30 June 2017

FORAGER

WHOLESALE VALUE FUND JUNE 2017

QUARTERLY REPORT

WHOLESALE VALUE FUND

FACTS

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

UNIT PRICE SUMMARY (EX-DISTRIBUTION UNIT PRICES)

Date	30 June 2017
Buy Price	$1.4278
Redemption Price	$1.4206
Mid Price	$1.4242
Distribution 30 June 2017	16.59cpu
Portfolio Value	$28.6m

VALUE TO THE FORE IN 2018

While many commentators declared 2017 the year value investing died, the Forager Wholesale Value Fund has had a stellar year. This quarter we reflect on a few old holdings driving that performance and introduce one new opportunity.

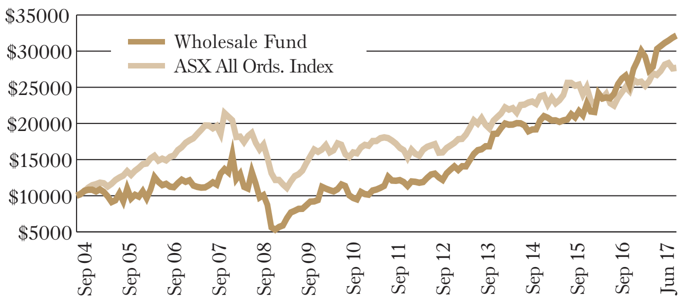
Table 1: Summary of Returns as at 30 June 2017

	Forager Wholesale Value Fund (Net of fees)	S&P All Ords. Accum. Index
1 month return	0.98%	0.28%
3 month return	3.30%	-1.54%
6 month return	15.49%	2.89%
1 year return	26.86%	13.12%
3 year return (p.a.)	18.84%	6.83%
5 year return (p.a.)	21.46%	11.60%
Since inception* (p.a.)	9.73%	8.32%

*Inception 2 September 2004
Investments can go up and down. Past performance is not necessarily indicative of future performance.

Another financial year has drawn to a close and it has been an action packed one for the Forager Wholesale Value Fund. Inside the portfolio, some long-held stocks have finally been delivering results and a few new names have made it into the portfolio.

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



Source: S&P Capital IQ
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JUMBO DELIVERS A DISAPPOINTING DEAL

Our March quarterly report discussed the need to actively extract value out of two of the Fund's largest portfolio holdings, **Jumbo International** (JIN) and **Enero Group** (EGG). We didn't expect things to happen quite so rapidly.

Jumbo is an online-reseller of lottery tickets in Australia. Thanks to a near monopoly on the lottery market, **Tatt's Group** (TTS) is effectively Jumbo's only supplier (Jumbo does sell some charity lottery tickets but revenue is negligible) and Jumbo represents approximately 7% of Tatts's sales nationally.

In April we were approached by a broker seeking to purchase a strategic stake in Jumbo on behalf of Gibraltan lottery company Lottoland. (Lottoland sells synthetic tickets on Australian and international lottery results and is effectively a new competitor to Tatts).

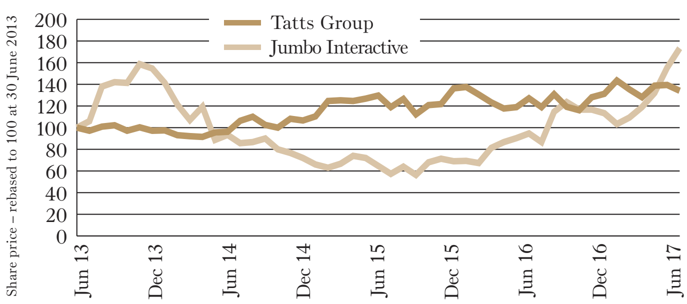
Prior to the approach, Forager's stake was 13% of Jumbo's outstanding shares and, while we didn't want to sell the lot, we saw a lot of potential value in giving Lottoland a seat at the table. The sale of a 5% stake was agreed at $2.55 per share and Lottoland purchased another 2% on market, giving it a 7% holding.

Our thinking was that this could only be positive. Lottoland might use its stake to launch a bid for the whole company at a higher price. Were that to happen, Tatts would be forced to respond (it could hardly let 7% of its revenue migrate to a competitor). Lottoland could offer Jumbo a better deal than Tatts is currently offering, increasing both revenue and margins for Jumbo. Or, the threat of a competitor could give Jumbo the opportunity to negotiate a much better deal with Tatts.

The cards were dealt for some significant value realisation.

Unfortunately Jumbo played about the worst hand possible. Managing director Mike Ververka refused to contemplate Lottoland's approaches and turned around and signed a horrible deal with Tatts. In exchange for contract certainty for five years – Tatts were hardly going to pull the pin now – Jumbo issued 15% of its stock to Tatts at a discount to the $2.55 price Lottoland paid and an even larger discount to the market price at the time. It also issued options over a further 8% of the company.

Chart 2: Tatts Group and Jumbo Interactive 5 year Share Price



Source: S&P Capital IQ

Not wanting to sell Lottoland's tickets is understandable. There are serious regulatory risks, let alone the moral concerns around selling an alternate product that doesn't pay any taxes to the government. But why wouldn't you at least pretend to entertain the idea? And why would you give your dominant supplier a blocking stake in the company at a discount to the market price? At the very least we were expecting the new deal to include the right to sell in Jumbo's home state, Queensland,

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but they couldn’t even manage to extract that. The share price is up, but our estimate of the value is down. That means the margin of safety has evaporated.

MACMAHON’S INDONESIAN ADVENTURE

As we put the finishing touches to this quarterly report, **Macmahon** (MAH) shareholders were about to vote on its future. Having just fended off a takeover offer from its largest shareholder **CIMIC Group** (CIM), shareholders are now being asked to consider another transformational proposal. This time the board is recommending a deal that will involve issuing 44% of the company’s equity to an Indonesian company in exchange for a mining contract worth US$2.9bn of revenue over its 14 year life.

In 2015 mining conglomerate Newmont, Japanese trading house Sumitomo, and local miner Bumi Resources decided to sell their combined 82% stake in PT Amman Mineral Nusa Tenggara (AMNT), owner of the giant Batu Hijau copper and gold mine in Indonesia.

Table 2: Top 5 Investments

Macmahon Holdings	10.5%
Reckon	8.3%
NZME	8.0%
Enero Group	7.4%
Jumbo Interactive	6.4%

Investments can go up and down. Past performance is not necessarily indicative of future performance.

The purchasers were listed Indonesian company **Medco Energi** (JKSE:MEDC) and fellow Indonesian company AP Investment (API). These two companies are respectively controlled by the Panigoro and Projosasmito families, two of Indonesia’s wealthiest business families.

If this is sounding confusing, don’t worry. The opaque structure is one of the concerning elements about the proposed transaction (in addition, the entity that will own 44% of Macmahon’s shares has the same shareholders as, but a different ownership structure to, AMNT).

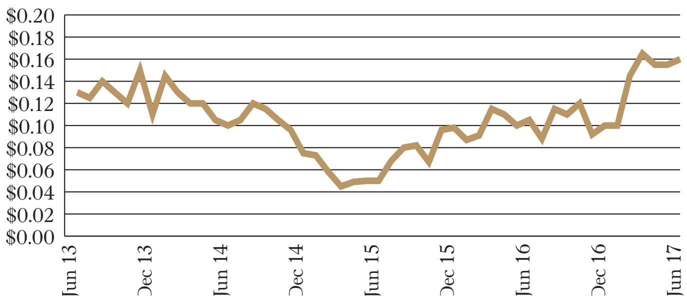
Doing business in Indonesia has historically been difficult for Australian companies and many have lost significant sums of money. And we have enough experience in the wider Asian region to know that you don’t let a controlling shareholder onto your register without giving it serious thought.

Having given it exactly that, however, we have decided to vote in favour of the deal.

The starting point is not a nice open share register. Macmahon already has a significant shareholder in CIMIC. That shareholder is a competitor and has shown absolutely no interest in offering fellow shareholders a fair price or helping the company grow and prosper. AMNT is going to exert more influence, but it is going to reduce CIMIC’s influence considerably and at least brings with it a transformational contract for the company.

The contract itself has been constructed to assuage a number of shareholder concerns. The revenue will be set at a level that anticipates a specific margin to Macmahon, with the potential for upside sharing and a cap on the downside at zero margin. The shares being issued to AMNT will be held by an Australian trustee for 30 months and, should the contract be terminated within that 30-month period, there is a mechanism for Macmahon to re-purchase a portion of those shares in exchange for the equipment it is buying from AMNT. If the contract turns out to be a disaster, it should largely be able to be unwound.

Chart 3: Macmahon Holdings Limited 5 year Share Price



Source: S&P Capital IQ

We are less concerned about the sovereign risk than others. Macmahon’s new CEO Mick Finnegan has a lot of experience operating in the region and Macmahon is entering into a services contract, not buying a mine. And the new owners of AMNT are financial buyers. They are doing this deal because they don’t have the skills to operate Batu Hijau themselves.

Most importantly, however, this transaction is going to make Macmahon more profitable and reliable. If shareholders vote in favour, our valuation on the stock increases roughly 20%, from something like $0.20 per share to $0.24 or so. It is a big if, yes, but if Macmahon can put its unprofitable Telfer contract behind it, it should be generating earnings per share of 3 cents or so in the 2019 financial year. If, as looks likely, its successful Tropicana contract gets expanded and extended, that would give Macmahon an order book that looks solid out to 2025 – the sort of thing stockmarkets tend to get excited about.

There have been more than enough disappointments during the four years Forager has owned this stock. There won’t be any chicken counting for a few years yet. The new management

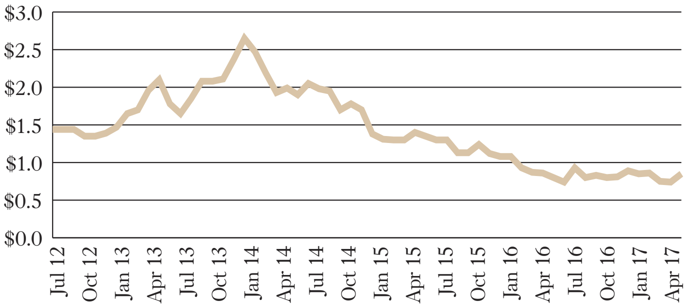
“WE HAVE ENOUGH EXPERIENCE IN THE WIDER ASIAN REGION TO KNOW YOU DON’T LET A CONTROLLING SHAREHOLDER ON TO YOUR REGISTER WITHOUT GIVING IT SERIOUS THOUGHT.”

team has been impressive over the past six months, and on balance there is enough upside to stay on for the ride.

CTI’S A LONG TERM COMPOUNDER

Forager has recently become a substantial shareholder in **CTI Logistics** (CLX), a courier and warehousing services company. CTI has a strong competitive position within the Perth delivery market where it carries out 30% of on-demand taxi-truck deliveries, 35% of courier deliveries, and 40% of same-day parcel deliveries. CTI also provides third party contract warehousing and it’s the national market leader in storage and distribution of floor coverings such as vinyl and carpet.

Chart 4: CTI Logistics Limited Share Price



Source: S&P Capital IQ

The end of the mining boom is hurting the company’s businesses. In 2016, CTI generated $150m in revenue but only $2m in net profits. As you can see in the chart above, the company’s share price has plummeted from as high as $2.75 in 2013 to $0.84 cents today – a 69% drop. CTI’s current market capitalisation is only $62m.

While last year’s sales reached the highest level on record due to an acquisition, profitability was well below what CTI has earned in the past. In 2014 and 2015 net profits were $10m and $6m respectively on a much lower revenue base.

Since then, competition has increased and demand for the company’s services fallen, but CTI should be able to adjust its cost structure to the new market conditions. CTI only owns a small fraction of the vehicles it uses and most of its workers are contractors.

Once the economy recovers CTI should bounce back. Its 30-year old delivery network is a hard asset to replicate. Furthermore, the flooring business should continue to grow as it benefits from a new bigger warehouse.

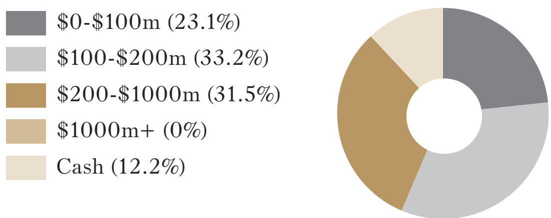
Based on the 2017 half-year result, CTI should be able to earn net profits of about $6m for the full year. This implies it’s trading at a multiple of about 10 times these ‘depressed’ earnings. Importantly, the company has net tangible assets of $63m and $20m worth of franking credits. These provide today’s investor downside protection.

STRONG MANAGEMENT TEAM

While we don’t spend much time talking to management we strive to understand whether their interests are aligned to those of shareholders. We also look at their past capital allocation decisions to gauge how capable they are in their line of business.

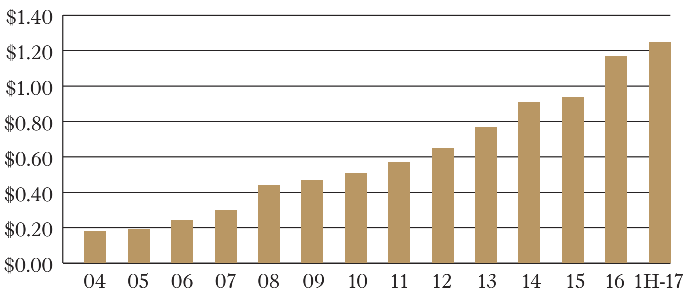
Insider ownership is usually one of the first things we look at when assessing management – there is no bigger incentive than ‘having skin in the game’. Management turnover is also an important factor. CTI’s three main directors own nearly 60% of the company and have at least 30 years of history with the business – each.

Chart 5: Portfolio Distribution According to Market Cap



While a long tenure and significant insider ownership are big positives, they can mean little without good financial performance. On this score, CTI’s directors have done an outstanding job over the years. As shown in the chart below, book value per share has grown from 18 cents in 2004 to $1.25 today, a compound annual growth rate of 17%. This is even more impressive when considering the company paid 58 cents in dividends per share over the period.

Chart 6: CTI Logistics Book Value Per Share



Source: S&P Capital IQ

Given the attractive valuation and management’s great track record, Forager bought shares in the company in late May. This has mostly happened through a small placement of new shares. About 2.4% of the Forager Wholesale Value Fund is invested in CTI Logistics.

Forager Funds Management
Suite 302, 66 King Street
Sydney NSW 2000

P +61 (0) 2 8305 6050
W foragerfunds.com