Spheria EMERGING COMPANIES

ASX: SEC

Investment Update

As at 30th September 2018

Spheria Emerging Companies Limited
ACN 621 402 588

Pre-tax net tangible assets[4]

$2.110

Company[7] performance (since inception)

7.5%

Company Facts

Investment Manager	Spheria Asset Management Pty Limited
ASX Code	SEC
Share price	$1.835
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	$122m

[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 pre-tax NTA increased by 0.5% for the month (pre the Company's 4 cent dividend), while the S&P/ASX Small Ordinaries Accumulation Index declined by 0.4%. The company paid its maiden fully franked dividend of 4 cents per share on September 21st. After allowing for the payment of the dividend the Company's pre-tax NTA decreased by 1.4% for the month.

The Company saw good contributions from Monadelphous Group (MND.ASX;+15%), Horizon Oil (HZN.ASX; +25%) as the Australian Dollar oil price climbed significantly and Sigma Healthcare (SIG.ASX;+11%). Detractors over the month included Bega Cheese (BGA.ASX; -12%), Mortgage Choice (MOC.ASX; -17%) and Mt Gibson Iron (MGX.ASX; -6%). We increased our weighting in Bega Cheese (BGA.ASX) which we have owned for some time as they raised capital to pay for their recent acquisition of the Koroit processing facility. Importantly Bega have been extremely adroit at deploying capital in the dairy processing industry unlike a number of their peers. Koroit is a large processing plant based in Victoria that was formerly owned by Murray Goulburn who were subsequently acquired by Canada's Saputo. The ACCC forced a fairly rapid divestment of Koroit by Saputo. Koroit has a processing capacity close to 800ML of milk making it one of the largest processing plants in the country and yet currently only processes around 300ML of milk due to the milk supply problems created by their former owners. At this level of supply the facility should earn in the order of $20m EBITDA on the acquisition price of $250m. BGA have indicated they should be able to attract additional milk supply to the tune of 400-450ML over the next year. We believe the incremental earnings on this milk supply should fairly significantly increase the earnings on this asset making it a very attractive investment for BGA shareholders.

Two things are exercising our minds at the moment – how to evolve with the constantly changing times and yet how to maintain our core disciplines based around long term investment beliefs. The investing environment and market structures are constantly changing. One good example of this is consumer attitudes towards traditional brands. The internet and evolution of decent quality private label brands are challenging the value of inaptly named FMCG (Fast Moving Consumer Goods) companies. Gillette for instance used to have a relatively impervious moat in the shaving category with a high market share and constant, and predictable, new product innovation (one blade, two blades, three blades, four…). With innovation came price increases and whilst the consumer may have objected to continually having to pay more for their ultra-close shave – there was little alternative. Competing with Gillette would have required very deep pockets and some degree of insanity. Launching a competing product would have required a factory of scale (or at least competitive sourcing), supermarket shelf space which would not have been easy or cheap to come by and significant investment in marketing to persuade consumers of the enhanced benefits of the new product. Over time many tried to launch against Gillette and failed.

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Commentary (continued)

The internet has enabled completely new forms of competition to come from seemingly nowhere and dramatically shrink Gillette's hitherto impenetrable moat. Dollar Shave Club for instance, was launched in 2011 with the novel idea that amusing, word of mouth advertising and a subscription club-type model could be an interesting thorn in Gillette's side. Not only did their advertising campaign go viral (I forwarded the campaign to numerous family members and colleagues for a laugh at the time. Note well worth watching if you are curious; there were 25m views of the original YouTube ad) the business took off and spawned numerous competitors all seeking to do something that had previously been thought virtually impossible. Unilever ultimately bought Dollar Shave Club for an estimated US$1.0bn dollars in 2016. The same direct model is working now in multiple categories and enabling other brands who are small but innovative to take on incumbents. Bellamy's and Sukin are other examples in the smaller companies space of upstart companies who have built sizeable and successful brands by taking on much larger multinational competitors again without traditional substantial advertising budgets. They have used word of mouth and social media amongst other things to gain traction in markets once dominated by traditional FMCG businesses.

In other areas the internet is changing the way software is bought with Technology One, Microsoft and many other software companies moving to sell subscription of software as a service (SAAS). This creates new revenue streams for innovative businesses who can now sell their hosting services as well as their software. In the mining space the advent of driverless trucks is dramatically lowering the cost of operating mines in the Pilbara. The increase in truck sizes is enabling orebodies previously thought to be waste dumps to be re-considered and re-opened as operating mines. As investors we need to be nimble enough with our thinking to understand and adapt to changing market structures yet anchored with an investment discipline that doesn't see us lurching from new emerging trend to even newer emerging trend.

We need to be adaptable enough to be investing in line with some of these shifting business dynamics and yet wizened enough to sift through the rubble of discarded investments looking for companies thought to be extinct and yet whose valuations either more than reflect this or who are able to adapt and to re-emerge as strong competitors. In the traditional media space, for instance, paywalls are successfully being applied to online newspapers with consumers showing a willingness to pay for access to quality journalism whilst trying to avoid the pervasiveness of pseudo journalism and "fake news". Free to air TV broadcasters are now broadcasting on demand TV which gets them significantly closer to the consumer in that they can now tell where and when their consumers are watching content and tailor and track the TV commercials being served to them. This makes their value to advertisers more akin to and in some cases better than the online platforms.

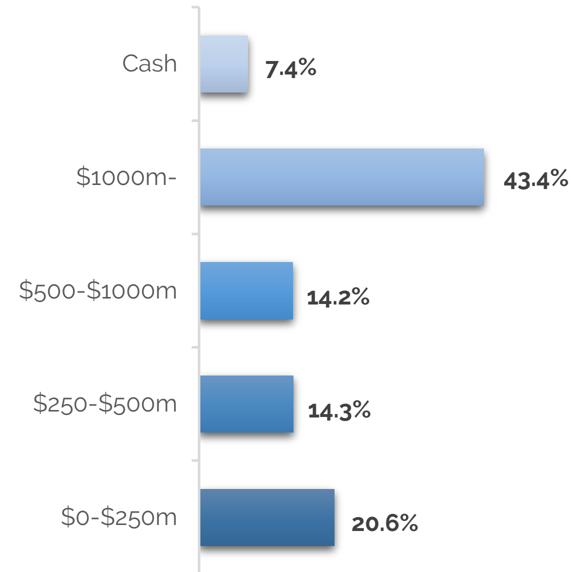
We are unequivocally of the view that after almost 10 years of bull market we are in the late stages of the market's run. Leverage is high in most of the Western world on account of the near decade long discount on interest rates. Most asset prices are at record highs and we are seeing corporate actively back in M&A mode not to mention large, well-funded Private Equity firms also on the prowl to deploy capital. Surprisingly with this backdrop we are still managing to find ideas that get neglected from time to time and we try to take advantage of pull backs in share prices of decently run businesses. Against this there are many pockets – and we have spoken ad nauseum about some of these before – where we believe the market's view is overly rosy. These are stocks with strong EPS growth rates which the market appears to be rewarding with scant regard to the cashflow or balance sheets required to attain this growth. Capital consumptive earnings growth is not worth the same to a shareholder as capital light earnings growth. It is a sign of the times that both are being equally rewarded.

Our outlook is essentially unchanged. Our view is that focussing on companies with solid cash flows and decent balance sheets will prove to be ultimately rewarding to shareholders. The Company has performed well over most time frames and has mostly kept up with an incredible surge in investor confidence over the past year or so. If, as anticipated, the over-hyped market sectors get tested in more challenging market environments our disciplines should see our investments perform reasonably well. We will continue to apply and modify our understanding of evolving market structures and dynamics whilst remaining anchored to the core fundamental disciplines we believe will give our investors the best longer term performance.

Top 5 Holdings

Company Name	% Portfolio
Bega Cheese Ltd	6.5
Technology One	5.3
Navitas Limited	5.1
Fletcher Building	4.8
Platinum Asset	4.5
Top 5	**26.1**

Market Cap Bands



Net Tangible Assets (NTA)[3]

Pre-tax NTA[4]	$2.110
Post-tax NTA[5]	$2.107

[3] NTA calculations exclude Deferred Tax Assets relating to capitalised issue cost related balances and carried forward tax losses of $0.003 per share. The NTA values are after the 2018 final dividend of 4.0 cents per share paid on 21 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 30th September 2018

	1m	3m	6m	Inception[6]
Company[7]	0.5%	2.3%	5.7%	7.5%
Benchmark[8]	-0.4%	1.1%	8.9%	8.9%

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), assuming the re-investment of any dividends paid by the company

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

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