Dear Lakehouse Investor,

Companies Held:	19
Cash Allocation:	15.3%
Top 5 Portfolio Holdings:	37.8%
Net Asset Value per Unit:	$1.7396
Fund Net Asset Value:	$219.5 million
Benchmark:	S&P/ASX Small Ordinaries Accumulation Index

May was another busy month for the Lakehouse Small Companies Fund. We attended an interstate corporate speed dating conference, met with 16 companies, completely sold out of a long-held position that was not working out, and topped up a number of existing holdings.

Overall the Fund slightly reduced its cash holding compared to last month to 15.3%, but remains above the upper end of our typical range of 5% to 15%. A number of the companies we met with during the month are prospective portfolio inclusions, though further work, and patience, is required before making a final investment decision. Also, given the strong run in the shares of growth companies, we think keeping a little extra dry powder is prudent.

Despite carrying a large cash position, the Fund returned +1.5% net of fees and expenses in May compared to a -1.3% return for the benchmark. For the fiscal year, the Fund has returned a net +23.8% compared to +1.0% for the benchmark. Since inception in mid-November 2016, the Fund has returned a net +83.5% compared to +32.2% for the benchmark.

We're pleased with the Fund's progress towards its ultimate objective of long-term outperformance, however, our team does not judge itself on short-term performance and neither should investors who embrace our long-term, high-conviction strategy.

The Fund's most significant contributor to performance during the month was **EML Payments** (+33.7%), which we haven't previously disclosed but will discuss in more detail shortly. During the month EML announced a new multi-year Australian salary packaging card deal and put some of its overcapitalised balance sheet to work by acquiring a new European e-card and e-voucher business.

The biggest detractor during the month was **Citadel Group** (-37.1%), which fell sharply following a profit downgrade due to a combination of project delays, lower customer spend leading into the May federal election, and the ongoing transition to more software-as-a-service (SaaS) based revenue. While a steep miss in terms of short-term expectations, our long-term thesis remains unchanged.

The Fund's five largest holdings as of the end of May accounted for 37.8% of the portfolio and are named in order of the Fund's allocation: **Pro Medicus, Afterpay Touch, Audinate**, EML Payments and **Nanosonics**. Four of the five positions should be well known to Lakehouse investors.

Zooming out, the Fund's largest sector allocations as of the end of the month were to information technology (61.6% of total capital), health care (15.6%), and consumer discretionary (4.1%), which is quite different to the benchmark's largest allocations: materials (18.8%), consumer discretionary (15.5%), and real estate (11.3%).

We continue to embrace a differentiated approach with an emphasis on companies and industries known for capital-light, recurring-revenue-centric business models. To that end, and considering the soft state of the Australian and Chinese economies, we have been and remain even more comfortable than usual being significantly underweight the likes of materials, consumer discretionary, and real estate.

Company News

Zooming in to our newly disclosed holding, EML Payments, in which the Fund has held an investment for a while now. We topped up our position as the share price continued to show weakness, while our view of the business continued to strengthen. Due to some recent business momentum, EML grew its way into our top five positions.

EML specialises in issuing and managing prepaid stored value products, physically and digitally. When talking about payment service providers, acquirers that operate payment terminals or accept payments online such as Worldpay or Adyen come to mind. EML is on the opposite side of the payment stack -- the issuer -- similar to a bank which acts as an issuer of cards. The company operates in niche verticals, offering bespoke customisations and speed that banks typically cannot offer.

For example, EML has worked with salary packaging companies in Australia to be able to offer a single card that categorises spend into multiple sub-accounts, with the ability to tailor usage restrictions. Members are linked to a group of accredited merchants who can offer them flash deals and discounts. All of these functions are linked to a mobile wallet solution, so they are easier to manage and report, whilst being compliant with regulators like the ATO. In the pre-EML era, salary packaging companies were using credit cards issued by banks, which were harder to track and limit.

The company is led by a de-facto founder, Tom Cregan, who has built EML from a business with one client and nine months left of capital to burn to a company that manages around 1,300 programs across 21 countries. In addition to that impressive track record, Tom is well motivated to create long-term value as he owns 6.6% of the company, roughly equal to 70 times his annual salary.

EML has the ability to tailor and integrate payment solutions to embed a financial service component into its user experience, often leading to the elimination of friction and better sales conversion. As a result, even though its value-add appears incremental, the end-customer experience is vastly improved. EML has found its product-market fit in niche verticals such as salary packaging reloadables and gaming payouts, translating into dominant market positions within a short timeframe.

EML has been able to extend its relationships with large players such as bet365 and GVC Holdings into the UK thanks to its success in the Australian gaming market. We think EML's offerings will eventually be introduced in all other markets which these global players operate in, including the recently legalised and potentially the largest gaming market in the world, the US. Though these gaming deals have significant runway, we suspect that there may be more verticals which EML could enter in the future.

Tailored payment solutions have significant development work and deep system integration, which creates sticky and loyal merchant customers. Recently, EML acquired its long-time competitor in the European mall gift card market, Flex-e-cards. The company's disclosure gave us a peek into customer churn metrics, which was disclosed as a quarter of 1% for the prior three-year period, also noting that EML has a similar churn for its own portfolio. Aside from these metrics, we find the growing card balances quite attractive as they offer potential upside if rates ever do increase.

Though there are a wide range of potential outcomes, we like EML's improving position in its niche verticals, strong customer retention rates, possible upside to increasing interest rates, and optionality inherent in the business. We feel comfortable investing alongside management with skin in the game.

Lastly, we turn to the small position that the Fund exited during the month, **BWX**. Our initial thesis strikes us as sound given Sukin's then-rapid growth in Australia supported by a strong balance sheet and engaged management with skin in the game. Unfortunately, we were slow to acknowledge that the thesis was gradually drifting away from its promising starting point as Sukin's growth faded faster than expected and the company made three acquisitions that ultimately stretched its balance sheet.

With some of this thesis drift in mind, we found a good opportunity to take roughly a third of our position off the table with the management buyout offer that came in May/June last year. In hindsight, we could've sold more then as the deal fell through eventually. Having had a fresh look at our investment case post the stock price correction that came afterwards, we decided BWX was good value at those levels and believed the newly elevated CEO, who struck us as a pragmatist, would stabilise the business.

Alas, BWX recently announced what was its third downgrade to FY19 EBITDA in under 6 months. Furthermore, the current CEO has left the business to be replaced by the head of **Blackmores**' ANZ division, who will now be the third CEO in under a year. BWX is now firmly in the midst of a turnaround and the current thesis looks nothing like our original one or of the type that we seek out in new opportunities. As such, we exited the balance of our remaining small position.

Looking Ahead

June marks the financial year end for most of our portfolio companies, meaning they soon head into a 'blackout' period. Consequently we don't anticipate talking to many companies again until full year results are released in August. For our parts, we plan to stay busy digging for new opportunities.

Finally, please note your June 2019 monthly Market Value Statement will be sent separately (and earlier) to the investor letter. Instead of our usual monthly letter, we'll release a more comprehensive Annual Letter reflecting the Fund's performance for fiscal 2019. Expect to receive the 30 June 2019 Market Value Statement in early July, and the Annual Letter in late July.

As always, thanks to all our investors for your time and trust.

Best Regards,

Joe Magyer, CFA
Portfolio Manager, Lakehouse Small Companies Fund
Chief Investment Officer, Lakehouse Capital

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