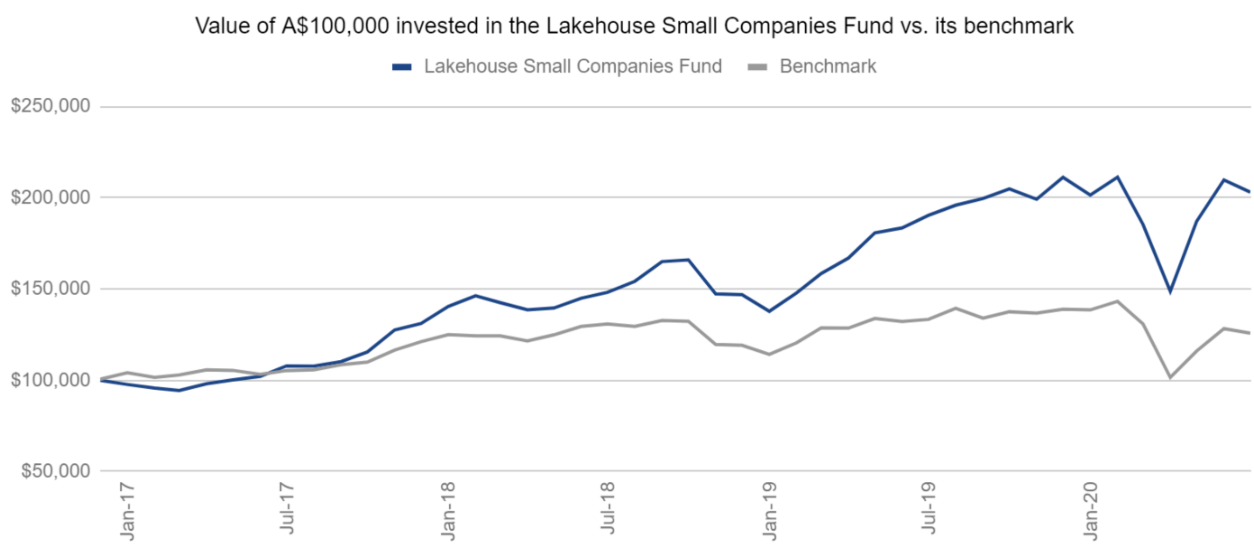
LAKEHOUSE SMALL COMPANIES FUND

ANNUAL LETTER
30 JUNE 2020

Dear Lakehouse Investor,

The Lakehouse Small Companies Fund finished strongly in a tumultuous year. The Fund returned 6.7% net of fees and expenses in fiscal 2020, which might look subdued if not for the benchmark's 5.7% loss, a pandemic, and the steepest drawdown in market history.

The Fund has delivered a net total return of 103.0% since inception in mid-November 2016 compared to a 25.8% return for its benchmark. In annualised terms, the Fund has returned a net 21.6% compared to 6.5% for its benchmark. For context, the Fund ranks number one out of 48 peers in the *Morningstar Equity Australia Mid/Small Growth category over the past 3 years.



Note: Fund performance is based on monthly ending NAV and includes distributions. The benchmark for the Fund is the S&P/ASX Small Ordinaries Accumulation Index. Source: Lakehouse Capital

We are pleased with the Fund's progress towards its goal of long-term outperformance and to have delivered a positive return in a year in which the benchmark and most of our peers posted a loss. The year was marked by intense volatility and the Fund's largest-ever drawdown but also a significant recovery reflecting our long-term-focused process and some well-timed purchases near the lows in March. It helped that we were early to appreciate the risks and opportunities brought on by social distancing including the pull-forward of adoption curves for many digital-first businesses.

2020 was a powerful reminder of the importance of having a clear philosophy and sound, repeatable process. For us, the philosophy is all about a long-term mindset and approach, backing our best ideas with conviction, and seeking out asymmetric opportunities where we think we have multiple ways to win and few ways to lose.

Our adherence to a very specific set of traits we seek in investments helped contribute to the year's outperformance. Namely, we're after companies that have strong positions in growing markets, pricing power with customers and suppliers, durable competitive advantages, aligned and experienced management teams with strong track records of capital allocation, conservative balance sheets, and attractive valuations that afford upside to our estimate of fair value. To help give a sense of how hard it is to find opportunities with the traits we seek, the Fund has been offered to participate in more than 300 institutional placements, IPOs, and pre-IPOs yet has only participated in eight.

Fund Metrics	
Companies Held	19
Cash Allocation	6.4%
Top 5 Portfolio Holdings	42.9%
Net Asset Value per Unit (mid)	$1.6880 (after a 16.61 cent distribution)
Fund Net Asset Value	$248.6 million (after a $24.5 million distribution)
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

Having a tight portfolio assembled via a consistent, rigorous process is always a positive but it was especially valuable during the COVID-19 crash as we were able to quickly contextualise the impacts of the virus and social distancing on our portfolio companies and make adjustments where appropriate. For a sense of how much time we've spent getting to know these companies and why we were not easily rattled out of them during the downturn, our team has held 231 meetings with our current group of 19 portfolio companies.

Speaking of not getting rattled, the Fund still owns 10 of the 21 companies it owned two years ago, making for a position-level implied holding period of about four years. That feels roughly right to us given our long-term orientation and the reality that a high proportion of smaller companies don't pan out.

We continue to take a balanced view of the economic backdrop and market opportunity set. Economies are struggling and markets have rallied hard from their lows, however, the market's rebound is on the heels of the steepest drawdown ever, markets are forward-looking, and some businesses are net beneficiaries of the dramatic shifts in some of the ways we all live, work, spend, and play.

We're rooting for a V-shaped recovery but take comfort knowing that our philosophy and process should continue to serve the Fund well if the recession and elements of social distancing drag on for an extended period. It helps that our portfolio companies are growing strongly -- revenue was collectively up 36.7% in calendar 2019 -- and that 89% of the Fund's invested capital backs companies with business models explicitly tied to recurring revenue. Our companies are also typically better capitalised than most small companies as 95% of the Fund's portfolio companies have more cash than debt compared to only 41% of the companies in the Fund's benchmark. Lastly, most of our portfolio companies have been net beneficiaries of the pull-forward in adoption curves brought on by social distancing.

The confluence of our selectivity, high-conviction approach, and a willingness and ability to invest differently from the crowd makes for a portfolio that looks quite different from the benchmark at the sector level. The fund's largest sector allocations are to information technology (64.5%), healthcare (16.5%), and financials (12.6%) compared to the benchmark which is led by materials (20.8%), consumer discretionary (14.3%), and real estate (13.1%).

We have a strong preference towards spaces with high and persistent returns on invested capital (e.g. software and household products) and away from those that are capital intensive (e.g. materials and energy) and highly competitive (e.g. retail and transportation). For that matter, we don't target sector allocations at all but rather specific investment traits regardless of sector.

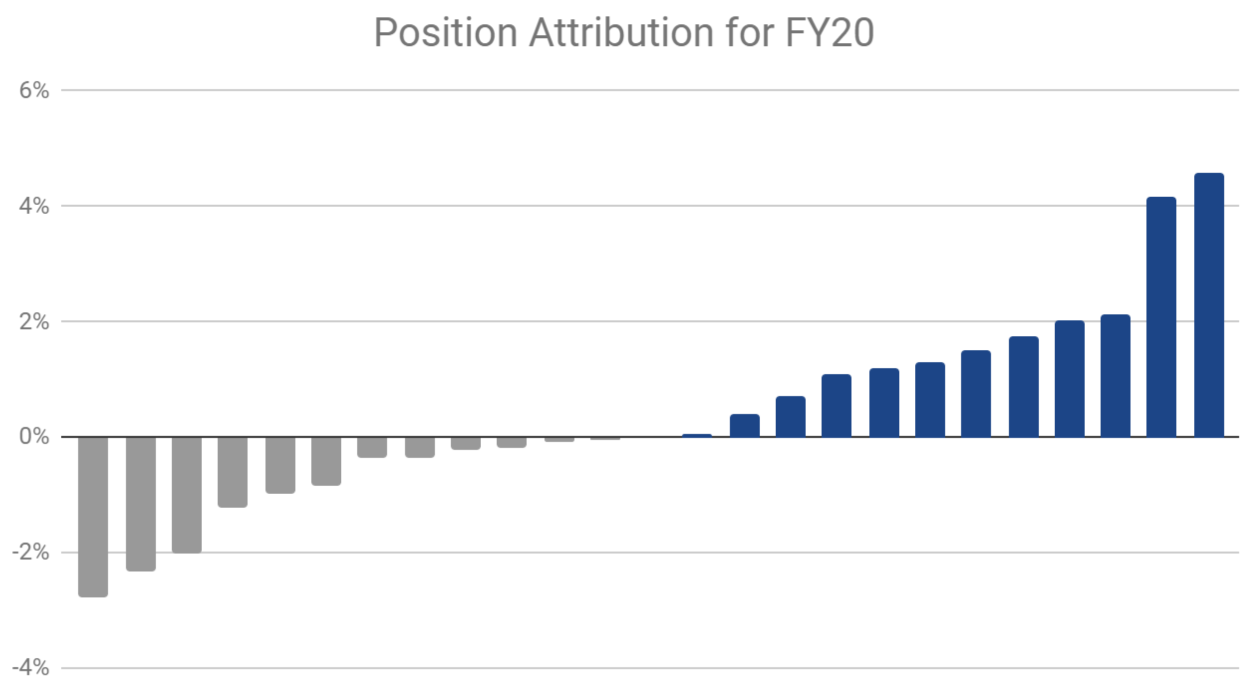
Two more things before we move to discuss performance in detail. First, the Fund's cash position averaged around 14% during the year and finished at 6.4%, or 12.6% inclusive of distributions that reinvested on 1 July. Running with a good-sized cash allocation has cost the Fund some performance and in light of that we are likely to sit lower than in our stated typical range of 5% to 15% than we have in the past, however, we take significant comfort in our ability to deploy large licks of capital quickly during downturns just as we did this year.

Second, on distributions, we note that the Fund's low turnover and emphasis on capital appreciation can make for a lumpy income stream. The final distribution of 16.61 cents per unit brought the total distributions paid to unitholders to 31.12 cents per unit since inception. We're pleased for these distributions to have been paid out to those investors who elected not to reinvest, however, we remind investors that we manage towards long-term total returns, not current income, and that we expect the ultimate distribution sizes to bounce around considerably from year to year.

Performance Reviews

Let's get back to our favourite subject: stocks. The Fund's largest holdings to finish the year, which made up 42.9% of the portfolio, were **Nearmap**, **EML**, **Pro Medicus**, **Netwealth** and **Nanosonics**. Each should look familiar to investors as we've discussed them in investor letters.

Turning to performance, the Fund had a materially higher strike rate in terms of positive contributors during the year (54%) compared to the benchmark (31%) which we expect can be chalked up to our strong orientation to quality companies. The Fund also got more bang for its buck: while the top- and bottom-quartiles of the benchmark roughly offset one another's contributions, the top-quartile of performers of the Fund added roughly 14 percentage points to performance compared to a drag of only nine percentage points by the bottom-quartile.



The biggest contributors to performance were **Pro Medicus** (+5.1%), **Afterpay** (+143.3%), and **Xero** (+50.3%) in order of contribution.

Most investors will be very familiar with fast-rising medical imaging star Pro Medicus, which has been a strong contributor to performance in the three-plus years it has been in the Fund and whose CEO, Dr. Sam Hupert, was a featured speaker at our 2018 Investor Day.

What might be less obvious to investors is how a company whose share price only increased 5.1% during the year somehow ended up being the Fund's biggest contributor to performance. The primary reasons are that 1) the Fund took advantage of a strong rally in the share price last calendar year to reduce the Fund's position at prices upwards of $37 and 2) to then pivot to being strong buyers during the downturn at prices as low as $15. With the additional context of the share price finishing the year a touch above $26, you can see that portfolio management added a good deal of value with this investment during the year.

Not that the company itself did not deliver strong fundamental results. The company won 5-year contracts with the Ohio State University and Northwestern Memorial for $9 million and $22 million, respectively, which advanced the company's market share, reputation, and reference client base across the important U.S. academic hospital sector. The company also signed a 5-year, $6 million deal with Silicon Valley based start-up, Nines, which is bringing together best-of-breed engineers and radiologists to develop a cloud-based machine learning and AI platform using Visage in the Cloud. While it's early days on the AI side, we are excited by this advancement and the optionality it adds to an already strong thesis.

Pro Medicus' pipeline is the largest it's ever been thanks to strong reputational momentum following multiple successful implementations with highly respected customers, the tailwinds of the ongoing heavy investment by US institutions into electronic health records, and modern imaging equipment generating increasingly larger datasets which are incompatible with legacy compress-and-send technology. The company's industry leading technology, track record of completing large implementations ahead of schedule, debt-free balance sheet, high and rising margins, hefty insider ownership and expanding optionality has us enthused to have Pro Medicus as one of our largest positions.

Afterpay was a significant contributor yet again. The company had another stellar year as integrated merchants and active users increased by 72% and 116%, respectively. The year wasn't all rosy with rolling regulatory concerns, however, we also appreciate that regulators tend to reach sensible outcomes when it comes to new and disruptive businesses that are loved by their constituents, which is the case here. It's also worth re-emphasising that Afterpay's domestic regulatory risk has been significantly diluted thanks to the strengthening of the balance sheet and ⅔ of active users now coming from the high-growth US and UK markets.

But the single biggest impact on the company was COVID-19, which had the dual effect of pulling forward the ecommerce adoption curve and leading Afterpay to tighten its transactional standards. Indeed, while we've always acknowledged a key risk with Afterpay was that the business model had not been stress tested through a recession, we've also thought the market did not appreciate the speed with which the company can modify the risk profile of its receivables book as it turns over roughly every four weeks. Impressively, underlying sales growth in the June quarter accelerated to 127% year-on-year from a 109% rate at the half-year in December despite a tightening of standards and social distancing undercutting in-store transactions. Another interesting twist during the year was that Chinese gaming, social networking, and payments giant **Tencent** emerged from the selloff with a significant stake and increased dialogue with the business.

Many investors have struggled with Afterpay's price for most of the time we've been invested in the company, however, few step back far enough to appreciate that the principal reason why the shares have been a smash success is that quarterly underlying sales have increased roughly 25-fold since we invested in early 2017. Still, as much as we respect the company's operating prowess, optionality, and the length of its runway, we have significantly reduced our position in response to the current valuation better reflecting the company's potential.

Xero has been yet another long-held Fund position that has been a consistent, quiet achiever. So quiet, in fact, that it hasn't been mentioned in our letters since it was last a top 5 holding in December 2018 despite its shares compounding at over 55% per year for the Fund. Given how little it has been written about even though it's been a portfolio stalwart, we'll take this rare opportunity to put its contribution in perspective.

In the time that we have held Xero, subscribers and annualised monthly recurring revenue have both increased by roughly 170%, gross margins have widened from 75% to 85%, and the business tipped into profitability generating $27.1m in free cash flow in FY20 -- catching the eye of more investors. The company continued to widen its global footprint in fiscal 2020, growing its topline by 30%, onboarding 467,000 new subscribers and adding over $1 billion in additional lifetime value.

The COVID-19-induced global recession may put some bumps in the road in the short-term but, if anything, its impact should only accelerate the adoption of cloud-based software. For that matter, we suspect that Xero's retention rates will hold up better than many expect as perhaps the last expense a struggling small business owner will cut is its affordably-priced subscription to the accounting software that helps the customer closely monitor their own cash flow.

We expect Xero to continue expanding as a platform for small business as the adoption of cloud technology spreads, and tax and compliance become increasingly digitised. The Xero ecosystem is spreading further and integrating more deeply, including with government agencies, as the company invests in new tools, features and partnerships. In fact, Xero is used in over 180 countries by more than 2 million paying subscribers, boasts 200 global banks and financial services connections, and over 800 add-on apps in the Xero App Marketplace. With $111.5m in net cash and less than 20% of its English-speaking market penetrated, versus adoption of over 50% in Australia and New Zealand, we continue to see a long growth runway ahead.

Not everything went to plan in the portfolio this year, though. The biggest detractors to performance were Nearmap (-40.5%), **Audinate** (-32.4%), and **Gentrack** (-65.0%). We'll discuss each in turn.

Nearmap shares ended fiscal 2019 within 9% of their all time high, which was nice, but soon fell short of lofty market expectations at the full year results. Investors were questioning the fundamentals of the business when Nearmap downgraded full-year guidance in January as churn more-than tripled to 20.6%. We hung in there after a deep-dive into historical churn and the specifics of the large customer losses convinced us the period was an outlier to Nearmap's fundamentals, increased mix of recurring revenue, and management's more conservative approach to revised full-year guidance gave us the confidence to top up... just in time for COVID-19.

Fortunately, the COVID-19 shutdowns had less of an impact on the business than the market feared, with a May business update revealing that Annualised Contract Value (ACV) surpassed $102 million, tracking toward mid-teens percentage growth for the full year. Although this is around half of the 36% ACV growth of fiscal 2019, we continue to like the company's data-driven approach to a large addressable market, recurring revenue model, and an emphasis on enhancing the product with more and fresher content. We're also pleased to see a push for additional features and tools including 3D imagery, artificial intelligence and roof geometry, all of which should establish new use cases and drive average revenue per subscription higher across the business.

Lastly on Nearmap, we were also happy to see in the May update that annualised churn has normalised below 10%, validating our view that the spike in churn at the half-year was an outlier. We continue to like Nearmap's prospects and expect the $32 million-plus cash balance will see it through to business-as-usual breakeven.

Audinate has slipped from being the Fund's third-largest contributor to its second-largest detractor in the space of twelve months despite little fundamental change in the business or thesis. Despite trimming the position in July 2019 when animal spirits were running high, hindsight tells us we didn't trim hard enough as the shares finished the year down significantly. Audinate's 'Dante' platform continued to expand as the global industry standard for the professional audio product market with 8 times the adoption versus the nearest competitor, up from 5 times at the end of FY19. The gap is widening as original equipment manufacturers (OEMs) rally around the leading standard, and we estimate that around 99% of new networked audio products are running on the Dante platform.

We topped up the Fund's Audinate investment through February and March as the share price waned and half-year results showed the company making good progress pushing beyond its traditional audio-segment-focus with their push into digital video and more deeply into complementary software applications. The path ahead may not be smooth sailing as we expect end demand for mid- and- large AV installations and upgrades will fall over the near-term and drag on Audinate's top-line. Still, owning the dominant digital audio protocol while still in the early stages of a large-scale market shift exemplifies the type of long-term opportunities we seek. Even though the company is hitting a cyclical rough patch, we are pleased with how this investment thesis is playing out and arguably strengthening as Audinate removes friction to broader Dante integration across the AV ecosystem.

Gentrack has been one of the more humbling investments over the life of the Fund. The thesis unravelling included four downgrades in seven months, heavy write downs of acquisitions, the departure of the CFO, CEO and eventually the chairman. We looked to exit as the investment thesis faltered but a lack of liquidity in the shares hampered our efforts. We did eventually find an exit, and the shares have since fallen further, though missing the subsequent fall is cold comfort and reinforced the importance of our conviction better than matching a lack of liquidity.

Part of the company's issue was the significant deterioration in the independent energy retailer market in the UK which had been a growth driver for the business in recent years. Four of Gentrack's customers fell into insolvency and Gentrack's board and management repeatedly stumbled in getting a handle on the situation, but were also carrying a damaged capital allocation track record following the full write-off of the CA+ acquisition only two years after it was made.

We have a degree of sympathy for the company as it hit these rocky times while also working through a transition to more subscription-based software. For that matter, in a business where license revenue can be lumpy, it can be hard to tell when there is a structural or cyclical issue. Unfortunately, we appreciated too late that the company's issues were indeed structural and then later compounded by cyclicality.

We were too patient with this position and have learned a number of things from this investment. To that end, during our annual investing team process review, we wondered whether the data suggests we have sometimes been sometimes poor at timing our exits, which is a common issue with investors such as ourselves who try to demonstrate a considerable degree of patience.

In the spirit of continuous improvement, we undertook a study of the performance of all positions we'd exited across both our funds from the date of our last sale through the end of the year. The results were better than expected: 52% of the companies we've exited have gone on to beat their benchmarks -- a toss up, basically -- but only 30% had gone on to outperform the funds themselves, suggesting we've been effective in redeploying capital from positions we've exited. There is room for improvement, though, as our experience with Gentrack highlights, and we plan to keep companies with drifting investment theses on a tighter leash going forward, particularly when liquidity is on the thinner side.

Thank You

Thank you for your continued trust and support. It means a great deal to us, particularly to our co-founders Joe Magyer and Donny Buchanan, and we are grateful to have such a strong, diverse, and aligned foundation of investors. Indeed, the Fund had net inflows during each of February, March, and April, which we think speaks volumes about the long-term mindset of the investors we've been so fortunate to cultivate.

We can't promise that the next couple of years will look like the past few but, regardless, we'll stick to our playbook, continue reinvesting in our own business to better serve clients, and keep doing our best for you.

Best Regards,
Team Lakehouse

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