LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

28 February 2021

Dear Lakehouse Investor,

February was a lively month as most of our portfolio companies reported half-yearly results. On top of digesting results, our team attended 40 meetings with current and prospective portfolio companies. There was some change at the portfolio level as we exited one position and initiated another. More on the exited position below, but we're still building the position in the new holding so will hold off discussing.

The month was also notable for the soft closure of the Fund to new investors in order to limit capacity, prioritise performance ahead of asset growth, and reserve the balance of the Fund's capacity for our existing investors. The Fund soft closed at around $400 million and we expect to hard close the Fund to top-up investments from existing investors at around $500 million in assets. Existing investors who are interested in increasing their investment can learn more here.

The Fund returned 0.6% net of fees and expenses during the month compared to a 1.5% return for the benchmark. Over the past 12 months the Fund has returned 43.1% compared to 17.2% for its benchmark. And, since inception in mid-November 2016, the Fund has produced a net total return of 165.2% compared to 53.3% for the benchmark. In annualised terms, the Fund has returned 25.5% per year since inception compared to 10.5% per year for the benchmark.

	1 Month	3 Month	1 Year	3 Year (p.a.)	Inception (p.a.)
Lakehouse Small Companies Fund	0.6%	4.4%	43.1%	23.0%	25.5%
Benchmark	1.5%	4.1%	17.2%	7.2%	10.5%
Excess Return	-0.9%	0.3%	25.9%	15.8%	15.0%

The Fund's largest sector allocations are to information technology (51.7% of total capital), healthcare (14.8%), and financials (12.5%) while the benchmark's largest allocations are to materials (21.1%), consumer discretionary (17.0%), and financials (14.1%). Our differentiated style should look familiar and our general preference to shy away from cyclical, capital-heavy sectors and companies has rewarded the Fund very well since inception.

Company News

Overall it was a pleasing reporting season in terms of business fundamentals, particularly considering the headwind of a rising Australian dollar and that economies are emerging from the impacts of COVID. Turning to specific companies, the Fund's most significant contributor to performance during the month was **EML Payments** (+29.6%) which reported a consensus-beating half year result. Meanwhile, the biggest detractor was **Netwealth** (-19.0%) which also reported. We'll discuss both companies in more detail shortly.

Fund Metrics	
Companies Held	23
Cash Allocation	14.5%
Top 5 Portfolio Holdings	34.6%
Net Asset Value per Unit (mid)	$2.2049
Fund Net Asset Value	$403.6 million
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

The Fund's five largest holdings as of the end of the month accounted for 34.6% of the portfolio and are named in order of the Fund's allocation: EML Payments**, Pro Medicus**, Netwealth**, Nearmap** and **Pinnacle Investment Management**.

EML Payments reported a strong set of half-year numbers with all segments of the business proving more resilient than the market expected. We took particular enjoyment from this result having held our shares tightly throughout the lows of the COVID panic: EML traded as low as $1.20 last March and closed out this month at $4.99.

EML's revenue and gross debit volume (GDV) were up 61% and 54% year-on-year, respectively, making for a strong finish to a challenging calendar year. Mall gifts cards were negatively impacted due to further lockdowns in Europe but were slightly offset by the increase in incentive gift card volumes. We expect EML to continue adding partners to distribute mobile gifting capabilities moving forward. General purpose reloadable (GPR) revenues went up four-fold, which now includes a full contribution from the recently acquired Prepaid Financial Services (PFS) business.

Looking back, the renegotiation of the PFS deal during the COVID downturn looks to have been among the best acquisitions made by an Australian listed company in 2020. EML paid a lower price, avoided debt on its balance sheet, and acquired a strong, complementary business. GPRs now represent more than half of the company's total revenue and will continue to add to the $1.9 billion of float from the stored value of cards, which bodes well in a rising interest rate environment.

