EGP Concentrated Value Fund

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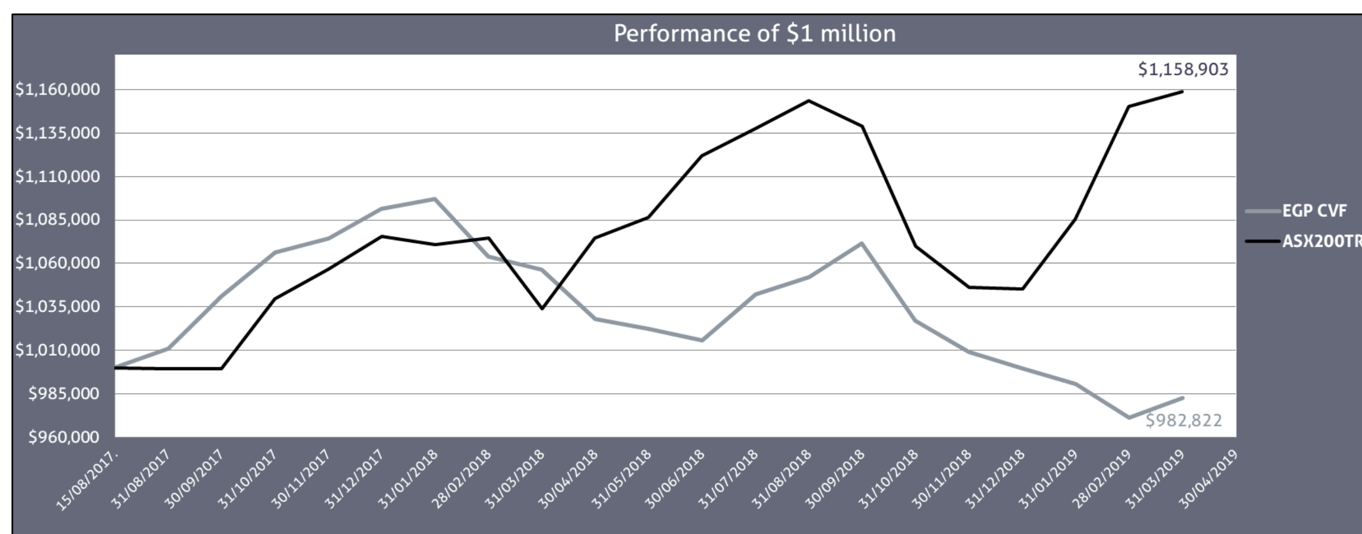
EGP Concentrated Value Fund – 31 March 2019

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%)	1.2%				(3.25%)
Benchmark FY19	1.4%	1.4%	(1.3%)	(6.1%)	(2.2%)	(0.1%)	3.9%	6.0%	0.7%				3.31%

*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 gained 1.2% in March. Our benchmark gained 0.7%.

We are pleased to have beaten the benchmark this month after a very difficult last 3 months. Our month was again harmed by the continued fall of our holding in SRG, which was our 3rd largest holding not long after we finished buying, without selling a share has fallen to our 10th largest holding. If the share price remains depressed, we'll likely resume buying as it looks incredibly good value at current level.

We have discussed the resolution of our investment in APN Regional Property Fund the last couple of emails and newsletters, if the deal closes successfully as we expect it to, we will have a 0.82% tailwind for our April result, having already booked the dividend (worth 0.09% to the fund in March). Our cash levels will rise to 19.8% and there are a number of excellent opportunities at present.

LawFinance:-

This month we discuss what has been an unnamed top-10 holding for the past few months. Lawfinance is probably the most complex investment we've ever tried to explain to our unitholders, but if the business model works as it should, the upside from current valuation is enormous, so it's worth taking the time to lay it out. The underlying businesses are not particularly complicated, but the capital structure certainly is.

The business first came to the ASX in a 2015 IPO/backdoor listing as JustKapital (JKL). JKL spent the first few years of its listed life in the litigation funding business. ASX listed IMF Bentham and Burford Capital listed in the UK have shown this industry to be a lucrative one when good cost control and case selection intersect. Unfortunately, the former is where JKL failed.

Founder Philip Kapp had big ambitions for the business, but seemed unable to operate the type of lean cost structure that a small capitalisation, early stage business requires in order to succeed and reach financial maturity. The FY16 & FY17 reports indicate Kapp extracted about $2.25m in remuneration over those two years alone, which an alarmingly high level of remuneration for a business with a sub-$20m market capitalisation. It is also evident from the accounts that employee costs, admin costs and other variable operating costs were running at unsustainably high levels as well.

Current CEO Diane Jones was brought in as CFO and in late 2017, Kapp resigned from the business. In the intervening period, the acquisition of what is now the primary business; the U.S. based National Health Finance (NHF) began.

After several false starts and a great deal of work, the NHF acquisition was finally completed at the end of 2018. The business has subsequently been renamed LawFinance (LAW). LAW operates three main businesses, the litigation funding business which is in run-off, the Australian disbursement funding business which was acquired in early 2016 currently trading as JustKapital Finance and the NHF business which specialises in medical lien funding.

One of the key complications is the enormous debt levels the business is presently operating with. As always with very high levels of leverage, this means if they get it right, the returns to equity will be spectacular, but likewise increases the risk of a disaster if something goes meaningfully wrong.

The value at 31 December 2018 (accounts are presented in US$, I have used AU/US$0.705c for a conversion value) as set out in Table 1. Note these are different to the balance sheet presented in the Annual Report as I have simplified for analytic purposes, for example using the collectable value of the assets rather than the cost value:

Debt Stack as at 31 December 2018	US$M	AU$M	
Secured Debt			
Atalaya (NHF: US$80m facility)	$39.902	$56.60	
AssetSecure (LAW: AU$35m facility)	$20.028	$28.41	
Syndicated acquisition facility	$29.644	$42.05	
	$89.574	**$127.055**	
Unsecured Debt			
NHF Founder Promissory note	$9.000	$12.77	
Vendor Loan	$12.546	$17.80	
Other Unsecured	$19.602	$27.80	
	$41.148	**$58.366**	
Total Debt	**$130.72**	**$185.42**	
Value Stack as at 31 December 2018			
Expected Back Book Collections	$87.000	$123.40	
Expected Front Book Collections	$9.000	$12.77	
Expected Litigation Financing Proceeds	$14.100	$20.00	
Expected Aus Book Collections	$26.860	$38.10	
	$136.960	**$194.270**	
Excess Value to equity:	**$6.24**	**$8.85**	*Table 1

Current anticipated collections are about $194m (US$137m). A simple deduction of the collectable funds less the debt leaves a value to equity of only about AU$9m, but as we will demonstrate in Tables 4, 5 & 6, as the enormously cash-generative nature of the business model unfolds; there will be considerable value to fall through to the equity line. In any case, once the business becomes a big producer of cash flow, the business will likely be valued on a multiple of the secured future cashflows.

The market capitalisation at the current trading price of around 6.5cps is only $32m. The difference between the cash we expect to collect from the business and the debt that is due to its funders is the equity value (profit). The market is correctly placing a small value on the equity at present as there is much the business must do over the next 12-18 months to demonstrate it can capitalise on the wonderful business opportunity it currently sits astride.

An added complication to the valuation is that 452.7m warrants were created as part of the funding for the acquisition. These are exercisable at 14c by 28 September 2022, they would provide a AU$63.4m equity injection into the business should they be exercised. We hope they are exercised, if they are it will mean the business is travelling very well, and the equity injection would deleverage the business.

Management indicate because of the AASB9 & AASB15 deferring profits into future periods, the business in the next couple of years will be better valued on cash flow than more traditional earnings metrics.

If we are to do this, we need to understand what the cashflows are likely to be. The circa AU$20m that will come out of the litigation funding book is likely to be lumpy and unpredictable in its timing, and will likely be used to extinguish corporate debt in any case (in Table 4 we take the management estimate of US$14.1m from litigation funding and simply apply it to the corporate debt), we will focus instead on the cash coming out of the US & Australian loan/lien books. We will assume for simplicities sake that the funds management expect to receive as cases complete will be received in 2019. In fact there are likely to be at least a couple of cases fall into 2020.

The loan books are best thought of in 3 parts. The 'back book' is the loan book that was acquired when NHF was purchased, the 'front book' is the loan book written since NHF was purchased and what I will refer to as the 'Aus book' is the original business.

At 31 December 2018, the back book was around US$87m, the front book about US$9m and the Aus book about AU$38m (US$28.9m – I will keep all calculations from here on in US$ in order to save repeatedly switching between currencies).

The Australian business is the easiest to work through; the collectable book grew a little over 20% through 2018. This book is likely to grow a little more slowly through 2019 and 2020; we will display our assumptions in the next table. I've used 8.25% on average debt for the Australian facility, interest is 7.95% on this facility, but there will be other costs.

The back book at NHF is likely to collect more slowly than any new business NHF write, as faster collection turnover will be a significant focus in the early part. If we allow for most of the collection to occur over 3 years with a tail of $10-15m, then the collections should run at around $2m per month in the next 3 years. This will likely be slower in years one and three and faster in the middle year. For simplicity I will assume a straight line collection of $24m per annum out of the back book. The debt used originating these books costs 13.25%, I've used 13.5% in my assumptions table to allow for other financing costs (line fees and the like). We will point out what an enormous swing factor an improvement in the cost of debt would be further below. The speed of collection for the back book is the single biggest risk in our view. The terms of the deal with Atalaya apparently require over 85% of the collections from the back book be applied to eliminating the Atalaya debt, meaning very little usable cash will come back to LAW/NHF until the full circa $31m of debt attributable to the back book is extinguished.

The front book at NHF is already collecting at a much faster rate than the back book as the singular focus of Diane Jones and David Wattel is on the highest possible return on capital deployed (we will expand on this further below). The front book was only about $9m at 31 December, but is hoped originations less collections will have grown this collectible to $55-65m by the end of 2019.

Given the focus on shorter dated liens, the cash collections in 2019 are likely to exceed the size of the front book as at 31 December, but it is extremely difficult to gauge exactly where they will land. We expect somewhere between $9-22m can be collected over 2019. We will use a mid-point figure of $16m for the front book collections, having laid out the above assumptions, our expectation of the cash flows coming out of the business will look like this for the next few years:

Assumptions	31-Dec-18	31-Dec-19	31-Dec-20	31-Dec-21	
US Back Book expected collections	$86.8	$62.8	$38.8	$14.8	
Atalaya Attributable back book debt	$31.0	$9.90	$ -	$ -	
US Front Book expected collections	$9.2	$55.2	$86.9	$113.2	
Atalaya Attributable front book debt	$8.9	$31.2	$49.1	$63.9	
Aust Book expected collections	$28.9	$33.2	$36.5	$39.2	
Asetsecure Attributable Aus book debt	$20.0	$23.0	$25.3	$27.2	
Actual/expected US back book cash collection	$21.5	$24.0	$24.0	$24.0	
Actual/expected US front book cash collection	$1.1	$16.0	$56.8	$80.0	
Actual expected Aus book cash collection	$9.0	$9.9	$11.3	$12.7	
Expected US deployment (COGS)		$35.0	$50.0	$60.0	
Expected AUD deployment (COGS)		$9.2	$10.2	$11.3	
US Overheads		$6.7	$7.4	$8.1	
AUD overheads		$2.6	$2.7	$2.9	*Table 2

*Table 2

If the assumptions in Table 2 look to be aggressive, the annual report indicates NHF CEO David Wattel thinks they are achievable. In order to achieve the bonus set out below, he needs to collect at least $50m from the back book and have $175m of net receivables by 31/03/20 (I have allowed for back book collections of $48m by 31 December 2020 and for combined front/back book receivables at that time to be only $125.7m)

Details of bonus
David Wattel is entitled to receive a US$4.15m non-discretionary bonus paid equally over 5 quarterly payments (US$0.83m per quarter) after satisfaction of the following criteria:

(a) US$50m of the acquired book of Net Receivables (Gross Accounts Receivables less provision for discounts) is collected; and

(b) Net Receivables (Gross Accounts Receivables less provision for discounts) has achieved the following hurdles:
- By 31/03/2020, Net Receivables is at least US$175m
- By 30/06/2020, Net Receivables is at least US$180m
- By 30/09/2020, Net Receivables is at least US$190m
- By 31/12/2020, Net Receivables is at least US$199m
- By 31/03/2021, Net Receivables is at least US$209m

The assumptions from Table 2 give the LAW business a pretty attractive looking cash flow for 2019:

	2019 cashflow estimate	Less interest	OPEX/Overheads	Remaining	
Aus Book	$9.9	$1.7	$2.6	$5.6	
Back Book	$24.0	$2.8	$6.7	$14.5	
Front Book	$16.0	$2.7	$ -	$13.3	
			Total	$33.5	*Table 3

Unfortunately, it is not quite that simple. Firstly, of the $24m we estimate they can extract from the back book, about $21m will be applied to extinguish the Atalaya debt that has funded the back book. This would leave about $12.5m ($33.5m minus $21m). The above cash flow calculation allows for the

cost debt that is provided by the secured debt funders, but doesn't allow for the unsecured debt and the syndicated acquisition facility. We estimate the interest cost on this debt of about $70.8m to be about $9.5m as there is some very expensive debt in this mix. This basically leaves only about $3m for the business to apply to other purposes. Finally, the original debt used to fund the collected Aus book and the front book must be repaid. We estimate these figures would be about $14m collectively, meaning a cash outflow for 2019 of about $11m.

Reworking the debt and value stack we showed at the start of the analysis should 2019 unfold as I've described above, it would look like this:

Debt Stack as at 31 December 2019	US$M	AU$M	
Secured Debt			
Atalaya (NHF: US$80m facility)	$ 41.058	$ 58.24	
AssetSecure (LAW: AU$35m facility)	$ 23.032	$ 32.67	
Syndicated acquisition facility	$ 29.644	$ 42.05	
	$ 93.734	**$132.957**	
Unsecured Debt			
NHF Founder Promissory note	$ 9.000	$ 12.77	
Vendor Loan	$ 12.546	$ 17.80	
Other Unsecured	$ 5.502	$ 7.80	
Plus Assumed Interest of $9.5m	$ 9.500		
	$ 36.548	**$ 51.841**	
Total Debt	**$ 130.28**	**$ 184.80**	
Value Stack as at 31 December 2019			
Expected Back Book Collections	$ 62.800	$ 89.08	
Expected Front Book Collections	$ 55.150	$ 78.23	
Expected Litigation Financing Proceeds	$ -	$ -	
Expected Aus Book Collections	$ 33.189	$ 47.08	
	$151.139	**$214.382**	
Cash flows:	**($11.0)**	**($15.7)**	
Excess Value to equity:	**$9.81**	**$13.91**	*Table 4

So we can see that despite the negative cash flow, the "excess value to equity" figure increased from AU$8.9m at 31 December 2018 to about AU$13.9m at 31 December 2019. Although the business didn't generate usable cashflow, the value to equity increased.

Whether such a result would see a similar increase in the market assessment of the share price is hard to say, probably not until the cash outflows can be stemmed. To see how this should happen in 2020, we use the same assumptions from Table 2 to create Table 5:

	2020 cashflow estimate	Less interest	OPEX/Overheads	Remaining	
Aus Book	$11.3	$1.9	$2.7	$6.6	
Back Book	$24.0	$0.7	$ -	$23.3	
Front Book	$56.8	$5.4	$7.4	$44.0	
			Total	$73.9	*Table 5

The cash flow available for management to apply to other ends will be much better in 2020. Firstly, the final $9.9m of back book debt should be extinguished sometime in the first half of the year. This would leave $64m. Once again, there will be unsecured debt to service whose interest costs are not accounted for in Table 5. Given the $11m of negative Cashflow in 2019, I have assumed the interest charge for this debt increases to $10.5m in 2020, leaving $53.5m. I estimate about $38-39m would need to be applied to the original funding from the Atalaya and Assetsecure facilities, leaving about $15m of cash available to start eliminating the debt and making the capital structure a little more relaxed.

Table 6 shows further value accruing to equity:

Debt Stack as at 31 December 2020	US$M	AU$M	
Secured Debt			
Atalaya (NHF: US$80m facility)	$ 49.096	$ 69.64	
AssetSecure (LAW: AU$35m facility)	$ 25.335	$ 35.94	
Syndicated acquisition facility	$ 29.644	$ 42.05	
	$104.075	**$147.625**	
Unsecured Debt			
NHF Founder Promissory note	$ 9.000	$ 12.77	
Vendor Loan	$ 12.546	$ 17.80	
Other Unsecured	$ 5.502	$ 7.80	
Plus Assumed Interest of $10.5m	$ 20.000	$ 28.37	
Debt to cover the 2019 negative cash	$ 11.047	$ 15.67	
	$ 58.095	**$ 82.404**	
Total Debt	**$ 162.17**	**$ 230.03**	
Value Stack as at 31 December 2020			
Expected Back Book Collections	$ 38.800	$ 55.04	
Expected Front Book Collections	$ 86.900	$ 123.26	
Expected Aus Book Collections	$ 36.508	$ 51.78	
	$162.208	**$230.082**	
Cash flows:	**$ 15.0**	**$ 21.34**	
Excess Value to equity:	**$ 15.08**	**$ 21.39**	*Table 6

By the end of 2020, the accounting profits should be starting to normalise. A business that is flowing back cashflows of greater than US$15m per annum will be worth a lot more than the AU$32m valuation presently ascribed the business, even with high debt levels.

Even if growth slows beyond 2020, in 2021, the cash flow should be much higher, given the entire remaining value of the back book will become free cashflow as the debt will have already been extinguished.

The application of the free cash to eliminate the corporate debt would further reduce the calls on cash to service the debt. If LawFinance can traverse the tight cashflow they will experience over the next 12 or 18 months, the opportunity for extraordinary gains exists.

Alternative Way to Think About Value:-

The NHF business will be the primary driver of value for LawFinance. The best place to start when thinking about the NHF businesses valuation is the attempt the company have made to simplify the business model on slide 16 of the last presentation:

Illustrative model

Origination cost	100	...our contribution
Receivable funding	900	...debt financing
Cash invested to fund medical costs	1,000	...cash to be invested
Expected Return multiple	1.65x	...return on investment net of provision for losses
Expected Return	1,650	

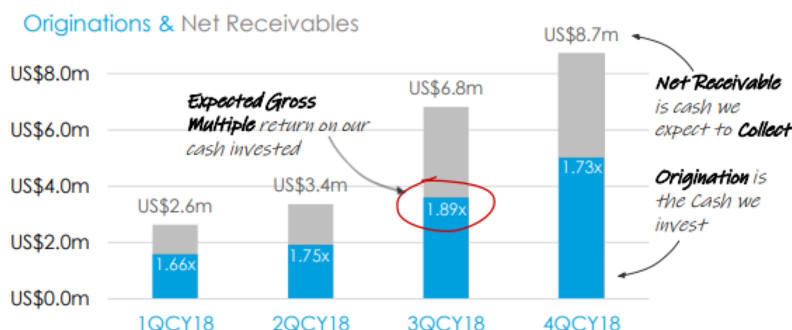
Cashflow	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Cash collection profile	-	5%	25%	35%	30%	5%
Cash invested	-1,000					
Cash collected		83	413	578	495	83
Operating costs		-99	-17	-17	-17	-17
Interest		-119	-137	-103	-42	0
Cashflow	-1,000	-136	259	458	437	66

SUMMARY	
Gross Cash Received	1,650
Costs & Interest	-567
Net Cash Received	1,083
Debt Repaid	-900
Net Cash return	**183**
Our contribution	100
Return on cash invested	83%

- We invest US$100 and finance US$900, which is used to purchase the lien rights for the medical expenses of the accident victim.
- The victim's law firm initiates legal action against the at-fault driver's insurance company for compensation to cover medical costs, other expenses and pain & suffering.
- In most cases the parties settle the claim and on average NHF has enjoyed a 1.77x return on the Cash Invested (we assume 1.65x in future).
- Cash Collection profile – sometimes cases settle in year 1, sometimes not until year 5 - the sooner the better for the victim and us.
- Overall, using these conservative inputs, NHF makes US$183 return on each US$100 invested.
- By improving the speed of collection and reducing the cost of financing, we expect to be able to increase this return.

The internal rate of return (IRR) on $1.83 returned in 30 months (the weighted average duration used in this example) on a $1 investment is 27.3%. Any business that has reasonable prospects of investing their capital at an IRR of 27.3% presents a good investment opportunity. In order to make a judgement about this, we must assess two things, the validity of this IRR figure and the depth of the reinvestment prospects for the cash inflows.

To assess the validity of the IRR, we need to understand whether the inputs are reasonable. There are 4 key inputs, return on investment, interest costs, weighted time to receive the return and operating cost. The 1.65x net return after provisions for losses is quite conservative in our estimation. NHF has historically produced more like a 1.77x cash on cash return (as noted on the slide), the most recent presentation indicates that over the past 12 months they've put cash out at a weighted average expected gross multiple of 1.78x:



If we change the cash collected to the historic return of 1.77x, and re-work the table from the company presentation, we get the results set out in Table 7 (I've added the IRR cell, IRR lifts to 32.6% if these assumptions are used):

Cashflow	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Cash collection Profile	0%	5%	25%	35%	30%	5%
Cash invested	-1000					
Cash collected		88.5	442.5	619.5	531	88.5
Operating costs		-99	-17	-17	-17	-17
Interest		-119	-137	-103	-42	0
Cashflow	-1000					
Summary						
Gross Cash Received	1770					
Costs & Interest	-567					
Net Cash Received	1203					
Debt Repaid	-900					
Net Cash Return	303					
Our Contribution	100					
Return on Cash Invested	203%					
IRR	**32.6%**					

*Table 7

The interest rate on the debt used to purchase the liens is presently very high and a key focus of management will be demonstrating the credit-worthiness of the business and reducing this cost. The incentives for the business to improve these rates are enormous. The $119 interest in year 1 in the worked example implies a little over a 13% rate on this debt (notes to the accounts show the rate is 13.25% p.a.). If they were able to find a facility that reduced this rate to 10% and retained the 1.77x cash on cash return from the table above, then the result would cause a further significant increase in IRR to 54% as shown in Table 8:

Cashflow	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Cash collection Profile	0%	5%	25%	35%	30%	5%
Cash invested	-1000					
Cash collected		88.5	442.5	619.5	531	88.5
Operating costs		-99	-17	-17	-17	-17
Interest		-91	-105	-79	-32	0
Cashflow	-1000					
Summary						
Gross Cash Received	1770					
Costs & Interest	-475					
Net Cash Received	1295					
Debt Repaid	-900					
Net Cash Return	395.3					
Our Contribution	100					
Return on Cash Invested	295%					
IRR	**54.0%**					

*Table 8

The next step to improve the IRR would be to improve the collection time. Management have migrated the NHF business to the Netsuite software system they use for the Australian disbursement business. They evidently think there's a step-change in productivity that can be harvested if the experience from the implementation of Netsuite into the Australian business can be replicated. We have modelled the reduction of collection time from the 30 months in management's presentation to 24 months, which we think should be achievable:

Cashflow	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Cash collection Profile	0%	15%	35%	35%	10%	5%
Cash invested	-1000					
Cash collected		265.5	619.5	619.5	177	88.5
Operating costs		-99	-17	-17	-17	-17
Interest		-91	-105	-79	-32	0
Cashflow	-1000					
Summary						
Gross Cash Received	1770					
Costs & Interest	-475					
Net Cash Received	1295					
Debt Repaid	-900					
Net Cash Return	395.3					
Our Contribution	100					
Return on Cash Invested	295%					
IRR	**71.6%**					

*Table 9

Recent conversations with management indicated the front book is collecting a good deal faster than the back book, they wouldn't be drawn on an exact figure, but I got the feeling it was a good deal shorter than the 24 months used in Table 9 which would further improve the IRR.

The final element we need to assess is the costs component. I could be persuaded that the implementation of the Netsuite system and the addition of scale to the business will likely reduce the operating costs as a proportion of each dollar originated, but think it best to take that as a bonus if delivered.

Management have implicitly indicated that an IRR of 27.6% is achievable. I have demonstrated above that if the business can be made to hum, there is the potential for a business that earns an IRR of >70%, which very few businesses are capable of doing for very long.

