MEREWETHER CAPITAL

31 August 2023 Investor Update

Merewether Capital Inception Fund Performance Summary (at 31 August 2023 net of fees and expenses)					
1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception*
1.27%	14.25%	10.46%	-2.65%		-25.74%

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 $0.7333 and ended the month with an indicative unit price of $0.7426 for a 1.27% return.

August is a busy month with full year financial reporting for most ASX companies. Overall I thought the reporting season was mixed, with companies exhibiting some consistent themes:

- Physical supply chains are recovering, providing a tailwind for companies who operate in global trade.
- Domestic wage inflation really started to bite for many companies who struggled to pass the higher costs onto customers.
- A lot of impairments and writedowns as higher interest rates mean stricter discount rates on valuations of intangible assets.
- Consumer spending is slowing down which impacted retailers, though travel and tourism continues to boom.
- The cyclical mining/construction sector is still strong, though the first cracks are appearing in mining exploration.

Like the overall market, the Fund's reporting season was mixed though on balance the positive results outweighed the negatives. In the small and micro cap space, the market's lack of patience remained a common theme. Company results remained unrewarded unless they were reporting strong numbers in the present, regardless of the outlook.

Like at half year reporting season in February, our best report came from **Rectifier Technologies** (RFT). Revenue for the electrical component company grew 144% to $39.8m and net profit grew 1213% to $6.5m, led by large sales to their electric vehicle charger customers. One negative with the result was growth flattened in the second half, but as the company grows rapidly while servicing large contracts, there will be some lumpiness to revenues and earnings.

Another negative was the sharp increase in working capital, however it is an unavoidable problem for fast growing manufacturers who need to order inventory ahead of executing on orders. Inventory on hand more than tripled on last year to $18.4m (from $5.9m) but provides a strong leading indicator for future growth into the new financial year.

Nonetheless, the result gave investors a glimpse of what RFT may look like as it continues to grow and scale. Adjusting for a loss on foreign exchange movements, the net profit margin was 18%, the return on equity was 45% and there was only $1m of capital re-investment required.

Very few businesses offer exposure to a rapidly growing thematic like high-powered electric vehicle charging while being capital light with high margins and high returns on capital. While there are genuine risks (such as customer concentration with two customers making up most of the revenue), a valuation of 11x earnings provides more than a sufficient margin of safety for those risks while balancing the potential of the business into the future.

Another great report came from **Smart Parking** (SPZ). Revenue (adjusting for currency movements) grew 21% to $46.1m and profit before tax grew 56% to $5m (a tax gain distorted the after tax figure).

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The strength in headline results were only more impressive after adjusting for the losses in the two expansion markets of Australia and Germany which combined for a $2.8m loss. Both are scaling rapidly (though further Australian growth relies on a favourable regulatory ruling in Queensland) with the potential to be breakeven or profitable this financial year.

Management noted they are likely to achieve their long-term goal of 1500 sites under management before their original target of June 2025, with the potential to do it this financial year with the benefit of an acquisition. I have previously written a blog post about SPZ (https://www.merewethercapital.com.au/blog/a-smart-way-to-play-the-uk-re-opening/) noting that if the company hits its 1500 site target it could be on a run-rate of $21m EBITDA based on extrapolating the unit economics of a site.

Despite a strong rally in the share price after the results, SPZ still trades on roughly 10x EBITDA and offers significant growth over the next few years and remains a high conviction position in the Fund.

A strong report from **Vysarn** (VYS) was expected after the company upgraded guidance twice in the lead up to results but it was going to be interesting how the emerging water services divisions were faring.

Pleasingly those segments performed very well, with the acquisition of Project Engineering (aquifer recharge) a highlight, contributing $1.5m profit before tax compared to an expectation of $850k at the time of acquisition in October 2022.

Despite the share price roughly doubling in the last four months, VYS shares still remain compelling value. An annual net profit result of $3.9m looks expensive against an $83m market capitalisation but given the first half result was a $55k loss the business trades on roughly 10x annualising the second half result.

Laserbond (LBL) had a strong report with revenue growing 25.7% to $38.6m and net profit growing 31.1% to $4.8m. The core Services segment drove the result, achieving 50% revenue growth assisted by the acquisition of a Queensland based factory last year.

The one blemish was a further delay in sales in the company's Technology division which continues to be hampered by supply chain issues and global logistics. Management's enthusiasm for the segment has not waned however, signing a new sale to an Indian customer and a sale to an American original equipment manufacturer a possibility.

Management commentary was extremely bullish on the outlook for the company, with further strong growth in Services expected from targeting new industries and geographies, margin recovery in Products after passing on price increases late in the financial year and delayed Technology sales to be completed.

LBL is not as cheap as other positions already discussed trading on 20x earnings, however with a highly aligned management team and an innovative product offering gaining deeper acceptance with customers I expect Laserbond to strongly grow earnings over the next couple of years and bring the earnings multiple down quickly.

XRF Scientific (XRF) continued to impress, reporting revenue up 38% to $55.2m and profit before tax up 36% to $11.1m (a changing tax rate impacted the after tax figure).

Being cyclically exposed to mining and construction customers the market is wary of any sign of growth slowing with XRF, and with a slightly weaker than expected fourth quarter shares were initially sold off sharply after the result.

However, XRF highlighted their order book remains at record levels and new products offer a new leg for growth in the new financial year which should offset any potential cyclical weakness.

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Like LBL, XRF is not cheap trading on 22x earnings but it shares many of the same characteristics of LBL and I expect the business to continue to compound earnings strongly over the coming years.

Underneath these stellar reports we had a group of companies with weak numbers for the last financial year but have set strong platforms into the 2024 financial year.

Austco Healthcare (AHC) announced revenue growth of 17% to $42m and profit before tax down 31% to $1.8m. Adjusting for Covid benefits in the last financial year profits were down about 10%.

However, digging deeper into the numbers and it is clear that the business is performing very well. Despite headline revenue growth of 17%, higher margin software revenue grew 65%, driving a record gross profit of $22.4m, a $3.6m increase on last year.

Of course, for net profits to decline despite record gross profit it implies heavy spending on operational costs which rose $3.8m on last year. Some of those costs won't be recurring such as an ad-hoc R&D team to assist with reconfiguring products for available parts with supply chain issues, as well as legal costs associated with the Teknocorp acquisition.

But the largest increase is the continued ramping in sales and marketing expense which is having an immediate positive impact for the business. AHC announced their order book is now up to $36.1m, a record high with strong momentum in contract wins.

The record order book and the cost platform set over the last two years puts AHC in great stead to increase profits over the next couple of years and rapidly bring down the current earnings multiple of roughly 40x down very quickly and we continue to hold a high conviction position in the portfolio.

Kip McGrath Education Centres (KME) reported revenue growth of 9% to $26.8m and net profit growth of 2% to $1.9m.

With a market capitalisation of $36m, KME trades on 19x earnings which is expensive for the current results and relies on profit growth to return to justify it. After years of disruption to profits, the coming financial year should finally be the start of progress as the company's growth investments begin to contribute to the bottom line.

Underpinning the business however is the strength of the core offering. Network revenue (total revenue regardless of corporate or franchisee) grew 10% despite a further rationalisation of underperforming centres primarily in South Africa. Total centres numbered 505 at the end of the financial year versus 537 last year.

While the core tutoring business in Australia, New Zealand and the UK grew profitably, expansion into the US was once again a drag on reported earnings losing $930k. Despite the loss, operationally the segment appears to be doing well, further expanding into US Federal Government funding for small group tutoring.

Tutorfly (KME's US brand) is now in 7 states and 11 school districts, up from 5 and 4 respectively last year. Contracts are in place for $2.6m in revenue for the next financial year (more than doubling the $1.2m this year), with the potential to grow as KME have tenders in the market with new districts.

Compumedics (CMP) was another company with ugly financial year 2023 results but has a much improved outlook. At a headline level, revenue grew 12% to $42.4m while net profit swung from $1.4m to a $6.1m loss.

However, the damage was done in a very poor first half as I wrote about back in the February report with the second half seeing a recovery in the business and recording a $1.1m net profit.

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Like KME, CMP's core business continues to do well, but importantly their "step-out" growth opportunities are starting to gain traction and appear to meaningfully contribute to the business moving forward.

I wrote in detail about CMP's growth opportunities in a blog post previously (https://www.merewethercapital.com.au/blog/is-the-market-asleep-to-this-microcap-med-tech-company/) and all three segments made good progress through the year.

Nexus 360 contributed $1.7m in software revenue compared to $1.3m last year, but exited the period with a run rate of $3m entering the new financial year. Somfit recorded it's first revenues of $600k from Australia, but booked orders of $1.2m and is awaiting FDA approval to expand into the US.

CMP management provided guidance of $44m revenue and $5m EBITDA for the 2024 financial year which would be a very strong result. Given the issues in the first half, the market has rightfully taken a wait and see approach, but if management can execute to that guidance I expect the stock to perform well.

Similar to CMP, **Prophecy International** (PRO) had a weak first half that impacted their full year results. Headline numbers were revenue growth of 19% to $19.6m and the net loss grew 47% to $2.5m.

However, $2.1m of that loss was recorded in the first half with the business likely approaching a run-rate breakeven by the end of the year. Like a lot of tech businesses PRO struggled to contain costs through the financial year, largely due to wage inflation across their software development and sales teams.

Despite only increasing the company's headcount by 2 people over the financial year (from 109 to 111), employee expenses increased from $11.8m to $14.7m due to a very tight labour market for skilled tech employees.

Nonetheless, with the business approaching breakeven and wage cost pressures easing, PRO is well placed to report profitability in the coming financial year and remains a high conviction stock in the portfolio.

Another member of the weak first half club was **Aerometrex** (AMX). At the headline level, the aerial photogrammetry provider reported revenue growth of 1% to $25.4m and the net loss before tax grew 42% to $5.2m.

For revenue, the biggest impact came the decision to cease their project-based photogrammetry which contributed $2.8m last year. Adjusting for only on-going revenue streams, growth was 14%. However, after a weak first half with revenue of $10m, the second half saw a record revenue result of $15.4m leaving the business with great momentum entering the new financial year.

The net loss also substantially improved in the second half, with a $1.2m compared to a $4m loss in the first half. With the end of project-based revenue AMX's business is much more recurring meaning we should see the second half momentum carry over and the potential to approach breakeven profit this year.

Unfortunately, we will never be spared from portfolio companies disappointing at times and we had two poor reports this season.

Xref (XF1) pre-announced their headline numbers in July meaning we shouldn't have seen too many surprises however as always the devil is in the details.

While the business recorded a small operating cash surplus as previously disclosed, the business ramped up their development spend to $2.5m from $1.4m last year. Combined with the $1.5m cash required for the acquisition of Voice Project, this meant that the cash balance fell from $11.3m last December to $6.8m at June. While normally that would be sufficient, XF1 has a $5m debt balance due in 2024.

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This leaves the balance sheet in a much more precarious position than I would have anticipated and means operational execution becomes very important over the coming year. In situations like this, I would always prefer management teams to be more conservative and look to reduce expenditure, however XF1 management have guided to going the other way and will maintain higher costs in an attempt to regain the growth that stagnated this financial year.

As I wrote last month there is genuine reasons to be optimistic growth can return as the business has brought new products to market and have the potential to expand within existing customers. That said, the balance sheet question marks now change the risk reward equation, and we reduced our position during the month to better reflect that.

The other disappointment was **CPT Global** (CGO). The headline numbers were revenue down 6% to $28.1m and net profit swung from $1.5m to a $1m loss adjusting for an impairment on a Canadian tax ruling.

Like XF1, it was the weakness of the balance sheet that causes the greatest concern, with CGO exiting the financial year with just $1.2m cash in the bank after losing $2.3m from operating activities.

Based on commentary from management it appears as though the headwinds that the business faced peaked in the third quarter of the financial year and have eased since, but as I outlined above I prefer to see management teams commit to reducing expenditure to see businesses return to profitability rather than relying on revenue growth which is much harder to forecast and subject to external factors.

Given that, we reduced our position similar to XF1 and will look to scale back up if I see execution moving forward.

Fortunately, there were no surprises from our companies that report quarterly (because this report is getting long!).

We will hear from those business later this month with their first quarter reports so expect updates for them in the September report.

Looking forward to the 2024 financial year, I am circumspect on outlook for the wider ASX given the uncertain economic outlook and valuations in the large cap space that look extremely steep.

However, for our portfolio I am much more optimistic. As I have outlined through this report, the bulk of our portfolio companies are growing strongly while still trading on very reasonable valuations. Underneath them we have a subset of positions who reported weaker 2023 results but have fantastic platforms set into the new financial year and should graduate to sitting alongside our best performers.

Inevitably, we have some positions which have disappointed and I am monitoring them carefully. Fortunately their portfolio weightings are small so if my investment theses are ultimately proven incorrect we won't feel much pain, but given their beat down micro cap statuses, I suspect if or when the operational execution improves we can add to our positions at bargain prices.

So far we have had a positive start to the new financial year (long may it continue), and I look forward to updating investors on our portfolio companies over the remainder of the year.

Thanks for your on-going support.

Luke Winchester (Portfolio Manager)

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