Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

Performance as at 31st July 2019

	1m	3m	1yr	Inception#
Fund^	-1.8%	-0.5%	-	4.5%
*Benchmark**	0.4%	-0.1%	-	1.6%
Value added	-2.3%	-0.4%	-	2.9%

^ Spheria Global Microcap Fund. Returns of the Fund are net of applicable fees, costs and taxes
* Benchmark is the MSCI Kokusai Microcap Index (AUD).
# Inception date is 1 March 2019. Past performance is not a reliable indicator of future performance.

The Spheria Global Microcap Fund (the 'Fund') returned -1.82% for the month of July, underperforming the benchmark which increased 0.44%. Since inception the Fund has returned 4.48%, outperforming the benchmark by 2.85% after fees.

The Global Microcap market drifted lower during July, and it was the drop in the Australian dollar late in the period which delivered a positive return for the benchmark. The re-emergence of trade tensions between China and the USA remains at the forefront of investors' minds. The European economy, which has close links to China, has slowed dramatically as a result of the trade war and the worst performing microcap markets in July were Spain, Germany and the Netherlands. German manufacturing PMI[1] has fallen from 56.6 in July 2018 to 40.5 in July 2019. Aside from 2017, Europe's economy has looked more like a Fiat 500 trying to keep up with the US's Ford Mustang.

Defensive sectors such as Utilities and Communication Services were among the best performing sectors. Gold miners were the real winner, up 12.1% in AUD during the month. The energy sector fell 3.5% in AUD as economic concerns weigh on the oil price.

The Fund's underperformance in July was largely driven by its exposure to cyclicals, particularly those European stocks impacted by China-US trade tensions. French company, Lectra (LSS FP), was the portfolio's largest detractor. Lectra is a manufacturer of platforms for the automated cutting of textiles for the fashion, automotive and furniture industries. The company's systems optimise textile cutting to reduce wastage and improve the quality of products. Lectra has a global fleet of 3,900 fabric cutting machines that generate a recurring revenue stream through consumables, parts and software maintenance. This recurring revenue represents 61% of total revenue.

However, growth is driven by new capital equipment orders and the China-US tension has caused customers to sit on their hands

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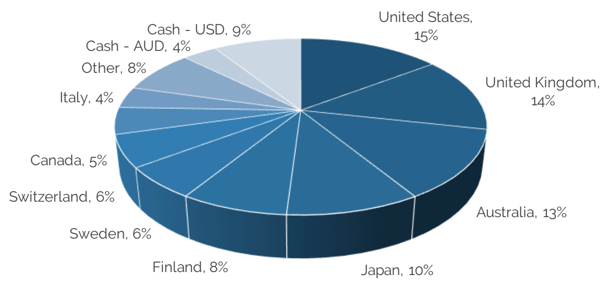
Top 5 Holdings

Company Name	% Portfolio
Alma Media (Finland)	3.6%
Coltene (Switzerland)	3.6%
Computer Model. (Canada)	3.2%
Poletowin Pitcrew (Japan)	3.1%
Lassila & Tikanoja (Finland)	3.0%
Top 5	**16.5%**

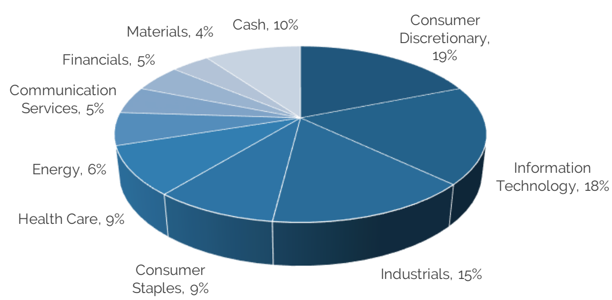
Source: Spheria Asset Management

Regional Exposure



Source: Spheria Asset Management

Sector Exposure



Source: Spheria Asset Management

[1] The Markit/BME PMI survey tracks sentiment among purchasing managers at manufacturing, construction and services firms. An overall sentiment index is generally calculated from the results of queries on production, orders, inventories, employment, prices, etc. (Source: Bloomberg)

with orders for new systems declining 21% in the second quarter. The company is transitioning to a software as a service (SaaS) model which further depresses short-term earnings but will lift earnings in outer years (we estimate from FY23) and will increase the proportion of "sticky" recurring revenue from customers. While it is unlikely earnings will bounce back quickly without an imminent resolution in the China-US trade dispute, the company can withstand any short-term earnings pressure with net cash of €104 million and strong free cash flow generation. We see long-term valuation support for the stock and the market's aversion to short-term earnings disappointment creates an opportunity to build a position in a high-quality company.

Other detractors included Computer Modelling Group (CMG CN), which gave up some of its strong price appreciation in May, and Mount Gibson Iron (MGX AU) as the market begins to price in lower iron ore prices from current elevated levels.

The Fund's top contributors were Alma Media (ALMA FH), which we wrote about last month and is also the Fund's largest holding, Addus Homecare (ADUS US) and Reno de Medici (RM IM). Addus Homecare is a US home care provider for the elderly[2]. State and local government agencies are its main clients. Addus' patients are typically at increased risk of hospitalisation or institutionalisation and its home care services help keep patients out of these higher cost care settings. Italian Reno de Medici is Europe's second largest producer of white lined chipboard (WLC) which is made from recycled fibres and typically used in packaging for products such as food & beverage, detergents, cereals, electronics, and toys. Reno de Medici, along with Austrian company Mayr-Melnhof, has been consolidating the European market for WLC manufacturing which will lead to improving industry returns. Free cash flow generation is strong and management is focused on improving return on capital.

At Spheria, our core philosophy is valuation discipline. Every year gym's around the country advertise heavily in January. Every year, most new year resolutions are broken. Discipline is hard to maintain, and that's why investment markets continue to reward it. During the dotcom boom it was hard to resist technology stocks, pre-GFC it was hard to resist financially engineered and heavily geared companies, and currently it is hard to resist high momentum growth stocks. The second largest industrial stock in the MSCI Kokusai Microcap index is one such stock, Polynovo (PNV AU). Polynovo's single product is a polymer which restores a patient's dermal scaffold to help treat a range of severe wounds and burns. The technology is compelling, the valuation less so. Investors are willing to pay an enterprise value of 78x FY19 revenue. The market capitalisation is $A1,064m, and FY19 revenue is forecast to be only A$13m with the company expected to breakeven in FY20.

When we contrast Polynovo against the Fund's largest holding, ALMA Media, our investment approach becomes apparent. Given Polynovo is loss making, metrics such as free cash conversion and return on capital lose meaning. However, it is clear from the table below that ALMA is producing strong free cash flow for equity holders today, whereas in the case of Polynovo shareholders are paying a significant amount for the promise of free cash flow to equity holders at some point in the future.

	ALMA Media (Finland)	Polynovo (Australia)
Index Weight	0.00%	0.18%
Enterprise Value (USD)	US$685m	US$676m
Profitable	+€39m	-$A6m
FCF Conversion (%/$)	140%	-$A7m
Gearing (Net Debt/EBITDA)	0.2x	-0.5x
ROIC (%)	25%	-31%
EV/EBIT (x)	10.1x	N/A
EV/Revenue (x)	1.8x	76.5x

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[2]Primarily focused on "dual eligible" patients who are entitled to both Medicare (patients over 65) and Medicaid (patients with lower incomes).

Resisting the allure of stocks such as Polynovo is difficult. However, if we cannot reliably forecast the company's financials and justify the valuation we will not buy the stock, no matter how promising the company's concept is. There are several examples where the Fund does own stocks which appear rich on short-term multiples such as SyntheticMR (SYNT SS) and MIPS (MIPS SS), both with EV/EBIT multiples of 35x and above. In these growth stocks investor's confidence has been shaken recently, which means consensus expectations are realistic and our earnings forecast show valuation upside. In the case of MIPS, the setback has been the emergence of a new competitor. For SyntheticMR, a slower than anticipated ramp-up by its partners Siemens and Philips. We have yet to find a growth company offering compelling value where the growth trajectory has been uninterrupted the past few years.

The Fund owns several stocks that would be considered value stocks such as Takeuchi (6432 JP), Somero (SOM LN) and Mount Gibson Iron (MGX AU), all with EV/EBIT multiples of 7x or less. By focusing on valuation discipline, rather than a simple value or growth style of investing, the Fund has the potential to outperform in both falling and rising equity markets.

When we contrast the portfolio to the index it has a slightly higher PE and a slightly lower EV/EBIT. The real contrast is the portfolio's free cash flow yield which is 5.4% compared to the index's -0.5% and gearing which is equivalent to -0.6x EBITDA (that is, the weighted average holding is debt free with net cash on its balance sheet) compared to the index's 1.4x.

Strong free cash flow and balance sheets mean the Fund is well positioned if funding tightens as the portfolio's companies will be able to self-fund their growth. We expect tighter credit conditions will catch out many companies and investors as this business cycle matures and the credit cycle turns.

	Spheria Global Microcap Fund
Benchmark (universe)	MSCI Kokusai Microcap Index (AUD)
Investment objective	The Fund aims to outperform the MSCI Kokusai (World ex Japan) Microcap Index in AUD over the long term.
Investing universe	Global listed microcap equities predominantly in developed markets with a market capitalisation of US$1.0bn and below at time of purchase.
Distributions	Annually
Fees	1.35% p.a. management fee & 20% performance fee of the Fund's excess return versus its benchmark, net of the management fee
Cash	Up to 20% cash
Expected turnover	20%-40%
Style	Long only
APIR	WHT6704AU
Minimum Initial Investment	$25,000