EGP Concentrated Value Fund

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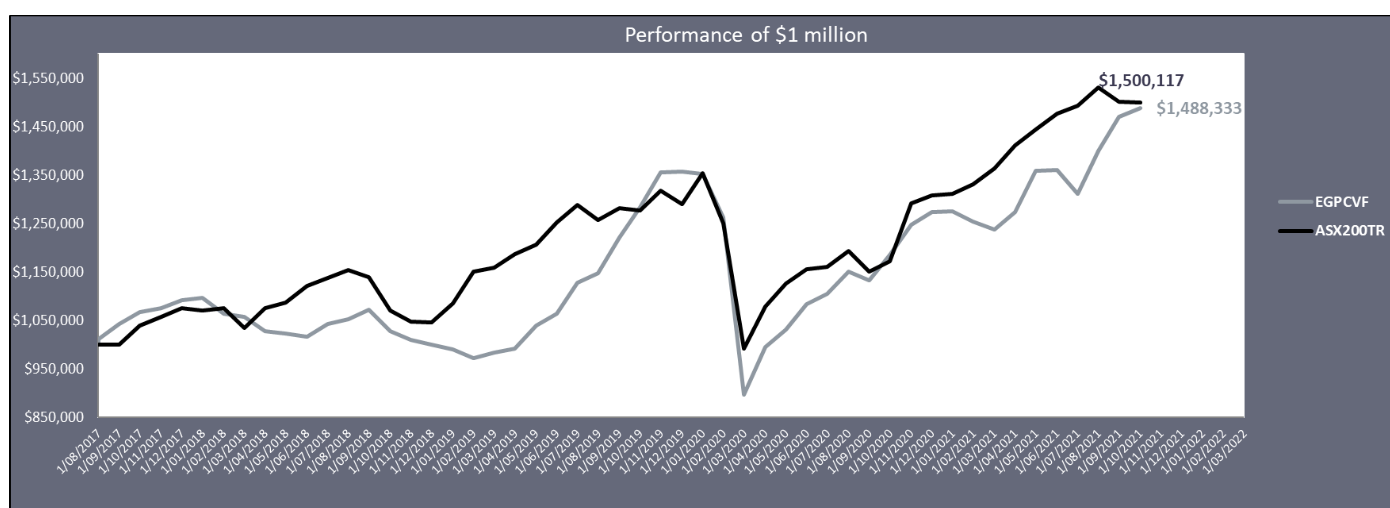
EGP Concentrated Value Fund – 31 October 2021

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%	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%									9.40%
Benchmark FY22	1.1%	2.5%	(1.9%)	(0.1%)									1.61%

*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 rose 1.2% in October. Our benchmark fell (0.1%). It was again a strong month for the fund in relative terms, though only mediocre in absolute terms after sharp falls in the last couple of days of the month took away much of the good performance generated through the month.

Redbubble (RBL) was among the detractors for the fund in October, with the market myopically focused on the business cycling the booming June and September 2020 quarters with negative growth (this should not have surprised given the 2020 boom in homewares when people were forcibly locked in their homes, nor in masks when people were misled into believing wearing masks would measurably slow COVID-19 transmission). The more far-sighted investor would instead look at the September 2021 Gross Transaction Value (GTV) of $142m, compare it to the September 2016 4C (RBL's first as a listed company) which had GTV of $36.6m and conclude this was a business that despite everything in the intervening 5 years [Brexit; the election of the Orange Man; the deaths of almost 300 million humans globally, including nearly 5 million of them attributed to a pandemic virus which caused thick-witted politicians to force their citizenry to endure unnecessary and far-reaching economic, social and logistical disruptions] had managed to grow its GTV by more than 30% annually, and achieve self-sustaining commercialisation.

Even if we strip out the TeePublic acquisition in 2018, which diluted RBL shareholders by ~19%, we still generate a per share organic revenue growth of 26.7% annually over RBL's 5 years as a listed company. Ask yourself what happens financially in a negative working capital marketplace business that has achieved cash flow positivity and has significant demonstrated operating leverage and a capacity to grow the top line at more than 20% annually. To save you the thinking time, the answer is "good things".

Against this challenging backdrop since listing, RBL's growth and demonstrated resilience in a large, attractive market with high returns on capital looks compelling. The business produced an operating cashflow of $11m for the quarter in what is traditionally the second weakest quarter for cashflow (the March quarter when the huge Christmas cashflows unwind being the worst).

Several unitholders have contacted me with concerns about RBL's legal positioning in respect to "fan art" especially. I have been sent at various times designs on the website referencing "Stranger Things", "Rick & Morty", "South Park", "Game of Thrones", "Squid Games" and "Dune". RBL management have discussed the legal risks in this area at considerable length, and the incoherent outlining of such concerns reflect poorly on the analytic capability of the folk raising such matters. RBL have (repeatedly and at length) explained the protections they put in place about such designs. They have also said when asked that they have a very good working relationship with Netflix (and others) around such matters, they describe Netflix especially as very pragmatic, understanding that fan art helps drive virality for their shows. They give RBL very clear guidelines about what is and is not allowable, and anything that is in a grey area is first checked with the pertinent brand owner before publication. Rights ownership is clearly an enormous business risk to RBL, and in simple terms, with nearly 800,000 selling artists regularly uploading new work, there will inevitably be breaches happening every day. RBL will be able to defend such breaches provided they have robust systems in place to prevent breaching materials getting onto the site in the first place, and that swiftly remove offending images/artworks when they are reported in the event they are somehow missed at the time of uploading.

The lawsuit "Hells Angels" are litigating against RBL shows the risks, but to me (with a grand total of 3 modules of Law studied!), the RBL legal position looks very strong on the publicly available evidence. For example, the "Hells Angels Australian trademark officer" (Gavin Hansen – no relation) became aware of an infringing image in early 2020. Rather than alerting RBL and asking to have it removed, according to court documents, he purchased items with the image! When asked why he did not contact RBL, he answered "I don't think they would've listened". Not a strong position to argue your trademark case from… The legal system will acknowledge the challenges a business like RBL face in maintaining image compliance and provided they have robust systems in place to prevent offending images appearing on the site, and to remove them swiftly when they become aware of them, they will generally find on the side of RBL. What the law will seek to punish are flagrant ignorance of image owner rights, which RBL clearly do not engage in.

PPK was also down for the month. As I stated on the quarterly investor Zoom meeting, I have a view as to why PPK's share price has performed poorly since Li-S Energy (LIS) listed. In simple terms, I think there was enormous interest in the LIS IPO and particularly large institutional money managers that wanted exposure to LIS realised that because the IPO was so oversubscribed, they would not get it by participating in the IPO. What I suspect they then did was to buy PPK as a proxy for LIS (given it would own almost half of the business post listing). This buying then reversed after LIS listed as these institutions sold their PPK on market to purchase the LIS they really wanted to own. If this is true, it is a terrible reflection on the analytical capabilities of these institutions, for it means they have missed the many other opportunities PPK has outside of LIS. PPK is worth much more than LIS in our estimation. Given we were up for the month despite these significant detractors, the rest of the portfolio movements were generally positive.

Hey, I've Seen This One! This is a Classic: -

One of the things I enjoy most about being a professional investor is the incredible variety of different industries and businesses I get to spend time learning and thinking about. One day I might be trying to decipher the outworkings of the impending global energy crisis consequent from the recent ESG megatrend (a crisis arising from trying to shut down the "carbon" energy base before a properly functioning "green" replacement energy base is built out. No-one could have predicted that…) with a view to where the best profit opportunities from some of the inaner behaviours might appear (our small exposure to Matrix Composites & Engineering seems to be capturing this trend well with the stock up 50% in October – following on from a 19% rise in September – with plenty of room to run if global oilers lift their maintenance to more sustainable levels). The next day, I might be learning about different battery chemistries, the day after that, perhaps researching the impacts of Artificial Intelligence on medical diagnostics.

With that said, one of the best parts of age (well, experience) is that we start to see things we have seen before. This is both an opportunity and a risk. Having had perhaps our most successful ever investment in Dicker Data (DDR), we learned the intricacies of the distribution industry well and now have several other investments in "distributors", including Shriro, National Tyre and Stealth Global. The opportunity is of course that when you understand an industry well, you can spot similar opportunities. The risk is that you allow your view of an industry to be coloured by your early experiences. Nothing we have done in distribution has been nearly as successful as DDR, though mostly we have generated respectable returns.

I mentioned in last month's newsletter that provided we completed our buying that we would discuss our third online retail business. The other two online retail businesses in the fund are Redbubble (RBL) and Cettire (CTT). Much like our early success with DDR, there is a risk our positive experiences owning fast-growing negative working capital online retailers with large addressable markets has coloured our view of that opportunity. In the case of RBL, since we first purchased shares in late 2017 have generated an internal rate of return (IRR) for the fund exceeding 50% annually on a position that has been of a meaningful size since it was commenced. In the case of CTT, since our purchase in January this year, our IRR has exceeded 1000% (this IRR will inevitably fall, we have only owned the business for 9 months so far).

Such outcomes naturally had us scouring the market for similar opportunities. We commenced building a position in MyDeal (MYD) in September and barring major dislocations in the market, believe it is now appropriately sized given our level of understanding about, and conviction in the business's prospects. It is the funds 10th largest holding at the end of October. MYD is almost half owned by founder Sean Senvirtne. I have spoken to Sean a couple of times as part of the research process, as you would expect, he is smart, engaged, and ambitious and given his large ownership, is beautifully incentivised to deliver outstanding outcomes from the platform he has created. We hope to surf that wealth creation wave with Sean in the same way we have with Martin Hosking at RBL and Dean Mintze at CTT.

Like many tech businesses, MyDeal is not what it set out to be. The business was launched as a group buying/daily deals website. Through subsequent strategy pivots, it has ended up where it is as a marketplace selling a variety of goods but focusing primarily on homewares and bulky items with a fast-growing private label and 3rd-party brands (think Bose/Dyson/Apple/Sheridan etc) business emerging from the marketplace created.

The primary aspect of the business that interests us is the "marketplace" element whereby MYD connects buyers and sellers and takes a fee from the transaction. This is a negative working capital business whereby MYD takes the customer funds upon purchase and often holds those funds for often extended periods until the transaction completes. This business on its own generates a significant cashflow enabling the business to grow without needing external capital (like RBL and CTT).

The reason I hesitated when I first looked at the IPO was the move into private label. This means bringing inventory onto the balance sheet and the risks associated with carrying it (obsolescence/discounting from misjudging demand mostly). I have observed the Kogan (KGN) business with interest and watched with each passing year as revenues and profits appear to grow handsomely, but often, more than 100% of the profits end up stored as inventory in a warehouse rather than as legitimate cashflows than could be paid to shareholders if no suitable high return on investment opportunities within the business existed.

If we look at the FY2020 KGN annual report, a closing inventory base of $228m served annual revenues of $781m. This implies 3.4 inventory turns using closing inventory over booked turnover. The consequence of this was that KGN

consumed $63m in operating cashflows despite adding ~$307m in additional sales in FY2020 and declaring a statutory profit. KGN's actual inventory turnover is much worse than this in truth because the business sells mobile plans, travel, insurance, internet, home loans and energy plans, all of which bring revenue without an inventory imposition.[1]

Compare that to Temple and Webster (TPW) for whom a $21.3m closing inventory was sufficient to serve the ~$326m of revenue (15.3 inventory turns), meaning the additional $150m of revenue TPW generated in FY2020 still allowed them to produce more operating cash ($24.5m) than their reported net profit ($14m).

The comparison of KGN and TPW is of course an unfair one, but it is mostly placed here to remind readers of what we want to avoid in a business model (**"Invert, always invert" – Charlie Munger**) and why the addition of private label inventory to the MYD business model caused me to hesitate about owning the business. We wanted to be sure it would be more like TPW than like KGN.

I view the MYD business model as much closer to the TPW business model than to KGN's. This is by dint of the marketplace origins of the business. In FY2020, TPW had 26% of sales out of their private label business (~$85m), if we measure the $21.3m of inventory against this figure, we get TPW's private label business with ~4x inventory turns, which is not meaningfully better than KGN's 3.4x and shows why it is so valuable to have a capital light drop shipping or marketplace business attached to your traditional inventory holding online retailing business.

Our conversations with MYD have caused us to believe the internal target for inventory turns is at least 5x. The company earmarked $11.25m of the IPO funds for inventory investment, and as you can see in the table cut from the latest 4C, regularly update the market on their progress toward that level of inventory.

Use of Funds as per prospectus	Estimated expenditure ($m)	Actual expenditure ($m)	Comment
Payment to Selling Shareholders	5.00	5.00	Completed
Investment in Personnel	7.00	1.96	On Track
Advertising and branding expenditure	11.50	1.47	On Track
Inventory investment	11.25	6.57	On Track
Working capital	2.25	0.00	On Track
Costs of the Offer	3.00	3.33	Completed
Total	**40.00**	**18.33**	

The same 4C with this table showed ~$1.8m of private label sales in September and ~$1m of 3rd party brand sales. If we annualise those numbers, we get ~$33.6m of sales arising from the inventory currently held. The $33.6m of run-rate turnover divided by the $6.57m September 30th inventory balance is 5.1x inventory turnover, which is aligned with managements targets.

Management mentions **"right, not rushed"** as the guiding philosophy for the execution of strategic initiatives. The fact that inventory turns are according closely with the published inventory growth indicate those words are not just lip-service.

If MYD get to ~$11m of inventory by the end of FY2022 (or soon thereafter) and achieve their target of turning that inventory at least 5 times annually, it would mean the private label/3rd party business would be generating ~$55m of run rate revenue. If the split between the two categories ended up roughly 50/50, we estimate the Gross Margin (GM) would be almost 30%, with ~20% GM in the 3rd party brands business and ~40% in the private label business (TPW earn 45% GM in their private label business so 40% should be achievable). That implies a ~$16.5m GM run rate at the end of FY22 for that business.

The marketplace business is lower margin (the price that is paid for the attractive working capital characteristics) ~14% looking at the ~$28.1m of sales commission over ~$209.5m of marketplace sales in the FY21 annual report. We see no reason after Q1 results that the marketplace should not generate something like $240-250m of revenue in FY22. At 14% GM, that would be ~$34.3m GM from the marketplace side of the business. This means the run rate GM for MYD exiting FY2022 should be something in the order of $51m. It will likely be less than this if the revenues are as

[1] To be fair to KGN, the year prior when inventory was better managed, and inventory turnover was 4.4x rather than 3.4x, the business produced operating cashflows roughly matching reported pre-tax profits. It also means if inventory is better managed this year, KGN could well produce cashflows exceeding reported profits.

described because the $16.5m for the inventory business is a run-rate and the actual FY22 GM figure from that segment would be lower as they build toward that figure.

The 4C for the September quarter was released this month and showed a business firmly in a sweet spot. The business generated $5.5m of operating cashflow despite adding ~$1.8m to the inventory base. One thing I was very impressed with was the no-nonsense, unpromotional presentation of the results. The business was cycling a booming quarter from September 2020 where huge revenues were generated in "COVID-19" related product sales such as disposable masks and hand sanitisers, which largely did not repeat this quarter, not to mention the stay at home products boom, the CEO had previously mentioned to me that in the first Covid lockdown, the business made booming sales in things like bread-makers which also would largely not have repeated for the most part this quarter. Management view was that in online retail, fads and fashions will always come and go and MYD will do their best to capture their share of any such event, meaning individually calling them out is probably unnecessary.

Getting a fix on the cost base is difficult to do because the business is about to engage in its first serious "brand development" advertising program. MYD has already demonstrated scale, so if we ignore this expenditure (they have earmarked a further $10m though based on the table on the previous page, so it is a material number), we can get a sense of where the business could be with respect to net profit before the branding expenditure. Going down the expenses in the Annual Report, if they generate $300m of GTV ($245m marketplace & $55m inventory sales run-rate) then the expenses might resemble the following:

- Advertising = $31.5m (10.5% has been used, which is like the 10.6% from FY20)
- Depreciation/Amortisation = $1m ($750k in FY20)
- Distribution Expense = $6m (distribution expense will likely run at ~13% of private label/3rd party revenues, but will hopefully reduce with growing scale)
- Employee Expense = $6.5m (30% above FY20 H2 run rate as they invest in personnel)
- Finance Costs = $300k (The business has $47m cash, but there are always finance costs…)
- Merchant Fees = $4.2m (1.4%, like FY20)
- Occupancy = $100k (was $80k in FY20)
- Professional Fees = $800k (same as FY20, assume much of this expense related to listing, so could be lower)
- Software = $2.5m (was $2m in FY20)
- Other Expense = $1m (was $900k in FY20)

This indicates the "expense base" before any serious expenditure on branding will be something like $54m, which is above the $50.8m of GM run rate we estimate MYD will exit FY2022 generating, meaning they will likely be modestly loss-making this year (though should still be slightly cashflow positive because of the attractive dynamics of the business model). We will need to deduct from this the money spent in FY2022 on brand marketing, but if done right, that is an investment that should pay itself back handsomely over time.

What the above indicates is that the business should be approaching breakeven in FY22 before branding expenditure, and likely profitable on a run-rate basis. The question then is what is MYD worth?

We think TPW is a pretty good proxy for MYD. There will be a substantial (and growing) crossover in product range. MYD will have lower margins on average, but similar cost ratios down the expense line. That being the case, EV/GM is a sensible comparator. TPW looks like it will generate ~$210m in gross margin in FY2022 and has a current EV of ~$1,450m (at $12.90 per share), for an EV/GM of ~7x. MYD per my estimates should generate a little over $50m of GM in FY22, at ~80c per share, MYD has an EV of about $160m for an EV/GM of just over 3x.

On this simplistic calculation, if TPW and MYD were priced on the same EV/GM multiple, the MYD share price would need to be ~$1.40. Things are never quite that simple. The market will award higher multiples to businesses demonstrating consistent growth, and stronger operating leverage. If MYD get close to the $50.8m of GM we discussed above, this would be ~53% growth over FY20's figure. If TPW get the $210m posited, their year-on-year GM growth would be ~42%. Advantage MYD.

After looking at the raw growth in generated margin, the eye of market participants will naturally fall to the elements of the expense line in the profit and loss, looking for demonstrated scale and operating leverage. It is in this area that

TPW should have an advantage, with almost 4x the GM to play with, the business should be capable of generating significantly higher cashflows and profits.

Once a view as to the operating leverage characteristics is established, the question becomes which business is likelier to sustain high rates of growth. In this regard, despite what some might view as less well-defined product categories, we think the wider product range potentially is an advantage to MYD. If the furniture and homewares market should have a period of weak performance, MYD's more diverse operations would mean it would likely be less impacted.

All things considered, were I to have a binary choice between MYD and TPW at current valuations, I think MYD is a lay down misère winner. MYD will need several quarters to prove the bona fides of the revenue and profitability opportunity as it is described here, but if they can, being awarded a GM multiple like TPW's is possible.

If for example the business could get to say $750m of GTV in 5 years' time, we expect the marketplace/private label & 3rd party split might get to about $500m/$250m, which would mean GM generation of ~$170m. How much of this falls through to the bottom line will depend on how aggressively the operating leverage in the business can be pushed. Our CEO (who owns 47.3% of the business, remember) is strongly incentivised to optimise this leverage.

As the business approaches $1b of revenues, the benefits of scale should start to become evident, advertising efficiencies (KGN is interestingly a leader in advertising efficiency, spending ~5% versus more than 10% for MYD), the ability to drive down logistics costs and even merchant fees combined with improving revenue per employee should really drive profitability. Our hope is that the business at that scale (~$170m GM) should be able to constrain costs to something in the $100-120m range, leaving a pre-tax profitability of $50-70m. Should that be achieved, the enterprise valuation of the business would likely be in the $1-2b range, or a return of 6-12 times on the current EV. A 6-fold return, if achieved in 5 years would provide an outcome that comfortably exceeds the 20% IRR we target at first investment, leaving us comfortable about the risk-weighted return we should achieve on this investment. To fall short of our 20% IRR target over the same period we think MYD would need to be earning less than $25m after tax in 5 years' time, which whilst possible, is a low probability outcome in our assessment.

Your Homework Project, Part Two: -

Considering our newly minted interest in MYD, I would really appreciate if as many of our unitholders and readers of the newsletter could download the MyDeal App to their phones, have a look around the store, if you see something you like, buy it and report back on your experience. Bear in mind that supply chains are currently stretched and delivery times remain longer than usual, so if it's Christmas shopping you intend to do, buy early, buy often and let me know what you think of the experience.

Of particular interest to me are MYD's "private label" brands, "Duke Living" in the homewares/furniture segment and "Esplanade Home" the bedding/Manchester brand that will launch in mid-November.

Quarterly Video Conference: -

We again had a failure with the recording function of the quarterly investor meeting, meaning a recording is unavailable. I believe I now understand the issue causing the problem and we will hopefully be able to produce a recording of the December 2021 update we run in January 2022. The event was well attended with more than 30 attendees, the surest way to ensure you get to see it is to attend, but I will make a concerted effort to see that future meetings are successfully recorded.

The ZFC update: -

As discussed in previous newsletters, Cipher Fund launch is expected to be in or around Q2 of 2022.

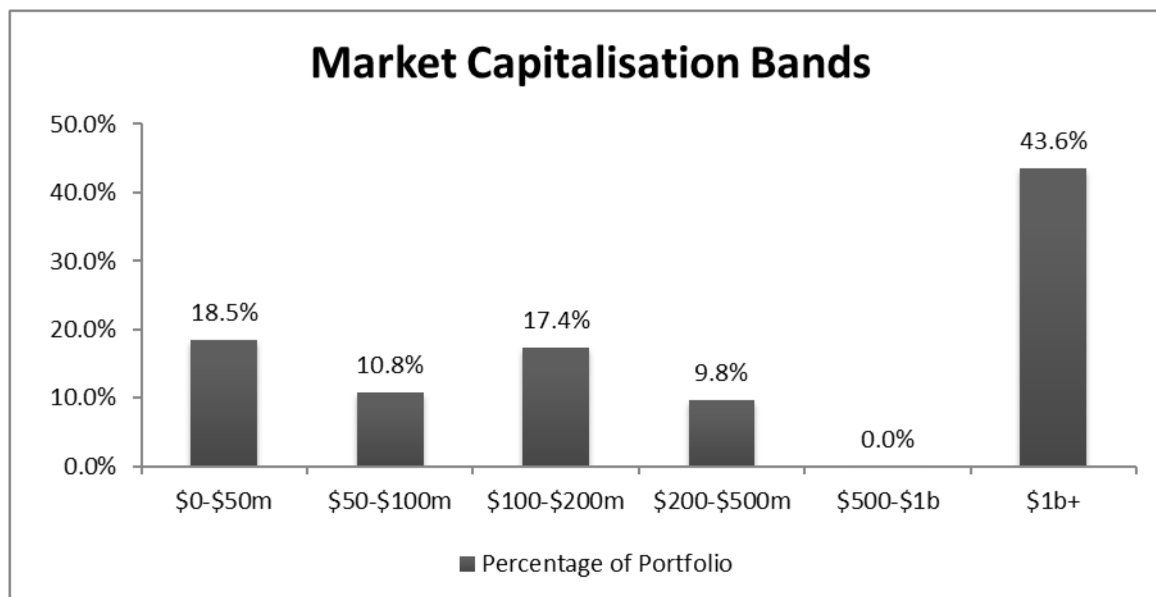
Prospective managers and investors are invited to contact CEO of ZFC, Brad Hughes (brad.hughes@thezfc.com.au) or myself.

Key Portfolio Information: -

Our top 10 holdings on 31 October 2021 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	9.0%	8.4%
2	Cettire (CTT.ASX)	8.5%	8.0%
3	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding	8.3%	7.8%
4	Li-S Energy (LIS.ASX)	8.0%	7.5%
5	Smartpay (SMP.ASX)	5.9%	5.5%
6	Redbubble (RBL.ASX)	5.5%	5.2%
7	Shriro Holdings (SHM.ASX)	4.9%	4.6%
8	Dicker Data (DDR.ASX)	4.4%	4.1%
9	National Tyre & Wheel (NTD.ASX)	3.9%	3.7%
10	MyDeal.Com.Au (MYD.AX)	3.5%	3.3%

Our largest 5 holdings comprise 39.6% of our invested capital, our top 10 holdings are 61.9% and our top 15 represent 76.7%. Cash and cash equivalents are ~6% of the portfolio. The median market capitalisation is $205.8m. Weighted average market capitalisation is $657m.



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	Fund Closed	Sharpe Ratio[1]	-0.13
Additional investments	Fund Closed	Sortino Ratio[1]	0.87
Applications/redemptions	Redemptions only, monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	18.7% 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	66.7% 68.6%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	48.8% 50.0%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	25.7% 28.0%
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	13.2% 11.9%
Fund Size	$90m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$1.2180 $0.0038	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$1.2198 $1.2161

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.

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Appendix 1: -

Combined funds cumulative return since inception: