EGP Concentrated Value Fund

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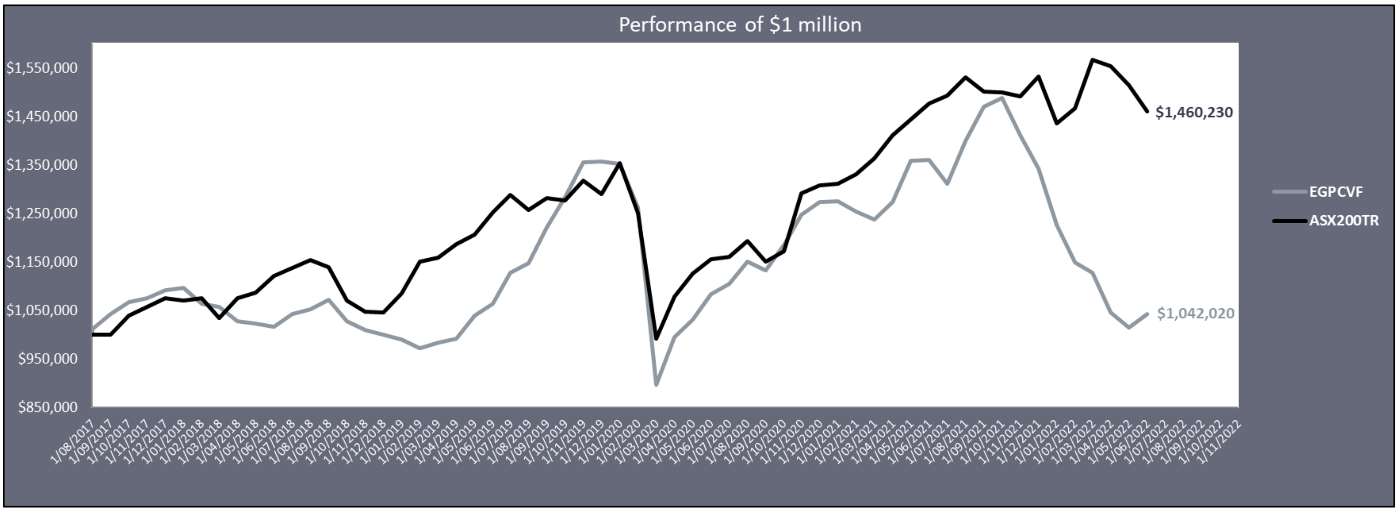
EGP Concentrated Value Fund – 31 July 2022

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%)	(6.0%)	(29.96%)
Benchmark FY22	1.1%	2.5%	(1.9%)	(0.1%)	(0.5%)	2.8%	(6.4%)	2.1%	6.9%	(0.9%)	(2.6%)	(8.8%)	(6.47%)
EGPCVF FY23	9.4%												9.36%
Benchmark FY23	5.8%												5.75%

*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 rose 9.4% in July. Our benchmark rose 5.8%. The fund was assisted by a broad-based increase in equity prices in July. We managed to generate meaningful benchmark outperformance for the second consecutive month after the shocking six months of underperformance that preceded June and July. We have now recovered 18.8% of the peak underperformance (set in May 2022), and as set out in last month's annual letter will commence the process of reissuing our PDS and opening the fund once we have recovered at least a quarter (25%).

Sharp improvements in the share prices of several holdings were registered despite no announcements that would have caused their prices to improve. To be sure, many of these stocks have recently suffered significant falls based similarly on no news, but sentiment seemed to turn quite sharply on July 1st, whether the reversal holds, neither us nor anyone else can tell.

Two stocks that rose following market updates were SRG Global (SRG), which gave guidance for strong FY23 earnings growth, following giving a similar guidance this time last year and subsequently exceeding it. The SRG business is now a meaningfully higher quality enterprise than it was a few years ago, larger and with a more predictable revenue base, yet it trades at around half the multiple it was awarded three or four years ago. The other was Smartpay (SMP), which I already wrote about in last month's report, but which continued its relentless rollout of terminals, and for the first time in the last few quarterly updates (which had similar results), the market responded positively.

The key negatives for July were found in our distributors. Dicker Data gave an update which was poorly received, they still demonstrated double digit earnings growth in the six months to June but will require a significantly better second half to approach the guidance implicit in their forecast quarterly dividend. National Tyre and Wheel (NTD) had a very difficult June half, only managing a modest half on half EBITDA increase despite a ~10% higher revenue than the December half as the effects of logistical, currency and inflation eroded gross margins alongside the substantial cost of consolidating warehouses and an ERP rollout. It is clear most of the headwinds have passed their peak and will likely soon become tailwinds, particularly the completion of the warehouse consolidation which will see meaningful cost benefits in future earnings.

Doing The Same Thing Versus Doing Something Different: -

After the valuation thesis I wrote in the June newsletter outlining why I thought Smartpay (SMP) was priced way below a reasonable valuation, I discussed the thesis with a smart investor with whom I occasionally discuss ideas. His view was that Tyro (TYR) is much cheaper and we would be better off owning that.

My explanation to him of my preference for SMP over TYR can best be summarised as "for SMP to be an excellent investment outcome, they need only continue to do what they are currently doing whereas for TYR to be an excellent investment outcome, they need to do something considerably different to the way they have done in recent history".

Because of our ownership of SMP, we watch TYR closely. It defied my belief that TYR which sported a valuation of about $2 billion for the first couple of years of its listed life did not buy SMP. SMP were clearly making headway with a relatively similar offering and were at least early in TYR's listed life around one-twentieth the valuation. Furthermore, TYR have a vertically integrated technology offering that requires volume to defray their high cost-base, additional scale would have been highly advantageous, the synergies that are so often discussed in takeovers must have been available in spades in a SMP/TYR deal.

On the surface, the argument that TYR is cheaper is easy to see. TYR should generate about $322m of revenue when they announce their results in August. Based on the last SMP update, they are annualising at about $65m of revenues, or barely more than one-fifth of Tyro's. TYR trades at ~1.2x revenue and SMP trades at ~2.4x revenue.

The willingness however, of investors to use revenue multiples over the past few years has been very flawed. Two businesses doing $100m of revenue each might have very different bottom lines depending on how their cost bases are structured. Long-time EGP holding Dicker Data is instructive in this regard. Their two largest competitors are Ingram Micro and Synnex. Both companies do more than US$50b in revenues globally and both are valued at around US$10b (Ingram has been in private equity hands for a couple of years, but that is about what I would estimate their valuation would be). This means they are each valued at about 0.2x revenue. DDR will generate perhaps a little over $3b of revenue in the year to June 30, 2022, but has a valuation of about $2.3b, or about 0.75x revenue. On a revenue basis, DDR is more than 3x overpriced compared to Ingram and Synnex.

But each dollar of new revenue to DDR produces a little over 3.5 cents of additional profit before tax (PBT), whereas Ingram and Synnex extract only 1.7c and 1.2c of PBT respectively from each dollar of revenue. Despite Synnex being about twenty times the size of DDR in revenues, it generates only one third of the PBT per dollar of revenue. Scale is important for a distributor, but clearly not the only factor in profitability.

Returning to TYR/SMP, despite SMP being about twice the valuation of TYR on a revenue basis, SMP is more profitable, and growing faster, which goes some way to explaining the valuation disparity.

The investment argument for TYR is that if they can strip as little as 10 or 15% from their cost base, they go from making significant EBIT losses to being roughly EBIT breakeven, if they can continue to generate the strong double-digit revenue growth they have consistently shown, operating leverage would arrive very rapidly. Bitter experience has taught us however, that stripping costs out of a business is infinitely harder than any management ever think it will be. The advantage of a trying to reduce costs in a fast-growing business is that it may not even be necessary. If historic revenue growth levels can be maintained (averaging 25% annually over the past 3 years), then the business could add ~$80m of revenue in FY23 (~$36.5m of gross profit), which would allow them to be modestly profitable at the EBIT line even if costs remained flat from FY22 to FY23. A similar result in FY24 (25% revenue growth and near zero cost growth) would see them generate a higher EBIT than SMP in that year.

The difference for our investment in SMP is that rather than relying on management to hold costs steady from year to year to try to achieve breakeven, the analysis investors must make is as to how hard management are likely to push on the sales and marketing side of the equation and will the earnings sacrificed to this endeavour produce a sufficiently high return that increased future profits will justify the short term reduction in current year profits. If SMP continue to add 400 terminals per month (the June update released in July confirmed more than 1200 were added) with the per terminal revenue holding at ~$4,500 per terminal, then they can add about $21.6m of revenue per annum. This remains a 33% revenue growth on the current run rate doing nothing more than maintaining the current trajectory. As we pointed out in the June report, the incremental EBITDA margin is at least 50% (was 62% in the March half).

SMP is a business capable of adding $10m+ of EBITDA per annum if they just continue to do what they have been doing for the past 3 years. TYR is a business that can add ~$30m of EBITDA per annum if they can prove they are capable of being far more focused on costs than they have ever been in the past.

Theoretically, based on the previous paragraph, TYR should be worth about 3x what SMP is based on their respective abilities to grow their earnings. As investors, we must however, “risk adjust” our valuations, since for TYR to be worth 3x SMP, they must change strategy, whereas SMP need change nothing.

TYR is currently worth about 2.4x what SMP is (~$390m market cap versus ~$160m market cap at time of writing). If SMP can continue their current trajectory, or even modestly accelerate it, anything less than a tripling of market cap (to $480m) would be a poor outcome over the next 3 or 4 years. If TYR manage to hold costs relatively flat over the same 3-4 year period, they should be worth 3x SMP’s valuation ($1,440m). The returns implied here are very attractive, SMP’s tripling over 3 years would be a ~44% annualised return (over 4 would be ~31.6%), whereas TYR achieving a $1,440m valuation over 3 years would be ~54% annually (38.6% over 4 years).

The question investors must ask themselves when reviewing the opportunity described in the previous paragraph is whether the higher prospective return offered if TYR successfully rein in their excessive cost base is enough compared to the relative certainty of SMP continuing to do what they have proven they can. For EGP’s style, we do not think it does.

With that said, these things must be monitored constantly. If for example the December 2022 results for TYR began to demonstrate some success in respect of the required cost-control, and SMP had not accelerated further and the valuation ration remained as it is today, the pendulum of preference would start to swing towards TYR.

Both TYR and SMP are highly attractive businesses in an inflationary environment. If their customers are forced to raise prices because of inflation, the share these businesses capture will grow proportionally.

The ZFC update: -

The launch of Cipher Fund is now expected in 2023.

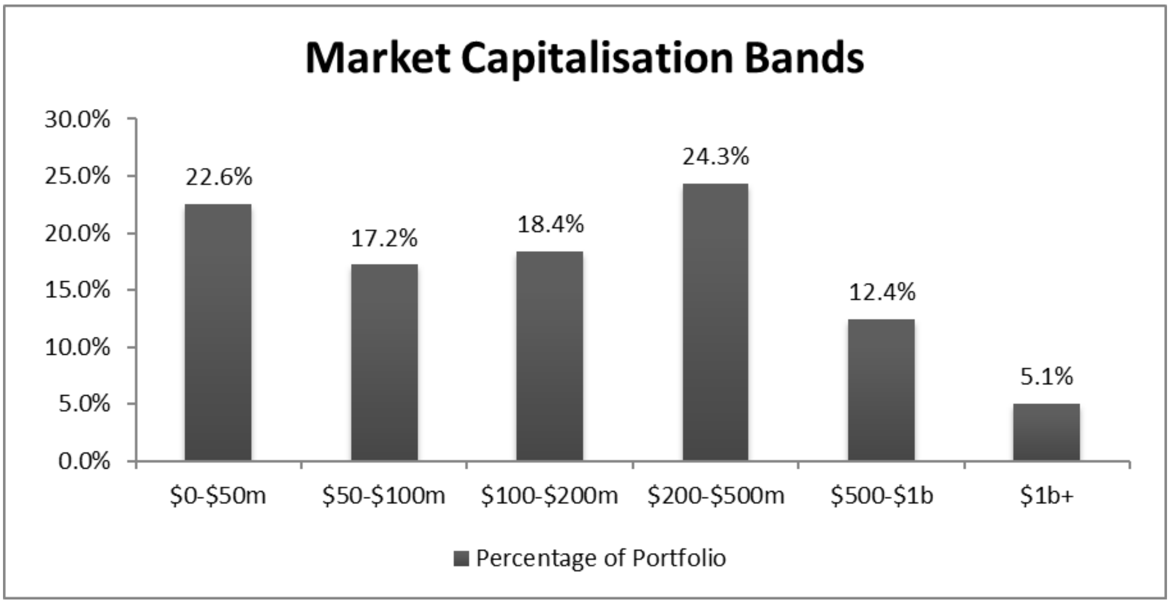
Prospective managers and investors are invited to contact CEO of ZFC, Brad Hughes (brad.hughes@thezfc.com.au) or myself.

Key Portfolio Information: -

Our top 10 holdings on 31 July 2022 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	12.4%	11.6%
2	Smartpay (SMP.ASX)	8.6%	8.0%
3	PayGroup (PYG.ASX)	6.3%	5.9%
4	Shriro Holdings (SHM.ASX)	6.1%	5.7%
5	Tellus (unlisted)	5.5%	5.2%
6	Dicker Data (DDR.ASX)	5.1%	4.7%
7	SRG Global (SRG.ASX)	5.0%	4.7%
8	LIS Energy (LIS.ASX)	4.7%	4.4%
9	Blackwall Limited (BWF.ASX)	3.9%	3.7%
10	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding & PPKME	4.0%	3.7%

Our largest 5 holdings comprise 39% of our invested capital, our top 10 holdings are 61.8% and our top 15 represent 77.6%. Cash and cash equivalents are 7% of the portfolio. The median market capitalisation is $142.4m. Weighted average market capitalisation is $333m.



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]	-0.17
Additional investments	Fund Closed	Sortino Ratio[1]	0.10
Applications/redemptions	Redemptions only, monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	19.4% 15.6%
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	58.3% 65.0%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	4.2% 46.0%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	(20.6%) (2.2%)
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	(2.6%) 4.3%
Fund Size	$52m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.8227 $0.0000	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.8240 $0.8215

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: