

Investment Update

As at 31st August 2020



Spheria Emerging Companies Limited
ACN 621 402 588

Pre-tax net tangible assets⁴
\$1.923

Company⁷ performance p.a.
(since inception)

1.0%

Company Facts

Investment Manager	Spheria Asset Management Pty Limited
ASX Code	SEC
Share price	\$1.50
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	\$91.8m

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

The Company's pre-tax NTA increased 10.1% in August, the S&P/ASX Small Ordinaries Accumulation Index increased 7.2%.

MONTHLY COMMENTARY

Markets had a strong August over the reporting season with investors broadly relieved that results were in line or in many cases better than feared. Whilst sell side consensus saw on balance negative revisions, the share price reactions from many stocks suggest that investors had already factored in a worse scenario. The Company was a beneficiary of the moves in August with many of our holdings performing strongly after releasing their annual results.

The recent reporting season was as we predicted "noisy" with results buffeted by many factors. Some companies partially or fully qualified for the Job Keeper allowance and saw a quick rebound in revenues post March and April. Others didn't qualify and saw no re-bounce. In some cases businesses saw rental abatements and in others, landlords were not so forgiving. Generally the market was willing to look through short term numbers and rewarded stocks with positive outlooks. Stock in the discretionary retail sector reported well with home furniture retailers, electronics other discretionary retail all reporting strong results and very positive short-term trading outlooks. Conversely travel and leisure stocks like Village Roadshow (VRL.AX), Corporate Travel (CTD.AX) and Flight Centre (FLT.AX) all reported tough trading conditions albeit that the Job Keeper allowance and rental abatements mitigated the worst of the revenue shortfalls. As the world awakens from the worst of the Covid 19 impacts we would expect consumer spending to normalise to a degree.

The market has been gyrated by two major distortions – the first being a "stimulus distortion" which has seen many people receive the Government's Job Keeper allowance of \$750 a week (even if they were earning materially less than this) and the early withdrawal of Super. The second being an "interest rate distortion" driven by even lower rates and the increasingly consensual view that these will stay low for a long period of time. The stimulus distortion has been further exaggerated by consumers inability to spend in certain categories (eg. Travel and Leisure) and thus funneling additional spending where they can. This has meant more money for homewares, electronics and household furniture as people stay at home and spend the Job Keeper allowance (its far easier to spend money you haven't actually had to earn than to spend one's savings.).

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The interest rate distortion has created a topsy turvy world. The more you lose the more valuable you are in this upside down world. At least that is the experience in the small cap space over the last 12 months. A simple backward looking screen at the small and micro caps comparing companies that made operating cash flow with those that didn't shows that those that didn't hugely outperformed. The simple average of the returns of the two groups shows that negative cash flow companies returned on average 108% to the end of August versus 18% for those with positive operating cash flow. The perverse logic here is that you will pay more for companies that will (or more accurately could) earn cash tomorrow than those that do today. This only makes sense if discount rates are actually negative. Whilst many short term rates around the world are slightly negative most long bonds are still in positive (albeit only slightly) territory. Unless the world really has lost its economic gravity, the market has generally sent these types of stocks back down to earth with a sharp thud and eventually re-rated profitable businesses. It is with this backdrop that we believe it is now – more than ever – time to focus on the fundamentals. If there is even a hint of inflation, the longer term bond will sell off increasing the required yield (interest rates) to own longer term bonds which will likely see a sharp reversal of this topsy turvy view of the world.

Investors need to distinguish between perceived wealth generation (share prices moving up with little in the way of sustainable businesses and earnings to support them) and actual wealth generation (creation of new goods and services supported by sustainable business models). Over the last year in small caps there has been a plethora of the former and precious little of the later. It is extremely unlikely that ultra low interest rates have been solely responsible for such sustainable wealth creation alone. Innovation, scientific breakthroughs, new networks and strong end demand are some of the ingredients for business to be sustainable. Businesses without cashflow are like the coyote chasing Roadrunner over the cliff – suspended in mid air before he realises that he's run out of road. In the US there has been a boom of retail investors using a platform called Robinhood. Robinhood charges investor zero commission but hands off all the investor orders to "market makers" who pay Robinhood for the trading flow. If you aren't paying for the product...

Major contributors to performance were:

Class Ltd was the largest contributor for the month as the stock returned 39% on the back of strong results and a very positive trading outlook. CL1 has lagged behind many of its SAAS peers on account of the perceived smaller market TAM compared to some of its peers. The results presentation highlighted their continued market share gains in the SMSF space plus the opportunity they have in the Trust space (through Class Trust) and the document and corporate compliance markets (through NowInfinity).

Corporate Travel (CTD) rebounded strongly over the month (returning 83%) as the company surprised investors with a much higher cash balance and a negligible current cash burn rate following significant business restructuring. This positions CTD well to survive the pandemic without the need for a dilutive capital raising despite the devastating effects of the pandemic on business travel volumes.

Major detractors to performance were:

IDP Education (IDP – not owned) was the largest detractor as it rallied 51% on delivering a better than expected 2H20 result and more positive current revenue trends than the market had priced in.

ZIP Co (Z1P – not owned) detracted significantly as it rose 54% on positive sentiment towards the buy now pay later space and in response to the announcement of a deal to provide finance to eBay Australia vendors. This was despite it reporting materially worse than expected FY20 results and analysts meaningfully downgrading forward EPS expectations.

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Outlook & strategy going forwards

We are staying the course with our investment philosophy to buy cash flow rich businesses at sensible valuations based on their fundamental position and industry dynamics. During the month we saw some recognition of the extent of undervaluation of our portfolio companies with some strong bounces seen from heavily oversold levels. The current topsy turvy world in smaller companies will revert at some point and we believe fundamentals remain more important today than ever.

Top 10 Holdings

Company Name	% Portfolio
Class Limited	5.2
City Chic Collective	4.0
Breville Group Ltd	3.9
Ht&E Limited	3.9
Corp Travel Limited	3.6
Sims Limited	3.3
Healius	3.3
Adbri Limited	3.3
Bega Cheese Ltd	3.3
Asaleo Care Limited	3.3
Top 10	37.0

Source: Spheria Asset Management

Market Cap Bands



Source: Spheria Asset Management

Net Tangible Assets (NTA)³

Pre-tax NTA ⁴	\$1.923
Post-tax NTA ⁵	\$1.997

³ NTA calculations exclude Deferred Tax Assets relating to capitalised issue cost related balances and income tax losses

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

⁵ Post-tax NTA includes tax on realised and unrealised gains/losses and other earnings

Performance as at 31st August 2020

	1m	6m	1yr	2yr p.a.	Inception p.a. ⁶
Company ⁷	10.1%	3.9%	0.6%	-2.0%	1.0%
Benchmark ⁸	7.2%	4.6%	2.1%	1.5%	4.4%

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/losses and other earnings, but excludes any provision for tax on unrealised gains/losses), assuming the re-investment of any dividends paid by the company

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

Disclaimer

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