LAKEHOUSE CAPITAL
A Motley Fool Company

LAKEHOUSE SMALL COMPANIES FUND LETTER

31 JULY 2017

Companies Held:	23
Cash Allocation:	7.1%
Top 5 Portfolio Holdings:	35.7%
Net Asset Value per Unit:	$1.0804
Fund Net Asset Value:	$105.0 million
Benchmark:	S&P/ASX Small Ordinaries Accumulation Index

Dear Lakehouse Investor,

July was a quiet month at Lakehouse: the lull before the reporting season storm. We only had six management meetings due to most companies battening down the hatches as they prepare their full year reports and presentations.

The unit price was equally calm. The Fund returned -0.1% net of fees and expenses during the month compared to a +0.3% return for the benchmark. Since inception in November 2016 the Fund has returned a net 8.0% compared to 5.7% for the benchmark.

The portfolio was little changed over the period as we closed July with stakes in 23 companies, one less than the previous month. We exited a small position in order to free up additional capital for an institutional capital raising and to carry a slightly larger cash balance into reporting season. This time of year often throws up a little more volatility which could let us opportunistically top up existing holdings, or build positions in companies we've been watching but haven't yet pounced on over price.

Our penchant for growing, scalable businesses with global opportunities could make for an interesting twist on this reporting season given the 3.2% rise in the Aussie dollar during fiscal 2017. Companies with a high mix of foreign earnings, particularly in US dollars, might release guidance for fiscal 2018 that undershoots underlying growth. We wouldn't be surprised if that left a few quality, global businesses selling for better prices coming out of reporting season, which would be fine by us given we have dry powder and a long-term view. It's worth remembering that it is ultimately the performance of an underlying business, not currency swings, that determines long-term success. Stay tuned.

Key Holdings

The biggest contributor to the Fund's performance during July was **Citadel Group** (+9.2%) while the biggest detractor was **Catapult** (-13.3%). These movements were despite no news for either company, serving as a good reminder of why investors should not read too much into short-term movements in share prices.

The Fund's top 5 holdings at the end of July were:

Company	Allocation
Altium (ASX:ALU)	7.5%
BWX (ASX:BWX)	7.4%
Gentrack (ASX:GTK)	7.1%
Catapult (ASX:CAT)	7.0%
Bapcor (ASX:BAP)	6.7%
Total Top 5 Holdings	**35.7%**

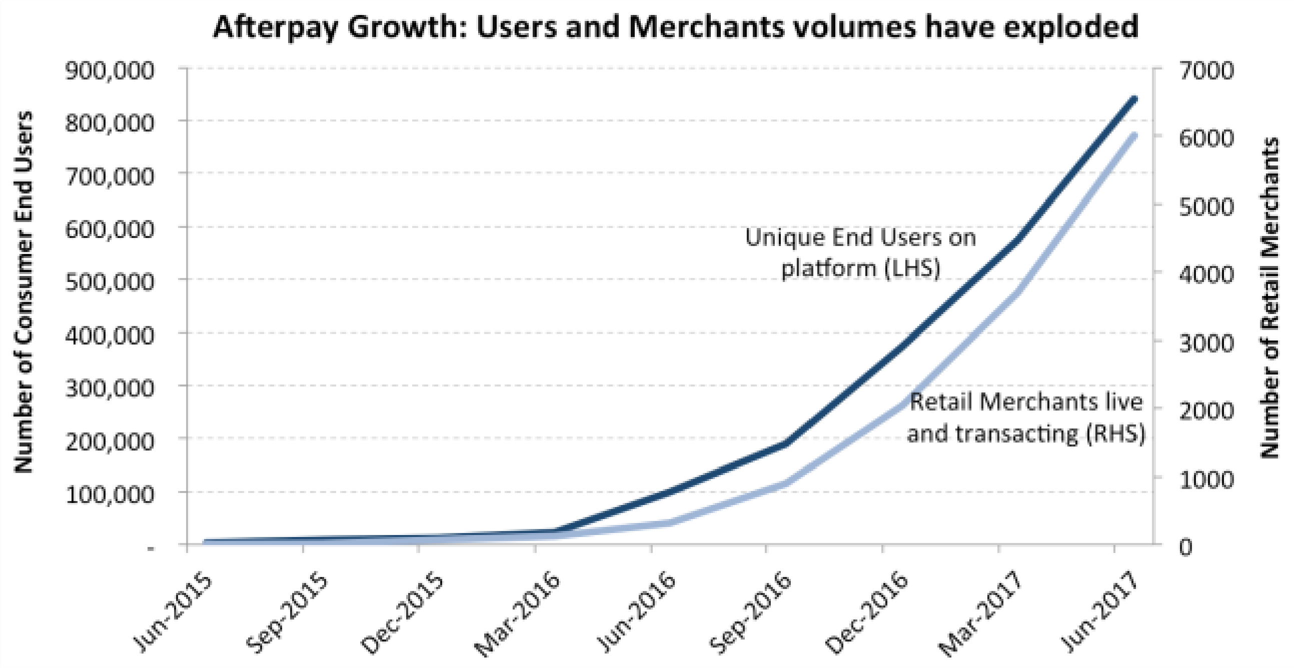
There was no change of names in the top five holdings throughout the month, although the order changed due to market volatility and topping up our investment in **BXW Limited**.

As previewed in the annual letter, during July BWX announced the acquisition of Mineral Fusion, the leading natural cosmetics brand in the United States. Mineral Fusion offers an ideal beachhead into the U.S. with distribution to an A-list of clients that is a carbon copy of what BWX would want to build for itself, but with 10 years of work already done. We have been surprised by the sagging share price since the announcement and have taken the opportunity to top up our stake, elevating BWX to our second largest holding despite the lower share price.

The recently merged **Afterpay Touch Group** is a position that we first mentioned in the annual letter. It is not among the Fund's 5 largest holdings, however, it was among its most impactful contributors in fiscal 2017 and merits a little more discussion.

The interesting part of this thesis rests on the Afterpay side of the business. Touchcorp's non-Afterpay-revenue was a meaningful $20.3 million last financial year, and remains a good-sized slice of merged group, but we expect will be rapidly overshadowed as network effects have taken hold in the Afterpay business.

Growth in both the number of Afterpay end users and retail merchants have exploded, with user numbers 8 times higher and merchants on the platform up almost 19 times over the past 12 months. Afterpay's platform now boasts over 840,000 users, more than 6,000 merchants and an annualised transaction value well in excess of $1 billion.

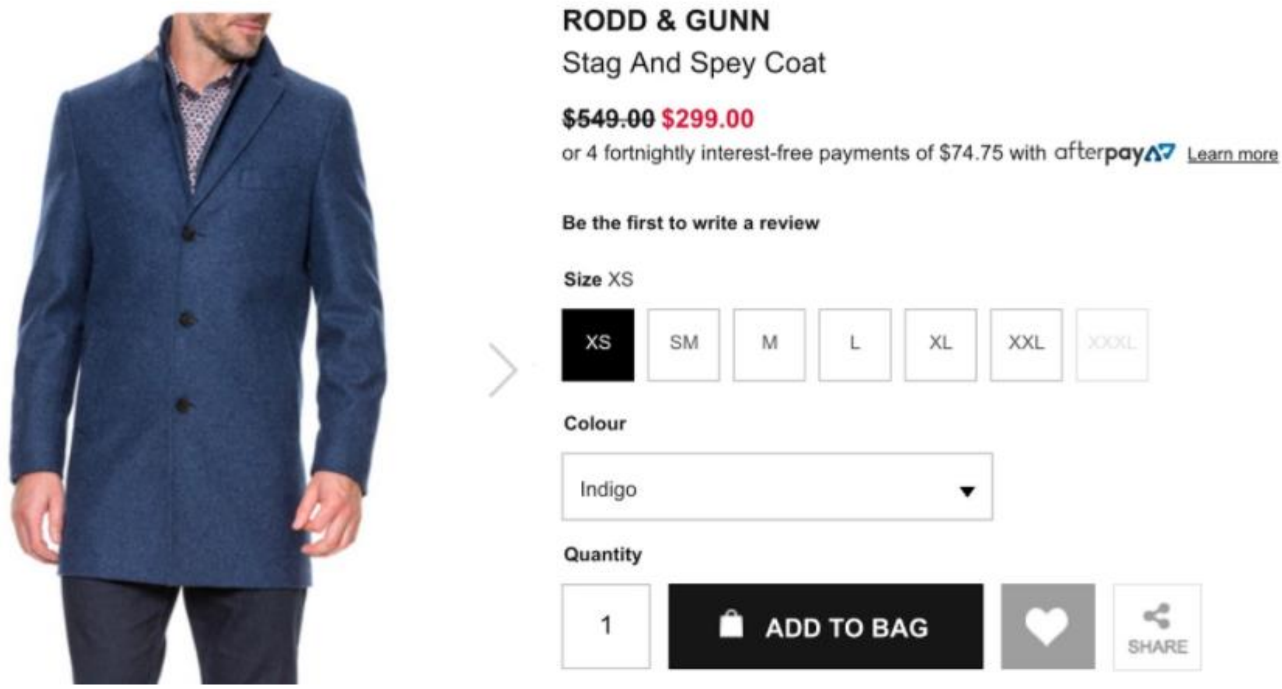


Source: Afterpay company announcements

The company estimates indicate that in a few short years, Afterpay has gone from a standing start to around 3% of all Australian online transactions and 15% of Australian online fashion transactions, and it continues to grow at ~50% quarter on quarter. At the core of this growth is the company's customer-centric focus: happy customers keep returning to the platform and are requesting it be added by retailers and retailers are taking notice. The fact that Afterpay does no outbound marketing to acquire merchants is testament to this and hallmark of a powerful network effect.

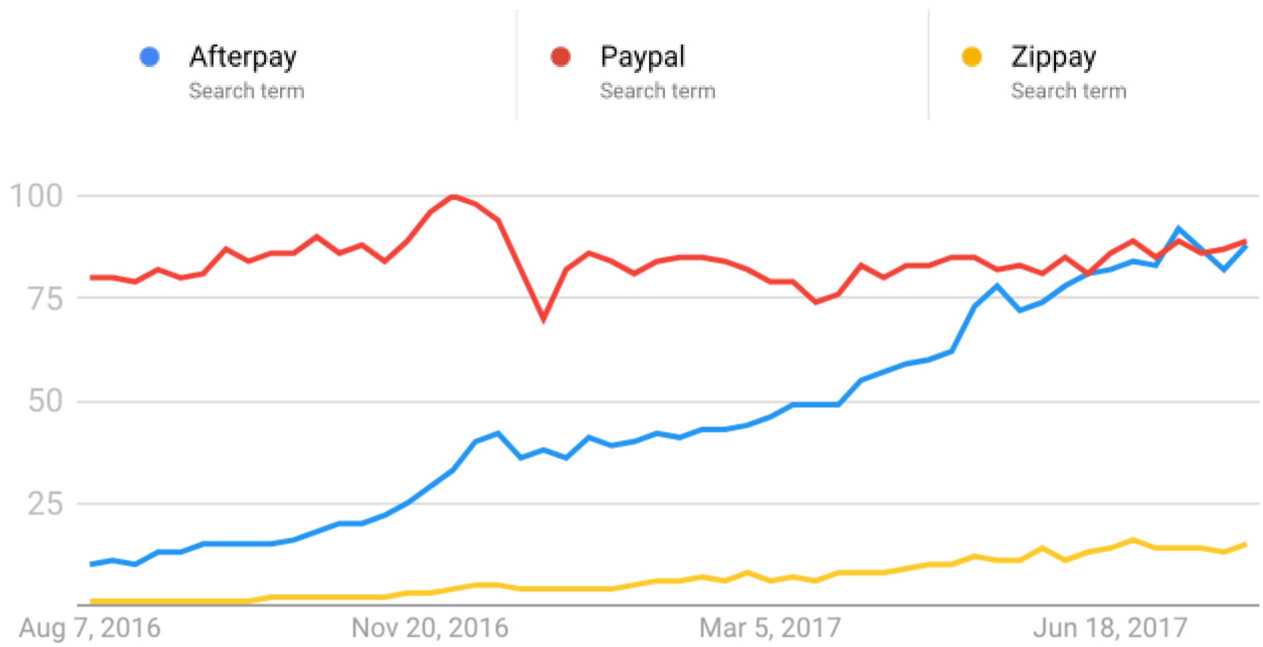
Afterpay offers significant benefits to both users and merchants. It allows customers to purchase the goods they want now without having to lay-by or incur establishment costs, interest or fees of any kind provided they make 4 on-time fortnightly payments.

From a merchant's perspective, offering Afterpay means there's no lay-by program to administer, no pesky credit card charge-backs for online or offline credit card fraud, and customers on average increase their basket size by around 20% per transaction. These benefits underscore why three-quarters of Afterpay transaction are repeat customers, and why you see merchants actively promoting Afterpay in both their online and bricks and mortar stores.



Google Trends is another tool we use to track interest in Afterpay. As the chart below shows, Afterpay is far out in front of local rival Zippay and has rapidly closed in on PayPal in Australia despite PayPal having a 16-year head start. Although this chart does not measure transaction volumes, it does provide a useful indicator of rapidly growing interest over time and recent trends bode well for continued growth.

Google Trends: Interest in Afterpay over time relative to Paypal & Zippay



Source: Google Trends

Afterpay has gained significant traction in Australian ecommerce, and we think there's still more room to run in the category as more users join, more merchants join, and users spend more with the platform as the service becomes more widely available.

We think the company's opportunity is larger than Australian ecommerce, though, thanks to soon-to-launch partnerships with Tyro, Trade Me, and BigCommerce. The Tyro deal will see Afterpay integrated with Tyro's network of EFTPOS terminals that service thousands of Australian small businesses. The tie up with TradeMe will mark Afterpay's first foray offshore and provides the ideal partner, and market, to test tube a global launch. Afterpay's integration with BigCommerce, one of the world's leading ecommerce platforms with 5,000 Australian and over 100,000 global online merchants spread across 150 countries, is an even larger opportunity that could allow Afterpay to patiently progress into in new countries.

It's hard to say whether Afterpay will succeed in gaining traction in offline retail or ecommerce outside Australia, however, it is well placed to have a go and the rewards for success at either could be substantial. What is more clear to us is that the business comes with larger-than-average risk given that Afterpay's core of fashion retail is at the very pointy end of discretionary spending. With record household debt saddling the Australian economy, consumer spending could cool off quickly, and if the Australian economic tide goes out this discretionary-spend-dependent business will be at the intersection of closed retail wallets and rising consumer credit risk.

Little can be done in the event of a spending slowdown. However, there are two countervailing points to consumer credit concerns. Firstly, the average order size runs at around $150, making for a very diverse creditor exposure. Secondly, and more importantly, the average Afterpay receivable has a tenor of less than 30 days, well below that of a standard consumer loan or even a credit card.

This dynamic of a very short-lived receivable cycle also delivers attractive economics to the business, as Afterpay's capital can be turned over 12-13 times per year. The rising degree of leverage in the capital structure, which strikes us as prudent given the model and lowers the company's cost of capital, leaves the business more exposed to a recession and the risk of rising interest rates potentially squeezing margins. We don't expect rates to shift meaningfully higher anytime soon, though, given the country's slow rate of growth and high existing debt levels.

The shares are further out on the risk spectrum than usual for us given the conventionally rich valuation and that its model has not been tested across a full economic cycle. However, we are comfortable with those risks given the company's significant growth and opportunities, and in the context that we have no other direct exposure to Australian lenders.

Looking Ahead

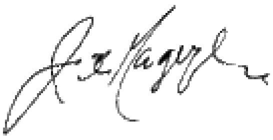
Our team remains enthused by the bright prospects of the companies in our portfolio. We're excited to receive report cards from many of our companies throughout August and September, and most importantly, discuss with management how the business is positioned for the years ahead.

We'll also get the chance to hear from other companies on our watchlist and to meet with their leaders to hear about the business models, what has them excited, and what's keeping them up at night. It is an extremely busy time, but as we've heard another investor quip, "if an analyst doesn't enjoy reporting season, they're probably in the wrong industry".

We look forward to continuing to keep you informed with our investor letters. Until then, hopefully a little extra volatility throws up some juicy investment opportunities.

As ever, thank you for your time and trust.

Best Regards,



Joe Magyer, CFA
Chief Investment Officer