EGP Concentrated Value Fund

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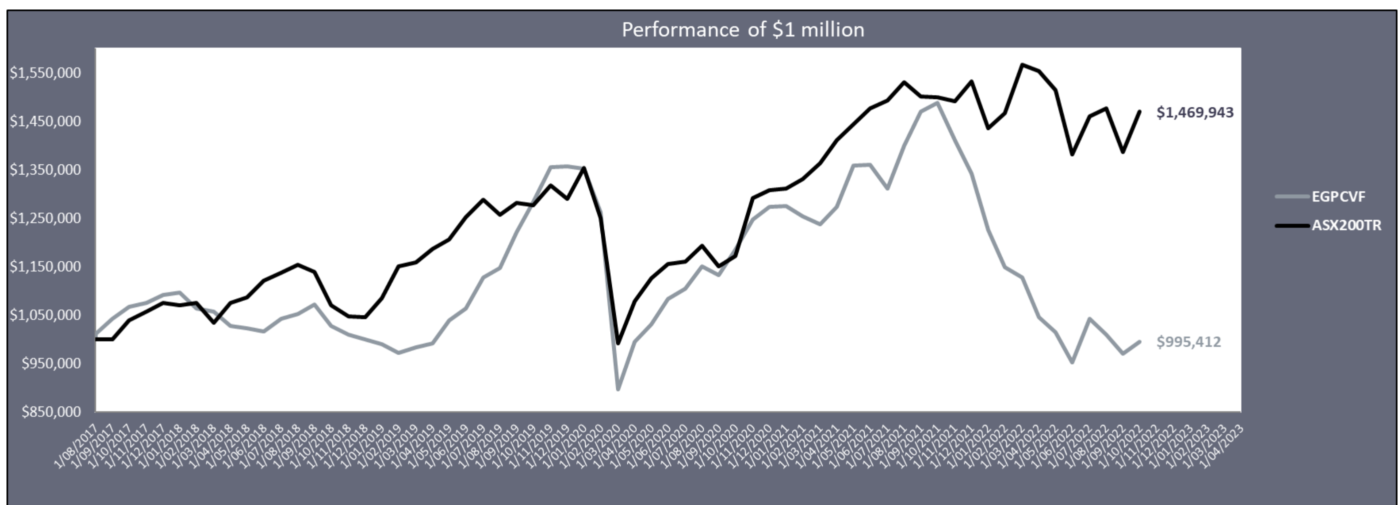
EGP Concentrated Value Fund – 31 October 2022

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%	(3.2%)	(3.8%)	2.6%									4.47%
Benchmark FY23	5.8%	1.2%	(6.2%)	6.0%									6.45%

*August 2017 is the period from August 15th-31st for both the fund and the benchmark in the above tables.



The Month That Was: -

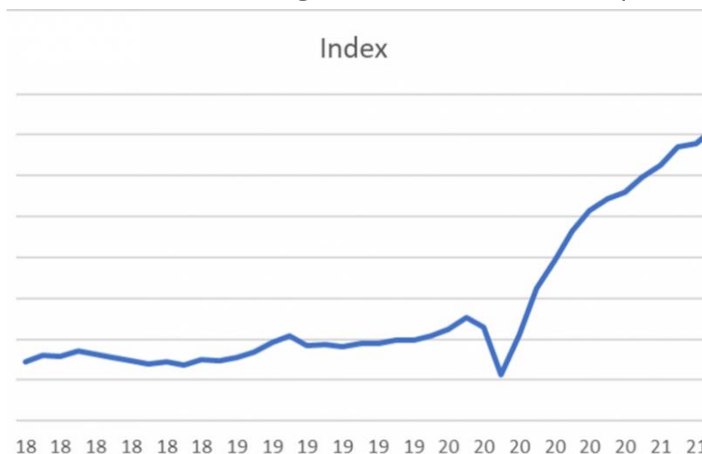
The fund rose 2.6% in October. Our benchmark rose 6.0%. The month was a decent one in absolute terms, but with our benchmark rising even more sharply, was not really one to celebrate, but with the way the past year or so has gone, we will take +2.6% every month we can get it, we would just prefer it if it was better than the benchmark. The +6% for the ASX200 is hard to explain, the "Big 4" banks accounted for a disproportionate share of this gain, with each up between 12 – 17% in October. Given the rising interest rate environment and sharp recent reversal in Australian housing prices, the buoyant valuations of our largest banks defy belief. We discuss inflation further below, but if it is persistent and interest rates need to continue to rise, mortgage defaults must eventually start to impact bank earnings. It is only 14 years since the GFC, but it feels like investors might have forgotten how swiftly banking earnings can reverse when conditions turn against them.

There is an enormous amount of coverage of inflation figures and the prospect of global recession in the financial media at present. I seldom discuss such things except in respect to how they might impact specific holdings but have received enough questions by email and telephone that some explanation of the lens through which I view these matters is warranted.

I have stated many times previously that the outcome of global quantitative easing post-GFC was always going to be inflation. The only question was one of timing. When asked, I would point out that the closest analog I could think of was post WWII when loose monetary policy globally had relatively benign effects for almost 20 years until the late 1960's when inflation started to arrive, slowly at first. When oil-shocks came, it really took off. From about 1973 to 1975, US interest rates went from about 3% to 13% as inflation went from 3% to about 11%. This time, it is the insanity of the global lockdown policy employed by poor Government decision making (globally), focusing on polling rather than science to guide the Covid response that let the inflation monster into the room.

Virtually every policy undertaken to attempt to temporarily defer deaths among the very old and very sickly instead resulted in a global cornucopia of misery that will create a "cost of living headache" in wealthy countries like Australia and instead rip the lives of the poorest and most vulnerable global citizens asunder. Global poverty is rising for the first time since WWII and it is the decisions of governments that have led us here, not some unavoidable externality.

I would not be so bold as to make predictions about where interest rates will go, but a couple of things stand in our favour relative to the stagflation of the 1970's. Firstly, the actions by central banks globally (particularly the US Federal Reserve) have been far more aggressive than they ever have previously. Inflation is (like most of economics) an outcome of the mind. If people expect prices to rise, prices will rise. This aggression in raising rates has crimped forward inflation expectations and therefore, probably, inflation. The other factor is that many of the underlying inflation contributors are almost certainly transitory. The linked graphic to the left indicates the change in Australian used car prices as Covid policy decisions seized up global supply chains. This graph has already rolled over and will likely be a consistent contributor to lower inflation for at least the next year or more. Cars are a relatively modest component of the inflation basket at ~3%, but there are multiple basket components that have similar graphical shapes, providing similar negative contributions as supply chains normalise.



As to recession risk, for some reason Australian finance writers spend a lot of time extrapolating US and European conditions when contemplating recession risk for Australia. The whole world is more interconnected than it has ever been, but if Australia is to have a meaningful recession, it will come because of a Chinese stumble, the rest of the world will only affect us at the margins. Unfortunately, a Chinese stumble is looking more probable than it has for decades. The Chinese population began shrinking this year 9 years ahead of forecast due to plummeting birth rates. The declining population would not present an issue if the number of people entering and exiting the workforce was roughly in balance. Unfortunately for China, the "one-child policy" chickens have come home to roost.

I have seldom seen it discussed in popular media, but the Chinese workforce peaked at 776.4m people in 2017. It was basically flat through 2018-19. The decline that commenced in earnest in 2020 (3.1% annual decline) will continue apace for at least the next decade or more. If the Chinese government are to navigate this headwind without significant economic harm, it will be one of the more spectacular economic achievements of the past few decades. The fact that the Chinese government watched the inanity of Western Covid lockdown policies, with all the concomitant damage it caused those economies and then basically replicated the same inane policies themselves, does not leave me filled with hope in this regard.

The Bouquets: -

October was characterised by a wide dispersion of movements across the portfolio, particularly considering relatively few market updates. The standout performer for the fund was Cettire (CTT), who confirmed the ~$2m EBITDA monthly run rate they announced for August had roughly held through the rest of the September quarter, which is traditionally their weakest quarter for both revenues and profits.

Those who have been reading our past few monthly reports will be unsurprised by the turnaround in share price, these results were well within our range of expectations. Market participants however, suddenly remembered what a powerful thing a fast-growing negative working capital business model is, with the cash pool growing by ~$7.3m on the quarter despite EBITDA of only ~$5.5m. The range of trading for CTT share this financial year would see Benjamin Graham's "Mr Market" look like a paragon of emotional stability and financial prudence. From lows of 34.5c per share in July to highs more than 5.5x higher at 192.5c briefly in October, the share price of CTT moves around violently from day to day. If the results continue to unfold roughly as described below, returns to all time high prices are very possible if broader market sentiment swings even remotely in the direction of where it sat in early 2021. On a longer timeline, even if sentiment does not return anytime soon, if the current business trajectory maintains, all-time highs will come, just further out.

The December quarter is, as you would expect for any retailer, the best quarter for CTT. In FY22, where Q1 was 18.4% of revenues, Q2 was 35.8%, with Q3 & Q4 ~22% and ~24%. If the $66.1m from Q1 FY23 matched the splits from last year, the December quarter would see almost $129m of revenue and the FY23 full year figure would be about $360m.

We are "only" modelling revenue for FY23 of $300m, so we have about a 16 or 17% margin of error compared to the run-rate. Operating leverage means the ~8.3% EBITDA margin from Q1 should be better in each of the next three quarters with fixed costs defrayed over much larger revenue figures. If CTT can just get to a 10% EBITDA margin on average across FY23, that would see $30-36m of EBITDA based on the revenue range discussed above. This is massive reversal of the $21.5m EBITDA loss delivered in FY22. Investors who understood the business and had read the prospectus could see what management were doing in rapidly scaling the business, but this did not prevent the wild gyrations in share price we have experienced over the past 18 months or so.

Management have indicated on investor calls that at a scale exceeding $400m of revenue, that EBITDA margins should "at least equal those generated before IPO". The FY20 EBITDA margin was just over 12%, so we can probably use that as a base expectation for the business in FY24 and beyond. On the current trajectory, ~$400m revenue is highly achievable for FY24, which would result in ~$48m EBITDA next year. Businesses with the attractive working capital characteristics and monstruous growth potential CTT have are seldom seen, least of all at these valuations.

As investors, what we are constantly searching for is a "variant perception", where our view of how the future will unfold is meaningfully different to how the average of market participants expect, CTT has this in spades. The analytical mistake we think other investors are making is in assuming the high customer acquisition cost is a permanent feature of the business model. Management have already indicated that free traffic is accelerating, in the first quarter unpaid visits grew 4x faster than total visits. If a customer returns via directly using your web address, or via the App, the margin earned on that sale is a step-change higher than if you paid to find them again. Increasingly, as Cettire matures as a destination for buying luxury goods at more palatable prices, the traffic costs should continue to fall, seeing delivered margins increase.

Smartpay (SMP) delivered a record quarterly update, yet somehow rose less than Westpac for the month of October. They announced more than 1600 additional terminals for the quarter, up from more than 1,200 terminals last quarter and the 900-1000 per quarter they were routinely adding through the lockdown affected previous 18 months.

The product clearly resonates with customers and with a ~1% market share of a massive market, and the significant recent step-up in sales and marketing, there is no reason to expect them to meaningfully slow their growth from current levels. The business is valued around $170m at current prices and should earn perhaps $20m of EBITDA in FY23 (it may be more, or less depending on accounting and the level of marketing aggression). That generates an EV/EBITDA multiple of about ~8.5x, which would be inexpensive for any decent business with modest growth prospects. The growth prospects for SMP are decidedly immodest. Look at two scenarios:

1. Current 1600 terminals per quarter growth maintains, current AU$4,339 per terminal maintains. In this scenario, SMP is adding AU$27.7m of new revenue each year. The incremental EBITDA margin is at least 30% and could easily be as high as 40% with improving operating leverage (corporate costs for example should scarcely change) even under the current aggressive growth settings and would be much higher if growth were scaled back. Given the scale of the opportunity, investors should want management to maintain aggressive settings. This scenario adds ~$8.3-11.1m to EBITDA annually.
2. The 900 terminals quarterly SMP were routinely adding through the various Covid restrictions is all they can manage. Revenue falls to $4k per terminal due to recessionary conditions. Under this scenario, SMP would still be adding ~$14.4m of new revenues annually and at least $5m of new EBITDA.

Under scenario 1 above, from a ~$20m EBITDA base in FY23, FY24 EBITDA would increase from 42-56%. Under scenario 2, EBITDA growth would "only" be 25%. Businesses with an addressable market of the scale SMP are targeting, having the level of success placing their product into market do not trade at 8.5x EV/EBITDA. For market of their scale, with demonstrated growth of that quantum, a valuation in the 10-14x EV/EBITDA would be far more appropriate.

The scenarios above also fail to account for the possibility that deployment of terminals continues to increase. This is likelier than scenario 2 in our estimation as the increased sales and marketing budgets continue to pay dividends.

The Brick Bats: -

National Tyre & Wheel (NTD) held their AGM and set expectations for an FY23 result that is below FY22. This is disappointing as FY23 is when most of the synergies from the raft of recent acquisitions were supposed to arrive. Unfortunately, the headwinds we have mentioned in the past couple of reports, particularly the weakening AU$ have continued to hurt margins. The stock fell hard, and despite years of watching the same behaviour from markets, this is still surprising. This is not some company selling a flash in the pan product like pet rocks, beanie babies or even "buy now pay later" services, the demand for which might evaporate tomorrow. It is Australia largest independent tyre retailer, selling a product that virtually everyone needs that must be replaced as required (by law), at an unmatched level of operational efficiency.

I had genuinely expected the AU$ had likely bottomed out at the turn of financial year and would turn from a headwind to a tailwind in FY23. This shows why I spend only modest effort on macro matters, even when you have a plausible view on what should happen, the timing will always remain too unpredictable to act reliably on that view. The Australian trade balance was $131.2b over the 12 months to July 2022. Over calendar 2012, it was a deficit of $16.8b. In Australia in 2012, total mineral exports were $149.9b, whereas in FY2022, they are forecast to have been $425b. Yet the average AUD/USD exchange rate in 2012 was ~$1.03, whereas it is currently ~$0.64.

The AU$ is considered a "resource currency", meaning that conditions in the mining industry are the major force on the value of the currency. The Australian economy is clearly performing better than the US economy, mining is in a larger boom than in 2012 and yet the AU$ is 38% below where was at that time. The difference is interest rates. By 2012, the US was already running a zero-interest rate policy, whereas Australia still had a 2.5% cash rate. In 2022, the US have increased their target interest rate to 3.75%, whereas Australian RBA target rate is 2.85%.

If interest rate conditions were the same now as in 2012, given how much better mining is performing and the Australian economy relative to the US economy is performing at least as well as in 2012, the AU$ would probably be 10 or 15% higher than in 2012. Instead, because interest rates are about 3% different than in 2012, it is instead nearly 40% below that level. In case it is not obvious, this makes no sense to me. If you want a demonstration of what a powerful factor interest rates are in economics, I can think of no better example than this. There are of course dozens of other contributory elements that change the currency calculus, but if you were to sit and list them for the AUD/USD

pair, you would find they the preponderance of them look better for the AUD relative to the USD than they did in 2012.

The conditions that have led to this dislocation in the value of the AUD will at some stage turn (with the caveat that if China falls over in a meaningful way, all bets are off). When they do, the currency issues that have been adversely affecting NTD's margin will start to positively effect margins. In the same way as price rises take time to push through, price falls either do not get passed through, or if they do, also take time. By then all the operational efficiencies from the acquisitions will have been harvested and NTD will likely very rapidly return to record levels of earnings.

The Redbubble (RBL) quarterly update was the other real disappointment for the fund this month. I had expected year on year growth to return, albeit at low levels, perhaps 4 or 5% growth. Instead, the figure was negative to about that level. We ordinarily would consider this a minor matter, not focusing on quarterly gyrations, but as discussed at length on the quarterly investor call, RBL have built their team to a scale to deliver more than twice the current revenue and at the current level of revenues, this is causing the business to haemorrhage cash. We have repeatedly asked management why the costs and revenues could not be scaled in tandem but have never received a satisfactory explanation. Unless the December quarter demonstrates a significant reversal of revenue fortunes for RBL (beyond the traditionally good Thanksgiving/Christmas trading), it is likely we will have to accept we were wrong on the thesis and sell our position.

The ZFC update: -

The launch of Cipher Fund is now expected in 2023. Brad and I are scheduled to meet with JANA later in November for an update on Cipher. We plan to provide further material Cipher Fund update when we are able.

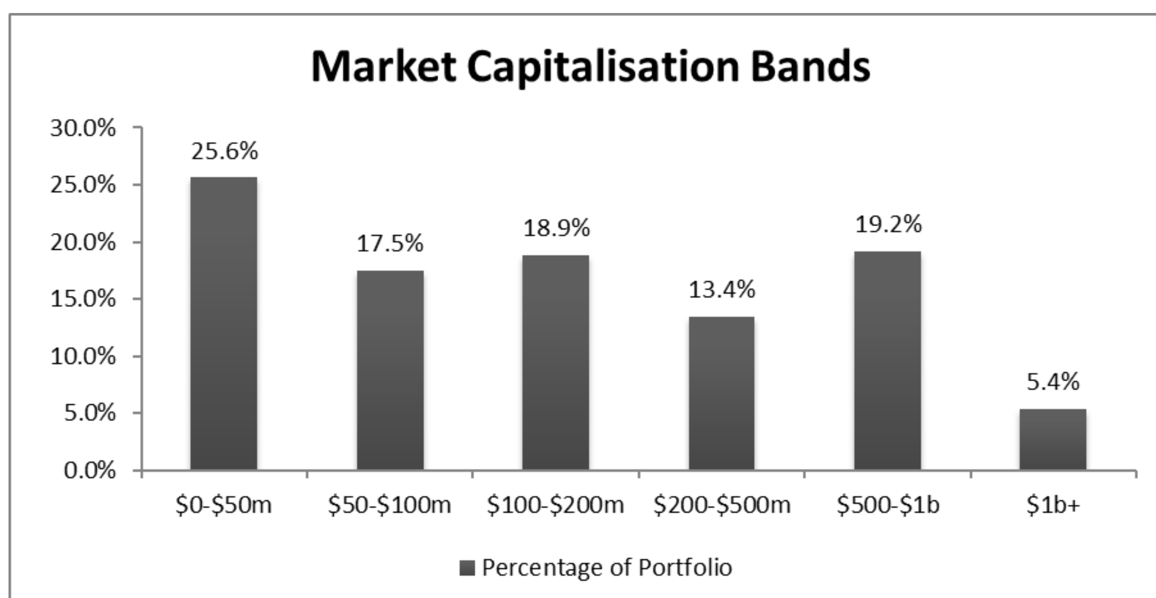
Prospective managers and qualified investors are invited to contact Brad (brad.hughes@thezfc.com.au) or myself.

Key Portfolio Information: -

Our top 10 holdings on 31 October 2022 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	12.0%	11.0%
2	Smartpay (SMP.ASX)	10.1%	9.2%
3	Cettire (CTT.ASX)	7.2%	6.5%
4	Shriro Holdings (SHM.ASX)	6.4%	5.8%
5	Tellus (unlisted)	6.1%	5.6%
6	Dicker Data (DDR.ASX)	5.4%	4.9%
7	SRG Global (SRG.ASX)	5.1%	4.7%
8	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding & PPKME	4.9%	4.4%
9	Blackwall Limited (BWF.ASX)	4.8%	4.4%
10	Scout Limited (SCT.ASX)	4.4%	4.1%

Our largest 5 holdings comprise 41.8% of our invested capital, our top 10 holdings are 66.4% and our top 15 represent 81.5%. Cash and cash equivalents are 8.6% of the portfolio. The median market capitalisation is $153.9m. Weighted average market capitalisation is $327.4m.



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]	-0.18
Additional investments	Fund Closed	Sortino Ratio[1]	-0.01
Applications/redemptions	Redemptions only, monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	19.1% 15.7%
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	57.1% 65.1%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	(0.5%) 47.0%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	(33.1%) (2.0%)
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	(8.1%) 4.8%
Fund Size	$48m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	(1.4%) 7.2%
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.7859 $0.0028	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.7871 $0.7847

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: