SPHERIA ASSET MANAGEMENT

Spheria Emerging Companies Limited (ASX:SEC)

Investment Update 31 January 2022

Overall Commentary

The company performance for the month of January was -7.7%, which outperformed the S&P / ASX Small Ordinaries Accumulation Index by 1.3%.

Company Facts

Investment Manager	Spheria Asset Mangement Pty Limited
ASX Code	SEC
Share Price	$2.25
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	$135.3m

1 Calculated daily and paid at the end of each month in arrears.
2 Against the Benchmark over each 6-month period subject to a high-water mark mechanism.

Performance as at 31st January 2022

	1 Month	6 Months	1 Year	3 Years p.a.	Inception p.a[3]
Company[1]	-7.7%	-0.2%	15.2%	13.6%	9.7%
Benchmark[2]	-9.0%	-4.6%	6.7%	10.1%	7.1%
Difference	1.3%	4.4%	8.5%	3.5%	2.7%

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 30th November 2017. Past performance is not a reliable indicator of future performance. All p.a. returns are annualised.

Markets

The local small and midcap indices were both materially lower over January – down close to 9% – as the market absorbed the continued newsflow around inflation and the reasonably material adjustment to interest rate outlooks by Central Bankers. As children who lived through the 80's, we had been suggesting that inflationary pressures were more than just transitory impacts of a post Covid crisis. Watching cafés raise prices 5-15%, cleaners readjust prices over 10% and seeing unions striking for better pay conditions, all suggested to us that cost increases were broad based and that labour rates were heading higher. It is somewhat ironic that inflation is precisely what Central Banks have been trying to engender for some time via the consistent debasement of currencies. This deflates the real value of the debt balloons which Governments around the world have taken on and sold predominantly to their own Central Banks. As rates rise, the value of bonds falls. This doesn't bode especially well for the balance sheets of Central Banks, all of which are now bloated with super low yielding bonds and all of which are now decreasing in nominal (and real) value as longer-term bond rates tick upwards.

Net Tangible Assets (NTA)[1]

Pre-Tax NTA[2]

$2.465

Post-Tax NTA[3]

$2.408

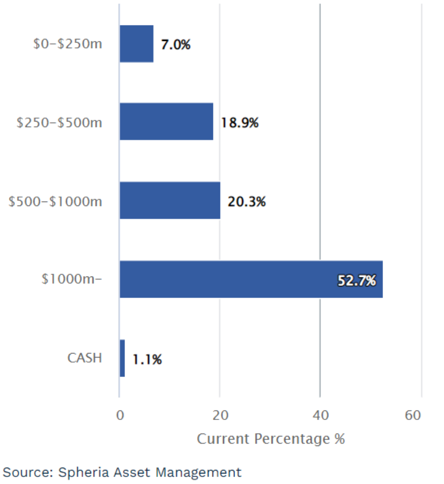
1 NTA calculations exclude Deferred Tax Assets relating to capitalised issue cost related balances and income tax losses.
2 Pre-tax NTA includes tax on realised gains/losses and other earnings, but excludes any provisions for tax on unrealised gains/losses.
3 Post-tax NTA includes tax on realised and unrealised gains/losses and other earnings.

Top 10 Holdings

Company Name	% Portfolio
InvoCare Limited	4.8%
Flight Centre Travel Group Limited	4.7%
Michael Hill International Limited	4.6%
Class Limited	4.5%
Blackmores Limited	4.1%
Seven West Media Limited	3.9%
IRESS Limited	3.9%
Adbri Limited	3.7%
Ht&E Limited	3.4%
Bega Cheese Limited	3.3%
Top 10	**40.8%**

Source: Spheria Asset Management

Market Cap Bands



Source: Spheria Asset Management

In a falling rate environment, momentum is your friend. The longer the duration, the growthier the company the more the stock can rise. If you use spot rates in your valuations even small decreases on a very small discount rate base can see sharp upward re-valuations in companies. This had led to quite a few smaller companies that we felt were – to put it mildly – trading significantly above intrinsic value. You could easily use a harsher description. The list of some of the worst hit stocks in January reads like an honor roll of companies with large market caps on small revenue bases, with even smaller earnings bases. On the other side of the ledger, valuation almost became a fashionable word. This is what makes investing in smaller companies generally an enjoyable occupation with volatility often creating some great opportunities.

Major Contributors for the Month

Adbri (ABC.ASX) rose 3% over January, strongly outperforming the small companies index. ABC announced over the month that Alcoa was extending their lime sourcing arrangements with ABC for a further 12 months due to supply constraints shipping lime from overseas. ABC will provide a minimum of 35% and potentially up to 50% of the supply they used to provide Alcoa. This is a reminder of the strategic nature of ABC's lime operations which are geographically important to mining customers in WA and SA.

Michael Hill Jeweller (MHJ.ASX) MHJ declined 3% over the month, strongly outperforming the market after they pre-announced a record profit result for the half year. The company benefiting from catch-up spend when lockdowns were eased in the last couple months of year and from great execution by a relatively new management team, which has significantly reshaped the business over the last two years. Further normalisation in its key operating markets of Australia, Canada and New Zealand will in theory continue to improve profitability and yet the valuation remains undemanding and a balance sheet possessing nearly $100m of cash provides plenty of firepower for an acquisition and capital management initiatives.

Seven West Media (SWM.ASX) outperformed over the month continuing its stellar recovery from the COVID abyss of early 2020. The balance sheet has been repaired and de-risked, and profitability has markedly improved due to better programming and cost improvements. The acquisition of Prime Media (PRT – SWM's regional TV affiliate) provides the company national reach and the ability to enhance its streaming service in regional markets. Putting aside the strategic benefits, SWM has paid an extraordinarily low multiple for PRT inclusive of cost synergies such that payback will be only 2-3 years, in our opinion. Management is executing well, and we believe further consolidation in the media market is afoot that will further strengthen and diversify SWM. We continue to believe the company is structurally undervalued and its competitive advantages not well understood.

Major Detractors for the Month

Nitro (NTO.ASX) was the largest detractor as the stock fell 25% over January. NTO declined with other technology related names. What has attracted us to NTO are the market share gains they are making against industry leader Adobe who continue to seed share to Nitro Pro. Nitro has expanded its product suite from document productivity software (similar to Adobe Acrobat) into e-signing, which we see as a potentially very large industry. NTO has recently strengthened their position in e-signing with the acquisition of European based Connective. With a high client retention rate (over 95%) and a business model which has largely transitioned from on-premise to a SAAS model, we believe the business will ultimately prove to be a successful investment despite the pull back in the share price. NTO's balance sheet is well funded with over $60m of net cash and it trades on just 4x EV/Sales.

Vista Group (VGL.ASX) detracted from performance as the share price declined 15%. We have spoken about VGL before and its strength in the cinema market as the leading provider of ERP software to cinema exhibitors. Whilst Omicron has tempered investors views on the speed of re-openings across Europe, we are of the view that appetites for sustained lockdowns amongst countries is rapidly waning and that VGL will see a dramatic improvement in prospects this year. The business remains in a strong position with a net cash balance sheet and is trading on around 14x recovered EV/EBIT.

Brainchip Holdings (BRC.ASX – not owned) surged 110% over January on news that it had been granted a US patent for its AI neuromorphic chip. BRC makes a low powered AI chip that could have applications in the aerospace and automobile industries. At present BRN has virtually no revenue, a skinny balance sheet (US$23m net cash as at September 2021) and is losing a significant amount of earnings and cash flow. Whilst the ultimate product may be a success with an enterprise value approaching $3.0 billion we continue to believe there is better investment alternatives elsewhere.

Outlook & Strategy

Periods like the market sell off in January serve as a useful reminder that the 'animal spirits' of investing need to be grounded by logic, reasoning, and fundamentals. The market is re-appraising the medium-term interest rate outlook in the absence of Central Bank QE and is waking up to the prospect that this will see 10-year bond yields rise from their all-time lows plumbed in CY2021. Whilst volatility seems unpleasant in the short term, rotations like the ones we have just seen tend to provide opportunities for our style of investing and should see a more rational approach to capital allocation in the smaller companies space. We have long argued that very low interest rates for a sustained period can lead to misallocation of capital. The funding of loss-making new enterprises against legitimate incumbent businesses for example, should come to an end if there is no reasonable prospect of them turning a profit. The market has been fixated by the idea of new technologies and business models for the past few years and been willing to fund ever expanding losses with a dim future prospect of earnings and cash flows. With rates on the rise this exuberance is likely to be tempered favouring strong existing business models on attractive valuations.

Fund Ratings

Zenith
RECOMMENDED

Further Information

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

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