EGP Concentrated Value Fund

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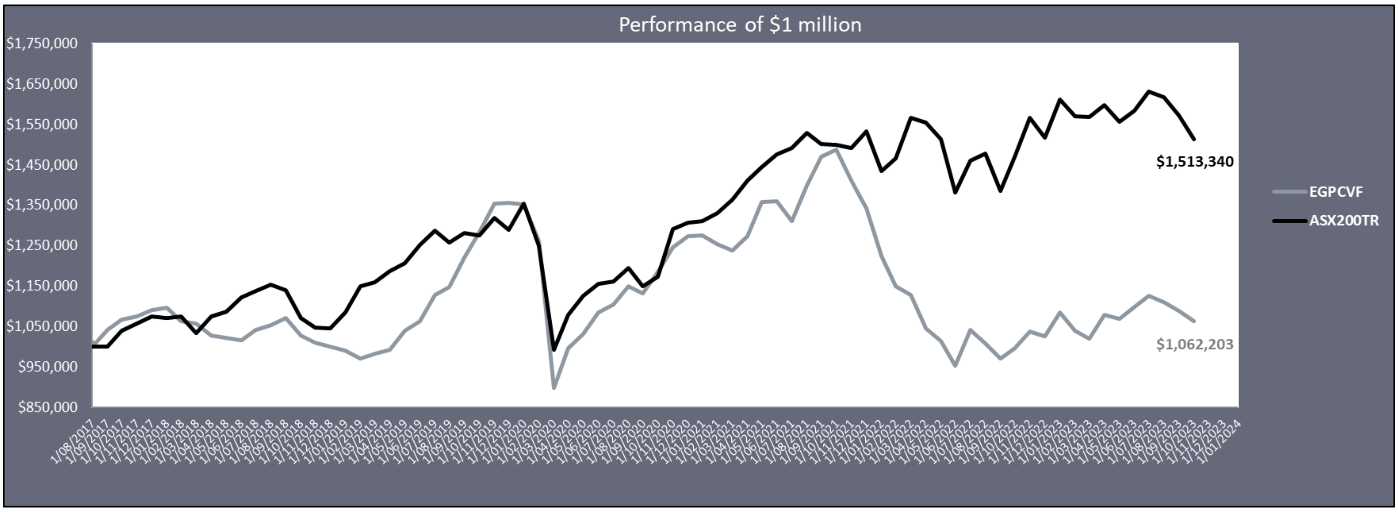
EGP Concentrated Value Fund – 31 October 2023

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%)	(2.4%)									(3.24%)
Benchmark FY24	2.9%	(0.7%)	(2.8%)	(3.8%)									(4.52%)

*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 (2.37%) in October. Our benchmark fell (3.78%).

The primary driver poor the poor recent performance of share markets globally seems to be the growing acceptance that persistently high inflation will require a longer period of elevated interest rates to bring under control.

My prediction in the June report that the sharp recent underperformance of small cap equities should give them a significant likelihood of outperforming in FY2024 and beyond has shown the difficulty of making such predictions! The Small Ordinaries is now down 7.3% in FY2024, a good deal worse than the 4.5% for the ASX200. I heard one fund manager this month describe finding value in the small cap space as "like shooting fish in a barrel", I would never use such a hubristic statement, but the disparity between the valuations for large and small cap equities in Australia is the widest I have ever seen it. The opportunity set looks very attractive.

The primary hurt for the portfolio came from our large positions in Smartpay (SMP, -15%) and Cettire (CTT -12%), which had been responsible in large part for fund outperformance leading into the end of FY2023 but have subsequently drifted from market favour.

I have written previously about the skittish nature of the market at present and the decision by SMP to eliminate their quarterly terminal deployment updates is likely a contributor to the recent share price weakness, as it has investors looking elsewhere for guidance. To wit, the investor day presentation by Tyro is what really seemed to scare SMP investors (Tyro was down nearly 40% in October) this month. The reaction is interesting because to some people a poorly performing key competitor could be viewed as a positive. To be fair, SMP and Tyro are not competing entirely head-to-head, growth for both continues to come from eating the Big 4 banks lunch. Long may these financial behemoths continue to treat the customers SMP delights with disdain.

But if conditions have grown harder for Tyro, they are likely to be harder for SMP also. We will get a read on recent performance this month when SMP publish their half year report, I expect the recent metronomic growth will largely hold, even if it were to moderate somewhat from FY2023 levels, the valuation is still attractive based on the Australian opportunity alone and if the NZ opportunity is even moderately successful, the returns from here will be mouth-watering.

SRG Global defied my expectation that they would lift guidance at the AGM, but they confirmed their +20% EBITDA guidance, which if delivered will leave the current valuation incredibly inexpensive, market participants are clearly of the view that the inflation monster is going to eat SRG margins, but management continue to sound confident it will not be so… I should comment on the fact I voted our holding against the proposed performance rights package for CEO David McGeorge. I consider him one of the best CEO's in his sector on the ASX, but the remuneration he has continually extracted from his board of directors over a period spanning years is out of control. He has consistently earned more than CEO's of businesses in the same sector multiples of SRG's size. Monadelphous is probably the gold standard in the sector and almost 5x SRG's size, but they have paid their CEO less over the past few years than SRG has paid Mr. McGeorge. Good performance should be rewarded, but the rewards must be tethered to economic reality.

The remainder of the portfolio largely followed the market, save for National Tyre (NTD), which was up almost 10% on the month as more investors become convinced FY2023 was the bottom of their cycle and in the same way the Tyres4U acquisition accelerated earnings to new records when the cycle last turned, the addition of the Dunlop distributorship should see a much better FY2024 left in the dust by a truly outstanding FY2025.

Portfolio Update: -

There were a handful of notable announcements in October, I will attempt to touch on the more interesting ones in this section.

The first notable announcement (.PDF) for the portfolio holdings came from Redbubble (RBL). The cost cutting, which we argued in the August report (.PDF) still leaves the company costs bloated relative to the revenue level and operational complexity has begun producing more noticeable results. In what is traditionally either the weakest or second weakest quarter of the year, modest positive cashflow was delivered, compared with the $17.6m cash outflow in the same quarter last year.

The initial spike in valuation only returned the share price to levels seen in July, the critical Cyber Monday/Black Friday/Christmas trading in the December quarter are what market participants will use to determine whether the company has "crossed the chasm" and can resume its growth trajectory without the need for external equity capital. This quarterly result seems to leave that possibility likelier than not. Our August write-up estimated a ~6% fall in revenues for FY24 would be the outworking of the increased focus on effective spending and GPAPA margin, this thinking held in the September quarter as revenues indeed fell 6% (although the falls were greater than that on a constant currency basis). Whether dialling back paid acquisition will hurt more than this in the December quarter is the "known unknown" that must be addressed to see investors return to RBL and have the valuation more closely resemble my view of fair value.

Next cab off the rank for an announcement that made market participants review their thoughts was PPK Holdings (PPK) which announced they had reduced their selling price for Boron Nitride Nanotubes (BNNT) to $150k per kilogram (.PDF) as compared to their nearest competitors pricing of $400k per kilogram. When PPK first began producing BNNT, the pricing was $1m per kilogram, meaning they have single-handedly driven the selling price down about 85% in a few short years.

The share price fillip triggered by this announcement struck your correspondent as curious. PPK has been the lowest cost producer of the highest quality BNNT available globally since they began producing commercial quantities. The problem has never been one of price, rather one of an end market of sufficient size failing to materialise despite the continuing price falls. Inevitably, as pricing continues to decline, the type and range of potential uses broadens, but the development of a truly commercial market for BNNT has taken much longer to arrive that I had thought likely once commercially viable production was proven.

The enormous potential of the addressable market for both BNNT and BNNS (White Graphene) remains, in the meantime, the two profitable divisions within PPK (Craig Ballistics and Power Plus Energy) ensure the company has no need of external funding whilst they attempt to exploit the various commercial possibilities, which I remain convinced leave PPK at this valuation embodies the characteristics value investors spend their time scouring equity markets for, that of "Heads I win big, tails I don't lose much". It is certainly difficult to dimension meaningful downside from here.

Cettire (CTT) was the next portfolio holding to make an October announcement (.PDF) that we thought in the pre-market was likely trigger a meaningful move in the share price. There was something in the announcement for everyone. For the "bulls", the 92% growth in sales revenue was unreasonably strong given general global economic malaise and the universally weak revenue performance from global luxury purveyors reporting the same quarter results. For "bears", the compression in Q1 EBITDA margin from 8.3% in FY23 to 6.8% in FY24, meaning the 92% revenue growth "only" resulted in 58.2% EBITDA growth. The push-pull from these competing narratives saw the share price remain relatively stable on the day this announcement was released, notwithstanding the stock had already fallen meaningfully in the first part of the month.

The nexus of the difference in these two figures was an uplift in return rates, which is an aspect of the business that is quite variable from quarter to quarter, making it difficult to model. The follow on from previous uplifts in return rates has been bumps in growth of repeat customer metrics, and that all important figure (revenue from repeat customers) continued to improve, up from 56% to 59% versus pcp. CTT bulls would make the inference that the fall in EBITDA margin is therefore an investment in creating yet more repeat customers as the ability to satisfactorily return an order appears to engender customer loyalty.

We posited (very early, given FY23 accounts were not yet available) FY24 revenue for CTT of ~$630m as possible and EBITDA of $55-65m ($60m mid-point) in our June 2023 newsletter (.PDF) as expected operating leverage arrived. If the ratio from FY23 holds (Q1 revenue = 15.9% of FY23 revenues), then FY24 revenue would resolve at **$799.4m**! 26.7% above the $630m I boldly stated was possible if "revenue growth did not fall too quickly", though it appears based on the Q1 result our expectation of the arrival of operating leverage may have gone awry.

These calculations show the folly of trying to use a single quarter to pinpoint any meaningful figure, we really need to use a range of outcomes to derive a useful valuation estimate. The $127.1m of sales revenue CTT achieve in Q1 means that to get to the $630m estimate I made in June would require $502.9m for the final 3 quarters. This compares to $350.1m in the last 3 quarters of FY23. That suggests revenue growth would need to slow to 43.6% for the remainder of FY24 for this to occur. Given 92% in Q1 and the 80% October month-to-date revenue growth, this seems an appropriately conservative base figure.

Likewise, the ~$800m extrapolated above seems aggressive. I doubt such a high number is achievable, but CTT has beaten revenue expectations to the upside frequently enough that it is not an unreasonable FY24 revenue stretch outcome.

Even if zero operating leverage is demonstrated, if the 7.04% EBITDA margin achieved in FY23, on the $630m-$800m revenue range outlined above, it implies $44.4m-$56.3m of EBITDA. At $2.65 (share price at time of drafting this section), the enterprise valuation (EV) for CTT is $950m. The mid-point of that EBITDA range is just over $50m (call it $50m even for easy math), implying EV/EBITDA of 19x.

If EBITDA is indeed $50m for FY24 that will be up 70.6% on FY23 and I can assure you, the opportunity to own businesses with the huge addressable market CTT has, with all key metrics growing at an incredible clip for 19x EV/EBITDA is uncommon.

The remarkable negative working capital business model has seen the cash balance grow from $30m to $59m over the year to September 30, 2023. Businesses that can self-fund working capital needs and grow cash under the growth rates CTT has exhibited since listing are like unicorns (rarely seen in the wild).

The simple assessment is that unless something goes horribly wrong, the share price should rise. I spend a good amount of my time for each of our holdings trying to break the investment thesis, and the only chink in the armour with CTT is the extreme willingness of the founder to sell stock at frequent intervals.

Dicker Data (DDR) released a quarterly update in the last hour of trade for October. Many investors believe the mediocre businesses try to hide weak results in this flood of late announcements. DDR defied this expectation, delivering another strong quarter as they cycle the acquisition indigestion exhibited last financial years results.

The 9-month YTD results saw revenues +8%, EBITDA +18.5% and PBT +10.4%. But in isolation, the quarter showed revenue growth slowing to +5.4% but EBITDA +22.6% and PBT +15%, These indicate that operational efficiencies are beginning to be extracted in meaningful quantum from the acquisitions and given the conditions in the PC market at present, generating any revenue growth at all is testament to what a well-run business this is. There is a natural refresh cycle to PC's, and with the Covid driven refresh beginning about three and a half years ago, it must be imminent.

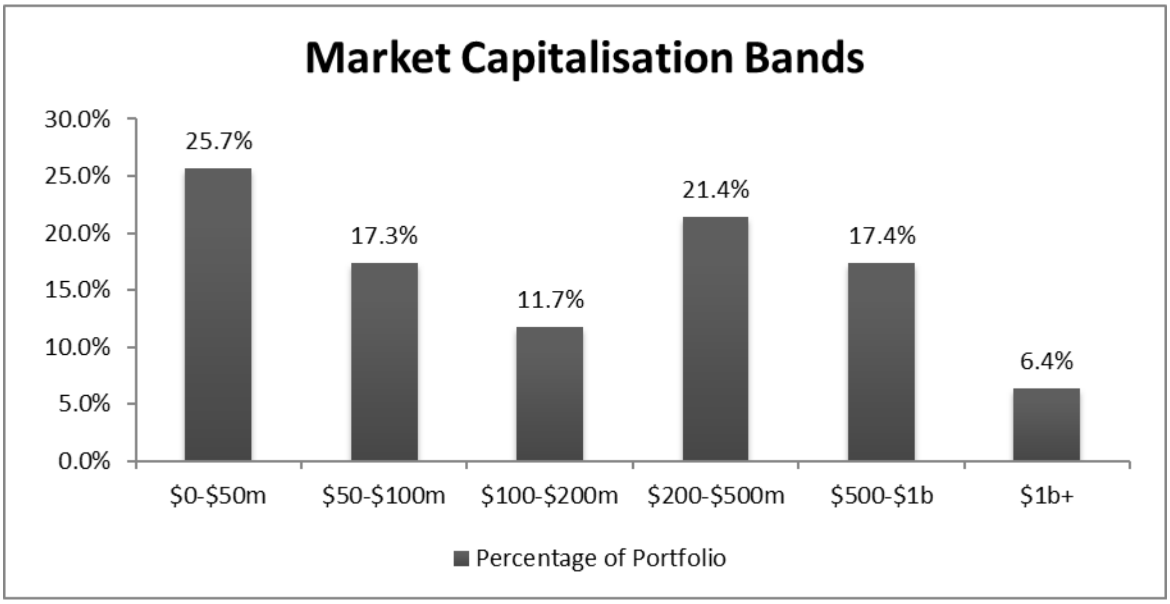
A final note on DDR is the divergence between EBITDA and PBT. This stems (mostly) from the significant debt DDR use to enable the businesses 100% dividend payout ratio. In an environment of rising interest rates, the additional interest payments erode the PBT growth. I would like to see management wind back their use of debt now that interest rates are much higher. An 80% payout ratio would still be outstanding and enable the business to deleverage meaningfully over the next few years. David Dicker is, however, a man with particular world views, one of which is that a business exists to pay its owners, so this is probably unlikely. The corollary of the very high ratio is the quite exquisite 44.1% pre-tax return on equity the business generates. Few on the ASX are the equal of that.

Key Portfolio Information: -

Our top 10 holdings on 31 October 2023 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	11.5%	11.2%
2	Smartpay (SMP.ASX)	10.0%	9.7%
3	Tellus (unlisted)	7.6%	7.4%
4	Shriro Holdings (SHM.ASX)	7.5%	7.3%
5	Dicker Data (DDR.ASX)	6.4%	6.3%
6	Cettire (CTT.ASX)	5.9%	5.8%
7	SDI Limited (SDI.ASX)	4.9%	4.7%
8	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding & PPKME	4.9%	4.7%
9	National Tyre (NTD.ASX)	4.8%	4.7%
10	Blackwall Limited (BWF.ASX)	4.1%	4.0%

Our largest 5 holdings comprise 42.9% of our invested capital, our top 10 holdings are 67.4% and our top 15 represent 85.4%. Cash and cash equivalents are 2.4% of the portfolio. The median market capitalisation is $171m. Weighted average market capitalisation is $366m.



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]	-0.20
Additional investments	Fund Closed	Sortino Ratio[1]	0.09
Applications/redemptions	Redemptions only, monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	18.1% 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	54.7% 61.3%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	6.2% 51.3%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	6.7% 2.9%
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	(3.6%) 8.9%
Fund Size	$35m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	0.7% 7.2%
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.8177 $0.0030	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.8189 $0.8164

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: