EGP Concentrated Value Fund

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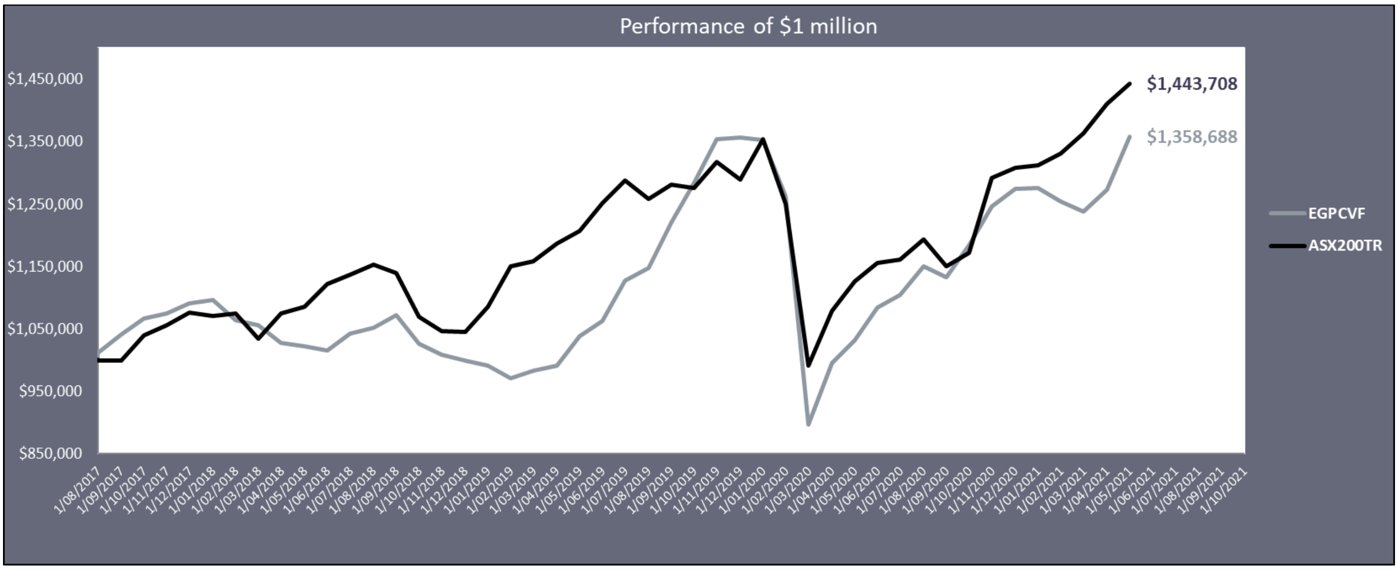
EGP Concentrated Value Fund – 31 May 2021

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%		25.35%
Benchmark FY21	0.5%	2.8%	(3.7%)	1.9%	10.2%	1.2%	0.3%	1.5%	2.4%	3.5%	2.5%		24.98%

*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 6.7% in May. Our benchmark rose 2.5%.

May delivered a strong month of returns for the fund. It was somewhat reduced on what it could otherwise have been with a few notable detractors, Smartpay reported annual results and ended the month meaningfully lower despite the company clearly demonstrating it has reached an inflection point, with operating leverage set to commence its work in FY22, we used the weakness to add to the position. Redbubble's (RBL) continuing loss of investor sentiment again hurt the fund's result. Again, we continued to use the weakness to add to the position, RBL is an incredible marketplace, the likes of which are seldom created and even more rarely available at the type of value investors pricing the market is currently ascribing to the business. ETSY has just acquired a business which appears to be meaningfully inferior to RBL for more than twice RBL's current market capitalisation. If the market does not soon wake up to the opportunity RBL currently presents, it may suffer a similar fate.

Lawfinance finally completed a massive restructure and recapitalisation which should (finally!) enable them to capitalise on the enormous opportunity of their National Health Finance business in the U.S. Nonetheless, tax loss selling and the desire of investors to see the new management team prove their skills saw the valuation contract 14% on the month.

Site Group was also a detractor as scepticism about their ability to stay viable long enough to monetise the massively valuable Clark land asset in anything other than a firesale. We feel like the market has overlooked the sale of the Australian business substantially easing the cashflow issues and the enthusiasm and determination of the major shareholders to ensure a result that avoids dilution and leaves a good result for current shareholders.

Profiting from the Grid Instability Renewable Energy Causes: -

This month's update will review Pacific Green Technologies Inc (PGTK.OTC). We have previously reviewed PGTK here (.PDF) and it is worth revisiting that piece before continuing as the key part of the story is now meaningfully different. We still expect to have an excellent financial outcome out of our association with PGKT, but the reasons are somewhat different now, or at least have been augmented by an exciting new opportunity.

It should make cautious shareholders nervous when the substantive reasons for owning a business change. This can potentially trigger "thesis creep", which is dangerous and when the primary economic driver for owning a stock changes, it warrants a complete, and dispassionate examination of the change of direction and the reasons for continuing ownership. That is what we shall try to do here.

The original driver of PGTK was the anti-pollution business. Primarily Marine Scrubber and Land-based Flue Gas Desulphurisation (FGD) Systems. A company presentation outlining these businesses is available here (.pdf). The company still has meaningful revenues to come from this aspect of the business, and the opportunity, particularly in respect of FGD projects remains enormous globally as major cities fight smog. Other opportunities outlined in the presentation likewise remain interesting as well.

The "pivot" the business is undertaking was announced on 18 March 2021, when the company agreed to develop 1.1GW of battery storage in the UK by 2023. The share price has barely reacted to this announcement, but if our estimate of the economics of the projects is even close, this is an enormously material opportunity for PGTK.

We estimate the 1.1GW of battery storage projects would likely cost ~£300m to develop. Customarily such developments would be ~75% debt financed. There is a non-zero possibility that very low-cost Government debt could be provided at even higher levels than this (which will improve the economics set out below but cannot be relied on other than being a prospective fillip to the already attractive economics).

If the projects are 75% debt financed, it would mean PGTK would need to find ~£75m of cash over the installation period. There is already more than US$20m cash on the balance sheet and the business has been intending to shift their listing to the NASDAQ, where some or all the remaining cash required might be sourced as part of such a transaction.

PGTK has also made a good history of using the enormous balance sheets of the Chinese entities they often partner with to help fund their working capital and equity needs. Shanghai Electric will work with PGTK on the installations and they not only have a long and successful history in grid scale battery installations, but definitely have the balance sheet capability to shoulder some of the equity component of the projects.

We estimate that upon completion of the 1.1GW of batteries, that the income from the collective projects would be in the range of ~£20-30m (before any earnings enhancement that *might* come from low cost/high LVR Government debt, or any balance sheet assistance Shanghai Electric might provide, for example by staging their profit component over two or three years).

£20-30m converts to US$28-42m annually, which compares incredibly favourably to the current enterprise valuation of <US$100m. Assuming the company had to raise US$50m on uplisting to NASDAQ, depending on the price at which

that equity was issued, might require dilution of between 45-50%, which should prove to be an excellent use of additional equity.

Ignoring the legacy aspects of the business (scrubber/FGD prospects etc), and any projects beyond the first 1.1GW of batteries, the mid-point earnings estimated above from the first 10 years of the storage would extinguish all project debt and leave the project “free-carried”. Projects such as this are customarily built with a 10-year power purchasing agreements (PPA’s), which have guaranteed minimum revenues, so the base earnings will guarantee debt-servicing and ensure the revenues are stable and predictable (market participants tend to pay large multiples for stable, predictable infrastructure earnings).

The price at which investors would capitalise these earnings is open to debate, but unless there is a reason to believe the battery will deteriorate very rapidly, we would think that 12-15x is not aggressive unless interest rates go way higher very soon. 12x US$35m is US$420m. Depending on the additional equity that was raised (high insider ownership means every effort will be made to minimise dilution), at the top end, if 70 million shares were on issue after the build out of the battery was complete, the implied valuation of US$420m and 70m shares on issue is US$6. This valuation could also be altered based on the structure of the project financing, if each project were siloed and any debt associated with it non-recourse, the multiple attributed to PGTK would likely be higher.

Depending on the remaining life of the battery installations at the end of the PPA period, PGTK would still hold an asset that should be capable of earning handsome returns. The future earnings of grid scale battery installations are likely to increase as increasing renewables and less stable baseload generation from non-renewable projects make the grid increasingly unstable, therefore amplifying the arbitrage opportunities for storage owners (store energy when power is cheap, discharge when the wind stops blowing, the sun stops shining and wholesale energy prices skyrocket). This article gives an example of the windfall earnings storage projects can earn when there are dislocations in power supply and traditional, on-call baseload is insufficient to supply the needs of the grid.

The idea of profiting from Government mandated market inefficiencies suits the libertarian leanings of my youth very nicely indeed!

Other than profits storage stands to make when major grid dislocations occur, more steady arbitrage profits are earned when over-reliance on unstable power sources (such as wind in the example below) cause huge swings in power prices storage owners can exploit (sudden 30 minute, or even 1-2 hour events where other suppliers are unable to ramp up supply quickly enough to fully enjoy the windfall profits available):

Figure 38 SA wind farms reduce output due to avoid high FCAS exposure

12 February 2020 example

The foregoing valuation ignores the earnings power of the scrubber/FGD businesses. Furthermore, it makes no allowance for the growth opportunities as PGTK’s renown in the grid scale battery market grows. Assume 50% of earnings not used to service debt are used to fund further battery installations. If the economics are like the estimates set out in this piece, equity for a further 2-300GW of installations would be generated in the first full year of operations, implying if sufficient suitable projects can be located, the business should be able to reinvest capital at returns exceeding 20%. As the cost of batteries continues to fall and ever higher proportions of global energy are generated by renewables, the prospective returns should remain attractive for many years.

What Should Management Do: -

Try to exploit the battery opportunity with as little dilution as practically possible. One of the key impediments to earning exceptional returns to equity with high ROE projects is when management is too liberal issuing equity before the market has had the opportunity to correctly price the opportunity.

This appears to be happening in respect of our holding in Tellus, which I wrote up here (.pdf). They are in the market to refinance the project debt acquired to build Sandy Ridge. They have decided to raise ~$40m of equity in conjunction at $2.20, which is a roughly 10% dilution to our holding. We hope the additional equity enables a significant acceleration of the value-creation timeline we discussed in that write-up lest the equity end up being awfully expensive indeed.

The considerably higher insider ownership at PGTK (than Tellus) means management is better incentivised to keep the dilution required to execute on their battery storage plan as minimal as prudently possible. We look forward to seeing how well management go about executing this very prospective opportunity.

The ZFC update: -

Progress has continued with The ZFC project in May. The approved name for the fund product Zero Fee Collective will launch in partnership with JANA is Cipher Fund.

JANA's senior leadership team have appointed a sub-committee including a project manager and we have currently agreed on a target fund launch date of October 2021. Brad and I continue to take meetings with a range of stakeholders to finalise the structures.

A thorough explanation of the goals of the fund and Zero Fee Collective more generally will be provided in the annual letter accompanying the June results next month.

As always, prospective investors or managers who are willing to operate with a ZFC compliant fee-structure are invited to contact CEO of The ZFC, Brad Hughes (brad.hughes@thezfc.com.au) or myself or if anyone is aware of prospective investors or managers please have them contact Brad.

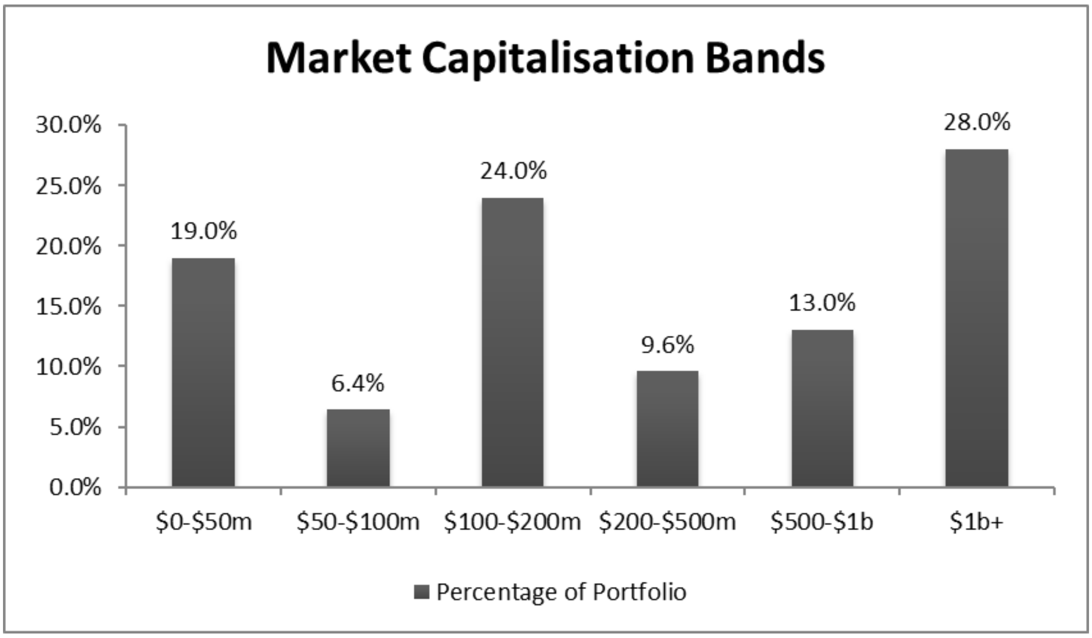
Brad will continue to stay in touch with prospective managers, investors and other interested parties as further developments occur.

Key Portfolio Information: -

Our top 10 holdings on 31 May 2021 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	PPK Group (PPK.ASX) inc. Li-S Energy & White Graphene pre-IPO holdings	13.8%	13.1%
2	United Overseas Australia (UOS.ASX)	9.9%	9.4%
3	Cettire (CTT.ASX)	8.0%	7.6%
4	Smartpay (SMP.ASX)	6.0%	5.6%
5	Shriro Holdings (SHM.ASX)	5.5%	5.2%
6	Redbubble (RBL.ASX)	5.0%	4.7%
7	Dicker Data (DDR.ASX)	4.3%	4.1%
8	Tellus (Unlisted)	4.0%	3.8%
9	National Tyre & Wheel (NTD.ASX)	3.7%	3.5%
10	Undisclosed	3.7%	3.5%

Our largest 5 holdings now comprise 43.2% of our invested capital, our top 10 holdings are 63.8% and our top 15 represent 78.0%. Cash and cash equivalents are 5.4% of the portfolio. The median market capitalisation is $204.3m. Weighted average market capitalisation is $556.8m.



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]	-0.13
Additional investments	$5,000 (Minimum) $200,000 (Maximum)	Sortino Ratio[1]	0.74
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	19.22% 15.91%
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	65.2% 69.6%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	35.9% 44.4%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	31.7% 28.2%
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	9.9% 9.9%
Fund Size	$87m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$1.1919 $0.0072	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$1.1937 $1.1901

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: