MEREWETHER CAPITAL

Merewether Capital Inception Fund Performance Summary (at 28 February 2023 net of fees and expenses)					
1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception* (p.a.)
-4.39%	-4.29%	-11.86%	-26.45%	-	-32.71%

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 an indicative unit price of $0.7032 and ended the month with an indicative unit price of $0.6723 for a -4.39% return.

February was half year reporting season for the vast majority of ASX listed businesses, and it is fair to say this was one of the toughest reporting seasons of my investment career. I have commented numerous times how resilient business earnings have been since Covid began, weathering all sorts of disruptions but it seems like the six months to December last year was when those issues finally caught up to businesses, and outlooks for most were also very cautious.

The main theme from this reporting season was the market punishing any business who did not report good earnings and offer a clear path for growth moving forward. Some businesses were able to do this structurally but painting a broad stroke the two sectors that had cyclical tailwinds behind them seemed to be mining/construction services and travel/tourism.

On balance I thought the reports from our portfolio companies met or exceeded expectations. Unfortunately, those companies who did stand out were left unrewarded by the market, while those who disappointed saw their share prices crunched.

The best report in the portfolio came from **Rectifier Technologies** (RFT). I have previously written how $42m USD (~$64m AUD) of recent electric vehicle charger supply contracts have led to a substantial pipeline of business to come through over the next couple of years, but the share price remained in limbo as the market waited to see execution (particularly given supply chain issues had delayed delivery already).

For the six months to December, RFT announced a tripling of their revenue from the prior period to $19.3m (up from $6.5m) and an eight-fold increase in net profits to $3.8m (up from $403k). With a focus on cash generation across the whole market, it was also pleasing to see free cash flow of $3.1m which was used entirely to pay down the recently incurred debt to expand their Malaysian manufacturing facilities.

Despite the tremendous result, shares were only up modestly for the month (~10%) however the muted response gave us the chance to add meaningfully to our position. At the current market capitalisation of $62m, RFT trades at around 8x earnings assuming the second half can be similar to the recent first half result.

Even though revenue will be lumpy and supply chain issues remain (though now easing), the contracts in place should make a similar second half result achievable. Looking past the current year, management spoke favourably about new product development, plus key customer Tritium recently announced its largest ever electric vehicle charger order from global giant BP.

XRF Scientific (XRF) has been our best performer since inception and did not disappoint with its report. Revenue growth of 46% and net profit growth of 34% (impacted by a higher tax rate) were the result of continued brilliant execution plus the tailwinds from their exposure to mining and construction clients.

Though the headline numbers were fantastic with all segments and geographies growing on last year, I took two interesting notes from the result. The first is that XRF continues to earn fantastic incremental returns on their capital. The headline return on equity over the last twelve months is 22.5%, a reasonable number, but the additional return on the additional equity on the previous twelve months is 76%.

Effectively this means XRF is a far more scalable and capital light business than first glance (at least while the cycle is strong!).

The second note was despite most investors focusing on organic growth and sometimes dismissing acquisitions, the right acquisition at the right price can be incredibly accretive. XRF acquired Orbis Mining in September 2021, paying $800k for a 50% stake. In the previous year the business had earned $2.3m revenue and $340k profit. Fast forward just over 12 months and Orbis recorded $3.4m revenue and $684k profit in just six months.

It is difficult to separate XRF's fundamental performance from the tailwinds they are benefiting from with their mining services exposure. For now, it remains our largest position which I am comfortable with given I believe the business is less cyclical than the wider market would believe and management have proven adept at executing throughout the cycle already.

Another industrial services business who reported well was **Laserbond** (LBL). Revenue grew 39% and net profit grew 32% (again slight impact from a higher tax rate).

Like XRF, LBL is benefiting from a strategic acquisition that is performing well after purchasing QSP (a Queensland based surface engineering company) back in February last year. The ability to purchase a company in a new geography with established clients and then roll-out LBL's technology to improve margins is a valuable one, and management have indicated they are looking at Western Australia as the next natural expansion geography.

Despite the strong headline numbers, LBL has yet to have any meaningful impact from its Technology division, which was established to license their technology to overseas partners for high margin license and consumables income. With orders in the pipeline, the second half should benefit from additional revenue from the Tech segment.

Austco Healthcare (AHC) was another holding where headline numbers masked strong underlying results. The company reported revenue growth of 29% but profits fell 9% as the prior period had $660k in Covid subsidies and benefits that weren't repeated. Adjusting for this, underlying profits grew 57%.

The highlight was 47% growth in their clinical workflow software revenue, which grew to a record 18% of total revenue and drove gross margins to 55%. The operational cost base had a sharp increase on the prior year ($9.6m v $7.3M) as the company invested in their sales and marketing and research and development for future growth, but importantly most of this additional investment was made in the second half of last year, with the operational cost base flat on that half and the business already showing scale.

At the current market capitalisation of $38m, AHC trades on roughly 14x the annualised $1.4m net profit from this first half result. However, with the second half generally being stronger and management indicating further strength in their software sales that multiple could fall to 11-12x for the full year.

Looking out to the medium to longer term, I expect AHC will also be a beneficiary of the financial difficulties facing one of their major competitors in Australia, **Hills Limited** (HIL). A core segment of HIL is Hills Health Solutions, a dominant player for nurse call solutions in Australia. HIL has particularly had a market leading position in large hospitals, which is why the recent contract win by AHC for the Queen Elizabeth Hospital in Adelaide could be the first sign they are able to start stealing valuable market share.

Another solid report came from a new position in **Vysarn** (VYS). I intend to write further about VYS in future reports or in a blog post, but like XRF the business is benefiting very strongly from a burgeoning mining cycle. At face value the business looks extremely cyclical with its core segment providing hydrogeological drilling (de-watering) services for mining customers.

However, what separates VYS from peers is the business is operating at a steady state run-rate from December last year with long term contracts with tier one mining customers.

VYS's core segment has 12 drill rigs contracted out to BHP, Rio Tinto and Roy Hill on multi-year contracts, with management clear they do not intend to invest further in the division, but rather harvest the free cash (~$8-9m per year) and invest in building a diversified water services company both organically and by acquisition.

Though in its early days the strategy has had some initial success with the first two acquisitions performing above expectations and generating significantly higher margins than the commoditised drilling segment. In the half year result VYS's acquisitions contributed $5.4m revenue and $1.1m profit before tax and both are growing quickly.

At a $50m enterprise value, VYS is fairly priced on the free cash coming from the core drilling business, but there is significant upside possible if management can continue to execute their strategy to shift to higher margin water services.

Smart Parking (SPZ) had an eventful month, first announcing that the Queensland government had removed access for parking lot operators to access their driver database for personal details to issue parking breach fines. Despite Queensland being a tiny portion of SPZ's business at <5% revenue (and still unprofitable), with the market fearing uncertainty the spectre of government regulation in any form saw shares sold off sharply.

Subsequent to that news, SPZ released a solid set of financial numbers. At the headline level 18% revenue growth and profits down 11% did not look favourable, but a combination of currency headwinds and the operating loss from the emerging German operations muted the profits in this half.

However, management remain very bullish on the outlook for the business, outlining the momentum the German segment displayed ending the half, signing some trials with large enterprises such as KFC, ALDI and Burger King that have the potential scale across their large networks.

Unfortunately, we did have some weak reports in the portfolio, and this was a reporting season where any weakness was punished very harshly. The common theme among our weak reports were lower revenue growth than expected, but also combined with an inability to control costs (or continuing to invest for growth in the future) meaning margins were crunched hard.

Kip McGrath Education (KME) was the best example of this dynamic. It has been a disappointing outcome for KME given the conviction I have had in the business for well over a year now. The share price was down over 40% for the month on the back of a mixed result. The headline numbers were revenue up 9% while profits fell 29%.

The slide in profits was largely due to an operating loss in their recently acquired US subsidiary Tutorfly which lost $600k compared to a breakeven result last year. At face value, this operating loss is alarming and wipes away roughly half of KME's profits from its core UK and ANZ businesses.

Digging deeper the Tutorfly loss is not as bad as it would appear, as the business has targeted growth through US Government funded tutoring programs and despite being successful with some new tenders they hadn't started until the new year. With the current contracts in place, it appears Tutorfly is on track to be breakeven in the second half of the financial year.

However, as I said previously the market is not willing to show much forgiveness for businesses reporting depressed profits in the present to sacrifice for growth into the future.

For KME in particular this attitude is frustratingly rational given the business has been reporting depressed profits now for over two years as we have seen Covid, investment in new technology systems and the push for a Corporate strategy all contribute to lower margins in recent years.

Given the low success rates of Australian businesses penetrating the highly competitive US market (especially micro caps) it was not unexpected that the market finally threw in the towel for KME and waits to see the numbers improve. I expect they will (and likely quicker than the market expects) but in the meantime as Tom Petty said, the waiting is the hardest part.

Prophecy International (PRO) was another position that suffered from weak headline numbers. Revenue increased 19% but the operating loss nearly tripled to $2.1m. The biggest contributor to the growing loss was foreign exchange as the USD strengthened against the AUD over the period.

What may have alarmed the market even more however was a $3m cash loss over the half. Again at face value it appears to be a very poor result, however it belies the lumpiness of cash collection for the business as they charge annually in advance to their large clients with the majority of them falling in the second half. On a conference call post the result, CEO Brad Thomas was clear he expects the business to be cash breakeven over the full year.

The other factor for a weak headline result was an acceleration of the shift from PRO's Snare subsidiary from a license-based revenue model to a subscription model. Using a simple example, where previously Snare would charge a customer $100k upfront for a perpetual license (with ~20% on-going maintenance fees), under a subscription model Snare would charge a customer $40k recurring annually. If that client is retained for over 3 years economically the subscription becomes the better revenue model and compounds much better as new customers build on top of the existing base of recurring income.

However, despite being a better revenue model long term, it muddies up the numbers in the short term. Instead of recognising a big lump of revenue and cash in the first year, it is now spread out over many years well into the future. Ironically, PRO shareholders should be quite familiar with this dynamic given the same shift happened with their eMite call centre analytics segment a few years ago. With that shift complete, eMite is now reporting exceptionally clean results and is the driver of the business from a statutory point of view.

In the latest half, Snare revenue fell from $4.4m to $3.3m, but within that annualised subscription revenue has grown from $675k to roughly $3m. While the short-term pain is frustrating, as that recurring revenue grows over time it will overwhelm the license revenue and set the base for strong profitable growth moving forward.

Xref (XF1) is our other technology stock which has performed poorly as their growth rate has slowed from the tailwinds provided by Covid. Revenue grew 8% while profits fell from breakeven last year to a $1.4m loss this year.

Again, there were some moving parts below those headline numbers, with the biggest impact coming from the sharp decline in revenue from XF1's RapidID segment which provide Know Your Customer checks. Last year RapidID saw a huge boom from their key crypto client Binance which saw an influx of new users. As the growth in new users declined, RapidID revenue fell 17% and offset the core Xref business growing 15%.

The short-term focus for XF1 will be completing the development of their subscription platform and bringing customers across to it. The shift from usage-based revenue to subscription will make revenue recognition much steadier and remove XF1 from the cyclicality of the wider hiring cycle.

Early signs are positive with the subscription product launching in the second quarter and already contributing $700k revenue to the latest result.

Despite increased costs in the last half to ensure they have to development capability to deliver the pipeline in front of them and speed up customer migration to the subscription platform, XF1 management have forecast a return to profits in the second half which is encouraging.

Aerometrex (AMX) delivered a weaker half than expected but largely because management made the decision to end their project based aerial imagery revenue and focus completely on their subscription model. Headline numbers were revenue down 12% and the operating loss up 9%, but removing the $2.3m of project based work in the prior half and comparable revenue was up 10%.

The MetroMap subscription service saw revenue growth of 32% and exited the period with annualised revenue of $7.3m. The biggest shock however came from the LiDAR segment seeing a decline in revenue of 4%. Management stated that some operational issues affected the ability to capture during the half, but with a new sensor installed and a $1.9m Department of Defence contract to be executed in the current half I expect the segment to return to strong growth.

CPT Global (CGO) reported revenue up 2% and profits down 52%. Again, the common theme with other reports is that the headline numbers for the IT services business don’t reflect the operational progress underneath.

CGO’s preferred reporting metric is operating profit which is the profit after the direct costs to service customers with their consultants. After this operational profit, corporate overheads are deducted to reach a net profit figure. For the most recent result, operating profit grew 18% on last year to a record $3m. However, below that number the business grew the corporate cost base from $920k to $2.2m which saw the fall at a net profit level.

As investors we love stability and simple forecasting but unfortunately in business it is never that simple. Businesses usually have to invest in waves and ahead of the revenue that will come in behind the platform being set. Chatting with the CGO CEO Luke Tuddenham after the result he explained how at a corporate level the business has brought on three new sales staff (two in the US and one in Australia) and appointed account managers within regions to handle administration tasks that were previously falling on their specialised consultants to complete and reducing the hours they could be billed out for revenue generating work.

While especially painful to have the extra cost base in place for a result in this reporting season in particular, it is worth noting that the business will scale strongly over the corporate cost base. As revenue and operating margin continues to grow, it will fall to the bottom line quickly in future periods.

Despite the share price reaction not being as severe as others discussed already, perhaps the most disappointing result came from **Compumedics** (CMP). I only wrote a blog post on the business back in November last year, highlighting how the medical device company had been disrupted by Covid but as those headwinds appeared to be easing the historical profitability of the business would return.

At the headline level revenue increased 14% while profits fell from roughly breakeven to a $7.2m loss. Within that loss, $6.9m was a non-cash impairment to the value of their MEG business as key customer Barrow Neurological Institute in the US returned their MEG unit to CMP as agreed specifications could not be reached. Management are reviewing the MEG segment, but did note they are proceeding with delivery of a MEG unit to their second customer Tianjin University.

Even adjusting for the non-cash impairments, profits still declined despite higher revenues as the business invested in additional sales and marketing resources primarily in the US as they prepare to launch new products into the market. Management has forecast for these costs to moderate in the second half and the business to return to strong profitability.

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28 February 2023

Investor Update

For our range of portfolio companies who report quarterly (see January report for the quarterly season round-up) there were no surprises from their half year reports.

Looking forward, 2023 appears to be following in the footsteps of 2022 with the general sentiment extremely weak. With how quickly central banks have increased interest rates on elevated levels of debt globally, it has been a waiting game to see when cracks in the global financial system would start to appear. The collapse of Silicon Valley Bank in the US and Credit Suisse in Europe are the first signs of that, but the difficulty for investors is determining whether they will be the last.

Central banks and Governments have already indicated that the GFC playbook is likely still in effect which is to backstop these institutions as much as possible to maintain the stability of the financial system.

Turning to our portfolio, the performance has obviously been poor however this reporting season confirmed my opinions that most of our businesses are profitable and growing (even at rates slower than hoped) and for those who remain slightly unprofitable, I believe they have the balance sheet strength to invest until profits emerge.

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)