FORAGER

31 December 2016

RNY'S PORTFOLIO LIQUIDATION DISAPPOINTS
A soft market means that RNY's properties will sell for much less than book value.

CARDNO BACK INTO SHAPE
With its debt problems gone, Cardno is set to prosper again.

VALUE TRAPS AND THE MEDIA SECTOR
The Wholesale Fund's latest investment isn't a typical old media company.

WHOLESALE VALUE FUND DECEMBER 2016 QUARTERLY REPORT

CONTENTS

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 2016
Buy Price	$1.4031
Redemption Price	$1.3961
Mid Price	$1.3996
Portfolio Value	$25.1m
Distribution 31 Dec 2016	2.5cpu

BAD NEWS TAINTS A GOOD YEAR FOR THE WHOLESALE FUND

A 18% return is not to be sniffed at. But 2016 could and probably should have been better for the Wholesale Fund investors. In this quarterly report we discuss the biggest detractor from performance for the year, RNY. We also introduce two of the Fund's newest holdings, Cardno and NZME.

Table 1: Summary of returns as at 31 December 2016

	Wholesale Fund	S&P All Ords. Accum. Index
1 month return	1.90%	4.17%
3 month return	–7.29%	4.41%
6 month return	9.85%	9.94%
1 year return	18.07%	11.65%
3 year return (p.a.)	12.00%	6.76%
5 year return (p.a.)	18.77%	11.59%
Since inception* (p.a.)	8.86%	8.42%

*Inception 2 September 2004

> *"Many shall be restored that now are fallen,*
> *And many shall fall that now are in honour."*
> — Horace

Those who have managed the first few pages of Benjamin Graham's *Security Analysis* might remember Horace's quote. Those who have been around stock markets for a while won't need Horace. For those newer to the game, mark the final quarter of 2016 as one where you learned a lesson that will hold you in good stead.

Priced to perfection growth stocks like **Sirtex** (SRX), **TPG Telecom** (TPM) and **Bellamy's** (BAL) were stock market stars for the first nine months of the year. Many provided disappointing updates between September and December and their share prices pummelled.

At the other end of the spectrum, previously unloved, old, "ex growth" companies like the large banks and miners dragged the All Ords Accumulation Index up to a respectable 4.2% return.

The Forager Wholesale Value Fund doesn't own many high growth companies. Our holding in **South32** (S32) benefitted from renewed market optimism towards the commodity space. But the final quarter of the year still had more than its fair share of travails.

Some of the Fund's best performers for the year experienced a healthy pullback in price. In the case of **Service Stream** (SSM), enough so to warrant an increase in portfolio weighting again. Elsewhere we suffered some serious blows to our estimate of value. Most notably, **RNY Property Trust**'s (RNY) net tangible assets (NTA) deteriorated over the year as its manager, New York based RXR Realty, announced it was liquidating the Trust's portfolio of office buildings (see page 4).

Although its stronger balance sheet has provided some protection, the operational performance of **LogiCamms** (LCM) has been worse. Many mining engineering companies benefitted from an upturn in commodity prices in 2016, including the Fund's investments in **GR Engineering** (GNG) and **MACA Limited** (MLD). LogiCamms was one of the few that didn't. The company produced terrible results for both the December 2015 half year and June 2016 full year, managed to further downgrade expectations for 2017 and proposed some outrageous resolutions at its annual meeting — most incredibly a resolution to award performance shares to management based on last year's woeful results (the poor CEO is only on a half million dollar base salary). Fortunately, these resolutions were voted down by us and other shareholders.

As the 18% return suggests, there were a number of strong performers during the year, including Service Stream, South32, **Jumbo Interactive** (JIN) and the aforementioned MACA and GR Engineering. With a few less disappointments, the year's return could easily have had a two in front of it.

RNY CAUGHT BETWEEN NEW YORK AND A HORRIBLE PLACE

It can take the market many years to recognise the value inherent in a business. We usually know whether our investment thesis has merit much earlier than that.

The first year or so of owning a company usually highlights a few aspects of the investment that weren't picked up in initial research. We get a better feel for management behaviour and we get more information about how a business fits into its ecosystem. Sometimes all of this confirms our initial thoughts. Sometimes it suggests we have something seriously wrong.

Table 2: Top 5 Investments

Reckon	8.3%
Service Stream	6.9%
Macmahon Holdings	6.2%
Cardno	5.4%
NZME	5.3%

RNY Property Trust is an exception to that generalisation. The stock has been in the portfolio for almost seven years. Four years into that ownership period, we were quietly confident of realising a return of between four and eight times the Fund's initial investment. Today it seems we will be lucky to get half of our money back.

