LAKEHOUSECAPITAL
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LAKEHOUSE SMALL COMPANIES FUND LETTER
31 MAY 2017

Companies Held:	24
Cash Allocation:	7.3%
Top 5 Holdings of Portfolio:	34.8%
Net Asset Value per Unit:	$1.0234
Fund Net Asset Value:	$97.5 million
Benchmark:	S&P/ASX Small Ordinaries Accumulation Index

Dear Lakehouse Investor,

May marked a few milestones for the Lakehouse Small Companies Fund. The Fund participated in its first IPO, increased its stake in a large holding via an institutional placement, and we reopened the Fund to new investors for the first time since launch.

The Fund's net asset value per unit increased by 1.9% in May compared to a 2.1% decrease for the Fund's benchmark. The most significant contributor to performance during the month was **WiseTech Global** (+24.5%), while **Catapult** (-21.8%) made for the largest detractor. The Fund is up 2.3% since inception compared to a gain of 3.3% for the benchmark.

We're pleased to have pulled close to the Fund's benchmark over the past couple of months after a slow start. Our team does not judge itself based on short-term results, though, 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 Fund is unlike most others in that we focus on smaller companies, not the widely-held large-caps that dominate the news. The Fund's holdings are followed by an average of only 5 sell-side analysts compared to 8 for our benchmark and 15 for the ASX/S&P 50. In the words of baseball legend and Hall of Famer Wee Willie Keeler, we hit 'em where they ain't.

We also embrace a long-term, high-conviction approach that leaves us saying "no" very often. We have a healthy respect for the limits of our circles of competence and have a very specific set of

attributes that we seek in our portfolio companies. As we've said before, and will say again as they're core to our approach, we're seeking:

- 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.

Our focus steers us towards cashed-up growth companies with models built upon extreme customer loyalty. We like knowing where our next meal will come from, and we like that 21 of the 24 companies in the portfolio had businesses built on recurring revenue in the form of subscriptions or multi-year contracts. The Fund's investments also collectively hold more cash than debt (while the opposite is true for the benchmark) and have grown revenue at 20.0% over the past year compared to just 5.1% for the benchmark.

You won't tend to find the companies we seek in commoditised, capital-intensive industries, which is why the Fund's sector allocations look very different to our benchmark. The Fund's largest allocations as of the end of May were to information technology (70.6% of total capital), consumer discretionary (8.0%), and consumer staples (7.4%) while the largest components of our benchmark were consumer discretionary (20.0%), materials (16.3%), and real estate (15.2%).

Key Holdings

We do not disclose all of the Fund's holdings in our letters -- doing so in the world of Aussie small-caps would be like showing your cards while playing poker -- though we do walk investors through our largest and most impactful positions in our monthly letters.

Below were the Fund’s 5 largest positions as of 31 May 2017:

Company	Allocation
Altium (ASX:ALU)	7.8%
Gentrack (ASX:GTK)	7.1%
BWX (ASX:BWX)	6.9%
Bapcor (ASX:BAP)	6.7%
WiseTech Global (ASX:WTC)	6.3%
Total Top 5 Holdings	**34.8%**

Catapult tumbled out of our top holdings in May as investors grew worried over the company’s level of cash burn in the third quarter. We do not share that concern as Catapult is a seasonal business -- the third quarter is weak while the fourth quarter is strong -- and its existing seasonality was even further exacerbated by last year’s XOS acquisition. We suspect skittish investors might be pleasantly surprised when the company delivers its next cash flow statement.

Regardless of where cash flow lands for the fourth quarter, it’s worth remembering that we invested in Catapult for what it would bring to the table in three years, not three months. We’re pleased that the company continues to invest for growth and, with the shares currently around 62% below their highs from last year, we think the current valuation fails to reflect the business’ multiple ways to win. We increased the Fund’s stake during May and continue to believe the business has a bright future.