We said the other factor is to estimate the depth of the reinvestment prospects. It's well and good to have a business capable of generating a return on equity of 27.3% (or even >70%), but if you have limited opportunity to reinvest the profits, then the opportunity whilst attractive will not generate spectacular returns. It is in the sheer scale of the opportunity that has us most excited about NHF.

The personal injury claims market in the U.S is worth >$20b annually. The market for medical lien funding is an immature one, but is estimated to be as much as $1b annually. NHF estimate they are the 3rd largest competitor in the space and speak for about 16% of current originations. If the market is really a $1b one and they can maintain a 16% share, it implies they could write US$160m of originations annually without growing market share.

An NHF business writing a steady state US$160m per annum of originations would be capable of earning about US$90-120m per annum in gross profit and generate at least US$50-70m in pre-tax profits. The business needs to do nothing like this level of business for an investment at the current valuation to be an extremely good one.

If NHF can raise their origination rates to US$5m per month, at US$60m in a steady state, the business should be capable of generating more than US$20m of free cashflow annually.

The business is run by three very strong key executives. Anthony Hersch primarily oversees the Australian operations, and these have performed outstandingly well since he's been with the business, he will be able to use the experience gained over this time with the disbursement funding business to

assist NHF in achieving the operational improvements that would see it generating the high IRR's discussed earlier. David Wattel is the co-founder of and continues to run the NHF business; he is an energetic entrepreneur who has very big plans for what NHF can be. The CEO of LAW is Diane Jones, was CFO at IMF Bentham and given the complex financial, systems and accounting threads that need to be tied together, an ex-CFO is the right person to oversee this business. Enormous discipline will be required to ensure the business traverses the consolidation period over the rest of 2019 and successfully transitions into the prodigious growth business it is capable of being in 2020 and beyond.

The difficulty with making a decision about valuation is that the rest of calendar 2019 the business will be treading a very difficult cash flow tightrope. If plans are not put in place to manage what appears to be a circa US$10 or 11m negative cashflow, the company risks spoiling the enormous equity upside from the explosive cashflows in the years beyond 2019 by needing dilutive equity capital to manage the transition.

There are opportunities for the business to mitigate the tricky cashflow situation through 2019. The most obvious is that if the targeted $20m in cash can be released as soon as possible from the litigation financing business, then it can be used to bridge the gap until the cashflow turns positive in early 2020.

Alternatively, depending on the appetite of lenders, they could bridge the gap with short term debt. An AU$10m facility for 18 months to 2 years would probably be enough to see them through.

A third option is to discuss with Atalaya the onerous terms requiring over 85% of the collections from the back book be used to extinguish the attributable debt. Atalaya are a financially aggressive organisation (judging by the cost and terms of the debt), so this seems improbable, though unwillingness to be reasonable will ensure that NHF are reluctant to deal with them as a lender next time negotiations come around and presumably the excellent returns Atalaya are earning on the facility will have them keen to be part of any future growth for NHF.

As to what is the business worth right now, we think based on the risk/reward that 6.5cps (AU$32m capitalisation) materially undervalues the business. We have shown that if LawFinance can navigate 2019 that by 2021 and beyond it is capable of generating US$15-20m (AU$21-28m) in free cashflows with lots of opportunity for growth. Businesses operating in higher risk lending tend to be given lower than market multiples, usually high single digits (7-9x) this is usually because of the high need to retain capital for growth, the LAW business model will be very capital light at maturity, but it is still prudent to assume the market will ascribe a low multiple.

If LAW can get through 2019 without further diluting the equity, it could be worth a market capitalisation of AU$150-250m in two to three years (using the 7-9x cashflow multiple). There are presently 483,635,367 shares on issue. There are convertible notes that could deliver 78,125,000 if converted (eliminating AU$5m of debt should that happen). There are also warrants exercisable at 14c in late September 2022 which would leave the total share count at 1,014,504,003 should they be exercised. The warrant exercise would deliver $63.4m of cash to the business and extinguish the syndicated acquisition debt. This equity injection would likely leave the market capitalisation more like AU$200-300m, which based on the issued shares would be 19.7 – 29.6cps, or between 3 to 4.5 times the current share price within two to three years.

This is an investment that is not without risk, mostly due to the enormous leverage currently contained within the business, but if management are successful in navigating the tight cashflow environment of the next 12 months or so without equity dilution, we will be sitting on a business worth much more than the current share price, with a prodigious opportunity ahead of them.

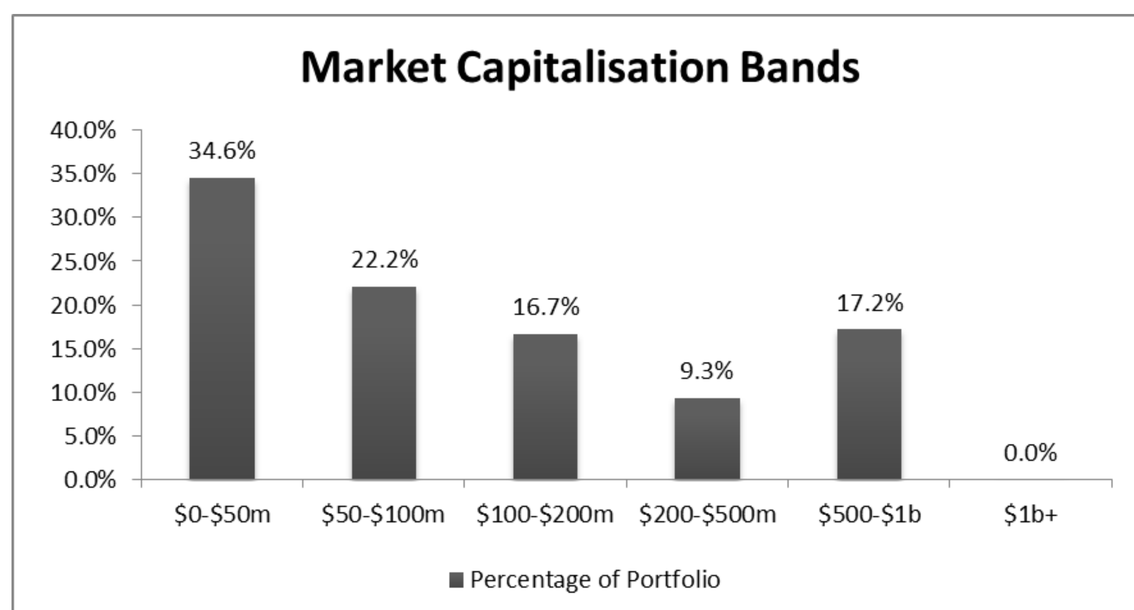
Key Portfolio Information:-

Our top 10 holdings at 31 March 2019 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	13.3%	11.5%
2	Kangaroo Plantation (KPT.ASX)	8.9%	7.7%
3	Legend Corporation (LGD.ASX)	8.4%	7.3%
4	APN Regional Property (APR.NSX)	5.5%	4.8%
5	LawFinance (LAW.ASX)	5.0%	4.4%
6	Undisclosed	4.4%	3.8%
7	Dicker Data (DDR.ASX)	3.9%	3.3%
8	Blackwall Limited (BWF.ASX)	3.8%	3.3%
9	Undisclosed	2.9%	2.5%
10	SRG Global (SRG.ASX)	2.9%	2.5%

Our largest 5 holdings now comprise 41.1% of our invested capital, our top 10 holdings are 59.0% and our top 15 represent 72.1%. Cash and cash equivalents are 14.3% of the portfolio.

The market capitalisation graph is set out below. This month, the median market capitalisation is $71.6m.



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 Max. Initial investment	$50,000 $2,000,000	Sharpe Ratio[1]	0.37
Additional investments	$5,000 (Minimum) $200,000 (Maximum)	Sortino Ratio[1]	0.30
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	6.89% 9.73%
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	48.7% 59.0%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	(1.7%) 15.9%
Custodian/PB	NAB Asset Services	1 year return[2] – EGP 1 year return – Benchmark	(7.0%) 12.1%
Responsible Entity	Fundhost Limited	3 year annualised return[2] – EGP 3 year annualised – Benchmark	N/A N/A
Fund Size	$55.2m	5 year annualised return[2] – EGP 5 year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.9453 $0.0068	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.9467 $0.9439

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	$1.9395

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