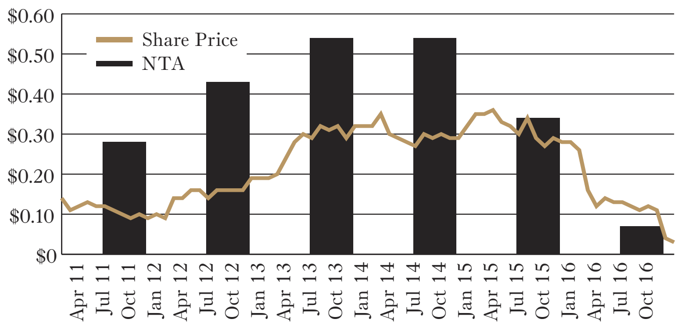
At the end of 2014 the Trust's reported Net Tangible Assets (NTA) was $0.54. Thanks to a falling Australian dollar and some deft debt restructuring, that was almost double the $0.28 reported in 2011. An improving US economy, falling unemployment and the prospect of more Australian dollar

> "WHILE WE ARE PLEASED WITH PERFORMANCE FOR THE YEAR IT COULD HAVE BEEN BETTER."

weakness had us thinking that its suburban office buildings were going to further increase in value.

Those valuations were based on expectations about the future income the buildings would produce. Today, the assets are being sold, and we are getting estimates of what someone else is prepared to pay for them. Unfortunately, the gap between the two valuations is enormous.

Chart 1: RNY – Share Price and Net Tangible Assets Value



Sources: S&P Capital IQ and RNY

If the valuations based on bids received so far are applied to the whole portfolio, management estimates the final proceeds to unitholders would be between $0.04 and $0.10 per unit. That's as much as 90% less than the NTA reported in 2014.

The deterioration is as surprising as it is disappointing. There is not a lot we can do about it. Despite owning 40% of the assets, the manager, RXR Realty, doesn't seem to have many ideas either. Unfortunately the assets are unwanted and the trust's debt and lack of cashflow mean selling is the only option.

CARDNO BACK INTO SHAPE

Over the past few months the Fund has been buying shares in **Cardno** (CDD), an engineering consultancy company. Gerry Cardno and Harold Davies started the business in Brisbane in 1945. The company thrived during the post-war boom years through to the 1970s, designing bridges, sewage systems, dams and roads throughout Queensland.

After listing on the ASX in 2004, Cardno expanded across Australia and internationally. A buoyant mining sector and 44 acquisitions saw revenue rise from $94m to $1.3bn over the period to 2014. By then it was valued at nearly $1.2bn, up from $35m when it floated.

Then commodity prices slumped. Mining and oil related investment evaporated and there weren't enough infrastructure projects to pick up the slack. Engineering firms competed fiercely for what work there was and the industry's profitability crumbled. Cardno's EBIT margin, a measure of its operating profitability as a percentage of net revenue, fell from around 15% in the boom years to less than 5% now.

This shouldn't have been a large problem. In a cyclical industry like Cardno's, wild fluctuations in profitability are to be expected. But Cardno was carrying a lot of debt. In June 2015, gross debt stood at $400m (net debt was $320m), while the business had less than $700m in net tangible assets.

With lenders increasingly likely to ask for their money back and mounting evidence that Cardno had overpaid for many of its acquisitions, investors dumped the stock. Cardno's market capitalisation fell to $250m in June 2016.

After raising $170m in new equity and selling three businesses for $150m, Cardno now has one of the strongest balance sheets in the industry with an estimated net cash position of $10m.

Crescent Capital, a private equity firm which owns nearly 50% of the company's shares, has appointed a new management team which can now focus on improving the business's performance.

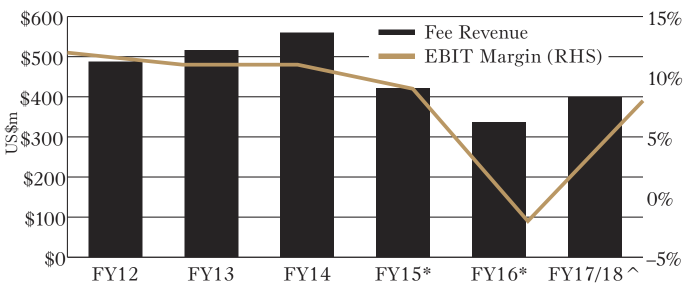
OIL, TRUMP AND CRESCENT TO DRIVE THE RECOVERY

Cardno operates mainly in Australia and the United States of America.

The Australian business generated $347m in revenue or approximately 45% of the Group's total in the 2016 financial year. Despite suffering from a fall in mining activity, operating profits fell only 10% to $37m thanks to the business's strong competitive position within the environmental and engineering industries in Australia. This part of the business should be able to at least match this result over the coming years.

In stark contrast, the American business, which accounts for nearly all the remaining fee revenue, is struggling. Fee revenue in the 2016 financial year was US$337m, down 20% from 2015, and the business made an operating loss of around US$4m.

Chart 2: Cardno – US Business



* = Adj. for business sales, except XP Solutions
^ = Estimate

Sources: S&P Capital IQ, Cardno and Forager estimates

The large fall in oil and gas prices was only one of the reasons for this poor performance. In fact, government spending, which is usually countercyclical to private investment, was put on hold in the US due to the 2016 federal elections. And, if this wasn't enough, Cardno's complex organisational structure prevented its US managers from reacting to the change in market conditions.

The recent decision of OPEC to restrict oil production (see

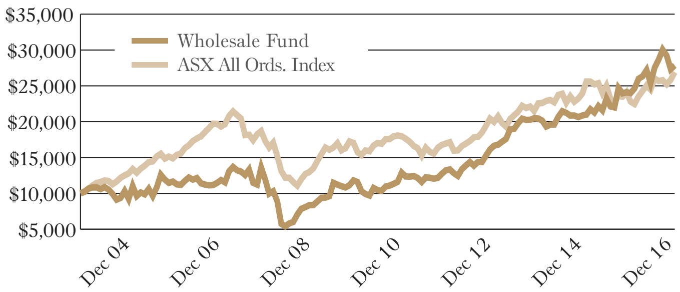
"IT CAN TAKE THE MARKET MANY YEARS TO RECOGNISE THE VALUE INHERENT IN A BUSINESS. WE USUALLY KNOW WHETHER OUR INVESTMENT THESIS HAS MERIT MUCH EARLIER THAN THAT."

page 6) should help the oil prices edge higher. At the same time, many infrastructure projects are expected to be rolled out over the coming years under new-president Donald Trump. And Crescent has given more power to front line managers by simplifying the company's organisational structure.

An increase in fee revenue to US$400m and a margin of 8%, well below the historical 10%, would see the division earn US$32m in operating earnings (chart 2). Importantly, this requires an improvement in the utilisation rate of the current workforce rather than additional investment.

Assuming corporate costs are $10m and the AUD/USD exchange rate remains around current levels, Cardno should earn an operating profit of around $70m within two years. Given the current enterprise value of $440m, Cardno is trading on a multiple of just over six times this estimate. This is low for a good business with a strong balance sheet that should resume paying dividends soon.

Chart 3: Comparison of $10,000 invested in the Wholesale Fund and ASX All Ords. Index



VALUE TRAPS, THE MEDIA SECTOR AND THE FUND'S NEWEST INVESTMENT

The Australian media sector has wrecked the careers of many fund managers over the past decade. First were the growth investors — those prepared to pay high multiples for a business they think can grow. A decade ago high earnings multiples (around 20 times profit) were supposedly justified as deregulation was meant to lead to a wave of consolidation. Media moguls like the Packers, Stokeses and Murdochs were supposed to mop up the sector at premium prices. **Fairfax** (FXJ) was the most prized target, and **APN News and Media** (APN) wasn't far behind.

Unfortunately for the optimists, James Packer and Kerry Stokes shrewdly sold down their media holdings. Rupert Murdoch practically ignored his country of birth as **News Corp** (NWS) pursued pay-TV assets in Europe.

Private equity were next in line for punishment. They emerged as the industry consolidators, using high levels of gearing to pay mind boggling prices for assets (in 2007, APN was the target of a bid by a private equity consortium that was blocked by a shareholder vote at $6.20 per share, a decision which cost them a lot. Perhaps they didn't foresee the structural changes that were about to hit the industry. More likely they just didn't anticipate how quickly change would come. Advertising dollars and classifieds revenue shifted online before the usual private equity tricks could be played.

Then the value investors wandered into the briar bush. Once the dust settled, multiples came down to around 10 times profit. In a relative sense, this looked attractive compared to the market. But it turned out ten times next year's profit is a lot to pay for a business that is rapidly going backwards.

We have thus far managed to avoid the sector. And we still don't think most valuations reflect the difficulties that lie ahead (particularly for free-to-air televisions stations). But we have made a recent foray into the media space with an investment in NZME.

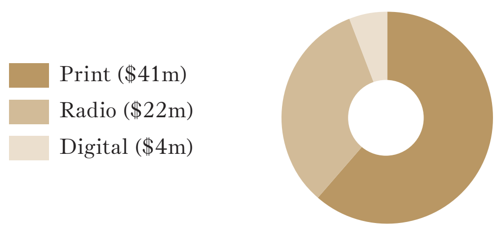
Primarily to address distressed balance sheets, media companies have been divesting assets. Unlocking shareholder value has been a very welcome by-product. You may see more on this front from Fairfax this year, with a potential divestment or demerger of its online real estate business Domain. But APN has been at the forefront of this trend, separately listing its outdoor business and selling its regional newspapers to News Corp.

The Fund's investment is its most recent.

THE SPINOFF

The newly created company is New Zealand Media and Entertainment, abbreviated to **NZME** (NZM). NZME is the spin-off of APN's three New Zealand media brands, APN NZ newspapers, **The Radio Network** (TRN) and GrabOne. The result of the demerger is a company with a portfolio of print, radio and digital brands. A majority of print revenue is derived from the New Zealand Herald masthead.

Chart 4: NZME – Earnings by Segment ($m)



Source: APN's explanatory memorandum dated 11 May 2016

Most of NZME's earnings are derived from radio and newspapers, with both holding appeal to us.

The stable earnings of the radio segment make this a more valuable business than the other segments. It is arguably worth as much as the entire enterprise value alone.

Some believe streaming services such as Pandora and Spotify will lead to radio's demise. Although this remains a possibility as more cars are connected to the internet, advertising revenues

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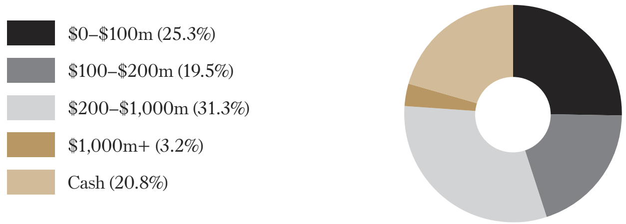
from radio have held up remarkably well around the world. Radio remains one of the most effective ways for advertisers to corral a large audience. It also plays a social function, being a form of companionship as people listen to their favourite hosts.

Chart 5: Portfolio Distribution According to Market Cap



And perhaps above all, radio and streaming are complementary. For many listeners, radio is an important part of their streaming experience. Listeners tune in to radio to hear the newest releases and discover new music, which they then add to their music stream.

The earnings from this part of the business almost justify the current valuation alone. And the newspapers are likely to be worth something meaningful.

With a large percentage of New Zealand's population located in Auckland, the *New Zealand Herald* is effectively a national newspaper, capturing a national readership and more importantly national advertising dollars. This makes it a valuable asset, particularly when compared to Fairfax's Australian metropolitan mastheads, which are effectively large regional papers.

Newspapers were the first to suffer revenue leakage to the internet. You should be under no illusion that the decline is coming to an end. But some national newspapers are showing that a subscription model can work. *The New York Times*, for example, is approaching the point where growing subscription revenues can offset declining advertising revenues. If any newspaper is going to survive, it will be a national masthead like the *NZ Herald*.

VALUATION SAVES THE COMPLICATED MATHS

Spinoffs often perform poorly early on. They may be too small to own for institutional investors with large-mid cap mandates. Or they may be too small for managers with billions in funds to obtain a material holding. Perhaps some Australian managers aren't mandated to hold New Zealand stocks.

Whatever the reason, the sell down provided an opportunity to buy NZME at very cheap prices.

And unlike most other media stocks, we don't believe NZME will turn out to be a value trap. Unshackled from APN, the demerger has enabled management to focus on stripping costs out of the business.

NZME and Fairfax are also in discussions to merge NZME with Fairfax's New Zealand operations. The potential merger is subject to agreement by both boards and approval by the New Zealand Commerce Commission (NZCC). The NZCC has indicated its initial opposition to the deal, with a final decision due in the first quarter of 2017. There is a lot of potential upside in the form of further cost cuts but it is looking increasingly unlikely.

That doesn't change our view.

As mentioned above, the radio assets underpin the current market capitalisation. And NZME should generate a lot of free cash flow for shareholders. Its net working capital requirement (receivables less payables) is close to zero. Capital expenditure required to maintain the business is low, running at about half of its depreciation and amortisation.

This enables the board to have a dividend payout policy of 60–80% of profit. The midpoint of this range implies a dividend of NZ$0.08 per share, which equates to a dividend yield of 15% (fully imputed for New Zealand shareholders).

In a world of overpriced assets, it's nice to find such value.

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