Spheria EMERGING COMPANIES

ASX: SEC

Investment Update

As at 31st August 2018

Spheria Emerging Companies Limited
ACN 621 402 588

Pre-tax net tangible assets[4]

$2.140

Company[7] performance (since inception)

7.0%

Company Facts

Investment Manager	Spheria Asset Management Pty Limited
ASX Code	SEC
Share price	$1.95
Inception date	30 November 2017
Listing date	5 December 2017
Benchmark	S&P/ASX Small Ordinaries Accumulation Index
Management Fee	1.00% (plus GST) per annum[1]
Performance Fee	20% (plus GST) of the Portfolio's outperformance[2]
Market Capitalisation	$129m

[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

Commentary

The Company's NTA increased 2.5% over the month after all Portfolio expenses and Company costs including tax on realised gains. The S&P/ASX Small Ordinaries Accumulation Index returned 2.5%.

Results season seemed more volatile than usual with sharp moves on little new information. Interpretation of near-term earnings direction seemingly the major share price driver. For the month, we saw significant upward moves in share prices of Infomedia (IFM, +37%), Breville (BRG, +26%), Vita (VTG, +22%) and Seven West Media (SWM, +21%) - all greater than 20%. On the flip side we witnessed a sharp deterioration in the share prices of Isentia (ISD, -54%) and Prime Media (PRT, -25%).

Interestingly, in the month of August thirteen companies in the S&P ASX Small Ordinaries Index rallied more than 20%, we owned three being IFM, BRG and SWM as mentioned above. Also, there were thirteen companies that declined greater than 20% in the index, we owned one of them being ISD. Given we run a portfolio and our weightings are based on risk as well as return, overall, we managed to generate a strong return for our clients despite a couple of big negative moves.

"People are overlooked for a variety of biased reasons and perceived flaws: age, appearance, personality. Billy, of the twenty thousand notable players for us to consider, I believe that there's a championship team of twenty-five people that we can afford because everyone else in baseball under values them - like an island of misfit toys." Quote from Moneyball (the movie version) on how to build a team on a limited budget that can achieve consistent success.

We never expect a perfect scorecard at results, as it's mathematically implausible. In fact, professional fund managers on average get only 52% of their calls right in the long term. Given the number of companies in our portfolio and the fact that businesses are volatile and operate in industries that are cyclical. it is inevitable that not everything is going to go right at the same time. But the losers of this round in many cases are winners in future rounds. Like Moneyball, our portfolio looks like "an island of misfit toys" but we feel this is due to misconception, which lends to mispricing, which can be exploited to achieve consistent returns over various cycles. Adopting a Moneyball strategy to investing means having a defined process and valuation bases that often means investing against the grain.

"Billy, this is Chad Bradford. He's a relief pitcher. He is one of the most undervalued players in baseball. His defect is that he throws funny. Nobody in the big leagues' cares about him, because he looks funny. This guy could be not just the best pitcher in our bullpen, but one of the most effective relief pitchers in all of baseball. This guy should cost $3 million a year. We can get him for $237,000." Quote from Moneyball on how baseball scouts are obsessed with appearances rather than the statistics which tell the true story.

Just over two years ago, Infomedia (IFM) was in the discount bin after a string of profit warnings and a clean out of board and management. The last profit downgrade was a by-product of the new team electing to invest in the business for growth and thus resetting expectations. This went down like a lead balloon at the time with the share price plumbing lows (52c), down nearly 60% in the space of a year.

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Commentary (continued)

Having watched from the sidelines for a long period (years in fact), we saw an opportunity to invest in a company that had a leading market position that had simply been underinvested. The market's obsession with short-term direction in earnings provided an opportunity to buy an underrated business at a relatively low multiple with strong cash generation and a great balance sheet. Now that the company is winning market share and is on a solid growth trajectory, it has rallied significantly and has become popular again for good reason. We have reduced our weighting on valuation grounds but remain supporters. Now it is a matter of finding the next Infomedia.

We have discussed Vita Group (VTG) before. Yes, it has one supplier in Telstra, but it had the same one supplier when it was trading at a share price of $5. Now it trades just above $1. It is highly cash generative and at last balance date had $18m of net cash on its balance sheet. Its contract with Telstra has been renewed, earnings rebased and its now trading on only 4x pre-tax free cash flow. Meaning a 4-year payback period. Apart from valuation, it is strategically important to Telstra given it influences around $1.5bn of revenue. The productivity of the stores it runs for Telstra is excellent and it is less prone to competition given its store footprint is skewed to regional markets where Telstra's network is superior. The one supplier issue is more than compensated by the price.

Earlier this year Ht&E (HT1) was the pariah of the media sector after a confluence of negative events including the loss of a material contract at Adshel, Metro radio (ARN) earnings disappointment and adverse development in respect of a legacy tax liability. The market reacted negatively, hammering the share price to the point where it was trading at half the valuation of its peers on relatively low earnings expectations and a worst-case tax liability scenario. We added significantly to the Company's long-held position on valuation grounds and given the strategic value inherent in Adshel and ARN. The eventual sale of Adshel to Oohmedia (OML) was done at an elevated price in a competitive auction process with APO such that despite the recent rally we believe the residual radio assets are now being valued at only 6x EBIT. This is nearly half the multiple that SXL, the best comparison, currently trades. The group will also have significant balance sheet capacity, even after a significant return of capital to shareholders.

The Company is a significant shareholder in PRT, which is more out of fashion than a straw hat in winter. However, it is not a big position in the Company given its market cap is <$100m. The reaction to the new affiliation agreement was startling as we believe the new terms to be quite favourable for shareholders, particularly given the cricket rights could lead to a significant upward shift in revenue share, particularly in the regional markets where pay-TV is less penetrated. Furthermore, there are signs of stabilisation in the regional TV markets that tend to lag the metro markets which have returned to growth. In fact, we forecast PRT to generate EBITDA in the $35 to $40m range in FY19, only slightly down on the $45m in FY18. We believe EBITDA is a better proxy of profit/cash flow given capex for the business is $3-4m a year whereas depreciation will be >$12m due to legacy amortisation and depreciations costs which artificially deflate NPAT (including NPAT guidance provided by company). In fact, we calculate the company is trading on 2.4x pre-tax free cash flow, which means shareholders will get their money back in 2.4 years – all other thing being equal. Add to that they have nearly $60m of franking credits versus a market cap of $87m and you quickly realise this company is brimming with value. In addition to its stand-alone valuation, there are enormous synergies in SWM buying PRT such that a merger is undeniably a huge win-win for both sets of shareholders. We estimate the synergies for SWM at >$10m p.a. assuming elimination of head office costs and national sales force duplication. This is one of the key reasons for our large exposure in SWM.

ISD looks like a dud rather than a stud. In all seriousness though, Meltwater's (its main competitor) aggressive pricing has led to significant price erosion and effectively a race to the bottom in the industry. How long they can continue with super low prices is hard to gauge given the dearth of publicly available financial information. Any relief on this front will be positive for ISD. According to market sources it will be hard for Meltwater to service the NSW government contract (won recently) which has complex requirements. In saying that cost savings at ISD failed to eventuate which was a massive own goal. The company needs to reconfigure its business and work out what client's value in an evolving media monitoring landscape. We will give the new CEO time given he is well credentialled and the business remains highly cash flow generative albeit at lower levels than we had forecast.

Just like the Chad Bradford example in Moneyball, we believe the companies discussed above were significantly marked down due to obvious issues such that the risk seems skewed to the upside based on simple maths. The issues discussed are knowns which are ignored when share prices are going up but amplified when they go down. ***Continued on next page…***

Commentary (continued)

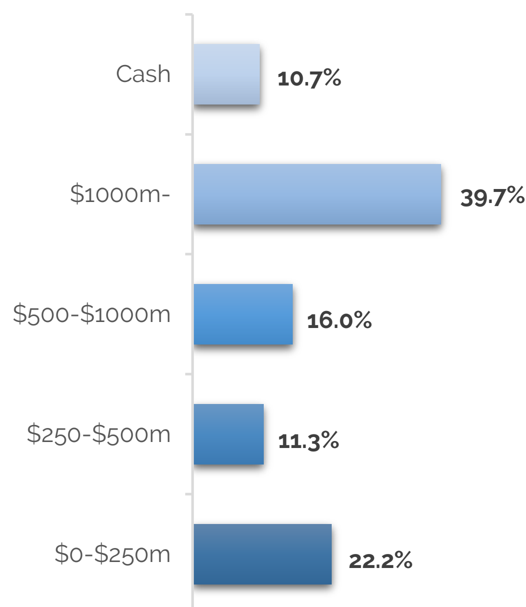
At some point valuation will matter for these companies, but in the meantime, they will produce a cash flow stream that in most cases will provide quick payback for shareholders.

In conclusion, we continue to seek out high cash flow companies with predictability in earnings based on competitive position, and most importantly where the valuation makes sense. Buying hyper popular companies on enormous multiples has worked in this market for a long period. At some point we believe this nexus will break and break badly. The dot-com bust of 2000/01 is a stark reminder that even the most celebrated companies can be cut down to size. Harking back to those days, high quality companies including CSL, Computershare and Technology One all fell by more than 80%, simply because they became way too expensive.

Top 5 Holdings

Company Name	% Portfolio
Technology One	5.5
Ht&E Limited	5.3
Navitas Limited	4.9
Fletcher Building	4.5
Platinum Asset	4.4
Top 5	**24.7**

Market Cap Bands



Net Tangible Assets (NTA)[3]

Pre-tax NTA[4]	$2.140
Post-tax NTA[5]	$2.136

[3] NTA calculations exclude Deferred Tax Assets relating to capitalised issue cost related balances and carried forward tax losses of $0.001 per share. The NTA values are before the 2018 final dividend of 4.0 cents per share payable on 21 September 2018, with ex-date 6 September 2018

[4] Pre-tax NTA includes tax on realised gains and other earnings, but excludes any provisions for tax on unrealised gains

[5] Post-tax NTA includes tax on realised and unrealised gains and other earnings

Performance as at 31st August 2018

	1m	3m	6m	Inception[6]
Company[7]	2.5%	2.1%	2.7%	7.0%
Benchmark[8]	2.5%	2.5%	6.7%	9.3%

Past performance is not a reliable indicator of future performance.

[6] Inception date is 30th November 2017

[7] Calculated as movement in Company's pre-tax NTA, which includes tax on realised gains and other earnings, but excludes any provision for tax on unrealised gains

[8] Benchmark is the S&P/ASX Small Ordinaries Accumulation Index

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