EGP Concentrated Value Fund

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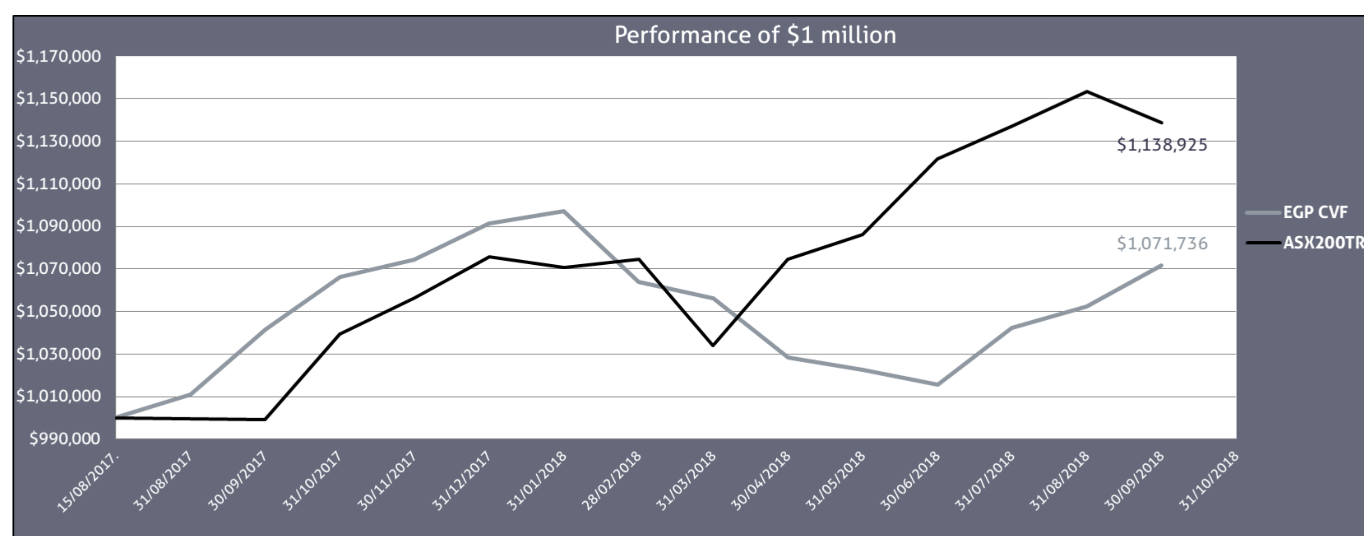
EGP Concentrated Value Fund – 30 September 2018

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%	1.8%										5.51%

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%	(1.3%)										1.53%

*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 1.8% in September. Our benchmark fell by (1.3%).

The modest disappointment we reported last month has turned around this month, with the fund outperforming by more than 3%. It seemed like a delayed reaction to a few of our positions, but the bulk of the freight in terms of outperformance this month was carried by two of the stocks we covered in last month's report, LGD and UOS, so we'll reprise those to explain why they are still cheap in our view.

Action in terms of buying and selling was again limited, save for a significant addition to our LGD position in the first few days of the month and a late commitment of almost 2% of the fund to a very exciting opportunity we will explain in coming months reports.

Our Largest Holding (Reprised):-

United Overseas Australia (UOS), our largest position rose nearly 7% in September. We would like to think our explanation of the investment merits of the business since inception in last month's letter was responsible, but we know it was not.

In fact a young analyst at InvestSmart wrote an article (you will need to sign-up for their free-trial to read the piece) recommending their readers buy the stock up to a limit price of 70c. The readership duly complied and the stock closed the month at 69c.

I have sung the praises of CS and Jim Kong repeatedly over the more than 7 years I've run the fund and for the more than 10 years I've owned UOS shares. I will give a small example of why they are the best in the business, but it is an important lesson in why I think the stock is so deeply undervalued.

Our company (UOS) holds 46.3% of the stock of UOAREIT, a Real Estate Investment Trust that was spun out of in 2006. The REIT holds about $244m of net assets, so these assets comprise about $113m of the $1,369m of assets we own a share of by owning UOS.

