FORAGER

30 June 2014

WHOLESALE VALUE FUND JUNE 2014

QUARTERLY REPORT

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FORAGER IS BORN

On 1 July this year, the investment manager Intelligent Investor Funds changed its name to Forager Funds and moved offices. The rationale behind the name change is discussed below. There is no impact on the Wholesale Value Fund and the investment team and strategy remain unchanged.

Three months ago the shareholders of Intelligent Investor agreed to sell Intelligent Investor's subscription business to listed company Australasian Wealth Investments. This was completed on 1 July and, as part of the transaction, the funds management business (which was not sold) had to change its name.

Rather than select an industry cliché such as a coloured rock, precious metal or incredibly high mountain, the new name, Forager, was chosen to reflect values of importance to investors such as performance, alignment and transparency. It also reflects the Investment Manager's approach: contrarian, persistent and prepared to look in under-researched areas to find value.

As well as the name change, the Investment Manager reached an important milestone with funds under management now over $140m. That's not large but it does enable Forager to employ the people and infrastructure required in a modern day funds management business.

The importance of this should not be understated. The Investment Manger does not need to devote swathes of time to trying to find cornerstone investors or appeasing asset consultants or research houses. More time can therefore be dedicated to company research on behalf of existing investors.

Aside from this, it's business as usual for the Investment Manager. The shareholders, chief investment officer and other staff are the same, the portfolio and investing strategy for the Fund is unchanged and the commitment to the principles of value investing is as strong as ever. The Investment Manager would like to extend a thank you to investors for their ongoing support.

PATIENCE IS HARDEST WHEN NEEDED MOST

In terms of current market conditions, the Investment Manager's view is that patience is the order of the day. Jeremy Grantham, head of US hedge fund GMO, summed up the value investor's dilemma a few years back:

'Only sleepy value managers buy brilliantly cheap stocks: industrious, wide-awake value managers buy them when they are merely very nicely cheap, and suffer badly when they become – as they sometimes do – spectacularly cheap.'

This may be a market where it pays to be sleepy. Financial market volatility is back to levels not seen since pre 2007.
On the 2nd of July, the entire day's trading range for the S&P 500 was 0.2%, the lowest since 1993.

The US market is regularly reaching all-time highs and is experiencing very little in the way of violent adjustment.

Closer to home Sportingbet is offering odds of $4.00 that Australian interest rates will move by the end of the year. In either direction. Odds that there will not be a rise or cut are $1.20.

The consensus view is obviously that the status quo – low volatility and generally improving economies – is immovable.

Of course the real world is very different. Shocks happen. And central bankers often change their mind very abruptly. The Investment Manager does not punt on interest rates, but the current level of complacency is too high.

There is nothing unusual about stock markets hitting new highs. Particularly in the US, where dividend payout ratios are very low, markets should march higher over time (the more return that comes out via dividend, as in Australia for example, the less return you should expect in the form of capital gains). And the Investment Manager is still finding plenty of new stocks to add to the portfolio.

But better opportunities will become available. There have been three great opportunities to buy in the past eleven years: 2003 was a great time to be buying high quality blue chips; 2009 was a great opportunity to buy anything; and in 2011 it was the time for small stocks.

Three good opportunities in a little over a decade is more than enough. The years in between are the problem. It's the waiting that does people over. Patience is rare, and most difficult to exercise right at the point you need it most. Now is a time to be patient.

WHOLESALE
VALUE FUND

FACTS

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

UNIT PRICE SUMMARY

Date	30 June 2014
Buy Price	$1.4115
Redemption Price	$1.4045
Mid Price	$1.4080
Portfolio value	$28.9m

WHOLESALE VALUE FUND PAUSES FOR BREATH

The Wholesale Value Fund recorded returns of minus 2.8% for the June quarter, versus positive 0.5% for the benchmark All Ordinaries Accumulation Index. Over the financial year the fund returned 13.9%, versus 17.6% for the benckmark.

While the result for the past financial year was perfectly acceptable, most of the return came in the first three months. In the six months of calendar year 2014 the Wholesale Value Fund is down 3.3% versus a positive 2.7% for the market, underperforming by nearly 5%.

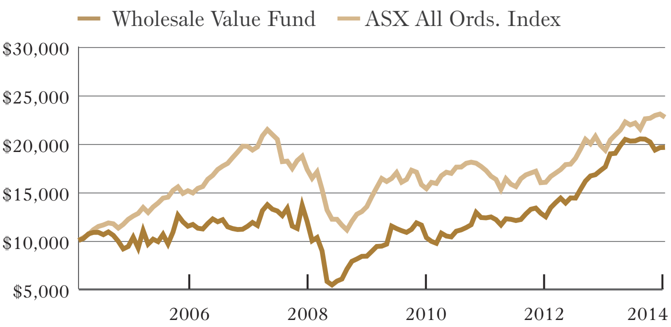
Summary of returns as at 30 June 2014

	Wholesale Value Fund	ASX All Ordinaries Accum Index
1 month return	0.12%	–1.41%
3 month return	–2.78%	0.47%
6 month return	–3.31%	2.68%
1 year return	13.89%	17.64%
2 year return (pa)	25.49%	19.15%
3 year return (pa)	16.72%	9.69%
Since inception* (pa)	7.09%	8.71%

*Inception 31 Oct 2009

It's been a lean period, particularly compared to the 41% returned in 2013 and 19% in 2012, periods where the benchmark returned 20% and 19% respectively. The chart to the right shows the contrasting performance of the Fund's largest five investments last year and the first half of this year. So far this year, the big holdings, with the exception of **Enero Group (EGG)**, have not boosted the Fund.

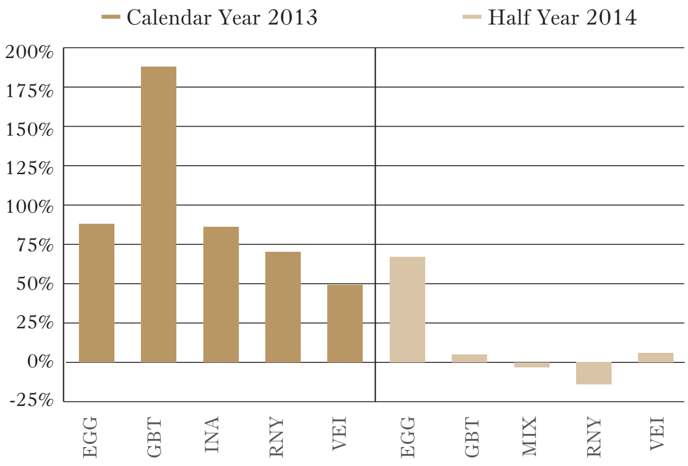
Performance of $10,000 invested in the Wholesale Value Fund



Source: Capital IQ

That is not a reflection on these companies—we touch on why a few of them are so exciting below—rather it reflects the reality of two exceptional years. And the reality of the nature of the Fund portfolio. Returns are expected to be lumpy and there will be inevitable periods of transition, usually following periods of strong performance.

Gains on largest five investments

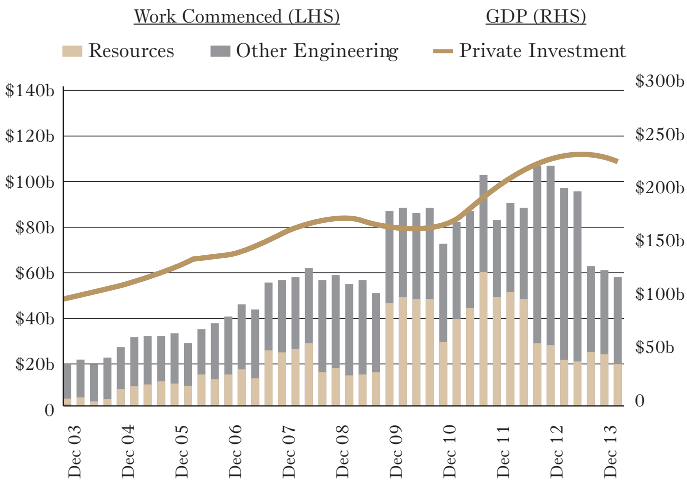


Source: Capital IQ

The estimated undervaluation of the portfolio and the preponderance of attractive new ideas look promising. We discuss below why one of the Fund's former star performers no longer looks attractive. Other stars, however, remain both cheap and robust. On the new ideas front, we have a nice pipeline of candidates, and the portfolio is changing as we cycle old ideas for new ones.

The economic outlook in Australia, however, remains a concern. The boom in new mining investment has now clearly come to an end but, as the chart below shows, the impact on the economy has been cushioned so far by the completion of old projects. The contribution of business investment to gross domestic product (GDP), currently at record highs, is set to fall heavily.

Engineering Work Commenced vs Private Investment GDP



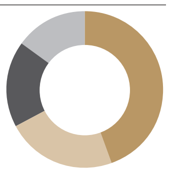
Source: ABS

"INVESTORS EXPECTING A REPEAT OF THE LAST DECADE'S COSY CHAIN OF RISING PROFITS AND EASY DIVIDENDS MAY BE IN FOR A RUDE SHOCK."

Investment from the last decade ensures Australia will export record tonnes of ore, but unlike investment and construction, the additional benefits to the wider economy are limited. The key export industries of iron ore and liquefied natural gas employ few people in production phase, are substantially foreign owned, and mostly use equipment sourced from overseas. They advantage the country mostly through tax revenues, and with commodity prices falling rapidly of late, the revenue reaped through taxation will be well short of forecasts.

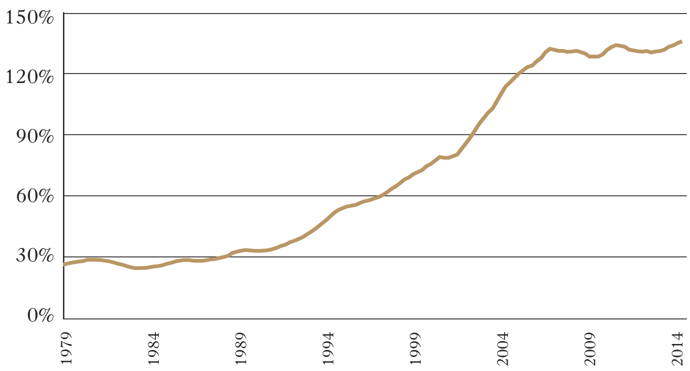
Portfolio distribution according to market capitalisation

- $0–$100m (44.6%)
- $100–$200m (22.8%)
- $200–$1000m (17.7%)
- $1000m+ (0.0%)
- Cash (14.9%)



The country is not well placed to withstand these contractionary forces. Leverage in the economy remains a problem, particularly in the household sector where debt as a percentage of GDP remains at record highs. With demand from China for our exports moderating, and investment falling, unemployment could rise and this leverage means the knock on effects could be severe. Investors expecting a repeat of the last decade's cosy chain of rising profits and easy dividends from 'sure things' like the big four banks may be in for a rude shock.

Debt to Disposable Income



Source: Reserve Bank of Australia

So what does this mean for the portfolio? Luckily value investors do not have to play fair (the idea is pretty much to play as unfairly as possible) so the Fund can cherry pick areas it likes and avoid other ones entirely. It has been a theme for the past five years, but we are still focused on finding foreign currency exposure on the ASX. The trends highlighted above are likely to force the Australian dollar, which has appreciated 5% to US$0.943 this year, lower long term.

We already have large investments in US commercial property trusts **RNY Property Trust (RNY)** and **Mirvac Industrial Trust (MIX)**, both discussed below. But a stronger play on this theme is to find operational exposure to the currency. A weaker Aussie dollar and reduced wage pressure will make Australian exporters (excluding miners) far more competitive. We are close to pulling the trigger on a couple of interesting ideas in that space, so stay tuned and we'll have more to say over the second half of the year.

UGL AUCTIONS OFF PROPERTY

After a long period of media speculation, contractor **United Group (UGL)** announced the $1.2bn sale of property services arm DTZ to a private equity consortium.

That equates to a multiple of approximately 12 times operating earnings before tax. When we first bought into UGL (at $7.13), it was intending to pursue a demerger of its engineering and property services segments, which we expected would lead to a rerating of the property group in line with global listed rivals CBRE Group and Jones Lang LaSalle (which trade at 15 and 16 times respectively).

A demerger might have created a better outcome for shareholders, but the December half-year results revealed rising debt, and this seems to have unnerved lenders. We're speculating, but it seems likely that the banks stopped the demerger from taking place.

The sale solves UGL's debt issues. But the price is lower than our estimated value, and transaction costs and capital gains tax reduce the final proceeds to around $1bn, so the margin of safety on the investment has been eroded. The engineering business is a strong one—the consumer rail division in particular is well placed—but the resources exposure is significant and our view on that industry is very pessimistic. There is also the risk that UGL might make a silly acquisition now that it has cash. The implied price of around $700m for the engineering segment seems closer to fair value than cheap. So the Fund's UGL shares have been sold, realising a small loss.

OPPORTUNITY IN THE MIX?

The Fund has significant exposure to US commercial property through ASX-listed trusts RNY Property Trust (RNY) and Mirvac Industrial Trust (MIX). Both have been held for a long time and both have already boosted the Fund's performance. We think there is more to come.

For the past 12 months, the management of MIX has been manoeuvring to sell its assets and return cash to unitholders. Slow but genuine progress is being made. MIX has sold a few disparate C-grade properties this year, and the portfolio now consists of B grade industrial property more attractive to buyers. Borrowings against the assets are secured for 18 months at 4.4%, comfortably less than the yield on assets of around 8%, making for a nice cash margin to investors.

“IF A SALE CAN THEN BE EXECUTED AT CLOSE TO NET TANGIBLE ASSETS, THE FUND DOUBLES ITS MONEY FROM HERE OVER THE NEXT FOUR YEARS, AN EXCELLENT RESULT.”

We think the chances of realising published asset backing or more in a sale are quite good, though commissions and wind-up costs could consume as much as 10% of the final proceeds. Macquarie and CBRE have been appointed to assist with the sale, and there’s no reason MIX could not be wound-up in the next six to twelve months. MIX units trade at an 18% discount to the net tangible assets (NTA) after adjusting for potential transaction costs, an attractive margin of safety with the finish line in site.

Property trust comparisons

	RNY	MIX
Current price	$0.27	$0.165
NTA	$0.54	$0.22
Cap rates	8%	8%
Cost of debt	6.5%	4.4%
Property type	Suburban office B-grade	Chicago industrial B-grade
Vacancy	19.1%	9.5%

The situation at RNY, the Fund’s largest investment, is more challenging. You can see above that the average cost of debt is 6.5%, more than 2% higher than for MIX. This reflects high interest mezzanine financing being used as part of a debt package arranged in 2012. On top of this RNY is required to reduce loan principal each year by US$5.5m, chewing up more than half of free cash flow.

MIX has a stable tenant base, but RNY has higher vacancies and a number of lease expirations this year. It needs to spend money to retain or attract tenants and it is generating precious little cash to do so. This leaves it little chance of paying distributions for the next few years.

Not all of these assets, some of which we’ve visited, will prove easily saleable. Many are single tenant buildings in locations only suitable for a specific tenant, removed from public transport connections. Most of the debt issues cannot be fixed until May 2017 and the portfolio probably cannot be sold at a decent price until this occurs. In the meantime management needs to do a good job on letting and cost minimisation.

But with these issues comes tremendous opportunity. MIX trades at a 25% discount to NTA, an attractive proposition. RNY trades at a whopping 50% discount to NTA. Cash flow is tight but the money being spent repaying debt and attracting new tenants builds value in the long term.

By 2017 the debt should be refinanced at more reasonable rates. If a sale can then be executed at close to net tangible assets, the Fund doubles its money from here over the next four years, an excellent result. That’s without assuming any benefits from a reduction in vacancies, rental growth or further compression in capitalisation rates. As we’ve argued previously, there are good reasons to expect additional value from these sources.

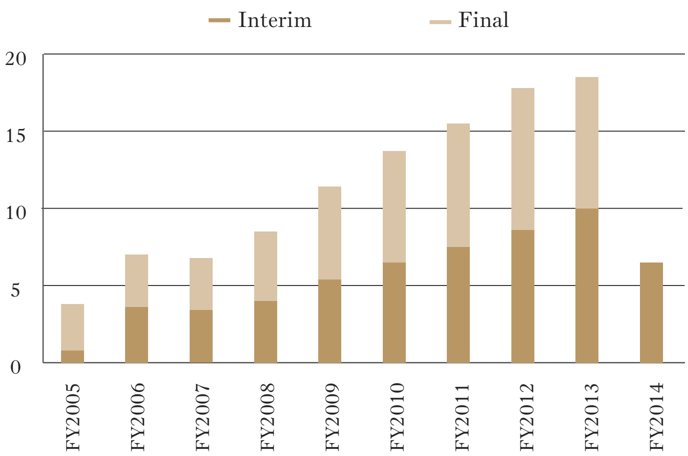
RNY units closed the quarter at $0.27 and, while the 14% fall in its unit price since 31 December 2013 has been hampering performance, the stock remains the Fund’s best idea.

INSPECTING EYES AND TEETH

In June we sold the last of the Fund’s shares in dental operator **1300 Smiles (ONT)**. It has been a very successful investment since first acquired in 2010. The last shares were sold at more than double the initial buy price of $2.90, and the stock produced an annualised return of 37% including dividends over the Fund’s period of ownership. As the rising chain of dividends below hints, managing director and major shareholder Daryl Holmes has done a terrific job with the company.

So why are we selling? In the table over the page we have lined up 1300 Smiles against one of the Fund’s largest investments, **Vision Eye Institute (VEI)**. The contrast is eye-popping; the market is suggesting that each $1 of profit is three times more valuable at 1300 Smiles than Vision, and each $1 of revenue is worth twice as much.

1300 Smiles dividends (cents per unit)



Source: 1300 Smiles

"THAT'S ACTUALLY A GOOD THING, BECAUSE BETTER PAY TO DENTISTS/DOCTORS MAKES THE BUSINESS MODEL MORE ROBUST."

Comparative multiples

	1300 Smiles	Vision Eye Institute
Revenue ($m)	41	107
Market cap ($m)	141	125
EV : revenue	3.2 x	1.3 x
Price : earnings	28 x	8–9 x

To an extent this is justified because the business model of 1300 Smiles is far stronger. The companies have similar operating expenses (see table below). You can see that 1300 Smiles pays a higher percentage of revenue to staff, 57% to 48%.

That's actually a good thing, because better pay to dentists/doctors makes the business model more robust. (The gap between the companies has actually closed substantially, when it listed, Vision was paying just 33% of its revenue to staff, which proved unsustainable. Eleven doctors left and it nearly went broke.) Despite paying more to staff, Holmes generates similar operating margins for ONT because of tight cost focus, conceding only 12% of revenue to overheads compared to Vision's 16%.

Margins comparisons (% of revenue)

	1300 Smiles	Vision Eye Institute
Staff	57%	48%
Consumables, lab fees, supplies	8%	12%
Rent, corporate, operating	12%	16%
Dep & amort	4%	5%
Operating margin	17%	18%

The multiple premium attributed to ONT is only justified by the potential growth profile derived from the attractiveness of ONT to dentists. ONT operates mostly in regional areas, where it does well by paying young dentists good salaries to work in areas where they wouldn't commit to owning a practice long term, areas which are under serviced by dentists currently. Whereas the ophthalmologists (eye doctors) at Vision earn less than they would at an independent practice, the dentists at ONT do better.

Is all this enough to justify an earnings multiple of nearly 30 times? Maybe. But it's not compelling and that's why we sold. Long-term returns come from dividends and capital growth. ONT's dividend yield today is just 2.6%. In order to generate a 10% return for today's investors, ONT would need to be multiples of its current size in a decade.

It will grow—ONT is only 0.4% of the $8.5bn dental industry in Australia—but that's a tough ask. Holmes has limited options for organic growth, improving practice utilisation or increasing fees and the like, because the company is already well-run. With 70% of earnings paid as dividends, there is little to fund acquisitions or invest organically. Incremental return on equity would need to be sky high.

On that front, too, things are getting tough. The management structure needs to be strengthened to support increased size and Holmes is running out of easy opportunities in regional areas. He has started making acquisitions in CBD locations, where the value proposition is very different and competition from other acquirers intense.

All these hurdles need to be overcome just to earn a reasonable return. In contrast, Vision, despite its lower quality, should earn better than 10% returns just by standing still, and any growth is a bonus. It's an easier and safer place to be. Vision shares rose 23% in the quarter to $0.745.

Top 5 holdings

	Description	Weighting
Vision Eye Institute	Ophthalmology clinics around Australia	11.5%
RNY Property Trust	Owner of suburban office B grade properties in the US	11.5%
GBST Holdings	Financial Industry software provider in the UK and Australia	7.0%
Hansen Technologies	Provider of billing and customer care software	6.3%
Mirvac Industrial Trust	US industrial property owner in the process of liquidating it's assets	6.2%

“IS ALL THIS ENOUGH TO JUSTIFY AN EARNINGS MULTIPLE OF NEARLY 30 TIMES? MAYBE. BUT IT’S NOT COMPELLING AND THAT’S WHY WE SOLD.”

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