Spheria EMERGING COMPANIES

**ASX: SEC**

# Investment Update

As at 31st October 2019

## Spheria Emerging Companies Limited
## ACN 621 402 588

Pre-tax net tangible assets[4]

$2.058

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

4.1%

## Company Facts

| | |
|---|---|
| **Investment Manager** | Spheria Asset Management Pty Limited |
| **ASX Code** | SEC |
| **Share price** | $1.68 |
| **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** | $109m |

[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 1.0% in October. This represented outperformance of 1.5% compared to the S&P/ASX Small Ordinaries Accumulation Index.

A late stage bull market is characterised by irrational exuberance with speculators growing in numbers and implicitly ignoring fundamental performance measures. When participants lose sight of fundamentals, companies that spin a good story are massively rewarded. Given the scarcity value in the Australian small companies' universe these kinds of stocks levitate to enormous heights. Eventually the weight of money fatigues given a lack of fundamental support and these top performing stocks begin to drop. We began to witness this trend in October with several high-flying stocks falling significantly. The corollary being that many maligned stocks were beneficiaries from the rotation. This theme benefited the Portfolio's performance for October.

Wisetech (WTC) was the most interesting headline in our space last month after a negative research report was the catalyst for a sharp fall in the share price from giddy heights. When you are on 120x PE, you make 34 acquisitions in a few years and your cash flow generation is relatively weak for a software company, there is ammunition aplenty. The distinct lack of consistency in that a negative report needs to be refuted whilst a positive report on a company is never questioned is simply hard to swallow. Why the share price matters so much for any company is also a red flag? If it falls to more palatable levels isn't it better buying it cheaper? Isn't that safer for all those mum and dad investors rather than buying at nose-bleed levels? The proof will be laid to bare in the next few years with the risk reward equation in our view skewed to the downside given the lack of valuation support and a risky acquisition strategy.

We liken Wisetech to Computershare's rise in the dotcom boom bust, it may be a good business it may be a sensible strategy, but any missteps and the share price falls can be catastrophic. For those that don't remember, Computershare rallied to 150x PE only to collapse from $10 to $1.35 as the challenges of integrating a myriad of acquisitions in various jurisdiction and different operating environments proved far more difficult than management and investors had contemplated. One learning from the Computershare fall is that valuation does matter, and at its lowest ebb there was a great opportunity to buy a decent business at a reasonable multiple. It's one of the reasons we maintain an open mind when investing in the small cap universe. Share prices movements are merely an entry/exit mechanism, the market can be very inefficient at both extremes.

WTC - down 33% off its peak to end of October - was not the only company that has seen a significant de-rate with peak to trough declines across the high PE complex including Appen (down 32%), Afterpay (down 23%), Promedicus (down 28%) and Nearmap (down 38%). The multiples being paid for these companies still feel very aggressive particularly given a couple don't even make money (depends on your definition these days) when accounting for items such as capitalised costs and share based compensation.

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The adage that nothing good happens after midnight can be adapted to the sharemarket in that nothing good tends to happen after 100x (PE). Those that choose to sprint a marathon wearing a blindfold might be in for an exhilarating run but are unlikely to finish the race. We instead have chosen a steady pace in these heady times. We are currently seeing the benefit of this in our strategies, although markets are very fickle and good companies can remain under valued for long periods and heavily promoted companies that hit a pothole can regain favour quickly, particularly when money is cheap and risk-taking a function of ultra-cheap money has been a highly successful strategy for too many years to remember.

The best performers for the month were **Class** (CL1), **Mortgage Choice** (MOC) and **Prime Media** (PRT) which rallied 36%, 25% and 24%, respectively. All three had been aggressively sold off in recent years yet the businesses continue to generate significant cash flow, have strong balance sheets, strategic merit and were inexplicably cheap prior to recent upward share price movements. Prime Media being the subject of a scrip-based takeover from Seven West media, it's content supplier. We believe the merger will unlock significant value for shareholders of the combined entity.

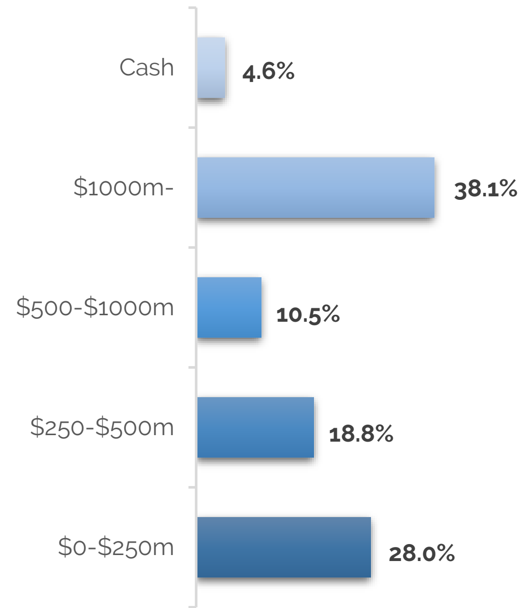
On the negative side of the ledger were **Bega Cheese** (BGA), **Ht&E** (HT1) and **Fletcher Building** (FBU), which declined 21%, 11% and 11% respectively. Bega warned of lower profits due primarily to the continued impact from the drought on milk supply and therein price of farm gate milk (their biggest input). Ht&E is exposed to the radio advertising market which has remained weak, as evidenced by industry data and SXL's significant profit warning (competitor to Ht&E). FBU fell due to a major fire that damaged a key construction project for the Sky City Convention Centre which has been beset with issues, we expect the potential losses to be material but one-off in nature. Hypothetically, a $200m overrun would trim 5% off our valuation. The company has a strong balance sheet after selling Formica for an incredible price.

## Top 5 Holdings

| Company Name | % Portfolio |
|---|---|
| Class Limited | 4.9 |
| Blackmores Limited | 4.7 |
| Ht&E Limited | 4.2 |
| Mortgage Choice Ltd | 4.2 |
| Platinum Asset | 4.1 |
| **Top 5** | **22.2** |

Source: Spheria Asset Management

## Market Cap Bands




Source: Spheria Asset Management

## Net Tangible Assets (NTA)[3]

| | |
|---|---|
| **Pre-tax NTA[4]** | $2.058 |
| **Post-tax NTA[5]** | $2.107 |

[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 October 2019

| | 1m | 3m | 6m | 1 yr | Inception p.a.[6] |
|---|---|---|---|---|---|
| **Company[7]** | 1.0% | 0.8% | -2.0% | 7.7% | 4.1% |
| **Benchmark[8]** | -0.5% | -1.8% | 2.2% | 14.4% | 6.4% |

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