EGP Concentrated Value Fund

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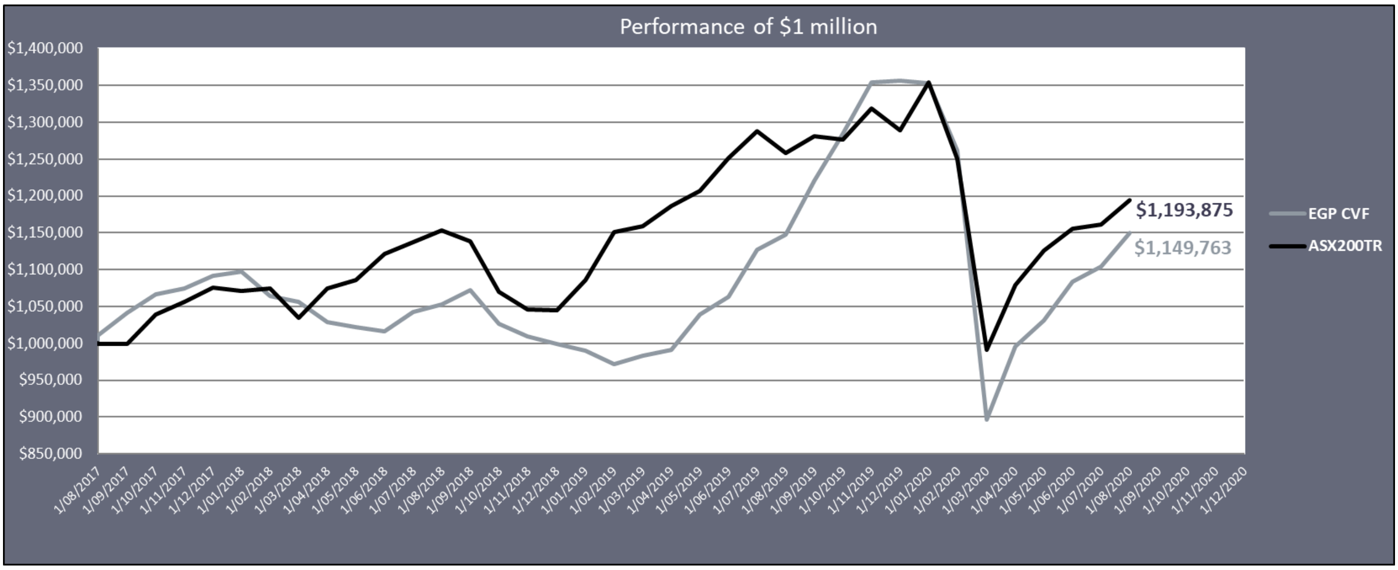
EGP Concentrated Value Fund – 31 August 2020

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%											6.08%
Benchmark FY21	0.5%	2.8%											3.35%

*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 rose 4.1% in August. Our benchmark rose 2.8%.

Virtually all surprises in August were to the upside in terms of results. As discussed last month, we revalued our unlisted investment in Tellus Holdings to $2 per share in line with recent trading in the off-market facility. We have also marked down (by 50%) a pre-IPO convertible note as a consequence of our expectation that the IPO will be much more difficult to get away in the present environment.

It's Déjà vu, All Over Again: -

The key benefit of experience as an investor is that when you have been around long enough, you'll have seen most things and these experiences give you a framework for assessing the probable outcome out of a similar situation when you come across it.

In early 2014, Dicker Data was a $140m business with ~$500m of revenue when it announced it was spending $65.5m (all cash/debt) for a business who's revenues were larger than their own in Express Data. Fast forward 6 years and Dicker Data has grown the profitability of the combined businesses from the ~$9.3m they were earning after tax before acquiring Express, to an annualised run-rate of ~$58.8m after tax today.

Mergers and acquisitions are often a graveyard for capital, but every now and again, you just see one that makes eminent sense. In July, National Tyre & Wheel Limited (NTD) announced what we think will prove to be such an acquisition. The tyre and wheel business doesn't have quite the same structural tailwinds DDR have experienced in the IT distribution sector, but for at least the next few years, we expect tyres will be consumed at levels above their historic levels due to behavioural changes triggered by COVID-19 (less public transport use with commensurately more commuting and more driving holidays).

NTD are a business that in FY20 generated ~$12m of EBITDA from a revenue base of ~$160m. The acquisition of Tyres 4U adds about $280m or $290m of revenue to the business. Like Express Data, the business has performed poorly and is nowhere near as profitable as the acquiring business. Like the Express Data acquisition, for it to work out, you need to believe the operational characteristics of the combined group eventually look more like the original business than the business that now represents most of the revenue.

From FY16-FY18, the NTD business had EBITDA margins between 10-11%, but irrational competitor behaviour and a weaker AU$ have negatively impacted margins in the past two years, with EBITDA margin averaging 7.5%.

There are a variety of opportunities to make the businesses work better together than they do separately. NTD will now be the largest independent tyre distributor in Australia and New Zealand. The two businesses have very different product composition meaning there is a considerable cross-sell opportunity (revenue synergies most acquirers would point out, though thankfully NTD have made no such reference) the key opportunity in this sphere is increasing volume based rebates if they can hit new sales thresholds with their suppliers. The combined business has a footprint of 30 distribution centres that will ultimately be compressed back to around half that amount, reducing rent, staffing, and logistics expenses (cost synergies the parlance here).

Our base expectation is that the NTD business will continue to deliver at least 7.5% EBITDA margin and that the acquired business in the second-year post acquisition will generate ~5% EBITDA margins. If this is achieved off the modestly improved revenue base the combined businesses generate, FY22 would see something like $175m of revenue and $13.1m of EBITDA for the NTD side of the business and the Tyres 4U business would generate ~$15m of EBITDA off ~$300m of revenues.

The pro-forma balance sheet provided post-acquisition shows $24.4m of net debt and at the 57c closing price in August, the market capitalisation is $65.6m for an enterprise value of $90m. If the estimates set out above are realised, the forward EV/EBITDA for our baseline expectation in FY22 is 3.2x. Given the complication of AASB16 lease accounting, we think EBITA is probably a more useful measure, it would be ~$25.5m in FY22 if the targets above are achieved. This should mean NPATA would be ~$17.5m (depending on how swiftly they eliminate the debt). Most of the debt will hopefully be repaid by the end of FY22 depending on the chosen dividend policy, if the preceding situation was achieved and the business traded on 10-12x NPATA, the implicit share price would be ~$1.50-$1.80, which is 163-216% upside. It is rare the opportunity to own a relatively simple business with such impressive upside potential comes along. Despite the relatively small size and illiquidity of NTD, we have aggressively bought since the acquisition announcement sufficient stock that it is now our 10th largest holding.

The ZFC revisited: -

We are now extremely confident in the positioning of our portfolio. Our commitment when we halted The ZFC was that we would revisit once EGPCVF had recovered the shortfall against our benchmark.

Whilst the disruption of COVID-19 reminded us that almost anything can happen, we are very confident of producing a year of outperformance and recovering the losses sustained in March. As such we have interviewed candidates to take control of the operational aspects of The ZFC.

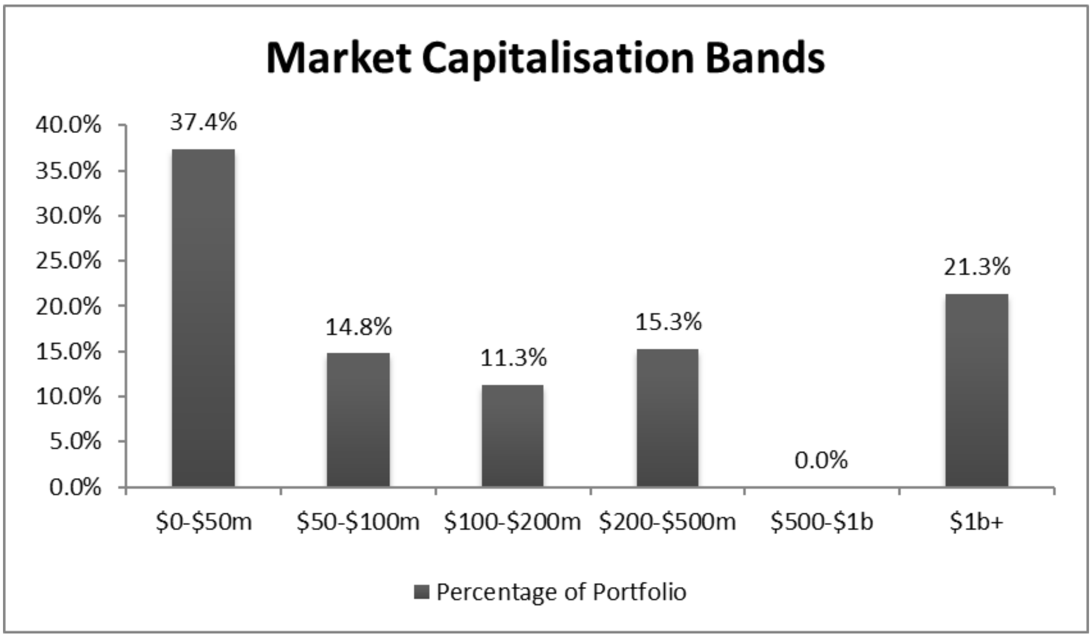
Over the next few months, they will put in place the administrative engine to ensure the fund/project is ready to go and then if EGPCVF is back in front of our benchmark and near previous highs, we will commence the launch for The ZFC with a view to starting in the first half of 2021.

Key Portfolio Information: -

Our top 10 holdings at 31 August 2020 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	10.8%	10.0%
2	Undisclosed	8.7%	8.1%
3	Smartpay (SMP.ASX)	6.4%	5.9%
4	Redbubble (RBL.ASX)	5.9%	5.4%
5	LawFinance (LAW.ASX)	5.4%	5.0%
6	Dicker Data (DDR.ASX)	4.7%	4.4%
7	Site Group International (SIT.ASX)	4.3%	4.0%
8	PPK Group (PPK.ASX)	3.9%	3.6%
9	Undisclosed	3.0%	2.8%
10	National Tyre & Wheel (NTD.ASX)	2.8%	2.6%

Our largest 5 holdings now comprise 37.1% of our invested capital, our top 10 holdings are 55.8% and our top 15 represent 69.1%. Cash and cash equivalents are 8.7% of the portfolio. The median market capitalisation is $83.2m. Weighted average market capitalisation is $318.4m.



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	$50,000	Sharpe Ratio[1]	-0.22
Additional investments	$5,000 (Minimum) $200,000 (Maximum)	Sortino Ratio[1]	0.69
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	20.75% 16.59%
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	64.9% 64.9%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	15.0% 19.4%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	0.2% (5.1%)
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	4.4% 6.1%
Fund Size	$72m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$1.0086 $0.0028	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$1.0101 $1.0071

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.