29 December 2017

FORAGER

WHOLESALE VALUE FUND DECEMBER 2017 QUARTERLY REPORT

WHOLESALE VALUE FUND

FACTS

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

UNIT PRICE SUMMARY (EX-DISTRIBUTION UNIT PRICES)

Date	29 December 2017
Buy price	$1.4799
Redemption price	$1.4725
Mid price	$1.4762
Distribution	$0.06
Portfolio value	$27.6m

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 29 December 2017

	Forager Wholesale Vaue Fund (Net of fees)	S&P All Ords. Accum. Index
1 month return	4.69%	2.03%
3 month return	6.15%	8.20%
6 month return	10.12%	9.31%
1 year return	27.18%	12.47%
3 year return (p.a.)	20.59%	9.23%
5 year return (p.a.)	20.31%	10.37%
Since inception* (p.a.)	10.14%	8.72%

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

It is often said that "the devil is in the detail". At Forager we love devilish detail; it helps us find opportunity in unlikely places. Particularly in rising markets, when cheap stocks are harder to spot, finding successful investments require some insight that isn't immediately obvious to fellow investors. One section of the annual report that helps us a lot is the note on segmental reporting.

Take **Jumbo** (JIN), an online lottery ticket retailer and long-term investment of the Fund. Jumbo's 2015 results were grim. Profit fell 80% to \$0.7m as costs rose faster than revenues. Forager had just bought another 3% of the company. What was a value manager doing buying a stock trading at 55 times after-tax profits?

There was a lot more going on under the headline numbers. Jumbo sells lottery tickets online in Australia. With ambitions to start "a new era as a truly international company", it was expanding operations into Germany, Mexico and the US. But Jumbo's plans for world domination were not going well. The notes to Jumbo's annual accounts showed the extent of the pain. Germany lost Jumbo \$3.6m in 2015, Mexico another \$300k.

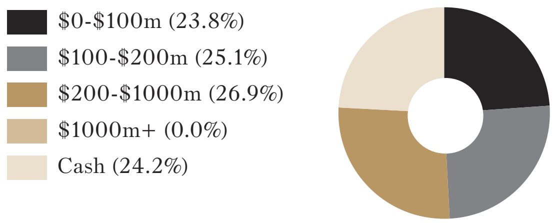
Overseas forays often result in recurring losses and messy exits. Jumbo's was no different. But it was because of such losses that the opportunity existed. The value of Jumbo's consistently profitable Australian operation was being masked by overseas start-up costs. High insider ownership suggested that management would eventually do the sensible thing and cut its losses.

And that's exactly what happened. The company's German operations were closed in early 2017, while the Australian business increased profits by 50%. Earnings are up ten-fold and the stock price has more than tripled.

Segmental reporting also provides information about corporate costs. **Enero** (EGG), another of our holdings, owns a handful of standalone marketing businesses. These make \$16m of earnings before interest, tax, depreciation and amortisation. The corporate costs of running a listed company are significant: \$6m evaporates on a CEO, board and support functions.

Stock market investors value Enero based on its profits after corporate costs. But potential private buyers for Enero already run their own corporate structure and wouldn't need another CEO. They would come to a higher value for the company by looking at just the earnings from the marketing businesses. A look at the headline earnings doesn't do justice to the value of the company.

Chart 1: Portfolio Distribution According to Market Capitalisation

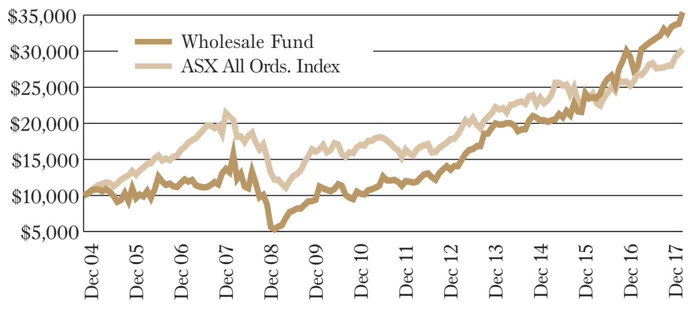


Extra segmental information can also be helpful in separating high multiple earnings from lower quality profits. Engineering, environmental and international development business **Cardno** (CDD) has a market leading position in the Asia Pacific region. This sector deserves a higher multiple than its more competitive business in North America. Other lower-quality businesses in construction and Latin America deserve a lower multiple still. Knowing what proportion of headline earnings come from which business is important.

As with the rest of the annual report, notes can be easily manipulated by management. Details about operations won't be disclosed perfectly, and usually not to the degree investors would like. They can also be inconsistent over time, making comparisons difficult. One particular trick management can use is to take costs that should be allocated to a business and lop them in with the corporate expenses, making the divisions seem more profitable than they are.

But looking at the notes to company earnings reports helps investors to better understand the headline earnings of a business. Armed with the details, we are better able to uncover more great opportunities.

Chart 2: Comparison of \$10,000 Invested in the Forager Wholesale Value Fund and ASX All Ords. Index



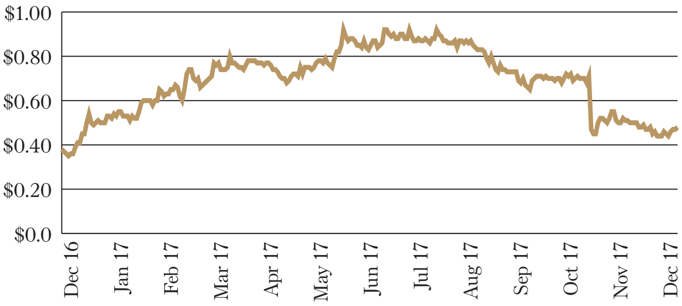
Source: S&P Capital IQ
Investments can go up and down. Past performance is not necessarily indicative of future performance.

FREEDOM TO DELIVER ON SENSIBLE EXPECTATIONS

One stock that has been the subject of both euphoria and panic over the past 12 months is life insurance company **Freedom Insurance** (FIG). Its share price soared from $0.40 in January to $0.90 in August, only to then collapse back to $0.40 in November. It is our view that this is mostly the result of the way it presents its accounts.

The Australian life insurance industry generates roughly $16bn of annual premiums. Banks and financial advisers still control 85% of the market. The remaining 15% belongs to the direct-to-customer channel. Within this Freedom has an 11% share, up from 6% a year ago.

Chart 3: Freedom Insurance's Share Price



Source: S&P Capital IQ

The banks and their related parties are under significant political and regulatory pressure due to poor customer outcomes. Commissions have been high, prices poor and policies difficult to understand. As a result, nimble players like Freedom should continue to win market share.

Still, Freedom should grow even without disrupting the industry. The overall market is expanding thanks to a growing and aging population. Over the past few years, Freedom claims it hasn't been stealing customers from anyone, rather it has been selling its policies to those who cannot afford a financial planner. Soon the company will launch new products which should also help to grow the business beyond its highly successful funeral expenses product.

The problem here is not market opportunity but barriers to entry.

Freedom's name is slightly misleading. This company does everything in the direct-to-customer life insurance market other than writing insurance policies. It creates the product, markets and distributes that product and administers policies. When it comes to writing insurance risk, though, that is handed off to Freedom's partner Swiss Re.

It requires little investment as Freedom uses Swiss Re's balance sheet to write new policies. And the products can be copied. So why should Freedom earn outsized profits?

In November Freedom announced that sales for the first half of this financial year will be in the range of $27m to $29m. This is a significant fall from the $33m it generated in the previous half. Perhaps this is evidence that assuming perpetual growth is a mistake even if, as explained above, this should be a growing business.

But the 50% share price fall since June makes the stock look good value.

What Freedom has been doing well over the years is finding uninsured customers first, and at a low cost. This requires ingenuity and experience, which likely take some time to build. Establishing a successful relationship with an underwriting company is likely to take some time too.

So, while new firms are likely to enter the industry, it will take time and serious effort before they become a serious threat. In the meantime, Freedom has the chance to build enough scale to maintain profitability even in a more competitive market.

But it's the difference between accounting profits and cashflows that make this investment most attractive.

When Freedom sells a policy, it receives an upfront commission from Swiss Re that roughly covers its customer acquisition costs. It also collects trail commissions over the life of the policy, and it's these trail commissions that represent Freedom's economic profit.

The upfront commission and the present value of this entire stream of future payments are both booked immediately as revenue. So in the early years of its existence, the company reports revenues well in excess of actual cashflows. As it matures they should roughly match. And if it stops writing new policies the cashflow will continue flowing for years despite not reporting any accounting revenue.

So, while it has a huge impact on the accounting profits, we aren't overly concerned whether Freedom's level of new sales changes by 10% or 20%, as long as it keeps building the annuity stream. If Freedom can generate about $60m of annual sales for each of the next three years, the value of the resulting stream of payments justifies the current market capitalisation of $110m.

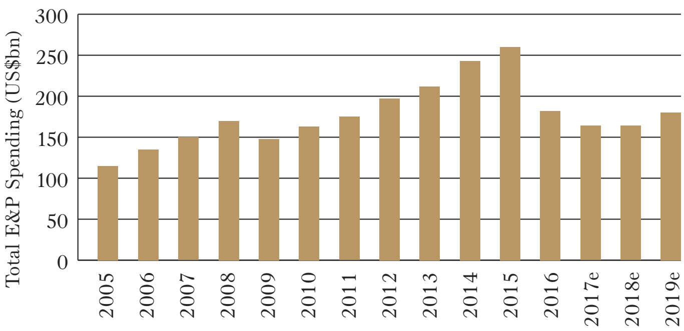
If the business doesn't grow there is little downside. If growth returns then Freedom should prove a great investment. Currently the Fund's investment represents 4% of the portfolio.

MMA TO RIDE THE OFFSHORE OIL RECOVERY

The last quarterly report spelled out a renewed bullish message from the International Fund team: the oil price is headed higher. The Australian Fund has not had as many oil exposed stocks to choose from, but we have recently re-established a position in this space. It's an asset heavy business in a difficult environment with an uncertain future. In many ways, a classic Forager investment.

MMA Offshore (MRM) owns vessels that it leases to the offshore oil and gas industry. These vessels mostly tow anchors and ferry supplies to drill rigs. The 2014 oil collapse pushed explorers and producers to reduce their spending on offshore fields. This left MMA, and competitors, without much work to do. To make life more difficult, the last few years also saw plenty of new vessels, ordered when the oil price was above $100 per barrel, finally ship out of the yards. MMA ordered vessels too, and spent $450m acquiring a Singaporean competitor.

Chart 4: Offshore Exploration & Production Spending



Source: Pareto Securities

Day rates to contract these vessels have now halved. This is barely enough to meet the costs of crew, leaving little to refresh vessels, pay interest on debt, or reward shareholders for their investment. Many older vessels are still sitting on the sidelines, running a skeleton crew until they are called upon to work again.

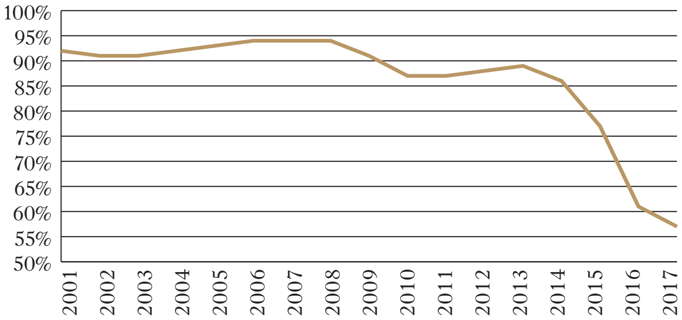
The destruction of value in the industry has been severe. Many firms sunk under heavy debt loads. And MMA nearly joined them. To stay afloat it had to sell its prized supply bases and some of the older vessels. The business lost $380m in the 2017 financial year as it wrote down the value of its remaining fleet. At 30 June that year it had net debt of $295m and a market capitalisation of just $60m, a far cry from $800m in 2014.

The Fund has owned MMA before, purchasing shares in early 2015 when the company was trading at one-third of book value. The value of the vessels fell faster than anticipated, and the tightening debt situation meant that either offshore activity had to improve quickly, or MMA needed fresh equity. We decided to sell the Fund's shares in mid-2016 at a loss.

So, what has changed?

A longer runway for one. MMA did raise that equity. Existing and new investors, including Forager, contributed $97m which were used to reduce debt. In tandem, MMA's banks extended the maturity of the debt to September 2021. The raising was priced at about half the current book value and five times expected future earnings.

Chart 5: Utilisation of Offshore Service Vessels



Source: Arctic Securities

We are also a few years closer to MMA's vessels getting back to work at reasonable rates. For 15 years prior to the oil collapse offshore support vessels were in use 90% of the time, against only 57% now. No vessels have been ordered in the last few years, and many of the currently waylaid vessels are too old to return to work. Meanwhile, offshore spending needs to rise to maintain oil supply.

MMA's core fleet of new, high spec vessels is in a good position to benefit. It's unlikely to be smooth sailing, though. While there are some early signs that activity is returning, it might be years before we see more normal earnings. MMA, with Forager on board, now has to time to wait for a recovery.

Table 2: Top 5 Investments

Cash	24.2%
Macmahon Holdings	9.6%
Enero Group	7.7%
Cardno	5.0%
NZME	4.7%

PORTFOLIO NEWS

In October, **CTI Logistics** (CLX) announced the acquisition of transport and warehousing business Jayde for $7.5m. The deal is consistent with CTI's strategy to acquire similar businesses outside its home state of Western Australia. Jayde will strengthen CTI's national transport network and add about $1.5m to CTI's net profits. If Jayde exceeds expectations in 2018, CTI will pay an additional $3m to the vendor. Despite the share price jumping 50% since May, the stock remains attractive.

At the annual general meeting for crane owner **Boom Logistics** (BOL) in November, the company disclosed that revenue for the first four months of the financial year was $62m, 24% higher than the previous year. This translated into earnings before interest and tax of $2m and, for the first time since 2014, positive net profit. Work won on coal sites in Queensland, a smelter at Olympic Dam and new wind farms suggest the outlook for 2018 is better. Wind farms especially are a $300m opportunity for Boom over the next few years. The stock jumped sharply, rising 150% since early September.

It was also an eventful quarter for our largest position, mining services company **Macmahon** (MAH). A contract at the Byerwen coal mine in Queensland was finally signed, with the three-year deal worth $450m in revenue. A new contract for Mount Morgans gold mine was also won, worth $250m over 5 years. The contract on the Telfer mine, owned by **Newmont** (NYSE:NEM) is on track to break-even for the 2018 financial year – a good result for this problematic contract. And a well credentialed chief financial officer was announced as the replacement for the exiting Jose Martins. If Macmahon can successfully commence full operations on Indonesia's giant Batu Hijau mine this coming quarter, the 2019 financial year should be excellent.

Online lottery seller **Jumbo** (JIN) announced a strong trading update in December, forecasting this half year's revenue at about $18.3m, up 14%, and net profit at about $4.4m, up 69%. Net profit excluding the closed and loss-making German operations rose 26%. Free from the drag of Germany, Jumbo is refocusing on its growing Australian business, including pushing further into charity lotteries. Online lotteries continue to take market share away from physical lottery sales, but Jumbo's supplier **Tatts** (TTS) is gaining ground with its own offering. Tatts reported its first quarter online lottery sales grew 30%.

Fund administrator **Mainstream Group** (MAI) continued its acquisition charge. Mainstream completed the previously announced purchase of the **IRESS** (IRE) superannuation business and the Trinity administration business in Ireland and the Cayman Islands. The group is now present in eight countries and has $123bn in funds under administration. To support Mainstream's global ambitions the group refinanced $11m of expensive debt into a three-year facility with the **ANZ** (ANZ). This will save close to $800k in annual interest costs.

Finally, **Dicker Data** (DDR), announced some additions to the group's line-up of vendor partners in New Zealand and Australia. In August the IT distributor lost a major supplier, Cisco, in the group's New Zealand business. NZ accounts for 11% of Dicker's revenue and delivered a $1.7m after tax profit last half. The business responded by extending its Australian relationships with Hewlett Packard Enterprise, Kensington, Seagate, and others into New Zealand. It also added Juniper products to its Australian portfolio, along with a product from the much-hyped Internet of Things operator, **Buddy** (BUD).

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