ASX: SEC

Investment Update

As at 31st December 2020

Spheria Emerging Companies Limited
ACN 621 402 588

Pre-tax net tangible assets[4]

$2.307

Portfolio[7] performance p.a. (since inception)

8.4%

Company Facts

Investment Manager	Spheria Asset Management Pty Limited
ASX Code	SEC
Share price	$1.915
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	$117.2m

[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 portfolio performance for the month of December was 6.0%, while the S&P/ASX Small Ordinaries Accumulation Index increased 2.8%.

Markets

Markets locally rose over December as strong returns in materials and a narrow grouping of high momentum tech stocks more than offset declines in "re-opening" trades, healthcare and a smattering of stocks that downgraded earnings. Materials performed strongly as iron ore prices reached highs not seen since 2011, Copper reached record high levels in $A terms and lithium prices rose off the canvas helping to supercharge already sky-high sentiment towards lithium stocks following Biden's election to the U.S. Presidency. Multiple tech stocks made record absolute highs and re-rated to record EV/Sales multiples. These include APT.asx and XRO.asx following their graduation into the top 20 and top 50 respectively, REA.asx, NAN.asx and PNV.asx.

Following strong returns in November most "re-opening" trades saw decent price weakness over December as the emergence of the B117 mutant strain in the U.K. added to concerns about rising case numbers in many northern hemisphere nations as they entered their winter. Locally we observed some strong negative share price reactions to downgrades or other negative news with A2M.asx, APX.asx, QBE.asx, AGL.asx, and IRI.asx downgrading guidance during the month. MSB.asx plummeted 46% on the early termination of their COVID-19 trial by the data safety monitoring board due to futility while SSM.asx fell 20% on a smaller than expected revised NBN contract.

The Fund outperformed due to an overweight to small and microcap media and retail exposures (which had lagged larger stocks in November), a significant re-rating in City-Chic Collective (CCX.asx), the receipt of a takeover offer for portfolio holding Asaleo Care (AHY.asx) and underweights to some of the larger index detractors.

Despite our recent outperformance we continue to observe and remain concerned about speculative excess in high momentum names. This is particularly so, in areas that are viewed as COVID-19 beneficiaries like e-Commerce, Fintech and Biotech but also in our view has more recently extended to certain areas of the materials space. Market participants appear to be all too willing to extrapolate current trends well out into the future - far beyond time horizons that one can credibly forecast and in some cases in direct opposition to the likely impact on supply and demand caused by current trends.

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Iron ore and iron ore equities for instance appear to be extrapolating strong prices into the medium term following the recent strength caused by higher than expected steel production in China (off the back of COVID-19 related stimulus) and somewhat weaker than expected Brazilian supply. This is despite Chinese authorities now actively cooling the white hot property market (accounts for 30-40% of finished steel demand) and the recent announcement of a raft of actions proposed by the Chinese Ministry of Industry and Information Technology to pressure iron ore prices in the medium term including the development of electric arc furnace capacity, the encouragement of new sources of iron ore capacity (particularly outside of the existing producers) and the encouragement of industry consolidation. Market participants also appear to be turning a blind eye to the rapid re-entry of marginal iron ore capacity moth-balled during the downturn and the impacts of material expansions announced by major players (e.g. Champion Iron (CIA.asx) is doubling capacity, Mineral Resources (MIN.asx) is targeting 92m tonnes in 3 to 5 years from 15m tonnes currently).

The stupendous returns out of lithium exposures recently also appears to be a case in point of over-extrapolation. Incredibly, the recent strength has seen the combined market capitalisation of PLS.asx, ORE.asx and GXY.asx trade 22% higher than the peak of the lithium bubble in 2018 despite the price of Lithium Spodumene concentrate being only about half of the then prevailing price and a massive proportion of the industry continuing to operate at a mere fraction of nameplate capacity. While we have no doubt that demand for lithium will grow strongly with the rise of battery electric vehicles, the industry has shown that there is no shortage of projects ready to enter production in a relatively short time frame and the small size of the industry can easily see this swamp new demand. Further, the tremendous market capitalisations ascribed to second and third tier lithium producers imply medium term prices that are well above the level that is required to incentivise the construction of new supply, let alone that required to see existing mothballed capacity restart.

Cobalt is a terrific example of the dangers or overextrapolation. During 2017 and early 2018 Cobalt was seen as the star battery material on forecasts of rampant demand from the growth of the then prevailing lithium-ion battery chemistries. This saw Cobalt triple from its 5-year average and many billions of market capitalisation ascribed to Cobalt mining hopefuls. Unsurprisingly however technological innovation has seen the development of batteries that use far less (or no) Cobalt. The metal now trades 63% below its peak and the mining hopefuls remain > 80% below their 2018 peaks.

Given the significant rise of passive, quantitative and direct retail investors in the market we should perhaps not be surprised that valuation disparities are at levels not seen since the dot.com boom and that price momentum can push valuations to extreme levels. We continue to try to ignore the noise and weight the portfolio towards more 'boring' and relatively unpopular names with proven, high returning and cash generative business models that remain at multiples below their historical relative trading ranges.

Major contributors for the month:

City Chic Collective (CCX.ASX) was the largest contributor returning 46% over the month after it acquired the E-Commerce and wholesale operations of UK plus sized fashion retailer Evans from bankrupt retailer Arcadia Group for A$41m in cash. While the deal is at a higher implicit multiple than the Catherine's plus sized fashion acquisition that fell over in September, we believe it is a better strategic fit given it will help City Chic accelerate its organic rollout of the City Chic brand in the UK and Europe and won't see City Chic acquire a brand that already crosses over with an existing portfolio holding.

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Asaleo Care (AHY.ASX) contributed positively as it returned 35% upon the receipt of an unsolicited proposal from its 36% major owner Essity AB of Sweden to acquire all the shares in the company it does not own. We believe the offer of $1.26 is opportunistic and inadequate, given Essity will benefit from synergies with putting its 100% owned Australian healthcare distribution operations together with Asaleo's B2B incontinence care operations. Other holders appear to concur as the company closed the month at $1.35. At the current price, the firm trades on 14x forward EBIT, which does not appear egregious for a business that has returned to solid top line growth following a period of significant re-investment in marketing and new product development.

Seven West Media (SWM.ASX) was the next largest contributor given the company's 29% return over the month. This followed a strong November performance off the back of a better-than-expected AGM trading update and sees the company 100% higher than end October levels and 200% higher than end September levels. Despite this the company continues to screen cheaply. While the balance sheet remains somewhat stretched, we see scope for this to be rectified in the near term through asset sales at materially higher implied multiples than the group trades on.

Major detractors for the month:

A2B Australia (A2B.ASX) was the largest detractor as it retraced 15% following a very strong performance over November. No doubt the Northern Beaches COVID-19 outbreak later in the month dented sentiment towards the business given reduced taxi usage from renewed COVID-19 restrictions for hospitality venues. While the company's short term performance in its core mobility business is likely to remain patchy the balance sheet is more than strong enough to see A2B through ($24m net cash). The company has also begun to articulate a measured strategy to grow its payments business into the non-taxi space in Australia and its mobility platform solutions business globally. We believe the market continues to discount an overly bearish outcome on the core mobility business let alone any success on the latter two growth opportunities.

IGO (IGO.ASX) - Not owned. IGO detracted performance as the market reacted boisterously (up 37% for the month) to its A$1.95bn acquisition of a 49% non-controlling interest in Tianqi lithium's Australian operations which comprise 51% of the world class Greenbushes hard rock lithium mine and 100% of the country's first lithium hydroxide plant being built in Kwinana. On the positive side the acquisition appears better priced than the top of the market acquisition of Kidman Resources (KDR.asx) by Wesfarmers (WES.asx) and Mineral Resources' Wodgina operations sale to Albermarle. However, the A$1.05bn increase in the market capitalisation of IGO to the end of December (c$1.5bn currently) appears to be capitalising a very positive outcome. Greenbushes is clearly a tier one lithium asset, yet IGO's non-controlling stake in the JV should attract a discount. Further the hydroxide plant is yet to be completed or commissioned and remains subject to potential capital cost increases and issues around ramp up. We also question why secondary processing operations such as lithium hydroxide manufacturing should be expected to earn excess returns in the long term given limited barriers to entry.

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Corporate Travel Management (CTD.ASX) detracted as the stock retraced 12.5% following a very strong bounce during November caused by the release of the highly positive vaccine results from Pfizer and Moderna. The acceleration of the COVID-19 pandemics in North America and Europe over December appeared to dent confidence, particularly new travel restrictions from the UK imposed by other nations who wish to restrict the spread of the more infectious B117 mutation that emerged in the UK. While the emergence of this mutant is likely to have some negative impact on CTD's North American and European businesses and therefore increase CTD's forecast cash burn we believe this is likely to be relatively modest given how much the firm has trimmed its fixed costs. Concern about this and potentially other mutations also appears to be putting pressure on governments globally to accelerate vaccine rollout timelines. We still see CTD as strongly placed to emerge from the pandemic in a sound financial position and with materially increased market share.

Outlook:

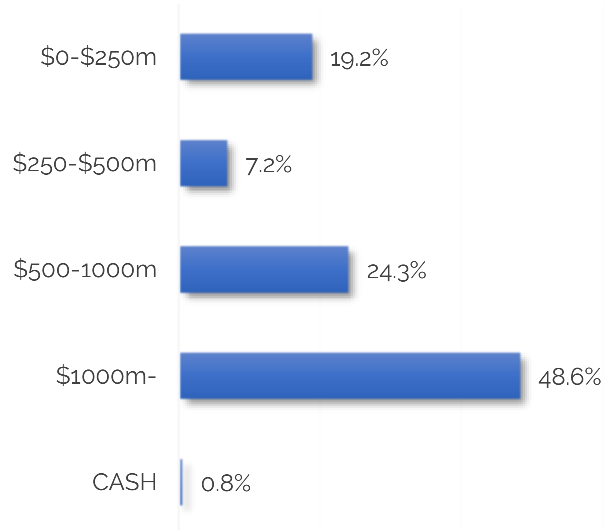
At the risk of boring the reader we are staying true to our investment philosophy to buy cash generative business models, with a track record of solid returns and at sensible valuations having regard to their industry dynamics and positioning. The month pleasingly saw yet more belated recognition of the undervaluation of our portfolio companies. However, we continue to see strong upside on an aggregate basis in our portfolio holdings. We also continue to be presented with opportunities for rotation into new names with strong fundamental valuation support. The market remains highly bifurcated amid concerning signs of speculative excess in momentum names. Rather than bemoan the market however we continue to try to optimise the risk reward equation for investors with a disciplined investment approach strongly guided by valuation.

Top 10 Holdings

Company Name	% Portfolio
City Chic Collective	4.3
Ht&E Limited	4.1
Fletcher Building	4.0
Mortgage Choice Ltd	4.0
Class Limited	3.8
Asaleo Care Limited	3.6
Adbri Limited	3.5
Healius	3.4
Seven West Media Ltd	3.3
Breville Group Ltd	3.1
Top 10	**37.2**

Source: Spheria Asset Management

Market Cap Bands



Source: Spheria Asset Management

Net Tangible Assets (NTA)[3]

Pre-tax NTA[4]	$2.307
Post-tax NTA[5]	$2.270

[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 December 2020

	1m	6m	1yr	2yr p.a.	Inception p.a.[6]
Portfolio[7]	6.0%	35.3%	12.4%	15.7%	8.4%
Benchmark[8]	2.8%	20.3%	9.2%	15.1%	7.4%

Past performance is not a reliable indicator of future performance.

[6]Inception date is 30th November 2017

[7]Calculated as the notional performance after fees excluding tax on realised and unrealised gains/losses and other earnings, and after company expenses

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