Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

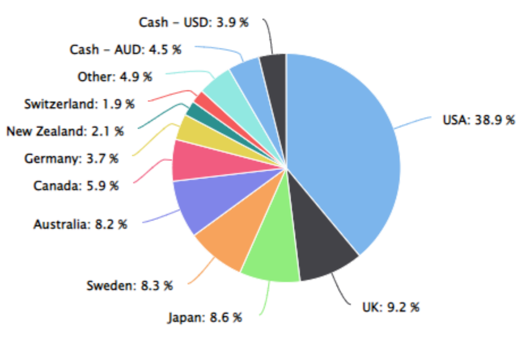
Performance as at 30th September 2022

	1 Month	3 Months	1 Year	3 Years p.a.[3]	Inception p.a[3]
Fund[1]	-3.7%	-0.6%	-22.1%	8.7%	8.7%
Benchmark[2]	-5.6%	-2.2%	-22.0%	8.4%	7.3%
Difference	1.9%	1.6%	0.0%	0.3%	1.4%

Overall Commentary

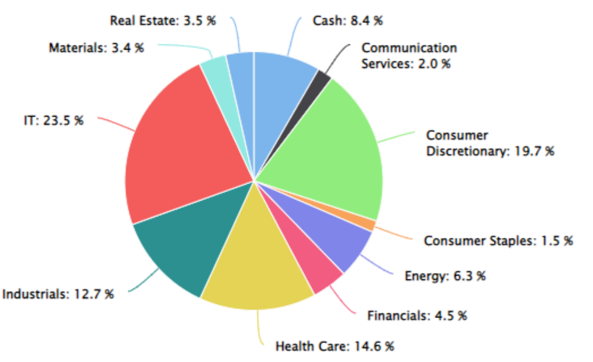
The Spheria Global Opportunities (previously Microcap) Fund declined 3.6% (after fees) in AUD terms during the month of September, outperforming the MSCI World Micro Cap Index by 2.0%. In USD terms the MSCI World Micro Cap index declined 11.5% and the MSCI World Smaller Companies Index (against which the Fund will be benchmarked going forward from the beginning of October) was down 10.2%. The AUD returns were lessened by the significant fall in the AUD which cushioned returns to AUD investors (ie the funds assets are predominately in currencies that rose against the AUD).

Regional Exposure



Source: Spheria Asset Management

Sector Exposure



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 Smalls	1,960	6.8	3.0	2.4	2.0	68.3
World Micro	148	-15.5	-1.2	3.1	0.8	64.8
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

Markets struggled over September after the respite in July and August. In Australia, the S&P ASX Small Ordinaries Accumulation Index declined over 11% with the S&P ASX Mid-Small Index marginally less impacted falling 9.0%. Globally markets were also well down over the month. Bond yields rose in the US and more modestly in Australia such that 10-year yields are now close to 4% in both countries. Other world political events haven't calmed investors nerves either with energy prices re-asserting themselves and a great deal of angst present with companies we have spoken to around rising energy prices for consumers.

Having said this, we have to acknowledge that markets are now down broadly 20-25% year to date. A lot of the present risks are known to some extent – inflation, rising rates, high energy prices and macro uncertainty around the Ukrainian situation. The extreme outliers in smaller companies – the large pockets of overvaluation in speculative growth names – have largely come back down to earth. Investors are now talking about valuation and discount rates again and a more sensible economic lens is being used to allocated capital. Whilst the macro environment continues to present risks, it is worth remembering that fortune favours the intelligently brave and much better opportunities appear at times like these than when there is a positive consensus around buying an over-promoted growth market.

With that in mind, and a degree of conservatism in our forecasts, we continue to look for the best opportunities across the market and try to sensibly rotate our portfolios into opportunities that we either thought were too expensive before and / or had material earnings risks.

Major Contributors for the Month

Channel Advisor (ECOM.US) – Rose 60% over the month after receiving a takeover offer from Commercehub (which is held by private equity firm GTCR and Sycamore Partners) after they lobbed in a US$23.10/ share takeover offer. This was a healthy premium after the stock had declined to under US$15 with the general market sell off. ECOM provides enterprise grade software to retailers and helps link their inventory and supply chains across multiple retail platforms to give customers one view of their stock on offer. ECOM was strongly cash generative and 85% of their revenue was recurring in nature. Whilst we were attracted to the quality of the business the takeover comes at a good time to hunt for new ideas.

Computer Modelling Group (CMG.CA) – rallied 13% over September in sympathy with strong oil prices. CMG is Canadian listed and is one of the leading hydrocarbon reservoir simulation software companies in the world. Their software helps Oil and Gas companies map, manage and optimize recovery from producing oil wells. Once an asset is in production, CMG's simulation software is an integral part of managing the production from the asset. Most of CMG's revenue is recurring in nature with 97% of the last quarter's revenue being maintenance from existing clients. Cash conversion has been over 100% over the past 20 years, it has a net cash balance sheet and only trades on 12x EV/EBIT on year forward.

OTC Markets (OTCM.US) – gained 11% over the month with no notable news flow. OTCM operates 3 over the counter markets for US based investors (OTC QX, OTC QB and the Pink Sheets). Each market has differing levels of disclosures and regulations with OTC QX being the highest level and most transparent of the three. The economics of the business resemble other stock exchanges – think ASX, NYSE etc. so revenue is driven by number of listings and turnover. OTC is highly cash generative and is used not only by smaller US companies to gain access to markets but by foreign companies who are unable to comply with the US listing regs of the NYSE and their own home market stock exchanges. Cash flow conversion is extremely strong at over 100% and the valuation is supported at 16x EV/EBIT.

Major Detractors for the Month

Vetoquinol (VETO.FP) – declined 28% over September as the company reported first half results which showed relatively defensive topline but some pressure on margins developing. VETO develops, manufactures, and sells veterinary drugs and non-medicinal products exclusively dedicated to animal health. Its product suite is broad and includes diagnostics and other services. Whilst many of their drugs are off patent their IP is in compounding the ingredients to improve efficacy. The business has been bolting on assets as larger players merge and are forced to divest non-core assets which has created significant opportunities for VETO. As you would expect VETO is extremely cash generative, has net cash on the balance sheet and now trades on just 12x EV/EBIT.

MIPS (MIPS.SS) – fell 29% over September as the company announced trading conditions were becoming tougher. MIPS supplies safety technology to the helmet market (predominately bike and ski helmets) although expanding into work safety helmets over time. The latter category represents a significantly bigger annual market as daily use and wear on these helmets typically sees them replaced annually compared to less frequent replacement in the leisure markets. The current trading conditions for MIPS are being impacted by a de-stock from helmet stockists who bought up incremental stock on the back of Covid demand. As this unwinds, manufacturers (and thus MIPS) have to wear the brunt of a period of lower-than-normal production levels until inventory at the consumer level clears. Given the extremely compelling value nature of the product and their leading safety credentials we feel it is really a function of time before the helmet market recovers and so to MIPS growth rates. MIPS is very cash generative and has a net cash balance sheet and is now trading on sub 20x forward EBIT (for what has been a 30% plus pa growth business).

Go Pro (GPRO.US) – declined 14% over the month on concern around consumer demand in the US. Electronics Retailers in the US appear to have overstocked based on strong demand over the past 2 years and fears that they would not be able to source sufficient stock going forward just as consumer demand started to taper as a result of higher energy price and interest rates. This is likely to manifest in further de-stocking from the retail channel and possibly see orders pushed forward for suppliers into the channel. Having said this GRPO is extremely lowly rated on any measure. GRPO is in the process of enhancing its offering to consumers by offering cloud storage and video editing software. This could make consumers sticky to the ecosystem and is designed to add incremental and higher margin revenue to the business. The balance sheet is pristine (US$250m of net cash), the valuation is low at circa 4x EV/EBIT and the business makes good cash flows.

Outlook & Strategy

It's always hard to be positive when you are sitting in a morass of negativity about markets. However, most great investors have made money betting against a fearful crowd. Over time, it's been proven that it's hard to time markets as we are overly prone to emotion and secondly that there have been few places to invest that have out earned the market as an asset class. Whilst there are many likely negatives it's worth remembering that we are buying individual businesses with, in some cases, innovative and adaptive management teams who have dealt with challenging environments before. We also need to keep in mind that a lot of the de-rating of reasonable companies has now put many of the companies we own on low to mid-single digit EV/EBIT multiples. Couple this with bullet proof balance sheets and we feel comfortable that returns will reward investors over time. Finally, there is some evidence that the pent-up inflationary forces we are dealing with could abate somewhat which may ease the rise of longer-term interest rates providing the market with some respite in time.

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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