The REIT houses 6 of the older commercial assets UOS built, aged between 10 and 23 years. There is one asset in particular in that group that has proven to be a difficult one, known as Wisma UOA Pantai. Over the past 2 years, the occupancy in that building has declined from 88% to 51% (the other 5 assets have occupancy levels between 80-96% at the last reporting – averaging around 90%).

The asset was carried in the December 31st 2017 report at a valuation of $29.98m.

At the June 30 2018 report, Note 9 of the accounts carried the following words:

> ***"The amounts presented in the statement of Financial Position under non-current assets held for sale relate to a controlled entity had, on 8 June 2018 entered into a Sale and Purchase Agreement in respect of the disposal of a commercial building, Wisma UOA Pantai for a consideration of $39.7m. The disposal had been completed on 25 July 2018."***

They sold the most troublesome asset in the REIT for 32.4% premium to the latest carrying value. This is immaterial in terms of the UOS valuation. It causes a mere $4.5m increase to UOS's earning this year, in the context of circa $100m of earnings and $1.37b of net assets, it's only a modest matter. But we think it's emblematic of the extraordinary conservativeness of the UOS accounts.

In our view, there are a number of similarly undervalued assets. One obvious example is the Vertical Towers A and B at the Bangsar South mega development. These towers are held on the UOS balance sheet for a combined valuation of $222.8m (in part because one of the towers is held in PP&E at cost because a number of the floors are used by the business for their operations). We estimate the pair could be disposed for at least $450m if the Kong's were inclined to sell them (holders of UOS own 69.6% of those buildings. A $4.5m gain may not be material, but the $158m gain attributable to UOS owners implied by those estimates most assuredly is). The Vertical Towers are just two assets that speak for just over 1/10th of the assets the business presently holds.

We think the stock is a gift at current prices. That of course doesn't mean it goes up, the market is a fickle mistress, but it makes us fairly confident about our largest position in coming years. Unless it was for portfolio management reasons (investor redemptions or if the position became too large), we would not sell unless the holding exceeded the NTA, which would require a rise of more than 40% from current levels.

Growth at A Remarkable Price (Reprised):-

Legend Corporation (LGD.ASX) was likewise profiled in last month's newsletter. The market assessment of the value of LGD increased by more than 35% in September. Again, we would like to think our explanation of the investment merits of the business was responsible for the rise, but again, we know it was not.

LGD released a market update on the 11th of September to alert investors to the fact that EBITDA was up 70% compared to the first two months of last financial year. My estimate from last month's letter plumped for a more than 40% increase in EBITDA in FY19, but things are clearly going much better than even I had anticipated. If the 70% EBITDA uplift were to hold for the entire financial year, the NPAT for the LGD business in FY19 could be a little over $11m (I estimated $9.1m last month, so this tells you how well the business is travelling), $11m translates into a little over 5cps of earnings (remembering due to the heavy D&A charge, cash earnings are customarily better than statutory earnings). The historic multiple for LGD has been a fairly modest 10.5-11x statutory EPS, which implies a share price of about 55c (or a further 50% upside from here). I will try to explain below that the business is better than it was historically and as such, potentially deserving of a higher multiple than it has traditionally been awarded.

I visited the Seven Hills facility through September and my evaluation of the investment merits of the business were materially enhanced by the experience. Brad Dowe runs a first class operation and the facility was clearly humming. Among the facts gleaned from the trip was the significant investment in IT logistics capability (all expensed as incurred, naturally) that the company has made in the past few years. Each major business has applications that allow the end customer to seamlessly order online without interacting with a sales person. The Apps have user manuals explaining product features; features such as these will see a progressive shrinking of the labour cost as a proportion of revenues. This increased productivity should allow LGD to capture progressively higher margins.

The two other key features that we suspect are not well understood about LGD's offering is the fact that they ship 98.7% of the orders they receive the same day. With the extraordinary breadth of their range, this means they have to hold a fairly substantial inventory, but because the client can rely on the service LGD provides, it allows clients to "de-stock" their own inventory and makes them enormously reliant on LGD. Provided they continue to provide this seamless logistics service, the significant inventory the company carries effectively allows them to build a moat not dissimilar to the one Reece possesses. It is self-reinforcing too, and Brad Dowe anticipates inventory levels can probably be grown at about half the rate of revenues as further productivity gains are made over time.

The second key feature is that the new products LGD are developing and the businesses they are focussed on acquiring are all higher margin than the existing businesses. Having increased exposure to sectors such as medical and defence also allows for higher margins. When we have multiple margin factors pushing in one direction, we could end up with what Munger calls "The Lollapalooza Effect"...

I thought when I first bought LGD for the fund that we were buying on less than 6x earnings. I figured we might own the business for a couple of years, with some earnings growth, dividends and a re-rate to nearer their historic multiple; we'd make 2 to 3 times our money over 2 to 3 years. I now suspect we own a business that has the capacity to steadily grow earnings for years to come.

We expect the business will prove to be far more resilient to future downturns as the breadths of the businesses are far wider than they were when the business last entered a cyclical downturn. At the end of FY2012, when the mining boom ended, about one-third of the revenues of LGD were exposed to the mining sector, I understand this number to now be less than 10%. We believe that comparisons to very high quality businesses such as Reece, while probably to be made cautiously now, will not seem so far-fetched in 4 or 5 years' time looking back on the business setup we faced in 2018.

It Rubs the Lotion on Its Skin:-

We have a small holding (just under 1% of the fund) in an NSX listed brand distributor called Heritage Brands (HBA.NSX). They primarily distribute make-up, tanning and skin care products, they also have some essential oil products. Their primary owned brands are Australis, Innoxa, Le Tan, Oil Garden and Cedel (acquired this year as an avenue to access the Chinese market). They are also licensed distributors for brands such as Skin Republic (the no. 1 face mask in Australia), Revlon and Hello Kitty.

We acquired the majority of our stake in July 2015 when they raised capital to acquire the Le Tan business. This half, after several false starts, it appears the business is really starting to fire on all cylinders.

The July half they just reported on (they use an unusual January/July balance date) showed revenues against the prior period up 19.5%, which fell down to a profit before tax against the prior period up 46%. The business has successfully found channels for a number of their brands into Singapore, Malaysia, the UK and the Philippines. Their European distributor is apparently interested in adding a number of new countries in the next 12 months as well as widening the current range. Management are keen to explore a channel into the US now that the underlying business is on a really firm financial footing.

On my estimates, based on the January half in 2019, the trailing twelve month (TTM) results should see something resembling the following:

Revenue	$65.5m (tricky to forecast, trading terms vary sharply year to year)
COGS	$36.4m
Advertising	$5.0m
D&A	$0.5m
Employees	$11m
Finance/Occupancy/Other	$6.5m
Profit before Tax	$6.1m

This doesn't look remarkably cheap at a high single digit EV/EBIT and about a 14x P/E, but a distributor with high margins, widening export channels and a proven international growth strategy probably trades at a higher multiple than this most of the time. Particularly one that's lifted PBT by more than 50% in the past 12 months and appears to have a number of avenues via which they should maintain growth for a number of years.

I don't rely much on industry comparisons, but BWX for example trades at EV/EBIT around 15x (if we generously accept the restructuring charges as true one-offs). I would hazard the next few years for Heritage Brands will be much better than they will be for BWX.

The real key to valuation will be how far they can push the export strategy. The export revenues come with slightly slimmer margins than the Australian business, but the earnings are much higher quality as the inventory risk is immediately passed off to their distribution partners.

Our final word on HBA is that the website is excellent for gifts for your Mother, girlfriend, Wife or daughter (or any males you might know with a beauty and skincare regime, we're modern thinkers), free shipping if you order more than $50 of goods too! Birthdays, Christmas gifts, if you're going to buy them anyway, you may as well support a company you're a shareholder in, so at least your gifting dollar will be partially returned to you as an increased unit price. With spring carnival imminent, if there's going to be the scent of spray on tan in your home, make sure it's a Heritage Brands spray tan…

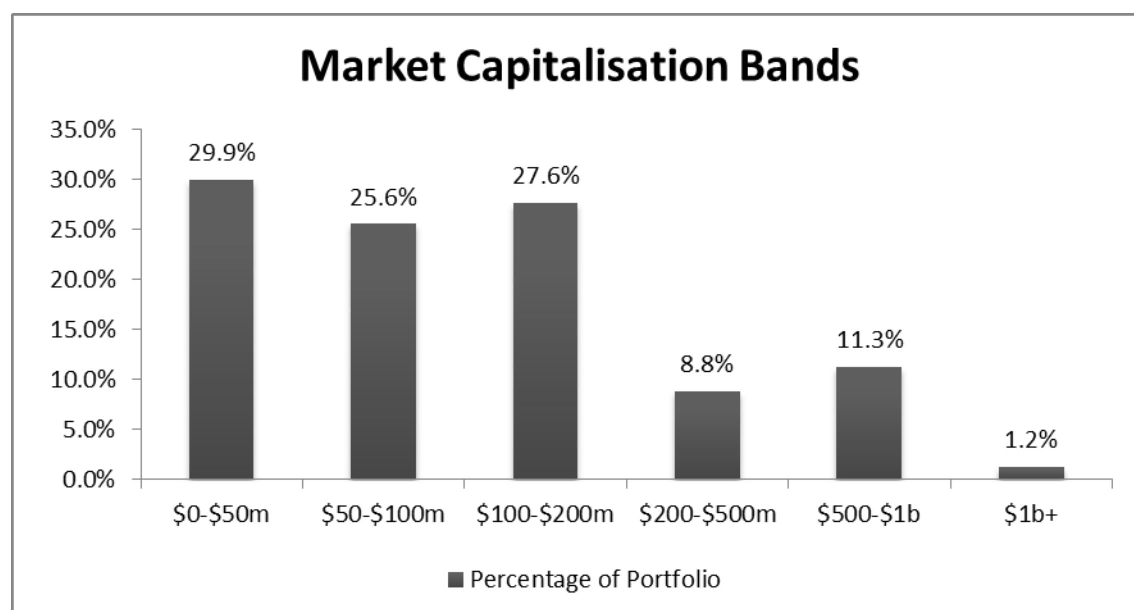
Key Portfolio Information:-

Our top 10 holdings at 30 September 2018 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	11.3%	9.8%
2	Kangaroo Plantation (KPT.ASX)	7.8%	6.8%
3	Legend Corporation (LGD.ASX)	7.6%	6.6%
4	Global Construction Services (GCS.ASX)	6.2%	5.4%
5	APN Regional Property (APR.NSX)	5.1%	4.5%
6	Blackwall Limited (BWF.ASX)	4.3%	3.8%
7	Undisclosed	3.6%	3.2%
8	Locality Planning (LPE.ASX)	3.6%	3.1%
9	Undisclosed	3.3%	2.8%
10	Redbubble (RBL.ASX)	2.8%	2.4%

Our largest 5 holdings now comprise 38.0% of our invested capital, our top 10 holdings are 55.5% and our top 15 represent 67.4%. Cash and cash equivalents are 13% of the portfolio.

The market capitalisation graph is set out below. This month, the median market capitalisation is $99.3m.



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]	0.65
Additional investments	$5,000 (Minimum) $200,000 (Maximum)	Sortino Ratio[1]	0.31
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	6.39% 7.23%
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	63.0% 63.0%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	7.2% 13.9%
Custodian/PB	NAB Asset Services	1 year return[2] – EGP 1 year return – Benchmark	2.9% 14.0%
Responsible Entity	Fundhost Limited	3 year annualised return[2] – EGP 3 year annualised – Benchmark	N/A N/A
Fund Size	$58.9m	5 year annualised return[2] – EGP 5 year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$1.0308 $0.0036	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$1.0324 $1.0293

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	$2.1109
EGP Fund No. 1 Pty Ltd Franking Credits	$0.0109

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