Merewether Capital

Merewether Capital Inception Fund Performance Summary (at 30 October 2023 net of fees and expenses)					
1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception*
-9.12%	-8.18%	-0.38%	-3.77%		-32.67%

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 $0.7409 and ended the month with an indicative unit price of $0.6733 for a -9.12% return.

After surviving a tough micro and small cap market in September, the Fund experienced a very tough October as the market conditions of 2022 reared their ugly heads again. Low liquidity and an intolerance for any balance sheet uncertainty saw many share prices smashed across our universe.

October also brought quarterly reporting season for micro and small companies, which provided the opportunity for them to address the market concerns for balance sheet uncertainty and demonstrate an ability to sustainably generate cash internally.

Unfortunately, I thought on the whole the reporting season was very poor and said as much in a recent Ausbiz appearance (https://ausbiz.com.au/media/winchesters-reporting-season-review-black-rocks-south-african-boost?videoId=32713). We are now two years into the micro and small cap bear market with the ASX Emerging Companies index still more than 30% down from its peak in November 2021.

Beyond the headline index return it is the complete lack of capital that has really emphasised the bear market. These conditions haven’t changed in the last two years and show no signs of changing in the near term. Yet some companies continue to fail to address their cost bases and make hard decisions required to generate sustainable cash flows and avoid the need for external capital injections.

In the last few months we have seen many micro and small cap companies issue highly dilutive capital raises to bring in much needed cash. Some examples include **Jayride** (24% discount), **Alcidion** (23%), **Somnomed** (21%), **Felix** (18%) and **Pentanet** (17%). Compounding these discounts to current share prices is the fact those share prices all sat at multi year lows, most 50-80% below their peaks. Simple mathematics means that the dilution required at collapsed share prices means for long term outperformance that the equity is impaired over the long term.

With share prices performing poorly and executives and boards ploughing headfirst into destructive equity dilution, it is no surprise to see minority shareholders voting against remuneration reports in the current AGM season. Board and executive remuneration must be voted on at every AGM, and while a strike (>25% no votes) has no immediate effect, strikes in consecutive years means the board will face a resolution to be spilled.

While that is quite rare, large votes against remuneration reports is seen as a protest vote and a warning shot to board and management that shareholders want to see operational changes. Unless we start to see those changes, I suspect there will be more shareholder led action against management and boards that aren’t looking after their interests.

Turning to portfolio news, while we had several trading updates from AGM’s as well as quarterly cash reports.

Rectifier Technologies (RFT) fell sharply on news articles that key customer Tritium was experiencing financial issues with concerns for the on-going business if they could not get an immediate capital injection.

While obviously not good news for RFT, the move in the share price likely overstates the operational impact. Given the balance sheet woes I expect current Tritium equity to be wiped out, but with a large order book, a newly built mega factory in the US and the Biden government electric vehicle charging infrastructure package to soon come into effect, it would be surprising if the business wasn't restructured in some way and operations continue largely unchanged.

Importantly, RFT continues to reduce their reliance on Tritium, winning new customers and bringing new products to market not only in the electrical vehicle vertical, but also in defence and data centres.

The best AGM update came from **Compumedics** (CMP) who reported a 23% increase in first quarter sales orders and 40% increase in recognised revenue. The strong start to the year meant the previous guidance of $5m EBITDA in FY24 was re-affirmed.

Management called out the commercialisation of their next generation epilepsy monitoring device Okti and sleep monitoring device Somfit in Australia as key drivers for the result. Importantly with Okti having US FDA approval and Somfit with a pending application, management noted that the sales pipelines in the world's largest market are progressing well.

With a roughly $40m enterprise value, 8x forecast EBITDA is a fair price for the core business, with lots of optionality built in over the coming years from further commercialisation of new products and technologies.

Laserbond (LBL) only provided a revenue update for their first quarter result, with revenue up 13% on last year. While a solid result, at face value it does appear LBL has yet to recognise significant revenue from their pent-up Technology segment backlog. Unlocking the bottlenecks preventing smooth completion of Technology projects is vital for the company achieving its medium-term revenue aspirations of $60m, so hopefully we get a positive update on that front at the half year report.

XRF Scientific (XRF) announced that their first quarter results were 8% revenue growth and 15% profit before tax growth. With a record backlog in place for their fusion machines that has revenue booked until the end of the financial year, XRF is well positioned to maintain growth. Management did note the first quarter was impacted by some timing issues with their labware division, holding large forward orders at the end of the quarter that are currently being fulfilled.

Turning to quarterly cash reports, it was a weaker than expected update from **8Common** (8CO) who suffered from timing mismatches as several large software implementations went live after the quarter end. This saw a $1m cash outflow for the quarter and left only $700k in the bank (since recovered to ~$1.2m as some large payments came in).

Pleasingly, 8CO management put measures in place to avoid the issues I discussed earlier this report of business impairing their long-term equity performance with destructive dilution. The 8CO Chairman provided a $1.5m working capital facility at a commercially friendly 8% interest rate. While ideally we want to own businesses that don't get their balance sheets into precarious positions, if it does happen it is positive to see aligned insiders respecting the long term potential of the business.

SKS Technologies (SKS) reported a strong quarter, generating a record $26.8m cash receipts and a $300k surplus. Beyond the headline financial numbers though, it was commentary that the order book is at a record $55m, with key projects won during the quarter with the Department of Defence and global IT company for a data centre project that was the highlight. SKS management have been focused on those two areas for some time, with the fruits of early investment now beginning to come through.

While cash receipts will be lumpy quarter to quarter, commentary was that the first quarter result leaves the company in good stead to hit their $90-100m revenue target for this financial year.

Knosys (KNO) delivered a strong quarterly result, generating $1.6m in cashflow. Like SKS, cash receipts are lumpy with annual payments from key customers, but management guided to being cashflow breakeven for the full year. While revenue growth has stagnated, management has reduced costs and focused onto key growth areas which hopefully has success in sparking growth again. With a market capitalisation of only $8m with $3.5m cash in the bank and nearly $10m in annual recurring revenue, there will be significant upside if management can return the business to growth.

At face value **Global Health** (GLH) reported a poor quarterly result with an outflow of roughly $1m. However, the first quarter is seasonally the weakest with large annual payments, and based on current trends the business should report cash flow positive quarters in the second half of the financial year.

Management continued with their cost rationalisation, shutting down their nascent Singapore office, and instead selling through channel and reseller partners headlined by an agreement signed with Fujitsu during the month.

While disappointing to give up hard earned gains over the last few months in a single month (as they say markets go up the stairs and down the elevator), we find ourselves in a similar position experienced over the last couple of years as micro and small cap share prices divert from fundamentals and be driven by liquidity and sentiment.

As I have said in the past, while frustrating this fundamentally only impacts long term performance if management teams are forced to dilute at depressed valuations. So far we have avoided this in our portfolio, and I am hyper focused to ensure that continues.

Thanks for your on-going support.

Luke Winchester (Portfolio Manager)


30 October 2023
Investor Update