

# LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

30 November 2020



Dear Lakehouse Investor,

November was another lively month as equity markets rallied on optimism following the announcement of multiple successful COVID-19 vaccine phase III trial results. The reduced US election uncertainty, including likely legislative gridlock that takes sweeping policy changes off the table, also served to hearten investors. For its part, the ASX 200 was up 10% in November, the best month since the index started over 20 years ago and the largest monthly gain since March 1988.

Our team was particularly busy as we held 38 meetings with current and prospective portfolio companies, digested trading updates from AGMs, increased positions in multiple existing holdings, and participated in an IPO. As the fund hasn't set its stake in the new IPO holding, we'll hold off on discussing it at this time.

November also marked a milestone month for the Lakehouse Small Companies Fund as it celebrated its fourth birthday. The trust that our earliest investors placed in us will always mean a great deal to us. In light of that, we're happy to report that trust has thus far been well placed. Morningstar reports that, for the four-year period ended 30 November 2020, the Lakehouse Small Companies Fund ranked number #1 out of 45 Funds in the Morningstar Equity Australia Mid/Small Growth category.

The Fund returned 5.9% net of fees and expenses during the month compared to a 10.3% return for the benchmark. Over the past 12 months the Fund has returned 20.3% compared to 6.0% for its benchmark. And, since inception in mid-November 2016, the Fund has produced a net total return of 153.9% compared to 47.3% for the benchmark. In annualised terms, the Fund has returned 25.9% per year since inception compared to 10.1% per year for the benchmark.

	<b>1 Month</b>	<b>3 Month</b>	<b>1 Year</b>	<b>3 Year (p.a.)</b>	<b>Inception (p.a.)</b>
Lakehouse Small Companies Fund	5.9%	7.3%	20.3%	24.6%	25.9%
Benchmark	10.3%	7.7%	6.0%	6.7%	10.1%
Excess Return	-4.4%	-0.4%	14.3%	17.9%	15.8%

The Fund's largest sector allocations are to information technology (58.7% of total capital), financials (14.1%), and healthcare (13.6%) while the benchmark's largest allocations are to materials (21.4%), consumer discretionary (16.7%), and real estate (12.6%). Our differentiated style should look familiar and our general preference to shy away from cyclical, capital-heavy sectors and companies has also rewarded the Fund very well during this volatile period.

## Company News

Turning to specific companies, the Fund's most significant contributor to performance during the month was **EML Payments** (+23.9%) while the biggest detractor was **Pro Medicus** (-8.8%). We will comment further on both shortly. The Fund's five largest holdings as of the end of the month accounted for 38.1% of the portfolio and are named in order of the Fund's allocation: **Netwealth**, EML Payments, **Xero**, **Nearmap** and Pro Medicus.

EML rallied off the back of the encouraging vaccine news as it brings forward the prospect of shopping malls reopening and their gift card business coming back online. The company also recently revealed exciting news about the initial FinLab investments, namely Interchecks and Hydrogen. Interchecks will likely be a key partner of EML in the US gaming market that will provide more choices for consumers on how to access their winnings. Hydrogen will work with EML to provide a one-integration touch point to allow customers to easily add features that EML and its partners can offer. This will help grow the pie for the customers, partners and EML.

Turning next to Xero, which is the Fund's longest-held position and had a big month on a number of fronts. News that the company would join the MSCI Australia Index had equity desks and passive funds scrambling to prepare, pushing the shares up 20.3% over the month. In a sign of the influence of index funds, almost 10% of the company's issued shares changed hands on 1 December 2020, the first day of inclusion.

Xero also reported its half-year results in November, which ironically revealed the business' underlying strength despite the challenging COVID environment. The COVID uncertainty prompted management to tap the brakes on sales and marketing spend, and led to \$54.3 million in free-cash-flow, or roughly double the dollar amount from the entirety of fiscal 2020. Put another way, free cash margins jumped to 13.2% of operating revenue from only 1.4% a year earlier. This came as a surprise to many as Xero has been investing heavily for growth since inception, accumulating large accounting losses in the process. We don't expect

Fund Metrics	
Companies Held	21
Cash Allocation	11.9%
Top 5 Portfolio Holdings	38.1%
Net Asset Value per Unit (mid)	\$2.1113
Fund Net Asset Value	\$345.0 million
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

this level of free-cash-flow generation to continue -- Xero could and should hit the gas of reinvestment again once economies open up -- but we think this spike in profitability speaks well to the underlying earnings power of a business.

In terms of revenue and subscriber numbers, both slowed materially due to a combination of COVID impacts and the deliberate reduction in customer acquisition spending. Annualised monthly recurring revenue growth halved to 15% while subscriber numbers grew by 'only' 19% compared to 30% in the prior-year half. We view this as a solid result in a very challenging market for small businesses. Perhaps the most pleasing detail was that churn held steady at 1.1% in spite of COVID, which speaks to how entrenched Xero is for customers.

The company has a fortress balance sheet with a net cash balance of \$178m, and total available liquid resources of over \$1 billion following the recent expansion of its convertible notes program. The company has expanded its reach through acquisitions in recent years, and this added balance sheet flexibility is a sign of more to come.

Nearmap held its AGM during the month and provided guidance for Annualised Contract Value to land between \$120 million and \$128 million for FY21, a 16.5% increase (at the midpoint) compared to FY20 and in line with consensus forecasts. The company's large capital raise in September leaves it with around \$130 million in cash, of which it plans to invest \$10 million to \$15 million in FY21. Reading this reinforced our view that the large equity raise was unnecessary given they already had \$34 million in net cash and the business had tipped toward cash flow breakeven. All eyes are on management to accelerate growth from here to their medium-to-long-term target range of 20% to 40%.

And finally Pro Medicus, which fell on no material negative news. To the contrary, there was a continuation of the company's recent run of news, with the announcement of a five-year, \$8.5 million contract renewal with Zwanger Pesiri, one of the largest private outpatient radiology providers in the U.S. The renewal follows a previous five-year contract and Dr Steve Mendelsohn, CEO of Zwanger Pesiri commented that: *"The speed and capabilities of their software is unrivalled in the market. Since implementing it 5 years ago, we have experienced significant increases in radiologist productivity and clinical accuracy which has underpinned our substantial growth over that time."* A strong endorsement from a long-time user and helps to explain the continued success of the business and its shares.

## Looking Ahead

December should be a quieter month as the industry winds down for the holiday season after a difficult year. We look forward to spending some more relaxed time with our families and hope you're able to do the same.

Thanks again to all our investors for your time and trust. It means a great deal to us, especially those of you who backed us early and hung in there during such an eventful period, and we'll continue to do our best for you.

Best Regards,

Lakehouse Capital

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