

Investment Update

As at 31st December 2018



Spheria Emerging Companies Limited
ACN 621 402 588

Pre-tax net tangible assets⁴
\$1.841

Company⁷ performance
(since inception)
-6.2%

Company Facts

Investment Manager	Spheria Asset Management Pty Limited
ASX Code	SEC
Share price	\$1.73
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	\$115m

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 5.1% during December. This represented underperformance of 0.9% compared to the benchmark S&P/ASX Small Ordinaries Accumulation Index which declined by 4.2%.

The small cap index fell sharply in the second half of the year with very little discrimination. Several of our larger positions were subject to takeovers including Navitas (NVT), TradeMe (TME), Sigma Health (SIG) and Greencross (GXL). Post balance date we note that Healius (HLS, formerly Primary Health Care) also announced a takeover bid from its major shareholder, Jangho Hong Kong. At this stage, it appears at least three of these deals will complete being NVT, TME and GXL. There is still doubt around SIG and HLS. The SIG takeover is at risk given the combined market share of the bidder (API) and SIG in the pharmaceutical wholesaling market, and the fact a similar merger was declined by the Australian Consumer Competition Commission (ACCC) in 2002. However, a lot has changed since then with Chemist Warehouse's increased dominance structurally changing industry dynamics and PBS reforms crippling industry returns, such that a two-player market might be necessary to generate an adequate return on capital. The HLS takeover has also yet to be agreed and faces potential FIRB issues that could flip it either way. Both SIG and HLS are trading at material discounts to offer terms with greater downside risk for SIG if the deal breaks given the fundamental valuation is stretched at these levels. In saying that SIG does have competitive advantage (scale, infrastructure and CSO qualification) which might see an overseas suitor show some interest.

What went right last year? (top 3 contributors to return)

Sirtex Medical (SRX) – as most are aware SRX was the subject of a bidding war in early 2018. The lesson learnt is be greedy when others are fearful and buy when risks are skewed to the upside. In this case we bought SRX after the medical trials proved somewhat disappointing relative to extremely high expectations. When we initiated the position in the company it was essentially trading on 10x EBIT (free cash flow before interest and tax) with \$120m of net cash in the balance sheet. Our research also indicated that the take-up of the product in the key USA market would be unaffected by the weaker than expected trial results. We ended up selling before completion of the final deal given our concerns in relation to foreign review approvals for the Chinese buyer in the USA. This proved incorrect, nevertheless we nearly doubled our money on this investment.

Technology One (TNE) – had a perceived hiccup at its first half result in February 2018 that created a huge opportunity to increase our position in one of the best companies in the small cap market at a ridiculously low multiple. For whatever reason we believe the market does not adjust for cash (gearing) when valuing companies (TNE has ~\$100m of cash) hence why we focus on enterprise values, EBIT multiples and free cash flow multiples. Clearly, the market has now re-engaged with TNE and it is now trading on a much fairer multiple given the robustness of the business model.

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Commentary (continued)

HT&E (HT1) – had its “Alan Bond” moment when it sold Adshel for an incredible price. The company is now back to its core and highly cash generative radio business that has sound growth expectations through the cycle. It has paid a large fully franked dividend and is sitting on a strong cash balance with potential upside to cash levels from a resolution of a tax office dispute. Again, the market does not appear to be adjusting the valuation to reflect the cash position. HT1 will be in a position of strength, if the economy continues to deteriorate to potentially acquire assets at distressed prices.

What went wrong last year? (bottom 3 detractors to return)

Class (CL1) – suffered an extraordinary de-rate as growth in account additions slowed due to lower industry formations, and the main competitor discounting to migrate desktop customers to its new cloud-based product. Taking a step back it is hard to rationalise the de-rate given when CL1 listed it had only 90k accounts and has almost doubled that to 170k now. Given the retention rate is 99.2%, there is a highly recurring revenue stream that would be the envy of many. Unbelievably, despite nearly doubling its account base the share price is nearly back to its IPO price. That is very difficult to comprehend given the lifetime value of its customers. It feels like competitor antics and emotion are over-riding objectivity of the value equation at this point. A worst-case scenario is the industry declines as lower value accounts are closed, analogous to the ATO taking on lower value (<\$6k) inactive accounts in the industry fund sector which will impact Link Admin (LNK). Incredibly, LNK has effectively re-rated (+15x EBIT) despite the documented ~10% headwind, whilst CL1 has de-rated to 10x EBIT on a “potential” scenario. With CL1 having over \$20m of cash in the bank, we expect some form of capital management in due course. We believe the company has ample fire power to buyback a significant amount (up to \$20m) of stock and make strategic acquisitions by utilising debt. We feel the next step for the industry is consolidation (organic growth having slowed) as smaller players lacking scale cannot be making money. The situation reminds us of Technology One (TNE) in 2000-03 when it fell over 80% to an all-time low of 20cps due to a slowing of its growth during the Dot Com bust – that company is now trading at over \$6 per share.

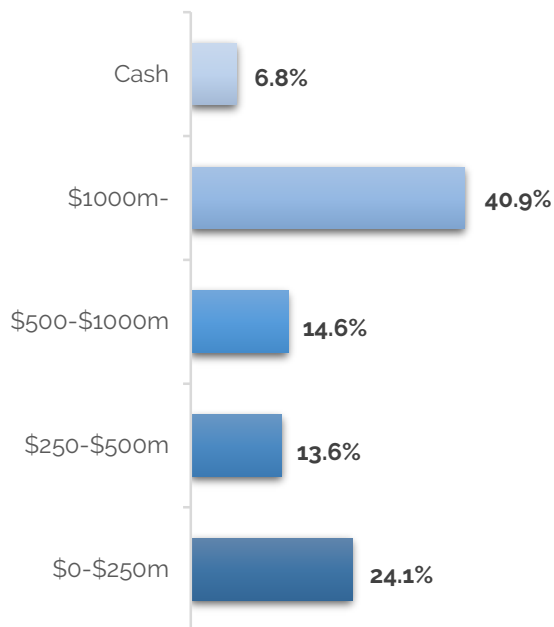
Isentia (ISD) – after multiple profit warnings investors justifiably gave up on Isentia. Investors paid the price for management's poor strategic decisions of the past, technological evolution that is structurally changing consumption and monitoring of media and the frankly irrational pricing of its main competitor. The new CEO is dramatically re-shaping the business but is constrained by a weak balance sheet (FY18 net debt of c1.8x forecast EBITDA) and an onerous copyright contract. We believe the balance sheet could be addressed expeditiously by the partial or full sale of the Asian division, albeit the suspension of the dividend ought to be sufficient to deleverage the business in time. Our understanding is that a renegotiated copyright contract (not assumed in guidance) could also be favourable for ISD and present a headwind to its key competitor, Meltwater. Regrettably aggressive price competition from Meltwater is likely to continue hence the need to re-engineer/automate the back-end systems to drive efficiency in a lower pricing environment. At c4x EV/EBITDA however the market is pricing the business for failure. We think the situation isn't so dire and hence retain our position.

Bega Cheese (BGA) – the share price was trounced in the back part of the year due to difficult conditions in the Australian dairy industry that resulted in a profit downgrade in December. The severe drought has reduced overall milk supply putting upward pressure on the farm gate milk price (a key input for BGA's dairy products). We believe the retracement to be an overreaction to a temporary affliction. On a through the cycle basis we believe BGA is fundamentally inexpensive given the quality of its assets and management/board.

Top 5 Holdings

Company Name	% Portfolio
Navitas Limited	6.3
Bega Cheese Ltd	5.6
Fletcher Building	5.4
Platinum Asset	4.7
Trade Me Group	4.7
Top 5	26.7

Market Cap Bands



Net Tangible Assets (NTA)³

Pre-tax NTA⁴	\$1.841
Post-tax NTA⁵	\$1.926

³ NTA calculations exclude Deferred Tax Assets relating to capitalised issue cost related balances and carried forward tax losses of \$0.002 per share.

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

⁵ Post-tax NTA includes tax on realised and unrealised gains and other earnings

Performance as at 31st December 2018

	1m	3m	6m	1 yr	Inception ⁶
Company⁷	-5.1%	-12.7%	-10.7%	-9.1%	-6.2%
Benchmark⁸	-4.2%	-13.7%	-12.7%	-8.7%	-5.5%

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

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

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