MEREWETHER CAPITAL

30 November 2022 Investor Update

Merewether Capital Inception Fund Performance Summary (at 30 November 2022 net of fees and expenses)					
1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception* (p.a.)
0.39%	-7.92%	-4.94%	-29.76%	-	-29.76%

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

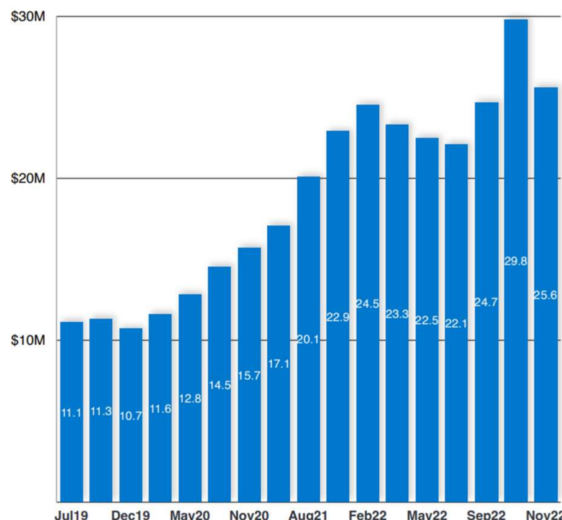
Dear Investor,

The Merewether Capital Inception Fund (the "Fund") began the month with a unit price of $0.6997 and ended the month with an indicative unit price of $0.7024 for a 0.39% return.

While any positive month is a relief in what has been a tough inaugural year for the Fund, the return is disappointing in the context our holding in **MSL Solutions** (MSL) receiving a takeover offer at a substantial premium during the month. We held a roughly 2% position size before a 29.5c takeover, a 64% premium to where the shares traded the day prior.

MSL is our second position that has received a large takeover premium in recent months after **PTB Group** (PTB) back in August. With PTB I assessed the likelihood of a competing takeover bid to be low and decided to realise profits immediately rather than wait for the takeover to become effective (which happened in late November). However, for MSL the operations are more strategic to a wider range of potential buyers so despite the high price tag (22x last year's earnings) I have not ruled out the chance of a competing bid and we continue to hold for now.

In other portfolio news, we had AGMs for most of the portfolio with various trading updates. **Austco Healthcare** (AHC) didn't provide any financial updates or guidance but disclosed their backlog of orders (image below). The $5m of contracts won in October accounts for roughly 15% of the total revenue recognised last year. $4m of other contracts in the backlog were executed in November, with commentary suggesting they were from higher margin product lines, boding well for the start to the new financial year.



Source: AHC AGM Presentation

We added to our position in **Prophecy International** (PRO) during the month after a positive update at their AGM. The company's eMite call centre analytics software continued its sales momentum, tacking on another $1.1m annual recurring revenue in the first quarter of the financial year, taking the total to $13.3m.

Balancing the excitement with eMite, PRO management did concede they have seen some slower sales decision making with their cyber security software Snare. This combined with the fact PRO are shifting Snare from a licensing revenue to a subscription revenue business meant first quarter new sales fell from $2.1m last year to $1.2m this year. Although that $900k fall was somewhat offset by the $600k subscription revenue that was added.

Despite the good update the PRO share price continued to slide on low liquidity. My view is the general sentiment around microcap technology and a misunderstanding of the company's financial accounts is giving us a fantastic medium-term opportunity.

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Rectifier Technologies (RFT) had a material announcement through the month, disclosing they had signed a $22m USD product order from i-charging, a Portuguese electrical vehicle charger manufacturer. This order is on top of the $20m USD order from Australian based Tritium and gives RFT a tremendous short-term outlook with both orders due for completion in 2023.

The RFT share price saw a small re-rate on the news, but well below what you would normally expect for an announcement of that magnitude. This is likely due to the fact the Tritium order was initially supposed to be completed in 2022 but due to supply chain and logistics issues could not be executed and was extended into next year.

The market is fair to question how RFT can execute $62m AUD worth of contracts in one year given the cumulative revenue over the last five years has been $73m. However, RFT management provided some good insight into their manufacturing at the AGM, highlighting that current manufacturing facilities can handle that capacity and manufacturing headcount will increase from 140 today to 205 by mid-2023. If they can avoid production and supply issues, the profit growth underpinned by these two contracts will be material.

Smart Parking (SPZ) provided some year-to-date figures through October at their AGM and growth continued with all operating metrics. After some questions around cash flow stemming from a previous update, it was pleasing to see a cash flow waterfall included in the AGM update to give shareholders full disclosure.

SPZ has performed well in a weak market for microcap peers, but I think it still represents fantastic value largely stemming from the fact the market does not appreciate how capital light the operating model is once sites are initially established. We already hold a large position in the Fund but have not sold any shares into the share price strength.

The most surprising update came from **Global Health** (GLH) which announced they were moving on from their recently appointed CEO Michael Davies and would be embarking on an organisational restructure. For some context, the business was profitable prior to Michael's appointment, but after raising capital the business was looking to leverage Michael's enterprise sales experience and flesh out their organisational systems and processes.

This meant expanding the cost base and tipping into a loss-making position, but with a clear plan to grow revenue and soon scale back into profitability. At one level the strategy was successful as the business won several contracts, but because of implementation delays due to staff shortages in the healthcare sector, the revenue would not come in soon enough to offset the elevated cost base.

At their AGM new management put a clear goal in place to restructure the business and return to profitability in 2023. While a focus on profitability is commendable in this environment, it remains to be seen what the restructure will do for the company's growth plans moving forward.

Xref (XF1) provided guidance at their AGM, stating that they expect sales to be flat on the prior period and revenue up 10%. The difference between the two figures is explained by Xref's operating model where they recognise sales as customer buy credits up front and recognise revenue as credits are used for reference checks in the software.

The mismatch between the two suggests that while activity on the platform remains robust, customers don't have the confidence to purchase lumps of credits up front, possibly due to questions over the near-term employment market or economy in general.

Xref will also get a boost from an acquisition announced during the month, buying Voice Project for $4m. The employee engagement platform will contribute $4m revenue, roughly 20% of Xref's revenue last year.

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November represented the anniversary of the Merewether Capital Inception Fund and it is fair to say it has been a challenging year.

A return for the year of almost -30% suggests highlights were few and far between, but we have had some positions perform well. **XRF Scientific** (XRF), **Smart Parking** (SPZ) and **Laserbond** (LBL) have been the three highlights in the Fund with XRF and LBL benefiting from exposure to buoyant mining and construction industries while SPZ had fortunate timing where their operational turnaround and pent-up demand post-Covid restrictions meant they could report strong profit growth off a depressed earnings multiple.

As discussed earlier **PTB Group** (PTB) and **MSL Solutions** (MSL) both received takeover offers during the year which were positive outcomes. I suspect we haven't seen the end of takeover activity in our portfolio and the microcap end of the market in general given how beaten down stock prices remain despite some optimism returning to the larger end of the market.

Most of our holdings can be lumped into the same bucket; stock prices hit hard despite the operating businesses performing up to expectations. This scenario is not a concern (in fact presents the best opportunities for long term investing) and we will remain patient and hold while the management teams continue to execute.

The important factor for most of these holdings is they remain well-capitalised and patience will be rewarded if the operational businesses continue to grow as expected. However, the two mistakes in the last year unfortunately do not tick this box and operational miscues are compounded by the need to massively dilute existing shareholders to bring emergency capital into the business.

Almost every business we own in the Fund is profitable and generating cash. There are a handful around breakeven, usually because management are re-investing any incremental profits back into growth.

The one exception to this is **intelliHR** (IHR). When we purchased IHR it was incurring heavy operational losses. Of course, capital was easy to come by in 2021 and it was the growth that was generated by those operational losses was the focus of the market.

IHR is generating growth in droves, annualising around 100% the last few years, all organic and a good chunk of it coming from existing customers who would expand their usage of the HR software over time. These are all fantastic attributes and there was a rationality to the IHR share price doing well.

As capital markets shifted in 2022, it became a race to see which businesses could shift with it. However, I think a key lesson learned is that it is very difficult to implement drastic change in business. Not only for larger businesses where legacy systems and processes reign supreme, but for any size business where culture is ingrained through a whole workforce.

When I spoke with IHR management during the year I was told of the various ways they were looking to reduce operating losses and bring the company to a breakeven state. Unfortunately, it has become clear those measures didn't go far enough, and likely relied on further strong revenue growth to compensate. While revenue growth has continued, a shift to larger enterprise customers has lengthened sales cycles and moderated growth to a degree.

At the time of writing IHR has not announced plans to raise capital but the market has already priced in large dilution. We continue to hold because I simply feel the mistake of purchasing a loss-making business too early in its life cycle would only be compounded by selling at current valuations.

At a market cap of $18m, IHR is generating annualised recurring revenues of $8.4m and still growing organically very strongly. The company is backed by both private equity and tech entrepreneur Bevan Slattery, so it is not out of the question for some short-term capital arrangement to be made that doesn't sacrifice long term potential.

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Further, we are in an environment with plenty of merger and acquisition activity in the tech space and IHR could present a valuable asset in the right hands. The software base is extremely modern with cutting edge analytics and could easily be integrated with legacy peers as seen by the partnership they have with payroll software provider Cintra in the UK.

The other mistake in the last year was our position in **Spacetalk** (SPA), the kids connected smart watch manufacturer. At a high level I can easily pinpoint the core of this mistake; confusing a good product for a good business. While the two often go hand in hand it is not always the case.

When we purchased SPA earlier this year the business was riding a wave of momentum. It had just reported a half year result with 50% revenue growth, raised capital late last year to shore up the balance sheet with nearly $10m in the bank and had only begun expansion into the valuable US market.

However, the business always had orange flags, primarily executive remuneration and in general poor disclosure in reporting. I didn’t view either of these as deal breakers, particularly given the company was searching for a new independent Chairman who could address both of those issues.

As capital markets turned over the year, I expected SPA could adjust. The business had previously shown an ability to bring new products to market and grow them with a constrained capital base so it was reasonable to assume they could again. However, it became clear with every update that this was not happening, and even worse the business was further ramping up its operational expense base.

This was more of the problem for SPA than other businesses because they must also deal with a much tougher working capital model where it can be months between the purchase of inventory and the payment is received from large retailers they are distributing through.

We participated in a shareholder led movement to remove the founder and executive Director in July which initially was unsuccessful, but the newly constructed Board eventually agreed with our views that he was not capable of driving the operational changes to return the business back to sustainable levels and he was terminated in October.

At that point the question I was asking myself was whether it was simply easier to sell our position and move on. What held me back was I viewed SPA’s problem as a capital one more than an operational one.

I wrote back in February that rather than dilute shareholders the business could look to sell their non-core Schools segment which generates very sticky cashflows and would have a lot of strategic value for the right buyer. Unfortunately, it was announced during the month that the new Board would push forward with a capital raise that would dilute the existing shareholder base by more than 50%.

This is a disappointing outcome and crystalises a path that I think was obvious since June when I first began talking with other shareholders about what actions we could take. Speaking with new management they have clearly identified the issues and are acting fast, but unfortunately if they were able to act six months earlier I suspect we could be avoiding the current situation.

The trading update provided during the month showed the promise that I saw in SPA when we first invested, with 39% sales growth over the crucial Black Friday/Cyber Monday period, a fantastic result given last year was a record by far. The business is also now providing SIM cards along with their smartwatches, bringing in another revenue stream and cash management appears much stricter.

We continue to hold our position because similar to IHR I feel the current valuation of $7m undervalues the core Schools segment, let alone the value of building a leading brand in an emerging consumer device space with the Devices segment.

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As this will likely be my last correspondence before the new year, I would like to wish investors the best over the holidays. While 2022 has been a tough year from an investment point of view, the support from investors and others has been fantastic and I appreciate the kind words and advice provided throughout the year.

I have no doubt 2023 will continue to provide challenges and lots of questions remain unanswered but underpinning my confidence for the new year is the historically low valuations among many of our portfolio companies and the microcap end of the market in general.

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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