Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

Performance as at 31st October 2020

	1 Month	3 Months	1 Year	Inception#
Fund^	-0.1%	1.6%	11.8%	11.9%
*Benchmark**	1.0%	6.2%	3.8%	3.0%
Value added	-1.1%	-4.6%	8.0%	8.8%

^ Spheria Global Microcap Fund. Returns of the Fund are net of applicable fees, costs and taxes
* Benchmark is the MSCI Kokusai (World ex Japan) Microcap Index in AUD (Net).
# Inception date is 1 March 2019. Returns are per annum.
Past performance is not a reliable indicator of future performance.

The Spheria Global Microcap Fund returned -0.1% after fees in October compared to the MSCI Kokusai Microcap Index which delivered 1.0%. Since inception, the Fund has returned 11.9% p/a after fees and the index return over the same time period has been 3.0% p/a.

Markets

Investors were still hoarding Covid stocks as if they were toilet rolls during a shut-down. Energy is well down the shopping list for investors, and that sector declined 7.1% in AUD. Perhaps it is somewhat related to the market's current obsession with electric vehicles. Microcap Workhorse Group shot from $2.48 at the beginning of June to a high of $30.60 in September and a market capitalisation of US$3.2 billion. A ritzy valuation for a company expected to make $19 million of revenue in 2020 and lose $107 million.

Regardless, the recent underperformance of energy looks far worse than even the dotcom boom. Many small cap energy stocks have de-rated to such an extent that they have slipped into the microcap universe. We are busy doing due diligence on a number of names that, like our current energy holding, are high-quality service providers or adjacent to the oil sector and hence benefit from more favourable industry structures (i.e. not a commodity). The universe of microcap stocks is continuously in a state of flux and that is why a well-resourced and consistent process is necessary to take advantage of the opportunities it presents. (Please see chart on the following page).

Financials, consumer discretionary and utilities led the market higher. We remain heavily underweight financials and the Fund took advantage of the recent strength in consumer discretionary stocks to reduce our weight.

Italy was the worst performing microcap market in October. One of the worst Italian stocks was Societa Sportiva Lazio, a Seria A soccer club. The club is doing reasonably well this season, but there's a reason soccer clubs are the playthings of wealthy tycoons. How much did that player cost!?

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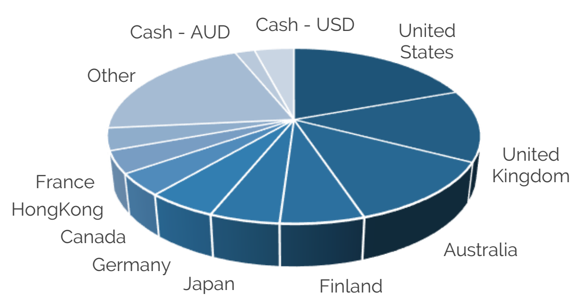
Top 5 Holdings

Company Name	% Portfolio
Fjordkraft (Norway)	3.2%
Inogen (USA)	3.2%
Poletowin Pitcrew (Japan)	3.0%
Computer Modelling (Canada)	2.9%
Hamburger Hafen (Germany)	2.9%
Top 5	**15.2%**

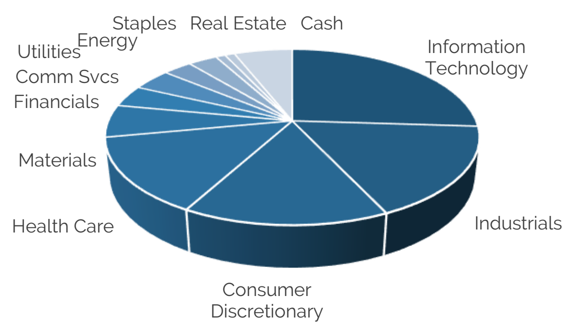
Source: Spheria Asset Management

Regional Exposure

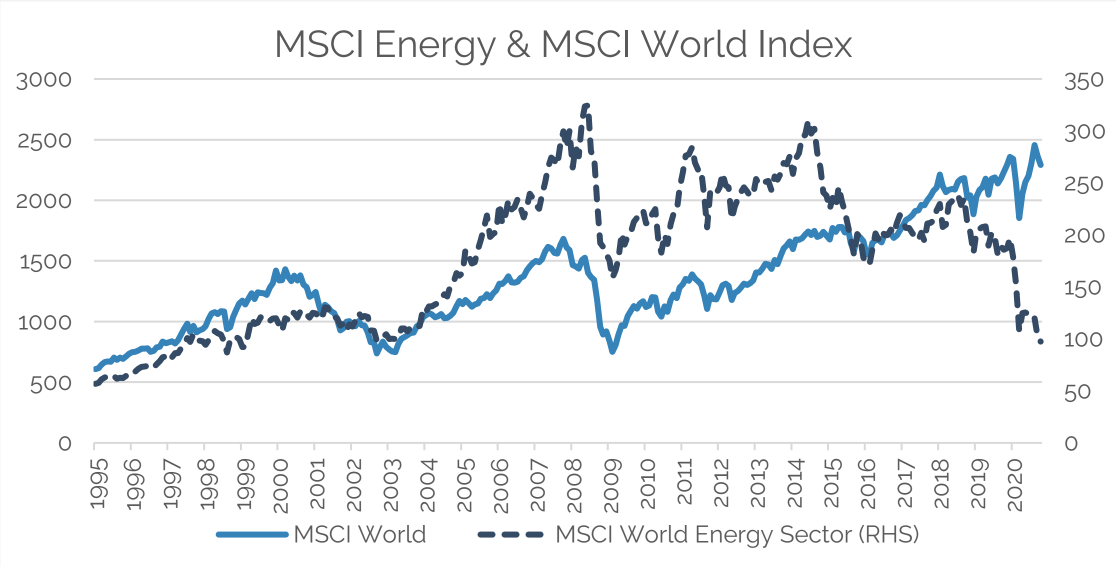


Source: Spheria Asset Management

Sector Exposure



Source: Spheria Asset Management



Source: MSCI. Spheria

Despite the outbreak of Covid cases in Europe, countries like France, Netherlands and the UK did not underperform. Instead, it was Norway, where Covid cases are only a smidgeon above the March highs, that was the second worst performing market. Energy again is partly to blame. Norway's Solstad Offshore began the month with a price of 94.4 NOK and ended it at 3.2 NOK. The company provides vessel services to the oil and gas industry. Not the best area to be involved in at present and a debt to equity conversion was required to save the company. Avoiding these types of scenarios remains front of mind for us.

Fund Performance

Razer

The Fund's underperformance was driven by a long tail of stocks in the index that rose with the speculative fervour of the market. There were few critical detractors and quite a few positions that rose handsomely during the month. Chief among them is Razer.

Razer is a Hong Kong based manufacturer of PC gaming peripherals. The company has a particularly strong market position in gaming mice, headsets and keyboards. The company has a track record of innovation, and it leads the charge in developing categories such as gaming controllers for mobile phones. For Australian investors, enter any JB Hi-Fi or Harvey Norman and you will notice its strong brand presence (look for its symbol of three green snakes intertwined shown at the top right of the box pictured below)

Source: Windows Central

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The launch of new Xbox and Playstation consoles should provide strong near-term earnings momentum, particularly with Covid relegating consumers to in-home activities. 5G gaming will, in time, also provide a boost for products such as the Kishi.

Given Razer's "street cred" with young gamers, the company provides an avenue for other service providers to tap these customers, especially financial services. Razer's payment platform is one of the largest digital payment networks in SE Asia. However, it is Razer's virtual currency service, Razer Gold, that holds the most promise. Razer Gold allows gamers to purchase content from a variety of game developers through one account. For the developers, it means they can monetise their products without the need to set up their own payment systems. 2019 saw Razer Gold process $2.1 billion through its system, a 50% increase from 2018.

Source: PC Gamer

We purchased Razer near a market cap of US$1 billion but only an enterprise value of US$500m as the balance sheet had US$500m of net cash. The company had IPO'd and over-promised on its new purpose-built mobile phone designed for gamers. This venture was an unmitigated disaster, and the company was incurring large losses. Our entry coincided with the company's decision to take its medicine, cut its losses and get back to its core business. Recent results showed continued strong revenue growth (+25%) and a return to profitability. Currently, its market capitalisation is US$2.7 billion with the stock having more than doubled since our initial investment.

Biospecific Technologies

We've mentioned in a previous monthly that, if patient, investors can buy biotechs at a price that places very little value on a company's drug development pipeline. One company that fits that bill is Biospecific Technologies. The company owns the intellectual property behind a product called Xiaflex. Xiaflex is indicated in two rare disorders, used to dissolve collagen which can form deformities. The only other alternative for people suffering from these rare conditions is surgery. Penetration of Xiaflex continues to grow, and given the lack of competition, pricing too provides a modest tailwind.

Biospecific's pipeline included further indications for Xiaflex in the treatment of frozen shoulder and plantar fibromatosis which is caused by a thickening of the feet's connective tissue. However, its most promising product was the recent approval of QWO, the first FDA approved product for the treatment of cellulite. Our modelling suggested that despite recent FDA approval for this product, no value was reflected in the share price. Perhaps this slipped under most investors radars as they grappled with the effects of Covid?

Allergan reported US$990 million of revenue for Botox in cosmetic indications during 2019, and growth of 9% from 2018. We doubt cellulite would reach these figures any time soon, but it does highlight the potential of such cosmetic treatments. The other advantage of this type of product is that it is user paid, and hence free from regulatory machinations around drug pricing.

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Our analysis seemed spot on with a takeover for the company launched in October. Shares rose from $61.02 to $88.69 (+45%) on the bid. In our opinion, this understates the true value of the shares and is a terrific deal for Endo, who distributes the product and is the new owner of the company. Nevertheless, our investors should be pleased with the return given the Fund only bought the position in June around US$61 a share.

BioGaia

BioGaia is one of the world's leading probiotic companies. Probiotics are live microorganisms known to play an important role in oral and gut health. However, this is an evolving area of science and new strains of probiotics continue to be discovered. BioGaia's R&D effort is impressive with the company holding 554 patents. Numerous clinical studies have been conducted on the effects of BioGaia's probiotics.

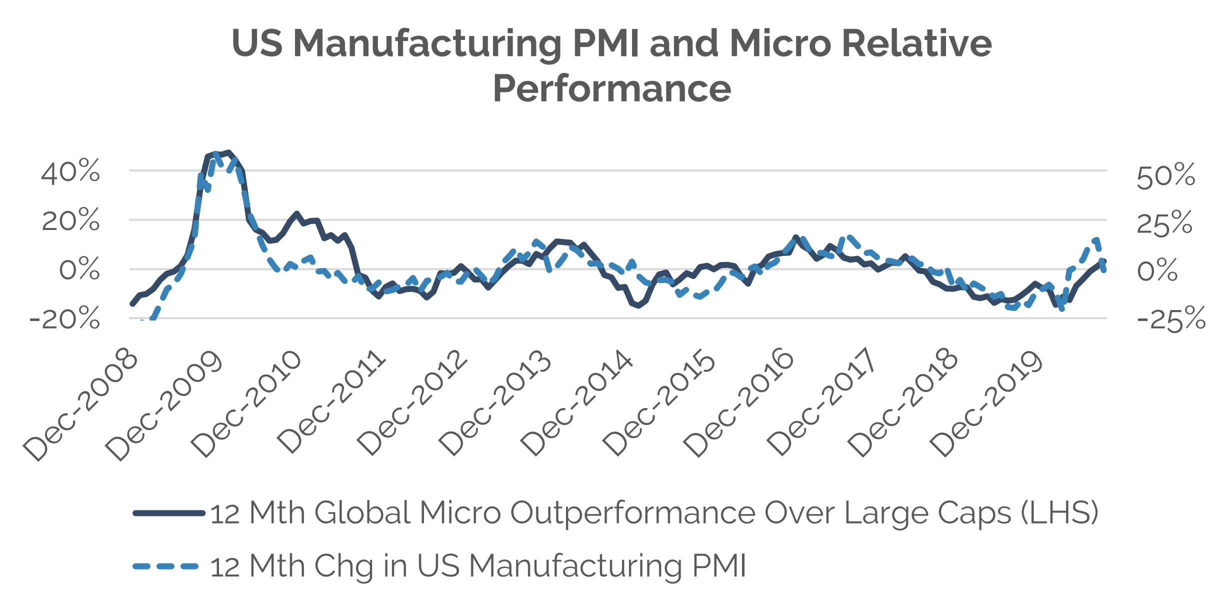
This is a high growth industry with expectations of high single-digit growth over the medium term. However, consumer and physician awareness remains low at present and BioGaia must compete against less credible competitors who often make unvalidated claims about their products, a practice prohibited in pharmaceuticals. We expect, this too will provide a tailwind to BioGaia over the long run as BioGaia joins the ranks of other probiotics leaders such as Sanofi, Procter & Gamble and Novartis in differentiating itself from less credible competitors.

As is often the case, growth does not happen in a straight line and October was a step-back for the company. Sales declined in the third quarter by 17%. Given the low current awareness of probiotics, the company's sales force is paramount to drive increased adoption, but they have been constrained due to Covid, particularly in Italy and Spain which are important markets for BioGaia.

We remain confident in the long-term potential of the company and for the near term are drawn to its historical free cash flow conversion of 85%, net cash balance sheet, and very high return on capital.

Outlook

We have waxed lyrical about the advantages of the global microcaps asset class. Aside from superior long-term returns and the greater potential for alpha generation, the asset class provides a valuable tactical asset allocation tool for investors. There is simply no better way to get exposure to a recovering economy and share market. As the chart on the following page shows, as economic growth accelerates, global microcaps routinely outperform their larger cousins.



Source: MSCI, Bloomberg. Spheria

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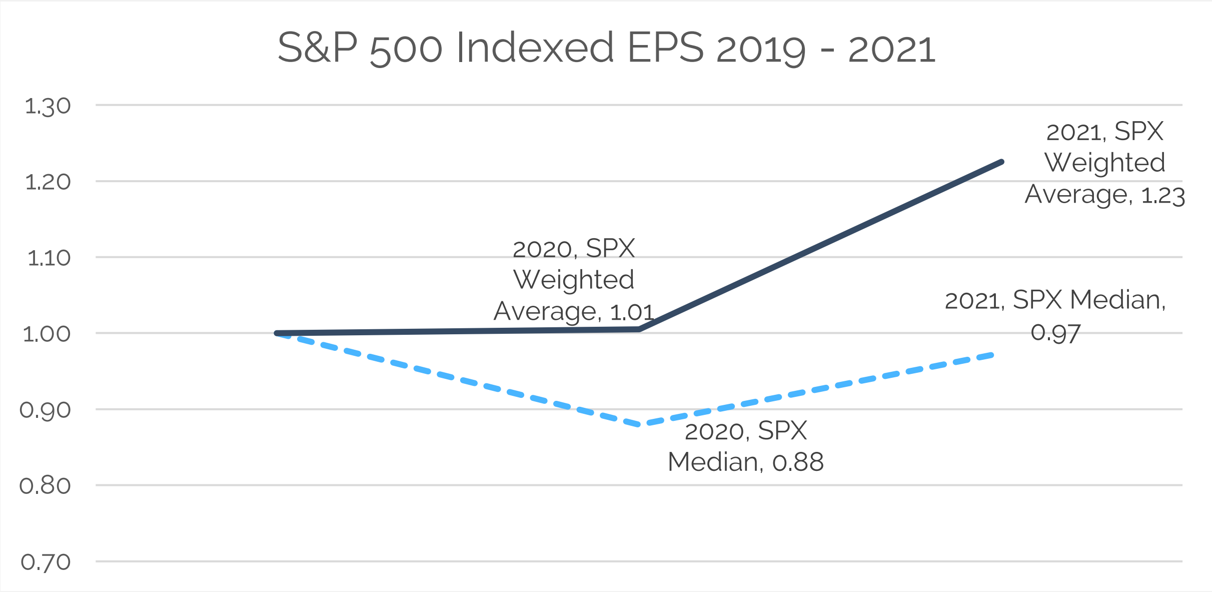
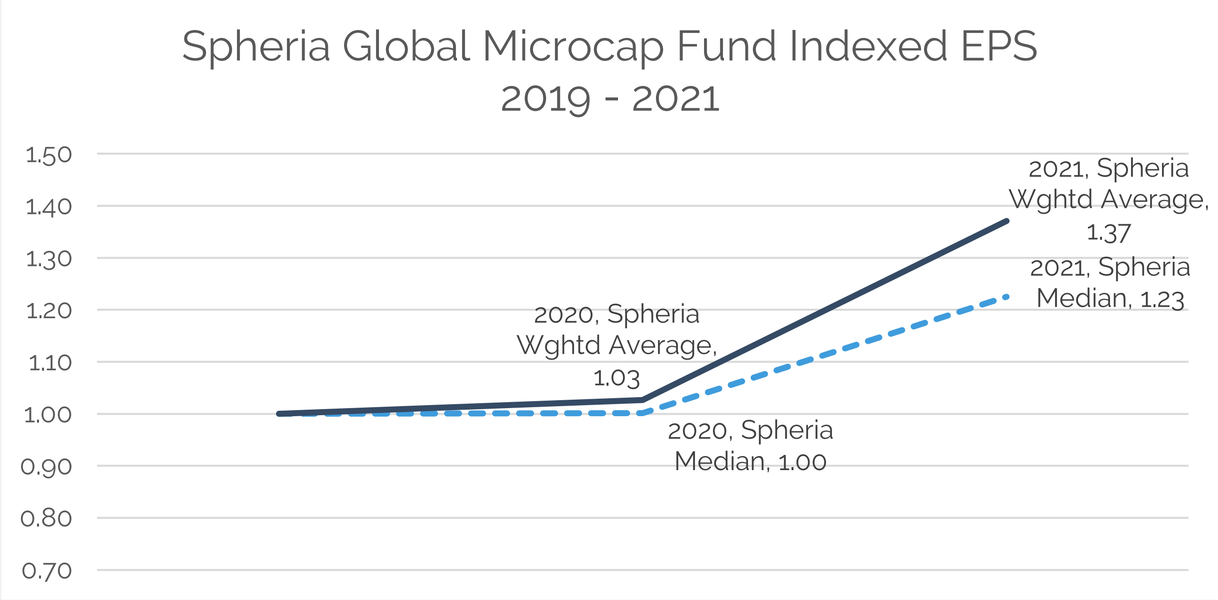
So, it is no surprise that as economies recover from Covid, it is microcaps that will likely deliver superior growth. Below we have indexed the earnings per share (EPS) of the S&P500 and Spheria's Global Microcap Fund for calendar years 2019, 2020 and 2021. There are a few conclusions we can draw from the charts:

- There is a large disparity between the performance of the median S&P500 company and the weighted average S&P500 EPS. We have been warning for some time around the risks of passive fund flows and the distortions this is creating in large-cap stocks. This chart illustrates how reliant the S&P500 has become on a handful of technology stocks.
- The Spheria Global Microcap Fund's EPS fares no worse than the larger multinational companies in the S&P500 during 2020. As we have highlighted before, these small companies find growth from a smaller base far easier, and many of these stocks can continue to grow regardless of the macro environment.
- Finally, note the superior growth into 2021 for the Spheria Global Microcap Fund over the S&P500. We should add, this is achieved by paying a lower earnings multiple than the S&P500 and by owning companies with superior balance sheets. Investing in microcap stocks isn't as straight forward as choosing S&P500 multinationals, but it sure is rewarding for investors..





Source: Bloomberg. S&P, Spheria

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	Spheria Global Microcap Fund
Benchmark (universe)	MSCI Kokusai (World ex Japan) Microcap Index in AUD (Net)
Investment objective	The Fund aims to outperform the MSCI Kokusai (World ex Japan) Microcap 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.
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