30 September 2015

FORAGER

FOCUSING ON WHAT MATTERS Subtle change in the way we will report to investors	TOO LATE TO PANIC ABOUT CHINA At Forager, we have been preparing for a China crisis for a long time.	NEW INVESTMENT IN MINING The Australian Fund invested in an out-of-favour 'spin-off'	BUYING BACK INTO GOOGLE It has only been a few weeks but we feel better already

SEPTEMBER 2015 QUARTERLY REPORT

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FOCUSING ON THE THINGS THAT MATTER

Investors who have been with us a while are going to notice a subtle change in this quarterly report. There will be much less focus on performance.

Dear Investor,

Investors who have been with us a while are going to notice a subtle change in this quarterly report. There will be much less focus on performance.

In July we attended an investing conference where one of the speakers was a representative of the MIT Endowment Fund. While most of us were there to talk about stocks, he talked about his experience watching funds management businesses from the outside. With more than US$10bn to look after and a stated philosophy of selecting active managers to invest on the fund's behalf, he had seen his share of funds management businesses.

His speech highlighted the mistakes he had seen bring funds management businesses unstuck. One common shortcoming was a disconnect between the philosophy underlying the investment process and the communication between the fund manager and his or her investors.

Why, he asked, does a fund manager who professes to invest for the long term feel the need to explain every little rise or fall in the unit price? Why are the quarterly reports focused on which stock rose 5% and which fell 10% when the investments are supposed to be held for three to five years? And what impact does all of this short-term, performance focused reporting have on the manager's actual investing?

When I look at the format of our historical monthly and quarterly reports, we are guilty. Yes, we write plenty about long-term investing and the underlying thesis behind the investments we make on your behalf. But the first paragraph of every report we have ever written has focused on the performance over the previous month or quarter.

It is of no use to you. Apart from encouraging you to think about the wrong things, you can get the performance off the website any time you feel like it. And reporting short-term results potentially impacts our investing without us even knowing it.

So, as of this quarter, the regular quarterly reports will be about our investments, why they have been made and how they are progressing. Then, shortly following 30 June every year, we will send you an annual performance report that shows you what we have achieved over the long term and how we have done it. This performance reporting will be much more detailed than anything we have provided before, but it will only come once per year and will focus on the long-term results.

While recognising that this is going to be quite different from the industry standard, reporting consistent with our investing is the right approach for our business and Forager's investors.

TOO LATE TO PANIC ABOUT CHINA'S ECONOMY

China's economy had me puzzled back in 2011. My understanding was that the country's growth miracle was founded on exporting cheap goods and labour to the rest of the world. Presumably, that would make it highly dependent on global GDP growth.

Yet as the United States and Europe, combined some 50% of global GDP, were muddling their way through the worst recession since the 1930s, China was reporting economic growth well in excess of 10% per annum. How is it possible for an export-driven economy to grow at double digit rates when its main trading partners are shrinking?

As an Australian fund manager, I needed to answer that question. China's hectic growth was driving voracious demand for Australian resources. That, in turn, was propping up our economy and sending resources stocks to stratospheric heights.

My research uncovered all of the usual bull and bear arguments. The bulls argued that the transition of China's population from unproductive rural peasants to educated city-dwellers had many decades to run, and that China's GDP per head was still a small fraction of the US or Japan. The most common bear argument seemed to be that a communist government could never create a first-world economy.

None of this made much sense to me. If all you needed was hundreds of millions of rural workers and a large gap between your GDP and America's, then India and Indonesia should also be growing as fast as China. As for the Communist Party, they made a decent fist of it over the prior 30 years. In fact, the ability to build decent roads and airports seemed something of an advantage when compared with the dysfunctional political system in the US (or Australia, for that matter).

Then I stumbled across research by Michael Pettis, a professor at Peking University in Beijing. It was one of the more important finds of my investing career.

IT'S THE INVESTMENT, STUPID

First, Pettis outlined what was happening in China's economy. Net exports had indeed fallen, from 8% of GDP in 2008 to 4% of GDP in 2009; but even the 8% was much smaller than I had expected for an 'export-driven' economy. That went some way to explaining why the global recession was not pounding China. It turns out China's economy was (and is) an investment-driven economy, with half of its GDP comprised of spending on roads, buildings, airports and the like. The fall in net exports was more than offset by an increase in construction, fired by government stimulus and associated debt.

That gave me a much better understanding of China's growth model. What Pettis explained next, however, was the crucial part. He explained that there was nothing unique about China's 'miracle economy'. In fact, every other economy that had grown in a similar fashion had eventually come unstuck:

'In all previous cases of countries following similar growth models, the dangerous combination of repressed pricing signals, distorted investment incentives, and excessive reliance on accelerating investment to generate growth has always eventually pushed growth past the point where it is sustainable, leading always to capital misallocation and waste. At this point – which China may have reached a decade ago – debt begins to rise unsustainably.

> "STOCK PRICES DO NOT WAIT FOR CURRENT DATA, THEY MOVE AS SOON AS EXPECTATIONS CHANGE ABOUT THE FUTURE. YES, CHINA'S ECONOMY IS DETERIORATING, BUT I CAN ASSURE YOU TODAY'S BUYER OF RIO TINTO IS ALREADY AWARE OF THAT FACT."

China's problem now is that the authorities can continue to get rapid growth only at the expense of ever-riskier increases in debt. Eventually either they will choose sharply to curtail investment, or excessive debt will force them to do so. Either way we should expect many years of growth well below even the most pessimistic current forecasts. But not yet. High, investment-driven growth is likely to continue for at least another two years.'

You may have read or seen some of the exposés of China's ghost cities, but Pettis explained in 2011 why and how the entire economy's growth was unsustainable. We have been preparing for a China crisis for a long time.

IF YOU ARE GOING TO PANIC, PANIC EARLY

Today China's economic problems are on the front page of newspapers around the world. Every week we see a new factory output statistic or Purchasing Managers Index that tells us the slowdown might be more of the hard variety than the soft. That would not surprise me one iota. But today's investors face a dilemma.

Sure, you can sell your Rio Tinto shares because the China dream is over. But you will be selling them for $50 each, not the $85 they were changing hands for in 2011. You can sell your BHP Billiton shares, but you will be banking $24 a pop instead of the $45 you could have received four years ago.

The stock market looks through the front windscreen, not the rear. Stock prices do not wait for current data, they move as soon as expectations change about the future. Yes, China's economy is deteriorating, but I can assure you today's buyer of Rio Tinto is already aware of that fact.

Indeed, Forager has added its first ever mining stock to its portfolios in the past few months. BHP Billiton spinoff South 32 owns a world class collection of mining assets in alumina, manganese, coal, silver, nickel and lead.

It is among the world's most efficient producers in each commodity class, which means that a majority of competing mines will be bleeding red ink while South 32 remains profitable. The balance sheet is robust, and the early indications are that the managers are top notch (and have been buying shares with their own money).

Today's share price suggests the company is only worth half the replacement cost of its assets. We expect things to remain ugly for a few years yet, but I find it hard to envisage a world where these assets produce such lowly returns over the long term.

I remain bearish on China's prospects and their impact on the Australian economy. Domestic interest rates will fall further and could potentially wind up at zero. But it is too late to sell your mining stocks now. The time to panic was four years ago.

Yours sincerely,

STEVEN JOHNSON
Chief Investment Officer

“WHILE RECOGNISING THAT THIS IS GOING TO BE QUITE DIFFERENT FROM THE INDUSTRY STANDARD, REPORTING CONSISTENT WITH OUR INVESTING IS THE RIGHT APPROACH FOR OUR BUSINESS AND FORAGER’S INVESTORS.”

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 September 2015
Buy Price	$1.4148
Redemption Price	$1.4077
Mid Price	$1.4113
Portfolio value	$68.9m

RETURNS AND PROMISE FOR AUSTRALIAN FUND

The ASX All Ordinaries definitely has a case of the jitters, but for all the fuss finished the quarter only 6% lower, or about 15% below its April high. Volatility is a benefit for long-term investors.

Following several years of steadily rising markets, 2015 has seen a pronounced increase in share price volatility. In contrast with the typical up-and-down market, the share prices of Australia's larger companies have been bumpier than those of their smaller brethren. Even when we have seen attractive prices at the small end of the market, poor liquidity has prohibited us from making any meaningful investments.

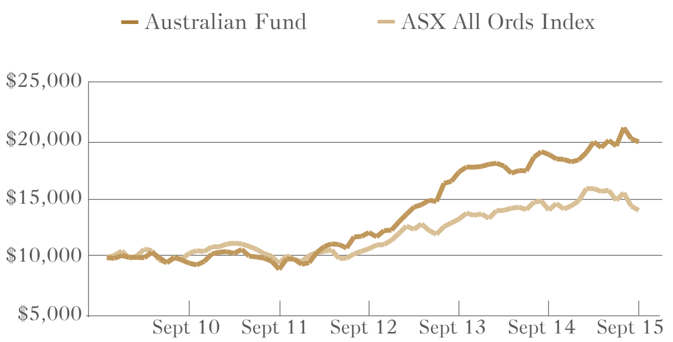
While we have one larger new idea (detailed below), we have spent most of the period digesting recent full-year results from our portfolio companies and assessing their progress against our investing theses. The news has not been as encouraging as in previous years, though we do have one standout performer.

Table 1: Summary of returns as at 30 Sept 2015

	Australian Fund	ASX All Ords Accum. Index
1 month return	–1.38%	–2.50%
3 month return	1.71%	–5.79%
6 month return	–0.05%	–11.68%
1 year return	5.67%	–0.16%
3 year return (pa)	17.92%	9.31%
5 year return (pa)	15.93%	6.28%
Since inception* (pa)	12.36%	5.93%

*Inception 31 Oct 2009

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



Inception 31 Oct 2009

SERVICE STREAM BACK ONLINE

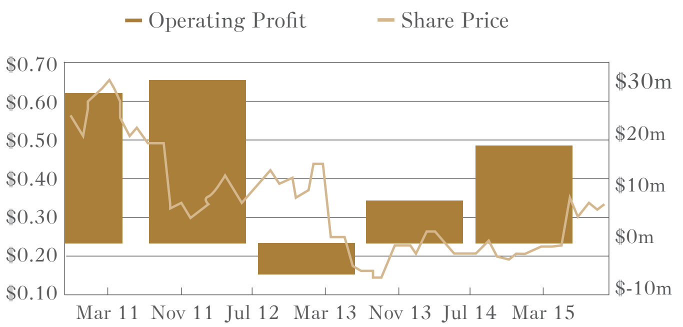
Service Stream (SSM), which provides blue-collar services to telecommunication companies and utilities, produced an excellent full-year result. It reported an operating profit before tax of $19m, more than double last year's effort and exceeding management's guidance.

Now the Australian Fund's second largest investment, the company has redeemed itself after a disastrous period in 2013 where it was forced to relinquish contracts with the National Broadband Network (NBN), wind up a joint-venture with Lend Lease (LLC), and suspend trading in its shares while it restructured debt.

With the debt now repaid, the company has a more promising future. If it can grow modestly while maintaining margins, full-year profit after tax this year could be around $16m, or 4.3 cents per share. Service Stream could easily be worth $0.50 per share, which is why we have not rushed to sell despite sitting on some nice profits from purchases at an average price of $0.19.

There is also the possibility it could do even better. Service Stream's Fixed Communications division, for several years the problem child, is performing well and should grow handsomely as the NBN rollout ramps up. In 2015, around 400,000 homes were connected to the NBN. But with some 10 million homes still to be connected, there is plenty of work for a decade to come.

Chart 2: Service Stream Share Price and Operating profit



Source: Capital IQ

The company has now run out of franking credits and will not be paying taxes any time soon due to its available tax losses. Not having to pay tax is great; and as we did with Watpac (WTP) in the same circumstance, we have indicated to Service Stream we would rather it not pay unfranked dividends for this period.

Shareholders pay full income tax on unfranked dividends, which spoils the whole benefit of the company's tax losses. A capital return or share buy-back would make much more sense. Ideally, common sense (rather than dividend fixation) prevails and the dividend is cut.

CONTRACTOR WOES

In the recent monthly report, we touched on the disappointing results from **Boom Logistics** (BOL), **Brierty** (BYL), **Coffey International** (COF) and **Hughes Drilling** (HDX). All reported higher than expected debt.

> "IN 2015, AROUND 400,000 HOMES WERE CONNECTED TO THE NBN. BUT WITH SOME 10 MILLION HOMES STILL TO BE CONNECTED, THERE IS PLENTY OF WORK FOR A DECADE TO COME."

Two of those companies, Brierty and Hughes Drilling, continued their inglorious runs in September. Unable to resolve a $9m dispute with Main Roads Western Australia, Brierty saw a decline in profit and tripped a bank covenant. That is a serious event, and the inability to resolve a claim with a major customer does not inspire confidence. This may prove to be just a hiccup for the civil contractor, but our suspicions are aroused that there may be deeper problems.

Hughes Drilling, which does exactly what its name suggests, found itself suspended from the ASX after failing to lodge its audited accounts on time.

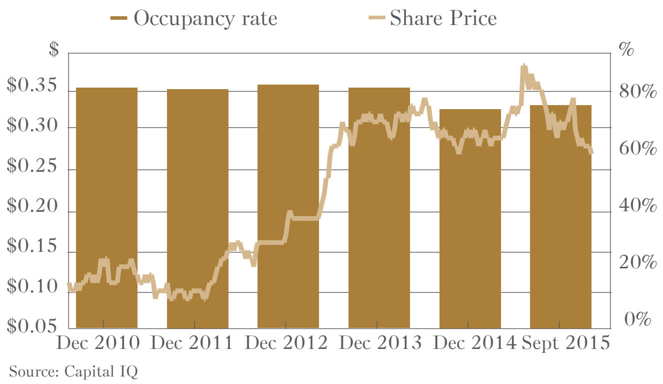
It is hard to know how to interpret this. Despite its impressive operational performance, the company has a management team as deep as Lake Eyre and could have simply missed the deadline. Or the delay could be due to issues the auditor might have raised.

We will not know until the accounts are published. These are unimpressive developments for both companies, but without a bit of trepidation their shares would not trade at such depressed prices. Time will tell whether we have assessed the value and risk correctly, but we are keeping the portfolio weightings small just in case.

STILL WAITING FOR RNY

The Australian Fund first purchased units of **RNY Property Trust** (RNY) in 2010. An owner of suburban office property near New York City, RNY had been decimated by the global financial crisis and ensuing recession. It was overleveraged and looked unlikely to be able to refinance large chunks of its expiring debt.

Chart 3: RNY Occupancy rate and Share Price



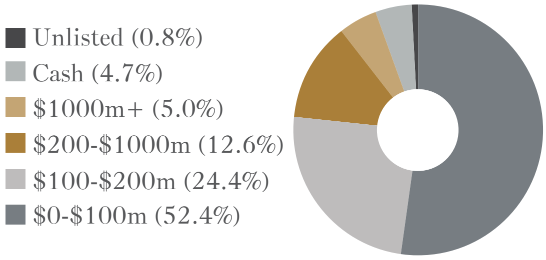
Source: Capital IQ

We reasoned that even if a few properties were repossessed by lenders, the other assets were worth far more than the unit price of $0.12. That has proved to be a good call, and the unit price has since more than doubled to $0.27. Net asset value per unit, aided by a stronger US dollar, has climbed from a low of $0.28 in 2011 to around $0.63 at today's exchange rate.

However, the process to value realisation has dragged out longer than we envisaged. Activity in the suburban office market remains anaemic with very few properties changing hands. Occupancy has declined from greater than 90% to less than 80% as management has struggled to retain tenants and replace those who leave.

This is partly because the economic recovery has been slow to spread to small and medium businesses. But there has also been a structural shift away from suburban office parks towards downtown office space close to public transport (living in New York City and "reverse commuting" to the suburbs has become increasingly popular).

Chart 4: Portfolio distribution according to market cap



That has meant the trust is not producing any cash flow and RNY investors are not being paid while we wait for value to be realised. So is it time to take our gains and move on? Or to press management to sell the properties and wind-up the trust?

We do not think so. For starters, at today's unit price there is a 130% return available for an investor who eventually manages to realise RNY's net asset value. Of course there are no guarantees the assets will actually be realised for net asset value, but that is a large and attractive gap. Secondly, to maximise the value these assets can be sold for, an orderly process is essential. If the properties are taken to market too quickly, with poor occupancy, too many upcoming lease expirations, or without clean financing, they will not attract a good sale price.

We will continue to wait. It requires patience, but that is what long-term investing is all about—delaying gratification today for better rewards tomorrow. In the meantime, management has plenty of work to do.

RNY is starved of the cash it needs to invest to attract tenants. A couple of assets could be sold in the next six months, and one tranche of debt expires in January. It is likely that more money can be borrowed through a refinancing of this facility, which will release cash the company can put to use.

There is no telling the exact finish date for realising our investment in RNY. Most of the remaining debt expires in 2017, so it is not likely to be earlier than that. But as we look ahead over the next six months, we are optimistic we will see the first signs of progress.

“WITH MINIMAL DEBT AND LOW-COST MINES, SOUTH32 IS WELL POSITIONED TO CUT COSTS AND WAIT THIS PERIOD OUT. MANY PEERS DO NOT HAVE THE SAME LUXURY.”

SOUTH32 SPINS OFF, SLIDES DOWN

One new addition to the portfolio we are excited about is **South32** (S32), formerly part of diversified miner **BHP Billiton** (BHP). The new spinoff owns a range of mines in the southern hemisphere including assets in Australia, South Africa and South America—hence the ‘South’ part of its name.

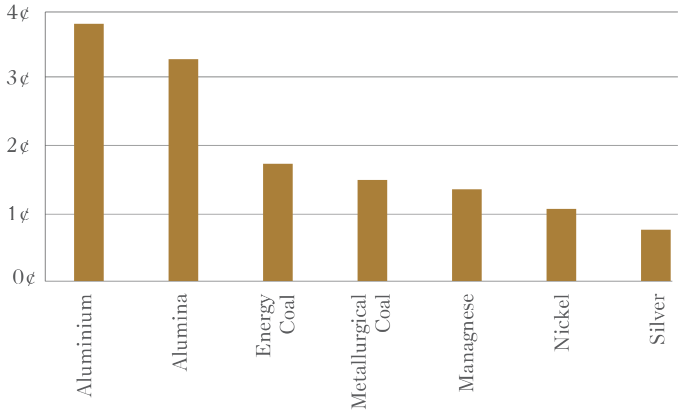
Most of the mines are high quality and low cost. But the commodities involved—aluminium, coal, nickel and manganese—are all in a deep slump, and South Africa and South America are not the easiest places to do business. Labour strikes and power outages are everyday operating risks.

Amid the ongoing rout in mining shares, the company’s stock price has slid 44% from $2.45 to $1.37. We sense opportunity.

The malaise in commodity prices is cushioned quite a bit by weaker local currencies in the regions in which South32 operates, lowering costs in US dollars. We do not expect a rebound in commodity prices any time soon, but with minimal debt and low-cost mines, South32 is well positioned to cut costs and wait this period out. Many peers do not have the same luxury.

Return on invested capital is currently a miserable 6.2%, but quality assets like these should earn better returns over the commodity cycle. We doubt all of South32’s depressed commodities will remain so forever, and South32’s shares are selling at just 52% of their US$2 tangible book value.

Chart 5: Impact of 10% change in commodity price to earnings per share



* = assume 30% tax rate and 1 AUD = 0.70 USD
Source: South 32, Forager

Speaking after the results were released, chief executive Graham Kerr was very upbeat on the potential for improved cost efficiency now that South32 had been cut loose from BHP. If other spinoffs are a guide, the savings will be significant. Management seems to have its head screwed on properly with respect to capital management (extraordinary for a miner); and with modest capital expenditure requirements, there is a chance it could do something clever such as a share buy-back.

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 Sept 2015
Buy Price	$1.4720
Redemption Price	$1.4647
Mid Price	$1.4683
Portfolio value	$84.4m

INTERNATIONAL FUND INVESTMENT REVIEW

This quarter was a tumultuous one for global stock markets, allowing the Fund to sell some fully priced investments and replace them with cheaper new ideas. Here's hoping for more pessimism.

Over the quarter the Forager International Shares Fund sold down or totally out of a handful of positions, including **Betfair Group plc** (LSE:BET) and **Deutsche Office** (DB:PMOX) highlighted here. Meanwhile, the team continued to turn over rock after rock in search of future opportunities.

When gloom prevailed from late August on, we pulled out our wish list and went shopping, adding UK-based jet engine manufacturer **Rolls Royce** (LSE:RR)—to be outlined in a future report—and giving **Google** (Nasdaq:GOOG) another go.

After details of **Volkswagen's** (XTRA:VOW3) ill-conceived attempt to defraud regulators and car owners emerged, we took a close look but decided to steer clear. We also identified a high quality but illiquid stock in Asia. If we can get a full position, we will tell you about it.

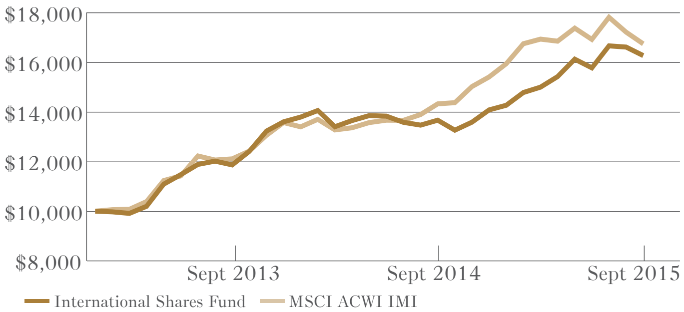
The Fund's cash weighting has fallen from 26% at the start of the quarter to 17% at the end. The hunt for bargains continues.

Table 1: Summary of returns as at 30 Sept 2015

	International Fund	MSCI ACWI IMI
1 month return	–2.07%	–2.73%
3 month return	3.13%	–1.05%
6 month return	8.47%	–1.12%
1 year return	19.04%	16.87%
2 year return (pa)	17.09%	17.58%
Since inception* (pa)	20.22%	21.53%

*Inception 8 Feb 2013

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



Inception 8 Feb 2013

BETFAIR CAMEO COMES TO AN END

Four wickets down for just 86 runs and facing a Pakistan bowling attack including Shoaib Akhtar, Wasim Akram and Waqar Younis, the defending champions were in serious trouble when Andrew Symonds walked to the crease in Australia's first game of the 2003 cricket World Cup.

Symonds, with a deserved reputation for wasting his prodigious talent, proceeded to belt 143 runs off just 125 balls. He saved the day, and the Australian team went on to win the third of its four consecutive titles.

As far as we know, Breon Corcoran cannot swing a cricket bat like that. But he has played a similar cameo as CEO of London-listed Betfair Group plc.

The Fund has owned the stock for little more than a year, and we only outlined the investment case nine months ago in the December 2014 Quarterly Report. At the time of first purchase, the Fund was entering a spot of bother itself. The oil price was tumbling, and the value of our investment in oil services stocks was tumbling with it. That trend has continued over the course of the past year, but Betfair, with some help along the way, has come to the rescue.

As Steve's introduction to this report explained, we resist letting short-term share price movements dictate our decision making. But it is clear that the value of our oil services companies is less than our original estimate. Conversely, the value identified in Betfair appears accurate and has since become more obvious and widely appreciated.

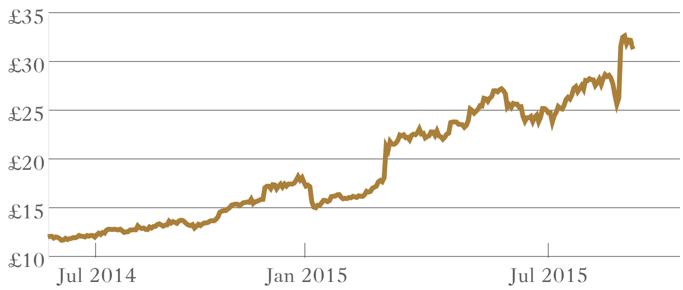
The company has grown revenue by 21%, clearly highlighting some of the latent earnings potential that was not being captured by previous management. That growth has been achieved without an increase in fixed overheads, confirming the scalability of the business model. And £200m of excess cash has been returned to shareholders, proving that the business is the cash machine we identified.

A highly successful year culminated with the announcement of a proposed merger with fellow gambling giant Paddy Power (ISE:PLSA).

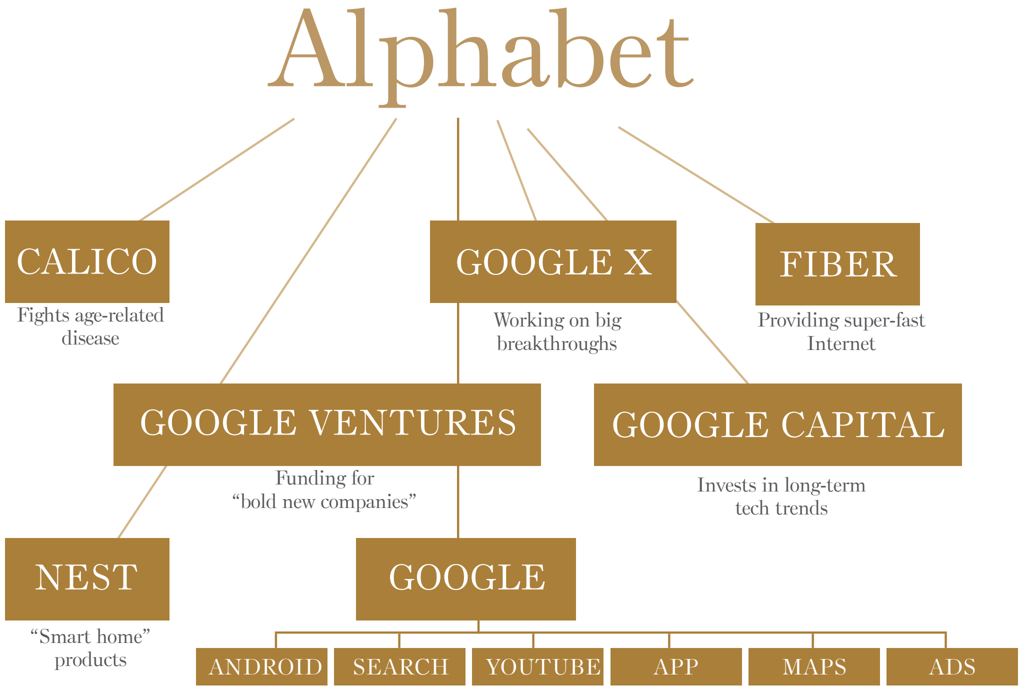
In the current world of frenzied deal making driven by fuzzy logic, this is one transaction that makes sense. Corcoran used to work for Paddy Power, and his family owns 3% of the company's shares. He knows the business well. Paddy Power's marketing prowess will feed Betfair's unique exchange model, and the combination should eliminate duplicate expenses.

In short, we could not be happier with how the company has progressed.

Chart 2: Betfair Group Share Price



Source: Capital IQ



Source: Alphabet

Just one problem—the share price has more than tripled since August last year. The price today implies an earnings multiple for the combined entity of roughly 35 times net income.

While Betfair is a high quality business, many of the risks that had investors concerned a year ago have not completely disappeared. In a world where governments are constantly looking to extract more money from gambling companies, Betfair still generates 20% of its revenue from markets where it does not have clear legislation or a licence to operate. And its nascent, loss-making operations in Italy are not showing the sort of progress we would like.

Reluctantly, we have decided to pull stumps on the remainder of the Fund's stake in Betfair. It has been an extraordinarily successful investment and one we will monitor closely in the future, but it is time to find a new Andrew Symonds for the Fund.

BUYING BACK IN TO GOOGLE SHARES

Selling **Google** (Nasdaq:GOOG) shares earlier this year was a heart-wrenching decision for the Forager investment team. Its core business is one of the world's best, and it is available at a very reasonable price. But how can you value a business where the CEO states he wants to use the profits to solve the world's problems?

When you make a big decision, you often know the next day if you made the right call. We sold our Google shares at the start of this year and have not felt comfortable with the decision since.

A month after we sold, the company hired a new CFO, Ruth Porat. Since joining the team, she seems to have made a clear impact on a number of the issues we lamented. She refocused the company's cost discipline, curtailing expense growth to more moderate levels. She also reined in capital expenditures—an area that had ballooned in recent periods. Most importantly, she changed the nature of the dialogue away from one obsessed with 'growth for growth's sake' to one about seeking attractive returns and shareholder consideration.

Given CEO Larry Page's public comments about his desire for Google to solve the world's problems, this shift felt to us like Porat was successfully championing a more pragmatic approach within the company. A recent reorganisation under the new name 'Alphabet' separates the core Google unit (including Search, YouTube and Android) from the company's more speculative endeavours. The two will operate and report separately, further suggesting that shareholders' interests are being valued in a manner previously unthinkable within the Googleplex.

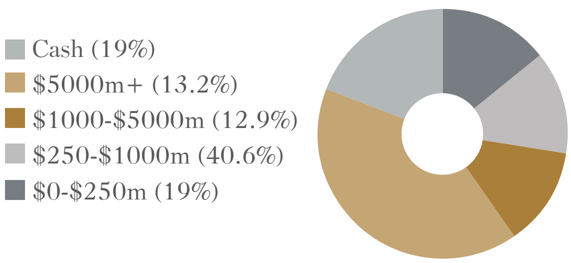
Why the change? It is hard to say, and perhaps it is only cosmetic. But one factor could be Google's highly talented employees. Page might be rich enough to ignore the Google share price, but the rest of his employees, for whom equity is a significant component of remuneration, do not have that luxury. If he wants to attract and retain the world's best and brightest, Page needs to start giving his share price some attention.

On the back of these developments and August's market whipsaw, we have opportunistically bought a little stock. We still have concerns. Ironically, this realignment could give Page even greater license to pursue ever loftier moonshots. And the issues with European (and now Indian) antitrust authorities are not going away any time soon.

But the global transition to online advertising is only getting started, and Google has a chokehold on the infrastructure that underpins the digital world. We love Google's position in mobile and believe that YouTube is in the early stages of dramatically growing its profitability.

It has only been a few weeks, but we are feeling better already.

Chart 2: Portfolio distribution according to market cap



DEUTSCHE OFFICE EXITS THE CONVEYOR BELT

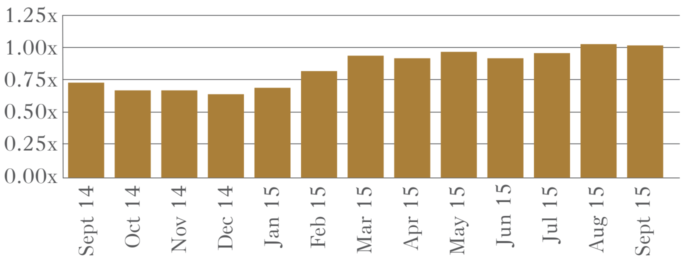
Investing is a game of probabilities, not absolutes. The most important job of an investor is to find mispriced bets to put on the conveyor belt. But you almost never know when, or indeed if, those bets will pay off until they do. Or don't. Fortunately, the Fund's investment in German commercial property owner Deutsche Office has gone largely to plan.

The case for Deutsche Office—then called Prime Office—was first outlined in the September 2013 Quarterly Report.

At the time, the group was still working through its post financial crisis hangover. It owned a mishmash of good and problematic properties with high vacancy rates and was going through a complex merger with a larger, unlisted property group. It did not pay dividends either. Conservative German yield investors said 'Nein Danke', leaving the Fund the opportunity to buy the stock at more than a 30% discount to the net asset value (NAV) of the properties it owned.

Those willing to untangle some complexity could see a path through all of these issues to a decent profit. The merger with German Acorn in early 2014 brought in a talented group of property managers who improved occupancy, cut costs and sold problematic properties at decent prices. The company refinanced expensive debt, lowering its interest costs.

Chart 4: Deutsche Office P/BV ratio



Source: S&P Capital IQ

Dividends started to flow, and German yield investors flocked back, willingly or forcefully compelled by Mario Draghi's quantitative easing program. Eventually the discount to NAV evaporated, and the stock began to trade at a small premium. Over the European summer, fellow commercial property owner **Alstria Office** (DB:AOX) announced an all-stock merger proposal and got the green light from Deutsche Office's controlling shareholder, Oaktree.

Over the past five months, the Fund sold down its stake and had completely exited by the end of the quarter. Most of this selling was done at very attractive prices after the Alstria bid was announced but before the late August market downturn. The total return on the Fund's investment eclipsed 50%, better again in Australian dollar terms. It is a great outcome from what ultimately proved a low-risk investment.

TRAFFIC CLEARING FOR KAPSCH

It's no Andrew Symonds, but small Austrian stock **Kapsch TrafficCom AG** (WBATG:KTCG) has been hitting some milestones.

It was only February when the Fund acquired shares in this global leader in the manufacture, installation and operation of electronic toll collection systems. With share price appreciation and a few additions, it has become one of our largest holdings.

The investment thesis was highlighted in the March 2015 Quarterly Report. To summarise, one of the company's two main divisions—Road Solution Projects (RSP), the one that focuses on building new toll systems—has been losing serious money in recent years.

Those losses overshadowed the other division—Services, Systems Extension and Component Sales (SEC)—which generates fat, reliable profits thanks to the truck-only tolling systems it gets paid to operate in Poland, Austria, Czech Republic and Belarus. The stock fell from more than €70 in 2011 to less than €20 in late 2014, and the market seemed to be thinking the problems in RSP were permanent.

We disagreed. Kapsch's problems were not only solvable, but they had already largely been fixed by management, headed by majority shareholder Georg Kapsch. These improvements merely had to find their way into the next few profit and loss statements.

Fast forward half a year to the company's first quarter results released in August. We rarely put reliance on any one quarter's profitability, but the company's cost cutting efforts are paying off. Losses have shrunk in the problematic RSP division while SEC continues to grow. Additionally, the company announced a number of important new contracts.

The first win includes a more than 25% increase in the size of the Belarussian network. Kapsch will install equipment and then collect additional, high-margin revenues on the operating contract, which runs until 2033. While doing business in Belarus entails risk, it is worth noting that Kapsch operates an important revenue generator for the government, maintains few assets in the country and is paid in Euros.

But this investment is not without risk. Truck tolling systems generate tremendous cash flow, but new contract wins are scarce and do not provide an obvious target for investment. Consequently, capital allocation remains a major question mark. Rather than pay out the fattest possible dividend, the controlling family has shown ambition to grow in other related areas.

Enter the budding third division: Intelligent Transport Solutions (ITS). ITS is a tech buzzword at the moment encompassing all sorts of technological systems for urban access, dynamic parking, low emission zones, and traffic management. Kapsch has made a few related acquisitions such as US-based traffic management software group Transdyn and the near bankrupt 'smart parking solutions' group Streetline.

Chart 5: Kapsch TrafficCom Share Price

Source: S&P Capital IQ

These acquisitions have not required major financial investments, but they have made us more cautious about the company's direction. To butcher Aesop's fable, we'd rather our investment case rest on the truck tolling bird in the hand than any potential birds in the ITS bush.

At the time of purchase, our downside analysis assumed Kapsch would continue losing quite a bit of money in ITS. The upside analysis was based on not losing so much. We spent no time trying to work out what it might look like if things actually went right. In that case the upside would take care of itself.

The second recent large contract win might cause a rethink. Kapsch announced that it has signed an agreement with the Dutch national road authority and will soon sign another with the English equivalent. The two countries, through a collaborative project called CHARM, are building an integrated traffic management system for their highways.

Kapsch will deliver and install its DYNAC software in traffic management centres in each country. The software helps authorities plan and optimise traffic flow. Importantly, this software was not even part of the Kapsch offering two years ago; DYNAC came with the Transdyn acquisition in early 2014.

The deal will generate about 45m of revenue during a two-year installation period, and a further €15m (cumulative) of maintenance support revenue over the next 10-13 years. Considering Kapsch generated €450m of revenue last year, this contract does not dramatically alter the company's revenue profile. But if the CHARM project foreshadows more ITS wins elsewhere, perhaps it is time to at least consider the upside.

Six months on, we are even more confident in our thesis, and the stock market is starting to take note. With a little luck, there will be more to come.

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