DECEMBER 2018 QUARTERLY REPORT

GULF MARINE'S DEBT BURDEN

Any restructuring of the balance sheet is bad news for existing shareholders

LOTTO24 AND ZEAL MERGER

The combined entity will double Lotto's existing revenue while adding only marginally to administrative costs

ACTION NEEDED AT THORN GROUP

The equipment finance division should be sold while Radio Rentals might be worth more dead than alive

ON THE OIL ROLLERCOASTER

It has been a wild ride for the Fund's oil exposed investments

Tough times in 2018

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FROM BAD TO WORSE IN 2018

Equity markets ended 2018 on a sour note. For Forager, the whole year was mostly out of tune. While welcoming lower prices in general, there are lessons to be learned from the year.

I usually don't like focusing on weekly or monthly performance numbers. It doesn't do you or us any good. We save it for the performance report every July and give the numbers their due once a year. We invest for the long-term, short-term is almost always a distraction.

Right now, however, the numbers need to be discussed.

For 2018, the performance of the Forager Australian Shares Fund was negative nearly 20%. The All Ordinaries Accumulation Index was down, but only by about 4%. And we have carried 25-35% cash throughout the year.

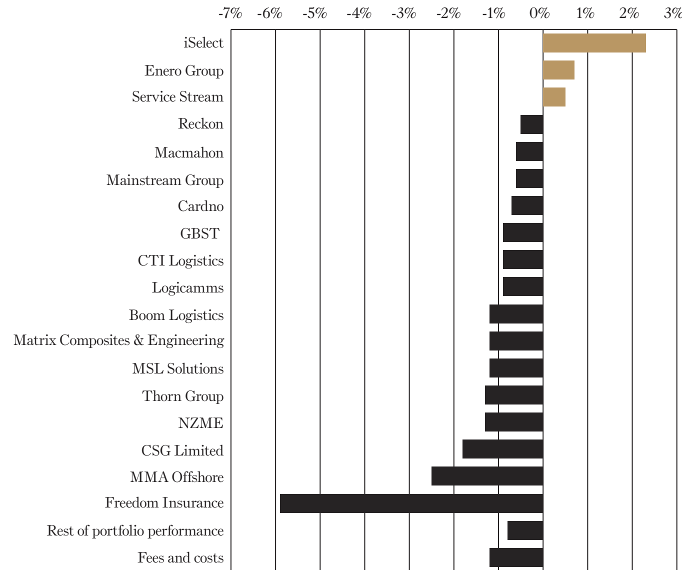
The Forager International Shares Fund has fared better. For the 12 months to December, the Fund is down 8%, versus its global benchmark which is roughly unchanged, both in Australian dollars. There have been some winners—particularly UK-listed **Blancco Technologies** (AIM:BLTG). And there are also some excuses, which we will come to in a moment, but it is still a poor result for a portfolio that started the year conservatively positioned.

What happened? What are we doing about it? And what does it mean from now? I'll come to each of those three questions in turn, starting with an explanation.

KEY CONTRIBUTORS TO PERFORMANCE

Both funds have had disasters. ASX-listed **Freedom Insurance** (FIG) is close to a wipeout at current prices. Paris-listed **Technicolor** (ENXTPA:TCH) has lost two thirds of its share price value this year. And the oil services companies in both portfolios have been pummelled along with the oil price in the second half of the year (see pages 6 and 13).

Chart 1: FASF Contribution for the 12 months ending 31 December 2018



There are a few other smaller investments that haven't gone to plan, like **CSG** (CSV) and **Rosenbauer** (WBAG:ROS). But most of the rest of the pain has been share prices getting walloped for companies where the investment case is on track.

Thorn Group (TGA), while its share price has fallen 57% this year, has made a lot of progress. Net debt has fallen to almost zero and the turnaround in its retail business is gathering steam.

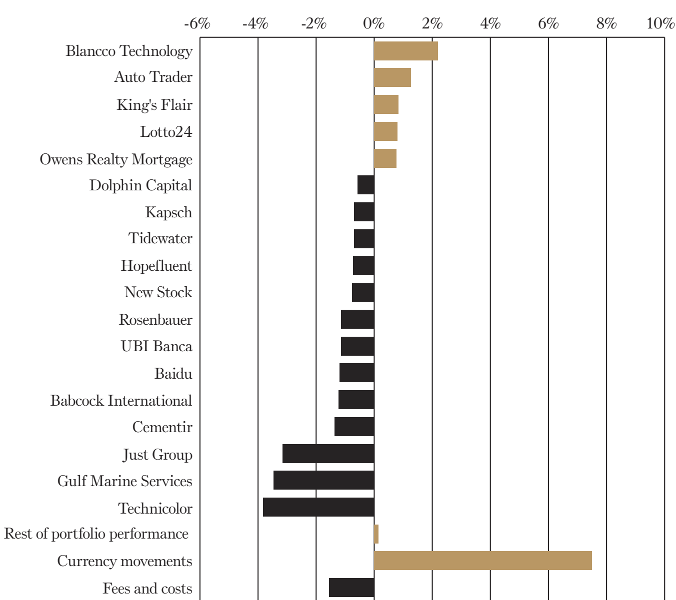
Cement company **Cementir** (BIT:CEM) has seen its share price halve despite selling its loss-making Italian operations for a good price and performing strongly in all of its other major markets.

Even **Just Group** (LSE:JUST), which looks like it belongs in the disaster category in the chart below, isn't anywhere near as bad as it looks. Despite strong sales numbers, regulatory issues caused its share price to almost halve since June. The regulatory issues have receded in recent weeks, but the share price has only retraced a small portion of its losses.

WELCOME VOLATILITY

This sort of share price volatility is welcome. If our investment cases continue to play out, it will eventually show up in the share prices. Price falls in the interim give us the opportunity to put more money to work—and when we are sitting on large piles of cash that can only be a good thing.

Chart 2: FISF Contribution for the 12 months ending 31 December 2018



We make money by investing in shares, not sitting on cash. And for the past few years there simply haven't been enough opportunities available that meet our return criteria. In a perfect world, the only stocks that fall are the ones we don't own. But the real world doesn't work like that. For great opportunities to become widely available, we need to suffer some pain on the stocks

"IF OUR INVESTMENT CASES CONTINUE TO PLAY OUT, IT WILL EVENTUALLY SHOW UP IN THE SHARE PRICES."

we already own. High cash weightings leading into this downturn mean we don't have to crystallise losses on investments where the underlying thesis is intact. And we come out the other side with a much more attractive portfolio.

The Australian Fund currently holds three stocks we didn't own at the start of the year. The International Fund has added seven.

To be clear, I don't think it is yet time to be getting greedy, particularly here in Australia. The stocks that have fallen most have serious issues—think Retail Food Group (RFG) and AMP (AMP)—and the stocks that are superficially cheap are likely to see their profits fall. Banks and property developers are top of that list.

My guess is that further patience will be rewarded. Only in the past few weeks have we seen some larger, better quality businesses fall to interesting levels. But now is clearly a far more attractive investing environment than 12 months ago.

REALISING VALUE EARLIER

One thing we can do a better job of is using size to our advantage. Forager owns significant stakes in a number of businesses that we think are worth multiples of their current share price, but where the board and management team aren't focused on optimising that value. We have been actively engaging with those companies but, where we don't see significant change, we must get more aggressive. Especially in an environment like this. Our performance needs the boost and there are places to redeploy the capital if we can successfully extract it from some undervalued stocks. You can read our analysis of the Thorn Group opportunity on page 12 for a good example.

BUILDING THE RIGHT TEAM

As CIO, fund performance is my primary responsibility. A year like 2018 hurts.

Oddly, though, it was a year in which the business made a lot of progress.

In 2019, Forager will be 10 years old. Reflecting on the past decade, there are many things I am proud of, including our long term performance.

While important, stock picking is only one aspect of my job. Successful long-term performance requires a successful team, and that's the other big part of my job—recruiting, retaining and developing a team of successful stockpickers.

Recognising the importance of this aspect of my role has been too long coming. Left to my own devices, I'll spend all my time looking at stocks (I share this attribute with most founders of funds management businesses). The appointment of Jeff Weeden as CEO, me properly realising the importance of good hiring (along with the timeframes involved to get this right), and even the recent poor performance itself, have all led to important changes at Forager.

While it's no consolation for our investors this year, 2018 was probably our best year yet on the management front. We have integrated three new analysts into the business and spent a long time finding a fourth, a highly experienced recruit who will start on the International Fund in February. We briefly introduce Paul Quah below and will do so in-depth in the coming months.

THE RIGHT PRODUCT STRUCTURE

We have recently contacted investors with a survey to get their views on introducing a performance fee on the International Fund, in return for a reduction in the current base fee. We believe this to be an important initiative that could better align staff with investment outcomes for investors in that fund. I also hope it might assist us attract, reward and retain high quality people to the business.

We won't do anything that doesn't have strong support from our investors, so I encourage you to provide feedback if you haven't already. Early feedback has been pretty emphatic. I won't spill the beans now but watch out for an upcoming blog on the topic.

SWIMMING HARD

The difficult thing about funds management as a business is that bad performance can be long separated from poor decision making. It can sometimes take a considerable amount of time before any of this work starts turning up in investor returns.

Eighteen months ago the performance looked wonderful but I wasn't feeling as great. The duck looked serene but the legs were thrashing furiously. Today I feel the opposite. While the duck might look like it is doing it tough, we've got the legs strong and are swimming hard.

Kind regards,

STEVEN JOHNSON
Chief Investment Officer

Introducing Paul Quah

Specialist experience:
Asian small/mid cap

Previous roles:

Ellerston Capital | Portfolio Manager/Analyst (Melbourne)

Acorn Capital | Portfolio Manager/Analyst & Head of Research (Melbourne)

CLSA Asia Pacific | Head of Regional Small Mid Cap Research (Hong Kong)

Macquarie Bank | Senior Analyst & Deputy Head of Small Cap Research (Hong Kong)

UBS Securities | Equity Research Analyst & Associate Director (Sydney)

Starting with Forager 4 February 2019

INTERNATIONAL SHARES FUND

FACTS

Inception date	8 February 2013
Minimum investment	$20,000
Monthly investment	Min. $200/mth
Income distribution	Annual, 30 June
Applications/redemptions	Weekly

UNIT PRICE SUMMARY

Date	31 December 2018
Buy price	$1.4461
Redemption price	$1.4404
Mid price	$1.4432
Portfolio value	$159.4m

BEAUTIES AND BEASTS IN EUROPE

2018 was a tough year for equities. Global demand for oil and the outcome of Brexit will be important variables for the International Fund portfolio in 2019.

Table 1: Summary of Returns as at 31 December 2018

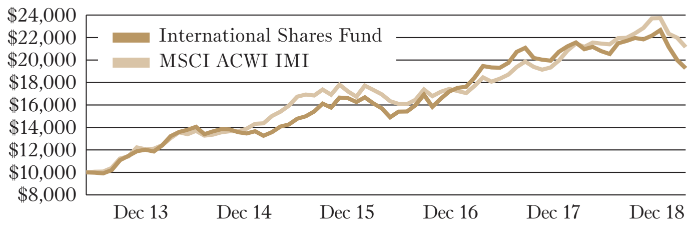
	FISF (Net of fees)	MSCI ACWI IMI
1 month return	-3.66%	-3.78%
3 month return	-14.98%	-10.88%
6 month return	-12.27%	-5.46%
1 year return	-8.10%	-0.10%
3 year return (p.a.)	7.05%	7.67%
5 year return (p.a.)	7.22%	9.28%
Since inception* (p.a.)	11.77%	13.55%

*Inception 8 February 2013
The value of your investments can rise or fall. Past performance is not necessarily indicative of future performance.

That 2018 was the worst for shares since the financial crisis came as something of a surprise. Especially to those focusing their investments on the United States of America. While those of us with substantial exposure to Europe and the UK had been doing it tough all year, US's S&P 500 was up around 2% midway through the year. It finished the year down 6%.

That still made it one of the best performing markets in the world. The MSCI Europe Index fell 13% and the UK's All-Share Index (a better guide than the FTSE index which is dominated by global companies with foreign earnings) fell 13%. China's index lost a quarter of its market value.

Chart 3: Comparison of $10,000 Invested in the Forager International Shares Fund and MSCI ACWI IMI



Source: S&P Capital IQ
The value of your investments can rise or fall. Past performance is not necessarily indicative of future performance. Assumes distributions are reinvested.

For Australian investors in international shares, Australian dollar depreciation sheltered them against the losses to some extent. The MSCI benchmark against which we measure ourselves finished flat, versus an 8% fall for an investment in the Fund.

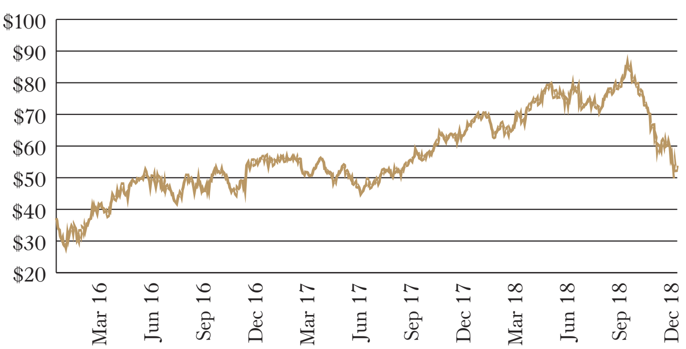
By now you have probably read countless explanations for the poor performance of global equities, most of them post-hoc justifications rather than anything particularly insightful. We won't waste your time rehashing them here. Stocks go up and stocks go down. We generally get more excited about the latter, as it allows us to make attractive investments.

There are, however, a couple of important thematics that are impacting your investment in the Forager International Shares Fund.

DEBT CLIFF LOOMS FOR GULF MARINE SERVICES

The first is a dramatic fall in the price of oil. From US$85 a barrel in October, the price for Brent crude fell some 36% to end the year close to US$54.

Chart 4: Brent Crude (US$ per barrel)



Source: Bloomberg

With both operational and financial leverage, the Fund's oil services stocks suffered a much worse fate. **Petroleum Geo-Services** (OB:PGS) is down 73% from its NOK44 peak. **Tidewater** (NYSE:TDW) has fallen 25% despite a strong balance sheet. And **Gulf Marine Services** (LSE:GMS), our largest investment of the three, has fallen 77%.

In December Gulf Marine announced that it is likely to breach covenants on its debt for the 2018 year. It is likely to get a waiver from its lenders—the breach was mainly the result of a delayed start to recently awarded contracts—but the board has also raised concerns about GMS's ability to meet its longer term obligations. Contracted principal repayments step up meaningfully in 2020 and, absent an improvement in the oil market, the board doesn't anticipate enough cashflow to meet them.

Their intention is therefore to begin negotiations with existing lenders and other potential capital providers well before 2020. While the business remains a reliable cash generator with some good long-term contracts, any restructuring of the balance sheet is going to be bad news for existing equity holders.

“STOCKS GO UP AND STOCKS GO DOWN. WE GENERALLY GET MORE EXCITED ABOUT THE LATTER, AS IT ALLOWS US TO MAKE ATTRACTIVE INVESTMENTS.”

Equity price movements across the whole oil services sector have been extreme. Most, including blue chips like **Halliburton** (NYSE:HAL), trade at lower prices than mid 2017 when the oil price was US$30 a barrel.

While we don’t think that is justified, many of these businesses do need a healthy oil market to be viable. The past three months suggest a market anything but healthy.

BREXIT WORRIES WORSEN

The second concern is the UK’s stumbling, bumbling, reckless approach to its departure from the European Union. We expected a lot of grandstanding on both sides of the Brexit argument. We expected a lot of politicking and plenty of threats to do something crazy. Ultimately, though, we expected the Brits to do what they do best and eventually settle on a sensible solution. That confidence seems misplaced.

The UK is leaving the EU on the 31st of March this year. If it doesn’t agree to new trading arrangements, tariffs and borders with its most important trading partner will be imposed on April 1st. It won’t be a joke.

While everyone seems to agree that would be an economic catastrophe, parliament has rejected Prime Minister Theresa May’s negotiated deal with the EU and no-one seems to have a remotely acceptable alternative.

The situation has become so farcical that support is swelling for another referendum on whether they want to leave at all. With this as a backdrop, it is no surprise that share prices of our UK holdings have been under pressure.

Fortunately, there has been some welcome positive news.

REGULATORY RELIEF FOR JUST GROUP

Annuity provider Just Group received a welcome Christmas present from the UK insurance regulator. A draft proposal on the treatment of equity release mortgages could have forced Just Group to raise capital equating to a quarter of its current book value, or more than half of the current market capitalisation. The final version, released in December, is far less onerous.

Our interpretation is that Just will need less than £200m of new capital—roughly 10% of its existing equity base—and has more than a decade to manage the transition.

While the share price rallied 20% on the day the final rules were announced, it has since sunk back to pre-announcement levels.

Just needs to wean itself off an unhealthy dependence on equity release mortgages. And its current capital buffer is too thin for the growth the company is achieving. It is, however, a meaningful player in a healthy and growing UK annuities market. Not surprisingly, more onerous capital requirements have led to dramatically improved pricing and Just’s direct distribution model is benefitting from deregulation of the market.

Yet it trades at half book value and less than five times this year’s expected earnings. It is not without risk, but there is plenty of potential reward.

There was further positive news from across the North Sea.

LOTTO24 TO MERGE WITH ZEAL

German online lotto ticket seller **Lotto24** (DB:LO24) has been a winning investment for the Fund over the past four years. This month, **ZEAL Network** (XTRA:TIM) launched an all-share takeover for the company that took us by surprise.

The two companies share history. In 2008, German authorities made online ticket sales illegal and destroyed the market overnight. ZEAL, the leading player in the German online ticket market, moved to the UK, took its three million German customers with it and started selling them ‘grey market’ tickets on the very same lotto draws. When the official German market eventually opened back up, ZEAL’s shareholders were making too much money to bring their customers back home. But they saw an opportunity to recreate the old ZEAL in Germany, listed Lotto24 on the stock exchange and funded it for the significant marketing expenses required to attract millions of new customers again.

They share common technology, so putting them back together shouldn’t be too complicated. And 65% of Lotto24’s shareholders have already agreed to the deal, so it’s going to happen.

The combined entity will generate more than double Lotto’s existing revenue while adding only marginally to the administrative cost base. ZEAL also brings €100m net cash to the table, and Lotto24’s existing shareholders could end up owning more than 60% of the merged entity.

The business should quickly become more profitable than Lotto24 was on a standalone basis, but it will also take away some of the upside. Overall it is likely to make for a safer, more attractive investment.

OWENS REALTY AND AMERICAN ACTIVISM

Owens Realty Mortgage (AMEX:ORM) has been a reminder about the importance of activism in the American context. Buy an underutilised asset in Europe or Japan, and your grandkids might still one day be complaining about it. In America, though, things tend to happen. It’s not foolproof, else there would be no under-utilised assets to find. But it is a place where

> “WHILE THE OFFER PRICE IS SIGNIFICANTLY BELOW OUR ESTIMATE OF VALUE, MOST OTHER MINORITY SHAREHOLDERS TOOK THE OFFER, LEAVING US WITH FEW OPTIONS OTHER THAN TO DO THE SAME. WE’LL TAKE THE HALF-WIN AND MOVE ON.”

we feel a little more comfortable about buying opportunities without a clear catalyst, because the shareholder base itself often becomes the catalyst.

Prior to the global financial crisis, Owens was an externally managed vehicle that made commercial loans to real estate developers, chiefly in Northern California. During the financial crisis much of the loan book became non-performing and converted into a portfolio of seized real estate in various stages of development. The group converted to a real estate investment trust for the tax benefit.

By the time the Fund first acquired shares in mid 2017, Owens had recommenced writing loans but still had a long tail of direct property investment. We were able to buy the stock at a 25-35% discount to a conservative valuation of its hard assets, with significant upside optionality.

But the situation wasn’t without risk. Chief among them was so called agency risk. Owens’ board and management was stacked by the same people that owned the management company, which received a healthy stream of fees for underwriting and managing loans. Rebellion was fomenting among the shareholder base. But the opportunity for activism took a blow when Owens bought back the entire shareholding of the largest shareholder (and agitator) at a large premium to market price. It was one of the more egregious ‘greenmail’ cases we’ve seen.

If the controlling parties thought that would end the rebellion, though, they miscalculated. The next largest shareholder eventually got to appoint some of its choices to the board. Other external parties stepped forward and got voted onto the board. From there, it was only a matter of time. More recently, **Ready Capital Corporation** (NYSE:RC) announced an all-stock merger offer that will give the combined group more adequate scale, and gives Owens shareholders a nice premium to the pre-deal price. The Fund is up an average of 20% on its investment, a nice outcome in a tough market. We’ve sold some of our stake.

FIRST FILIPINO INVESTMENT MADE AND SOLD

In July the Fund made a small investment in **Melco Resorts and Entertainment Philippines** (PSE:MRP). The company owns one of only three modern casinos in Manila’s Entertainment City—the Philippines’ equivalent of Cotai in Macau and Sentosa Island in Singapore.

Adjusted for low ongoing maintenance requirements, the stock was trading at six times earnings. Low in a booming Filipino gaming market. Also low compared to local and international peers. Importantly, negligible debt and a 15-year casino licence suggested that the business would prove resilient even if growth stopped. While we were hoping to own the business for years, its majority shareholder had other ideas.

Until recently **Melco Resorts and Entertainment** (Nasdaq:MLCO) owned 70% of Melco Philippines. In November the parent company launched a tender offer for the rest at a 30% premium to the Fund’s purchase price.

While the offer price is significantly below our estimate of value, most other minority shareholders took the offer, leaving us with few options other than to do the same. We’ll take the half-win and move on.

BETTING ON FAST FASHION

Another new investment is **Hallenstein Glasson Holdings** (NZ:HLG). Hopefully this one stays in the portfolio a lot longer.

Hallenstein operates fashion retail stores across Australia and New Zealand under the Glassons and Hallenstein Brothers brands.

Glassons stores are smaller than your average Zara or H&M. They target female, mostly millennial consumers with fast fashion styles and a range of basics, and generate almost 65% of the company’s revenue.

