MEREWETHER CAPITAL

30 June 2022

Investor Update

Merewether Capital Inception Fund Performance Summary (at 30 June 2022 net of fees and expenses)					
1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception* (p.a.)
-8.93%	-26.05%	-32.82%	-	-	-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 $0.7389 and ended the month with a unit price of $0.6729 for a -8.93% return.

Any hope that the market declines since the start of 2022 may abate for investors in June was swiftly ended in the first week of the month with global markets plunging yet again. June ended up being the culmination to a horrendous second half to financial year 2022 for the Inception Fund and global markets in general. Macroeconomic jitters were also met with end of financial year tax loss selling on the ASX which saw most local indexes down double digits.

With a new financial year dawning, naturally people begin to ask what it will bring, and in the context of the declines of financial year 2022 most are focused on when the pain will end and if it is time to buy? Of course, these questions are difficult to answer and usually miss the forest through the trees.

I have participated in media interviews in recent weeks with questions like that inevitably asked to me and I consistently answer that as investors our goal shouldn't be to pick the bottom of the overall market. Our goal is to put together a portfolio of businesses (many which will bottom before the broader market) that are more likely to provide us with acceptable risk adjusted returns over desired investment timeframes.

Our investment timeframe for the Inception Fund is 5+ years and I have never come across a larger discrepancy between my investment timeframe and the broader market than I see right now. Most of our stocks are cheap and growing strongly with prospects unaffected by current events.

I hope to pen more blog posts soon to dig deeper into many of these companies, highlighting my investment theses, and hopefully demonstrating the confidence I have in them over a long-term investment time frame.

However, when I look across the broader ASX, I am not comforted by valuations that support prospects for strong risk adjusted returns. To pick on a few "market darlings" to highlight my point:

- Despite share price falls, some tech companies still trade on extremely high multiples such as Pro Medicus on over 120x earnings and Altium and Wisetech not far behind at over 90x respectively. At valuations this high these businesses require flawless execution to deliver solid long-term returns for investors today.
- REA Group and Lovisa both trade over 40x earnings which seem reasonable given their historical levels, but there are valid question marks over future earnings as we see the effects of a weaker housing market and consumer sentiment.
- Even stocks that seem on reasonable multiples like ARB Group and Breville (both around 20-25x earnings) ignore the fact their trailing earnings were heavily inflated by the fiscal stimulus that went to consumers during Covid.

These stocks were all beneficiaries of the "quality/growth at any price" mentality which seeped into markets over the past few years. I suspect it will be very difficult to overcome that mentality in the short term and these businesses will rally many times on their way to normalised multiples be that through further price declines or earnings catching up over time. Either way investors today will either suffer from the regressing multiple or the opportunity cost of holding into the long term as earnings catch up to valuations.

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Looking forward, I expect headlines to get worse before they get better. There will be genuine pain as rates continue to normalise, not only to asset prices which inflated well past reasonable levels, but also for heavily indebted consumers and businesses who feasted on low rates even with the knowledge that normalisation would come in time.

Beyond that though, it is also our human bias to seek out news and information to affirm our views. When investment sentiment turns negative, our news feeds and timelines are flooded with negative articles to reinforce those opinions. Good news or optimism is quickly stomped down as the bear mentality is fed.

I implore investors to look past the negative headlines which tap into our emotions and drive irrational behaviour. As an example, when Russia invaded Ukraine wheat prices skyrocketed on the back of expected supply disruptions from two of the largest producers globally. Headlines were quickly filled with prophetic calls for food shortages and global unrest. Fast forward a few short months and the wheat price is back at the pre-invasion level, but very few headlines noting that. In the end the mechanisms of supply and demand have done their job perfectly with the US and other European countries bringing forward their wheat seasons as well as farmers switching some livestock feed from wheat to other alternatives such as corn.

We will see many more headlines in the coming months about energy, inflation and whatever else will come over the horizon. As investors we shouldn't ignore these, but assess them rationally and ask the most important question; does this news affect the earnings engine outlook of any of the companies I own? You will often find that despite many believing the world is ending, the answer is usually no.

Turning to the portfolio, we had many updates from portfolio companies during June, with all of them positive and a reminder of the stark differences you can get between share price action and fundamental business progress when markets get irrational.

I wrote a blog post on **Smart Parking** (SPZ) a holding which updated the market during the month. We added to our position on the back of the update which showed the strength in the first half of the financial year had continued into the second half. Management declined to provide formal financial guidance, but they provided many operational metrics which allowed investors to work backwards to roughly calculate financial results.

Based on those metrics, I expect SPZ to nearly double the $5.1m EBITDA they reported in the 1H, leaving the business trading on roughly 6x EBITDA while generating significant cash for capital returns or further acquisitions. SPZ is now a meaningful position in the fund which I expect to contribute positively as they continue to execute their growth plans.

Kip McGrath (KME), another large holding also gave an update during the month. They expect to report 25% revenue growth and 17% profit growth for financial year 2022 and provided very positive commentary on the outlook for private tutoring, particularly as Governments around the world provide funding to catch up students who fell behind during the Covid pandemic. I spoke with Storm McGrath (CEO) after the update and gained a lot of confidence in my growth projections into financial year 2023 as Storm confirmed most of the costs invested for growth over the last few years is now behind them and margins expected to dramatically expand in the future.

8Common (8CO), also a large holding in the Fund gave guidance for their upcoming fourth quarter results with the travel and expense management software provider finally seeing the recovery in post-Covid restriction business travel. Expected transaction-based revenue of $820-830k would be a record quarter (previously $720k in the fourth quarter of 2021) with the recovery purely from increased user numbers as per user business trip numbers are below pre-Covid levels. With the large Federal Government contract kicking in now I expect 8CO to grow strongly throughout financial year 2023.

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You will notice a common theme across these businesses (which extends to most of the Inception Fund portfolio), which is they are expected to grow their earnings in the next year or two despite the uncertainty of global conditions. Rather than pay excessive valuations for businesses with earnings uncertainty (a few highlighted previously) I believe we have built a portfolio of businesses with better certainty for earnings growth at valuations which don't require it to earn a sufficient return.

During the month I gave a presentation to the Reach Markets audience (https://reachmarkets.com.au/meet-fund-manager-luke-winchester-2/) where I discussed the general market but also three stocks. One of those stocks was **Aerometrex** (AMX), the provider of aerial imagery. In the presentation I noted it has been our worst performer in the portfolio, but despite that the business had fundamentally performed to my expectations and selling at the time seemed irrational.

AMX was trading at 22c the day I gave the presentation or roughly a $20m market capitalisation. This compared to about $12m in cash and $11m in the depreciated value of planes on their balance sheet. To have a business trading below liquidation value shows how irrational selling was in the first week of June and while AMX was the most extreme example in our portfolio, there were others where the motivations for selling was not driven by business fundamentals but rather sentiment, tax loss selling or some other irrational reason.

Late in the month AMX won a large contract with the Department of Defence to sell some datasets for $2.5m. The company gave financial guidance of $4.5-5m EBITDA which even adjusting for the up-front costs of aerial capture likely leaves the company positive on a cash flow basis. Since the announcement the stock has traded north of 40c or nearly double the levels it was in early June. Unfortunately, we were not one of the brave buyers in that time ignoring the irrationality on display, but obviously welcome the sharp re-rate and expect the company to continue to grow in the future.

I have used the AMX example to highlight the significant returns available to investors willing to stomach the volatility of investing in a bear market. While many businesses traded at insane valuations and deserved to have share prices cut in half (or more!), many babies have been thrown out with the bathwater, particularly in microcaps where liquidity is the major driver of short-term share prices.

Finally, we had contract wins from two of our smaller software holdings, **Global Health** (GLH) announced contracts amounting to over $400k in additional recurring revenue, a solid contribution to their ~$5m current base. **MSL Solutions** (MSL) announced they had been selected to upgrade the point-of-sale solutions for The Gabba and Suncorp Stadium by the Qld Government. The contract was for $3.6m over a 5-year term, however included some hardware and implementation revenue so it is difficult to ascertain how much will be recurring revenue.

So far, the start to July has been positive. I suspect this is mostly the reversal of the tax loss selling seen in the back end of June but it is providing a better environment for businesses with positive trading updates as good news is no longer being ignored. As I look into the new financial year, I don't expect a smooth recovery. Valuations haven't bottomed out and there appears to be further bad news to come. However, I don't share the same negative outlook for our portfolio because I don't believe it has those characteristics. Valuations are more than reasonable and I expect good news from the businesses in the near 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)

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