# Spheria Emerging Companies Limited ASX: SEC

Investment Update 30 September 2023

## Overall Commentary

The Company returned -4.4% (after fees) during the month of September, underperforming the S&P-ASX Small Ordinaries Accumulation Index by 0.4%.

## Company Facts

| Investment Manager | Spheria Asset Management Pty Limited |
|---|---|
| ASX Code | SEC |
| Share Price | $1.895 |
| 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 | $113.4m |

[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 September 2023

| | 1 Month | 3 Months | 1 Year | 3 Years p.a. | 5 Years p.a. | Inception p.a[3] |
|---|---|---|---|---|---|---|
| Company[1] | -4.4% | -4.1% | 5.0% | 7.4% | 3.8% | 5.0% |
| Benchmark[2] | -4.0% | -1.9% | 6.8% | 2.6% | 1.6% | 2.9% |
| Difference | -0.4% | -2.2% | -1.9% | 4.8% | 2.2% | 2.0% |

[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]

2.072

Post-Tax NTA[3]

2.143

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

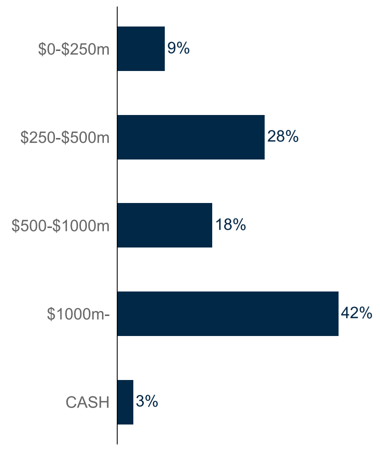
[2] Pre-tax NTA includes tax on realised gains/losses and other earnings, but excludes any provisions for tax on unrealised gains/losses.

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

## Top 10 Holdings

| Company Name | % Portfolio |
|---|---|
| IRESS Limited | 5.2 |
| Link Administration Holdings Limited | 4.1 |
| Supply Network Limited | 3.8 |
| Adbri Limited | 3.7 |
| Breville Group Limited | 3.6 |
| Bega Cheese Limited | 3.5 |
| Vista Group International Limited | 3.5 |
| Deterra Royalties Limited | 3.5 |
| Insignia Financial Ltd. | 3.2 |
| Bravura Solutions Limited | 3.1 |
| **Top 10** | **37.1** |

## Market Cap Bands




Source: Spheria Asset Management

## Markets

Many parts of the sharemarket especially the smaller company end have entered something resembling the "Twilight Zone" where unusual phenomena are so frequent that nothing really surprises us anymore. Case in point being the extreme disconnect in valuations between "growth" and "value" companies where the definition of each is simply a gauge of popularity or unpopularity in the case of value. Money is also clearly exiting the smaller end whether it be a flight to safety or industry funds exiting mandates given the marginal incremental contribution to performance given their increased size. The selling in certain names and the lack of risk appetite has meant extremely large drawdowns for anything resembling a negative earnings delta. This has been accentuated in anything that has debt regardless of whether the company's cash flow can support that debt. We have been caught in several of these situations across the portfolios and even when this equation has been addressed via capital raisings and/or asset sales the stigma has continued to weigh on the company's valuation and share price despite the sharp reduction in risk. Interestingly, earlier in the year we entered Bravura Solutions (BVS) a little early, only for it to have a near death experience where we were a key party to a significant recapitalisation at 40c. Subsequent to the raise the company inexplicably traded down to 29c. Since that time, we were heavily involved in re-working the board and ultimately the senior management team and the BVS share price has more than doubled from the bottom to trade in excess of 70c (at the time of writing). We feel several of our names are in a similar position but are still early in that recovery cycle.

**Major Contributors to Performance**

Over the month the largest contributors to performance were from overweight positions in Horizon Oil (HZN.ASX, +38bps), Regis Healthcare (REG.ASX, +28bps), and Deterra Royalties (DRR.ASX, +26bps).

**Horizon Oil (HZN.ASX)** share price rose over 12% in September on the back of a strengthening oil price. For those not familiar with HZN, it has substantial interests in two conventional oil fields. The larger one being in the Beibu Gulf (off China) which has produced around 10k barrels of oil per day (bopd) on a gross basis for the last ten years and is forecast to do so for at least a further six years. The other being Maari that is off New Zealand and has produced around 5k bopd which has at least another 4 years of production at or around these levels. When we first acquired our position in HZN about 7 years ago it was trading around 4c and facing numerous issues including too much debt and serious corruption allegations in respect of its PNG gas assets, which were subsequently divested. It is now trading at 18c and has returned over $150m (9.5cps) of cash to shareholders over the last three years.

**Major Detractors from Performance**

The largest detractors from performance included overweight positions in Star Entertainment Group (SGR.ASX, -45bps), Bega Cheese (BGA.ASX, -44bps), and Appen (APX.ASX, -30bps)

**Star Entertainment Group (SGR.ASX)** share price declined by 34% over the month after a deeply discounted capital raising that was to some extent pre-empted by the market. After raising $750m to pay off higher cost debt and refinance its debt facilities, the company is in a better position to navigate a confluence of unknown and expected liabilities, with the most pressing unknown being the AUSTRAC penalty which has weighed heavily on the share price since Crown announced it would pay $450m in May 2023. We expect an agreement likely to be announced in November with the size of the penalty - to an extent - reflecting affordability given SGR's ability to pay remains somewhat constrained given it is unable to raise additional capital from equity or debt markets which have been fully tapped, in our opinion. Like Crown we expect the penalty to be payable on an instalment basis to help manage group cash flows. With this out of the way and NSW gaming levies decided the only other major outstanding liabilities of note are in relation to the Queens Wharf development. We believe these are manageable in the short to medium term, with long-term prospects of a favourable resolution reasonably strong, in our view. Generally, these distressed points in a company's lifecycle are when the greatest returns are made particularly when the underlying assets are well positioned.

**Bega (BGA.ASX)** share price continued to fall in September, down 16% over the month after a relatively weak result in August. We have written about Bega in a number of recent commentaries surrounding issues that have plagued the company and the industry including labour supply shortages, inflationary pressures and the supply/demand dynamics within the milk industry. Unfortunately, export prices for milk powders and cheeses have continued to decline impacting the commodity side of the business. This has further impacted sentiment albeit we believe it is cyclical in nature and will recover at some point with some sign in recent weeks of an improvement in pricing. Positively, the business has transitioned away from being a bulk dairy business, into predominately branded with 85% of group sales having some degree of pricing power. Further cost reductions and an improvement in export prices will improve the outlook for the business as will a reduction in industry milk processing capacity which also seems to be occurring with Saputo rationalising its manufacturing footprint in Australia.

### Outlook & Strategy Going Forward

We feel our portfolio is well balanced between companies that are trading and executing well and are relatively popular and those that are in the throes of turnaround or recovering from a challenging experience. Given past experiences, we feel that the good companies where valuations are very compressed (IRE, LNK, SGR, BGA) trading at share prices that feel very uncomfortable is where the most returns tend to be had. In the meantime, our performance is being supported by businesses like SNL, MAD, DRR, HZN that are trading well from an economic perspective and are not ridiculously expensive.

### 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

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