FORAGER

30 June 2016

BREXIT SENDS THE WORLD INTO A TIZZ
The UK decides to go it alone and heads out into the great unknown.

BREXIT BASHES LLOYDS AND COUNTRYWIDE
Forager's UK investments are at the pointy end of Brexit risks.

RECKON'S MANY DAYS OF RECKONING
The ugly duckling of accounting software looks like an opportunity for investors.

EL.EN. RIDES THE INKING WAVE
Tattoo removal machine manufacturer made its way into the International Fund.

JUNE 2016 QUARTERLY REPORT

CONTENTS

BREXIT SENDS THE WORLD INTO A TIZZ

Volatility has been a welcome feature of financial markets over the past year. The most recent bout, thanks to Brexit, creates some real issues to worry about.

Three times in the past 12 months financial markets have been in a tizz. We went close to a bear market in August 2015, officially entered one in February of this year and then saw frantic currency and equity selloffs after the Brits voted to leave the European Union in the final week of June.

The first two of those were buying opportunities. There didn't seem to be a lot of rational logic behind some of the selling, and we were able to pick up businesses like **Alphabet** and **South32** at very attractive prices.

It may yet become irrational, but so far the response to the latter, Brexit, has been orderly and appropriate. This is not jumping at shadows. Brexit has the potential to have a very serious impact on the wider UK economy and many of the companies operating within it.

Irrespective of your view on the politics (I have some sympathy for a country wanting less political interference from a supra-national body), the economics of Brexit range between not great and bad.

The optimists' argument goes that, while the EU allows free trade within its borders, it is actually quite protectionist against the rest of the world. This is true, as any Australian farmer can tell you (some 70% of European farm receipts are government subsidies, compared with just 4% in Australia). Freed from those shackles, the UK will become a rich bastion of free trade with rest of the world.

The world these people live in, where countries run around signing free-trade agreements willy-nilly, is not the one I have been living in for the past four decades. Domestic politics and self-interest make individual free-trade deals almost impossible to negotiate. The Trans-Pacific Partnership between 12 Pacific Rim counties including Australia, Japan and the US has been seven years in the making, has been dramatically watered down from original expectations and still hasn't been ratified by respective governments. The proposed Transatlantic Trade and Investment Partnership between the US and Europe was first proposed in 1990 and is still no chance of being finalised. While Canada's agreement with the EU, often proposed as the template for the UK, took seven years to negotiate and also still hasn't been ratified. Even in Britain, I'm not sure unfettered free trade is what the average person is in favour of — particularly those who voted in favour of Brexit.

The argument the UK will be better off outside the EU is nonsense. The UK has been one of the largest beneficiaries since joining the European Economic Community in 1973. According to a recent article in the *Financial Times*, the UK has gone from being the "sick man of Europe", where GDP per head had previously grown roughly half as quickly as it had in Germany, France and Italy to a point in 2013 where Britain became "more prosperous than the average of the three other large European economies for the first time since 1965".

Table 1: Performance

	1 Quarter	1 Year	3 Year (p.a.)	Since Inception (p.a.)
Australian Shares Fund	–0.04%	18.06%	16.00%	13.40%
ASX All Ords. Accum. Index	4.00%	2.01%	8.24%	6.50%
International Shares Fund	2.72%	0.44%	11.35%	14.52%
MSCI ACWI IMI	4.40%	–0.77%	13.69%	16.50%

From an economic perspective at least, open access to one third of the global economy, which the UK has with its current membership of the EU, is about as good as it gets.

For all of these reasons, I still think the most likely post-Brexit outcome is something that looks largely similar to the current arrangements. Some commentators have even suggested a precedent for a second referendum if new arrangements can be negotiated that allow Britain to stay in the EU with some restrictions on immigration. Or an arrangement similar to that which Norway has where, in exchange for unfettered access to export markets, it agrees to be bound by most EU rules, contributes to the EU budget and accepts unlimited immigration from other EU countries.

All of that is still highly uncertain. Both the governing Tory party and the main opposition Labour Party are in complete disarray in the UK, so no one even knows who is going to be doing the negotiating. And European leaders have expressed contempt for any agreement which might incentivise other countries to go down a similar path.

Even if the ultimate outcome is a positive one, the route from today's disarray to a happy place is going to be tumultuous. The prospect of exit is going to have an immediate impact on consumer spending, business investment and (probably) house prices. How much is anyone's guess, but these risks are real and worth treading carefully around.

Hence we have been giving a lot of thought to these risks as we assess our portfolio exposures to the UK economy and the opportunities that emerge as stock prices fall. We have direct exposure in the International Shares Fund (see page 7) and indirect exposure through **GBST** and **Enero** in the Australian Shares Fund (see page 11). But we are also concerned about the broader implications of a general trend towards rising protectionism around the world.

A hit to global trade has been one of the key factors in our risk exposure analysis for the past few years, but we have

> "FROM AN ECONOMIC PERSPECTIVE AT LEAST, OPEN ACCESS TO ONE THIRD OF THE GLOBAL ECONOMY, WHICH THE UK HAS WITH ITS CURRENT MEMBERSHIP OF THE EU, IS ABOUT AS GOOD AS IT GETS."

generally focused on exposure to the overall level of trade. This is obviously a heightened risk with Britain leaving the EU, but there are potential further consequences of a rise in global nationalism that need to be contemplated.

We own a lot of European businesses that are predominantly focused on international exports (El.En., Kapsch, Rosenbauer, B&C Speakers and Rolls Royce). These companies — particularly the first four — are massive beneficiaries of the EU project. How did a Linz-based fire truck manufacturer, or a medical device manufacturer based in Florence, become global leaders in their fields?

The answer is that, despite being from small cities, they have free and unfettered access to 500 million potential customers and the world's largest economy in the EU. The EU also has the ability to use its leverage to negotiate access to other large markets like the US, and these companies become immediate beneficiaries. What chance is tiny Austria of negotiating an equivalent deal with dozens of other countries? The much-derided rules of the EU also govern things like public tenders, ensuring the process is open, transparent and less susceptible to vested interests. What chance is Kapsch of winning a toll road contract in Bulgaria in a world without these rules?

I'm not for a moment pretending the EU is perfect, and there are fundamental flaws that need to be fixed. Hopefully Brexit is the wake-up call needed to remedy some of those. But on balance the European project has been an extraordinary economic success story over the past 50 years and some of the companies we own are specific beneficiaries.

A far right candidate, Norbert Hofer, came within a whisker of winning the presidency of Austria in May this year and National Front's Marine Le Pen is expected to be prominent in next year's French presidential election. Both are keen on putting up physical and economic borders. From an investment perspective, their desire to unravel Europe's integration, and the public's desire to support them, is something we need to be contemplating.

As I have pointed out many times in the past, there is no correlation between economic growth and stock market returns. Our job is to build portfolios that are resilient to a wide range of potential outcomes. And the best opportunities always arise when fellow investors are at their most pessimistic. So do not think such turmoil would be without opportunity. But we have some very interesting years ahead of us and it would seem we are going to earn our keep.

Kind regards,

STEVEN JOHNSON
Chief Investment Officer

"OUR JOB IS TO BUILD PORTFOLIOS THAT ARE RESILIENT TO A WIDE RANGE OF POTENTIAL OUTCOMES. AND THE BEST OPPORTUNITIES ALWAYS ARISE WHEN FELLOW INVESTORS ARE AT THEIR MOST PESSIMISTIC."

INTERNATIONAL SHARES FUND

FACTS

Fund commenced	8 February 2013
Minimum investment	$20,000
Monthly investment	Min. $200/mth
Income distribution	Annual, 30 June
Applications/Redemption	Weekly

UNIT PRICE SUMMARY

Date	30 June 2016
Buy Price	**$1.3892**
Redemption Price	**$1.3822**
Mid Price	**$1.3857**
Distribution 30 June 2016	**4.44cpu**
Portfolio Value	$89.3m

INTERNATIONAL FUND SOILED BY BREXIT

It was shaping up as a good year for the Forager International Shares Fund. Then the Brits voted to leave Europe behind.

Table 1: Summary of Returns as at 30 June 2016

	FISF	MSCI ACWI IMI
1 month return	–6.36%	–3.40%
3 month return	2.72%	4.40%
6 month return	0.86%	–0.96%
1 year return	0.44%	–0.77%
2 year return (p.a.)	7.03%	10.83%
3 year return (p.a.)	11.35%	13.69%
Since inception* (p.a.)	14.52%	16.50%

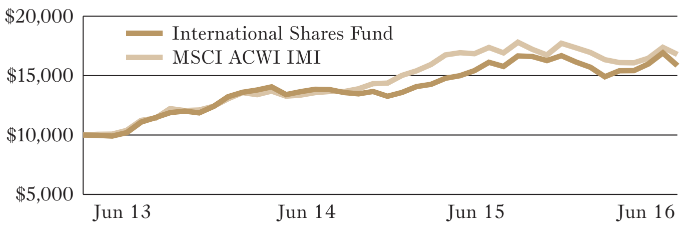
*Inception 8 February 2013

Much has been made of the fact that the FTSE 100 rose in the aftermath of Brexit. Between the day of the vote and 30 June, the index of large capitalisation stocks listed on the London Stock Exchange increased nearly 3%.

Unfortunately, the real picture is worse than that and, as explained on page 3, we think the damage is real.

Companies that generate most of their revenues outside the UK and don't earn much pound-denominated revenue constitute the majority of the FTSE 100. Those that are domestically focused did it much tougher, as a quick look at our portfolio will tell you.

Chart 1: Comparison of $10,000 invested in the International Shares Fund and MSCI ACWI IMI



The share price of **Lloyds Bank** (LSE:LLOY) fell 25% during that week and was already down on worries prior to the vote (the return for the year was –35%). Lloyds is a very well capitalised bank with dominant market share in a highly concentrated local banking market. We expect it to navigate any choppy waters ahead and maintain its market leading position. But its loans are mostly against residential property, which could fall in value, and it is the largest business lender in the UK. It is unlikely to come through a recession unscathed.

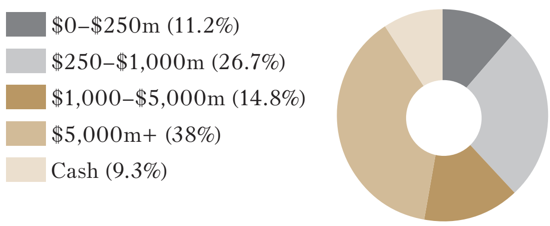
Neither is **Countrywide** (LSE:CWD). It and fellow listed real estate agency **Foxtons** (LSE:FOXT) are dependent on real estate prices and, more importantly, transactions. At the very least, the velocity of property sales is likely to decrease. The good news is that both businesses have a good proportion of their revenue coming from rental management, and this part should be robust. We are treading carefully but continue to hold Countrywide and reinstated Foxtons to the portfolio in the midst of the selloff.

Table 2: Top 5 Investments

Lotto 24	6.2%
El.En	5.3%
Halliburton	5.0%
Kapsch	4.6%
Baidu	4.3%

The only other UK stock in the portfolio is **Rolls Royce** (LSE:RR) and it should be a beneficiary of the turmoil. Most of Rolls' revenues are in US dollars and a good chunk of its expenses are pound denominated, so the weakening pound is good news. The company released an announcement stating that profits would be £40m higher if exchange rates stayed where they were prior to the Brexit vote. They should be hundreds of millions higher after.

Chart 2: Portfolio Distribution According to Market Cap



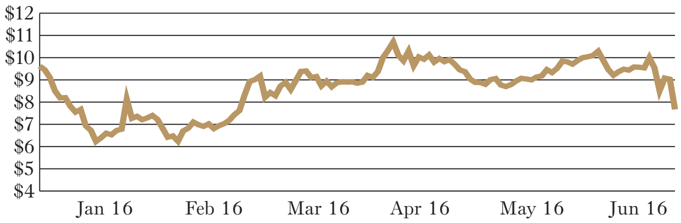
“THIS IS AN INDUSTRY THAT HAS HISTORICALLY BEEN CHARACTERIZED BY HIGH LEVELS OF DEBT, HYPER-CYCLICALITY AND BAD ACTORS.”

TROUBLED SHIPPING, CHEAP STOCKS

Earlier this year we ventured into one of the most beaten up sectors of the market, international shipping, making a small investment in Monaco-based **Costamare** (NYSE:CMRE). Costamare is one of the largest independent owners of containerships in the world. It boasts a fleet of sixty vessels that can collectively haul 333,000 standard-sized freight containers (TEU), and it charters those vessels out to international shipping companies. It does not own the actual containers, nor does it provide logistical services to the broader commercial universe of companies who trade their goods globally. It simply owns and operates ships.

Investors have plenty of reasons to avoid shipping. This is an industry that has historically been characterised by high levels of debt, hyper-cyclicality and bad actors. The containership sector is somewhat unique within shipping in that it is fairly straightforward and not subject to many of the vagaries that affect other shipping markets. But it has taken it on the chin the last few years as a surge in new super-sized vessels has overwhelmed weak demand.

Chart 3: Costamare Share Price



Source: S&P Capital IQ

Despite these risks, Costamare benefits from a number of advantages that are appealing from an investment perspective. Firstly, Costamare’s charter contracts are long-term in nature. Most sectors within the shipping industry work on spot or short-term business, but Costamare’s ships are tied up under multi-year contracts with large, financially sound customers. The company has already locked in its revenue for the next two years, giving us confidence both in its expected profit and its ability to withstand volatility in the market. Looking back, the company has maintained an operating profit margin of greater than 40% in every year that we have public information, with a peak-to-trough decline in operating profit of only 13% during the financial crisis.

Secondly, we believe management is of high quality. The founding Konstantakopoulos family owns 65% of the shares, aligning their interests with ours. Sensibly, they look to pay down the debt on their vessels as they age and use excess cash flow to fund a sizable dividend. They have over thirty years of experience in the sector with an admirable record of buying and selling vessels at opportune times. Within the shipping industry, the calibre of this management team is rare.

When we purchased the shares earlier this year, the stock had sold off almost 70% over the previous six months. It was sporting a dividend yield of 17% and a price to earnings multiple of 4, providing a suitable margin of safety for this type of business. The stock rebounded for much of the first half, getting close to a sensible exit price before the recent Brexit development changed the outlook. Global GDP growth and global trade are both likely to fall, leaving us to think it will take longer for a recovery in Costamare’s market. The stock has pulled back and we will continue to wait for a more advantageous exit opportunity.

EL.EN. RIDES THE INKING WAVE

If you have recently visited Bondi Beach, this won’t come as a surprise: tattoo removal is a growth industry. It’s an important trend for one of the International Shares Fund’s largest investments.

In early January the Fund purchased shares in **El.En.** (BIT: ELN), a manufacturer of medical and industrial lasers based in Florence.

The medical division accounts for 70% of El.En.’s sales and almost all of its profits. Products span machines used for the removal of hair and tattoos to more complex devices used for the treatment of conditions such as kidney stones and vaginal atrophy. The remainder of the business — its industrial division — focuses on lasers used to cut wood, metals and glass during manufacturing processes.

Aging and more health-conscious populations mean that the medical market for lasers should continue to grow — industry expectations are for the market to be worth in excess of $4bn by 2020 compared to $2.2bn today.

El.En.’s share of this is roughly 7% and company-wide sales have grown from €25m in 2000 to €220m in 2015, mainly thanks to strong demand for its medical lasers.

While competition is quick to copy the company hit products, El.En., which was founded in 1981 by a university professor and one of his students, has a strong history of innovation as demonstrated by its ability to roll out new and successful products year after year.

Profits have been reinvested in expanding the business distribution network across the world, acquiring smaller businesses with great products that lacked the scale to compete on a global stage, and paying dividends to shareholders.

Its balance sheet looks great too. At the end of the 2015 year, the company had around €60m in cash and only €20m of debt. Despite this cash balance, the company’s return on capital has been robust.

Insiders have a lot of skin in the game, owning more than 50% of the company. And we have been impressed with their focus on capital allocation and long-term decision-making.

“WERE THAT TO HAPPEN, WE WOULD EXPECT THE STOCK TO TRADE MEANINGFULLY HIGHER. IF IT DOESN’T, WE’RE MORE THAN HAPPY TO OWN A GROWING, DIVIDEND PAYING BUSINESS AT A VERY SENSIBLE PRICE.”

Table 3: Comparable Valuations for El.En.

	EV/Sales	Price/Book
Syneron (Nasdaq:ELOS)	0.8x	1.5x
Zeltiq (Nasdaq:LSTQ)	3.4x	7.0x
Cutera (Nasdaq:QTR)	1.3x	3.4x
Biolase (Nasdaq:BIOL)	1.2x	2.8x
Cynosure (Nasdaq:CYNO)	2.7x	2.5x
El.En (BIT:ELN)	**0.8x**	**1.3x**

Source: Company data, S&P Capital IQ

GREAT PRICE FOR A GREAT LITTLE BUSINESS

At the time Forager purchased its shares El.En. had a market capitalisation of €185m, traded on a price to earnings ratio of 15 times and sported a dividend yield of about 3%.

On top of a growing business and a bullet-proof balance sheet, El.En. also owned a 4.5% stake in **Cynosure** (NASDAQ:CYNO), a leading American company in the medical laser industry (and a former subsidiary of El.En.). While contributing little to the company’s profitability, this investment was then worth €37 million.

After adjusting for the value of this investment the company was actually trading on a price to earnings ratio of only 12. This looked extremely attractive, not only because of the quality of the business and the growth to come, but also because the company‘s main competitors, most of them still unprofitable, were trading at much higher valuations (see table 3).

Since the Fund’s investment, Mr Market seems to have regained his senses and El.En.’s share price has increased nearly 40%. We are not sellers yet, because we have been more than happy with the company’s progress.

Medical lasers are continuing to sell well and the company’s industrial products are starting to contribute to profitability too. The company recently sold its investment in Cynosure and plans to reinvest part of the proceeds in expanding its distribution network.

El.En. should be able to generate in excess of €230m in revenue in 2016 and €15m in net profit, excluding a gain on the sale of Cynosure shares. Adjusting for the excess cash in the business, it still only trades on a multiple of 13 times this year’s expected earnings.

At a recent meeting with management, the CEO expressed some dismay at the valuation gap between his stock and US-listed peers. So much so that he suggested the board would consider a US listing for the company.

Were that to happen, we would expect the stock to trade meaningfully higher. If it doesn’t, we’re more than happy to own a growing, dividend paying business an attractive price.

AUSTRALIAN SHARES FUND

FACTS

Fund commenced	31 October 2009
Minimum investment	$10,000
Monthly investment	Min. $100/mth
Income distribution	Annual, 30 June
Applications/Redemption	Weekly

UNIT PRICE SUMMARY

Date	30 June 2016
Buy Price	**$1.4643**
Redemption Price	**$1.4570**
Mid Price	**$1.4607**
Distribution 30 June 2016	**17.75cpu**
Portfolio Value	$98.3m

BREXIT AND BRIERTY MAKE FOR ROCKY QUARTER FOR AUSTRALIAN FUND

The mixed business performance of the March quarter continued into June, with prospects diverging further at mining services companies and Brexit scuppering GBST's share price.

Table 1: Summary of Returns as at 30 June 2016

	Australian Fund	S&P All Ords. Accum. Index
1 month return	–3.92%	–2.28%
3 month return	–0.04%	4.00%
6 month return	5.75%	1.55%
1 year return	18.06%	2.01%
3 year return (p.a.)	16.00%	8.24%
5 year return (p.a.)	18.15%	7.30%
Since inception* (p.a.)	13.40%	6.50%

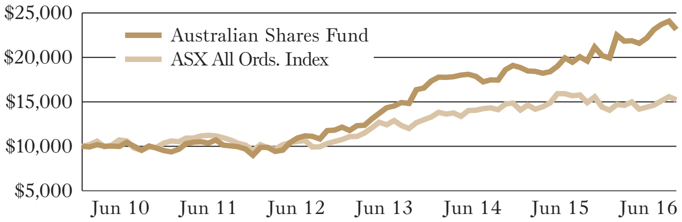
*Inception 31 October 2009

At one point we were starting to lament the lack of things to write about in this quarterly report. There hadn't been much news of note since March, either in the portfolio or in the wider market.

That changed dramatically as the results of Britain's referendum on leaving the European Union started to filter through on Friday 24 June.

The Forager Australian Shares Fund has some direct exposure to the UK. Software company **GBST Holdings** (GBT), marketing group **Enero** (EGG) and **Smart Parking** (SPZ), roughly 12% of the portfolio between them, generate significant portions of their revenue in Britain.

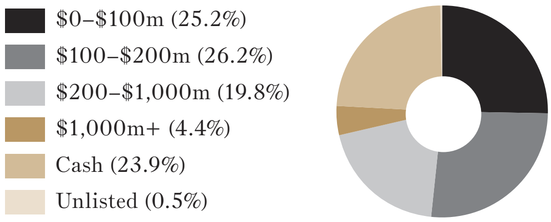
Chart 1: Comparison of $10,000 invested in the Australian Shares Fund and ASX All Ords. Index



We don't anticipate a huge impact on GBST's revenue — that is underpinned by contracts in place and legislative changes that are unlikely to be abandoned. But with UK revenue more than half of the total for GBST, the translation impact of a 10% fall in the pound exchange rate versus the Australian dollar is meaningful. Compounding the effect, only one third of the costs associated with GBST's UK business are incurred in pounds, meaning costs won't fall as much as revenue (most of the programming work is done in Australia and Vietnam).

Still, the share price fall since the vote, some 16%, has been dramatic. We expect its UK operations to remain a profitable, growing part of the business and a full split from Europe might even create more work for GBST untangling its clients' systems. We added to the investment in recent days.

Chart 2: Portfolio Distribution According to Market Cap



Surprisingly, the share price of Enero hasn't fallen at all. Public relations companies Frank and Hotwire, two of the best businesses in this marketing group's stable, are based in London and earn most of their revenue in pounds. Some 62% of the group's operating earnings came from the UK and Europe in the first half of this financial year. There is no cost mismatch here but a UK recession is unlikely to be good news for Enero.

Outside these two stocks and a small investment in Smart Parking, the Fund is well placed to withstand the impact if there is a global economic slowdown as a response. We have a higher than usual cash weighting at the moment and little exposure to economically sensitive businesses. Indeed, an equity market sell-off would be welcome for the opportunities it might create.

Table 2: Top 5 Investments

Service Stream	9.7%
Macmahon Holdings	6.7%
Reckon	6.6%
Enero Group	4.9%
Jumbo Interactive	4.9%

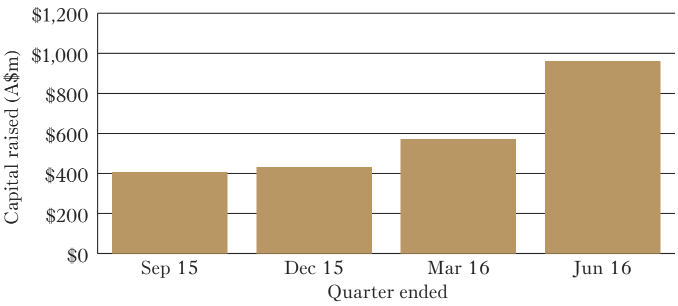
"UNFORTUNATELY SOME OF THE COMPANIES WE OWN ARE FIGHTING FOR SURVIVAL RATHER THAN FIGHTING FOR WORK."

MINING SERVICES SECTOR EMERGES FROM THE WORST

As explained in our annual performance report (see insert), the performance of our portfolio of mining services companies has been more mixed than we would have liked.

There are clear signs of an improving external environment. On our estimates, there has been some $960m of new capital raised in the junior resources sector in the past three months (more than double the previous run rate). Most of that is for gold projects and that means more work for the services companies. **MACA** (MLD), **Macmahon** (MAH) and newish portfolio addition **GR Engineering** (GNG) have all announced numerous new contracts over the past six months.

Chart 3: Capital raised in ASX mining/metals and energy sectors*



Source: S&P Capital IQ

Unfortunately some of the companies we own are fighting for survival rather than fighting for work. While we expected some woes, the most disappointing aspect is that many of the problems are self-inflicted.

Two years ago **Brierty** (BYL) had net cash and a healthy order book of civil engineering work that wasn't dependent on the mining sector at all. Through losing $22m on one of those road contracts and incurring massive cost blowouts on a new mining contract with Rio Tinto, the executives managed to steer it from that relatively safe position to one where its significant debt load and negative operating cash flows are threatening its survival.

Coal mining services company **Hughes Drilling** (HDX) has done an even better job of destroying a perfectly good business. This company should be generating cash and paying dividends thanks to its dominant and highly efficient drilling business on the east coast of Australia. Instead, managing director Bob Hughes's reckless, debt-funded global expansion plans have finally caught up with him. The company's shares are currently suspended from trading while its auditors and bankers question Hughes's balance sheet and underlying profitability. Unless it gets an injection of fresh capital, it is unlikely the company will survive.

Thanks to hitting the jackpot with Coffey International and relatively good results from MACA and Macmahon, we are going to get reasonable results from the basket as a whole. That doesn't make it any less frustrating seeing our returns crimped by management blunders.

RECKON'S MANY DAYS OF RECKONING

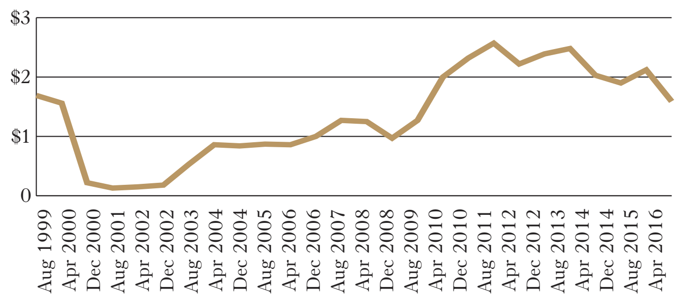
It was a "make or break" year according to the Chairman. **Reckon** (RKN) had spent the previous two years shedding the excesses of the dot-com era and 2002 was the first clean look at a business refocused on its core accounting software products.

Shareholders judged it a success. By the time the company announced its 2002 "maiden profit", the share price had risen more than threefold from a low of just $0.07.

By 30 June this year, Reckon's shares were changing hands for $1.46. With plenty of franked dividends along the way, those who have held the stock since have done exceptionally well. But it is once again make or break time for the company.

Reckon's success from 2002 to 2012 came via localising and distributing a product called Quickbooks, the small and medium business accounting software of US giant **Intuit** (NASDAQ:INTU). Disagreements over how to respond to the entrance of a competing cloud-based product from New Zealand company **Xero** (NZSE:XRO) led to the relationship falling apart in 2012 and the distribution agreement ending in 2014. Since then Reckon has had to rebrand the software in its own name and develop a product that can compete with Xero, all with a research budget a fraction of the size. While that might not sound like the ideal backdrop for investing success, there are a number of reasons we think these make or break years will be good for investors.

Chart 4: Reckon Share Price



Source: S&P Capital IQ

Reckon's business software segment comprises just 43% of the group's earnings before interest, tax, depreciation and amortisation (EBITDA).

The second largest segment, which sells practice management software for large accounting firms, is a cracker. Comprising 38% of group EBITDA, this business has huge market share at the big end of town, claiming four of the five largest Australian

“WITH PLENTY OF FRANKED DIVIDENDS ALONG THE WAY, THOSE WHO HAVE HELD THE STOCK SINCE HAVE DONE EXCEPTIONALLY WELL.”

accounting firms as clients. Reckon charges on a per seat basis, meaning the accounting firms pay more as they employ more staff, and switching costs are significant. Reckon's software is well integrated into these organisations, so changing providers is a nightmare and retention rates are very high.

Another part of the business sells software for cost recovery and document management, which comprises 19% of group EBITDA. This business fits nicely with what they already offer clients but the technology has wide applicability. For instance, document management is not just for accountants. Professions such as legal, insurance and financial planning present opportunities for Reckon. The business also has global scale, with the company having a presence in the US, UK and New Zealand. And it has been growing quickly.

These annuity-style businesses are highly attractive in a world of low interest rates and, applying some optimistic multiples, you could justify the current stock market valuation with these two businesses alone.

Which brings us to the final piece of the investment puzzle. Is its legacy small business software worthless?

Compounding the termination of its distribution agreement, Reckon has had significant new competition from Xero, and industry stalwart **MYOB** (MYO) has substantially improved its offering. But the arrival of Xero hasn't been all bad news.

Rather than destroying competitors, Xero has made the whole industry vastly more profitable for everyone. As Xero has grown to become an industry behemoth, it has grown the total number of customers with it. Many small businesses that were previously using spreadsheets are now using Xero's user-friendly offering. As MYOB and Reckon get their acts together on their own cloud offering, it will likely grow the market further.

Probably more importantly, Xero's subscription-based business model is vastly superior to the old model of selling perpetual licences on a disk. In the old days a small business would buy a disk for $500–$600 from **Harvey Norman** (HVN) or **JB Hi-Fi** (JBH) and install the software on their own computer. Many of them never bothered to update the software until they needed a new computer, if then. Not only does this leave the software provider managing dozens of historical versions of their software, it means they only get paid once every five years or so and have to pay a healthy chunk of their margin to the retailer.

Under an online model, software is updated and improved without the user even noticing. The distribution cost is close to zero. And a customer typically pays $20–$30 per month, which adds up to significantly more revenue over the average life of a customer. More revenue times more customers equals an industry much larger than the old one.

And, as good as Xero's product is, Reckon's existing database of clients is a very valuable asset. Many thought the end of Quickbooks was the end of Reckon but its customer retention has been unbelievably good. They have added net customers over the past few years, despite their cloud offering being well behind the competition. This shows its brand is strong and customer switching costs are high even at the small business level.

If they can migrate a decent chunk of that client base across to Reckon's own cloud offering, it is going to be a very good business.

We are fully cognisant of the fact that this industry is changing quickly and that Reckon is starting well behind the competition. But with a market capitalisation less than one tenth of its two main competitors, many of its advantages are being forgotten.

“WE HAVE A HIGHER THAN USUAL CASH WEIGHTING AT THE MOMENT AND LITTLE EXPOSURE TO ECONOMICALLY SENSITIVE BUSINESSES.”

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