EGP Concentrated Value Fund

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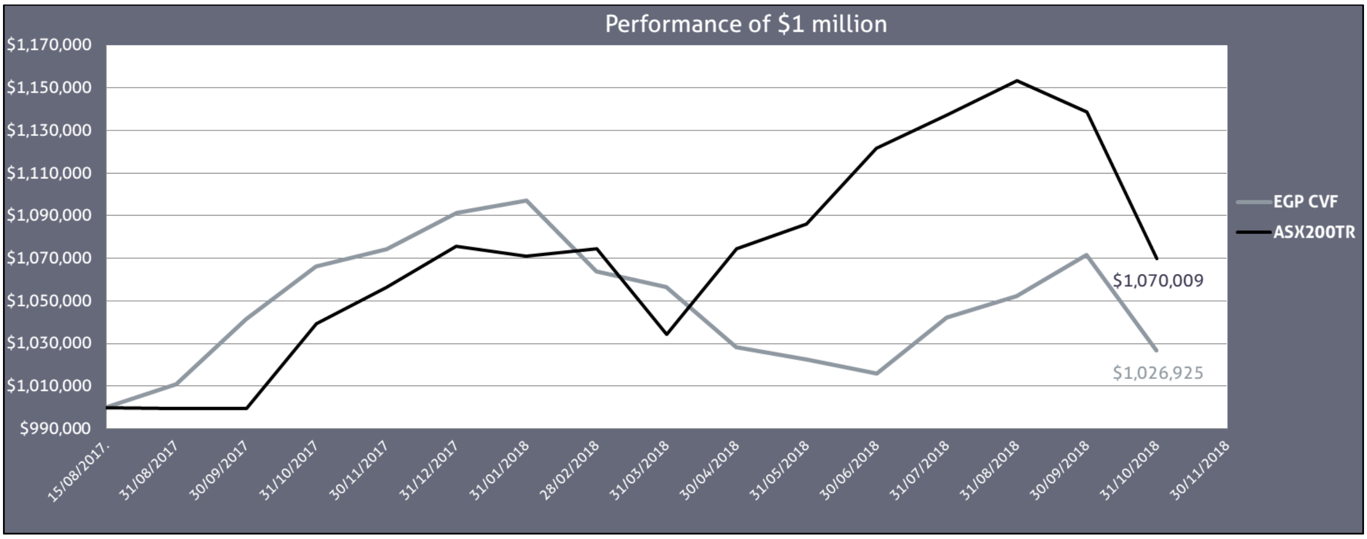
EGP Concentrated Value Fund – 31 October 2018

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.

EGPCVF	Jul	Aug*	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FYTD
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%
FY19	2.6%	1.0%	1.8%	(4.2%)									1.10%

Benchmark	Jul	Aug*	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FYTD
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%
FY19	1.4%	1.4%	(1.3%)	(6.1%)									(4.61%)

*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 by (4.2%) in October. Our benchmark fell by (6.1%).

We are always pleased to report a month of meaningful outperformance. We are nonetheless aware that relative outperformance is cold comfort to most investors, what they care about through time is absolute performance. We remind investors we have generated all of our historic outperformance in the markets down months. Since the inception of the original fund in 2011, we have now reported 41 periods where our benchmark fell by at least 2% (two of them, March 2017 and October 2018 have been in the EGPCVF structure); we have outperformed the market on every one of those occasions. Interestingly, more than 100% of the outperformance the fund has generated has come in these strongly negative periods. The EGPCVF has not yet operated long enough for such trends to be meaningful, but I view periods of strong negative sentiment as critical to our ability to outperform through time.

We are enormously pleased to report that our investors seem to intuitively understand the nature of opportunity that comes with major market declines; our inflows for October were our best so far in 2018.

In truth, we were expecting to report a much better level of outperformance for October than we ultimately did. At its worst this month, our benchmark was down by more than 8.7% and at that point, our outperformance was about 5%. Unfortunately, as the market turned positive late in the month, a few of our positions finally succumbed to the negative sentiment. Shriro was the only stock with a specific negative announcement, with weakness in their appliance business continuing and the "Trump Tariffs" apparently causing issues out of what was supposed to be the growth engine of the business (Chinese made BBQ's exporting into the USA), which caused the stock to fall sharply.

Late in the month, Redbubble announced a capital raising which caused the stock to trade sharply lower to around the capital raising price. The deal actually looks like a very good one and we have participated modestly in the placement. Our 3rd and 4th largest holdings Legend and SRG Global traded down around 10% month on month too, despite respective positive announcements from the companies.

We are often asked why we use the ASX200TR as our benchmark given we tend to focus our investment efforts on small capitalisation stocks. This month gives a good example of why. While the ASX200TR was down 8.7% at its worst this month, the Small Ordinaries Total Return was off by as over 11% through the month and closed 3.5% worse than our benchmark at 9.6% down for October. Over a long enough time frame, the ASX200 is a much better quality index in our estimation.

Another COG in the Machine:-

Consolidated Operations Group (COG.ASX) is the unimaginative name given to our 11th largest holding. The business was listed in 2003 as Armidale Investments Corporation (AIK) and was a listed investment company that lost lots of money, primarily by investing in financials through the GFC. As a consequence, the company carries about $78m of taxable losses. This becomes relevant further down.

About 5 years ago it began to transition into one of the two key current businesses (TL Rentals) which specialises in equipment leasing and rental. About 3 years ago, current CEO Cameron McCullagh joined the business and they have since developed a second key element of the business, aggregating asset finance brokers.

It is important to understand Cameron has considerable previous success aggregating fragmented industries. The relevant section of his biography is this:

"Founded and assisted in the growth of White Outsourcing to an entity with back office administration of over $30 billion. AS CEO of Employers Mutual Limited (EML Group), Cameron grew it from 30 people to over 1,200, managing over $1 billion in annual workers' compensation premiums. As COO, Cameron took operational responsibility for the successful listing on the ASX of the insurance broking accumulator Steadfast Group."

There are several important points around Cameron's stewardship. Firstly, he pays himself a very modest stipend, averaging less than $100,000 per annum over the past two years. The reason he can do this is because he owns almost 20% of the business, and therefore expects to participate in the wealth created by the business more than by the salary he earns. More importantly than that, he has acquired this stake the old fashioned way, putting hard money down for his stock via variously participating in any equity issuances and accumulating on market. His stake was not acquired via cheap equity grants or performance rights. His most recent purchase was only last month at prices above the current market.

Speaking of insider buying, a new appointment in Patrick Tuttle has just been appointed to the board and also wasted no time in spending about a quarter of a million dollars acquiring stock. Given his employment background, this seems a strong endorsement of someone with intimate industry knowledge. I wish all public company directors were as inclined to immediately acquire meaningful stakes with their own money on market when they take directorships; I am thoroughly convinced directorial oversight would be vastly improved by such actions.

The businesses generated normalised EBITDA of $14.4m in FY18. They have guided $17.1-19m of EBITDA in FY19. The midpoint of guidance at $18m implies 25% EBITDA growth year on year. It is important when assessing companies conducting roll-up strategies to understand where the growth is coming from, is it all acquired growth? How are the underlying businesses performing organically?

This is relatively simple to do with COG, they made 4 small acquisitions in FY18, one which completed in July (so will not contribute materially to FY19 growth) and three others that we can reverse engineer will contribute about $560k to FY19 EBITDA if they match FY18 figures. They also acquired the final 20% of CFG (Consolidated Finance Group – they really don't waste any intellectual energy naming their businesses!) which will contribute from 1 July 2018 and should add just over $500k of EBITDA in FY19 based on the figures they presented when announcing the deal.

This means of the $3.6m of EBITDA growth implied by the mid-point of company guidance, about $1.07m or less than 30% of the growth will come from acquired EBITDA. The remaining more than 70% will come from organic growth and the benefits of scale. This implies that had they stopped acquisitions this year, they would still have grown their EBITDA by around 17.5%, which indicates very healthy underlying economics.

Subsequent to the announcement of $18m EBITDA guidance, they have made two acquisitions that should add about $3.6m in annualised EBITDA, but given they won't be owned for the full year, will likely contribute circa $3m of EBITDA in FY19.

At 11cps, the market capitalisation is $147.2m. At 30 June, they had cash of just over $36m, but a little over $3m of that was customer cash, so $33m of their own cash. They had no corporate debt. They have spent $17.6m of the cash balance making two acquisitions so far this year. This means the current EV (Enterprise Value) is about $132m.

Given our work above, we expect the EBITDA assuming no further acquisitions in FY19 will be $21m. This implies an EV/EBITDA multiple of about 6.3x (at 11cps), which is extremely undemanding given the attractive fundamentals in which the industry operates and the disciplined way in which Cameron McCullagh and his team have pursued the opportunity. Banks are increasingly walking away from the equipment financing sector as direct operators, but are happy to deal with large groups such as COG on a wholesale basis.

It is important to note that joining the group has considerable upside for the selling broker. They get access to VBI's (volume based incentives) as part of the group they would never have before and a wider range of products across the network that have benefits for their clientele. For COG the industry is attractive because there is an aging cohort of owners that have no clear succession plan for their business. For someone nearing retirement and wanting to find a way to monetise their business, selling to COG makes a lot of sense, they get a significant cash payment up-front, something like 60% and then have the opportunity over the next few years to utilise the improved earning power membership of COG gives them to increase the payment they will receive for the final 40% of their business.

The partial ownership of many of the acquired businesses makes for quite tricky analysis. Given the large pool of tax losses available to the group, 100% ownership would be highly beneficial as it would eliminate the cash tax paid by partially owned businesses. I have asked Cameron McCullagh about why they haven't opted for 100% ownership more regularly to utilise the tax losses, he considers the 'skin in the game' model to be critical to the success of the strategy. The tax losses will get used in due course; in the meantime, getting the business model perfect is more important. Structuring the acquired businesses with earn-outs and put/call options allows COG to fully consolidate the businesses at some future point when the original owner/operator is no longer crucial to the ongoing viability of the business.

An important consideration in the assessment of EBITDA is the calculation of amortisation. When businesses such as the equipment brokers COG are buying are purchased, a large intangible for "customer contracts" is created and then amortised over the first few years of ownership. The expense is a non-cash cost and assuming the businesses are on average retaining the customer or continuing to grow organically (as we demonstrated above they are), then the cost is not a true business expense.

Of the roughly $21m of EBITDA attributable to COG in FY19, there will be around $1m of depreciation to account for. This will leave $20m of EBITA. Interest costs last year at the consolidated level were around $4m, the "attributable" figure is unlikely to be higher than that in FY19. The consolidated taxation was $3.1m, given CFG will disappear into the consolidated group in FY19, I would hazard that figure will reduce and that COG's attributable tax is likely to be less than $2.5m.

This will leave an NPATA (Net Profit after Taxation & adding back Amortisation) of about $15.5m. With 1.338 billion shares on issue, this would give an EPSA (Earnings per Share + Amortisation) figure of about 1.16cps. At the last traded price of 11cps, COG is trading at less than 10 times this figure.

Given the highly cash generative quality of the EBITDA figure, and the attractive prospects of the continuing industry consolidation, I believe an EV/EBITDA multiple in the high single digits is warranted. 9x the $21m EBITDA figure posited above implies and Enterprise Valuation of about $189m. Given the cash balance is roughly $16m; this implies an equity valuation of about $205m under the current situation, which would equate to a share price of 15.3cps.

A 9x EBITDA valuation customarily requires a business with fairly clearly demonstrable business quality. Some may well consider the journey a little too early for COG to confidently determine such qualitative attributes. I won't go into a detailed analysis of how I've arrived at the figures, but within a couple of years, I expect COG will have a return on equity approaching 15% and will have demonstrated a capacity to reinvest its earnings at a high double digit rate of return, I estimate this could be as much as 20% or more.

A business operating in a fairly rapidly growing and deeply fragmented industry with a capacity to reinvest earnings at a strong rate of return is one we hope we can own for a number of years. We are hopeful that any future growth for the business will be able to be funded internally without further recourse to shareholders.

With a current share price of 11c, 15.3c only implies a roughly 40% upside, which is a narrower margin of safety than I would customarily seek. However, value in a situation such as this is not a static thing and we expect Cameron McCullagh and his team will continue to find suitable, value accretive acquisitions.

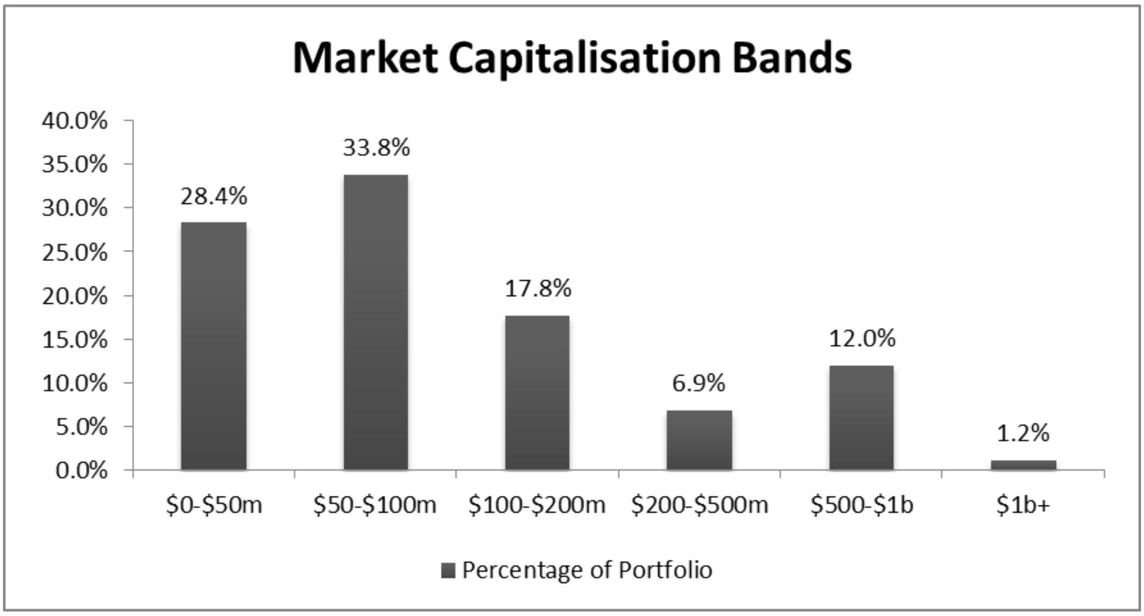
Key Portfolio Information:-

Our top 10 holdings at 31 October 2018 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	12.0%	10.5%
2	Kangaroo Plantation (KPT.ASX)	8.1%	7.1%
3	Legend Corporation (LGD.ASX)	7.3%	6.4%
4	Global Construction Services (GCS.ASX)	5.9%	5.1%
5	APN Regional Property (APR.NSX)	5.3%	4.7%
6	Locality Planning (LPE.ASX)	4.2%	3.6%
7	Blackwall Limited (BWF.ASX)	4.0%	3.5%
8	Undisclosed	3.8%	3.3%
9	Undisclosed	3.2%	2.8%
10	Redbubble (RBL.ASX)	3.0%	2.6%

Our largest 5 holdings now comprise 38.5% of our invested capital, our top 10 holdings are 56.6% and our top 15 represent 69.1%. Cash and cash equivalents are 14.1% of the portfolio.

The market capitalisation graph is set out below. This month, the median market capitalisation is $72.6m.



As always, investors with any questions, suggestions, comments or investment ideas should feel free to drop me a line – Tony@egpcapital.com.au

Fund Features		Portfolio Analytics	
Min. Initial investment Max. Initial investment	$100,000 $2,000,000	Sharpe Ratio[1]	0.95
Additional investments	$5,000 (Minimum) $200,000 (Maximum)	Sortino Ratio[1]	0.47
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	7.45% 9.37%
Distribution	Annual 30th June	Largest Monthly Loss – EGP Largest Monthly Loss - Benchmark	-4.2% -6.1%
Management fee	0%	Largest Drawdown – EGP Largest Drawdown - Benchmark	-7.4% -7.2%
Performance fee (<$50m) Performance fee (>$50m)	20.5% (inc GST) 15.375% (inc GST)	% Of Positive Months – EGP % Of Positive Months - Benchmark	58.6% 58.6%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	2.7% 7.0%
Custodian/PB	NAB Asset Services	1 year return[2] – EGP 1 year return – Benchmark	(3.7%) 3.0%
Responsible Entity	Fundhost Limited	3 year annualised return[2] – EGP 3 year annualised – Benchmark	N/A N/A
Fund Size	$57.2m	5 year annualised return[2] – EGP 5 year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.9877 $0.0039	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.9892 $0.9862

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.

The information in the below table is provided for shareholders in EGP Fund No. 1, and does not relate to the EGPCV Fund.

EGP Fund No. 1 Pty Ltd Equivalent Price	$2.0237
EGP Fund No. 1 Pty Ltd Franking Credits	$0.0109