FORAGER

30 September 2016

MINING SERVICES UPDATE
A review of the key lessons from investing in this industry.

GR ENGINEERING STANDS OUT
Management makes a difference in the crowded world of mining engineering.

COAL PRICE SENTIMENT
From fear to fear of missing out.

WHOLESALE VALUE FUND SEPTEMBER 2016 QUARTERLY REPORT

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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	30 September 2016
Buy Price	$1.5404
Redemption Price	$1.5328
Mid Price	$1.5366
Distribution 30 June 2016	2.5 cpu
Portfolio Value	$24.7m

MINING LESSONS FOR THE FORAGER WHOLESALE FUND

As sentiment towards mining and mining services turns positive, we review the mixed performance of the Fund's exposures and outline why GR Engineering stands above the pack.

Learning from mistakes is important. It also isn't as straight forward as it sounds for long-term investors. We often have to wait years to get feedback on our investing decisions. And once we have that feedback, it is fiendishly difficult to separate skill from luck.

Was buying **Whitehaven Coal** (WHC) at $0.39 in January a good investing decision? Was selling it at $0.78 a few weeks later the right thing to do? The share price closed at $2.45 on 30 September, so the former looks like a stroke of genius and the latter an act of stupidity.

Table 1: Summary of returns as at 30 September 2016

	Wholesale Fund	S&P All Ords. Accum. Index
1 month return	4.82%	0.40%
3 month return	18.48%	5.30%
6 month return	18.16%	9.51%
1 year return	39.58%	14.01%
3 year return (p.a.)	15.82%	6.42%
5 year return (p.a.)	21.52%	11.04%
Since inception* (p.a.)	9.74%	8.16%

*Inception 2 September 2004

Whitehaven is a highly leveraged coal miner. Our view in January was that it may go bust, or it may be worth a lot of money, but on a probability weighted basis the low share price was an interesting opportunity. The coal price has doubled in the six months since (see chart 5) and, if it stays at these levels for a couple of years, Whitehaven could repay a lot of debt very quickly.

The upside case is playing out, for now. But did we get the probabilities right at the time? We don't know. You never do.

Which brings us to the Fund's mining-related investments. Over the past six months, investor optimism has returned to the sector. Share prices are up a long way and, on average, the Fund has made excellent returns. It's an appropriate time to reflect on what lessons, if any, should be learned from our foray into this previously unloved sector of the market.

THE BAD

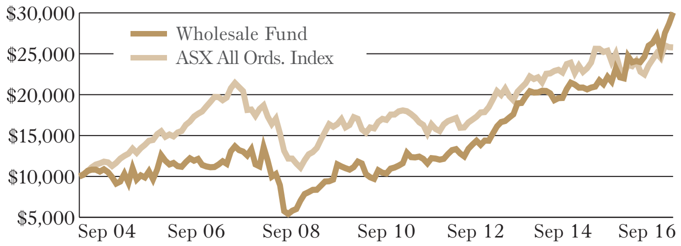
Starting with what can be learned from mistakes, by far the two most disappointing mining services investments have been **Hughes Drilling** (HDX) and **Brierty** (BYL). Hughes's woes culminated in the company being placed into voluntary administration during September. While recapitalisation proposals may emerge, the existing equity is now worthless.

When we first invested in this company in 2013, it had net debt of $22m and had generated $10m of profit. With the expansion of its fleet of rigs, we anticipated $12m profit in 2014 and a lower net debt number. This future never materialised. Following a debt fuelled expansion binge over the next two years, net debt blew out to $45m while profit halved. Unsurprisingly, a day before the company was placed into administration, its auditors notified ASIC that they suspected Hughes's directors had contravened the Corporations Act.

Like Hughes, Brierty's wounds were self-inflicted. In 2014, the company had net cash on its balance sheet and made a $10m profit in 2014. That turned into a $48m net debt position and a $50m loss by 2016. Just one bad contract was largely responsible for the company's Civil division reporting a $31m loss before tax in 2016. It is at serious risk of joining Hughes in the mining services graveyard.

Both companies have significant insider ownership, which shows that skin in the game won't always save you. But they do show how important management is in this business. Understanding return on capital is paramount. And it is a business where one bad contract can send you broke, so having the right person signing deals is more important than usual.

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



THE GOOD

Reiterating the management lesson, one of the best examples of success is **MACA** (MLD). We acquired a stake in MACA in June last year, paying $0.81 per share. The company performs contract mining for small to mid-tier miners mostly in gold and iron ore. Driven by negative sentiment on a falling iron ore price, MACA's share price collapsed well before its results deteriorated.

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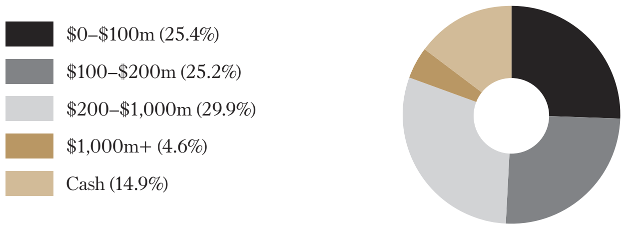
MACA has been able to replace some of that with work from small and mid-tier gold miners. At its 2016 financial year result in August, revenue was some 20% lower than its record 2015 financial year, but MACA has been able to stabilise the business at that level and maintain margins.

This year’s share price performance is a testament to the company’s management team’s ability. It’s navigated the business through the downturn while maintaining a $42m net cash position and generating $40m of free cash flow in 2016.

During the quarter the investment in MACA was completely exited. Its valuation was no longer compelling, with the stock looking fully priced. It was sold at levels that were roughly double the Fund’s entry price last year.

Chart 2: Portfolio Distribution According to Market Cap



THE UGLY

If MACA was the good, Hughes and Brierty the bad, then **Macmahon** (MAH) would be the ugly. Macmahon remains one of the largest investments in the Fund. It’s very cheap, on both an earnings and an asset basis, but the business still has its problems.

It is probably the best example of the cash these mining services businesses can generate as they shrink. Our thesis here was that the accounting profits would be woeful but that, given it didn’t need to buy any new equipment for several years, Macmahon would generate oodles of cash flow. That has largely played out and the company balance sheet now shows net cash of $56m, compared with net debt of $56m at the end of the 2014 financial year.

Unfortunately, that cash isn’t coming out to shareholders any time soon. Over the past year Macmahon lost $13m on a new contract at **Newcrest**’s (NCM) Telfer mine and expects to lose another $10m over the next six months.

Telfer isn’t Macmahon’s only problem. It is currently losing $0.5m per month in Nigeria. While management wants to leave this region, it could incur a $2.5m exit payment. On top of this, adverse currency movements would result in a further $8m of plant and equipment write downs.

Although profitable, Macmahon has been a frustrating investment to date. The company should be generating $20m of profit a year, instead of the $1m reported in 2016. We are prepared to give this management team some leeway, and a takeover offer from the company’s largest shareholder **CIMIC** (CIM) is still a possibility. The lesson is that most of the variability in these businesses is to the downside. The best case is that a contract delivers the profit expected when it was tendered, but it is only downside from there.

ONE OF THE BETTER MINING SERVICES BUSINESSES

One of the Fund’s most recent investments in the mining services industry, was in **GR Engineering** (GNG). It is turning out to be an excellent business.

GR has been able to carve out an attractive niche for itself within the highly competitive engineering sector. The company specialises in designing and building mineral processing plants for a fixed price. Most of its clients are junior miners that happily outsource these risky projects to a specialist. Even if that means paying a bit more.

Drawing on decades of experience, GR has been able to consistently avoid cost overruns and time delays. And, so far, it hasn’t had to deal with any contract disputes, mediation, arbitration or litigation. Thanks to this excellent track record, the company often wins additional work from old clients to carry out plant modifications, upgrades and expansions at a later date. The only major competitor in Australia is Sedgman, now owned by CIMIC. Market shares vary year by year depending on contract wins, but generally the two companies have a 25% share each. While Sedgman dominates the coal segment, GR dominates the gold segment.

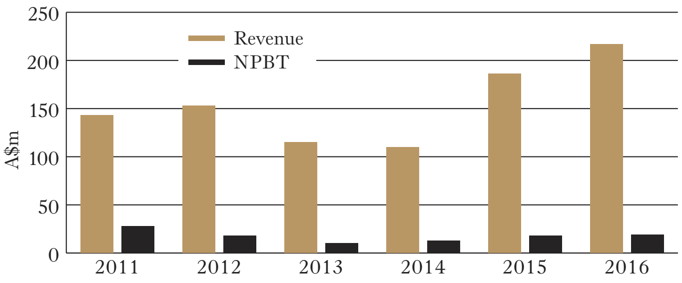
Table 2: Top 5 Investments

Reckon	8.7%
Service Stream	8.7%
Macmahon Holdings	7.6%
Jumbo International	6.2%
GR Engineering	5.6%

As Chart 3 shows, revenue can swing wildly depending on the state of the mining sector and large contract awards. Since listing in 2011, annual revenue has ranged between $110m and $217m. But despite this inherent volatility the business has proven resilient. Since bottoming at $10m in 2013, profits have averaged $18m per year and have been increasing despite a weak mining environment. Importantly, contrary to the other mining services businesses in the portfolio, GR doesn’t require much capital to grow. Since 2011 GR has outlaid only $6m in capital expenditure and paid $77m, nearly all of its profits, to shareholders in dividends.

“BIDDING FOR WORK AT A FIXED PRICE IS NOT FOR EVERYONE. AS FORGE GROUP’S COLLAPSE SHOWED, A COUPLE OF BAD CONTRACTS COULD BE ENOUGH TO BRING THE WHOLE BUSINESS DOWN.”

Chart 3: GR Engineering – Mineral Processing



Sources: GR Engineering, S&P Capital IQ

MANAGEMENT MATTERS IN THIS INDUSTRY

More often than not it’s the industry structure that best explains shareholder returns in the long term. But in GR’s industry good management is paramount. Bidding for work at a fixed price is not for everyone. As Forge Group’s collapse showed, a couple of bad contracts could be enough to bring the whole business down. On this front GR is well served. Management has decades of experience in managing such projects and an impressive history of creating value for shareholders.

Instead of diversifying the business across many sectors, GR’s management has been focusing only on building processing plants for miners. Over and over. This specialisation forms the backbone of the company’s competitive advantage as it allows it to price contracts accurately. Management, though, has still been able to reduce the business’s risk profile.

GR has expanded its service offering over time to include an increasingly large number of different commodities. This ensures that GR can continue to win work even if the state of a particular commodity market deteriorates. Also, in 2014 GR acquired Upstream Production Solutions. This business is run separately from the core engineering business and mainly provides operational, maintenance, and well-management services to the oil and gas sector in Australia and South East Asia. GR bought this business opportunistically from a large corporation that needed to sell it quickly. Upstream Production Solutions had $5m of net working capital at the time, was generating about $30m in revenue and $2m in profit before tax. The purchase price of $6m was a steal.

POSITIVE OUTLOOK

Currently there are an estimated $1.5 billion worth of projects being tendered to the market. GR has completed 30 consulting jobs in 2016 and is currently working on another 15. This has historically been an accurate leading indicator for subsequent contract awards. We expect GR to win its fair share of work, especially in the gold segment, where it has historically been the leading player. GR’s mineral business should be able to generate around $200m in revenue and earn $20m in operating profit this financial year. 2018 should be another good year. Beyond that it’s hard to say.

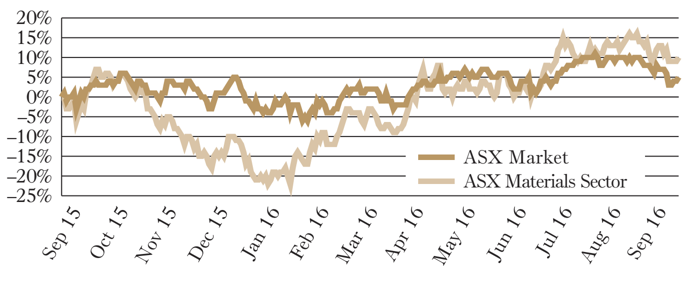
But the oil and gas business, Upstream Production Solutions, should help to mitigate this lack of visibility thanks to its larger focus on operational and maintenance types of work. This business should generate at least $65m in revenue per annum over the next three years based on current work in hand. While margins are lower than those of the mineral business, Upstream should generate at least $5m per year of operating profits during this period.

GR currently has a market capitalisation of $240m and $65m in net cash. Its price to earnings ratio and dividend yield are 13 and 6% respectively. Despite the stock price nearly doubling since the Fund’s purchase, these valuation metrics are not demanding for a well-run business that should grow over the coming years. Directors and senior managers own more than 50% of the company. So we expect that they will continue to run it prudently and allocate capital sensibly. Despite this, and the strong balance sheet, bidding fixed prices remains a risky business and so position sizing is critical. Currently, 5.6% of the Fund is invested in GR and we think that this is appropriate.

COAL SENTIMENT NEARS A 180 DEGREE TURN

The first nine months of 2016 have seen an extraordinary rebound in sentiment towards commodities. Miners and the contractors who service them were the most out of favour part of the market at the start of the year. A large chunk of the best performing fund managers from 2012 to 2015 had a simple strategy. Short mining, long everything else.

Chart 4: The Great Levelling – Market vs Materials

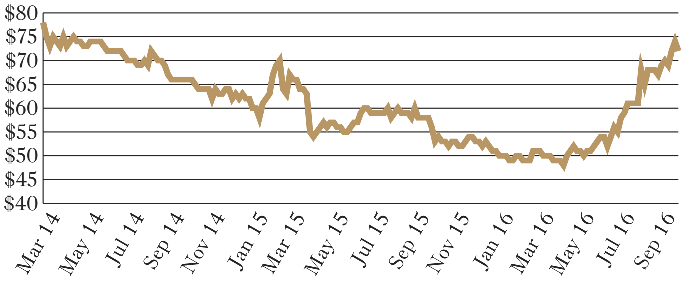


Source: S&P Capital IQ

“WAIT AND SEE IS NOT AN OPTION. MANY INVESTORS WANTED TO SEE A RECOVERY IN THE COAL PRICE BEFORE BUYING COAL MINING STOCKS. BY THE TIME THAT HAPPENED, SHARE PRICES HAD ALREADY TRIPLED.”

Sentiment couldn’t have been much worse during the first quarter of the year. And of all commodities, coal seemed to bear most of the brunt of this negative sentiment. Its price had been on a downward slope for years. Headlines in the *Australian Financial Review* (AFR) during the first quarter of 2016 included “*Coal set for dramatic shake-out*”, “*Australian coal ‘high risk’ on exports*”, and “*China coal demand tipped to fall further.*”

Chart 5: Coal Price ($ per tonne)



Source: S&P Capital IQ

Sentiment was so bad that Chinese coal miner Yankuang established an e-commerce platform. Its new goal? To sell Australian beef, milk powder and vitamins to mainland Chinese consumers. In China, a tonne of coal had become cheaper than a tonne of water.

Negative sentiment led to valuations that implied disaster scenarios. A number of mining and mining services stocks were trading at large discounts to book value. Some were trading at cash backing or even less. And this provided the opportunity for those with intestinal fortitude.

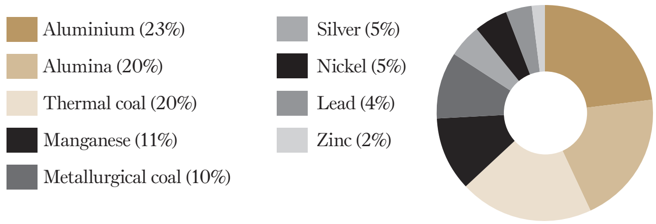
As mining stocks and commodity prices began to rally, the initial market reaction was disbelief. In March, one large broking house believed that the rally was running ahead of reality and downgraded a number of its recommendations.

Fast forward to today and sentiment is turning. Brokers have almost universally revised their coal price forecasts higher. Much higher. Anywhere from 25% to 65%. Just three weeks ago, the above mentioned broker materially upgraded its commodity price forecasts as well as its recommendations for those same stocks it had downgraded six months earlier.

SOUTH32 BENEFITS FROM THE HIGHER COAL PRICE

South32’s (S32) share price was $0.89 on 21 January. While the company is well diversified by commodity, coal is one of its largest exposures. The stock price closed the September quarter at $2.41, an astonishing increase of 171%.

Chart 6: South32 2017 Forecast Sales by Commodity



Sources: Forager Estimates

Despite the coal price rally, there are a few coal bears hanging around. We lean towards a bearish view ourselves.

It’s as though Mr Market is saying “I can’t believe the coal price is going up, but I’d better buy some coal stocks in case it goes up more.” AFR headlines in September tend to support this view. These include: “*Panic buying: coking coal prices surge*”, “*Temporary coking coal rally might hang around for a while*” and “*New Hope cautious on coal price rally*”.

Many of the fund manager stars of 2015 have now started buying mining and mining services stocks. Perhaps not so much because they believe their future prospects are bright but because they don’t want to risk not owning them as commodity prices rise. While sentiment is slowly turning positive, it is not quite at euphoric levels yet. The excellent management of South32 and GR Engineering mean our preference is to hold those stocks for many years. In general, though, we have been reducing the Fund’s exposure to commodities.

The final lesson, then, is an old one: Wait and see is not an option. Many investors wanted to see a recovery in the coal price before buying coal mining stocks. By the time that happened, share prices had already tripled and more. “Investors hate uncertainty” is something you will frequently read in the financial press. What they are talking about is perceived uncertainty, because the future is always inherently uncertain.

Buying when perceived uncertainty is rife has been a very profitable approach.

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