FORAGER

30 June 2016

BREXIT MAKE FOR ROCKY QUARTER FOR FORAGER WHOLESALE VALUE FUND
UK-exposed GBST will continue to grow but Pound depreciation hurts profitability.

MINING SERVICES SECTOR EMERGES FROM THE WORST
But some of the Fund's companies are suffering from self inflicted wounds.

RECKON'S MANY DAYS OF RECKONING
The ugly duckling of accounting software looks like an opportunity for investors.

WHOLESALE VALUE FUND JUNE 2016

QUARTERLY REPORT

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“RECKON IS STARTING WELL BEHIND THE COMPETITION. BUT WITH A MARKET CAPITALISATION LESS THAN ONE TENTH OF ITS TWO MAIN COMPETITORS, MANY OF ITS ADVANTAGES ARE BEING FORGOTTEN.”

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 2016
Buy Price	**$1.3214**
Redemption Price	**$1.3148**
Mid Price	**$1.3181**
Distribution 30 June 2016	**19.93cpu**
Portfolio Value	$21m

BREXIT AND BRIERTY MAKE FOR ROCKY QUARTER FOR FORAGER WHOLESALE VALUE FUND

The mixed business performance of the March quarter continued into June, with prospects diverging further at mining services companies and Brexit scuppering GBST's share price.

Table 1: Summary of returns as at 30 June 2016

	Wholesale Fund	S&P All Ords. Accum. Index
1 month return	–4.71%	–2.28%
3 month return	–0.27%	4.00%
6 month return	7.49%	1.55%
1 year return	20.03%	2.01%
3 year return (p.a.)	14.64%	8.24%
5 year return (p.a.)	16.04%	7.30%
Since inception* (p.a.)	8.39%	7.87%

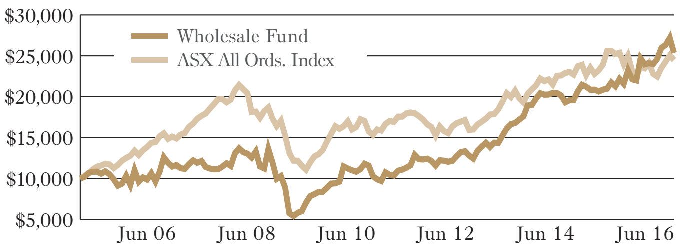
*Inception 2 September 2004

At one point we were starting to lament the lack of things to write about in this quarterly report. There hadn't been much news of note since March, either in the portfolio or in the wider market.

That changed dramatically as the results of Britain's referendum on leaving the European Union started to filter through on Friday 24 June.

The Forager Wholesale Value Fund has some direct exposure to the UK. Software company **GBST Holdings** (GBT), marketing group **Enero** (EGG) and **Smart Parking** (SPZ), roughly 12% of the portfolio between them, generate significant portions of their revenue in Britain.

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



We don't anticipate a huge impact on GBST's revenue — that is underpinned by contracts in place and legislative changes that are unlikely to be abandoned. But with UK revenue more than half of the total for GBST, the translation impact of a 10% fall in the pound exchange rate versus the Australian dollar is meaningful. Compounding the effect, only one third of the costs associated with GBST's UK business are incurred in pounds, meaning costs won't fall as much as revenue (most of the programming work is done in Australia and Vietnam).

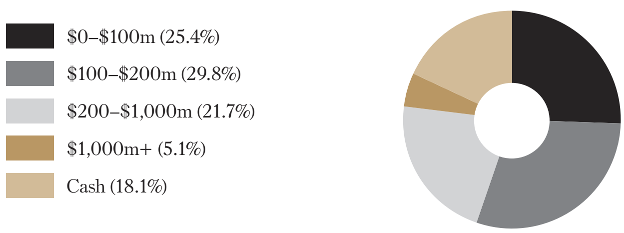
Still, the share price fall since the vote, some 16%, has been dramatic. We expect its UK operations to remain a profitable, growing part of the business and a full split from Europe might even create more work for GBST untangling its clients' systems. We added to the investment in recent days.

