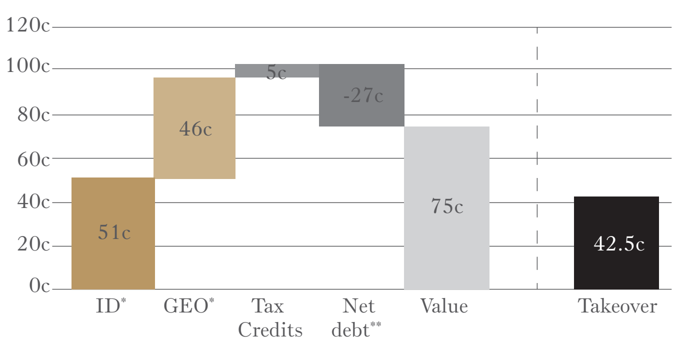
Coffey has too much debt, but that is a fixable problem, not a reason for selling the business on the cheap. Despite the offer price of $0.425 being a huge premium to where Coffey was trading prior to the offer, our view is that the business is worth more. With the Australian dollar buying just 70 US cents, the value of Coffey's International Development business alone justified the bid price and the deal didn't include any value for its significant franking credit balance.

Unfortunately, other shareholders didn't share our view and we were too slow out of the blocks in convincing them otherwise. Tetra Tech had received acceptances equating to 80% of the register prior to Christmas and, faced with the prospect of a prolonged and drawn out stalemate, we decided to throw the towel in and accept the offer.

With an average purchase price in the low twenties, the investment has been a good one for the Wholesale Value Fund and contributed meaningfully to an excellent year in 2015. That shareholders left too much on the table is a slight sour note in the encore.

# "THE TREND TO OUTSOURCING, AND POTENTIAL CONSOLIDATION AMONG SERVICE PROVIDERS, PRESENTS GOOD GROWTH OPPORTUNITIES FOR MAINSTREAM AT HIGH INCREMENTAL RETURNS."

### Chart 5: Forager's Estimate of Value for Coffey




* = Adj. for corporate costs
** = Adj. for cash needed in ID business

On a side note, the lack of consideration given to franking credits in takeover bids has been an extremely frustrating theme throughout 2015. Both Vision Eye Institute and Coffey handed huge piles of franking credits to international acquirers who have much less use for them than we do.

Boards make two big mistakes. They assume only a certain percentage of their shareholder base will value them, when we know from past experience that everyone benefits when franking credits are part of the deal. The shares simply trade from shareholders who don't value them to new ones at a price that benefits both parties.

And, while a typical incentive fee for advisors depends on the price shareholders receive for their shares, boards never include franking credits in that number. Investment bankers want to maximise profit and minimise effort. If they aren't getting paid for it, the chance of them working hard to a find a solution that includes franking credits is zero. Give them a share of the spoils and we are much more likely to get the right result.

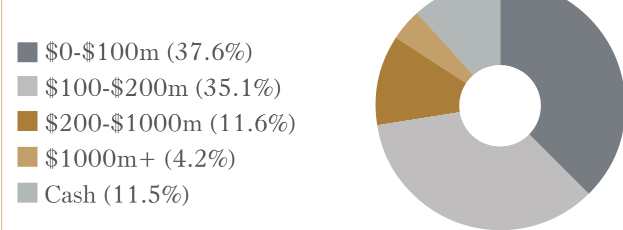
Hopefully 2016 sees a more enlightened approach.

## PARKING OPERATOR SMARTENS UP

We'll finish up this report talking about parking, which is perhaps the only thing less interesting than fund administration. The company of interest, **Smart Parking** (ASX:SPZ), develops hardware sensors and software applications that allow drivers to find vacant parking spaces and pay fees using their mobile phones.

As people fiddling around with loose change could attest, car park management, like fund administration (last reference to it I promise), is stuck in the dark ages, so it should be a promising business. But getting customers – usually local councils – to sign contracts is a painfully slow process. Smart Parking has London's Westminster council on board and a significant number of high profile trials under way, but this part of the business is only bringing in $4m of revenue at the moment and losing money. There's value in the technology, but it's hard to be sure how much.

### Chart 6: Portfolio Distribution According to Market Cap




Smart Parking has another source of value, however, in a managed services segment which operates car parks on behalf of landlords, often large supermarket chains. This segment, bought in 2011, was previously called Town & City Parking and operates in the United Kingdom. It was a disastrous acquisition (Smart Parking subsequently filed law suits against the vendors for mismanagement and poor disclosure surrounding the state of the business at purchase).

But management is intent on fixing this segment and seems to be making progress. With some $20m of revenue it should be able to generate enough profit to fund expansion on the technology side of the business.

We made an investment in Smart Parking in 2014, at an average purchase price of $0.15 per share. At the time we thought the $43m market capitalisation was almost justified by the stable parking management business and that the parking technology business was an interesting option for the future.

Progress has been slower than anticipated but a few meaningful contract wins and dramatic improvement in profitability over the past six months has rocketed the company's share price to $0.245 at the end of December. It's a very small position and will remain small given the speculative nature of the business, but Smart Parking looks to have turned a corner.

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