MEREWETHER CAPITAL

30 April 2022 Investor Update

Merewether Capital Inception Fund Performance Summary (at 30 Apr 2022 net of fees and expenses)					
1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception* (p.a.)
-7.11%	-12.07%	-	-	-	-15.47%

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 $0.9099 and ended the month with an indicative unit price of $0.8452 for a -7.11% return.

Last month I wrote that March provided a relief from the severe market weakness in January and February. It didn't take long for April to wipe out any speculation that markets had stabilised with extreme volatility resulting in the worst start to a calendar year since the 1970's for major global markets. Perhaps it is no coincidence that inflation, the topic du jour of the market and now also the election media cycle, is also at levels not seen since the 1970's.

I remain unconvinced that we are entering a multi-year phase of structurally higher inflation and interest rates, but it has become painfully obvious that the market doesn't care about my opinion. And to be fair, it must be acknowledged that I (alongside many other fund managers and market commentators) wasn't even alive the last time inflation was a problem for society.

I recently tweeted (@lukewinchester9) that it is currently hard to find fundamental reasons to be bullish, and I couldn't help but notice that every article on respected market opinions website Livewire (https://www.livewiremarkets.com/) was bearish and focusing on inflation and interest rates. Generally speaking, it is when there is peak pessimism that the market finds a bottom and begins the slow climb higher against the "wall of worry".

Of course, there are no guarantees that happens and like in every bear market it is hard to see anything but negative signals and further pain ahead.

Stepping back from the headlines, there is one fundamental reason to be bullish on the Merewether Capital Inception Fund moving forward; I believe we have a portfolio of growing businesses at reasonable valuations (with many getting downright cheap).

In the face of poor share price performances, many of our holdings provided trading updates in April, with most being satisfactory, some extremely positive and a handful disappointing that required some action.

Starting with the positives, one our largest holdings **XRF Scientific** (XRF) reported 15% revenue growth and 28% profit growth during the quarter, an exceptional result given there were questions about whether they could maintain their margin growth in the face of rapid lithium price increases (a core ingredient to their high margin Consumables product). With their exposure to the resources sector, XRF was one of our few holdings to perform strongly in April and we resisted "cutting our flowers" by holding our full position. At current prices the business trades on 15-16x this year's earnings which is a fair valuation.

PTB Group (PTB) a provider of maintenance, repair and overhaul services for aircraft engines upgraded their earnings guidance from $12.9m to $15.5m at the mid-point of the respective ranges. I travelled to Brisbane during the month and met with PTB management at their workshop and received fantastic insight as to how they are generating significant growth and the plans being put in place for it to continue. Like XRF, the valuation is fair around 14x earnings, but if it can maintain anywhere near its current growth rates of 20-30%, I believe it becomes cheap very quickly. With the expansion of their new Leasing division, management are confident that the strong growth can continue.

Our largest holding **Xref** (XF1) has been swept up in the wave of selling that has affected the wider tech sector, but their third quarter update was solid as the business maintained its trajectory of scaling up as their revenue grows faster than costs and generates significant cash. Xref has generated ~$2m in cash surplus through the first three quarters of the financial year, and given the fourth quarter is seasonally the strongest, that figure could be substantially higher for the full year. At current prices Xref is valued around 22x cash flows which is higher than XRF and PTB, but the premium may be warranted as Xref is more scalable as a cloud tech platform and have only begun their international expansion. Given our initial large holding of Xref we have not added on the weakness but my conviction in the outlook has only strengthened, and I expect it to be a significant contributor to the Fund's performance moving forward.

8Common (8CO) is another large holding that reported on their March quarter, which at first glance was weaker than expected but after speaking with management I believe the issues are temporary and the investment thesis remains strong. 8Common are a provider of expense management software (Expense8) with the large catalyst for growth being the roll-out of a whole of Federal Government contract over the next couple of years. Historically 8Common had run at roughly breakeven but about a year ago began heavily investing into the development of a new product CardHero. CardHero integrates with Expense8 and allows customers to use virtual pre-paid debit cards eliminating the need for traditional credit cards or a re-imbursement system. While the product is innovative and has large potential, the investment exceeded management's initial budget resulting in significant cash outflows (~$500k a quarter). However, that development spend is behind them now with the CardHero product launched and should allow the business to return to at least break even. When the Federal Government agreement is fully integrated in a couple of years and generating $7-8m in annual recurring revenue I believe 8Common can earn ~$2m which is 11x the current valuation.

In my February report I mentioned **Spacetalk** (SPA), noting that it was one of the few companies in our portfolio that is likely still reliant on external capital which has become a problem in recent months as markets have completely shunned these businesses meaning any sort of capital raising would be destructive at extremely depressed share prices.

At the time, I wrote that despite a disappointing share price the underlying business was performing well on the back of more than 50% growth in the crucial second quarter which includes Black Friday and Christmas sales. Unfortunately, during the month the company released a disappointing third quarter result where the growth rate slowed to just 11%. The main cause of the disappointment came from the core Australian business which saw revenue fall 34%. Some of this could be explained by cycling a tough comparison period last year, but Spacetalk had previously called out a large marketing campaign through March which obviously didn't translate into the revenue which was expected.

I have a call scheduled with Spacetalk management, and along with other shareholders will discuss the future of the business and how short-term shareholder value may be unlocked while still focusing on the longer-term growth story of building a global consumer brand. For now, we have held our position and look forward to engaging with management.

The other holding discussed in February was **intelliHR** (IHR). Like Spacetalk, it is the other holding in the portfolio reliant on external capital. They also reported their quarterly cash report during the month and disappointingly the company's cash burn increased rather than seeing management begin to show some cost discipline and move towards breakeven. With just $8m left in the bank and burning $3m in the last quarter, the market can clearly see intelliHR requiring another capital injection soon and has begun to sell down the stock as a result.

In the commentary with the third quarter result, intelliHR management did acknowledge some factors that should lead to a reduced cash burn moving forward but it is likely a case of too little too late.

In the February report I wrote that these companies have to make hard decisions. My best example of this comes from our largest holding Xref who during the peak of Covid uncertainty reduced their workforce from nearly 100 employees to below 60. Given salaries is by far the greatest cost to tech businesses, Xref was able to move from a $4-5m cash burn per year to essentially breakeven in a couple of quarters.

In the last quarter, intelliHR's staff costs increased 10% on the previous quarter. Of course, their revenue grew at a much faster rate however given the magnitude of the operating cash burn management needed to be willing to make the hard decisions and take action to reduce their cost base. Given I didn't see signs of this we reduced our intelliHR position and may look to exit completely unless a sudden shift in the trajectory occurs. It is frustrating to be a seller of a business who is operationally performing exceptionally well but we are in a period where management's operational execution is not the most important factor to judge performance.

The most critical duty for a management team in the micro caps we invest in is to execute their business plans and focus on optimising and growing the operations of their business. However, during periods of extreme market stress the ability of management to show capital discipline becomes paramount, demonstrating they can be self-sufficient if external capital is unavailable, or bolstering their cash balances to have flexibility to invest or acquire struggling competitive peers if opportunities arise.

We are clearly in a highly stressed market right now for micro caps, which is why my recent communication with management has focused heavily on capital allocation and balance sheet management. I am pleased to report that nearly every management team provided thoughtful responses about how they are currently thinking about capital allocation, especially compared to where their share prices may trade.

Finally, I would just like to add that like all shareholders I have been disappointed in the start we have had in the Inception Fund. While it may be little consolation always remember that I am the largest single shareholder in the Fund with the vast majority of my family's wealth invested alongside you. While I have been through a few times like this in my years investing, it never gets easier.

In my introduction letter I wrote that we would experience times like this which is why attracting shareholders who could share my long-term vision would be of the utmost importance. As I outlined earlier in the letter, I believe we have a great portfolio of small, growing businesses that I believe will perform well in the coming years for the patient investor. While it is difficult at the moment, it is the seeds we sow now that will lead to the strong performance I expect 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)