

# Spheria Australian Microcap Fund

ARSN 611 819 651 APIR WHT0066AU



## Performance as at 31<sup>st</sup> August 2021

	1m	6m	1yr	3yr p.a.	5yr p.a.	Inception p.a.#
<b>Fund^</b>	<b>5.3%</b>	<b>21.4%</b>	<b>67.6%</b>	<b>16.2%</b>	<b>14.5%</b>	<b>16.3%</b>
<i>Benchmark*</i>	5.0%	15.6%	29.5%	10.1%	11.0%	11.7%
<i>Value added</i>	0.3%	5.8%	38.1%	6.1%	3.5%	4.5%
<i>Microcap Index **</i>	7.3%	16.3%	43.3%	19.7%	13.5%	15.2%

^ Spheria Australian Microcap Fund. Returns of the Fund are net of applicable fees, costs and taxes

\* Benchmark is the S&P/ASX Small Ordinaries Accumulation Index. All p.a. returns are annualised.

\*\* Microcap Index refers to S&P/ASX Emerging Companies Accumulation Index.

# Inception date is 16 May 2016. Past performance is not a reliable indicator of future performance.

## Commentary

The Spheria Australian Microcap Fund returned 5.3% (after fees) during the month of August, outperforming the ASX Small Ordinaries Accumulation Index by 0.3%.

## Markets

Markets locally rose strongly over August adding yet further to the stunning recovery in the small/mid-market since the lows seen in late February 2020. Performance was relatively broad based but biased to sectors enjoying strong sentiment with significant gains seen in battery materials names, biotechs and fintechs but also solid performance in REITS, many COVID-19 re-opening plays and several under-owned names that had high short interest. Gold exposures significantly underperformed as the equities followed the gold price down after a "flash crash" early in the month on fears of U.S. Federal Reserve QE tapering but failed to rise as the gold price recovered the entirety of the loss later in the month. Iron ore exposures were also significant underperformers during the month as the benchmark for iron ore fell a further 20% during the month after rolling over from record highs in July.

Retail exposures that had traded well through COVID-19 on share of wallet gains as services spending was diverted to goods spending, were amongst the laggards as the market turned its names to those who might benefit from re-opening. Companies reporting disappointing results or outlook not directly relating to COVID-19 were unsurprisingly punished with Electro Optical Systems (EOS.ASX), Starpharma (SPL.ASX), AMA Group (AMA.ASX), Synlait (SM1.ASX), Bravura Solution Ltd (BVS.ASX), Paradigm Bio (PAR.ASX), Mesoblast (MSB.ASX) and Altium (ALU.ASX) all down more than 10% for the month.

The Fund outperformed due to an overweight to re-opening names, an underweight to gold and long positions in several stocks that saw earnings upgrades (e.g., GR Engineering and Austin Engineering).

While the Fund has performed well on a relative and absolute basis and we continue to find opportunities for rotation that tick our boxes on cashflow, balance sheet strength and valuation we remain concerned about speculative excess in certain areas of the market. High momentum names

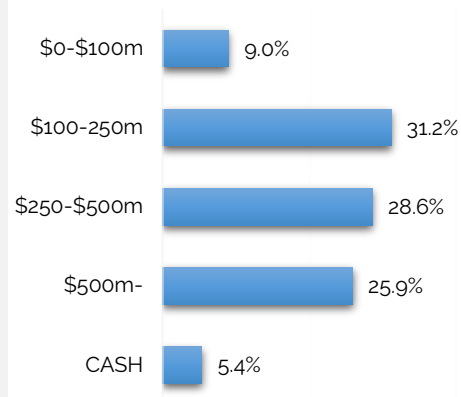
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## Top 5 Holdings

Company Name	% Portfolio
Class Limited	5.1
Supply Network	4.9
Vista Group Int Ltd	4.6
Michael Hill Int	4.1
Seven West Media Ltd	4.1
<b>Top 5</b>	<b>22.9</b>

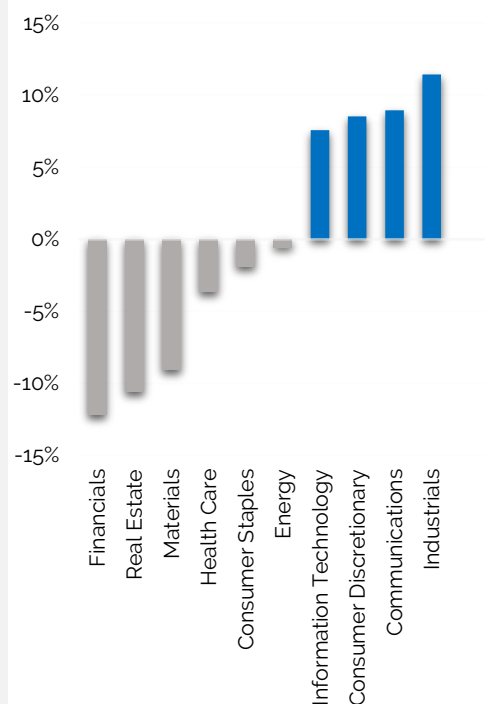
Source: Spheria Asset Management

## Market Cap Bands



Source: Spheria Asset Management

## Active Sector Exposure



Source: Spheria Asset Management

exposed to popular thematics in the battery materials, fintech and biotech names in particular appear to have become completely detached from any semblance of intrinsic value. We will continue to avoid these names and instead focus our attention on the quiet achievers that generate solid cashflows at decent valuations and are being ignored by the crowd. We believe the market remains conducive to elevated levels of M&A activity that have historically buoyed our returns given our preference for undervalued, cash generative businesses with underleveraged balance sheets sees our portfolio companies being the target of this activity more commonly than the average index constituent.

## Major Contributors for the Month

**Austin Engineering (ANG.ASX)** was the largest contributor as the stock rallied 30% during the month following the delivery of an inline result and as the new Managing Director outlined his strategy to materially improve profitability. The group has already implemented a c\$10m cost out process and committed to a \$6.5m investment to overhaul the manufacturing process to significantly improve labour productivity. We believe even assuming only a small fraction of the expected benefits flow through to the bottom line would suggest Austin trades on a mid to low single digit EBIT multiple.

**Class (CL1.ASX)** contributed after delivering a marginally better than expected result that saw it return 16% after it had badly lagged the market since delivering an inline 1H21 result. We still see the specialist provider of cloud-based accounting, investment reporting, document and corporate compliance software as well placed to deliver double digit earnings growth and continue to believe it screens well compared to other software exposures.

**GR Engineering (GNG.ASX)** was the next largest contributor as the specialist Engineering, Procurement and Construction contractor of mineral processing plants delivered a result above expectations and provided outlook commentary that saw solid upgrades to consensus. With a solidly net cash balance sheet and a mid-single digit EBIT multiple we still see upside in the name given strong tailwinds in its clients' commodity exposures and its excellent record of delivering processing plants on time and on budget.

## Major Detractors for the Month

**Vita Group (VTG.ASX)** was the largest detractor as it returned -10% over the month after reporting a tough 2H21 result driven by COVID-19 social distancing restrictions. Vita has succeeded historically due to exceptionally strong sales skills making its consultants better able to drive profitability from stores than other Telstra store franchisees. The social distancing restrictions in place and lower mall traffic is impacting on Vita's ability to upsell customers into better margin products and services. The market may also have been disappointed that the group was not able to finalise the sale of its franchised business back to Telstra by result date in-line with Telstra's stated intention. We continue to see Vita as undervalued given its ownership of an emerging skin health clinic business (Artisan) with \$30m of annualised sales, \$31m in net cash, \$75m in franking credits and a Telstra franchised business that we believe is worth well more than the implied valuation derived from the current market capitalisation.

**Pilbara Minerals (PLS.ASX - Not owned)** detracted as the stock rose another 26% over the month as the benchmark lithium carbonate price in China rallied 32% over the same period. The stock had already run hard previously however with the cumulative stock return over 80% since end May while the lithium price is up 38% cumulatively. Trading at more than 10x NTA for a producer that has shown itself to be well outside the bottom quartile of cost producers (retained earnings are negative \$254m post the last commodity cycle) we feel the stock has gotten well ahead of the fundamentals, particularly in light of an obvious and very large industry supply response. Interestingly we note that fellow lithium producer Mineral Resources (MIN.ASX) sold its entire 5.4% holding in PLS.ASX in early September.

**Michael Hill International (MHJ.ASX)** detracted upon returning a modest -2% in a market that was strongly up for the month. The retailer of fine jewellery across Australia, New Zealand and Canada reported a hugely improved

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FY21 result vs. FY20 with \$70m of EBIT (despite thousands of lost store trading days due to COVID-19) and a net cash balance of \$70m. We believe this to be the fruits of a comprehensive overhaul of the business over the last two years by MD Daniel Bracken. While the delta outbreaks in NSW and Victoria are costing the company millions a month, the result also showed the benefit the group should enjoy once these states come out of lockdown, with like for like sales in July and August in the Canadian network (shut for months on end in the 2H21 period) running at +24%. On less than 4x our estimate of sustainable EBIT we see Michael Hill as the cheapest retail exposure on the ASX.

## Outlook & Strategy

While we never seriously doubted that humanity would find a way through the challenges of COVID-19, we are even more firmly of the view that the Australian economy will see out the delta outbreaks in New South Wales and Victoria with vaccination rates rising rapidly and the international experience suggesting that the current crop of vaccines are sufficient to keep morbidity at acceptable levels (even if booster doses like those being rolled out in Israel are eventually required). Our philosophy of buying cash generative business models, with solid balance sheets and returns and sensible valuations remains unchanged despite the challenges of managing money against a benchmark increasingly driven by retail, quantitative and index investors. We feel conditions remain conducive to high levels of corporate activity given plentiful liquidity, procyclical boards and record levels of private equity dry powder. We believe this will continue to present a tailwind for our returns given our predilection for undervalued, cash generative businesses with modestly or underleveraged balance sheets. We will continue to avoid names trading well above their intrinsic value and stick with our disciplined investment approach that is driven by valuation fundamentals.

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	Spheria Australian Microcap Fund	Platform availability
Benchmark (universe)	S&P/ASX Small Ordinaries Accumulation Index	ASGARD
Investment objective	The Fund aims to outperform the S&P/ASX Small Ordinaries Accumulation Index over the medium to long term.	BT Panorama
Investing universe	Primarily listed companies outside the top ASX 250 listed companies by market capitalisation and companies listed on the New Zealand Stock Exchange with an equivalent market capitalisation	BT Wrap
Distributions	Annually	HUB24
Fees	1.35% p.a. management fee & 20% performance fee of the Fund's excess return versus its benchmark, net of the management fee	IOOF Portfolio Service
Cash	<ul style="list-style-type: none"> <li>Up to 20% cash</li> <li>Typically 5% - 10%</li> </ul>	Macquarie Wrap
Expected turnover	20-40%	mFund
Style	Long only	MLC Wrap / Navigator
APIR	WHT0066AU	Netwealth
Minimum Initial Investment	\$100,000	One Vue
		uXchange

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