EGP Concentrated Value Fund

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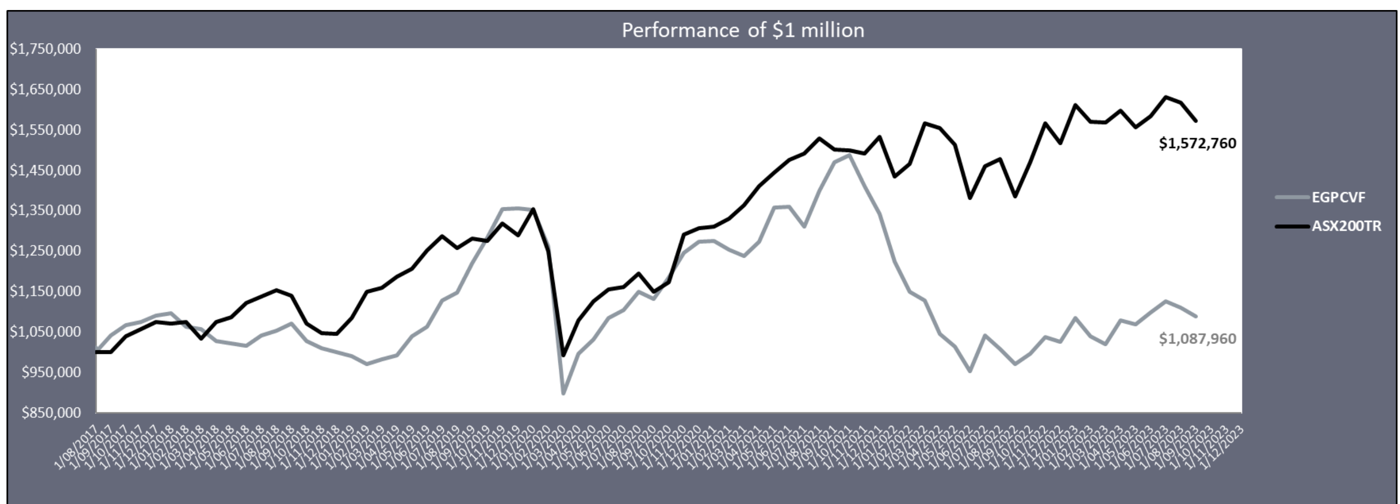
EGP Concentrated Value Fund – 30 September 2023

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%)	5.7%	(0.9%)	2.7%	15.21%
Benchmark FY23	5.8%	1.2%	(6.2%)	6.0%	6.6%	(3.2%)	6.2%	(2.4%)	(0.2%)	1.9%	(2.5%)	1.7%	14.78%
EGPCVF FY24	2.6%	(1.5%)	(2.0%)										(0.90%)
Benchmark FY24	2.9%	(0.7%)	(2.8%)										(0.77%)

*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 (1.98%) in September. Our benchmark fell (2.84%).

We made the decision to continue with Fundhost as our administrative backbone as we work to re-open the fund. Part of the drive for re-opening was my view that the small and micro capitalisation markets are as dislocated as I have ever seen them and the opportunities for outsized performance are therefore likely to be very good over the next few years.

This month has shown how difficult such broad views can be to make, with the small cap index falling 4.0%, much worse than the ASX200TR we use, which fell "only" 2.8%. The small index has somehow meaningfully underperformed the larger indices in the first quarter of FY2024.

There were however signs of support for the thesis within the portfolio. National Tyre (NTD) made an important announcement which I discuss further below and although it did not get the full reaction that the news warranted, the fact that it was well received is more than we have seen for the past couple of years, I discuss NTD further below. Stealth Group (SGI) has also seen creeping share price growth despite nothing announceable to drive the reaction and Shriro (SHM) held up well post their large dividend as they followed up with the details of their capital return. Respectable performance from these positions were not enough to compensate for the weakness in the remainder of the portfolio.

Portfolio Update: -

I intended to write about SDI Limited (SDI) in last month's report. However, the report was already 9 pages long after writing about some of the other things I thought would interest readers. I try to walk the line between a detailed, interesting newsletter and something so long it is unlikely to be read by all but the most committed unitholders…

The investor updates from SDI in August had some important details that help us to think about what the business is likely to look like in the next few years. And that is what market participants are pricing in (theoretically all cashflow between now and the end of time, but in practical terms, the next 3-5 years).

The SDI investor update (.pdf) included the following slide:

UPDATE ON NEW WAREHOUSE FACILITY

The new site will bring increased production efficiencies when we are due to relocate warehousing in September 2023

Planning is currently underway for the redevelopment of the new site and relocation by FY 2027

Included in the project cost is the acquisition of new machinery, expected to drive production capacity and efficiency

Estimated total Project cost of $60m with an expected total ROI (EBT/Rev) of greater than 20%

- Land and buildings $45m
- Plant and equipment $15m

Modern scalable manufacturing site that will deliver:

- Production efficiencies to further scale future volumes and enhance margins (highly automated facility)
- Risk mitigation and enhanced control over end-to-end supply chain and
- Labour productivity and improvement
- Commitment to sustainability
- Material waste reduction

This slide tells you the business expects to generate ~$12m of additional EBIT from the move to a new warehouse and manufacturing facility. The business in FY2023 generated EBIT of ~$12m, so they are telling you they expect the earnings of the business to roughly double over the next 4 years. That assumes they are excluding any natural growth in earnings over those 4 years.

SDI management have indicated the current manufacturing/warehousing footprint can at most deal with $140m of revenues. They generated $108m in FY2023 and have grown that figure metronomically from $50.5m over the past 15 years (>$5% CAGR), that translated through to ~7% annual growth in NPAT over the same stretch (~1.4x operating leverage). Conversations with management have revealed their expectation that the new facility as conceived will allow the business to get to ~$200m revenue before any further expansion is required.

SDI currently has a ~$113m enterprise valuation (EV), meaning it trades on about 9.4x EV/EBIT multiple, which is on the low side for a business with such a long and relatively steady history of profitable growth. If the business is successful in doubling EBIT over the next few years, a fairer multiple for the business is probably 11-13x EV/EBIT. This implies the valuation in 4 years' time should be in the range of $264m-$312m if they are successful in growing EBIT to $24m by FY2027. This is ample prospective upside to justify the large weighting we have to SDI in our portfolio.

The questions we need to ask ourselves are two. Firstly, how confident are we that management will achieve the $24m EBIT figure? This is I suspect the easier of the two questions, there are known inefficiencies in the current manufacturing operation, the $24m EBIT would require little more than maintaining the current revenue trajectory and harvesting the significant increase in gross margin the move will enable. With that said, construction budgets have a way of running long and over cost, but management seem remarkably assured about both costs and timelines. I suspect the estimates on the slide above allow ample time and cost slack.

The second question is how SDI will fund this growth? The mid-point of the prospective EV range posited above is $288m and implies 1.55x upside for the EV, which implies a 26.4% growth annually in EV if the EBIT growth is achieved in 4 years as implied by the presentation. Depending on what the mix of debt and equity employed in the growth plans chosen will impact the equity performance.

We assume that the entirety of $60m must be funded. This is aggressive because some of the expenditure has already begun and the business spent $4.8m on Plant in FY23 and some of the $15m set aside for Plant in the $60m budget will presumably come from CAPEX they would have undertaken in the normal course of business. Furthermore, management have indicated that the sale of the existing properties, which exist across multiple titles can be done sequentially as the various properties are vacated, will generate cash in the ballpark of $18-20m.

The prior paragraph to my way of thinking probably implies SDI need to fund perhaps $35m of land/building/PPE over and above their ordinary capital needs in the next 4 years. If we further assume their EBIT grows approximately sequentially (it will likely be more back-ended than this), then EBIT would be roughly as follows:

- FY2024 = $15m
- FY2025 = $18m
- FY2026 = $21m; &
- FY2027 = $24m

How these figures translate into NPAT will depend significantly on how much debt is employed and at what price. The current net-debt is ~$18m. Interest expense for the June half was $528k, or $1.06m annualised. The imputed interest rate is <6% on the debt currently utilised. If the debt-load doubled sequentially (+$18m, or approximately half of the $35m required from the previous paragraph) over the 4-years above, and interest was 7.5% on the balance, it would imply an interest expense growing from $1.7m in FY24 to $2.7m in FY27, the EBIT posited above would become NPAT (assuming a 30% tax rate) of:

- FY2024 = ~$9.3m
- FY2025 = ~$11.2m
- FY2026 = ~$13m; &
- FY2027 = ~$14.9m

The business assuming sequential growth into its FY2027 EBIT target should generate something in the order of $48.4m of after-tax profits over this period. SDI in FY2023 paid a 3.25c per share dividend on approximately 6c per share of earnings. If it were to maintain a policy of ~50% dividend payments, there would be >$24m of earnings retained over the next 4 years, which should be close to enough to fund the additional required capital, particularly if the improved efficiency of the new facility allows SDI management to grow working capital needs more slowly than revenues.

Timing is an important consideration, but the point of the foregoing passages is to demonstrate that it is possible with only a modest increase in debt to make the proposed move without the need for additional equity. $36m of net debt is eminently serviceable by a company with such significant property holdings against which the debt can be secured, particularly if it were backed by $24m of operating EBIT. If the business were able to get to FY2027 as described above, with net debt of $36m, the implied equity value from the $288m EV midpoint inferred earlier is $252m. To get from

the current equity valuation of ~$95m to $252m in only 4 years would result in a heroic annualised capital return of >27% with any dividend payments received additive to that figure.

The business, however, will almost certainly not want to "tippy-toe" quite such a debt and equity tightrope to fund these plans. History indicates SDI is backed by a prudent and conservative board and management, and they will almost certainly derisk the manufacturing transition by raising equity at some point. The very significant ownership by the founder and chairman will provide protection against too much dilution at too low a price.

Considering the funding pathway set out above, in my view, the most equitable and prudent way for SDI to ensure the balance sheet remains comfortably positioned over the next 4 years is probably to turn on the dividend reinvestment plan (DRP) to fund any additional capital the business need, this enables existing shareholders to participate proportionally in providing the required capital to ensure they avoid dilution and means management need not obsess over the share price and the most optimal/equitable time and price to raise equity.

If management have a clear view on the equity they will require over the next 4 years to complete the new factory with an appropriate level of breathing room, then they could have the DRP underwritten. Say they decided to augment the balance sheet with $16m of fresh equity over the next 4 years, the next 8 dividends (interim and final) could be underwritten to the tune of $2m each.

Irrespective, even if the business were to meaningfully under-achieve their FY2027 earnings expectations, or to dilute us significantly along the way to fund the build, there is a sufficiently strong return on offer that we would still expect to do well from SDI out of anything but a dental economic winter.

National Tyre (NTD) made the announcement (.pdf) that they had won the distribution for the Dunlop brand from Goodyear as they choose to withdraw from the Australian tyre distribution market. Initially up about 30%, the stock closed the month down from those highs, but still well up for the month.

The initial reaction might appear over-done, but distribution is a scale business and the Dunlop revenues of $118m if they were all to stick would represent a roughly 20% uplift on FY2023 sales. If margins are remotely similar and the additional cost impost is meaningfully less than 20%, the outworking of that should be well more than a 20% uplift in profitability. The additive profitability was far from the most positive element of the announcement. The withdrawal of Goodyear from the Australian tyre distribution scene leaves NTD in the box seat when it comes to retaining the Coopers distribution, which has weighed heavily on investors' minds.

The transaction also supports the frenzied acquisition spree NTD undertook in recent years as the footprint they have established leaves them as the obvious first contact for a brand owner wanting to easily access a comprehensive Australian tyre distribution footprint.

For investors the trouble is that the industry has proven itself to be a difficult one to predict the earnings for, with earnings whipsawing wildly about, consider:

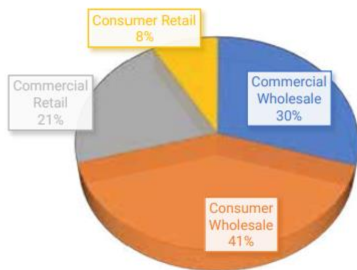
	FY2020	FY2021	FY2022	FY2023
Revenue	$158.9m	$461.5m	$555.5m	$582.3m
NPATA	$5.7m	$21.1m	$15.5m	$8.0m
NPATA margin	3.6%	4.6%	2.8%	1.4%

Despite the revenues being highly predictable, various operating factors, most over which management have scant control whipsaw various cost elements around to leave the final NPATA margin extremely hard to predict. The AU$, oil prices, shipping and other logistics costs have all moved around capriciously in the past few years. A confluence of "good" movements in FY2021 meant the business probably slightly "over-earned" in that year, but the back half of FY2022 and most of FY2023 saw incredible headwinds which seem to have passed.

With the AU$ having been persistently low and shipping/logistic prices almost back to pre-covid levels, the only significant factor impacting costs for FY2024 will be oil prices which are a significant contributor to tyre prices. As set out in last month's newsletter, our expectations were for $11-15m NPATA in FY2024, with a skew to the high side of that as the second half was so much better than the first and management indicated it improved sequentially through the year, implying the exit run-rate earnings were better than the half.

The Dunlop revenues will commence mostly in the second half of FY24 and according to the announcement are expected to add to earnings from Q4FY24 onwards. We need to look out at what FY25, the first full year of the Dunlop contribution might look like.

I spoke with CEO Peter Ludemann this month and he indicated the wholesale margins on the Dunlop arrangement will be broadly like the wholesale margins of the remainder of the business and that the Dunlop distribution would be run for profitability, not for revenues. He also said given the existing footprint, the cost impost required to service the Dunlop revenues should be modest.



Unfortunately, the reports segment geographically and the only guide we have to the wholesale/retail split is from the graphic embedded to the left of this text. This indicates the FY23 wholesale retail revenue split was 71%/29%.

I have seen a broker report for NTD this month positing the wholesale margin for the Dunlop distribution as being likely to be about 25%. This approximates my attempts to reverse engineer the wholesale and retail margins (I estimated 26% and 36%). If we assume there is a 10% revenue cannibalisation, the remaining $106m of revenue would add about $26.5m of gross profit. It would surprise me if there were more than $12m of new costs required in the business to service this additional grow profit, meaning the Dunlop deal should add about $15m to NTD's EBIT.

Barring any acquisitions in the meantime, FY2025 will be clear of the various ERP implementations, redundancies and warehouse consolidations that have muddied results (-$2.4m in FY23 & -$4.4m in FY22). The business should generate somewhere close to $700m in revenues and EBIT in the ballpark of $42-46m. The question then is at what price is it realistic for us to expect the market to price these earnings at.

$44m of EBIT would translate into a little over $24m of NPATA. Because of the historic earnings roller-coaster, market participants would be unlikely to pay much more than 8-10x NPATA for NTD. That low multiple would likely grow if a track record of a few years of more stable earnings is delivered. The midpoint, or 9x NPATA would deliver a market capitalisation of ~$220m. This compares to the market capitalisation of just under $110m at the time of writing. A doubling of equity valuations over 2 years equates to >41% annualised. If that is remotely realistic, we are significantly underweight NTD.

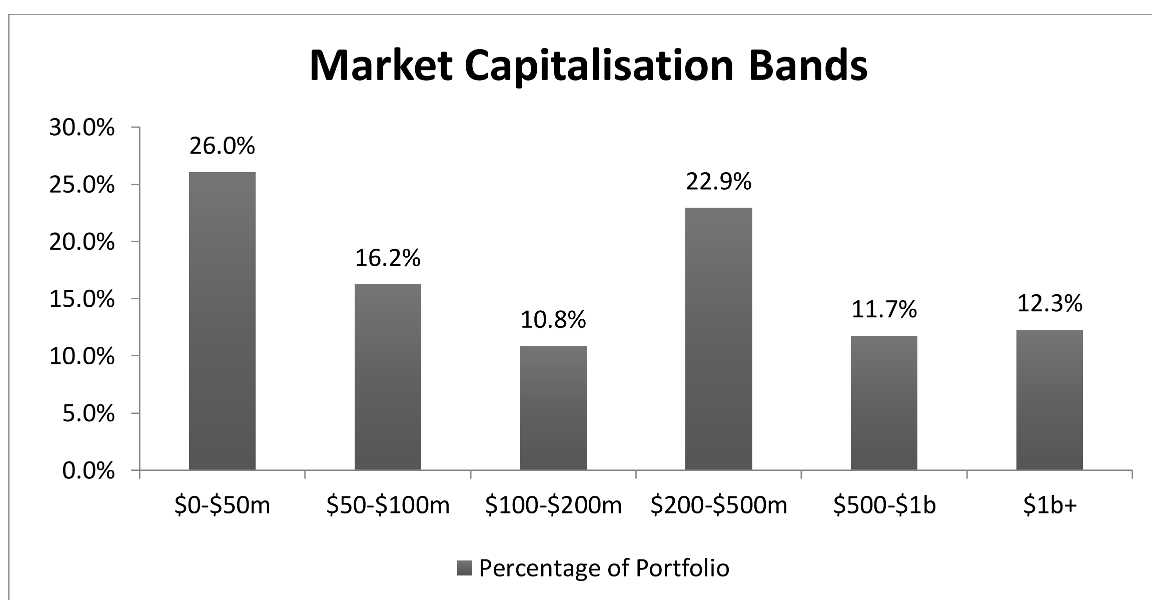
The foregoing assumptions do not feel overly "hairy-chested", $24m NPATA is a 3.4% NPATA contribution on $700m revenue, which is comfortably below the levels achieved in FY20 & FY21 despite the significant increase in scale. 9x NPATA is not an aggressive multiple, the outworking of that would be about a 5.7x EV/EBIT multiple, which is low given the earnings are likely to be far more stable in the forward 3 or 4 years than they have been in the previous few given the newly broadened composition of the businesses revenue base.

Key Portfolio Information: -

Our top 10 holdings on 30 September 2023 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	Smartpay (SMP.ASX)	11.7%	11.3%
2	United Overseas Australia (UOS.ASX)	11.7%	11.3%
3	Shriro Holdings (SHM.ASX)	7.4%	7.1%
4	Tellus (unlisted)	7.3%	7.1%
5	Cettire (CTT.ASX)	6.5%	6.3%
6	Dicker Data (DDR.ASX)	5.7%	5.6%
7	SDI Limited (SDI.ASX)	4.7%	4.6%
8	Blackwall Limited (BWF.ASX)	4.5%	4.4%
9	National Tyre (NTD.ASX)	4.3%	4.2%
10	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding & PPKME	4.2%	4.1%

Our largest 5 holdings comprise 44.6% of our invested capital, our top 10 holdings are 68.1% and our top 15 represent 85.4%. Cash and cash equivalents are 3% of the portfolio. The median market capitalisation is $171m. Weighted average market capitalisation is $378m.



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]**	**0.14**
Applications/redemptions	**Redemptions only, monthly**	**Annualised Standard Dev. – EGP** **Annualised S/D - Benchmark**	**18.3%** **15.1%**
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**	**55.4%** **62.2%**
Auditor	**Ernst & Young**	**Cumulative return[2] – EGP** **Cumulative return[2] – Benchmark**	**8.8%** **57.3%**
Custodian/PB	**NAB Asset Services**	**1-year return[2] – EGP** **1-year return – Benchmark**	**12.2%** **13.5%**
Responsible Entity	**Fundhost Limited**	**3-year annualised return[2] – EGP** **3-year annualised – Benchmark**	**(1.3%)** **11.0%**
Fund Size	**$37m**	**5-year annualised return[2] – EGP** **5-year annualised – Benchmark**	**0.3%** **6.7%**
Mid-Price for EGPCVF Units **Accumulated Franking per Unit**	**$0.8375** **$0.0029**	**Buy Price for EGPCVF Units** **Sell Price for EGPCVF Units**	**$0.8388** **$0.8363**

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: