Spheria Australian Microcap Fund

ARSN 611 819 651 APIR WHT0066AU

Performance as at 31st December 2018

	1m	FYTD	1yr	2yr p.a.	Inception p.a.#
Fund^	**-5.0%**	**-11.1%**	**-13.6%**	**3.6%**	**8.0%**
*Benchmark**	*-4.2%*	*-12.7%*	*-8.7%*	*4.7%*	*5.8%*
Value added	-0.8%	1.7%	-4.9%	-1.1%	2.2%
*Microcap Index ***	*-3.9%*	*-18.5%*	*-19.9%*	*-3.0%*	*1.1%*

^ 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.

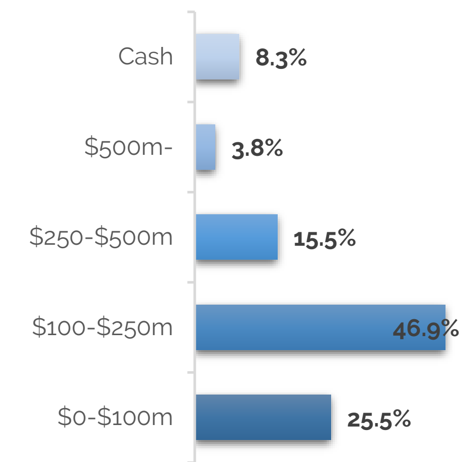
** Microcap Index refers to S&P/ASX Emerging Companies Accumulation Index.

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

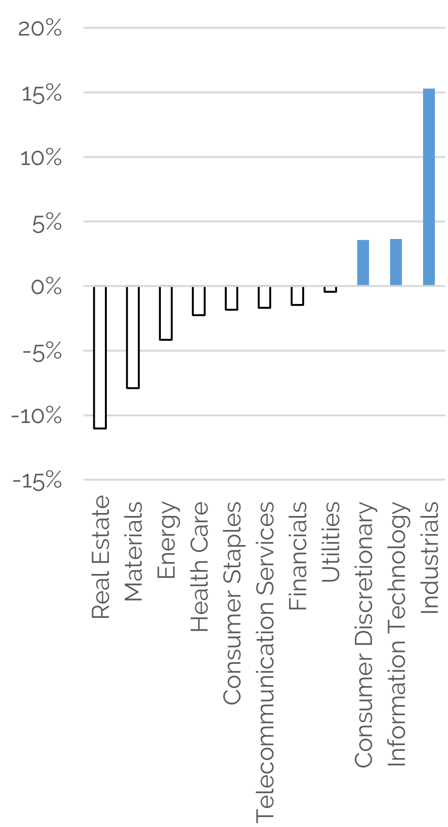
Top 5 Holdings

Company Name	% Portfolio
A2B Australia Ltd	5.3
Class Limited	4.8
Vita Group Ltd	4.0
City Chic Collective	3.7
Mount Gibson Iron	3.7
Top 5	**21.4**

Market Cap Bands



Active Sector Exposure



Commentary

The Spheria Australian Microcap Fund decreased 5.0% in December, underperforming the Benchmark by 0.8%. For the year ending 31st December 2018, the fund underperformed by 4.9%.

It was a difficult year for the fund but even more so for the microcap universe. The better proxy for the latter being the S&P/ASX Emerging Companies Accumulation Index, which fell nearly 20%. The benchmark we use is essentially a small cap index - which given the market cap ceiling of A$500m for an individual holding in the fund – means we can invest in < 13% of the index, making it a poor comparison. Nonetheless, there is never a perfect benchmark and we acknowledge that mistakes were made. Ironically, we believe the outlook for this fund has improved dramatically given the sharp decline in valuation multiples and the abysmally low expectations the market has for anything microcap. Compare this to one or two years ago when both valuations and earnings expectations were nothing short of exuberant, and you can understand the rationale behind our contrarian stance. It is nigh impossible to predict the catalyst for the turnaround, but we can hazard a guess that it will be led by takeover activity amongst our more beaten up names. This same dynamic buoyed performance in Spheria Australian Smaller Companies strategy last year. Regardless, we are not banking on this happening, and remain very comfortable with the medium to long term prospects for businesses that comprise the portfolio.

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

Mount Gibson Iron (MGX) – MGX recovered strongly on the back of a strong iron ore price and increased confidence in the Koolan Island restart. It was only a few years ago the company was written off when it was trading sub 20c versus its cash backing at the time of approximately 30c. Cash is higher now at about 40cps due to cash generation from operational mines less money spent on the re-start of Koolan Island. Ore sales at Koolan are expected to commence at the end of March 2019. The mine has a six-year life, is low cost and at current iron ore prices would be worth an incremental 70cps, equating to a potential valuation > $1 per share. Investing in microcaps is never easy, MGX case in point, given it fell nearly 90% from peak to trough in 2014 to 2016. It has not been a ride for the fainthearted but

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symptomatic of the irrational behaviour that permeates this end of the market. There tends to be opportunity in times of fear and derision.

City Chic Collective (CCX) –Another recovery story where if you had bought the stock at 10c in December 2017, it went on to increase nearly 10-fold by the end of 2018. We were not that brave given there was a good chance it was headed to the administrators at that point. However, in one of the most remarkably lopsided deals we have seen in a long time, they were able to divest the weakest part of the business including > $100m p.a. of store leases for a cash payment of ~$30m. Whilst the share price rallied sharply after the deal, it was well short of our revised valuation, providing a brief opportunity to secure a large slice of the company (which we did) at an average entry price of 67cps. The share price ended the year at 98c after peaking at $1.46 after a furious rally that was not sustained (we partially sold into this rally).

A2B Australia (A2B, formerly Cabcharge) – Another one where the market reassessed prospects for the business after it was significantly oversold in 2017. Like MGX and CCX when we bought them, the balance sheet was never an issue with approximately $20m of net cash. In this case, A2B was priced for oblivion given the view that ride-sharing would annihilate the taxi industry. It appears this is not the case to date, with regulation affording taxis competitive advantages, and increasing regulatory compliance/costs and competition impacting ridesharing companies. Constructive deregulation of the Victorian taxi industry has incentivised significant taxi fleet growth in that market, with many drivers who could not afford licences now able to purchase them for just over $50 a year. This has led to more loyalty, better working hours and improved service quality. If the other States and Territories follow, a national resurgence is possible.

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

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.

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 it 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.

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Mortgage Choice (MOC) - fell due to falling industry mortgage volumes (regulatory driven credit tightening) and continued noise that broker commissions will be banned. We note that MOC's FY19 settlement guidance implies a 17% decline in settlements from the levels achieved in FY17. Remarkably MOC only saw 10% declines during the GFC, which highlights the dangerous extent of the credit contraction imposed on the Australian economy. As to potential changes to broker commissions, we note that MOC's trail book from its $55bn of loans is worth at least $1 per share in a run-off situation on a conservative basis. We believe trail commissions in the worst-case scenario would be grandfathered, otherwise, the elimination would fall straight to the bottom line of the banks (unpalatable for all stakeholders outside of the Big 4 banks!). This run-off scenario gives us great confidence that risk is skewed to the upside for MOC. On the other hand, if we assume commissions are NOT banned, we note that brokers continue to increase share given their independence, service proposition and competition they bring to the market. Without brokers (a flat fee model) we believe it will be back to the days of the Big 4 banks dominating mortgage volumes at the expense of competition. Anyone with some corporate memory will remember the gouge that occurred back then. This is hardly the outcome the government and ACCC would desire. Let's hope the financially illiterate fail in their back to the future agenda.

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	Spheria Australian Microcap Fund
Benchmark (universe)	S&P/ASX Small Ordinaries Accumulation Index
Investment objective	The Fund aims to outperform the S&P/ASX Small Ordinaries Accumulation Index over the medium to long term.
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
Distributions	Annually
Fees	1.35% p.a. management fee & 20% 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	20-40%
Style	Long only
APIR	WHT0066AU
Minimum Initial Investment	$100,000

Platform availability
ASGARD
BT Panorama
BT Wrap
HUB24
IOOF Portfolio Service
Macquarie Wrap
mFund
MLC Wrap / Navigator
Netwealth
One Vue
uXchange