Merewether Capital

31 August 2022

Investor Update

Merewether Capital Inception Fund Performance Summary (at 31 August 2022 net of fees and expenses)					
1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception* (p.a.)
5.81%	3.23%	-16.55%	-	-	-23.72%

Indicative performance is reported net of all fees and assumes reinvestment of distributions. Past performance is not a reliable indicator of future returns. * Inception Date 26 November 2021

Dear investor,

The Merewether Capital Inception Fund (the "Fund") began the month with a unit price of $0.7209 and ended the month with an indicative unit price of $0.7628 for a 5.81% return.

It was pleasing to have a strong August with most of the gains coming from the strong fundamental performance of our portfolio businesses reporting their financial results during the month.

Overall, the market still feels very jittery and unsure of which indicators to focus on. There are plenty of macroeconomic factors to suggest serious problems are coming for businesses soon, but overall it was a strong reporting season with most businesses remaining resilient and outlooks cautious yet optimistic.

August also brought some interesting acquisition activity with large private equity firms making offers for Nearmap and Nitro Software, two beaten down tech stocks. Ultimately this feels like the endgame for a few listed tech stocks who have struggled to adapt to the new paradigm of capital markets.

For many years the underlying investment thesis for many tech companies was that they were sustaining large operating losses as they invested heavily into strong unit economics. The theory was simple; invest heavily upfront, and at some unknown point in the future either scale revenues faster than the costs or wind those costs back and harvest the profits from a sticky customer base.

The problem was as capital markets dried up through the first half of the year it provided the first test to the theory and many tech companies have failed.

With the market demanding a pivot to sustainability and cash generation many companies could not comply, realising that the outsized spending had led to cultures that were difficult to change quickly. Fiscal discipline was never a consideration for executives and employees in decision making, and markets had become fixated on the high growth rates only achievable with crazy levels of sales and marketing spend. Unable or unwilling to cut costs, most of these businesses continue to be punished on the listed markets with investors not trusting the visibility to cash generation.

This creates an environment that is a perfect hunting ground for private equity. Beaten down stocks starved of capital, many with inflated cost bases that can be slashed away with some stricter decision making. Normally having companies taken over is a good outcome for investors, but for long term investors of many of these tech companies even a decent premium to today's prices will be well below the highs of 2021.

I expect we will see further acquisition activity in the tech space, however it may not be the remedy that long term investors are hoping for.

Turning to reporting season, I was extremely pleased overall with the outcomes from our portfolio companies. Most reported to the higher end of my expectations and were rewarded with share price gains. While a handful were slightly worse than hoped, there were certainly no debacles.

The highlight of the month was our holding in **PTB Group** (PTB) who announced they had received a takeover offer that valued them at a 40% premium to their last price. We held a ~3% weight in the Fund prior to the takeover so it was a pleasing outcome to see come through during the month.

Disclaimer: The material contained within this document about the Merewether Capital Inception Fund ("Fund") has been prepared and is issued by Authorised Representative No. 001292724 (Merewether Capital Management Pty Ltd) of AFSL No. 534584 (ARC Funds Operations Pty Ltd). Figures referred to in document are unaudited. The document is not intended to provide advice to investors or take into account an individual's financial circumstances or investment objectives. This is general investment advice only and does not constitute advice to any person. Neither Manager nor the Fund's trustee (Evolution Trustees Limited ACN 611 839 519, AFSL No 486217 ("Evolution")) guarantee repayment of capital or any rate of return from the Fund. Neither Evolution nor the Manager gives any representation or warranty as to the reliability, completeness or accuracy of the information contained in this document. Investors should consult their financial adviser in relation to any material within this document. Past performance is not a reliable indicator of future performance. Investors should consider any offer document of the Fund and any other material published by the Manager or Evolution in deciding whether to acquire units in the Fund. This information is available at https://www.merewethercapital.com.au/.

At the time of the announcement the price was probably fair, but later in the month PTB reported their financial results and strongly beat their prior guidance and offered a strong outlook for the business moving forward, quickly making the takeover premium look undervalued. While I would ideally like to hold and let a business like this compound into its full value, with the opportunities being thrown up in other areas of the microcap market right now I was happy to realise profits and redeploy.

I wrote about **Smart Parking** (SPZ) in my June report alongside a blog post to further flesh out the investment case. The company had provided an investor update in June with operating metrics but no financial guidance despite all the inputs required to back work the financials being provided. It created a compelling investment case for anyone willing to look at the stock and do the work as it likely confirmed another strong result coming up.

We added to our existing small position in June with the position becoming a meaningful one prior to the report, so it was pleasing to see confirmation of that strong second half as well as bullish commentary on the trading conditions so far into the new financial year. SPZ is growing strongly and with the cash it is generating has three options available to them; organic growth by winning new sites, look for strategic acquisitions or buy back their own shares. The management team has shown flawless execution for many years, and I trust them to maximise value for shareholders moving forward with those options available to them.

XRF Scientific (XRF) was another fantastic report with revenue rapidly growing in the fourth quarter after their last update back in March. The growth came from lower margin segments of the business meaning profits did not scale as quickly, but nonetheless the momentum into the new financial year from the strong fourth quarter bodes extremely well.

XRF is currently our largest position and with strong momentum and trading on about 13x this year's earnings I am comfortable with the weighting while remaining mindful of the underlying cyclicality of their mining customer base.

Another peer in the mining/heavy industry services space **Laserbond** (LBL) also reported positively, overcoming multiple headwinds to grow their profit margins. I had feared a much worse outcome back in May when the company downgraded their revenue expectations for the year from $35m to $30-31m. In fact, I trimmed our position anticipating that lower revenue combined with inflationary cost pressures from disrupted supply chains and a tight labour market would mean LBL would struggle to report profit growth.

My concern was misplaced however with the business reporting 25% revenue growth (in line with the guidance) and nearly doubling profits after adjusting for Covid benefits and a lower tax rate from the accelerated asset write-down scheme in the prior period.

Reading through the results for XRF and LBL I was reminded of something I wrote back in my February report specifically about those two businesses (given they are more cyclically exposed than many other companies in the portfolio):

"Instead, I focus on the fact both businesses are run by extremely competent management teams who have seen multiple economic cycles and are adept at managing capital allocation within them. I trust those management teams to execute their long-term growth visions while managing any short-term issues as they have consistently done since the onset of Covid."

Both LBL and XRF have had valid excuses to disappoint investors this reporting season. LBL has struggled to find skilled labour for their niche surface coating service for years which has only been exacerbated since Covid. The key input into XRF's high margin consumable product is lithium which is also seeing it's price spike to record levels.

Disclaimer: The material contained within this document about the Merewether Capital Inception Fund ("Fund") has been prepared and is issued by Authorised Representative No. 001292724 (Merewether Capital Management Pty Ltd) of AFSL No. 534584 (ARC Funds Operations Pty Ltd). Figures referred to in document are unaudited. The document is not intended to provide advice to investors or take into account an individual's financial circumstances or investment objectives. This is general investment advice only and does not constitute advice to any person. Neither Manager nor the Fund's trustee (Evolution Trustees Limited ACN 611 839 519, AFSL No 486217 ("Evolution")) guarantee repayment of capital or any rate of return from the Fund. Neither Evolution nor the Manager gives any representation or warranty as to the reliability, completeness or accuracy of the information contained in this document. Investors should consult their financial adviser in relation to any material within this document. Past performance is not a reliable indicator of future performance. Investors should consider any offer document of the Fund and any other material published by the Manager or Evolution in deciding whether to acquire units in the Fund. This information is available at https://www.merewethercapital.com.au/.

Despite these headwinds, both businesses were able to maintain their pricing and pass increased costs onto customers and grow margins in a difficult period where not many industrial businesses can say the same.

It is a handy reminder that sometimes as investors we do not have to try and time economic or capital cycles if we have invested alongside competent management teams who can do that for us.

Prophecy International (PRO) was another holding that reported well. The provider of enterprise software solutions grew it's recurring revenue by 72% and brought in nearly $3m in cash flow. However, the business model and how it is accounted for understated the quality of the result with reported profits falling slightly on last year to a $2m loss.

The culprit is the fact that PRO receives cash upfront from its clients who then subscribe to their software solutions for a period of time (usually 6-12 months). From an accounting point of view revenue is only recorded as the software is used over time, leading to a mismatch between cash received and revenue reported particularly in periods of high growth.

In this report revenue was $16.4m but invoices were $20.8m, providing the healthy cash flow which will flow into reported profits in the coming financial year. The additional benefit for PRO is that they are free to use that cash to invest and grow, calling out record pipelines for both of their software solutions into the future. A business model that allows for your customers to fund your growth is an attractive one indeed.

Austco Healthcare (AHC) was another resilient result in the face of continued Covid disruption for the nurse call systems and software provider. Revenue increased 15% on last year but was up 25% from the first half of the year to the second half as access to hospitals and aged care facilities to install their systems continued to improve. Despite the increased revenue the order book continues to grow, highlighting the growth that will come through in the future.

Margins continue to be pressured by supply chain issues and chip shortages, with the gross margin falling slightly from 53.5% to 52.4%. At the earnings margin it was exacerbated by the scaling up of sales staff, particularly in the US. I do not expect AHC management to be wasteful with the investment for growth given they have been very conservative in their outlook since the onset of Covid, with the original plan to scale up the investment in sales put on hold since late 2019 when they raised capital.

As I have discussed in prior reports, several holdings provided recent guidance or updates so there were no surprises when audited reports were released. **Aerometrex** (AMX), **Kip McGrath** (KME) and **MSL Solutions** (MSL) all reported to the higher end or exceeded that guidance which was pleasing.

AMX received a boost through the month with larger peer Nearmap receiving a takeover bid from private equity as discussed earlier. At a multiple of 7x revenue, it makes the 2x valuation of AMX look very reasonable. The business continues to execute its growth plan nicely with revenues continue to shift from project based to subscription and owning their proprietary datasets allows for "off-the-shelf" sales also. The recent sale to the Department of Defence for ~$2.5m highlights the opportunity in that segment.

We added to our small holding in MSL after the result which showed much higher quality earnings than expected. With no context to the guidance provided before the report, there was confusion about how revenues could fall on last year (after adjusting for an acquisition that was made) but earnings could grow so strongly.

The answer came from management shifting the UK segment away from low margin reselling of external software to focusing on their internal software at much higher margins. With a strong backlog of revenue underpinned by recent contract wins with large stadia customers, I believe MSL is positioned to do well over the next year or two.

Disclaimer: The material contained within this document about the Merewether Capital Inception Fund ("Fund") has been prepared and is issued by Authorised Representative No. 001292724 (Merewether Capital Management Pty Ltd) of AFSL No. 534584 (ARC Funds Operations Pty Ltd). Figures referred to in document are unaudited. The document is not intended to provide advice to investors or take into account an individual's financial circumstances or investment objectives. This is general investment advice only and does not constitute advice to any person. Neither Manager nor the Fund's trustee (Evolution Trustees Limited ACN 611 839 519, AFSL No 486217 ("Evolution")) guarantee repayment of capital or any rate of return from the Fund. Neither Evolution nor the Manager gives any representation or warranty as to the reliability, completeness or accuracy of the information contained in this document. Investors should consult their financial adviser in relation to any material within this document. Past performance is not a reliable indicator of future performance. Investors should consider any offer document of the Fund and any other material published by the Manager or Evolution in deciding whether to acquire units in the Fund. This information is available at https://www.merewethercapital.com.au/.

There were also no surprises from the companies who report quarterly. Generally, the only gremlin that does not show up in quarterly cashflow reports is share based compensation (a real expense, but non-cash) which was modest throughout the whole portfolio.

Unfortunately, our record was not unblemished (and I never expect it to be!) with two reports disappointing against my expectations.

CPT Global (CGO) reported a revenue decline of 10% and because of the leverage in the business profits fell 57%. The headline profit number overstated the weakness in the result, cycling a tough comparison period last year and some one-off costs in the second half impacting the profit line.

The business is currently undergoing a transformation from an IT consulting business to one who leverages their expertise through software solutions. While that strategy pivot is the right one long term, it will come with some short-term volatility.

Even on the lower profit number CGO trades on a reasonable profit multiple of just 11x earnings. We have held our existing small position for now, but if I gain confidence in the recovery of earnings or the shift to software solutions it is a position that may be added to.

Luckily our other disappointment was also a small position within the portfolio with **Rectifier Technologies** (RFT) reporting revenue growth of 23% and profit before tax growth of 19%.

The opposite of CGO above, while those numbers look solid at face value, I expected more from RFT after a significant contract announcement earlier in the year. In early February RFT announced a $20m USD contract with leading electric vehicle charger manufacturer Tritium, with the commentary highlighting that the orders are scheduled to be delivered before the end of the 2022 calendar year.

With only $8m revenue in the second half of the financial year compared to $5m in the prior period, it suggests that little of the Tritium contract has been recognised yet. At current exchange rates the deal is worth roughly $30m AUD and assuming the delivery in the calendar year is still intact RFT will hopefully have a bumper start to FY23 coming.

Like CGO, we have held our small position in RFT but any confidence in the successful delivery of the Tritium contract or further large wins could see the position being added to.

So far, the start to financial year 2023 has been a positive one. I know the road to generate the returns I expect for investors will be a long one, but I remain confident we are firmly on that road. Reporting season confirmed that most of our portfolio holdings are performing well and on the trajectory to becoming bigger businesses in the future.

As always, if you ever have any questions about the Fund or its holdings, please call me on 0423 510 004 or email luke@merewethercapital.com.au

Thanks for your on-going support.

Luke Winchester (Portfolio Manager)

Disclaimer: The material contained within this document about the Merewether Capital Inception Fund ("Fund") has been prepared and is issued by Authorised Representative No. 001292724 (Merewether Capital Management Pty Ltd) of AFSL No. 534584 (ARC Funds Operations Pty Ltd). Figures referred to in document are unaudited. The document is not intended to provide advice to investors or take into account an individual's financial circumstances or investment objectives. This is general investment advice only and does not constitute advice to any person. Neither Manager nor the Fund's trustee (Evolution Trustees Limited ACN 611 839 519, AFSL No 486217 ("Evolution")) guarantee repayment of capital or any rate of return from the Fund. Neither Evolution nor the Manager gives any representation or warranty as to the reliability, completeness or accuracy of the information contained in this document. Investors should consult their financial adviser in relation to any material within this document. Past performance is not a reliable indicator of future performance. Investors should consider any offer document of the Fund and any other material published by the Manager or Evolution in deciding whether to acquire units in the Fund. This information is available at https://www.merewethercapital.com.au/.