FORAGER

MARCH 2021 QUARTERLY REPORT

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Leverage and lessons in the stockmarket casino

FORAGER

CHIEF INVESTMENT OFFICER LETTER

QUARTERLY LETTER MARCH 2021

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FORAGER FUNDS PERFORMANCE SUMMARY (as at 31 March 2021)

	1 month return	3 month return	6 month return	1 year return	3 year return (p.a.)	5 year return (p.a.)	10 year return (p.a.)	Since inception* (p.a.)
Forager Australian Shares Fund	1.21%	2.11%	29.05%	125.82%	3.33%	7.22%	12.22%	10.96%
Forager International Shares Fund	2.20%	11.16%	33.66%	86.88%	21.23%	18.87%	-	17.27%

Past performance is not indicative of future performance and the value of your investments can rise or fall.
Performance in FASF is calculated using Net Asset Value (NAV), not the market price.

*8 February 2013 for FISF and 30 October 2009 for FASF

The March quarter of 2021 was a fitting end to a crazy 12 months.

Archegos Capital, a hedge fund managing the family money for Tiger Cub Bill Hwang, blew up. Spectacularly. This fund, that few of us had heard of prior to its implosion, reputedly had $US10bn of assets and indirectly owned somewhere between US$50bn and US$100bn worth of stocks. That's the size of the South Australian economy.

Greensill Capital blew up too. This trade finance business—founded by Lex Greenhill from Bundaberg in Australia—was a rapidly-growing trade finance business with tens of billions of dollars of loans outstanding. Trade finance companies typically lend against secure inventory in transit and money due from highly-rated corporates. Greensill was apparently lending against hypothetical receivables that might be generated in future. It is now in insolvency and is going to be a lot messier to unwind than a hedge fund.

And retail stockbroker Robinhood had a liquidity moment of its own. A $3bn capital call from its clearing house caused the broker to restrict trading in popular "meme" stocks like **Gamestop** and **AMC**. Its shareholders stumped up the cash, fortunately. You probably don't think about it much—your share purchases and sales settle without a second thought—but the consequences of a broker failing to pay you for shares you think you have sold are ugly.

A LEVERAGED CASINO

There's a common thread in all of these events. Leverage.

Every Robinhood client is given a margin account if they sign up to a premium tier. From the Robinhood website:

"When you sign up for Robinhood Gold, you'll be able to receive extra buying power when you enable borrowing. This buying power represents the cash you have already available to spend, plus the amount you may borrow on margin."

Margin lending is the type of leverage that has been bringing retail investors unstuck for decades. The gamification of investing has allowed punters access to options, contracts for difference and a myriad of other ways of betting significantly more money than they have.

That no one knows exactly how much Archegos owed tells you something too—the investments were held via total return swaps with investment banks that allow hedge funds to skirt disclosure rules. The leverage implied in these total return swaps is apparently between four and ten times the amount of equity the fund holds. One of Achegos's counterparties, Swiss investment bank Credit Suisse, has announced losses of US$4.7bn related to the implosion. (It also lost billions of its own and clients' money lending to Greensill).

None of this is new. But both the speed and magnitude of market moves have been highly amplified by new tools, online accessibility and social media.

As you will read in this month's International Fund report, our International Fund owned two stocks that more than tripled from their pre-COVID levels in little more than a year. We added a business in January, **Bed Bath and Beyond**, because we think it is cheap on the basis of a successful long-term turnaround. Its share price doubled and then halved within the first two weeks of the Fund owning it. That created the opportunity for profit, but it's not a sign of a healthy market being driven by fundamentals.

In the back half of 2020, this explosion in leverage and gamification of investment worked mostly to push share prices up. The first quarter of 2021 was an insight into how it works on the downside, too. I doubt we have seen the last of the blowups.

LESSONS FROM A DECADE OF GROWTH STOCK PERFORMANCE

I wrote in last month's International Fund report that Forager has been selling some wonderful business over the past few months. You will read this month that we have sold every share the International Fund owned of some companies that we think have very bright prospects.

That has been controversial for some of our clients. Never sell a great business is a lesson many have taken from the past decade of growth stock outperformance.

I argued last month that it's not the right lesson. What has worked is not necessarily what works.

Which doesn't mean there are not lessons. If holding great businesses forever is the wrong conclusion, hold for longer than you did seems irrefutably obvious given the value of some of these businesses today.

A REFRESHER ON BUSINESS VALUATION

The value of a share is the present value of all the future cashflows that it is going to pay you into perpetuity. We aim to buy those shares at discounts to fair value and sell them when they reach or exceed it, amplifying the returns that are generated by the underlying business.

With perfect foresight, the logic of this strategy would be irrefutable.

Of course, the future is unknowable and highly variable. In practise we make a best estimate of what those future cashflows are going to be and put a lot of work into understanding the range and magnitude of the uncertainties. Our estimation is going to be off the mark. The question is which way.

The main lesson of the past 10 years is that getting it wrong on the low side (being too conservative about the future of a business) can be as expensive as getting it wrong on the upside (being too optimistic). When someone says they sold a wonderful business way too early, what they actually mean is that they drastically underestimated its value.

So, with that all as a precursor, here are some of the shortcomings I have gleaned when it comes to erroneously concluding a stock is expensive.

REVERSION TO THE MEAN IS A THING. BUT IT DOESN'T NEED TO BE SOON

Jo Horgan, the founder of Australian makeup giant Mecca Brands, was quoted in the the *Australian Financial Review* last week saying: "With same-store sales (growth), we have an absolute goal as a business that we'll never get below 10 per cent" [my emphasis]. I admire Jo's optimism. And I'd love to own a share in her business (she says there are no plans to list on the stock exchange). In the long term, however, not only are we all dead but everything reverts to the mean. It's not possible for any business to grow faster than the global economy forever, otherwise a slice of the pie becomes bigger than the pie itself.

But forever can be a long time away. A common valuation mistake is to assume a good business stops growing rapidly far too soon. My valuation models often assume high growth for the immediately visible future, but a reversion to more subdued growth within the next five to ten years.

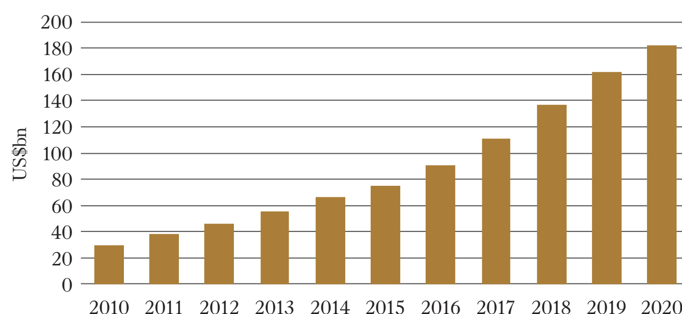
Google and **Facebook** are recent examples of businesses still growing 20% per annum as they head into their third decades of existence. Australian examples like **Cochlear** and **Resmed** have grown at more than 10% per annum for three decades. Sometimes the insight into a stock is not what's going to happen over the next five years. It's what is going to happen in the decades after that, when the power of compounding really kicks in.

GREAT PRODUCTS CREATE THEIR OWN DEMAND

Total addressable market is some jargon you will hear a lot when it comes to growth companies. Rather than making the common mistake of underestimating the growth runway, analysts jump straight to the endpoint. Back in 2010, the Google argument was something like this: Global advertising spend is roughly US$500bn. We expect it to grow 5% per annum over the next 10 years, making for a 2020 addressable market of US$800bn. Online should grow to 30% of the total and I think Google, being the great business it is, can be 30% of the online share. Adding all that up, in 2020 I think Google will be generating US$73bn of revenue.

That wouldn't have seemed a stupid guess in 2010. Alphabet's revenue was US$29bn in that year, making it already one of the world's largest advertising businesses. But it was wrong by a factor of more than two (parent company Alphabet's 2020 revenue was a whopping $182bn). Analysts weren't wrong about the shift to online. They just underestimated how much additional demand Google's products would create from customers that previously weren't spending a cent. Millions of small businesses that couldn't afford newspapers or radio now have a way of advertising to potential customers. Google has grown the market and pinched its competitors' revenue.

ANNUAL REVENUE OF ALPHABET FROM 2010 TO 2020



Source: Bloomberg

The lesson here is not to think of addressable market as something static. It, too, is a variable. And when you find a great company it invariably finds a way to grow demand for much longer than anticipated.

THE WORLD IS SMALLER THAN IT'S EVER BEEN

The concept of winner takes all is nothing new. It is simply economies of scale taken to their logical conclusion. Warren Buffett recognised in the 1960s and '70s that most US cities were going to end up with just one newspaper. The newspaper with the most readers generates the most advertising revenue which allows it to spend the most on creating content that attracts the most readers. Supermarkets (size makes for lower prices) and stock exchanges (liquidity) have long shown the same characteristics.

The difference in the 2020s is that the winners can be global. Melbourne had one great newspaper business, and so did every meaningful city in the world. Now there's Google, which dominates the Western world. Netflix is not just killing Australia's Nine, it's killing every free to air and cable channel in the world.

This is worth keeping in mind when contemplating the value of your business. Harrods and Selfridges were wonderful London-centric businesses. What if **Farfetch** is the Harrods of the world?

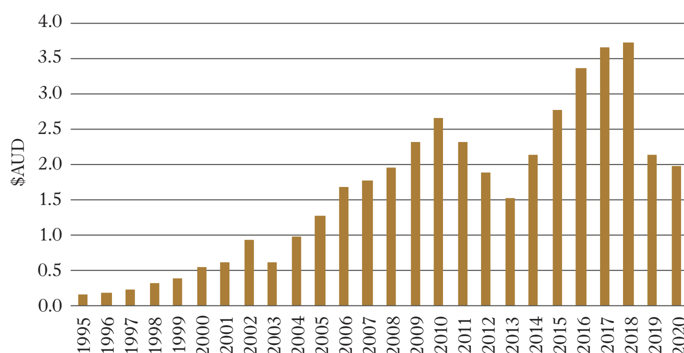
STANDARD HEURISTICS ARE FLAWED WHEN VALUING RAPIDLY GROWING COMPANIES

All of this plays into the most common mistake. "Rocket to the Moon trades at 40x earnings, therefore it is expensive". It's a lazy conclusion (I've been guilty). And it can be very wrong.

Twenty years ago someone (me?) looking at **Cochlear** could have reached that exact conclusion. It was trading on a price to earnings ratio of more than 30.

With the benefit of hindsight, you could have paid 150 times earnings and have still generated a 10% annual return (including dividends). All of these heuristics, or rules of thumb, have assumptions behind them that need to be probed. Under what scenario is 40 times earnings expensive? What would it take for 40 times earnings to be cheap?

COCHLEAR LIMITED BASIC EARNINGS PER SHARE



Source: Capital IQ

Conventional measures lose relevance in the context of long-term compounding math. When a company compounds earnings exponentially (15% per annum for the last 20 years in the case of Cochlear), the fair value can be a seemingly absurdly high multiple of early-year earnings.

CONSERVATISM STILL THE NAME OF THE GAME

Having said all of that, I'd still argue the wider trend at the moment is towards dramatic overvaluation of potential growth. The logic used above is being applied to a lot of businesses that don't deserve it. Very few of today's optimistically priced growth stocks will become the next Google or Cochlear. And, because so much of the anticipated value depends on what happens in 10 and 20 years' time, the consequences of overestimating long-term growth rates can be dramatic.

We need to be wary of selling just because a share price has risen. We need to put as much work into the decision to sell a great business as we did the decision to buy it.

But growth is just another variable. We're going to apply the same margin of safety we apply to all the other variables. And we're not going to let the exposure to any one business become an irresponsibly large part of either Forager portfolio.

As Scottish poet Robert Burns wrote in *To a Mouse*, "In proving foresight may be vain: The best laid schemes o' mice an' men, gang aft agley." Often go awry they do.

Kind regards,

Steven Johnson
Chief Investment Officer

FORAGER

INTERNATIONAL SHARES FUND

MONTHLY REPORT MARCH 2021 www.foragerfunds.com

FORAGER INTERNATIONAL SHARES FUND PERFORMANCE SUMMARY (as at 31 March 2021. Net of all fees and expenses)

	1 month return	3 month return	6 month return	1 year return	3 year return (p.a.)	5 year return (p.a.)	Since inception* (p.a.)
International Shares Fund	2.20%	11.16%	33.66%	86.88%	21.23%	18.87%	17.27%
MSCI AC World Net Index in $A	4.28%	6.52%	14.47%	26.63%	12.16%	13.43%	14.53%

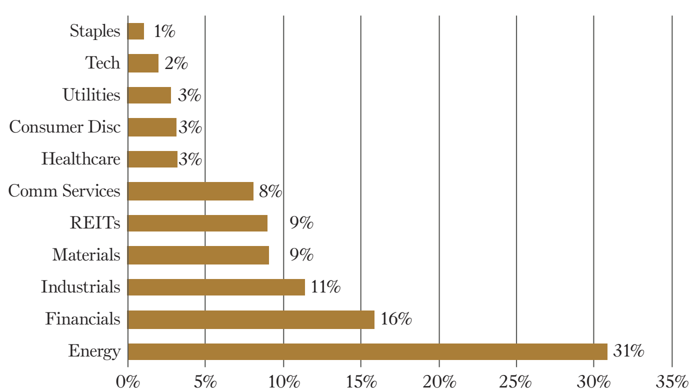
MSCI AC World Net Index in $A is an abbreviation of MSCI All Country World Investable Market Index (Net) in Australian dollars.
Past performance is not indicative of future performance and the value of your investments can rise or fall.

*8 February 2013

The world's stock markets continued their year-long recovery in the first quarter of 2021. For the three months, the MSCI ACWI IMI (AUD) added 6.5%, taking the 12-month return to 26.6% (March 2020 was close to the market bottom). That's despite the Australian dollar also rebounding rapidly and subtracting some 18% from returns in Australian dollars.

While the initial market bounce was driven by COVID beneficiaries and tech stocks, recently the recovery has been more widespread. In the March quarter, oil stocks, travel stocks and other 2020-laggards picked up the baton.

1Q21 SECTOR PERFORMANCE (TOTAL RETURN %)



Source: Baird

This changing of the guard has made outperformance difficult for many of last year's best-performing fund managers. US broker Baird estimates that only 6.2% of global funds outperformed the market in 2020 *and* are outperforming so far this year.

The Forager International Shares Fund is in this small minority. The return for the March quarter was 11.2%, lifting the 12-month return to 86.9%. While we'd caution against focusing on any one quarter's returns, the positive performance so far this year is a sign that the portfolio still has plenty of exposure to stocks that were out of favour, at least until recently. Perhaps more importantly, several of last year's best performers have been sold in their entirety and replaced with new ideas.

A (HOPEFULLY) TEMPORARY FAREWELL TO SOME STAR PERFORMERS

Before those new ideas take the limelight, though, those exiting stage left deserve some recognition. To find one stock that more than doubles in price is usually a sign of a good year. The past 12 months have delivered more than a few of those, and several that have done a lot more than double. That's a reflection of the crazy market volatility of the past year, a dose of good luck and a lot of hard work looking for the next and most attractive idea.

Farfetch (NYSE:FTCH) was one of the strong performers we sold throughout the quarter. We were sorry to see it go. The original thesis was simple. We thought that Farfetch was going to be the dominant platform for the global luxury industry. A market capitalisation of roughly US$6bn did not seem adequate for such a platform. We started buying the stock in July 2020. It didn't take long for a couple of good results and a joint venture announcement to convince the rest of the market. After less than eight months we sold out of our Farfetch investment completely. At this point the business had a market capitalisation north of US$20bn. It's still a wonderful business, but it was priced as one too.

Since then, Farfetch has reported another quarter of great results. More than US$1bn of luxury goods were sold on its platform in the three months ended 31 December 2020. Revenue increased 38% and the business had its first quarter of positive adjusted earnings before interest, tax, depreciation and amortisation.

GAN Limited (NASDAQ:GAN) is a software systems provider for casinos and sportsbook operators in the US online gambling market. We started buying shares in this company before it even listed on the Nasdaq stock exchange (it was listed in the UK on the AIM), for a price equivalent to US$8.50. The Nasdaq listing was a raging success and GAN was the largest contributor to the Fund's 2020 financial year performance, despite the Fund owning shares for just a few months. While we were still excited about the prospects of this business, much of its rosy future was quickly reflected in the stock price. Recently, though, concerns about GAN's acquisition of Coolbet, changes in the business' strategy and increasingly promotional language from management led us to reassess our confidence. We sold our final parcel of shares this month at a price of US$25.41, making roughly 3x our investment in just over 12 months.

When it comes to the 2021 financial year performance, however, **Celsius** (NASDAQ:CELH) will take some catching. The energy drink company reported its results for the third quarter this month. Investors were a bit disappointed by revenue growth, both in the US and internationally. But the business is still growing like crazy and there is no evidence of a slowdown in demand for the company's products. The most recent Nielsen data shows sales of Celsius energy drinks up almost 100% on the prior year.

That's much better than our original expectation. But Celsius' market capitalisation was more than US$3.5bn when we sold our last share in March 2021, reflecting extreme optimism for a business that generated US$130.7m of revenue last year and was barely profitable. We sold a significant portion of our holding at almost 10x the price of the initial investment.

We also sold our stake in **Ulta Beauty** (NASDAQ:ULTA) this quarter. While the contribution of this stock is miniscule in comparison to those discussed above, a 37% share price increase in a 15-month holding period is not to be sneezed at. Especially for a bricks and mortar retailer that hasn't been able to trade for much of the year.

Similar to the above companies, we're still confident in Ulta's long-term business model. However, at current prices, a full recovery has definitely been priced in. Ulta will be a structural winner in the US beauty retail market. However, it remains to be seen how much consumer demand has permanently shifted online and at least some of Ulta's current competitive advantage lies in its physical stores.

Don't be surprised if you see any of these stocks reappear in the portfolio. With a few minor caveats, price is the main concern. Already all three have seen their share prices fall significantly from recent highs. That's especially true of Farfetch, where the stock has been caught up in the liquidation of family office come hedge fund Archegos, and is trading much closer to fair value again.

The new portfolio additions have also been at the smaller end of the market. As at 31 March, 22% of the portfolio was invested in stocks that the Fund did not own at the start of 2021. While we're not disclosing names just yet (for this reason there is no table of top holdings in this report), we are still finding plenty of growing, underappreciated companies trading at attractive prices.

HASN'T ALL BEEN CRAZY

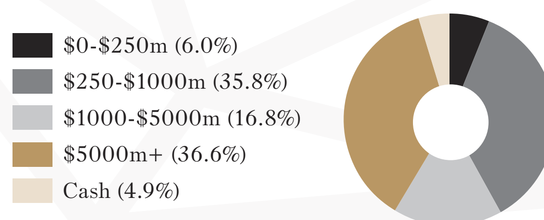
Thankfully, for our stress levels at least, there are plenty of longer-hold holdings producing sound results and more modest share price rises. **Zebra Technologies** (NASDAQ:ZBRA) posted a strong final quarter and a resilient 2020 full-year result, with the stock hitting an all time high on the back of strong earnings and great outlook commentary. Warehouse automation continues to be a strong growth driver for the company and it continues to significantly outspend its competitors on research and development. Zebra has more than doubled its automation patent filings over the past 12 months.

As a reminder, the company is the market leader in mobile computing, specialty barcode printing, and data capture and scanning. You can see its products every time a scanner is used at BWS, JB Hi-Fi or Bunnings. The company's product portfolio continues to evolve rapidly as it defends its leading market share, while also broadening the addressable markets that the business can sell into.

APi Group (NYSE:APG) was also a strong performer in the quarter, with the share price almost doubling since we first invested in the company in the middle of 2020. Despite this, we continue to see the business as undervalued given its growth prospects and significant recurring revenues. December quarter results came in ahead of the market's expectations and management reiterated their targets for 2021 and beyond. These targets include continued margin expansion and strong cash generation. The management team is hosting their inaugural investor day on the 22nd of April. We expect to hear more details on opportunities to expand profitability and an update on their acquisition pipeline.

NZ-listed retailer **Hallenstein Glasson Holdings** (NZSE:HLG) grew sales by 14% to NZ$182.0m in the six months to 1 February 2021. A lot of that growth came from Glassons stores in Australia, with sales for the segment increasing by 27% in the period, despite disruption from COVID-related closures. This is one part of the business we're excited about. There should be further growth from here, with management indicating that there are a number of new Glassons stores under consideration in Australia. Another is digital sales, which now represent almost a quarter of HLG's revenue. Web statistics indicate that traffic coming from countries outside of Australia and New Zealand is making up an increasing proportion of that. The potential to generate significant online sales from countries like the United States looks realistic and is something we haven't attributed much value to, yet.

PORTFOLIO DISTRIBUTION ACCORDING TO MARKET CAPITALISATION



Canadian manufacturing company **Linamar** (TSX:LNR) has weathered the crisis admirably. This business, founded and still managed by the Hasenfratz family, has historically spent a good chunk of its prodigious cashflow diversifying away from automobile parts manufacturing. It now has sizeable businesses making agricultural equipment (combine harvesters and the like) and construction gear (scissor lifts and platforms under the Skyjack brand).

That didn't protect the business in 2020. Demand in all three end-markets was woeful, with COVID hitting both automobile demand and construction, and agriculture suffering from poor harvests in North America and Brazil.

Yet the results show why we like owner-led businesses. Linamar still managed a profit of C$315m for the year and generated cashflow of more than C$1bn. It continues to gain market share at the expense of competitors and is guiding to "strong double digit growth" in earnings for 2021. Despite a recent rally, the shares still look cheap. We're expecting this to be the year it fires on all three cylinders.

STOCK EXPOSURE BY GEOGRAPHY

FUND OBJECTIVE

The Fund is an international equities fund, targeting undervalued securities on the world's stock markets. The Fund's investment objective is to outperform the MSCI All Country World Investable Market Index (Net) in Australian Dollars (MSCI AC World Net Index in $A) over a rolling 5-year period. The Fund's goal is to produce superior long-term returns from a portfolio of 20–40 businesses, irrespective of short-term share price movements^.

FUND PERFORMANCE BY MONTH AND FINANCIAL YEAR

FY	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Total Return
2013								-0.26%	-0.62%	2.88%	8.74%	3.47%	**14.73%**
2014	3.61%	1.11%	-1.26%	4.59%	6.58%	2.82%	1.40%	1.92%	-4.64%	1.85%	1.46%	-0.16%	**20.54%**
2015	-1.81%	-0.82%	1.47%	-2.93%	2.43%	3.63%	1.33%	3.59%	1.47%	2.84%	4.54%	-2.17%	**14.06%**
2016	5.61%	-0.29%	-2.07%	2.55%	-3.19%	-2.74%	-5.08%	3.36%	0.09%	3.64%	5.84%	-6.36%	**0.44%**
2017	4.55%	3.84%	1.91%	0.52%	4.65%	5.55%	-0.63%	-0.13%	2.25%	4.97%	1.69%	-4.25%	**27.42%**
2018	-0.76%	-0.43%	3.99%	2.31%	1.62%	-2.76%	0.97%	-1.78%	-1.22%	4.64%	0.97%	1.21%	**8.81%**
2019	-0.55%	1.50%	2.22%	-6.62%	-5.49%	-3.66%	5.11%	5.19%	-4.03%	4.79%	-2.68%	1.85%	**-3.31%**
2020	0.07%	-1.92%	3.09%	0.95%	4.83%	4.73%	3.62%	-6.03%	-15.53%	9.78%	12.60%	-0.22%	**13.74%**
2021	1.36%	10.05%	1.63%	2.36%	10.85%	5.98%	2.07%	6.56%	2.20%				**51.51%**

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FACTS

Fund inception	8 February 2013
Minimum investment	$20,000
Monthly investment	Min. $200/mth
Distribution	Annual, 30 June
Applications/Redemption	Weekly

UNIT PRICE SUMMARY

As at	31 March 2021
Buy Price	$2.1172
Redemption Price	$2.1087
Mid Price	$2.1129
Portfolio Value	$235.7m

The Fund is forward-priced; you will receive the price struck subsequent to the receipt of your application/redemption.

ABOUT FORAGER

With approximately $400 million of funds under management and a focus on long-term investing, Forager Funds is a unique Australian asset management company.

Following a strong ten-year track record, Forager is a sustainable business but is nimble enough to invest in smaller listed companies not accessible to many investment managers.

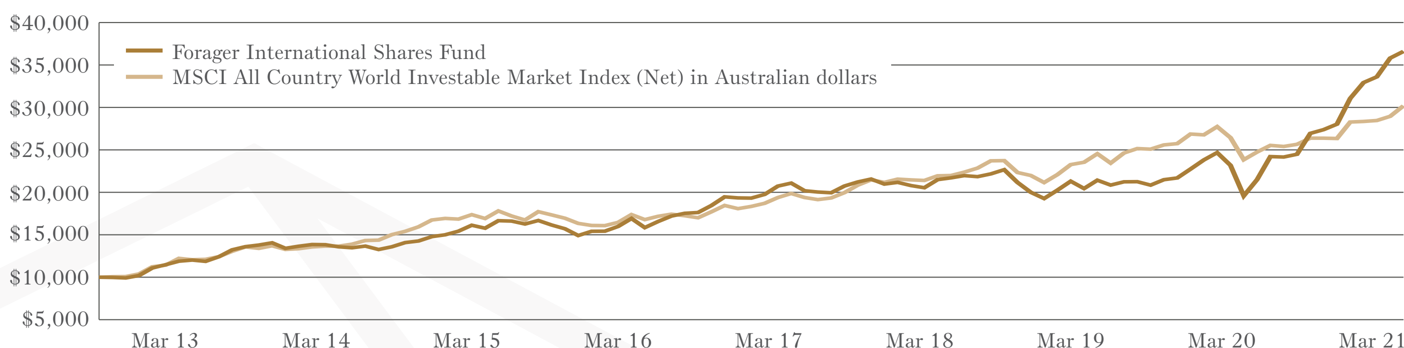
The company is majority owned by staff. Forager's shareholders support the desire to place performance before revenue. That means capping the size of funds before too much money becomes an impediment to performance.

Key investment staff are strongly aligned with investors through co-investment and / or equity in the Forager business.

FUND CHARACTERISTICS

- Concentrated portfolio of global equities
- A combination of large liquid resilient businesses
- With smaller value based opportunities
- Flexible mandate allows for a wide range of markets
- Investment team with deep pockets of expertise
- Strong focus on managing portfolio risks
- Weekly applications and redemptions

COMPARISON OF $10,000 INVESTMENT OVER TIME



Source (MSCI AC World Net Index in $A): S&P Capital IQ. The above figures assume that all distributions have been reinvested. Past performance is not indicative of future performance.

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AUSTRALIAN SHARES FUND

MONTHLY REPORT MARCH 2021

www.foragerfunds.com

FORAGER AUSTRALIAN SHARES FUND PERFORMANCE SUMMARY (as at 31 March 2021. Net of all fees and expenses)								
	1 month return	3 month return	6 month return	1 year return	3 year return (p.a.)	5 year return (p.a.)	10 year return (p.a.)	Since inception* (p.a.)
Australian Shares Fund (ASX:FOR)	1.21%	2.11%	29.05%	125.82%	3.33%	7.22%	12.22%	10.96%
All Ordinaries Accumulation Index	1.84%	3.61%	18.56%	41.14%	10.09%	10.57%	7.97%	8.04%

The value of your investments can rise or fall. Performance is calculated using Net Asset Value (NAV), not the market price.
Past performance is not indicative of future performance.

*30 October 2009

During March the Fund rose 1% bringing the quarter's performance to 2%, shy of the All Ordinaries Accumulation Index's 4% return. This time last year, we encouraged you to ignore the dramatic drawdown in prices during the March 2020, as it was driven by large share price movements on tiny volumes in a highly dysfunctional market.

Likewise, we believe you should largely ignore the 125% return showing as the Fund's one year number in this monthly report. Those dysfunctional markets are the starting point 12 months ago, and we don't think they were at all reflective of the underlying portfolio.

Still, the underlying companies were making good progress prior to that March meltdown and the good news continued throughout 2020 and further into the March quarter of this year.

After the frenzy of February reporting season, March is usually a quiet period. That was not so this year. A takeover was announced for one of the Fund's largest investments, another significant holding clocked a record quarter of new sales and a smaller one stitched up a transformational deal.

