

Overall Commentary

The portfolio performance for the month of October was 2.7%, while the S&P/ASX Small Ordinaries Accumulation Index returned 0.9%.

On 29th October 2021 the Company paid its first quarterly dividend to shareholders of 2.5c per share fully franked.

Company Facts

Investment Manager	Spheria Asset Management Pty Limited
ASX Code	SEC
Share Price	\$2.60
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	\$156.4m

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 October 2021

	1 Month	6 Months	1 Year	3 Years p.a.	Inception p.a ³
Company ¹	2.7%	13.6%	45.9%	15.9%	12.6%
Benchmark ²	0.9%	7.9%	31.0%	13.5%	9.8%
Difference	1.8%	5.7%	14.9%	2.3%	2.9%

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 modestly higher over the month as market participants looked through increasing noise around inflation and the implications for monetary policy. This was despite some rather wild moves in shorter dated debt – the local three-year bond yield rose a staggering 90bps over the month for instance – as markets began pricing in the inevitability of some rate rises by Central Banks given the inflation being seen globally. Unsurprisingly, there was significant dispersion in performance during the month. Gold equities significantly outperformed as market participants finally went bargain hunting in the space following material underperformance in prior months. This more positive sentiment was helped by a US dollar gold price that rose 1.5% over the month despite the back up in bond yields as long-term real interest rates (as measured by 10-year US Treasury inflation protected security yields) went deeper into negative territory. Battery material names again meaningfully outperformed as benchmark lithium, nickel and cobalt prices surged higher.

Net Tangible Assets (NTA)¹

Pre-Tax NTA²

\$2.713

Post-Tax NTA³

\$2.574

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.

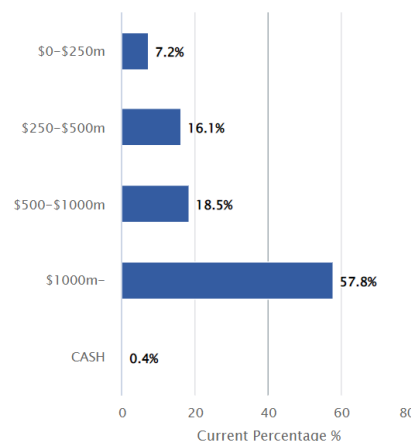
³ Post-tax NTA includes tax on realised and unrealised gains/losses and other earnings.

Top 10 Holdings

Company Name	% Portfolio
Flight Centre Travel Group Limited	5.3%
Class Limited	4.7%
IRESS Limited	3.7%
Blackmores Limited	3.6%
Vista Group International Limited	3.6%
Ht&E Limited	3.5%
Adbri Limited	3.5%
Monadelphous Group Limited	3.4%
Corporate Travel Management Limited	3.2%
Bega Cheese Limited	3.2%
Top 10	37.7%

Source: Spheria Asset Management

Market Cap Bands



Source: Spheria Asset Management

Amongst the losers during the month were coal stocks as the benchmark Newcastle thermal coal price halved during October following Chinese Government intervention in the market to stem rampant speculation and hoarding. These were joined by a motley crew of stocks that put out disappointing updates or had negative newsflow during the month (e.g., Marley Spoon (MMM.ASX, -44%), Strike Energy (STK.ASX, -36%), EML Payments (EML.ASX, -27%), Starpharma (SPL.ASX, -20%), Codan (CDA.ASX, -20%) and PointsBet Holdings (PBH.ASX, -19%). Concerningly there were several companies that cited rising input costs as a reason for forecast margin contraction (e.g., Pact Group (PGH.ASX) and Marley Spoon (MMM.ASX)).

M&A activity was once again fairly elevated during the month with HUB24 (HUB.ASX) bidding for Class (CL1.ASX) at a 72% premium to last, Senex (SXY.ASX) receiving an approach from POSCO International of South Korea and Gold Road (GOR.ASX) and Ramelius (RMS.ASX) engaging in a bidding war for gold junior Apollo Consolidated (AOP.ASX).

The Portfolio outperformed due to an overweight to Class (CL1.ASX) and low multiple media, consumer discretionary and mining service names which were re-rated during the month, alongside underweights to several large index constituents that put out disappointing updates during the month.

Major Contributors for the Month

Class (CL1.ASX) was the largest contributor after returning 70% during the month upon entering into an agreed scheme of arrangement which will see it purchased by HUB24 (HUB.ASX) for a combination of cash and scrip. We had been perplexed at the unwillingness of the market to reward Class for re-investigating the business in recent times and so are not entirely surprised that a corporate has instead recognised the value in the franchise.

HT&E (HT1.ASX) contributed as the stock rose 18% after settling a tax dispute with the ATO that the latter first raised in an assessment in 2018. Whilst the settlement will see a cash payment of \$20.3m to the ATO and the ATO keep a \$50.7m deposit paid earlier by HT&E, we and evidently most of the market had assumed the company would need to pay the full \$195m of the assessment (\$102.5m in tax claimed, \$49m of penalties and interest of \$43m). HT&E also disposed of its holding in Ooh Media (OML.ASX) acquired during the pandemic for \$49m, banking a tidy \$31m profit. Post period end HT&E entered into an agreement to purchase Grant Broadcasting, the second largest regional radio operator in the country. The deal is materially EPS accretive due to the re-leveraging of the balance sheet, but we think the business only needs to deliver a fraction of its estimated \$20m in revenue synergies to also be value accretive.

Seven West Media (SWM.ASX) contributed as the stock rose 12% during the month. The franchise has materially deleveraged its balance sheet over the last several years and meaningfully cut costs and improved its profitability. This reality was reflected in a new debt facility agreed during the month which will see the margin over BBSY halve versus that paid under the old facility. Despite its deleveraging efforts, SWM.ASX continues to trade on a mid-single digit EBIT multiple. Subsequent to month end the firm announced the agreed acquisition of its regional affiliate Prime on a low single digit EBIT multiple in a deal we believe will prove both highly earnings accretive and more importantly value accretive (a much harder feat to pull off in today's M&A landscape).

Major Detractors for the Month

Flight Centre (FLT.ASX) was the largest detractor as the stock retraced 7% after a very strong performance over September. We continue to like the business and believe the market is underestimating the potential for the leisure business in particular to return to robust levels of profitability as the world exits the pandemic. Flight Centre has more than halved the fixed cost base of its leisure operations but retained the capacity for handling very large volumes through its online brands and through home based independent contractor travel agents.

Adbri (ABC.ASX) detracted upon retracing 8% over the month on no significant news. We continue to like the producer of cement, lime, concrete and aggregates as we believe the market is not giving it credit for the likelihood that it replaces lost lime revenue and earnings with new Western Australian mining project clients.

Liontown Resources (LTR.ASX – not owned) detracted as the Western Australian project developer of lithium spodumene soared 32% over the month to trade at a market capitalisation (and EV) of over A\$3.6bn. We struggle to reconcile the valuation given the company has had to assume a highly optimistic US\$1,392 per tonne 10-year weighted spodumene price to generate its recently released A\$4.2bn NPV8 for its flagship Kathleen Valley project and aims to be in production in the first half of CY2024. We note current mineral producers and developers in Western Australia continue to report strong cost inflation due to COVID-19 induced labour shortages and sharply higher steel and energy prices. We are generally cautious the lithium sector as previous cycles have shown spodumene producers have responded to incentive pricing much faster than market forecasters have anticipated, albeit typically with higher capex and opex costs than investors expected. Additionally, we now see some risk to the aggressive demand growth forecasts for lithium-ion batteries widely relied on by the industry given battery producers are now raising prices materially to account for surging cathode, anode, energy and labour costs. For instance, BYD of China raised prices 20% only last week. Further, we see a risk that this commodity price cycle in lithium could help firmly establish sodium ion batteries in the energy storage market in particular given surging spot lithium carbonate and hydroxide prices. We note that the world's number one battery producer CATL, recently demonstrated a commercial sodium ion battery with impressive energy density and cycle life. They touted the chemistry's strong cold weather capacity performance and very rapid charging capability as enabling hybrid lithium ion/sodium ion battery packs for EV applications also.

Outlook & Strategy

The market is at an interesting inflection point with rising costs pressuring business models without real pricing power and the prospect of rising interest rates (at least nominal rates) potentially leading to a market less willing to back cash burning concept stocks. While the COVID-19 pandemic is not over, the continued rollout of vaccines and the development of effective anti-virals makes us more confident that services will trend back towards their historical share of consumption and GDP. We therefore remain constructive towards sectors hurt by the pandemic and wary of capitalising profits that have been boosted above a sustainable baseline by COVID-19 induced behaviours. While we would expect to see higher rates at some time in the not-too-distant future, boards are emboldened, balance sheets are flush with cash and both equity and debt capital remains cheap and readily available. We therefore expect continued elevated M&A activity that has historically buoyed our returns given our preference for cash generative business models that are typically both undervalued and underleveraged. There are pockets of the market (particularly exposed to popular thematic) that appear well and truly overheated, with the battery materials space in particular looking frothy. We will continue to avoid these areas. Pleasingly we continue to be presented with opportunities for rotation into names that tick our boxes on cashflow, balance sheet strength and valuation.

Fund Ratings



Further Information

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

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