Spheria Opportunities Fund

ARSN 144 032 431 APIR WHT0025AU

Spheria ASSET MANAGEMENT

Performance as at 31st October 2018

	1m	FYTD	1yr	2yr p.a.	Inception p.a.#
Fund ^	**-5.8%**	**-2.8%**	**9.8%**	**13.9%**	**11.7%**
*Benchmark**	*-8.4%*	*-6.2%*	*3.5%*	*10.6%*	*9.1%*
Value added	2.6%	3.4%	6.3%	3.3%	2.6%

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

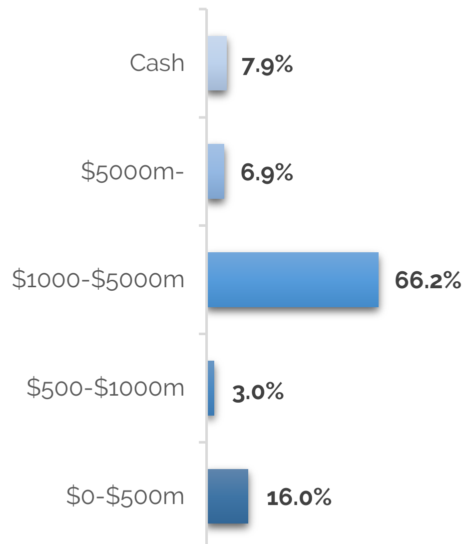
* Benchmark is the S&P/ASX Mid-Small Accumulation Index.

Inception date of the current investment strategy is 11th July 2016. The Fund was established in June 2010. Past performance is not a reliable indicator of future performance.

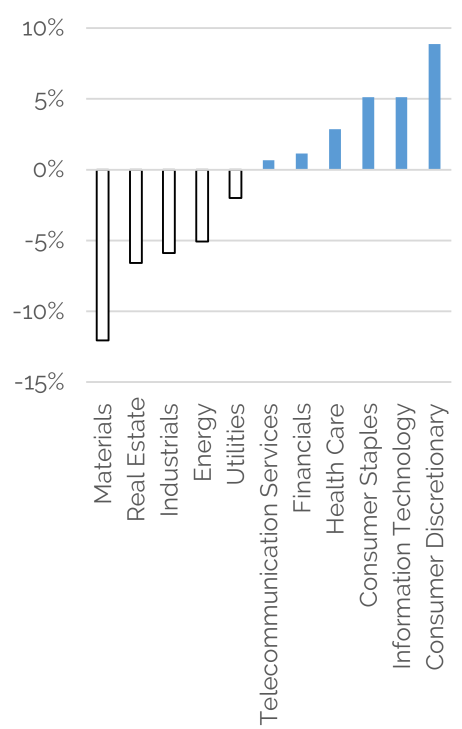
Top 5 Holdings

Company Name	% Portfolio
Healthscope Limited	7.0
Bega Cheese Ltd	5.9
Navitas Limited	5.7
Fletcher Building	4.8
Platinum Asset	4.4
Top 5	**27.8**

Market Cap Bands



Active Sector Exposure



Commentary

The Spheria Opportunities Fund decreased 5.8% in October outperforming the Benchmark by 2.6%. For the year ending 31st October 2018, the Fund outperformed by 6.3%.

The Australian sharemarket fell considerably in October, falling in sympathy with a US market that is finally showing signs of cracking under the pressure that has afflicted emerging markets since the beginning of the year. The Australian small to mid-sized companies space had seemingly been immune to the volatility until October, with a select cohort of market darling stocks driving the index higher, effectively camouflaging broader weakness. Clearly, there is a linkage between these darlings and the US market, particularly names in the technology sector. We believe the fundamental link is tenuous, however, with the majority of small cap and mid-cap market darlings in Australia and New Zealand a function of a narrow universe and excess demand for anything resembling growth. In most instances the growth is purely at the top line and at the expense of cash flow and returns. These companies generally need third party funding to continue their strategies which is easy to come by when there is excess liquidity. With central banks now tightening the screws it may mean the fairy tale is coming to an end. We wonder if this will see a changing of the guard in the next few years with many a maligned company finding greater favour. In our view, that is where the value lies with recent takeover activity lending support to this thesis.

A review of the **index movements** for the month is telling as the **largest decliners** were the **hyper-popular** names of the last couple of years. We share colour on some of the more notable decliners below. Whether by good fortune or good management we did **not** own any of the following companies:

- Largest decliner was Kogan (KGN) which fell 50% after a significant profit warning. Its share price had ridden the Amazon wave over the last couple of years, only to be dumped in the last few months by management and now by its investors. It is down over 70% from peak to trough.
- WPP is a media agency group that also had a profit warning due to structural and cyclical issues. Its share price fell 35% and its long serving CEO announced his intention to retire.
- Corporate Travel (CTD) declined 34% after the release of a critical research report from a hedge fund that had shorted the stock. Regardless of the substance of the report we expect travel related companies to struggle in the next few years as technology and macro-economic factors affect demand for their services.

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- Afterpay (APT) fell 30% after a spectacular re-rating in the last couple of years driven by strong uptake of merchants and consumers for its layby product. Given it earns very little and has an extremely high valuation, a lot can go wrong and just about everything has to go right to justify its rating.
- Domain (DGH) fell 29% after a major profit warning due to weakness in its print advertising and digital display, which is a function of a deteriorating housing market thus illustrating the cyclicality of the business. It is not priced for cyclicality given its high rating nor for structural headwinds facing its print advertising exposure.

The **top ten performers for the month in the index** included a number of gold companies and a couple of companies subject to takeover proposals including MYOB (MYO), Healthscope (HSO) and Navitas (NVT).

As most are aware **we are a large shareholder in NVT**. We were not surprised by the takeover interest given it is a global leader in its field and is a fantastic cash flow generator. The derating witnessed in recent years was due to the loss of three profitable contracts. In spite of this earnings headwind the company has grown earnings on an underlying basis and is one of the few truly global growth businesses in the Australian market. We also believe there is a significant cost out story and potential to streamline the group with SAE generating EBIT losses in several regions. The divestment or exit of SAE in those markets would therefore be addition by subtraction for NVT. Our fundamental valuation is slightly higher than the takeover offer price of $5.50 per share, and therefore we believe the bidding consortium should pay more for control. We are surprised the share price is trading at a material discount to the bid given the valuation appeal and the fact an insider is party to the deal.

The Fund holds a significant position in Healthscope (HSO) which saw the previously spurned suitor return with a repeat takeover proposal. It appears the consortium has impeccable timing, with institutional shareholders bowling over themselves in the stampede for the exit. Whilst there are short to medium term headwinds for HSO and the private hospital sector, we note that HSO is coming to the end of a large capital expenditure program that will generate a return. While this will be low in the early years, the current return on that capital investment program is zero which means it's only getting better. Furthermore, the company will be awash in cash soon with the receipt of > $400m from the NSW Government for the Northern Beaches Public Hospital, in addition to the proceeds from the sale of its Asian pathology division for a neat price ($279m), when considering regulatory issues in Malaysia. We feel the company is at an inflection point, to give up on it now seems bizarre given the long-term infrastructure like nature of its key assets, which are near impossible to replicate in high density metropolitan catchments. It has been nearly 20 years since Ramsay Healthcare (RHC) faced similar criticism levelled at its North Shore Private Hospital, only for it to become a crown jewel for the company.

Outside of takeovers, there was a bright spot in the Fund with Vita Group (VTG) significantly upgrading its profit guidance with 1H19 EBIT expected to grow 15 to 24%. We believe this illustrates an unappreciated strength of VTG's business in that its store network is skewed to regional areas where Telstra's network is unrivalled. Unbelievably, VTG is trading on only 3.5x free cash flow, which equates to a three-year and a half year payback for shareholders assuming no growth. With Telstra completing its 5G rollout in the next 12-18 months there will be a significant upgrade cycle for handsets, which means the assumption of "no growth" could be seriously conservative. The consumer obsession with their handset is unlikely to subside anytime soon. We believe VTG is well positioned to benefit from this trend.

As noted earlier, it appears the divergence in valuations between the market darlings and the more maligned segments of the small to mid-cap space is now converging with the catalyst being takeover activity amongst the lower rated companies. Recent announced takeovers (in the small to mid-sized market) include Scottish Pacific, MYOB, Navitas, Healthscope, Watpac, Steel & Tube (NZ listed) and Fairfax. Whilst not specifically positioning for takeovers our work around industry structure, valuation and a focus on cash flow generative businesses means this is a by-product of our investment process. We suspect there will be more takeover activity in our portfolios, albeit tighter funding markets may eventually stymie that.

We remain positive on the outlook for our portfolios as valuations are appealing. Furthermore, our companies have relatively strong balance sheets and robust cash flows. A downturn will affect them, but they should come out the other side stronger by taking market share from weakened competitors. Our quality filters ensure that the companies we invest in have genuine cash flows that match earnings, we avoid companies whose strategy is to recklessly acquire growth. We believe these kinds of companies will come unstuck in the next few years as liquidity recedes. The market is brutal to even the most celebrated companies when the integrity of the business strategy and financial reports comes into question.

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	Spheria Opportunities Fund
Benchmark (universe)	S&P/ASX Mid-Small Accumulation Index
Investment objective	The Fund aims to outperform the S&P/ASX Mid-Small Accumulation Index over the medium to long term
Investing universe	Primarily listed companies outside the top 50 ASX listed companies by market capitalisation and companies listed on the New Zealand Stock Exchange with an equivalent market capitalisation
Distributions	Half yearly
Fees	0.99% p.a. management fee & 15% performance fee of the Fund's excess return versus its benchmark, net of the management fee
Cash	• Up to 20% cash • Typically 5% - 10%
Expected turnover	30-40%
Style	Long only, risk aware
APIR	WHT0025AU
Minimum Investment	$25,000