EGP Concentrated Value Fund

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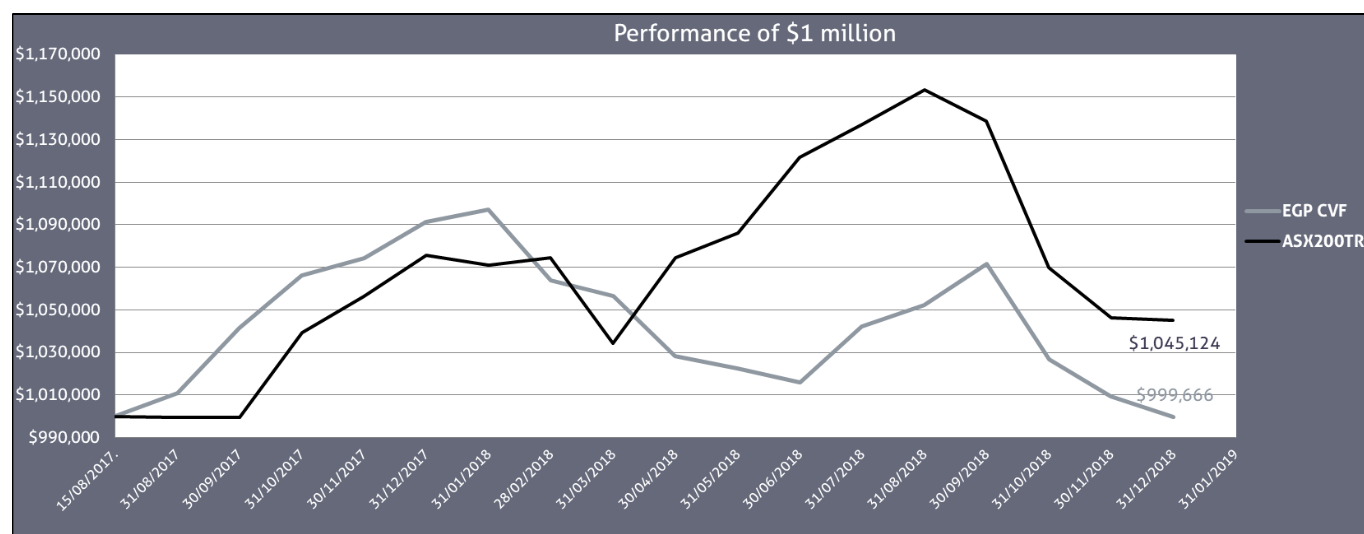
EGP Concentrated Value Fund – 31 December 2018

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%)	(1.0%)							(1.59%)
Benchmark FY19	1.4%	1.4%	(1.3%)	(6.1%)	(2.2%)	(0.1%)							(6.83%)

*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 fell by (1.0%) in December. Our benchmark fell by (0.1%).

The relatively modest movements in the final valuations for the portfolio and the benchmark belie a remarkably volatile month in December. The ASX200 was up nearly 2% early in the month before being down around 3.5% with 10 days to go and then up again before closing the month only modestly down. The portfolio was down as much as 2.5% through the month, but didn't have as strong a comeback to finish the month. As mentioned in the accompanying email, the Small Ordinaries index was especially volatile, finishing down 4.2% with a 6.3% swing from top to bottom.

Three positions accounted for substantially all of the fall in the unit price for the fund this month. The first was Blackwall (BWF.ASX) which fell over 10% on thin volumes and no news. We expect a solid result for BWF (discussed here in December 2017) in February, though they are cycling a large

performance fee from a revaluation gain in the prior period. We remain very excited about the long term prospects of the business, particularly the WOTSO business which should produce a meaningful uplift in EBITDA in this half as some significant properties contribute meaningful revenues for the first time. With the pending settlement of the Bakehouse Quarter sale, Stuart Brown and his team will be cashed up at just the right time with the Australian property market showing its first meaningful reversal in many years.

Redbubble (RBL) which we discussed at length in last month's report was the worst performer for the portfolio this month, with a more than 20% drawdown. We remain confident about the long term value creation potential of the business. We still expect a reversal of the reduced growth shown over Thanksgiving 2018 that has caused the share price to crater.

