EGP Concentrated Value Fund

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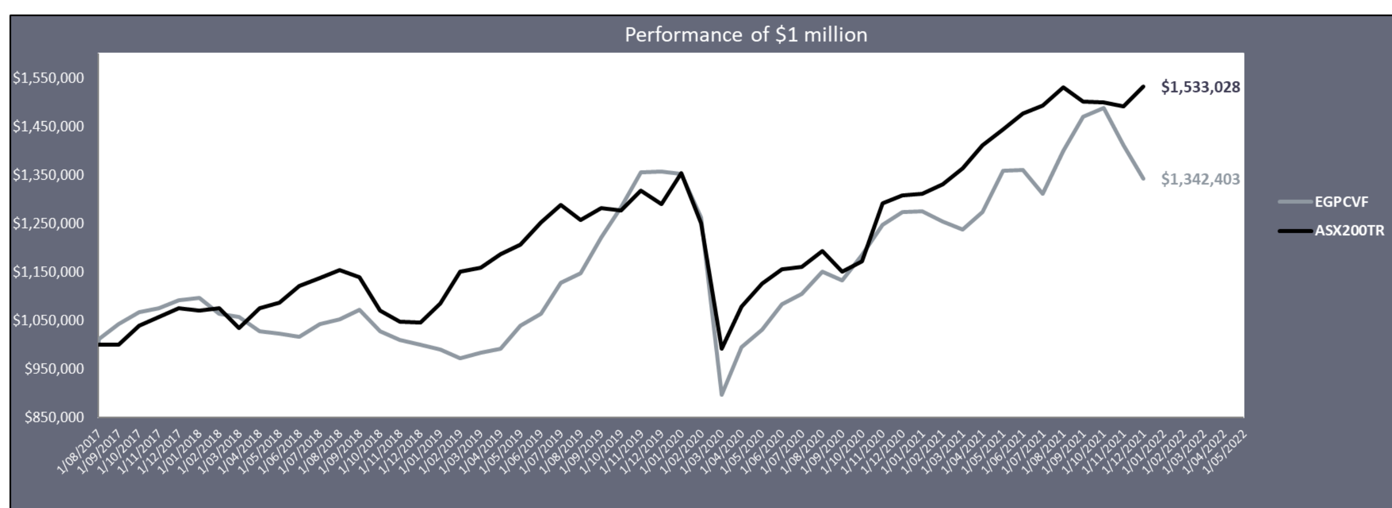
EGP Concentrated Value Fund – 31 December 2021

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%)	(4.8%)							(1.32%)
Benchmark FY22	1.1%	2.5%	(1.9%)	(0.1%)	(0.5%)	2.8%							3.84%

*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 (4.8%) in December. Our benchmark rose 2.8%. The last two months of 2021 were not the way we wanted to finish the year. It was the worst two month stretch of underperformance in the more than ten years the fund has operated. We have always invested benchmark unaware though the divergence from the benchmark has been widening (in both directions) of late, we have on average been 3.66% different to the benchmark performance each

month over the last year, compared to about 2.88% since EGPCVF launched in 2017 and less than 2.5% per month over the full history since 2011.

I obviously do not like underperforming, and the past few years have not been anything like my best work in terms of investment performance outcomes. But part of the reason I write these long monthly newsletters outlining our ideas is to ensure our investor group understand the positions we hold, and our reasons for doing so. Then, when periods of poor performance come along, as they inevitably will for every fund manager, we understand well together what we own and why.

I have enormous conviction in our largest holdings. Particularly in the cases of PPK and LIS (the two that have caused the most unit price damage in the past two months), we think they have demonstrated commercial cases for highly unique, world-changing products and that it is only a matter of time before the market realises this. The Boron Nitride Nanotubes (BNNT) that PPK produce have already demonstrated their commercial application in the first product they were seriously tried in (Lithium Sulphur Batteries). The Li-S battery is a step-change better than any other battery anyone in the world can currently produce and the enabling mechanism for that is BNNT, which at present only PPK can produce in the quantity, quality and at a price point that makes commercial Li-S battery production feasible. The testing on the many other applications (ballistic glass, hardened alloys, dental products, precious metals etc) continues and if the early successes in the trials with these additional projects can be replicated, PPK will become one of the most successful companies in Australia. The difficulty the market is having is trying to price the likelihood of, and timing of such commercial success. What investors do not understand it that the BNNT division of PPK is already profitable and has been for the past couple of years and is currently stockpiling BNNT ahead of the anticipated demand as the development of further applications completes.

Microcaps are Hard: -

Given the aforementioned period of underperformance, I thought fellow investors might find it helpful looking at a few of the underperforming positions over coming months to revisit the investment case and review the investment merits of the idea. I will preface this section by pointing out that all equities are hard (not just microcaps), there are armies of smart people working on how to best value the world's largest companies. This army's analytic capabilities still did not prevent Apple Corporation trading in a valuation range that had a low in March 2021 of around $1.9 trillion to a high in the last few weeks of the year more like $2.9 trillion (and passed $3 trillion in the New Year too). We can all agree a trillion dollars is an incredibly wide valuation range for the company with the most analysts poring over their prospects. Apple became the first company to gain a trillion dollars in market valuation inside a calendar year (although Microsoft got very close this year too). Such swings make the moves of several millions of dollars in the microcap end seem trifling in comparison but demonstrate that regardless of the size of a business, pinning down a precise valuation is not simple. It is harder still in businesses in the very early stage of their development such as Scout Security (SCT), which we discuss below.

We participated in an equity raising for SCT in November/December 2020. The company had secured what appeared to me to be a transformational/company making deal with a large telecommunications service provider in the United States called Windstream/Kinetic. Scout is a security business that provides equipment for home security, but the equipment sales are primarily a means of securing a monthly SaaS revenue stream for services provided to interact with the devices (margins on the devices are modest, but margins on the SaaS revenues are excellent) that the company refers to as RMR (Recurring Monthly Revenue). The website gives a good outline of how the products and services work. Prior to making the investment, I spoke with people who owned/used the products and they universally praised them.

The businesses primary commercial "pinch point" had been how to get the revenues to scale. Undercapitalised, mass advertising was not an option. As attractive as the products are and as good as the service is, home security will never "go viral". The company had several existing "white label" deals with major corporations (Stanley Black & Decker and Prosegur being the most prospective ones), these had so far failed to see sufficient uptake to bring the business to self-sustaining commercialisation.

What excited us was the Windstream opportunity. Telecoms and cable companies in the US rely on packaging up deals for their customers to secure contract tenure and make their offerings more compelling. Windstream were keen to add the Scout range to their various other products and services (internet, telephony, TV etc). The expectation from

Windstream was that over 24 months they should be able to get ~10% of their ~1.4 million subscribers to take up the Scout offering.

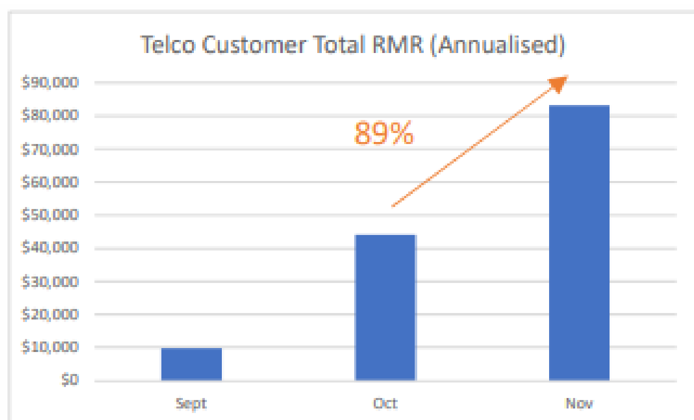
At the 13.5c price at which our original investment was made, the enterprise valuation of the business was about $18m. Scout estimated their RMR from each Windstream customer would be ~AU$6. This implied that if Windstream's targets could be achieved, that Scout could get to an annualised RMR of more than AU$10m (140,000x$6x12=$10,080,000) from this one deal. Provided "churn" is relatively low, such SaaS revenue streams, particularly if there is meaningful further prospective growth are often valued at 10x or more. This implied that within 2 years of the launch of the Windstream rollout, that contract alone could be worth in the ballpark of $100m or more than 5 times our investment, with Stanley Black & Decker, Prosegur and any other deals the company could secure in addition thrown in for free.

The asymmetry was attractive. But as with so many things in business, and especially with Covid inserting itself into the equation, things with Windstream have taken much longer than expected, with their rollout of the Scout products to their customers running around 6 months behind schedule.

This delay has seen the company operating with negative cashflows and sailing close to the edge of their balance sheet capacity. This has seen the shares plunge from a post Windstream announcement high of about 18c per share to 2.9c at the time of writing. When the market loses faith at the microcap end, the reaction is savage and that is exactly what has happened to Scout.

While acknowledging the current market capitalisation of around $4m, we maintain a view that this business could, without too much going right very easily be a $50-100m business (despite the delays, the Windstream contract could still very easily achieve the targets as set out below). Despite the delays in Windstream launching the Scout product, the early indications are that the relationship may well deliver not only the targeted revenue but could well deliver more. Management have also repeatedly stated they are in talks with numerous other prospective distribution partners, with further deals in the telecommunications space highly likely if the Windstream rollout gathers pace.

The ASX release from Scout on 8 December showed this graph:



My suspicion that part of the reason for the recent collapse in the share price is the laughably small numbers included on this graph (and in prior announcements). The annualised RMR three months into the rollout is only ~$82,000 per annum and even with very good growth in November (+89% month on month), only ~$40k was added to that annual balance, which if maintained for a year would only see the number grow to a little over $500k, which will not cover costs (the business had a little over $2m of cash outflows in FY2020).

What I suspect management may not have articulated well enough is the very steady approach to the rollout Windstream have taken. I understand that they have an "elite" sales team with only a handful of members that spent the first few weeks refining their sales pitch and developing the "script" which is being progressively rolled out to the remainder of the sales team. I suspect rather than being linear, the revenue growth as Windstream trains progressively more sales staff in selling Scout products will get cumulatively larger. The modelled "attach rate" was 10% and the company has been achieving 15% in the first few months of the rollout (admittedly with their best sales agents). Furthermore, the modelled RMR was $6 per customer and the company is achieving $8 of RMR per customer signed. These lead indicators make the targets the company mentioned at the time the equity for the Windstream deal was raised seem entirely more plausible. If the current attach rate and RMR were to hold (we do not anticipate that,

something close to the original target is quite sufficient), the RMR to Scout once all 1.4m Windstream customers have been offered the product would exceed $20m annualised.

Another factor the market has overlooked is CEO Dan Roberts demonstrated propensity for writing deals with customers that enable up-front payments to SCT for development costs that have enabled the company to minimise the regularity with which they have had to ask shareholders for capital as the business matures and revenues develop. There is a non-zero prospect that some of the deals currently under negotiation will include such up-front revenues, abrogating the need for further equity or debt capital.

Our investment in Scout has been a difficult one so far, with the share price fall from 13.5c to 2.9c very painful to watch and damaging for our reported unit price. But not a lot needs to go right for the share price to be multiples of where it presently trades. In fact, a simple acceleration of the existing Windstream rollout is probably enough for that. Any improvement in the various white label deals, or any further deals with new customers would all be additive to the Windstream prospects.

We think at the current share price the risk reward setup is meaningfully more attractive than when we first invested in SCT, not because success is any more certain, but because the lower valuation makes the asymmetry even more significant. Success from here could see upside in many, many multiples of the current share price, depending (as all investments do) on good execution and judicious management of the capital structure. One thing that will be both a significant advantage to SCT and potentially an anchor for the share price is a significant number of options and conversion rights that can be exercised at 7c per share. The double-edged sword means that if the business performs well, there will be significant capital inflows and debt extinguishment to assist with growth as the options are exercised and the notes converted. The other side of this coin is that this will come with dilution and depending on the intentions of those exercising the options and converting, could weigh on the share price, keeping it anchored somewhere in proximity of the conversion price.

I wrote this piece and largely completed it around the 20th of December. In a postscript that made a lot of the preceding information out of date (certainly the information on share price, balance sheet deficiency and CEO), the company announced on 23 December that the company was undertaking a placement to directors at 8.75c (more than 3x the 2.9c the shares traded at before the announcement), and taking on $450k of convertible debt to ensure the company has the funding to see the Windstream relationship mature. CEO (and founder) Dan Roberts is also stepping into a different role in the business, enabling a new CEO with a deep background in SaaS growth to take the reins and (hopefully) accelerate the commercialisation of the product range.

The ZFC update: -

As discussed in previous newsletters, Cipher Fund launch is expected to be in or around Q2 of 2022. We remain very excited about what Cipher Fund could mean for EGP unitholders and those interested in a diversified equities portfolio operated by a group of managers with an alignment structure not yet commonplace in the industry.

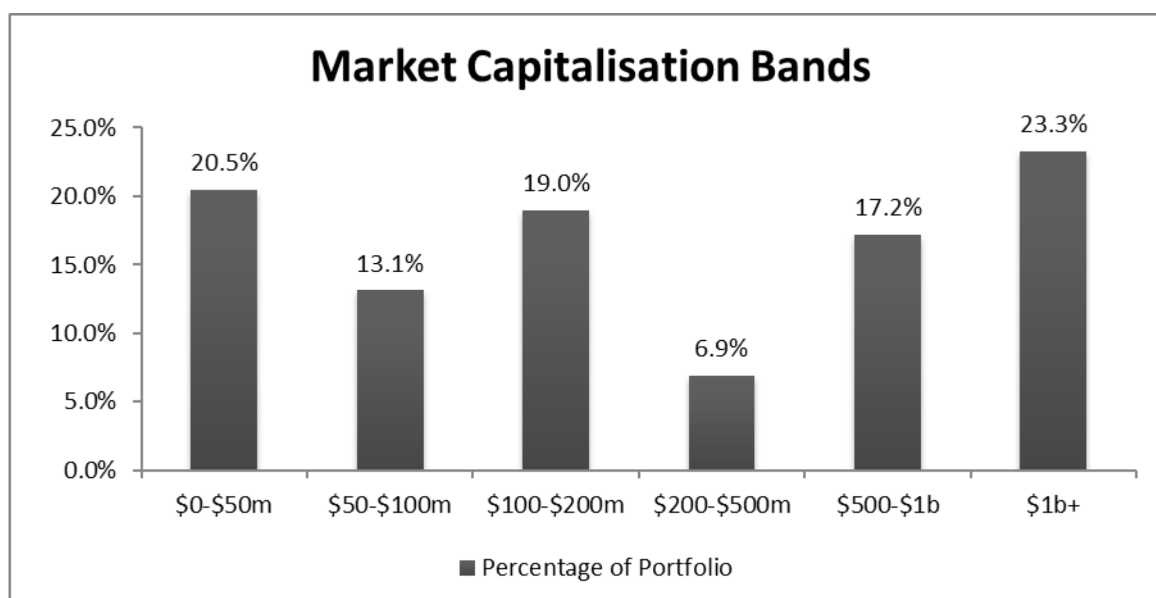
Prospective managers and investors are invited to contact CEO of ZFC, Brad Hughes (brad.hughes@thezfc.com.au) or myself.

Key Portfolio Information: -

Our top 10 holdings on 31 December 2021 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	9.5%	9.1%
2	Cettire (CTT.ASX)	8.9%	8.5%
3	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding	6.5%	6.2%
4	Smartpay (SMP.ASX)	6.0%	5.7%
5	Li-S Energy (LIS.ASX)	5.7%	5.5%
6	Shriro Holdings (SHM.ASX)	5.4%	5.2%
7	Redbubble (RBL.ASX)	5.0%	4.8%
8	Dicker Data (DDR.ASX)	5.0%	4.8%
9	National Tyre & Wheel (NTD.ASX)	4.1%	3.9%
10	MyDeal.Com.Au (MYD.AX)	4.0%	3.9%

Our largest 5 holdings comprise 37.7% of our invested capital, our top 10 holdings are 59.9% and our top 15 represent 75.6%. Cash and cash equivalents are 4.5% of the portfolio. The median market capitalisation is $196.7m. Weighted average market capitalisation is $556m.



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]	-0.13
Additional investments	Fund Closed	Sortino Ratio[1]	0.61
Applications/redemptions	Redemptions only, monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	18.8% 14.9%
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	63.9% 67.7%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	34.3% 53.3%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	5.4% 17.2%
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	10.3% 13.6%
Fund Size	$77m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$1.0986 $0.0042	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$1.1003 $1.0970

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.

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Appendix 1: -

Combined funds cumulative return since inception: