LAKEHOUSE CAPITAL
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LAKEHOUSE SMALL COMPANIES FUND LETTER
28 FEBRUARY 2018

Companies Held:	20
Cash Allocation:	12.8%
Top 5 Portfolio Holdings:	36.4%
Net Asset Value per Unit:	$1.4170
Fund Net Asset Value:	$143.1 million
Benchmark:	S&P/ASX Small Ordinaries Accumulation Index

Dear Lakehouse Investor,

February was a busy month for the Lakehouse team. Half-year reporting season was in full swing, volatility burst back onto the scene, and our team had 23 company meetings. Small-cap growth companies were ground zero for volatility, spurred on by the messy stories unfolding around **GetSwift** and **Big Un Limited**, neither of which the Fund owned.

We don't mind volatility. While it heightens the anxiety of low-conviction traders, it creates opportunities for long-term investors. We made the most of the lively reporting season by building a position in a company we've been following for some time at what we think is an attractive price. We also added to existing portfolio names at prices we're enthused about. Adding the new investment increases the total portfolio holdings to 20.

The Fund declined 2.6% net of fees and expenses in February compared to a flat 0.0% for the benchmark. The Fund has now returned a net 32.1% thus far in fiscal 2018 compared to 18.1% for the benchmark. Since inception in mid-November 2016 the Fund has returned a net 42.9% compared to 24.4% for the benchmark. We're pleased with our early pacing towards our goal of long-term outperformance, however, our team does not judge itself based on short-term results and neither should investors who embrace our long-term, high-conviction strategy.

The Fund's most significant contributor to performance during the month was **Altium** (+52.3%), whose growth accelerated. The most significant detractor was **BWX** (-34.1%), which grew strongly but underwhelmed relative to expectations. We continue to own meaningful positions in both companies.

The Fund's 5 largest holdings as of the end of February accounted for 36.4% of the portfolio, and are named in order of the Fund's allocation: **Afterpay Touch**, **Altium**, **Gentrack**, **Bapcor**, and **ELMO Software**. More on ELMO in a bit, which is a position we've owned since its IPO last year but that we have not commented on previously.

Zooming out, the Fund continues to look very different to its benchmark and the broader Australian market. The Fund's largest sector allocations as of the end of the month were information technology (67.4% of total capital), health care (7.9%), and consumer discretionary (5.6%), which is a stark contrast to the benchmark's largest allocations: materials (18.8%), consumer discretionary (18.2%), and real estate (10.9%).

We consider the Fund's divergence from the benchmark a positive as it is driven by our emphasis on quality and growth plus a willingness to take high-conviction positions. Indeed, the Fund's portfolio companies collectively grew revenue by 36.4% over the past year, outpacing the 9.8% growth of the benchmark.

Portfolio Companies

Zooming back in, we said last month that we'd follow up with a little more colour on Afterpay Touch following its half-year result.

Afterpay Touch reported another set of strong results with underlying sales of the Afterpay unit, which made up 79% of group revenue, up 534% year on year. The network effect is in full swing as the number of users and merchants continues to grow quickly while spend per user is also climbing.

Notably, the in-store offering had a break-out month in December, accounting for 8.5% of underlying merchant sales in the Afterpay unit. We had kept low expectations on in-store breaking through, as we'd seen successful online payment companies fail to crack the in-store nut, but Afterpay now has clear traction with in-store and what is now a longer growth runway. For context, while online retail is gaining share from offline, the relevant offline addressable market for Afterpay in Australia today is around 8x the size of the comparable online market.

Afterpay management continue to impress with their execution. We feel optimistic about translating their track record to US-expansion plans with Matrix Partners, given that little is being risked relative to the potential upside. The ongoing ASIC review into the sector introduces near-term uncertainty, however, we remain enthused about Afterpay's long-term prospects.

Back to ELMO. The Sesame-Street-sounding name is actually an acronym for E-Learning Management Online. The business provides cloud-based HR and payroll software to mid-market enterprises with 100-1,000 employees. The product offering spans 12 modules which are used by more than 1,000 customers.

ELMO typifies many of the attributes Lakehouse looks for in a company. The business holds a strong position within a growing market, boasting customer retention of over 93% implying an average customer life exceeding 14 years. Founders and management own almost 77% of the stock creating strong alignment. The business runs with a net cash balance yet is growing at over 30% and continues to expand its addressable market through smart acquisitions.

Since listing in June 2017 ELMO has made four bolt-on acquisitions which have expanded both its product offering and customer reach, plus added to the company's intellectual property and talent pool. The company has grown the average number of modules per customer from 2.0 at the end of 2016 to 2.5 at the end of 2017. This growth in revenue per customer, combined with 90%-plus retention rates, means the business experiences negative revenue churn, which is exceedingly rare.

ELMO's small size -- it has a market capitalisation of around $300 million -- and concentrated share register means it has been under-the-radar for many analysts and investors. The company is currently only covered by 2 sell-side analysts, but following prospectus forecast upgrades of 40% to revenue and 110% to EBITDA (after acquisitions) ELMO looks to be drawing more attention.

The business is well positioned to continue growing, particularly through increasing average number of modules per customer. The recent addition of payroll, remuneration, surveys and salary benchmarking modules put more weapons in its arsenal, and it plans to add three new modules over the next 2 to 3 years.

We are particularly excited about ELMO's payroll module as the ATO has made Single Touch Payroll (STP) reporting mandatory for employers with more than 20 employees from 1 July 2018. STP aligns employer ATO reporting obligations with their payroll processes, each time they pay employees. ELMO is in a strong position to sign-up organisations offering their STP-ready solution, and then expand with its growing suite of modules.

Lastly, it's worth noting that Lakehouse built most of its stake during the company's IPO process in June 2017 when it listed on the ASX at $2.00 per share, which compares quite favourably to the $5.56 price at which the shares traded at the end of February. The increase in value on that purchase, plus a couple of top-up investments we made along the way as we believed the investment case had strengthened, is what led to ELMO's making its way into our top five holdings.

Looking Ahead

With reporting season behind us we're now starting to see IPO and pre-IPO activity pick up and we'll continue to sift through new opportunities.

Thanks to all our investors for your time and trust. We're honoured to have you with us and look forward to what the future holds.

Best Regards,

Joe Magyer, CFA
Chief Investment Officer

P.S: Something New! We can now accept regular, recurring BPAY payments. Existing investors who add to their investment via BPAY (using their investor profile ID number as the reference) do NOT need to fill out an application form.

To add to your investment simply BPAY the payment and Registry will confirm additional units in the Fund. No further action is required. **BPAY payment assumes no changes to the beneficial owner.* [Click here for more details](#).

Please read the Product Disclosure Statement before purchasing additional units in the Fund.