Spheria Australian Smaller Companies Fund

ARSN 117 083 762 | APIR WHT0008AU | mFund SPM02

Performance as at 31st October 2021

	1 Month	3 Months	1 Year	3 Years p.a.	5 Years p.a.	Inception p.a[3]
Fund[1]	2.8%	8.1%	46.3%	16.3%	14.4%	13.7%
Benchmark[2]	0.9%	3.7%	31.0%	13.5%	11.5%	10.4%
Difference	1.9%	4.4%	15.3%	2.8%	2.9%	3.3%

1 Spheria Australian Smaller Companies Fund. Returns of the Fund are net of applicable fees, costs and taxes.
2 Benchmark is the S&P/ASX Small Ordinaries Accumulation Index.
3 Inception date of the current investment strategy is 11th July 2016. The Fund was established in June 2005. Past performance is not a reliable indicator of future performance. All p.a. returns are annualised.

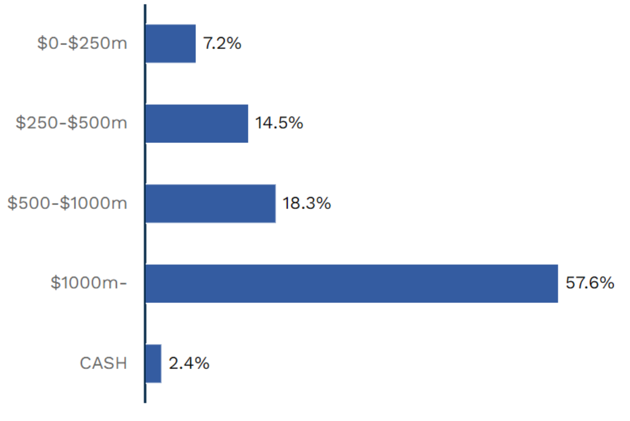
Overall Commentary

The Spheria Australian Smaller Companies Fund returned 2.8% (after fees) during the month of October, outperforming the ASX Small Ordinaries Accumulation Index by 1.9%

Top 5 Holdings

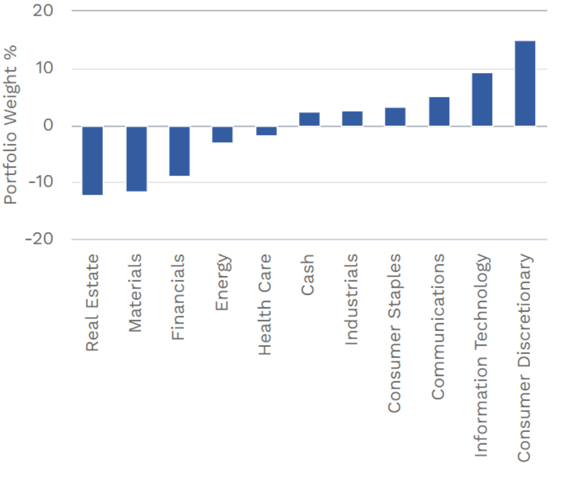
Company Name	% Portfolio
Flight Centre Travel Group Limited	5.1
Class Limited	4.5
IRESS Limited	3.9
Blackmores Limited	3.7
IOOF Holdings Limited	3.5
Top 5	**20.7**

Market Cap Bands



Source: Spheria Asset Management

Active Sector Exposure



Source: Spheria Asset Management

Markets

The local small and midcap indices were modestly higher over the month as market participants looked through increasing noise around inflation and the implications for monetary policy. This was despite some rather wild moves in shorter dated debt – the local three-year bond yield rose a staggering 90bps over the month for instance – as markets began pricing in the inevitability of some rate rises by Central Banks given the inflation being seen globally. Unsurprisingly, there was significant dispersion in performance during the month. Gold equities significantly outperformed as market participants finally went bargain hunting in the space following material underperformance in prior months. This more positive sentiment was helped by a US dollar gold price that rose 1.5% over the month despite the back up in bond yields as long-term real interest rates (as measured by 10-year US Treasury inflation protected security yields) went deeper into negative territory. Battery material names again meaningfully outperformed as benchmark lithium, nickel and cobalt prices surged higher.

Amongst the losers during the month were coal stocks as the benchmark Newcastle thermal coal price halved during October following Chinese Government intervention in the market to stem rampant speculation and hoarding. These were joined by a motley crew of stocks that put out disappointing updates or had negative newsflow during the month (e.g., Marley Spoon (MMM.ASX, -44%), Strike Energy (STK.ASX, -36%), EML Payments (EML.ASX, -27%), Starpharma (SPL.ASX, -20%), Codan (CDA.ASX, -20%) and PointsBet Holdings (PBH.ASX, -19%). Concerningly there were several companies that cited rising input costs as a reason for forecast margin contraction (e.g., Pact Group (PGH.ASX) and Marley Spoon (MMM.ASX).

M&A activity was once again fairly elevated during the month with HUB24 (HUB.ASX) bidding for Class (CL1.ASX) at a 72% premium to last, Senex (SXY.ASX) receiving an approach from POSCO International of South Korea and Gold Road (GOR.ASX) and Ramelius (RMS.ASX) engaging in a bidding war for gold junior Apollo Consolidated (AOP.ASX).

The Fund outperformed due to an overweight to Class (CL1.ASX) and low multiple media, consumer discretionary and mining service names which were re-rated during the month, alongside underweights to several large index constituents that put out disappointing updates during the month.

Major Contributors for the Month

Class (CL1.ASX) was the largest contributor after returning 70% during the month upon entering into an agreed scheme of arrangement which will see it purchased by HUB24 (HUB.ASX) for a combination of cash and scrip. We had been perplexed at the unwillingness of the market to reward Class for re-invigorating the business in recent times and so are not entirely surprised that a corporate has instead recognised the value in the franchise.

HT&E (HT1.ASX) contributed as the stock rose 18% after settling a tax dispute with the ATO that the latter first raised in an assessment in 2018. Whilst the settlement will see a cash payment of $20.3m to the ATO and the ATO keep a $50.7m deposit paid earlier by HT&E, we and evidently most of the market had assumed the company would need to pay the full $195m of the assessment ($102.5m in tax claimed, $49m of penalties and interest of $43m). HT&E also disposed of its holding in Ooh Media (OML.ASX) acquired during the pandemic for $49m, banking a tidy $31m profit. Post period end HT&E entered into an agreement to purchase Grant Broadcasting, the second largest regional radio operator in the country. The deal is materially EPS accretive due to the re-leveraging of the balance sheet but we think the business only needs to deliver a fraction of its estimated $20m in revenue synergies to also be value accretive.

Michael Hill International (MHJ.ASX) contributed as the stock rose 12% during the month following the release of its quarterly sales update. Despite losing 20% of the quarter's store trading days relative to last year, total sales were only down 10% as the business reported 16% LFL sales (including very strong online sales). Pleasingly GP margins were reported as being up 100-200bps in all territories, after being up a similar amount last year. With the added benefit of Government wage support in Australia and New Zealand during the lockdowns (and some modest landlord concessions) this will help to limit the earnings hole the delta outbreak will cause Michael Hill in 1H22. The Canadian experience after their lockdown ended in early July is encouraging with the business generating 18% LFL sales in this territory. Sales were up 26% 1Q22 vs 1Q20 (pre-COVID-19). We feel the business is very well placed for the key Xmas trading season in 2Q22 and still see the stock trading on a mid-single digit next twelve months EBIT multiple.

Major Detractors for the Month

Flight Centre (FLT.ASX) was the largest detractor as the stock retraced 7% after a very strong performance over September. We continue to like the business and believe the market is underestimating the potential for the leisure business in particular to return to robust levels of profitability as the world exits the pandemic. Flight Centre has more than halved the fixed cost base of its leisure operations but retained the capacity for handling very large volumes through its online brands and through home based independent contractor travel agents.

Adbri (ABC.ASX) detracted upon retracing 8% over the month on no significant news. We continue to like the producer of cement, lime, concrete, and aggregates as we believe the market is not giving it credit for the likelihood that it replaces lost lime revenue and earnings with new Western Australian mining project clients.

Liontown Resources (LTR.ASX – not owned) detracted as the Western Australian project developer of lithium spodumene soared 32% over the month to trade at a market capitalisation (and EV) of over A$3.6bn. We struggle to reconcile the valuation given the company has had to assume a highly optimistic US$1,392 per tonne 10-year weighted spodumene price to generate its recently released A$4.2bn NPV8 for its flagship Kathleen Valley project and aims to be in production in the first half of CY2024. We note current mineral producers and developers in Western Australia continue to report strong cost inflation due to COVID-19 induced labour shortages and sharply higher steel and energy prices. We are generally cautious the lithium sector as previous cycles have shown spodumene producers have responded to incentive pricing much faster than market forecasters have anticipated, albeit typically with higher capex and opex costs than investors expected. Additionally, we now see some risk to the aggressive demand growth forecasts for lithium-ion batteries widely relied on by the industry given battery producers are now raising prices materially to account for surging cathode, anode, energy, and labour costs. For instance, BYD of China raised prices 20% only last week. Further, we see a risk that this commodity price cycle in lithium could help firmly establish sodium ion batteries in the energy storage market in particular given surging spot lithium carbonate and hydroxide prices. We note that the world's number one battery producer CATL, recently demonstrated a commercial sodium ion battery with impressive energy density and cycle life. They touted the chemistry's strong cold weather capacity performance and very rapid charging capability as enabling hybrid lithium ion/sodium ion battery packs for EV applications also.

Outlook & Strategy

The market is at an interesting inflection point with rising costs pressuring business models without real pricing power and the prospect of rising interest rates (at least nominal rates) potentially leading to a market less willing to back cash burning concept stocks. While the COVID-19 pandemic is not over, the continued rollout of vaccines and the development of effective anti-virals makes us more confident that services will trend back towards their historical share of consumption and GDP. We therefore remain constructive towards sectors hurt by the pandemic and wary of capitalising profits that have been boosted above a sustainable baseline by COVID-19 induced behaviours. While we would expect to see higher rates at some time in the not-too-distant future, boards are emboldened, balance sheets are flush with cash and both equity and debt capital remains cheap and readily available. We therefore expect continued elevated M&A activity that has historically buoyed our returns given our preference for cash generative business models that are typically both undervalued and underleveraged. There are pockets of the market (particularly exposed to popular thematics) that appear well and truly overheated, with the battery materials space in particular looking frothy. We will continue to avoid these areas. Pleasingly we continue to be presented with opportunities for rotation into names that tick our boxes on cashflow, balance sheet strength and valuation.

Platform Availability List

If a fund is not available on your preferred platform, please contact us. Please check with your platform for minimum investment requirements and fees.

- AMP North
- Asgard
- BT Panorama
- BT Wrap
- CFS FirstWrap
- DPM
- FNZ Group
- HUB24
- IOOF Portfolio Service
- IOOF Pursuit
- IOOF Wrap
- Macquarie Wrap
- Mason Stevens
- MLC Navigator
- MLC Wrap
- MLC Wealth Administration
- Netwealth
- OneVue
- PowerWrap
- Praemium
- Premium Choice
- SimpleWrap
- Wealth02 uXchange

Spheria Australian Smaller Companies Fund	
Benchmark	S&P/ASX Small Ordinaries Accumulation Index
Investment Objective	Outperform the S&P/ASX Small Ordinaries Accumulation Index over the medium to long term
Investing Universe	Primarily listed companies outside the top ASX 100 listed companies by market capitalisation and companies listed on the New Zealand Stock Exchange with an equivalent market capitalisation
Holdings	Generally 20-65 stocks
Distributions	Half-Yearly
Fees	1.10% p.a. Management fee & 20% performance fee of the Fund's excess return versus its benchmark, net of management fee.
Cash	Up to 20% cash, typically 5% - 10%
Expected Turnover	30% - 40%
Style	Long only
APIR	WHT0008AU
Minimum Initial Investment	$25,000

Spheria Australian Smaller Companies Fund

ARSN 117 083 762 | APIR WHT0008AU | mFund SPM02

Fund Ratings

Further Information

For more information, please contact Pinnacle Investment Management Limited on 1300 010 311 or email distribution@pinnacleinvestment.com

Disclaimer

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