Hallenstein Brothers stores target males in a similar age group. The clothing range is much broader through—men can shop for suits, board shorts and track pants in the same place. There are 42 Hallenstein Brothers stores in NZ. The three Australian stores are still in the testing phase, but we expect more stores to be rolled out if this holiday season performance meets expectations.

Hallenstein first caught our attention with its 2018 interim report. The company reported like-for-like sales growth of 10.8% on the prior year, at a time when many retailers were reporting negatives. A lot of the revenue growth was coming from Glassons Australia—a segment that has historically been small and barely profitable. While that wouldn’t be a surprise to anyone who has a millennial daughter or who has recently visited a store, the stock is too small and illiquid to elicit much analyst attention. So we took a closer look.

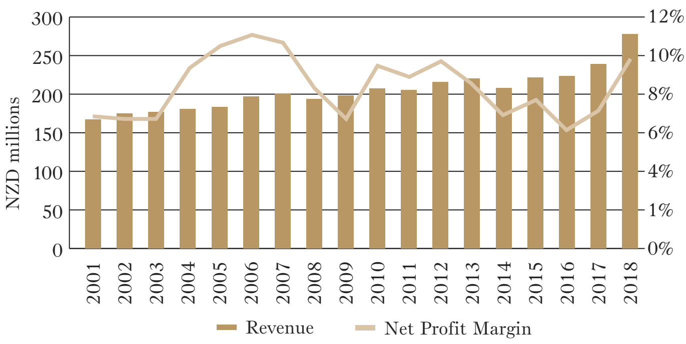
There are a number of things to like. The business has been generating high returns on equity for a long period of time, pays fat dividends and has no debt. Pair that with significant inside ownership and a conservative management team and you have a reasonably strong base case. Our bull case hinges on under appreciated growth prospects.

The growth in Glassons Australia to date is evident both in the numbers and inside stores. The company has reformatted stores, recruited a new buying team and embraced the preferences of their target market—largely millennials—by diverting a lot of marketing towards social media and ‘influencers’. It certainly looks like it’s working. There are currently 32 Glassons stores

in Australia. We think this number could almost double. At around 10 times earnings, little of this potential growth is priced in.

The other two segments have been the backbone of the business historically. The profitability has been high, albeit volatile, for a long time. These stores are also part of the reformatting program. While growth in these two concepts isn't part of our valuation, there is room for pleasant surprises.

Chart 5: Hallenstein Glasson Holdings



Source: S&P Capital IQ

The next couple of years are vital for the investment case. We want to see management opening new stores in Australia. And doing so profitably. We want to see the new buying team continuing to get it right. And we want to see margins maintained, rather than off-the-shelf excuses relating to inclement weather or getting online right. If this plays out we should do well from the stock. Hallenstein represents 2.3% of the portfolio.

Chart 6: Portfolio Distribution According to Market Capitalisation

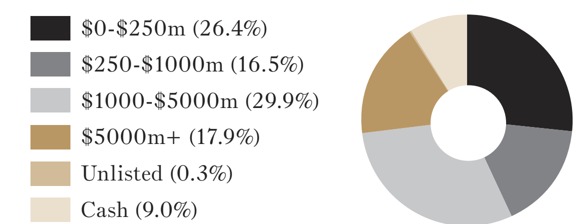


Chart 7: Stock Exposure by Geography

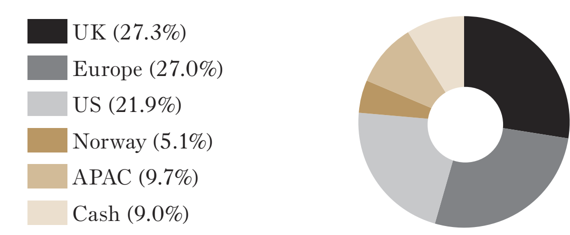


Table 2: Top 5 Investments

Blancco Technology Group Plc	8.6%
Just Group Plc	6.8%
Auto Trader Group Plc	6.8%
Alphabet Inc	5.8%
Flughafen Wien AG	5.3%
Cash	9.0%

PORTFOLIO NEWS

While in Hong Kong recently, Alvise Peggion met with the Fund's Asian portfolio companies.

The share price of real estate agent **Hopefluent** (SEHK:733) fell another 21% over the December quarter and is down 35% for the year. The Chinese property market is cooling down as the government tries to stop investors from speculating on house prices. In November, floorspace sold grew just 1.4% compared to the same month last year. Prices were flat across most cities.

Hopefluent recently merged its property sales operations with those of **Poly** (SHSE:600048), one of the largest property developers in China. The combined entity will have priority access to Poly's new projects which should support sales. The current market valuation of less than four times earnings suggests that profitability will all but evaporate. We are not so sure and Hopefluent, while risky, remains a small percentage of the Fund's assets.

King's Flair (SEHK:6822) generates most of its sales by producing kitchenware for US clients. While trade tensions between the US and China have continued to make headlines over the quarter, tariffs have not yet impacted the business.

In the meantime, King's Flair continues to grow its reusable water bottle business in China which now accounts for around 20% of sales. New products for toddlers have also been launched recently. The company remains well capitalised with HK$500m of net cash. Despite being in a small minority of Hong Kong-listed shares to perform well this year, King's Flair trades on a price to earnings ratio of seven and sports an 11% dividend yield. It accounts for 3.2% of the portfolio.

AUSTRALIAN SHARES FUND

FACTS

Inception date	30 October 2009
ASX Code	FOR
Income distribution	Annual, 30 June

UNIT PRICE SUMMARY

Date	31 December 2018
NAV	$1.34
Market price	$1.33
Portfolio value	$152.5m

NO EASY OPTIONS ON THE ASX

It has been a frustrating year and Fund performance has been bad. While waiting for more opportunities to put a large cash pile to work we'll be working to unlock the full value in existing investments.

Table 3: Summary of Returns as at 31 December 2018

	Australian Fund (Net of fees)	S&P All Ords. Accum. Index
1 month return	-3.68%	-0.45%
3 month return	-13.03%	-8.98%
6 month return	-17.06%	-7.28%
1 year return	-19.38%	-3.53%
3 year return (p.a.)	5.34%	6.60%
5 year return (p.a.)	7.49%	5.71%
Since inception* (p.a.)	10.78%	6.72%

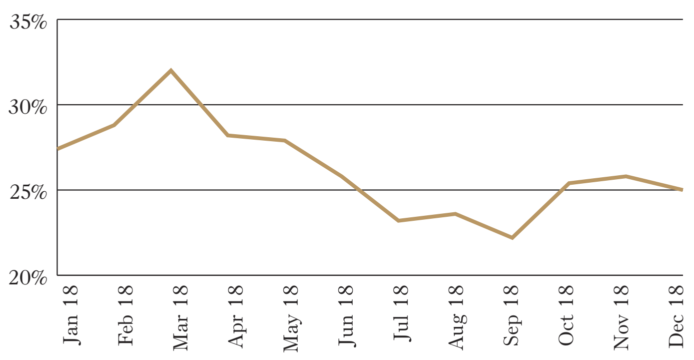
*Inception 30 October 2009
The value of your investments can rise or fall. Past performance is not necessarily indicative of future performance. Returns are calculated using NTA, not market price.

NO EASY OPTIONS ON THE ASX

Frustrating might be the best way to describe 2018. As described in our CIO's introduction to this quarterly report, the performance itself has been bad. Down 19% in a year is not good. It is especially galling when you start the year with lots of cash and hold more than 20% cash throughout the year. More frustrating, though, is that we still hold lots of cash today.

Bear markets are usually an opportunity to put money to work at attractive rates of return. That's why we welcome them. You should expect that a year of bad performance comes with significant investment into new and existing ideas at attractive valuations.

Chart 8: FASF Cash Weighting



The reasons 2018 hasn't delivered that are threefold.

First, some of the poor performance has been a result of bad investments rather than bad markets. Investing more in mistakes is often a way of compounding the error. That we didn't invest too much additional cash in these is a positive (selling them would, of course, have been better).

Second, there has been a lack of liquidity in the smaller stocks that are attractive at today's beaten down prices. December saw a distinct change—the broker hotline has been ringing far more regularly—but for most of the year we weren't seeing enough significant trades taking place despite lower prices. The Forager Australian Shares Fund is roughly $150m in size, so we need to invest almost $5m for a 3% weighting. Trades of $20,000 in a stock at low prices can move and impact on our performance without giving us the opportunity to put the share price and cash to work.

Thirdly, the larger end of the market has been frustratingly rational. There are three main groups of stocks: hammered but structurally challenged; seemingly cheap but facing cyclical headwinds; and the expensive defensives.

The structurally challenged are those where the share price has been hammered but the business model is under threat. Think **Retail Food Group** (down 88% this year), **iSentia** (down 80%) or **AMP** (down 53%).

The seemingly cheap group contains the banks, consumer discretionary stocks and anything property related. They look cheap on the basis of historical earnings, but those historical earnings are likely to fall.

And the final group contains those whose businesses look fine but the stock prices expensive. Herein lies the conundrum. Which of these three groups are going to give us attractive returns?

Our view, as we head in to 2019, is that patience will still be rewarded.

The structurally challenged are particularly dangerous. If they are struggling in this economy, how are they going to fare in a recession? And low multiples on cyclical businesses are often deceiving. You make money on cyclical businesses by paying high multiples of low earnings, not the other way around. We will get opportunities, but the housing downturn has only just started and the wider economic effects are yet to be felt.

Which leaves the expensive defensives. While we think they are a sensible place for a diversified investor to park their cash, they are still a long way from prices that provide the returns we aim for in this fund.

> “THE STRUCTURALLY CHALLENGED ARE PARTICULARLY DANGEROUS. IF THEY ARE STRUGGLING IN THIS ECONOMY, HOW ARE THEY GOING TO FARE IN A RECESSION?”

Table 4: Expensive Defensives

	Yield	Forward P/E
Amcor	5.0%	14.4
Aristocrat	2.6%	15.2
Aurizon	5.4%	17.4
BHP Billiton	8.4%	12.9
Cochlear	1.8%	37.4
Computershare	2.9%	16.6
CSL	1.5%	30.5
IAG	5.3%	17.1
Newcrest	1.2%	24.3
Ramsay Health Care	2.5%	20.3
Woodside	5.9%	13.9
Woolworths	3.5%	21.3
Average	**3.8%**	**20.1**

Source: Bloomberg

So, for now, patience is still required. While we wait, there is plenty to keep us busy.

THORN WORTH MORE DEAD THAN ALIVE?

For the majority of the Fund’s current portfolio, we broadly support the path the Board and management teams have embarked on. For those it’s a matter of letting a good strategy play out, then waiting while earnings rise and the share price catches up. But there are investments that could use some changes to bring about value realisation.

Mostly these centre on strategic direction, capital allocation and management incentives. We haven’t been shy to voice an opinion on these important matters before, but so far our value realisation tools can be thought of as ‘activism-lite’. Examples include voting against shareholder unfriendly resolutions at annual general meetings and working with the Boards and management teams of companies to encourage change behind the scenes. In 2019, we might need to take it up a notch.

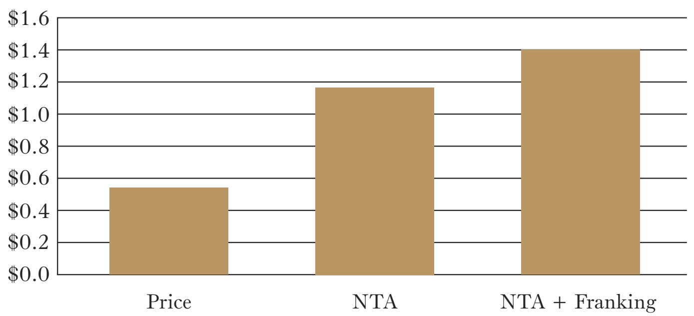
Why not just sell and move on? Getting more ‘active’ in a business usually comes with a big investment of time. That time could be spent finding new opportunities for the portfolio. And there is no guarantee that getting involved will change what needs changing. But, for some stocks, we think it’s worth it.

These are some where the upside from agitating, the chance of getting a favourable outcome and portfolio weighting are all high. And owning a large chunk of a company means we are more likely to have an impact. The Fund is a substantial shareholder (owning more than 5% of a business) in about half of the portfolio.

One that fits all the criteria is **Thorn** (TGA), the provider of washing machines and TVs to cash strapped consumers and equipment-backed loans to small and medium businesses. It has been a troubled business for a few years.

At a 6.4% weighting, Thorn is a meaningful investment for the Fund. And owning 10.4% of the business makes us a big shareholder. Thorn shares trade at close to half of the company’s net tangible assets. That excludes a large franking credit pile. So how do we realise this value?

Chart 9: Thorn Value



Source: Company Annual Reports

In the past half-year, earnings from Thorn’s equipment finance unit rose 37% as the loan book grew 16% to $333m. That looks good at a glance. Better still the company has recently renegotiated its debt facilities: there is now more capacity for growth and less equity required to write new loans.

But the business is young and untested in tougher economic times. It was only launched in 2010. And if it runs into trouble, with $288m of debt, the risks are high. We’ve been vocal on equipment finance: it should be sold while the market is buoyant. Those recent debt facility changes will make it easier for a buyer to step up.

> “THORN SHARES TRADE AT CLOSE TO HALF OF THE COMPANY’S NET TANGIBLE ASSETS. THAT EXCLUDES A LARGE FRANKING CREDIT PILE. SO HOW DO WE REALISE THIS VALUE?”

The Radio Rentals question is trickier. The business has brand recognition, a strong market position and loyal customers. And management has made good progress in the turnaround, lifting new leasing by 34% last half. We could see a path to a 10% return on equity over time.

But recent regulatory scrutiny has made us more cautious. In the Financial Services Royal Commission, community expectations of financial services were shown to be substantially higher than the historical norm. The ongoing Senate Committee Inquiry is now looking closely at consumer leasing businesses.

With high operating costs, new leasing levels would need to climb substantially to generate decent returns on equity. Even if that happens, it will require capital and will delay any reasonable steady state profits.

There is another way: place the business into run-down. Close the stores. Cut costs. Collect existing interest and principal payments. On our numbers Thorn could realise more than its net assets in less than four years. While there are risks, they are mostly in management’s control (unlike the risks around a regulator forcing them to close the business).

We’ve made these views clear to the Board and management of the company. While the response has been sympathetic, it’s time for urgent action.

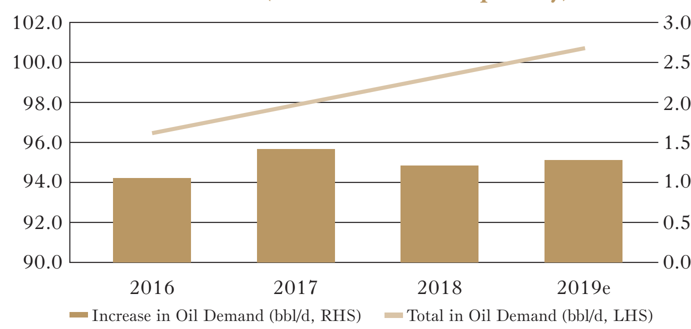
ON THE OIL ROLLERCOASTER

The oil price has been on a rollercoaster for the past five years. From the depths of US$28 per barrel in early 2016 the price rose to US$85 per barrel last October. Things seemed to be going well for oil producers and service providers. But it was short lived. Oil is now trading closer to US$54 per barrel, down more than a third in a few months. It’s also been a wild ride for the Fund’s oil exposed investments. So where to now?

There has been plenty of oil related news to keep track of over the past year: Iran sanctions, OPEC and Russia turning on the taps (then getting ready to turn them off again), Trump’s many tweets, rising US interest rates, trade disputes, and even more tweets. Throw it all together and you get plenty of oil price volatility.

World oil consumption is still set to increase by 1.4 million barrels per day in 2019. The US, now the world’s largest oil producer, is pumping furiously but an agreement by the Organization of the Petroleum Exporting Countries (OPEC), plus Russia and others, will remove 1.2 million barrels per day of supply from the market. All told, expectations are now for oversupply to switch to undersupply by the second quarter of 2019.

Chart 10: Oil Demand (millions of barrels per day)



Source: International Energy Agency

This should help the oil price. But the Fund’s oil investments are not oil producers.

Instead our investments are in two offshore oil service providers. They need a steady supply of offshore oil exploration and development spending, not another couple of dollars on the oil price.

A steady supply of spending is more likely to come when prices are reasonable and, importantly, stable. Price stability would lead to confidence. Confidence would lead to spending. And spending would lead to more work for **Matrix Engineering** (MCE) and **MMA Offshore** (MRM).

Before the recent fall in oil price we were starting to see some confidence returning.

Matrix, the oil and gas equipment provider, announced its first large new contract win in three years. The company will provide its main riser buoyancy product to two drillships, replacing aging buoyancy. The company also noted an increase in quotation activity for other jobs.

Many offshore rigs have been parked on the sidelines and riser buoyancy replacement has been low on the list of capital expenditure priorities for rig operators. With rigs returning to work though, there should be plenty of replacement buoyancy needed after years of underspending. New rig orders, while still slow, may also increase. The revenue potential is substantial if orders resume. And the costs are largely fixed.

Alongside the contract win Matrix raised $3m in new equity. The Fund participated, raising our ownership in Matrix to 15% of the company.

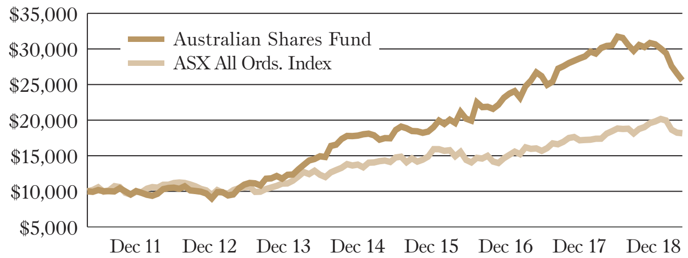
MMA Offshore was also showing some signs of making better use of its fleet of offshore support vessels. The company told its annual general meeting in November that the utilisation of its fleet had been 79% during the year. More work would mean MMA would be able to put even more vessels to use and, eventually, raise the rates it charges.

The company is on track to be cash flow neutral for the current financial year, which would be a good achievement for a business that has struggled with losses for years. It last traded at $0.15 per share, a 61% discount to the $0.38 per share value of its vessels.

Neither company had seen the benefit of the high oil prices in mid-2018—mostly because they weren't high long enough to encourage more offshore oil spending. So lower oil prices now are unlikely to impact shorter-term performance much.

Longer term, stabilisation of oil prices, even at levels a little above today's prices, would mean offshore oil producers could stop worrying about prices and start worrying about spending capital to grow oil production.

Chart 11: Comparison of $10,000 Invested in the Forager Australian Shares Fund and ASX All Ords. Index



Source: S&P Capital IQ
The value of your investments can rise or fall. Past performance is not necessarily indicative of future performance. Values are at NAV, not market price. Assumes distributions are reinvested.

Chart 12: Portfolio Distribution According to Market Capitalisation

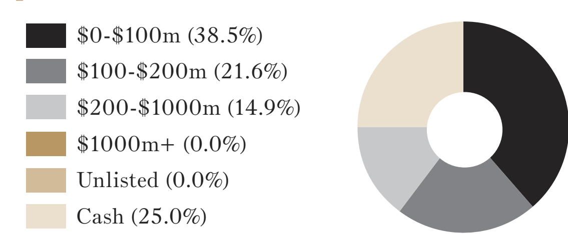


Table 5: Top 5 Investments

Macmahon Holdings Limited	10.2%
iSelect Limited	9.6%
Enero Group Limited	9.2%
Thorn Group Limited	6.4%
MMA Offshore Limited	4.6%
Cash	25.0%

PORTFOLIO NEWS

Comparison website **iSelect** (ISU), the Fund's second largest holding, was on guard in December as its largest shareholder (and fierce competitor) Compare The Market bought another three percent of the company. It now owns 23% of iSelect. Compare The Market started buying in April, after a 64% downgrade, CEO departure and 55% share price fall. At this time the Fund acquired 9% of the company.

Takeover law would usually require an owner of more than 20% of a listed company to bid for the rest of the business. The 'creep' provision is one exemption to this, allowing would-be acquirers to buy three percent of a company's shares every six months. While it's good to see Compare The Market is still interested, a higher shareholding weakens iSelect's bargaining position.

Fortunately, the takeover is not the only game in town. At the annual general meeting iSelect was talking up a strong first quarter and a return to historical profitability in the 'short to medium term'. With iSelect getting stronger, Compare The Market will need to pay an appropriate price for any deal to get a thumbs up from shareholders.

Funeral insurance trail book owner **Freedom Insurance** (FIG) had an eventful December. First the company announced that it may face a liquidity shortage in 2019 and provisioned for customer remediation expenses. Then, sensibly, it announced the termination of a potential deal to buy the St Andrews Insurance business from **Bank of Queensland** (BOQ).

Lastly the company updated expectations for the current reporting period, widening losses by $2m and flagging a review to the value of its trail asset. This has been one of the Fund's worst investments and is now a 0.4% portfolio weighting. We will continue to engage with management and the Board on realising the remaining value in the business.

Meanwhile, engineering services company **Cardno** (CDD) announced two new acquisitions. Armed with $100m in extra debt from a renegotiated debt facility the company got to spending the money. It agreed to pay $21.6m for Victorian firm TGM, emphasising their regional footprint. The US$55m acquisition of Raba Kistner was also announced later in the month. The Texas consulting firm specialises in transport infrastructure projects. The company is also fresh from appointing new CEO Ian Ball to take over from executive chairman (and major shareholder appointee) Michael Alscher.

Lastly, crane operator **Boom** (BOL) agreed to union driven labour rate increases of 20% to 50% for its NSW depots. To cover the cost increases prices to customers will need to increase by 10% to 20%. The Newcastle depot, unsustainable with those labour rates, will close. All told the company will be hit with a $3m impact from the industrial relations dispute and still forecasts a 30% profit increase on last year. Importantly, the company seems to be showing a renewed focus on capital allocation by selling some older assets, renting rather than purchasing cranes and announcing a share buyback.

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Forage
verb, for·aged, for·ag·ing.
to search about; seek; rummage; hunt (for what one wants).