EGP Concentrated Value Fund

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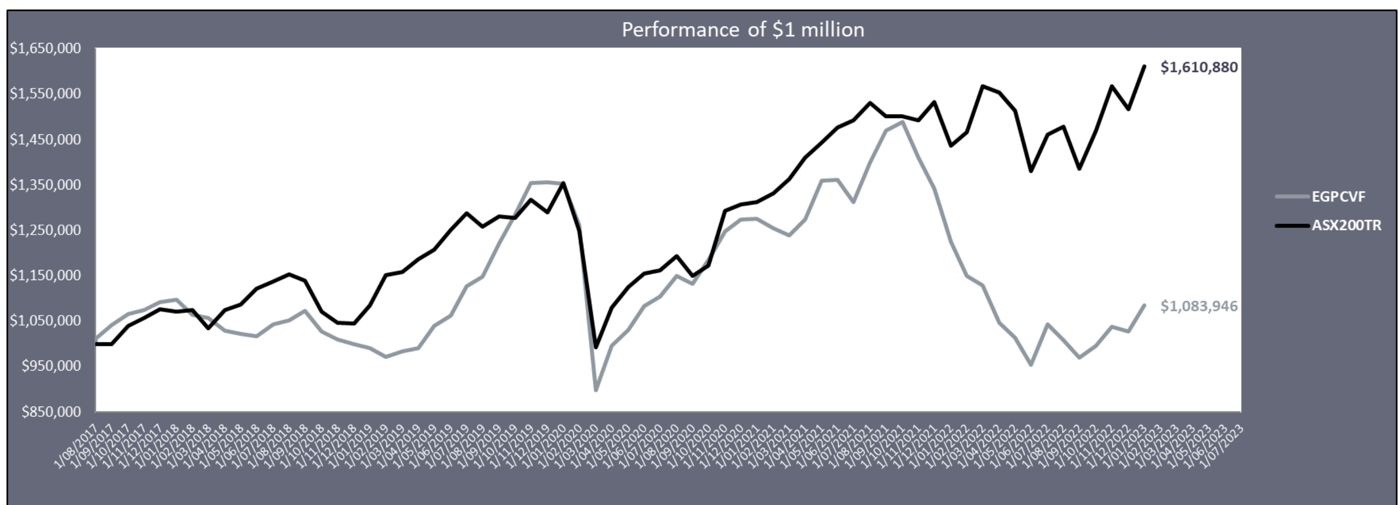
EGP Concentrated Value Fund – 31 January 2023

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%	4.3%	(1.1%)	5.6%						13.76%
Benchmark FY23	5.8%	1.2%	(6.2%)	6.0%	6.6%	(3.2%)	6.2%						16.66%

*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 5.6% in January. Our benchmark rose 6.2%. Much like the October and November reports, a satisfactory month for the fund was made to look ordinary by very strong index performance.

The quarterly investor teleconference held in January was the most strongly attended in several quarters with around 30 attendees. We will continue with using the MS Teams format as there seems to be a preference among our investor group for that product. I am thankful for the numerous investors who spoke in support of EGPCVF continuing in its current format without any change, my fellow investors have been incredibly understanding about the poor performance of the past few years and in particularly, the horror 8-month stretch that commenced in November 2021.

Portfolio Update: -

The primary drivers of the sound January return for the fund were Smartpay (SMP) and Cettire (CTT), with a minor assist from SRG Limited (SRG). The main negative contributor was once again PPK Holdings (PPK) an investment which has hurt the fund immensely over the past year and a half, but which we still believe presents perhaps the most asymmetric return profile available in the Australian share market.

SMP ran up sharply (around 25%) leading into their quarterly update (.PDF). The update was a blockbuster, adding 1950 terminals in the December quarter which is traditionally a weak quarter for terminal additions. Merchants are understandably loathe to tamper with their payments systems in the crucial Christmas trading period, but something in the SMP offering tempted more merchants than ever before to switch to SMP in the quarter. After trading higher briefly post-announcement, SMP's share price has largely traded below the pre-announcement prices, leaving rational thinkers to wonder what the expectations of those bidding the shares up before the announcement were!

SMP have a March balance date, so unlike most of our other investee businesses which will report December results in February, we will need to wait until May to see how FY23 accounts will look. Given the approximate doubling of SMP share price over the past 4 months, the question was (understandably) asked on the quarterly investor call about how I will handle the SMP holding and whether we have been selling. I will outline a couple of ways to think about valuation in the following section. As I mentioned on the call, we have modestly trimmed our SMP position for portfolio sizing reasons, not valuation reasons. If the current strong performance continues, we will continue with a portfolio sizing approach until selling for valuation reasons starts to make sense, when we would be more aggressive.

Using the numbers available, we can triangulate with reasonable accuracy the exiting revenues for SMP at the end of FY2023 will be. There were 14,520 Australian terminals deployed at December 31st. SMP has added 5,637 terminals to that figure in the past year, with the past two quarters adding 1,600 and 1,950 respectively. It feels safe to assume that a cadence of ~1,500 per quarter is now a conservative baseline. This would see the business exit FY23 with ~16k terminals deployed. The revenue per terminal over the 12 months to December was NZ$4,801. In the current inflationary environment, that seems unlikely to fall, but we can likewise use NZ$4500 as a conservative baseline.

This would see the Australian business entering FY24 with NZ$72m of revenue locked in. The NZ business was run-rating at NZ$19m of revenue at the half, so ignoring the growth in FY24, using the 25% EBITDA margin management has guided as their target during this aggressive growth phase, we can use NZ$22.75m as a minimum value for FY24. The current market capitalisation for SMP is AU$289m (~NZ$315m). At 31 March, depending on working capital movements, SMP should be approximately NZ$12-15m net cash, meaning the EV at current prices is ~NZ$300m. This means the EV/EBITDA at the beginning of FY24 will be a little over 13x. This is in the ballpark of what a company with a highly cash-generative business and some growth prospects should trade at. If we assumed SMP would pay 50% or more of their earnings as dividends and grow EBITDA at perhaps 10-15% annually, 13x EBITDA would be quite a fair valuation multiple. But SMP's earnings have grown much better than that, with underlying EBITDA taking the following trajectory since the rollout of the Australian acquiring business began in earnest:

- FY2021 = $7.6m
- FY2022 = $11.1m (+46%)
- FY2023 (estimate) = $19m (+71%)
- FY2024 (estimate) = $22.8m - $30m (20% - 58%)

The mathematically astute among you will note the FY22/23/24 growth rates are much better than the ~10% used to justify a 13x EV/EBITDA valuation multiple. The average growth rate over 3 years assuming SMP hit the mid-point of

the FY24 EBITDA range posited above exceeds 50%. Given the growth rate and the long runway, barring a major technological change in the payments environment, SMP should be able to grow their revenues and earnings at rates exceeding that 10% figure for years.

If we take the simple approach of assuming the current valuation of ~13x EV/EBITDA fairly values the business earnings "as is", to estimate the level of return available from the current valuation, we need to estimate how well the business can continue to grow its earnings. If we use a range of possible outcomes, assuming in the worst case, things get more difficult than they have been, we might use 4,000 terminal additions per annum as a reasonable worse case, even through the various Covid lock-down quarters, SMP seemed to find a way to place almost 1k terminals per quarter, with the past two quarters averaging 1,775, a near halving to 1,000 seems VERY conservative. On the bullish side, if we assume the cadence from the past two quarters can be maintained, then more than 7k per year is the target.

Using NZ$4k per terminal as a worse case revenue figure and the NZ$4.8k that SMP delivered in the past year as the best case, we can triangulate a range of revenue growth expectations. NZ$16m-33.6m is the range. To calculate the additional EBITDA this revenue would deliver, we need to estimate the margin. Management have repeatedly announced a target EBITDA margin of 25% during this aggressive growth phase. In the September half, the incremental EBITDA margin was 30.3%. If the business were to wind back from growth to maintenance, I estimate the incremental EBITDA margin is closer to 40%. A range of 25-35% therefore seems a reasonable margin to apply to growth in revenue.

This implies SMP can add NZ$4m-11.8m of fresh EBITDA. The (very conservative) bottom end of this range still represents >10% EBITDA growth, the top end >60%. A valuation multiple of 12-14x seems prudent, meaning the above range of outcomes would add NZ$48m-165m of enterprise value to the business were it achieved. Given the current enterprise value of $300m, this implies a growth in valuation from current levels in the range of 16%-55%. After the past few years, the bottom end of that range would be satisfactory, though the top end of the range would be far more welcome. For valuation to become a factor in any decision to sell SMP, the share price would need to rise almost 50% from its current level, absent any other change in business conditions.

SRG made no operational announcements in January, and with the shares up about 4.3% lagged index performance. In the first couple of days of February, the business announced a $220m, 5-year contract win, which maintains the steady build in their order book running through the past few years. SRG has grown into such a large business, exiting FY22 with an almost $700m revenue run rate, that adding ~$40m per year of revenue is scarcely material to the business (~5.7% uplift), but it reinforces the continuing improvement in the quality and predictability of SRG's earnings, which we expect investors will eventually award a higher valuation multiple as these qualities prove out with each passing quarter.

Redbubble (RBL) gave their December update. The shrinkage in sales that has plagued them post the lockdown boom seems to have finally abated. They have finally acknowledged what the market has been telling them for more than a year, the massive cost base they saddled themselves with in anticipation of continued growth needs to go. They have commenced the process of re-sizing the cost base to what now appears to be the revenue reality. They will now need to take the approach I have always advocated of growing their cost base in tandem with their revenues.

We delayed the release of the January report to incorporate commentary around CTT's December results, given the holding has grown much larger and the business released the results early in February. The strong CTT result had been largely guided with the 8.5m EBITDA for the 4 months to the end of October announced with the AGM commentary. The Thanksgiving/Christmas sales period did not disappoint, with those months almost doubling the first 4 of the financial year for a $16.7m EBITDA outcome for the half.

The most incredible aspect of the report was that a Sales revenue jump of 65.1% ($113.7m - $187.7m) was delivered despite a 36.5% decrease in the sales and marketing expense. The increasing reliability of repeat customers is really starting to show in the profitability numbers. Repeat customers have grown from 46% of revenues to 56% in the past year, and the profitability of repeat customers is much higher as "Customer Acquisition Cost" is the largest expense for CTT. That repeat customers spend 30% more per order underscores the value of the captured customer book.

The number of orders per active customer has likewise grown by 9.7% per annum over the past four years. It was announced with the results that January sales revenue was up 80% year on year. If CTT can deliver 50% sales growth in the June half and maintain the ~9% EBITDA margin, this would see an EBITDA figure for FY2023 of about $30m, which any reasonable observer must acknowledge is an incredible turnaround after the FY2022 year of investment

which saw a negative EBITDA of $21.5m. The question for analysts is how much higher the EBITDA margin can go as the customer base grows. If CTT can maintain a 25% annual revenue growth over the next 3 years and get the EBITDA margin to 12.5%, and both seem very achievable, this would see FY2027 EBITDA exceeding $80m. CTT does not look fundamentally cheap based on $30m of FY2023 earnings, but if they were to earn $80m 3 years hence, the current valuation would prove to be very attractive.

The ZFC update: -

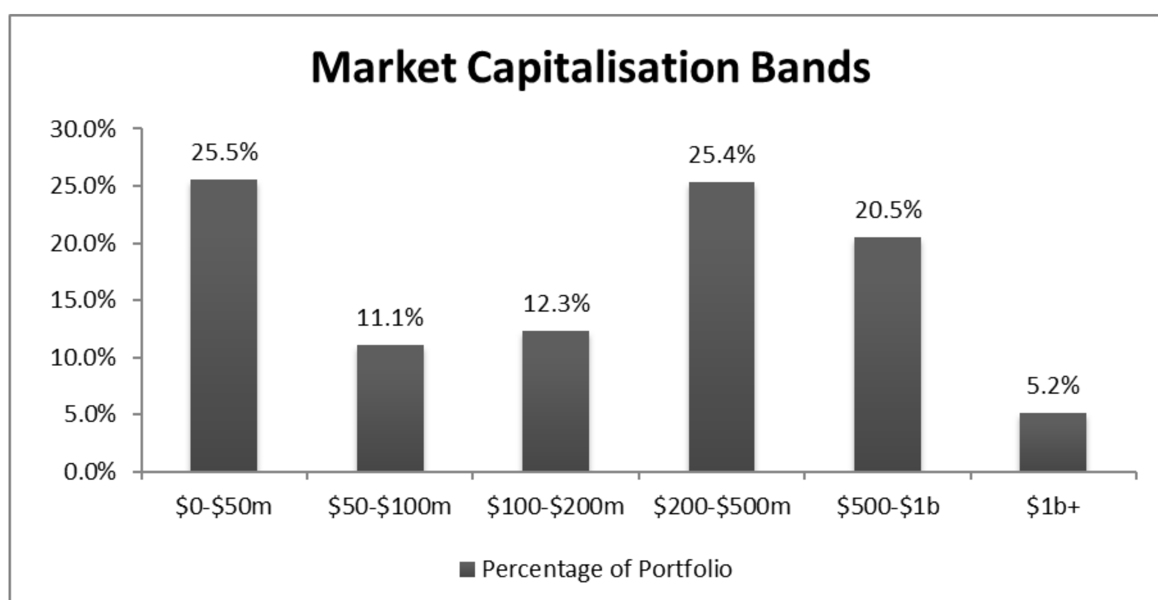
We continue to work with JANA and further updates will be made when able. Prospective managers and qualified investors as always, are invited to contact Brad (brad.hughes@thezfc.com.au) or myself.

Key Portfolio Information: -

Our top 10 holdings on 31 January 2023 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	Smartpay (SMP.ASX)	13.0%	12.3%
2	United Overseas Australia (UOS.ASX)	12.7%	12.0%
3	Cettire (CTT.ASX)	7.8%	7.4%
4	Shriro Holdings (SHM.ASX)	6.8%	6.4%
5	Tellus (unlisted)	6.0%	5.7%
6	Dicker Data (DDR.ASX)	5.2%	4.9%
7	SRG Global (SRG.ASX)	4.8%	4.6%
8	Blackwall Limited (BWF.ASX)	4.5%	4.3%
9	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding & PPKME	4.5%	4.2%
10	SDI Limited (SDI.ASX)	4.3%	4.1%

Our largest 5 holdings comprise 46.3% of our invested capital, our top 10 holdings are 69.6% and our top 15 represent 85.6%. Cash and cash equivalents are 6% of the portfolio. The median market capitalisation is $236.9m. Weighted average market capitalisation is $367m.



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]	0.14
Applications/redemptions	Redemptions only, monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	18.9% 15.8%
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	57.6% 65.2%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	8.4% 61.1%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	(11.5%) 12.2%
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	(7.2%) 7.7%
Fund Size	$48m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	(0.1%) 8.4%
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.8558 $0.0033	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.8571 $0.8545

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: