MEREWETHER CAPITAL

Merewether Capital Inception Fund Performance Summary (at 31 January 2024 net of fees and expenses)					
1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception*
0.39%	10.81%	1.75%	6.10%	-12.70%	-25.39%

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 $0.7432 and ended the month with an indicative unit price of $0.7461 for a 0.38% return.

After a strong end to the 2023 calendar year, January brought back tough memories for small and micro-cap investors as the Australian market once again saw a sharp divergence in returns against their larger peers. The ASX 200 index, driven by the banks and technology companies, increased over 1% to hit a record high late in the month, eclipsing the record set in August 2021. In contrast, the Emerging Companies index (the closest proxy for small and micro-cap companies) fell -5.2% and remains over 30% off its high set in January 2022.

Fortunately, the biggest driver of the weak returns for the Emerging Companies index was its high exposure to speculative mining explorers, especially those tied to battery minerals such as lithium, nickel and cobalt. With no exposure to mining explorers, our Fund was able to consolidate its strong December return in January.

January also brought quarterly cashflow reporting for most small and micro-cap companies, and while doing an episode of The Call on ausbiz (link here) I commented that it was clear the tough capital conditions present for the last two years have now fully permeated into the mindset of most management teams and boards. Nearly every report I read had a focus on reducing cash outflows as boards and management teams continue to understand that without evidence of sustainable business operations they cannot access equity capital without significant discounts and dilution.

This was the common theme across our portfolio holdings who report quarterly cashflows as well, with **8Common** (8CO), **Aeeris** (AER), **Global Health** (GLH) and **Knosys** (KNO) all reporting substantial improvements in their cashflows and each approaching the breakeven inflection point if not there already. Despite being small weightings in the Fund, the low enterprise values of these nano-caps could mean significant upside if they can grow through the breakeven inflection point and prove to the market they can profitably scale with the runway of growth still before them.

Our standout quarterly cashflow result came from **SKS Technologies** (SKS) who continued the momentum I wrote about back in my November report. The business generated nearly $3m in cashflow for the quarter, a notable result for a business with a market capitalisation of only $30m. To be fair SKS is a contracting business with lumpy cashflows so extrapolating any one quarter is rife with danger, however even on a rolling 12 months the business has generated over $5m in free cash.

Importantly, the contracted work on hand is also now $93m, more than double the $40m from a year ago and supports the continued growth of the business. With the company's short-term working capital debt facility now fully paid off the balance sheet is in a much cleaner position and supports the likelihood of significant dividend increases over the next few years.

After announcing substantial new product orders last month, **Compumedics** (CMP) gave a first half trading update with record half year revenue of $26m or a 35% increase on last year. The significant growth does include a large chunk of revenue from the company's first MEG sale, however even excluding it revenue would still be a record $21.3m or 11% higher.

It is also pleasing that the current revenue growth is being bolstered by the forward order book, with sales orders taken for the half $30.3m or 74% higher than last year. Again, the large MEG sales discussed last month boosted this number, but even excluding them sales were $21.1m or 21% higher.

How cleanly the revenue growth translates to profit growth will be important in the upcoming report, with the company "expecting to return to profitability" and will provide an update to their current full year guidance of $44m revenue and $5m EBITDA.

Given the business has done $21m and $22m revenue over the last two second half years, it is likely revenue will fall into the $48-50m range after the $26m recorded in the first half this year. CMP was able to generate $3m EBITDA on the $22m revenue in the last half year, meaning it is likely EBITDA will fall into the $6-7m range. With an enterprise value around $75m, I expect CMP is trading slightly above 10x EBITDA, a very reasonable valuation for a medical device company.

Aerometrex (AMX) also provided a trading update, with revenue expected to increase 20% to $12m and EBITDA up 100% to $750k at the midpoints of their guidance ranges. With a roughly 40/60 split in the seasonality of revenue for the business between the two half years, it leaves AMX in a very strong position if the growth can be maintained into the stronger second half where the bulk of EBITDA is earned.

Perhaps the most pleasing part of the update was the cash balance slightly growing over the half, as despite recording operating earnings AMX is a capital intensive business and must spend cash maintaining their fleet of planes and executing on their image capture program.

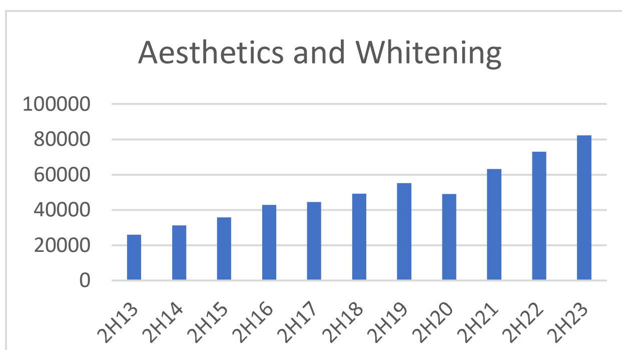
However, the company also announced that as the business model has now fully shifted away from contract-based image capture they no longer require a full in-house aviation fleet, and will outsource some image capture in the future, freeing up capital for higher margin growth areas.

We also added a new position to the Fund in January with an initial purchase of **SDI Limited** (SDI). SDI (or previously Southern Dental Industries) is a business I have followed for many years, but after a trading update early in the month decided an investment looked compelling.

As the former name implies, SDI is a manufacturer of dental products, though despite manufacturing in Australia for over 50 years, they only have modest penetration in their home market with the vast majority of revenue coming from overseas (primarily Europe and the US).

While SDI's headline revenue growth has been steady over the last ten years, roughly doubling from $56m to $108m, it masks that the business has seen an underlying shift between their product lines. Historically the business relied on Amalgam, the product used in the classic "silver" tooth fillings, a dental segment that has been in terminal decline as customers preferred the more natural tooth-coloured alternatives.

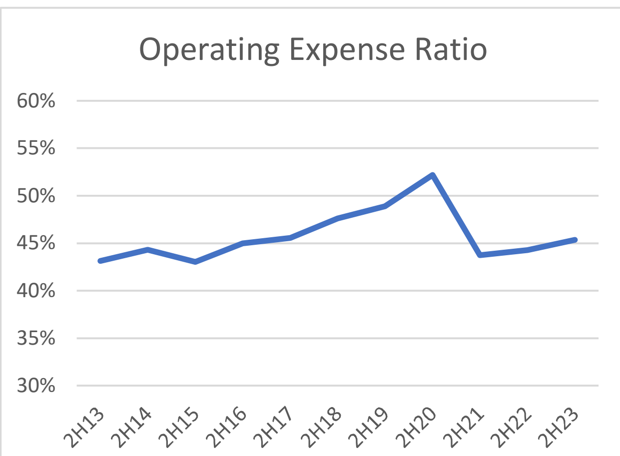
Seeing the shift in the industry, SDI management began investing in their alternative products and looking to grow their non-Amalgam segments of Aesthetics and Whitening products. Remove the terminal revenue decline of the Amalgam segment and the success of the Aesthetics and Whitening segments becomes clear, as they have grown revenues from $26m to $82m over the last ten years:



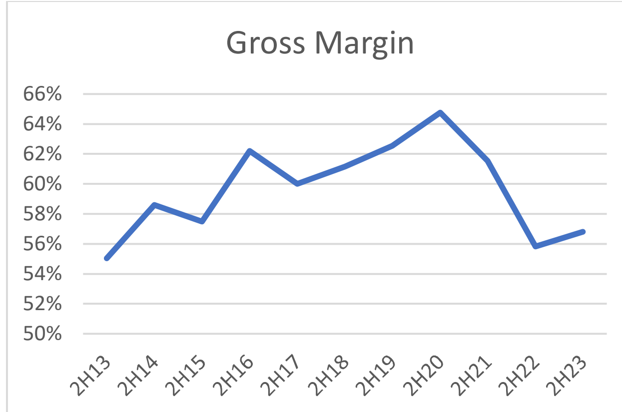
For a business with the remarkably steady compound growth seen in their non-Amalgam segments you would expect SDI to attract a premium multiple from the market, but this has not been the case with the share price trading only slightly above where it was ten years ago (though admittedly with a steady 4-5% dividend yield along the way).

Some of this can be explained by the muddying of the headline numbers as Amalgam revenue rolls off, but at less than 15% of total revenue now that is far less of a problem than it used to be. I believe the bigger issue for the stagnating share price is that the steady revenue growth has not resulted in steadily increasing profits.

Some of the reasons for that is outside of SDI management's control such as movements in currencies with ~90% of their sales coming from overseas and the bulk of their cost base in AUD. Looking at the expenses in their control however and you can see that while the expense ratio steadily rose from 2016 to 2020, management have since brought it back to historical levels:



If revenue has steadily grown and operating costs have been brought back in line, why have profits stalled out? The answer is through the pandemic it simply cost SDI more to ship and warehouse their products around the globe. You can see the sharp deterioration in the gross margin in beginning in the 2021 financial year:



Prior to the pandemic SDI was enjoying healthy growth in their gross margins as the Aesthetics and Whitening segments are higher margin than the legacy Amalgam, and further penetration of their revenues was bringing the group margins higher.

The gross margin hit a peak of 66% in the half ending December 2019, before bottoming out at 52% in the half ending December 2021. With a revenue base of ~$100m, a 12 percentage point decrease in gross margins is a significant hit to the business, and it was remarkable that it could be absorbed by the revenue growth and reduction in operating expenses to keep profits flat.

Hopefully the finer details outlined so far gets to the crux of the SDI investment thesis which is as gross margins recover the better unit economics of the Aesthetics and Whitening segments will no longer be muddied and will lead to significant profit growth.

With that in mind, it was a trading update early in January which has given me the confidence to initiate a new position as the commentary from management is that the recovery in gross margins has begun. Management advised the market that for the first half the financial year revenue had increased 3% to $52.1m, with non-Amalgam increasing ~6% (slightly below historical rates but impacted by a cyber security attack on key global distributor Henry Schein) and Amalgam decreasing 12%.

More importantly however was commentary that "product margins increased by 5%, reflecting further improvements in logistic costs and regional market and product mix."

With a gross margin of 56% last half year, it implies a gross margin of 61% for the current half year, strong growth not only year on year, but also on the 59% gross margin that was reported in a trading update given at the AGM for the first four months of the half. It implies the final two months of the half had gross margins returning back towards the historical highs in the mid-60's, providing a strong run-rate into the seasonally stronger second half where SDI normally has a 45/55 revenue split between the halves.

With management guiding to $3.1m net profit for the first half and the revenue seasonality split generally seeing the second half come in with a 50% higher profit, SDI is on track to do $7-8m net profit this year, perhaps even more if the gross margin recovery trajectory continues. At a current market capitalisation of $85m, 11x earnings is not an expensive price to pay for a business that could more than double earnings if the gross margins recover back to pre-Covid levels.

Of course, no investment is without risk and for SDI the clear one is the business is embarking on a significant capital project to build a new manufacturing facility as they have outgrown their existing one. The project is estimated to cost ~$60m over the next five years. If plans go smoothly, I expect the project can be funded from debt and operating cashflows, but for a project of that size there is no guarantee it goes smoothly.

Looking forward, attention turns to half year reporting season in February where we will get a pulse check on the continued growth of our portfolio companies.

Thanks for your on-going support.

Luke Winchester (Portfolio Manager)