Table 2: Top 5 Investments

Service Stream	10.5%
Reckon	7.5%
Macmahon Holdings	7.2%
Enero	6.5%
South 32	5.1%

Surprisingly, the share price of Enero hasn't fallen at all. Public relations companies Frank and Hotwire, two of the best businesses in this marketing group's stable, are based in London and earn most of their revenue in pounds. Some 62% of the group's operating earnings came from the UK and Europe in the first half of this financial year. There is no cost mismatch here but a UK recession is unlikely to be good news for Enero.

Chart 2: Portfolio Distribution According to Market Cap



Outside these two stocks and a small investment in Smart Parking, the Fund is well placed to withstand the impact if there is a global economic slowdown as a response. We have a higher than usual cash weighting at the moment and little exposure to economically sensitive businesses. Indeed, an equity market selloff would be welcome for the opportunities it might create.

“UNFORTUNATELY SOME OF THE COMPANIES WE OWN ARE FIGHTING FOR SURVIVAL RATHER THAN FIGHTING FOR WORK.”

MINING SERVICES SECTOR EMERGES FROM THE WORST

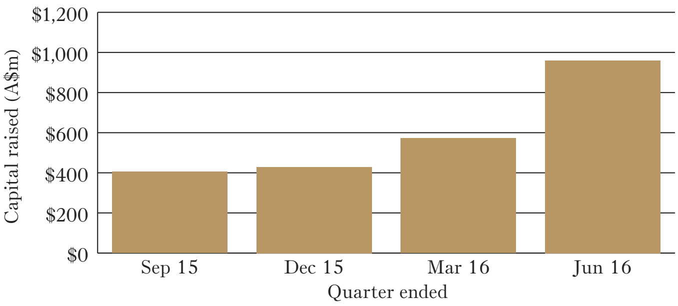
The performance of our portfolio of mining services companies has been more mixed than we would have liked. There are clear signs of an improving external environment.

On our estimates, there has been some $960m of new capital raised in the junior resources sector in the past three months (more than double the previous run rate). Most of that is for gold projects and that means more work for the services companies. **MACA** (MLD), **Macmahon** (MAH) and newish portfolio addition **GR Engineering** (GNG) have all announced numerous new contracts over the past six months.

Unfortunately some of the companies we own are fighting for survival rather than fighting for work. While we expected some woes, the most disappointing aspect is that many of the problems are self-inflicted.

Two years ago **Brierty** (BYL) had net cash and a healthy order book of civil engineering work that wasn’t dependent on the mining sector at all. Through losing $22m on one of those road contracts and incurring massive cost blowouts on a new mining contract with Rio Tinto, the executives managed to steer it from that relatively safe position to one where its significant debt load and negative operating cash flows are threatening its survival.

Chart 3: Capital raised in ASX mining/metals and energy sectors*



Source: S&P Capital IQ

Coal mining services company **Hughes Drilling** (HDX) has done an even better job of destroying a perfectly good business. This company should be generating cash and paying dividends thanks to its dominant and highly efficient drilling business on the east coast of Australia. Instead, managing director Bob Hughes’s reckless, debt-funded global expansion plans have finally caught up with him. The company’s shares are currently suspended from trading while its auditors and bankers question Hughes’s balance sheet and underlying profitability. Unless it gets an injection of fresh capital, it is unlikely the company will survive.

Thanks to hitting the jackpot with Coffey International and relatively good results from MACA and Macmahon, we are going to get reasonable results from the basket as a whole. That doesn’t make it any less frustrating seeing our returns crimped by management blunders.

RECKON’S MANY DAYS OF RECKONING

It was a “make or break” year according to the Chairman. **Reckon** (RKN) had spent the previous two years shedding the excesses of the dot-com era and 2002 was the first clean look at a business refocused on its core accounting software products.

Shareholders judged it a success. By the time the company announced its 2002 “maiden profit”, the share price had risen more than threefold from a low of just $0.07.

By 30 June this year, Reckon’s shares were changing hands for $1.46. With plenty of franked dividends along the way, those who have held the stock since have done exceptionally well. But it is once again make or break time for the company.

Reckon’s success from 2002 to 2012 came via localising and distributing a product called Quickbooks, the small and medium business accounting software of US giant **Intuit** (NASDAQ:INTU). Disagreements over how to respond to the entrance of a competing cloud-based product from New Zealand company **Xero** (NZSE:XRO) led to the relationship falling apart in 2012 and the distribution agreement ending in 2014. Since then Reckon has had to rebrand the software in its own name and develop a product that can compete with Xero, all with a research budget a fraction of the size. While that might not sound like the ideal backdrop for investing success, there are a number of reasons we think these make or break years will be good for investors.

