Merewether Capital

Merewether Capital Inception Fund Performance Summary (at 30 June 2023 net of fees and expenses)					
1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception*
12.42%	8.70%	4.33%	8.59%		-26.93%

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 $0.6500 and ended the month with a unit price of $0.7307 for a 12.42% return.

June brought an end to the financial year 2023, one that small and micro-cap investors will be happy to put in the rear-view mirror. For FY23 the Fund returned 8.59% which is pleasing given the conditions in the pockets of the market we are looking to invest in, but in the context of a very poor FY22 there remains plenty of work to do.

The dominating factor across the ASX in FY23 was simply size and liquidity. There is some rationality to this; with cloudy outlooks for the global and domestic economies the companies best positioned to weather any issues and emerge on the other side are those with larger operations and balance sheets. Smaller business who are earlier in their growth lifecycles generally can’t offer the defensive characteristics investors sought in FY23, and broadly as a group were sold off in favour of larger peers. Smaller businesses who are still reliant on external capital were punished most of all, with many forced to source capital at debilitating dilution levels.

There was one consistent theme for small and micro-cap companies over the financial year; companies who demonstrated profitable growth were rewarded, while those who couldn’t were punished. Across our portfolio, our best performers were clearly in the first camp. Austco Healthcare, Rectifier Technologies, Smart Parking, Vysarn and XRF Scientific all performed well on the back of strong profit growth and providing good outlooks for the future.

Underneath these star performers are a group of small and micro-cap companies I would say the market is patiently waiting to see further execution. Businesses hovering around breakeven, growth slowing from good FY22’s or trading on high valuations that need fundamental performance to backfill into.

The bulk of our portfolio sits in this group, with share prices trading flat at best or drifting slightly downwards over the financial year. 8Common, Aerometrex, Compumedics, Kip McGrath, Laserbond, Prophecy International are examples of businesses like this as the market is generally sitting on the sidelines waiting for genuine profit growth (i.e. not EBITDA) to emerge or for the business to grow into a reasonable valuation.

Across the small and micro-cap universe, it is these businesses that offer the best opportunities as we enter FY24. As the market sits back and waits to see if management can execute and emerge with profitable growth, we can dig deeper and get conviction that these businesses are moving in the right direction and take positions at substantial discounts to fair value.

The final group of small and micro-caps are those that have been unable to show any sign of scaling towards profitable growth and require further capital to simply keep the lights on. These businesses were punished harshly in FY23 as the market was no longer willing to play venture capitalist for business models that have yet to prove themselves.

Fortunately, I believe we currently have no exposure to businesses like this in the Fund. While we had businesses disappoint and see profits decline with share prices hit hard such as CPT Global and Xref, in my opinion both have solid balance sheets and will be self-sufficient until operations turn around.

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Unfortunately, we did hold a business for the majority of the financial year which fit into the final group and in no surprise was our worst performer in the Fund. We sold our position in **Spacetalk** (SPA) late in the financial year after coming to the view my investment thesis was broken (and with brutal honesty was broken some time ago). I wrote about the problems the business faced back in the November 2022 monthly report, as the business was loss making with debt and a poor working capital cycle.

New management have done well to drive operational improvements but are doing it by "shrinking to greatness" and pulling back from international markets to focus on the core profitable Australian/New Zealand segment. In the short term this is likely the correct decision as it is the quickest path to sustainable profits and cashflow, but my original thesis was the business being able to drive further penetration into much larger international markets.

I have no doubt there is strategic value inside SPA worth more than the current market valuation but I don't see a clear way it gets realised and the debt on the balance sheet remains an issue. We will watch from the sidelines and I will take the lessons from this disappointing investment.

Turning to portfolio news, June was another month with positive updates from our companies.

Austco Healthcare (AHC) is experiencing some fantastic operational momentum right now, and this continued in June with the announcement they had won the single largest contract in the company's history. A $7.4m contract was awarded for a new 548 bed hospital being constructed in Vancouver. Like the $3.9m contract announced in May, the contract includes all of AHC's higher margin upsell products such as real time location services and clinical workflow software. The win cements Austco in the market for tier one customers and shows they can win these contracts against much larger and established peers.

Aerometrex (AMX) announced that the Department of Defence had made another annual purchase of their "off-the-shelf" datasets. While the amount of $1.7m was less than the $2.5m last year, given the sale is for data sets already captured with sunk costs, the incremental revenue will largely convert to profits.

While not considered recurring revenue as the Government prefers to transact through project-based tenders, it further entrenches AMX into the Federal Government which is very positive.

Kip McGrath Education Centres (KME) gave a trading update with their unaudited financial year figures, guiding for $27m revenue (10% growth) and $1.8m net profit (roughly flat). While the headline numbers are decent and in the ballpark of my expectations (although admittedly towards the lower end), the devil will be in the details when the full annual report is released as KME now has multiple reporting segments.

After the trading update it was disclosed that the vendors of the Tutorfly business which KME purchased last year had sold the shares they received in remuneration in a large cross trade which multiple KME directors participated in to the value of $150k. Given the share price over the past year it was pleasing to see the board and management stump up cash to acquire more shares to show confidence in the outlook for the business.

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)