ASX: SEC

Investment Update

As at 31st October 2018

Spheria Emerging Companies Limited
ACN 621 402 588

Pre-tax net tangible assets[4]

$1.968

Company[7] performance (since inception)

0.3%

Company Facts

Investment Manager	Spheria Asset Management Pty Limited
ASX Code	SEC
Share price	$1.765
Inception date	30 November 2017
Listing date	5 December 2017
Benchmark	S&P/ASX Small Ordinaries Accumulation Index
Management Fee	1.00% (plus GST) per annum[1]
Performance Fee	20% (plus GST) of the Portfolio's outperformance[2]
Market Capitalisation	$117m

[1] calculated daily and paid at the end of each month in arrears
[2] against the Benchmark over each 6-month period subject to a high water mark mechanism

Commentary

In a difficult month for the Smaller Companies universe, the Company's pre-tax NTA decreased by 6.7% during October. This represented outperformance of 2.9% compared to the benchmark S&P/ASX Small Ordinaries Accumulation Index which declined by 9.6%.

The Australian sharemarket fell considerably in October, falling in sympathy with a US market that is finally showing signs of cracking under the pressure that has afflicted emerging markets since the beginning of the year. The Australian smaller companies space had seemingly been immune to the volatility until October, with a select cohort of market darling stocks driving the index higher, effectively camouflaging broader weakness. Clearly, there is a linkage between these darlings and the US market, particularly names in the technology sector. We believe the fundamental link is tenuous however with the majority of small cap market darlings in Australia and New Zealand a function of a narrow universe and excess demand for anything resembling growth. In most instances the growth is purely at the top line and at the expense of cash flow and returns. These companies generally need third party funding to continue their strategies which is easy to come by when there is excess liquidity. With central banks now tightening the screws it may mean the fairy tale is coming to an end. We wonder if this will see a changing of the guard in the next few years with many a maligned company finding greater favour. In our view, that is where the value lies with recent takeover activity lending support to this thesis.

A review of the **index movements** for the month is telling as the **largest decliners** were the **hyper-popular** names of the last couple of years. We share colour on some of the more notable decliners below. Whether by good fortune or good management the Company did **not** own any of the following companies:

- Largest decliner was Kogan (KGN) which fell 50% after a significant profit warning. Its share price had ridden the Amazon wave over the last couple of years, only to be dumped in the last few months by management and now by its investors. It is down over 70% from peak to trough.
- WPP is a media agency group that also had a profit warning due to structural and cyclical issues. Its share price fell 35% and its long serving CEO announced his intention to retire.
- Corporate Travel (CTD) declined 34% after the release of a critical research report from a hedge fund that had shorted the stock. Regardless of the substance of the report we expect travel related companies to struggle in the next few years as technology and macro-economic factors affect demand for their services.
- Afterpay (APT) fell 30% after a spectacular re-rating in the last couple of years driven by strong uptake of merchants and consumers for its layby product. Given it earns very little and has an extremely high valuation, a lot can go wrong and just about everything has to go right to justify its rating.

Continued on next page…

Commentary (continued)

- BWX declined 29% after a profit warning, with the usual "hollow" skew of earnings to the second half to placate investors wanting the guidance crutch. Increased competition in the natural skin care market, a flurry of acquisitions by BWX and a debt laden balance sheet are cause for concern.
- Domain (DGH) fell 29% after a major profit warning due to weakness in its print advertising and digital display, which is a function of a deteriorating housing market thus illustrating the cyclicality of the business. It is not priced for cyclicality given its high rating nor for structural headwinds facing its print advertising exposure.

The **top ten performers for the month in the index** included a number of gold companies and a couple of companies subject to takeover proposals including MYOB (MYO) and Navitas (NVT).

As most are aware the Company has a **large shareholding in NVT**. We were not surprised by the takeover interest given it is a global leader in its field and is a fantastic cash flow generator. The derating witnessed in recent years was due to the loss of three profitable contracts. In spite of this earnings headwind the company has grown earnings on an underlying basis and is one of the few truly global growth businesses in the Australian market. We also believe there is a significant cost out story and potential to streamline the group with SAE generating EBIT losses in several regions. The divestment or exit of SAE in those markets would therefore be addition by subtraction for NVT. Our fundamental valuation is slightly higher than the takeover offer price of $5.50 per share, and therefore we believe the bidding consortium should pay more for control. We are surprised the share price is trading at a material discount to the bid given the valuation appeal and the fact an insider is party to the deal.

The Company also benefited from speculation surrounding a potential takeover of Greencross (GXL) with the share price rallying 7% over the month. GXL entered a trading halt in early November with a private equity suitor expected to acquire the company.

Outside of takeovers, there was a bright spot in the Company's portfolio with Vita Group (VTG) significantly upgrading its profit guidance with 1H19 EBIT expected to grow 15 to 24%. We believe this illustrates an unappreciated strength of VTG's business in that its store network is skewed to regional areas where Telstra's network is unrivalled. Unbelievably, VTG is trading on only 3.5x free cash flow, which equates to a three-year and a half year payback for shareholders assuming no growth. With Telstra completing its 5G rollout in the next 12-18 months there will be a significant upgrade cycle for handsets, which means the assumption of "no growth" could be seriously conservative. The consumer obsession with their handset is unlikely to subside anytime soon, we believe VTG is well positioned to benefit from this trend.

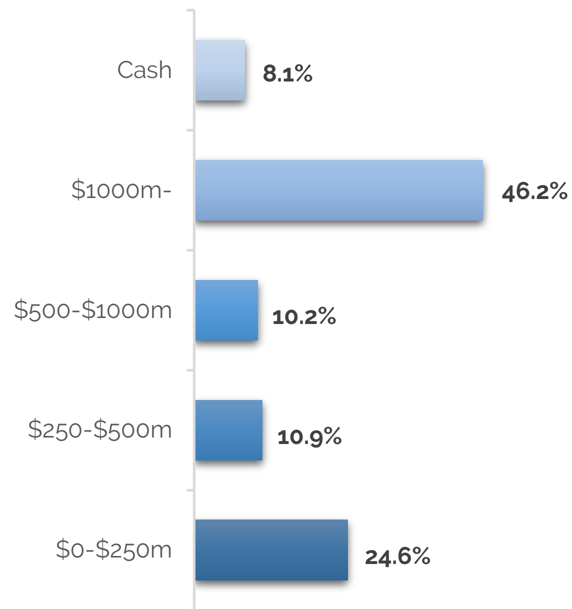
As noted earlier, it appears the divergence in valuations between the market darlings and the more maligned segments of the small cap space is now converging with the catalyst being takeover activity amongst the lower rated companies. Recent announced takeovers (in the small cap market) include Scottish Pacific, MYOB, Navitas, Healthscope, Watpac, Steel & Tube (NZ listed) and Fairfax. Whilst not specifically positioning for takeovers our work around industry structure, valuation and a focus on cash flow generative businesses means this is a by-product of our investment process. We suspect there will be more takeover activity in the Company's holdings, albeit tighter funding markets may eventually stymie that.

We remain positive on the outlook for the Company as the valuations of its portfolio companies are appealing. Furthermore, these companies have relatively strong balance sheets and robust cash flows. A downturn will affect them, but they should come out the other side stronger by taking market share from weakened competitors. Our quality filters ensure that the companies we invest in have genuine cash flows that match earnings. We avoid companies whose strategy is to recklessly acquire growth. We believe these kinds of companies will come unstuck in the next few years as liquidity recedes. The market is brutal to even the most celebrated companies when the integrity of the business strategy and financial reports comes into question.

Top 5 Holdings

Company Name	% Portfolio
Navitas Limited	6.8
Bega Cheese Ltd	6.3
Fletcher Building	5.0
Platinum Asset	4.8
Technology One	4.6
Top 5	**27.5**

Market Cap Bands



Net Tangible Assets (NTA)[3]

Pre-tax NTA[4]	$1.968
Post-tax NTA[5]	$2.015

[3] NTA calculations exclude Deferred Tax Assets relating to capitalised issue cost related balances and carried forward tax losses of $0.003 per share. The NTA values are after the 2018 final dividend of 4.0 cents per share paid on 21 September 2018.

[4] Pre-tax NTA includes tax on realised gains and other earnings, but excludes any provisions for tax on unrealised gains

[5] Post-tax NTA includes tax on realised and unrealised gains and other earnings

Performance as at 31st October 2018

	1m	3m	6m	Inception[6]
Company[7]	-6.7%	-3.9%	-1.9%	0.3%
Benchmark[8]	-9.6%	-7.7%	-4.2%	-1.5%

Past performance is not a reliable indicator of future performance.

[6] Inception date is 30th November 2017

[7] Calculated as movement in Company's pre-tax NTA (which includes tax on realised gains and other earnings, but excludes any provision for tax on unrealised gains), assuming the re-investment of any dividends paid by the company

[8] Benchmark is the S&P/ASX Small Ordinaries Accumulation Index