The final big detractor to the fund performance in December was Locality Planning Energy (LPE), which fell about 10%. We added considerably to our holding through December and remain very excited about the prospects for LPE and as such, we will make it the subject of our profile for the month.

Our short-term investment in APN Regional Property Fund (discussed here) appears to finally be close to reaching the long promised 'liquidity event'. We have agreed to work with Mitch Dawney of Dawney and Co to ensure the managers act in the best interests of the unitholders in achieving the highest possible transaction price. We generally eschew 'activism' as it rarely generates a sufficient financial reward for the time and stresses involved, but in the case of APR, we think we can assist in ensuring we get the highest and best offer for the asset. This should ensure that even though it has taken longer to resolve than expected, the IRR we earn on the trade should still be above our target of 20% per annum.

Funding Secured:-

We released an article about one of our portfolio holdings, Locality Planning Energy (LPE) on Livewire this month, in which we promised to expand the analysis in our monthly newsletter. We first discussed LPE in the September update last year (.pdf), that update is worth reading to cover some of the basics we will not repeat here.

LPE is a large holding for the fund and the poor share price performance over calendar 2018 has been a meaningful contributor to what has been EGP's worst ever year on both a relative and absolute basis. For this reason, it is worth revisiting in our last report for 2018.

The question one must always ask when assessing the prospects of a business is "if I came across this business today, would I buy it". Such an approach assists with avoiding "anchoring bias". To this end, I spent some time this month going over LPE from a "first principles" basis.

A key issue with LPE is pinpointing the true potential profitability of the business as it matures (given there are considerable working capital commitments). The breakneck pace at which the business has grown has made analysis yet more difficult.

Revenues have performed like this over the past few years:

- FY2016 = $1.8m
- FY2017 = $10.2m
- FY2018 = $19.7m &
- FY2019 = $44.2m (management forecast)

From a presentation given earlier this year (.pdf), management expect the recent rapid revenue growth to continue, and profitability to rapidly emerge:

Shown in $ millions	FY 18/19 E	FY 19/20 E	FY 20/21 E
Gross Revenue	$44.2	$79.7	$115.2
Cost of Goods	$34.4	$63.6	$92.8
Gross Profit	$9.80	$16.0	$22.4
Margin %	22%	20%	19%
Operational Expenses	$9.10	$11.3	$13.0
Profit (NPAT)	$0.68	$4.65	$8.20

The business at 31 December 2018 will likely have about 250GWh under management, which should translate into an annualised revenue run-rate of about $55m ($220,000 per GWh) at the halfway point of FY19. Given the business recently obtained access to a $30m finance facility, growth should accelerate through 2019 and beyond. We estimate they will finish FY19 with about 300GWh under management, for annualised revenue run-rate of around $66m, meaning managements $80m revenue estimate for FY20 looks quite achievable.

Growth will likely be steady in their core embedded network market, what should enable LPE to accelerate growth is an expanded product range, with two key additional offerings.

Firstly, they have developed a Direct Market Customer (DMC) product. Put simply, the supply of electricity to any customer (though still specialising in and focusing on strata communities). Among the benefits of the DMC product is that it creates what I would term "positive churn". When a customer leaves an LPE embedded network, LPE always replaced them when the next tenant arrived (as the strata unit remained contracted to LPE), but the leaving customer was likely to need to find another supplier. Now they can take their LPE service with them, management estimates this positive churn will add at least 4-500 customers per year if they can retain all of them.

In Q1 FY18, LPE added about 1,000 DMC customers without much marketing, equating to around 5GWh of annualised supply. With some modest marketing, we expect this figure could be meaningfully higher, management have a stated target of 27,000 DMC service points by the end of 2020 which implies more than 1,000 per month for the next couple of years.

The second is the recent addition of a solar product. This product is being targeted at strata properties too small to be suitable for an economic embedded network. The key with the LPE product is that they install a system that is small enough that it shouldn't ever send power into the grid (i.e. sized so that maximum system output = minimum community consumption at the time of maximum output). The economics of small-scale solar are difficult if you are exporting most of the electricity you make back into the grid at wholesale prices. The 3.4 year payback period management estimate is an attractive rate of return (about 23% annually) and the achievement of this figure requires only a 40% sign-up to the LPE solar plan, which management report they are finding easy to achieve. Higher take-up will result in an even higher return on investment.

There are 50.2m shares on issue after a recent consolidation. With the share price recently around the 80c share price, this indicates a market capitalisation of about $40m. For a business with a demonstrated growth profile, long customer tenure (with a current weighted average more than 7 years customer contracted period) and a highly profitable business model, this low valuation is hard to reconcile.

If we first address the growth, LPE were Australia's 15th largest energy retailer at the end of FY18 and the 2nd fastest growing, yet only spoke for less than a quarter of one percent of the market meaning their growth pathway has many years to run if they can continue to deliver:

Table 1.1: Residential electricity customers 2016–17 to 2017–18

Residential electricity	2016–17 customer numbers	% of market share 2016–17	2017–18 customer numbers	% of market share 2017–18	Variation in market share	Customer numbers % change
Origin	1 903 767	30.79%	1 869 626	29.66%	–1.13%	–1.79%
AGL	1 411 503	22.83%	1 378 777	21.87%	–0.96%	–2.32%
EnergyAustralia	1 108 680	17.93%	1 062 092	16.85%	–1.08%	–4.20%
Ergon Energy	598 848	9.69%	613 300	9.73%	0.04%	2.41%
Red Energy	214 698	3.47%	248 176	3.94%	0.46%	15.59%
Alinta Energy Retail Sales	64 903	1.05%	240 936	3.82%	2.77%	271.22%
Aurora Energy	238 374	3.86%	241 125	3.82%	–0.03%	1.15%
ActewAGL Retail	180 567	2.92%	180 579	2.86%	–0.06%	0.01%
Simply Energy	112 044	1.81%	125 240	1.99%	0.17%	11.78%
amaysim Energy	96 889	1.57%	97 198	1.54%	–0.03%	0.32%
M2 Energy (trading as Dodo Power & Gas)	57 268	0.93%	49 269	0.78%	–0.14%	–13.97%
Powerdirect	38 490	0.62%	35 748	0.57%	–0.06%	–7.12%
Lumo	47 488	0.77%	35 082	0.56%	–0.21%	–26.12%
Powershop Australia	34 807	0.56%	34 748	0.55%	–0.01%	–0.17%
Locality Planning Energy	8166	0.13%	15 120	0.24%	0.11%	85.16%

Source: Annual report on compliance and performance of the retail energy market 2017–18 (.pdf)

In order to achieve their next target of 450GWh under management, LPE would still speak for well below 1% of the Australian retail market.

The second important factor in contemplating valuation is the long customer tenure. People struggle to understand this as the maximum contract most people encounter for retail electricity is for two years. The contract LPE has however is with the strata body. This is part of the reason it takes so long to get a strata building to convert to an embedded network, as despite the considerable savings, it locks in the building to a very long-term contract and the committees take a long time to agree to such decisions. In order to sweeten this deal, or further extend the tenure of the contract with the strata body, LPE will provide certain utility services such as hot water, gas supply or central air-conditioning. Provision of such services enables contracts with the strata body to run up to 10 years, which is how the current 7.2 year average contracted tenure has been achieved. As the DMC customer base expand, the proliferation of customers on more normal contracts will see the weighted average contract tenure shorten. We anticipate by the time LPE reach the next targeted level of 450GWh under management that the weighted average customer contract will be reduced to around 5 years. This is still uncommonly long in the retail electricity industry and means that LPE should command a valuation premium compared to its peers.

The third factor in described above is the profitability. LPE provide a very low-cost retail price to their customers, but through incredible operational efficiency, still deliver the best pricing available in the market. I would strongly encourage every EGP unitholder reading this newsletter to look into signing over your electricity contract to LPE, click here:

https://www.localityenergy.com.au/site/customers/join-lpe/sign-up-with-lpe or call 1800 040 168

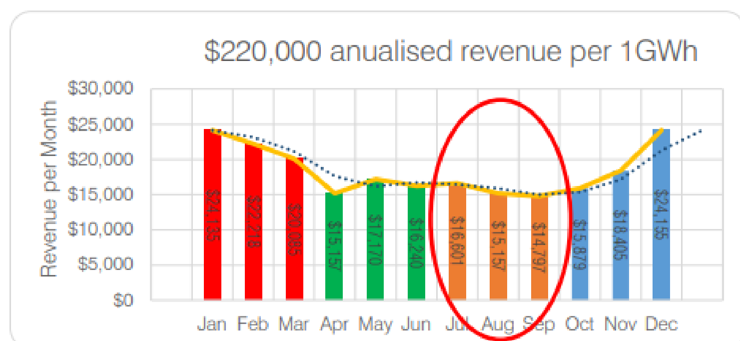
In all seriousness, you should pull out your last bill, compare and give them a chance. I doubt your current deal is anywhere near as good as the one they'll give you and the handful of investors I've talked to that have signed over have found the experience very easy. Rather than complex discounting regimes, they offer a simple low daily rate and low tariff. Our own household is still in a contract which was the best at the time we signed it, but will switch to LPE in August 2019 as soon as the contract expires.

The fact that they can deliver a commodity service at a highly competitive price and still enjoy good margins means the business should be nicely sustainable. Clearly, large, well-funded competitors could compete more aggressively, particularly in the DMC market, but the tiny size of LPE means they

would truly be cutting off their nose to spite their face, which I think makes aggressive competitive behaviour by large competitors unlikely.

The final factor leading to the current low valuation is that people are having difficulty stacking up the reported revenue numbers with the forecast revenues. For example, against the FY19 forecast revenue of $44m, the business reported $6.34m of operating cashflow in the September 4C. I suspect some investors have multiplied $6.34m x 4 = $25.4m and decided they will fall miles short of the $44m revenue target in FY19. There are two key reasons why we think this is a mistake.

Firstly, as management have pointed out, there is a distinct seasonality to the retail consumption of electricity. They have used this graphic to explain:



The quarters according to this graphic consume electricity in roughly the following way:

- March Quarter = 30.2%
- June Quarter = 22.1%
- September Quarter = 21.1%
- December Quarter = 26.5%

The September quarter is the weakest quarter for retail electricity consumption and for cashflow purposes, it is made doubly weak by the fact it follows on from the second weakest (June quarter) consumption period. If LPE were not growing, the March quarter would have the strongest cashflow by a long way, with the June and December quarters well behind and the September quarter well behind those.

The second factor is the rapid growth meaning much of the revenue does not yet show in cashflow as it is 'hiding' in working capital. Best way to explain this is the 5GWh of DMC customers they acquired in the September quarter if they were acquired equally through the quarter were provided about a quarter million dollars or so of electricity consumption (network charge + usage) at the retail price, but that because they will all be billed quarterly, not a single one of these customers would have paid their bill in the September quarter. Given the DMC customer additions spoke only for around 22% of the GWh under management growth in the quarter, this means at least $1m or more of the revenue generated in the quarter did not yet appear in the cashflow statement. The current 7-8GWh per month rate of growth means this shortfall will continue. What will change is the proportion of the cashflow the missing revenue comprises. As the business grows, the amount of 'missing growth revenue' will shrink, unless the growth rate accelerates.

We don't really operate with 'price-targets' on our holdings at EGP, but as we pointed out in the Livewire article, a price of $1.50 per share by this time next years, which is nearly double the current share price would not make the stock expensive if the current growth trajectory can be maintained and if the economics of the LPE value proposition remain compelling. LPE is also far from the only stock we hold in our portfolio where a doubling of the current market price would not leave the stock overpriced. It is for this reason we are so excited about 2019.

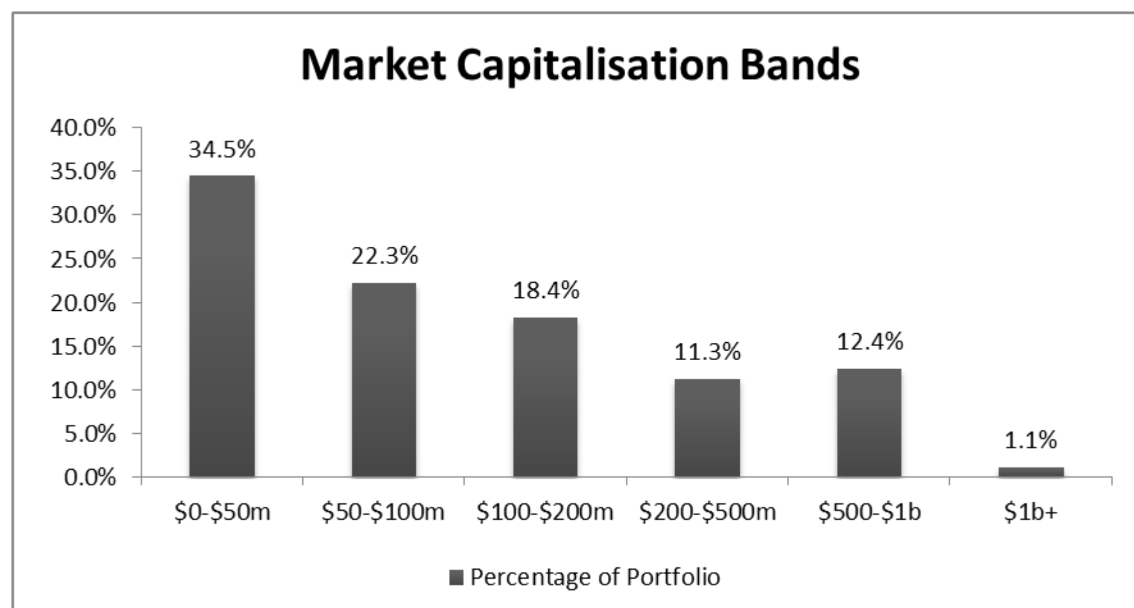
Key Portfolio Information:-

Our top 10 holdings at 31 December 2018 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	12.4%	10.7%
2	Kangaroo Plantation (KPT.ASX)	8.3%	7.2%
3	Legend Corporation (LGD.ASX)	7.5%	6.5%
4	APN Regional Property (APR.NSX)	5.4%	4.7%
5	Undisclosed	4.8%	4.2%
6	SRG Global (SRG.ASX)	4.7%	4.0%
7	Locality Planning (LPE.ASX)	4.3%	3.7%
8	Blackwall Limited (BWF.ASX)	3.7%	3.2%
9	Undisclosed	3.3%	2.8%
10	Dicker Data (DDR.ASX)	2.8%	2.4%

Our largest 5 holdings now comprise 38.4% of our invested capital, our top 10 holdings are 57.2% and our top 15 represent 69.8%. Cash and cash equivalents are 13.8% of the portfolio.

The market capitalisation graph is set out below. This month, the median market capitalisation is $77.9m.



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	$50,000 $2,000,000	Sharpe Ratio[1]	0.96
Additional investments	$5,000 (Minimum) $200,000 (Maximum)	Sortino Ratio[1]	0.51
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	7.21% 9.06%
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% -9.4%
Performance fee (<$50m) Performance fee (>$50m)	20.5% (inc GST) 15.375% (inc GST)	% Of Positive Months – EGP % Of Positive Months - Benchmark	51.5% 51.5%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	0.0% 4.5%
Custodian/PB	NAB Asset Services	1 year return[2] – EGP 1 year return – Benchmark	(8.4%) (2.8%)
Responsible Entity	Fundhost Limited	3 year annualised return[2] – EGP 3 year annualised – Benchmark	N/A N/A
Fund Size	$55.9m	5 year annualised return[2] – EGP 5 year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.9615 $0.0040	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.9629 $0.9600

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	$1.9723
EGP Fund No. 1 Pty Ltd Franking Credits	$0.0111

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