EGP Concentrated Value Fund

Address: P.O. Box 1873,
Macquarie Centre, NSW, 2113

Mobile: 0418 278 298

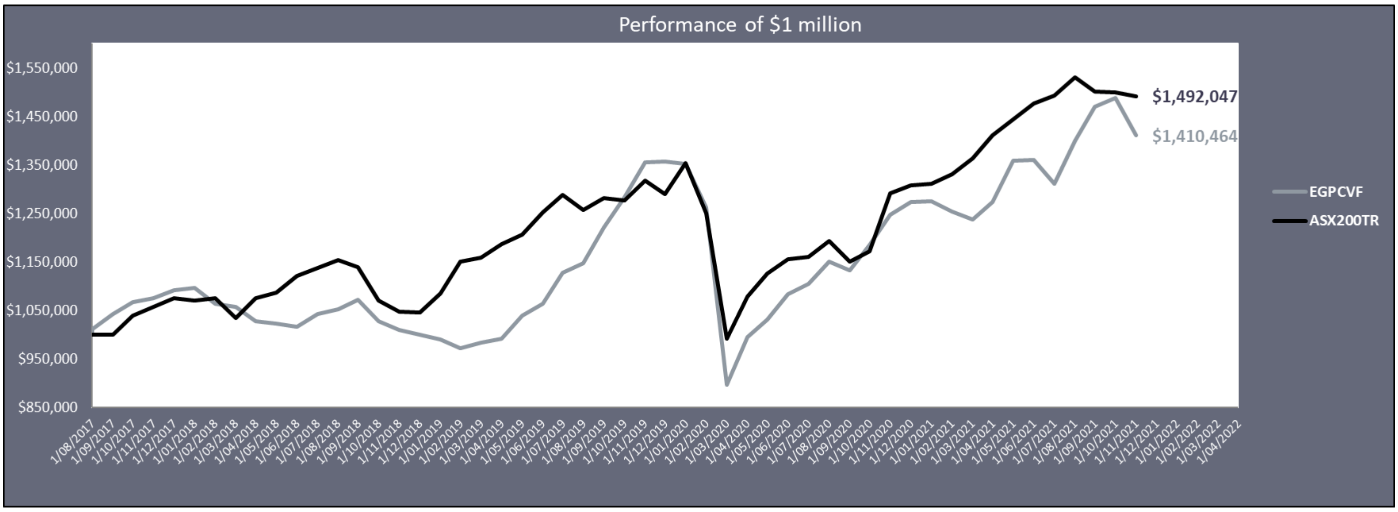
Email: tony@egpcapital.com.au

EGP Concentrated Value Fund – 30 November 2021

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%	(0.3%)	(6.7%)	(28.9%)	11.0%	3.6%	5.1%	1.99%
Benchmark FY20	2.9%	(2.4%)	1.8%	(0.4%)	3.3%	(2.2%)	5.0%	(7.7%)	(20.7%)	8.8%	4.4%	2.6%	(7.68%)
EGPCVF FY21	1.9%	4.1%	(1.5%)	4.6%	5.3%	2.2%	0.1%	(1.7%)	(1.3%)	2.9%	6.7%	0.1%	25.50%
Benchmark FY21	0.5%	2.8%	(3.7%)	1.9%	10.2%	1.2%	0.3%	1.5%	2.4%	3.5%	2.5%	2.3%	27.80%
EGPCVF FY22	(3.6%)	6.7%	5.1%	1.2%	(5.2%)								3.68%
Benchmark FY22	1.1%	2.5%	(1.9%)	(0.1%)	(0.5%)								1.07%

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



The Month That Was: -

The fund fell (5.2%) in November. Our benchmark fell (0.5%). My warning in last August's newsletter that the increased concentration would likely result in more monthly volatility continues to prove correct. Unfortunately, this month for the first time since the statement was made, the volatility was of the negative type. The 8 largest holdings in the portfolio suffered meaningful price declines in November. Few of these were on relevant business updates, just sentiment shifts. We will briefly discuss the monthly movements of our top ten holdings below.

1. Cettire hit an intramonth high of $4.80 per share as they announced at the AGM that the 181% sales growth announced for July had accelerated slightly to 184% for the 4 months to the end of October. The share price was eventually caught up in the broader market reversal late in the month, declining more than 20% to close at $3.81. I revisit the Cettire thesis below.
2. United Overseas Australia declined 9.8% in the month. Intelligent Investor which had previously covered the stock apparently ceased coverage, perhaps driving some sales in a thinly traded stock. They released the Q3 results for their majority owned Malaysian listed UOADEV business. These showed that the hollowing out of the "unbilled sales" appear to have stopped with the level increasing for the first time since before the beginning of COVID. Consolidated cash over the past 3 years has increased from $242m to $718m, as these unbilled sales were turned to cash, leaving the business spectacularly positioned to run the ruler across the many struggling developers (or their projects) that don't have the security of the UOS balance sheet.
3. Li-S Energy fell 17% in the month. As outlined previously when discussing the valuation, it could potentially have a very wide range of outcomes. The company with only a few things working could easily be worth ten times the current valuation, but if the deals take longer to come, the market will inevitably grow more sceptical/impatient and handicap the price. The first OEM collaboration was announced this month, but it was with a very early-stage manufacturer of Prime Mover battery conversions (Janus Electric – well worth looking for their videos). For the market to really catch fire on the prospects of LIS, an announcement with a Fortune 500 sized collaborator is likely needed and given the incredible technology we are sure will eventually come. Late note - a deal with the drone subsidiary of Fortune 500 Boeing was announced to almost no market reaction, perhaps drones are still seen as too niche, an EV collaboration might be required to excite market participants.
4. PPK Holdings fell more than 15% on the month, on nothing but a strong AGM update. The reversal of sentiment for PPK has been as swift as it has been brutal. This is incredibly surprising given the world changing development of Boron Nitride Nanotubes (discussed many times previously), but like LIS, market participants are indicating they need more concrete progress towards commercialisation to maintain the higher valuation. I am very confident these will come, the early testing of introducing BNNT into a variety of products has had too much success for other commercial outcomes not to eventuate.
5. Smartpay (SMP) fell about 6% and given the positive AGM update issued this month was the most surprising fall for the portfolio. SMP has demonstrated a large, credible, highly profitable demand for their service and despite the lockdowns in their two most important markets, continued to add hundreds of terminals per month. Unencumbered by Government imposed restrictions, this business will display incredible operating leverage in the next few years and the market will eventually price the business more sensibly.
6. Shriro fell only about 2% on the month. The AGM will be held mid-December and it will be most investors first opportunity to see the new Chair in action. She has an excellent resume and should be able assist with the acceleration of the company's foray into Europe.
7. Redbubble fell 15% in the month, it is among the most shorted stocks on the ASX, which means if my assessment that businesses will be fairly successful in retaining newly won COVID customers is correct, these short-sellers will need to buy back the stock at much higher prices. Website traffic analysis indicates modestly more visitors to www.redbubble.com (+10.3% year on year according to Semrush) in November, although the smaller www.teepublic.com site is down by almost as much. My view remains in 5-years time, this business will be generating much higher revenue figures and be more profitable than it already is.
8. Dicker Data fell about 6% in the month. The only announced thing potentially spooking the market COO Vlad Mitnovetski, who has been a relentless purchaser of stock selling some of his holding. David Dicker also sold stock recently, not long before the blockbuster Q3 result was announced.

<u>Cettire Revisited: -</u>

When an investment has moved sharply, it pays to revisit the thesis to pin down whether the fair value has moved sufficiently to leave the position worth holding. I originally wrote about Cettire (CTT) in the April 2021 Newsletter. The exercise will be a reminder of how fluid valuations are when evaluating true "hyper-growth" businesses. At the time that was published, we proposed the approximate revenue trajectory that would be required to justify various rates of return:

	Jun-21	Jun-22	Jun-23	Jun-24	Jun-25	Jun-26	CAGR
0% return	$81.0	$121.5	$164.0	$196.8	$226.4	$250.0	25%
10% return	$81.0	$133.7	$200.5	$270.6	$338.3	$400.0	38%
20% return	$81.0	$145.8	$233.3	$326.6	$408.2	$495.0	44%

To end up with 0%, we estimated the business would need to be doing ~$250m of sales revenue (Gross revenue less returns and allowances) by FY2026. To get ~10% annually, we felt that the right figure would be ~400m, and to get a 20% return, the figure would need to be closer to ~$495m.

Our original estimate was for $81m of revenue for FY21 at the time of publication, which simply doubled the December half in the June half. They finalised revenue at $92.4m, so the revenue CAGR to hit each of those numbers reduced significantly (25%-22% / 38%-34% & 44%-40%).

Furthermore, after 4 months of FY2022 trading, CTT has delivered $57.8m of sales revenue. The first 4 months of the financial year are among the weaker luxury months, with November and December the strongest. Ignoring that, if we annualise the first third of the year, CTT would generate $173.4m for FY2022. This sees the required revenue CAGR to hit each of the numbers in the above table reduce yet further (9.6%, 23.2% & 30%).

But weighing against that from a valuation viewpoint, the share price has almost doubled since the original report. If you buy an investment that you think can earn 20% annually for the next 5 years and then it doubles in the first ~6 months, your expected IRR from that point forward (assuming the valuation has remained static) has been reduced to just over 5%.

CTT is however annualising at a revenue rate 19% higher for FY2022 than the most optimistic projection from the original thesis (using the weak first third of the year), in truth it is hard to imagine the business does not achieve at least $200m in FY2022 given the trajectory. But for conservatism, we will use the lower figure for our conservative starting point to see what would be required for a 0% return. We will use $200m for the estimated required rates of growth for a 20% rate of return.

Analyst's must remember that because scale is happening more swiftly than originally projected, a lower rate of revenue growth is required from this higher base because the operating leverage will manifest earlier because of the faster growth rate (depending on how aggressively they lean into branding expenditure etc.), accelerating the rate at which revenues generate profitability.

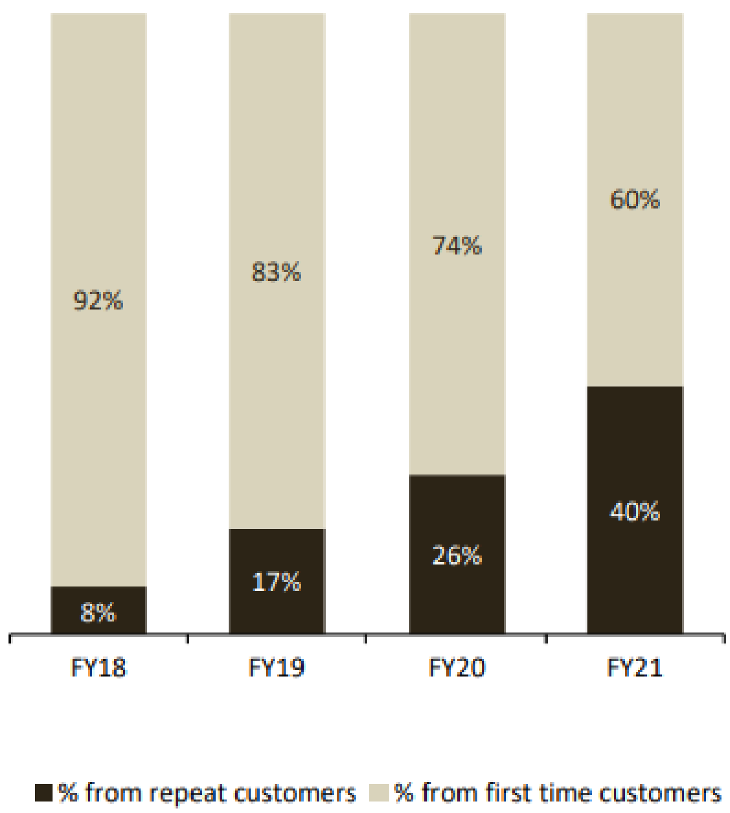
	Jun-22	Jun-23	Jun-24	Jun-25	Jun-26	Jun-27	CAGR
0% return	$173.4	$215.0	$260.0	$300.0	$355.0	$390.0	17.5%
20% return	$200.0	$290.0	$390.0	$490.0	$600.0	$700.0	28.5%

The enterprise value (EV) is approximately $1.35b at present. Using the same simple thinking from the first report, we would expect a capital light marketplace business that had gone from virtually nothing to almost $400m of revenue in 8 years would be unlikely to trade at less than a 25x multiple of pre-tax earnings, with the almost $100m of earnings the business would have generated over the 5 year period, this would leave a <$1.25b EV, implying the business would need to be earning ~$50m pre-tax in FY2027 to have generated a flat investment return.

The FY2020 margin including "other income" was ~25%. At $390m of FY2027 revenue, we would expect GP of ~$98m. For growth to have slowed from >170% per annum to under 10% per annum, it is reasonable to assume they had taken their foot right off the advertising pedal, at 6.4% of sales (roughly half of the FY2020 figure), that expense would be ~$25m. As the business has moved away from Shopify and develops more pricing power over merchant costs (and assuming BNPL gradually trends lower in cost to merchant, as is my expectation), they will hopefully deliver a merchant fees expense of perhaps $10 or 11m on sales of this level. If employee costs, administration and D&A can be delivered at about $10 or 12m (roughly double the FY2020 figure), then the total cost base would be a little over $45m meaning the business would deliver the ~$50m of profit required to deliver a roughly flat investment return over the next 5 years. This outcome would require an incredible loss of momentum from the business. It is likely the FY2022 revenue number ends up being closer to the FY2023 figure of $215m required for the flat return, which would require a level of revenue deceleration to “only” end up at $390m in FY2027 that is hard to envisage with the current revenue trajectory CTT is displaying.

For CTT to earn a 20% IRR over the next 5 years, the EV would need to go from ~$1.35b to $3.35b. I estimate the FY2027 revenue number would need to be ~$700m. The advertising as a proportion of revenue would likely have remained higher (than in the 0% IRR assumptions above) to get to this higher revenue number, we’ll assume 8% for $56m. The extent to which CTT can get customers for repeat purchases will inform whether they can reduce their advertising as a proportion of revenues this far. I would estimate that to get to 8% the revenue from repeat customers would need to be above 60% by FY2027. The trajectory graphed here on the left of the page would seem to indicate that should be easily achievable.

Share of gross revenue from repeat customers is growing[1, 2]



Merchant costs of 2.5% would see $17.5m consumed there, and the employee costs, administration and D&A should be capable of being delivered for ~$15m for this faster growth and higher revenue number. This means the pre-tax earnings would be ~$87m. The business would have generated something like $250m of free cashflows in the intervening period. This means the EV target is $3.1b. Would the market pay ~35x pre-tax earnings for a business that had grown revenues with a CAGR of 63% over the preceding 7 years? Almost certainly the multiple would be higher, depending on the prevailing growth rate in the more recent years at that point.

The above valuations are intended to be indicative rather than prescriptive. They demonstrate that despite the sharp rise in CTT’s share price, the required revenue CAGR to achieve a 20% investment return has fallen meaningfully in the last 6 months. That is the reason why many investors are attracted to “hyper growth” companies, despite looking very expensive on traditional valuation metrics, if high revenue growth can be sustained, those metrics change VERY swiftly.

Before we declare that CTT is unambiguously cheaper now than when we last wrote about it, I would point out the difference in compounding at 28.5% off a $200m revenue base and compounding at 44% off an $81m revenue base. The former is harder than the latter because of the law of large numbers, but they each add a similar amount of revenue growth over a 5-year period.

With that noted, the market they are addressing is enormous and they have scarcely scratched the surface. For example, online fashion behemoth Farfetch reported earlier this month with quarterly sales growth of 33%. This validates the capacity even for very large businesses in the sector to still grow at strong rates. Farfetch sold more than US$1b of merchandise in the quarter (roughly twice what we estimate CTT would need to sell in 5 years’ time to earn a 20% IRR) and still managed to generate 33% period on period growth at the revenue line. It also demonstrates how rapidly CTT is gaining market share against the most important competitor in their sector, growing roughly 5 times as quickly.

The ZFC update: -

As discussed in previous newsletters, Cipher Fund launch is expected to be in or around Q2 of 2022.

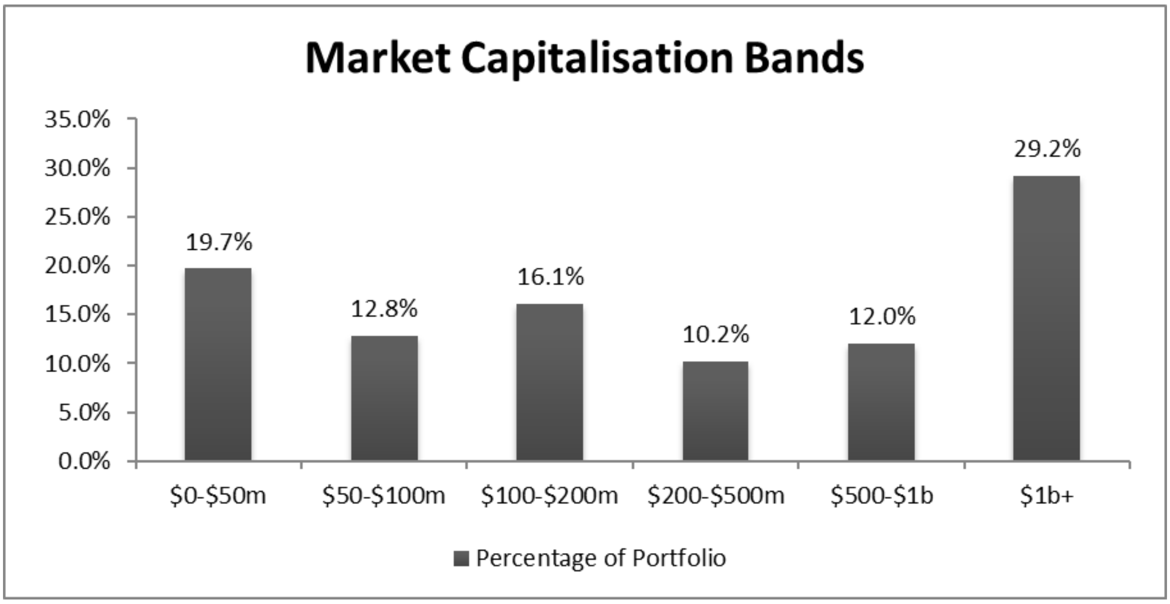
Prospective managers and investors are invited to contact CEO of ZFC, Brad Hughes (brad.hughes@thezfc.com.au) or myself.

Key Portfolio Information: -

Our top 10 holdings on 30 November 2021 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	Cettire (CTT.ASX)	9.0%	8.5%
2	United Overseas Australia (UOS.ASX)	8.7%	8.2%
3	Li-S Energy (LIS.ASX)	7.0%	6.6%
4	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding	7.0%	6.6%
5	Smartpay (SMP.ASX)	5.9%	5.5%
6	Shriro Holdings (SHM.ASX)	5.2%	4.8%
7	Redbubble (RBL.ASX)	5.0%	4.7%
8	Dicker Data (DDR.ASX)	4.4%	4.1%
9	National Tyre & Wheel (NTD.ASX)	3.9%	3.7%
10	MyDeal.Com.Au (MYD.AX)	3.8%	3.6%

Our largest 5 holdings comprise 37.7% of our invested capital, our top 10 holdings are 60.0% and our top 15 represent 75.8%. Cash and cash equivalents are 6.5% of the portfolio. The median market capitalisation is $205.1m. Weighted average market capitalisation is $591m.



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	Fund Closed	Sharpe Ratio[1]	-0.14
Additional investments	Fund Closed	Sortino Ratio[1]	0.76
Applications/redemptions	Redemptions only, monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	18.8% 15.1%
Distribution	Annual 30th June	Largest Monthly Loss – EGP Largest Monthly Loss - Benchmark	-28.9% -20.7%
Management fee	0%	Largest Drawdown – EGP Largest Drawdown - Benchmark	-33.9% -26.7%
Performance fee (<$50m) Performance fee (>$50m)	20.5% (inc GST) 15.375% (inc GST)	% Of Positive Months – EGP % Of Positive Months - Benchmark	65.4% 67.3%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	39.4% 49.4%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	17.6% 27.4%
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	10.7% 11.8%
Fund Size	$85m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$1.1543 $0.0040	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$1.1560 $1.1525

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.

DISCLAIMER:

EGP Capital Pty Ltd (ABN 32 145 120 681) (EGP Capital) is the holder of AFSL #499193. None of the information provided is, or should be considered, general or personal financial advice. The information provided is factual information only and is not intended to imply any recommendation or opinion about a financial product. The content has been prepared without considering your personal objectives, financial situations or needs. You should consider seeking your own independent financial advice before making any financial or investment decisions. The information provided in this presentation is believed to be accurate at the time of writing. None of EGP Capital, Fundhost or their related entities nor their respective officers and agents accepts responsibility for any inaccuracy in, or any actions taken in reliance upon, that information. Investment returns are not guaranteed. Past performance is not an indicator of future performance. The fund is closed to investments there is no PDS in use.

Appendix 1: -

Combined funds cumulative return since inception: