Overall Commentary

The Company performance for the month of October was 6.1% (after fees) slightly underperforming the S&P/ASX Small Ordinaries Accumulation Index by 0.4%.

During October, the Board of SEC resolved to pay a quarterly dividend for the period ended 30 September 2022 of 2.1 cents per share, which was paid on 3 November 2022. The dividend is fully franked at the corporate tax rate of 30%.

Company Facts

Investment Manager	Spheria Asset Mangement Pty Limited
ASX Code	SEC
Share Price	$1.905
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	$114.6m

Performance as at 31st October 2022

	1 Month	3 Months %	1 Year	3 Years p.a.	Inception p.a[3]
Company[1]	6.1%	-0.4	-15.8%	6.2%	6.2%
Benchmark[2]	6.5%	-4.9	-18.3%	1.5%	3.4%
Difference	-0.4%	4.5	2.5%	4.8%	2.8%

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

Sharemarkets rebounded strongly in October, we managed to keep up for the most part. Our performance was aided by a bidding war for Nitro Software (NTO) a key holding in the portfolio. The private equity led acquisition of Nearmap (NEA) in mid-August – at a significant premium – kickstarted a flurry of M&A activity in the tech space, with the aforementioned NTO followed recently by a spate of public to private proposals for Tyro Payments (TYR), Elmo software (ELO), and Readytech (RDY). Interestingly, premiums offered seem unusually generous given the macro backdrop with ELO for example being a 100% premium to the undisturbed share price. It may indicate there is healthy appetite (i.e. multiple parties) hunting for acquisitions in the technology space and perhaps weakness in the Australian dollar is providing greater firepower for acquirers who are mostly USA based. Whether this takeover activity permeates more broadly (outside of the tech sector) will likely be a function of the cost and availability of debt, albeit many corporates are sitting on healthy balance sheets providing flex for M&A and have an imperative to get bigger with organic growth moderating due to weakening macro conditions. Strategic growth may therefore be on the agenda particularly for multi-nationals with majority US dollar denominated earnings.

Net Tangible Assets (NTA)[1]

Pre-Tax NTA[2]

$2.176

Post-Tax NTA[3]

$2.209

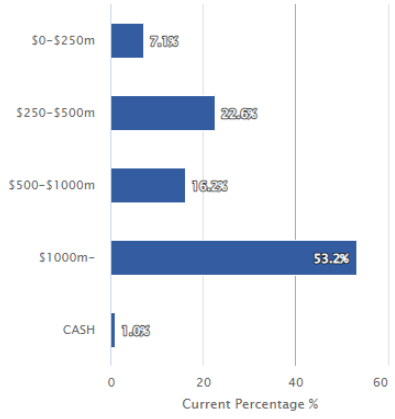
The NTA values shown above are after the dividend of 2.1 cents per share paid on 3 November 2022. The ex-date of the dividend was 19 October 2022.
1 NTA calculations exclude Deferred Tax Assets relating to capitalised issue cost related balances and income tax losses.
2 Pre-tax NTA includes tax on realised 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	5.2%
Flight Centre Travel Group Limited	5.1%
Monadelphous Group Limited	4.4%
IRESS Limited	4.4%
Nitro Software Limited	4.3%
Blackmores Limited	4.3%
Michael Hill International Limited	4.0%
Universal Store Holdings Limited	3.4%
INSIGNIA FINANCIAL LTD.	3.4%
Event Hospitality and Entertainment Ltd	3.2%
Top 10	**41.8%**

Source: Spheria Asset Management

Market Cap Bands



Source: Spheria Asset Management

Major Contributors for the Month

Positive performance contributions from companies owned included:

Nitro Software (NTO.ASX) – jumped almost 30% in October and is now up over 80% from its August lows after the business received two takeover proposals during the month. The first from Potentia Capital who increased their initial indicative offer from $1.58 announced in August to $1.80 via a formal takeover offer. The second from Alludo (a software company owned by KKR) at $2 a share. The Nitro board has unanimously supported the Alludo proposal, however, with two genuine buyers there is potential that the battle for control escalates. We continue to remain supportive of the business and despite the increased price, it still may be somewhat opportunistic given the recurring nature of the business's revenue, growth potential, and its well-funded balance sheet.

Flight Centre (FLT.ASX) – after falling last month FLT rallied 17% in October on no company specific news. Many travel related companies including Qantas, Auckland Airport and Air Canada – to name a few – reported stronger than expected results during October with demand for travel continuing its rebound. This is supportive for FLT and echoes the company's recent result with the Leisure division transaction values returning to 70% of pre-COVID levels and the Corporate division now above pre-COVID levels. The business has emerged from COVID with a leaner cost structure particularly in its Leisure division and is trading on only ~10x recovered EV/EBIT. Share price recoveries out of previous sharp downturns including World Trade Center (2001) and the GFC (2008) were pronounced and multi-year in nature, we suspect history will repeat despite a potentially weaker macro-economic backdrop.

Regis Healthcare (REG.ASX) – rallied 19% in October, post its AGM. The company announced average occupancy for Q123 was 91%, which was an improvement from FY22 (89%). REG is one of the few remaining listed aged care players after significant M&A in the space over the last couple of years. We believe it is the highest quality play in the sector given its centres are predominantly in higher socioeconomic areas where it is possible to charge more, and affordability is less of an issue. We believe the government will be forced to better subsidise the industry to increase supply of beds, given rising demand for beds due to an ageing population and increase in chronic conditions particularly dementia. Higher returns for the industry will be the key incentive to drive greater supply. REG is inexpensive and has significant land value on its balance sheet that underpins its valuation.

Major Detractors for the Month

Adbri (ABC.ASX) – fell 14% in October after the company provided an abysmal trading update and announced the CEO would be leaving the business. Net profit after tax (underlying) in CY23 is now expected to be between $75-85m, about one-third less than expected. This fall a continuation of the last four years' experience with earnings in a significant downtrend since CY18 and having more than halved since then. Interestingly, the company is now generating a ROIC of less than 6% on a historic cost basis. Whilst there are industry wide issues plaguing returns, we feel mismanagement has also played a major role, this situation is therefore salvageable in the appropriate hands and at worse there is enormous value in the property assets underpinning the business with the Kwinana Upgrade project, for example, to free up a significant land bank in Munster that could be worth +$300m (2027-2031) after rezoning and development. In the short to medium, Moorebank is expected to bring in ~$50m and Badgerys +$100m, respectively. Whilst the balance sheet is stretched due to capital expenditures (primarily Kwinana) and lower earnings, we feel there is enough buffer in debt covenants and assets sales to ride out this challenging period.

Bega Cheese (BGA.ASX) – declined 7% in October as the milk supply equation continues to deteriorate. There is simply too much milk processing capacity when supply is shrinking due to cyclical factors like high beef prices, placing upward pressure on their key input cost. There has also been a lag passing on these higher input costs and the major grocery players don't always play ball particularly when consumers are facing significant cost of living pressures. Historically, the time to buy BGA has been in these cyclical downturns. We feel the balance sheet is in a strong position to weather this downturn given stronger than expected cash flow generation in FY22. The company has also announced the CEO would be stepping down after 13 years at BGA and replaced by the current COO, Mr Pete Findlay.

Invocare (IVC.ASX) – share price gained about 1% but underperformed the broader market in October on no new news. Like other businesses in the current environment, IVC has been impacted by inflationary pressures, wet weather, and tight labour markets. Whilst this has been challenging for IVC we feel these external pressures will soon abate albeit attracting workers to the industry remains a challenge. The business is also increasing pricing to offset inflationary pressures. Volumes continue to be strong with excess deaths tracking well above historic averages in Australia and New Zealand. This phenomenon is being felt across the globe. Being the leading funeral and crematorium business in Australia we feel the business will benefit substantially from this particularly if it is a permanent trend. The business also operates the leading pet cremations business in Australia and whilst a small part of the business today it has had incredible growth, with a 500% increase in volumes over the last year. IVC is trading on less than 15x CY23 EV/EBIT which is relative attractive for a strong business in a defensive industry.

Outlook & Strategy

Despite all the negativity, the Australian economy is actually travelling well with strong employment underpinning consumer demand and strength in commodity prices driving capital investment. It is possible bureaucrats in Australia engineer a softer landing than the market is currently suggesting, albeit offshore events may upset that equation. Our meetings with companies suggest that inflationary pressures are abating somewhat. The outlook for interest rate rises may therefore be tempered, which is a key driver of sharemarkets. We think these are reasons to be constructive on the investment outlook particularly given depressed valuations across our portfolio that are imputing a deep recession in many circumstances.

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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