LAKEHOUSE CAPITAL
A Motley Fool Company

LAKEHOUSE SMALL COMPANIES FUND LETTER
31 MARCH 2017

Companies Held:	24
Cash Allocation:	16.2%
Top 5 Holdings of Portfolio:	34.3%
Net Asset Value per Unit:	$0.9829
Fund Net Asset Value:	$88.7 million
Benchmark:	S&P/ASX Small Ordinaries Accumulation Index

Dear Lakehouse Investor,

March was yet another busy month for the Lakehouse Small Companies Fund. We initiated stakes in 3 new companies, added to existing positions, and had 43 company meetings.

The Fund's net asset value per unit increased by 3.9% in March compared to a 2.7% increase for the Fund's benchmark. The most significant contributor to performance during the month was **Pro Medicus** (+27.3%), which we'll discuss shortly, while **Citadel Group** (-6.5%) made for the largest detractor. Since inception the fund is down 1.7% compared to a gain of 5.7% for the benchmark.

While it was a good month for the Fund our team does not judge itself based on short-term results and neither should investors who embrace our strategy. Instead, our short-term focus is on the disciplined execution of a process that we think leaves us well placed to deliver on our objective of long-term outperformance.

Our preferred style of companies has been out of favour, however, we think makes for greater opportunity. For example, *The Australian Financial Review* recently noted that, according to Realindex, calendar 2016 was the worst year for quality and growth in 15 years.

Meanwhile, since the Fund's launch in mid-November, Mr. Market has been living large by bidding up the share prices of large-cap companies and disregarding shares of smaller companies.

Index (or Fund)	Total Return (16/11/16-31/3/17)	Average Market Cap ($M)
S&P/ASX 50	12.3%	$25,635.6
S&P/ASX Midcap 50	11.4%	$4,400.0
S&P/ASX Small Ordinaries	5.7%	$955.3
Lakehouse Small Companies Fund	-1.7%	$537.7
S&P/ASX Emerging Companies	-4.8%	$193.7

Sources: Bloomberg, S&P, and Lakehouse calculations. Returns include reinvested dividends. Dates encompass the Fund's launch on 16 November 2016 through 31 March 2017.

We won't pretend to know when small-caps will once again be the life of the party or when quality and growth will be back in fashion. We expect the tides will change eventually, though, and consider time the friend of our strategy. As Benjamin Franklin said, "the bitterness of poor quality remains long after the sweetness of low price is forgotten".

Our team has continued to put more of the Fund's capital to work given what we think is a promising environment for our strategy. The Fund's cash allocation decreased from 29.8% at the end of February to 16.2% at the end of the March as we opened new positions and increased others. We expect to remain net buyers should the status quo hold.

The Fund's largest sector allocations are to information technology (60.9% of total capital), consumer discretionary (8.6%), and consumer staples (6.3%). We look very little like our benchmark as a result, which is dominated by consumer discretionary (20.8%), materials (17.5%), and real estate (14.1%). Information technology is the second-from-smallest sector at just 4.7% of the benchmark.

Our significantly different weighting is rooted in our very specific, differentiated process. As a reminder, we seek the following attributes in our portfolio companies:

- Strong positions in growing markets.
- Pricing power with customers and suppliers.
- Durable competitive advantages grounded in; scale, strong brands, network effects, or high customer switching costs.
- Aligned and experienced management teams with strong track records of capital allocation.
- Conservative balance sheets.
- Attractive valuations that afford upside to our estimate of fair value.

Few companies meet such standards, hence our more concentrated approach of typically owning 15 to 30 companies at a time, and the ones that do make the cut tend to land more frequently in certain industries. You won't find many miners or retailers that can lay claim to pricing power or locked-in customers, for example, but 21 of our 24 portfolio companies have business models built upon some form of subscriptions, long-term contracts, or license or maintenance contracts.

We also sleep well knowing that our portfolio companies have a collective net cash position, unlike our benchmark, and they are collectively growing quickly despite a sluggish domestic economy. The Fund's portfolio companies grew their revenue by a collective 19.4% over the past year compared to around only 5.8% for our benchmark.

We don't plan to disclose all of the Fund's holdings in our letters -- doing so would hurt performance because other investors could front-run the Fund as we build and reduce positions -- but we'll walk you through our largest positions and other positions of note in our monthly letters.

Below were our five largest positions as of 31 March 2017:

Company	**Allocation**
Bapcor (ASX:BAP)	8.2%
Altium (ASX:ALU)	7.7%
Gentrack (ASX:GTK)	6.3%
BWX (ASX:BWX)	6.3%
Pro Medicus (ASX:PME)	5.7%
Total Top 5 Holdings	**34.3%**

The mix of our top 5 positions changed this month with **Gentrack** and Pro Medicus eclipsing other positions that we remain positive on. Just as investors should not read too much into our short-term performance, neither should they overthink whether a position bobs out of our top 5 positions.

Gentrack and Pro Medicus are both charming in their own ways but the two lightly-followed software companies have many things in common: high-margins, strong balance sheets, loyal customers, footprints outside Australia, and leadership teams with significant skin in the game. Each of them also gave us reason to add to our existing positions in the past few weeks.

Gentrack develops billing and CRM software for energy utilities and water companies as well as comprehensive operations systems for airports. Its software is mission critical, value-adding, and very difficult to strip out or replace. Indeed, as of the company's prospectus in 2014, the company noted that its average customer tenure exceeded 9 years. The company grew EBITDA by 16% this past fiscal year despite a currency headwind and a ramping up of staff to take advantage of a sizeable opportunity in the UK with the deregulation of its water market.

We increased our position following the recent acquisition of Junifer Systems, a UK-based company that offers billing and customer information software-as-a-service offerings to utilities. Junifer is growing quickly -- it now has 25 utility customers after going live with its first energy supplier in 2012 -- and profitably with an impressive 38.8% EBITDA margin. The acquisition is a good fit with the company's UK strategy and the timing strikes us as excellent with the New Zealand dollar -- Gentrack's functional currency -- at an all-time high against the pound.

The company ticks all our boxes, including an attractive valuation given its growth and durability at less than 23 times consensus forecasts for this year, and we'll have more to say about the business after it reports first-half earnings in late May.

Pro Medicus, meanwhile, develops medical imaging software and radiology information systems (RIS). The latter, which is at the company's roots, is essentially a practice management software solution for radiologists. The former, which the company acquired for a song in 2009, is a viewing system that is growing like gangbusters thanks to its speed, functionality, and scalability.

The company has delivered explosive growth over the past 2 fiscal years with revenue roughly doubling and pre-tax profits roughly quadrupling thanks to major wins for the company's medical viewing software. We think more is in store thanks to the onboarding of new imaging clients, including an epic win of a reference client in the Mayo Clinic, as the company's product is widely recognised as best-in-class. Helping matters is the company's ability to deliver rapid, seamless implementations. For example, the company recently completed a seamless implementation of its imaging software for a major US-health system far ahead of schedule while displacing 9 separate legacy systems.

We already had a stake in Pro Medicus but our enthusiasm picked up when the company began repurchasing shares in late December, which was the first time the company had bought back shares in more than 4 years. Notably, the last time the company repurchased shares it created huge value for shareholders -- it paid around $0.25 a share and the shares finished March selling for $5.76 -- so we took the recent repurchases as a very positive sign. We were further emboldened when the company announced a sizeable new, enterprise-wide contract for its RIS product with Primary Health Care.

Pro Medicus is not conventionally cheap -- the shares sell for about 72 times trailing net profit after tax -- but we expect the company to deliver significant earnings growth over the next two years as major new customer wins combine with significant operating leverage. The business is highly scalable and managed to grow first-half pre-tax profit by 31.2% after stripping out net foreign currency gains and despite rolling over a difficult prior comparable period. Further, the company has guided for a strong second half and is enthused about its pipeline, giving us that much more confidence.

Looking Ahead

The past few months have been bumpy for many small-cap investors, including for our Fund, but we're even more enthusiastic about the outlook for our strategy today than when the Fund launched in November. We're happy to have built up positions in many high-quality, fast-growing companies at attractive valuations and significant discounts to their recent highs. While we're not fortune tellers, we feel confident that the strong and rising fundamentals of the portfolio will shine through with the fullness of time.

As ever, thank you for your time, trust, and patience.

Best Regards,

Joe Magyer, CFA
Chief Investment Officer