30 June 2015

FORAGER

WARNING ON INTEREST RATES
Equities look attractive relative to current interest rates. What happens if interest rates rise?

GOOD NEWS DOWN UNDER
Company specific news helped the Australian Fund significantly outperform the market.

MINING SERVICES MELTDOWN
Despite losses, the sector provides opportunity aplenty as the mining meltdown evolves.

A LONG RIDE WITH HARLEY
Harley-Davidson is a wonderful business being battered by a strong US dollar.

# JUNE 2015
# QUARTERLY REPORT

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# MORE JITTERS PLEASE

It has been a good start to the year for Forager Funds. The risks inherent in today's extremely low interest rates are cause for concern, however there are pockets of extreme value on offer.

Dear Investor,

It's been an excellent start to the calendar year for the Forager Funds. As you'll read in the coming pages, we've received positive news in relation to a number of important investments. Being able to buy a stock for less than you think it is worth is important. Getting validation of your valuation (eventually) is more so and very welcome when it arrives.

### Performance

| | 1 Quarter | 1 Year | 3 Year (p.a.) | Since Inception (p.a.) |
|---|---|---|---|---|
| Australian Shares Fund | –1.73% | 12.31% | 21.86% | 12.61% |
| ASX All Ordinaries Accum | –6.25% | 5.67% | 14.47% | 7.32% |
| International Shares Fund | 5.18% | 14.06% | – | 21.01% |
| MSCI ACWI IMI | –0.07% | 23.79% | – | 24.61% |

Stock markets around the world have been jittery. It started in Australia, where the benchmark All Ordinaries index is now down 9% since the end of April. Then the Chinese market began its own meltdown, with the Shenzhen Composite index falling 21% since mid-June (although it is still up 125% in the past 12 months). And in the last week of the financial year, the Greek government's decision to abandon negotiations with its European counterparts and impose capital controls sent global markets into a tizz.

It's only a minor tizz, so far. Internationally, most markets remain expensive and compelling investing opportunities are few and far between.

Investing is never easy. It's easy to say you need to be greedy when others are fearful. It is difficult to do so when there are genuine and rational reasons for fear. Likewise we are told to be fearful when others are greedy. There are exceptions, such as the dot-com bubble of 15 years ago or the new one of today (see **page 13**), but rarely is there a flashing red light indicating when investors are being greedy. Take the current environment as a case in point.

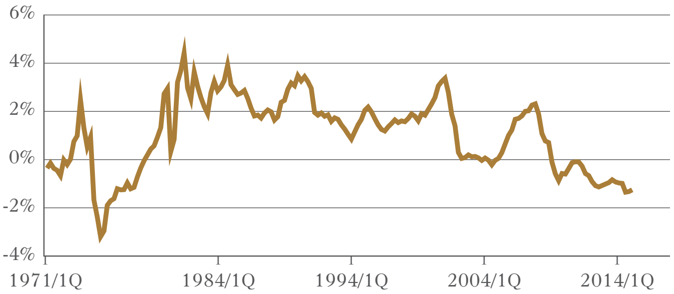
The **annual report** of the **Bank of International Settlements** (BIS) was released at the end of June. The bank's annual missive became famous after its pre financial crisis warnings about the stresses building up in the global financial system. This year's version begins with a summary of the current state of affairs:

*"Globally, interest rates have been extraordinarily low for an exceptionally long time, in nominal and inflation-adjusted terms, against any benchmark. Such low rates are the most remarkable symptom of a broader malaise in the global economy: the economic expansion is unbalanced, debt burdens and financial risks are still too high, productivity growth too low, and the room for manoeuvre in macroeconomic policy too limited. The unthinkable risks becoming routine and being perceived as the new normal."*

That's hardly a backdrop for a bout of irrational investor exuberance, is it?

Asset prices around the world are extremely high relative to historic norms. Across all asset classes and most parts of the world, the returns on offer are measly. But most investors buying these assets are not doing so with greed as their driving emotion, rather with a sense of reluctant resignation that they need to do something more with their cash.

### Chart 1: G3 Real Policy Rates




Source: BIS

Ten years into the future, we will all be experts on whether 2015 was the right time to be fearful or not. As we sit here today, it's not straight forward. Are asset prices dangerously high, or are they simply a reflection of the current interest rate environment?

## DANGEROUS ASSUMPTIONS

Perhaps both. There's no doubt you can make a logical, rational case for equities and property relative to today's interest rates. The dangerous part is the assumption that those interest rates will stay at current levels. What just a few years ago would have been "unthinkable" in the words of the BIS, has become a "routine" assumption. Their concerns are worth quoting in full:

*"For monetary policy, there is a need to fully appreciate the risks to financial and hence macroeconomic stability associated with current policies … a more balanced approach would mean attaching more weight than hitherto to the risks of normalising too late and too gradually. And, where easing is called for, the same should apply to the risks of easing too aggressively and persistently.*

*Given where we are, normalisation is bound to be bumpy. Risk-taking in financial markets has gone on for too long. And the illusion that markets will remain liquid under stress has been too pervasive. But the likelihood of turbulence will increase further if current extraordinary conditions are spun out. The*

> “MOST INVESTORS BUYING THESE ASSETS ARE NOT DOING SO WITH GREED AS THEIR DRIVING EMOTION, RATHER WITH A SENSE OF RELUCTANT RESIGNATION.”

*more one stretches an elastic band, the more violently it snaps back. Restoring more normal conditions will also be essential for facing the next recession, which will no doubt materialise at some point. Of what use is a gun with no bullets left?”*

I don’t like the BIS’s chances of influencing Federal Reserve Chairman Janet Yellen and her compatriots around the world. It is not human nature to trade a short term and known risk – derailing a fragile economic recovery – for a longer term and less identifiable risk – allowing financial imbalances to accrue. But the warnings are very pertinent for investors. Negative real interest rates are not normal nor sustainable. We need to plan our investments so that they deliver our objectives in a higher interest rate world, and tread very carefully in the meantime.

### POCKETS OF VALUE, ESPECIALLY AT HOME

Fortunately, there are a few pockets of extreme value keeping us busy. There are international opportunities in the oil services sector and in Japan (see **page 11**). And the whole Australian Fund is looking particularly prospective. When I look across that portfolio, I couldn’t give two hoots about global monetary policy or the direction of the domestic economy (see **page 7**).

For the most part, the best investment opportunities today are not high quality businesses. As much as we would love to own them, the best businesses on the ASX are particularly expensive at the moment and the consequences of owning expensive stocks are currently being felt by investors in darlings like **Seek** (ASX:SEK) and **Flight Centre** (ASX:FLT). Relatively minor disappointments sent those two companies’ share prices down 17% and 15% respectively during the quarter.

**Macmahon Holdings** (ASX:MAH), on the other hand, has done nothing but disappoint shareholders for the past three years. We initially bought it knowing it was a terrible business and that the external environment was going to deteriorate further. It has still managed to disappoint us (see **page 8**). Yet price compensates for a lot of ills. The announcement of a large contract loss in February pushed the share price down to 3.4 cents, at which point the market capitalisation was $40m.

During the June quarter Macmahon’s management announced they have sold some assets in Mongolia for US$63m and settled a law suit for $19m, bringing roughly A$100m cash into the coffers. We estimate it now has $40m of net cash, a business that should generate $30m of annual cashflow for shareholders and surplus equipment that could sell for $50m, even in today’s distressed environment. Yes, it remains a horrible business, but the share price was absurd. At today’s market capitalisation of $85m, it remains too cheap.

There are currently a significant number of similar opportunities listed on the ASX and we own 10 of them (see **page 9**). They are of varying quality and have varying degrees of exposure to the mining services space. The common factor is that they are cheap.

Hence we head into the new financial year with a sense of optimism about the prospective returns on offer.

### WHICH FUND IS THE BEST INVESTMENT?

Having expressed some excitement about the Australian opportunities currently on offer in a number of public forums recently, several investors have contacted me asking about the relative merits of the two portfolios. At this point in time, the value on offer should be fairly obvious from what I’ve written above. But I would caution against trying to time investments into a fund like it is a stock.

There are significant benefits to investing internationally, not the least of which are currency diversification, a wider opportunity set and returns that are less correlated with your Australian portfolio.

Perhaps more important, though, is that the evidence suggests none of us are particularly good at timing our investments. Fidelity apparently did an **analysis** of investor returns and found that the clients who had the best returns were the ones who had forgotten they had an account. Another key group of outperformers were the account holders who had died.

I’ve heard Kerr Neilson talk about something similar with Platinum’s investors; apparently their analysis suggested the average client’s return was almost 2% less than the overall fund return.

My advice is to focus on getting your broad asset allocation where you want it. Let us worry about finding the best opportunities in which to invest your money. Today they might be in Australia, tomorrow anywhere in the world.

Yours sincerely,

**STEVEN JOHNSON**
Chief Investment Officer

“NEGATIVE REAL INTEREST RATES ARE NOT NORMAL NOR SUSTAINABLE. WE NEED TO PLAN OUR INVESTMENTS SO THAT THEY DELIVER OUR OBJECTIVES IN A HIGHER INTEREST RATE WORLD, AND TREAD VERY CAREFULLY IN THE MEANTIME. ”

# 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 2015 |
| **Buy Price** | $1.5281 |
| **Redemption Price** | $1.5159 |
| **Mid Price** | $1.5220 |
| **Portfolio value** | $65.0m |

# AUSTRALIAN FUND PERFORMANCE

Good news from a number of stocks propelled the Australian Fund to an excellent year relative to the index. The portfolio is well placed for a better year ahead.

Negative returns are nothing to crow about, but the past three months represented a particularly good quarter for the Australian Shares Fund. Our unit price fell 1.7%, but that was in a market where the index fell 6.3%. Many portfolio companies saw their share prices fall as much or more than the market – which is to be expected. But company specific news from **Service Stream** (SSM), **Macmahon** (MAH) and **Infigen** (IFN) meant that strong gains in those three stocks almost offset the falls elsewhere.

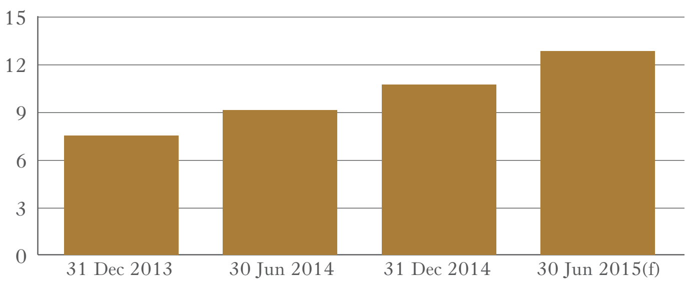
**Table 1: Summary of returns as at 30 June 2015**

| | Australian Fund | ASX All Ords Accum. Index |
|---|---|---|
| 1 month return | –2.34% | –5.40% |
| 3 month return | –1.73% | –6.25% |
| 6 month return | 7.54% | 3.32% |
| 1 year return | 12.31% | 5.67% |
| 2 year return (pa) | 14.99% | 11.50% |
| 3 year return (pa) | 21.86% | 14.47% |
| Since inception* (pa) | 12.61% | 7.32% |

*Inception 31 Oct 2009

It has been almost 18 months since we significantly increased the Fund's investment in Service Stream, participating in the company's capital raising in January last year. The share price hardly moved over the ensuing period, while the management team quietly went about increasing profitability and stabilising the company's revenue. Progress was obvious in the results for the year to 30 June 14 and the half year to 31 December 14, but investors took no notice.

**Chart 2: Service Stream's EBITDA**




Source: Service Stream

For whatever reason – perhaps the progress became too obvious to miss – that changed with a market update provided in May.

The company, which provides installation and maintenance services to telecommunications and utilities clients, now forecasts full year earnings before interest and tax of $23.5m for 2015. That should translate to profit after tax of $11m and represents healthy growth relative to recent periods (see chart). Our estimate of the current run rate is $14m of net profit next year without any significant growth. Relative to a $114m market capitalisation, that looks cheap despite the 37% price increase during the quarter.

### INFIGEN FINALLY STARTS TO BLOW WIND

Waiting a couple of years for something to happen with Service Stream is nothing compared to our investment in Infigen. The Fund has owned securities in this wind farm owner since 2010. It hasn't paid a dividend and the unit price has spent most of that time trading between $0.20 and $0.30, a meaningful drag on the average annual return.

That could be changing, thanks to a few events during the past six months. First, the Federal parliament has published an amendment to Australia's renewable energy policy, reducing the 2020 target for renewable energy from 43,000 Gwh to 33,000 Gwh.

**Chart 3: Infigen share price**


Source: S&P Capital IQ

Despite being a significant reduction, that's good news for Infigen as there was a risk that the target was abolished altogether. The new target still requires plenty of new windfarms in the next four years. Infigen has a large portfolio of approved but undeveloped projects which should now proceed (hopefully with someone else's money) and its existing assets can be re-contracted to utilities that need to increase their renewable energy purchases.

Second, late in June Infigen announced that it has sold its US Solar business for US$37m, plus up to US$30m more if certain post-sale targets are met. We hadn't attributed any value to this part of the business until they sold a couple of projects for US$15m during 2014, so it's an unexpected windfall. It also sits outside the assets over which the company's lenders have security, so shouldn't be confiscated by the banks.

There are a few more pieces of the puzzle that need to be put in place before Infigen's value will become obvious to the wider market. It currently has its US wind portfolio up for sale and a price in excess of US$350m is essential if Infigen is to refinance its debt. Even then, we anticipate a rights issue will be required,

“WAITING A COUPLE OF YEARS FOR SOMETHING TO HAPPEN WITH SERVICE STREAM IS NOTHING COMPARED TO OUR INVESTMENT IN INFIGEN.”

but that is all looking increasingly likely. If achieved, Infigen could be paying significant distributions by this time next year and will look appealing to yield-seeking investors prepared to pay us a much higher price. Its closing price was up 14% during the quarter.

### RARE VALUE IN MEDIOCRITY

The Australian Fund first ventured into mining services in 2013, and the results since have been poor. Shares in mining contractor Macmahon were selling for a third of our original purchase price by February. **Hughes Drilling** (HDX), which provides production drilling for coal-miners, saw its share price fall by nearly 70% after our first purchase. It has since doubled but, even after buying more shares at lower prices, we are still slightly under water.

With the exception of some healthy fully franked dividends from **Brierty** (BYL), there aren't any counterbalancing big winners in the sector as yet, either. We've asked ourselves whether continued investment is justified and have done a full review of our investments and the wider sector, including some miners. The answer is a resounding yes.

On average, mining is a tough business. In terms of the sheer extent of value destruction, the junior miners are the worst of the bunch. Management act like poker machine addicts—the next big jackpot is always just around the corner, so cash rarely stays in the bank for long and almost never gets paid out as dividends. It is mostly gambled on losing bets.

One percent of miners hit the jackpot, the rest run out of cash and return to shareholders for more money. We continue to keep an eye out for value, but other than BHP Billiton (BHP) spin-off **South32** (S32) at the larger end of the market, we haven't found much to invest in.

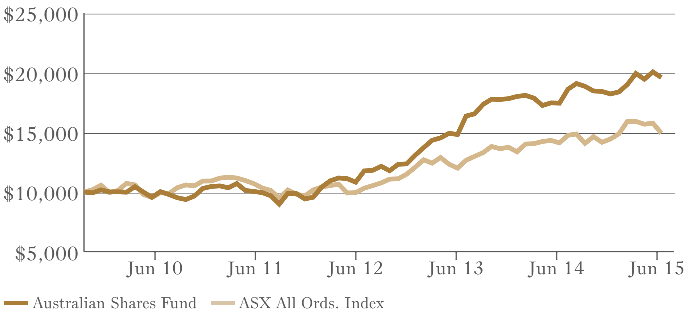
The service providers too are a mediocre bunch. In favourable circumstances they can mimic good companies, but when conditions deteriorate they are usually shown to be cyclical beasts. As investors in **United Group** (UGL) and **Forge Group** (FGE) would know, profit is often earned by taking on risks that aren't apparent until the company is battered by them.

Our experience to date, particularly with Macmahon, gives us further reason to be wary. The first purchase of shares in the company was two years ago, just prior to it reporting $1.3bn in revenue for the 2013 financial year. It was obviously going to shrink, but we had pencilled in $700m per annum as a sustainable amount of revenue. That number turned out to be wildly optimistic: for the coming 2016 financial year it could be less than $300m. The company has failed to renew every contract that has expired, hasn't been able to land one new win and had an important long-term contract with Fortescue cancelled.

But from our review we've concluded, despite the mediocrity, there's remarkable value in the service providers. A few of them are better quality then they look. But for the most part it's because, as the commodities boom has faltered, share prices have plummeted. These businesses are average, but not *this* average.

They are also less risky than they were two years ago. Having closely watched the sector for two years now, we are beginning to see the operating results of companies progressing through the difficult business conditions. The results aren't pretty, but they aren't catastrophic either, and our conviction is strengthening that the value here is real and hugely mispriced.

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




Source: S&P Capital IQ

Even our friends at Macmahon have managed to pull a rabbit out of the hat. Its Mongolian business – on care and maintenance since the Mongolian government stopped paying the bills in August last year – has been sold for net proceeds of US$63m, or approximately 6.5 cents per share (compare that with a pre-announcement share price of 4.6 cents). We need to make sure the rabbit doesn't run off into the bushes (the CFO seemed reluctant to discuss the best way of returning this cash to shareholders) but, now that it has more cash in the bank than debt outstanding, it is hard to see it ending in disaster.

The story is similar across the sector. At these prices, many service providers in the Australian Fund will likely produce more cash flow in a just a few years than their current enterprise value. Others trade at a fraction of their liquidating asset value. Some have both huge earning yields and sell at a discount to tangible assets, increasing the protection.

Having swept the sector, here's a summary of our best picks and the opportunity as we see it. Any one of these businesses could have a tough run, and it's highly likely one or two will. But together the combined earning power, cash generation and asset backing for each dollar invested is very impressive. It's as exciting a bucket of stocks as we've ever had in the portfolio.

# "THE COMPANY HAS FAILED TO RENEW EVERY CONTRACT THAT HAS EXPIRED, HASN'T BEEN ABLE TO LAND ONE NEW WIN AND HAD AN IMPORTANT LONG-TERM CONTRACT WITH FORTESCUE CANCELLED."

In his 2009 report to Berkshire Hathaway shareholders, Warren Buffett said: "Big opportunities come infrequently. When it rains gold, reach for a bucket, not a thimble". The Australian Fund has topped up in the best on offer, and our bucket is out and ready to collect.

Despite the drag from mining services, the past 12 months have been excellent for the Australian Shares Fund, with an investment returning 12.3% versus the 5.7% return from the index. Pregnant with opportunity at the moment, we are hopeful of even better to come.

| Company | Description | Opportunity |
|---|---|---|
| Hughes Drilling | Production drilling | Price / earnings < 5 x |
| Boom Logistics | Crane hire | Price / net tangible assets = 0.25 x |
| Logicamms | Engineering services | 45% cash backed, price / earnings = 6 x |
| Brierty | Civil and contract mining | Price / earnings < 5 x |
| Mining and Civil Australia | Civil and contract mining | EV / EBITDA = 1 x |
| Macmahon | Contract mining | EV / EBITDA = 1 x |
| Watpac | Construction, civil, mining | EV / EBITDA = 2 x |
| Coffey | Geosciences | EV / revenue = 0.2 x |
| MMA Offshore | Offshore oil and gas vessels | Price / net tangible assets = 0.24 x |
| South32 | Diversified miner | Price / net tangible assets = 0.6 x |

# 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 2015 |
| **Buy Price** | $1.5048 |
| **Redemption Price** | $1.4928 |
| **Mid Price** | $1.4988 |
| **Portfolio value** | $79.9m |

# INTERNATIONAL FUND PERFORMANCE

International stockmarkets have had another strong financial year, and the Fund is still sitting on more cash than is ideal. But some interesting new investments were added to the portfolio over the quarter.

Another financial year has passed and the talking points haven't changed. Everyone still grumbles about Greece. For what it's worth, we think the financial apocalypse risks are overblown but have zero direct and limited indirect exposure. Everyone is still talking about China coming unhinged (our concerns remain), but that's more directly impacting Australian miners than the wider world.

**Table 1: Summary of returns as at 30 June 2015**

| | International Shares Fund | MSCI ACWI IMI |
|---|---|---|
| 1 month return | –2.17% | –2.62% |
| 3 month return | 5.18% | –0.07% |
| 6 month return | 12.03% | 9.81% |
| 1 year return | 14.06% | 23.79% |
| 2 year return (p.a.) | 17.25% | 21.69% |
| Since inception* (p.a.) | 21.01% | 24.61% |

*Inception 8 Feb 2013

And despite the concerns, it's been another bonanza year for stocks. The global index rose 24% over the past 12 months—although more than half of that was due to the lower Australian dollar. Despite a much better second half, the International Fund sorely lagged the index, up only 14%. Our large cash balances and well documented missteps in oil services stocks are the explanations.

Bigger picture, we'd love for the jitters of recent weeks to take a more convincing grip. The likes of **Betfair** (LSE:BET) and **Madison Square Gardens** (Nasdaq:MSG) have been extremely profitable new ideas during the past year, showing that opportunities still exist and money can still be made. Right now we are finding prospective opportunities in Japan and have a couple of European small stocks that we are particularly excited about.

But we're still sitting on more cash than we'd like. New ideas came on over the year, but older ideas came off the other side of the conveyor belt, too. The cash balance was 26% at 30 June 2015, down from almost 40% a year prior. We want to get that cash invested, but aren't about to rush it in a market as optimistic as this one. Cross your fingers for widespread pessimism.

## JAPAN: LAND OF THE RISING SUN (AGAIN)

Japanese stocks have doubled over the past 30 months, as measured by the benchmark Nikkei 225 index. Bargains are harder to find, but the rally is justified.

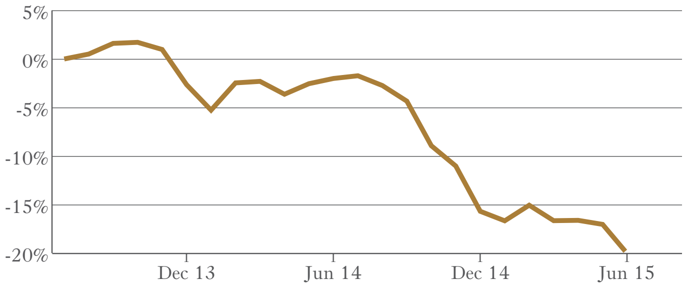
Firstly, stocks were very cheap at the start of that period (20+ year bear markets tend to do that). Secondly, the yen has fallen a long, long way. It took less than 80 yen to buy one US dollar as recently as late 2012. Today, that dollar costs 123 yen. Such depreciation does wonders for the competitiveness and profitability of Japanese exporters and those competing against imports.

There's a more speculative but potentially very impactful third force at work—cultural change. The generation-long bear market in Japanese equities and property, and the price deflation that went with it, had seeded a 'cash is king' mentality. According to the Financial Times, publically-traded companies are sitting on cash reserves approaching US$1 trillion. Although we've seen widely varying estimates, a quick flick through Japanese balance sheets makes it obvious that there's a lot. That unproductive cash weighs down returns on equity and, ultimately, stockmarket returns.

The old mentality is currently being pressured on all sides, including on high.

A new corporate governance code, pushed through by Prime Minister Shinzo Abe, encourages listed companies to have at least two independent directors and cut down on cross-shareholdings under a 'comply or explain' system.

**Chart 2: JPY depreciation**




Source: S&P Capital IQ

Pressure is also coming from foreign agitation, directly egged on by the Japanese government. In one of the more high profile cases, Daniel Loeb's Third Point bought a stake in formerly secretive industrial robots company FANUC. After initially resisting, the company doubled its dividend and took the oh-so-controversial step of opening an investor relations department.

And it's coming from everyday shareholders – the so called Mrs Watanabes of the world. Having shunned the stockmarket for decades, they're back in droves for the first real bull market in a long time, and increasingly supportive of change.

Independent directors, dividend increases, buybacks, even a few hostile takeovers—these were almost unheard of a few years ago and their emergence signals a significant shift in Japanese business mentality.

While the share prices of large companies have already increased substantially, there are opportunities at the smaller end of the market where stock prices don't yet fully reflect the positive impact of the changes taking place. Change comes very slowly in Japan, but once a trend takes hold – especially when led by the blue chip end of town – it is usually widely adopted. One example is **Toa Corporation** (TSE:6809).

“WE’RE STILL SITTING ON MORE CASH THAN WE’D LIKE. NEW IDEAS CAME ON OVER THE YEAR, BUT OLDER IDEAS CAME OFF THE OTHER SIDE OF THE CONVEYOR BELT TOO.”

Toa is a significant player in the market for pro audio and public address systems. Sound familiar? We know a bit about the sector because of the Fund’s holding in **B&C Speakers**, (BIT:BEC) although the two companies rarely compete head to head.

About 35% of sales come from a rapidly growing foreign segment benefitting from the weaker yen. The remainder are domestic—but given that much of its competition is foreign, the lower yen helps. The headline return on equity is uninspiring—around 8%—but is closer to 15% adjusting for the company’s substantial net cash balance. The Fund bought on a headline price earnings ratio of 14 times, but it’s more like 9 times adjusting for cash. It’s a good business for the price paid, and one that could benefit significantly from preparations for the 2020 Olympics in Tokyo. Most importantly, management have indicated they want to use the balance sheet more effectively and increase its return on equity.

The Fund has made a small investment in Toa and also has a small stake in **Meisei Industrial** (TSE:1976), a similar opportunity. We are optimistic we can add more.

## HOG HEAVEN

Before Occupy Wall Street appropriated the term to slag the ultra-rich, ‘the 1%’ was how outlaw motorcycle clubs members endearingly referred to their own kind. It is said that 99% of people are good, decent and law abiding. Outlaw gangs were proud to be the other 1%.

The Fund’s latest investment, **Harley-Davidson, Inc.** (NYSE: HOG), sells to them. More importantly, though, it also sells to that part of the 99% that want to associate with some of the same ideals—freedom, Americana and a little up yours to the rest of the world. It’s a much bigger market.

Established in 1903, Harley-Davidson is the biggest motorcycle manufacturer in the world. Selling more than 270,000 units annually, Harley generates 60% of its business in the US and the rest elsewhere. It owns a valuable second division that finances customer and dealer purchases, but almost 80% of profits come from the core division that manufactures and sells bikes. Harley-Davidson dominates the US motorcycle market with market share of more than 50%.

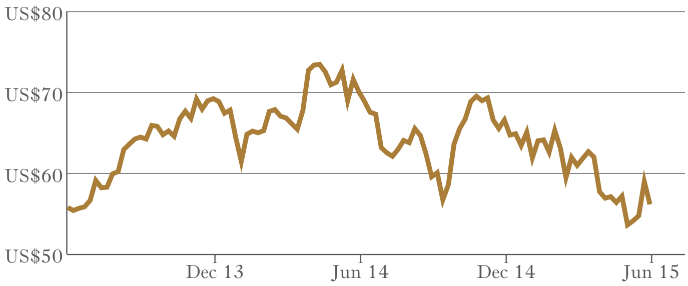
Harley is arguably the most American of brands. The first American to enter Germany after WWII rode in on a Harley—or so goes the popular myth. They have been immortalised in touchstone movies like *The Wild One* and *Easy Rider*.

Popularity amongst homecoming WWII soldiers was passed onto their Boomer offspring and, increasingly, to the next generation. Harleys are timeless. No one would blame a non-aficionado for confusing a 1950 Harley Sportster for today’s version.

This unique position gives Harley a true competitive advantage. Harley is not simply selling a motorbike—it is selling an image, a lifestyle and a sense of community among misfits. The company fosters this by sponsoring an official owners group with more than one million members, the Harley Owners Group (H.O.G., get it?). This group organises rides, rallies and other events that afford Harley owners the chance to interact, compare bikes and build relationships through this shared interest.

The company has capitalised on this brand by charging a premium for its bikes. Whereas most motorbike and car manufacturers would kill for a 10% operating profit margin, Harley makes 20%. It has not suffered a loss in the last twenty-five years, the entire record of its public filings. The motorcycle division has earned an average return on capital of greater than 33% since 2008. Harley-Davidson has been a tremendously profitable enterprise for decades.

**Harley-Davidson’s share price**




Source: S&P Capital IQ

Yet since the peak about a year ago, the stock has fallen by a quarter. The US dollar has appreciated against other currencies, particularly the Yen. This shift hurts. Harley’s main rivals are Japanese imports—Honda, Suzuki and Yamaha. With the Yen’s substantial decline, these companies have been able to reduce sticker prices for American buyers while maintaining Yen revenues.

While these tactics have an effect at the margin, we believe that market share shifts won’t be huge. Harley has faced all of these forces before and has proved remarkably resilient. For many Harley buyers, a cheaper Honda is as relevant as discounted chiffon when they’re looking for a leather jacket. We suspect the issues facing Harley will abate and that results will rebound.

At the time of our purchase, Harley’s stock was trading on a price earnings ratio of 15 times temporarily depressed earnings. It’s not the cheapest stock we’ve ever bought but this is a well above average business with limited downside. Management has proven adept at focusing the company on its most pressing challenges, and has an admirable track record of wise capital allocation decisions.

International sales have grown steadily over the last decade and should continue to expand in Asia and Latin America. A stronger housing market should also fuel a resurgence in US motorcycle demand, which is still well below the 2006 peak.

Longer term, the company has developed a prototype electric bike that has received very enthusiastic reviews. It has the expertise and resources to innovate when inspired. If a few of these triggers ignite, today’s price will end up looking cheap.

We are happy to have acquired a small position in such an appealing business and will settle in for the long ride.

"INDEPENDENT DIRECTORS, DIVIDEND INCREASES, BUYBACKS, EVEN A FEW HOSTILE TAKEOVERS—THESE WERE ALMOST UNHEARD OF A FEW YEARS AGO AND THEIR EMERGENCE SIGNALS A SIGNIFICANT SHIFT IN JAPANESE BUSINESS MENTALITY."

## WEWORK: THE UBER OF DUMB INVESTMENTS

At its peak, the tech bubble of 1998–2000 was indiscriminate. Everything got bid up to unjustifiable, genuinely insane prices. Some knew it with foresight, everyone worked it out with hindsight.

Whether the current excitement in tech-related stocks is a similar bubble is arguable. What is evident, though, is that the euphoria is more discerning. Technology incumbents like Microsoft and IBM have been largely ignored and may be cheap. While we no longer own Google (see **March 2015 letter**), we wouldn't call it particularly expensive. And while Facebook's price tag may look bubbly, it's an amazing business and may well grow fast enough to justify the current cost.

One pocket of the tech sector that is receiving a lot of attention is the 'sharing economy'.

You have an empty apartment available for the next month, somebody travelling to your city needs accommodation over the same period, Airbnb brings you together. You want to get from A to B, someone with a nice car is prepared to drive you at half the price of a taxi, Uber brings you together.

The sharing economy is creating amazing new industries made possible by technology. But not every sharing solution will be naturally monopolistic in nature. Referencing every upstart as the Uber of this or the Airbnb of that will lead to a lot of disappointment. Not every upstart will deserve a multi-billion dollar valuation.

A case in point—recently Fidelity and a few other investors pumped $400m into a private company called **WeWork Companies Inc., valuing the whole company at around US$10bn**.

WeWork has been described as the, wait for it, Uber of shared office space. It takes medium and long term leases on office space in places like Manhattan, fits them out and then rents them to individuals, small organisations and geographically mobile workers on shorter term leases.

The company and the financial press seem to think that what WeWork does is as revolutionary as what Uber has done to private transport. We have our doubts.

What Uber has done has been genuinely revolutionary, it has first mover advantage and the business has substantial network effects. It's a winner-take-most business. In those geographies where it's able to overcome its legal challenges (no small or certain task), Uber will likely dominate its business for a long time.

In contrast, the shared office sector has been around for decades. In the past, the Forager Australian Shares Fund has owned the global number two player, Australian-based **Servcorp** (ASX:SRV). And more recently we've done a lot of work on the industry's 800-pound gorilla, UK-listed **Regus plc** (LSE:RGU), although the Fund doesn't own the stock.

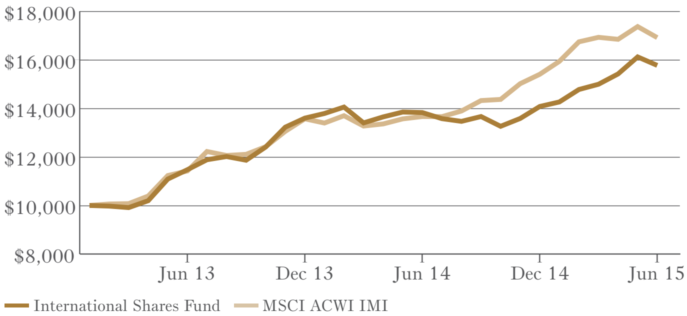
WeWork might bring some fresh ideas to the sector—it's probably better defined as a co-working space than a shared office space (the distinction relates mainly to the density of beards). They even offer free beer on tap. Base pricing seems reasonable, at least at first glance. Apps and online systems give tenants the opportunity to connect.

But there's plenty of competition, and not just the Servcorps of this world. This missive was written at Gareth's office in Vienna, a single-site co-working space owned by two brothers and a third friend. The beer costs €2 but the meeting rooms and ping pong are both free. Tenants can use the office social network to message anyone in the building, order lunch and find someone to play table tennis against. There are dozens of similar alternatives in this small city.

If WeWork decides to set up in Vienna, Forager is unlikely to even consider moving its European branch office—that need has already been met. That makes WeWork very different from Uber.

The main problem isn't the concept but the price—there's a lot of promise in a $10bn price tag. WeWork currently controls around 3.5m square feet (325,000 square metres) of office space in 43 individual locations, mainly major US downtown areas. That's a total area of about 1.55 times the size of the Empire State Building. Its $10bn valuation would buy three or four Empire State Buildings outright. And remember, it doesn't own the real estate.

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




Source: S&P Capital IQ

An even starker comparison is against the global leader in shared offices. WeWork's $10bn valuation buys 43 centres, around $232m per centre. Regus's £2.6bn (US$4.1bn) enterprise value buys 2,269 centres, or US$1.8m per centre. That's a valuation differential of 130 times.

The typical WeWork centre is different from the typical Regus office, generally bigger and certainly cooler. But if an apple is selling for 130 times the price of an orange, we're not buying apples.

WeWork could, possibly - just maybe - grow into its $10bn valuation. It would need to grow incredibly quickly for a very long time. It would need to manage that growth very, very well. It needs competitors to sit pat, unable to replicate. It needs landlords to not put the squeeze on rents. It needs tenants to really, really love the offering for the price paid. It needs no repeat of the financial crisis.

More likely, though, Fidelity's punt will prove the Uber of dumb investments.

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