FINALLY IN THE MAINSTREAM

At the last quarterly report, having just received a bid for **WPP AUNZ** (WPP), we discussed other Fund investments that may draw the attention of acquirers. Fund administrator **Mainstream** (MAI) was one we described as 'more valuable in the hands of an acquirer'.

And so it was that Mainstream received a takeover bid from global administration group Vistra in early March. We'd like to think that a little prodding from Forager helped set the business on the current path.

In early 2020, before COVID-19 sent investors back to school for their virology degrees, the Forager team sat down with the board of Mainstream. The Fund had been a long term supporter of the company, holding the shares since listing in late 2015. And we continued to see that the business's value was not being appreciated by the stock market.

The title of the presentation that day was "opportunity to deliver significant shareholder wealth". A clearer strategy, clearly communicated, would draw the attention of stock market investors. And a higher share price would force potential acquirers to pay more when it finally came time to realise the full value of the business in a sale. Since then the Fund has seen the value of its investment in Mainstream more than double.

The Vistra bid came in at $1.20 per share, a skinny 12% premium to the pre-bid price. Not much of a premium in the usual scheme of takeovers. Not much at all when considering the highly recurring nature of Mainstream's revenue, strategically important domestic business and plenty of growth opportunities.

The bid featured a clause rarely used in takeovers. The 'go shop' clause allows a target more flexibility in seeking a higher bid from a different party. Mainstream had until midnight on 11 April to seek a higher bid from other parties under this clause. Global behemoth **SS&C** (NASDAQ:SSNC) came to the party with a $2 per share bid, a stunning 67% premium on the Vistra offer.

Mainstream's share price rise and subsequent bid is another case of value being unlocked among the Fund's investments.

A COVID-19 HIT TO AN ENTERPRISING SECTOR

Predicting COVID-19 effects was not an easy task. A home furnishings boom in the middle of a recession? Nope. A motorbike retailer more than doubling profits? Unlikely. Funeral homes seeing a terrible year? Surely not.

Everything is easy to rationalise after the event. But the way different sectors were impacted by COVID-19 was surprising.

One of those is the enterprise software sector. These companies sell software to other companies. Think accounting, customer relationship management and project planning software. Unlike software sold to individuals or small businesses, where the user

simply buys the product and starts using it, most enterprise software is heavily integrated into a company's operations and often customised for each client.

Forager has owned a few of these businesses over the years, including **Hansen** (HSN) and GBST. Once ingrained in a customer's operations, they are almost impossible to remove, making for sticky revenues and attractive long-term investments.

It wasn't any surprise, then, that they were viewed as something of a safe haven in the early months of the COVID-19 panic. In a world where some companies weren't generating any revenue at all, recurring reliable revenues from large corporates looked relatively attractive.

Yet look at the table below. On the ASX at least, many of these companies are today trading well below their pre- COVID-19 prices.

Name	Ticker	Mkt Cap (AUD m)	20 Feb 20 to 30 Mar 21
Bravura	BVS	665	-55%
Elmo	ELM	461	-37%
Gentrak	GTK	138	-36%
Appen	APX	2,250	-35%
LiveTiles	LVT	192	-33%
Iress	IRE	1,780	-30%
Altium	ALU	3,530	-27%
Infomedia	IFM	567	-25%
Integrated Research	IRI	389	-20%
Readytech	RDY	170	-15%
Bigtincan	BTH	382	-7%

It turns out that this prediction wasn't right either. Apparently, some of the revenue isn't as recurring or reliable as investors had come to believe.

Most enterprise software companies earn significant amounts of upfront implementation revenue. That depends on winning new clients. And some of the "recurring" revenue is related to clients requesting changes or introducing new features. With employees working from home and much bigger problems to deal with, most corporates have moved IT system upgrades down their lists of priorities.

The impact was widespread. **Bravura**'s (BVS) UK wealth management clients have hit pause on new deployments. Sales of **Integrated Research**'s (IRI) performance monitoring solutions have been slow. **Infomedia** (IFM) cited timing delays on new sales of car-servicing software.

The problems are real. The timing of a recovery is often uncertain. But as COVID-19 subsides deals will return, and investor optimism will likely come back alongside them.

There are a handful of enterprise software names amongst the Fund's investments: **Gentrack** (GTK), **Fineos** (FCL), **Readytech** (RDY) and the Fund's largest investment **RPMGlobal** (RUL). The pandemic influenced the businesses in different ways and they remain at different stages of recovery.

The recovery at utilities and airports software provider Gentrack took a big step backwards during the pandemic. The airport software segment continues to be a no-fly zone. But utilities revenue looks to be growing. A new management team is formulating a recovery strategy.

For insurance software provider Fineos, COVID-19 caused a slowdown in new contract signings as its large North American insurance clients had bigger things to worry about. And with fewer new wins came less implementation revenue than had been expected. Despite the disruption Fineos still grew revenue by 30% last half. After a lull the company signed up American Public Life in early April.

Over at education and payroll supplier Readytech, revenue growth did not skip a beat. With 90% of revenue being mission critical software purchased by subscription, total revenue excluding acquisitions grew 9% last half. The company seems confident of similar growth ahead. Management also took the opportunity to size up the business, entering the government software market by acquisition.

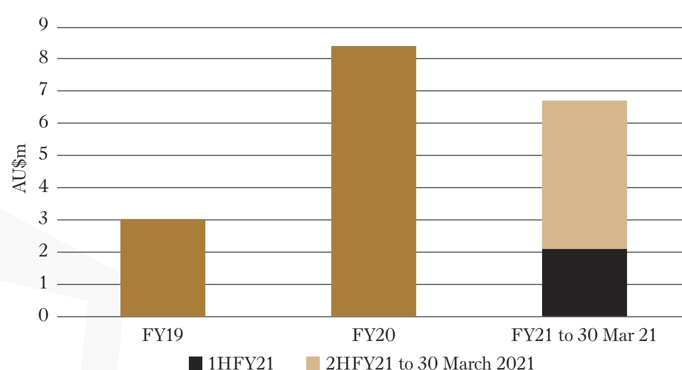
But it was the Fund's largest investment that is showing the brightest sparks of recovery.

STRIKING SOFTWARE GOLD

Management at mining software provider RPMGlobal highlighted the hit to new software sales in the company's annual report in August: *"We continue to see solid growth in the software sales pipeline however currently we are experiencing delays in finalising deals as miners reprioritise both their capital and operating expenditure in response to COVID-19."*

That lull at the end of last calendar year gave way to the company's biggest quarter of new software sales. Since December, RPM has added an annual $4.6m of high quality recurring revenue. That revenue will contractually last for three years, with some contracts dragging out to 5 years. The average miner will remain a client much longer than that. Some products are becoming industry standard, shutting the door on competition. With new software, mining clients flush with cash and motivated management, new contract wins are set to continue.

ADDITIONAL SUBSCRIPTION SOFTWARE ANNUAL RECURRING REVENUE



RPM, like Mainstream, is more valuable in the hands of an acquirer. CEO Richard Matthews has form running and selling software businesses: first Mincom and then eServeGlobal (which remains listed but sold a big division). The growing recurring revenue will be attractive to a range of large suitors. With a high corporate overhead, any sale will allow the acquirer to reduce costs dramatically. Owning $11m worth of RPMGlobal stock, all acquired on-market, Matthews has a big incentive to maximise value if any bidder shows interest.

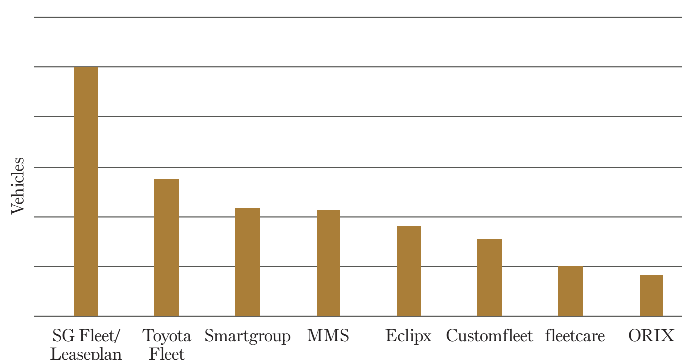
The whole enterprise software sector has been a recovery laggard. As RPM shows, however, share prices start to move when the deals start coming back. For all of these businesses, that is only a matter of time.

SG FLEET DOING THE TAKING OVER

SG Fleet (SGF), the fleet management and novated lease provider, struck a deal to buy the Australian and New Zealand assets of competitor Leaseplan for $387m. The case for consolidation among the fleet management and novated leasing players has been strong for years. Scale will bring more efficiency. It took time, but SG Fleet has finally managed to consummate a deal.

And what a deal it is. The combined group will be close to double the size of the next biggest Australian fleet manager and move into the top three in New Zealand. Recurring revenue will move to 70% of total, from 56% at the standalone SG Fleet. And it gives SG Fleet access to a flexible warehouse financing facility, something the company had identified as strategically important. Most importantly, the added scale brings synergies worth $20m a year, to be realised over the next two to three years. Earnings per share will rise by more than 20%, inclusive of synergies, following the merger. The Fund took up its entitlement in the capital raise to fund the deal and stands to buy more shares should retail shareholders not fully participate later this month.

AUSTRALIAN FLEET MANAGEMENT & LEASING



There is possibly one more major deal to be done before the ACCC starts to cast a disapproving gaze. With other dance partners either already engaged or staying firmly put, this leaves **McMillan Shakespeare** (MMS) and **Eclipx** (ECX) as the lone groovers. The Fund owns the latter and would welcome further consolidation.

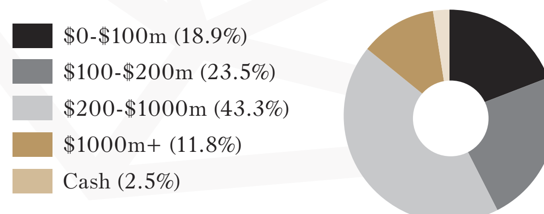
TOURISM SET TO TAKE FLIGHT

In the flurry of reporting season, tourism stocks were largely quiet. After all, there isn't much to report. For most players losses continued, though at a lower rate as domestic tourism returns. Cash cushions remain fluffy, able to absorb further travel disruption. And investors are in a holding pattern, eager to see Australia reopen to international tourists and looking forward to more normalised earnings starting to flow from the middle of next year.

The Fund's tourism investments are mostly in two businesses: skydive and Great Barrier Reef tour operator **Experience Co** (EXP) and campervan operator **Tourism Holdings** (NZX:THL).

Both have large operations in New Zealand and will benefit from the newly announced travel bubble with Australia. While New Zealanders are unlikely to help the domestic tourism industry too much, Australian made up 40% of New Zealand's international arrivals pre-COVID-19. While we don't stay as long and don't spend as much as some other travellers, the flood of travel-starved Australians across the ditch will be a boom to the New Zealand tourism industry. It's a first, and important, step towards the normalisation of global travel patterns and will be a good guide to how a global recovery unfolds in 2022.

PORTFOLIO DISTRIBUTION ACCORDING TO MARKET CAPITALISATION



TOP 5 HOLDINGS (as % of NAV)		
RPM Global Holdings Limited	**(ASX:RUL)**	8.9%
Mainstream Group Holdings Ltd	**(ASX:MAI)**	7.6%
Enero Group Limited	**(ASX:EGG)**	5.3%
Thorn Group Holdings Limited	**(ASX:TGA)**	4.9%
NZME Limited	**(ASX:NZM)**	4.0%
Cash		2.5%

FUND OBJECTIVE

The Fund targets securities that Forager believes are undervalued and invests predominately in securities listed on the ASX. Its investment objective is to outperform the All Ordinaries Accumulation Index over a rolling 5-year period and its goal is to produce superior long-term returns from a select number of underlying investments, irrespective of short-term price movements^.

FUND PERFORMANCE BY MONTH AND FINANCIAL YEAR

FY	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Total Return
2010					-0.69%	2.52%	-1.66%	0.08%	-0.34%	4.60%	-4.27%	-4.40%	**-4.41%**
2011	4.97%	-2.40%	-2.80%	-1.54%	3.12%	6.59%	1.58%	0.47%	-1.49%	3.40%	-5.39%	-0.82%	**5.12%**
2012	-1.00%	-2.61%	-7.20%	9.89%	-0.02%	-4.62%	1.53%	8.90%	5.02%	2.17%	-0.51%	-2.64%	**7.76%**
2013	8.70%	0.44%	2.83%	-3.07%	4.57%	0.33%	5.83%	4.86%	4.51%	1.41%	2.65%	-0.69%	**36.87%**
2014	10.45%	1.13%	4.77%	2.50%	-0.11%	0.38%	1.05%	0.48%	-1.28%	-3.44%	1.28%	-0.15%	**17.73%**
2015	6.70%	2.56%	-1.23%	-2.06%	-0.21%	-1.15%	0.94%	3.38%	4.87%	-2.42%	3.13%	-2.34%	**12.31%**
2016	7.94%	-4.46%	-1.38%	12.87%	-2.97%	0.22%	-1.33%	2.70%	4.40%	2.48%	1.51%	-3.91%	**18.06%**
2017	6.99%	3.25%	4.50%	-1.99%	-4.65%	1.76%	7.20%	1.29%	1.60%	1.16%	1.16%	1.00%	**25.16%**
2018	2.32%	-0.95%	2.69%	0.95%	0.21%	4.06%	-0.57%	-3.18%	-2.64%	2.77%	-0.97%	1.91%	**6.50%**
2019	-0.62%	-1.90%	-2.19%	-6.16%	-3.78%	-3.68%	0.98%	4.46%	-0.95%	-2.02%	-3.97%	-1.46%	**-19.66%**
2020	6.67%	-1.09%	4.38%	1.54%	-3.22%	-1.50%	2.46%	-10.97%	-39.71%	20.57%	18.04%	-2.16%	**-18.36%**
2021	3.70%	18.80%	2.00%	7.79%	13.22%	3.56%	-3.05%	4.07%	1.21%				**62.17%**

Past performance is not indicative of future performance and the value of your investments can rise or fall. Performance is calculated using Net Asset Value (NAV), not the market price.

FACTS

Fund inception	30 October 2009
ASX Code	FOR
Distribution	Annual, 30 June

UNIT PRICE SUMMARY

As at	31 March 2021
NAV	$1.68
Market Price	$1.48
Portfolio Value	$183.1m

ABOUT FORAGER

With approximately $400 million of funds under management and a focus on long-term investing, Forager Funds is a unique Australian asset management company.

Following a strong ten-year track record, Forager is a sustainable business but is nimble enough to invest in smaller listed companies not accessible to many investment managers.

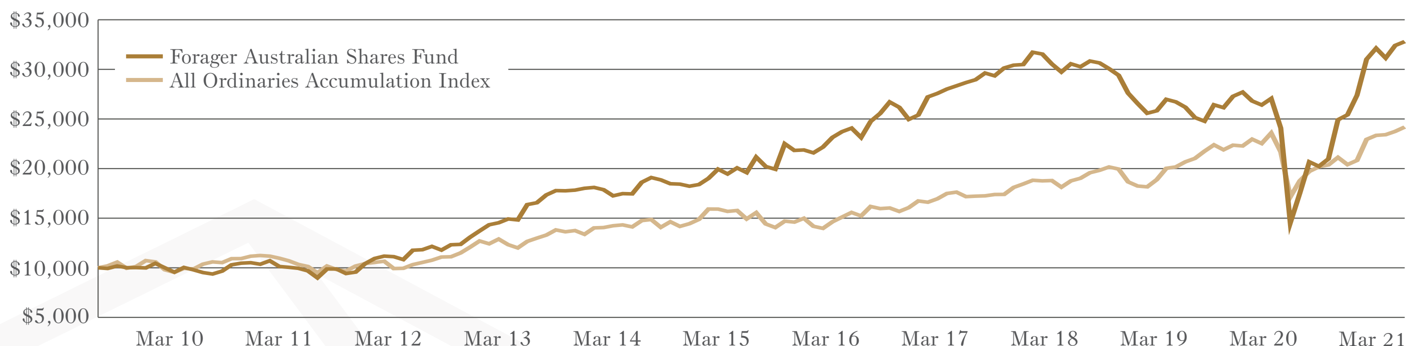
The company is majority owned by staff. Forager's shareholders support the desire to place performance before revenue. That means capping the size of funds before too much money becomes an impediment to performance.

Key investment staff are strongly aligned with investors through co-investment and / or equity in the Forager business.

FUND CHARACTERISTICS

- Concentrated portfolio of ASX-listed stocks
- Long track record in identifying unloved gems
- Restricted fund size allows investment in smaller businesses
- Strong focus on managing portfolio risks
- Listed on ASX as a Listed Investment Trust (LIT)
- Structure offers Forager flexibility in distressed markets

COMPARISON OF $10,000 INVESTMENT OVER TIME



Source (All Ords): S&P Capital IQ. The above figures assume that all distributions have been reinvested. Performance is calculated using Net Asset Value (NAV), not the market price. Past performance is not indicative of future performance.

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