EGP Concentrated Value Fund

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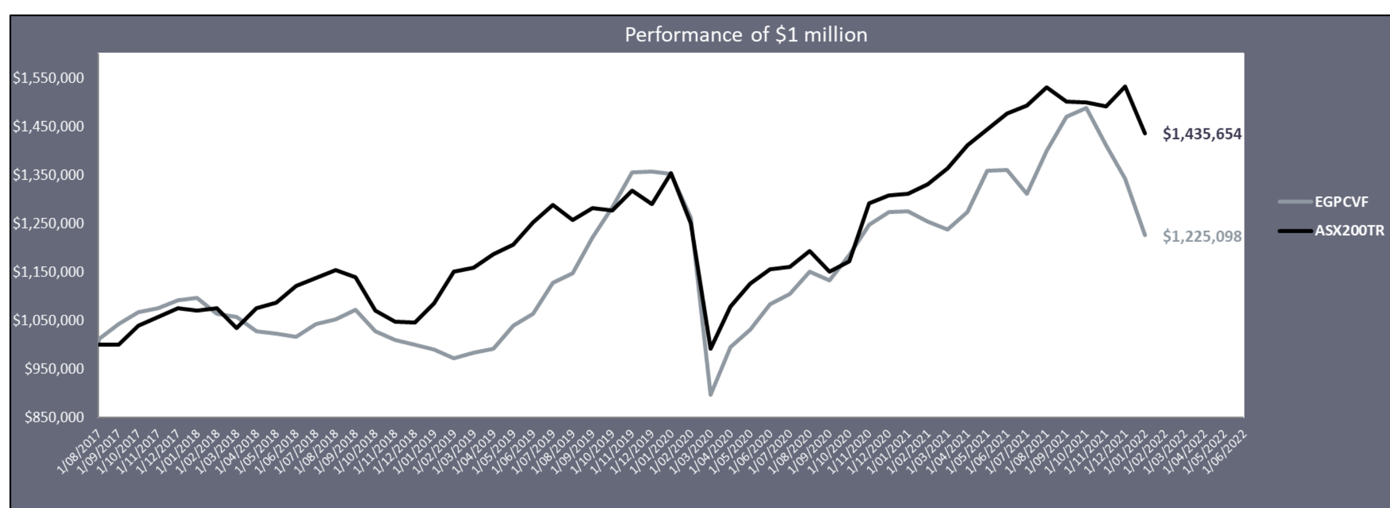
EGP Concentrated Value Fund – 31 January 2022

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%)	(8.7%)						(9.94%)
Benchmark FY22	1.1%	2.5%	(1.9%)	(0.1%)	(0.5%)	2.8%	(6.4%)						(2.75%)

*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 (8.7%) in January. Our benchmark fell (6.4%). That is without doubt the worst 3 months I have experienced as an investor, both as a fund manager and as a private investor for more than a decade before that. I'll review the performance of some of our individual holdings below, but fellow unitholders can be assured I will not rest

in my efforts to restore the performance gap against our benchmark. I will then redouble my efforts to return the fund to historic levels of outperformance.

The sharp fall in the index meant that some good announcements from our holdings were ignored and that some weak announcements were received especially poorly. One announcement I thought should have been better received was this one (.pdf) from United Overseas Australia (UOS). It sets out the fact that despite owning a hospitality heavy property portfolio, they will (again) post a handsome profit in 2021 ($80m). Part of this welcome result comes from the transfer of the Ho Chi Minh property from inventory into investment properties as occupancy levels rose. I had flagged this impending valuation uplift several times in previous reports. Offsetting this large uplift was the ultra-conservative write down of the valuations of some the various hospitality assets the group own. Conservatism is embedded in the DNA of UOS, I have owned the company either personally or in the fund since 2008 and cannot recall them booking anything other than an additional profit on the disposal of any property asset. With the ~$66m of December half NPAT, the total assets of UOS (ignoring currency movements) will now be about AU$1.6b, up from <AU$700m 10 years ago. In our estimation, the orderly disposal of the UOS property portfolio would likely result in proceeds comfortably exceeding AU$2b given the vast landholdings held at cost and the very conservative valuations adopted across the property assets.

UOS is a relentless wealth creation machine and yet remains ignored by investors even though this prodigious value creation can be purchased for about 62 cents in the (incredibly conservative) NTA dollar. One final point on UOS was an important partnership announced in December (.pdf) with Singaporean property behemoth Capitaland. SGX listed Capitaland REIT and operating businesses have a combined capitalisation of ~AU$32b and Capitaland manages assets exceeding $120b. This relationship now gives them two sets of eyes for opportunities in the Vietnamese market, the Capitaland joint venture and the direct UOS business, which has already commenced their second Vietnamese project. Management have clearly come to the view that there is an excellent opportunity in Vietnam. The association with Capitaland might hint at an exit plan for the UOS shareholders at some future point.

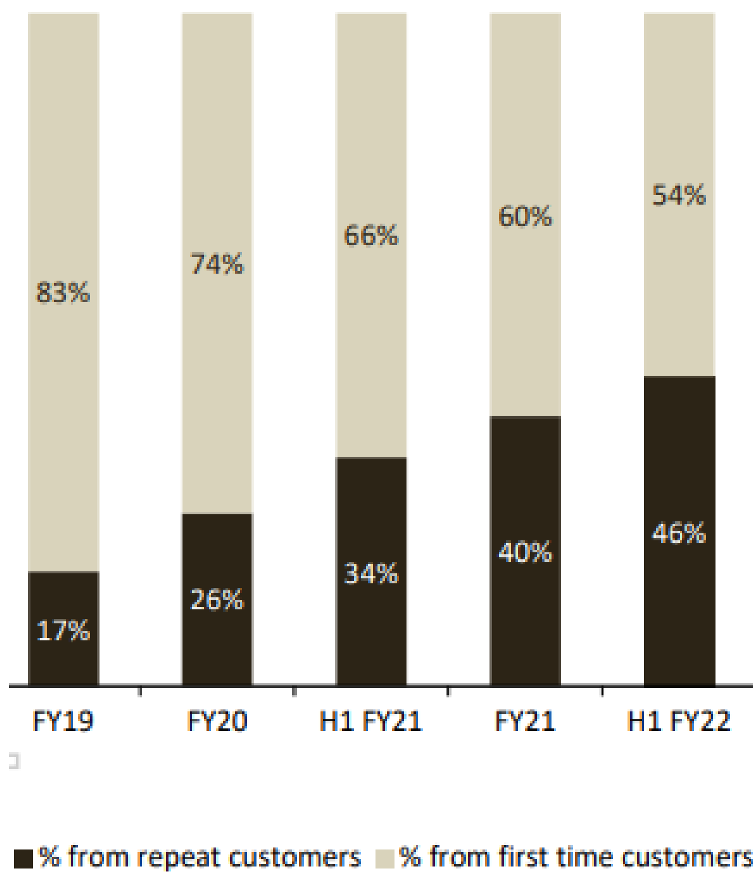
Our three online retailers were hit especially hard in January, particularly Redbubble (RBL). My view has been non-consensus on RBL for the great majority of our time owning the stock and has clearly been wrong over the past year or so as the share price has fallen from highs around $7 to lows below $2. We were expecting that after excluding Covid related sales (masks predominantly) that RBL would be able to roughly match the booming December 2020 lockdown and stimulus enhanced sales. On that basis, sales were down about 5% year on year, furthermore, management added staffing costs to the business as they prepare for the return of growth in 2022.

The loss of market support for RBL is puzzling to anyone able to look at the trajectory over the past few years. Even with the challenges set out below for all online retailers, this remains a business that generates ~$700m in sales annually and could comfortably be run for profit if management were not trying to maximise the long-term shareholder value. The current enterprise value (EV) of $370m does not nearly reflect the strong position the business is in (despite the challenges referenced below). With >$140m in cash, the business is amply capitalised to exploit a massive global opportunity.

“Growth” investors often panic when they don’t see sequential revenue growth. “Value” investors usually panic when they see negative operating leverage. Unfortunately, the December 2021 RBL result exhibited both factors. Furthermore, there was an industry-wide spike in “Customer Acquisition Cost” (CAC) for online retailers as brick-and-mortar retailers competed hard to regain relevance as the world re-opened post Covid.

Both RBL and MyDeal (MYD) reports showed that the gatekeepers of internet traffic (Google and Facebook mostly) responded to this additional demand with massive price increases. This article shows just how good conditions were for Google (Alphabet) as revenue growth of >30% flowed through into profit growth of ~90%. Google is evil, but it is nonetheless exceptionally profitable, $1.8 trillion sounds like a big valuation for the business, but it seems clear that unless something unforeseen appears to break their dominance that years of profitable growth for Google seems inevitable. Despite the disdain I have for the Google business, if I was locked away from society for the next 10 years and forced to put my entire net worth into a single stock, I would have to think hard about choosing Google. UOS and PPK would of course figure high in the consideration as regular readers will understand, but Google is a juggernaut it is hard to imagine being slowed. Antitrust regulations are the only obvious risk to such a near monopoly business.

The "inevitability" of Google and Facebook et al scalping the margins of online retailers means we will need to do some reworking of our models for CTT, RBL and MYD (and any other business highly reliant on acquiring customers through online channels). The "lifetime value" of a customer is meaningfully lowered if they cost a lot more to acquire, making it critical for online businesses to ensure they maximise the value of each customer they do manage to acquire.



These businesses will be much more reliant on retaining and monetising their existing customer bases to optimise the creation of value (i.e. getting customers they have already captured to return via free means, such as using mobile applications, emails, push notifications and the like). On this front, all three businesses appear to be doing quite well, MYD's December announcement flagged transactions from returning customers at 60.1% for the period compared to 52.7% in the same period last year. RBL said "repeat rates" had increased from 40% in the December 2020 half to 45% in the December 2021 half. Cettire is a younger business, but is engendering incredible loyalty in its customer base, I would not have thought it possible for a business growing as fast as they are to exhibit repeat rates as high as those graphed to the left.

PPK Holdings (PPK) and Li-S Energy (LIS) were again very damaging to the fund NTA in January. I am now convinced nothing short of a major industry partnership will meaningfully revive investor sentiment in LIS. One should never hang their hat on comparison valuations (the comparator may itself be overvalued), but NYSE listed Quantumscape (QS) is valued at roughly thirteen times the valuation of LIS, despite their nascent battery technology being inferior to the Lithium Sulphur battery and being not meaningfully further along in its development (both businesses are currently producing 10-layer batteries for testing). The most discernible difference between the two businesses is the fact that Volkswagen have invested $300m into QS, giving the business more money to develop their battery and the imprimatur of an industry partner. LIS have intimated they are in discussions with automakers, from the 4C ***"We are also identifying strategic opportunities and engaging with product manufacturers, including automotive manufacturers, for the end-use of Li-S Energy batteries and for manufacturing licensing."***. If LIS can partner with one of the major automakers or battery manufacturers, it will be a valuable industry validation of their battery.

LIS management are deliberately coy about the scale of the opportunity that exists with electric vehicle (EV) batteries. Consider this, just the top ten automakers generated US$1.5 trillion of revenue in 2020. In an EV, the battery currently costs about one-third of the cost of the car and is projected to still be as high as ~20% by 2030. Most estimates of the global EV battery market by 2030 are in the US$150-200b. EV's are just one of the numerous uses the LIS battery can be directed towards, by 2030, the annual global value of the battery markets the LIS technology can be applied toward likely exceeds half a trillion US dollars per annum. Just a sliver (e.g. a 5% royalty on only 5% of that market would be a US$1.25b revenue stream) of that opportunity would guarantee massive success for LIS. The first published broker research on LIS I have seen was published this month by Blue Ocean (.pdf) and gives a good insight into the market LIS are targeting and further detail on some of the major competitors.

The PPK business will be buoyed by any positive developments in LIS, but followers of the business need to remain cognisant of the myriad of other commercial opportunities PPK are pursuing. We have outlined at length in previous reports the opportunities in bullet resistant glass and other ballistic materials, hardened alloys, precious metals, dental, hardened plastics and polymers and many other prospective applications. There should be a steady stream of announcements about the R&D progress of many of these applications over the course of 2022. Furthermore, there

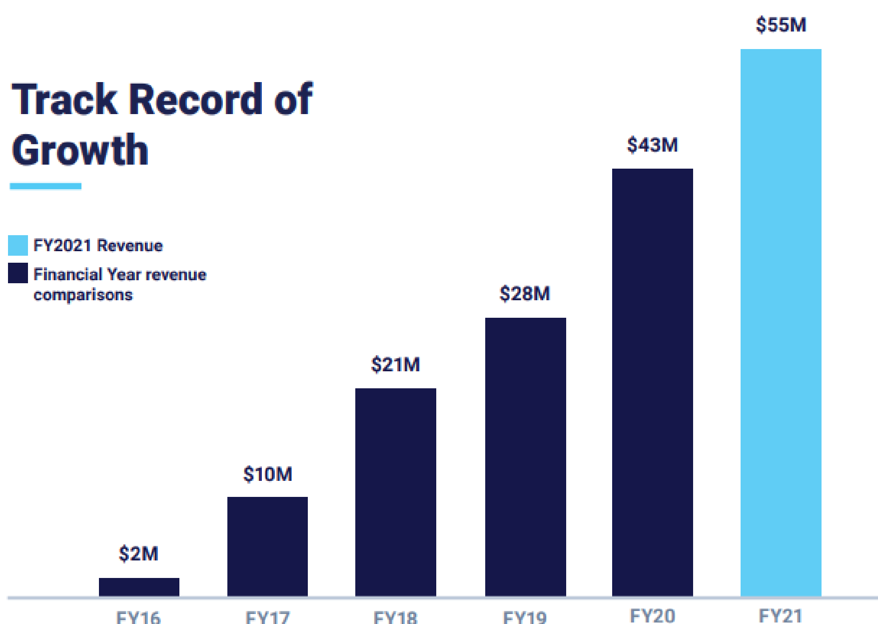
are numerous other technology applications PPK are pursuing. Their facemask technology is apparently best in class and as much as we would like to see the end of them, facemasks are likely here to stay for some years in certain areas. They also have the demerger of the mining services business, which will enable a swathe of investors currently precluded from holding PPK shares for ESG reasons to commence buying. Finally, the White Graphene business is incredibly prospective. I have written about this in more detail previously but pending the finalisation of commercial agreements and manufacturing arrangements, the business will likely IPO sometime in 2022. The market sizes of some of the potential applications for White Graphene rival the LIS opportunity, but commercialisation is likely much simpler as boron nitride nanosheets (White Graphene) will mostly be an additive to existing manufacturing processes.

Quarterly Investor Update: -

The recording successfully worked this month, though getting it into a distributable format proved difficult. As someone who despises most "Big Tech" businesses, but Google especially, we have tried hard not to use their YouTube platform as it is probably the worst of all Google products for the authoritarian leanings of their management. The two services we have previously used to publish these updates (Dtube and Newtube) both failed to successfully host/publish the recording. We have used the Vimeo platform this time, but the tendrils of the large tech businesses are working hard to choke out any competing services. You can watch the update here.

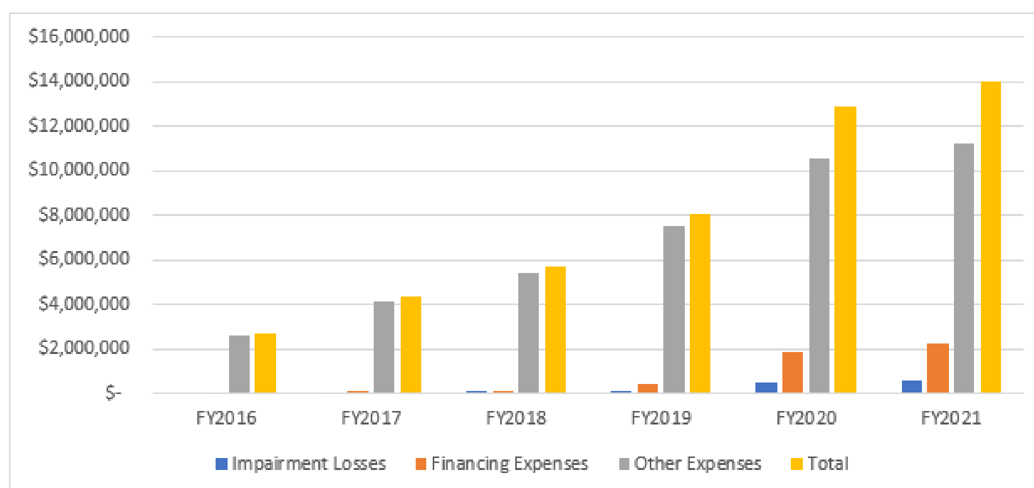
Microcaps are Hard, Part II: -

We will continue last month's theme of reviewing some of our positions that have not worked out as anticipated at the time of investment and why we still hold them. This month we will review Locality Planning Energy (LPE). We wrote about LPE here (.PDF) in December 2018, and the performance of the share price since then has frankly been abysmal. If we look at the management revenue forecast for FY2019 outlined in that newsletter ($44.2m) and compare it with what prevailed ($28.5m), we get a sense of why market participants give zero credence to published forecasts LPE management makes (to be fair, the large shortfall against FY2019 guidance can be partially explained by extraneous factors, not the least being an unexpected and sharp fall in Queensland electricity prices in the period). With that said, it is worth reviewing the historic revenue performance of the business:



That is an unequivocally strong, consistent demonstrated revenue trajectory. The primary issue that the company has had to date however is that operating cost growth (OPEX) has consistently exceeded both management projections and investor expectations. As such, the jaws of operating leverage have been wired shut by this aggressive cost growth. The equivalent operating cost graph has been (much) steeper than we had modelled at the time of our original investment, though appears to be flattening, finally as the graphic on the next page indicates.

	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
Impairment Losses	$ -	$ 79,187	$ 121,964	$ 122,489	$ 505,039	$ 598,039
Financing Expenses	$ 79,495	$ 117,774	$ 156,048	$ 403,338	$ 1,841,979	$ 2,217,719
Other Expenses	$ 2,588,478	$ 4,155,718	$ 5,438,701	$ 7,527,473	$ 10,556,220	$ 11,230,789
Total	**$ 2,667,973**	**$ 4,352,679**	**$ 5,716,713**	**$ 8,053,300**	**$ 12,903,238**	**$ 14,046,547**



The sharp slowdown in the "other expenses" line in FY2021 is the critical reason for thinking that operating leverage is about to appear in LPE's results. Last year was the first year the business has managed to show meaningful cost control and if it can be continued, very real operating leverage should soon appear in the reported results.

Pinpointing the gross profit (GP) for LPE can be tricky as it swings meaningfully from year to year depending on the outcomes of hedging. If we look through the last two years, $97.8m of revenue and $82m of electricity cost of goods sold (COGS) indicates the average gross profit (GP) has been about 19.2%. If we extend it to the last three years, GP is 19.9%. The gross margin is however declining as larger scale commercial sales give up some margin for the larger electricity volumes. Margins for the last couple of years have been higher than they will be in future for two reasons. Firstly, the business had a higher proportion of revenues from the strata part of the business, as the direct market component of the business grows, the businesses natural GP level will fall. The business also benefitted from falls in wholesale electricity prices in the past couple of years, which improves margins as it takes time to pass on these savings to customers. This has now reversed, and the business will likely have its lowest margin in years this year as they follow the major retailers in passing through the almost 30% rise in Queensland wholesale electricity prices.

We are modelling a 17-18% underlying GP at maturity (i.e. ignoring hedging effects). As mentioned, margins for FY2022 will likely be below this as the falls in wholesale prices over the past couple of have reversed, depending on how quickly management have re-priced customers, margins could be as low as 15% in FY2022.

The company has added $15m and $12m of revenues in the past two years (with declining retail electricity prices providing a significant headwind) and the last two market updates have indicated ~30% year on year customer growth has been observed in the first 5 months of FY2022. If the 30% customer growth translates into equivalent revenue growth, LPE should increase revenue by around $15m in FY2022 to ~$70m.

At the normalised margin we expect of ~17.5% on $70m of revenue would imply more than $12m of GP for FY2022 (if actual margins come in at 15%, this number will temporarily be closer to $10.5m or $11m until price rises are fully passed through). Total operating costs in FY2021 were $14m but appear to be flattening. This would indicate that if LPE can maintain the recent restraint in cost growth, the business will not be far away from the breakeven point. Marginally profitable or almost profitable microcap businesses are a dime a dozen on the ASX though, what makes LPE more interesting than other marginal microcaps are three key things.

The first is the prospect of the jaws of operating cost (finally) opening. If LPE can continue to add $10-15m of revenues annually at even only a 17.5% GP margin, that produces an additional $1.8-2.6m of GP annually. If the OPEX cost growth to service that additional revenue can be kept to $500k per annum for example, that means the business can add at least $1.3-2.1m of reliable, secure, recurring pre-tax profit annually. Such additional earnings would likely be valued at a multiple of 10-14x. This implies LPE can potentially add $13-28m per annum of market capitalisation by

simply maintaining their current revenue trajectory with good cost discipline. This compares incredibly favourably to the current market capitalisation of $12.1m at the 13cps share price at the time of writing. Furthermore, LPE carries an exceptionally expensive debt burden, the $2.22m financing cost in FY2021 was for total average borrowings of barely more than $14m throughout the year, these expenses include more than just interest, but given the highly predictable cashflows, the scale of the business must surely be close to the point where more traditional bank financing can be obtained, potentially bringing the cost of debt down to a mid-high single digit cost. Even at a 7.5% financing cost (high for such reliable cashflows) the lower cost of debt would strip more than $1.1m in financing costs from the cost base annually. For a company with only a $12m market capitalisation on the cusp of profitability, that potential cost saving is alone worth close to the market capitalisation, the rest of the business is currently effectively being thrown in for free if they could successfully execute such a refinancing.

Secondly, one thing we feel management have failed to properly articulate to the market is the substantial investment in growth the current cost base contains. The single greatest thing management could do to help prospective investors value the company more accurately would be to explicitly break out "growth OPEX" in their investor presentations.

The sales team required to deliver the ~$15m per annum of revenue growth is large, and we estimate costs upwards of $1m per annum with base salaries and inducements being paid to the sales team. Furthermore, the team required to service the onboarding of all these new customers is also larger than it would be if the business were to stop growing and operate on a lean, "steady state" basis. If management were to decide to stop growing and to cut the staffing back to the leanest possible level that could service the existing customer set, I would hazard there at least another $1m of employee costs that could be removed. The P&L with $2m removed is a very different looking one but given the importance of scale to the business model, it would be a mistake for the long-term value creation of the business for management to take this austerity approach to running the business. With that said, the >$6m per annum of employee costs, alongside $2.2m of IT costs feels far too large for the level of complexity of the business at the current scale should have. If the business could run find a way to make the current staffing/IT cost base hold steady for a couple of years whilst maintain the revenue trajectory, the shareholder value accretion would be enormous.

The final point is the value of the existing LPE revenue base to an acquirer. Although the business might be only close to breakeven, or at best marginally profitable at the current scale in the current structure as an ASX listed microcap, the same revenue base plugged into a more mature entity produces a very different level of profitability. As an example, before being sold by Amaysim to AGL, the Click Energy business had a GP of $73.3m and had operating expenses of $44.7m, or 61% of GP (one can only assume that AGL expected to improve that ratio too through better scale and efficiency). This would imply that the ~$13m GP run rate LPE currently produces would create $5.1m of prospective pre-tax profit to an acquirer of similar operational efficiency (costs 61% of revenue) to Amaysim's Click Energy business. Given the long-duration contracted nature of much of the LPE revenue base, to an acquirer, it would be much more valuable than the Click Energy business was, where the weighted average contracted tenure was less than 1-year whereas we understand the weighted average tenure for LPE customers exceeds 5 years.

An acquirer should be able to comfortably justify a 14x pre-tax profit multiple, particularly if they expected to be more efficient than the 61% cost ratio in the Click Energy example. Such a multiple implies a ~$70m enterprise valuation (EV). If we subtract the ~$15m of debt the business carries from this figure, the $55m remaining compares very favourably to the current $12m market capitalisation. This valuation allows nothing for the optionality of the various other businesses LPE operate, the shared solar, virtual power plant and carbon-neutral central hot water all provide optionality above the primary electricity business valuation.

With such significant value-accretion on offer to a corporate acquirer of LPE, if LPE management don't turn the company to profitable account before too long, there is a non-trivial risk that someone larger somehow gains control of the company and does the job for them without the full value being captured by the shareholders who have provided the capital and support for the business to get to where it has.

As to the question why we still hold LPE despite the poor performance of the share price, and the notable historic failure of management to deliver on their promises? The answer is simply that we cannot be sellers in a situation where under a variety of relatively plausible situations that upside measured in multiples of the current valuation can be observed.

Furthermore, we are of the view the world is entering an extended period of meaningfully higher energy prices. The term "Greenflation" has started to enter the lexicon of folk who have spent the past decade or more insisting the transition to green energy would presage lower global energy prices. This speech by ECB member Isabel Schnabel outlines the burgeoning view that to transition to a greener energy future, energy prices will remain elevated for an extended period. This is exacerbated by the fact ESG investors are restricting the flow of capital available to invest in even very prospective non-renewable energy projects, as such the trend of diminishing supply meeting still growing demand can only result in higher energy prices.

Such an environment will provide a significant tailwind to businesses such as LPE that simply clip a margin from the selling of energy. If you were going to make $100 margin selling energy and then the prevailing price is suddenly 30% higher, without any additional cost, you are now making $130 margin (once you successfully pass through the price rises). Given the already very strong revenue growth LPE is experiencing, such a tailwind would further improve the operating leverage.

The biggest risk to LPE is in funding their obligations to the Australian Energy Market Operator (AEMO). The business must post cash to AEMO based on the forecast load for the direct market customers. For a more bankable business, they could rely on their banking relationship to give a bank guarantee for this amount, but LPE's relative immaturity as a business means they must post cash to AEMO. Many millions of cash are tied up in funding this obligation and unless the refinancing mentioned earlier is successfully executed, there could be a requirement for further capital that the equity market will be reluctant to fund.

Thankfully, LPE's embedded network customers (approximately 26,000 customers), are fully hedged through fixed price load following forward purchase contracts with Shell Energy. These do not require AEMO credit support.

To ensure the significant equity upside is realised, management needs to act aggressively on two fronts. First, cost control must be prioritised, the equity will not be re-rated until market participants can see managements determination to make the business self-funding. Secondly, the refinancing must be prioritised and must ensure there is a viable way to finance any continued growth on the direct market business. Absent this, direct market business must be eschewed in favour of less capital hungry embedded network customer growth.

The ZFC update: -

As discussed in previous newsletters, Cipher Fund launch is expected to be in or around Q2 of 2022. Brad and I have spoken to JANA and understand funding discussions are proceeding with their client's. We remain very excited about what Cipher Fund could mean for EGP unitholders (who will own a stake in the management company) and to wholesale investors interested in a diversified equities portfolio operated by a group of managers with an alignment structure not yet commonplace in the industry.

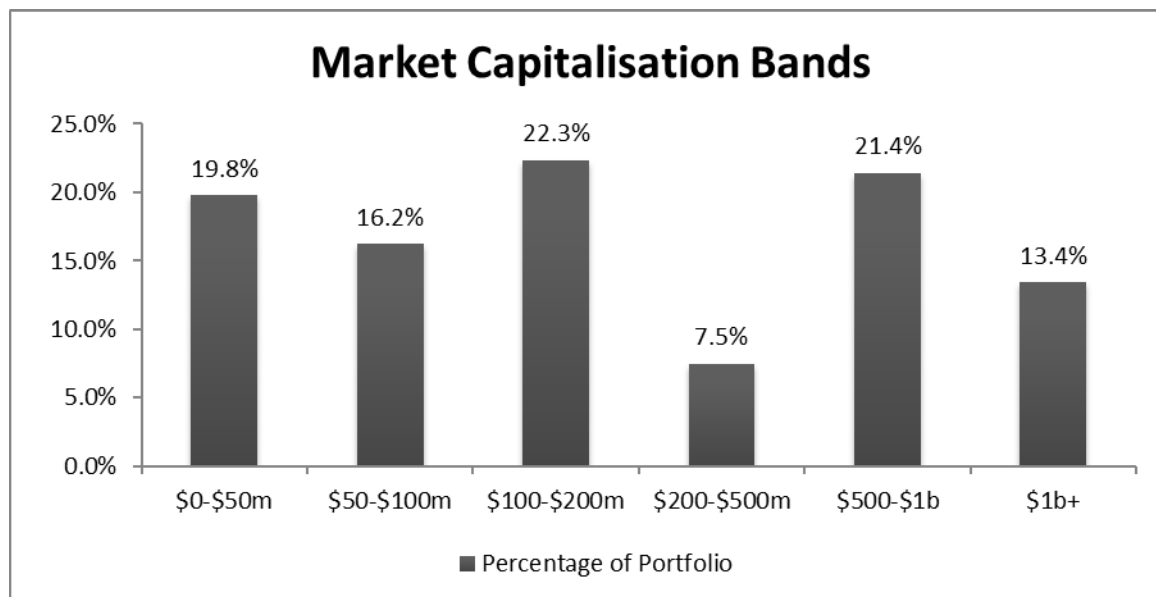
Prospective managers and investors are invited to contact CEO of ZFC, Brad Hughes (brad.hughes@thezfc.com.au) or myself.

Key Portfolio Information: -

Our top 10 holdings on 31 January 2021 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	9.9%	9.4%
2	Cettire (CTT.ASX)	8.1%	7.6%
3	Smartpay (SMP.ASX)	6.9%	6.6%
4	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding	6.0%	5.7%
5	Shriro Holdings (SHM.ASX)	5.6%	5.3%
6	Li-S Energy (LIS.ASX)	5.5%	5.2%
7	Dicker Data (DDR.ASX)	4.7%	4.5%
8	Blackwall Limited (BWF.ASX)	4.6%	4.4%
9	Tellus (unlisted)	4.5%	4.3%
10	National Tyre & Wheel (NTD.ASX)	4.0%	3.8%

Our largest 5 holdings comprise 36.6% of our invested capital, our top 10 holdings are 59.9% and our top 15 represent 75.0%. Cash and cash equivalents are 5.1% of the portfolio. The median market capitalisation is $155.3m. Weighted average market capitalisation is $452m.



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]	-0.16
Additional investments	Fund Closed	Sortino Ratio[1]	0.49
Applications/redemptions	Redemptions only, monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	19.1% 15.2%
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	63.0% 66.7%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	22.5% 43.6%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	(4%) 9.4%
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	7.3% 9.8%
Fund Size	$70m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$1.0026 $0.0042	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$1.0041 $1.0011

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: