LAKEHOUSE CAPITAL
A Motley Fool Company

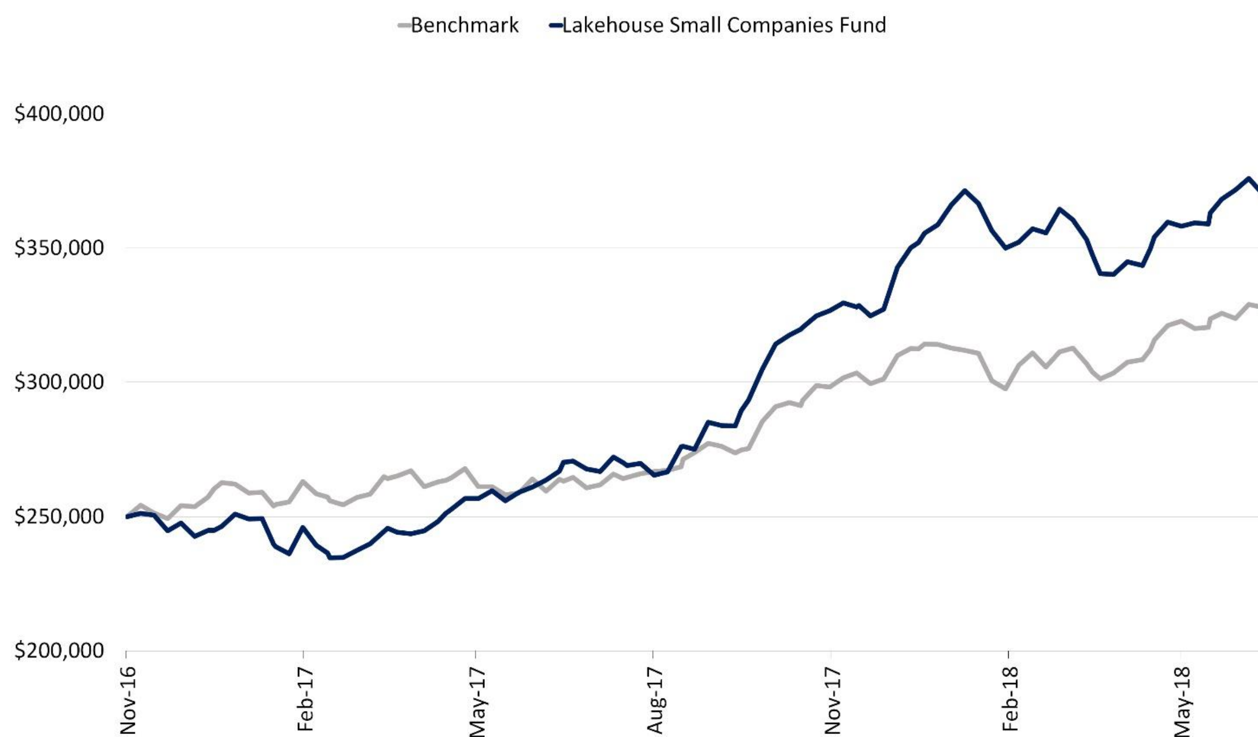
LAKEHOUSE SMALL COMPANIES FUND
ANNUAL LETTER
30 JUNE 2018

Dear Lakehouse Investor,

2018 was a very good year for the Lakehouse Small Companies Fund. The Fund returned 37.3% net of fees and expenses compared to 24.2% return for its benchmark. Since inception in mid-November 2016, the Fund has returned 48.4% net of fees and expenses compared to 30.8% for its benchmark.

We are pleased with the Fund's early pacing towards its 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.

Companies Held:	21
Cash Allocation:	14.2%
Top 5 Portfolio Holdings:	33.6%
Net Asset Value per Unit:	$1.4142 (ex 5.88 cent distribution)
Fund Net Asset Value:	$154.5 million (ex $6.4 million distribution)
Benchmark:	S&P/ASX Small Ordinaries Accumulation Index

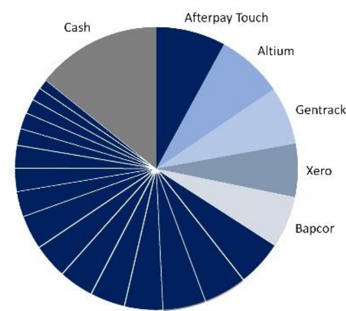


Note: Fund performance includes distribution. The benchmark for the Fund is the S&P/ASX Small Ordinaries Accumulation Index. Past performance is not indicative of future returns.

Lakehouse Small Companies Fund ARSN 615 265 864 (Fund). The responsible entity for the Fund is One Managed Investment Funds Limited (ACN 117 400 987) (AFSL 297042) and Lakehouse Capital Pty Limited (ABN 30 614 957 603, authorised representative of AFSL 400691) is the Investment Manager for the Fund.

Top 5 Holdings
Afterpay Touch
Altium
Gentrack
Bapcor
Xero
Total: 33.6%

Lakehouse Small Companies Fund: Portfolio Holdings



For that matter, while we're pleased for the Fund to have distributed 7.0287 cents per unit in 2018, investors should know that we're not an income-centric Fund and that our emphasis on buying and holding growth companies with long runways means that distributions will be lumpy year to year.

Our day to day focus is not on short-term performance but the consistent application of a process that prizes quality and patience. Doing so puts time on our side and allows us to act with conviction when opportunities present themselves. As Lincoln said, "Give me six hours to chop down a tree and I will spend the first four sharpening the axe."

Unlike some managers who dabble with different styles and strategies, we're very specific about the traits we seek in portfolio companies. Namely, we're after companies that offer:

Strong positions in growing markets. Industry leaders capture an outsized share of industry profits, and growing markets put the wind at their backs. This is all the more true in the winner-take-most markets for which we have a particular fondness.

Pricing power with customers and suppliers. Pricing power is the financial distillation of a business' competitive position. Little wonder that many of the world's most successful businesses are price setters while laggards are price takers.

Durable competitive advantages grounded in scale, strong brands, network effects, or high customer switching costs. We have a penchant for businesses with wide and widening moats. In particular, we're fond of businesses with extremely loyal customers and highly visible recurring revenue streams. Indeed, 18 of the Fund's 21 holdings today have models explicitly built upon recurring revenue streams.

Aligned and experienced management teams with strong track records of capital allocation. The importance of management increases exponentially next to a company's growth and reinvestment rate. As it happens, our portfolio companies are collectively growing very quickly, so we make it a point to get to know the people leading our companies. That's why members of our team have caught up with leaders of our current 21 portfolio companies a total of 165 times.

Conservative balance sheets. A well capitalised business will almost always live to see another day. One better, it can play offence while others play defence. We're not dogmatic on owning businesses without debt -- some businesses are far more valuable to shareholders when a prudent amount of leverage is applied -- but we have a strong bias towards balance sheets with untapped capacity.

Attractive valuations that afford upside to our estimate of fair value. Valuing the types of high-growth companies we prefer is an exercise in false precision. Nonetheless, while we're not slaves to spreadsheets, we strive to pay prices that we think boost the odds of a favourable outcome.

It's unusual to find opportunities that tick a few of those boxes at a time. In our experience, though, they tend to most often be found in two spaces: software and consumer. That's why, despite our being generalists with a range of experience across multiple sectors, these areas are a particular fascination and focus for us.

The Fund's three largest sector allocations are to information technology (64.8%), health care (9.3%), and consumer discretionary (5.9%), which makes for a stark contrast to the benchmark's top three of materials (19.5%), consumer discretionary (19.0%), and real estate (10.8%). IT only makes up 9.0% of the benchmark. Notably, though, the Fund is not simply an overweight version of the sector as it owns stakes in less than ¼ of the IT companies in the benchmark.

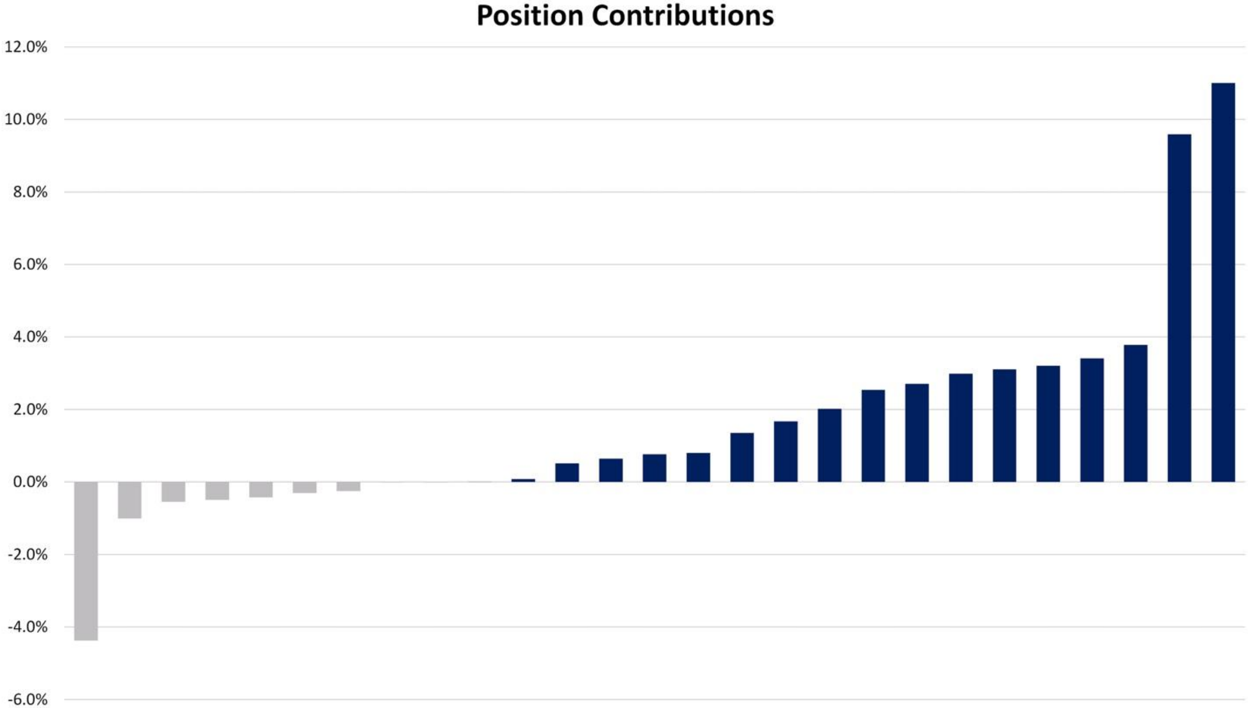
Another striking measure of differentiation between the Fund and the broader realm of Aussie smalls is the relative lack of attention our portfolio companies receive. The Fund has fewer than 4 analysts rating its average holding on a weighted basis compared to more than 8 for the benchmark. Just because a business might be overlooked does not necessarily mean it is a good purchase but, all else equal, it does give enterprising investors a better chance of getting ahead of the curve.

Perhaps no measure captures the Fund's style than the growth of its portfolio companies. The Fund's median portfolio company grew its revenue by 41.1% over the latest year's worth of audited results compared to just 10.3% for the benchmark. Growth for growth's sake can be value destroying, however, aggressive reinvestment by businesses with attractive unit economics, long-view and level-headed leaders, and large addressable markets with winner-take-most dynamics can create immense amounts of value in a short amount of time. We won't get them all right, as we'll shortly discuss, but when we do the results can be very pleasing.

Performance Review

The Fund's gains were broad-based during 2018. 67% of the holdings that the Fund held at some point during the year contributed positively to performance compared to around 60% for the benchmark.

A superior batting average is nice, however, magnitude matters more than strike rate in investing as a small number of winners can more than offset a large number of ordinary performers. The Fund scored high marks here as well with the contribution from the top quintile of its holdings during the period contributing about 4.8 times as much as the bottom quintile detracted. For context, this compares to a ratio of about 3.8 for the benchmark.



The largest contributor to the Fund's performance during the year was **Afterpay Touch**, whose share price increased 216.9%. The business had a big year as the number of active users on Afterpay increased 223.4% to 1.8 million through the 12 months ended in March with underlying merchant sales increasing by even more as network effects unfold. We also think Afterpay still has significant potential here and abroad. Here in Australia, the company is onboarding about 30 merchants and 3,000 users each day yet still has less than ⅓ of PayPal's Australian active user base and 1/10th of the Australian adult population. Afterpay is also making headway in physical stores which made up 8.5% of the company's underlying sales in December.

Looking overseas, the company also surprised the market with the speed and quality of its US launch. The company had 247 merchants that were either live or coming online soon as of the end of June including Millennial-centric Urban Outfitters -- for context, Urban Outfitters' revenue alone is more than 50% larger than Australian icon Myer. The opportunity is vast -- Goldman Sachs estimates the US online fashion market is around 20 times the size of Australia's -- and Afterpay's early traction is promising.

Like most disruptive businesses, though, not all of the company's wide range of outcomes are favourable. The shares are not conventionally cheap, the business model has not been tested across an economic cycle, and the international push may end up a large waste of time and capital. Also, while we think Afterpay has a strong incentive alignment with its customers and that its recent moves to cap late fees and introduce additional checks in the registration process are positives for all stakeholders, we can't be sure of the results of the ongoing inquiry by ASIC into the 'buy now, pay later' space.

Still, while the risks are real and we've taken some chips off the table with this position, we continue to believe that Afterpay Touch has long growth runways in Australia, the US, and other markets. We'll accept what remains a wide range of outcomes knowing we may be holding now and paying later. Such is life with high-conviction growth investing.

The second largest contributor was **Altium**, which entered 2018 as the Fund's second-largest position and whose shares delivered a total return of 167.7%. Growth in the subscription pool has accelerated for at least three consecutive years as the company continues to execute and innovate.

Even better is that the latest edition of the company's flagship Altium Designer product, which has a new UI and improved speed, stability, and functionality, did not ship until late in the second quarter, suggesting there's still room to run. Meanwhile, semiconductor sales are on a tear, which bodes well for demand for the company's software, and Altium's cloud service, NEXUS, has finally gone live and is contributing.

We have taken some profits on Altium as the Fund's investment swelled, however, we've maintained a large position as businesses with 30% EBITDA margins, net cash positions, and 30% revenue growth, as Altium posted in the first half in year-on-year terms, are few and far between.

The bronze medalist contributor was **Xero**, whose shares increased by 86.0% in 2018. The business had a watershed year as it swung from a EBITDA loss of NZ$28.6 million in fiscal 2017 to positive EBITDA of NZ$26.0 million in fiscal 2018. Operating revenue increased 37.6% during that period and customer lifetime value (LTV) increased at an even faster clip (45.5%) thanks to increasing gross margins and falling revenue churn.

Less positive is that the company's founder and longtime flagbearer, Rod Drury, has stepped back from the role of CEO. We don't have strong views as yet on his replacement, Steve Vamos, but look forward to hearing more about his plans for the business. Notably, they won't include COO and CFO Sankar Narayan, who was passed over for the CEO role and thereafter recently announced he is stepping away from the business to pursue other opportunities.

Fortunately, Xero's products, competitive position, and economic model are all strong and arguably strengthening, and we're inclined to give Vamos some rope. To that end, it's worth noting that, as Xero has grown its way into the S&P/ASX 100, the Fund may continue to hold but not increase its stake in the business.

Now let's turn to the detractors. Far and away the largest detractor to performance was **Catapult Group**, which entered the year as the Fund's largest position and whose shares fell 47.4% during the year. Very little went right for the business: growth has been solid but underwhelming, two of the company's directors and co-founders sold a meaningful chunk of their shares in early January, the business raised capital for the second time in less than a year at a valuation that made us wince, and shareholders delivered the company its first strike on remuneration.

Suffice to say we're disappointed with both the business and our position sizing heading into this fiscal year. Still, we have not thrown in the towel on this thesis as Catapult has a very loyal customer base and is still a leader in growing markets. Also, financially speaking, the current leadership team appears more structured and cost-conscious than the last, the business has plenty of cash in the bank, and the shares have an undemanding valuation with an enterprise value of only around 2.5 times consensus full-year revenue.

We still also think Catapult could do well from here, and perhaps be a take-out target by a strategic buyer for the above reasons. For that matter, we would not be surprised to see a financial buyer show interest given the same reasons, the diverse and recurring revenue stream, and assorted offices and initiatives that could be sold, shuttered, or streamlined. Catapult's co-founders would need to be on board with any sale but, in light of some of their share sales in January, we wouldn't be surprised if they were supportive of someone cutting them a large cheque.

We're not banking on a white knight to save shareholders, though, and we're comfortable giving the new leadership team more time to right the ship. This investment is down but not out.

Thankfully, the second- and third-largest detractors to Fund performance were far less impactful as they were both smaller positions on cost and suffered smaller losses during the period. They were **Hansen Technologies** (down 20.2% during the year on a total return basis) and another company in which we are still building out a position (which the Fund first bought into this year and is down 21.7% on cost). We may comment on these positions in future letters but, in light of the small relative detractions, will simply note that the Fund remains invested in both companies.

The Fund's turnover strikes us as quite low, and we suspect our brokers would nod their heads in disappointed agreement. Still, the Fund did not sit on its hands during 2018. The Fund exited 6 of the 24 holdings with which it started the year, opened stakes in 3 new ones, and finished the year at 21 holdings.

The net reduction in positions, combined with the realisation of gains on some outsized winners, led to the Fund's cash balance increasing from 7.4% to 14.2% over the course of the year. If you're reading between the lines, you're probably guessing that means we're seeing fewer opportunities right now than we did this time a year ago, which is the right read. It's not so much a sweeping macro call, though, as it is that small-caps have been on a run and we like to err on the side of patience.

To the extent that we are watching the broader economy, we're mindful of the fragile state of household finances. According to the RBA, the ratio of household debt to disposable income in Australia has continued to rise, and is approaching three times the proportion it was during the last Australian recession, suggesting borrowers, lenders, and investors could be caught flat-footed whenever the next Australian recession arrives.

We're also mindful that the air seems to have gone out of the property market with CoreLogic reporting that national home prices have fallen for nine consecutive months on a month-on-month basis. The causes have been a confluence of factors -- tighter lending standards, high absolute price levels, and increasing costs and hassle for foreign investors -- that remain a headwind today.

All that said, while we're conscious of areas of softness and fragility, and are inclined to carry a bit more cash than usual, we do not have strong views on where the Australian economy is headed. Even if we did, our objective is long-term outperformance, and if we jumped at every shadow our feet would never touch the ground. Instead, we continue to place emphasis on businesses that we think are well-run and with bright long-term prospects.

Thank You

On behalf of all of us at Lakehouse Capital, thank you for your continued trust. It means a great deal to us and we are incredibly fortunate and grateful to have such a strong, diverse, and aligned foundation of investors.

To that end, we've dedicated a wall in our office to photos of our investors and their loved ones to serve as a daily reminder of the folks we serve. If you'd like to get a picture up on the wall, feel free to email us one at investorsupport@lakehousecapital.com.au or drop one in the post to us at Level 14, 5 Martin Place, Sydney NSW 2000.

Best Regards,

Joe Magyer, CFA
Chief Investment Officer

Sole use and confidentiality: This report has been prepared by Lakehouse Capital Pty Limited (ABN 30 614 957 603, authorised representative of AFSL 400691) and by its officers, employees and agents (collectively "Lakehouse") for the sole use of its clients as a record of the performance of their investment. The contents of this report are confidential, and the client may only disclose such contents to its officers, employees or advisers on a need to know basis, or with the prior written consent of Lakehouse.

Disclaimer: The responsible entity for the Lakehouse Small Companies Fund (ARSN 615 265 864) is One Managed Investment Funds Limited (ACN 117 400 987) (AFSL 297042) ("OMIFL"). The information contained in this document was not prepared by OMIFL but prepared by other parties. All of the commentary, statements of opinion and recommendations contain only general advice and have not taken into account your personal circumstances. This report contains general financial product advice only. Any investment in Lakehouse or OMIFL products need to be made in accordance with and after reading the Product Disclosure Statement and Additional Product Disclosure Statement dated 15 November 2016. The opinions, advice, recommendations and other information contained in this report, whether express or implied, are published or made by Lakehouse in good faith in relation to the facts known at the time of preparation. Information is current as at the date of the letter, unless otherwise noted. Past performance is not indicative of future performance.

Limitation of liability: Whilst all care has been taken in preparation of this report, to the maximum extent permitted by law, neither Lakehouse or OMIFL will be liable in any way for any loss or damage suffered by you through use or reliance on this information. Lakehouse and OMIFL's liability for negligence, breach of contract or contravention of any law, which cannot be lawfully excluded, is limited, at Lakehouse's option and to the maximum extent permitted by law, to resupplying this information or any part of it to you, or to paying for the resupply of this information or any part of it to you.

Disclosure: Lakehouse, its directors, employees and affiliates, may, and likely do, hold units in the Lakehouse Small Companies Fund and securities in entities that are the subject of this report. Copyright: Lakehouse owns the copyright to this publication. Its contents may be used for your own personal use, but you must not (without Lakehouse's consent) alter, reproduce or distribute any part of this publication, transmit it to any other person or incorporate the information into any other document.