EGP Concentrated Value Fund

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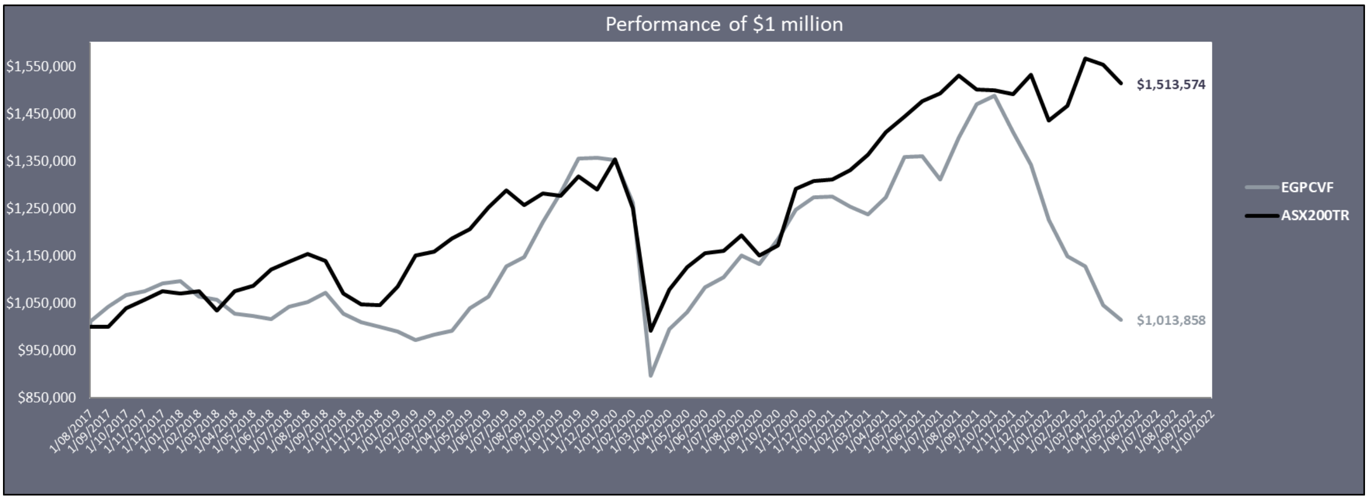
EGP Concentrated Value Fund – 31 May 2022

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%)	(7.3%)	(3.0%)		(25.47%)
Benchmark FY22	1.1%	2.5%	(1.9%)	(0.1%)	(0.5%)	2.8%	(6.4%)	2.1%	6.9%	(0.9%)	(2.6%)		2.52%

*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 (3.0%) in May. Our benchmark fell (2.6%). I have pointed out before that the Small Ordinaries and Emerging Companies indices are far more appropriate comparisons for the types of equities we hold. In May, these indices fell (7.01%) and (7.74%) respectively. The median market capitalisation of the Small Ordinaries is $885m compared to $144.5m for our fund. The median of the Emerging Companies index is also larger than our fund. I chose the ASX200TR index because I feel it is the best Australian index, but in months such as the one that just passed, we need to be cognisant that it is not always a useful benchmark in the short term.

The reason we outperformed the small companies' indices sharply in May was mostly the takeover bid launched by Woolworths (WOW.ASX) for what was our 10th largest holding before the bid, mydeal.com.au (MYD.AX). The MYD takeover is a timely reminder of the enormous latent value in our other marketplace businesses such as Cettire and Redbubble, and that if the market does not award such businesses a sensible valuation, they are at risk of succumbing to such takeover approaches. WOW struck an incredible deal (I viewed MYD as worth meaningfully more than the bid price), the value they will be able to generate out of owning MYD will be enormous provided they do not allow large company bureaucracy to trump innovation.

The good outcome from the MYD bid was unfortunately outweighed by negative months for our larger "value" holdings that should be outperforming in the current "growth/value rotation". UOS, NTD and SHM all weighed heavily in May, SHM provided an earnings downgrade, but are still positioned to generate more than $20m of EBITDA in FY22 against an enterprise valuation that should be below $60m at current prices based on the significant cash liberation from inventories in the June half.

In the case of NTD, despite no news, the price fell sharply. Investors are jumpy nervous about the effects of logistical issues on revenues in the short term and sharply rising input costs (oil prices comprise around one third of the cost of a tyre) in the longer term, but the substantial benefits of the integration of the recent acquisitions and the very low valuation mean we think NTD is likely to generate a very strong investment returns in coming years.

UOS is now the cheapest it has been compared to net tangible assets since the global financial crisis fourteen years ago. The company continues to suffer from the complete indifference of the board and management toward investor relations and without some indication that they ever intend to close the spread between share price and NTA, it will presumably persist. The primary comfort is the ongoing very strong operational performance of the business.

Matrix Composites & Engineering: -

On the quarterly investor teleconference in April, a question was asked about whether I had "changed" the investment style for EGP given the significant exposure to technology style investments which have been largely responsible for the awful recent unit price performance of the fund.

I have always referred to my investment approach as "generalist" in nature. Over the 13 years I have run EGP, most of the investments the fund has made have fallen into the "industrials" category and tend to be businesses that appeared to have good prospects that I viewed as under-priced based on the valuation the market had ascribed. But we have always maintained exposure in varying levels to businesses that do not necessarily look cheap based on current fundamentals, but for which if the future unfolds as I expect, will deliver very good investment returns.

There are certain areas such as resources and biotechnology where although we do not specifically exclude investments, we have seldom committed capital as I feel the variables in such investments are often beyond the reach of analysis (and often largely outside of the control management).

Despite my general preference to steer clear of resources, every few decades, structural issues can arise that mean certain commodities end up in structural supply/demand mismatch, which means despite the awful capital allocation executives in the sector usually exhibit, good investment returns are highly probable.

On the call, I noted that virtually all investment sectors exposed to the fossil fuel industry are currently exposed to what is likely to be a multi-year environment caused by structural issues that mean it is likely to be a very attractive place to have capital invested for the next few years. There are several drivers for the high returns on capital the fossil fuel sector should experience for the next 3-5 years (or more depending on how long the inputs persist). Four key factors among these are the following contributors:

1. The structural failure of governments globally that have ensured that exploration and development for fossil fuels has been made increasingly costly and difficult by dint of both legislative changes and social pressures without properly providing for the replacement of the inevitably diminishing supply this causes. Fossil fuels are a finite resource and to the extent possible, should be left for future generations who will almost certainly have higher and better uses for fossil fuels than we presently do (by way of example the median US passenger car achieved ~13.5 miles per gallon in 1975 and is closer to 35MPG now – the longer we can leave fossil fuels

in place, the more we will be able to do with them). This should be done by encouraging development and deployment of new technologies to replace fossil fuels as swiftly as sensible economics enables (provided the whole of life environmental effects of the replacement technology are demonstrably superior). Pig-headedly making fossil fuel development difficult will only serve to make the world's poor suffer. Short-sightedness in pursuit of an (admirable) environmental goal will shortly unleash energy poverty into a world that had been on an uninterrupted poverty reduction streak that had run from the end of World War II until the implementation of insane Covid lockdown policies globally in 2020 saw the first substantial worsening of global poverty in decades. The Covid "blip" will likely be nothing compared to the wave of energy poverty the poor energy policy of wealthy countries over the past few decades will soon deliver the worlds poor. All it took was one cool winter, one warm summer and one year of below average wind in Europe for [the price of gas to rise 17-fold] (subscription required). Rich countries will always get their requirements for energy filled no matter the cost, but the poorer folk of the world will simply go without. Seasoned energy observers have been warning for years about the shortcomings of the current generation of renewable energy to provide reliable baseload power, but policymakers could not resist the siren song of the renewable movement, and now the worlds poor will wear the consequences.

2. The reluctance for major businesses in all fossil fuel segments to commit capital given the terrible capital allocation decisions they made through the last fossil fuel boom (~2003-2011). There was an incredible amount of uneconomic capital expenditure (CAPEX) into areas such as shale-oil and tar-sands oil extraction and fracking through the last boom. Chastened Boards and Executives currently appear to be more focused on returning capital all through the fossil fuel industries than they have ever been.
3. The reluctance of companies to approve even projects with highly attractive economics. Major fossil fuel producers have been captured at board level in several cases by activist investors who are using Environmental, Social and Governance (ESG) pressures to prevent CAPEX approval on new projects. The ESG excuse is being used, but in many of these cases, the true aim of the activist is likely an improvement in the return on investment of any new CAPEX (see point 2). Increasingly language around "energy security" is being used to supersede ESG, meaning more project approvals are likely with higher energy prices, but the tsunami of capital that usually follows the type of high prices that energy markets are currently experiencing is unlikely to arrive.
4. The traditional fallback providers of supply in times of high demand are not able to respond the way they have previously. OPEC has a more limited capacity to fill supply shortages in the oil market than ever before. The last oil price spike was solved not by OPEC, but by the United States going from an importer to an exporter of energy, mostly by dint of the uneconomic CAPEX boom discussed in point 2. Indonesia and Australia (and to a lesser extent Russia) are traditionally the coal producers that step into the breach when global coal demand outstrips supply. The Indonesian economy is growing so quickly that it is absorbing much of the additional supply it can bring on. Despite Australian coal being the cleanest and lowest carbon available in the seaborne market, it is close to impossible to bring new supply to market here. Any additional Russian supply that can be mustered will undoubtedly find a home in the many countries not sanctioning them, but it will barely touch the sides of the global supply/demand imbalance as old mines are decommissioned and no new mines replace them. The only realistic chance for meaningfully lower coal prices in the medium term would be a massive Chinese recession, this seems unlikely, having watched the behaviour of Western Governments since the GFC, any hint of a Chinese recession will surely be met with massive stimulus that will only serve to prop up coal demand. There will likely be enormous capital flow into developing gas supply over the next 5 years, it is the most carbon efficient of the fossil fuels, and it is the market most likely to see a substantially lower (or at least closer to the long-run average than coal or oil) price once these substantial investments are made. Gas is even being declared "ESG" by a variety of Governments and industry bodies, which will only provide further tailwinds. But major developments take years to complete, so in the medium term, all major fossil fuels are likely supply constrained.

These factors are likely to lead to a sustained period of high energy prices, especially in oil and coal, the gas market is less predictable. The narrative that has taken hold that the Russian invasion of Ukraine is the driver of high energy prices is demonstrably false when on looks at the price trajectories of gas, oil, and coal in the year or more before the invasion. [This article](#) is fully four months before the invasion began. Should that conflict resolve peacefully tomorrow, and all trade restrictions be removed, only a modest diminution in the prices of fossil fuels would likely result.

As mentioned on the quarterly investor call, we have a small exposure to one coking coal producer which with prices where they have been for the past couple of months is trading on greater than a 60% free cashflow yield on enterprise value (EV). I have no view on where coking coal prices will be over any 3, 6 or even 12-month period, but would be very surprised given the underinvestment in new supply and continued structural demand if prices did not remain elevated compared to their historic averages unless a major Chinese recession were to occur.

The other investment I discussed on the call was Matrix Composites & Engineering (MCE). MCE's primary market is in providing subsea buoyancy to the oil and gas market. They have a couple of other businesses they have developed or bought in corrosion technologies and advanced materials to try to smooth out revenues given the enormous cyclicality of the subsea buoyancy market, but the prospective value of MCE is driven by the oil and gas market. MCE operate out of a facility in Henderson W.A that is more befitting a company of several hundred millions of dollars of market capitalisation (the company was briefly valued at more than $700m in 2011) than the $14m EV business it is at today's prices.

I will not write a long treatise on the valuation for MCE, simply pointing out that revenues after MCE listed from 2011-2015 were between $144m - $187m and EBITDA was as high as $50m and averaged more than $20m per annum. Furthermore, MCE have seen off much of the competition as bankruptcy has effectively left their primary market a duopoly meaning if total revenue in the subsea buoyancy sector gets anywhere near the levels of those years, the revenues generated by MCE could be higher than in those boom years. 2011 roughly coincided with the and of the last oil price boom, but revenues sustained for years afterwards meaning the boom when it comes is unlikely to be a short run situation.

To give an understanding of how difficult the past 5 years have been, revenues have averaged $27.2m annually, only 17.4% of their yearly average in the 2011-15 period. The outworking of this is that not only has there been virtually no CAPEX on new subsea buoyancy, but that existing operating rigs have been severely undermaintained through the CAPEX strike. With the dual tailwinds of new rig deployments and catch-up maintenance, the prospect of industry revenues not getting close to the boom years of 2011-15 in the coming few years seems unlikely.

For an investment in MCE to work out very well, we do not need a return to the >$50m EBITDA business MCE once was. If the business could produce $20m of EBITDA from say $120m of revenues, MCE would likely have an EV exceeding $100m again, which is ample upside from the current valuation.

MCE has a much lower depreciation charge now than during the peak years, and as such would be a more profitable business if it were to produce the same level of EBITDA. With that said, there is likely to have been some underinvestment in maintaining the plant through the very difficult past 5 years, so some catch-up expenditure is likely there.

Finally, taking the business from the $27m of revenue it has averaged in the past few years to $100m+ will consume considerable working capital, so the business whilst it would look profitable as it was growing, would not likely produce much free cashflow until it found a stable, higher revenue base, so an investor in MCE is banking on a re-rating of the valuation as conditions improve rather than a steady stream of dividends.

<u>The ZFC update: -</u>

The launch of Cipher Fund is now expected in 2023.

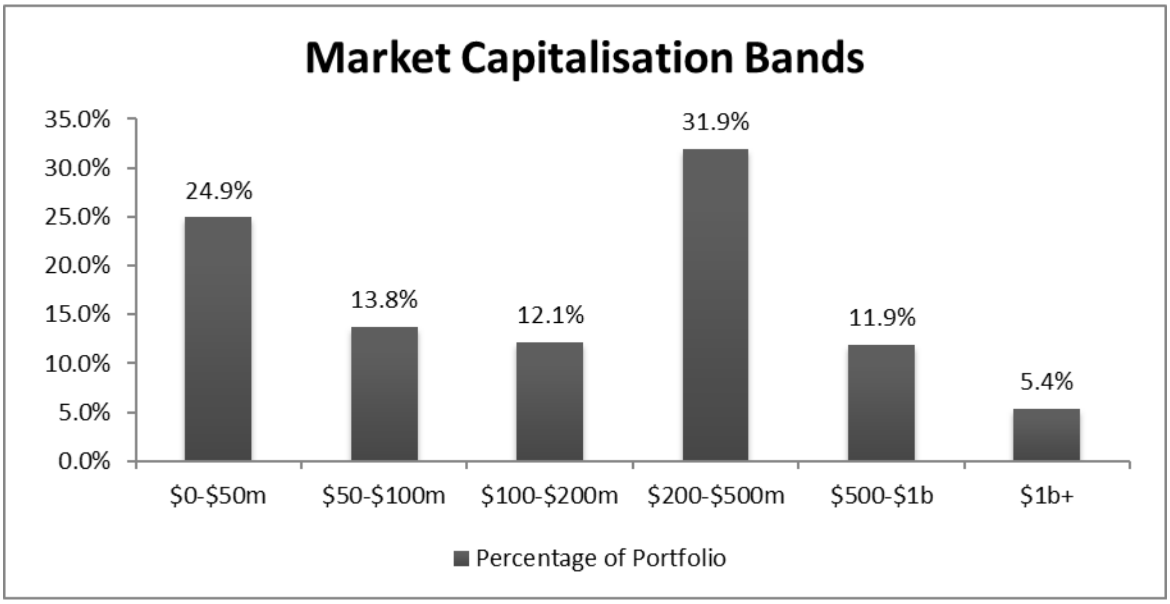
Prospective managers and investors are invited to contact CEO of ZFC, Brad Hughes (brad.hughes@thezfc.com.au) or myself.

Key Portfolio Information: -

Our top 10 holdings on 31 May 2022 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	11.9%	11.3%
2	Smartpay (SMP.ASX)	8.3%	7.9%
3	Shriro Holdings (SHM.ASX)	6.5%	6.2%
4	MyDeal.com.au (MYD.AX)	6.2%	5.9%
5	Tellus (unlisted)	5.9%	5.6%
6	Dicker Data (DDR.ASX)	5.4%	5.1%
7	Blackwall Limited (BWF.ASX)	4.4%	4.2%
8	SRG Global (SRG.ASX)	4.3%	4.1%
9	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding	3.9%	3.7%
10	National Tyre & Wheel (NTD.ASX)	3.8%	3.6%

Our largest 5 holdings comprise 38.7% of our invested capital, our top 10 holdings are 60.4% and our top 15 represent 76%. Cash and cash equivalents are 5.4% of the portfolio. The median market capitalisation is $144.5m. Weighted average market capitalisation is $352m.



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]	-0.15
Additional investments	Fund Closed	Sortino Ratio[1]	0.03
Applications/redemptions	Redemptions only, monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	19.1% 15.0%
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	58.6% 65.5%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	1.4% 51.4%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	(25.4%) 4.8%
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	(0.8%) 7.9%
Fund Size	$54m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.8297 $0.0081	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.8309 $0.8285

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: