Spheria Emerging Companies Limited (ASX:SEC)

Investment Update 31 March 2022

Overall Commentary

The Company performance for the month of March was 2.6%, which underperformed the S&P / ASX Small Ordinaries Accumulation Index by 2.7%.

The Board of SEC has resolved to pay a quarterly dividend for the period ended 31 March 2022 of 2.5 cents per share, which will be payable on 6 May 2022. The dividend will be fully franked at the corporate tax rate of 30%.

The Company is pleased to announce the dividend reinvestment plan (DRP) is now available to shareholders.

Company Facts

Investment Manager	Spheria Asset Mangement Pty Limited
ASX Code	SEC
Share Price	$2.29
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	$137.7m

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 March 2022

	1 Month	6 Months	1 Year	3 Years p.a.	Inception p.a[3]
Company[1]	2.6%	-1.0%	13.2%	12.6%	10.4%
Benchmark[2]	5.3%	-2.3%	9.7%	9.6%	8.1%
Difference	-2.7%	1.3%	3.5%	3.0%	2.3%

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 up sharply over March, despite global concerns over the war in Ukraine, rising inflationary pressures and disruptions to the global supply chain. Supply chain issues continue to be exacerbated by the war in Ukraine and the Western sanctions imposed on Russia. Investing in these markets is anything but dull!! Energy prices also continue to rise with other commodity prices – Iron Ore and Lithium also continuing to post gains over the month. Lithium prices in particular are being pushed higher by current demand apparently well exceeding mine supply. We think the current lithium price is unsustainable as, whilst demand is strong, the supply constraints are likely to be relatively temporary. A significant number of lithium miners have announced increases in production to try to take advantage of prices which are three times their peak reached in late 2017.

Net Tangible Assets (NTA)[1]

Pre-Tax NTA[2]

$2.563

Post-Tax NTA[3]

$2.491

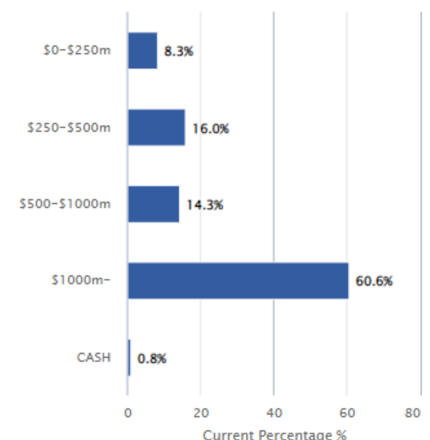
1 NTA calculations exclude Deferred Tax Assets relating to capitalised issue cost related balances and income tax losses.
2 Pre-tax NTA includes tax on realised gains/losses and other earnings, but excludes any provisions for tax on unrealised gains/losses.
3 Post-tax NTA includes tax on realised and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

Top 10 Holdings

Company Name	% Portfolio
Blackmores Limited	5.2%
InvoCare Limited	4.9%
Flight Centre Travel Group Limited	4.7%
IRESS Limited	4.1%
Michael Hill International Limited	3.9%
Monadelphous Group Limited	3.9%
Seven West Media Limited	3.6%
Ht&E Limited	3.3%
INSIGNIA FINANCIAL LTD.	3.3%
Adbri Limited	3.3%
Top 10	**40.2%**

Source: Spheria Asset Management

Market Cap Bands



Source: Spheria Asset Management

We typically value businesses on sustainable earnings and are prepared to look through either excessively high or low earnings to help us get a better view of a stock's real value. Sustainable earnings are key though and whilst we have been prepared on occasion to invest in temporarily loss-making business you cannot re-write the laws of economics any more than you can the laws of gravity just because you want to buy an investment story. Sustainable business economics require some anchoring in fundamentals and nothing is more likely to prove this to be the case than a rising interest rate backdrop. As someone wisely once said in order to get the right outcomes you need to measure the right things. The tremendous focus on growth by the market over the past few years has seen the market's focus narrow to areas of marginal economics. *If we can add one more user/viewer/ borrower at slightly less than the cost of acquiring them, this will be value enhancing to investors.* The problem with such narrow focus is that in many cases companies have been chasing revenue growth to the exclusion of all else. There is no point acquiring a customer/ sales lead if the business is unprofitable and servicing your customers takes time, effort and energy. In one previously vaunted segment of the small cap investment universe, the BNPL sector for instance, bad debt write offs are suddenly seeing a sharp increase and competition at the point of sale is seeing marketing costs (read CAC or customer acquisition costs) rise sharply. This is further eroding already marginal economics to begin with. We will continue to scour through some of these fallen angels but with a keen eye to the long term sustainability of the business model.

Major Contributors for the Month

Flight Centre (FLT.ASX) rose 12% over the month as the market started to look ahead to the rebound in travel globally. With Australia decisively re-opening borders and much of the rest of the world embracing travel, we believe FLT is well positioned with a much lower cost of doing business to profit strongly from a rebound in both corporate and consumer travel. FLT's cash burn was significantly reduced during the latter half of their H1 result and continues to trend promisingly over the beginning of H2. Travel in the Northern Hemisphere is rebounding strongly, and we believe there are signs travel may over-recover for a period of time as consumers revenge spend on travel. We believe FLT is trading on sub 10x recovered EV/EBIT at current levels and should enjoy a tremendous earning and cashflow recovery as travel rebounds.

Iress Ltd (IRE.ASX) bounced 15% over the month with other technology names. IRE remains a strategically well-placed IT name with incredible user loyalty in both the asset management and adviser channels in Australia and the UK, with customer churn rates at just 1.4% p.a. The company has implemented a share buyback ($100m) and is on track to meet their 2025 revenue and profit targets. We continue to see IRE as an attractive investment.

NIC (not owned) declined 17% over the month largely, it seems, on aggressive moves in the Nickel price. The LME closed trading in Nickel for 10 days during March as a massive, short squeeze saw the metal trade to over US$100,000/t. Once trading resumed on March 17th Nickel prices traded down closing the month at around US$32,000/t. Nickel mining shares saw a volatile trade over the month as prices rose and then subsequently collapsed.

Major Detractors for the Month

Vista Group (VGL.ASX) fell 15% over the month after delivering FY 21 results, which were slightly disappointing. VGL has gone through a difficult period with its cinema chain customers facing tough times due to COVID related lockdowns and the postponement of cinema content as movie makers have held back content until audiences return. VGL raised capital during the past 18 months and remains net cash. We believe they are well positioned to benefit from re-opening of cinemas and more importantly see a significant upgrade cycle as customers embrace the new Vista Cloud product.

Blackmores (BKL.ASX) Blackmores shares fell 8% over the month on limited news flow. BKL has repaired its balance sheet, invested in its own manufacturing facilities, and continues to reinvest in new product development and marketing initiatives all of which will drive longer term shareholder value. BKL's international business (Indonesia and Thailand) continue to power ahead with market share gains in both markets. With further operating leverage and cost savings underpinning the growth investment initiatives we feel BKL is in a good position to compound earnings at around 15% p.a. for the next few years and remains a strategically attractive brand for acquirers.

Invocare (IVC.ASX) declined 6% over the month on limited news flow. IVC is Australia's largest funeral care provider with over a 30% market share. The company has spent the past 2 years investing significant capital to upgrade many of its facilities and to expand into pet cremations and funerals (a new growth area). Unlike many counties internationally, Australia saw its death rate decline over the past 2 years as COVID related deaths remained extremely modest by international standards and the COVID lockdowns saw a dramatic reduction in flu-related deaths. Whilst we clearly don't want to see things return to "normal", it would seem some kind of reversion would be likely with IVC and other industry players likely to see a resumption back up to normal or possibly above-normal industry conditions. IVC's balance sheet is in good shape, the company has historically been a good free cashflow generator and the company has substantial property holdings.

Outlook & Strategy

Moves in markets keep things interesting for management teams and investors alike. Our process is based upon trying to be prepared for unforeseeable circumstances, which is why we base our investment decisions on fundamentals like strong balance sheets, good cash flow generation and, importantly, valuation. Valuation has seemingly been a lost art amongst small cap investors over the past 3 years as subnormal interest rates have seen valuations flung to the wind. Popular thematic and disruptive businesses have captured imaginations and – like the sirens in Homer's Odyssey – drawn unwitting investors in. With a backdrop of global rates on the rise and despite additional risks like the war in Ukraine, our sense is that discount rates and inflation will continue to be the dominant market conditions for some time. Strong businesses with a good ability to mitigate inflationary impacts are likely to do relatively well, assuming valuations are not overly high to begin with. The commodity cycle is in full swing, and we would similarly expect this to benefit our exposure to mining service names. We continue to assess our discount rates based on prevailing market conditions, but it would seem wise for smaller company investors to consider a rate environment at least modestly higher than the prevailing 10-year bond yields imply.

Fund Ratings

Further Information

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

Disclaimer

Spheria Asset Management Pty Ltd ('Spheria') (ABN 42 611 081 326), a Corporate Authorised Representative (No. 1240979) of Pinnacle Investment Management Limited ('Pinnacle') (ABN 66 109 659 109, AFSL 322140), is the investment manager of Spheria Emerging Companies Limited ('SEC' or the 'Company') (ABN 84 621 402 588). While SEC and Spheria believe the information contained in this communication is based on reliable information, no warranty is given as to its accuracy and persons relying on this information do so at their own risk. Subject to any liability which cannot be excluded under the relevant laws, Spheria and SEC disclaim all liability to any person relying on the information contained in this communication in respect of any loss or damage (including consequential loss or damage), however caused, which may be suffered or arise directly or indirectly in respect of such information. Any opinions and forecasts reflect the judgment and assumptions of Spheria and its representatives on the basis of information at the date of publication and may later change without notice. Disclosure contained in this communication is for general information only and was prepared for multiple distribution. The information is not intended as a securities recommendation or statement of opinion intended to influence a person or persons in making a decision in relation to investment. The information in this communication has been prepared without taking account of any person's objectives, financial situation or needs. Persons considering action on the basis of information in this communication are to contact their financial adviser for individual advice in the light of their particular circumstances. Past performance is not a reliable indicator of future performance. Unless otherwise specified, all amounts are in Australian Dollars (AUD). Unauthorised use, copying, distribution, replication, posting, transmitting, publication, display, or reproduction in whole or in part of the information contained in this communication is prohibited without obtaining prior written permission from SEC and Spheria.

Zenith Disclaimer: The Zenith Investment Partners ('Zenith') (ABN 27 103 132 672, AFS 226872) rating (assigned Spheria Emerging Companies Limited – February 2022) referred to in this piece is limited to "General Advice" (s766B Corporations Act 2001) for Wholesale clients only. This advice has been prepared without taking into account the objectives, financial situation or needs of any individual, including target markets of financial products, where applicable, and is subject to change at any time without prior notice. It is not a specific recommendation to purchase, sell or hold the relevant product(s). Investors should seek independent financial advice before making an investment decision and should consider the appropriateness of this advice in light of their own objectives, financial situation and needs. Investors should obtain a copy of, and consider the PDS or offer document before making any decision and refer to the full Zenith Product Assessment available on the Zenith website. Past performance is not an indication of future performance. Zenith usually charges the product issuer, fund manager or related party to conduct Product Assessments. Full details regarding Zenith's methodology, ratings definitions and regulatory compliance are available on our Product Assessments and at https://www.zenithpartners.com.au/our-solutions/investment-research/fund-research-regulatory-guidelines/.