EGP Concentrated Value Fund

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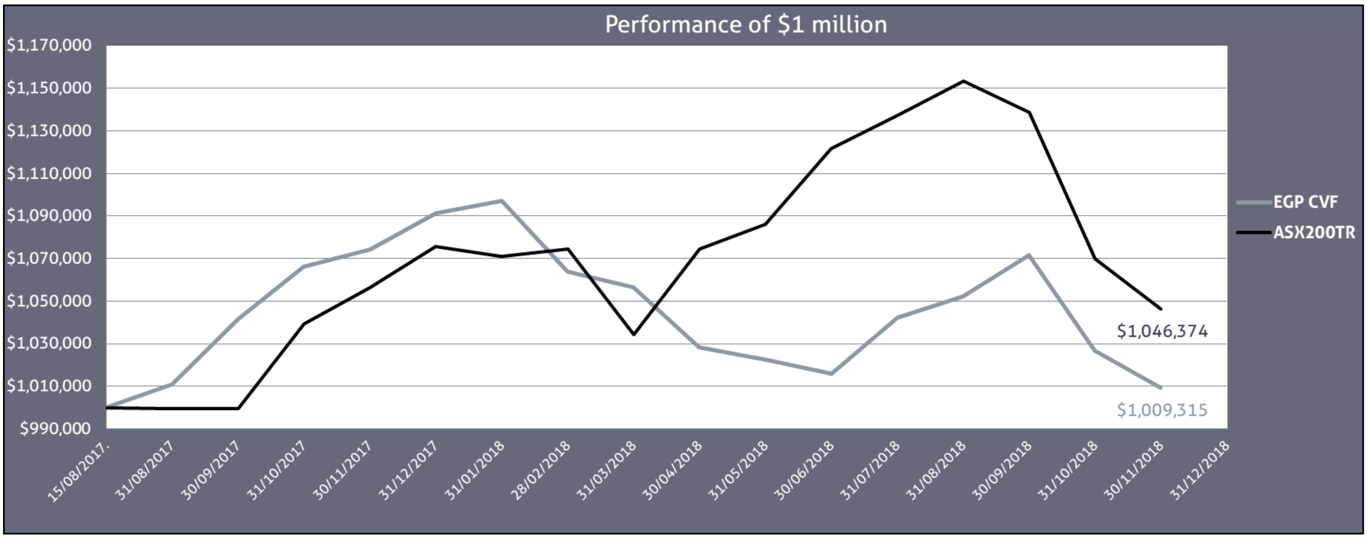
EGP Concentrated Value Fund – 30 November 2018

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.

	Jul	Aug*	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FYTD
EGPCVF 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%
Benchmark 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%
EGPCVF FY19	2.6%	1.0%	1.8%	(4.2%)	(1.7%)								(0.64%)
Benchmark FY19	1.4%	1.4%	(1.3%)	(6.1%)	(2.2%)								(6.72%)

*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 fell by (1.7%) in November. Our benchmark fell by (2.2%).

We are generally pleased to report a month of meaningful outperformance. As we said in the accompanying email though, November was a weaker month than it should have been. The two key contributors that meant the outperformance was weaker than it should have been were Redbubble and SRG Global. These investments are discussed in some detail in the rest of the newsletter.

There was one other poor November performance from our holdings and other than that, the portfolio held up remarkably well. We are now of the view the portfolio is the cheapest it has ever been since the first fund was created in 2011. Timing in the market is unpredictable, but the personal view of your fund manager is that anything short of a compounded double-digit annual performance over calendar 2019 and 2020 would be disappointing.

Has the Redbubble Burst?:-

At EGP, we consider our wheelhouse to be 'value' investing, whereby fixed assets can be purchased at below their saleable value, or sustainable earnings can be purchased at well below their intrinsic value. Redbubble we own for different reasons, it is a fast-growing ecommerce business that is hoping to earn its first profit in FY19; it is an uncommon investment for EGP, but an investment we have added to again this month, we will explain why below.

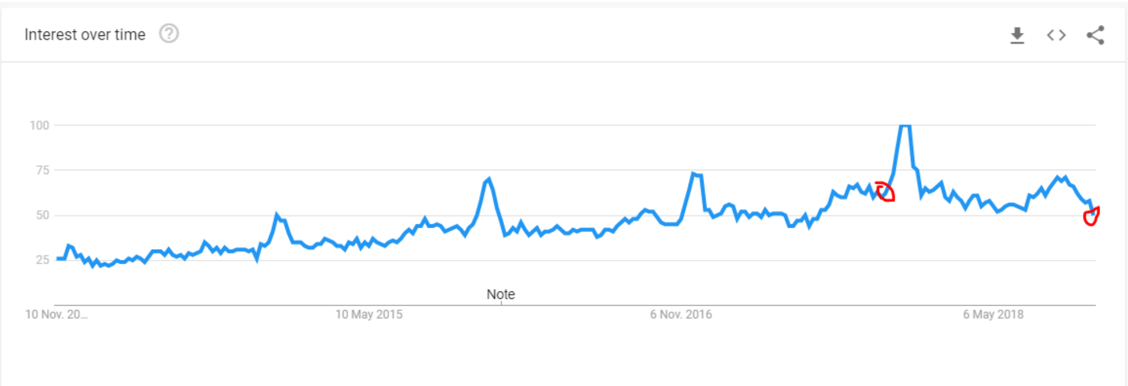
I first wrote in our monthly blog about Redbubble at the end of November last year. That blog is a good introduction to the attractive features of the business model for the uninitiated, such as the very attractive negative working capital profile the business operates with. The share price when that blog was written a year ago was 83c. In the intervening 12 months, the share price has been as high as $2.05 (intraday) in February and this week briefly traded again at 82c. It closed this month a couple of days later at $1.165.

It is examples such as this that help a Fund Manager remind their clients that the reason superior returns are on offer when investing in equities is because achieving these superior returns will generally require a little more stomach than other less volatile (but less remunerative) investment alternatives.

In the investor commentary released with the Redbubble September quarter sales/cashflow update on 24 October, the following words appeared:

"In recent weeks, the business has seen some softness in organic search traffic and revenue due to Google, as it does regularly, changing its algorithms. Based on its previous experiences, Redbubble expects this effect to be short-lived as the business takes actions to respond."

I started to track the Google Trends search data closely. On November 5th, I took this screenshot:



We contemplated trimming our position as the difficulties with the Google algorithm were clearly causing a greater challenge than anything they'd previously encountered. We decided as a long-term investor to do nothing and rely on management doing what they'd done previously and correcting their organic search results.

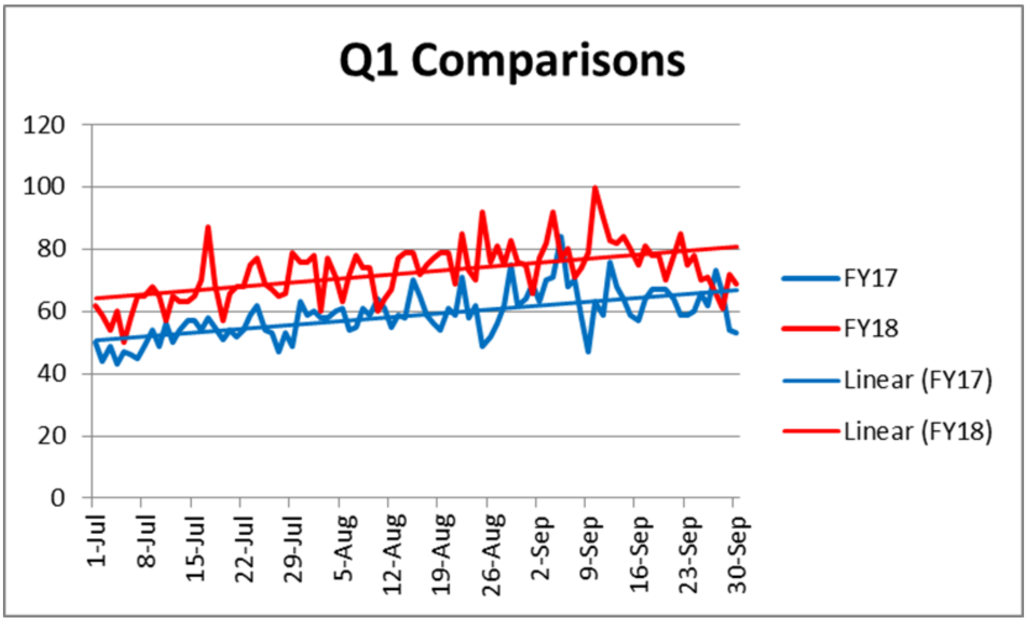
This whole period was complicated by the fact Redbubble had raised capital to acquire their competitor TeePublic. The share price gradually eroded from around $1.50 on 5 November to $1.10 on 27 October when they announced their Thanksgiving weekend sales as savvy investors looked at the weak organic search and sold.

Redbubble has guided to "at least 30% Revenue growth on a constant currency basis". They had achieved 31.2% in the September Quarter and 30% or more with monotonous regularity over preceding quarters. When they announced 14.3% constant currency growth for the important Thanksgiving weekend sales period (20.3% including TeePublic), the high-growth investors attracted to Redbubble were understandably spooked.

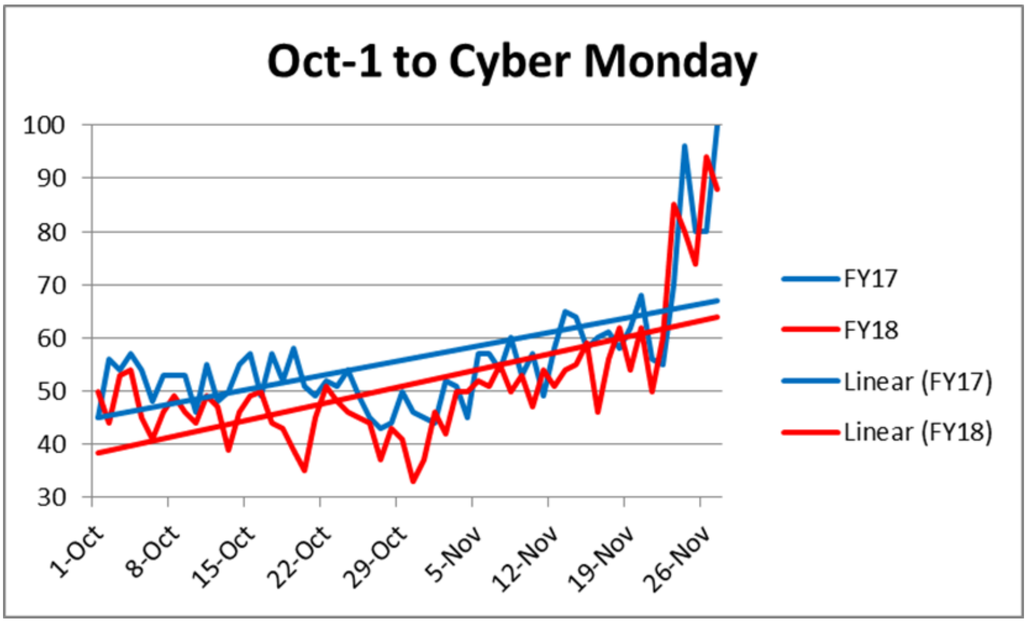
As mentioned earlier, the share price fell sharply to as low as 82c. We started a more detailed analysis to decide whether we should be panic selling with the rest of the market, exploiting the buying opportunity, or sitting on our hands.

The first piece of analysis we did was to examine the quarter by quarter Google Trends (GT) figures to decide how reliable an indicator they are for Redbubble's sales figures. GT results two or three years ago were much more correlated with the Redbubble final sales results than they are now, but a large portion of the sales growth is still predicted by the GT numbers. The reducing reliability of GT as a predictor is substantially due in our estimation to the growing repeat customer base that visit the store directly and a small, but growing number of users of the iOS and Android Apps.

The September Quarter 2018 versus September Quarter 2017 figures are graphed below:

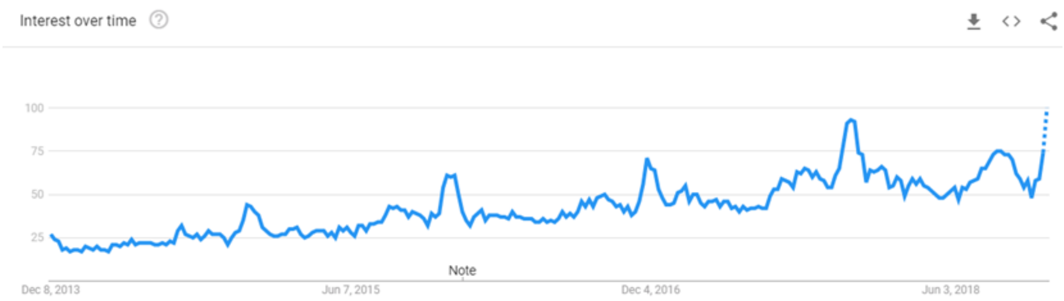


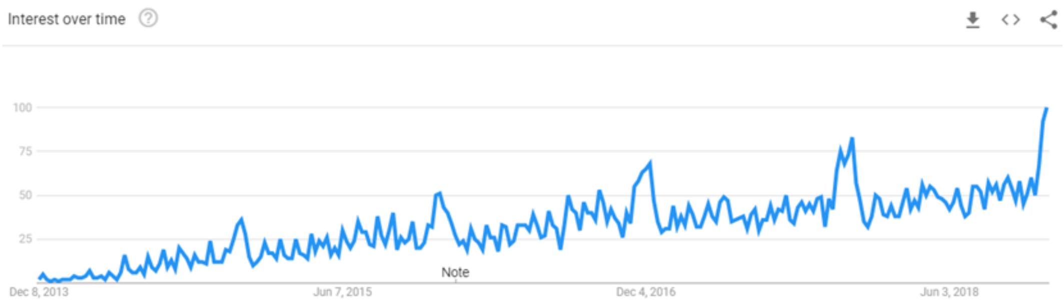
The daily GT results had been about 23% higher and relatively constant through the quarter. Looking at the first picture in the article, the GT results clearly started to weaken early in October. We mapped the GT results for the start of December quarter to "Cyber Monday" (the last day of Thanksgiving sales weekend, the results looked like this:



The FY18 results were 8.8% below the comparable FY17 period, which given the strong predictability of GT to Redbubble's sales results makes the fact that they achieved any Thanksgiving weekend growth over FY17 remarkable. Interestingly, the month of October the results were 12.4% down year on year, with November down 5.4% as management clearly started to get on top of the search algorithm change.

What caused us to add modestly to our holding the day after the weak Thanksgiving sales results was the following GT results retrieved that morning:





The first chart is Redbubble over 5 years, the second is TeePublic. The dotted line for the Redbubble chart indicates the result was based on incomplete data, but the implication was clear, Redbubble had cracked the new algorithm and organic search was spiking higher. The chart shows levels more than 10% above the prior comparable period, from as much as 12.4% down earlier in the quarter.

The TeePublic GT chart shows their GT figures are up more than 47% against the prior year, indicating the acquired business is flying. The cumulative implication of these two GT charts indicate the shortfall observed over the Thanksgiving weekend are likely to be substantially recovered now the important organic search driver appears to have been rectified.

Management mentioned that 63% of December quarter sales come in the 35 days after the end of the Thanksgiving weekend, so they appear to have recovered in time to ensure this quarter will likely not be impacted as much as market participants had imagined following the weak Thanksgiving update.

The incident has managed to hammer home a very important risk to the business, which is the enormous dominance Google hold over Redbubble and any other businesses reliant in large part on organic search traffic to succeed. It is likely that Google makes these algorithmic adjustments in part at least to assist their own paid AdWords results. The enormous power Google wield in this area makes me very nervous about the proper functioning of free markets. It also makes me want to own Google stock as that type of market power in extraordinarily uncommon.

We added to our holding in the expectation the business will return to its prodigious growth trajectory and that the self-reinforcing strength of the business model will resume. The wonderful negative working capital nature of the business means now they've passed breakeven, the faster the business grows, the more cash it will produce, allowing it to reinvest and grow faster still.

As the business grows, important scale factors kick in. The same order I placed this time last year would now be 5% cheaper this year, with the margin Redbubble earns unaffected as their global fulfilment and logistics supply chain builds out.

Redbubble is a difficult business to pin down a fair value for. The range of potential outcomes are very wide, and will depend much on how well they can navigate issues such as the Google algorithmic changes they have dealt with over the past couple of months. If the business can maintain anything like the circa 30% growth rates they've been able to manage, and control their operating expenditure, the business should easily be worth a meaningfully more than it is at present.

The business is presently operating with much more modest "operating leverage" than it will ultimately be capable of generating at increased scale. Costs are currently growing at about 20% while revenues grow at 30%+. The expectation I am working on for my valuation model is that in a couple of years' time, operating cost growth will be able to be kept at 10% or thereabouts. Charges such as depreciation and amortisation as a proportion of earnings will also slow greatly as the business scales, also likely to be as little as 10% annually.

If the business can control costs in the way described above, profits should grow at an explosive rate in coming years. Based on the company's guidance, they should generate about $3-5m of EBITDA off about $325m-340m of gross transaction value, or about $260m-270m in statutory revenue in FY19.

If we make some assumptions about growth for the next few years:

1. Revenue growth of 30%/27.5%/25% & 25% for the next 4 years;
2. OPEX/D&A growth of 17.5%/15%/12.5%/10%;
3. GP margin holds at 35% (as savings from scale are passed on to the customer) &
4. Paid marketing is held at 27.5% (well above historic figures)

Such a result would look something like this:

	2019	**2020**	**2021**	**2022**	**2023**
Revenue	265.0	344.5	439.2	549.0	686.3
Gross Profit	92.8	120.6	153.7	192.2	240.2
Paid Marketing	-25.5	-33.2	-42.3	-52.8	-66.1
GPAPA	67.2	87.4	111.5	139.3	174.2
OPEX	-62.2	-73.1	-84.0	-94.6	-104.0
EBITDA	**5.0**	**14.3**	**27.4**	**44.8**	**70.1**
D & A	-10.0	-11.8	-13.5	-15.2	-16.7
EBIT	-5.0	2.6	13.9	29.6	53.4

***Please note these are not forecasts, simply the outworking of the assumptions listed above the table.**

Redbubble are likely to have somewhere between $25-30M of net cash at the end of FY19. The current share price of $1.165 gives a market capitalisation of just under $300m based on the current shares on issue, and implies an enterprise valuation (EV) of around $275m.

If anything like the EBITDA outcomes listed above is achieved over the next 4 years, a $275m EV will look to have been a remarkable opportunity. For a potential reference point, Appen (APX) has had a similar EBITDA trajectory over the past 4 years to the one derived for 2020-2023 from the assumptions in the above table. They have guided $62-65m of FY19 EBITDA and today have a market capitalisation of about $1.5B and an EV/EBITDA of about 24x. That is a remarkably high multiple, but any business that can grow EBITDA at the circa 100% rate APX presently is can chew into a demanding multiple very swiftly.

We are by no means suggesting Redbubble will have a market capitalisation of $1.5B in 4 years' time, and the outcomes in the table should be discounted heavily based on the considerable uncertainty around their achievement.

If the 2022 outcome proffered in the table took until 2023 to achieve, the investment result for the investor who buys at today's prices would still be very respectable.

When a value investor like EGP is investing in a growth business like Redbubble, what we are looking for is basically the same thing as with our more traditional investments, a margin of safety. In the case of Redbubble, the margin of safety comes from the fact that they would need to significantly undershoot on growth for the current valuation to present a significant risk to the one true danger to investors, the permanent loss of capital.

When Integrity Becomes a Question:-

An investment EGP holds in SRG Global (previous ticker code GCS, now SRG) has caused a need for discussion of management integrity and thought about when one must act based on a board or management team that no longer deserves the benefit of the doubt.

SRG Global has come about via the recent merger of SRG Limited with Global Construction Services. The share price of GCS has declined significantly since the merger was announced, including more than 20% in November. This suggests investors think something has reduced the value of the business since then.

There are three likely factors we think that would account for the share price reduction. In our estimation, the first two of these factors probably account for perhaps 30 or 40% of the fall in the share price, with the final factor accounting for the remainder.

The first is a general weakness in the construction sector. Businesses in the sector have come under some recent price pressure as the outlook for construction companies seems generally less favourable than is was 5 or 6 months ago. Among the things affecting sentiment is the recent placement into administration of the RCR Tomlinson business, causing people to remember the occasionally unpredictable nature of contracting outcomes. The sentiment of the investing community is something outside of management control and management should pay it no attention.

The second factor is the outlook for the business more specifically. This factor is somewhat within the control of management, although the timing of contracts is in the hands of clients and large contracts shifting a few months can cause large swings in annual revenues and profits. The key issue for GCS is that management at the time of the merger gave tacit credence to the market consensus of pro-forma EBITDA for the combined business of $55-60m in FY19 (EBIT of $42-47m).

Given the merged businesses would speak for 50% each of the EBITDA and one of the businesses would be consolidated for only 9 months, this implied EBIT of $36.8m-41.1m in FY19. The negative reaction of the market to a mid-point EBIT forecast at last week's AGM of $32.5m is unsurprising; it was a downgrade of 12-21% on expectations. Management did guide a "step-change" in FY20 earnings, but to be fair; hitting the FY19 EBIT expectation of $47m from $32.5m in FY19 would be a 45% "step-change" whilst only really providing what the market had expected a year earlier.

The third factor and what we wanted to discuss today are question marks around the execution of the board of the fiduciary duty they owe to shareholders. As part of the merger, the CEO's of the respective businesses had performance rights vest that in the case of the SRG CEO David McGeorge had many years to run and given the apparently weak FY19 result looked unlikely to be achieved.

From the FY17 SRG annual report, we can see that at the time of merger, the unvested performance rights Mr McGeorge held were structured like this:

- 250,000 Performance Rights, for the period ending 30 June 2018
- 350,000 Performance Rights, for the period ending 30 June 2019
- 350,000 Performance Rights, for the period ending 30 June 2020
- 350,000 Performance Rights, for the period ending 30 June 2021
- 500,000 Performance Rights, vesting 1 July 2019, subject to continuous employment
- 500,000 Performance Rights, vesting 1 July 2021, subject to continuous employment

The 250,000 FY18 rights required SRG achieve underlying earnings per share (EPS) of 15.39c or higher for vesting, with pro-rata vesting from 13.84c. SRG limited achieved underlying EPS of 12.8c in FY18. Absent the merger, the rights would have expired worthless with the performance falling well short of the target.

The 350,000 FY19 rights required 17.7c EPS for full vesting. This would require a 38% uplift for this year, which given the forecast EBIT for the combined group is looking so much weaker than expectations seems like it was highly unlikely to occur.

The 350,000 FY20 rights required 20.35c for full vesting. This would have required an EPS CAGR of 26.1% over FY19 and FY20.

The 350,000 FY21 rights required 23.4c for full vesting. This would have required an EPS CAGR of 22.3% over FY19 and FY20.

The 1 million continuous employment rights may well still have vested.

I should point out that I have no issue with the rights themselves. Although the 'continuous employment' rights seem needlessly generous, the 4 tranches of rights linked to 15% EPS growth would have resulted in significant shareholder wealth creation had the performance targets been met.

The point here is that the 2,300,000 performance rights, worth $4,117,000 at the time of the merger announcement vested and that at least in the case of the 1,300,000 related to EPS growth seem highly unlikely to have been earned had the merger not happened.

The SRG business at the time of the merger announcement had a market capitalisation of $156m, the vesting of the performance rights that had not been earned and to a large extent seemed unlikely to be earned effectively gifted 2.64% of SRG to the CEO.

I should be clear here that I do not hold this against David McGeorge, his job as an employee selling his time and efforts for remuneration is to ensure he obtains the highest value he can for that time. No, the mistake here rests with the board of SRG that allowed a situation where an egregiously large and unearned package vested when it should not have.

The only question some investors in SRG (of which we were not at the time of the merger) have posed to me that only David McGeorge can honestly answer is whether one of the factors driving the decision to merge was the fact that a substantial part of the generous performance right package was likely to go begging were a transaction that triggered their automatic vesting not initiated.

The correct path for the board to have taken in this situation in my estimation is to have carried forward the rights into the merged entity at the same ratio as the scrip conversion. This would have resulted in the FY18 rights lapsing and the following carrying forward to the combined business:

- 867,650 Performance Rights, for the period ending 30 June 2019, requiring EPS of 7.14c for full vesting.

- 867,650 Performance Rights, for the period ending 30 June 2020, requiring EPS of 8.21c for full vesting.

- 867,650 Performance Rights, for the period ending 30 June 2021, requiring EPS of 9.44c for full vesting.

- 1,239,500 Performance Rights, vesting 1 July 2019, subject to continuous employment

- 1,239,500 Performance Rights, vesting 1 July 2021, subject to continuous employment

The outcome above would have completely removed from consideration the idea that the triggering of the vesting of the rights had any input into whether the merger was a good idea. There was a similar issue triggered in the vesting of rights to the GCS CEO Enzo Gulloti by the merger, but on a meaningfully smaller scale.

Unfortunately the board of the merged business has recently compounded these errors. After meeting with both CEO's on the roadshow presenting the merger, I said separately to each that there had been considerable discussion among other investors I knew about the extraordinary generosity bestowed upon the CEO's via unearned performance rights vesting. My advice to them was, whatever you do, do not come back at the next AGM to ask for new performance rights. I told them if they did, our shares would be voted against any such grant.

Unfortunately, this is exactly what happened, with a total of 3 million performance rights issued (worth more than $2m at the time of proposal). Worse than this, the materials sent out for the AGM give no indication what, if any, hurdles are required to be jumped in order for these rights to be earned. Needless to say, we voted against this resolution at the AGM.

As an investor who spends a lot of time contemplating the incentives of the people running the businesses we own, the replenishment of these performance rights has left a truly foul taste in my mouth. I reiterate, the CEO's of the merged businesses here have done nothing but pursue their own economic interests as they should in a free market. The scrutiny in this situation falls squarely on the shoulders of the respective boards that have allowed such egregious awards to occur. Given the shareholder wealth that has been consumed by unearned performance rights, the question we are left asking is whether we should continue to hold given behavioural change is about as common as unicorn sightings.

It is the intention of EGP to continue to hold our shares in SRG/GCS as we think the underlying trends for the business for the next few years are extremely favourable. If they can earn the $60m of EBITDA that was mooted for FY19 in FY20, the historic EV/EBITDA multiples the businesses have traded on could see a share price appreciation of between 60-100% over the next couple of years. Irrationally selling at fire-sale prices because the board has failed to properly execute on their duties is not our style.

We were a shareholder of Structural Systems (the precursor to SRG Limited) and profited very nicely from the outstanding job David McGeorge did executing a turnaround for that business. We hope to have a similar experience a second time, simply wanting any awards accumulating to him through the process to be carefully considered by the board for appropriateness.

What I can guarantee is that if the egregiously generous awards continue without establishing appropriately difficult hurdles to ensure shareholders get value when performance rights vest, is that our patience is not infinite. If the incentives don't appropriately moderate in coming years, even if the business remains undervalued as it is at present, we will be forced to act. Until then, we remain hopeful the value of the business will be restored and the board will start to handle performance rights with a little more prudence.

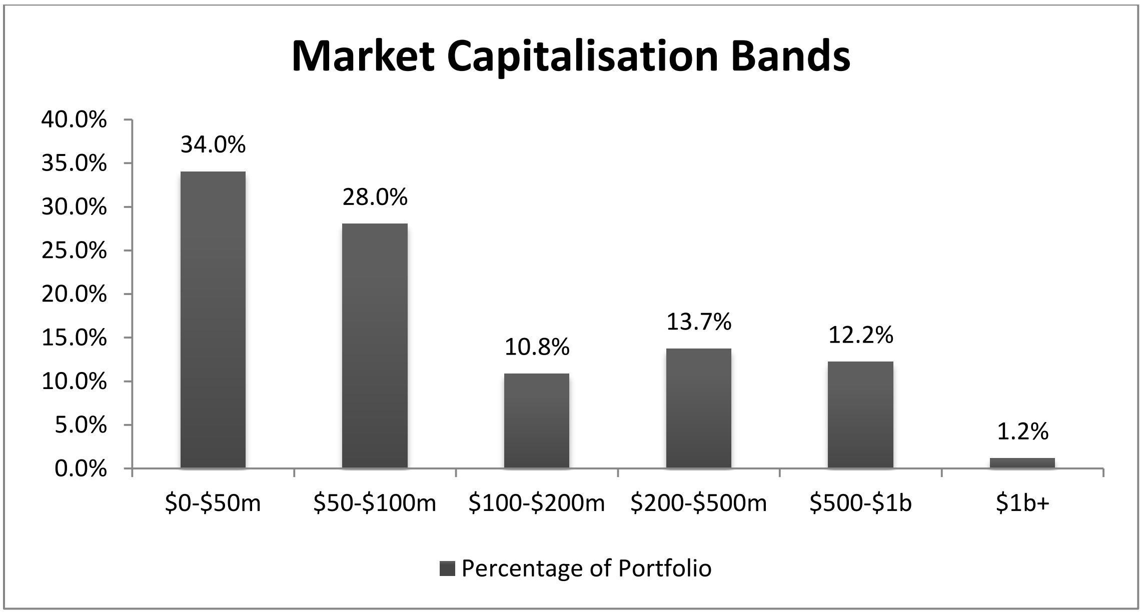
Key Portfolio Information:-

Our top 10 holdings at 30 November 2018 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	12.2%	10.5%
2	Kangaroo Plantation (KPT.ASX)	8.0%	6.9%
3	Legend Corporation (LGD.ASX)	7.2%	6.2%
4	APN Regional Property (APR.NSX)	5.4%	4.7%
5	Undisclosed	4.8%	4.1%
6	Global Construction Services (GCS.ASX)	4.7%	4.0%
7	Blackwall Limited (BWF.ASX)	4.2%	3.6%
8	Locality Planning (LPE.ASX)	4.1%	3.5%
9	Undisclosed	2.9%	2.5%
10	Consolidated Operations Group (COG.ASX)	2.7%	2.3%

Our largest 5 holdings now comprise 37.7% of our invested capital, our top 10 holdings are 56.3% and our top 15 represent 69.2%. Cash and cash equivalents are 14.2% of the portfolio.

The market capitalisation graph is set out below. This month, the median market capitalisation is $70.7m.



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 Max. Initial investment	$100,000 $2,000,000	Sharpe Ratio[1]	0.97
Additional investments	$5,000 (Minimum) $200,000 (Maximum)	Sortino Ratio[1]	0.65
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	7.39% 9.35%
Distribution	Annual 30th June	Largest Monthly Loss – EGP Largest Monthly Loss - Benchmark	-4.2% -6.1%
Management fee	0%	Largest Drawdown – EGP Largest Drawdown - Benchmark	-7.4% -9.3%
Performance fee (<$50m) Performance fee (>$50m)	20.5% (inc GST) 15.375% (inc GST)	% Of Positive Months – EGP % Of Positive Months - Benchmark	54.8% 54.8%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	0.9% 4.6%
Custodian/PB	NAB Asset Services	1 year return[2] – EGP 1 year return – Benchmark	(6.1%) (1.0%)
Responsible Entity	Fundhost Limited	3 year annualised return[2] – EGP 3 year annualised – Benchmark	N/A N/A
Fund Size	$56.2m	5 year annualised return[2] – EGP 5 year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.9708 $0.0040	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.9722 $0.9693

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	$1.9900
EGP Fund No. 1 Pty Ltd Franking Credits	$0.0109
