EGP Concentrated Value Fund

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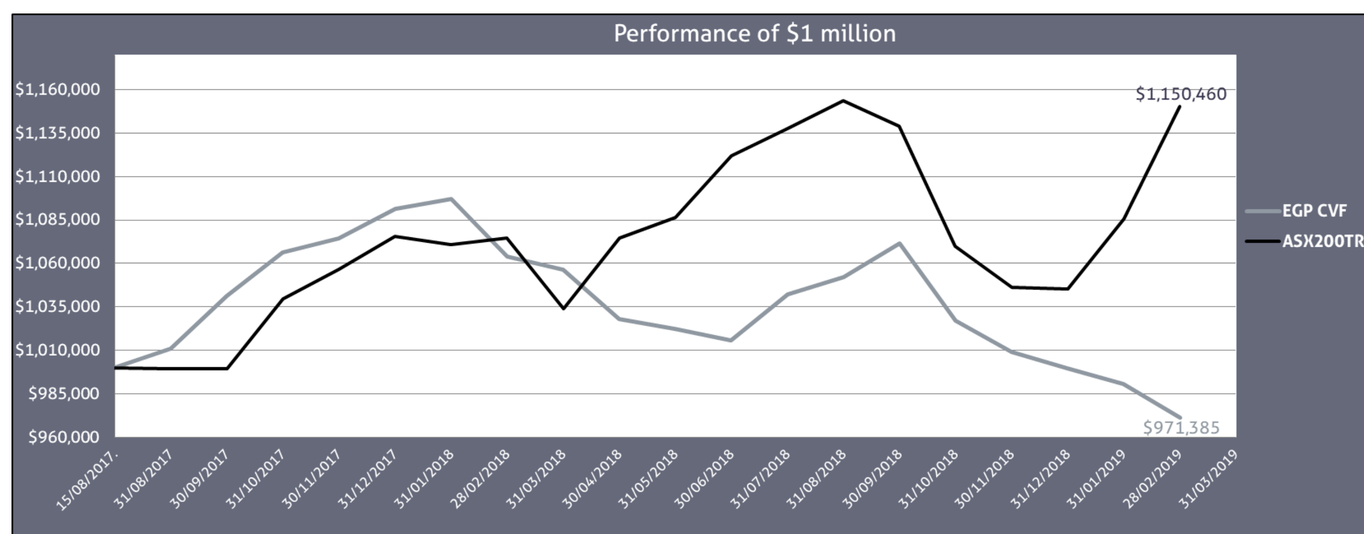
EGP Concentrated Value Fund – 28 February 2019

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%)	(0.9%)	(1.9%)					(4.37%)
Benchmark FY19	1.4%	1.4%	(1.3%)	(6.1%)	(2.2%)	(0.1%)	3.9%	6.0%					2.56%

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



<u>The Month That Was:-</u>

The fund fell by (1.9%) in February. Our benchmark rose by 6.0%.

The benchmark has now risen by more than 10% over January and February this year. In the 8 years we've run EGP, the benchmark has only ever advanced over a two month period by more than 10% twice before. Both previous times were also in a January/February. The first was in 2013 when the benchmark advanced 10.6% in January/February and ended the calendar year up 20.2%.

The second time was in January/February 2015 when the benchmark advanced 10.4% before ending the year up only 2.6% overall. I have no view on what a 10% advance for the benchmark implies for the final outcome in 2019, but the 10% change in two months for the value of all listed businesses clearly makes no sense, the values of businesses change much more slowly than that. It does mean

EGP now trail our benchmark by a long way and we will redouble our efforts to close the gap as soon as practicable.

There were 4 holdings that substantially caused our losses in February. The largest was our holding in SRG Global (SRG), which reduced our unit price by about 0.8% and which through its poor performance since the share price peaked in November 2017 has reduced our unit price by about 6%. We talk about this and other mistakes in the next section of the newsletter.

The second was Kangaroo Plantation Timbers (KPT), which reduced our February unit price by about 0.7%. This holding will again be discussed in the third section of the newsletter.

The third was Locality Planning Energy, which also cut about 0.7% out of the unit price this month and has cost the fund more than 3% of its value since we began buying the stock.

Finally, a previously undisclosed holding Konekt Limited (KKT) that trimmed about 0.5% from the unit price in February and has reduced our fund by about nearly 3.5% since we began buying. We will discuss the investment further in the next section.

Collectively our investments in GCS/SRG, LPE and KKT have cut more than 12% from the value of our units. This is a meaningful sum and warrants a more detailed discussion, which we will provide below.

Mea Culpa:-

It is clear through the poor performance over the past 13 months that I have made mistakes in terms of capital allocation. As outlined above, 3 decisions alone have collectively cost the fund over 12% of its value. If I had never heard of these businesses, we would be up more than 9% since the inception of EGPCVF, rather than down 2.9%.

I have previously written that one of the trickiest challenges of equity investing is that there is a very long and unreliable feedback loop. Sometimes bad decisions can be quite profitable in the short-term, sometimes good decisions can look very bad in the short term, before working out well. Sometimes a good decision is ruined by something unknowable at the time of investment; sometimes a bad decision is saved by such an event. Almost always, it takes at least two or three years to be able to tell if the underlying changes in the share price of a business are justified by the performance it delivers.

We will try to assess where along this spectrum the three investments fall.

The first we will discuss Locality Planning Energy (LPE), readers will be well aware of this business as we have discussed it several times previously. LPE closed the month of February at 47 cents per share. This is less than half of our average purchase price, and as mentioned has cost the fund about 3%. We first purchased shares of LPE in February 2017 at what is the equivalent of $1.00 per share (it was 2c, but they have consolidated 50 for 1).

At the time, they had 72GWh of power under management, a revenue run-rate of about $8m per annum and were burning a little over $2m of cash per annum. The plan to get to 450GWh by late in 2020, at that level we expected a revenue run rate of about $90+m and profit before tax of about $7m. What we had modelled was >$6m of NPAT in FY21 and that the market capitalisation at that point in time should exceed $100m given the rapidly growing and very secure profitability.

Had you told me at that time that revenues would be $32m for FY19 (this is the reduced guidance management forecast in January), I would have been somewhat disappointed, we were working off about $40m of revenue and a modest profit in FY19. Revenue has been a little slower than forecast and costs have grown a little more quickly than we anticipated.

With this said, if LPE achieve the $32m revenue target they have set themselves for FY19, it will mean they have added $20m of revenue in the second half, and that revenue over the FY17/FY18/FY19 has been $10m/$20m/$32m. The $20m of revenue added in the second half of FY19 will be partially

because of pent-up demand from the capital constraints in the final quarter of calendar 2018 and will probably not be repeated. It is however possible that with the financing they have in place that $12-15m per half of new revenue can be added from this point forward.

Given they will exit FY19 on a >$40m annualised revenue run rate, if they can add $25m in each of FY20 and FY21, then they will still deliver the $90m of revenue that we originally targeted for FY21. The next question is can they still deliver the >$6m of profit from that revenue we originally forecast.

LPE have averaged a gross profit margin of 23 & 25% over the past 2 halves. Their long-term target is 18%. If we assume at $90m of revenue they get 18%, it implies GP of $16.2m. Their current annualised cost base is $7.8m and they claim this includes one-off charges amounting to around $1m relating to costs for establishing their line of credit. Management say there should be only modest growth for the next doubling of revenue, if we assume the $1m of 'non-recurring' costs are replaced by normal operational costs, the $7.8m cost run-rate should hold, leaving a profit before tax of $8.4m.

So despite a stumble caused by the reduction in wholesale electricity tariffs and lack of cash to connect customers, the original expectations at our time of purchase are still well within reach. We thought the share price could get to $2 within 4 years ($100m market capitalisation) when we were buying at $1, which would have given us close to our target IRR of 20% annually. If they deliver $8m+ of PBT in FY21, or at least a run-rate level of profitability near that, then our original hopes for a $100m equity valuation in FY21 (about $2 per share) should be approximately realised. The difference is from the current share price of 47c, the IRR over the 2.5 years between now and then if that happened would be much higher than the original 20% targeted (although would remain the same for us having owned if through the whole period).

So we would describe LPE at this point as being only slightly behind where we had expected it to be when we first started buying, but certainly with a pathway to still deliver the investment outcome we'd originally hoped for. Had we known the pathway the investment would take in terms of share price, we'd much prefer to be building our holding now.

In order to meet our expectations, we will be looking for 3 key things. Revenues for the next 10 quarters (as announced in the 4C) would need to look something like the following (plus or minus a 5-10% factor for reasonable variation in any given quarter):

	Q3FY19	Q4FY19	Q1FY20	Q2FY20	Q3FY20	Q4FY20	Q1FY21	Q2FY21	Q3FY21	Q4FY21
Receipts from customers	$8.8m	$10m	$10.7m	$14.9m	$18.6m	$14.9m	$15.4m	$20.9m	$25.4m	$19.8m

It is against the revenue targets from the table above that we will measure the growth progress of the business. The second key part to our valuation getting to where we hope will be the cost control. We will be looking for costs other than "cost of goods sold" to average $2m per quarter for the first 4 or 5 quarters above and to increase to no more than $2.2-2.3m per quarter by the last few quarters (most of the increase should be growing depreciation and interest costs, not other operating costs).

The final pillar of the valuation will be that they maintain at least the 18% gross profit margin they have guided to. If the margin falls below this, the economics deteriorate, if they can keep the margins above 20% as they have been for the past couple of halves, the economics improve.

So rather than be guided by the share price, we will be guided by the performance the business delivers, confident that if they can deliver something similar to the three paragraphs described above, we will do very well.

Our second review of the holdings that have caused us the most damage will be SRG Global (SRG). We bought the GCS business at about 54.5 cps in August and September of 2017. The business

performance initially was better than expected and the share price rapidly moved to a price in the high 80c range, briefly trading above 90c. At prices above 90c, we thought the business was fairly fully valued. Unfortunately, reluctance to trim the position was driven in part by the fact we had only held the position a few months and a large Capital Gains Tax (CGT) event would be triggered by any sales. We decided we were better to try to hold the position until at least 12 months had passed and that given the sentiment for the business was positive and conditions seemed strong that the price would likely stay elevated.

This was a large and expensive mistake. Sentiment for the business turned negative, a number of large contracts the company bid on have been delayed and then an unpopular merger with SRG was announced. The share price has fallen from around 90c in November 2017 to close February at 38.5c.

At 38.5c, the market capitalisation of the merged SRG Global business is less than $170m. After deducting the cash pile, the enterprise value is about $150m. The combined EBITDA of the businesses in FY18 were $43.7m. Guidance midpoint for the FY19 result is for EBITDA of $34.5m. The combined business is missing a couple of month's earnings because of the timing of the merger, but a negative reaction to what is effectively a 20% downgrade is understandable. What I am not sure about is if it justifies the 60% fall in share price the business has seen over the past year or so.

Adding back in the couple of months missing EBITDA, the business would probably have guided $38-42m for FY19. Given the EV of $150m, this has the business trading on an EV/EBITDA of 4x or less what should be 'trough' earnings in FY19. The GCS side of the business is bidding a number of very large contracts that it expected would have been awarded late in 2018, but have not yet been awarded. This indicates that there is an element of 'delay' rather than 'loss' of earnings. GCS has historically traded on a 5.5-6x EV/EBITDA multiple and SRG has averaged over 7x through the past few years.

Management have guided to a step-change in earnings in FY20. I consider a 'step-change' would be at least 20%, possibly more. As such, we are expecting at least $48m of EBITDA in FY20, possibly a good deal more.

At $50m and a multiple of 6x EV/EBITDA (we think this is fairly conservative given the exciting outlook in the international dams business and the flammable cladding remediation businesses), the EV would double. With $25-30m of cash falling into the EV, this implies an increase of about $180m to the equity valuation, or a more than doubling of the equity value.

We think the current share price of SRG is a perfect example of the short-termism of the equities market, one weak half and the business gets hammered, but if we look at the medium term prospects of the business it looks remarkably cheap.

Finally, we mention for the first time our holding in Konekt Limited (KKT). KKT is a business that provides two key services. The first is the "workcare" business that provides return to work services (amongst a group of adjacent services). The second is an 'employment' business which was acquired in late 2017. We became shareholders through that acquisition.

At the time of the acquisition, we thought in this FY19 that the business would be capable of earning around $13-14m of underlying EBITDA. Unfortunately, from the time of the employment business acquisition, the original workcare business has had a series of things go wrong.

This was my mistake from an analytical viewpoint. I grossly overestimated the quality of the earnings in the work care business. It turns out KKT have almost no ability to influence their revenue numbers; they are instead at the whim of a number of very powerful customers. One of these powerful customers was Medibank via the Australian Defence Force (ADF), when Medibank lost the ADF contract, KKT appear to have lost their role in delivering that service. In the 18 months prior, the volumes at ADF had been collapsing in any case, as had volumes in the other side of their business.

The workcare business was doing revenue of about $53m per annum at the time the employment business was acquired (FY17), this revenue looks like being at least $10m lower in FY19. The business runs on fairly lean margins and despite cutting costs to maintain margins as best they could, earnings have fallen sharply in that business.

The $13-14m of EBITDA we thought would be the companies earning power now looks to be more like $9-9.5m. At the current share price of 22c, the market capitalisation of KKT is $23m. They have $13m of net debt for an EV of $36m. At $9.5m EBITDA, they trade at less than 4x EV/EBITDA.

I estimate their maintenance capex requirement is about $2.5m and possibly less given the significant recent capex in consolidating their property footprint, interest is about $700k, leaving about $6.3m of cashflow that can be harvested before tax, which will grow as the debt falls and interest expense reduces. The acquisition of the employment business delivered usable tax losses of which $23.5m remain, at a 30% corporate rate, these tax losses are worth about $7m in future tax that won't need to be paid.

Effectively, if KKT can ensure the $9-9.5m EBITDA result is the trough in their earnings, you are acquiring it on a free cashflow yield of about 17.5% at 22cps. The business carries a franking balance of $4m and pays a dividend of 1cps, which we think they can sustain (4.5% yield). The employment business is a counter-cyclical one as revenues should grow in the event of rising unemployment.

Given the difficulties the business has faced over the past two years, it is possible they may be able to return to some modest growth in FY20, despite a further reduction in revenues from the likely loss of their ADF business. The business is working on a cost out program to try to prevent a fall in earnings from the ADF revenue lost. A recent entry into disability services and prospects of growth from opportunities in the National Disability Insurance Scheme are other potential upside opportunities.

We think if they can stabilise their earnings at a minimum of $9m EBITDA that the business could reasonably be valued at a free-cashflow yield of 10%, which would imply a $60m+ EV, or a share price of about 44c. If a few things start to turn from headwinds to tailwinds, KKT could even be worth more than this. Unfortunately, our average buy price is 42cps and we will need both earnings to stabilise and sentiment to meaningfully improve in order to get our original capital back.

Clearly I purchased KKT with an insufficient margin of safety. Of the three investments described in this section, it is this one that looks like it was a mistake from which we are unlikely to have any prospect of earning a satisfactory return on our investment.

Run Through Our Other Large Holdings and Their Value Propositions:-

We've written voluminously about our largest holding United Overseas Australia (UOS) and how its founders CS & PL Kong took a few million dollars raised at IPO in 1987/88 and have turned it into $1.5 billion of conservatively valued assets over the past 30 years, whilst returning over >$100m to shareholders along the way.

The most remarkable thing about this story is that despite this incredible and incredibly consistent performance, you can still buy shares in this business for less than two thirds of the Net Tangible Assets (NTA). The shares closed February 2019 at 65 cents each and the NTA is $1.023 per share (up from 92c last year despite the 3c in dividends).

Ten years ago (February 28 2009), the share price was 13c (admittedly at the bottom of the GFC) and NTA was 40c, in the subsequent 10 years, buyers of UOS shares received an 8 cent per share capital return in 2012 and 23.7 cents per share worth of dividends. Most businesses that had delivered financial performance of that pedigree would trade at a significant premium to book.

One of the most extraordinary elements of the UOS investment proposition is shown in the following extract from the P&L:

		CONSOLIDATED	
	Notes	2018 $'000	2017 $'000 *(Restated)*
Property and construction revenue	4	440,493	327,757
Cost of sales	4	(270,250)	(157,955)
Gross profit		170,243	169,802
Other revenues	4	116,205	101,468
Other income	4	11,878	28,417
Property maintenance expenses		(31,351)	(25,358)
Occupancy expenses		(83)	(50)
Marketing expenses		(3,163)	(7,008)
Administrative expenses		(31,797)	(26,512)
Other expenses from ordinary activities		(30,190)	(19,853)
Foreign exchange gain/(loss)		2,304	(800)
Share of results of associate		(17)	6,286
Finance costs		(7,962)	(6,653)
Profit before income tax		196,067	219,739
Income tax expense		(35,848)	(44,024)
Profit for the year		160,219	175,715

UOS has built a portfolio of recurring income (in the form of Rent, Parking, Hotel, Management Fees and Other) that more than covers off all operating costs of the business (in fact leaving a $12m surplus). This is an exceptionally secure situation underpinning their primary source of earnings, the development business. The business crossed this threshold where recurring earnings cover all costs in 2016 and the profitability of this segment looks set to continue to grow at a nice rate as further gains in recurring revenue outstrip cost growth. Ten years ago, this pool of recurring income was about $22.5m per annum, it has increased more than five-fold over the ensuing ten years to >$116m.

The development business has been running in a fairly steady-state for the past 6 years, with average sales of about MYR1.443B (about AU$500m at current exchange rates) annually and average unbilled sales sitting at about MYR1.441B. This year's sales were MYR1.48B and unbilled sales sat at MYR1.5B at December 31 2018. This all should indicate that revenues out of the development business are likely to at least remain steady for the next couple of years, though they have announced only a little over MYR1B of launches in 2019 at this stage.

Among 'aces up the sleeve' of UOS are:

1. AU$587m of inventory, this is carried at cost on the balance sheet. If in conjunction with the slowing down of the number of new projects being launched, the company focuses on pushing these inventory levels down, latent profits will be realised. The company has historically generated gross margins of 45%. In 2018, these margins slipped to just below 40%. Even if we assume the profitability of the inventory is meaningfully below these levels, at perhaps as low as 30%, it implies at least $176m of pure profit (70% attributable on a look-through basis to UOS owners), pure in the sense that all costs to create the inventory have already been expensed.
2. Latent undervaluation of the "Investment Properties" section of the balance sheet. As I wrote in September 2018, the Vertical Towers are carried at about $230m below a reasonable estimate

of the price at which buildings of their size and quality would change hands in a sale. Underscoring our view that the valuations of the investment properties are very conservative, the company announced on 12 February 2019 that Inland Revenue (Malaysian equivalent of the ATO) had raised taxes and penalties of AU$13m. Their argument is that two of the small investment properties were undervalued when taken from inventory into investment properties. The company intends to stand by their expert valuations, but a meaningful incremental uplift to NTA would be booked if Inland Revenue win the case.

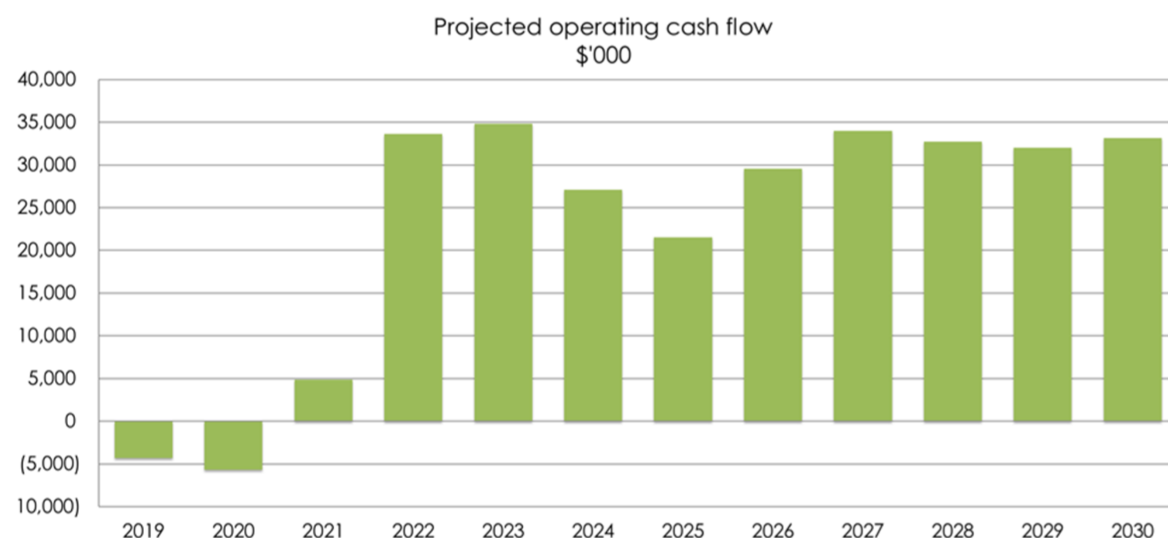
3. The growth opportunity in Vietnam. The business has made a small investment in Ho Chi Minh City; the opportunity in Vietnam looks significant. We visited the site last year and there is an incredible opportunity there if the current development works well. The underlying property fundamentals in Vietnam seem to support a very large runway for growth if the first development proceeds as expected.
4. A pipeline based on the current landbank of over MYR10B of future development prospects.

We view UOS as grossly undervalued; hopefully the above explanation assists in understanding why. If I were not running EGPCVF and operating only my own portfolio, at least one third of my investable assets would be entrusted to CS & PL Kong to continue delivering value for UOS. Unfortunately, the fact that we are an open-ended fund and the relatively illiquid nature of UOS means we only have less than an eighth of our net worth entrusted to these spectacular capital allocators.

Our second largest holding is Kangaroo Island Plantation Timbers (KPT). KPT caused considerable damage to our unit price as they fell from a high of $2.40 in the month to close at $2.01 after the company elected to raise capital in. The bolstering of the balance sheet makes sense given the continuing delays in the wharf approval process.

As we mentioned last month, we continue to think that the stock will re-rate significantly in the event the wharf is given approval and that the stock will trade at least twice its current price after the first full quarter of cash flow is delivered, bringing home the reality of just what a highly cash generative business this will be. The graphic presented by the company below is in our view very conservative given the strong fundamentals underpinning the markets into which KPT will sell its products post wharf approval.

There is untold potential long-term economic upside as we've pointed out previously is the potential uplift in the enormous landholding KPT owns along with the better utilisation of the wharf assets, given how relatively lightly used the facility will be based off only the timber exports.



Our 3rd largest holding is Legend Corporation. The company released a spectacular first half result, and the market didn't flinch. Given the slight seasonality in the business, we think LGD will likelier than not record earnings above the 4.3cps that were the highest in its history in the last mining boom. Despite the multi-year tailwind of the infrastructure boom and the outstanding recent performance of the business, it trades at a P/E of less than 8x what we think it will earn in FY19. The business has seldom commanded a high multiple, but has averaged 11x over its listed history. We think it's a better business than at any time in its listed life and in combination with the rosy outlook for the next few years probably deserves not much less than the market multiple of 15x.

Our 4th largest holding is the APN Regional Property Fund (APR). As mentioned in last month's letter, we have tendered our stock into a buyback that should net over $1.40 per share. Along with the dividend, these two events should add just over 0.9% to the unit price when concluded and add more than 5.5% to our cash holding.

Our 5th largest holding remains undisclosed as we continue to buy. We think it is a spectacular opportunity on which we are hopeful of making a multiple of our money over the next few years. We intend to outline the investment thesis for this investment in next month's report.

Finally, I should touch on our Tellus Holdings investment which has been revalued to $1.50 per share (our acquisition price was $1.20) based on the completion of a recent capital raising (in which we did not participate). We outlined our thesis for Tellus in this blog last year. GR Engineering have commenced work (.pdf) on the project and the company expect to begin accepting waste in October 2019 and be fully operational by March 2020.

We think Tellus is a desperately needed solution to a problem of epic scale. Our biggest concern is that the business is acquired before we fully profit from the enormous potential of the assets. If the project is delivered successfully without delay or cost overruns, we'd be surprised if the value of our holding isn't doubled soon thereafter.

Other Notable Portfolio Actions:-

We sold our Reece (REH) shares in February. This was a decision based partly around having better risk adjusted return expectations out of alternatives for the capital, but partly because we think the acquisition of Morsco in the US has added a risk to REH that is hard to quantify and makes us nervous. Given the outlook in the Australian business should be tough for the next few years as the construction boom abates, we think REH presents a strong chance of stagnant share prices for the next few years. If this occurs, but in the meantime the Morsco acquisition is satisfactorily bedded down without issues, there is a strong chance REH returns to the portfolio at some future point.

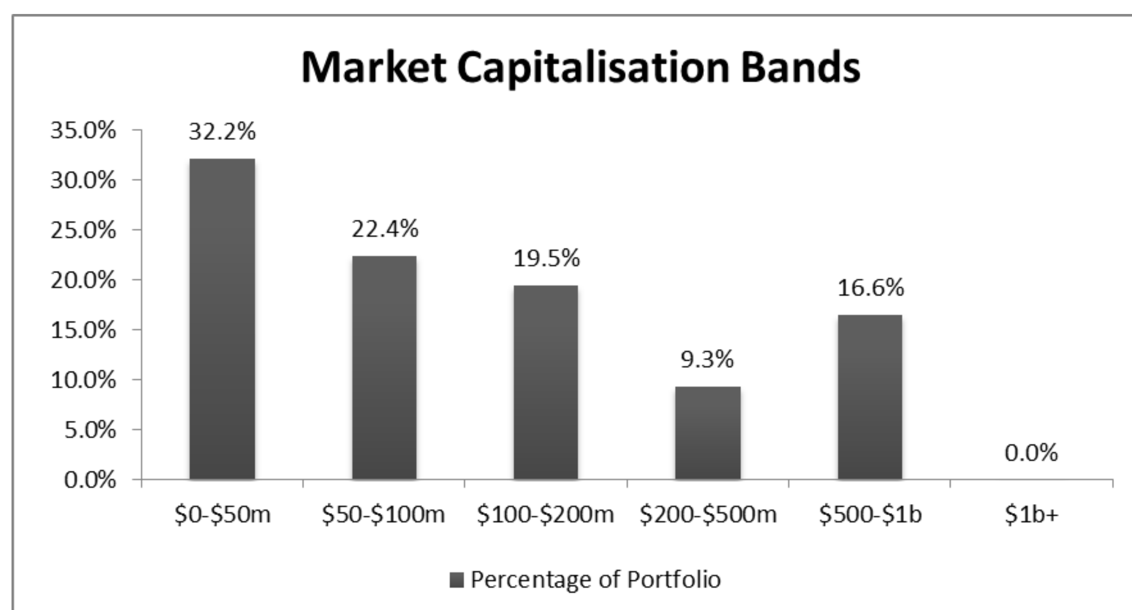
Key Portfolio Information:-

Our top 10 holdings at 28 February 2019 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	13.1%	11.2%
2	Kangaroo Plantation (KPT.ASX)	9.1%	7.7%
3	Legend Corporation (LGD.ASX)	8.3%	7.0%
4	APN Regional Property (APR.NSX)	5.7%	4.8%
5	Undisclosed	5.1%	4.2%
6	Blackwall Limited (BWF.ASX)	4.0%	3.4%
7	SRG Global (SRG.ASX)	3.7%	3.2%
8	Dicker Data (DDR.ASX)	3.2%	2.7%
9	SDI Limited (SDI.ASX)	3.2%	2.7%
10	Tellus Holdings (unlisted)	2.9%	2.5%

Our largest 5 holdings now comprise 41.2% of our invested capital, our top 10 holdings are 58.2% and our top 15 represent 71.2%. Cash and cash equivalents are 15% of the portfolio.

The market capitalisation graph is set out below. This month, the median market capitalisation is $78.7m.



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	$50,000 $2,000,000	Sharpe Ratio[1]	0.35
Additional investments	$5,000 (Minimum) $200,000 (Maximum)	Sortino Ratio[1]	0.38
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	7.00% 10.00%
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	-9.4% -9.4%
Performance fee (<$50m) Performance fee (>$50m)	20.5% (inc GST) 15.375% (inc GST)	% Of Positive Months – EGP % Of Positive Months - Benchmark	45.9% 56.8%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	(2.9%) 15.1%
Custodian/PB	NAB Asset Services	1 year return[2] – EGP 1 year return – Benchmark	(8.7%) 7.1%
Responsible Entity	Fundhost Limited	3 year annualised return[2] – EGP 3 year annualised – Benchmark	N/A N/A
Fund Size	$54.3m	5 year annualised return[2] – EGP 5 year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.9343 $0.0044	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.9357 $0.9329

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	$1.9172
EGP Fund No. 1 Pty Ltd Franking Credits	$0.0111

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