Spheria Global Microcap Fund

ARSN 627 330 287 | APIR WHT6704AU

Performance as at 31st August 2022

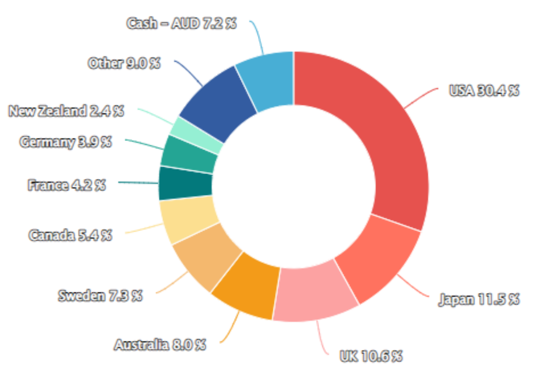
	1 Month	3 Months	1 Year	3 Years p.a.[3]	Inception p.a[3]
Fund[1]	-4.9%	-4.4%	-22.5%	10.1%	9.8%
Benchmark[2]	-0.2%	-2.1%	-18.0%	10.8%	9.2%
Difference	-4.6%	-2.3%	-4.5%	-0.8%	0.6%

1 Spheria Global Microcap Fund. Returns of the Fund are net of applicable fees, costs and taxes.
2 Benchmark is the MSCI World Microcap Index in AUD (Net) from 1 July 2021 and prior to that MSCI Kokusai (World Ex-Japan) Microcap Index in AUD.
3 Inception date is 1 March 2019. Past performance is not a reliable indicator of future performance. All p.a. returns are annualised.

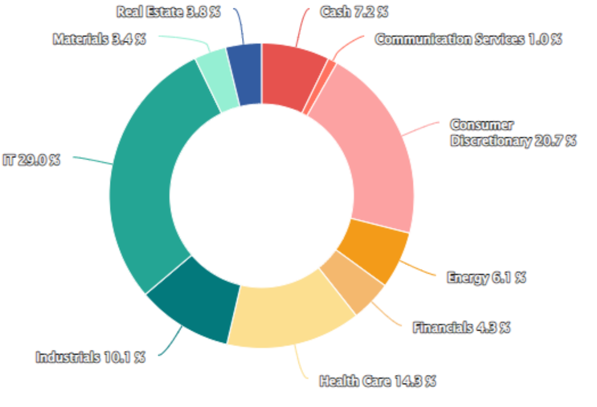
Overall Commentary

The Spheria Global Microcap Fund declined 4.0% (after fees) during the month of August, underperforming the MSCI World Microcap Index by 4.0%.

Regional Exposure



Sector Exposure



Source: Spheria Asset Management

Global Characteristics

	Average Mcap (USD)	EPS Growth (%)	Trailing FCF Yield (%)	Dividend Yield (%)	Net Debt / EBITDA	FCF Conversion (%)
Spheria	927	-22.4	4.3	6.4	-1.1	90.7
World Micro	148	-15.5	-1.2	3.1	0.8	64.8
World Smalls	1,960	6.8	3.0	2.4	2.0	68.3
S&P500	72,627	14.9	4.9	1.5	1.0	89.6
Nasdaq	5,806	6.6	3.6	0.8	0.4	92.3

EPS= Earnings per Share, FCF = Free Cash Flow, Negative Net Debt / EBITDA figures show a debt free, or net cash balance sheet.

Markets

It was clearly a tough month performance wise for the fund with several of our consumer facing companies citing continued supply chain challenges and concerns about potentially weaker demand in the next couple of quarters. The market doesn't like uncertainty and has continued its relentless sell-off of such names without regard to balance sheet strength and valuations, which are now pricing in very bleak economic scenarios. We feel it is time to be constructive in the consumer space as confidence measures are at extreme lows and the risk-reward equation has moved favourably for longer term investors.

Major Contributors for the Month

Nitro Software (NTO.AU) – jumped 37% after an off-market raid by a private equity firm, Potentia Capital, at $1.58 which was a significant premium to the undisturbed price. We partially sold into the raid for liquidity reasons but remain supporters of the company as we believe the product (PDF software) is excellent and the pivot in strategy to bring forward profitability (over growth) as sensible. This change in strategy clearly did not mesh well with some investors who sold the company down aggressively which has facilitated the opportunistic takeover approach. We feel Potentia Capital will need to substantially increase its offer to gain control of the company. At worst, if they decide not to, the offer highlights value in the asset and its broader strategic appeal.

Napco Security Technologies (NSSC.US) – continued its upward march, gaining 16% on the back of a strong Q4 result. Napco is a provider of alarm, locking and access control systems. While it has a history as a hardware company, its recent success has been driven by rapid growth in its high-margin subscription revenue, linked to the connected services it provides for its wireless products. It's benefiting from an upgrade cycle in the commercial security alarm/fire radio market as it makes the transition from 3G networks and copper cabling with on-premises servers, to 4G networks and cloud-based servers, as well as increased government funding for K-12 and higher education campus security systems in response to mass shootings. Management made the strategic decision over the past year to source components at any cost, and to fly the components to their manufacturing facilities rather than sending them by sea. They sacrificed short-term gross margins on hardware to keep product available, and a result, gained significant market share where competitors couldn't supply product. Napco now gets to reap the reward of sticky, high-margin recurring services revenue over the long-term which more than makes up for the short-term loss of hardware margin.

Somero Enterprises (SOM.LN) – gained 7% over the month with no notable news flow. Somero has been a stalwart of the Spheria Global portfolio since inception and has featured more than once in these commentaries as a top contributor. Somero is the world's leading manufacturer of laser screeds for concreting. Laser screeds employ laser guidance technology to perfectly level out concrete floors, achieving a superior finish to the traditional method of hand concreting. While a niche product, the value of being able to produce perfectly level concrete floors has increased with the rise of e-commerce. Perfectly level floors achieved by laser screeds allow for higher racking and more efficient distribution centres for e-commerce companies such as Amazon. This structural tailwind has helped Somero deliver a compound revenue growth rate of 20% over the past 10 years. Despite this, it is still trading at a bargain price of 5x EV/EBIT.

Major Detractors for the Month

Sonos (SONO.US) – after rallying 20% and featuring as one of our top contributors in July, Sonos declined 32% in August off the back of a disappointing Q3 result and Q4 outlook. Management called out weakening consumer confidence (particularly in higher income consumers where Sonos are strongest), continuing supply constraints leading to shortages in some of their most popular products, and forex headwinds caused by strength in the USD, with ~45% of Sonos' revenue coming from outside the US. Sonos is a name regular readers of this commentary may be familiar with – it is the 4th largest contributor to the fund's performance since inception. We initiated a position in Sonos early 2019 when it was on the precipice of profitability. It grew to one of the largest positions in the fund over the next 2 years, and we exited in early 2021 when the valuation was looking stretched. We moved back into Sonos in June 2022 after it had fallen over 50% from its highs. We believe the long-term story for Sonos remains intact as the market leader in Wi-Fi connected speakers with a loyal customer following and a large, underpenetrated addressable market.

BML (4694.JP) – fell 9% during August, giving back some of its recent gains (top contributor for June and July). BML is the second largest player in the Japanese pathology market, with a leading position in routine testing for GPs. The company also competes with hospital labs who are under pressure for volume as Japan transitions to more treatment in the community setting. BML's focus on high volume general testing for smaller clinics, including regional areas, has thus underpinned solid growth in volumes and its large central lab provides a competitive advantage which has underwritten stable margins over time. BML also has been a significant beneficiary from COVID testing in recent years and this may persist for longer than anticipated. Excluding COVID testing, we have BML trading on 3x EV/EBIT with A$1bn of net cash on its balance sheet.

Core Laboratories (CLB.US) – declined a further 15% last month, outpacing the continued fall in the price of oil, down 9% over the same period. We believe the outsized slide is due more to investors fear of external factors (Russia/Ukraine war, strong USD) rather than business performance, with management providing a positive business update in late July indicating customer demand is beginning to ramp back up. As a leading provider of proprietary and patented reservoir description, the business is highly linked to oil and gas exploration and development spend. They remain a leader in the space with enviable market share both in the US and internationally. The balance sheet is modestly geared, and we forecast a return to levels of profitability last seen in FY19 over the next two to three years, which is not fully reflected in the share price.

Outlook & Strategy

Those countries with energy reliability and security have been relatively insulated from the recent economic malaise afflicting many countries in particular those in Europe that rely on Russian gas and had too rapid a transition to renewable sources of energy that have proved insufficient and unreliable thus leading to sky-rocketing energy prices that have fed inflationary pressures. High energy prices have also had a significant impact on industries which have significant exposure to power in their cost structure. To add insult, the withdrawal of central bank stimulus (that had engorged households on debt) and rising interest rates to combat said inflationary pressures is placing even more pressure on household disposable income. This vicious feedback loop is putting investors in a spin with share price falls across sectors that are heavily exposed. Further, highly valued companies and sectors that are long duration in nature have been pummeled by rising yields due to relative valuation arguments. Whilst the economic backdrop is somewhat depressing, we believe opportunity presents in such situations and long-term fundamental investors will be rewarded from here in the right companies – those with strong balance sheets, sustainable franchises and solid cash flows where valuations now make much greater sense.

SPHERIA ASSET MANAGEMENT

Spheria Global Microcap Fund

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Platform Availability List

The Spheria Global Microcap Fund is available on the below Platforms. Please check with your platform for minimum investment requirements and fees.

BT Panorama | HUB24 | Macquarie Wrap | Netwealth

Praemium

Spheria Global Microcap Fund	
Benchmark	MSCI World Micro Cap Index
Investment Objective	Outperform the MSCI World Micro Cap Index in AUD (Net) over the long term
Investing Universe	Global listed microcap equities predominantly in developed markets with a market capitalisation of US$1.0bn and below at time of purchase
Holdings	Generally 30-80 stocks
Distributions	Annually
Fees	1.35% p.a. management fee & 20% performance fee of the Fund's excess return versus its benchmark, net of the management fee.
Cash	Up to 20% cash
Expected Turnover	20% - 40%
Style	Long only
APIR	WHT6704AU
Minimum Initial Investment	$25,000

Fund Ratings

Zenith APPROVED

Further Information

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

Disclaimer