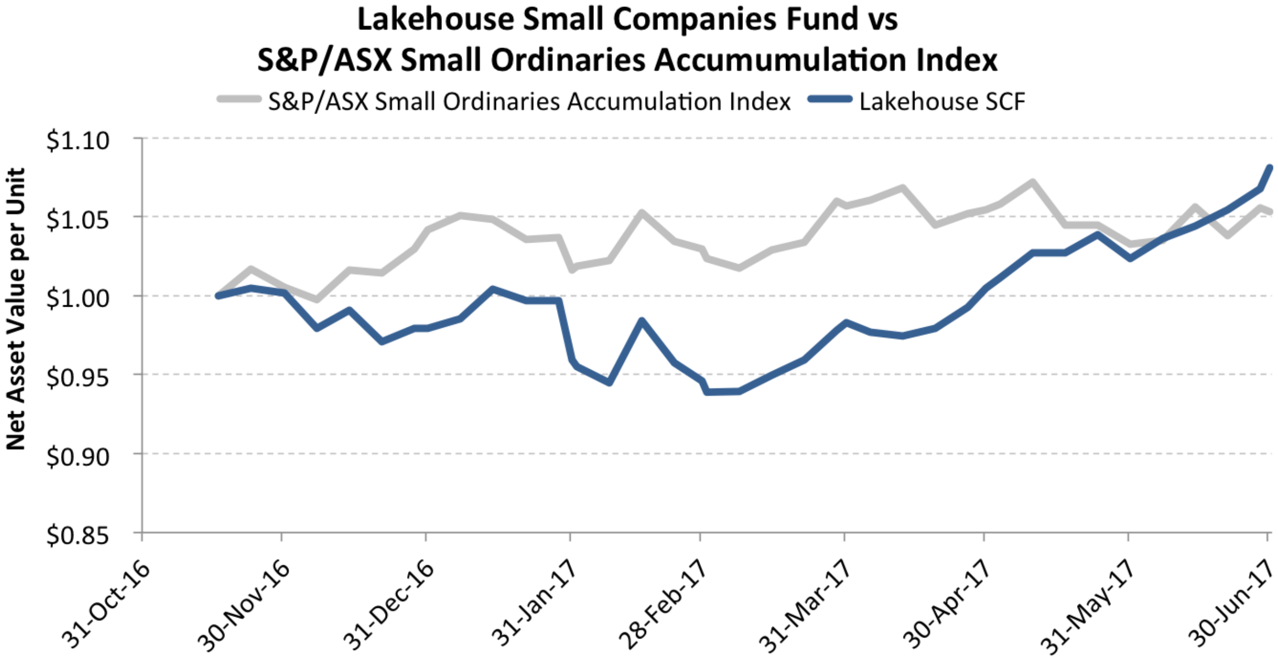
LAKEHOUSE SMALL COMPANIES FUND ANNUAL LETTER
30 JUNE 2017

Companies Held:	24
Cash Allocation:	7.4%
Top 5 Holdings of Portfolio:	36.3%
Net Asset Value per Unit:	$1.0813
Fund Net Asset Value:	$104.6 million
Benchmark:	S&P/ASX Small Ordinaries Accumulation Index

Dear Lakehouse Investor,

We're pleased to present you with the Lakehouse Small Companies Fund's annual letter for the June-ended fiscal year. The Fund isn't actually a year old yet -- it launched in November -- but we're also pleased to have surpassed $100 million in assets, invested in two IPOs and two institutional capital raises, and that our team has held more than 130 meetings with companies.

We're also encouraged that the year ended as fruitful as it was busy. The Fund finished an abbreviated fiscal year strongly after getting off to a slow start, returning 8.1% net of fees and expenses compared to an increase of 5.3% for the benchmark over the same period.



It is nice to have pulled ahead of the benchmark, however, our team does not judge itself based on short-term results and neither should investors who embrace our long-term, high-conviction strategy.

Our team is very specific regarding the types of companies that we seek for the Fund. Namely, we're looking for opportunities with the following traits:

- 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 on growth, quality, and prudent gearing tends to steer us away from cyclical, commoditised, and capital-hungry industries, explaining much of why the Fund's top holdings and sector allocations look very different to our benchmark.

For a sense of that, as well as our degree of conviction, below were the Fund's five largest positions as of 30 June 2017.

Company	Allocation
Catapult (ASX:CAT)	8.1%
Altium (ASX:ALU)	7.4%
BWX (ASX:BWX)	7.2%
Gentrack (ASX:GTK)	7.1%
Bapcor (ASX:BAP)	6.6%
Total Top 5 Holdings	**36.3%**

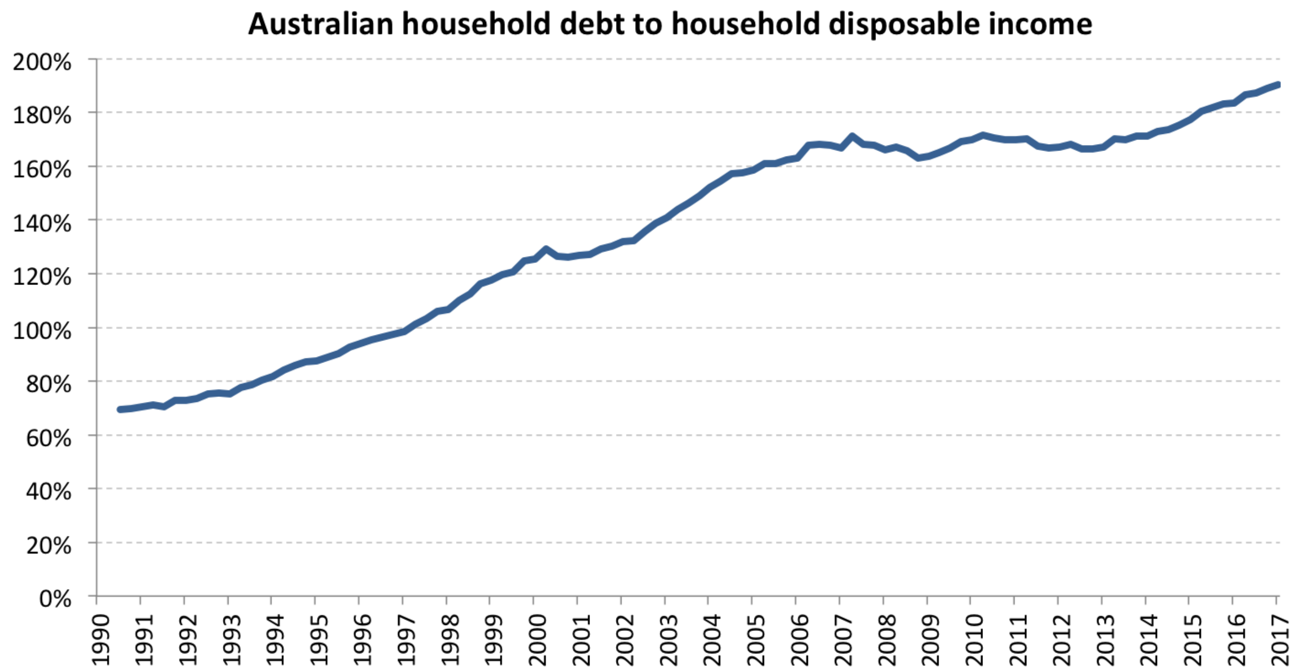
Investors who have been following along with our monthly letters will no doubt recognise most of the names on our list. They are companies we know very well -- we've met the combined lot 19-plus times -- and we trust that you're familiar with them as well as we've discussed them in our monthly letters. Given that we'll only reserve commentary later in the letter for the ones that were among our top performers.

The Fund's largest sector allocation as of the end of June was to information technology, mostly in enterprise software, comprising 70.9% of total capital. We're heavy on enterprise software today because the industry is home to the largest pool of companies that fit with our style and focus. The next largest sector allocations were to consumer discretionary (7.3%) and consumer staples (7.2%).

In contrast, the largest components of our benchmark were consumer discretionary (21.0%), materials (16.1%), and real estate (14.2%). We expect our allocations to change over time as our opportunity set evolves, though we expect to continue to overweigh sectors with prospects that align with our focus and time horizon.

Also contributing to our sector tilts today are our broader views about the Australian economy. Our primary focus is on finding and holding great businesses, not salivating over monthly jobs numbers or making sweeping macro calls, but we'd have to have our heads in the sand to not acknowledge the mounting issue of housing affordability. Residential property prices in capital cities have increased by a cumulative 44% over the past 5 years compared to only a 13% increase in wages.

We have no firm view on where property prices land five years out from now, however, we are mindful that the imbalance around affordability has forced buyers to stretch their personal balance sheets. The proportion of Australian household debt to disposable income has also come close to tripling since the last Australian recession, leaving households more exposed to higher interest rates and an economic pullback than they were in the early 90's recession when unemployment reached 11%. Given the above we expect that low rates are here to stay in Australia.



Source: Australian Bureau of Statistics (E2 Household Finances, series BHFDDIT)

We have no firm view on when the next Australian recession will arrive. All we know is that one will sometime and, given the levering up of personal balance sheets since the last recession, we suspect the pain will be more acute and have more profound knock-on effects than expected. For that matter, we'll note there are 40-something portfolio managers in Australia today who were not old enough to buy a beer the last time the country stumbled through a recession.

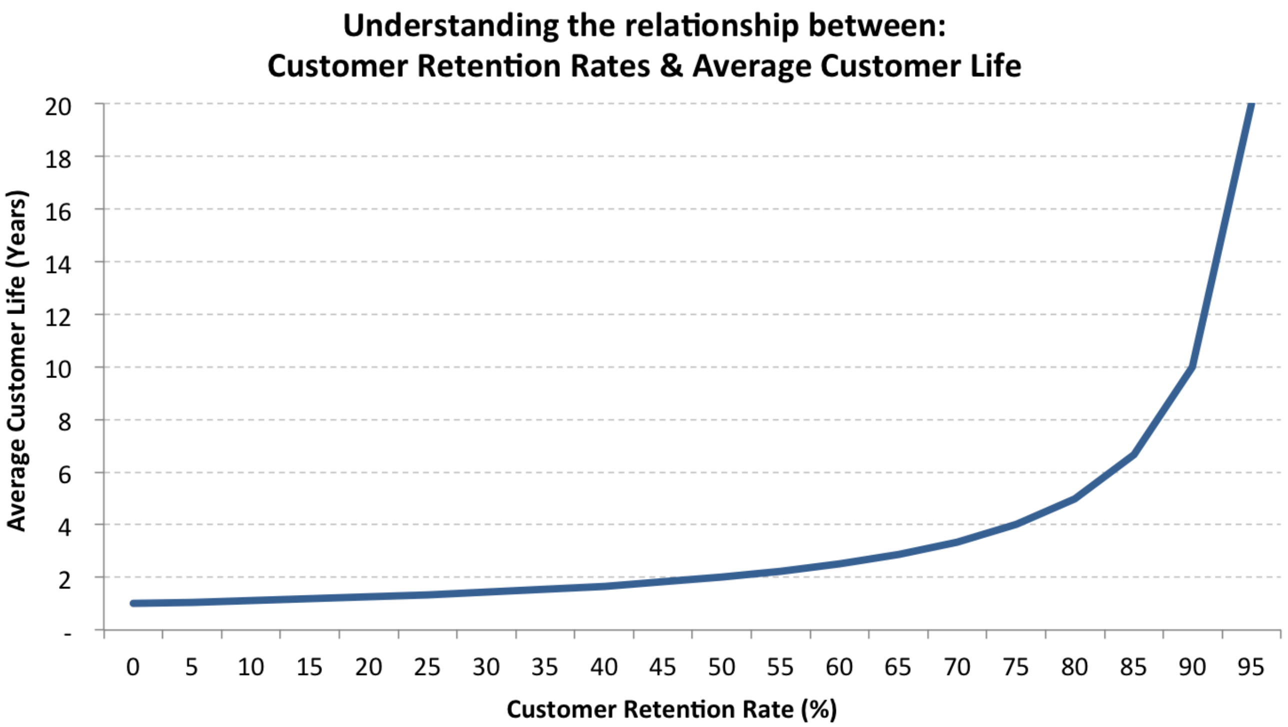
We appreciate all that sounds rather bearish, however, our team remains long-term bullish on Australia. I suppose the ultimate vote of confidence in that regard was the decision to settle my family here in Australia, and I'm pleased to say we Magyers are now permanent residents. Australia remains a great place to live, work, play, and invest, and our team is confident that certain industries will continue to post the growth profiles that excite us regardless of when a recession rears its head.

The nature of the Fund's holdings today speaks to that mentality. The companies in the Fund today, which are on average smaller and less covered than those of our benchmark, have grown revenue at 27.6% over the past 12 months compared to just 5.7% for the benchmark. We also sleep well knowing that the Fund's portfolio companies collectively hold more cash than debt, while the opposite is true for the benchmark.

Most of the companies held in the Fund have business models built upon extreme customer loyalty by virtue of great products, service, and execution. 21 of the 24 companies in the portfolio had businesses built on recurring revenue in the form of subscriptions or multi-year contracts.

We think extreme customer loyalty is a trait sorely underappreciated by most investors because of the difficulty in conceptualising retention rates, the ability of such firms to cross-sell, their pricing power, and the failure of accounting standards to appreciate that booking income and creating wealth are not one and the same.

Let's say we have two companies: Spacely Sprockets, which has an annual customer retention rate of 90%, and arch-rival Cogswell Cogs, which comes in at 80%. The fundamental difference between the two looks small, however, Spacely and its 90% retention has an average customer life of 10 years compared to just five years for Cogswell at 80%. Average customer life becomes exponential as retention rates move closer to 100%. Diagrammatically, this is represented in the graph below.



Thanks to its superior retention rate, and accounting for the time value of money, Spacely can roughly afford to outspend Cogswell by about 50% on marketing, customer onboarding, and research and development while still achieving a comparable return on investment. All else equal, odds are good that Spacely will climb to a clear and sustainable leadership position. For that matter, if Spacely is judicious with passing on pricing increases, it can further entangle customers by offering related services.

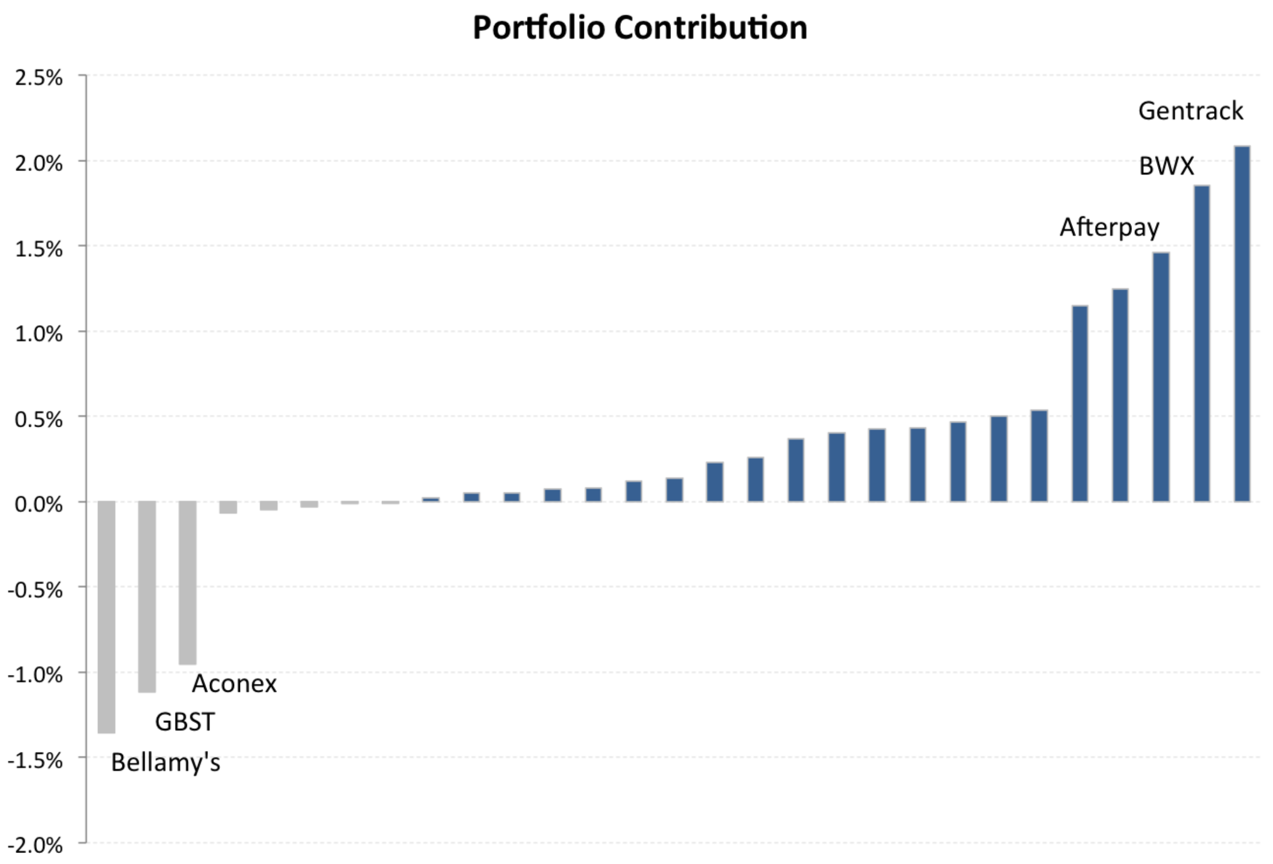
The appeal of such a model is not obvious from looking at an income statement, though, because much if not all of the investments made to develop and market services are expensed in the year they're incurred. The mismatch makes for an ironic effect: Current-year profits and intrinsic value move in opposite directions because the short-term cost of customer acquisition is dwarfed by the long-term value of the extremely loyal customer.

Getting back to Spacely and Cogswell, it's possible that Cogswell will boast the finer looking financial statements today even though Spacely has more loyal customers. Why? Cogswell is growing its customer base at a slower clip, hence it has fewer customer acquisition costs to expense today, plus it probably is spending less on R&D.

The net result is that Cogswell has a prettier set of numbers to crow about even though its rival, Spacely, is winning market share and growing its intrinsic value at a faster rate. Count on us to continue to back businesses that prioritise creating long-term wealth over posting short-term profits.

Best & Worst Performers

The biggest dollar contributors to the portfolio during our abbreviated fiscal 2017 were **Gentrack** (+2.1% of portfolio performance), **BWX** (+1.9%), and **Afterpay Touch Group** (+1.5%). The largest detractors were **Bellamy's Australia** (-1.4%), **GBST** (-1.1%), and **Aconex** (-1.0%). We'll discuss each in turn.



Gentrack is a boring yet beautiful enterprise software company that offers billing and CRM systems for utilities and water companies plus comprehensive operations systems for airports. The company's software is deeply embedded and mission critical, making for high margins (32% EBITDA) and loyal customers (average customer tenure exceeded 9 years as of the 2014 IPO).

The market warmed to the thesis after the company made a trio of smart, complementary acquisitions. The shares do not look conventionally cheap at 27 times consensus estimates for this fiscal year's earnings, however, that number does not account for a full year's worth of the company's recent accretive acquisitions or that the business is yet to feel much of a contribution from the recent

24% increase in headcount aimed at accelerating growth. We have averaged up on the Fund's position and look forward to the thesis continuing to unfold.

BWX is a vertically integrated maker and marketer of skin and hair care products. The company's flagship brand, Sukin, is Australia's leading natural skincare brand. The Sukin line of products makes up 82.7% of BWX's total revenue and an even higher share of gross profit. We think the business, and Sukin in particular, still has considerable room to run at both home and abroad.

Sukin's first-half export revenue increased 115.7% year on year and the business has what amounts to in-the-money call options on large markets including the UK, China, and now the US via the recent acquisition of natural cosmetics company Mineral Fusion. The business is also thriving domestically -- first half Sukin revenue increased by 48.7% year on year -- thanks to new products and wider distribution. We think the headroom for new products remains very high given that high-end rival Neutrogena has around 3X the number of products on the market.

We think the shares are very reasonably priced at just under 31 times earnings today given the above opportunities, strong balance sheet, proven leadership team, and the recent guidance reaffirmation of 30% EBITDA growth for fiscal 2017. We likewise have averaged up on this position as we think the investment case has strengthened.

Afterpay Touch Group is a position that we are noting for the first time. We will discuss the position in depth in our next monthly letter, however, we will briefly discuss our thesis here in light of the position's strong performance.

The bulk of the Fund's investment in Afterpay Touch comes via the stake that we established in Touchcorp, a transaction platform for merchants, following the announcement that it intended to merge with Afterpay, a consumer-facing "Shop Now, Pay Later" payment option. The merger made great sense to us as the destinies of both companies were intertwined: Afterpay relies heavily on Touchcorp's risk-rating engine, Touchcorp owned 26% of Afterpay, and the bulk of Touchcorp's market value was in its Afterpay stake. We were highly confident the deal would close and were pleased to invest through Touchcorp and capture a discount to the conversion price in what would be a stronger, rapidly scaling business.

The crown jewel of the combined entity is Afterpay, which has largely flown under the radar despite posting exceptional growth. The number of end users on the platform increased from 100,000 to 840,000 during fiscal 2017 while underlying sales grew even faster as network effects took hold. And despite the company's doing no outbound marketing to merchants, the number who accept Afterpay increased from 318 to over 6,000 during the period. Afterpay also has valuable call options in its soon-to-launch partnerships with Tyro, Trade Me, and BigCommerce.

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. We are comfortable with those risks given the company's significant growth and opportunities, though, and in the context that we have no other direct exposure to Australian lenders. We look forward to detailing our views on this position in greater depth in the coming weeks.

Turning to the detractors, **Bellamy's Australia** was by far the most significant hit to performance. We've discussed the causes at length previously, as well as our decision to exit and realise a 44.7% loss, so we don't see much therapeutic value in rehashing the gory details.

Having several months to reflect on our decisions, however, we've settled on a couple of important conclusions about our decisions with Bellamy's. The first is that, based on the information available to us at the time, we still think the shares offered the type of asymmetric upside that would speak to us today. We should have sized the position with less conviction given the reliance on key suppliers, though, and have internalised that lesson. By way of example, we held off on backing Afterpay until after it had de-risked its reliance on Touchcorp by agreeing to merge.

We are less sanguine, however, with our decision to top-up our stake after the company's initial downgrade. Granted, the issue did indeed seem temporary, the company had up until then shot the lights out, the additional shares we'd purchased were about 40% cheaper than the previous day's close, and we would later find out that management had been less than forthright with investors. Ultimately, though, buying more was a process mistake as the investment case and our trust in management had been weakened. To that end, we do not regret exiting our position following the company's lengthy suspension of trading as by then our original investment thesis had been staked in the heart.

GBST was our second-largest detractor. We exited the position in June, realising a 28.7% loss, after we concluded that the company's issues were a little less cyclical and a little more structural.

We made a mistake in not appreciating the headwinds that would be created by Brexit's hammering the British Pound and the high odds that the tumults might delay large projects among GBST's clientele of financial services firms. We thought these risks were priced into the shares, however, we were wrong.

The second mistake we made was in not realising the extent to which GBST's competitive position had slipped over the past couple of years. The sudden departure of the company's former CEO in late 2015 should have been a firm hint that all was not well, as was the company's aggressive increase in research and development spend. We took the company's increased spend on R&D as a positive -- we're for growth and prudent reinvestment -- but further thinking and digging led us to conclude that the higher spend reflected an underlying fundamental issue rather than an opportunity. Compounding matters is that playing catch up in enterprise software is difficult as sales cycles are long and reputations are slow to change.

It's still fair to say that some of the company's headwinds will pass. Namely, the lapping of the Pound's devaluation and the unlikely-to-be-repeated loss of a large customer in Australia. The shares are also statistically cheap today, at least if you think that the company can regain its footing. Our view on the competitive landscape has changed, though, and we now think that the company's prior underinvestment will cost it future business wins plus require a higher ongoing level of R&D spend than the market expects. We wish the business well but will watch from the sidelines until it proves our (belated) concerns unjustified.

Unlike the other detractors discussed, we have not reduced our stake in **Aconex**. The company's results have disappointed this year, however, unlike Bellamy's and GBST we think the issues here are indeed cyclical. Namely, a currency headwind from a stronger Aussie dollar, a stutter step at the acquired Conject business in the UK, and the company rolling over a very tough comparison in its key region of Australia and New Zealand. As far as the former goes, we note that first-half revenue growth across Australia and New Zealand of 6% over the prior year came despite capital expenditures in Australia falling by 12.5% during the same period.

We're not thrilled with how the position has performed to date but remain enthused about its long-term prospects and increasingly diverse mix of customers across industries and geographies. It also helps that the shares are not dearly priced today at about 55% below their 52-week high.

One last thing: The Fund had no distribution this year due to its having zero taxable income. We consider this somewhat of an aberration and that investors should expect that the Fund will pay distributions on a semi-annual basis in the future, though with the caveat that we expect most of the Fund's total returns to come from capital growth over time, not income. Investors should receive their annual distribution statements soon if they have not already.

To Infinity And Beyond

It is still early days -- *very* early -- but we're pleased with the foundation we've built for the Fund's future and are excited to watch how our investment cases unfold in the years to come.

Thank you for your time and trust, and we're honoured to have you with us at Lakehouse Capital.

Best Regards,

Joe Magyer, CFA
Chief Investment Officer