Alan Kohler Interview with David Lamm – Executive Chairman and CIO – NGE Capital Limited

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FULL TRANSCRIPT

This week's fund manager interview is with David Lamm, the Executive Chairman and Chief Investment Officer of NGE Capital. Now, NGE stands for New Guinea Energy, which is what the company used to be until David converted it into a Listed Investment Company, which is what it is now.

It's a very interesting LIC. It has a very concentrated portfolio, and what you're investing in with this business is David Lamm's expertise, I guess. He's got some interesting ideas all over the world. His biggest investment is in RUSAL, the Russian aluminium producer, but he's also got a big investment in a London-based company PLC called Yellow Cake, which just owns uranium. It doesn't mine it, it just owns uranium, which is interesting in itself.

Look, they've got some interesting investments, including one unlisted investment called Powerwrap, which is a competitor to Netwealth and HUB24, and so on these investment platforms, plus a few other resources investments as well. It's trading at a discount of about 15% to NTA, has been less of a discount. The share price popped up last year quite a lot after they had a big win with mineral deposits. They had a fair size shareholding in mineral deposits, which was taken over at quite a big premium to the share price, so they made some money out of that, but they've also had some big losses.

The trouble with a very highly concentrated portfolio like NGE's is that you can have big losses and big wins, but so far, their wins have outweighed their losses, so they seem to be doing well. They've got an interesting portfolio to look at, and it's worth listening to David's philosophy and also what he's charging, which is salaries, not fees, but the salary's a fair bit. Here's David Lamm, who is the Executive Chairman and Chief Investment Officer of NGE Capital.

David, perhaps you could just take us through some of the background to NGE Capital, because I think there was a backdoor listing in 2016. Now, you had a previous business, or have got a business called Kentgrove Capital. Can you tell us why you didn't float or didn't IPO Kentgrove Capital and instead went for New Guinea Energy as a backdoor listing?

Okay, sure. It's not exactly how I thought about it back then, so going back three and a half years ago, I came across a company called New Guinea Energy. It wasn't NGE Capital back then, so same ticker but New Guinea Energy.

The company was trading at the time at a discount to cash-backing, and it also had some potentially very large upside from oil and gas licences it had back then that had farmed out to the majors, and should they have drilled those licences and succeeded, there would have been some large payments coming the way of New Guinea Energy. So, I invested...

David, it also owned a piece of Karoon Gas, didn't it?

No, I can get there as well.

Sorry. Okay, keep going.

Back then, the company had one large shareholder, which was George Soros, who owned 19.9% of the company, and I bought that stake off him. At the time it was good investment for us, we thought, effectively 32 cents of cash in today's terms. We've done a consolidation since then, so 32 cents, and now we're looking at, some years on, and we've got NTA of 83 cents and the share price is about 74, 75.

It didn't eventuate as an RTO, it really was an investment that I made in a big way, for me, into New Guinea Energy and then decided to convert that company into a listed investment company. And there are a few reasons for that. One is that at the time, we had this potential large upside that we wanted to retain, and in the end, they amounted to zero. Oil Search and others spent $200 million drilling wells and came up with nothing, so we didn't realise the benefit of that, but we did realise the benefit of investing the capital that NGE had.

Over that time, we closed the three offices the company had in Sydney, Brisbane and Port Moresby, we ceased exploration drilling and expenditure and began to invest in companies. One of those, that you mentioned earlier, was Karoon Gas. That was, in fact, before we formally converted the company to a listed investment company. It was a great investment back then for us.

We could do it, at the time, partly because we were an oil and gas company back then, and subsequent to converting into a listed investment company, we can now invest in a much wider mandate of companies, which we have been doing and quite successfully, I might say.

Well, indeed. We'll get onto that in a moment. But why did you decide to put Karoon Gas into NGE rather than Kentgrove Capital? And perhaps you could explain to us how you distinguish, how you decide what goes into Kentgrove and what goes into NGE.

Yeah, sure. Kentgrove is a very small managed fund and there hasn't been many new investments in Kentgrove since the emergence of NGE. We're not a large managed fund, so some of the investments that NGE has made has been pre-existing investments by Kentgrove that NGE has also invested in. The strategies are very similar. Going forward, we would look to where we make new investments, do it on a pro-rata basis.

But having said that, without going into too much detail on private Kentgrove Capital, it's a very small fund.

Right, so you could merge the two businesses, couldn't you?

Yeah, we could and it would be for consideration, and there'd be a few things to take into account. One of them is NGE Capital, as we renamed it from New Guinea Energy, has a very material amount of tax losses, so to the tune of, at the moment, about $45 million, although potentially some more than that.

We can utilise those within NGE Capital. It's quite advantageous for us and, indeed, all shareholders within NGE because, for example, for the last two years we've made a lot of profits and haven't had to pay any tax, and actually for some time I don't think we'll have to pay any tax. That's one consideration where we would have to be very careful in how we restructure NGE Capital to not taint those tax losses.

I think Kentgrove's shareholding in NGE is now up to 27% or so. Is that right?

Correct.

And you've done that through creep, have you?

Creep and buybacks, so since we invested first at, obviously, 20% or slightly under, we've both crept but also bought back over 10% of NGE's shares. Partly that's because NGE has been trading at a material discount to NTA actually the whole time, and where the discount blew out, we purchased back shares and we would seek to continue doing that if the material discount persists.

Now you mention the discount, obviously it closed to some extent. Early on it was 24%, 25% discount, but now it's back to 15 or so percent. Why do you think that discount is in existence? You should be snapping it up.

Well, look, I did, and to that extent we crept and bought a lot of shares about a year ago at 45 cents, and that's been a great investment and I can't do that all the time, but we have been doing that. The company's been buying back where the discount existed, and I personally have been buying. I bought some in my super fund and it's been a fantastic investment for me.

To your question, why does the discount exist? In my opinion, there's no good valid reason. Funds should trade at NTA. Trillions are invested in managed funds. Money goes in and out at NTA, they all have management fees, but the right price is NTA. The difference with LICs is that there's captive capital, there's no opportunity to subscribe and redeem units. However, NTA is a fair price, but as you know and your listeners would know, share price is determined by how many buyers and sellers there are in the market, so to quote Buffet, in the short-term the market's a voting machine, in the long-term it's a weighing machine, and at the moment there aren't enough guys out there who know about us and are buying our shares.

Now, over two years since we came on board, there has been some transition in the shareholder base from guys that were in there for sort of 10-bagger striking oil to guys that want steady or safe returns out of an investment company, and so there has been some transition of shareholders selling out and new shareholders buying in. I think that's largely run its course. Perhaps not fully but largely. My opinion is the only real justification for LICs trading at a discount or a premium to NTA is the skill of management.

If management are likely to destroy value for the LIC, then it should trade at a discount. If management are expected to grow NTA, and indeed, if it's above market returns, then there'd be justification for it to trade at a premium. Over the past two years, I believe we should have justified to our investors and to the market that we grow NTA and we do a good job of that, and therefore I don't believe that the discount is justified.

And perhaps one last point on that. Fortunately, and I touched on this before, we inherited a very large pile of tax losses from prior management, which we can utilise, and so there's some added justification for us to, in fact, trade even at a premium.

If I could venture an opinion, possibly one of the reasons you're at a discount because your investment philosophy seems a little confusing. You've got some unlisted stocks, some listed. You've got something on the New York Exchange. You've got RUSAL, which is a Russian business, you've got a PLC on the London Stock Exchange. I imagine it's probably difficult for investors to get their head around what you're doing.

Yeah, look, fair enough. We're not an index FUM. We don't measure ourselves against an index, or invest alongside an index. Index style investing is a no-lose strategy. But it's also a no-win strategy. If you want to beat the market and generate great returns then you have to be able to invest where you see real value. Our investment strategy which you said might be confusing based on what we invest in, is actually very simple.

Our investment strategy is summed up in four points. One, we'll only invest in a compelling opportunity otherwise we'll hold cash. Two, we invest based on fundamental analysis. Three we target investment returns that can generate strong returns with an adequate margin of safety. And four, we aim to hold a concentrated portfolio of high conviction investments and that allows us in terms of your pointing to our investments being across the world, yeah, we will invest not just in Australian stocks but in overseas stocks where appropriate. We typically will not make investments in unlisted companies, although you pointed out we do have one which is quite material and that was really a pre-IPO investment but it's still not yet listed.

Our strategy is to generate strong risk adjusted returns over the medium to long term and the way we do that is through concentrated investing and we're going to look different ideas and different parts of the market and invest in a significant way for the company where we see value.

Yes, and you are very concentrated. You had a big win last year with mineral deposits which took your NTA from, I'm just trying to remember now, 64 to 74 cents or something like that. A big increase in NTA and so your share price popped up as well. It was because Mineral Deposits was taken over at a big premium to what you owned it at.

Yeah, sure. We invested in a material way, at circa 40 cents into Mineral Deposits. It got eventually taken over for a $1.75, a fantastic investment for us. There were other factors that caused the pop in our share price back then. One of them was Powerwrap where we invested at 6 cents a share and then it was re valued at 10 cents a share after the company did a large raising at that price, and actually other shares of ours did well, over the same time. We haven't been perfect in our investments. We've had a few doozies, namely…

Godfrey's would be one, wouldn't it?

Yep, Godfrey's absolutely was a disaster for us as has been Millennium Services. We've had two or three duds and we certainly take responsibility for that and we apologise to our shareholders when we get it wrong and we got it wrong.

Tell us about, let's talk about Powerwrap, you mentioned Powerwrap. Now it's 20 percent of your portfolio which is a lot. You're on the board of Powerwrap, what percentage of Powerwrap's capital does NGE own?

NGE bought roughly 9% of Powerwrap when it invested a year and a half ago and back then the investment wasn't quite 19% of our NTA. We had to revalue Powerwrap up in accordance with the capital raise that Powerwrap did subsequently, so it's become a larger percentage. After we invested the company was supposed to IPO shortly thereafter. It was supposed to replace board and management and so I had never intended to end up on the board although I wasn't comfortable with the pace of how the business was moving back then and what was represented to us at the time of our investment. I ended up on the board and the company is now slated to IPO in the coming months.

And do we have any idea of what the price will be in the IPO?

No, I don't. That will be determined by the brokers and the market. Obviously, I can't comment on that.

You couldn't tell us if you did know.

Correct.

It competes with HUB24 and Netwealth and those businesses doesn't it?

Yeah, that's right. It's in that same space which, when we invested, and one of the reasons we invested, is it's quite an attractive space. The industry has tailwinds, and it's actually quite a big player in that space.

Yeah, but it's very competitive. What does Powerwrap do that the others don't do?

One of the things that Powerwrap does that the others don't do is looks after very well higher net worth clients and planners, where they can take off platform assets and manage them quite efficiently and effectively and it provides a level of service that's not provided by their competitors in HUB and Netwealth.

Your biggest investment is in RUSAL, tell us about that and why you're there, why you're in it.

Yeah, sure. RUSAL is a very large aluminium producer. It accounts for about 6 percent of global aluminium supply, a tier 1 producer, low cost. It's a Russian company. It's listed on the Hong Kong Stock Exchange as well, that's where we purchased our shares.

The situation arose where the United States put sanctions on the company and ultimately its controlling shareholder Oleg Deripaska, and as a result the share price halved almost overnight and we invested after that point where we were of the opinion that the aluminium price responded to that event by increasing 28% shortly thereafter and the United States are a very big importer of aluminium. RUSAL is the biggest supplier of seaborne aluminium, the biggest producer outside of China as well and it was one of those cases where we thought it was too big to fail and the US could never allow that to happen.

The US and Treasury Secretary made a number of comments saying they didn't have any issue with RUSAL, it was really the owner of RUSAL or the controlling shareholder of RUSAL and didn't want to impact the global aluminium markets or the thousands of employees that RUSAL has, so we were of the strong opinion that those sanctions would be wound back. They were continually extended, extended, extended, which is highly unusual and eventually on the 28th of January this year, they were lifted.

The case was a peculiar one where US shareholders were prevented through the brokers from actually purchasing shares and indeed, in most cases had to sell their shares and we in Australia were not caught up in those sanction rules so we were able to purchase and hold the shares and it's done very, very well for us. We invested at around $2.30 Hong Kong per share and the shares are now are trading at about $3.75, so it's been a fantastic investment for us and maybe part of the reason why our NGE shares have gone up since the end of the last month because I think some of our investors will look through to our portfolio and see the share price movement. It's been a great investment.

RUSAL, looking through, also has a 27.8% stake in another large company called Norilsk Nickel. The look through value of that stake is actually more than the whole company, more of the whole of RUSAL, over US$9 billion and that is also a Tier 1 producer of nickel, platinum, palladium primarily, and also copper. Low cost, large scale producer. Some electric vehicle thematic as well in there because of the grade of nickel that Norilsk Nickel produces. All around the investment actually has real Tier 1 assets trading at a PE of around 3, maybe 3.5 times EV/EBITDA of about 2 to 2.5 times and this is seriously cheap and we invested at much lower prices than that.

You're not selling RUSAL I take it?

No, we haven't sold any and we will. It's a very large position for us but I think it's got a way to go still.

Sounds like you should buy Norilsk as well.

Yes. We have an investment effectively in Norilsk throughout holding in RUSAL, so we kind of get that 2 for the price of 1 situation, almost. We're happy with both companies.

Tell us what the fee situation is. What fees are you charging at NGE and who gets the fees? Is it Kentgrove Capital?

The fees, you have to note it's an internally managed Listed Investment Company which means there aren't fees as such. I am an employee of NGE. I get paid a salary so do the other employees of NGE Capital. Our salaries or the salaries of the investment team, equate, to put it in perspective, to roughly 1.2 percent of NTA. If you want to compare it to other LICs that's effectively the base fee. Over the past two years as we've grown NTA by roughly 25% a year, we received a bonus each year of approximately 100 percent of our salary for achieving that NTA growth target.

Does that take it to 2.4 percent of NTA then?

Yeah, if you'd like to think about it like that, then yes.

2.4 percent's enormous!

Well for the best performing LIC over the period, I'd say it's not very high and if you compare it to the performance fees of other LICs, it's actually very low.

Is it the case that as the NTA increases, as more money is invested, perhaps you'll do some raisings, that percentage will come down?

Yeah, so the...

Or is the intention to maintain the percentage?

The base salaries as a percentage of overall NTA will likely come down over time as we grow NTA, assuming we can grow NTA. It's not fixed as a percentage of NTA.

Yeah, right. Okay. I think I'm done. Is there anything else we should know?

Look, other things to note, you've obviously seen some of our other shareholdings. Happy to comment on them if you'd like. Yellow Cake is another big one ours. It's a play on the uranium price. We've seen a lot of upside.

What does it own? What does Yellow Cake PLC own?

It's owns uranium. Physical uranium. There's a lot of uranium companies, exploration style companies in Australia. It's hard for us to see how any of them will ever get into production profitably, if at all, however, uranium's trading at about $29 a pound, which is loss-making for most of the producers in the world, and here if you can just buy the actual commodity, the downside is limited, but if you look back to just over 10 years ago, uranium peaked at

$143 a pound, and so the upside from the actual commodity, I could easily see the uranium price going from where it is today, about $29, to easily doubling to $60, or tripling to $90, or going up further. There's been constant curtailment of production in recent years, and the market for uranium continues to grow.

More reactors getting built, and so we see it as the lowest risk play is to actually buy the physical commodity. Typically, we're more happy to buys companies that produce earnings, here there's no production of earnings, but we think that the downside is limited, the upside is large.

It's a listed company that just owns uranium, just owns Yellowcake?

Yeah, that's correct. Listed in...

Where's the stuff it owns? Where is it?

It is held at Cameco's facilities. There's about three storage facilities of uranium in the western world, or I should say, outside of China and Russia. It’s in Cameco, which is a very large listed company, a Canadian listed company and they hold physical uranium on behalf of a lot of industry players.

And do you know what they're plan is? To just sit on it until the price gets to a certain level, or what?

Yeah. Well, good question, because how do you know how these things will end up? But their plan is essentially to sit on it.

Right.

They have an option to buy more uranium via the Kazakhstani company, Kazatomprom at spot prices. Kazatomprom is the largest producer in the world, and at the moment they're trading at about a 10% discount to their NTA, and they're effectively like a Listed Investment Company with one stock and one strategy, which is to own uranium, and I think their plan is to grow the value of the uranium holdings. There's a similar company listed on the Toronto Stock Exchange, which has been around for longer and larger, again doing exactly the same thing, and in general, they just trade a bit below or a bit above NTA, based on the uranium holdings.

At some point in time in the future, you could easily see there being a crunch or a mass shortage of uranium, and someone may want to buy the entire holding.

One thing I should ask you is, how do you find these things?

Yeah, good question. All sorts of ways, and as you can see that we've got investments all over the place, and our idea generation is such that we've got screenings, we've got theories that then we go chase down ideas. This one in particular, I've been invested in uranium a long time ago. I thought, it's been a long time, the price has come off. It may be a cyclical low. Often you see commodities or prices for anything down circa 80%, and there's only one way to go and that's up. We started looking at the uranium companies, but just couldn't find anything that was worth investing in, and then came across this in our research, which made a whole lot of sense. It was a simple idea.

But in general, we're looking for ideas all over the place, or we're reading and listening to a lot of people and I guess most importantly, we only have to come up with a handful of ideas each year to generate really good returns. You mentioned concentration before, and the way I think about it is, and Buffett’s really guided to this, which is a sensible level of diversification is having five stocks account for 80% of your portfolio, and that's how we see it, and that's actually how our portfolio has evolved.

We don't target that, but that's just how it is at the moment, and how it often is. The reason is such that, if you have 20 or 30 investments, how good is your 20th or 25th best idea. It's just not going to be that good. We'd rather concentrate our capital in the handful of our best ideas.

It seems you've actually got six stocks, listed stocks that account for about, I think about 60% of your portfolio, but you've said the listed equities count for about 72%, so there's a gap between those six and the list of equities. What else do you own? Have you got a broad portfolio?

So, we've listed our top holdings. We don't list all of our holdings. We often don't like to list the holdings where we're building a stake, so that we do. There are a few in our portfolio that are not on this list. One is Millennium Services, which dropped off, as actually the share price declined, it became a small percentage, and so, it dropped off the list. There's one or two others. There's actually a new investment that we've got. It's quite a large investment. I can't talk about it on this call because we haven't yet disclosed it to the market. I'll hold off on that one. But there's another one that we're quite excited about. There is one that I can talk about. Well actually, there's a few that I can talk about if you've got the time on this call. One of them is Horizon Oil, which we've been invested in and we haven't made money out of it yet, but we think that it's a really good investment, and should do really well for us.

Why is that?

The market cap of the company is adjusted market cap for options and things, is about $200 million. Right now, it's generating about $100 million of cash flow a year, so if you just think about that, about two times cash flow, it sounds cheap to me, EBITDAX. It's an oil producing company, so it produces oil. The last half it did US$44 million of EBITDAX. It's US$88 million, $125m Australian dollars, and...

What's EBITDAX, what does that mean?

Earnings before interest, tax, depreciation, amortisation and exploration cost.

Exploration, right, okay.

I's an oil and gas metric. Yeah, we look at things in a few different ways. But the best way for this company in terms of how we value it, is doing a DCF analysis. A discounted cash flow analysis. Because it's got cash flows, we can see the production profile looking out quite a few years, and our discounted cash flow analysis says that at an oil price of where it is today, it's about 18 cents a share. A fair value for this company, just for its cash flow, the share price today is at 12 cents, so we've got some fair upside just to our valuation of its actual real cash flows.

Now, of course, it's subject to oil prices. Oil prices can go up and down. That's a risk. Why we like it is because we've got some downside protection because we're buying in. We own the shares at a fair discount to the current valuation, but then the kicker is that they own a whole lot of licences and ground in Papua New Guinea, and these licences, it's a giant potential LNG project. Nothing's happened with that. I don't think there's any value in the stock for that. They, some years ago, sold down some stakes in that, and have various extra payments on FID, or on starting to work, on completion.

There are some issues with that at the moment, where Repsol, who's one of their partners, is trying to sell their stake to a Chinese company, and the PNG Petroleum Minister was blocking it, and we believe that there's a good chance that they resolved that standstill, because it's in everyone's interest to allow that to go through, and therefore for the field to be developed. The read through for this company, for Horizon Oil, is if it goes ahead, the sale, there's a look through value for that asset. And if it goes ahead and end up being developed, a long way before it actually gets developed, that the value for Horizon could be something like 10 to 20 cents a share, so we get upside just from its current production, but then we get potentially another 100% maybe 200% upside on our investment from their PNG LNG project.

That's a style of investing that I really like, where we've got downside protection and we make money, most likely, in a best case, we make a lot of money if things go right and actually, I think the balance of probabilities is it probably will go right.

Very interesting. Well, we will have to leave it there, David. It's been interesting to talk to you. Thank you.

Thanks very much, Alan.

That was David Lamm, the Executive Chairman and Chief Investment Officer of NGE Capital.

END OF TRANSCRIPT