FORAGER

DECEMBER 2019 QUARTERLY REPORT

BARGAIN BAGGED AT MOTORPOINT
Motorpoint is not your average car dealership and it should continue winning market share.

BLANCCO UNLEASHED
Good news continues for the International Fund's largest investment.

REVVING UP AT RPM
RPM looks to be a rare find: a growing recurring revenue business at a valuation a value investor can live with.

THE PLAGUE OF ACCOUNTING ADJUSTMENTS
Non-cash. One-off. Non-recurring. It's worth casting a very sceptical eye over those adjustments.

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TURNING TEN, GROWING OLD

Forager's first decade has seen its fair share of drama and action. While the second decade won't be much different, we should be better for the experience.

I had an early morning coffee with my grandmother on New Year's Eve. Born in the 1920s and known to all my friends as Oma, she's now living through the twenties again.

Asked what she thought of it, her only opinion on the matter was that "getting old sucks". "It's going to fly by, Steven. Make the most of it."

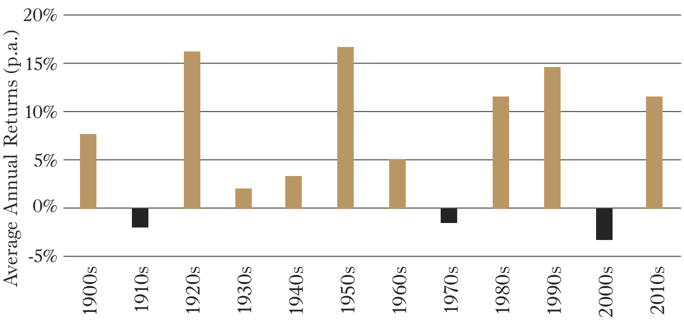
Fly by it does. As we roll into the twenties of this century, Forager is entering its second decade. Founded in 2009, our Forager Australian Shares Fund turned ten during the December quarter (the Forager International Shares Fund launched three years later).

REFLECTIONS ON THE FIRST DECADE

It's been a good period to be invested in the stock market. The average annual return from owning the Australian All Ordinaries Accumulation Index was 8%, slightly lower than the long-term average of 11%. Globally, the MSCI All Country World Index returned 9% p.a. and the S&P 500, a broad measure of stocks in the US, 13% p.a.

Just being invested was the most important aspect to any investor's returns in the teens. It was, too, the most important aspect to an investor's returns in almost every decade of the past century.

Chart 1: US Stock Market Real Returns by Decade



Source: Robert J. Shiller

There have only been three 10-year periods in the past 120 years where the real return (adjusted for inflation) from owning US stocks was negative. The worst of those was the naughties (2000-2009), where the real return was -3% per annum. I'm using data from the US market here because we have a longer time series but the returns from the Australian market have been similar.

Today's zero interest rates mean a bank deposit is almost certain to lose roughly 2% per annum in real terms over the coming decade. For shares, the worst decade on record delivered only slightly worse than that.

Whether you invest with Forager, another fund manager, in an index fund or do it yourself, just being invested is the most important thing you can do. Don't forget it.

Our job is to do better than that, and on that front there is plenty more to take from Forager's first decade.

LEARNING ON THE JOB

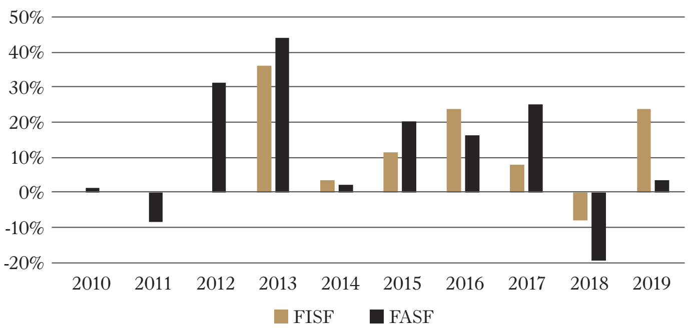
It has been a steep learning curve. In 2010 Greg Hoffman and I ran for the board of mortgage company RHG. The company was amassing a huge cash pile as its mortgage book shrank and we wanted the board, chaired by RHG's largest shareholder John Kinghorn, to pay it out to shareholders.

We didn't win that battle with the Kinghorn family but the war was very successful. RHG was one of our most successful investments (and personally my biggest by some margin).

In 2012 we used the Takeovers Panel for the first time. RCU, a property trust we owned a large stake in, was gifting control to its largest shareholder through a friendly rights issue. We complained to the Takeovers Panel and successfully forced a restructure of the deal, invaluable experience that ended up preserving a lot of value for unitholders. Later that same year we ended up in the Supreme Court of NSW forcing the trust to give us our money back.

At this point we were still just three people: myself, Matt Ryan and Kate Fergusson. After a rocky couple of years (the Australian Shares Fund was 10% underwater after the first two years), we started kicking some goals. As investments in distressed property trusts like **Ingenia** and **Mirvac Industrial Trust** paid off, investor patience was rewarded. The return for the 2013 calendar year was a whopping 44%. From the start of 2012 to the end of 2017 we launched a new International Shares Fund and strung together six years of strong absolute and relative performance. **Service Stream**, **Jumbo Interactive**, **Vision Eye Institute** and **Hansen Technologies** were among the other big winners, more than offsetting the odd dud investment in the likes of Hughes Drilling and Brierty.

Chart 2: FISF and FASF—Performance by Calendar Year



That December of 2017 was the end of the good run, though, and we bookended the decade with another two-year period of even worse performance. The Australian Shares Fund has lost 17% over the past two years, and the performance of the traded units has been worse.

"JUST BEING INVESTED HAS BEEN THE MOST IMPORTANT ASPECT TO ANY INVESTOR'S RETURNS IN THE TEENS."

PREPARING FOR SUCCESS

As you can see in the rest of this report, we've been making steady progress on resurrecting that Fund's performance. Periods of underperformance are part of the territory when running concentrated portfolios of stocks. Four years out of 10 is not far from what I would expect. But some things will be different in our second decade.

The biggest one for me is making sure we have the right people and business structure to succeed.

We have historically been good at making tough but important strategic decisions, the most significant of which was listing the Australian Shares Fund on the stock exchange. We didn't know when, but we knew that fund was going to suffer periods of underperformance, potentially significant. Not having the pressure of outflows over the past few years has been fundamental to the long-term prosperity of the fund.

But there are things I would do differently. In early 2013 we launched an International Shares Fund with two new analysts and a lot of the same clients. Then we lost a few key staff members, including both Matt and Kate heading off to do something different with their lives. Trying to manage a new fund, a new team and find replacements for people who had been instrumental in our success put significant organisational strain on the business.

Late last year I listened to a great interview with Daniel Ek, the founder of Spotify, on the Invest Like the Best podcast. Talking about his early management lessons, Ek explained how a Dubai chocolate maker taught him that a growing business needs to "build in a buffer" if it wants to be successful. While growth is great, it also creates problems that will need to be fixed and resourced.

We're not trying to dominate the global market for audio like Spotify, but the same is true for any business. If you don't invest in anticipation of growth, then the growth you are hoping for can be the thing that brings you unstuck.

I don't for a moment regret launching the International Shares Fund. Its returns have been healthy and the experience gained so far is going to be invaluable. I want it in my own portfolio and think it has a very important role to play in yours. We just need to do a better job of preparing for success.

The past two years have seen a lot of investment in human and financial resources, at both a board level and in the investment management teams. As a business we head into the twenties much better prepared to deal with unexpected hurdles and, hopefully, growth.

FLEXIBILITY

I'd also like to see us more flexible with construction of our portfolios.

That means being contrarian when contrarian ideas are offering attractive payoffs, but willing to keep it simple when those great opportunities don't exist.

We owned some high-quality businesses in the early days of the Forager Australian Shares Fund. Businesses like Macquarie Airports (subsequently slimmed down and renamed **Sydney Airport**), **Spark Infrastructure** and **ARB Corporation**.

You should prepare for us to own them again. Consistency is something every financial advisor wants from their fund manager. I want you to prepare for inconsistency.

Over the next decade, I want us to do a better job of adjusting portfolios for whatever market environment we are presented with. The big returns are still going to come from small, unloved and contrarian ideas. But there's nothing wrong with higher quality, reasonably priced investments while we wait for those ideas to present themselves.

LESS CASH, MORE SHARES

And finally, I want our funds to hold less cash.

You need to be invested. And so do we. We've made mistakes over the past decade. We've written mea culpas. But the most significant negative impact on performance was holding too much cash for long periods of time. A deeper investment team and a greater breadth of larger, quality companies will help. But you will see me much more vigilant about making sure we are mostly invested, most of the time.

THE FUN PART

For all of the stress of the past two years, I'm immensely proud of what we have built over the past decade. We've survived, grown and made a lot of money for our clients.

An investment of $100,000 in the Australian Shares Fund at inception is worth $264,115 today* and $100,000 in the International Shares Fund has turned into $238,124 in less than seven years.

Yes, it's been a friendly backdrop. Yes, I'm hopefully writing to you in a decade saying we have done better. But, from a one-man shop 10 years ago to a team investing money all over the world, we have come a long way. The experience should serve us well.

The next decade will also fly by. Who knows, my Oma might even see it out. Come what may, I promised her I will enjoy it. But making you some great returns is going to make it all the more pleasurable.

Kind regards,

STEVEN JOHNSON
Chief Investment Officer

*Returns calculated at 31 December 2019 using NTA, not market price. At the last traded price on 31 December, the value would be $229,141.

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	31 December 2019
Buy price	$1.7251
Redemption price	$1.7182
Mid price	$1.7216
Portfolio value	$171.8m

SANTA RALLIES FOR INTERNATIONAL FUND

The last quarter of 2019 saw strong share price movements for many of the Forager International Shares Fund holdings. Overall, the net asset value increased by a touch under 11%, versus an increase in the MSCI World Index of less than 5%.

Table 1: Summary of Returns as at 31 December 2019

	International Fund (Net of fees)	MSCI ACWI IMI
1 month return	4.73%	-0.36%
3 month return	10.82%	4.63%
6 month return	12.13%	8.67%
1 year return	23.58%	26.54%
3 year return (p.a.)	6.95%	13.20%
5 year return (p.a.)	11.08%	11.68%
Since inception* (p.a.)	13.41%	15.35%

*Inception 8 February 2013
The value of your investments can rise or fall. Past performance is not necessarily indicative of future performance.

Returns were driven by some good newsflow from the Fund's largest investment **Blancco** (AIM:BLTG) see page 7, US-listed **Zebra Technologies** (Nasdaq:ZBRA) and further rapid growth at Clearpay, the UK subsidiary of **Afterpay** (ASX:APT). The Fund has a meaningful interest in Clearpay through UK-listed **Thinksmart** (AIM:TSL), see the November Monthly Report. The share price of the latter was £0.08 just six months ago. It has since distributed about £0.03 per share of cash to shareholders and ended the year trading at £0.23.

Then the Tories won December's UK election by a huge majority. While there is plenty of negotiating yet to be done, the UK will be officially leaving the European Union at the end of January. Five years ago, that would not have been seen as a good thing for UK stock prices.

Yet they, particularly the smaller, domestically focussed stocks, rallied hard leading into the election and rose further in the days after the result was announced. That's because any Brexit is better for business than a Jeremy Corbyn-led Labour government, and the margin of the victory makes a "softer" Brexit more likely. A small group of hard core nationalists inside the Tory party will have less blackmail leverage than if the result had been closer.

It is also because so much pessimism had been priced into the UK stock market. It remains one of the cheapest in the world, and we remain excited about the opportunities available. One good example is car supermarket **Motorpoint** (LSE:MOTR).

BAGGED A BARGAIN WITH MOTORPOINT

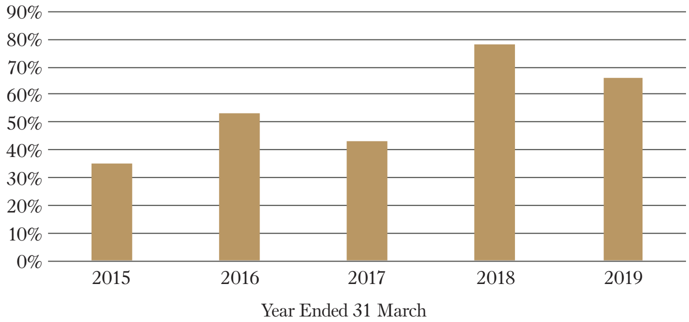
Motorpoint Group runs 12, soon to be 13, used car dealerships across the UK. Car dealerships have a reputation for poor economics—slim margins, heavy investment requirements, cyclical and poor returns on those investments over the cycle. Most listed UK dealerships live up to that reputation. Motorpoint is different.

Its sites are big, typically 500 or more cars on each site. The group sells near new vehicles, less than 2 years old driven fewer than 15,000 miles. It sells them cheaply in a low pressure environment. Fixed price and no haggle is a model that's worked well elsewhere.

It stocks a wide range. Unlike franchised dealers, it is not beholden to any car maker and can source whatever is cheapest or most in demand. It even buys unsold inventory in bulk, direct from other dealerships. If you've got 1,000 cars of the same make, model and even colour, and want to move them with a single phone call, Motorpoint is one of the few numbers worth dialling.

It sources those cars cheaper than most but marks them up no more than other dealerships, passing on the savings to customers. This enables it to move stock significantly faster than the competition. That makes Motorpoint less capital intensive than most dealerships and enables it to generate higher profit from each car slot over the course of a year. This explains its industry-crushing return on equity.

Chart 3: Motorpoint Group Plc Return on Equity



Source: S&P Capital IQ

“WE’VE BOUGHT AT A PRICE EARNINGS RATIO OF 11 TIMES, ARGUABLY A PREMIUM TO THE FRANCHISED PLAYERS (WHO WON’T ACTUALLY MAKE ANY MONEY IN 2019) BUT THE COMPARISON IS CHALK AND CHEESE.”

STRENGTH IN DIFFICULT TIMES

The March-June quarter was a particularly tough one for the UK used car market, exacerbated by several major franchised dealerships destocking inventory in order to generate desperately-needed cash. Used car prices fell and Motorpoint wasn’t spared some pain. But the business has rebounded strongly since July and the company has been taking significant market share in all of its markets.

Despite being a growing company, Motorpoint is able to return most of its profit to shareholders via dividends and buybacks. Opening up a new site takes a humble net investment and starts contributing meaningfully to profit from the third year of operation. New sites thus create significant value for shareholders. After a pause in new openings over 2018 caused by the paucity of sites available (at least at the prices Motorpoint is prepared to pay), it was our hope that management would soon resume new openings. There are good signs on this front.

The 13th site, Swansea in Wales, opens soon. West Glasgow is next and the company almost has its talons on a 15th site. The financial troubles of other car retailers even opens up the opportunity to buy their unwanted sites on the cheap.

The Fund initially acquired shares in May during the industry downturn and added in September when the founder, who’s no longer involved in the business, sold discounted stock to settle a divorce. We’ve bought at a price earnings ratio of 11 times, arguably a premium to the franchised players (who won’t actually make any money in 2019) but the comparison is chalk and cheese. Motorpoint is a business that will continue winning market share, particularly in any downturn. The stock is up 40% on the Fund’s average purchase price, but we haven’t sold a single share yet.

BLANCCO UNLEASHED

Things have been falling into place for Blancco Technology Group, the gold standard in data erasure software and an emerging leader in mobile diagnostics (read our September 2018 Quarterly Report for a more detailed explanation of the business and opportunity).

The mobile diagnostics arm will be less familiar to investors, despite making up one third of revenue. Blancco provides solutions to diagnose and fix problems with mobile phones.

Customers can be telco companies, retailers, insurance providers and third-party processors of used mobile phones. This is the division we were most sceptical about when acquiring the shares in 2017. Blancco wasn’t a clear leader in the field. Nobody offered a full suite of solutions for customers.

That scepticism is melting away.

The technical improvement offered by each successive generation of phone has been decelerating while price has been accelerating. This helps establish both repair and second-hand markets. Globally, 146 million phones were traded in the secondary market in 2017. International Data Corporation forecasts that number will double by 2022. These phones will need to have their condition assessed, fair trade-in prices estimated efficiently and old data erased properly. After a few strategic acquisitions in 2019, Blancco can now help with all of that.

Blancco has already cut processing times by more than 30% and there’s more to come. This solution will be attractive to third party processors of used mobile phones, where time is money, and will lead to significant market share gains. That investment has likely already paid for itself in new business wins.

We’re increasingly confident about the Mobile segment’s ability to contribute. But the legacy erasure offering won’t be dragging down the growth rate. Blancco added large channel partner SHI International to its existing distribution partners in November. And in December it achieved Advanced Technology Partner status with cloud computing giant Amazon Web Services. Blancco will offer its solutions to AWS customers to clean up their old data systems effectively after they migrate to the cloud. The agreement doesn’t extend to erasure within the cloud (for example when an AWS client moves to a competitor) but is a foot in the door. At the least, it’s an imprimatur of the superiority of Blancco’s solutions.

Management are rightfully cautious about the magnitude of business to come from AWS, and London brokers who research the stock haven’t changed their revenue forecasts. But it’s done no harm to our confidence that Blancco can grow its revenue at 15% annually over the next few years, with profit growing much faster.

Chart 4: Blanco Technology Group Plc Share Price

Source: S&P Capital IQ

Interestingly, little of this good news made its way into the share price until December, when it jumped 29% (from £1.33). We’ve sold some stock for risk management reasons, but Blancco is still underpriced enough to deserve its 11.5% portfolio weighting. We were pleased to see the appointment of well credentialed new independent board member Catherine Michel and hope to see an additional appointment over the coming year.

“THE COMPANY MAY NOT HAVE THE RESOURCES AVAILABLE TO COMPETITORS LIKE APPLE, GOOGLE OR AMAZON, BUT IT’S BECOME THE INDUSTRY LEADER THROUGH FIRST MOVER ADVANTAGE AND MANAGEMENT’S SINGULAR FOCUS ON AUDIO STREAMING.”

OUT WITH THE OLD

The Fund sold two long-held positions this quarter, chiefly to make way for new investments. Shares in Austrian tolling equipment company **Kapsch TrafficCom** (WBAG:KTCG) were acquired early in 2015. The market was mispricing the prodigious cash flows coming from European truck tolling contracts and overcapitalising the losses from several new contract bids that proved unsuccessful. The stock almost doubled over the course of 2015 and we took some profits, but not enough. Progress has since stalled. Kapsch made a large acquisition that hasn’t yet proven itself. While ad hoc business, particularly in the US, has been robust, big multi-year contracts dried up. One that was awarded, in Germany, was soon cancelled after a legal challenge. A poor first half result and sharp downgrade to full year profit outlook was the last straw for us.

The Fund also exited its position in **Cementir** (BIT:CEM), which we first purchased in early 2017. The stock has done well over the last three years, and the company still has good long-term prospects. We decided to use the recent strength in Italian mid-cap stocks to take profits in Cementir in favour of purchasing **CRH** (ISE:CRH). We’ll provide more information in a future report. Both Cementir and Kapsch remain on the watchlist.

IN WITH THE NEW

On to some of our new investments. The Fund has made several US-listed investments this quarter. **Spotify** (Nasdaq:SPOT), the largest music streaming subscription service globally, is one such company. The Spotify platform provides almost 250 million consumers across 79 geographies access to more than 50 million songs on demand. The company may not have the resources available to competitors like **Apple** (Nasdaq:AAPL), **Google** (Nasdaq:GOOG) or **Amazon** (Nasdaq:AMZN), but it’s become the industry leader through first mover advantage and management’s singular focus on audio streaming.

Spotify commands almost 50% of the paid music streaming market and continues to gain market share. Playlists, which are estimated to make up 40% of listening on the platform, help engrain users. More than 113 million users are paying premium subscribers.

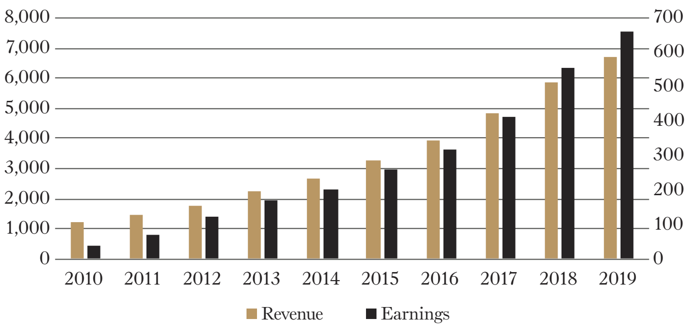
There’s also a free music service, where revenue is generated through advertisements. It has a lot of untapped potential for increased advertising dollars and as a pipeline for future premium subscribers. Spotify’s Creator Services also offers a huge opportunity. It involves music labels and creators paying to promote their work, using Spotify’s huge user base and knowledge about the musical preferences of each user.

Unlike many other high-growth tech companies, Spotify already generates cash. We bought the stock for less than 3 times 2020 revenue, cheap considering the revenue runway and margin expansion ahead.

Ulta Beauty (Nasdaq:ULTA), a specialty beauty retailer with more than 1,200 stores across the United States, is another recent investment. It differs from other beauty retailers by being a one-stop-shop, carrying more than 20,000 products from 500 different brands across all price points.

Ulta is a great business and has been for a long time. Revenue has increased by 20% per annum over the past decade, while earnings grew at almost double that pace. We think there is still growth to be had in the United States, and even more internationally. Management announced plans to test an expansion into Canada earlier this year. The company has a healthy balance sheet with no debt (ignoring leases) and has been buying back stock for the past few years. After a 30% share price drop in late August, we took the opportunity to buy a high quality business at a reasonable price.

Chart 5: Ulta Beauty Inc Revenue and Earnings ($USm)



Source: S&P Capital IQ

The Fund also initiated a position in **SkyWest** (NYSE:SKYW) this quarter, the largest and most diversified regional airline operator in the United States. The company is well-positioned to benefit from stronger demand for regional air services, driven by larger airlines partnering with companies to offer connecting flights through large hubs to smaller cities and airports. Regional airline economics are generally more favourable than large airline economics. Airfare prices have been increasing more rapidly while staff costs are lower. Regional airline pilots earn around $80,000 per year, roughly half the amount of a mainstream airline pilot.

SkyWest continues to take market share due to its efficient operations. Over the past decade the company has doubled its market share at the expense of other regional players. As the mainstream carriers continue to reduce the number of regional airline partners that they use, SkyWest is in a favourable position to continue taking share.

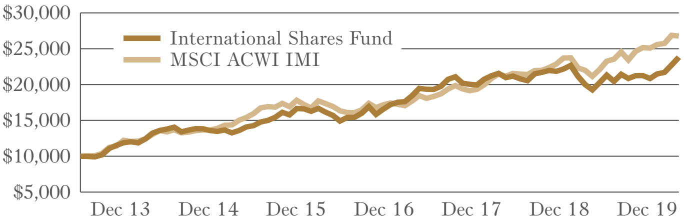
The stability of cash flows and future earnings relative to traditional airlines is often overlooked. SkyWest has a diverse base of contracts that provide strong certainty of future revenue and it is not exposed to cyclical factors such as ticket pricing and fuel costs, unlike other airlines. Despite this, it continues to trade just above the likes of Delta and United at ten times earnings.

"DESPITE RECORD HIGHS FOR STOCK MARKETS IN THE US, THE PORTFOLIO LOOKS WELL PLACED FOR THE COMING YEAR AND BEYOND."

Another recent investment is **Yum China** (NYSE:YUMC), discussed in our October Monthly Report. The US-listed spinoff from **Yum Brands** (NYSE:YUM) owns KFC and Pizza Hut in China. The abridged thesis is that Yum China has a long runway for new store openings at high incremental returns on capital. That's particularly valuable in a world of miniscule interest rates. We expect some cost challenges near term due to higher chicken costs and an accelerated store rollout. But we are comforted by the resiliency of the business. Having grown to almost 9,000 stores over the last three decades, the business enjoys significant scale economies and is highly cash generative. Management have committed to returning surplus capital to shareholders.

As you can see, it has been a busy end to the year for the Forager International Shares Fund, with several new investments and significant progress with some of the old. The Fund's cash weighting remains low. Despite record highs for stock markets in the US, the portfolio looks well placed for the coming year and beyond.

Chart 6: Comparison of $10,000 Invested in the Forager International Shares Fund and MSCI ACWI IMI



Source: S&P Capital IQ
The value of your investments can rise or fall. Past performance is not necessarily indicative of future performance. Assumes distributions are reinvested.

Chart 7: Portfolio Distribution According to Market Capitalisation

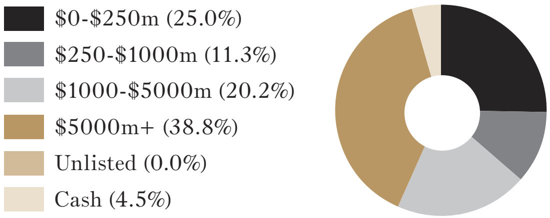


Chart 8: Stock Exposure by Geography

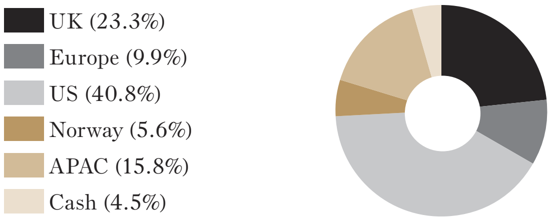


Table 2: Top 5 Investments

Blancco Technology Group Plc	11.5%
Zebra Technologies Corp	5.5%
Babcock International Group Plc	4.8%
Alphabet Inc	4.8%
Motorpoint Group Plc	4.3%
Cash	4.5%

AUSTRALIAN SHARES FUND

FACTS

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

UNIT PRICE SUMMARY

Date	31 December 2019
NAV	$1.36
Market price	$1.18
Portfolio value	$154.9m

BLUE CHIPS REIGN IN 2019

We worked hard and made significant progress throughout 2019. The profitable thing to do was stick to owning blue chips.

Table 3: Summary of Returns as at 31 December 2019

	Australian Fund (Net of fees)	S&P All Ords. Accum. Index
1 month return	-1.50%	-1.90%
3 month return	-3.20%	0.75%
6 month return	6.60%	3.59%
1 year return	3.26%	24.06%
3 year return (p.a.)	1.31%	10.41%
5 year return (p.a.)	7.71%	9.30%
10 year return (p.a.)	10.00%	7.86%
Since inception* (p.a.)	10.02%	8.31%

*Inception 30 October 2009
The value of your investments can rise or fall. Past performance is not necessarily indicative of future performance. Returns are calculated using NTA, not market price.

Despite a much improved second half, it was a weak year for the Forager Australian Shares Fund. Our portfolio returned 3%, versus a market return of 24%.

In the 2016 financial year, we tried to temper enthusiasm about our 18% year by pointing out some significant tailwinds:

It should be noted that the performance of the Australian Fund is flattered by a poor index return that wasn't reflective of the overall market. Dragged down by high weightings to banks and large miners, this broad index dramatically underperformed the average stock listed on the ASX. A better barometer of average stock performance, the MVIS Australia Equal Weight Index, returned 8.9% for the year. Our return, 18.1% net of all fees, is still an outstanding result, but any fund manager with a mandate as broad as ours shouldn't be slapping backs too hard just for beating the All Ords.

The trend has reversed over the past couple of years, with larger companies trouncing their smaller brethren. The two year return for the Small Ordinaries Index is 11%, versus a weighted average of 23% for the largest 50 stocks.

That's not an excuse. There is nothing stopping us owning large stocks.

In fact, at the start of 2019, our CIO Steve Johnson wrote an article for Livewire titled A recession proof, property proof ASX portfolio. An equal weighted investment in the 12 stocks he selected would have returned 29% for the year, some 5% more than the return of the All Ordinaries Accumulation Index.

Table 4: Steve's Recession Proof, Property Proof ASX Portfolio

	1st Jan	31st Dec	Price Change %	Dividends Paid	Total Return %
Amcor	$13.25	$15.57	17.5	$0.81	23.6
Aristocrat	$21.84	$33.67	54.2	$0.56	56.7
Aurizon	$4.28	$5.23	22.2	$0.24	27.8
BHP Billiton	$32.82	$38.92	18.6	$3.33	28.7
Cochlear	$173.57	$224.73	29.5	$3.30	31.4
Computershare	$17.19	$16.78	-2.4	$0.44	0.2
CSL	$185.16	$275.76	48.9	$2.66	50.4
IAG	$7.00	$7.66	9.4	$0.32	14.0
Newcrest	$21.80	$30.25	38.8	$0.32	40.2
Ramsay Health Care	$57.73	$72.53	25.6	$1.52	28.3
Woodside	$31.32	$34.38	9.8	$1.80	15.5
Woolworths	$29.42	$36.16	22.9	$1.02	26.4
				Average	**28.6**

Source: ASX website

> “THE COMPANY HAS ALSO CHANGED THE WAY IT SELLS ITS SOFTWARE... NOW, THE MAJORITY OF RPM’S SOFTWARE IS BEING SOLD ON A SUBSCRIPTION MODEL: EQUAL ANNUAL FEES INSTEAD OF A BIG UPFRONT PAYMENT AND A MUCH SMALLER MAINTENANCE FEE. BUT THAT MEANS A HOLE IN REVENUE AND PROFITS IN THE FIRST YEAR OF A SALE.”

Assembling the blue chip portfolio took Steve about a day’s work. Admittedly, 20 years’ experience helps. All of them are familiar.

But we spent 2019 working long hours to identify new ideas, learning about new businesses and extracting value from those companies we already own.

THE LESSON: OBVIOUS IS NOT ALWAYS WRONG

Forager’s motto is “opportunity in unlikely places”. It’s an approach that has served us well over the past decade. Despite a horrible past two years, our clients are still ahead of the index since our Australian Shares Fund’s inception in 2009. That’s thanks to countercyclical, contrarian investment ideas like **Jumbo Interactive** (JIN) and **Service Stream** (SSM).

If you want to generate returns better than the crowd, you need to be different. That much is obvious.

THE CROWD IS OFTEN RIGHT

The lesson of 2019, though, is that you don’t *always* need to be different. You don’t *always* need to be doing better than the crowd.

Steve didn’t write that article because he suddenly felt like writing about blue chips. He wrote it because he thought the Australian economy was struggling, house prices were weak and most of the beaten up stocks were structurally challenged. Interest rates were likely to be cut and big, defensive, seemingly expensive stocks were likely to be the best performers. There are times when targeting average and patiently waiting for the appropriate time to make contrarian moves is the right thing to do. Last year was one of those times.

THE CONTRARIAN WANTS TO BE CONTRARIAN

The contrarian’s time will come again. A number of those value stocks we have been working on made good progress in 2019. New boards and management teams have been installed at **Thorn Group** (TGA), **MSL Solutions** (MPW) and **Logicamms** (LCM). All three are showing signs of a turnaround under way, yet the share prices have mostly gone backwards.

Money continues to flood into passive funds, creating less and less interest in those stocks not in an index. And the returns at the big end of the market have mostly come from multiple expansion rather than earnings growth. That’s unlikely to be repeated.

As we roll into 2020, it’s likely time to be contrarian again. But that doesn’t change the lesson of the past year.

Sometimes simple is best.

REVVING UP AT RPM

One of the newest investments in the Forager Australian Shares Fund doesn’t look like much of a value stock. Losses over the last five years total $22m. It doesn’t look like much of a growth stock either. Revenue has only grown 5% per year over the same period. And it’s not exactly bombed out: the share price is up by a third in 2019.

So why have we bought shares of **RPM Global** (RUL)?

The company is one of the few listed global enterprise software providers in Australia. It operates in a space well known to Australians: mining. Of all the world’s mining software, 60% has been developed in Australia. RPM’s software helps clients work out when to mine sections of a deposit, when dump trucks need a service, and how to best budget for future mine profitability.

The business started its listed life as Runge more than a decade ago. Then, a mostly people-focussed mining consulting business, it struggled through the GFC and the subsequent few years. RPM still owns that mining consulting business and a coal testing laboratory. But in late 2012 the company installed a new managing director and began a major transformation.

Richard Matthews, a veteran of the Australian enterprise software space, made major changes. He cut staff numbers by 40%, installed new senior executives and upgraded the company’s stale software suite. New products and a few acquisitions followed.

Since Matthews focussed the company on the software business, recurring maintenance revenue from installed software has grown by 13% per year. Because the product is difficult to replace, less than 5% of this revenue stream is lost every year.

So far, this increasing revenue has not translated into profits for RPM.

Creating the software hasn’t been cheap. Software development spend more than doubled over the past five years to $14m per year. With work on a few new products now completed the development spend declined last year and will continue to fall.

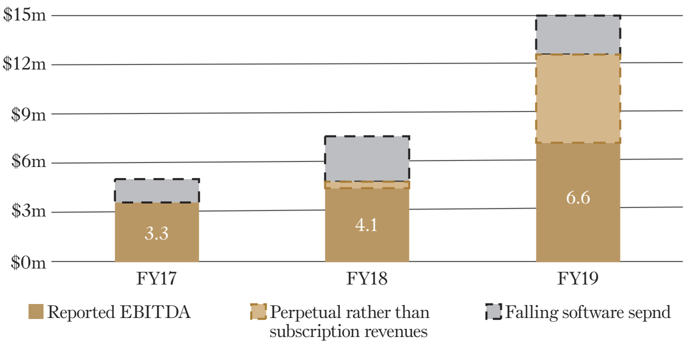
The company has also changed the way it sells its software. A few years ago a client would have purchased a perpetual licence upfront and paid a maintenance fee every year. Now, the majority of RPM’s software is being sold on a subscription model: equal annual fees instead of a big upfront payment and a much smaller maintenance fee.

But that means a hole in revenue and profits in the first year of a sale. Over three years the total amount received under both models remains the same. And over ten years the subscription model results in RPM receiving 80% more revenue. Recent subscription sales have been strong: sales from July to mid-November exceeded the whole of last financial year.

Adjusting for lower expected software development spend and the move from perpetual licenses to subscriptions makes for a big change to profits. Earnings last year would have been double the reported level.

"WE SPENT 2019 WORKING LONG HOURS TO IDENTIFY NEW IDEAS, LEARNING ABOUT NEW BUSINESSES AND EXTRACTING VALUE FROM THOSE COMPANIES WE ALREADY OWN."

Chart 9: RPM Global—Business Model Changes



Source: Forager estimates, RPM Global

Matthews also has form turning around and then selling software businesses: first Mincom and then eServeGlobal, which remains listed as **Wameja** (WJA) but sold a big division. Owning 3.5% of the company, all acquired on-market, Matthews has a big incentive to maximise value if any bidder comes knocking.

In the meantime the business will continue to grow a valuable stream of cashflows. About 5% of the current market cap (after adjusting for cash holdings) will be generated in free cash flow this year. After three years of growth and strong cash generation, that 5% should grow to 19%. RPM looks to be a rare find: a growing recurring revenue business at a valuation a value investor can live with.

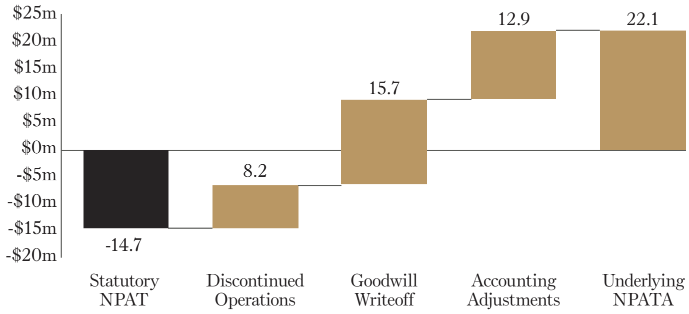
THE PLAGUE OF ACCOUNTING ADJUSTMENTS SWEEPING THE ASX

Non-cash. One-off. Non-recurring. These words are littering the annual reports and presentations of many ASX listed companies. Unlike RPM, where reported earnings understate reality, many management teams will use adjustments to overstate reality. It's worth casting a very sceptical eye over those adjustments.

Take the curious case of **Amaysim** (AYS). In its most recent results presentation the telco disclosed its profit and loss statement in two ways. Statutory results meet today's accounting standards. Amaysim's adjusted results add back certain expenses to give a rosier picture to investors.

The company's adjustments include costs relating to legal proceedings, redundancies and integration expenses. Costs relating to acquired software are also added back. And that's even before we get to closed operations and the writedown of amounts paid for past acquisitions. Those results are stated under both old accounting standards and new. Amaysim reported a statutory loss of $14.7m in the past year. After plenty of adjustments the company points to net profit of $22.1m.

Chart 10: Amaysim—FY19 Earnings Adjustments



Source: Amaysim, Forager analysis

According to Chartered Accountants Australia and New Zealand, in the decade to 2014 the number of Australian listed firms reporting adjusted earnings doubled to 42%. You won't be surprised to read that, on average, the adjustments are net additions to earnings. It's likely to have increased since, with more companies making more adjustments.

Let's start with some of the most common adjustments we've seen in the recent reporting season: shares issued to management as compensation for working at the company, redundancies as companies reduce staff, and bad debts from clients who fail to pay. All are real costs to the business. While often termed one-off, some companies bear these costs every year. For others a bad debt once every few years is a regular part of business.

Another common adjustment is the non-cash goodwill writeoff. Goodwill is created when a business is acquired for more than the value of its assets. If that business then performs badly, as acquisitions often do, accounting standards require that goodwill be recorded as an expense. That's a cash cost, just one paid years ago.

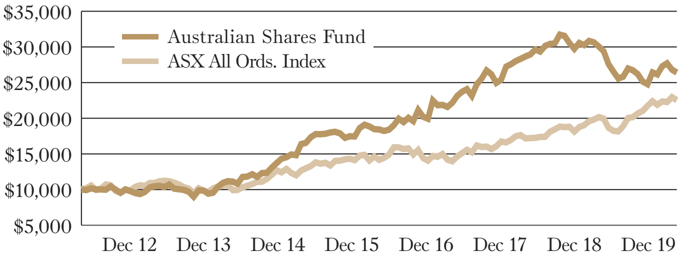
Wasting shareholder money on bad acquisitions is a symptom of bad capital allocation from management and the board. The series of woeful debt-fuelled acquisitions by **Retail Food Group** (RFG) led to the company's almost-demise. The later writedown of those acquisitions is a result of bad decisions years ago.

Of course, not all adjustments are illegitimate: some costs are unlikely to arise again or should be spread evenly over a few years. A writedown of acquisitions made by an old management team and board can signal a renewal by new leadership. And recent accounting standard changes have created an artificial gap between profits and cashflows, clouding financial performance. New lease accounting and revenue recognition standards are providing plenty more scope for adjustment.

More companies are presenting earnings adjusted to fit a rosy management picture. And adjustments will get more extreme as accounting changes filter through to company presentations over the next year. Investors will need to be on guard.

"STATUTORY RESULTS MEET TODAY'S ACCOUNTING STANDARDS. ADJUSTED RESULTS ARE FICTIONAL NUMBERS WHICH ADD BACK CERTAIN EXPENSES TO GIVE A ROSIER PICTURE TO INVESTORS."

Chart 11: Comparison of $10,000 Invested in the Forager Australian Shares Fund and ASX All Ords. Index



Source: S&P Capital IQ
The value of your investments can rise or fall. Past performance is not necessarily indicative of future performance. Values are at NAV, not market price. Assumes distributions are reinvested.

Chart 12: Portfolio Distribution According to Market Capitalisation

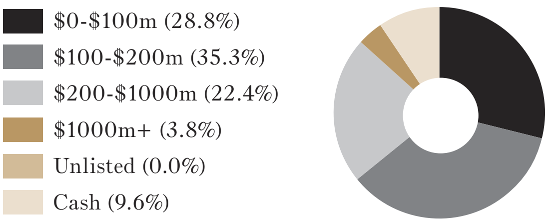


Table 5: Top 5 Investments

Macmahon Holdings Limited	10.2%
CSG Limited	7.1%
Thorn Group Limited	6.7%
Enero Group Limited	6.3%
iSelect Limited	5.8%
Cash	9.6%

PORTFOLIO NEWS

Experience Co (EXP), operator of skydiving and reef adventures, agreed to sell its Great Barrier Reef helicopters business to the Morris Group for $17.5m. Proceeds from the sale will be used to repay debt. The company's ballooning and whitewater rafting businesses are also up for sale.

The new management team, led by CEO John O'Sullivan, is making progress in restructuring and refocusing the business. The remaining skydiving and reef adventures businesses are scalable, with high market shares and better returns on capital.

Enero (EGG), the marketing services group, announced the resignation of CEO Matt Melhuish, concluding his eight year tenure. During this time Matt led Enero's transformation to a more streamlined and profitable business. He will remain with the company until March 2020 and will then pursue other interests. The company also affirmed that it was performing in line with the same period in the past year.

The long-running class action saga at consumer leasing and equipment finance provider **Thorn Group** (TGA) has finally come to a close with court approval of the settlement. The company has paid $25m to settle the misdeeds of the past. Now, with the class action behind it, a focused and refreshed board and a new CEO due to start in February, the business is in better shape than it has been for years.

Smartgroup (SIQ), the salary packaging and novated lease provider, announced that it will receive lower future fees from its insurance underwriter. This will result in an after tax impact of $4m for the 2020 calendar year and a full year impact of $8m, about 10% of after tax profits.

Recent regulatory attention has interrupted the long history of growing revenue per novated lease for Smartgroup and its competitor **McMillan Shakespeare** (MMS). Coming after a series of stock sales and a change of CEO, this latest news has caused us to exit the investment.

WPP AUNZ (WPP) announced the completion of its sale of the Kantar Australian and New Zealand division to its UK parent **WPP PLC** (LON:WPP). The $150m proceeds of the sale will be used to reduce debt and should allow the payment of a fully franked dividend. We have encouraged the board to pay a large dividend and restructure the business further.

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Forage
verb, for·aged, for·ag·ing.
to search about; seek; rummage; hunt (for what one wants).