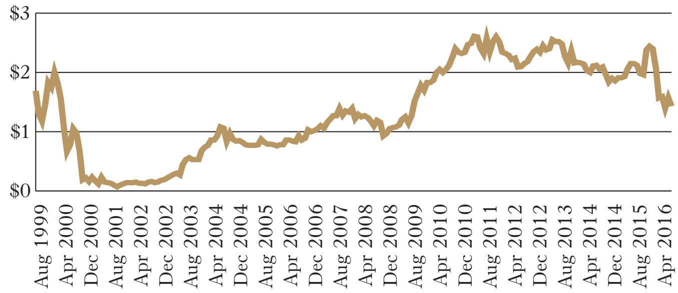
Reckon’s business software segment comprises just 43% of the group’s earnings before interest, tax, depreciation and amortisation (EBITDA).

The second largest segment, which sells practice management software for large accounting firms, is a cracker. Comprising 38% of group EBITDA, this business has huge market share at the big end of town, claiming four of the five largest Australian accounting firms as clients. Reckon charges on a per seat basis, meaning the accounting firms pay more as they employ more staff, and switching costs are significant. Reckon’s software is well integrated into these organisations, changing providers is a nightmare and retention rates are very high.

Another part of the business sells software for cost recovery and document management, which comprises 19% of group EBITDA. This business fits nicely with what they already offer clients but the technology has wide applicability. For instance, document management is not just for accountants. Professions such as legal, insurance and financial planning present opportunities for Reckon. The business also has global scale, with the company having a presence in the US, UK and New Zealand. And it has been growing quickly.

“WITH PLENTY OF FRANKED DIVIDENDS ALONG THE WAY, THOSE WHO HAVE HELD THE STOCK SINCE HAVE DONE EXCEPTIONALLY WELL.”

Chart 4: Reckon Share Price



Source: S&P Capital IQ

These annuity-style businesses are highly attractive in a world of low interest rates and, applying some optimistic multiples, you could justify the current stock market valuation with these two businesses alone.

Which brings us to the final piece of the investment puzzle. Is its legacy small business software worthless?

Compounding the termination of its distribution agreement, Reckon has had significant new competition from Xero, and industry stalwart **MYOB** (MYO) has substantially improved its offering. But the arrival of Xero hasn't been all bad news.

Rather than destroying competitors, Xero has made the whole industry vastly more profitable for everyone. As Xero has grown to become an industry behemoth, it has grown the total number of customers with it. Many small businesses that were previously using spreadsheets are now using Xero's user-friendly offering. As MYOB and Reckon get their acts together on their own cloud offering, it will likely grow the market further.

Probably more importantly, Xero's subscription-based business model is vastly superior to the old model of selling perpetual licences on a disk. In the old days a small business would buy a disk for $500–$600 from **Harvey Norman** (HVN) or **JB Hi-Fi** (JBH) and install the software on their own computer. Many of them never bothered to update the software until they needed a new computer, if then. Not only does this leave the software provider managing dozens of historical versions of their software, it means they only get paid once every five years or so and have to pay a healthy chunk of their margin to the retailer.

Under an online model, software is updated and improved without the user even noticing. The distribution cost is close to zero. And a customer typically pays $20–$30 per month, which adds up to significantly more revenue over the average life of a customer. More revenue times more customers equals an industry much larger than the old one.

And, as good as Xero's product is, Reckon's existing database of clients is a very valuable asset. Many thought the end of Quickbooks was the end of Reckon but its customer retention has been unbelievably good. They have added net customers over the past few years, despite their cloud offering being well behind the competition. This shows its brand is strong and customer switching costs are high even at the small business level.

If they can migrate a decent chunk of that client base across to Reckon's own cloud offering, it is going to be a very good business.

We are fully cognisant of the fact that this industry is changing quickly and that Reckon is starting well behind the competition. But with a market capitalisation less than one tenth of its two main competitors, many of its advantages are being forgotten.

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