EGP Concentrated Value Fund

Address: Suite 2, Level 11, 37 Bligh Street
Sydney, NSW, 2000

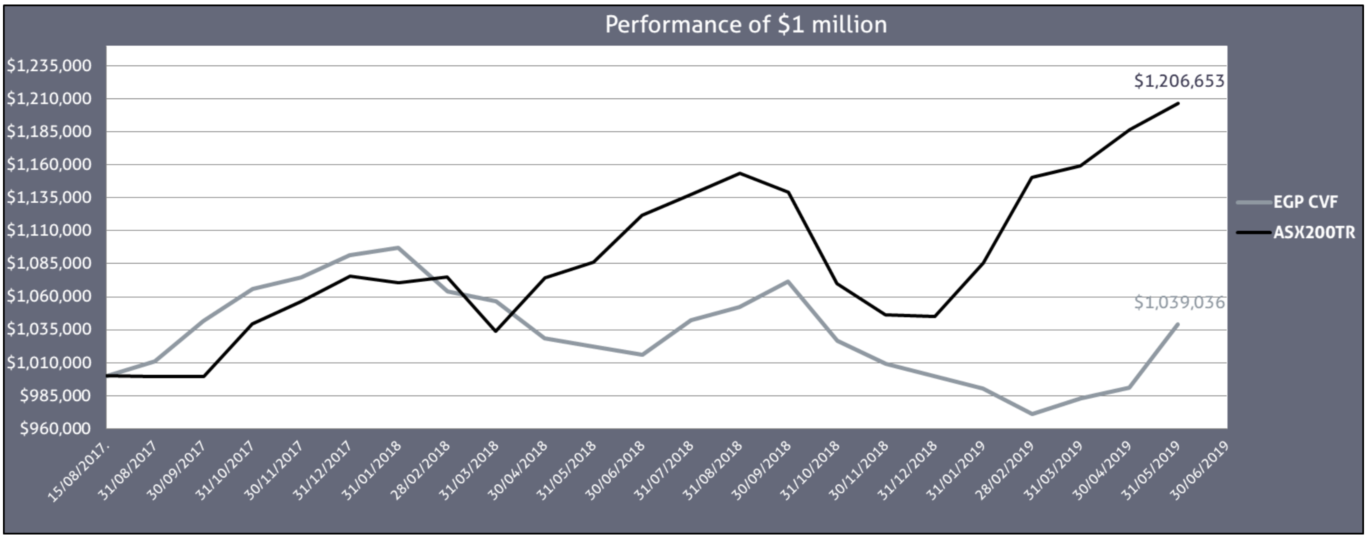
Mobile: 0418 278 298

EGP Concentrated Value Fund – 31 May 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%	0.9%	4.8%		2.29%
Benchmark FY19	1.4%	1.4%	(1.3%)	(6.1%)	(2.2%)	(0.1%)	3.9%	6.0%	0.7%	2.4%	1.7%		7.57%

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



The Month That Was:-

The fund rose by 4.8% in May. Our benchmark rose by 1.7%.

The rise in our benchmark in May was truly remarkable on a global basis. By way of comparison, the Dow Jones Industrial Average was down 6.7% in May, meaning the Australian indices outperformed it by about 8.4% in a single month. Market followers will be aware there was a very positive market response in the days following the unexpected return of the Morrison Government in the federal elections mid-month. The ASX200 is now up an incredible 15.5% in just the first 5 months of 2019.

The fund had a very strong month as positive news out of a number of our holdings was finally enough to begin the process of correcting the latent undervaluation in our book of assets. One of your fellow unitholders told me they had no fear of upside volatility whatsoever and we were glad to be able to provide a little of that for them in May.

Growth at A Remarkable Price Revisited (Again):-

We first discussed our position in Legend Corporation (LGD) in August 2018. When we wrote about LGD in August, we said it was likely we were finished buying as the price had risen meaningfully. We covered it again in September 2018 after the price rose sharply that month to as high as 38.5 cents per share. We still thought the stock was undervalued at that price given the significant growth opportunities ahead of the business in coming years, and our view that 38.5c only put LGD on a price to earnings of below 9, which remained unusually cheap for a business with good growth prospects.

The price since September 2018 steadily drifted lower, since late March, we've added almost 20% to our LGD holding at prices averaging 29.3c. We could not believe we were able to accumulate the stock at such an incredibly low price. We wrote again about LGD last month, telling you we had been the purchaser of a majority of the stock that traded in April. Looking back through the trading that took place in April, I can confirm EGPCVF purchased 63.6% of all the LGD shares that traded in April 2019.

We had continued purchasing all the way up until May 15th; I mention this as it is important to note that nothing fundamental had changed in the LGD story, the stock was remarkably cheap on any reasonable valuation basis when we first commenced buying it in July of last year. Although the price rose substantially, it remained very cheap, and as a conviction investor, we did what we should do when we are confident in our analysis and continued adding to our position.

On the 24th of May, LGD announced they have entered into a scheme implementation agreement with the Private Equity buyer Adamantem Capital. The bid price is 36.5 cents per share. As noted above, a price that touched 38.5 cents per share in September last year did not tempt us into selling, as we felt it still materially undervalued the business. So the price is one we consider to be very disappointing, notwithstanding the fact that it is pleasing to be validated by the fact that an outside bidder sees the fundament and opportunity that we saw.

At the close of May, the price for LGD was 38 cents per share, and the stock has not traded at or below the bid price since it was announced. This seems to indicate to us that there is a feeling by market watchers that there is an above average chance an improved bid is necessary, though the premium to the cash bid price could also be due in part to the fact there has been a 7 cent fully franked dividend component to the bid announced, making it worth 39.5c to the zero tax buyer.

Given we estimate the franking balance will be in excess of 11 cents per share at the June 30th, one cashless way the bidder might sweeten the bid is to enlarge the fully franked dividend component of the consideration.

Based on our expectations for the LGD FY2019 full year, we think the bid values the business at less than 8.5x on a price/earnings basis for FY19 and about 7.7x FY20 (which the market should be starting to contemplate as we near the end of FY19). The bid is a little over 5x our expectation of FY19 EV/EBITDA and a little under 5x FY20 EV/EBITDA. We cannot recall a business with such attractive industry growth prospects being acquired successfully at such low multiples; we hope LGD is not the first such case.

We will stay in touch with management in coming weeks and months. Unfortunately, with their tacit approval of the initial low bid, they have put shareholders in an invidious position where they may be inclined to accept the offer, assuming that the low price implies management has a dimmer view of the future prospects than certainly we do at EGP. The bid will require 75% of votes cast to be in favour, we have spoken with other sizeable shareholders who appear to feel as we do the bid is significantly below fair value (certainly below "takeover premium" value), if enough shareholders feel that way, perhaps we can keep LGD listed and instead enjoy the growth in profits and dividends that we think lays ahead for the business.

AGM's in May:-

We have a number of our holdings with December balance dates, which means May AGM's. We attended a number of these in May. The first we will discuss is LawFinance (LAW) on 15 May. We wrote a lengthy valuation piece on LAW in the March update. We pointed out that although LAW is probably the business we own with the most upside potential if they get the model right, that it is sized at a relatively modest 4% of our portfolio because there are significant challenges to the cashflow of the business in the next year or so, so there is meaningful downside risk to consider. Management were remarkably upbeat at the AGM, they insist there are plenty of ways they can manage their way through the next 12 months until the business really starts to throw back large sums of cash to make the balance sheet look less precarious than it does at present.

CEO Diane Jones is among the most forthright executives I have ever encountered, she says there are workable solutions to their cashflow needs and that she has plans in place. These appear to range from the cash flowing from the litigation book to possibly selling of a tranche of the older NHF book to reduce the size of the 'back book' which has the onerous covenants limiting the usable cashflow from collections. The market still appears to be in 'wait and see' mode with LAW, but when delivery becomes evident for this business, it will be a snowballing valuation that will move very swiftly. Businesses with the ability to earn triple digit returns on equity are incredibly rare; we think LAW is such a business if management can traverse the cashflow issues without raising further equity.

Our second May AGM was for Dicker Data (DDR), which we have held since 2012, and which has a history of consistently delivering strong results year after year, whilst paying out substantially all of its earnings as cash dividends. The outcome of this consistently high payout ratio combined with high earnings growth (averaging 20.4% per annum EPS growth since the 2011 IPO) is a return on equity of 42% and a pre-tax return on tangible assets of more than 94%.

After a strong rise in share price over the past couple of months, for the first time since listing, the DDR share price seems to be properly reflecting the excellent job DDR management do running the business, it trades at around 20x what they will earn in calendar 2019, which is a quite full valuation, but not 'expensive' for a business with a history of paying all its earnings to shareholders and still growing the per share earnings by strong double digits.

Normally quite reserved Chief Operating Officer Vlad Mitnovetski at the AGM excitedly described the opportunity ahead of DDR in coming years, he seems to think growth can not only be maintained, but with the expansion of their Kurnell warehouse, has the possibility of accelerating. It's not just talk either - he has been consistently buying stock in meaningful quantities on market over the past couple of years. We are unlikely to add to our DDR position at these prices, but despite the apparent full valuation, are unlikely to trim the position, preferring to see how much further David Dicker's team of all-stars can take this business once the new facility opens.

The final AGM I will discuss is for our largest position, United Overseas Australia (UOS). My family has owned UOS since 2008, this year was the 8th consecutive year I've attended the AGM in Kuala Lumpur. I have written about this business numerous times, followers of EGP will be very familiar with the story, but I will relay some of what I thought were the key points coming out of this year's AGM.

The 2018 annual report revealed that the completion dates for the United and Sentul Point megadevelopments have been moved into 2019, these were originally slated for 2020 completion. Sentul Point looks the more advanced of the two projects, but both are almost sold out, so confident are management in the United Point project that the sales office has been demolished to enable a clearer run at construction as the project nears completion.

Property developers can be tricky to value given how widely cashflows can vary from earnings. The commitment of large sums of cash with progressive recognition of profits that frequently prove to be smaller than forecast leave many tossing developers into the 'too-hard' basket. The commencement of the Sentul and United Point megadevelopments exhibited just such an issue for UOS. The balance sheet went from $297m net cash at the end of 2015 to about $107m of net cash at the end of 2017, despite the business reporting $270m of cumulative NPAT over the intervening two years. This began unwinding in 2018 (net cash balance $194m) and will complete over 2019 and 2020.

One aspect of property development in Malaysia many followers of UOS will be unaware of is the 'instalment' nature of the contracts, with the buyer obligated to meet contractual payments upon the developers' completion of certain milestones. This means developers in Malaysia aren't taking nearly the same level of risk as they do in Australia where if the property market falls while the building is being constructed, the buyer can walk away and only lose their deposit. The instalment regime in Malaysia looks as follows (my abridged version of such a contract):

1. Upon signing of agreement 10%
2. Within 30 days of receipt by purchaser of developers written notice of completion of:
    a. Foundations completed 10%
    b. Structural framework completed 15%
    c. Walls, doors and window frames completed 10%
    d. Roofing/ceiling, electrical wiring, plumbing, gas, telcom trunking & cabling 10%
    e. Internal and external finishes, including walls 10%
    f. Sewerage serving building 5%
    g. Drains serving building 2.5%
    h. Roads serving building 2.5%
3. Date purchaser takes vacant possession, with water/electricity available 17.5%
4. Issue of strata title to purchasers solicitor 2.5%
5. Defect Period:
    a. Expiry of 8 months 2.5%
    b. Expiry of 24 months 2.5%

United and Sentul Points have a gross development value (GDV) of around AU$1 billion. Something like half of that cash will flow back to UOADEV (the Malaysian listed development business of which UOS owns 70%) in the last few months of the projects, a firehose of cash that has been about four years in the making, but whose revenue has been progressively recognised over the life of the project.

UOADEV have RM3.8b (about AU$1.3b) GDV of projects currently under construction, about RM1.3b (about AU$450m) of GDV that will launch in 2019, and a pipeline over the next 8-10 years currently valued at RM12.6b (about AU$4.3b) of GDV. They have the balance sheet to push through the pipeline in perhaps 5 or 6 years if they wanted to, but they are easing the pipeline out in such a way that margins can be maintained and the scale of the company (UOADEV) remains similar.

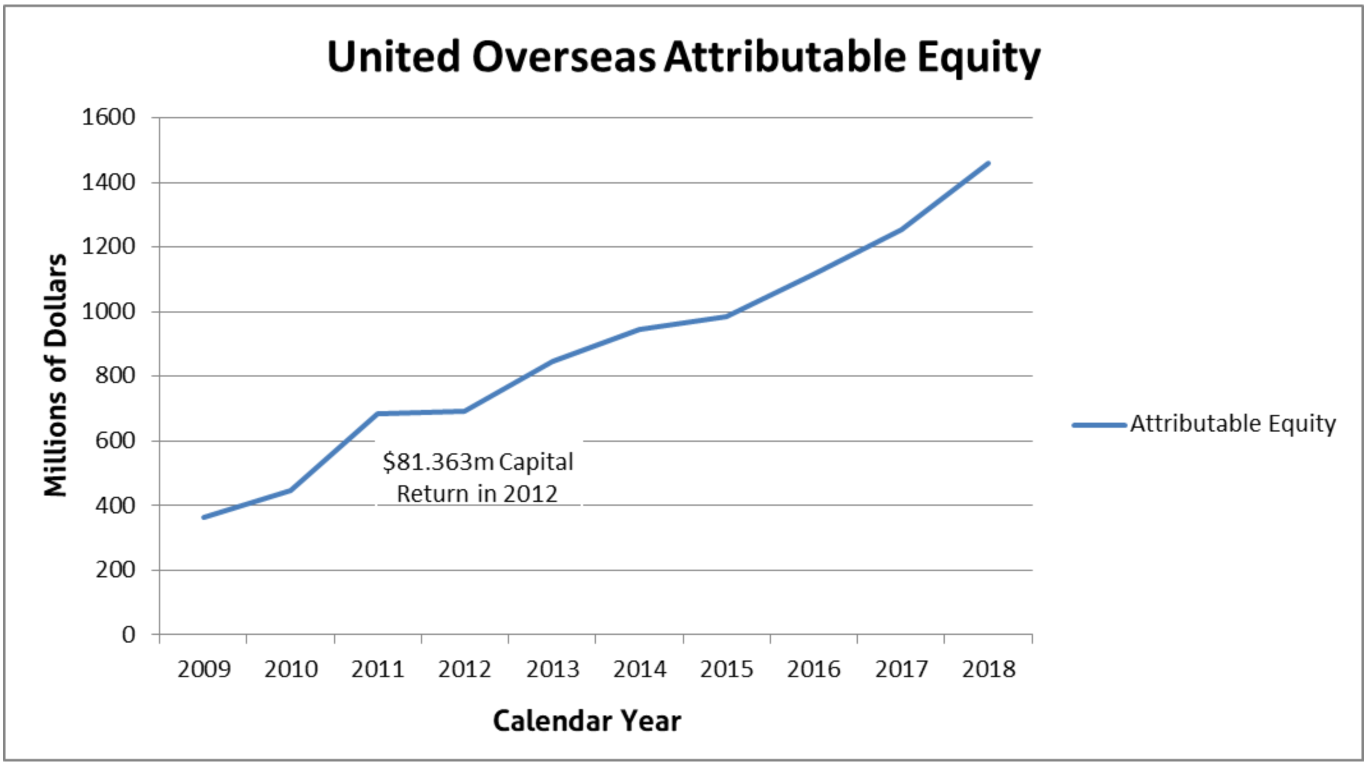
One of the key strengths of the mighty balance sheet UOS possesses is their ability to hold (predominantly commercial) inventories until they fill the buildings with tenants, enabling them to sell those inventories at higher margins than those sold off the plan (predominantly residential). The current run rate for UOADEV is about RM1.3b per annum of revenue, with RM1.4b of unbilled sales and inventories of RM2.15m (likely to generate sales revenues of RM3.0-3.2b), meaning almost 4 years revenues (RM4.4 to 4.6b) at the current billing run-rate is already secured, meaning forward earnings visibility is actually very good.

Meaningful undervaluation of the assets on the balance sheet remains a key element of the demonstrable undervaluation of the stock. A simple look at the valuations per square metre versus valuations of similar quality assets in a number of Malaysian listed REIT's indicates the carrying values of the UOADEV assets are exceptionally conservative.

Land values hold even more latent value, when we sat with management after the UOADEV AGM; I asked what the cost would be to acquire the remaining vacant land around Bangsar South now given how much more developed the suburb is now than when the land was acquired in 2006. They indicated they would expect to pay about 40 times their original purchase price. They still hold more than 20 acres of land at Bangsar South on the balance sheet at cost (around $7.2m). This is the reason the margins on developments at Bangsar South exceed those of more recently acquired land, land cost as a portion of such developments are negligible. There's almost RM5b of development left to do at Bangsar South.

Further profit growth for UOS is likely to come at the parent company level with the recent foray into Vietnam apparently progressing better than expected. The commercial property market is grossly underserved in Ho Chi Minh City and A-Grade rental can apparently command as much as three times the rate per square metre of similar Kuala Lumpur office space. The cost for construction is apparently modestly higher, and land costs considerably higher, but it still sounds like there is an opportunity in Vietnam that should be available for at least the next decade to make much better margins in commercial property development than can presently be earned in Kuala Lumpur.

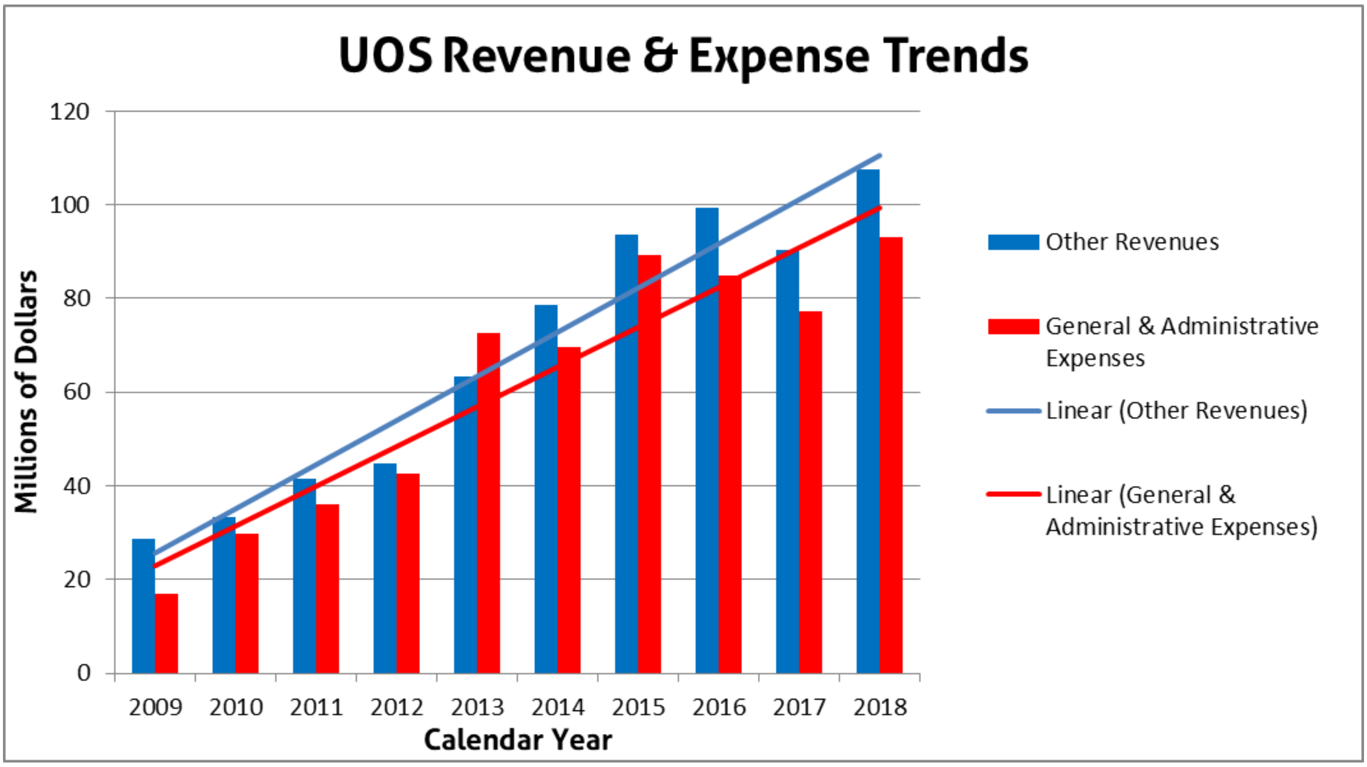
The understanding most frequently obtained when we explain the UOS investment opportunity to someone new to the story is "Oh, so it's an asset play". With the shares trading at below 70c and the stated net tangible assets of $1.023 per share certainly makes UOS qualify as an 'asset play'. Our view of the assets were they revalued to full saleable asset value is that they would likely be at least $1.30 per share and possibly a good deal higher. The way we view UOS at EGP is that it's a 'compounder with incredible downside protection due to assets'. To explain this visually, we have graphed the growth in attributable (i.e. excluding minority interests) tangible equity over the past 10 years:



We can see remarkably consistent growth in the underlying asset values, the only year where the line is relatively flat was 2012, the year UOS made a capital return of $81.4m after listing the development business on Bursa Malaysia. The rate of NTA compounding in demonstrated over the past 10 years is 14.9% annually, ignoring the capital return. If we factor the capital return, the compound annual growth rate is 17.4%. If we go back 20 years, the rate of compounding exceeds 24% annually.

If you purchase an asset at two-thirds of the tangible asset backing (the approximate UOS discount at present) and the asset compounds at 17.4%, the effective rate of compounding on the price paid for assets is about 26%.

The second mistake in analysing UOS is to treat it as a pure developer. The 'other income' line in the accounts, which accounts for all non-development revenue (other than revaluation gains), such as rental, hotel, car parking and management fees has grown at a similar rate to the underlying NTA, it graphs like this:



The 'General & Administrative' expense, which is the entire operating cost for the business (including the entire operating cost for the property development business) is more than covered by the 'recurring income'. This means that the business would be profitable even if they were not making money from the development arm, or put another way, 100% of the profits from the development arm fall to the bottom-line as the operating cost base is already covered by the recurring income.

UOS is our largest position because we consider it to be the best risk adjusted opportunity available on the ASX at present. We don't own it with any expectation that we will double our money in any given year, but with the expectation that over any reasonable period (5 years or more), we find it very hard to imagine that we won't earn at least a double digit return. We can easily conceive of a 5 year period for the broader indices where the return is much lower than that.

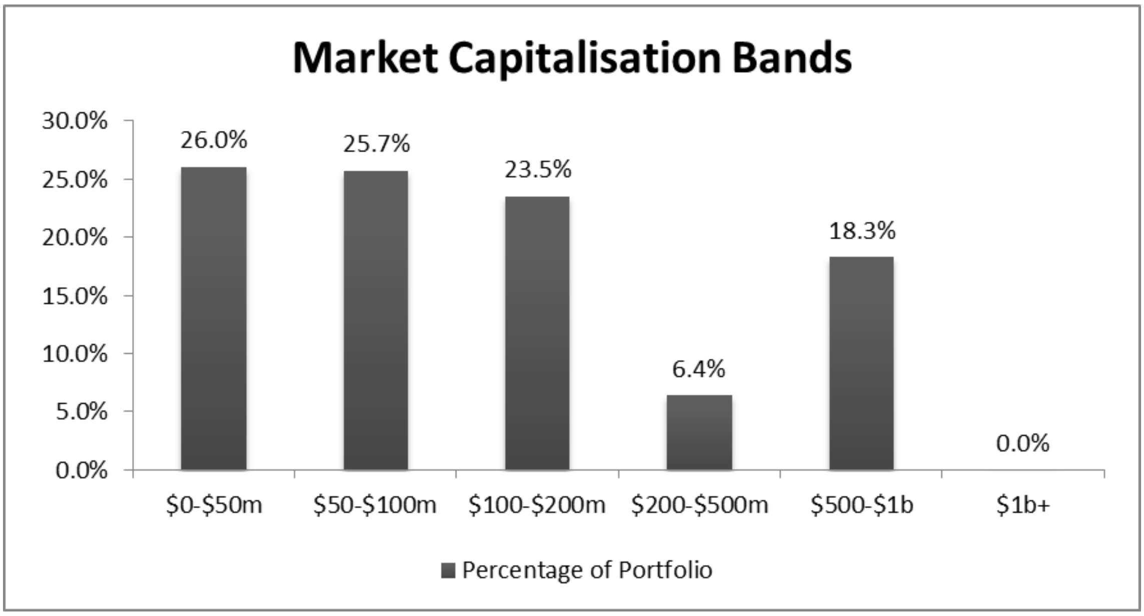
Key Portfolio Information:-

Our top 10 holdings at 31 May 2019 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	13.5%	11.4%
2	Legend Corporation (LGD.ASX)	11.0%	9.3%
3	Kangaroo Plantation (KPT.ASX)	8.9%	7.5%
4	Dicker Data (DDR.ASX)	4.8%	4.0%
5	LawFinance (LAW.ASX)	4.7%	4.0%
6	Undisclosed	4.4%	3.7%
7	SRG Global (SRG.ASX)	3.9%	3.3%
8	Blackwall Limited (BWF.ASX)	3.7%	3.1%
9	Undisclosed	3.4%	2.8%
10	Locality Planning (LPE.ASX)	3.4%	2.8%

Our largest 5 holdings now comprise 43.0% of our invested capital, our top 10 holdings are 61.7% and our top 15 represent 74.6%. Cash and cash equivalents are 15.9% of the portfolio.

The market capitalisation graph is set out below. This month, the median market capitalisation is $90.4m.



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]	0.38
Additional investments	$5,000 (Minimum) $200,000 (Maximum)	Sortino Ratio[1]	0.34
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	7.50% 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	-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	53.5% 62.8%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	3.9% 20.7%
Custodian/PB	NAB Asset Services	1 year return[2] – EGP 1 year return – Benchmark	2.2% 11.1%
Responsible Entity	Fundhost Limited	3 year annualised return[2] – EGP 3 year annualised – Benchmark	N/A N/A
Fund Size	$57.2m	5 year annualised return[2] – EGP 5 year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.9994 $0.0072	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$1.0009 $0.9979

1 Sharpe and Sortino Ratios calculated using the Monthly Benchmark ASX200 Total Return Index

2 Return is net of all fees and costs and assumes reinvestment of dividends. 1, 3 and 5 year figures are rolling annualised figures.

Past performance is not an indicator of future performance.

The information in the below table is provided for shareholders in EGP Fund No. 1, and does not relate to the EGPCV Fund.

EGP Fund No. 1 Pty Ltd Equivalent Price	$2.0470