EGP Concentrated Value Fund

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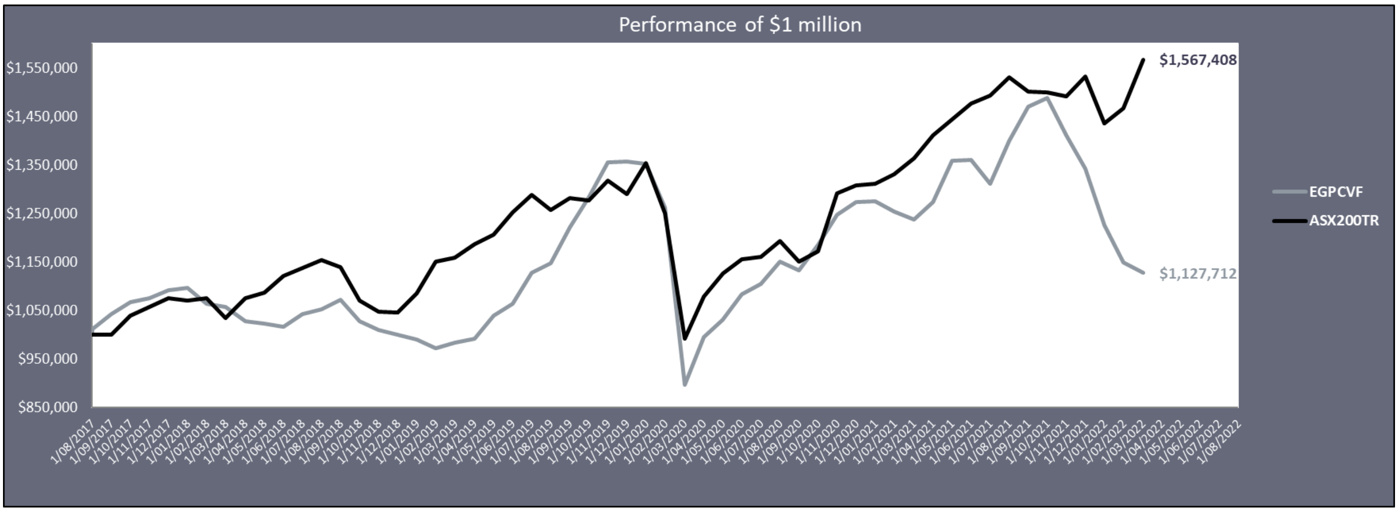
EGP Concentrated Value Fund – 31 March 2022

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%)	(6.2%)	(1.9%)				(17.10%)
Benchmark FY22	1.1%	2.5%	(1.9%)	(0.1%)	(0.5%)	2.8%	(6.4%)	2.1%	6.9%				6.17%

*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 (1.9%) in March. Our benchmark rose 6.9%. We just completed in consecutive months the two worst months of relative performance in the twelve-year long history of the fund. The negative performance for the fund this month would have been almost as large a positive figure had we not owned Cettire (CTT) which we will discuss further on in the report, but even absent that, we would have underperformed quite significantly.

I detest when a fund manager makes excuses for their underperformance, so I will say at the outset, I clearly had our fund mis-positioned for the environment as it has unfolded the past few months.

I have always split our portfolio into three categories that might be broadly called "traditional value" (with high asset backing and/or large, stable earning capability relative to market price), "growth at a reasonable price" (where despite not appearing "cheap" on traditional valuation metrics, our view of the next few years means the business is meaningfully under-priced) and "others" which might comprise a variety of different special situations. Traditionally, when major sectoral allocation changes swept the market, we always had part of our portfolio working well while the other part was suffering, thereby muting any underperformance.

