

ROBUST AGAINST RECESSION

China's slowdown is hitting home for Australia. A defensive stance is still warranted.

TECH STOCKS DELIVER

GBST and Hansen have been delivering stellar results for the Australian Fund.

COLLECTING TOLLS IN VIENNA

What's better than owning a toll road? Owning the technology that collects the tolls.

GOOGLE GETS PUNTED

Google's business is humming along nicely. How it spends the profits has us very concerned.

MARCH 2015 QUARTERLY REPORT



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RBA SENDS 2015 OFF WITH A BANG

An interest rate cut and the prospect of more to come put a rocket under the Australian market in the first three months of the year. Steve Johnson explains that it's the economy you need to be worried about.

Dear Investor,

The first quarter of 2015 was kind to global sharemarkets and both of Forager's funds. Domestically, the Reserve Bank of Australia has been late to the global low-interest rate party but a cut in February had the same impact as similar actions by central banks around the world in recent years: prices for property and shares headed sharply higher and the local currency fell against the US dollar.

Performance

	1 Quarter	1 Year	3 Year (p.a.)	Since Inception (p.a.)
Australian Shares Fund	9.43%	11.59%	22.15%	13.59%
ASX All Ordinaries Accum	10.21%	13.25%	14.72%	8.96%
International Shares Fund	6.51%	11.88%	–	20.84%
MSCI ACWI IMI	9.88%	27.54%	–	27.89%

There are more rate cuts to come for Australia and that could mean even higher prices for stocks, particularly those paying high dividends. It seems simple – just buy a stock with a reasonable yield and watch it rise – but thoughtless investing is always risky. I'm unsure whether this global monetary experiment ends in inflation, deflation or the world sails through just fine. But I know that equities are not bank deposits.

Regardless of how reliable an historical dividend has been, shares are not low-risk investments and should not be bought on the basis of yield alone. Australian dividend payout ratios are high – far too high in my opinion – and the underlying profitability of any business can change dramatically.

The good news is that Australian investors' obsession with yield is also creating opportunity. There's very little interest in those stocks not paying dividends and not perceived as 'reliable'. That's led to some cheap investments for the Australian Fund. Despite plenty of nervousness about the domestic economy (see below), we're optimistic about the prospects for this portfolio.

IRON ORE: HOW LOW CAN IT GO?

In the first few days of April this year, the benchmark iron ore price slipped below US\$50 a tonne. That's down 50% in the past year alone and more than two thirds from its peak in 2011. How much further can it fall?

No one has any idea. Particularly in the short-term. But the question is irrelevant in any case.

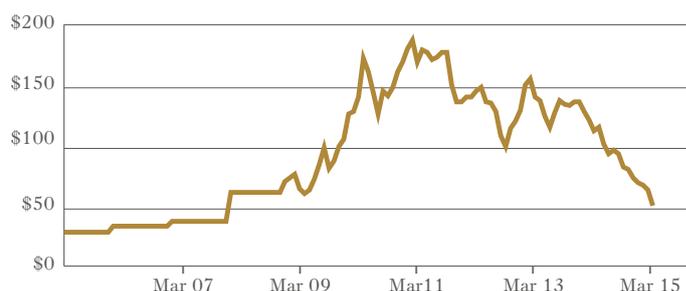
Prices for iron ore are falling because the market is dramatically oversupplied.

Demand is unlikely to increase rapidly enough to fix the problem. In fact, while most observers have finally woken up to the fact that China's construction boom is unsustainable, analysts are still forecasting somewhere between slow and no growth for Chinese iron ore demand.

Even to maintain the same level of demand – that's zero growth – China would have to build the same number of roads, railways and airports as last year, adding significantly more infrastructure and debt to an economy that is plagued by too much of both.

It seems perfectly reasonable to expect the demand for iron ore to fall. Perhaps dramatically.

Chart 1: 10 year iron ore price (USD)



Source: S&P Capital IQ

Meanwhile, **BHP Billiton** plans on increasing its iron ore production by 65 million tonnes per annum (mtpa) over the next few years. **Rio Tinto**'s plans include an additional 50mtpa. And Gina Rinehart's new Roy Hill mine will add 55mtpa to the market in 2016. Combined, these three players plan on adding roughly 20% to the supply of internationally traded iron ore.

If demand is, at best, growing only slowly, it's clear that supply needs to be removed from the market somewhere. Iron ore mines need to close.

Many directors are sitting around boardroom tables wasting their time pontificating about where the iron ore price will bottom out. The simple fact is that if your mine is in the least efficient quintile of global production, the price is going to fall to a level that puts you out of businesses.

Australia's high cost operators like **BC Iron**, **Atlas Iron** and **Mineral Resources**'s Minara mine will close first. But they're only small players. It's going to take something significant, either **Fortescue Metals** going under or Rio or BHP Billiton curtailing expansion plans before the market is going to be anything like balanced.

However painful, and however low the iron price needs to fall to make it happen, this is the only way the market can return to balance.

WHAT NEXT FOR AUSTRALIA?

We're what the asset consultants would describe as 'bottom up' investors. That is, we value companies and we buy them when we think they're cheap. Macro, or 'top down' investors look at the

“REGARDLESS OF HOW RELIABLE AN HISTORICAL DIVIDEND HAS BEEN, SHARES ARE NOT LOW-RISK INVESTMENTS AND SHOULD NOT BE BOUGHT ON THE BASIS OF YIELD ALONE”

big picture first. Armed with a theme, they then find stocks that will help them profit if the world plays out the way they expect.

Obviously a top down investor still puts a lot of work into the individual stocks they end up buying. And a bottom up investor should – indeed must – put a lot of time and effort into understanding the macro environment a company operates in and how that environment is expected to impact a company’s future profitability.

Hence, while picking individual stocks for the past five years, our concerns about a China slowdown have influenced our portfolio allocation in three distinct ways. One, we obviously don’t want to own resources stocks. Two, we prefer exposure to foreign currencies. Three, we are wary of exposure to discretionary spending and the domestic Australian economy. Indeed these concerns were some of the main reasons for starting the International Fund in early 2013.

China’s growth has slowed dramatically and the first two pennies have dropped. Mining stocks have been smashed and the Aussie dollar has fallen. Yet the third concern – the flow-on effect of a commodities meltdown on the wider Australian economy – is yet to be reflected in stock prices. Sure, the unemployment rate has crept up, but bank share prices are hitting all-time highs.

Obviously the more iterations between China’s economic growth and the company you are looking at, the less direct the impact will be. It’s hard to imagine how China’s economic growth slows dramatically without impacting commodity prices. It’s less certain, but still likely, that this will cause the Aussie dollar to fall.

When it comes to the wider Australian economy, there are a lot of other factors at play.

We are more likely to be wrong the further we extrapolate from the epicentre. But it is fairly clear that the Australian economy is about to go through a very difficult adjustment period as the commodities boom ends.

So we demand an even greater margin of safety when looking at discretionary retail stocks, as well as Australian financials, housing and anything else dependent on Australian consumers. We will buy them, if they are cheap enough, but we require a higher-than-usual expected return, because we think the risk is higher than usual at the moment.

Take retailer **Myer Group** for example. There’s a pretty straight forward case for this stock being cheap. It trades at roughly 10 times downgraded earnings, yields 9.3% on last year’s dividends and, in our opinion, is probably making less profit than it should. The margins, at 2.4%, are very low relative to the competition and its own historical averages.

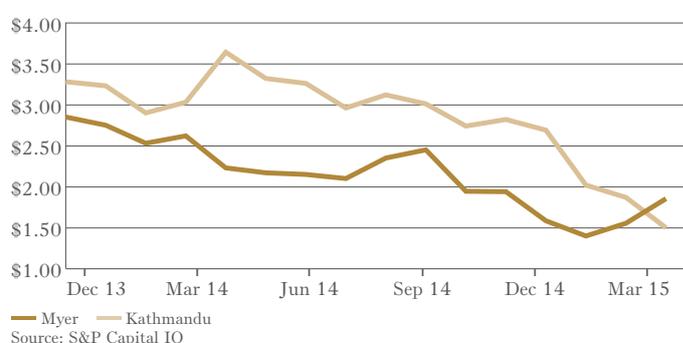
There are plenty of things to worry about. The internet and foreign retailers are encroaching on Myer’s space. The stores look tired. And Westfield is stealing the profit (almost all of the margin deterioration in recent years has been due to increasing rents). None of these issues are easily fixed.

In a normal economic environment, however, I’d say the potential rewards outweigh the risks at this price. The time to buy retailers is when the margins are low. And at these prices a

private equity bid is surely on the cards. The same case could be made for **Kathmandu** (see the Chart 2).

But is now the time to be wading into the consumer discretionary sector?

Chart 2: KMD and MYR chart



Not unless the stock is cheap enough to sail through a recession and still look cheap. And neither of these stocks meet that criteria.

FESSING UP ABOUT OUR MISTAKES

December’s quarterly report caused concern to some of our newer investors. The discussion of 2014’s mistakes made some people, understandably, question why they’d invested with a fund manager who keeps stuffing up.

Yet it was nothing new to investors who’ve been with us for years. We regularly discuss our mistakes and there wasn’t anything special about 2014. We aim to get fewer wrong each year but there will always be errors.

That’s not only true of us, because all fund managers make mistakes. The difference is that we are open about them with you, our investors. And for good reason.

As a result of our confessionals and general transparency, most of our investors understand that we are human, that we get things wrong from time to time and that our returns are likely to be lumpy and often differ markedly from the index.

That understanding and the long-term nature of the investments our clients place with us as a result, are our main advantage over the competition. In the short-term, we probably attract less money. In the long-term, we have a sustainable business and our investors receive, we hope, superior returns.

So come the end of this year, you’ll be reading about the things that we got wrong in 2015.

Yours sincerely,



Steven Johnson
STEVEN JOHNSON
 Chief Investment Officer

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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	31 March 2015
Buy Price	\$1.4307
Redemption Price	\$1.4193
Mid Price	\$1.4250
Portfolio value	\$74.9m



INTERNATIONAL FUND PERFORMANCE

The Forager International Shares Fund lagged the index again this quarter. But a few new opportunities were added to the portfolio that hold potential to pay off over the long term. We continue hunting for more.

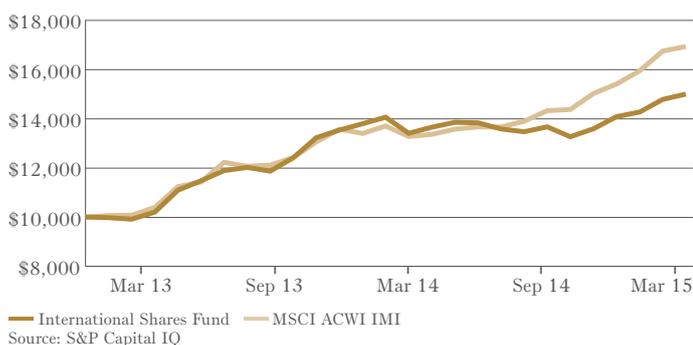
Over the month to 31 March 2015, the Forager International Shares Fund rose 1.5%, slightly outperforming +1.1% from the benchmark index. But it trails over the past three months, +6.5% against +9.9% from the index.

Table 1: Summary of returns as at 31 March 2015

	International Shares Fund	MSCI ACWI IMI
1 month return	1.46%	1.11%
3 month return	6.51%	9.88%
6 month return	9.74%	18.20%
1 year return	11.88%	27.54%
2 year return (p.a.)	22.99%	29.61%
Since inception* (p.a.)	20.84%	27.89%

*Inception 8 Feb 2013

Chart 1: Performance of \$10,000 invested in the International Shares Fund vs MSCI ACWI IMI



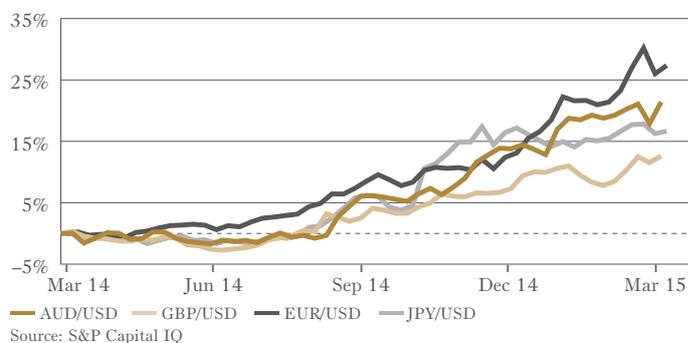
If you read mainly local financial media, you might think the Australian dollar is the most rapidly depreciating currency in the developed world. You'd be wrong.

While the little Aussie battler has fallen 18% against the US dollar over the past 12 months, the Euro has fallen 22% versus the greenback. Much of that happened in the past three months. Various European policies, such as quantitative easing, are broadly achieving their intended debasing ... err ... stimulative goals.

The effect on stocks has been pronounced. Since the New Year's fireworks, the German bellwether DAX index is up 22% and the French CAC 40 up 19%. Export-focused companies have generally done even better – Volkswagen, BMW, BASF and many more are up more than 30% since 1 January. Nemetschek AG, an architectural software company Gareth visited in Bavaria barely 6 months ago –

to better understand its position on our wish list – has almost doubled since (unfortunately, we don't own it). As we lamented on Facebook last month, 'every stock we've bought in Europe recently has gone up. So has every stock we haven't bought in Europe.'

Chart 2: US Dollar Strength



But as John Hempton pointed out in his February letter to Bronte Capital investors, it would be wrong to make the unthinking assumption that stocks, particularly of exporting companies, are now expensive just because they've gone up. Hempton made the point with one of his European stocks (MTU Aero Engines), we'll make it with one of ours.

B&C Speakers S.p.A. (BIT:BEC) is up 28% since 1 January. But half of its revenue is sourced from outside the Eurozone, and much of the rest is sold to European speaker companies that ultimately export it elsewhere. Those European clients are themselves receiving a competitive boost from the falling Euro versus their main competitor, US-based giant JBL Speakers (which doesn't buy components from B&C).

Granted, the currency benefit isn't one way. Much of the company's raw materials costs (such as neodymium, the powerful magnet) are priced in US dollars. But that's the same for all participants regardless of their geographical location, and will prove a 'wash through' in the longer term. Labour, another crucial input, is different. The recently cheapened Euro gives the company and some of its key customers a clear cost advantage versus competitors based outside of Europe.

To internationalise the recent stock price move, in US dollar terms the B&C's share price is up 'only' 14% since 1 January. That may well short change the positive effects of recent Euro depreciation for the company. To pinch a phrase from Hempton, the cheaper Euro is 'wildly good' for B&C's competitive position.

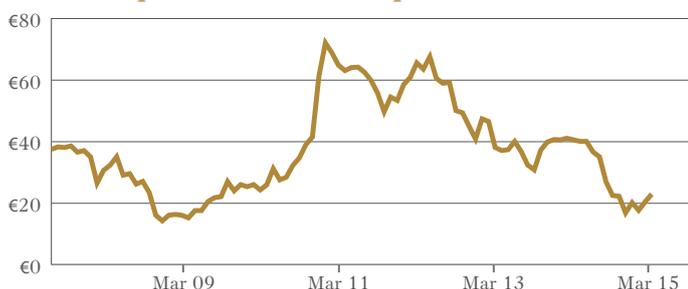
Rising share prices can be disheartening for those seeking to acquire value investments. But we're doing our best to fight lazy assumptions and continue seeking value in Europe, as elsewhere. On that front, a few new investments were made over the past three months, the largest of which is now outlined.

“THE RECENTLY CHEAPENED EURO GIVES THE COMPANY AND SOME OF ITS KEY CUSTOMERS A CLEAR LABOUR COST ADVANTAGE VERSUS COMPETITORS BASED OUTSIDE OF EUROPE”

KAPSCH: NOT JUST A PROVERBIAL TOLL COLLECTOR

It can be an expensive experience driving around Sydney or Melbourne. For those looking to get some bills back via the stockmarket, it might pay to look on the other side of the world. Austrian company **Kapsch TrafficCom AG** (WBAG:KTCG) is a global leader in free flowing electronic toll collection systems. It has two main divisions. Road Solution Projects (RSP) is focused on new road builds. It makes all the on-road equipment that hangs from gantries over motorways and allows for high speed, cashless toll collection – transceivers, readers, automatic number plate recognition, smart cameras – and the systems that sit behind the hardware. In some markets, like Australia, it mainly sells its product to the road builder. All tollways in Sydney except the Harbour Bridge, and a large percentage of Melbourne and Brisbane toll roads, use Kapsch equipment. In other markets, it offers full turnkey installation and system integration.

Chart 3: Kapsch TrafficCom share price



Source: S&P Capital IQ

Services, System Extensions & Component Sales (SEC) is the recurring revenue business that sometimes flows from past RSP sales. The most important part of this segment is the full operation of specialty truck tolling systems that the company previously installed in Poland, Austria, Czech Republic and Belarus, on multi-year contracts.

Also important to SEC is the sale of on-board units. Kapsch is easily the largest manufacturer of toll tags globally, selling more than 9 million of them last year. On board unit sales are recurring in nature. That's especially true in the important E-Z Pass system which spans the 13 most north easterly states of the United States, an extremely populous area where Kapsch has a contracted monopoly at least until 2021. SEC generates dependable revenues and high margins.

Life since listing in 2007 fits into two stark halves. From 2007 to 2011, revenues in both RSP and SEC grew very rapidly. When it came to profit, RSP would make a little or lose a little each year. But that was ok because it was winning a lot of business that generated future recurring revenue for the SEC business, where the real money is made.

Over the past three years, RSP has run into numerous obstacles. Most importantly new, large scale European truck tolling systems have all but dried up. A national system approved for Slovenia and awarded to Kapsch was cancelled. Another in Hungary was given to local players in a last minute about face by a nationalistic

government. A long-discussed system in Russia was abandoned. France and Denmark delayed projects. Belgium, one of the few projects to get off the ground, was won by a competing consortium. As a result, RSP revenues have fallen and the division has been losing a lot of money – enough to mask the significant profitability of the SEC segment. Since peaking in 2011 Kapsch TrafficCom's share price has halved, then nearly halved again. We think it's fallen too far.

Seth Klarman once opined that every investment firm has copious information, accurate databases, powerful computers and well-trained analytical talent. These alone will no longer provide a competitive edge. 'To add value you must stand apart from the crowd'.

Valuing the SEC segment is uncontroversial. It generates €60–70m of earnings before interest and tax (EBIT) and does so with low capital requirements – many of the assets it utilises are owned by the road operator or national government. Some of the operating contracts are long term in nature, others have only a few years to run but a strong likelihood of being extended. Even if the company never won another new operating contract, it's hard to come up with a value for this division alone that is less than the entire enterprise value of Kapsch – about €350m – and easy to envisage a substantially higher number.

Where we've stood apart from the crowd is in dealing with the RSP losses, which have been running at €35–50m the past three fiscal years. The market seems to be assuming that losses in RSP will continue indefinitely, while failing to win any new large operating contracts that would ultimately add value to the SEC business. Thus their valuation for the RSP business is a big number, with a minus in front of it.

We disagree. The evidence suggests that recent losses in RSP stem not from the contracts it won but from the contracts that it didn't win. Kapsch expanded its cost base expecting growth, a continuation of the 2007–2012 experience, and then the world changed. That's a solvable problem.

Management is incentivised to act sensibly – the company is run by Georg Kapsch, whose family control 63% of the stock. While it's possible that the company wins operatorship of a few new European truck tolling systems, Kapsch is focused on reducing the cost base in case they don't. For starters, it can slash some of the €15m incurred annually setting up in new markets for new bids, and some of the €20–25m in generic technological research and development that is all expensed to the RSP division.

Over the past nine months, the company has restructured and claimed the heavy lifting would be done by the end of its 2015 fiscal year, which ended on 31 March. They've consistently telegraphed that they expect company-wide EBIT margins of around 10% for the 2016 year just started, a vast improvement on the recent past. We think that's achievable. Dividends, cancelled a few years ago, are to be reinstated in a few months' time – an important sign of confidence.

The Fund acquired stock in Kapsch TrafficCom in January at prices around €21.70. If management hits its 2016 targets, those shares were acquired on a forecast EBIT multiple of around 7.0–7.5 times,

“BETFAIR HAS COMPETITIVE ADVANTAGES THAT ARE VERY DIFFICULT TO REPLICATE AND, LONG DISGUISED BY POOR MANAGEMENT, THESE ADVANTAGES ARE NOW SHOWING UP IN THE FINANCIAL STATEMENTS”

too cheap for a business with highly recurring revenues and remaining growth options. The portfolio weighting is 4.0%. We’ve stood apart from the crowd, time will tell if profitably.

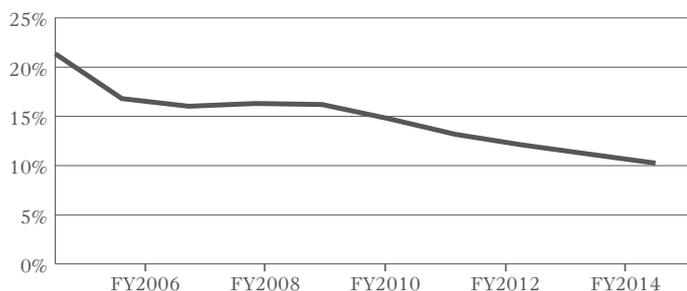
GOOGLE HEADS FOR THE DARK SIDE OF THE MOON

When the Fund made its original investment in **Google Inc.** (NASDAQ:GOOGL) back in 2013, the rationale was straight forward. The company had a quasi-monopoly position in a tremendously profitable business (search); it had other exciting businesses that were just hitting their stride (Android and YouTube), and it was using the cash flow from these efforts to innovate and maintain its place at the leading edge of technology. Importantly for us, its stock was trading at a relatively economical valuation.

Google was always an “ad tech” company, so pursuing opportunities both within and adjacent to the digital advertising space seemed the most promising. The evolution of Adwords, Adsense, Doubleclick, Android, and YouTube – Google’s most valuable assets – provided such a legacy. Indeed, the price we were paying at the time was attractive only assuming future endeavours bore returns consistent with the company’s historical performance. This was a key aspect of our investment thesis.

But as we have all heard countless times, past performance is not indicative of future results. From 2001 through 2011, Google spent USD\$24bn on capital investment and M&A, building a business that increased pre-tax profit by USD\$12bn. Pardon the admittedly simplistic analysis, but the rough math suggests a 50% return on that investment. Since then, in the past three years alone, the company has spent USD\$38.5bn and managed to increase profit by only USD\$4.6bn, a 12% return. Something has gone awry.

Chart 4: Google 10 year Return on Capital



Source: S&P Capital IQ

It is impossible to invest in Google without investing in Larry Page. Together with co-founder Sergey Brin, he controls both the company and the purse strings. He is young and rich. It is not surprising that someone who has achieved that level of success brims with optimism, but it is his idealism that gives us concern. He believes in the power of technology to cure all of society’s ills, and that Google is best positioned to take that challenge. As shareholders, we can think of a few alternative paths to chart, most of which would delegate the role of altruist to a non-publicly traded entity.

Google likes to refer to these ambitious, long-term projects as moonshots. We admire Larry’s desire to avoid the stagnation trap in which most mature tech companies eventually find themselves.

But a glance through Google’s latest ventures suggests that the company has entered some sort of capex death spiral. High-speed consumer broadband, self-driving cars (an idea we actually like), biotech, consumer wireless, consumer electronics, and low earth orbiting satellites – these are Google’s moonshots. Most of these businesses require significant upfront investment, and many of them are in markets that lack appealing economics and are increasingly competitive. Perhaps more telling? None of them have much to do with Google’s existing business.

Has the honeymoon come to an end? In January, we had gnawing concerns over the future of Google’s traditional search business, and Europe was continuing to ratchet up regulatory pressure. Factoring these risks together with our concern over the unfettered spending, we could no longer make a compelling case to own the stock. Reluctantly, the Fund liquidated its stake earning a 32% return on our initial purchase.

BETFAIR GALLOPS AHEAD

UK-listed **Betfair** (LSE:BET) continued its stellar run. The share price rose 28% during March and 42% for the quarter. The betting exchange announced the acquisition of another US horse race broadcasting business, HRTV, in February but it was the quarterly results that set the share price racing. Revenue increased 20% for the quarter and earnings before interest, tax, depreciation and amortisation increased 17%. Except for the introduction of a new UK tax, the increase would have been 51%.

Betfair has competitive advantages that are very difficult to replicate and, long disguised by poor management, these advantages are now showing up in the financial statements. The share price has more than doubled since our purchase less than 12 months ago but the business is surpassing our most optimistic expectations. It remains an important holding for the Fund.

HORNBACH BUILDS MARKET SHARE

German DIY retailer **Hornbach Baumarkt** (DB:HBM) and its property-rich parent **Hornbach Holdings** (DB: HBH3), which you should view as one holding, is a sleeper in the portfolio. Unlike the European exporters outlined earlier, the group is reliant on the health of European consumers. Unsurprisingly then, it hasn’t shot to the moon like much else on the continent – Hornbach Baumarkt stock is up ‘only’ 15% over the quarter.

The full year result showed impressive 4.4% same-store sales growth. But this was flattered by an unusual weather pattern in the first quarter last year. The 4th quarter same-store growth of 2.4% is perhaps a better indicator of conditions, with the non-German stores finally pulling their weight. The number of stores increased by 8 to 146 (mostly through acquiring sites from a bankrupt competitor). Hornbach’s German market share now sits at 11.0%, up from 10.0% last year and 9.2% in the 2011/12 year, and higher in the megastore category. Hornbach is now the clear number three player. The stock looks cheap on an earnings and assets basis, and will look even cheaper if continued consolidation of the German DIY market encourages profit margins to rise from pitiful to merely slim.

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	31 March 2015
Buy Price	1.5549
Redemption Price	1.5425
Mid Price	1.5487
Portfolio value	\$63.5m



AUSTRALIAN FUND PERFORMANCE

A strong contribution from the Australian Fund's software businesses made for a good start to the year, but not quite enough to beat the benchmark. High prices make the search for value harder but there are opportunities around.

The benchmark ASX All Ordinaries Accumulation Index returned a booming 10% in the March quarter. Surging share prices for software companies **GBST Holdings** (GBT) and **Hansen Technologies** (HSN) helped the Australian Fund produce a 9% return for the same period.

Table 1: Summary of returns as at 31 March 2015

	Australian Fund	ASX All Ords Accum. Index
1 month return	4.87%	-0.03%
3 month return	9.43%	10.21%
6 month return	5.72%	13.04%
1 year return	11.59%	13.25%
2 year return (pa)	17.94%	13.22%
3 year return (pa)	22.15%	14.72%
Since inception* (pa)	13.59%	8.96%

*Inception 31 Oct 2009

Chart 1: Comparison of \$10,000 invested in Australian Shares Fund vs ASX All Ordinaries Accum Index



The rising market is being fueled by increased conviction that interest rates in this country will be low for a long time, and that's emboldening investors to bid up the price of blue-chip shares as well as bonds, property and anything else that generates reliable (or sort-of-reliable) cash flow. Since the global financial crisis the Australian market has rallied from 11 to 17 times earnings, and it's starting to look overstimulated.

Low interest rates certainly increase the present value of fixed-interest investments like bonds, but the relationship between interest rates and the value of shares is not clear cut – low interest rates often signal a poor environment for corporate earnings. The Reserve Bank has not, of course, sent interest rates to emergency lows without reason, it is concerned the Australian economy is in a frail state.

Investors should take heed too. A huge cycle of investment in resources is coming to an end with the completion of the

major gas liquefaction plants. The iron ore price has tumbled, weakening a key revenue earner for the country. If the country's other key export, coal, is any guide, iron ore has a long period of structural adjustment ahead. It could be a deep depression of endless cost-cutting and oversupply.

Chart 2: RBA cash rate versus All Ordinaries



A lower Australian dollar should rekindle demand for our non-resource exports but can cushion the blow only a little. Ideally investment in infrastructure would pick up some of the slack, but as portfolio holdings **Coffey International** (COF) and **Infigen Energy** (IFN) can attest, political uncertainty has gridlocked decision making. With important projects being delayed and cancelled, the expected help could be too little, too late.

For now the impact seems contained to the energy and mining sectors, but second and third order effects will surely flow to other sectors. As tax receipts and employment fall in the resource states of Queensland and Western Australia, spending must be trimmed elsewhere too. This impacts demand, which hurts not only discretionary consumer sectors like retail, but also housing, finance and white-collar services. The logical outcome should be weak revenues and earnings across the economy, which could be a nasty spectacle with the sharemarket so highly priced.

Balanced against this, low interest rates could drive the market higher still in the interim. So how should investors respond to these circumstances? We're not willing to speculate on ever-tightening dividend yields and intend, as we have always done, to steer clear of the high-priced blue chips. This might make the market hard to outperform in the short-term.

That's actually how it should be. Our job is to find long-term value which means we must steer clear of today's glamour stocks and focus on what is disliked, overlooked or misunderstood.

Misunderstood might be the key term, because where something is disliked but well understood then it is no bargain. Indeed there are resource companies whose shares have fallen 90% that are much *better* understood now than they were previously. Where things are both disliked and misunderstood there is great opportunity but the market only affords us this severe pessimism occasionally. Pockets of mining services today or in infrastructure five years ago, for example.

“IN THE UK, GBST HAD THE SUPER-CHARGED COMBINATION OF HIGH SWITCHING COSTS AND AN OVERWHELMING DRIVER FOR CHANGE”

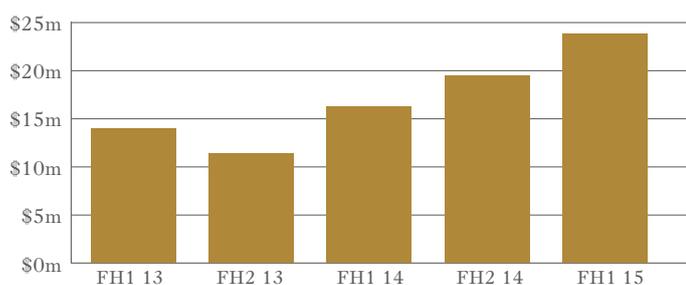
But when the sharemarket is high, like today, there aren't that many disliked things just lying around. So it's not easy to buy super cheap. To generate returns through a bull cycle, we need to identify things that aren't obviously cheap so much as misunderstood, their true value not apparent straight away. These opportunities occur in all markets rather than just depressed ones.

SOFTWARE SUPERB

Examples of these misunderstood opportunities can be found in GBST and Hansen, by far the best performers in the Australian Fund over the last year, where the value on offer was far greater than it appeared on the surface. In the case of GBST it was much greater than we originally understood also.

When we first came across GBST, a provider of software to the finance industry, it traded at 26 times statutory earnings and had a bit of a scruffy history. Its Australian operations were profitable and stable, but it had acquired an international capital markets business called Syn which was a disaster and was losing money. Offsetting this, the expansion of GBST's wealth management platform Composer into the UK looked to have some potential.

Chart 3: GBST International wealth management revenue



Source: GBST

We deduced that underlying profitability was being hidden by the loss making Syn, and by amortization charges being made in addition to heavy research and development expenses. Stripping those negative amounts out, and GBST traded around 6 times pre-tax earnings, a cheap price we thought for a business with fairly stable customers and revenue, certainly much cheaper than peers like **Iress** (IRE). Potentially the Australian business was also suffering from low trading volumes in capital markets which could recover, boosting earnings.

That analysis was fair enough, but the true value of the UK business wasn't completely apparent to us. It was set to be immense. Changes to regulations were forcing the retirement industry, which traditionally had offered annuity-type pension products, to offer a far greater range of investment options, more like the superannuation system in Australia. The incumbents of the UK retirement industry had legacy software platforms unable to offer multiple investment products and were compelled to upgrade.

Like Hansen does in billing and invoicing, GBST runs a business where customers encounter very high costs to switch providers. This means revenue is rather 'sticky' – when customers join they often stick around for decades. That permits healthy profit margins. In the UK, GBST had the super-charged combination of high switching costs and an *overwhelming driver for change*. That pointed to a dramatic and permanent expansion in activities and huge value creation. Customers were forced to upgrade to remain in business and each one who signed-up potentially generates revenue for 20 years.

Along with rival Bravura, GBST had stepped on the proverbial gold mine. You can see the results to date in Chart 3. That's growth every six months, not annualised, and will continue for years yet.

In early 2013, GBST was a bargain at twice the price. You had something like the opportunity that the market sees in front of accounting software provider **Xero** (XRO): enormous scale growth from which defensive revenues and high margins will flourish long-term. But unlike Xero, the market hadn't understood the opportunity well, and GBST didn't trade at 30 times revenue.

Value investors must always demand a discount to fair value, but it's important to be aware that for some businesses fair value can be a high multiple of today's earnings (conversely for others it can be a very low one). The business model of a software company is nothing at all like a supermarket or an asset intensive property trust where the capital gains on offer are either capped or incremental. Dramatic growth potential at high margin has a lot of value, as is becoming apparent. GBST shares finished the quarter 58% higher at \$5.98. Hansen shares were 27% higher at \$2.32.

The lesson is to watch closely and be alert for hidden earnings power. A business trading at 15 times earnings can offer as much value as another trading at half tangible assets. These misunderstood opportunities are out there today.

HUGHES MAKING THE HARD YARDS

Moving back to the 'disliked' part of our investing activities, mining service providers have been rudely dropped from most investor portfolios as gloom envelops commodity markets. To an extent the pessimism is justified, mining services companies tend to feature a nasty dual-combination of flakey business models and cyclical industry exposure. We've argued there's value in the sector but so far are poorer for the experience.

Good companies have an uncanny way of making hard yards through tough times however, setting themselves up for brighter results when conditions eventually turn. That seems to be the case with **Hughes Drilling** (HDX), which reported an impressive interim result against the general tide. The company provides – you guessed it – drilling services to the mining sector and reported a big jump in profit from its west coast operations. That led to overall underlying profit 38% higher than the six months prior.

“GOOD COMPANIES HAVE AN UNCANNY WAY OF MAKING HARD YARDS THROUGH TOUGH TIMES HOWEVER, SETTING THEMSELVES UP FOR BRIGHTER RESULTS WHEN CONDITIONS EVENTUALLY TURN”

Margins on the east coast, the historic profit engine of the business, remain suppressed due to the dire state of the coal market, but Hughes continues to gain new contracts nonetheless. It seems to be through the worst of it now. Utilisation should improve and full year profit is likely to be stronger than the first half.

Hughes shares can be purchased today at half book value, despite having rallied 52% to \$0.16 in the March quarter, which makes it interesting but far from the cheapest thing in the sector. In the table below we've lined Hughes up against equipment hire business **Emeco Holdings** (EHL). You can see that Emeco trades at a much bigger discount to its book value.

	Emeco	Hughes
Price / tangible book value	0.2 x	0.5 x
Return on equity	(6%)	19%
Debt / EBITDA	4.5 x	1.7 x

But you can also see why Hughes might be the better investment idea. Emeco is losing money and has too much debt, which puts shareholders in a precarious situation unless conditions improve quickly. If losses were to continue like this for another 3 years before heading back to a more 'normal' return on equity, investors today need to demand something like a 40% discount to book value to make a reasonable return, factoring nothing in for the cost of distress.

The market discount is bigger than that and Emeco may prove a decent investment for the brave. But Hughes, with a more workable debt load and an excellent return on equity, is plausibly worth twice book value if it can just maintain current revenue and margins.

It's likely to do better on both counts. The company is run by a passionate owner manager in Bob Hughes, who possesses a wealth of drilling experience and knows how to run a lean ship. Hughes also has its own in-house drill manufacturing capabilities through Reichdrill which is delivering new equipment cheaper and quicker than competitors can manage. That has afforded Hughes a big cost advantage in a price sensitive market.

Hughes sells for the princely sum of 3 times earnings (astute readers might have noticed the nice combination of a big discount to book value and high return on equity) and, as you'd expect for a company so cheap, it's not all roses and petals. The industry is volatile and the debt, though not as high as Emeco's, is higher than we would like. Hughes has only recently become public and is still a maturing business, the corporate team is slim and the business is basically being run in the Managing Director's head. There is plenty of key man risk and it's plausible the cost advantage is lost if competitors step-up their game.

But the cheap price compensates us well for these risks and Hughes is a very interesting investment proposition.

Mid-tier construction group **Watpac** (WTP) also has a mining services division, which, just like **Macmahon** (MAH), is watching revenue evaporate. **BC Iron** (BCI) recently announced the early termination of Watpac's services at the Nullagine Joint Venture mine in Western Australia's Pilbara region. That contract accounted for around \$100m per year in revenue and will be hard to replace.

There's still value in that mining segment however, and with a strong balance sheet and conditions improving in Watpac's east coast construction market, the company has plenty of flexibility as to how to manage these difficulties. On top of this management has begun to make noises about using its excess cash for capital management purposes (usually this means a share buyback or capital return).

Today's share price of \$0.80 doesn't reflect the value of the excess capital on top of the construction and mining segments, and we added a few more shares to our investment in the Australian Fund in March.

SERVICE STREAM'S ONE SOLID PERFORMANCE

Chairman Peter Dempsey announced 'another solid performance' from **Service Stream** (SSM), a significant Australian Fund investment.

In all the recent turmoil we must have missed the other 'solid' performances from this telecommunication services business over the past few years.

Nevertheless, the half year results were pleasing. The Fixed Communication segment, the cause of all yesterday's headaches, continues its regeneration, reporting a 29% growth in revenue and 23% higher earnings before interest, tax, depreciation and amortisation than six months ago.

The National Broadband Network rollout is yet to ramp-up in earnest. But it is already an important revenue contributor for Service Stream and can be a major source of value for the next 10 years, assuming the management team can avoid some of the execution disasters of the past.

While the first half results suggest that's looking more likely, the market hasn't changed its view. Service Stream shares finished the quarter 16% higher at \$0.22 but were basically unchanged after the results were announced.

The dividend was reinstated with a 0.5c interim payment. At a market capitalisation of \$80m, Service Stream trades at around 10 times earnings based on the half year results. That's on thin margins – the multiple of revenue is only 0.2 times – and we expect revenue can grow too. Debt is now under control and the associated risk has dropped a long way since we initially ventured in to this. Let's hope for more solid results to come.



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