FORAGER

30 September 2017

WHOLESALE VALUE FUND SEPTEMBER 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 September 2017
Buy Price	$1.4509
Redemption Price	$1.4437
Mid Price	$1.4473
Distribution	$0.03
Portfolio Value	$27.0m

POSITIONING FOR THE FUTURE

Selling some strong contributors over the past quarter has left the Fund with higher cash levels. There are a few opportunities on the radar, but a buoyant market makes reinvesting cash harder. A healthy correction would help.

Table 1: Summary of Returns as at 30 September 2017

	Forager Wholesale Vaue Fund (Net of fees)	S&P All Ords. Accum. Index
1 month return	2.67%	0.05%
3 month return	3.74%	1.02%
6 month return	7.16%	-0.53%
1 year return	11.08%	8.53%
3 year return (p.a.)	17.13%	7.30%
5 year return (p.a.)	18.89%	10.08%
Since inception* (p.a.)	9.84%	8.24%

* Inception 31 August 2004
Investments can go up and down. Past performance is not necessarily indicative of future performance.

The past few months have seen cash levels in the Wholesale Value Fund creep up to 32%. This has not been a macro call. Some of the better performers of the past few years have been sold. Other positions also required a rethink as circumstances changed. With limited distress in the market at the moment, putting that cash to work will take some time.

Many of the stocks that have been fuelling the Fund's performance over the past three-plus years have delivered on or exceeded expectations. Some are now trading higher than our most optimistic initial assessment of value. Despite some updated thinking along the way, these stocks are on the way out of the portfolio.

Take **Service Stream** (SSM). The network services provider has come a long way. In August 2014, the business reported just $17m in earnings before interest, tax, depreciation and amortisation (EBITDA) and had just raised $19m to stave off the banks. On the day it released its results, the company had a market capitalisation of only $80m. Today, after delivering $48.4m of EBITDA in the most recent financial year, it is valued at more than half a billion dollars.

Expectations are much loftier now than they used to be. Investors are expecting growth to continue well into the future, despite the looming likelihood of peak activations on the nbn, an important source of growth for the company. Now trading on a price to earnings multiple of 16 times, Service Stream's valuation is beginning to factor in plenty of certainty at an uncertain time.

For engineering and environmental services business **Cardno** (CDD), which was only added to the portfolio mid last year, expectations have also heated up. Close to home the business is performing well and more work will come from a flood of infrastructure projects on the east coast of Australia over the next few years. Yet the Americas division is yet to turn.

A forecast of $55m to $60m of EBITDA for the current year shows management has some confidence in margins improving. With the share price rising sharply in the past year most, if not all, of the upside here has already been priced in.

Jumbo Interactive (JIN) is in the same camp. The online reseller of lottery tickets saw fewer major jackpots this year and still turned in a reasonable $7.6m net profit from its ongoing Australian operations. A special fully franked dividend of $0.15 per share in July and the promise of an 85% future payout ratio highlighted Jumbo's capital light business model. However, as its ticket supplier **Tatts Group** (TTS) spent to improve its own offering, Jumbo has lost online market share. As we wrote in our June Quarterly Report, the margin of safety in Jumbo has largely evaporated.

Then there are positions which have been reconsidered as circumstances changed. Reckon was one of these, described in detail later in this report.

Remote power plant owner **Pacific Energy** (PEA) was another. Growth in this business is dependent on new and expanding power requirements, mostly from gold mines. The more generators deployed, the more the business earns. Growth, then, requires capital investment. Pressure from larger and better financed competitors has increased and the business has been missing out on new contracts. Pacific Energy is trading at over 1.4 times its book value and over 1.7 times its tangible book value. Given the likelihood of lower returns on capital in future, the current valuation does not offer a sufficient margin of safety. The Fund has sold its stake in Pacific Energy.

Some new stocks have already been added to the portfolio in recent months. Assuming the desired portfolio weightings can be achieved – sufficient liquidity is proving frustratingly difficult to come by – you will read about some of these in future quarterly reports. There are also plenty of interesting opportunities to keep an eye on.

You should, however, expect the cash weighting to continue rising in the short term. That is an unfortunate consequence of the excellent performance over the past few years. It is going to require patience (from you and us) to put that money to work.

WHY WE'VE SOLD RECKON

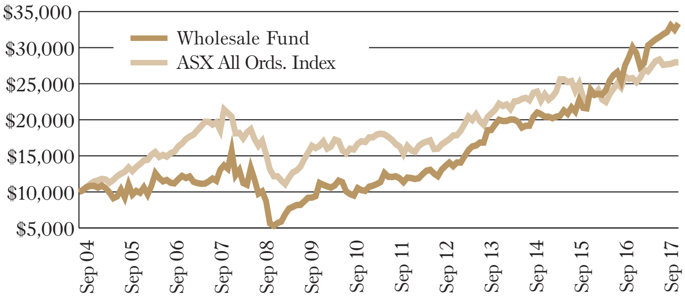
As mentioned previously, not all sales have been the result of investment cases coming to fruition. The Fund's second largest holding, Reckon, was sold in late July. And it wasn't thanks to good news.

First, the spin-off of Reckon's document management business has eroded value. Now called **GetBusy** (AIM:GETB), the business has been separated from the rest of Reckon. It started trading on London's AIM exchange in August. It is either difficult or impossible for Australian shareholders to own the shares. The best of some bad options was to sell Forager's holdings into a bookbuild, where we received roughly $0.16 per Reckon share. This rapidly growing part of the business was pencilled in at $0.30-$0.40 per share in our valuation.

Second, the management incentives here felt skewed. Reckon founder Greg Wilkinson, CEO Clive Rabie, and his son and COO Daniel Rabie underwrote a rights issue for GetBusy. Greg and Clive are directors and large shareholders, while Daniel became CEO of GetBusy. They had a clear incentive to underwrite the issue at the lowest price possible and have ended up owning a larger percentage of GetBusy than they do of Reckon. One can't help but wonder if Greg and Clive have laid the groundwork to move on from the Australian company.

Third, while management were running around the UK drumming up interest in GetBusy, Reckon's Australian business has been under assault. US giant **Intuit** (NasdaqGS:INTU) recently added its cloud-based Quickbooks product to an already competitive Australian market dominated by **Xero** (XRO) and **MYOB** (MYO). In a recent results update, Intuit claimed it already had more than 50,000 online subscribers in Australia, dwarfing Reckon's 39,000 at the time. Reckon used to distribute Quickbooks in Australia. Its customers are familiar with the name and are surely the main target of Intuit's marketing expenditure.

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



Source: S&P Capital IQ
Investments can go up and down. Past performance is not necessarily indicative of future performance.

Much of Reckon's spend on this part of the business has been tagged as "new business initiatives" and excluded from underlying earnings. If they want to compete, the spend needs to be permanent.

Finally, most importantly, we lost confidence in our valuation of the Practice Management division. This is the part of the business that we had been using to underpin the downside valuation of the entire Reckon business. The main product, APS, is core software for a significant percentage of Australian accounting firms, apparently including four of the top five.

Unpicking this part of the business isn't easy. Management change the divisional allocation of businesses every year. For the most part, these changes seem to have resulted in propping up the growth of Practice Management.

Our unpicking suggests the APS part of the business – the piece worth a strategic premium – might represent little more than half the Practice Management division's revenue.

The rest, mostly law-firm billing software nQueue Billback, doesn't deserve the same multiple as APS.

None of this is terminal. Reckon's current price compensates for a few sins. The customer base is valuable and those currently paying will likely hang around longer than most people think.

Throw in a loss of confidence in management, though, and it adds up to a significant erosion of our margin of safety. Reckon will be navigating its many challenges without us on board.

TECHNOLOGY: PAIN AND PROMISE

Aside from the specific disappointments related to Reckon, a growing requirement to invest in technology was a general theme of the recent reporting season.

You might not think a business focussed on providing labour to build and connect physical networks needs to spend much on technology? Yet Service Stream has been making investments in technology to drive efficiencies and improve client service. For the second year running the business spent $7m on systems and technology, almost 15% of its EBITDA. Service Stream claims its technology is one important reason its margins are so much higher than its competitors.

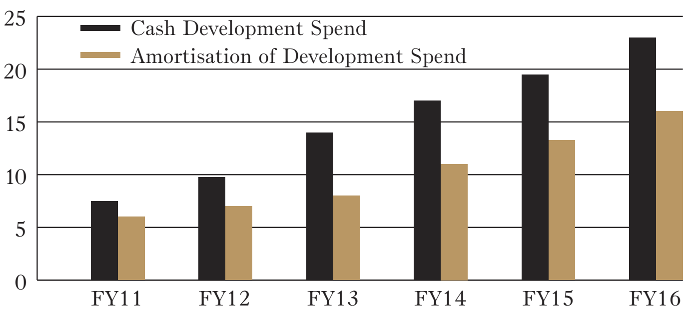
Mainstream BPO (MAI), an administration provider for financial services companies, spent $2m mostly to help the business automate its workflow. It claims 43% of transactions were automated last year, up from 19% in the prior year. If the money is well spent, client service levels and efficiency will improve as automation increases. Less direct staff involvement means lower costs. Competitors which can't or won't make the same spend run the risk of being stuck with a higher cost base.

SOFTWARE PROVIDERS ALSO NEED TO INVEST

And then there are the businesses which sell software. Like Reckon. While they should be beneficiaries of growing technology spend, they have problems of their own. Frantic change means they can be left behind as technology shifts. Domestic competitors can spring up quickly with fresh solutions. International businesses can enter the relatively small Australian market and bring their greater resources to bear.

Take the example of Reckon's small and medium enterprise accounting products. Accounting software has shifted online. Traditional local competition from MYOB continues. Xero has also claimed market share with its sleek online-only products. Then there are the global behemoths: Intuit and **The Sage Group** (LSE:SGE). Intuit, a former partner, spent $1bn on research and development last year. Meanwhile, Reckon spent a little over $22m, mostly to develop its own cloud product. It is likely too little, too late.

Chart 2: Reckon's Development Spend and Amortisation



Source: Company Filings

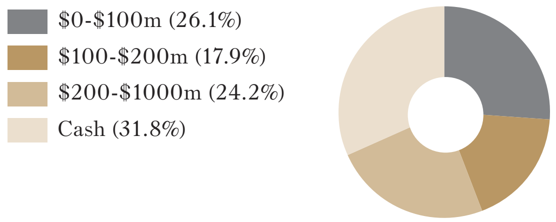
GBST (GBT), a Fund investment which makes software for financial services clients, surprised the market in August by announcing that its products would need an additional $50m of "investment" over the next three years. Underinvesting in the product over the past few years meant that the code has become dated. Meanwhile, competitors did invest in their products. Radical changes were needed and investors have had to pay the price.

In many cases, technology spend made by companies has been capitalised. Cash has been spent but has not immediately been recognised as an expense on the profit and loss statement.

Instead, it is first recognised as an asset on the balance sheet and then expensed over time. Often company presentations will ignore this amortisation, referring only to EBITDA. Investors will have to pay closer attention to both current cash expenditure and future amortisation expenses.

We also shouldn't forget that many technology projects will end in failure, over time and over budget. And, with the increasing speed of technological progress, many will not last the three to five years they were originally designed for. More software assets will be written off from company balance sheets. Management will be tempted to make this seem "one-off" in nature.

Chart 3: Portfolio Distribution According to Market Cap



Valuation metrics will have to be reassessed too. A common valuation multiple, enterprise value to earnings before interest, taxation, depreciation and amortisation (EV/EBITDA) ignores those capitalised costs. Just looking at price to earnings ratios in a period of rising cash software spend will paint an overly rosy picture for as long as a company's cash spend is higher than the amortisation.

Across all industries, technology continues to become more important. The prize for getting it right will be significant, as will the costs of failing to keep up.

Table 2: Top 5 Investments

Cash	32.0%
Macmahon Holdings	11.0%
Enero Group	8.1%
Cardno	5.4%
NZME	5.0%

RESULTS WRAP-UP

Mining contractor **Macmahon** (MAH) had an eventful year. A problematic contract lost the company $29m, a new CEO came on board in October, an opportunistic takeover by CIMIC was rebuked, and a new Indonesian contract resulted in a new top shareholder. For the year just gone the business delivered only $360m of revenue and lost $23m of shareholders' money. The company is sticking by its guidance for a much brighter future. With the share price rocketing higher, it is going to need to deliver.

Marketing and communications business **Enero** (EGG) is another long on promises and short on results. The company was buffeted by exposure to the UK over the year, with revenue slipping 12% to $100m and net profit falling 26% to $4.9m. Marketing Agencies Naked and BMF performed well in Australia, while UK-centric tech public relations business Hotwire was bolstered by an acquisition in the US. The net result is not enough. Enero's valuable portfolio of businesses are still bearing the burden of a high corporate overhead and the company needs to grow to justify its existence.

New Zealand media business **NZME** (NZM) produced a reasonable result for the first half of its financial year. While revenue fell 3%, net profit increased by 1%. Printed newspapers continued to suffer, with revenue falling 4%, while radio revenue fell 6% despite gaining market share. The contribution from online continued to power along, up 20%. The second half will see earnings pressured by the absence of the Lions tour, no America's Cup and less cost reduction.

Oil equipment supplier **Matrix Composites and Engineering** (MCE) had a disappointing 2017 financial year. Sales fell 65% to $33m and the company posted an operating loss of $4.4m. Part of its $14m net cash is funding the commercialisation of new products. While this could create new sources of revenue, an investment in Matrix remains a bet on a higher oil price and subsequent recovery in offshore drilling.

It was a hard year for **CTI Logistics** (CLX) too. The company generates most of its revenue in Western Australia, which has seen a significant downturn in economic activity in recent years. Underlying net profit was only $4m compared to $10m at its peak in 2013. A mild recovery in its home state and cost savings related to a restructuring of the company's leases should see profitability edge higher over the coming years.

Finally, **Brierty** (BYL), operating in civil infrastructure and mining services, was the worst performer for the quarter, entering administration in September. This cost the Fund approximately 0.3%. The business has struggled to be profitable for some time and booked a net loss of $2.9m on revenue of $126.4m, down 41% from last year. It finished the financial year with $35m in debt and only $1.5m in book value.

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