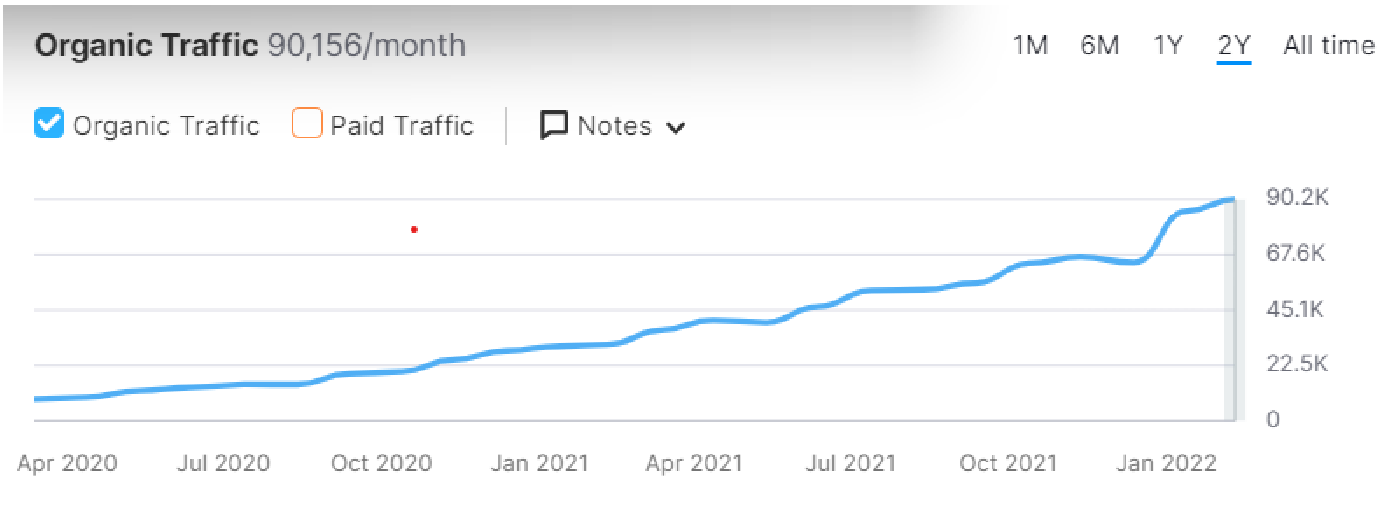
Since the end of October, our chosen benchmark (ASX200TR) is up 4.5%, predominantly driven by resources with the ASX200 Resources index which is up a staggering 33.7% over that period. Unfortunately, the construction of our portfolio in hindsight was too heavily weighted to technology companies and the ASX All Technology index is down by (19.2%) through the same 5 months. A 5-month divergence of 53% for any two components of the index is a highly unusual event, and one as I have explained I did not position the fund well for.

Unfortunately, we have a dearth of resources exposure in the fund and the weak performance of our "value" holdings has not shielded us from the poor performance of our "growth" (technology) holdings. When there is a massive rotation out of highly priced growth, demonstrably cheap stocks such as United Overseas (trading at roughly half of NTA), Shriro Holdings (will be less than 5x ex-cash earnings by 30 June at current pricing, with a sustainable 12.3% {17.5% grossed up} dividend yield) and National Tyre (about 6.5x earnings with good growth optionality once the integration of the recent acquisitions is completed) usually see buying, but have not in this rotation.

CTT almost halved over the course of March, costing the funds NTA more than 3% and consequently has fallen out of our Top Ten holdings. The price had fallen considerably through the beginning of the month when the news arrived pre-open on 23 March that founder Dean Mintz had sold $47m of stock. The stock traded between $1.55-1.65 the day before the transaction, and the transaction was done at a meaningful discount (as block trades almost always are) of $1.35. The subsequent market response to this announcement was unsurprisingly poor, there is a considerable precedent for well-timed insider sales and many market participants have assumed that the sale will presage bad news for the business. The price is now meaningfully below the price at which the CEO sold stock.

Aside from what we have discussed in previous newsletters (primarily customer acquisition cost {CAC} being high in the December quarter), there is no fundamental basis driving the movement in the share price. As much as I would have preferred to have avoided the massive fall that CTT has taken, I am not in the habit of using anything other than fundamentals as part of our decision-making process.

To that end, with rising CAC the primary fundamental concern, we are tracking CTT's ability to generate organic traffic to their website, if you must first pay to first find a customer but can then attract them to return to your website through unpaid/organic means (via direct visitation, emails, or other push notifications), then paying up to find them makes better sense. The graphic below shows what an outstanding job CTT have been doing in getting organic traffic to their website. Over the course of the past two years, the monthly organic traffic has grown roughly 10-fold:

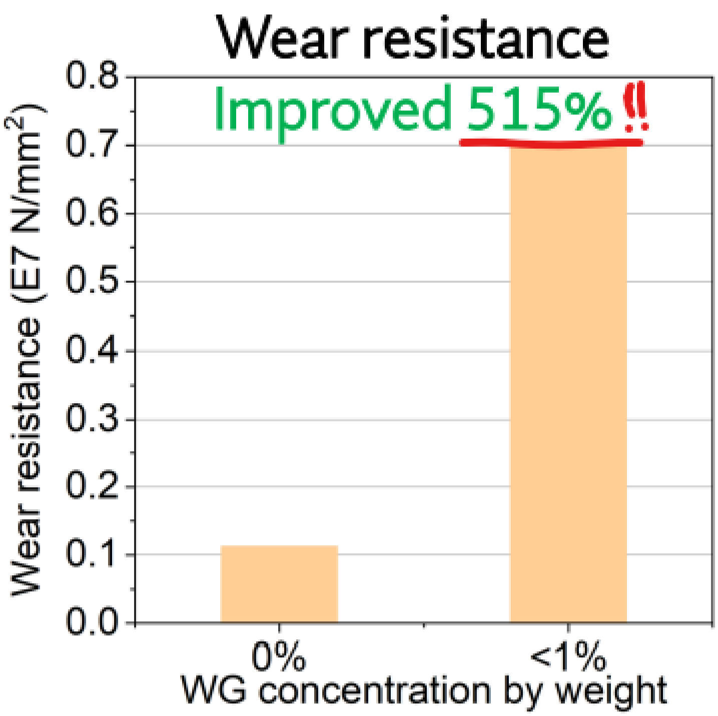


As to whether the sale of a large block of shares by the CEO counts as a "fundamental" reason to reconsider the investment, as much as there have been many examples of well-timed insider sales, there are also countless examples of founders with substantially all their wealth tied up in a business wanting to liquidate some of that wealth for legitimate reasons. From our own portfolio, Dicker Data (DDR) founder David Dicker made a substantial ($42m) sale of DDR stock in August 2021, with the subsequent two quarters results showing profit before tax up 26% and 29.6% respectively against the prior periods.

It would potentially pay the sceptics about Dean Mintz' motives in selling some stock to consider the psychological effect the movements in the valuation of his holdings since listing might have had too. When CTT listed in late 2020, Mintz retained ~216m shares, which at the 50c listing price was worth $108m. He had also received some cash via the IPO process. He was now very wealthy. Over the next year, as the business performed brilliantly, the share price marched steadily higher, peaking at $4.805 in mid-November 2021, at which time, the value of his holding was $1,039,024,647. A billion dollars and change. Then through a reversal of market sentiment, over the next four months, he watched the value the market ascribed his holding fall back to about $335m.

Contemplate how after spending September/October/November thinking you were worth more than a billion dollars to find your net worth had fallen some $700m by March, despite no change in the trajectory of your business. It would sting. Mintz has limited experience in the listed environment, and probably had a broker persuade him that one of the things weighing on the share price was the prospect of a founder sell-down and he could solve that problem himself. He compounded the mistake of selling by only escrowing his remaining holding until the next financial reporting date. He would have been far better to put at least a year or two of escrow in place.

Our instinct on CTT would usually be to buy more shares in this situation, as the revenue trajectory is meaningfully above even the most bullish case discussed in our original investment thesis, if this continues, CTT will at current prices will prove to have been an incredible opportunity. Instead, we will wait for the next market update to ensure the thesis remains intact. Confirmation that this is the case will likely see the valuation rise sharply, but the performance of the portfolio in the past few months mean we must act with even more caution than usual.



PPK Holdings (PPK) released some very positive results (.PDF) from the first serious testing they have conducted on boron nitride nanosheets (White Graphene). There were some incredible performance uplifts reported in a range of paints and coatings, but this improvement to wear resistance in a water-based polyurethane stood out for me. A >500% increase in wear resistance achieved by the addition of White Graphene to the composition is clearly a development with incredible commercial prospectivity. Unfortunately, as discussed last month, market participants are not currently awarding commercial prospects with any meaningful value. For PPK to regain the support of market participants will likely take an announcement of a significant actual sales from one of the many ventures they are now running. Announcements have intimated that there are discussions taking place for commercial sale quantities of boron nitride nanotubes (BNNT). The announcement of even a modest contract of perhaps a kilo or two per month of BNNT would be very well received by investors. Anything more significant than that would be company-making.

Another announcement of significance for the portfolio was the sale by Site Group Holdings (SIT) of 62.5% of the subsidiary that holds the Clark landholding that has been the central plank in our investment thesis for SIT. To the casual observer, the sale would look like selling off the family farm to stay viable, which to some extent it is, but there is good reason to think the latest development represents a turning point. Covid has had a devastating impact on SIT. We have always been comforted that there is a land asset hidden in the business, but as the difficult period for the education business extended, finding a way to realise value for shareholders in anything other than a firesale looked difficult. Owning 37.5% of something valuable is better than 100% of nothing.

The current transaction looks to have solved this matter. Included in the consortium acquiring the 62.5% stake are Nicasio Alcantara, who is a native of the Philippines with decades of experience navigating the Filipino commercial framework. Nicasio was always likely to be part of the deal, and while his skillset is valuable, to Australian domiciled investors, the participation of Paul Weightman's Stara Investments is likely to carry more weight. Paul was founder and CEO for more than 20 years of property behemoth Cromwell Property Group. Interacting with Paul through the sale of the 62.5% interest in Site Group Holdings (which owns the Clark lease) has been very good for my confidence in how the property development will unfold.

There is a clear path to value creation now. The increase to the Floor Area Ratio (FAR) and extension of the lease will be completed as a matter of priority. Once received, the value of the property is materially improved, to ensure the property subsidiary is fully funded to maximise the value created from the rest of the landholding, a small land sale is likely to be targeted as soon as practicable thereafter. The progress at Clark despite Covid has been enormous (outlined in a recent market announcement), with SIT and their A-grade partners holding the last large parcel inside the special economic zone, and the business now being sustainably funded, extracting as much of the enormous value as possible now looks a very realistic prospect. If management can successfully execute a turnaround in the education business at the same time, the outcome would be truly excellent.

Microcaps are Hard, Part IV: -

I have previously written about my affinity for distribution businesses, given our 10-year-old and very successful association with Dicker Data. In terms of other distributors, we have also had good returns from our National Tyre investment and sound returns from our Shriro Holdings investment. The fourth, and smallest distributor in the portfolio is a business called Stealth Global Holdings (SGI), it is the one we have not had success with to date and as such I thought it a suitable candidate for review in our "Microcaps are Hard" series.

SGI distributes industrial consumables; its best-known competitor would be the Wesfarmers owned Blackwoods business. The Wesfarmers Industrial & Safety division generates nearly $2b of revenue (almost twenty times the size of the current SGI revenue base), so is only somewhat comparable. Complicating the "industrial consumables" business, SGI owns United Tools and C&L Tools which would compete with Total Tools, Sydney Tools, Trade Tools, and Bunnings "Tool Kit Depot". It also owns Skipper Transport Parts compete with the likes of Bapcor, Maxiparts and Supply Networks on truck side, and Supercheap, Repco on the car side. The tools and parts businesses are perceived as a useful point of difference for SGI and discrete parts of the industrial products will be ranged in these businesses to expand the revenue opportunity.

We first purchased SGI shares for 20 cents in the September 2018 initial public offering, we have subsequently added to our holding several times as execution was demonstrated in line with the promises management made for prices as low as 6.4 cents per share. We now own more than 8.5% of SGI at an average price a little over 13.6 cents per share, which is whereabouts the share price has traded in recent weeks and months. Therefore, the investment thesis fits in the "Microcaps are Hard" series, we have had what is currently almost 2% of the fund's assets tied up in SGI for a weighted average of 2.7 years for no return.

The metrics at the current valuation I view as compelling. In communicating with another SGI investor, a summary of my reply to his email was as follows:

"As to the FY25 strategy, they can definitely generate $200m of revenue, just keep acquiring things… The margin is always riskier, but I'm confident they should get close to the 8% target, most similar businesses at scale have higher margins than that.

If they can, it's a ~$16m EBITDA business, that will probably get awarded a 6 or 7x EV/EBITDA valuation (depending on how large the D&A charge ends up being) at that level of earnings. This implies a $96-112m enterprise valuation ($104m midpoint), the question we need to answer is how much equity dilution will it take to get there, and how much debt will the enterprise carry at that point?

If you figured it was carrying 1.5x EBITDA in debt (~$24m), that leaves an equity valuation of ~$80m, with the big swing factor to how well shareholders do is "how much dilution is required to get there?""

The current equity valuation at 13 cents per share is just shy of $13m (99.7m shares on issue). Even if we assumed SGI needed to dilute existing holders by as much as 50% to achieve their FY25 strategy, the $80m equity value outlined above would imply a fourfold increase in the equity value over the next 3 years, so if execution is good, there is clearly an amply attractive investment upside. Now we will review the business and decide how probable it is they can get to the FY25 target revenue of $200m and EBITDA margin of 8%. The experience on margin in the three years since listing indicates the 8% EBITDA margin should be an absolute base-case if they can get to $200m of revenue:

	FY2019	FY2020	FY2021
Revenue	$62.8m	$67.9m	$69.7m
EBITDA (underlying)	$2.1m	$3.2m	$4.4m
EBITDA Margin	3.2%	4.6%	6.4%

Despite relatively modest revenue growth, the margin has doubled to 6.4% in the first two years post-listing. The significant margin growth is due largely to a decision to give up about $20m of revenues into Africa that were at very low margins. Gross margin was 18.5% in FY18 pre-listing when the African business comprised most of the revenue and was 29.8% in FY21 once the African business had been largely exited.

For simple maths, if we assume the EBITDA margin of the African business was ~3% and deduct $22m of revenue from FY19 and $2m from FY21 (the approximate revenue levels into that market), the change looks as follows:

	FY2019	FY2021
Revenue	$40.8m	$67.7m
EBITDA (underlying)	$1.44m	$4.34m
EBITDA Margin	3.5%	6.4%

This implies the incremental margin on the ~$27m of revenue added in the two years is about 10.8% meaning the 8% should be a quite achievable target if $200m revenue can be attained (i.e. ~7% on the first $100m plus ~11% on the next $100m = ~9% EBITDA on $200m revenue).

On the revenue, as I point out in the correspondence quoted above, this can be easily done via acquisition, but we will look now at how close they can get organically with the foundation they already have in place.

The half-year investor presentation (.PDF) says the company is run rating at an annualised revenue of more than $100m. Between the $44.3m revenue that was announced in the December half ($88.6m annualised), the additional $9m annually from having the Skipper acquisition included in the full half and the $8m annually acquired with the United Tools acquisition, the business should already be at >$105m once these acquisitions are integrated. The same presentation on page 9 indicates several large new contracts have been won that will deliver $18m annualised over the next 18 months. Most of that 18-month period will land in next financial year meaning based on the current footprint, SGI are entering FY2023 with ~$120m of revenue as a reasonable expectation unless there is a significant contract loss or other extraneous event.

Much of the $18m of new revenues mentioned in the investor presentation have been won in contracts that will be more capital efficient than the broader business. SGI have developed an automated unmanned onsite solution that enables a "store" to exist on remote sites, which is very efficient for clients. Client employees simply scan out the item they want, and it is automatically logged for replenishment, the stores have a stocktake every fortnight and any missing stock not correctly scanned out is billed and replaced.

The stores are stocked with a 4–6-week supply of high use items and a variety of ancillary items that will be removed from the "store" and replaced if they do not turn over at least every 8 weeks. Early versions of this offering have been very well received by clients and the return profile of these contracts are attractive, with the containerised "store" placed on site for perhaps $20,000 of capital cost and stocked with an average of $120-160k of inventory. If the stock is turned every 7 or 8 weeks on average, that implies ~7 inventory turns per annum for such a store. Seven turns of $140k of inventory is about $1m annually for such a store, which even if the contract is priced more keenly than the 29.8% gross profit generated companywide, a 25% margin still produces ~$250k of GP the business earns from a store that has a ~$20k capital cost and probably requires perhaps half a day of staffing per fortnight to stocktake/restock.

Further to this, recent acquisitions provide considerable scope for upsell, additional or replacement products from the existing SGI range into the newly acquired businesses should provide some relatively easy revenue gains. The United Tools acquisition especially has the potential to drive meaningful revenue uplift. My understanding is that the $8m of revenue that SGI discuss when talking about the acquired business is only a sliver of the revenue that runs through the stores, I understand the total revenue base of the 35 acquired stores exceeds $100m annually and much of it has range crossover with the SGI inventory base but was previously mostly being sourced from other suppliers.

United Tools is effectively a buying group, with the enhanced scale, their inclusion in SGI group should significantly widen the revenues running through the buying group and in a virtuous circle further enhance SGI's buying power, enabling them to increase margins (or become more competitive driving revenues) in other parts of the business.

If SGI can capture only $30m of additional revenue through cross-selling and range widening, then the business would effectively have $150m of the $200m target for FY25 secured. If the other $50m of revenue needed to be acquired over the next 3 years, even if the multiples paid for acquisitions was equivalent to SGI's, this implies only 33% dilution, compared to the 50% discussed earlier in the investment thesis.

As to our expectations for FY23, with the extra scale, a ~7% EBITDA margin is not an unreasonable expectation if the $120m of revenue posited above can be delivered in FY23, then $8-8.5m of EBITDA is possible. The current enterprise valuation is about $20.5m (~$13m of equity and ~$7.5m of debt after the ~$3.2m of cash is received from the United Tools acquisition and the Bisley divestment). The valuation of about 2.5x EV/EBITDA is quite remarkable and allows an enormous margin of safety if the business underachieves for any reason.

One of the reasons in my view that SGI is being awarded such a meagre current valuation is the persistent recurrence of "non-recurring" items in the financial reports. There have been substantial such items in each year since listing such that many analysts will have grown sceptical of whether these are truly one-offs. I am more circumspect, they have made a steady stream of acquisitions and borne costs to find, do due diligence on, and integrate those acquisitions, the charges are large relative to the size of the business but have enabled the highly prospective foundation described above to be built. If management can ensure any expenses and integration costs for the two most recent acquisitions are incurred before the June 2022 results, thereby ensuring the December 2022 result is free from adjustments or non-recurring items, it would go a long way to reassuring prospective investors of the true earning power of the business.

If SGI can get to around this time next year with the market convinced that >$120m of revenue and >$8m of EBITDA will be the FY23 result, they would likely have a meaningfully higher equity valuation, perhaps as much as double current valuation. That substantial reduction in the cost of capital would make finding and paying for the acquisitions required to ensure the FY25 $200m revenue target is achieved much easier, by either issuing equity as part of the consideration, or raising equity to pay for the transaction.

Unitholders interested to learn more about the Stealth business can watch [this recent video] (Vimeo) presentation from managing director Mike Arnold. Mike gives an excellent outline of the business and the investment opportunity despite having Covid at the time he gives the presentation.

Quarterly Unitholder Video Conference: -

The March quarter investor video conference will be held at 12:30pm Sydney time on 27 April 2022. The link to access the meeting is: https://us02web.zoom.us/j/88251364749?pwd=WDFpOGJYOFFCRWpTUFYwMjBmb2RtZz09

The ZFC update: -

Following a recent meeting with JANA; the launch of Cipher Fund is now expected in 2023.

Our partner in the Cipher project; JANA are undertaking a meaningful reorganisation that requires no launch of any new products for the remainder of 2022. We anticipate further information to become publicly available later this year.

JANA have acknowledged that they continue to see the merits of the Cipher Fund and are able to continue to work with ZFC; albeit on a timeline that has become extended.

Whilst Brad and I will continue to explore options in consultation with our partner; we will continue to update stakeholders as further relevant information becomes available and Brad will be in contact with Managers.

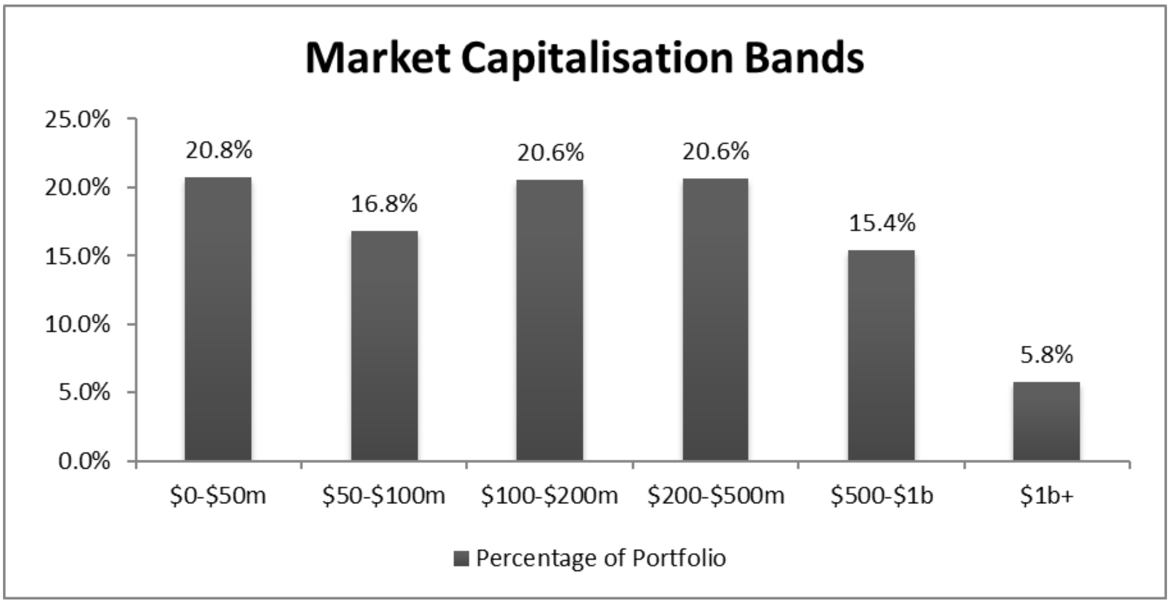
Prospective managers and investors are invited to contact CEO of ZFC, Brad Hughes (brad.hughes@thezfc.com.au) or myself.

Key Portfolio Information: -

Our top 10 holdings on 31 March 2022 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	11.1%	10.3%
2	Smartpay (SMP.ASX)	7.1%	6.6%
3	Shriro Holdings (SHM.ASX)	6.4%	5.9%
4	Dicker Data (DDR.ASX)	5.8%	5.3%
5	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding	5.2%	4.8%
6	Tellus (unlisted)	5.1%	4.7%
7	Blackwall Limited (BWF.ASX)	4.8%	4.4%
8	Li-S Energy (LIS.ASX)	4.4%	4.1%
9	National Tyre & Wheel (NTD.ASX)	4.1%	3.8%
10	SRG Global (SRG.ASX)	3.9%	3.6%

Our largest 5 holdings comprise 35.4% of our invested capital, our top 10 holdings are 57.6% and our top 15 represent 74.3%. Cash and cash equivalents are 6.1% of the portfolio. The median market capitalisation is $163.1m. Weighted average market capitalisation is $404m.



As always, investors with any questions, suggestions, comments, or investment ideas should feel free to call (0418 278 298), or send me an email – 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]	0.24
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	60.7% 67.9%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	12.8% 56.7%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	(8.9%) 15.0%
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	4.7% 10.6%
Fund Size	$63.5m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.9229 $0.0072	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.9243 $0.9215

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.

Appendix 1: -

Combined funds cumulative return since inception: