EGP Concentrated Value Fund

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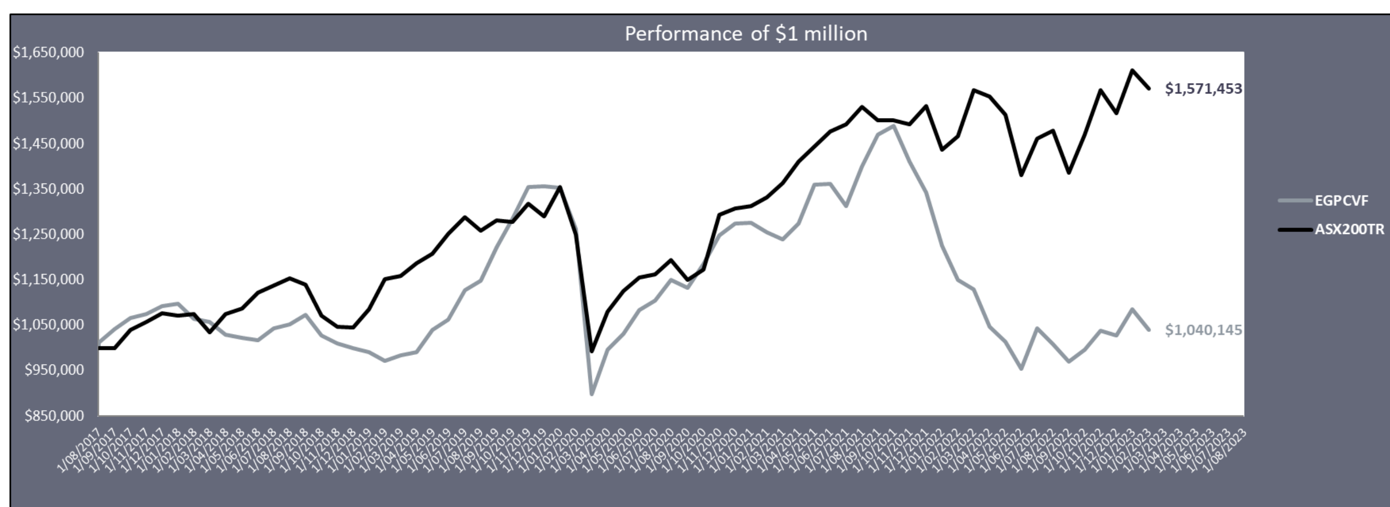
EGP Concentrated Value Fund – 28 February 2023

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%	(4.0%)					9.16%
Benchmark FY23	5.8%	1.2%	(6.2%)	6.0%	6.6%	(3.2%)	6.2%	(2.4%)					13.80%

*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 (4.0%) in February. Our benchmark fell (2.4%). We were doing better than the market early in the month, but in the end, the share price pain from the few poorly received results outweighed the gains in those well received.

The strong theme from many of our investee businesses in the December half was for cashflow performances that were below the underlying business performance, the strong exception being United Overseas Australia (UOS), which continues to gush cash as the inventory runs off.

Such outcomes are seldom well regarded by market participants, and several holdings were sold off because of this. I've always found this quite short-sighted because these businesses will likely normalise these working capital issues, many in the June half, but such matters are often treated as a permanent change in the cash generating quality of a business. It is interesting that most of our holdings had the balance sheet capacity to behave this way to keep both suppliers and customers happy. I have discussed this matter with some of the affected businesses, it is unusual to have your own payables balance shrink in tandem with your receivables growing, most businesses would try to share the pain with their suppliers. The feedback has generally been that the goodwill generated through such behaviour is valuable and given the broad logistical issues of the prior year or so, holding additional inventory has also been regarded as a good business practice. We pay our managers to make these judgements, overall, the decisions seem reasonable.

Portfolio Update: -

Many of our holdings reported either half or full year results this month. I will provide some thoughts on some of the larger ones, or those that made large price movements.

Dicker Data (DDR) reported early in the month, and for the first time since their acquisition of Express Data almost a decade ago, failed to grow their after-tax earnings year on year, for largely the same reasons, as integration costs and the distraction of integrating acquisitions impacted cost control. Revenue growth continued unabated and annualising the December half would see $3.29b of FY23 revenue, up 6% on FY22 without the inevitable growth that will be achieved when the warehouse footprint is increased by 70% in the next few months. For the first time in several years, DDR stock has gotten into our target buying range and were it not for the even greater bargain of PPK (see below), we would have commenced buying DDR for the first time since the COVID price dislocation.

The myopic focus of market participants of a "growthy" multiple for DDR on a business whose earnings were flat is understandable, but any reasoned review of the business status would likely arrive at the conclusion that strong growth will return in coming years. It is an industry with secular tailwinds and is demonstrated "best of breed", a return to something resembling the historic trajectory does not feel outlandish. My modelling has ~$3.8b of revenue in FY24 and a return to a PBT margin of 4%. This would see PBT rise from $107m in FY22 to ~$153m in FY24, or about 20% annually for the next two years. This would be NPAT of about $107.5m, which implies a forward price to earnings multiple of less than 14x which is seldom available for a business with a track record as spectacular as DDR.

Shriro (SHM) released a half year result that was ahead of my expectations, but the share price was unmoved. SHM delivered EBITDA of $12.4m for the half and reiterated guidance for $18.5m for the full year. Their December/June EBITDA split has been 62/38 in recent years and implies $20m EBITDA for the full year if it were to hold. At $20m EBITDA, PBT would be >$14m, at the lower $18.5m guidance, this would be ~$12.7m. These should be very close to cyclical trough earnings for SHM, the business earned >$25m PBT in FY21.

Traditionally businesses exhibiting the sort of earnings cyclicality SHM does trade at high multiples at the bottom of the cycle, and lower multiples when conditions are good. SHM currently has an enterprise value (EV) $68m, but this fails to account for the >$10m increase in net working capital (receivable + inventory – payables) in the half. I estimate over calendar 2023, about $8m of that amount will unwind, meaning the effective EV is closer to $60m. At the low end of the PBT range above ($12.7m), this implies a >21% pre-tax earnings yield, at the higher end of the range ($14m), it exceeds 23%. These numbers are surprising for a reliable (if lumpy) business like SHM. That a business which has paid 73.5c in dividends (fully franked mind you!) in the past 7 years to shareholders is available for 78c per share is even more surprising. Despite the weaker trading in the Australian business, the international business grew at over 80% on the previous period. A continuance of the momentum in the international business would see it become a meaningful contributor to group earnings relatively swiftly. When a fast-growing segment meets a stable, slow growing segment, the resulting earnings inflection is seldom well anticipated by market participants, observe SMP.

Management have been careful to water down expectations in the international segment, noting retailers say the BBQ channel is well stocked leading into the Northern Hemisphere summer, but the new pizza oven is likely to ensure the strong growth continues.

Tellus released their December commentary, the wall of revenues we have been awaiting continues to prove elusive. Rather than write a long treatise on this position, I will link to the update (.PDF), which despite delays in revenue growth continues to show a large and growing pipeline of opportunities. This will be a large, profitable monopoly business at some stage, I just hope management can get us there before the need to raise dilutive capital arrives.

UOS continued their post-Covid revival. I wrote a piece on UOS that was too long to include in this newsletter and will instead include it in the March newsletter. Given the already lengthy piece on PPK below and considerable detail on some other holdings, I felt many readers would be overtaxed if the UOS piece was included this month.

To anyone paying attention to the progress of UOS, particularly their most important asset, the Malaysian listed UOA Development business, all the lead indicators for an extended period of stellar earnings aping the one commencing in 2012 when UOS produced the best results in their history are in place. In that period a fast-growing order book was underpinned towards the end by the twin megadevelopments of United Point and Sentul Point, which totalled RM3.0b in GDV (gross development value).

This time, the first 16 acres of the Jalan Ipoh landholding will underpin the growing order book, the company has stated publicly this development has a RM6.1b (>AU$2b) GDV. If market conditions allow this development and the many others running concurrently to progress at good pace, the company is likely to be setting revenue and profit records a few years hence. This very strong business setup would seem to make it a no-brainer to use the massive cash balances to eliminate shares at these bargain basement prices. Instead, management have raised the dividend by 50% and the DRP (dividend reinvestment plan) will soon see a mountain of new shares issued at the steepest discount to NTA in the 35-year listed history of the business. Exquisite capital allocation at the operational level for UOS is unfortunately not matched by a similarly opportunistic and disciplined process at the corporate level.

SDI Limited (SDI) released a result that we were slightly disappointed with and given the market reaction, most investors felt similarly. The continuing strong revenue growth and improved gross margin performance were as expected, but these did not produce the strong earnings uptick I was expecting because the expenses grew much faster than I had modelled, meaning only a modest improvement in profitability. Travel expense increased sharply, and some wage inflation was evident. It could be argued that travel expense is a lead growth indicator, the company has several new products it has been unable to showcase at trade shows because of Covid, hopefully future results will have me applauding the foresight of what was substantial post-Covid travel expenditure. Calls with management reiterated that the high expenses for the half were an aberration, whilst the strong revenue growth dating back years through all manner of economic challenges is expected to continue. We remain confident SDI will demonstrate exceptional operating leverage in coming years as cost growth moderates and operating scale begins to show real benefits for shareholders via EPS growth.

Blackwall (BWF) released a result that confirmed everything I pointed out in the September newsletter (.PDF), with the Wotso management revenues providing an earnings kicker that should only accelerate in coming halves. Investors shrugged their shoulders, I sometimes feel only management and a very small handful of investors understand what a fine little business BWF is, steadily growing earnings and paying handsome dividends. Eventually these things get noticed, we are patient.

Matrix Composites (MCE) saw their share price rise sharply through the month as the burgeoning order book continued to draw investor attention. We first outlined MCE in last May's newsletter (.PDF), and our investment thesis has been playing out very much like I had hoped, if only with new contract wins a little slower than I had anticipated. Unfortunately accompanying the results was a trading halt and VERY large capital raising that means the business performance will now be shared with a share register more than 50% larger.

I did point out in the original May piece that funding working capital would be the biggest challenge of a return to being a much larger revenue business. Unfortunately, management have taken the easy way out and raised a mountain of cash. It is the downside of relatively modest management and board ownership, if there were a controlling shareholder, they would likely have raised the capital in more modest tranches as required, at ever increasing prices as new contract wins rolled in and revenues increased. But when others will bear substantially all

the dilution, and there are willing bidders for a large capital raising, buying a bulletproof balance sheet is not something most managements and boards can resist.

National Tyre (NTD) released a result that they had already guided in previous months. This did not stop investors selling the shares off sharply. If everything management says about the worst of conditions being in the rear-view mirror prove correct, the current valuation will likely prove a rare opportunity. Almost every issue that has been a headwind has now either abated, or become a tailwind (with the exception of the ERP implementation, which sounds like it is a continuing distraction). Tyres are not really a discretionary product, so once the price rises that have harmed margins cycle through, the earnings impact will be significant, and the propensity for investors to project every trend into perpetuity will also reverse from headwind to tailwind.

Things That Make You Go Hmmm: -

I have been thinking about PPK Holdings (PPK) a lot in the past few months, judging by the regular inbound calls and emails about the holding, more than a few of our investors are giving it some thought too. I admit whenever I am given to thinking about PPK, I find myself mystified at how market participants are so grossly mispricing the incredible prospectivity of their portfolio of businesses and technologies.

I found myself thinking of Smartpay (SMP), which was the last time I felt the mispricing of one of our portfolio holdings was so observable and obvious. In the October 2022 newsletter (.PDF), I opened my discussion with this comment:

"Smartpay (SMP) delivered a record quarterly update, yet somehow rose less than Westpac for the month of October."

Since then, SMP has risen by about two thirds, whilst Westpac has fallen ~6%. Later in that same newsletter, I expressed my puzzlement at the AU$ trading at 64c, it has likewise responded to my thesis that it was mispriced, rising about 8% (which is a similarly dramatic move for a currency as the SMP share price change).

Emboldened by this response to my most recent admissions that I could not understand how market participants were arriving at their pricing, I will explain a little further why I think PPK is so severely mispriced.

I will first acknowledge that a set of accounts that look like this would scare many away, myself included for a great majority of my investing career:

Comparison to previous corresponding period	31 December 2022 $'000	31 December 2021 $'000	Change $	Change %
Total revenues from continuing operations	465	59	406	688
Profit/(loss) from continuing operations before tax [1]	(8,203)	2,056	(10,259)	(499)
Profit/(loss) from continuing operations after tax attributable to owners of PPK Group Limited	(7,681)	5,613	(13,294)	(237)
Profit/(loss) after tax attributable to owners of PPK Group Limited	(5,924)	7,612	(13,536)	(178)
Basic and diluted earnings / (loss) per share – cents	(8.6)	6.3	(14.9)	(236)
Net tangible assets per share – cents [2]	77.3	115.8	(38.5)	(33)

But the most spectacular investment returns seldom arise out of sets of accounts that scream "buy me now". For reference, I have attached below the FY2019 SMP accounts where profits collapsed as the business was investing heavily in the Australian acquiring opportunity. In the intervening three and a half years since this ugly SMP full year report was released, the share price is up more than 800%. I view the opportunities PPK are pursuing as potentially meaningfully more valuable than the markets SMP chases:

For the year ended 31 March 2019

		Group	
		2019	2018
			Restated
	Note	$'000	$'000
Continuing operations			
Revenue	5 & 6	21,097	20,518
Other income	7	15	16
Operating expenditure	8	(14,695)	(10,509)
Earnings before interest, tax, depreciation, share options expense, amortisation, impairments and unrealised foreign exchange		6,417	10,025
Depreciation and amortisation	8	(6,535)	(6,211)
Unrealised foreign exchange adjustments		167	-
Share option amortisation	25	-	(15)
Net finance (costs)	8	(1,814)	(1,396)
Impairment	8	(490)	(179)
		(8,672)	(7,801)
(Loss) / Profit before tax		(2,255)	2,224
Tax benefit	9	427	346
(Loss) / Profit for the year from continuing operations of owners		(1,828)	2,570

PPK has a current market valuation of ~$100m, for that you get:

1. A 45% interest in Craig International Ballistics (CIB). CIB generated $2.7m of EBITDA in the first half and the operating environment for ballistic protection is only improving, it will likely generate >$6m of EBITDA in FY2023 and is unlikely to see earnings fall for the next few years, so strong is the operating environment. Similar businesses with similarly rosy outlooks would conservatively command a 9-12x EBITDA multiple in a sale transaction, implying a $54-72m valuation range. The prospective value of PPK's share is therefore ~$28m. Furthermore, as the CIB business is so capital light, the dividend stream from this investment will fund the lions share of the corporate costs for PPK.
2. The LIS Energy (LIS) business has a current market valuation of just under $200m at the lowly valuation of 31c per share. Between their direct ownership and their share of the BNNT P/L business, PPK owns almost exactly half of LIS, or ~$100m.
3. The White Graphene business recently raised equity at a $73.25m post-money valuation. PPK owns just shy of 60% of this business, implying a ~$44m value to this holding.
4. The AMAG business raised capital in November at a $16m post money valuation. PPK own just under 1/3 of this business, implying a ~$5m value to this holding.
5. The Mask Innovation business was a failure after extended delays in the approval process meant the pandemic was over before they could bring their product to market. As stated in the half-yearly, PPK are exploring a sale of the land associated with this business. Using mapping software to view the land and looking at similar land sales in the area, this landholding might easily be worth $5m+.
6. The remaining businesses include BNNT Technology Pty Ltd, BNNT Precious Metals, Strategic Alloys, Ballistic Glass and 3D Dental. I have ordered these in my estimation of most to least valuable. I expect, given time and the development of end markets that the BNNT Technology business is likely to be the most valuable asset in the PPK

stable. The other businesses will all take further research and development to commercialise, but there is likely to be a commercial end market for more than one of the other businesses also.

So even ascribing zero value to the assets listed in point 6 above, we arrive at a "sum of the parts" valuation of ~$182m. About double the value being ascribed by the market, ignoring the several million dollars of cash held directly at the parent level. Valuations can move around wildly, particularly the large LIS holding. But the point remains that investors can buy PPK for materially less than the easily calculable value of their major holdings.

More importantly, the holdings are themselves undervalued in my estimation. The LIS business for example has successfully passed every testing hurdle it has arrived at. In a world desperate to decarbonise, it seems unlikely that the best-known battery technology for mobility applications will fail to find a substantial commercial niche.

The White Graphene business will likely be the first of the stable to produce meaningful revenues. The gelcoat results reported in August last year (.PDF) have led to testing programs with OEM's and will almost certainly result in contracts being signed if not this half, certainly in calendar 2023. I am genuinely of the opinion the current suite of PPK businesses will produce more than one multi-billion dollar business.

The problem is that market participants are not currently of a mind to pay for anything that looks "blue sky" in nature or valuation. Some highly prospective businesses that may not be fully funded to commercial maturity are currently being awarded paltry valuations. The mistake analysts are making I suspect is lumping PPK into that category. Between the CIB revenue stream and the prospective sale of the Mask Innovation landholding, a buyback feels like a far more likely prospect. Some observers may not be aware just what large shareholdings the board and senior management have and how strong their capital allocation record is alongside their incentive to behave rationally. We will continue to augment our holding as long as this mispricing persists, and we remain persuaded of the commerciality of the holdings.

The ZFC update: -

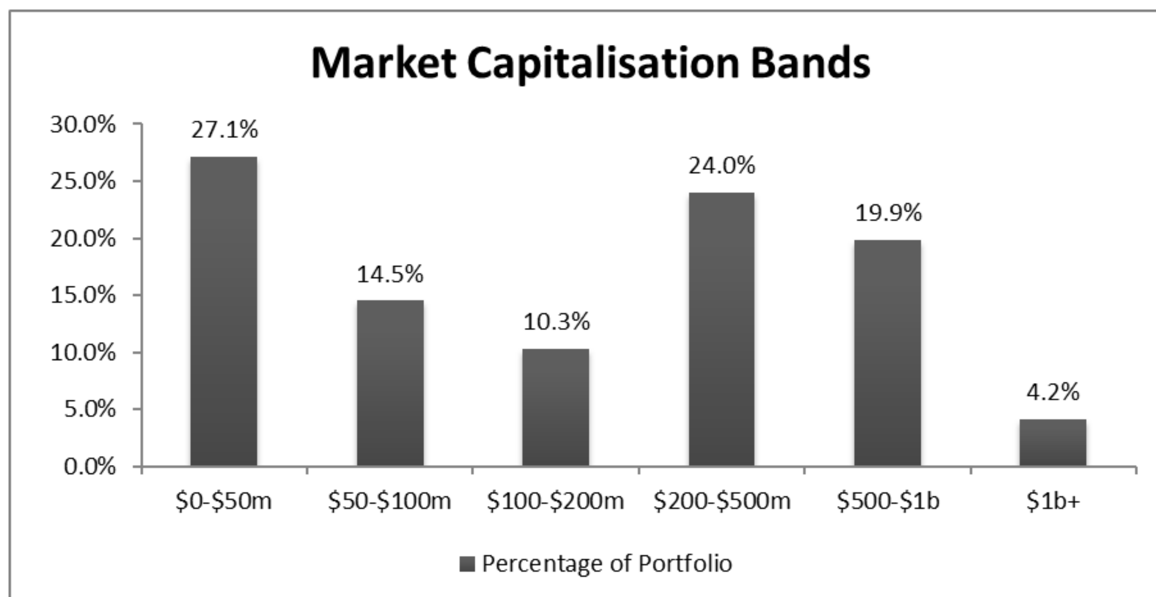
We continue to work with JANA and further updates will be made when able. Prospective managers and qualified investors as always, are invited to contact Brad (brad.hughes@thezfc.com.au) or myself. Brad will contact prospective managers when material information is able to be provided.

Key Portfolio Information: -

Our top 10 holdings on 28 February 2023 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	Smartpay (SMP.ASX)	12.9%	12.1%
2	United Overseas Australia (UOS.ASX)	12.8%	12.0%
3	Cettire (CTT.ASX)	7.1%	6.6%
4	Shriro Holdings (SHM.ASX)	7.0%	6.6%
5	Tellus (unlisted)	6.2%	5.8%
6	SRG Global (SRG.ASX)	4.9%	4.5%
7	Matrix Composites (MCE.ASX)	4.8%	4.5%
8	Blackwall Limited (BWF.ASX)	4.6%	4.3%
9	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding & PPKME	4.4%	4.1%
10	Dicker Data (DDR.ASX)	4.3%	4.0%

Our largest 5 holdings comprise 46.1% of our invested capital, our top 10 holdings are 69.2% and our top 15 represent 86%. Cash and cash equivalents are 6% of the portfolio. The median market capitalisation is $185.5m. Weighted average market capitalisation is $319m.



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]**	**-0.16**
Additional investments	**Fund Closed**	**Sortino Ratio[1]**	**0.07**
Applications/redemptions	**Redemptions only, monthly**	**Annualised Standard Dev. – EGP** **Annualised S/D - Benchmark**	**18.9%** **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**	**56.7%** **64.2%**
Auditor	**Ernst & Young**	**Cumulative return[2] – EGP** **Cumulative return[2] – Benchmark**	**4.0%** **57.2%**
Custodian/PB	**NAB Asset Services**	**1-year return[2] – EGP** **1-year return – Benchmark**	**(9.5%)** **7.2%**
Responsible Entity	**Fundhost Limited**	**3-year annualised return[2] – EGP** **3-year annualised – Benchmark**	**(8.4%)** **5.1%**
Fund Size	**$46m**	**5-year annualised return[2] – EGP** **5-year annualised – Benchmark**	**(1.1%)** **8.0%**
Mid-Price for EGPCVF Units **Accumulated Franking per Unit**	**$0.8212** **$0.0039**	**Buy Price for EGPCVF Units** **Sell Price for EGPCVF Units**	**$0.8224** **$0.8200**

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: