EGP Concentrated Value Fund

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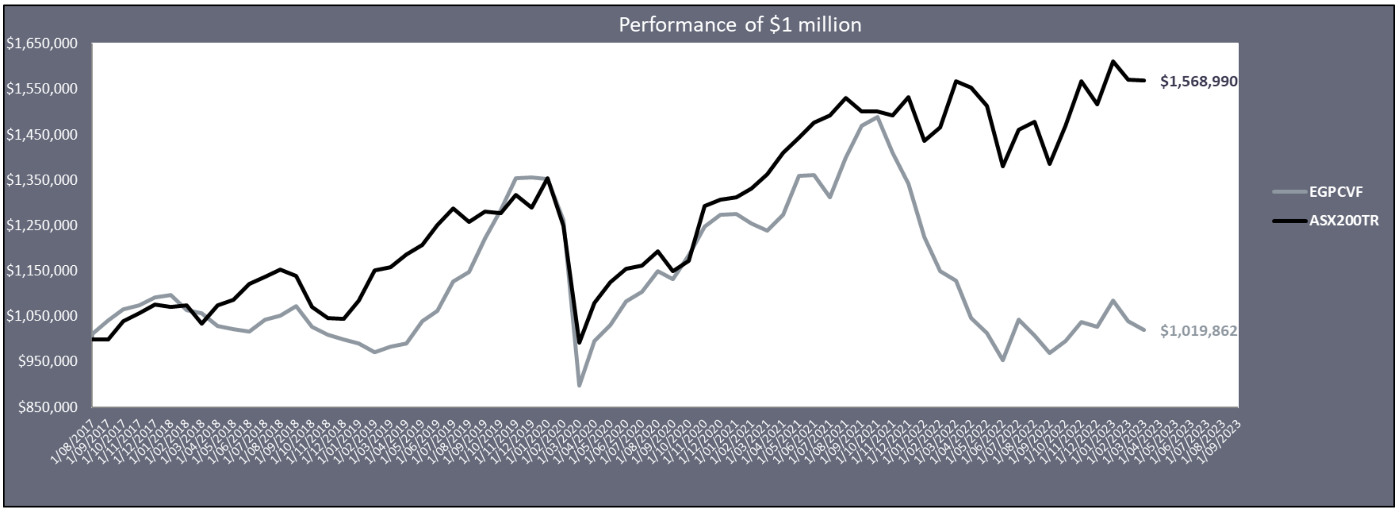
EGP Concentrated Value Fund – 31 March 2023

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%)	(2.0%)				7.03%
Benchmark FY23	5.8%	1.2%	(6.2%)	6.0%	6.6%	(3.2%)	6.2%	(2.4%)	(0.2%)				13.33%

*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 (1.95%) in March. Our benchmark fell (0.2%). It was once again a month of two halves, where we were doing much better than the market early in the month as it was falling sharply, but in the end when a series of consecutive rallies happened to leave the month much better than it looked like it was going to be for the benchmark, while many of our investee businesses failed to join in with the market bounce. April has started off with a bang with the fund up quite a bit driven by some exciting announcements we will discuss in next month's newsletter.

I stand by my reasoning for doing so (it is the best index in the country) but would now describe my decision to benchmark against the ASX200, rather than the Small Ordinaries, or the Emerging Companies (Microcaps) index as the biggest mistake of my professional career. The Small Ordinaries is down about 21.4% from its highs, and the Emerging Companies index is down about 24.5%. Over the same period, the ASX200TR (our benchmark) has risen 4.5%. The choice of benchmark would not have improved our results (which are ultimately all that matter) but would at least have given the very poor stretch we have traversed the past 18 months some much needed context given that our equity exposures are exclusively in these microcap businesses.

Consequently, the valuations of companies in the microcap and small-cap space are better than they have been at any time in the history of EGPCVF, which is interesting because the valuations across the ASX200 for example do not look meaningfully better than they have been at various times over the same period (a 29% divergence in the indexes will do that!).

The splay in valuations between the very large and the very small end of the market is highly anomalous and unless the market has permanently changed, some sort of mean reversion, which should result in significant outperformance of microcaps over their large cap peers must result at some stage. This is of course no guarantee that sentiment in the sector will change anytime soon, but unless "this time it's different", and it almost never is, something has to give. Eventually.

There were very few significant operational updates from our investee businesses in March. The most significant was an announcement from Shriro (SHM) that they would be exiting their kitchen appliances business. The company was at pains to point out that the division was loss-making and that exiting the business would liberate about $12m of cash from working capital, but investors still sold the stock down on the announcement. A few days after the announcement, they said they had received an offer for the business, which would simplify and accelerate the exit.

The negative reaction is understandable, distribution is a volume business, and even if it was loss-making, the $37m of revenue in the segment gives bargaining power when it comes time to negotiate with freight providers and the like, where forcing a few dollars off the price of shifting each parcel/pallet is much easier to do if you are moving a lot of stock. I am hopeful that this exit is a precursor to expanding the business in one of their better performing segments, but the search for expansion opportunities has been a largely fruitless one for SHM in recent years.

Portfolio Update: -

The microcap market is presently in what I would describe as an uncommonly "needy" state. Investors are looking for constant reassurance that underlying business conditions are not suddenly deteriorating. This is in stark contrast to the market a couple of years ago, where once a few good announcements had been made, the assumption was that conditions would remain good (or even improve). A solid example of this phenomenon in March was in our largest holding Smartpay (SMP), which at one stage was down as much as 18% for the month, despite (or more likely ***because*** of) the fact they have not released any trading information to the ASX since mid-January.

When I last wrote about SMP in any length, I posited that for the shares to be overpriced, the cadence of their terminal deployment program would need to fall back below 1000 per quarter (from 1950 in the most recent quarter). With the share price falls since then, for the current price to be justified, they would probably need to produce a number lower than that, perhaps below the ~900 they were deploying even in Covid lockdown affected quarters.

I find this prospect exceedingly unlikely, and although I generally abhor short-term market predictions, if the trading update due from SMP this month reveals they deployed >1580 terminals (the average of the past three quarters), I will be shocked if the share price does not rally sharply. The only caveat to that would be if they announced some other trading issue impacting the profitability of that growth. Given SMP is positively exposed to inflation, it is hard to imagine what that might be, for every challenge in terms of employee costs and advertising expense that inflation could bring, it would bring an even greater force on terminal revenue, more than offsetting any negative impacts.

Another large holding, SRG Limited (SRG) suffered similar falls early in the month (down as much as 14% intra-month) before a couple of modest (~$50m each – small in the context of a business with over $1.5b of work in hand) contracts were announced in the back half of the month, soothing the market nervousness, and resulting in the share price closing only modestly down on the month.

This level of skittishness, this "shoot first and then wait to see if there's something to ask questions about" attitude in the microcap sector is generally indicative of a breadth of good buying opportunities as implied by the valuation divergence described in the segment above this one.

I mentioned in last month's report that United Overseas Australia (UOS) would be the primary subject of this month's report. 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 first stage of the Ipoh 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.

To outline the enormity of the achievements of UOS through the Covid disruptions, it is probably helpful to most readers to see some key data in a tabular format:

Quarter	Unbilled Sales	Other Income	Cash Holding	Inventories
September – 2019	RM1,050m	RM82.3m	RM811.5m	RM2,053.4m
December – 2019	RM990m	RM70.4m	RM943.4m	RM2,045.5m
March - 2020	RM641m	RM58.8m	RM979.5m	RM2,026.1m
June – 2020	RM578m	RM37.3m	RM1,098m	RM2,015.5m
September – 2020	RM402.2m	RM47.5m	RM1,191.3m	RM2,036.7m
December – 2020	RM383.6m	RM47.3m	RM1,760.6m	RM1,962.5m
March – 2021	RM225m	RM38.6m	RM1,864.9m	RM1,970.1m
June – 2021	RM101.3m	RM38.9m	RM1,934m	RM1,947.8m
September – 2021	RM134.1m	RM39.5m	RM1,939.1m	RM1,939.6m
December – 2021	RM92.5m	RM46.9m	RM1,794.3m	RM1,907.4m
March – 2022	RM122.9m	RM51.1m	RM1,796.2m	RM1,924.4m
June – 2022	RM123.9m	RM53.3m	RM1,867.4m	RM1,920.6m
September – 2022	RM181.1m	RM68.9m	RM2,042.4m	RM1,868.8m
December – 2022	RM203.4m	RM74.1m	RM2,163.4m	RM1,843.6m

September 2019 was not chosen as a starting point for the table for any special reason, it was just a period a little before Covid policy madness swept the world. It is also around the time the quarterly "Other Income" peaked. Other income comprises the "recurring" incomes of the group, rental, parking, cleaning, security services and the like. The collapse in these revenues through Covid reminds us that even very secure revenues can disappear if circumstances are sufficiently difficult. The yellow highlighted section of the "Other Income" column shows the bottoming out of this revenue stream. That came the quarter after the disposal of a major building, which caused the highlighted jump in the "cash holding" column. Cash holdings have risen relentlessly over the tabled period as the unbilled sales (and some inventories) were progressively turned into cash and less development meant their need to consume cash was largely eliminated.

The "Other Income" will likely reach new all-time highs in 2023, which is remarkable given the hollowing out of these earnings caused by the disposal of the UOA Tower at Bangsar South in late 2020. It shows what a remarkably well (and conservatively) managed business this is. The earnings provided by the other income more than cover all the operating costs of the business and mean that even if the property development business was not profitable (it is VERY profitable), the business would still make money. This is not the type of property developer we are used to hearing about, this is a business managed with an incredible conservatism and a multi-decade lens.

The company now has an absolute mountain of cash that means no matter what conditions are like, they will be under no financial pressure as they rebuild their pipeline now that the Kuala Lumpur property market has digested the glut of properties completed in recent years. This is in stark contrast to most of their Malaysian listed competitors, many who have mountains of debt, which will put their businesses under immense pressure as the terms roll off and the debt must be refinanced in this new higher-interest world. As an aside, that mountain of cash will now become a substantial earnings tailwind as interest rates rise.

The "Unbilled Sales" figures peaked at around RM1.7b in 2018 alongside the operational decision to put the brakes on major development as the Kuala Lumpur property market digested the aforementioned oversupply of both residential and office properties. The arrival of Covid accelerated this runoff, with the bottom in at December 2021 when the figure had fallen to only RM92.5m. This figure has risen in each of the four subsequent quarters as the progressive launch of new projects has begun to augment the unbilled sales. If the uptake of the major project at Jalan Ipoh is strong, you can expect that figure to rise sharply for the next few years.

As mentioned, unfortunately this outstanding operational performance is marred by the complete disinterest management show in having their stock trade anywhere near the stated value of their assets. Management does their own reputations an enormous disservice by behaving in this way, but after years of telling them the many ways they could exploit this opportunity to the advantage of all UOS stakeholders, I have accepted that their behaviour is unlikely to change. We just need to accept that they will extract full value from the assets at a time of their choosing.

UOS trades presently at very close to 50 cents per dollar of balance sheet value. As I have said many times previously, the NTA is grossly understated for reasons including, but not limited to – a massive landbank held at historic cost, conservative carrying values in the investment properties and the massive inventory held at cost, which has historically been realised at margins meaningfully higher than those earned by the development business. I estimate in an orderly liquidation, the assets could realise as much as a 30% premium to carrying value.

The difficulty as a fund manager is that the patience of my unitholders is a factor that must be considered when thinking about UOS as an investment. Even though the operational performance of the business has been magnificent, the shares trade at around the same level they did 6 years ago, with a modest annual dividend payment all we have had to show for this excellent operational performance. The progressive widening of the trading discount between share price and NTA has hidden the rest of the performance.

For an individual these pressures do not exist, you can just put the shares "in the bottom drawer" solid in the knowledge that if the future looks remotely like the past, at some point, you will do very well out of owning UOS. If I cannot get management to wake up to the importance of fulfilling their fiduciary duties, the "bottom drawer" will not be an option and we will need to find some other way to realise a fairer valuation.

The ZFC update: -

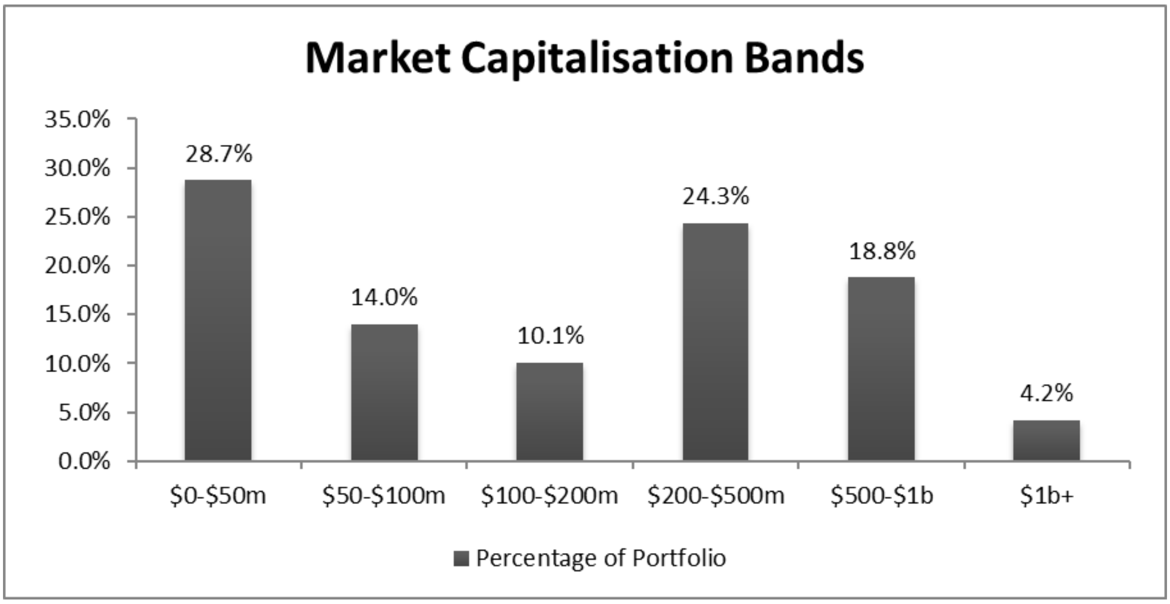
We continue to work with JANA and further updates will be made when able. Prospective managers and qualified investors as always, are invited to contact Brad (brad.hughes@thezfc.com.au) or myself. Brad will contact prospective managers when material information is able to be provided.

Key Portfolio Information: -

Our top 10 holdings on 31 March 2023 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	Smartpay (SMP.ASX)	12.8%	12.1%
2	United Overseas Australia (UOS.ASX)	12.8%	12.1%
3	Cettire (CTT.ASX)	6.6%	6.2%
4	Shriro Holdings (SHM.ASX)	6.5%	6.1%
5	Tellus (unlisted)	5.9%	5.6%
6	SRG Global (SRG.ASX)	5.0%	4.7%
7	Matrix Composites (MCE.ASX)	4.8%	4.5%
8	Blackwall Limited (BWF.ASX)	4.4%	4.2%
9	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding & PPKME	4.3%	4.1%
10	Dicker Data (DDR.ASX)	4.2%	3.9%

Our largest 5 holdings comprise 44.7% of our invested capital, our top 10 holdings are 67.4% and our top 15 represent 85.4%. Cash and cash equivalents are 5.6% of the portfolio. The median market capitalisation is $167.5m. Weighted average market capitalisation is $307m.



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]	0.03
Applications/redemptions	Redemptions only, monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	18.7% 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	55.9% 63.2%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	2.0% 56.9%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	(9.6%) 0.1%
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	4.4% 16.5%
Fund Size	$44m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	(0.7%) 8.7%
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.8052 $0.0054	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.8064 $0.8040

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: