Spheria Emerging Companies Limited ASX: SEC

Investment Update 30 June 2023

Overall Commentary

Company performance was -0.6% (after fees) during the month of June, underperforming the S&P-ASX Small Ordinaries Accumulation Index by 0.6%.

Company Facts

Investment Manager	Spheria Asset Management Pty Limited
ASX Code	SEC
Share Price	$1.90
Inception Date	30 November 2017
Listing Date	5 December 2017
Benchmark	S&P/ASX Small Ordinaries Accumulation Index
Dividends Paid	Quarterly
Management Fee	1.00% (plus GST) per annum[1]
Performance Fee	20% (plus GST) of the Portfolio's outperformance[2]
Market Capitalisation	$113.9m

[1] Calculated daily and paid at the end of each month in arrears.
[2] Against the Benchmark over each 6-month period to a high-water mark mechanism

Performance as at 30 June 2023

	1 Month	3 Months	1 Year	3 Years p.a.	5 Years p.a.	Inception p.a[3]
Company[1]	-0.6%	0.5%	9.6%	13.5%	5.2%	6.0%
Benchmark[2]	0.0%	-0.5%	8.4%	5.2%	2.3%	3.4%
Difference	-0.6%	1.0%	1.1%	8.3%	2.9%	2.6%

[1]Calculated as the Company's investment portfolio performance after fees excluding tax on realised and unrealised gains/losses and other earnings and after company expenses
[2] Benchmark is the S&P/ASX Small Ordinaries Accumulation Index.
[3] Inception date is 30 November 2017. Past performance is not a reliable indicator of future performance. All p.a returns are annualised.

Net Tangible Assets (NTA)[1]

Pre-Tax NTA[2]

2.198

Post-Tax NTA[3]

2.225

[1] NTA calculations exclude Deferred Tax Assets relating to capitalised issue cost related balance and income tax losses.

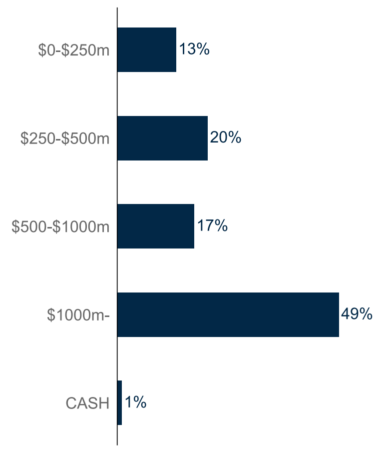
[2] Pre-tax NTA includes tax on realised gains/losses and other earnings, but excludes any provisions for tax on unrealised gains/losses.

[3] Post-tax NTA includes tax on realised and unrealised gains/losses and other earnings.

Top 10 Holdings

Company Name	% Portfolio
IRESS Limited	4.8
Adbri Limited	4.1
InvoCare Limited	4.1
Vista Group International Limited	3.9
Bega Cheese Limited	3.7
Supply Network Limited	3.7
Insignia Financial Ltd.	3.5
Breville Group Limited	3.2
Deterra Royalties Limited	3.1
Blackmores Limited	3.1
Top 10	**37.3**

Market Cap Bands



Source: Spheria Asset Management

Markets

Company performance was -0.6% (after fees) during the month of June, underperforming the S&P-ASX Small Ordinaries Accumulation Index by 0.6%.

Sharemarket returns were broadly stronger for global markets. Closer to home the Australian Small Ordinaries index was weighed down by tax loss selling into financial year end. The Financials and Energy sectors led the charge as Materials and Consumer Discretionary weighed on the benchmark. Investors are being challenged by mixed signalling from the RBA and conflicting economic data, as well as the market's seemingly schizophrenic response, whereby good economic news is interpreted as bad news for markets in one breath and vice versa in the next. As the market fixates on these short-term gyrations, we seek to exploit them by remaining disciplined and positioning for the long term instead of reacting to noise.

The flurry of corporate activity at the smaller end of the market continued through the month of June with Fanatics trumping Draftkings' bid for Pointsbet's US business, ARN Media raiding Southern Cross Media for 14.8% of the register and at the pointier end of the market, Limeade receiving a bid at an incredible 325% premium to the last traded price. Interestingly, it appears that investor risk appetite is increasing with M&A activity heating up again at the cash burning end of the market. We've also seen fresh capital come to market as Redox (a $1.2bn chemical distribution business) managed to find enough support in a high interest rate environment to make it the largest Initial Public Offering of 2023. We continue to avoid the allure of "shiny new toys" preferring to own businesses with more transparent and longer track records to analyse.

During the month the portfolio added to GWA Group (GWA.ASX), Link Administration Holdings (LNK.ASX) and Johns Lyng Group (JLG.ASX) all on valuation grounds. It reduced its holdings in Technology One (TNE.ASX), Flight Centre Travel Group (FLT.ASX), Blackmores (BKL.ASX) and Smartgroup Corporation (SIQ.ASX) into share price strength.

Major Contributors to Performance

Over the month the largest contributors to performance were Vista Group International (VGL.ASX, 86bps), Adbri (ABC.ASX, 34bps), Supply Network (SNL.ASX, 26bps) and Smartgroup Corporation (SIQ.ASX, 24bps).

Adbri (+34bps)

This month, Adbri's share price experienced some relief as investors recognised the valuation disparity between Adbri and its peers. Boral for example trades at a robust 23x EBIT, whilst Adbri trades at only 13x. The market believed Adbri would need to issue equity capital because its net debt position is expected to peak at 3x net debt to EBITDA, relating to Kwinana's increasing CAPEX requirements. Adbri had been absorbing inflationary cost pressures and is just now beginning to reap the benefits of price rises that had lagged the cost burden. With industry rivals becoming more rational and with high barriers to entry (extensive investment in capital intensive assets), as demand improves across the commercial, industrial, multi-family, and infrastructure segments of the market, we expect this business's earnings to increase significantly.

Smartgroup Corporation (+24bps)

Continued its run of outperformance during the month reflecting the market's growing appreciation for the strong volume growth that lies ahead for the business. At its first quarter update issued in May, the company pointed to strong growth in lead volumes (+31%), with electric vehicle quotes comprising over 20% of total novated leasing quotes. Reflecting this, SIQ's vehicle order pipeline sat at a healthy $16m, up from $15m at 31st December 2022. Further, novated leasing yields were up +3% versus the prior corresponding period. Thus, with rising interest rates and cost of living pressures crimping demand in most corners of the economy, novated leasing demand remains robust, benefiting from pent-up demand as covid related new vehicle supply chain constraints gradually unwind, and tailwinds from the introduction of new legislation abolishing FBT on EV's and hybrids bolsters the case for salary packaging one's vehicle. Having acquired the stock <$5/share, SIQ has been a strong performer for the fund. At current levels the value equation is more balanced than it was, but we remain attracted to its growth profile, consolidated industry structure, strong cash flow profile and minimally geared balance sheet.

Major Detractors from Performance

The largest detractors were Bega Cheese (BGA.ASX, -86bps), Appen (APX.ASX, -72bps), Link Administration Holdings (LNK.ASX, -39bps) and not owning Paladin Energy (PDN.ASX, -22bps).

Appen (-72bps)

Appen more than doubled post the recent capital raise (peaking in the first week of June) and has since given back some of the return as investors take profits. Global AI has gained a lot of attention of late, with investors (and speculators!) on the lookout for the next Nvidia. There are not many ways to get leverage to AI in the Australian listed market outside of Appen and with a refreshed management team already making inroads as demonstrated at the investor day in May we are confident of what lies ahead for this business. Appen is well placed to benefit from the growth in generative AI which requires human input, particularly as it relates to ensuring the accuracy of the outputs. Appen has been pivoting towards Large Language Model (LLM) type work with the expectation that this market will grow to more than $100bn by 2030. The recent capital raise provides ample funds to invest in the growth of the business for the next couple of years. A substantial US$300m of revenue (admittedly vs a peak of around >US$400m) alongside a re-engineered cost base will mean the business achieves profitability in the short to medium term. On a price to revenue metric the company is trading on less than 1x. Assuming the business can generate 10% EBIT margins (not a stretch in our view) it would be generating US$30m of EBIT and trading on a modest 10x EV/EBIT. As a reminder this stock once traded above $40 a share!

Bega (-86bps)

Bega issued an earnings report and announced the sale and leaseback of its Port Melbourne facility to Charter Hall for $114.6 million. The funds will be utilised to enhance Bega's balance sheet and to assist the company's transition to a mostly branded business. Bega Group's brand portfolio includes the celebrated Australian brand Vegemite, as well as Bega Peanut Butter, Dare, Farmers Union, Yoplait, and Daily Juice. Bega maintains its normalised EBITDA estimate at the low end of the previously guided range of $160 - $190 million. Bega has been significantly impacted by inflationary cost pressures in recent years, notably in its bulk business but we remain convinced that once this pressure begins to dissipate, returns should improve. With the industry ripe for consolidation, we believe the primary risk for Bega is an opportunistic approach from a strategic investor, as the stock trades at its lowest price in over a decade.

Outlook & Strategy Going Forward

We remain constructive on markets and continue to see strong valuation support, in particular at the smaller end. We remain fully invested and are finding an abundance of opportunities in under-owned pockets of the market including the consumer discretionary space, where true value has emerged as investors focus far too much on the next earnings print and are seemingly discounting quality businesses like Breville Group (since rerated in July post writing) and Premier Investments which have strong free cash flow and return profiles, a proven ability to ride out market cycles, and are further supported by strong balance sheets.

With the dislocation between value and price in small companies at historic highs, we expect M&A activity to ramp up even further over the next 6 - 12 months. Strategic buyers and private equity alike have a demonstrated propensity to take advantage of depressed valuations and a willingness to take a longer-term view than many other market participants. This is but one way that value ultimately gets realised, supporting our conviction that remaining true to our investment process will deliver just rewards.

In recent times we have witnessed a huge asset allocation away from equities and fund manager’s hoarding cash, all in anticipation of a “buy the correction moment”. This has helped to drive a wedge between large and smaller cap performance, in our view. But with the Australian population set to grow strongly next year due to decade high levels of migration and superannuation contribution rates increasing to 12% from July 2025, a peak in interest rates could see an epic wall of capital flood back into equities, a backdrop that is almost certain to see smaller companies outperform.

Last quarter’s dramatic move to the upside in the beaten-up tech sector serves as reminder of just how rapid these moves can be and that almost by necessity they tend to be led by areas of the market that have been neglected. It is in these neglected parts of the market where we focus our efforts and tend to find our best ideas.

Fund Ratings

Zenith RECOMMENDED

Recommended Lonsec Research

Contact Us

For more information, please contact Pinnacle Investment Management Limited on 1300 010 311 or email distribution@pinnacleinvestment.com

Disclaimer

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