FORAGER

DECEMBER 2017 QUARTERLY REPORT

MADNESS INFECTS GLOBAL STOCKMARKETS
A rational bull market is showing signs of mania.

THE LONELY ASIAN VALUE INVESTOR
In a world of exuberance, there are still pockets of apathy and pessimism.

JUMBO RETURNS ARE IN THE DETAILS
We love devilish detail; it helps us find opportunity in unlikely places.

MMA TO RIDE THE OFFSHORE OIL RECOVERY
An asset heavy business with an uncertain future: a classic Forager investment.

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STOCKMARKET MANIA TAKING HOLD

This bull market has been one of the longest on record. It has also been mostly rational. The past six months have seen that change for the worse.

"Nothing so undermines your financial judgement as the sight of your neighbour getting rich."
— John Pierpont Morgan

Although it has been more than a century since Morgan's words, little has changed about human nature. The main difference being that, in our digitally connected world, we have a lot more neighbours.

As 2017 comes to a close, I'm seeing more of my "neighbours" apparently making fortunes. And increasing signs of impaired financial judgement as a result.

Granted, this is a bull market that is now more than eight years old. For most of that period, however, it has been a reluctant and nervous bull market.

The arguments between bulls and bears have been grounded in logic. The bears have argued that company earnings are unsustainably high and that multiples are well above long-term averages. The bulls countered that interest rates were lower than historical averages, likely to stay that way and that equities were relatively cheap as a result.

Both of those arguments have merit and you could have a well-considered reason for being on either side of the fence (or, in my case, sitting on top of it).

The back half of 2017, however, saw an increase in something more common in previous bull markets: mania. Crypto-currencies are the most obvious manifestation. Not since the 2000 tech bubble have I seen so many people talking about and speculating in something they know absolutely nothing about.

But it is becoming increasingly prevalent in the stock market too.

GET WARY OF GETSWIFT

ASX-listed GetSwift is a logistics software startup with a fully-diluted market capitalisation of roughly half a billion dollars.

Despite generating less than $1m of revenue last year, a flurry of ASX announcements has investors excited.

In September GetSwift announced an "exclusive 5 year agreement with N.A. Williams" that, once up and running, is expected to generate $138m per annum of revenue. The only problem being that N.A. Williams doesn't seem to be a company of any significance. Even Google doesn't know much about it and the only financial information I could find suggested US$23m of revenue and 90 employees.

The ensuing months saw a flurry of other deals announced and then, in November, the big daddy of them all: "GetSwift is pleased to announce that it has signed a global master services agreement with Amazon."

Even the bulls of yesteryear would have been sceptical. One can only assume this is the same Amazon that built the world's most sophisticated cloud computing service because it couldn't find an offering that met its requirements. The same Amazon that already offers same day delivery to more than 8,000 cities and towns. The same Amazon that spent US$21 billion on research and development in the past 12 months.

I will be very surprised if Amazon buys logistics software off anyone. Let alone an Australian minnow with less than $1m of revenue.

Chart 1: GetSwift's Share Price

Source: S&P Capital IQ

In the mania of late 2017, however, it is being lapped up. The GetSwift share price has rocketed from $0.25 at listing to $4.00 at the time of a recent capital raising. It was up 84% on the day of the Amazon announcement.

Picking on GetSwift is possibly unfair. It is but one of at least a dozen small companies I could have chosen. It is emblematic, however, of the frenzy that has taken hold at the speculative end of the market.

IT'S LONELY AT BOTH ENDS OF THE SPECTRUM

I was in my early 20s when the original dot com bubble inflated then imploded. Lacking experience, I couldn't fathom the stupidity of what people were doing at the time. How could anyone possibly slap a billion dollar valuation on a business that doesn't generate any revenue or even have customers?

This coming year I turn 40. Watching the same dynamic unfold, less than 20 years later, I've realised it's not stupidity causing the problems. The rationale people put forward for participating in these frenzies is not investment logic. The reason they do it is because they are suffering from FOMO: fear of missing out. People see someone else apparently getting rich, and they want a piece of the action.

Most Forager investors have seen this sort of folly in the past, too, and are experienced enough to resist the urge.

That doesn't make it easy. Just as the mental and emotional fortitude required to buy stocks gets harder the longer a bear market reigns, not participating gets harder the longer a manic bull market rages. It can get lonely feeling like you are the only person requiring profits and dividends to justify buying a stock.

Personally, I prefer the loneliness of a bear market. At least nobody wants to talk to me about it. The most painful thing of a manic bull market is all of the new experts telling me I don't know what I am doing. It could all come to an end in the next few weeks, but we should prepare for it to last much longer.

"NOT SINCE THE 2000 TECH BUBBLE HAVE I SEEN SO MANY PEOPLE TALKING ABOUT AND SPECULATING IN SOMETHING THEY KNOW ABSOLUTELY NOTHING ABOUT."

Table 1: Dotcom Bubble 2.0

Company Name	Market Cap ($m)	Annual Revenue ($m)	Price Change in 2017 (%)	Business Description
Updater, Inc. (ASX:UPD)	735.8	1.19	203	Develops and markets tools for consumers to complete their moving-related tasks in the United States.
GetSwift Limited (ASX:GSW)	682.4	0.33	1,120	Cloud-based logistics software for delivery companies.
Livehire Limited (ASX:LVH)	335.2	0.78	278	Human resources software for large corporations.
Buddy Platform Limited (ASX:BUD)	310.2	1.10	350	Technology infrastructure for the Internet of Things.
Yojee Limited (ASX:YOJ)	232.7	0.13	750	Sharing-economy logistics technology platform in the Asia-Pacific region.
LiveTiles Limited (ASX:LVT)	174.3	1.77	250	Website creation software.
DigitalX Limited (ASX:DCC)	160.4	0.06	613	Consulting services for blockchain and cryptocurrency companies. Owner of some Bitcoins.
Linius Technologies Limited (ASX:LNU)	131.6	0.04	264	A video virtualisation engine that transforms video files into data structures for enterprise customers. Whatever that means.

Source: S&P Capital IQ

Prepare to be called a dinosaur, to be accused of not understanding that this time it is different and for periods of underperformance. There is every chance we are about to experience a *real* bull market.

PERFORMANCE REPORTING

Speaking of underperformance, I have been receiving a few queries about a relatively weak second half of the year for the Forager International Shares Fund.

Since June 2015 we haven't been commenting on short-term performance, leaving the discussion of what's working and what isn't for our Annual Performance Report. Given we are long-term investors, it doesn't help you or us to be focusing on the past three months. Our policy is to disclose fully – you can see every winner and loser in the performance report – but in a manner consistent with our long-term strategy.

It's an approach that has been well received by Forager's early investors. Newer investors, however, can be forgiven for thinking we are trying to hide something. In this industry, selective disclosure is the industry standard. It is a fair assumption that anything you aren't told isn't good.

I don't need to promise you we have been applying this policy consistently. You can go back and read the quarterly reports from this time last year and see for yourself. We don't talk about short-term performance. In the bad times or the good.

Perhaps as importantly, investing with Forager is not going to deliver you index-like returns. Both the Australian and International funds are concentrated portfolios of businesses that should deliver us healthy investment performance over long periods of time. Those returns typically come from individual business outcomes.

Broad upward moves in indicies like the S&P 500 or the Hang Seng index are more likely to hinder than help our ability to find those opportunities.

While you wait for the warts and all discussion to come out in July this year, focus on the businesses we own and the underlying business performance. If they keep delivering the goods, we will ultimately deliver the returns.

NEW STARTERS AT FORAGER

The new year brings a couple of new starters in the Forager research team. Chloe Stokes and Jeffrey Tse are both joining us as analysts and will be learning the ropes over the next few years.

Forager's success to date has been dependent on a small team of individuals. Whilst I hope to keep my job for many years to come, training the next generation and passing on our skills to is going to be an essential part of any future success.

You will likely come across Chloe and Jeffrey on a road show or video in the next 12 months. Please make them welcome.

Kind regards,

STEVEN JOHNSON
Chief Investment Officer

INTERNATIONAL SHARES FUND

FACTS

Inception date	8 February 2013
Minimum investment	$20,000
Monthly investment	Min. $200/mth
Income distribution	Annual, 30 June
Applications/redemptions	Weekly

UNIT PRICE SUMMARY

Date	29 December 2017
Buy price	$1.6166
Redemption price	$1.6102
Mid price	$1.6134
Portfolio value	$180.0m

THE LONELY ASIAN VALUE INVESTOR

Long run returns are inversely correlated with the starting-point level of optimism. In a world of increasing optimism, that's concerning. There are, however, a few places left where apathy allows the Fund to put your investment sensibly to work.

Table 2: Summary of Returns as at 29 December 2017

	FISF (Net of fees)	MSCI ACWI IMI
1 month return	-2.76%	-1.36%
3 month return	1.09%	6.06%
6 month return	3.87%	9.19%
1 year return	7.71%	14.75%
2 year return (p.a.)	15.54%	11.77%
3 year return (p.a.)	14.20%	11.19%
Since inception* (p.a.)	16.32%	16.56%

*Inception 8 February 2013
Investments can go up and down. Past performance is not necessarily indicative of future performance.

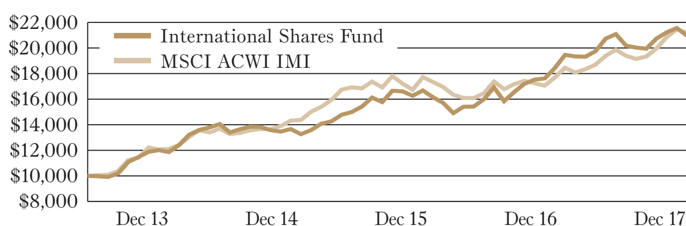
It is a "mystery". That's what value investing godfather Benjamin Graham told the 1955 US Congressional Committee on Banking and Commerce when asked what causes a cheap stock to find its value.

"That is one of the mysteries of our business, and it is a mystery to me as well as to everybody else. [But] we know from experience that eventually the market catches up with value."

Today in Graham's home market of the United States, there are far fewer listed companies that would meet his definition of cheap. The realisation mechanism is, however, less of a mystery.

Activist hedge funds, less insider control and active markets for mergers and acquisitions have all contributed to faster value realisation. Although still well short of where it should be, there is also more internal focus on generating an appropriate return on a company's assets.

Chart 2: Comparison of $10,000 Invested in the Forager International Shares Fund and MSCI ACWI IMI



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

BEN GRAHAM VALUE IN ASIA

The stockmarkets of Hong Kong and China more closely resemble the investment markets of Graham's time. There are many stocks that meet Graham's criteria for screamingly cheap—often trading at a discount to the amount of net cash on their balance sheet, for example—but the prospects for realising that value are murky to say the least. Activist funds are a rarity. Many companies are controlled by one person or their family and friends. Most are frustratingly content to sit on huge piles of non-interest bearing cash deposits, sometimes for decades.

Navigating this quagmire is not straightforward. Should you ignore the "deep value" stocks and pay high prices for well governed stocks? Should you buy these cash boxes and hope something changes? Should you ignore the region altogether?

Whilst not allocating much capital to Asia over the past five years, we have been travelling to the region at least once a year since starting the Forager International Shares Fund in February 2013. Having met large numbers of companies and fellow value investors, we are confident there is a middle ground.

The attractive opportunities might best be described as not perfect, but promising. They won't tick all the boxes for a typical western fund. But they also don't have the least desirable characteristics of many of their compatriots.

SLOWLY BUILDING A PORTFOLIO

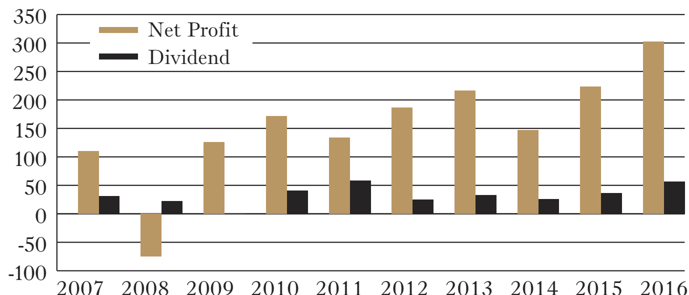
Hopefluent (HKSE:733) and **King's Flair** (HKSE:6822) are two such portfolio stocks mentioned in the September Quarterly Report. Both companies can be justifiably criticised for hoarding excess cash. In King's Flair's case, the company has HK$518m of net cash relative to a market capitalisation of HK$750m. Hopefluent has half its HK$2.4bn market capitalisation in net cash.

In a perfect world both companies would invest that money in growing the business or return it to shareholders. Then they wouldn't be trading where they are, of course. But we think both have a few characteristics that separate them from their fellow Hong Kong cash hoarders.

The first is that they pay dividends. In King's Flair's case, 70% of its profits are being returned to shareholders (at today's price, that's a yield of circa 8%). Hopefluent has committed to a 25% payout ratio, but even that should equate to a yield of about 3% for the coming year. Dividends themselves provide an important source of return, reducing the reliance on the stockmarket recognising the value in your investment. They are more important as a signal. Management teams with nefarious intentions don't tend to bother giving any money back to external shareholders.

“THE ATTRACTIVE OPPORTUNITIES MIGHT BEST BE DESCRIBED AS NOT PERFECT, BUT PROMISING. THEY WON’T TICK ALL THE BOXES FOR A TYPICAL WESTERN FUND.”

Chart 3: Hopefluent’s Net Profit and Dividends



Source: S&P Capital IQ

Second, both companies have long track records of sticking to their knitting. While large unproductive cash balances might be frustrating, it’s better in a bank account than invested in a Chinese hotel or Macau casino. Particularly in Hopefluent’s case, the managers have been able to successfully apply retained profits to new adjacent businesses.

Finally, both companies have controlling shareholders who–as far as we can tell–have the vast majority of their wealth tied up in the same company external shareholders are investing in.

The related party diagram for most Hong-Kong-listed companies has more roots and branches than the Tudor family tree. These two companies are simple businesses with simple shareholdings. If they fail to grow the value of their businesses, the founders and their families will suffer more than us.

HAPPILY LONELY VALUE INVESTORS

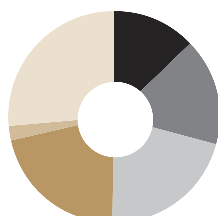
Most brokers in Hong Kong still find Forager’s valuation-based approach perplexing. The only stocks that go up, they tell us, are growing companies in popular sectors.

For all the disappointed westerners retreating back to the comfort of more familiar markets, though, we know a few value investors doing well in Asia precisely because of the growth obsessed mentality of the crowd.

We don’t want to commit more than 2% of the portfolio to either of the small cap stocks mentioned above, but five or six of them adding up to 10% or so of the portfolio would leave us well placed to join the successful.

Chart 4: Portfolio Distribution According to Market Capitalisation

- $0-$250m (12.7%)
- $250-$1000m (16.4%)
- $1000-$5000m (20.9%)
- $5000m+ (21.3%)
- Unlisted (2.0%)
- Cash (26.6%)



PICKING THROUGH THE MEDIA DEBRIS

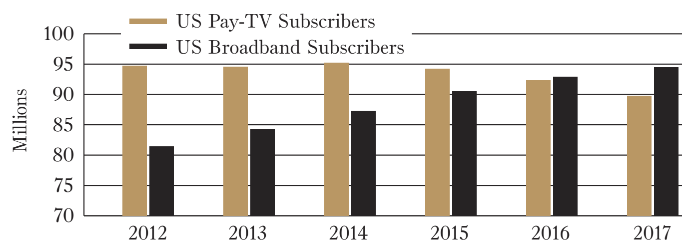
Everybody in the US hates their cable company. Customers have been leaving in droves for the greener pastures of streaming services like Netflix. That’s likely to continue and accelerate. So why invest in **Technicolor SA** (ENXTPA:TCH), a business closely aligned with the fortunes of the cable industry?

Spoiler Alert: The price is deeply depressed and there’s more to the company than the obvious headlines.

Technicolor is a world leader in digital technology within the media and entertainment industry. The company operates four rather distinct businesses, the largest of which it calls ‘Connected Home’. This division manufactures and sells pay-TV set top boxes and broadband modems and routers. Cable and telco companies purchase these products on behalf of customers of their services.

As Technicolor’s largest business, Connected Home tends to command the most attention. The cord cutting trend in the US is a big headwind. Fewer customers mean fewer set top boxes. Adding to that long-term challenge, a recent spike in the price of a key input has squeezed profit margins. DRAM chips is the name of that key input, and Bitcoin mining is the one explanation for the price spike.

Chart 5: US Pay-TV and Broadband Subscriber Trends



Source: Leichtman Research Group Press Release

This division is more than just a set top box business exposed to the stagnation of cable, though. Positively for Technicolor, the number of broadband internet subscribers has been increasing. That has led to increased sales of broadband hardware. As providers upgrade their networks, Connected Home should see a boost as customers upgrade their modems.

The intensity of competition in this business has also eased relative to where it was several years ago. A wave of consolidation has left Technicolor as the clear number two player with few peers. Facing less competition, the company won some new contracts recently. Most of them won’t commence until 2018 or later. There are challenges, but Connected Home also has plenty of unappreciated value.

> "MOST BROKERS IN HONG KONG STILL FIND FORAGER'S VALUATION-BASED APPROACH PERPLEXING. THE ONLY STOCKS THAT GO UP, THEY TELL US, ARE GROWING COMPANIES IN POPULAR SECTORS."

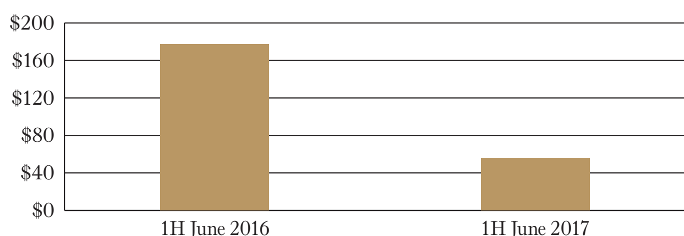
Technicolor's next most important business involves creating special visual effects for the movie and entertainment industry. It owns several leading visual effects (VFX) studios which create high-end digital content for blockbuster movies, television, advertising and video games. Demand for computer-generated imagery and related content is so great that the business is completely booked through to the end of 2018. We view this business as a hidden gem.

One of Technicolor's oldest businesses involves the replication and distribution of physical disc media (CDs, DVDs and Blu-Rays). Of course, this is anything but a growth industry. Just about everyone involved in manufacturing DVDs has closed shop, with Technicolor and Sony the exceptions. A lot of clients don't want to deal with Sony, who they view as a competitor. We see Technicolor benefitting from a 'last man standing' strategy. So while the absolute number of DVD sales will continue to shrink, Technicolor's strong position will enable it to generate healthy cash flow.

Technicolor's last business develops intellectual property (IP) in the field of digital technology for the media industry. The company, creator of the first ever colour movie, has pioneered a range of technologies and standards related to image processing, colour rendering, video compression, and connectivity. The company employs hundreds of research scientists who patent these technologies and license them to makers of all types of consumer electronics devices. Over half of the world's manufacturers of TVs, DVD and Blu-Ray players, cameras, and smartphones utilise Technicolor's IP.

This segment is currently undergoing a transition that has temporarily depressed its earnings. For most of the past decade, the segment's most valuable IP related to the MPEG-2 video compression format. Those patents expired in 2015 leading to a major drop in revenue over the last 18 months. The market seemingly believes this segment has no further value. We disagree.

Chart 6: Decline in Technicolor's Licensing Business



Source: Company filings

First, it has recently established a joint venture with Sony which we think will lead to growing revenues in the future. The technology this joint venture will licence is proven IP, related to digital television, that Technicolor has licensed by itself in the past. In partnering with Sony, the company believes it has improved its negotiating position and that the combined portfolio will yield more royalty income.

Second, Technicolor has planned for a future beyond MPEG-2 and helped develop the next generation video format, HEVC. This format enables a more efficient transmission of ultra high-definition content and is only beginning to be deployed. Key industry players support it and the data suggests it has already become the de facto standard. Technicolor's efforts to licence this technology will determine whether it can match MPEG-2 as a profit engine. But we view things as encouraging.

Interestingly, the week before Christmas management disclosed that it's in 'negotiations for a strategic transaction' relating to the IP business and is confident of reaching an agreement. We don't know if the proposal is related to the whole division or part thereof. But there are some assets in the division that might prove more valuable in the hands of a bigger player like Samsung or Sony.

Several ducks lined up to make Technicolor an attractive investment for the Fund. We mentioned the recent trends working against it—these served both to depress current earnings and sentiment. Numerous recent contract wins in both the Connected Home and DVD businesses had yet to begin generating revenue and profit. And the licencing business owns some technologies that are not being 'monetised' today and could prove very valuable. Any strategic transaction could bring forward that value realisation.

We think the VFX and the licencing business as it currently stands justify the entire market valuation for Technicolor. The shrinking but cash-generative Connected Home and DVD businesses are thrown in for free. We are also getting a free option on any future growth in licensing from potential hits such as its HEVC IP. With multiple ways to win, some optimism in the face of market pessimism is cautiously warranted.

Chart 7: Stock Exposure by Geography

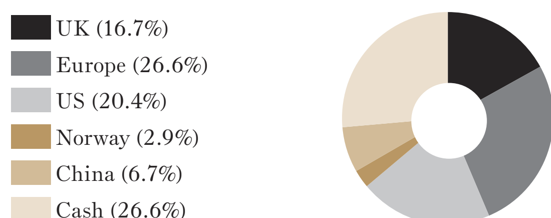


Table 3: Top 5 Investments

Cash	26.6%
Technicolor	5.9%
Just Group	5.0%
Alphabet	4.7%
Cementir	4.4%

PORTFOLIO NEWS

Hong Kong-based **King's Flair** (SEHK:6822) is focusing on increasing sales of reusable water bottles in China. Asian sales represent only 17% of group revenue but generate higher than average margins. Growing this part of the business should cushion erosion in margin from its traditional business—standing as a middleman between US kitchenware brands and Chinese manufacturers. King's Flair is also looking for additional office space for its growing team, which are currently cramped in like sardines. The company's large cash pile of HK$500m might be put towards this use, but renting probably makes more sense given Hong Kong's sky-high real estate prices and low rental yields.

Chinese search engine company **Baidu** (Nasdaq:BIDU) reported third quarter revenue growth of 29% and operating profit growth higher still. The comparable quarter last year was the nadir for the company's healthcare scandal and subsequent clean up, so growth rates will soon temper. Management's outlook for the current fourth quarter is for revenue growth of 30% (like-for-like) versus the same quarter last year. But it would be a slight backward step compared with the third quarter just passed. That spooked the market. There were some apparently self-imposed restrictions on online video content during the recent 19th party congressional meeting, lest viewer's eyes were drawn elsewhere, and the effect should be short lived.

In October, **Alphabet** (Nasdaq:GOOG) reported a strong result for its third quarter. Revenue grew 24% from the prior year with good results across all its businesses, particularly mobile search and YouTube. While some mobile-related costs continued climbing, progress in other areas lead to 34% growth in operating profit. Alphabet continues to be a core holding of the Fund.

As management had previously forewarned, petrol station operator **Murphy USA** (NYSE:MUSA) endured a difficult third quarter. Hurricanes Harvey and Irma impacted many of Murphy's stores—many were closed for a period, some for weeks. The company was eventually able to find its footing and take advantage of an attractive market for selling fuel. Earnings jumped 64% from the previous year, though management continued to exercise caution when looking ahead.

Resort developer and liquidation play **Dolphin Capital Investors** (AIM:DCI) was mentioned in the September 2017 Quarterly Report. The investment case rests on two particularly saleable assets which, when added to a net cash pile, more than justify the current share price. Some second-tier assets and a tail of more speculative stuff offers the upside. The company recently announced a partnership to build a One&Only Resort on their land on Kea Island, one of those second-tier assets. The deal is with a major global player who'll invest their own cash to fund the development. It offers a new valuation reference for Dolphin's stake in Kea, significantly higher than the number formerly in our spreadsheet. The stock price response was muted.

The ongoing rebound in the North American shale market proved a boon for US oil services group **Halliburton** (NYSE:HAL). Increased activity for its pressure pumping services in the region more than made up for continued weakness in international offshore markets. Revenue was up 42% from the previous year while operating profits fared even better, growing almost fivefold.

It wasn't the best third quarter from loudspeaker components manufacturer **B&C Speakers** (BIT:BEC), with revenue down 3% and operating profit down 12%. Asia Pacific and North America were weak regions. The strong Euro is surely biting. Management's full year outlook suggests a decent fourth quarter. B&C recently closed the acquisition of Eighteen Sound, a highly regarded smaller competitor also based in Italy. Eighteen Sound was previously owned by a cash-strapped conglomerate and B&C has coveted it for years.

The volatile share price of **UBI Banca** (BIT:UBI) belies its excellent progress. The Italian bank reported improvements in its non-performing loan portfolio in both the second and third quarters and has been able to modestly grow its loan book. Ridding itself of bad debts is the most important aspect of this turnaround. But growth in the Italian economy and subsequent growth in the loan book are helpful facilitators of the process. UBI Banca has a well-defined plan for delivering a healthy return on its equity by 2020 and remains on track to deliver it.

AUSTRALIAN SHARES FUND

FACTS

Inception date	30 October 2009
ASX Code	FOR
Income distribution	Annual, 30 June

UNIT PRICE SUMMARY

Date	29 December 2017
NAV	$1.88
Market price	$2.05
Portfolio value	$171.5m

GREAT IDEAS FROM DEVILISH DETAIL

The 2017 year saw a number of successful investments come to fruition. In this quarterly report, we explore some of the tools used to find ideas old and new.

Table 4: Summary of Returns as at 29 December 2017

	Australian Fund (Net of fees)	S&P All Ords. Accum. Index
1 month return	4.06%	2.03%
3 month return	5.27%	8.20%
6 month return	9.57%	9.31%
1 year return	24.92%	12.47%
3 year return (p.a.)	20.30%	9.23%
5 year return (p.a.)	20.75%	10.37%
Since inception* (p.a.)	15.17%	8.05%

*Inception 30 October 2009
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.

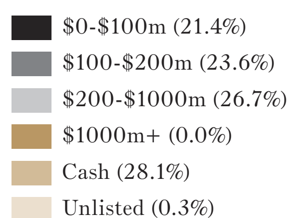
Overseas forays often result in recurring losses and messy exits. Jumbo's was no different. But it was because of such losses that the opportunity existed. The value of Jumbo's consistently profitable Australian operation was being masked by overseas start-up costs. High insider ownership suggested that 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 8: Portfolio Distribution According to Market Capitalisation



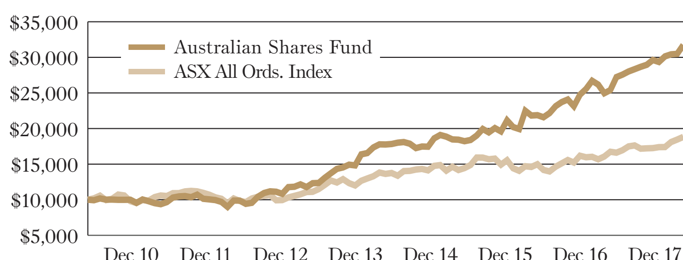
Extra segmental information can also be helpful in separating high multiple earnings from lower quality profits. Engineering, environmental and international development business **Cardno** (CDD) has a market leading position in the Asia Pacific region. This sector deserves a higher multiple than its 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.

“COMMISSIONS HAVE BEEN HIGH, PRICES POOR AND POLICIES DIFFICULT TO UNDERSTAND. AS A RESULT, NIMBLE PLAYERS LIKE FREEDOM SHOULD CONTINUE TO WIN MARKET SHARE.”

Chart 9: Comparison of $10,000 Invested in the Forager Australian Shares 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 10: 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

> "THE DESTRUCTION OF VALUE IN THE INDUSTRY HAS BEEN ENORMOUS. MANY FIRMS SUNK UNDER HEAVY DEBT LOADS. AND MMA NEARLY JOINED THEM."

annual sales for each of the next three years, the value of the resulting stream of payments justifies the current market capitalisation of $110m.

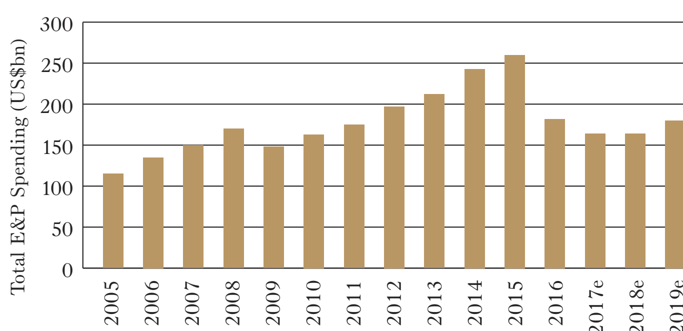
If the business doesn't grow there is little downside. If growth returns then Freedom should prove a great investment. Currently the Fund's investment represents 4% of the portfolio.

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 11: 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.

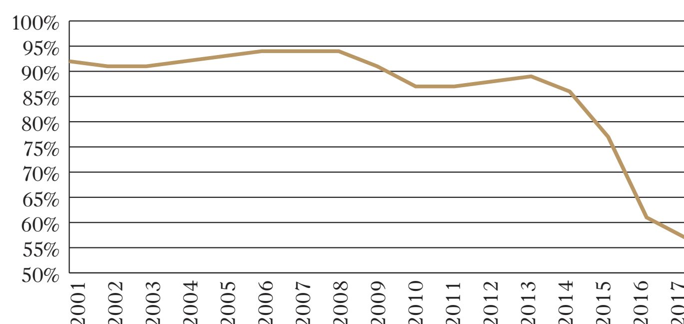
The destruction of value in the industry has been severe. Many firms sunk under heavy debt loads. And MMA nearly joined them. To stay afloat it had to sell its prized supply bases and some of the older vessels. The business lost $380m in the 2017 financial year as it wrote down the value of its remaining 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 it will be 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 12: 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 5: Top 5 Investments

Cash	28.1%
Macmahon Holdings	9.7%
Enero Group	6.2%
Cardno	4.9%
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).

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

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