

Investment Update

As at 30th June 2021



Spheria Emerging Companies Limited
ACN 621 402 588

Pre-tax net tangible assets⁴
\$2.599

Portfolio⁷ performance p.a.
(since inception)
11.4%

Company Facts

Investment Manager	Spheria Asset Management Pty Limited
ASX Code	SEC
Share price	\$2.40
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	\$144.4m

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 June was 5.0%, while the S&P/ASX Small Ordinaries Accumulation Index returned 3.1%. Over the quarter to the end of June, the portfolio rose 8.7%, while the Index returned 8.5%.

Markets

Markets locally rose over June with strong returns in particular in a narrow subset of high momentum technology names and in materials names exposed to popular thematic (e.g., lithium, mineral sands) and to coal following strong price rises in both coking and thermal coal. Gold fell 7% over the month with equity exposures similarly coming under pressure. Despite the benchmark WTI price rising almost 10% over the month oil and gas names were mixed. Several technology stocks made record absolute highs and re-rated to record EV/Sales multiples despite no material newsflow. These included Pro Medicus (PME.ASX), Megaport (MP1.ASX), Realestate.com.au (REA.ASX) and Seek (SEK.ASX).

Most re-opening trades were neutral to down for the month following the emergence of the delta strain in the U.K. (originally responsible for the second wave in India) which has seen a strong resurgence of cases (mostly amongst children and young adults and the unvaccinated), albeit with a much less pronounced rise in hospitalisations and no material increase in deaths. Locally we observed some strong negative share price reactions to weaker than expected earnings forecasts e.g., Nuix (NXL.ASX) and Integrated Research (IRI.ASX) or other negative newsflow, e.g., Nuix (NXL.ASX) on management resignations and ASIC investigations and Genworth (GMA.ASX) following the Commonwealth Bank (CBA.ASX) announcing it will put to tender its lender's mortgage insurance volumes that currently go to Genworth. Corporate activity was elevated over the month with Altium (ALU.ASX) rejecting a proposal from Autodesk of the U.S., Isentia (ISD.ASX) receiving a recommended bid at a 154% premium to the last price, Reckon (RKN.ASX) having 19.9% of its shares acquired by Novatti (NOV.ASX) and the media reporting that IRESS (IRE.ASX) was the subject of a failed raid on its register during the month.

The Portfolio outperformed due to an overweight to small and microcap gaming, media and retail exposures, the sale of its holding in Isentia (ISD.ASX at a 154% premium to last) and newsflow that portfolio holding IRESS was the recipient of a failed raid at a substantial premium to last. The underweight to gold also contributed to performance.

Despite our recent outperformance we continue to observe and remain concerned about speculative excess

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in high momentum names although we have noted a narrowing of the field of names that continue to re-rate as some former highflyers have come down to earth following disappointing newsflow. While some COVID-19 beneficiaries in the e-Commerce, Fintech and Biotech space have de-rated (albeit in most cases to levels that are still well above our measure of value), these appear to have largely been replaced by cohorts of stocks within the materials space that are seeing price action that is difficult to justify. In particular, those companies exposed to popular thematic (e.g., battery materials and rare earths) appear to be capitalising near record high prices and enormous margins 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 (i.e., expensive share prices equals a low cost of capital for new supply in these materials).

Given the significant rise of passive, quantitative and direct retail investors in the market and the unprecedented liquidity that Central Banks have injected into the financial system 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 are trying to remain disciplined and weight the portfolio towards more 'boring' and relatively unpopular names with proven, high returning, cash generative business models that remain at multiples below their historical relative trading ranges. Given rising inflation (both measured inflation and inflation expectations) that is being generated by high levels of fiscal and monetary stimulus alongside shortages of raw materials and certain intermediary goods (e.g., silicon chips) we are mindful of purchasing companies with pricing power that should be better placed to maintain margins in an inflationary environment. If Central Banks eventually take the punchbowl away (or at least stop spiking it with vodka) we are hopeful that our focus on purchasing undervalued securities should impact us less than the market more broadly which is currently paying extreme multiples for firms that are forecast to have strong outer year growth. In the meantime, the high levels of liquidity appear to be feeding an M&A cycle that should support our returns given our focus on buying undervalued, cash generative businesses with underleveraged balance sheets means our portfolio companies are more often the target of this activity than the average index constituent.

Major Contributors for the Month

Isentia (ISD.ASX) was the largest contributor as the mandate exited the position in the provider of media monitoring services at a 154% premium to last as UK media monitoring provider Access Intelligence built a blocking stake in ISD.ASX prior to announcing a proposal to acquire the entire firm. Isentia has been the victim of an almost perfect storm of negative impacts with two unprofitable but well-funded 'disruptors' churning clients to lower price points and hence destroying the Australian industry's profit pool and more recently a left-field cyber security incident that slowed momentum in contract wins and was a major hit to current year pre-tax profit and cashflow. While we saw scope for better value in the future in the absence of the offer, the standalone firm would have probably required a capital raising and the path to recovery was likely to be an extended one.

Ainsworth (AGI.ASX) contributed as the manufacturer of gaming machines rallied another 27% to end the financial year up 349% from the nadir it hit in mid-November. Whilst the pandemic has significantly negatively impact Ainsworth's operations the firm has never been in danger of insolvency given property holdings in the U.S. that at one point exceeded its market capitalisation.

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The end market of casinos, pubs and clubs in its two major markets of Australia and the United States have recovered strongly and in many cases are now in a position to recommence expenditure on new machines. As a result, the group returned to profitability in the 2H of the financial year. New management in our view has made sensible changes to personnel to improve the product development cycle which we feel have been obscured by the pandemic. We still see potential for Ainsworth to leverage its valuable portfolio of intellectual property and regulatory approval to improve earnings well above the level it was generating prior to COVID-19.

City Chic Collective (CCX.ASX) contributed as it rallied 17% over the month. The mainly online specialty retailer of plus sized female apparel across three brands in Australia, the US and the UK appears well positioned to benefit from the re-opening that continues to occur in these nations and the significant bounce back in apparel expenditure (depressed by lockdowns in the U.S. and U.K in particular) that is accompanying this trend.

Major Detractors for the Month

Geopacific Resources (GPR.ASX) was the largest detractor as it retraced almost 15% despite finalising its project funding facility with Sprott for the development of its Woodlark Island project and declaring final investment decision now that the project is fully funded to completion. We believe tax loss selling played a major part in this price action with the stock up 12% since the June financial year end. We still see Geopacific as incredibly undervalued trading at a market capitalisation of less than \$180m despite \$143m of cash as at March 31 2021 and having spent \$33m on the project. This effectively implies a net present value of zero for the project despite a robust bankable feasibility study that generates a post-tax NPV8 of A\$347m at a A\$2,200 gold price (vs. spot of A\$2,400). We also see scope to add materially to this base case given strong in pit, extensional and regional exploration potential and our view that the conservative assumption around mining dilution (30%) on the orebody is likely to lead to positive reconciliation once the project commences production during the second half of 2022.

Genworth (GMA.ASX) detracted as the monoline provider of lender's mortgage insurance fell 20% following the announcement that its largest customer Commonwealth Bank (CBA.ASX) intends to tender its volumes from the end of December 2022 (the end of the current exclusivity period). While not good news given CBA.ASX accounts for more than 50% of Genworth's gross written premiums per annum, we believe the share price fall is an overreaction. Firstly, there is a good chance that CBA.ASX recontract with Genworth given the significant integration of systems that exist between the two which allows CBA.ASX to rapidly get LMI volumes sent to Genworth approved (and hence keep its market leading response rates). Secondly, CBA.ASX as the largest customer will have the sharpest pricing of Genworth's 50+ bank and non-bank customers and therefore the lowest profitability (and ROE). Thirdly, the stock now trades at a 32% discount to net tangible assets (which is already conservatively stated given provisioning taken early on during COVID-19 has proven to be far too high as unemployment has been much lower than expected and home price growth much higher). Were Genworth to lose this volume it would allow a substantial amount of regulatory capital to be returned to shareholders either through dividends or buybacks. Finally, the last major transaction in the space (the sale of Westpac's internal LMI book) was undertaken at NTA.

Pro Medicus (PME.ASX – not owned) detracted as the stock rallied 27% on no material news to close the month at an EV of over \$6 billion for a company with an annualised run rate of revenue somewhere in the mid \$60m mark. While we view PME.ASX as a very high-quality company we

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feel the market is being far too generous in its valuation of the firm, particularly given the regular material share sales by insiders.

Outlook & Strategy

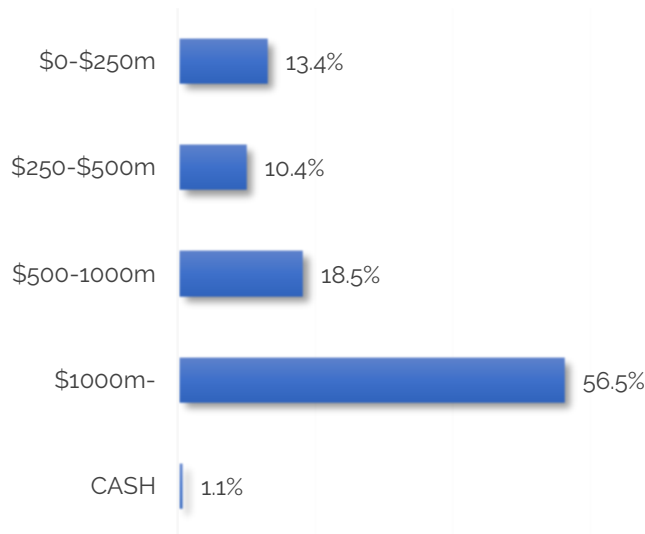
We continue to believe that the interests of our investors are best served by staying true to our investment philosophy of buying cash generative business models, with a demonstrated track record of solid returns and at a sensible valuation given their industry dynamics and positioning. While the emergence and spread of variants of COVID-19 with greater transmissibility and in some cases the ability to evade vaccines (especially sterilising immunity as opposed to the prevention of hospitalisation or deaths) is likely to cause volatility, the evidence overseas suggests the current crop of vaccines have firmly broken the once firm link between rising cases and hospitalisations and deaths. We continue to place an informed bet on the ingenuity of humankind to conquer this challenge. The rising specter of inflation and some emerging signs of a reluctance by Central Banks to pump prime to the same extent as they have since the emergence of COVID-19 means we are focusing our efforts on finding business models with pricing power and trying to avoid those that are likely to see unexpected compression in margins (e.g., mining contractors). The market continues to be conducive to high levels of corporate activity given plentiful liquidity, procyclical boards and record levels of private equity dry powder. We anticipate we may be the beneficiaries of future activity given our predilection for undervalued, cash generative businesses with modestly or underleveraged balance sheets. Pleasingly we continue to be presented with opportunities for rotation into new names with strong fundamental valuation support as Mr Market's attention waxes and wanes in different names. The market remains highly bifurcated amid concerning signs of speculative excess in concept stocks and those leveraged to popular thematic. We continue to avoid these overvalued names and instead try to maximise the risk reward equation for investors with a disciplined investment approach strongly guided by valuation fundamentals.

Top 10 Holdings

Company Name	% Portfolio
Adbri Limited	5.0
Fletcher Building	4.4
Healius	4.1
City Chic Collective	3.7
Iress Limited	3.4
Flight Centre Travel	3.3
Monadelphous Group	3.3
loof Holdings Ltd	3.2
Bega Cheese Ltd	3.2
Seven West Media Ltd	3.2
Top 10	36.8

Source: Spheria Asset Management

Market Cap Bands



Source: Spheria Asset Management

Net Tangible Assets (NTA)³

Pre-tax NTA⁴	\$2.599
Post-tax NTA⁵	\$2.496

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 30th June 2021

	1m	6m	1yr	3yr p.a.	Inception p.a. ⁶
Portfolio⁷	5.0%	14.9%	55.5%	11.1%	11.4%
Benchmark⁸	3.1%	10.8%	33.2%	8.6%	9.4%

Past performance is not a reliable indicator of future performance.

⁶Inception date is 30th November 2017

⁷Calculated as the Company's investment portfolio performance after fees excluding tax on realised and unrealised gains/losses and other earnings, and after company expenses

⁸Benchmark is the S&P/ASX Small Ordinaries Accumulation Index. All p.a. returns are annualised

Disclaimer

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