30 September 2014

FORAGER

WHOLESALE VALUE FUND SEPTEMBER 2014

QUARTERLY REPORT

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FOCUSING ON WHAT COUNTS

It is easy to get caught gazing into a financial crystal ball. Disparate returns for our two funds show why focusing on underlying business performance is far more important.

Dear Investor,

In the three months to September Forager Wholesale Value Fund produced an 8.34% return in a quarter where the index went backwards a touch.

Long-term investors will be accustomed to lumpy returns. So what I am about to write will not be news. But with a significant number of new investors joining the Forager fold over the past 12 months, it is worthwhile reiterating what we do.

Performance

	1 Quarter	1 Year	3 Year (pa)	Since Inception (pa)
Wholesale Value Fund	8.34%	7.37%	22.35% pa	7.76% pa
ASX All Ordinaries Accum	–0.29%	5.89%	14.04% pa	8.52% pa

We don’t try and pick stock price movements. We buy businesses that we think are cheap. And what determines our results is not short-term price movements but long-term business performance.

Michael Lewis recently wrote an article for Bloomberg titled *The Occupational Hazards of Working on Wall Street*. He talked in the article about the propensity for finance professionals to express opinions about things they know nothing about:

“Anyone who works in finance will sense, at least at first, the pressure to pretend to know more than he does.

It’s not just that people who pick stocks, or predict the future price of oil and gold, or select targets for corporate acquisitions, or persuade happy, well-run private companies to go public don’t know what they are talking about: what they pretend to know is unknowable.”

Every time I am interviewed or receive questions in a public forum, I am asked what I think is going to happen to the Australian dollar, or how the Australian market is going to trade today. It gets a little tiring responding ‘I don’t know’. But it’s the response I should give every time and it’s the response you should give when you get asked the same question.

Our focus needs to remain steadfastly on finding cheap businesses and monitoring them closely to track their progress against our expectations of cheap. Here’s an example.

In December 2011 we bought **Mirvac Industrial Trust** (MIX) units for the Fund. The purchase price of this first lot was 7.6 cents per share, less than half MIX’s net tangible assets at the time. We were confident the assets were worth their book values.

From the beginning, management had a plan to work towards an exit for Australian investors. Over the ensuring three years, they refinanced debt, sold some problematic assets and then put the remainder up for sale.

That process reached its conclusion in September this year when MIX announced it had reached agreement to sell the vehicle. Subject to a shareholder vote that is unlikely to cause problems, $0.214 per unit will be returned to investors in December (see page 10).

MIX’s unit price has moved around all over the place over the past three years. In some quarters it has made a significant positive contribution to the Fund unit price, in others a negative contribution. But the final outcome is what you and we should be focussed on. We almost tripled our money in roughly three years. Whether that return shows up in the first year or the last is irrelevant, what matters is that we buy something for less than our estimate of its value and that our estimate turns out to be correct.

This works both ways of course. **Enero Group** has been a significant positive contributor to performance over the past year, but that doesn’t change the fact that the decision to invest in it was a mistake. Looking back over our old research, the expectation was that Enero could generate $200m per annum of revenue. This year it fell short of $120m.

The stock price has more than tripled from its low point last year because the market dramatically over-reacted to the company’s problems. Still, the business is quite clearly worth less than we originally thought.

Your focus and ours needs to remain on business performance, not stock price movements.

CHINA’S CORRUPTION CRACKDOWN HITS HOME

Most Australian investors would think a corruption crackdown in China has little impact on life in Australia. Historically, you would be correct. Today, however, China is Australia’s largest export partner and the power struggle under way in China has significant ramifications for this large island.

First, some background. In August, Zhou Yongkang became the latest ‘tiger’ to be snared by a corruption investigation. President Xi Jinping’s crackdown on graft has been snaring ‘flies’, or low level officials, and high-level ‘tigers’ for more than a year. As Jonathan Feasby explains in the *Financial Times* however, Zhou, is the biggest tiger yet.

“Zhou is the highest-level target of a corruption investigation in the history of the People’s Republic. He heads an extensive clan network running through the internal security apparatus, the oil and gas industry and the Sichuan provincial government. The attack on him, and the scope and duration of the campaign, confirms the view that Xi is the most powerful Chinese leader since Deng Xiaoping and represents a new form of governance of the world’s second-largest economy.”

Xi’s corruption crackdown is important in and of itself. For the Chinese economy to continue growing it needs to allocate resources more efficiently. Less corruption would be a significant first step down that path.

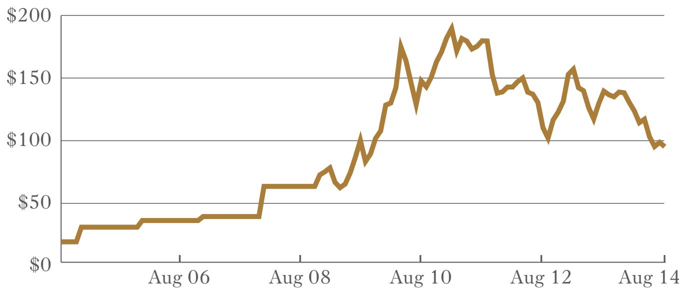
"WE DON'T TRY AND PICK STOCK PRICE MOVEMENTS. WE BUY BUSINESSES THAT WE THINK ARE CHEAP. AND WHAT DETERMINES OUR RESULTS IS NOT SHORT-TERM PRICE MOVEMENTS BUT LONG TERM BUSINESS PERFORMANCE."

But it is of far more symbolic importance. In his most recent newsletter, Michael Pettis explained why power is so important.

"It is no secret that during the past two or three years we have entered the most-heavily politicized stage of Chinese growth since the reforms implemented by Deng Xiaoping in the 1980s. This is not a coincidence. I have been arguing since at least 2010 that the very nature of the reforms China must implement means that it will be a highly politicized process, and will require tremendous centralization of political power."

There are a lot of very rich, very well connected people in China who have benefitted enormously from the growth model of the three decades. Changing that model, away from State Owned Enterprises, away from debt-funded infrastructure and towards small business and consumption is going to upset a lot of people.

Chart 1: 10 year iron ore price (US$/Dry Metric Ton)



Source: The Steel Index (TSI)

Which is why the political power to investigate one of the most powerful people in the country is so important. It suggests Xi and his fellow Politburo members might actually be able to pull the transition off.

And what's that got to do with Australia? Well, Zhou Yongkang might not be a household name here but most people can probably tell you the iron ore price. The two are closely related.

The iron ore price is down because the Chinese economy is slowing at the same time as global supply is rapidly rising. If Xi has his way, it will slow further yet. Authorities have officially abandoned the 7.5% growth target previously forecast for the Chinese economy in 2014. If required to rebalance the economy, they seem willing to accept much lower growth rates in future.

That will mean less demand for Australian resources, less income for Australian governments and slower GDP growth or a recession.

Despite significant falls in resources-related stock prices, we remain cautious on the sector and the wider Australian economy. As you'll read on page 6, more than half the Australian Fund portfolio is invested in companies that own foreign assets or generate revenue in foreign currencies. Whilst we have benefited from that exposure already, we remain convinced that such a stance remains prudent.

Yours sincerely,

STEVEN JOHNSON
Chief Investment Officer

"WHETHER THAT RETURN SHOWS UP IN THE FIRST YEAR OR THE LAST IS IRRELEVANT, WHAT MATTERS IS THAT WE BUY SOMETHING FOR LESS THAN OUR ESTIMATE OF ITS VALUE AND THAT OUR ESTIMATE TURNS OUT TO BE CORRECT."

WHOLESALE VALUE FUND

FACTS

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

UNIT PRICE SUMMARY

Date	30 September 2014
Buy Price	$1.5102
Redemption Price	$1.5026
Mid Price	$1.5064
Distribution	$ 0.0190
Portfolio value	$29.4m

PERFORMANCE

Australia's mining boom is well and truly over, with iron ore the latest commodity to nose-dive. The pain could be protracted but the Fund is well placed to prosper through tough times.

IRON ORE: BUYER'S MARKET

The Forager Wholesale Fund had a bumper September quarter, clocking up an 8.1% return in a period where the benchmark retreated a touch. Iron ore is the big driver of the market jitters; the spot price having now fallen a brutal 44% from its high of US$137/t last year to US$77/t at the end of September.

News to nobody, the insatiable demand for iron ore from China, which buys most of the world's seaborne iron ore, has moderated. But the real issue, at least from an Australian perspective, has been the huge amount of new supply added to the market over the course of the decade-long boom. Majors **BHP Billiton** (BHP), **Rio Tinto** (RIO), **Fortescue Metals** (FMG) and Brazil's Vale S.A. have all expanded operations and are producing record volumes.

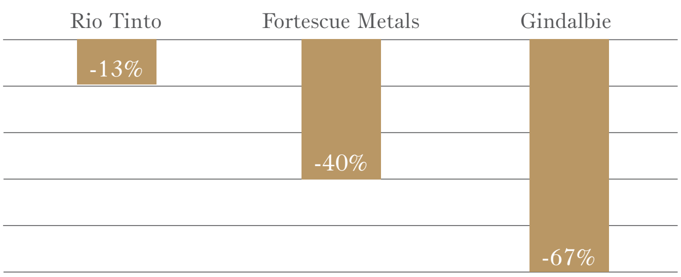
Table 1: Summary of returns as at 30 September 2014

	Forager Wholesale Fund	ASX All Ords Accum. Index
1 month return	–1.07%	–5.26%
3 month return	8.34%	–0.29%
6 month return	5.33%	0.18%
1 year return	7.37%	5.89%
2 year return (pa)	21.57%	14.38%
3 year return (pa)	22.35%	14.04%
Since inception* (pa)	7.76%	8.52%

*Inception 2 Sep 2004

The weight of all this supply has unsurprisingly pushed the price of iron ore lower, and the share prices of iron ore producers with it. But although the majors added most to supply, they have low-cost operations which afford some protection. Higher cost, marginal producers are the ones to suffer disproportionately. Northern Territory miner **Western Desert Resources** (WDR) recently went into receivership, and Chart 1 shows how **Gindalbie Metals** (GBG) has suffered more than Fortescue, which itself suffered more than Rio Tinto, one of the lowest-cost miners in the world.

Chart 1: Tough Going in Iron Ore



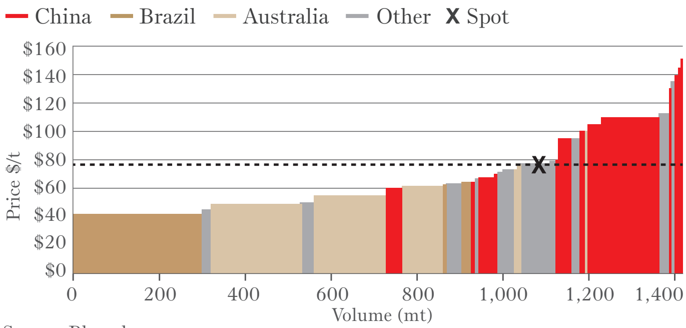
Source: Capital IQ

Perhaps there's one more ace in the Chinese stimulus pack in the short-term but the long-term outlook is decidedly grim. And, just as has happened in the coal industry, the response to lower prices could prove counterintuitive. Rather than immediate withdrawal of supply, some miners might increase production to try to reduce costs per ton and stay solvent. Smaller miners in particular are likely to produce as long as they have some cash, even at a loss, in the hope the market rebounds. This compounds oversupply. It could take decades for the market to rebalance.

NO SALVATION IN CHINA

The salvation many are hoping for is that higher cost Chinese producers will disappear from the market, relieving the pressure on price. Chart 2 shows the marginal cost of supply to China from both domestic supply and imports from Brazil and Australia (it excludes 'sunk' capital costs and makes no allowance for a return on investors' capital). In other words, it's an estimation of the additional cost to extract iron ore from the ground, ignoring the cost of infrastructure already in place. It's clear that China does indeed have higher cost mines (mainly because of poorer quality deposits).

Chart 2: Global Iron Ore Cost Curve



Source: Bloomberg

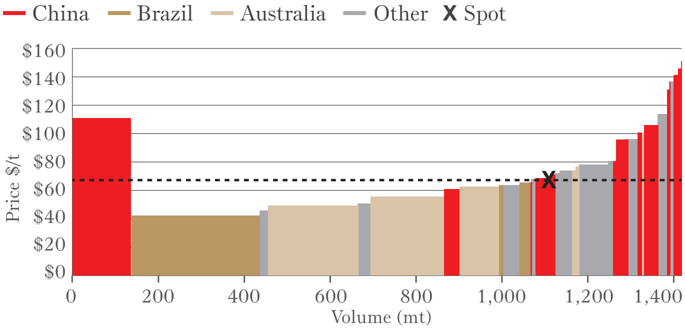
If China had demand of 1.1 billion tonnes next year, the cost curve suggests a marginal price of around US$76 would clear the market. That makes most of China's domestic supply uneconomic. But whilst a private company might respond to big losses by closing down, the Chinese government has different incentives. It is a major consumer of iron ore and can benefit from tipping the market into oversupply, at least in the short-to-medium term.

As an example, suppose China commits to continue producing 135 million tonnes, despite incurring costs of $110/t to extract it. If we move this supply to the front of the cost curve, you can see in Chart 3 that the new marginal price slips to US$65. The benefit to China through reduced prices is US$12bn (US$11 per tonne for the full 1.1 billion tonnes of demand), while the cost is just US$6bn on the loss making-supply (US$30 per tonne for 135 million tonnes of domestic production).

What would you do if you were China? Australian miners banking on the withdrawal of Chinese competitors might be clutching at straws.

"BUT WHILST A PRIVATE COMPANY MIGHT RESPOND TO BIG LOSSES, CHINA HAS DIFFERENT INCENTIVES. IT IS A MAJOR CONSUMER AND CAN BENEFIT FROM TIPPING THE MARKET INTO OVERSUPPLY."

Chart 3: Modified Iron Ore Cost Curve



Source: Bloomberg

GLOBAL PROTECTION

While the impact is felt most forcefully on projects, employment, and profits in the mining sector, the iron ore slump will also have a major impact on the wider economy, in particular state and federal government revenues. The surest protection for investors is to seek adequate foreign exposure, both to diversify from the Australian economy and to directly benefit from a weaker Australian dollar.

Table 2: Forager Wholesale Fund foreign exposure

Stock	Currency Exposure	Details
RNY	USD	100% US commercial property
Hansen	USD,EUR	22% revenue from USA, 35% from Europe, Middle East and Africa
GBST	GBP	39% of revenue from UK
MIX	USD	100% US commercial property
Enero	GBP,USD	37% revenue from UK, 12% from USA
Infigen	USD	50% of revenue from US wind farms
Thinksmart	GBP	Some Australian cash, only operating business is UK based
Astro Japan	JPY	100% Japanese commercial property
Smart Parking	GBP	Parking management business, 90% of revenue based in UK

We've been sounding the alarm bells on the mining boom, the Australian economy and the potential for a weaker currency for a long time now. We've been pleased by the value we've found in ASX-listed companies with foreign exposure. Software providers **GBST Holdings** (GBT) and **Hansen Technologies** (HSN) have been two of our strongest selections here and both reported excellent full year results, with earnings before interest, tax, depreciation and amortisation up 24% and 54% respectively.

But there are plenty more in the portfolio – companies included in Table 2 constitute half the Australian Fund portfolio. The $A fell 7% in the quarter to US$0.875 and we're well placed if it keeps falling.

Another way to potentially benefit from the carnage in mining is to invest directly in the sector, which has gotten cheaper by the day. At the moment our investments are limited to mining services, in companies that look extremely cheap and have defensive qualities – production-oriented services, decent long-term contracts or substantial asset backing, for example. Holdings include **Macmahon Holdings** (MAH) and **Brierty** (BYL) which was our best performing investment in the quarter, up 47% on the initial investment including dividends. There's value around but there are also a lot of traps, and a lot of factors outside the control of each company. So we are keeping the aggregate investment in the sector moderate.

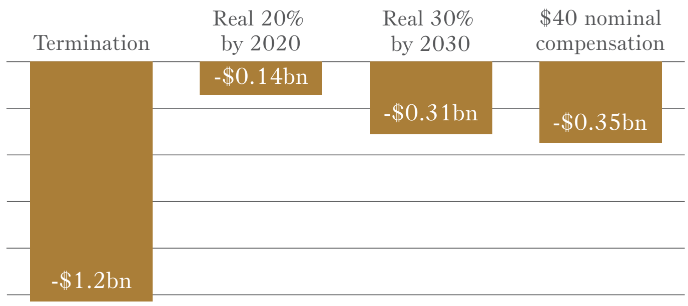
INFIGEN'S POLITICAL HEADWINDS

Wind energy producer **Infigen Energy** (IFN) has economic net tangible assets of $590m, nearly three times its $200m market capitalisation. Superficially this makes it very cheap. But with a whopping $1.7bn in financial liabilities, and support required from a now-hostile Australian government, the situation is finely poised.

Politics come into play because a major part of Infigen's revenue is derived from subsidies available to it from the Renewable Energy Target (RET) scheme. The RET, which supports renewable energy in Australia, is currently the subject of vigorous political and business debate. Critics, including most of the current federal government, view it as an expensive form of carbon abatement and an unnecessary burden on Australia's already oversupplied generation capacity.

A government-commissioned review recently recommended the scheme be downgraded or discontinued, and changes seemed likely. As Chart 4 shows, any changes could have a huge impact on Infigen's revenues over the next 15 years.

Chart 4: Possible RET Scenario Impacts



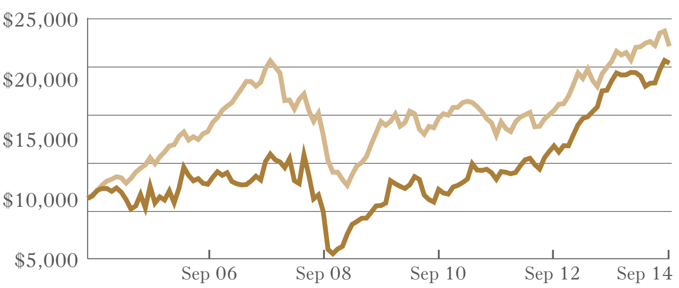
Source: Infigen Energy

The uncertainty has also had an immediate impact on the market price of the renewable energy certificates Infigen sells as part of its electricity production. The total ('bundled') price for uncontracted renewable electricity has fallen to around $70/MWh.

"THE UPSIDE IS HUGE IF INFIGEN CAN REALISE ITS $590M ASSET BACKING. IT'S A SMALL POSITION IN THE PORTFOLIO GIVEN THE LEVERAGE INVOLVED BUT ONE WE ARE WATCHING WITH INTEREST."

For Infigen to have any hope of surviving its tighter loan covenants in 2016, it desperately needs that price to recover to $100/MWh or more. Without regulatory support, this seems unlikely and a loan default is a real possibility.

Chart 5: Comparison of $10,000 invested in Forager Wholesale Fund vs ASX All Ordinaries Accum Index



Source: Forager, Capital IQ

But all isn't lost yet. The RET is popular with voters and in a curious turn of events Senator Clive Palmer has become a defender of the scheme, blocking changes unless the Coalition government is re-elected with a mandate. With the more extreme potential changes seemingly impossible, the Coalition has reached out to Labor looking for a compromise and the talk of major change has softened noticeably. Even if changes are made, there is a good chance of compensation to protect the credibility of the Australian government in the eyes of private investors.

This is all positive news for Infigen, whose security price has rallied 27% from its mid-September low to $0.26. It continues to be a high-stakes play with covenants bearing down, but asset sales in the United States could provide short-term flexibility if the long-term picture around the RET becomes clearer. As a final resort management is confident that, in the event of default, $104m can be recovered from assets outside the debt facility.

That was a really interesting back-stop when the market capitalisation was $150m, but today less so. Still some protection is better than none and the upside is huge if Infigen can realise its $590m asset backing. It's a small investment given the leverage involved but one we are watching with interest.

WE WISH YOU WOULD ALL BE FRANK

Marketing conglomerate **Enero Group** (EGG) reported full year operating earnings before interest, tax, depreciation and amortisation of $9.0m, up from $3.6m the year before. That sounds impressive, but it's still a skinny margin, especially once $3.3m in depreciation is accounted for. Net revenue fell 6% to $119m, continuing a long run of shrinking turnover.

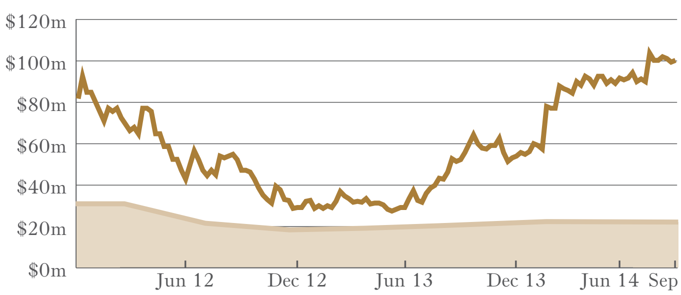
Nevertheless management commentary was upbeat and the stock price gained 9% in the quarter. As you can see in Chart 7, there has been a substantial rebound in sentiment since last year.

The market capitalisation is now $100m which, after adding back a number of non-recurring expenses, is still a little over twenty times current earnings. The market is baking in further improvements in margin and, as we've argued previously, there is some logic to it.

The statutory accounts show profits to non-controlling interests of $1.5m, which is the founder's minority 25% stake in public relations agency Frank PR. This suggests that Enero's controlling 75% stake probably earned $4.5m itself after tax. Frank PR accounts for only 10% of Enero's overall headcount but most of its current profit. It gives an idea of the potential for profit if a few of the other agencies start to fire.

They never seem to all fire at once, though, and we aren't convinced Enero is a bargain today. That contrasts with the situation last year, when the market capitalisation fell to a low of $27m, scarcely more than the $19m of net cash Enero had in the bank.

Chart 6: Enero's confidence dip



Source: Capital IQ

For those investors not familiar with the history of our investment in Enero, the initial buy decision was a costly mistake. It then presented us with a difficult, bias-tainted choice. Do we sell, clear the slate and move on, potentially falling prey to one form of bias? Or do we double down, grabbing a bargain and exposing your investment to another form of bias – commitment bias?

It's hard to know in the haze whether you've adequately countered all your important biases. The problem is so acute that we know of fund managers that will sell their shares and then decide whether to repurchase in an attempt to clear their heads.

For us, it was enough to face the previous mistake squarely and then take another look at the company as it currently stood. At $27m it looked cheap to us, really cheap. To help insure against delusion, we ran the whole investment case past a colleague with no previous involvement for input. With that feedback received we gritted our teeth and bought more.

Mistakes are unavoidable. But thinking afresh after the initial insult and doubling-down when appropriate can sometimes pay off.

"FRANK PR ACCOUNTS FOR ONLY 10% OF ENERO'S OVERALL HEADCOUNT BUT MOST OF ITS PROFIT. IT GIVES AN IDEA OF THE POTENTIAL IF A FEW OF THE OTHER AGENCIES START TO FIRE."

ASTRO CASHES IN, MIRVAC CASHES OUT

Japanese retail and office trust **Astro Japan Property Group** (AJA) cashed in on the low interest rate environment, refinancing of most of its debt with new ten year loans. The new loans require interest payments of 1.4% per annum. That's hardly usurious but we'd expected closer to 1% in Japan. Manager Eric Lucas seems to be willing to pay a little more to lock in funding costs for a long period of time.

World interest rates will rise at some point, so that's probably a good move. Reductions in principal repayments mean that Astro has upgraded its distribution forecast to 20–25 cents per unit, which equates to a yield of 4.5%–5.6%.

Table 3: Summary of major investments

Stock	Portfolio Weighting
RNY Property Trust	12.3%
Hansen Technologies	8.4%
GBST Holdings	8.3%
Mirvac Industrial Trust	7.6%
Vision Eye Institute	7.6%

Astro also sold a potentially problematic retail asset for $36m and has commenced an on-market buyback for up to 5% of its outstanding shares. The units are trading at a 25% discount to their net asset value (NAV) of $5.94, so a buyback could add some value.

Unfortunately the fee structure is problematic, an issue that only gets worse as it sells properties and gets smaller. Management and trust fees consume 25% of the group's profit before tax. It's a significant drag and means Astro is likely to continue to trade at a discount to NAV. It either needs to get bigger or sell its assets and return the proceeds to unitholders. Lucas has shown himself to be a capable operator, avoiding large dilutive capital raisings and executing a string of value-boosting restructures since the financial crisis. But if offered close to net asset value for the stock, we'd happily take it. Astro units finished September at $4.45, up a healthy 42% on our purchase price.

Lastly for the quarter, Chicago warehouse landlord Mirvac Industrial Trust (MIX), one of the Fund's largest investments, announced a proposed scheme takeover for $0.214 per security, after transaction costs. We'd been hoping for $0.20 so it was a nice result. The sale will occur in $US and, with the $A having fallen since the announcement, the expected proceeds have edged up to A$0.219.

Our earliest purchases of MIX were made in 2011 at $0.075, so it's been an excellent investment for the Fund. The unit price rallied 27% to $0.21 in the quarter, which still leaves a potential 4.5% return for investors willing to wait a couple of months, depending on the currency movements. We doubt there will be any problems come voting time and the proceeds should be in the bank by Christmas.

“THE EXPECTED PROCEEDS HAVE EDGED UP TO A$0.219. OUR EARLIEST PURCHASES OF MIX WERE MADE IN 2011 AT $0.075, SO IT’S BEEN AN EXCELLENT INVESTMENT FOR THE FUND.”

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