EGP Concentrated Value Fund

Address: Suite 2, Level 11, 37 Bligh Street
Sydney, NSW, 2000

Mobile: 0418 278 298

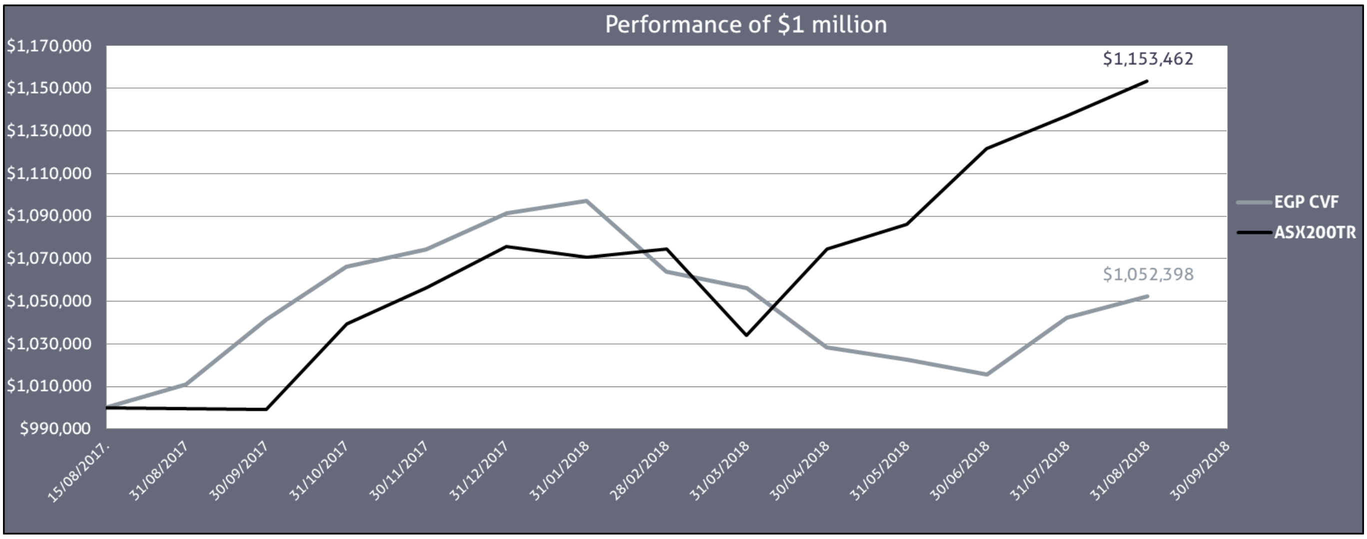
EGP Concentrated Value Fund – 31 August 2018

EGP Concentrated Value Fund is a managed investment scheme focused primarily on owning Australian listed businesses. It targets 3 – 5% annual outperformance of Australia's preeminent ASX200 index over the long term. Managed by a performance oriented co-owner, we run a portfolio that is genuinely different. The sole objective is to deliver the strongest possible risk adjusted returns. The fund manager has their entire investable asset base in the fund, meaning focus on risk is unusually intense.

EGPCVF	Jul	Aug*	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FYTD
FY18	N/A	1.1%	3.0%	2.4%	0.8%	1.6%	0.5%	(3.0%)	(0.7%)	(2.7%)	(0.6%)	(0.7%)	1.58%
FY19	2.6%	1.0%											3.60%

Benchmark	Jul	Aug*	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FYTD
FY18	N/A	(0.1%)	(0.0%)	4.0%	1.6%	1.8%	(0.5%)	0.4%	(3.8%)	3.9%	1.1%	3.3%	12.18%
FY19	1.4%	1.4%											2.83%

*August 2017 is the period from August 15th-31st for both the fund and the benchmark in the above tables.



The Month That Was:-

The fund rose by 1.0% in August. Our benchmark rose by 1.4%.

The result for the fund in reporting season was actually a little disappointing. We thought the results on net were meaningfully better than we had expected with few exceptions. Holdings that generated the greatest returns in August included COG, GCS, LGD (see section on this investment below) and SDI. Major detractors from performance included BWF, CAF (a very small holding thankfully) and UOS (discussed in the next section).

Action in terms of buying and selling was fairly muted in the portfolio for the month, with cash levels changing only 0.2% for the month, although September has begun with a few transactions of reasonable size that will in our estimation embed future profits into the portfolio.

Our Largest Holding:-

In the Top 10 holdings table below, UOS once again ranks number 1. It has held this ranking in the EGP portfolio for all but a few months of the seven and a half years the fund has operated. But for those of you who have only joined us for the new fund, you've probably only seen cursory descriptions of the stock.

The business earned $43m in the first half (from a market capitalisation of less than $1b – it trades about 10x annualised earnings), increased per share NTA from 91c to 97c and yet the share price fell over the month this result was reported. Unbilled sales have grown and the profit growth for the next couple of years is almost certain due to high sales and pre-sales, yet the business is selling for less than two thirds of NTA. It is truly a remarkable opportunity in our view. We would not sell a share in the business at below NTA unless we were required to do so for liquidity purposes.

The history was covered in some detail in the 2015 Annual Letter, but for newcomers, I thought it worth running through why it is such a favourite of EGP. Barring a major re-pricing, we expect to own the stock for many years to come and liken it to being a fund manager through the 70's and 80's who had discovered Berkshire Hathaway; there was rarely a sensible price at which to sell the stock.

To give newcomers a sense of the value that has been created, I'll go back to the beginning…

An investor in the IPO in late 1987 or early 1988 paid 20 cent per share. The shares were split 10 for 1 in 2007, so the equivalent of 2 cps using the current share price is the IPO cost base. Investors for their 20c investment at IPO have subsequently earned $3.16 per share in dividends (15.8x their original capital). The annual dividend IPO investors receive is 1.5x their original investment.

They have also received another $0.95c in two capital returns (4.8x their original capital).

Furthermore, their original 20c of NTA is now worth $9.6612 per share (48.3x their original capital).

They have made 69x their IPO money.

An IPO investor that chose to DRP their stock ever since that option became available has earned just a shade over 20% annually for just over 30 years. A $10k IPO investment (50,000 x 20c shares) is now roughly 2.69m shares worth $1.735m (at 64.5c), but with an underlying NTA of $2.6m.

Anytime you find yourself wondering why United Overseas Australia is our largest holding, come back and re-read this section. We don't expect to generate the same outstanding return as has been seen over the past 30 years, but we'd be surprised over any 5-10 year period we don't get a respectable double-digit result.

Growth at A Remarkable Price:-

Growth at A Reasonable Price (GARP) is a term coined by legendary investor Peter Lynch. We think we have found a better version of GARP with our latest revealed holding. We have lately been accumulating shares in Legend Corporation (LGD.ASX). The stock is our 5th largest holding in the below table at 5.2% of the invested portfolio. In fact on Monday (after month-end) we acquired another line of stock that takes the position to a near tie for 3rd. We unveil the stock now as we are unlikely to add meaningfully more unless prices again fall. Despite this, the stock looks remarkably cheap to us at current prices.

LGD manufactures and supplies tools, equipment and consumables across a very wide cross-section of industry, including IT & T, Defence, Medical, Electrical, Mining, Rail and Power. The business operates in three divisions with "Electrical, Power and Infrastructure" the largest, followed by "Gas and Plumbing", with the smallest (but highest margin) division being "Innovative Electrical Products".

LGD has a number of features we customarily look for in our largest holdings, notwithstanding the good growth prospects and attractive purchase price as I'll set out below, the business is 31% owned by the 3 person board. The CEO himself speaks for nearly 29% of the outstanding shares. Another feature we like is the business is clearly run for cash flow rather than accounting profits. Depreciation and Amortisation are run as aggressively as possible, meaning the accounting is exceptionally conservative. Over the past 5 years Capex has on average been less than the depreciation and amortisation charge by around $1.5m annually. In the context of a business that has on average earned a little over $6m of NPAT annually through that period, that shows exceptional cash generating ability. At a recent meeting, the CFO said LGD has a number of perfectly good assets on the balance sheet that have been fully depreciated.

The LGD story over the past few years has been one of acquiring earnings cheaply in order to offset declines in the existing businesses. Earnings peaked in FY12 at $9.4m after tax, and were $6.0m in FY18 just completed. Over the past 10 years, the business has generated operating cash flows of nearly $100m, a little over a third of that has been spent on acquisitions and around a sixth on Capex. Just under half has been available for extinguishing debt and paying dividends. In the context of a $57m market capitalisation business, this is good cash generation capability.

The best part of it is that the hard work on acquisition integration now appears to be done (save the recently completed Celemetrix acquisition) and the industries in which LGD operate are in the early stages of a cyclical upswing. The business has had three consecutive halves of half-on-half profit growth. With the Celemetrix (CLX) acquisition that was completed in March of this year, earnings are set to grow sharply in FY19.

The business generated $12.4m of EBITDA in FY19, the maximum earn-out the CLX vendors can get requires an average of $3.75m of EBIT for FY19 & FY20. Given the D&A for LGD in the first half was $939k and for the full year was $2,441k, and that the CLX acquisition was consolidated for 4 months, we can reverse engineer a D&A charge for the CLX business of about $1.6m. If we assume they don't quite get the full earn-out EBIT, say $3.4m, then EBITDA for the CLX business should be about $5m.

Note 2 of the annual report shows CLX contributed $895k of profit in the 4 months it was owned. Given we can estimate the D&A for CLX at $563k, we can roughly deduct $1.46m from the LGD FY18 EBITDA to figure the original business generated $11m of EBITDA without CLX. Given the improving conditions the management commentary describes in recent reporting, a high single-digit growth in revenues for the non-CLX businesses seems reasonable; this should translate into low double-digit EBITDA growth. If I estimate a 12% EBITDA growth (it could well be more than this as some one-off matters cost the Gas division around $500k that should be easily returned in FY19), we get a little over $12.3m for the non-CLX businesses (we think this is very conservative). Add back the $5m EBITDA for the CLX purchase and we get a little over $17.3m of FY19 EBITDA.

D & A will likely be just over $3m (much of this will be true non-cash amortising the customer relationships acquired through the CLX purchase), leaving an EBIT of about $14.3m. Interest is hard to guess as there was an excess of working capital at June 30 balance date which apparently normalised through July and August. I would estimate interest should be no more than $1m, but with facility charges perhaps an interest charge of $1.3m would see a round $13m PBT. Applying the 30% corporate tax rate leaves us with just over $9.1m of NPAT.

As mentioned above, the market capitalisation at 26.5cps is $57m and we think the normalised net debt is about $15m. So in our estimation, LGD trades on a prospective EV/E for FY19 of less than 8x. On a FY19 prospective EV/EBITDA basis, LGD stock is trading less than 4.2x.

In our view, a free-cash flow basis is probably the best way to value the stock, but given the strong industry outlook for the next few years and the very conservative accounting, we can't see a reason the stock should trade on less than 12x EV/E, which implies a $109.2m EV based off our $9.1m NPAT estimate. This implies an equity value of 43.8cps. The stock has previously traded at 40cps when it was last earning amounts similar to

On Depreciation:-

I linked to a recent podcast I was a guest on in the monthly email. For those who missed it, you can listen to it here. The rest of the Rask Finance website is worth navigating around. Owen is doing a good job trying to pull together some threads of personal finance and investing into a central place for those who care about wealth creation and I'm sure more interesting podcasts than my own will follow in due course.

One point I mentioned in the podcast that some fellow investors have commented on was my obsession with removing depreciation from my life and family budget, particularly in the early years when from a poor beginning, we were trying to build a capital base which would ensure a secure financial future. There are two primary ways to build a savings base, they are to minimise your outgoings and maximise your income. The majority of the financial foundation my family built between my ages of say 20 and 35 years came from focusing on minimising costs.

More than any other single factor, I am sure depreciation picks the pockets of the middle class. There are over 19 million registered vehicles in Australia. If we use the number of persons under 14 and over 65 as a proxy for 'non-drivers', that means there are slightly more vehicles than people of driving age. There are more than 1.2 million new cars sold in Australia every year.

The average new car costs $27,994. I was surprised when I looked into this (as someone who has purchased more than 30 vehicles – more on this below - and never taken a car loan) but about 64% of the costs of all vehicle sales are paid for by financing.

The average car at the end of 3 years ownership is worth 55-60% of its purchase price. The median household income in Australia is about $84k per year. Living expenses for an average Australian family of four are apparently $5,378 per month or $64,500 (I think with frugal living, this could be substantially reduced by the way…). This leaves $19,500 of 'disposable income'.

If using the price figure above, we assume the average household owns 1.5 vehicles which they replace every 3 years, then the cost of depreciation to this family would amount to about $5,950 per year, or in other words, it would either consume a little over 30% of their 'disposable income', or add nearly 26% to their disposable income (depending on which side of the ledger it comes from). Stretching the replacement out to a five year period would have the effect of reducing the annual depreciation cost to this example family to below $5k per annum. Stretch it further to 8 years and it drops to around $3,400.

The way we learned to beat the insidious depreciation monster for our family (as discussed in the podcast) was to use vehicle auctions to replace our vehicles regularly at bargain prices. The target was to buy a vehicle that was less than two years old and preferably with less than 40,000 kilometres on the odometer. I aimed to buy the vehicles so well at auction that I could replace them within 12 months (when they still had some manufacturer's warranty attached for the buyers' security) by private sale at a price equal to or higher than what I'd paid. Our strategy was to attend an auction (usually ex-government vehicles) with at least 10-15 target vehicles in mind and a strict valuation framework. For example if I thought a vehicle had a current private sale valuation of $18,000 I would set a bid maximum of $15,300. If successful this would usually allow us to drive the car for 8-12 months and then sell it privately for $15,500 - $16,500.

We managed to largely remove vehicular depreciation from our family budget for more than 10 years (in fact we turned it into a modest profit centre). As a side benefit, we often removed some components of running costs too, for example if I bought a vehicle with good tyres and on-sold before the tyres needed replacing, or purchased a vehicle that came with the remainder of a free servicing package. As we were a two car family, I estimate our savings over the more than ten year stretch we operated this program amounted to at least $80k versus the alternative of buying new and replacing within 3 years. Given the period I was focused on this activity ended about 3 or 4 years ago (when the time spent pursuing the activity began to exceed the benefits as a proportion of our total family wealth – I intend to continue minimising depreciation by owning cheaply acquired vehicles for very long stretches, I would estimate this activity has added in excess of $300k to our family worth, given the money saved was invested at returns averaging about 15% or so over the past 15 years.

In truth it isn't that high as the alternative would never have been buying two new cars every three years (far too extravagant for my tastes), but the example is supposed to be indicative of the wealth gains that can be had by managing one important and expensive area of the average budget well and investing the savings.

There is obviously a time cost to this exercise too. I used to try to mitigate this by attending an auction when we'd already sold one of our two vehicles and acquiring two replacements at once, prior to selling the excess vehicle. In order to make the most of the strategy, you must also have the cash available so you're not dealing with financiers. Buying and selling your vehicles without encumbrances is the only way to go for simplicities sake.

The other cost is that in order to do best financially from the activity, one need be completely indifferent to the car you drive. My Wife Sue was especially tolerant in this regard (she tolerates many oddities in me to be fair). We owned Toyota Prius', Camry's, Holden Astra's, Nissan Tiida's, Ford Focus, Hyundai ix35's and a Subaru Liberty etc. When we found a car we enjoyed using (we loved the Liberty) ownership might stretch out to 18 months or so and we may take a small loss at sale due to the longer ownership period. Cars we did not enjoy driving got turned over more quickly, such as the Tiida's which were always unpopular at auction, but not hard to sell privately at a price above what we'd paid, so we turned them over fairly quickly and profitably.

Although I'm not a car fan, I am a big fan of deal-making and getting the better of the system, so I didn't find it as much of a chore as it probably sounds. For some people, this activity would be an enormous burden, but to me it was just a way of allowing me to keep our family in late-model cars and simultaneously turbo-charge our wealth creation. Given how valuable it was to us as a young, financially bereft family, I thought it useful to share with our investors who may find themselves in a similar position, or perhaps have children who might exploit the strategy.

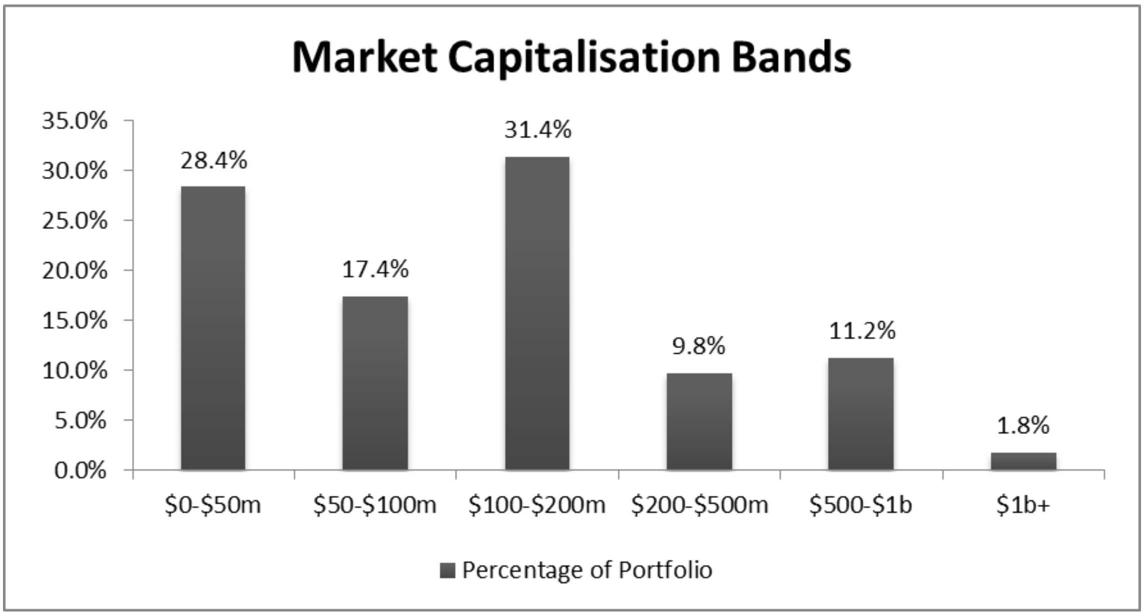
Key Portfolio Information:-

Our top 10 holdings at 31 August 2018 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	11.2%	9.4%
2	Kangaroo Plantation (KPT.ASX)	8.6%	7.2%
3	Global Construction Services (GCS.ASX)	6.5%	5.4%
4	APN Regional Property (APR.NSX)	5.5%	4.6%
5	Legend Corporation (LGD.ASX)	5.2%	4.4%
6	Locality Planning (LPE.ASX)	4.0%	3.4%
7	Blackwall Limited (BWF.ASX)	4.0%	3.3%
8	Undisclosed	3.6%	3.0%
9	Redbubble (RBL.ASX)	3.0%	2.5%
10	Dicker Data (DDR.ASX)	2.9%	2.4%

Our largest 5 holdings now comprise 36.9% of our invested capital, our top 10 holdings are 54.3% and our top 15 represent 67.3%. Cash and cash equivalents are 16.1% of the portfolio.

The market capitalisation graph is set out below. This month, the median market capitalisation is $104.6m.



As always, investors with any questions, suggestions, comments or investment ideas should feel free to drop me a line – Tony@egpcapital.com.au

Fund Features		Portfolio Analytics	
Min. initial investment	$100,000	Sharpe Ratio[1]	0.39
Additional investments	$5,000 (Minimum) $200,000 (Maximum)	Sortino Ratio[1]	0.22
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	6.51% 7.16%
Distribution	Annual 30th June	Largest Monthly Loss – EGP Largest Monthly Loss - Benchmark	-3.0% -3.8%
Management fee	0%	Largest Drawdown – EGP Largest Drawdown - Benchmark	-7.4% -3.8%
Performance fee (<$50m) Performance fee (>$50m)	20.5% (inc GST) 15.375% (inc GST)	% Of Positive Months – EGP % Of Positive Months - Benchmark	60.0% 68.0%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	5.2% 15.4%
Custodian/PB	NAB Asset Services	1 year return[2] – EGP 1 year return – Benchmark	4.1% 15.4%
Responsible Entity	Fundhost Limited	3 year annualised return[2] – EGP 3 year annualised – Benchmark	N/A N/A
Fund Size	$57.3m	5 year annualised return[2] – EGP 5 year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$1.0122 $0.0016	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$1.0137 $1.0106

1 Sharpe and Sortino Ratios calculated using the Monthly Benchmark ASX200 Total Return Index

2 Return is net of all fees and costs and assumes reinvestment of dividends. 1, 3 and 5 year figures are rolling annualised figures.

Past performance is not an indicator of future performance.

The information in the below table is provided for shareholders in EGP Fund No. 1, and does not relate to the EGPCV Fund.

EGP Fund No. 1 Pty Ltd Equivalent Price	$2.0725
EGP Fund No. 1 Pty Ltd Franking Credits	$0.0109