EGP Concentrated Value Fund

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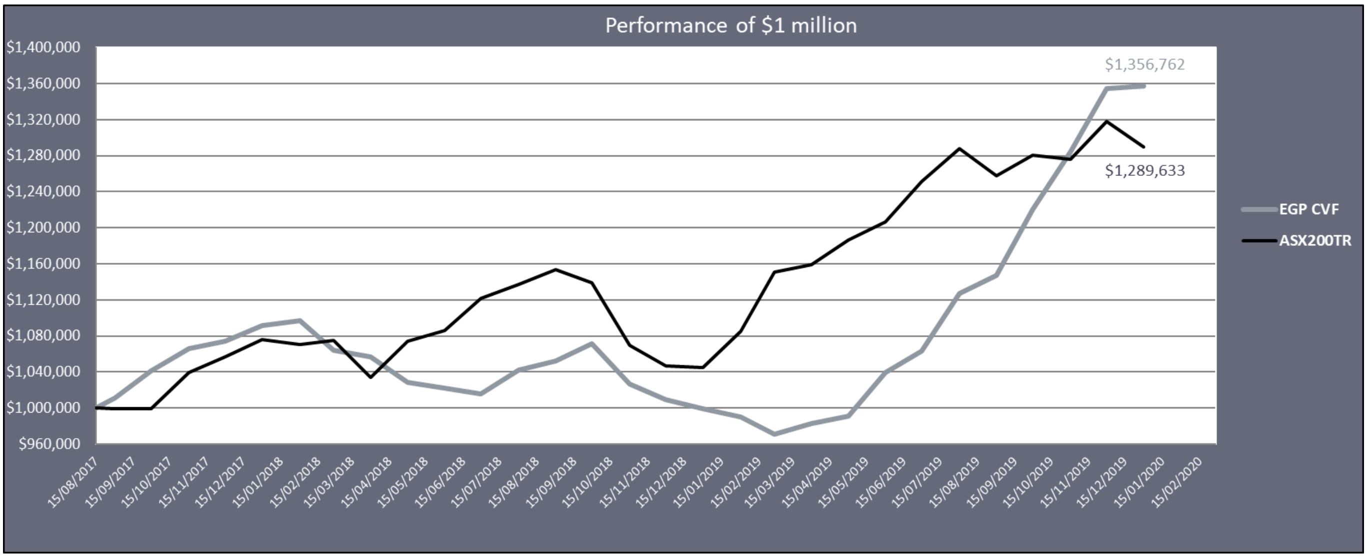
EGP Concentrated Value Fund – 31 December 2019

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%	2.3%	4.63%
Benchmark FY19	1.4%	1.4%	(1.3%)	(6.1%)	(2.2%)	(0.1%)	3.9%	6.0%	0.7%	2.4%	1.7%	3.7%	11.55%
EGPCVF FY20	6.1%	1.8%	6.4%	5.2%	5.5%	0.1%							27.62%
Benchmark FY20	2.9%	(2.4%)	1.8%	(0.4%)	3.3%	(2.2%)							3.06%

*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 0.1% in December. Our benchmark fell by (2.2%).

The fund finalised calendar 2019 with a result to investors after all fees and costs of 35.69%, which is our best calendar year, besting the 34.97% we delivered in calendar 2013. The 23.39% for our benchmark was likewise the best performance for our benchmark, besting the 20.26% it delivered in calendar 2012.

We would like to take this opportunity to thank all the investors who stayed with us through the period of underperformance that ran from February 2018 to February 2019. Now it is behind us and our performance has returned to more like historic levels, we are able to view the period with more pragmatism and think it will make the fund stronger long-term as our investor group will be better positioned psychologically to deal with future periods of underperformance (which will inevitably come, our portfolio is VERY different to our benchmark). The contribution of the unitholders to the performance of an open-ended fund like ours is something that is rarely discussed, but when the instinct of the investor group is to add capital during periods of underperformance, the likelihood of outperformance is substantially enhanced. Likewise, if your investor group is flighty and prone to withdrawing funds at inopportune times, they can potentially harm the fund performance and certainly can harm their own performance.

The best example of "unitholder self-harm" I am aware of came from a study Fidelity Investments conducted into their Magellan fund from 1977-1990, Peter Lynch's tenure which saw an average annual return of 29%. Investors in this fund should have made substantial returns over that period. However, Fidelity Investments found in their study was that the average investor in the fund ***LOST*** money!

This is staggering, but I have read several accounts of this and believe the story is based in truth and not some apocryphal tale. I have said before, one of EGP's greatest sources of pride is that our investor group have outperformed our reported performance by a meaningful margin. When we last calculated it, the IRR of our investor group, the outperformance was greater than 1% per annum, which in terms of our long run average of 15.57% annually is definitely material, an additional 1% on a 15% return would mean a 6.66% better result for our investors simply by judiciously timing investments into EGP.

The month was mostly uneventful, with only a couple of big movements for the portfolio, another downgrade by Redbubble (RBL) was the most painful negative one. We still think RBL are in the process of creating a very large and successful marketplace, but like all growth businesses, there will be stumbles. We think the punishment meted out by the market for a business still growing its top line at >20% yar-on-year is probably overdone, consequently we added materially to our position in December. The most recent stumble has prompted one of the larger institutional investors in RBL to adopt an activist tone, with this letter sent to the board late in the month urging them to investigate value creation options. The business is materially cheaper than most comparable businesses, especially when growth rates are considered, but we would still prefer to see another couple of years of the current board executing the current strategy before throwing up our hands and selling out to a competitor.

Some important late news from three of our four largest holding meant December 2019 was an important one for the fund. The two pieces of positive news from Site Group (SIT) and Lawfinance (LAW) will be discussed briefly in the section below.

Negative news came from our fourth largest holding, Kangaroo Island Plantation Timbers (KPT), with about 13.3% of KPT's forest (by area), or 17.4% by value of standing timber damaged by recent bushfires on Kangaroo Island. The current Australian fire season has been an especially bad one, now already one of the five or six worst since European settlement, with almost two months of summer still to run, it could potentially end up one of the worst if conditions don't soon turn. We should all be incredibly thankful for the amazing job our rural fire services do, especially considering they are primarily staffed by volunteers. Wonderful people.

Fortunately for our investment in KPT, the forests are insured, with about $20m of payment apparently due (less a $5m excess), meaning the business will be well funded to re-plant and rehabilitate the damaged forests. Assuming a reconfiguration of the harvest program to move the replanted sections of forest to the end of the harvest sequence, it should ultimately have a relatively modest impact on the businesses future cashflows provided not too much further fire damage is sustained.

Stars Aligning: -

We covered the investment thesis for SIT in our August 2019 newsletter. The primary value driver for SIT will be the 30-hectare landholding in Clark in The Philippines. The company on 31 December 2019 announced a $15m debt facility which will allow them to commence progression the horizontal works on the site, as well as enabling the highly prospective international training business to pursue opportunities that had previously been left under pursued due to capital constraints. The debt is convertible into equity at 12cps, which is a premium of more than 70% to the closing share price. We would prefer not to have our significant equity holding diluted, but the additional value that will likely be created by having this capital available should hopefully more than offset the dilution. This looks to us like a very positive development for our SIT investment. 2020 should see steady progression in the value realisation process for the land, and hopefully with the additional funding, the international training business will more fully achieve its potential this year also.

We wrote about LAW in our March 2019 newsletter, I was careful to point out at that time that it was easily the riskiest position in our top ten holdings. This was mostly due to the precariously placed balance sheet. If the business was able to navigate their way to "re-equitising" without the need for further equity capital, there was potential for breathtaking gains to the equity, but the real risk of loss was also a prospect that needed to be considered due to the very stretched balance sheet. In short, if the business tripped up and the support of its lenders was lost, there could be very real issues.

The downside risks have this month been substantially eliminated. The high esteem in which we already held CEO Diane Jones, COO Anthony Hersch and board member Anthony Murphy has also been substantially enhanced. They have raised capital that will virtually ensure the NHF business will be able to execute on the extraordinary opportunity it faces. There is now substantially less downside risk in the investment, but it must be acknowledged that the risk reduction came at the cost of a commensurate reduction in the upside potential due to the dilution that raising capital necessitated.

The most important hint to the value delivered by the board and management comes from the conversion of the US$22.1m vendor loan and promissory note for equity options. These options are in three tranches of 25c, 40c and 60c in 2, 3 and 4 years. This is important for two reasons. Firstly, it demonstrates the value the NHF vendors think can be generated by the business, they would not willingly swap hard cash payments for equity options if they didn't think they were a realistic prospect of ending up better off as a consequence of the options being exercised. The second is obviously the elimination of a big piece of debt from the balance sheet.

Further to this, a significant portion of the corporate debt will be converted to equity as part of the transaction. Furthermore, most of the remaining corporate debt has been converted into a note with interest capitalised at a 6% coupon with a 10c equity conversion.

The outgoings to meet the interest payments are very significantly reduced by the transaction. The company is now very well capitalised to do several things that have the potential to meaningfully enhance the equity value of the business. They will find it much easier to replace the very expensive, and highly restrictive facility currently provided by Atalaya. They will also be in a much more comfortable position to finalise the litigation funding business without the pressure of desperately needing the funds that these settlements will release. They can also potentially look to sell the Australian legal funding business, the future for LAW is clearly tied to the successful execution of the NHF business, the Australian business, whilst an outstanding one is very small with far more limited growth opportunities and if a buyer could be found for this business, the combination of freeing up management bandwidth and the application of the capital to the higher available returns presented by NHF would be highly desirable.

The results for the December 2019 half and for the June 2020 half will still look poor on a statutory basis, but the results beyond that will start to look progressively better as the effects of the AASB 9 start to be overcome by time.

We won't reprise the very long explanation of the LAW business, gluttons for punishment are able to re-read the March newsletter. What we will provide is this link to a note by Lucerne who are a fellow fund manager with a substantial shareholding in LAW, who are clearly at least as bullish on the prospects of the newly recapitalised business as we are. If the business can achieve anywhere near the business scale we think is possible (they describe the opportunity as circa US$16b, capturing 3-5% of this would create a huge business), investors in LAW will look back on the last couple of difficult years with exceptional fondness.

The Zero Fee Collective: -

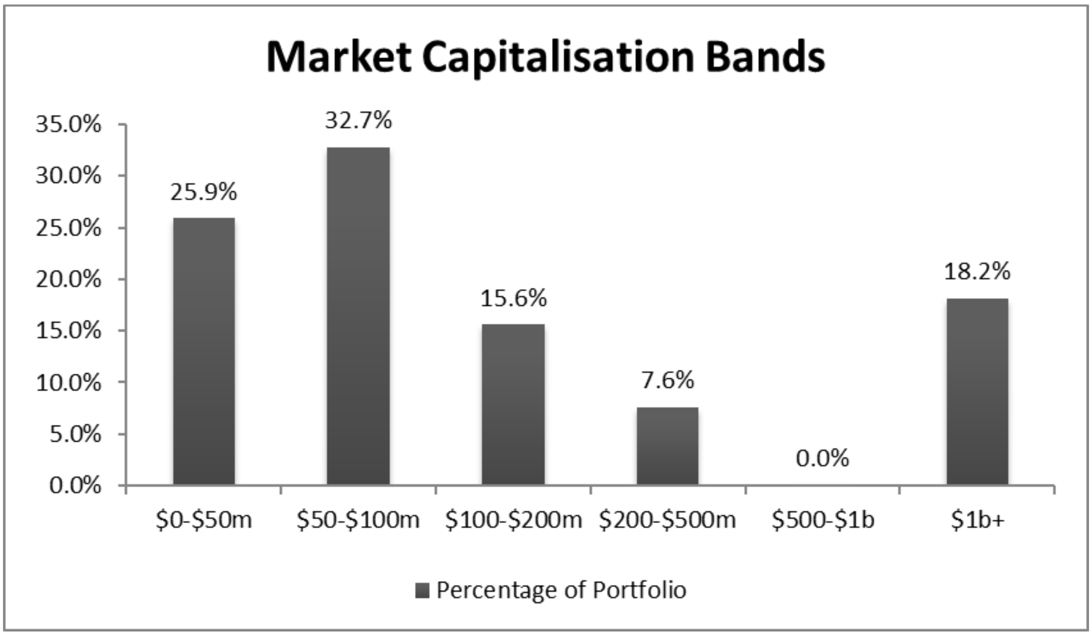
We were blown away by the interest exhibited for the ZFC Fund from only our own investor group after our discussion in last month's newsletter. We have had enough firm interest to think it is likely that the ZFC will comfortably generate subscriptions of at least $50m, which is the minimum viable size for a fund of that type in our view. The initial sizing of The ZFC will be $100m and priority will be given to those who express interest first if we get greater than $100m of total interest. Please send emails expressing interest to ZFCInvestors@egpcapital.com.au to ensure you're kept abreast of developments. We remain committed to a launch in the second half of 2020 at this stage. Fund managers interested in being part can contact us ZFCManagers@egpcapital.com.au so we can discuss how you might be part of the initiative.

Key Portfolio Information: -

Our top 10 holdings at 31 December 2019 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	11.6%	10.2%
2	Site Group International (SIT.ASX)	9.8%	8.7%
3	LawFinance (LAW.ASX)	6.1%	5.4%
4	Kangaroo Plantation (KPT.ASX)	6.0%	5.3%
5	Smartpay (SMP.ASX)	5.6%	4.9%
6	Undisclosed Holding	4.0%	3.6%
7	Dicker Data (DDR.ASX)	3.7%	3.2%
8	Locality Planning (LPE.ASX)	3.2%	2.8%
9	Undisclosed Holding	2.9%	2.7%
10	Blackwall (BWF.ASX)	2.9%	2.7%

Our largest 5 holdings now comprise 39% of our invested capital, our top 10 holdings are 55.5% and our top 15 represent 66.8%. Cash and cash equivalents are 11.7% of the portfolio. The median market capitalisation is $91.9m. Weighted average market capitalisation is $414.9m.



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	Closed to new investors	Sharpe Ratio[1]	1.19
Additional investments	$5,000 (Minimum) $20,000 (Maximum)	Sortino Ratio[1]	1.01
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	9.44% 9.10%
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	65.5% 62.1%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	35.6% 29.0%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	35.7% 23.4%
Responsible Entity	Fundhost Limited	3 year annualised return[2] – EGP 3 year annualised – Benchmark	N/A N/A
Fund Size	$84m	5 year annualised return[2] – EGP 5 year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$1.2331 $0.0110	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$1.2350 $1.2313

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.