MEREWETHER
CAPITAL

Merewether Capital Inception Fund Performance Summary (at 28 Feb 2022 net of fees and expenses)					
1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception* (p.a.)
-4.90%	-8.59%				

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 $0.9612 and ended the month with an indicative unit price of $0.9141 for a -4.90% return.

Before I begin, I would like to apologise for the lateness of this letter, there was a significant delay due to the calculation of the special intake we made during February. Thankfully due to this experience I think all parties understand the process better and I don't expect the issues to occur again.

After a couple of months of intense volatility, I thought I would pen a longer report this month. The timing also works well as we have completed the ASX reporting season in February, providing me the opportunity to give updates on various holdings.

Last month I wrote that while January was volatile, I remained optimistic that it could be short lived as we came into reporting season in February because it would give the market an opportunity to focus on business fundamentals. Of course that optimism proved false as the factors that drove the volatility in January worsened (fears of inflation and higher interest rates), culminating in late February when a global geopolitical risk emerged through the Russian invasion of Ukraine.

As the month progressed, I was constantly reminded of the power of the three most important words in investing: **I don't know**.

As investors, we try to know as much as possible about the companies we invest in. Their business models, management teams, industry dynamics, competitors, the potential for future growth just to name a few. An ability to truly know the businesses in your portfolio is important, as it allows you to stomach short term volatility and hold businesses on their paths to becoming much larger in the future.

However, a by-product of this desire to know companies intimately is that sometimes investors can extend themselves too far. Warren Buffett would call it going outside of your "circle of competence". It usually presents itself as investors venturing into businesses, sectors or geographies they don't understand. What makes this worse is a little knowledge can be a dangerous thing and the Dunning Kruger effect can quickly kick into gear.

I won't profess to be immune from venturing outside of my circle of competence at times, and of course the catch 22 of all this is that as investors, we must constantly be learning and evolving with dynamic markets. Knowing when to stretch yourself into new areas or pull back to your comfort space is a tricky one that must be constantly considered.

However, at times of extreme market stress, it is macroeconomics that becomes the main driver of short-term share prices and an investors innate desire to know everything shifts to trying to understand, forecast or position portfolios for macroeconomic forces.

It doesn't take long to see the problem with shifting your investment focus by being dominated by macroeconomics; the field is so wide-ranging that it is impossible for anyone to get remotely close to being an expert.

Since the onset of Covid, an investor who has focused their attention on macroeconomic forces had to become an expert in epidemiology, unprecedented fiscal and monetary responses on rapidly shifting economies, global logistics and supply chains, inflation, interest rates, physical commodities and now geo-politics.

The irony to the complexity of macroeconomics is that in the two years since the onset of Covid, the one constant through every reporting season is great businesses with great management teams have taken it all in stride and continued to perform well. For investors, it was better to say **"I don't know"** to the ever-changing macroeconomic risks and allow the businesses they own to manage the risks and opportunities that emerged.

For investors, it has been extremely easy to become spooked out of a great business if the focus is solely on external noises. Even in our portfolio, I am sometimes asked by other investors about how I think about investing in companies such as **Laserbond (LBL)** or **XRF Scientific (XRF)** given they are exposed to mining cycles.

I am asked for my opinion on where are we in the cycle. Are we late cycle? Are these businesses overearning? Should we lighten or sell? My answer to these questions is always "**I don't know**". I can agree that we aren't in the bottom of a cycle but where we are exactly, I am not sure.

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.

All that said, while I will never let macroeconomics dictate the Inception Fund portfolio from a top-down view, we must always be aware of the environment in which the businesses we own operate in. From late 2021 and accelerating in January and February, the main change in markets has been a shortening of investment timeframes.

Previously, the market had been very forgiving of businesses who were incurring upfront operating losses. The general view was that they were creating long term economic value that would be extracted in later years. This view has quickly changed, and those businesses have seen their share prices sharply sold.

The lack of patience for losses creates a problem for these businesses as they are generally reliant on the market for capital by performing equity raises every 12-18 months. Cost of equity has now increased, and it is hard to see the sentiment driving that changing any time soon.

Furthermore, it creates a tough dynamic for the management teams of these businesses. They are still very early in their growth phases, but potentially stripped of the capital that is the lifeblood to that growth. It leaves two choices; continue to chase growth and stomach the increased dilution of capital raises at lower share prices, or wind back their growth to more sustainable levels and allow the existing business to largely self-fund from the current operations.

The next few months will be crucial for these businesses and I suspect those management teams who are willing to make hard decisions, temper growth to more sustainable levels and demonstrate some operating leverage will be rewarded by the market. Those that won't (or can't!) will continue to see their share prices punished. We have two businesses in the Fund that I think are still reliant on external capital to grow: **intelliHR (IHR)** and **Spacetalk (SPA)**.

intelliHR is the more traditional of the two in the sense that it is generating heavy operating losses as it attempts to scale up a nascent global human resources software business. The operating metrics and customer reviews of the software suggest the decision to spend heavily for short term growth is the right one despite not being rewarded by the market. This is due to new customers being inclined to stay on a sticky platform that provides long term value to the business.

Despite rapid revenue growth of more than 100% over 1H22, operating costs have grown just as fast, with the market rightly asking when operating leverage will kick in. The business will soon break through $10m annualised recurring revenue which is a number where most SaaS businesses start to see scale over their cost base. I expect to see the same for IHR and have expressed this view to the management team also.

Spacetalk (a manufacturer of kids smartwatch devices) is a bit trickier as its growth doesn't show in heavy operating losses (in the recent result the business reported a modest EBITDA loss), however growth requires heavy investment in working capital. The business must build up large quantities of inventory to supply smartwatches into global distribution deals and then work extremely hard to ensure they aren't squeezed by onerous payment terms from much larger retailers.

The growth of an app-based subscription model will add a revenue stream that will offset ongoing working capital costs. However, in the short term it is a growing pain that is expected to continue due to the nature of the product. One option available to management is to spin off their non-core "Schools" segment which provides SMS messaging capabilities to schools and represents a low growth steady income stream.

On a recent call, the Spacetalk CEO said the Schools segment produces close to $2m free cash flow annually and requires little re-investment. Even in a desperate sale for immediate cash injection, I expect the segment could be sold for $8-10m. It would be a major red cross against management's capital allocation skills if they opted to raise capital in the current market versus selling the non-core Schools segment. This is something I will monitor in the future.

While the share price performances have been disappointing, the fundamental performance of each business has been strong and has continued in the latest reporting season. With our investment theses intact, we haven't redeemed holdings in either intelliHR or Spacetalk.

Turning to the recent reporting season, I was overall extremely impressed with how our portfolio companies reported. While it wasn't always accompanied by share prices rising given the macroeconomic environment, my confidence in the "earnings engines" of our portfolio companies certainly increased. Some highlights include:

Kip McGrath Education Centres (KME) reported revenue growth of 33% and net profit growth of 193% over the December 2021 half year (adjusting for JobKeeper in the previous period). The two drivers of growth for the business (online lessons and corporate centres) continued strongly and management's claim of front-loading expenses in FY21 seemed accurate with significant operating leverage over the strong revenue growth. With the purchase of five new corporate centres in January and a price increase per lesson from $62 to $68, I expect Kip McGrath's profit growth to surprise the market moving forward.

Austco Healthcare (AHC) reported revenue growth of 15% and net profit growth of 83% over the December 2021 half year. A provider of nurse call systems for hospitals and aged care facilities, Covid has impacted the business' ability to get on site and perform installations. Because of this, their order book continues to grow, now at a record $24.5m ($21.3m when last updated in late January).

Smart Parking (SPZ) reported revenue growth of 70% over the December 2021 half year and moved from a net loss last year to a $2.1m profit. We trimmed some of our holding leading up to the report due to the risk of regulation in their core UK business that would severely impact revenue. Speaking with management after the result, they acknowledged the risk of regulation but also highlighted the opportunities it could provide as well as the strong growth in their non-UK geographies.

XRF Scientific (XRF) reported revenue growth of 24% and profit before tax growth of 56% over the December 2021 half year (adjusting for JobKeeper in the previous period). The manufacturer of equipment for laboratory testing of minerals and materials has benefited greatly from the boom in mining activity in the last few years. The company continues to reap the benefits of a capital expenditure cycle undertaken back in 2018 with incremental returns on equity and profit margins in excess of 30%.

Aerometrex (AMX) reported revenue growth of 32% and over the December 2021 half year and moved from a small EBITDA loss last year to a small profit. The provider of aerial imagery datasets and software saw strong growth in their three core segments of 2D Subscription, LiDAR and 3D. The business has fleshed out it's executive team and capabilities to support substantial growth in the future, particularly in the US with their world leading 3D product.

Thanks for your ongoing support.

Luke Winchester (Portfolio Manager)