EGP Concentrated Value Fund

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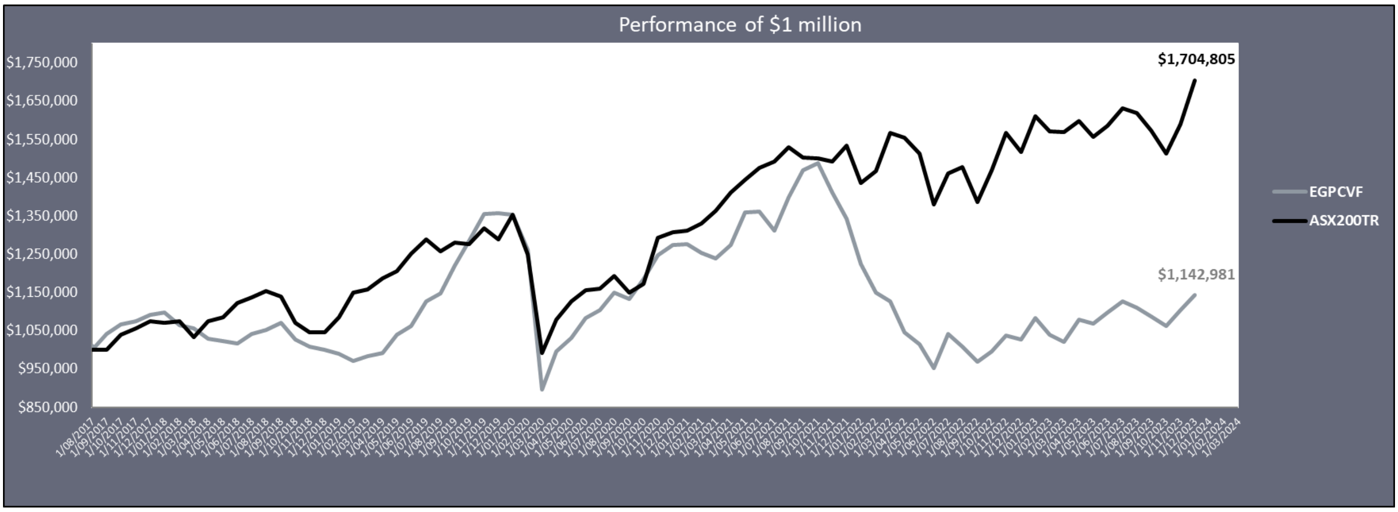
EGP Concentrated Value Fund – 31 December 2023

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%)	3.9%	3.6%							4.12%
Benchmark FY24	2.9%	(0.7%)	(2.8%)	(3.8%)	5.0%	7.3%							7.57%

*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 gained 3.58% in November. Our benchmark gained 7.26%. It was an explosive month for indexes globally as inflation fears continued to ease. We had numerous portfolio holdings participate in the euphoria, Smartpay and Shriro were the largest holdings that moved with the index, but we also had large parts of the portfolio not participate. We expect that as results filter in over the next couple of months, that should reverse. The 4 January market update (.PDF) by SDI is an example, with the stock up ~10% for January at the time of writing with the broader market down almost 1.5%.

Portfolio Update.

As always, December was a quiet month for market announcements. After my November newsletter screed on the reasons for UOS migrating some of their massive cash hoard from their UOADEV subsidiary up to the UOS parent level, some additional detail arose in early December (.PDF). The JV with Singaporean group Capitaland has finally borne fruit and UOS have committed US$74m of the US$247m required to fund a new Vietnamese development.

One of the options I gave for why the cash migration was taking place was that the opportunity set at the parent level may be better than at the Malaysian subsidiary. This commitment sees this option rise in prominence. It does not invalidate the prospect that the larger cash level at the parent could be used as a mechanism to take out minority interests at some point. US$74m = ~AU$109m and the project is likely to take more than 3 years from groundbreaking to completion (this project is comparable in scale to the United and Sentul Point developments which took approximately 4 years each), with most of the capital cost likely required in years 2 and 3. The current 20 sen dividend at UODAEV sees $226m per annum arrive at UOS annually if maintained biannually.

As mentioned in these pages when the Capitaland MOU was first announced, given the age of our founders at UOS, the Capitaland relationship could also be a way for the founders to exit should that be their intention. The significant JV in Vietnam will be a useful way to test the compatibility of respective businesses cultures, and Capitaland has ample capital firepower to takeover UOS if they thought the deal made sense. Increasingly, it seems likely that something significant will occur at UOS in the next few years. In the meantime, all the key operational business indicators are "up and to the right", so even if there is no corporate action, we expect to do well anyway.

Cettire (CTT) struggled in December as their largest competitor Farfetch's (FTCH) troubles continued. FTCH shares have fallen from a peak of $73 to trade below $1 at the time of writing. The willingness of businesses like FTCH to run at massive losses because they are "tech" always mystified me. There are valid reasons why certain businesses, particularly in "winner takes all" tech verticals even once they attain multi-billion-dollar valuations might "choose" to run at a loss. Facebook eschewing advertising until they had completed the capture of the majority of the world's users made sense. To a lesser degree, UBER running at a loss because of first time rider incentives and rolling into new markets was also probably the "optimal path" for lifetime value creation.

But for a retail-tech business like FTCH, once a reasonable level of revenue has been established, bottom-line profitability should have been prioritised. FTCH has a ~US$2.3b revenue base and >US$1b of gross profit. For such a business with all the efficiencies tech should offer not to be profitable defies belief. CTT should make something in the order of $25-30m of NPAT off a revenue base of perhaps AU$650-700m in FY24. This profitability along with a net-cash balance sheet gives the CTT optionality and ensures that if market conditions for some reason turn, they are less likely to be taken out by a low-ball takeover offer as appears to be likely result for FTCH.

I maintain that having your most important competitor hobbled is a net positive for CTT. FTCH will surely behave more rationally under new ownership which is likely to see the price CTT (and all other competitors) pay to acquire customers fall, which is likely to either benefit growth rate, profitability, or both for CTT. Calendar 2024 is setting up with useful tailwinds for almost all our major holdings.

And Now for Something Completely Different.

The case studies in this newsletter are overwhelmingly discussions of businesses we own, or in some cases have owned/sold. For something different, I thought it might be instructive to discuss a stock we reviewed and decided against owning.

One of the categories I frequently review for opportunities are what I refer to as "broken IPO's". An IPO as most readers would know is an "Initial Public Offering", one of my mentors insisted it means "It's Probably Overpriced". In my experience, he has been correct often, the vendors of an IPO almost always time an offering for conditions that maximise pricing, particularly if they are taking capital off the table in the transaction.

In first couple of years of the fund, I had a strict policy that required a business to be listed for 3 years before I would allow it to be held by the fund. The reasoning behind this is that the rigour of the challenges to the account presentation will usually uncover shortcomings that may have been able to be disguised in the less challenged environment of a privately run enterprise. Also, particularly at the very small end of the market, costs meaningful to the size of the business often arise, making the business less profitable than it was in a privately run situation. Layers of costly compliance are required of publicly run businesses that can be done without in private enterprise.

I am not generally a fan of such hard/fast rules and as I have discussed previously, the first time I broke my 3-year listed rule was to buy Dicker Data (DDR), which has been one of our best investments. To be fair, their accounts have always been so clean and simple that a couple more years of the rigour of analyst prodding was never likely to surface something unexpected.

Over the past 6 weeks or so, I have spent a good deal of time reviewing a business called MLG OZ Limited (MLG). The business was founded by Murray Leahy in 2002 and IPO'd in 2021 at $1 per share for a $146m market capitalisation, or an enterprise valuation (EV) of $168m. Of the $70.7m raised, the founder kept/sold $20.7m and the remainder was used primarily to retire debt.

The IPO is an interesting read for anyone wanting to better understand the mining services industry. MLG hit their prospectus forecasts for FY2021, generating EBITDA of $42.7m (16.8% margin), EBIT of $24.2m (9.5% margin) and NPAT of $12.5m (4.9%), all which meant the IPO valuation undemanding if such earnings were sustainable. The business model is an interesting one, the 4 main components of the business (Construction Materials/Site Services and Civil Works/Crushing and Screening/Bulk Haulage) are frequently contracted to multiple groups for each mine site. Large mines like to have fewer, larger contracts and the benefit to MLG is the ability to shift plant around various sites to optimise plant life (i.e. a piece of plant that has been in a heavy use environment might be moved to a light use environment as it approaches the end of its useful life, thereby extending life).

The business appears not to have been well prepared for the labour shortages and the inflation monster that was triggered by the globally idiotic government response to the Covid pandemic. NPAT fell from $7.1m in the December 2020 half to $1.8m in December 2021. This was despite a 17.5% increase in revenues. The issue was that every key expense line grew much faster than that, cruelling the bottom line.

The business has seemingly been scrambling since then to reprice contracts and find other ways to get control of the cost side of the business and the most recent results indicate that the profitability is returning to the business. The second half result for FY2023 delivered a 10.4% (underlying) EBITDA margin and discussions with management reveal their view that 15% is a reasonable expectation of the EBITDA margin the business is likely to be capable of returning to once the price rises have fully washed through the business.

The revenue line has been excellent, but the past couple of years the business has started to show signs of that most concerning outcome known as "profitless prosperity":

Past Financial Performance of MLG	2019	2020	2021	2022	2023
Revenue ($k)	199,625	205,136	254,016	289,775	383,845
Net profit ($k)	16,578	5,692	12,457	4,814	810
Share price at year end ($)	N/A	N/A	0.940	0.480	0.615
Dividends paid (cents per share)	nil	nil	nil	1.71	nil

FY2023 looks worse than it was because of a significant write-off of crushing and screening equipment, with the "underlying" NPAT being $10.5m, looking back through the accounts, such write-offs have not been a feature, so we can likely take management at their word on the "one-off" nature of this expense.

Markets of course are forward looking. This is a sample of the commentary from the most recent company presentation:

- Margin delivery in Q1 trending above FY23 second half run rate
- Revenue higher than pcp
- Majority of projects delivering more consistently
- Strong utilisation and productivity continues to drive higher volume for clients and revenue for MLG
- Cost focus and careful management of people helping return improved profitability
- Procurement savings starting to contribute to stronger margins

Based on this, it is likely that revenues will exceed $400m (I will estimate $425m based on uplift from repricing and contract wins) in FY2024, and it would seem reasonable, given the 15% EBITDA margin target for FY2025 that 12% is a reasonable estimate for FY2024, or $51m EBITDA ($425 x 12%).

FY2024 is half over though, so investors will be starting to contemplate FY2025. Management has said they expect to hit a $40m monthly revenue run-rate before the end of FY2024, which indicates $500m for FY2025 is achievable. Hopes for 15% EBITDA margin may be achievable, but that future is almost 2 years ahead, so we shall use 14% for conservatism. This indicates $70m EBITDA for FY2025 and the following trajectory:

- FY2023 = $38.1m (actual underlying);
- FY2024 = $51m (estimate see above); &
- FY2025 = $70m (estimate, see above).

The prospectus pricing for MLG was 4.1x. The current EV is current EV for MLG (@ 64c share price and using the $54m net debt as last announced) is $148m. If they achieve $51m in FY2024 and 4.1x is the correct multiple, that implies $209m EV or around 41% upside.

Look a year further ahead and if the $70m described above was achieved, that would imply a 94% valuation upside. Some of this EV is likely to be consumed by additional debt load, but it is entirely conceivable that there is an 80% equity upside to MLG if the earnings pathway described above is achieved.

So why have we passed on the opportunity?

MLG is a massively capital-intensive business, $38.2m was invested in new plant in FY2023, that is a number eerily like FY2023 EBITDA... There remains $177m of plant on the MLG balance sheet after disposal/write-down of $23.2m of crushing and screening equipment in FY2023, the market capitalisation of MLG is currently below $100m! Charlie Munger used to make this comment of capital-intensive businesses:

"It reminds me of the guy who looks at all of his equipment and says, 'There's all of my profit.' We hate that kind of business."

The tragedy of most mining services businesses is that they consume substantially all available cash when things are going well. They can very often generate a poultice of cash when operating conditions turn sour, but the valuation will be in the toilet at that point despite the improved cash generation!

There are no obvious scale benefits for the business either. Each site operates with its own management and aside from defraying listing and senior executive costs across a larger revenue base, the only obvious scale benefits derive from the ability to utilise staff and equipment slightly more effectively. But the efficiency differences between this business at 1000 employees and $175m of plant would not be significantly better if the business was 2000 employees with $350m of plant.

Despite that, there is plenty to like about MLG. Along with the potential undervaluation described above, you are aboard with a founder who still owns 51% of the business and is therefore incentivised to behave rationally. My sense (though derived from only brief exposure) is that Murray Leahy is an “A-grader” with deep and wide industry knowledge and a strong understanding of industry dynamics and direction.

The risk of putting this commentary out into the market is that if the earnings and valuation pathway above plays out, at some stage in the next couple of years, investors will send me this newsletter when the stock is $1.15 and say “you missed an 80% gain even though you saw how the business would unfold”. But the nature of businesses such as MLG is that like what happened to them in FY2022/2023, the rug can be pulled out from under you very swiftly.

With that said, I suspect mining services will be a boom industry for the next 5 or 6 years at least, for the first time in almost a decade, the mining majors like BHP and RIO have lately really grown their forward development pipelines, so for those who believe that narrative, businesses like MLG might arrive at the destination I describe above in a couple of years and find there is still some years to run before the cycle turns.

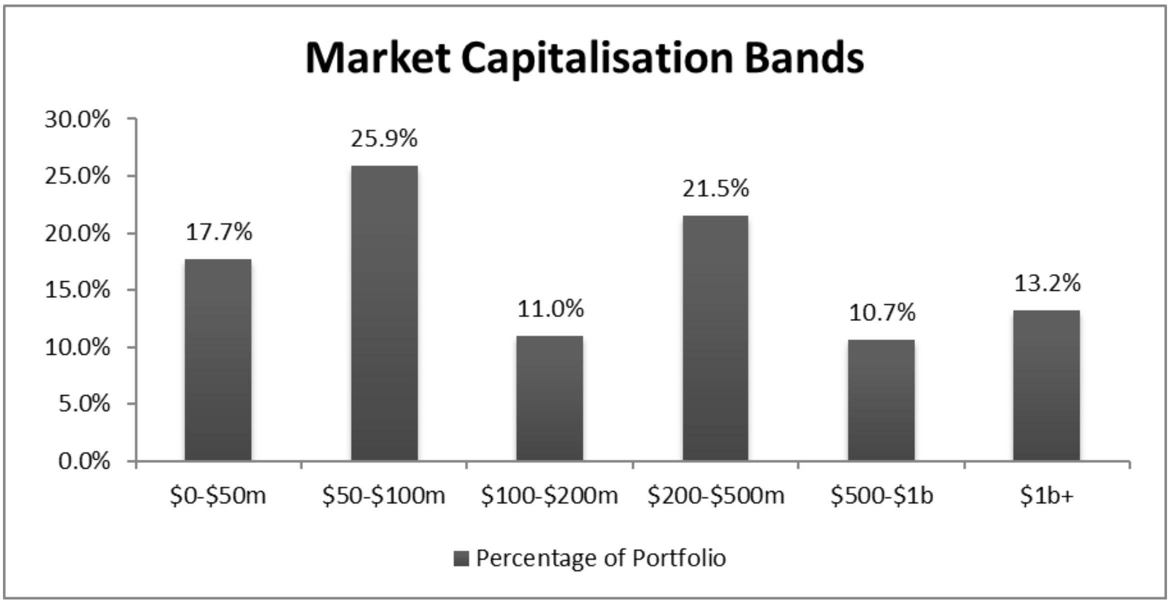
As I have described in previous newsletters, my preference is for SRG as a better exposure to a similar opportunity as described in the previous paragraph. Comparable undervaluation if they deliver on their respective pipelines without incident. SRG carry way less debt compared to revenues and earnings. The SRG contract profile has much less risk of suffering in a cyclical turn as MLG and SRG has only 2/3rds of the plant of MLG on their balance sheet despite more than twice the revenues and a market capitalisation more than 3x the size.

Key Portfolio Information: -

Our top 10 holdings on 31 December 2023 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	10.7%	10.3%
2	Smartpay (SMP.ASX)	10.6%	10.2%
3	Shriro Holdings (SHM.ASX)	7.1%	6.8%
4	Dicker Data (DDR.ASX)	7.1%	6.8%
5	Tellus (unlisted)	7.0%	6.7%
6	Cettire (CTT.ASX)	6.2%	6.0%
7	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding & PPKME	5.5%	5.4%
8	Undisclosed	4.9%	4.7%
9	Undisclosed	4.6%	4.5%
10	Blackwall Limited (BWF.ASX)	4.3%	4.2%

Our largest 5 holdings comprise 42.4% of our invested capital, our top 10 holdings are 67.9% and our top 15 represent 87.4%. Cash and cash equivalents are 3.4% of the portfolio. The median market capitalisation is $164.1m. Weighted average market capitalisation is $405m.



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	$50,000	Sharpe Ratio[1]	-0.16
Additional investments	$500k Maximum	Sortino Ratio[1]	0.19
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	17.9% 15.2%
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	55.8% 62.3%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	14.3% 70.5%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	11.4% 12.4%
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	(3.6%) 9.2%
Fund Size	$37m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	2.7% 10.3%
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.8798 $0.0038	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.8812 $0.8785

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.

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This report contains some forward-looking statements which reflect the expectations of EGP about the prospects of companies held within the portfolios of the funds. While EGP considers its expectations to be based on reasonable grounds, there is no guarantee that those expectations will be met. Actual performance of the portfolio companies will be impacted by a variety of factors, including circumstances that cannot be foreseen, and could differ significantly from the expectations of EGP. These statements should therefore not be relied upon as an accurate representation or prediction as to any future matters. Where portfolio companies do not perform in line with EGP's expectations, the funds could be adversely impacted.

Appendix 1: -

Combined funds cumulative return since inception: