30 June 2014

FORAGER IS BORN
A reflection on the journey to date

BUYING INTO BASKETBALL
International Fund buys some New York Knicks

SOME OUT, SOME CHANGE
Australian Fund cycling new ideas for old

STILL INVESTING OFFSHORE
Some of the cheapest US stocks are on the ASX

JUNE 2014 QUARTERLY REPORT

CONTENTS

FORAGER IS BORN 1

An important milestone 1

Patience is hardest when needed most 2

INTERNATIONAL SHARES FUND 4

International Fund performance 5

Bargain in basketball 5

From Russia with profits 6

Oil services rationality returns 7

AUSTRALIAN SHARES FUND 8

Australian Fund pauses for breath 9

UGL auctions off property 10

Opportunity in the MIX? 10

Inspecting eyes and teeth 11

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FORAGER IS BORN

On the first of July this year, Intelligent Investor Funds changed its name and moved offices. Steve Johnson explains why, reflects on the journey so far and ponders the challenges ahead.

Dear Investor,

If you've been checking your emails or have visited our website recently, you are probably getting ready to read this quarterly report the same way you usually do. If you prefer to read things the old-fashioned way, you might be a little confused right now.

Don't worry. Your investment has not been hijacked by the Australian Greens Party. I am still here and so is the rest of the team from Intelligent Investor Funds. We're still running the same funds and investing exactly the same way we were. But we've had a name change and, as you can see, have a new brand to go with it.

Performance

	1 Quarter	1 Year	3 Year (pa)	Since Inception (pa)
Australian Shares Fund	-2.35%	17.73%	20.19%	12.67%
ASX All Ordinaries Accum	0.47%	17.64%	9.69%	7.68%
International Shares Fund	3.17%	20.52%		26.21%
MSCI ACWI IMI	2.95%	19.63%		25.20%

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

Coming up with a new name was always going to be controversial.

We didn't want another industry cliché. So no coloured rocks, precious metals or incredibly high mountains. Our clients are not large institutional investors. And our investing style doesn't require a maths PHD. So we wanted it to feel accessible and approachable.

Of course we wanted it to represent the things that are important to us: performance, alignment and integrity. I would guess those things are important to you too. Finally, we wanted it to say something about our investing approach: different, contrarian and prepared to look where others will not.

One of the names that came up through the process was 'truffle'. Like most of the other ideas thrown forward, many staff were vehemently opposed to it. 'Frivolous' was the common feedback. And pigs. All anyone could think of was pigs.

But we did appreciate the thinking behind it. Truffles stink. They are ugly. But they are worth a lot of money. Just like a lot of the stocks that make their way into our portfolios.

At the time, I was in Oslo, Norway, visiting some oil and gas services companies with analysts Gareth Brown and Kevin Rose. One of the analysts we met with was telling us about an absurdly expensive restaurant in Copenhagen where they do not use any commercially grown food. It's called Nobu and every day staff go out into the forest and find food for the evening meal. Mushrooms, grubs, berries, bark and the like.

They call them forager restaurants, he told us, and apparently they are all the rage all over Europe.

Forager, forager, forager. I woke up at 2am with the word echoing in my head. That's not bad. 'No it's not', said Gareth at breakfast. 'No it's not' said the team back in Sydney when I called them.

And that's how Forager came to be. Some more hard work from the branding company working on it with us, and we have settled on the name and branding you see throughout this report (the "o" in Forager represents a rough diamond). The old Value Fund has become the Forager Australian Shares Fund and the International Fund is now the Forager International Shares Fund.

With our investing style there are even more parallels with foraging than truffles.

You do not need to be large or have huge amounts of capital behind you. In fact, having to feed a huge team is a decided disadvantage. Foragers look in every nook and cranny and eat things that others do not even know are food. We want to stay small, look for stocks that no one else wants to own and remain extremely flexible.

Both the amount and type of food on offer ebbs and flows with the seasons, just as investing opportunities come and go in different parts of the market. Share prices are even less predictable than the seasons, but we make our money from an understanding that the markets move in cycles. What's hot today can be out in the cold tomorrow, and vice versa.

And finally a forager needs to know which food is edible and which is poison. Plenty of juicy looking mushrooms should not be eaten, just like plenty of cheap looking stocks should not be purchased. Working out which is which is key.

We like the name Forager and hope that you do too. Now it is time to get back to business.

AN IMPORTANT MILESTONE

On that front we have come a long way in the past five years, and what has been achieved is worth a small celebration. There are a lot of people who want to be fund managers. And a lot of people who try to emulate those who have made a success of it. But for every Kerr Neilson or Chris Mackay, there are probably 98 attempts that fail within the first five years. We've managed to clear that hurdle with some momentum. We have more than 1,000 clients who are prepared to give us genuinely long-term money. We have $140m of funds under management. That's not large but it does enable us to employ the people and

> “WE HAVE REACHED THE POINT WHERE ALL WE NEED TO DO IS MAKE OUR EXISTING CLIENTS MONEY AND WE WILL HAVE A SUCCESSFUL BUSINESS.”

implement the infrastructure that you need in a modern day funds management business. In short, through a lot of hard work and some good fortune, we have managed to build a platform that gives us every chance for success.

The importance of this should not be underestimated. We do not need to devote vast swathes of time to trying to find a cornerstone investor. We do not need to worry about access to platforms or financial advisors. We do not need to change our investment style to appease some asset consultant or research house. We have reached the point where all we need to do is make our existing clients money and we will have a successful business.

That is the challenge ahead of us for the next 30 years or more. And an exciting and difficult challenge it is going to be.

Because on the investing side of the equation we are only at the end of the first session of a five day test match.

We’ve weathered some tricky conditions. We’ve played a few attractive shots. But we haven’t proven anything to anyone, least of all ourselves.

We need to find larger opportunities as our funds under management grows. In the Australian Fund, we are committed to closing the fund to new investors when we reach$150m-$200m. Even at that size, life is going to be much more difficult than it was at $20m. We need to broaden and deepen our international experience. We wrote in the March quarterly report about the opportunities available in some emerging markets, singling out Russia for special mention. That market was the world’s best performing over the three months to 30 June, yet we were only able to put a small amount of capital to work. With more experience, knowledge and a lot of hard work, we will be able to deploy more capital quickly when these opportunities arise. Most of all, we need to prove that we can add value over 10, 15 and 20 years, through all sorts of markets and with a lot more scale.

Perhaps that’s the most exciting thing about this juncture. It’s been an amazing effort from a great bunch of people to get Forager off the ground. It looks fantastic and it’s worth celebrating. But after months of very long hours and plenty of distraction, now we get back to doing what we love. Looking for opportunity and improving ourselves as investors.

PATIENCE IS HARDEST WHEN NEEDED MOST

Having said that, it’s been a good time to have a few distractions. Jeremy Grantham, head of US hedge fund GMO, summed up the value investor’s dilemma a few years back:

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

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

The US market is regularly reaching all-time highs and is experiencing very little in the way of violent adjustment. Closer to home Sportingbet is offering odds of $4.00 that Australian interest rates will move by the end of the year. In either direction. Odds that there will not be a rise or cut are $1.20.

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

Of course the real world is very different. Shocks happen. And central bankers often change their mind very abruptly. We are not here to punt on interest rates. But we are here to say the current level of complacency is too high.

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

But we will get better opportunities than this. We have had three great opportunities to buy in the past eleven years: 2003 was a great time to be buying high quality blue chips; 2009 was a great opportunity to buy anything; and in 2011 it was the time for small stocks.

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

Yours sincerely,

Steve Johnson

Chief Investment Officer

“THREE GOOD OPPORTUNITIES IN A LITTLE OVER A DECADE IS MORE THAN ENOUGH. THE YEARS IN BETWEEN ARE THE PROBLEM. IT’S THE WAITING THAT DOES PEOPLE OVER.”

INTERNATIONAL SHARES FUND

FACTS

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

UNIT PRICE SUMMARY

Date	30 June 2014
Buy Price	$1.3815
Redemption Price	$1.3705
Mid Price	$1.3760
Portfolio value	$61.5m

INTERNATIONAL FUND PERFORMANCE

Units in the Forager International Shares Fund increased 3.2% in value over the June quarter, just beating the 3.0% return of the MSCI World Index. Over the financial year, the fund returned 20.5%, eclipsing the 19.6% return of the index despite the Fund's significant cash weighting (currently 44%).

Since inception on 8 February 2013, the fund has risen 38.3% compared with 36.6% from the index. Of the Fund's return since inception, roughly 7% has come from the effect of currency movements (a generally lower Australian dollar boosts the value of the Fund's international shares and foreign currency cash holdings). A little over 30% of the return has come from the local currency price appreciation of the stocks in the portfolio.

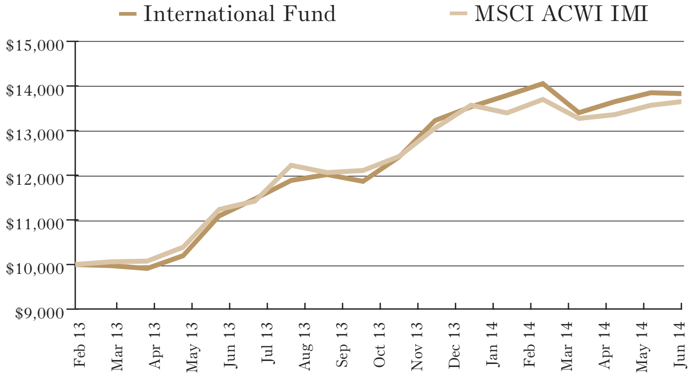
Considering the Fund's significant cash weighting, which has been between 40% and 50% for most of the Fund's life, a 38.3% return in 17 months exceeds what we could have hoped for and what you should expect in future. In Australian dollar terms, the underlying stocks are up more than 60% on average.

Summary of returns as at 30 June 2014

	International Shares Fund	MSCI ACWI IMI
1 month return	-0.16%	0.71%
3 month return	3.17%	2.95%
6 month return	1.68%	0.69%
1 year return	20.52%	19.63%
Since inception* (pa)	26.21%	25.20%

*Inception 8 Feb 2013

Performance of $10,000 invested in the International Shares Fund



Source: Capital IQ

The biggest contributors have received significant ink in past monthly and quarterly reports—**B&C Speakers (BIT:BEC)** and **Veripos (OB:VPOS)** have been the biggest winners, followed by US blue chips **American Express (NYSE:AXP)**, **AIG (NYSE:AIG)** and **Google (NASDAQ:GOOG)** and then a longer list of second liners including **Hornbach Holdings (DB:HBH3)** and **IDT Corp (NYSE:IDT)**.

While it is good to learn from and celebrate past successes, that is not the focus of this review— the first under the Forager name. Future performance will be driven more by what we are buying and holding today. Despite generally pricier markets around the globe, there are some cheap, even bargain-priced, opportunities for those prepared to look far and wide. As alluded to earlier, emerging markets is one such area. But it is not the only one.

BARGAIN IN BASKETBALL

Basketball fans invested in the Fund (all five of you) have something to boast about—you are now minority owners of the New York Knickerbockers (Knicks) and Madison Square Garden, 'the Mecca of Basketball'. Owner **Madison Square Garden Company (NASDAQ:MSG)** was added to the portfolio in May and accounts for 4% of your investment.

Summary of major investments

	COUNTRY	PORTFOLIO WEIGHTING
Google Inc	US	6.2%
Japanese Portfolio of Net-nets	Japan	5.4%
American International Group	US	5.4%
American Express Co	US	5.0%
Madison Square Garden	US	4.0%

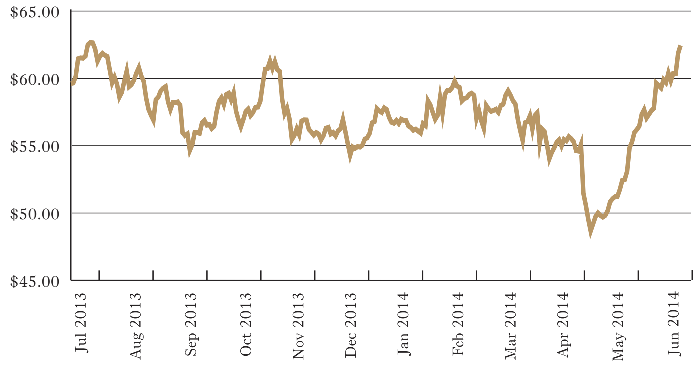
For many years, the company was a fully-owned subsidiary of Cablevision Systems, a major cable operator in the New York City metro area started by industry pioneer Charles Dolan. Spun out in 2010, it remains controlled by the Dolan family, most prominently son Jim. The business is split into three main segments: MSG Sports, MSG Media and MSG Entertainment.

MSG Sports owns the New York Knicks of the NBA, the New York Rangers of the NHL (hockey) and the New York Liberty of the WNBA (women's basketball). As advertisers struggle for eyeballs and cable operators fight to retain customers, live sports content—often unavailable online—has become an ever more valuable differentiator. We also think it can make the transition to 'paid online' more easily and successfully than most content.

The recent 'forced' sale of the LA Clippers in June for US$2bn is the latest data point in a long-term upward trend in franchise valuations. If the Clippers, LA's ugly duckling, are worth US$2bn, then the Knicks, one of the league's two true marquee franchises (along with the LA Lakers), are worth as much or more. It is no surprise that the MSG share price reacted positively after the news of the sale.

> “BASKETBALL FANS INVESTED IN THE FUND (ALL FIVE OF YOU) HAVE SOMETHING TO BOAST ABOUT”.

The Madison Square Garden Company share price



Source: Capital IQ

MSG Media is comprised of regional sports networks, MSG Network and MSG +, cable channels whose main assets are the rights to televise the Knicks, Rangers and Liberty games. RSNs, as they are known in the cable industry, are high quality businesses with sticky customer bases, proprietary content, and modest capital requirements. Generating earnings before interest and tax (EBIT) margins of more than 40%, we estimate this business would be worth more than US$3bn as a separate entity. Finally, MSG Entertainment produces concerts and other live events in a diverse collection of venues, some of which are owned, and others of which are managed through long-term leases. Among the company’s owned properties, Madison Square Garden stands out as one of the most recognisable arenas in the world. But MSG also owns The Forum in LA, and The Chicago Theatre, and has long-term lease rights for Radio City Music Hall and The Beacon Theatre in New York.

There are several valid reasons why investors might shun the stock, including the Dolan family’s complete voting control and the questionable antics of chairman Jim Dolan. Though only second generation wealthy, he acts more like the folklore third generation. There is the hodgepodge nature of the assets, and also the issue of NBA player union power and risk of strikes at bargaining time.

So what’s to like? There is value aplenty here, even after the 22% share price rise since the Fund’s purchase. At the time of purchase, MSG’s stock price valued the business (`net of the cash holdings on its very conservative balance sheet) at US$3.7bn.

At that price, we estimated that we were obtaining a very high quality business (the RSNs) at little more than fair value, and getting everything else, including The Garden (and its development ‘air’ rights), almost for free.

That’s a laughably cheap price for the famous arena that sits squarely in the middle of midtown Manhattan, directly on top of Penn Station, the busiest commuter rail hub in the United States. One day the whole site will be redeveloped more fully, and the seller could almost name their price for such prime Manhattan commercial real estate. It is worth well over $1bn, perhaps $2bn or more. Throw in the Knicks (which we think are worth at least $1.5bn, but probably $2bn or more), the Rangers and a bunch of smaller assets, and the margin of safety is quite compelling.

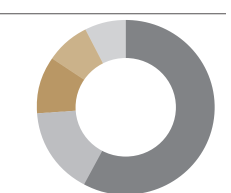
FROM RUSSIA WITH PROFITS

We first looked at dominant Russian bank **Sberbank (MICEX:SBER)** after a presentation at the Italy Value Investing Seminar in July 2013, filing it under ‘interesting’.

It barely collected any dust. The panic surrounding the Ukrainian crisis sliced more than one-third off the stock (in US dollar terms) in the first three months of 2014, and the Fund acquired a position in mid-April. The London-listed Sberbank American Depository Receipts (LSE:SBER) currently make up 2.5% of the Fund’s assets. Roughly half of the underlying Russian rouble exposure has been hedged back into US dollars, as partial insurance against greater turmoil in the region.

Currency exposure

- USD (53.4%)
- EUR (14.6%)
- NOK (9.9%)
- GBP (7.3%)
- CHF (6.8%)



Sberbank dominates the Russian banking sector in a way that would make an Australian Big Four bank blush. It commands a 44% share of Russia’s retail banking deposits—partly a quirk of the 1998 crisis when a government guarantee applied to deposits with this bank alone. Every sane Russian transferred their bank account to Sberbank. It has about a third of the market for retail and corporate loans and far and away the biggest branch presence in the country. The Russian government owns a little more than half of the shares outstanding.

The bank has a significant funding cost advantage versus competitors, and this translates into a very high net interest margin (NIM)—the difference between what the bank pays on deposits and what it collects on loans—of around 6%. We are anticipating significant contraction in this figure over the coming years. But the high NIM versus competitors and the quite conservative balance sheet (for a bank) gives Sberbank ‘last man standing’ status among Russian banks in any deeper crisis. We also think any erosion of the NIM is likely to be compensated by a concurrent expansion in the loan book; Russia’s personal debt levels are extremely low by global standards.

Although the stock has risen 13% on the Fund’s average purchase price, it still trades on a price earnings ratio of about 5 and a price to book value of less than 1.0 times. This is extremely undemanding for a bank generating 20%+ return on equity, with a hardy balance sheet and an extremely impressive history of earnings per share growth.

The stock pays a 3.0% yield despite currently paying out only 15% of its earnings (versus, say, the Commonwealth Bank which pays out about 75% of its earnings). There is significant scope,

“WE’VE GONE IN EYES WIDE OPEN TO THE LIKELY SHRINKING OF THE MARGIN AND INCREASE IN BAD DEBTS OVER THE COMING MONTHS AND YEARS. EVEN ALLOWING FOR THAT, THE STOCK LOOKS DIRT CHEAP.”

and also fresh political pressure, to expand the dividend. But there are also opportunities to reinvest retained earnings at high rates of return. Either suits us fine.

We’ve gone in eyes wide open to the likely shrinking of the NIM and increase in bad debts over the coming months and years. Even allowing for that, the stock looks dirt cheap.

Of course, every investor in Russian stocks takes on some risk that their investment goes to zero. All Russian stocks, even those not controlled by the government as majority shareholders, should be viewed as a non-voting minority stake in partnership with Putin. While in the good books now, Sberbank might not always hold favour in political circles and no Russian company is completely immune from being Yukos-ed (wiped out). But we think it is considerably more likely that the Fund’s modest speculation will double or triple in value in a few short years, and feel the upside outweighs the risk.

OIL SERVICES RATIONALITY RETURNS

The September 2013 quarterly report included some of our thoughts on oil. The market was short-term pessimistic, particularly about the plans for oil majors to curtail capital investment. Shareholders of the majors wanted less exploration and development in favour of more dividends, and some promised to give them just that. That did not bode well for oil services firms reliant on such spending.

But we found the longer terms arguments for higher oil prices and, in particular, higher offshore exploration and development more convincing. Without investing in new developments, the majors would eat through their reserves, and talk would eventually swing back to investment and exploration.

With that possible macro tailwind emerging, we acquired three as-then-unnamed oil services businesses—an owner of drill rigs, an owner of seismic services vessels and a provider of vessel positioning information. These stocks were cheap enough that we could be quite wrong on the oil outlook and still make money.

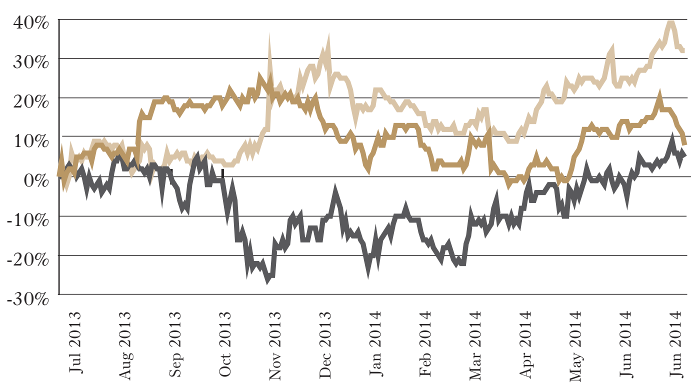
The market seems to be warming somewhat to our views about capital spending requirements. A recent article in *The Times* focused on the ‘irresponsibility of shareholders demanding that oil majors slash their spending on new projects’. It juxtaposed the planned spending reductions by Shell, BP and others with the lack of spare capacity in the global oil system, recently given prominence by turmoil in Iraq and Russia, both major exporters. The International Energy Agency is apparently concerned.

Far be it for us to get between shareholders and dividends. But if the majors do not drill, the oil price will likely rise further, eventually providing a renewed incentive to drill.

Importantly, the sentiment shift isn’t just playing out at the macro level. The three original oil services stocks have performed well. The vessel positioning information provider—Veripos—turned into one of the Fund’s great first year successes, with the investment doubling in six months before being sold in a takeover.

The owner of seismic services vessels—Norwegian company **Dolphin Group (OB:DOLP)**—is now up 15% on our average purchase price despite tanking straight after we bought it. The stock trades on a forward price earnings ratio of 6 times.

Performance of the Fund’s oil stocks



Source: Capital IQ

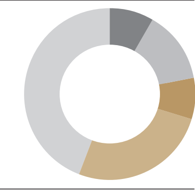
Awilco Drilling (OB:AWDR), the owner of two mid-water North Sea oil rigs, is up 19% on our average purchase price. That return excludes the juicy dividends collected over the past ten months. The group pays quarterly dividends which work out to an annual yield of 19% on the current stock price, even higher on the Fund’s average purchase price.

More recently, as outlined in the March 2014 quarterly, the Fund acquired shares in the much larger, global-leading oil & gas engineering and construction company **Subsea7 (OB:SUBC)**. The team held meetings with the managements of Subsea7 in London, Awilco Drilling in Aberdeen and Dolphin Group in Oslo in May, along with other European companies. Though useful, it did not ultimately change our investment thesis significantly.

As mentioned earlier, there are plenty of value opportunities for those who are prepared to look widely at stocks of different Sberbank and Madison Square Garden Company, the Fund has also started accumulating a position in a smaller European industrial stock. It has been on our wish list for a while and only recently ran into sufficient pessimism. While not as cheap as the aforementioned, it is a world leader in its small niche, and available at an attractive price. We’re not done buying, though, so this is a tale for another day.

Portfolio distribution according to market capitalisation

- $0–$250m (8.4%)
- $250–$1000m (13.6%)
- $1000–$5000m (7.9%)
- $5,000m+ (26.1%)
- Cash (44.0%)



AUSTRALIAN SHARES FUND

FACTS

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

UNIT PRICE SUMMARY

Date	30 June 2014
Buy Price	$1.4458
Redemption Price	$1.4343
Mid Price	$1.4401
Portfolio value	$53.0m

AUSTRALIAN FUND PAUSES FOR BREATH

The Forager Australian Shares Fund recorded returns of minus 2.4% for the June quarter, versus positive 0.5% for the benchmark All Ordinaries Accumulation Index. Over the financial year the fund returned 17.7%, versus 17.6% for the benckmark.

While the result for the past financial year was perfectly acceptable, most of the return came in the first three months. In the six months of calendar year 2014 the Australian Fund (previously the Value Fund) is down 2.1% versus a positive 2.7% for the market, underperforming by nearly 5%.

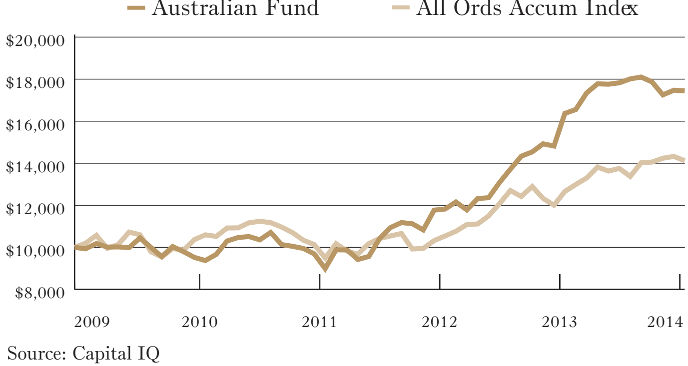
Summary of returns as at 30 June 2014

	Australian Fund	ASX All Ordinaries Accum Index
1 month return	-0.15%	-1.41%
3 month return	-2.35%	0.47%
6 month return	-2.12%	2.68%
1 year return	17.73%	17.64%
2 year return (pa)	26.94%	19.15%
3 year return (pa)	20.19%	9.69%
Since inception* (pa)	12.67%	7.68%

*Inception 31 Oct 2009

It's been a lean period, particularly compared to the 44% returned in 2013 and 31% in 2012, periods where the benchmark returned 20% and 19% respectively. The chart to the right shows the contrasting performance of the Fund's largest five investments last year and the first half of this year. So far this year, the big holdings, with the exception of **Enero Group (EGG)**, have not boosted the Fund.

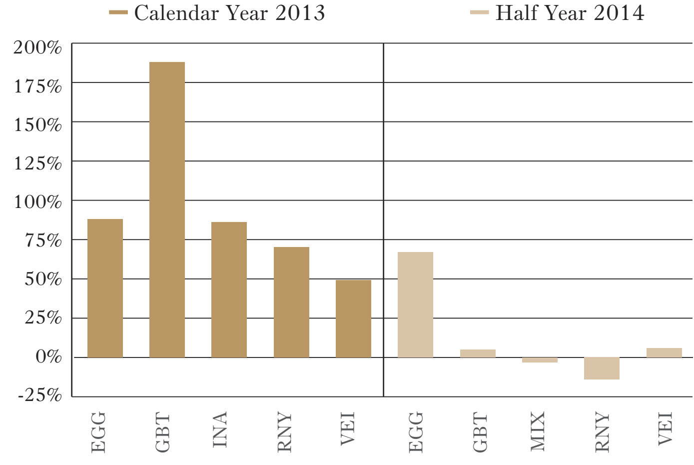
Performance of $10,000 invested in the Austrailan Shares Fund



Source: Capital IQ

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

Gains on largest five investments

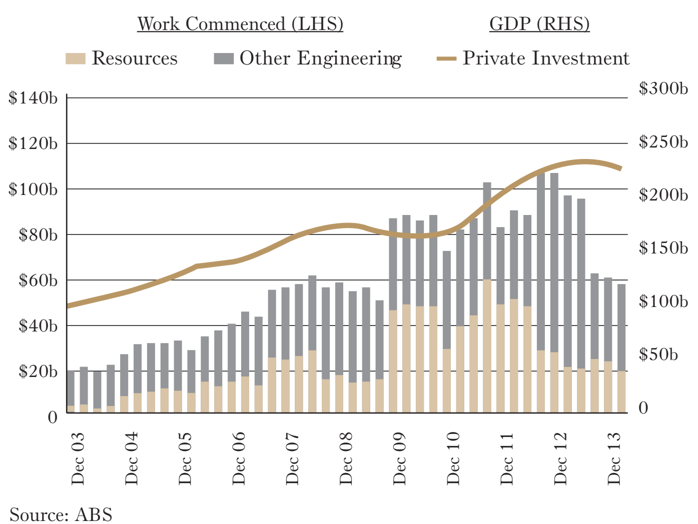


Source: Capital IQ

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

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

Engineering Work Commenced vs Private Investment GDP



Source: ABS

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

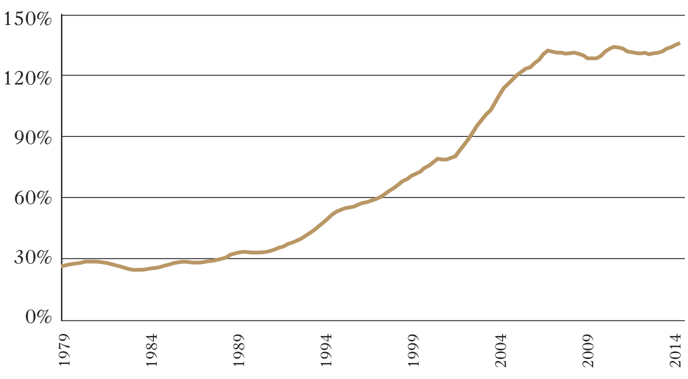
Investment from the last decade ensures Australia will export record tonnes of ore, but unlike investment and construction, the additional benefits to the wider economy are limited. The key export industries of iron ore and liquefied natural gas employ few people in production phase, are substantially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

Portfolio distribution according to market capitalisation

- $0–$100m (41.4%)
- $100–$200m (20.5%)
- $200–$1,000m (18.0%)
- Cash (18.8%)
- Unlisted (1.3%)

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

Debt to Disposable Income



Source: Reserve Bank of Australia

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

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

UGL AUCTIONS OFF PROPERTY

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

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

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

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

OPPORTUNITY IN THE MIX?

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

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

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

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

Property trust comparisons

	RNY	MIX
Purchase price	$0.17	$0.11
Current price	$0.27	$0.165
NTA	$0.54	$0.22
Cap rates	8%	8%
Cost of debt	6.5%	4.4%
Property type	Suburban office B-grade	Chicago industrial B-grade
Vacancy	19.1%	9.5%

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

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

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

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

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

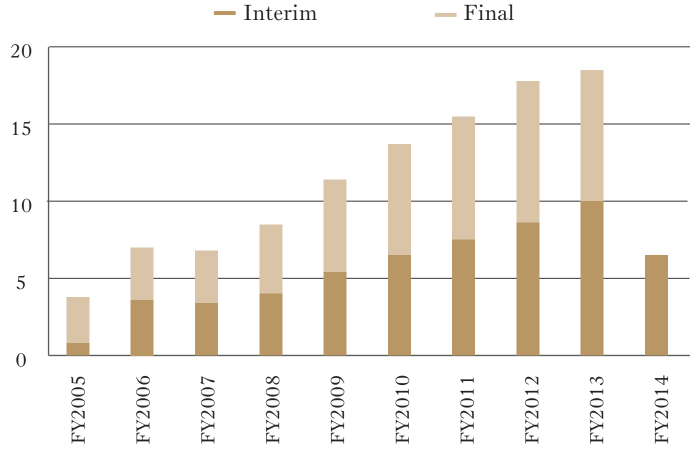
RNY units closed the quarter at $0.27 and, while the 14% fall in its unit price since 31 December 2013 has been hampering performance, the stock remains the Fund's best idea.

INSPECTING EYES AND TEETH

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

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

1300 Smiles dividends (cents per unit)



Source: 1300 Smiles

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

Comparative multiples

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

To an extent this is justified because the business model of 1300 Smiles is far stronger. The companies have similar operating expenses (see table below). You can see that 1300 Smiles pays a higher percentage of revenue to staff, 57% to 48%. That’s actually a good thing, because better pay to dentists/doctors makes the business model more robust. (The gap between the companies has actually closed substantially, when it listed, Vision was paying just 33% of its revenue to staff, which proved unsustainable. Eleven doctors left and it nearly went broke.) Despite paying more to staff, Holmes generates similar operating margins for ONT because of tight cost focus, conceding only 12% of revenue to overheads compared to Vision’s 16%.

Margins comparisons (% of revenue)

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

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

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

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

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

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

Selection of holdings

	Description	Weighting
Vision Eye Institute	Ophthalmology clinics around Australia	9.3%
GBST Holdings	Financial Industry software provider in the UK and Australia	6.3%
Mirvac Industrial Trust	US industrial property owner in the process of liquidating it’s assets	5.1%

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

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