Spheria Emerging Companies Limited (Company)
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20 October 2022

Market Announcements Office
ASX Limited
Exchange Centre
20 Bridge Street
Sydney NSW 2000

Dear Sir/Madam,

Spheria Emerging Companies Limited (ASX:SEC) – Monthly Investment Update

Please find attached a copy of the investment update for the month ending 30 September 2022.

For further information, please contact 1300 010 311.

Authorised by:

Calvin Kwok
Company Secretary

Overall Commentary

The Portfolio performance for the month of September was -9.4% outperforming the S&P/ASX Small Ordinaries Accumulation Index by 1.8%.

The Board of SEC has resolved to pay a quarterly dividend for the period ended 30 September 2022 of 2.1 cents per share, which will be payable on 3 November 2022. The dividend will be fully franked at the corporate tax rate of 30%.

Shareholders who would like to participate in the DRP for this dividend need to elect to do so by Friday 21 October 2022.

Company Facts

Investment Manager	Spheria Asset Mangement Pty Limited
ASX Code	SEC
Share Price	$1.90
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	$114.1m

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 30th September 2022

	1 Month	3 Months %	1 Year	3 Years p.a.	Inception p.a[3]
Company[1]	-9.4%	0.1	-18.5%	4.4%	5.0%
Benchmark[2]	-11.2%	-0.5	-22.6%	-0.8%	2.1%
Difference	1.8%	0.5	4.1%	5.2%	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

Markets struggled over September after the respite in July and August. The Small Ordinaries Accumulation Index declined over 11% with the Mid-Small Index marginally less impacted falling 9.0%. Globally markets were also well down over the month. Bond yields rose in the US and more modestly in Australia such that 10-year yields are now close to 4% in both countries. Other world political events haven't calmed investors nerves either with energy prices re-asserting themselves and a great deal of angst present with companies we have spoken to around rising energy prices for consumers.

Net Tangible Assets (NTA)[1]

Pre-Tax NTA[2]

$2.070

Post-Tax NTA[3]

$2.139

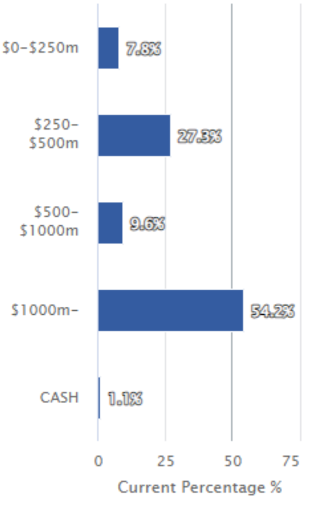
1 NTA calculations exclude Deferred Tax Assets relating to capitalised issue cost related balances and income tax losses.
2 Pre-tax NTA includes tax on realised gains/losses and other earnings, but excludes any provisions for tax on unrealised gains/losses.
3 Post-tax NTA includes tax on realised and unrealised gains/losses and other earnings.

Top 10 Holdings

Company Name	% Portfolio
InvoCare Limited	5.4%
Monadelphous Group Limited	5.4%
Michael Hill International Limited	5.2%
Flight Centre Travel Group Limited	4.6%
Blackmores Limited	4.2%
IRESS Limited	4.0%
Nitro Software Limited	3.5%
INSIGNIA FINANCIAL LTD.	3.4%
Bega Cheese Limited	3.3%
Universal Store Holdings Limited	3.2%
Top 10	**42.1%**

Source: Spheria Asset Management

Market Cap Bands



Source: Spheria Asset Management

Having said this, we have to acknowledge that markets are now down broadly 20-25% year to date with smaller and microcaps worse affected than Australian large caps. A lot of the present risks are known to some extent – inflation, rising rates, high energy prices and macro uncertainty around the Ukrainian situation. The extreme outliers in smaller companies – the large pockets of overvaluation in speculative growth names – have largely come back down to earth. During September for example several smaller company names were suspended and subsequently removed from indices. These stocks included AVZ Minerals (AVZ.ASX), BWX (BWX.ASX) and Firefox (FFX.ASX) which in aggregate represented close to 1.2% of the small cap index. Investors are now talking about valuation and discount rates again and a more sensible economic lens is being used to allocate capital. Whilst the macro environment continues to present risks, it is worth remembering that fortune favours the intelligently brave and much better opportunities appear at times like these than when there is a positive consensus around buying an over-promoted growth market.

With that in mind, and a degree of conservatism in our forecasts, we continue to look for the best opportunities across the market and to try to sensibly rotate our portfolios into opportunities that we either thought were too expensive before and / or had material earnings risks.

Major Contributors for the Month

Positive performance contributions from companies owned included:

Michael Hill International (MHJ.ASX) – rose 7.5% in September, in contrast to the broader market which fell during the month. MHJ announced their annual results at the end of August and as has been the trend for the last two years, continue to drive earnings growth ahead of revenue, seeing margins expand. Despite a significant number of store days being lost due to COVID-19 lockdowns at the start of the financial year, group revenue grew 7% and EBIT grew 11.1%. This was driven by continued store productivity, growth in digital, and a 76% growth in loyalty members. The balance sheet finished the financial year with ~$96m of net cash and as such the company announced a share buy-back of up to 5% of the company's issued capital to deliver further earnings accretion to long term shareholders. Despite the impressive results and strong balance sheet, the company is trading on ~4x EV/EBIT and yielding over 7%.

Monadelphous (MND.ASX) – share price increased 1.1% in September, continuing to trend higher after a solid return in August after the company announced their FY22 results. As discussed in the last commentary, the Maintenance and Industrial Services division grew revenues by 19% and now represents over 60% of group revenue. We view this transformation favourably as it is less risky than construction related revenue and more recurring in nature. We consider Monadelphous as one of the highest quality mining services businesses in Australia and is a second order beneficiary of the capex mining cycle. The stock has $180m of net cash and trading on an EV/EBIT multiple of around 10x.

Nitro Software (NTO.ASX) – remained flat over the month but outperformed as the market fell in September. As discussed in last month's commentary, NTO received an off-market offer by a private equity firm Potentia Capital at $1.58 which saw the share price hover around these levels over the month. Despite Nitro rejecting the Indicative Proposal on the belief the offer undervalues the company investors will await to see if another bid is proposed. We continue to remain supporters of the company as we believe the product (PDF productivity and e signing software) is excellent, the client base is strong, and the product retention is high. We are supportive of NTO's earlier pivot to profitability and positive cashflow over high revenue growth at disproportionate cost. Our sense is the current offer is too low given the recurring nature of most of the company's revenue, the growth potential and a well-funded balance sheet. At an EV/Sales multiple of around 4x it remains lowly priced for a global growing SaaS business.

Major Detractors for the Month

Flight Centre (FLT.ASX) – fell 20% in September on no news. We believe the share price movement over the month was more a reflection of the macroeconomic environment than stock fundamentals. Consumer discretionary names over the last few months have been heavily impacted on the view that higher interest rates and inflation will crimp consumer spending. Whilst we do agree than some consumer discretionary names, particularly those that benefited from COVID-19, may come under pressure we don't feel the same applies to travel. Consumers have been unable to travel for over two years because of COVID-19 and pent-up demand is extremely strong. As Flight Centre announced at their full year result in August, corporate travel TTV is now trading above pre-COVID and leisure close to 70% of pre-COVID levels. As most economies (except for China) are now open we see the consumers wallet being over indexed to travel and FLT being a key beneficiary of this. The business has now been generating positive cash flow since March 2022 and is trading on ~8x pre-COVID EV/cash EBIT.

New Hope Coal (NHC.ASX, Not Owned) – which rallied strongly (+28%) during the month following the release of their FY22 result. Similar to other coal names, NHC has benefited from the record coal prices in the last 12 months, with the company recording record earnings and cash flow as a result. The industry has been underinvested and has seen coal companies like NHC benefit from this. We have avoided owning names like New Hope Coal due to ESG concerns and at this stage of the cycle are weary of jumping into names where commodity prices are at all-time highs and any reversal could see shares linked to the commodity fall too.

Iress (IRE.ASX) – fell 21% in September, as the company downgraded guidance at the end of the month. The announcement came as a surprise to the market, as the company had only confirmed guidance six weeks earlier when they announced their 1H22 result. The company's NPAT is expected to be in the range of $54-$58m, which is a 17% downgrade to the midpoint of their original guidance in August. The company flagged macro conditions, delays to conversion of new sales opportunities and higher technology costs driven by the US Dollar strength as the drivers of the downgrade. Whilst the announcement was disappointing, we feel the impacts are temporary with macro headwinds causing a lengthening of the sales pipeline and increased costs likely to normalise in the medium term as inflation eases. The contra to the earnings downgrade was the announcement that Iress had secured a new agreement with Commonwealth Superannuation Corporation to adopt Iress software, Acurity, for the administration of the defined benefit scheme members. We feel this is a positive and endorses the strength of the Iress product and technology. IRE is now trading on ~15x FY23 EV/EBIT, for a SaaS business with sticky recurring revenue.

Outlook & Strategy

It's always hard to be positive when you are sitting in a morass of negativity about markets. However, most great investors have made money betting against a fearful crowd. Over time, it's been proven that it's hard to time markets as we are overly prone to emotion and secondly that there have been few places to invest that have out earned the market as an asset class. Whilst there are many likely negatives it's worth remembering that we are buying individual businesses with, in some cases, innovative and adaptive management teams who have dealt with challenging environments before. We also need to keep in mind that a lot of the de-rating of reasonable companies has now put many of the companies we own on low to mid-single digit EV/EBIT multiples. Couple this with bullet proof balance sheets and we feel comfortable that returns will reward investors over time. Finally, there is some evidence that the pent-up inflationary forces we are dealing with could abate somewhat which may ease the rise of longer-term interest rates providing the market with some respite in time.

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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