EGP Concentrated Value Fund

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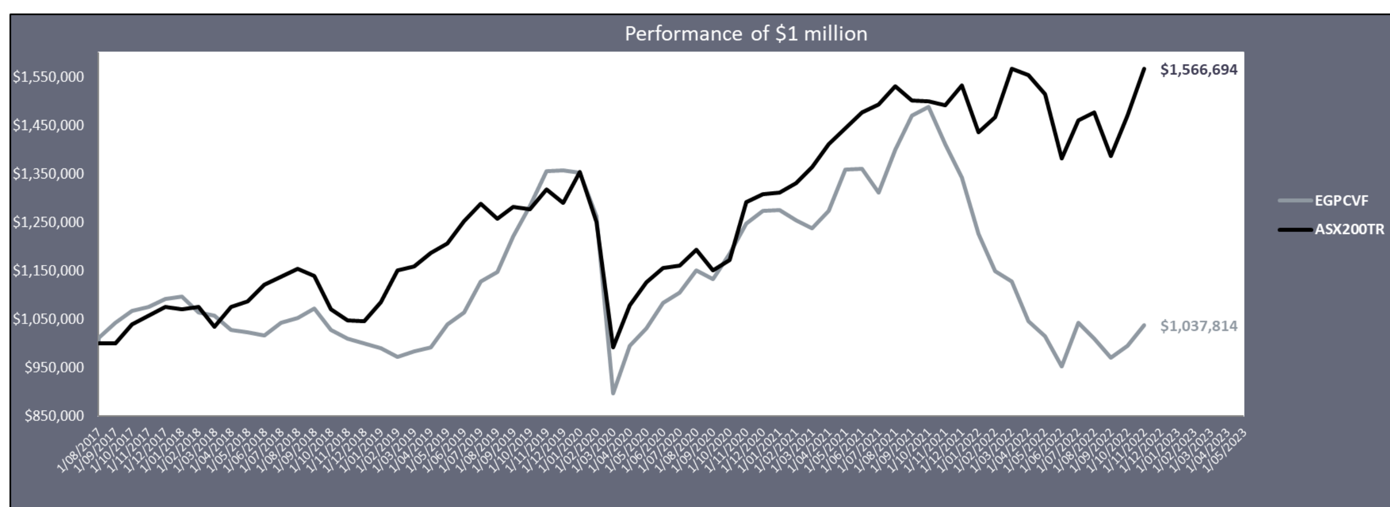
EGP Concentrated Value Fund – 30 November 2022

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%	(5.2%)	(4.8%)	(8.7%)	(6.2%)	(1.9%)	(7.3%)	(3.0%)	(6.0%)	(29.96%)
Benchmark FY22	1.1%	2.5%	(1.9%)	(0.1%)	(0.5%)	2.8%	(6.4%)	2.1%	6.9%	(0.9%)	(2.6%)	(8.8%)	(6.47%)
EGPCVF FY23	9.4%	(3.2%)	(3.8%)	2.6%	4.3%								8.92%
Benchmark FY23	5.8%	1.2%	(6.2%)	6.0%	6.6%								13.46%

*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 4.3% in November. Our benchmark rose 6.6%. Like last month, it was a decent one for the fund, but like last month, our benchmark outpaced us. I do not wish to participate in the fund manager trope whereby "our portfolio is rising for legitimate fundamental reasons and the market is rising despite the fundamentals", yet the sharp recent gain for the market does feel like it is in contradiction with reality.

If the benchmark movements were being driven solely by the strength in commodity producers, it would be easier to understand. The current mining boom is a step-change greater than 2012's "unprecedented" boom we were told by experts were going to see the Federal budget back in surplus (this was only 10 years ago). As discussed in last months newsletter, enhancing this mining boom is a mystifyingly weak AU$. Even more puzzling is that in a boom roughly three times larger than the 2012 one, we still run Federal budget deficits.

Yet the 13% gain by the ASX200TR over the past two months has been augmented disproportionately by the large financials sector, in the middle of the most significant reversal in housing prices in a generation, with a backdrop of the most aggressive interest rate hiking cycle most mortgage holders have seen in their adult lives.

Commonwealth Bank is up 18.9% over that two month stretch. To be sure, CBA is one of the best banking franchises in the world, but at almost 20x earnings and about 2.5x book value, the valuation does not seem to reflect the current situation of their primary exposure to Australian housing. For context, JP Morgan, which most banking analysts would agree is among the best banks in the world trades at roughly half the valuation of CBA at ~11.5x earnings and ~1.3x book.

Portfolio Update: -

November was peppered with AGM updates and was wrapped up by a site visit to the PPK/LIS/BNNT/White Graphene manufutures production facility in Waurn Ponds near Geelong.

The best update of our portfolio holdings was undoubtedly from SDI. Their presentation showed sales growth of 11.6% in local currencies for the first four months of FY2023. This follows on from 16% growth in FY2022. The difference is that in FY2022, all that growth ultimately led to a 12.5% fall in earnings as a variety of logistical and Covid related disruptions impacted profitability. Freight costs alone were responsible for 157% of the fall in earnings in FY2022 (i.e., earnings would have been >7% higher if freight costs had held their prior levels. The logistical disruptions have led to SDI spending significantly on warehousing to hold additional inventory which has culminated in their purchasing a new site to expand operations over coming years.

The update mentioned logistic costs continue to impact margins, but also that operating expenses have begun to normalise. I expect the December half will be materially better than the corresponding period, but that will only be the beginning, over the next few halves, margins will return to around the average of the pre-covid period (caveat is the significant recent wins in amalgams, which are lower margin) and will result in a significant fillip to earnings. Investors barely reacted to the SDI update, which feels a lot like the muted reaction to the spectacular SMP operating update in mid-October, but investors eventually figured that update out with SMP up more than 40% since then.

Speaking of Smartpay (SMP), they released their first half results late in the month. The revenue figure was pre-announced, but it gave us the opportunity to see what was going on down the profit and loss. There were no real surprises, the miracle of operating leverage in a fast-growing, negative working capital business is on display in all its glory. The Australian business should really be analysed on its own, but even anchored by the NZ business, which is not growing, revenue was up by 68.3%. Down the P&L, depreciation grew only 17.4%, and because of the retirement of the convertible note, finance costs FELL. Headline OPEX grew at 57.9%, but that was a story of different parts. Employee costs grew at roughly half the pace of revenue, but marketing costs more than doubled.

As an investor, I would generally prefer to see every cost line grow more slowly than the revenue line. One exception I will happily make is to marketing, when it has the demonstrated positive outcomes every increase in marketing SMP has had over the past few halves has had. Marketing costs were up ~74% in the PCP, producing revenue +68% this period, so the revenue growth is clearly strongly correlated to the marketing spend. At some point once management feel additional marketing spend would be ineffective, the incredible operating leverage the business is currently demonstrating (+68% revenue = +116% EBITDA) will accelerate, although off a slowing revenue growth figure.

Two things out of SMP Management in October leave me very bullish despite the sharp increase in share price in the month. The first was a stated "churn" of 1.1%. Off the current Australian terminal fleet, that equates to only ~12 terminals per month that would need to be replaced to maintain the fleet size. This means the marketing budget could be almost completely extinguished and the business would probably hold similar revenues in perpetuity. It is truly an annuity business, and at the flip of a switch, could be turned into a cash flow monster should management (or an acquirer) choose to do so. We prefer that given they still speak for a low single-digit market share that they continue to grow at the fastest pace prudence enables.

United Overseas Australia (UOS) released a quite special update (.PDF) from their Malaysian Listed subsidiary UOADB. Market participants collectively shrugged their shoulders as they always seem to do with UOS! The near tripling of profits in the September quarter is not especially notable, development profits are lumpy, and the prior comparable period was a weak one.

Most notable was the accelerated sales cadence. Because there has been only limited new projects released through the Covid disruptions, this means a preponderance of these sales are out of the deep inventory pool. This has increasingly been the case over the past few years, with a combination of excess inventory in the key Kuala Lumpur market followed on by Covid causing the company to wind back new project launches in the past 3 years. Over the past four years, inventory has contracted from RM1.64b to RM1.26b. The effect of this on profit margins has been interesting to observe:

2019. GP = 37.4%
2020. GP = 42.5%
2021. GP = 45.4%
2022. YTD GP = 48.5%, with Q3 GP of 56.2%.

Unfortunately, these increasing margins have been on declining revenues due to the dearth of new project launches, but as discussed below, that will sharply reverse in 2023.

When I said in last months report that there was enormous latent value hiding in the inventory, it was not hot air. That value is real and observable and is testament to the benefits of carrying a Balance Sheet resembling Fort Knox. Any unsold inventory when a project completes, UOS simply hold in inventory (usually generating rental income) waiting for conditions to be favourable enough to get sales at the price point that represent full value.

My view is that the outstanding inventory balance is unlikely to sell for much less than a 50% margin, which underwrites ~RM630m (~AU$210m) of profits in coming periods, not a trifling amount in the context of the market capitalisation. This ignores the massive conservatism of the carrying values of the investment properties and the ~1000-acre land bank carried at cost.

The other notable point was the sharp growth in "Other Income", which mostly comprises rental style earnings from inventories and investment properties. YTD revenues of RM173.4m is up 48% on the PCP. These revenues were hollowed out at the end of 2020 when their largest asset, the UOA Corporate Tower was sold. Based on the run rate from the current quarter, 2023 will likely exceed the "Other Income" peak of RM262.8m in 2019 before that large asset disposal and the Covid disruptions.

Founder and Managing Director of UOS, CS Kong was interviewed this month, which is extremely rare and there are a couple of quotes in the article that are instructive as to how UOS think about creating value.

"The key is to build something convenient. Take Bangsar South, for example. Properties there were priced at RM300 psf when we started. Now, they are over RM700 psf. This is due to the convenience we have created."

This quote speaks to the business model on the megadevelopments, Bangsar South, United Point, Sentul Point and the newly commenced Jalan Ipoh. The interview says UOS have spent RM60m (~AU$20m) building "Bamboo Hills", with food and beverage outlets and other amenities that will make it a desirable destination from the get-go as they construct AU$8-10b of property there over the next decade or so.

UOS does some more traditional developments on smaller land parcels, but even these tend to incorporate value add features to maximise the desirability for the end user of the property product. After nearly three years of very modest launches, they head into 2023 with big plans, including commencing a residential mixed-use project at Jalan Ipoh with an RM6 billion (~AU$2b) gross development value. This being the first substantial development at Jalan Ipoh, the

margins will probably be lower than those currently being earned, but there is about a 15-year pipeline ahead in Ipoh and by the end of that, they will be developing much higher value properties like Laurel Residence (.PDF) at Bangsar South, the pictures on page 2 and 3 of that document help explain why UOS earns much higher margins than any other listed Malaysian property developer. The site has gone from a squatter colony to the most desirable suburb outside of the CBD in just over a decade.

The other quote I thought encapsulated the UOS philosophy well was this:

"When we want to build something, we must be sure that it will be convenient for people. We don't build in places with no transport. For us, we want to be very sure that there is NO (my emphasis here) risk and that there is demand. Even when the market is bad and people still need to buy a place, we believe they will choose something that is convenient and affordable."

Every development is near major transport links, if a site lacks some amenity making the location more desirable, they build it. This explains why Bangsar South has a variety of hotels, medical facilities, and other entertainment options. Many of these facilities have a lower yield potential then alternatives, but the high yield properties would not be worth what they are without the amenity. This relentless focus on what the property user will value is why such enormous margins are earned from the developments conducted on mature parts of the land bank.

As mentioned earlier, we were invited to tour the LIS/PPK/BNNT/White Graphene facilities on the Deakin campus at Waurn Ponds in November. The progress they have made in advancing the production of the newest nanomaterial in a very short timeframe is truly astounding. In under 3 years, with the Boron Nitride Nanotube (BNNT) facility, they have single-handedly lowered the global price point by around 95%. PPK's BNNT division can produce and sell BNNT profitably at a price below which any other known producer can produce. The 20 furnaces lined up in the Waurn Ponds facility can each produce around a quarter kilo of BNNT each cycle, with at least 3 cycles completed each shift. Assuming no downtime and 15 shifts per week, this implies a current annual production capability somewhere in the order of 3.5 tonnes per annum, and the scalability of production is now demonstrated and swiftly replicable.

With that said, market participants are clearly not concerned with production capability as much as confidence that there is a large end market for BNNT. Talking with senior staff on the tour who are conducting the negotiations with prospective buyers, clearly price point has been more of an impediment than it was at first expected to be (given the tiny quantities generally needed to produce an effect). But as the production cost and sales points continue to fall, an ever-widening range of commercially viable applications are arising. The applications which are less price sensitive (such as precious metals and the battery applications) continue to be researched to the point they will begin consuming larger quantities of BNNT.

BNNT production is in an interesting catch-22 situation, whereby until they begin taking orders in larger volumes, they will be unable to continue to scale up production to find out just how low they can push the production costs, which would in-turn add new prospective applications, a virtuous circle. When orders come, they will likely come in a rush, and PPK's ability to scale quickly will be tested. Given the handsome margins they will command on those sales, the valuation of the business is likely to move very fast once those orders arrive.

The LIS battery development projects are extremely impressive to observe. What has been done from an R&D perspective with very modest capital expended to date is truly incredible. There are dozens of early-stage companies that would do well to take a leaf out of the LIS book. The timeline for commercialising the battery is not one management can easily influence or accelerate. There are steps that need to be taken and even if they had ten times as much cash in the bank, they would not be able to move much faster.

With the current mood equity markets have towards businesses as early in their commercialisation process as LIS, it is hard to see what is likely to make the current low valuation change in the near term. Theoretically, market participants should be discounting all future cashflows for a business in valuing a share price, but with the wide range of potential outcomes, this is hard to do with any sort of precision. Given the Li-Sulphur and Li-Metal technologies are a step-change better than all current or developing technologies in terms of their applications for battery mobility, and LIS appears to be leading all other known competitors in commercialising these technologies, and the multi-trillion-dollar market that batteries are developing into, the current market capitalisation feels unambiguously low.

With the unpromotional nature of the LIS leadership, absent a significant partnership/JV/equity stake from a major battery manufacturer, or perhaps even a vehicle manufacturer, analysts will likely remain skeptical about the

likelihood the battery will ever be a commercial success. LIS do not need external capital to complete the commercialisation process, but they may well need the imprimatur of an external investor with industry expertise for market participants to believe that successful commercialisation is truly likely, and to therefore command a valuation more in keeping with the massive market opportunity they are pursuing.

The White Graphene facility is earlier in its development than the BNNT facility, but the production engineers have clearly cracked the code as far as being able to produce that nanomaterial at scale, the small footprint currently being used will soon increase production by a factor of more than 10x. Management is clearly confident the commercialisation process for White Graphene will be a much simpler one than BNNT has proven to be for two key reasons. The first is that the price point for Boron Nitride Nanosheets (BNNS or White Graphene) will be much lower than for BNNT. The other reason is that synthesising BNNS into a product production process is much simpler than it is with BNNT.

Despite the much lower price point of BNNS/White Graphene, margins almost as good as BNNT are likely to be generated provided no competitor emerges able to match the low production costs of BNNS by White Graphene. The lower price of White Graphene will be more than offset by the massive scale of the end markets the product is targeting. The market announcement (.PDF) about gelcoat alone shows an incredible improvement in that product which is currently a >AU$2b annual market that is forecast to double by 2030. This is just one discrete industry into which the introduction of White Graphene revolutionises product effectiveness. For context gelcoat speaks for less than 2% of the global paints and coatings market, and announcements shared previously indicate positive outcomes in the application of White Graphene to many other paints and coatings. Paints and coatings in turn represent only a small fraction of the prospective applications for BNNS/White Graphene.

Finally, it seems no month is complete without one of our larger holdings being taken to the woodshed. This month it was the turn of Cettire (CTT). CTT has been a significant positive contributor financial year to date, but unfortunately the strong share price rise tempted founder Dean Mintz to (again) sell a large tranche of shares.

As I said when the previous share sale was conducted, it is not unreasonable for a founder who finds perhaps 99% or more of their net worth tied up in a single business that is subject to a variety of influences that are not always completely under the control of the business to wish to crystallise some of that wealth to ensure they are permanently and generationally wealthy regardless of how the world unfolds.

I have said this to friends and fellow investors alike that the fact that someone like Nathan Tinkler went bankrupt after reaching billionaire status should not be possible as personal risk management should ensure that a significant portion of that equity wealth is turned to cash and debts should either be extinguished, or held to a modest proportion of total wealth. From memory, at the time of the merger of Aston Resources into Whitehaven Coal, Tinkler personally held more than 12% of the combined business, which would still be worth in the region of $1b had he not been forced to sell to repay debts. This was just one of many assets held by Mr Tinkler.

The fact that Dean Mintz is clearly more conservative than someone like Nathan Tinkler is incredibly pleasing to me, it shows a streak of prudence I hope all our CEO's possess. With that said, he has now liquidated more than $100m in cash between the sale of equity stakes at IPO and in the two subsequent transactions. Taxes have surely eaten a hole in that figure, but by any standard, our CEO should now have more liquid wealth than he is ever likely to need.

Investors more broadly clearly feel (based on the stock trading below the discounted price the stake was sold at) that the sale indicates a lack of faith in the longer-term prospects of the business. I am willing to give the benefit of the doubt for now, in his position I feel I would have done something similar. From this point forward, any further (significant) sales, I would have to take as an indicator of a lack of faith in the sustainability of the business. Because now that the business is profitable and generating cash, as the owner of almost half of the business, if our CEO wants to turn some of his investment into cash, he can do this by way of dividends, even a modest 30 or 40% payout ratio, given how profitable the business has now become would generate a significant annual income.

The ZFC update: -

The launch of Cipher Fund is now expected in 2023. Brad and will meet with JANA this month. We continue to intend to update on the progress of Cipher once we have information that can be shared.

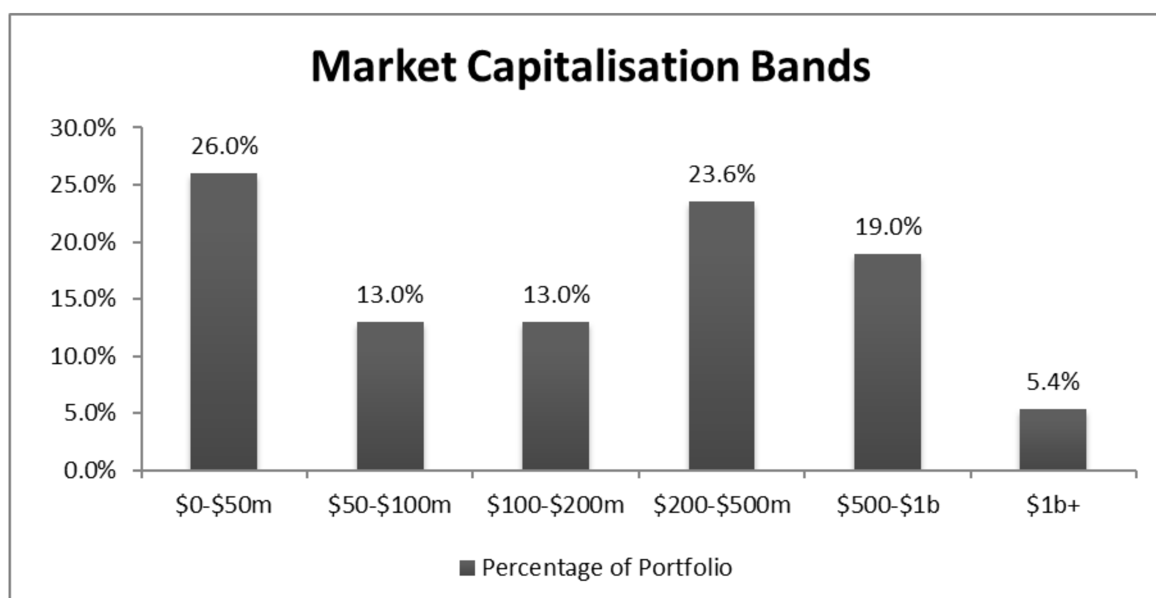
Prospective managers and qualified investors are invited to contact Brad (brad.hughes@thezfc.com.au) or myself.

Key Portfolio Information: -

Our top 10 holdings on 30 November 2022 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	12.4%	10.9%
2	Smartpay (SMP.ASX)	10.5%	9.3%
3	Shriro Holdings (SHM.ASX)	6.9%	6.1%
4	Cettire (CTT.ASX)	6.6%	5.9%
5	Tellus (unlisted)	6.1%	5.4%
6	Dicker Data (DDR.ASX)	5.4%	4.8%
7	PPK Group (PPK.ASX) inc. White Graphene pre-IPO holding & PPKME	5.3%	4.6%
8	SRG Global (SRG.ASX)	4.9%	4.3%
9	Blackwall Limited (BWF.ASX)	4.9%	4.3%
10	Scout Limited (SCT.ASX)	4.7%	4.1%

Our largest 5 holdings comprise 42.5% of our invested capital, our top 10 holdings are 67.7% and our top 15 represent 83.3%. Cash and cash equivalents are 11.5% of the portfolio. The median market capitalisation is $143.3m. Weighted average market capitalisation is $336.5m.



As always, investors with any questions, suggestions, comments, or investment ideas should feel free to call (0418 278 298), or send me an email – Tony@egpcapital.com.au

Fund Features		Portfolio Analytics	
Min. initial investment	Fund Closed	Sharpe Ratio[1]	-0.15
Additional investments	Fund Closed	Sortino Ratio[1]	0.07
Applications/redemptions	Redemptions only, monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	19.0% 15.7%
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	57.8% 65.6%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	3.8% 56.7%
Custodian/PB	NAB Asset Services	1-year return[2] – EGP 1-year return – Benchmark	(26.4%) 5.0%)
Responsible Entity	Fundhost Limited	3-year annualised return[2] – EGP 3-year annualised – Benchmark	(8.5%) 5.9%
Fund Size	$49m	5-year annualised return[2] – EGP 5-year annualised – Benchmark	(0.7%) 8.2%
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$0.8194 $0.0031	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$0.8206 $0.8181

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: