MEREWETHER CAPITAL

31 October 2022
Investor Update

Merewether Capital Inception Fund Performance Summary (at 31 October 2022 net of fees and expenses)					
1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception* (p.a.)
-1.21%	-2.94%	-17.21%	-	-	-31.24%

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 $0.7083 and ended the month with an indicative unit price of $0.6997 for a -1.21% return.

October was a relatively quiet month for global markets (if such a thing exists in 2022) as markets absorbed the official central bank moves in policy rates as well as the speeches and rhetoric that accompany them.

Commentary in markets is now focused on the upcoming "pivot"; the point in time where central banks cease raising interest rates and tightening liquidity and begin cutting interest rates and easing financial conditions once again. While I think it is inevitable that this will happen at some point (everything is a cycle after all), trying to time this pivot will be extremely difficult.

Back in February (which feels like a lifetime ago!) I wrote the three most important words an investor can have for complex macroeconomics is "I don't know". I feel the importance of this approach is higher than ever, as the forthcoming pivot will likely come on the back of sluggish global economies weighed down by the effects of interest rate rises on record personal and corporate debt levels.

With so many moving parts I am focused on being flexible and adapting my views as the situation changes. One of the biggest mistakes an investor can make is trying to force the market to their views of how things should be rather than how things actually are. Further, any macroeconomic views I have are always considered through the lens of how they affect individual businesses.

Looking at the Fund, I don't think we have large exposure to the biggest issues set to face economies or markets over the next year or two.

The most obvious issue will be the health of the consumer as central banks target discretionary spending power to combat rising inflation. So far consumer spending has been remarkably resilient much to the ire of central bankers, but it is well accepted that the effect of interest rate rises has a lag and it is the expectation that we will see weakness through 2023.

We have little exposure to the consumer wallet (in particular retailers) with **Kip McGrath Education Centres** (KME) and **Spacetalk** (SPA) the only consumer discretionary positions in the Fund. For KME however, with the learning difficulties for primary school aged children through Covid lockdowns I expect tutoring services will not be viewed as discretionary in the short term and likely to receive Government support for stretched household budgets.

Another obvious issue is leveraged balance sheets. The Fund has almost no companies with debt, and for those few that do it is asset backed or offset by a healthy chunk of cash. Across the ASX the issue should be relatively manageable given most Australian companies tend to be equity rather than debt funded but for the US it is something to watch closely.

But as an example, I'll cherry pick **Domino's Pizza** (DMP) given it is a high-profile example of a leveraged balance sheet. At the last report DMP had $645m of corporate debt on their balance sheet compared to equity of $422m and net profit of $165m. With the cheap cost of debt as interest rates were cut to effectively zero, DMP was paying an average interest rate of 1.3% on their $645m debt, or roughly $8m in interest payments a year.

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With the rapid spike in debt yields this year, it wouldn't be unreasonable to think when the debt is re-financed it could attract interest rates of 5% or more. All things equal, an interest bill of $8m could become more than $30m and net profit falls by roughly 15%. The natural business response is to de-lever the balance sheet, but then assumptions for growth rates and dividend payouts need to be made to adjust for more free cash flow going towards debt repayment rather than reinvestment or returned to shareholders.

This is of course a very simple back of the envelope calculation and in reality it is much more complex with interest rate swaps and other forms of hedging but it serves the purpose of showing there will be issues in the coming years for businesses who have levered up their balance sheet with the ultra-low interest rates seen through Covid.

As I said, we have no real exposure to this issue, firstly micro-cap companies can't access the cheap debt like their larger peers and secondly their operations and earnings are much more volatile which makes serviceability tough.

One more issue is the continued normalisation of Covid earnings. We have already seen this play out completely in the most obvious Covid beneficiaries like e-commerce, but in general large corporate profit margins spiked to record levels in 2021 from a combination of Government stimulus and consolidating market share as smaller private competitors were unable to compete through Covid lockdowns.

Margins began to normalise in 2022 but there is likely further to go. Conversely, many companies in the Fund portfolio are in the opposite position with earnings that will normalise in a positive direction as operations were impacted heavily through the Covid period. We may have a few positions who are over-earning with abnormal profit margins, the two most prominent candidates being **XRF Scientific** (XRF) and **Smart Parking** (SPZ) which I am currently reviewing.

October is the month where smaller ASX businesses report their first quarter cash flow results and many larger companies provide trading updates at AGMs. We had steady news flow through the month which on balance was quite positive.

Our most recent purchase **Compumedics** (CMP) gave an update at their AGM which included guidance of $40m+ revenue and $4m+ EBITDA. While solid, you can read my blog post on the business for why I think that guidance seems very conservative with plenty of headroom to upgrade throughout the financial year.

XRF Scientific (XRF) gave a trading update with first quarter revenue growth of 32% and profit before tax growth of 45%. Based on the first quarter the business likely does $7-8m net profit for the full year leaving it trading on roughly 15x earnings. That is a fair price but must be considered in the context of whether the business is overearning as profit margins continue to expand with buoyant mining activity.

Laserbond (LBL) also gave a first quarter trading update at their AGM, disclosing revenue grew 36% on last year. Importantly, this number was only generated from the two core Products and Services segments, with the lumpy Technology licensing sales yet to be converted. That said, LBL has made two recent acquisitions so not all of that growth is organic and no specific profit number was released although management did say they have maintained margins despite inflationary pressures.

For the companies who report their quarterly cash results, **SKS Technologies** (SKS) was the best with the integrated AV/IT contractor producing $2m cash flow for the quarter. While that looks impressive on their $20m market cap, it is worth noting that cash receipts are lumpy for the business as they contract large projects with onerous payment terms so there is often a mismatch between cash coming in and cash going out. Nonetheless it was a solid result and the business exited the quarter with a strong backlog for further growth.

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Another good quarter came from weather and climate software business **Aeeris** (AER). While the bottom-line result was breakeven, that is the stated strategy from management as they scale up their new Climatics segment which is looking to establish itself in the nascent physical climate reporting industry. Cash receipts growth was more than 60% on last year with extremely positive commentary on the outlook for the business with additional sales and marketing driving a health pipeline of new business.

Enterprise knowledge management software provider **Knosys** (KNO) also reported a solid quarter bringing in $1.1m cashflow and nearing $10m in annualised recurring revenue. While cashflow quarter to quarter can be lumpy, management commentary focused on being breakeven for the financial year and further growth in the business.

The weaker updates came from our two positions which have disappointed all year: **intelliHR** (IHR) and **Spacetalk** (SPA). I will write more in-depth on both next month which will be the one-year anniversary of the fund and I will give a deeper discussion on our performance and what I got right and what I got wrong.

In the most recent quarter, IHR continued to heavily burn cash with another $2.3m coming off their cash balance and leaving them with just $3.1m in the bank. While expenses stayed flat, the disappointment came from customer receipts also staying flat despite growth in the business and measures being taken to bring forward cash such as discounts for annual payments and use of third-party integrators to speed up implementation and billing.

SPA aren't required to produce detailed cash reports but their quarterly updates include the cash balance which fell by $2.8m. While alarming, it is worth noting that SPA make most of their revenue in the upcoming quarter with Black Friday/Cyber Monday and Christmas all being peak consumer purchase periods. A chunk of the cash burn would have gone towards inventory purchases to service the impending sales.

Nonetheless, revenue was down 36% for the quarter which management explained by the lack of new retail distribution coming online which comes with a large initial order to fill an inventory channel. Even adjusting for that it was a poor quarter, though the news that Best Buy in the US would be stocking their smartwatch in 600 stores was a positive.

I will discuss both positions in more detail next month and analyse their outlooks moving forward.

Turning to November, we will have more annual general meetings for portfolio companies which I will hope to attend some virtually and potentially two or three in person (calendar permitting). Hopefully with more trading updates we can see some positive performance within the Fund as our companies continue to grow.

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)

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