ASX: SEC

Investment Update

As at 31st August 2019

Spheria Emerging Companies Limited
ACN 621 402 588

Pre-tax net tangible assets[4]

$1.986

Company[7] performance p.a. (since inception)

1.3%

Company Facts

Investment Manager	Spheria Asset Management Pty Limited
ASX Code	SEC
Share price	$1.65
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	$109m

[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 decreased by 4.6% in August. This represented an underperformance of 0.7% compared to the S&P/ASX Small Ordinaries Accumulation Index which decreased by 3.9%.

The small cap index fell nearly 4% in August driven primarily by macro-economic factors rather than reporting season per se. Weight of money continued to bolster the insane valuations of fashionable stocks that spin a good story even when their fundamentals are unappealing. In our opinion this is possibly the most inefficient market we have witnessed since the dot-com boom that culminated in the crash of March 2000. The following years were a halcyon period for value managers that survived the relentless march of the momentum tech zealots preceding that bust. Regrettably we see more and more parallels between then and now. We can only hope that the market participants cheering this mania along today are simply a genuinely optimistic lot, rather than displaying the type of behaviour that saw Henry Blodget become infamous post the dot-com bust.

As a fundamentally based investor (I.e. we value securities and invest accordingly) it was comforting to read a news article about Michael Burry - who made a fortune betting against mortgage securities before the 2008 crisis, a trade immortalised in the "The Big Short" – extolling the virtues of smaller value stocks that are being unduly neglected around the world. Like us and other active managers he sees another contrarian opportunity emerging from what he calls the "bubble" in passive investment. As money pours into exchange-traded funds and other index-tracking products that skew toward big companies.

"The bubble in passive investing through ETFs and index funds as well as the trend to very large size among asset managers has orphaned smaller value-type securities globally," Burry said in an email to Bloomberg News.

Our strategies are heavily skewed to small cap value and this has detracted from performance in recent periods. However, like Michael Burry we believe this is where the opportunity is but only the minority will take advantage of this situation given the closure of many value based small cap managers in Australia over the last six months. In our view, money is made by the minority and mediocrity awaits the majority. It's an unfortunate conclusion but a shakeout seems likely with passive strategies the most obvious loser.

Major positive movers in the portfolio (August reporting period)

Isentia (ISD) – bounced 31% in August after reporting a solid result with earnings stabilising, strong free cash flow, debt reduction and emerging signs of a turnaround in the core Australian business. The new CEO has just ticked over a year but has clearly made major strides on technology innovation, sales productivity, reducing churn and importantly culture. The interim copyright licence order from the Australian Copyright Tribunal should allow it to compete on a more even playing field and also provide capital to invest back into technology and cost efficiencies (the order sees a meaningful reduction in ISD's largest non-personnel expense). The company looks screamingly cheap at 7x free cash flow, particularly if it can begin to grow earnings in FY21 and beyond.

City Chic Collective (CCX) – rallied 18% in August after reporting another strong result post last year's restructure and divestments. CCX is a specialist at plus-size female fashion with 44% of sales online, up from 36% in FY18. Northern Hemisphere sales (mainly USA) comprise 20% of group revenue, up from 16% in FY18. The company generates strong cash flow and has net cash of $23m. Inventory is very low ($19m) as you would expect given the high online component of group sales. Trading on a free cash flow multiple of 14x, we think it's relatively cheap versus its online peers that mostly sell third party product and generally exhibit weak cash flow trends. ***Continued on the next page…***

Healius (HLS) – rose 11% after a better than expected result, albeit expectations were low leading into the result. The medical centre division which has been a millstone around HLS's neck for a long time showed encouraging signs of a turnaround in the 2H19. There continues to be speculation that HLS will be taken private that has also bolstered the share price. We continue to view the company as primarily a pathology business (second largest in Australia) and believe this is not yet reflected in the share price given peer trading multiples.

Major negative movers in the portfolio (August reporting period)

Blackmores (BKL) – fell 19% after reporting a weak result. Expectations were low going into the result given BKL's lack of traction with its China strategy, and the impact on Daigou trade in Australia due to a Chinese government crackdown on this channel. The market disliked the outlook however. Further weakness in sales is expected in 1H20 as Chemist Warehouse (BKL's largest customer) apparently over-stocked in 2H19. Whilst conditions will remain difficult in the short to medium term given weakness in China and Australia sales, more pertinent is the company is on a path that will drive significant cost out of the business (with a new highly experienced MD appointed) and potentially generate much higher margins more akin to its peers. However, this will be a painful process and potentially costly given the headcount of 1400 people within the business. On a positive note, the Asian division (ex-China) grew sales >30% in FY19 and comprises nearly 20% of group sales and is nearly equivalent to China (in-country) sales.

Mount Gibson Iron (MGX) – declined 18% during the period on the back of further iron ore price weakness after a stellar rally. The company reported a result in line with expectations. Clearly, the valuation for MGX is sensitive to the price of iron ore and the premium for 65% Fe. This premium has narrowed recently but will likely expand if the iron price (62% Fe) falls further providing some cushioning for MGX versus other iron ore miners with lower grade ore. We used the fall in share price to buy back shares we had sold at higher levels given the share price is now pricing in a much lower long-term iron ore price. This affords us a significant margin of safety as does the $385m of surplus cash/investments the company holds versus its market capitalisation of ~$800m.

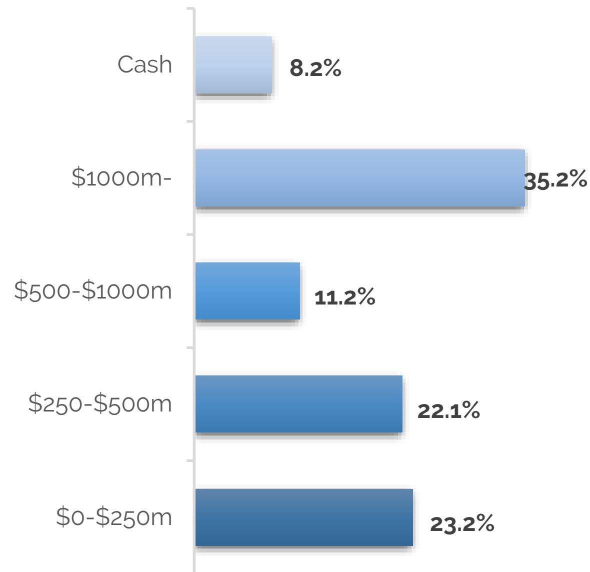
Class (CL1) – dropped 18% during the month despite a strong result with revenue growing 13%. The solid result was overlooked due to guidance that the company will invest more aggressively in product development and technical capability to improve the current product suite and enter new adjacencies. Revenue is expected to grow at 10% in FY20 but margins will fall due to the investment, meaning earnings will be broadly flat. If the company was popular this would have been met with resounding cheers from the market with a thirst for top-line growth, but given the antipathy toward the stock it was instead met with derision. Emotion seems to be overriding any common-sense with many market darling technology companies losing money to deliver top-line growth being richly rewarded by the market. Many will never make money. This would appear a dangerous game given what we learned during the dot-com boom and ensuing bust. CL1 is clearly not in this camp given it has highly recurring revenue (~$40m) and is generating EBIT of around $12m pa and has nearly $20m of surplus cash. At 3x EV/Revenue for a SaaS business with 99% client retention we feel strongly that a shift away from the prevalent momentum strategies should see CL1 shareholders richly rewarded for their patience.

Top 5 Holdings

Company Name	% Portfolio
Healius	4.8
Ht&E Limited	4.7
GBST Holdings..	4.6
Sims Metal Mgmt Ltd	4.1
Blackmores Limited	4.0
Top 5	**22.3**

Source: Spheria Asset Management

Market Cap Bands



Source: Spheria Asset Management

Net Tangible Assets (NTA)[3]

Pre-tax NTA[4]	$1.986
Post-tax NTA[5]	$2.059

[3] NTA calculations exclude Deferred Tax Assets relating to capitalised issue cost related balances and income tax losses

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

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

Performance as at 31st August 2019

	1m	3m	6m	1 yr	Inception p.a.[6]
Company[7]	-4.6%	-5.0%	-1.8%	-4.5%	1.3%
Benchmark[8]	-3.9%	1.4%	4.1%	0.9%	5.8%

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/losses and other earnings, but excludes any provision for tax on unrealised gains/losses), assuming the re-investment of any dividends paid by the company

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