MEREWETHER CAPITAL

February 2024 Investor Update

Merewether Capital Inception Fund Performance Summary (at 29 February 2024 net of fees and expenses)					
1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception*
-3.85%	4.61%	-3.39%	6.71%	-14.13%	-28.26%

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 $0.7461 and ended the month with an indicative unit price of $0.7174 for a -3.85% return.

Overall global markets were strong in February, buoyed by the continued investor interest in the broad artificial intelligence thematic. More importantly however, February brought half year financial reporting season for most ASX companies, meaning we had fundamental numbers to cut through the broader narratives that had penetrated markets over the last few months.

In that context the Fund performance last month was somewhat disappointing. While far from our worst month, in the past it has usually been macroeconomic concerns or a lack of liquidity hurting our performance, whereas in February we had a mix of strong and weak financial reports, with unfortunately our larger positions being the weaker ones.

Austco Healthcare (AHC) was a weaker report than expected. While headline revenue growth of 11% looks acceptable, adjusting for the contribution of an acquisition completed late in the period meant organic revenue growth was minimal. Compounding the muted revenue growth was the fact revenue skewed towards lower margin hardware sales meaning the gross margin fell from 54.8% to 51.9%. Positively, operating costs were largely steady resulting in net profit only falling from $1.4m to $1.2m.

It was not all bad news however, as AHC continued to increase the top of its "funnel", with a contracted order book at record highs up more than 100% on last year from $20.3m to $44.4m

Investors will want to see the record contracted order book filter down the rest of the funnel as AHC execute on work and generate revenue, profits and ultimately cash. Nonetheless, as a provider of nurse call hardware and clinical workflow software, AHC is often at the mercy of their customers as to when they can execute work creating a lumpiness that results in weaker periods such as this one every now and then.

Further to their financial result, AHC also announced the acquisition of Amentco, another Australian based reseller of AHC's hardware and software, furthering their sales and support footprint locally as main competitor Hills Healthcare continues to struggle.

At it's current $56m market cap AHC looks optically expensive trading around 23x this year's net profit, however with the elevated order book and the full effect of recent acquisitions there will be significant growth for AHC over the next year or two and I expect that multiple to shrink significantly.

Compumedics (CMP) released a solid report but in what was unfortunately a theme across other Fund holdings, revenue growth did not leverage into profit growth leaving the market underwhelmed. Revenue increased 38% to $26.4m and it was pleasing to see the Covid effects on logistics and warehousing costs continue to subside with the gross margin increasing from 50% to 55%.

Despite the step increase in gross profit, CMP maintained their heavy investments into sales and marketing and research and development meaning there was still an operating loss of about $1.5m for the half.

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While the market in general is reluctant to look too far into the future for micro-cap companies, I give CMP more rein for heavy investment given the new products they are releasing to market, in particular in the US for their new Somfit device with recent FDA approval as key competitor Philips has withdrawn from the sleep testing market.

Looking to the second half, CMP management upgraded their full year guidance from $44-45m revenue to $46m+ but maintained their EBITDA guidance at $5m which based on the first half result will have the business profitable at an operating level.

Like AHC, at the current $47m market cap CMP looks optically expensive as it likely only generates a small operating profit for the full year, but with sales orders taken for the last half 75% higher and the rapid commercialisation of new products, I expect profits to emerge quickly.

Kip McGrath Education Centres (KME) was the weakest report in our portfolio, continuing a disappointing trend. Like previous reports, KME had the same problem of revenue growth being overshadowed by poor cost control.

Revenue growth of 28% was a good result, but net profit fell from $650k profit last year to a modest loss this year. The biggest contributor to that was the loss of a Middle Eastern government funded tutoring contract which contributed roughly $500k to net profit last year, however even excluding that contract the business still didn't show any scale with the strong revenue growth.

Other shareholders have expressed frustration at management's lack of cost discipline which is a sentiment I share and remain supportive of any actions which would see the business return to the profit growth exhibited in the past.

Even after the weak first half result, management have guided to a net profit in line with last years $1.9m. At the current market cap of $18m, that would leave KME trading on less than 10x earnings, highlighting it would not take much of a change in sentiment to see the share price appreciate significantly from these beaten down levels if management can prove to the market their focus on profitability.

Laserbond (LBL) was unfortunately another position that couldn't translate modest revenue growth into profit growth, as 9% revenue growth saw profits fall 16%. The biggest impact to the result was having to source a new supplier of raw materials for their Products segment, causing manufacturing delays and higher costs from air freighting materials. Given these issues were known at the AGM in October, I would have liked for LBL management to be more conservative and advise the market earlier of potential issues.

From a longer-term view, the more important news from LBL was the acquisition of a 40% stake in Western Australian based Gateway Group for $10m, split 50/50 between cash and shares. LBL management has flagged for some time the strategic value of having a presence in WA given their mining and industrial customer base. The Gateway acquisition does look extremely synergistic and gives LBL a fantastic foothold to expand their operations in a key state.

LBL has been a core position of the Fund since inception and assuming a second half recovery with pent up Products orders the business trades around 15x it's current valuation, the cheapest multiple for many years despite imminent expansion into Western Australia and the US.

Prophecy International (PRO) released a good report with revenue growth of 29% and an improved profit result with a net loss of $1.6m compared to $2.3m last year. As I have written in the past, with a substantial negative working capital model (customers pay cash up front before rendering services), statutory profits are not an accurate measure of PRO's success as the business runs as cashflow breakeven and invests for the future.

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Like most software businesses, the value of PRO is not in what is being generated today, but the long-term value of recurring revenue from global enterprise clients with minimal churn. Annualised recurring revenue (ARR) grew 21% but accelerated over the year with last quarter adding $2.3m in ARR, before adjusting for $400k of legacy ARR that management flagged would roll off this year from old, unsupported products.

At the current $50m market cap, PRO trades on 2x it's current $25m ARR which is cheap for a software business that has stagnant revenues, let alone one that grew it's ARR by ~10% in the last quarter alone.

Rectifier Technologies (RFT) released a weak report, with revenue falling over 60% from $19.3m to $7.2m and profits falling from $3.8m to a $2m loss. While those headline numbers are shocking it is an unfortunate side effect of RFT being reliant on two key customers, both of whom reduced their sales orders from RFT in a weaker EV charging infrastructure market.

While the results for the past six months were disappointing, there are green shoots for optimism, primarily the fact the business remained cash flow positive due to a $6m increase in customer deposits. The sharp increase in customer deposits supports the management commentary of a strong recovery in the second half of the year potentially supported by news flow of new products for defence and megawatt electric heavy vehicle charging.

Our best report came from **SDI Limited** (SDI) which I wrote about last month, and it was pleasing to have a thesis play out as expected. The business continued its momentum in the higher margin Aesthetics segment, but it was a strong recovery in the gross margin that was the highlight as Covid headwinds continued to ease meaning that even modest revenue growth was able to hit the bottom line strongly.

Despite only 3.5% revenue growth, lower shipping and warehousing costs meant net profit grew 37%, even after a $700k impairment expense on existing plant and equipment prior to the impending capital expense for a new manufacturing facility.

Given the historical earnings skew from a stronger second half, SDI is on track to earn $9-10m in net profit this year, leaving the current valuation looking exceptionally cheap at around 10x earnings. Perhaps investors will want to see the return of strong revenue growth before affording a higher multiple, but given this half was affected by cyber security hacks at key distributor Henry Schein impacting ordering cycles I expect the business to return to its historical low double digit growth rates for non-Amalgam segments.

SKS Technologies (SKS) was another exceptional result, with revenue up 20% to $53.7m and profits up over 4x to $1.8m. Management commentary was buoyant for this growth to continue not only into the second half of the financial year but also next year given the record order book in place at $96m, more than double the value at last year.

Full year revenue guidance was upgraded to $120m, implying a strong second half of ~$67m and will likely see the business report a net profit between $4-5m for the full year. At the current market cap of $41m, SKS trades on less than ten times earnings with strong growth expected over the next couple of years as they continue their focus on higher margin defence and data centre work.

Smart Parking (SPZ) continued its strong run of operational execution with revenue growth of 20% and profit growth of 15%. However, adjusting for foreign exchange movements and a higher tax rate for their UK operations, profits grew 60% highlighting the exceptional scalability inherent to their operating model.

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The report wasn't perfect however with the German operations still loss making despite a partial contribution from an acquisition made during the period. Given the size and immaturity of automated number plate recognition in Germany I understand why management will continue to invest in the geography, but I hope to see scalability emerge in the near future.

At the current market cap of $150m, SPZ looks fully valued at about 25x adjusted profits, but as I have written in the past, I think the business model is fundamentally misunderstood by the market with the incremental site unit economics warranting heavy investment upfront to acquire new sites. With the target of 1500 sites brought forward to December this year, I expect SPZ can grow profits by more than 50% next year and continue that strong growth into the future.

Vysarn (VYS) also released a strong report, revenue grew 34% and profits swung from a small loss last year to a $4.1m profit. This was expected given the weakness in the prior period, but there was also modest growth on the stronger second half from last year.

However, looking forward management were very cautious on the outlook for the broader mining sector, primarily due to the continued weakness in lithium and nickel prices. Management guided to a slightly weaker second half profit result given these concerns as well as some additional costs from the on-going investment into their water asset management venture.

Shares were sold off after the result by ~15% and while I appreciate the market's reaction to the cautious outlook, it potentially overlooks the fact this is a management team who have proven themselves ultra conservative with their guidance to market, best outlined by upgrading their original profit guidance twice last year. We added modestly to our position on the pullback and VYS remains a core position of the Fund.

Trading on about 12x earnings, VYS is a fair price for the business today, but with the potential to expand into new water services verticals organically or by acquisition I expect VYS to continue to grow strongly and embed itself further into higher margin segments.

Finally, **XRF Scientific** (XRF) also released a solid report with revenue up 6% and net profit up 16%. Normally those sorts of numbers would indicate a "business as usual" half, but underneath the hood there were some drastic shifts in the company's segments.

The core Consumables segment grew revenue 24% on last year, with continued demand from mining customers as XRF continues to grow its market share. However, the nascent German office suffered a sharp fall with revenue down nearly 65% to $1.6m. Management acknowledged tough economic conditions for German industrial customers, but the second half is expected to improve with strong orders on hand.

At the current market cap of $170m and on track to do $9-10m net profit this year, XRF appears fairly valued for the business today, but with a management team with an established track record of execution and several growth avenues opening up over the next year or two, we are in no rush to exit our core position and would look to top up on any pullback.

Despite having a few weaker reports than hoped for this reporting season, on the whole investment theses across our portfolio remain intact, valuations remain reasonable (some downright cheap!) and confidence and liquidity continues to emerge in the ASX microcap space, which should leave us well positioned for the coming months.

Thanks for your on-going support.

Luke Winchester (Portfolio Manager)

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