EGP Capital

EGP Concentrated Value Fund

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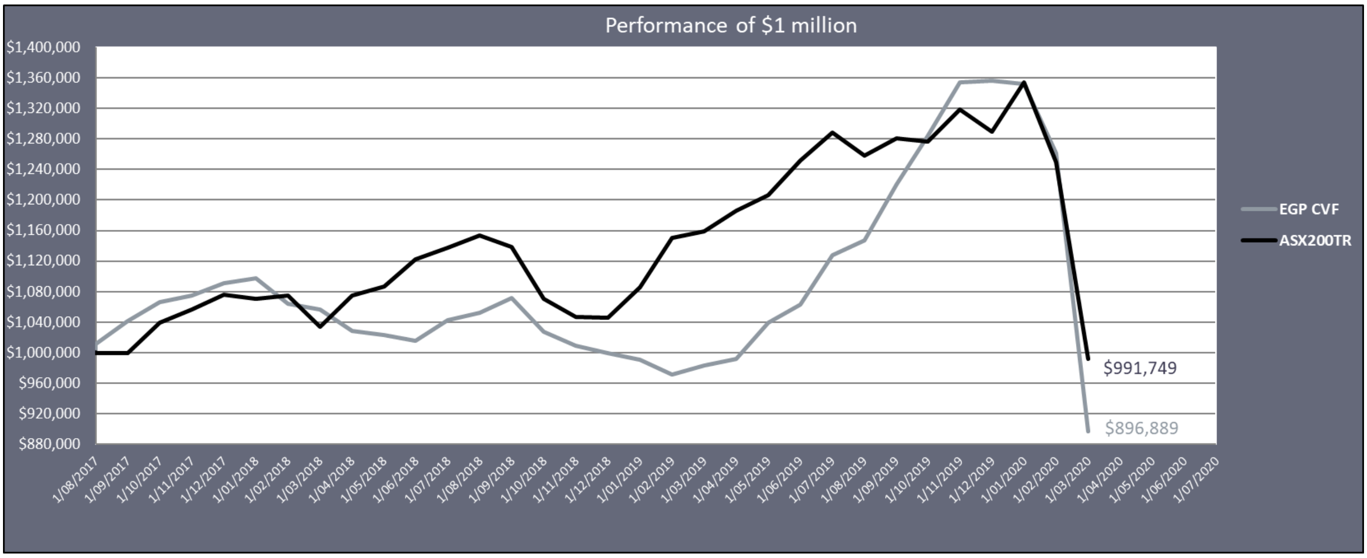
EGP Concentrated Value Fund – 31 March 2020

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%)				(15.61%)
Benchmark FY20	2.9%	(2.4%)	1.8%	(0.4%)	3.3%	(2.2%)	5.0%	(7.7%)	(20.7%)				(20.74%)

*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 28.9% in March. Our benchmark fell by 20.7%.

Since the fund was established in 2011, there have been 46 periods (we initially measured our performance weekly) where our benchmark declined by more than 2%. In the first 45 such periods, we outperformed the benchmark. The benchmark retreat this month was the most dramatic in decades and unfortunately, our record of outperformance in falling markets was also broken.

I was an investor through at least a few other potential pandemics, including the swine flu (which evidently infected more than 1 billion people & killed at least 500,000 people, but had the notable economic advantage of occurring on the way out of the GFC), bird flu, MERS, SARS & Ebola. Statistically speaking, some of those diseases were meaningfully deadlier but through a combination of luck, or better management than China managed when the outbreak occurred in Wuhan, these other outbreaks ultimately ended up being much less serious than COVID-19 has been.

All of these felt similar in the outset, there was a valid concern that each of them could have been quite globally significant if they got out of control. At various points, it appeared they may have.

I've expended much analytical effort trying to decide how similar future situations can be filtered between "false positives" (with almost no market outcome) and true positives (as we have just observed) to ensure a better outcome will be achieved than what we have delivered through February/March 2020 should a similar situation arise.

My sense is that a swine flu like outcome is that the best case given how seriously the virus is being taken globally. If this is true, it means about 100x as many infections as are present globally (if the estimates of underlying infection rates being at least 10x the reported rates are correct) and around 10x as many deaths as have already been reported globally. This means things will sound like they're getting much worse for a long time yet.

The tricky thing about that is that the market usually turns well before the data says it should. I've been trying to decide what the likely datapoints market participants will look for are, with no real sense of what they might be. There will always be some country with worsening infections, I guess it will be when the weight of cases globally really slows steadily for a couple of weeks, and mortality rates start to sharply drop as the most effective treatment protocols are agreed.

Probability weighting outcomes feels way more difficult now than in the GFC. In the GFC, it was certain that at some point, governments were going to step in to prevent the wholesale seizure of the financial system, you just had to decide at what point deployment of capital made sense. Just suring up the financial system in this case is likely not enough, fiscal and monetary responses on a scale never seen before will be applied and their effects will be unpredictable.

The range of outcomes in this situation feel incredibly wide. If the significant measures being taken globally are effective and/or a treatment that is already safety tested is found to be effective, then the recovery has the potential to occur almost as swiftly as the fastest ever collapse which preceded it.

With that said, the scale of the damage we are likely inflicting on the economy if the global shut-down continues for more than a matter of a few weeks could result is something economically very few living people will have seen. The ultimate outcome is likely somewhere between those two points, but as stated, probability weighting where things land is incredibly hard to do at present.

Given my Wife and I are the largest investors (with our entire family net worth in the fund), I'll be doing everything in my power to make our investors whole as swiftly as possible and once that journey is complete, to try to return to delivering strong outperformance of our benchmark we have been known for since inception.

Commentary on our Top Ten Holdings: -

Given the significant fall in the market valuations of our investments, holding our cards close to our chest is now inappropriate, so I have unmasked all of our top-10 holdings and will give a brief discussion of how we anticipate they will be impacted by COVID-19.

1. UOS entered the GFC (June 30 2007 accounts) with only $45m of total cash and only around $7m of net cash (they did realise additional cash of $28m in November 2007 and $44m in early 2008 by selling office towers) and managed to use the fact they were among the only "cashed up" property

developers in Malaysia to turn the GFC into an opportunity to buy distressed assets and create enormous value such that the $176m of NTA attributable to UOS shareholders at 30 June 2007 had become $637m by 30 June 2012 despite a capital return of $84m in late 2011 (meaning it had effectively become closer to $720m, or a return exceeding four times in five years).

The capital base of UOS is almost ten times larger now than in mid-2007 ($1,575m), but they enter this crisis with a capacity to invest they could only dream about in the GFC. The December 31 2019 balance sheet for UOS shows $407.3m of cash, and about $276m of net cash, meaning the capacity to deploy capital if fellow developers get into a state of distress is truly remarkable.
The next 5 to 10 years for UOS should be an amazing opportunity, and given the highly liquid nature of the NTA and the record of thriving in crisis environments, it is more than a little puzzling that it is trading at such a deep discount, the stock traded at 59c through March, which is about a 45% discount to the more than $1.06 of very conservatively stated NTA.

With that said, our suspicion that commercial real estate will likely be one of the losers out of the COVID-19 crisis long-term. The enforced "work from home" will be a baptism of fire for many businesses and more than a few (especially those with clear and measurable staff outputs) will potentially learn that any diminution in staff productivity can potentially be offset by reducing costs associated with commercial real-estate footprints. This will likely foment a meaningful change in the way corporations use space. Co-working and other unconventional providers of such space are likely to be the beneficiaries. WeWork would be the likely winner here, but they may well not make it, so the space will be wide open. UOS have the Komune co-working brand, but whether they can properly exploit this opportunity will only be apparent in a couple of years.

2. SIT fell particularly hard in March (down 63%). The market cap at the 2.5c March closing price is less than AU$20m. The 30-hectare asset in Clark Special Economic Zone based on recent transactions is worth between US$90-US$150m (AU$146-AU$244m, or 18.6c – 31.1c per share less any transaction costs and taxes) based on similar transactions undertaken in the area in the past year or two. Naturally, if recession ensues, this valuation could fall.

   Two unfortunate things happened in March to cause the spectacular share price fall. The first one was obviously the COVID-19 causing an issue for their education business. The second was their lender reneging on $15m debt deal announced on 31 December 2019 when they went to make the second drawing this month. This has put them in the invidious position of being poorly funded at the worst possible time, which probably explains the panicked selling through the month.

   The announcement on 27 March 2020 contained the seeds of how the cash shortage will be dealt with, as SIT will house and feed 700 BPO workers who are unable to leave Clark while the Philippines remains locked down. Along with standing down the staff not required to house and feed these workers, this is likely to leave the Clark asset more profitable than if they were continuing to provide education. The Australian business I understand is feverishly reviewing the various supports offered by the Government to ensure they are not too significantly impacted by the enforced disruption to their Australian business. Other courses will be delivered online.

   If the monetary value of the Clark landholding can be realised, CEO Vern Wills as the largest shareholder stands to benefit more than anyone else. As such, we are inclined to think he will find a way to fund the business until such time as the value can be extracted from the asset to reward shareholders and assist in realising the potential of the burgeoning international education business. We think Vern is highly motivated to find a solution that doesn't dilute existing shareholders too much. Clearly the market doesn't agree at this point.

3. We added modestly to our DDR holding in March. Among the ASX listed businesses, we expect very few will be in as clear a position to benefit from COVID-19 in the near-term. The equipping of staff to work from home will be a massive tailwind. I have spoken to multiple people whose employers have granted equipment allowances to their staff in order to facilitate working from home.

   The key unknown is how aggressive DDR will be in harvesting margin from the demand spike? If the behaviour of Coles and Woolworths is any indicator, all discounting will disappear, and margins on anything supply constrained will be flexed to ensure supply remains available.

   The March quarter is not usually the strongest one for the business, but there is a decent chance that DDR will post record revenues/profits. The demand spike will likely continue into the June quarter. 2020 was supposed to be a disrupted year as they built their new warehouse and offices at Kurnell. It now looks like 2020 will be another year of spectacular growth for one of the most prodigious businesses on the ASX over the past 5 years. Once the efficiencies of the new warehouse are fully realised, the revenue and profit growth should continue apace. Our expectations were for a pause in profit growth this year before resuming growth in 2021, COVID-19 in the case of DDR appears to have solved that.

4. The price of SMP was almost halved in March. There are likely three drivers for this. COVID-19 is the first and most obvious. SMP are providing payment terminals primarily to small business operators, many of these businesses were shuttered in March for an indeterminate period.
   The second is the collapse in the share-price of recently listed competitor Tyro. Some of the recent advance in SMP's price was attributable to extrapolating the high valuation of Tyro's business to SMP, with the fall in Tyro of a similar magnitude to that of SMP.

   Finally, question marks about the likelihood of the sale of the NZ business completing have had some effect. The decision of the NZ Commerce Commission has been put back to May (declining to allow the transaction by the Commerce Commission would be almost as puzzling as our own bureaucrats initially blocking the Vodafone/TPG merger. Perhaps the only more competitive space than telecommunications would be the payments industry). More likely is that the buyer could have some cause to back out of the transaction due to a (presumably) material downturn in the NZ business. It remains possible that they will look through that short-term issue if the transaction still makes sense, but it remains possible (we don't know the terms of the agreement) that there could be a decrease in the offer price.

   It would seem logical that the consensus is for either the NZ deal to fall over, or to at least be meaningfully reduced as if it goes ahead on the original terms, there is an implicitly negative valuation being applied to the Australian business, which notwithstanding COVID-19 is comfortably the superior of the two businesses due to the additional margin earned from acquiring over the terminal rental model of the NZ business.

5. LAW was down over 60% in March. The recent capital raising and debt to equity conversion was supposed to be the watershed moment that unleashed the potential of what is a truly special business model. Unfortunately, the arrival of COVID-19 has hobbled them at the starting line.
   The business relies on a functioning court system to make the collections that recycle the debt facility. Court systems in both Australia and the U.S. are either stopped or operating at well below normal capacity. In the case of the Australian business, checks need to be run with Centrelink prior to the release of funds, so even when the court system functions, collections are being impeded by other issues beyond the control of the business. The business has reacted swiftly, releasing almost one-third of the US staff to lower operating costs while the key facility lenders (Atalaya and Assetsecure) have apparently both been very collegiate in developing arrangements.

The other effect of the massive reduction of economic activity is the reduction in car accidents, which are the primary source of new business. This is not such an issue as there is no shortage of "paper" available for LAW to buy, their issue has always been the restrictions imposed by the U.S. facility severely limiting new originations. There are a couple of potential solutions to that problem. Firstly, given the very strong performance of the front book (new lending since LAW acquired NHF), under the circumstances, the lender may be amenable to the idea of growing the front book, particularly if the lending can be done on even more attractive terms than has historically been possible, which is likely given the cashflow difficulties some holders of such paper may find themselves in. Secondly, for some time, LAW have been investigating a facility to separate the back book, which in and of itself would eliminate the restrictions on new lending.

To be sure, COVID-19 is a challenge LAW could have done without, but as they pointed out in their last market update, the funds lent are still collectible. The cost to the business will be a potential diminution in the rate of return earned as the debt is carried longer than it otherwise would have been.

6. We marked down the value of our unlisted WOTSO holding this month slightly more than the fall of the index. We also marked our other large unlisted holding in geological waste deposit business TELLUS this month by 20% (it has subsequently come to light that trading in the grey market for TELLUS will take place this month at prices above our pre-mark-down carrying value, so we may need to mark the holding back up in April). These mark-downs were nothing other than the assessment that were these businesses listed, they would likely trade much lower in the panicked state of the market.

   We think the WOTSO business could be a long-term beneficiary of the shift in how corporations use office space. With that said, there will be significant challenges to the business in the immediate term. The team at WOTSO/Blackwall are expert in unconventional property and will almost certainly find a way to turn the challenge of COVID-19 into an opportunity. The listing of WOTSO that was supposed to occur later in the year will, however, almost certainly be postponed.

7. SDI are a considerable beneficiary of the severe fall in the AU$, silver price and global logistics costs. Given the likely sharply lower incidence of routine dental work over coming months however, there will be a short-term fall in their revenues as routine dental is the primary driver of end sales for most of the SDI product range, but this is likely to simply build pent-up demand once conditions normalise.

   I attended a dental conference in early March, and in speaking to some of the SDI sales representatives there, in Australia at least, the supply chain impact of COVID-19 on some of their competitors actually allowed SDI the opportunity to have new dentists try their products (dentists are sticky customers as once they get used to using a product, they are reluctant to change unless there is a demonstrably superior alternative). The Australian market, however, is only a small one for the business as the bulk of sales are export. We think longer term SDI will end up a stronger business after global dental conditions normalise, we added modestly to our holding in March.

8. It was my intention given the state of the markets to reduce the carrying value of our KPT holding to between $1-$1.20 (in consultation with Fundhost who have final say) if the stock remained suspended. The stock came out of the suspension on the last day of March and traded sharply lower, closing at 91cps, which is around half of the hard assets of the business.

   Think what you will about the likelihood of the wharf approval and other valuation factors, but the underlying value of the land on Kangaroo Island whether it continues to be timberland or is returned to alternative uses is very likely to hold up well (particularly if a wharf is available). Most of the remaining assets are now cash. We will hopefully know before the end of the financial year whether the South Australian government will approve the wharf. Between KPT bending over backwards to alter the design to meet community feedback and the presumed desire of Government to stimulate the Kangaroo Island economy to assist its recovery from bushfire, it would be reasonable to think the likelihood of wharf approval has improved rather than diminished. We are invested alongside a board who mostly have a meaningful amount of their personal worth in KPT shares, so we're confident they will work hard to realise the best valuation possible.

9. We were intending to write a comprehensive review of PPK group in an upcoming monthly report once we were sure we had completed accumulating all we wished to own. I will be brief here and say simply that PPK has partnered with Deakin University and developed a way to make Boron Nitride Nanotubes (BNNT) at a cost no one else is currently able to match. BNNT sell for around US$1m per kilogram, the commercial scale production of them is analogous to Isaac Newton's alchemy, only unlike alchemy, the process has been proven.

   The best way to think about the prospects of BNNT is to contemplate the market for Carbon Nanotubes (CNT), which did not exist in 2014 and will be between US$5-10b in 2020. We will likely expand our thinking about PPK in the next monthly report.

10. Not much I can say about Pacific Green Technologies, the business was profiled at considerable length in last month's report.

    The share price is around half of where we acquired our position and at the US$1.34 closing price for March implies a market capitalisation of about US$60m. The company has circa US$20m of cash and as outlined in the report, we believe the earning power of the business under "non-COVID-19" conditions to be around US$30m with enormous growth potential if the land-based scrubbing opportunity is even modestly delivered.

The Zero Fee Collective: -

Despite the remarkable response we've had in respect of The ZFC, in practical terms, it is now unlikely we will launch a new vehicle until we have recovered the losses the fund has suffered in February/March. This is likely to mean this project will drag out until at least 2021. Once we have returned EGPCVF ahead of our benchmark and recovered the recent falls, we will employ a CEO for The ZFC business to take it to launch.

We will continue to register interest and remain fully committed to eventually launching this much needed product to widen the mainstream prevalence of fund managers available with a more investor friendly fee-structure.

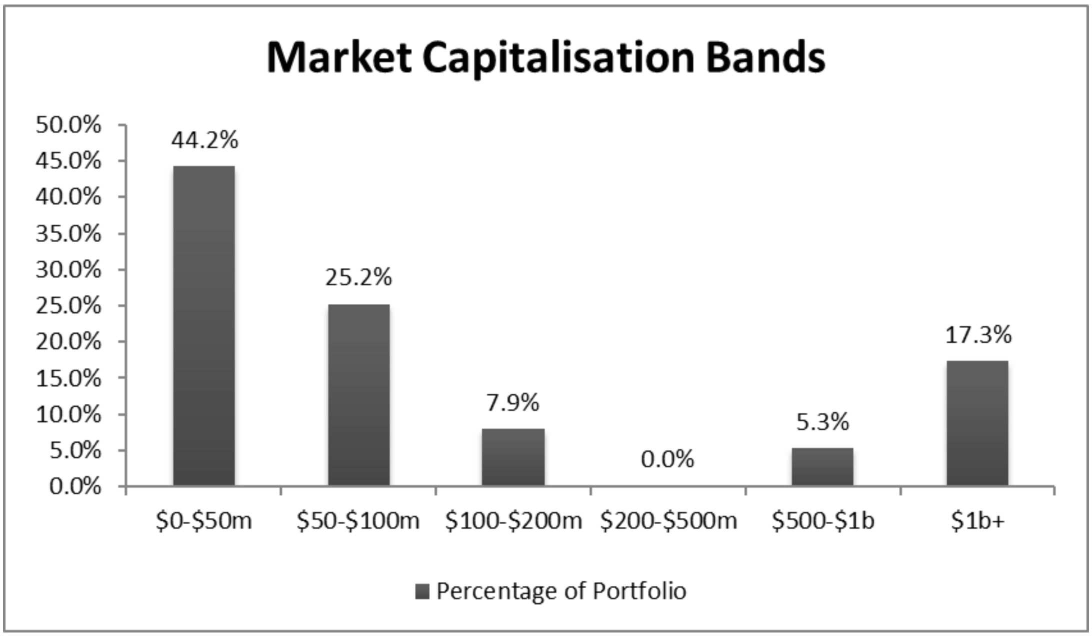
The November 2019 newsletter (.PDF) gave a more detailed outline of what we have in mind for The ZFC. Please keep sending emails expressing interest to ZFCInvestors@egpcapital.com.au to ensure you're kept abreast of developments. We remain committed to a launch in the second half of 2020 at this stage. Fund managers interested in being part can continue to contact us ZFCManagers@egpcapital.com.au so we can discuss how you might be part of the initiative.

Key Portfolio Information: -

Our top 10 holdings at 31 March 2020 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	15.7%	12.7%
2	Site Group International (SIT.ASX)	5.5%	4.5%
3	Dicker Data (DDR.ASX)	5.3%	4.3%
4	Smartpay (SMP.ASX)	4.8%	3.9%
5	LawFinance (LAW.ASX)	4.1%	3.3%
6	WOTSO	4.1%	3.3%
7	SDI Limited (SDI.ASX)	4.0%	3.2%
8	Kangaroo Plantation (KPT.ASX)	3.8%	3.1%
9	PPK Group (PPK.ASX)	2.6%	2.1%
10	Pacific Green Technologies (PGTK:OTC)	2.3%	1.8%

Our largest 5 holdings now comprise 35.4% of our invested capital, our top 10 holdings are 52.3% and our top 15 represent 63.0%. Cash and cash equivalents are 19% of the portfolio. The median market capitalisation is $51m. Weighted average market capitalisation is $283m.



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	$50,000	Sharpe Ratio[1]	-1.63
Additional investments	$5,000 (Minimum) $200,000 (Maximum)	Sortino Ratio[1]	-3.03
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	20.86% 16.78%
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	59.4% 59.4%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	-10.3% -0.8%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	-8.8% -14.4%
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	N/A N/A
Fund Size	$60m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.8154 $0.0121	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.8166 $0.8142

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.