Spheria Global Microcap Fund
ARSN 627 330 287 APIR WHT6704AU

Spheria
ASSET MANAGEMENT

Performance as at 28th February 2021

	1 Month	3 Months	1 Year	Inception#
Fund^	3.3%	13.1%	31.0%	22.2%
*Benchmark**	8.1%	21.6%	40.1%	20.6%
Value added	-4.8%	-8.5%	-9.1%	1.6%

^ 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.

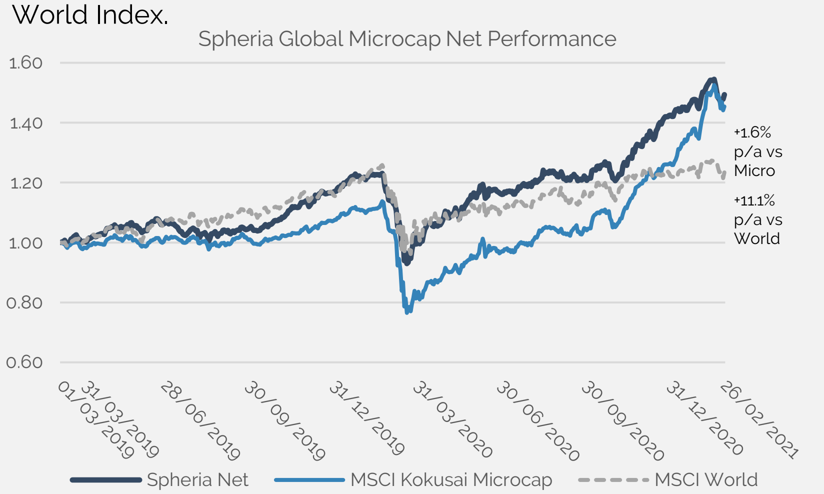
Top 5 Holdings

Company Name	% Portfolio
Fjordkraft (Norway)	4.2%
Steelcase (USA)	3.4%
Coltene (Switzerland)	3.1%
Vetoquinol (France)	3.1%
Inogen (USA)	3.0%
Top 5	**16.8%**

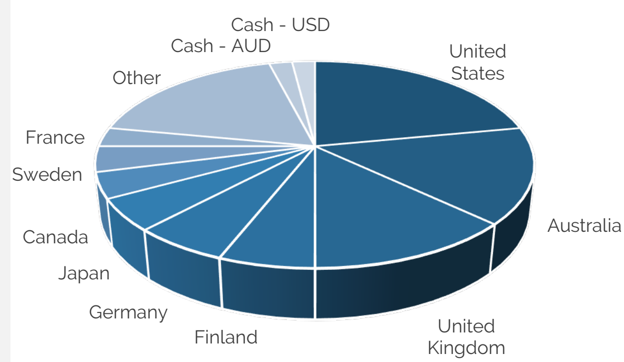
Source: Spheria Asset Management

The MSCI Kokusai (Ex-Japan) Microcap Index registered another strong month in February, up 8.1%. Since its lows, the Index has bounced 88.7%. In comparison, since its lows, the MSCI World Large Cap Index in AUD is up 28.7%.

As the chart below shows, the Spheria Global Microcap Fund has not kept pace with its benchmark in recent months, lagging by 4.8% in February to return 3.3% after fees. Since inception, the Fund has delivered 22.2% p/a after fees, 1.6% p/a better than the MSCI Kokusai Microcap Index and 11.1% p/a more than the MSCI World Index.

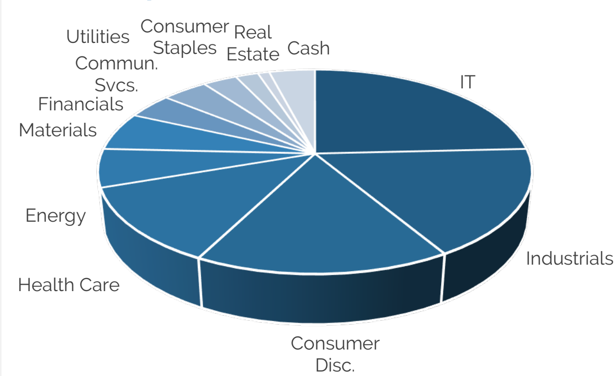


Regional Exposure



Source: Spheria Asset Management

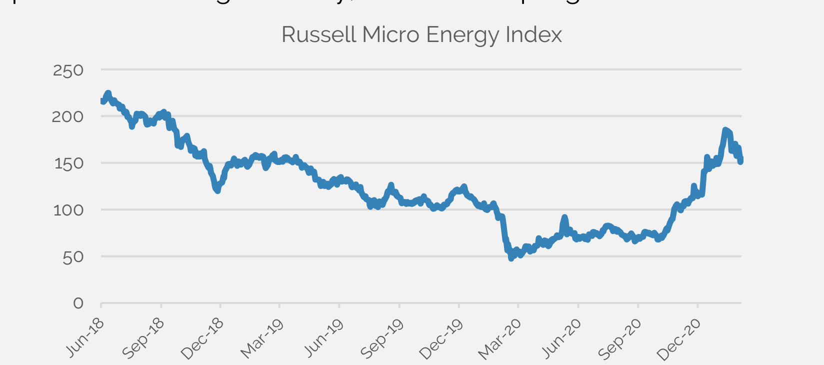
Sector Exposure



Source: Spheria Asset Management

Markets

Microcap energy had a spectacular month, up 25.4%. As shown below, the sector was very beaten up at the lows but has since posted a stunning recovery, more than tripling.



Source: Bloomberg

Utilities and Real Estate lagged in February, weighed down by expectations that the abrupt re-opening of the economy with vaccines' help will spark a bout of inflation and higher treasury yields. Central banks are keeping a poker face and encouraging markets to look through any short-term inflation. In many respects, this makes sense since the underlying issues driving price deflation (whatever they are?) have not changed.

However, suppose markets decide to ignore this advice and inflation expectations take on a life of their own. In that case, we expect that central banks will have no option but to instigate yield curve controls, most likely with the assistance of macroprudential regulatory changes forcing the banking sector to help with the effort. This scenario is exceptionally bullish for gold since inflation, coupled with low interest rates, will provide a nirvana for the yellow metal like never before. Hence, for a manager like us who still practices valuation discipline, gold remains a sensible hedge for our investors since our shares (those that make free cash flow) are unlikely to participate to the same extent in any tomfoolery yield curve control unleashes on markets.

The other way the Fund could be a material winner under this scenario is its underweight to the US market. It is hard to envisage how the Federal Reserve's yield curve control will not result in a material depreciation of the USD, even if other central banks continue to work together as a cartel. And once again, we enjoy reminding our readers that only 20% of the Fund is in the USA (and the USA represents 24% of USD global GDP), unlike the large-cap MSCI World Index that has a USA weight of 66%.

While we do not try to predict macro outcomes, rest assured we spend considerable time considering the potential implications for your precious capital, come what may.

Canada, the USA and Hong Kong led microcaps higher at a country level. Israel and New Zealand were the laggards, both falling slightly in AUD. Canada is no doubt benefiting from the run in commodity prices, including energy. As we discuss later, the USA remains the epicentre of a speculative mania. As for Hong Kong, we can chalk February up as a relief rally. Since the Fund's inception, no country has fared worse (other than Portugal, which is only 0.11% of the Microcap Kokusai Index), down 19.5% in AUD. It is no wonder given the 2019 riots, followed by Covid and increasing Sino-US tensions. After being underweight the country during most of the Fund's history, the Fund is currently close to Index weight at 4%. Both of the Fund's Hong Kong holdings are in the IT sector and have done well recently (adding 0.54% to relative performance in February). Hopefully, the worst is behind for Hong Kongers.

Fund Performance

<u>Sonos</u>

Sonos was the Fund's top performer in February, adding 0.70% of relative performance. We have spoken about Sonos extensively in these monthlies since it has been one of the Fund's top holdings for some time. We purchased the company when its market capitalisation was approximately US$1 billion. At the time, the stock had delivered a string of disappointments since listing, and it had a high proportion of short interest from hedge funds. The market was concerned about the threat of competition from Google and Amazon.

Today, the company's market capitalisation is US$4.5 billion. Concern has swung to optimism, and there is now an expectation that Sonos can extract royalty payments from Google for its wireless technology patents. Short interest in the stock has halved.

We had been selling gradually into its recent share price strength, and we have now exited the stock altogether. Sonos is a good opportunity to remind our investors how we manage these successful investments as they transition up from microcap status. We do not commit to a hard market cap target for when we must exit an investment. However, we abide by a framework designed to give investors in the Fund confidence that we will remain true to label and focus on investing in the microcap universe. The criteria for exiting a stock on the grounds of size include:

- *Has the thesis played out?* Yes. In the case of Sonos, our primary thesis was that the market was capitalising low margins into the share price and we saw no reason why the company could not achieve margins in-line with other peers in the segment.

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We also identified significant valuation upside caused by overblown concerns around the competitive threat from Google and Amazon.

- *Valuation upside?* Sonos is no longer attractive from an absolute valuation standpoint. Indeed, our valuation is now below the current share price. While valuation is always a relative exercise for equity managers, it is fair to say that we are finding better risk-return elsewhere in our vast universe of opportunities.

- *Has the company been discovered?* One of the Fund's key advantages is finding companies before the rest of the market has. Typically, when we first invest in companies, coverage ranges between none and up to two to three sell-side analysts. Part of what we look for when exiting an investment is whether coverage has increased. If the broader market has discovered the company on the back of its success, then we feel our job as microcap investors has largely been accomplished. However, Sonos is a different case to most of our investments. It is a small-cap company that was already well covered but has slipped into the microcap space following a string of disappointments. These types of investments have been a fruitful area for the Fund. Along with Sonos, we have picked up Core Laboratories, Revolve and Razer in a similar fashion.

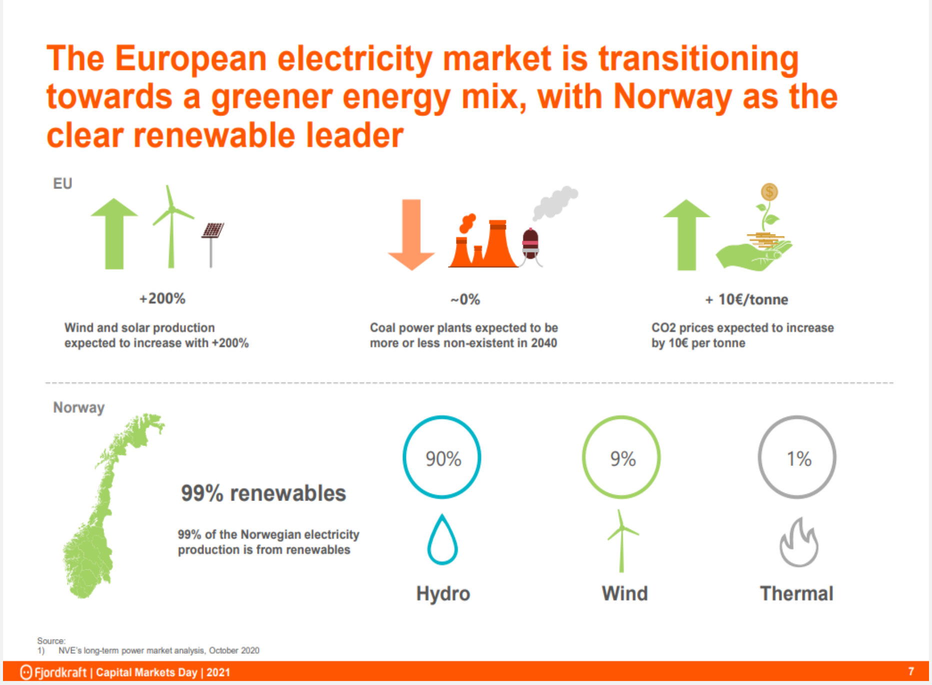
Had any of these criteria not been met, then there may be a case to hold the position for a while longer (so long as the valuation does not become stretched – valuation discipline is not negotiable).

We believe in the importance of transparency, internally within the team and externally with our clients. Hopefully, this gives you, the investor, a better sense of our decision-making process.

<u>Fjordkraft</u>

Fjordkraft was again the Fund's largest detractor. This high-quality business with regulatory tailwinds recently held an investor day. The consistent and clear message around the company's strategy continued to impress us. One sell-side analyst has turned bearish on the company and has been convincing enough to scare many holders out of the stock.

However, at 13x FY21 PE and a dividend yield of 6% for a defensive growth business, excuse us for discounting his hysteria. We have used the recent weakness to increase our position further. The company exhibits strong Spheria characteristics – strong free cash flow conversion, valuation upside, conservative financial leverage, favourable and improving industry structure, and a high return on capital.



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Outlook

If there is one thing we have learnt over our combined 100+ years of investing in small and microcap stocks, Mr Market disapproves of people making money too easily. Things tend to go pear-shaped at the exact point when retail investors view the sharemarket as a sure-fire path to quick riches. When hubris takes hold, risk ratchets up, principles are neglected, and hard lessons must be relearnt.

There is little doubt about the incremental investors' mindset at present. The Microcap Kokusai Index regularly has its fair share of profitless concept stocks, but the current cohort is a genuinely spectacular exhibit of speculative froth.

The table below shows the Microcap Kokusai Top 10 as at the end of February. Only two of the companies generates a profit, and yet all these companies have a market capitalisation well in excess of US$1 billion.

Company	BBG Ticker	Index Weight	Market Value ($USm)	Revenue ($USm)	EBIT (Adj. - $USm)	February Return (USD)
Marathon Patent Group Inc	MARA US	0.48%	2,831	1	-4	45.4%
Microvision Inc	MVIS US	0.38%	2,214	9	-26	109.3%
Riot Blockchain Inc	RIOT US	0.37%	2,954	7	-9	113.2%
Nano Dimension Ltd	NNDM US	0.36%	2,448	7	-15	-28.4%
Gevo Inc	GEVO US	0.33%	1,920	24	-26	-4.4%
Cassava Sciences Inc	SAVA US	0.29%	1,896	0	-5	145.1%
Sm Energy Co	SM US	0.27%	1,590	1,127	137	65.2%
Ocugen Inc	OCGN US	0.25%	2,059	0	-11	518.6%
Bionano Genomics Inc	BNGO US	0.24%	2,141	10	-26	-11.9%
Silvergate Capital Corp	SI US	0.23%	2,966	99	30	37.1%

Source: Bloomberg

Marathon Patent Group, formerly a patent troll firm, proudly announces on its home page that it is "one of the first NASDAQ-listed Cryptocurrency mining companies". Microvision promises to cash in from automotive LiDAR technology required to guide autonomous vehicles. Riot Blockchain aims to be one of the largest and lowest-cost producers of bitcoin in North America. The list goes on.

The silver lining of the market's current bout of risk-taking is that many investors are glossing over companies that, in a relative sense, are now perceived as safe, pedestrian, boring. And yet, we think the recent additions to the portfolio are among the best since its inception. Recently added stocks include:

- A growing Danish media company on a P/E of 9x with a net cash balance sheet. Coverage from only one local sell-side analyst.
- A US company that Google includes as a partner and helps customers manage their e-commerce channels. The company trades on a P/E of 27x with strong growth and net cash.
- A US MedTech company that is profitable and doubling its revenue every two years, but has a market capitalisation of only US$500 million with net cash.

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As the table below shows, the portfolio is full of businesses with strong prospects but are already delivering earnings and cash flow. Contrast the portfolio's free cash flow yield of 5.3% with the Index's Top 10. Contrast the portfolio's net cash balance sheet with the Top 10 who are burning cash rapidly and must frequently come back to the sharemarket asking for more equity.

Metric	Index	Spheria
Price to Earnings (Prospective)	26.6x	25.4x
EV / EBIT (Prospective)	18.0x	18.4x
FCF Yield (Trailing)	2.1%	5.3%
Net Debt / EBITDA	1.7x	**-0.5x**
Free Cash Flow Conversion	69%	**114%**
Proportion of Companies that are Profitable	45%	88%
Companies	4,132	51
Average Market Cap	US$ 225m	US$ 800m
Largest Market Cap	US$ 6,400m	US$3,200m

When the hot air inevitably escapes from names such as those in the Index's Top 10, many microcap investors are likely to rediscover a desire for solid fundamental characteristics, the likes of which our portfolio possesses. It is only a matter of time.

We also remain optimistic about the Fund's prospects relative to larger peers. Despite the large run in microcaps, we continue to see attractive relative value to larger peers as large-cap companies continue to be pumped up by boundless passive inflows. The table below shows the metrics for a selection of our holdings relative to their larger-cap peers. In our opinion, there is just no contest between the value that is available in the microcap universe relative to larger caps.

		Train Manufact.	Animal Pharma	Gold Mining	Dental Equipment	Real Estate Develop.	IT Consulting
Large Peer	Company	Alstom	Zoetis	Newcrest	Envista	Berkeley	Accenture
	3-Yr Sales Growth	+2.5% p/a	+8.3% p/a	+8.1% p/a	-1.2% p/a	-10.8% p/a	+5.2% p/a
	PE	24x	39x	14x	23x	13x	31x
Spheria Global Micro	Company	Talgo	Vetoquinol	Perseus	Coltene	Watkin Jones	Adesso
	3-Yr Sales Growth	+22.6% p/a	+8.6% p/a	+20.3% p/a	+8.7% p/a	+8.3% p/a	+15.6% p/a
	PE	15x	26x	14x	26x	12x	27x

The critical risk to investing in microcaps remains their relatively weak balance sheets, low free cash flow yield, and in more recent times, the increasing hot air evident in this space. However, Spheria's process based on over 100 years of combined experience directly addresses these limitations. Using a consistent and proven framework means we remain confident that the Fund can outperform the Microcap Kokusai benchmark and the MSCI World Index over the investment cycle.

Spheria Global Microcap Fund

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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