In other news, we have also been asked by a few investors for our thoughts on the risks that electric cars pose to **Bapcor**’s core business of selling replacement parts for ‘traditional’ vehicles powered by combustion engines. In short, electric vehicles require far fewer moving parts than the petrol- and diesel-powered vehicles that rule the road today, so a shift towards electrics could theoretically make for a smaller market for Bapcor. When you drill down into the data, though, the risk begins to look far off, even for our investment horizon.

The first reason we see disruption via electric cars being a remote risk is that very few Australians are buying electric cars. Why? The few electric cars on the market today are expensive and have less range and support infrastructure than their petrol and diesel brethren. The combined share of petrol- and diesel-powered vehicles in Australia is increasing, not decreasing, and reached 97.7% of the fleet in 2016. And if you’re thinking that Australia is lagging the world, note that electrics only made up around 1% of new vehicle sales in the US last year.

What about Tesla? The torchbearer of the electric car movement has made plenty of headlines, however, it has not made many cars: Tesla delivered fewer cars globally in 2016 than Australians bought in April. Despite all the fanfare, Tesla does not even rate among Australia's top 30 makes of registered passenger vehicles.

Even if we consider the global top selling electric vehicle, the Nissan Leaf, which has sold some 4.7 million vehicles globally, only 600 Leafs have been sold in Australia. Equivalent to 0.003% of the Australian motor vehicle fleet. It's also worth noting that a number of reported electric vehicles are actually hybrids. Some two-thirds of the initial 2015 sales of the BMW i3 were reported to have the reassurance of a back-up petrol engine.

Some have likened the rise of electric cars to the disruptive rise of smartphones, however, we think that's like comparing apples and pineapples. The smartphone was a vast leap forward compared to its predecessor whereas the difference between electric and petrol vehicles is more incremental. The financial barriers to change in autos are also much higher than in phones. A base iPhone 7 Plus will run you about $1,300, or about one week's wage, while the base Tesla Model X will run you about $150,000 in New South Wales, which is akin to a house downpayment.

The most important factor forestalling disruption, though, at least beyond the reality that electric cars aren't gaining traction in Australia, is the long replacement cycle of vehicles. Unlike a smartphone, which a typical buyer will hold for less than 3 years, the average vehicle in Australia is more than 10 years old. Roughly speaking, that means even if electrics immediately and magically matched diesel's 20.9% of new vehicle sales, it would take about 14 years before a fifth of Bapcor's target market would be supplanted by electrics.

What about driverless cars? We've given this one considerable thought, as well, though the same point rings true about long replacement cycles stymying disruption and risk to Bapcor's business, and one also needs to factor in the significant societal acceptance and legislative change that would be required. We're also obliged to note there are true driverless cars on the road today. Tesla's Autopilot feature would be the closest thing available but, again, the brand has not made a dent in Australia.

Turning back to Bapcor, it's worth noting the company's shares are already priced as though the company is under siege. The multiple of around 17 times consensus forward earnings that Bapcor sells on is comparable to that of **Flight Centre**, which has disappointed the market with downgrades and whose market was disrupted many years ago. We think that is odd, particularly given that Bapcor's core trade business that focuses on replacement parts for used autos is far more defensive than selling holiday packages to Fiji.

We expect that electric vehicles will gain share over time as their travel range improves and prices fall, however, the simple reality is that few of them are selling and that the long replacement cycle for vehicles means disruption of Bapcor's business is at least a generation away. We see little downside in the shares today given these dynamics, the company's history of beating expectations,

the highly visible and reliable demand for its products, and a valuation that isn't demanding. We remain happy long-term holders.

Looking Ahead

Our team is enthused. We've been hard at work unearthing new ideas -- we met with 14 different companies in May alone -- and feel very good about the long-term prospects of the portfolio we have assembled. We're also pleased to have a substantial, active watch list with which we feel comfortable acting upon on short notice.

As ever, thank you for your time and trust.

Best Regards,

Joe Magyer, CFA
Chief Investment Officer

P.S. One more thing: Lakehouse Capital is hiring for an experienced research analyst to join our growing business. If you know someone that shares our style and long-term view and would be interested in joining our team, please check out the job posting.

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