Lastly, we're also excited about EML's key strategic initiative, Project Accelerator, which leverages the company's distribution to be able to partner with up-and-coming fintechs to bundle solutions with EML's product offering. We believe EML will improve win rates over time as the company integrates open banking capabilities and offer more comprehensive disbursement options. The business pipeline has never been stronger and we can't wait to see what the management team goes after next. On top of that, EML is sitting on $137 million of cash, which will play a part in future optionality. We remain confident holders.

Pro Medicus' run of large contract wins continued (yet again) this month, adding a A$31 million, 7-year deal with a 5-University Health System in California. The recent wins have been well documented in these letters across October, November, December 2020 and January. At risk of sounding like a broken record, this latest contract is for yet another public cloud deployment further underscoring the momentum in hospitals migrating to the cloud. Visage 7 is replacing a legacy system and unifying all five universities diagnostic imaging departments on a single system. An interesting bonus of the single system, and this contract, is it allows affiliates across the five distinct health systems to standardise on Visage, potentially adding further revenue to the transaction-based model.

Turning to the company's half year results. Revenue grew a modest 7.8%, while underlying profit before tax was up strongly, at 25.9%, as examination volumes continued to emerge from COVID impacts in North America. The business' usual highly profitability was amplified in the half through a combination of operating leverage and reduced travel and marketing expense, pushing earnings margins (before interest and tax) from 51% to 59%. These levels are unlikely to be sustainable, but founder-CEO Sam Hupert believes the COVID change to remote sales, service and implementation have persisted long enough that some structural cost reduction will remain.

The company's share price has run following the unprecedented stretch of contract wins where the full revenue impact won't be seen until the 2022 financial year. Consequently, we took the opportunity to take some chips off the table, but Pro Medicus remains our second largest position for good reason. The business has delivered on a strong pipeline of new business with more in the hopper, a proven cloud capability, growing optionality with it's archive product and AI Accelerator program, and remains in a strong financial position with over $50 million in net cash.

Netwealth reported a pleasing half year result, with revenue and net profit growing 22.3% and 34.5%, respectively. The company continues to lead net fund flows for the industry, adding $9.5 billion over the 12 months to September, which is as much as the next three largest platforms combined (Hub24, Macquarie, Praemium). We estimate the company increased its market share by 0.70%-0.75% in the half, with 0.40% of that in the second quarter, pointing to an acceleration in market gain. Overall we estimate Netwealth's current market share at 4.5%, meanwhile it is capturing 46% of net fund flows from firms that are flow-positive.

With $4.5 billion in net flows already achieved in fiscal 2021, and an acceleration in account growth to its highest level in almost three years during the December quarter, the company upgraded its previous full year guidance of $8 billion in net flows to between $8.5 billion and $9 billion. The Netwealth thesis continues to play out as the founder-led company organically leads net flows across the industry, gobbling up market share, with a long runway ahead.

Nearmap had an unusual run into its half year as a short report was issued days prior disputing the company's efforts in the North American market. In our view the short report relied significantly on information that was already understood by the market plus opinion and hearsay significantly from competitors and former employees.

Nearmap wasted little time in poking holes in the report by reporting their own results earlier than initially planned. Annual contract value (ACV) grew 41% in the key North America market and looks set to pass the home ANZ market as the largest source of ACV in the next year. Metrics across the board improved in North America as the company rolled over last years' big churn event, with churn in North America falling to 6.5% from 16.9% a year earlier and (pre-capitalisation) gross margins expanded from 29% to 53%. Growth in the ANZ market was more subdued but churn still improved from 7.2% to 6.0% and gross margins edged 3 percentage points higher to 93%. We expect gross margins in the dispersed but commercially huge US market to drift much closer to those of the established ANZ market as the business scales.

The higher customer retention led to an improvement in the ratio of lifetime value to customer acquisition cost and we calculate the company is now generating around $2.5 in present value for each dollar it spends acquiring customers. While it's been a bumpy ride at times as a Nearmap shareholder, we remain enthused about the long-term prospects, including the launch of HyperCamera 3, likely expansion into other geographies and continued build out of new AI tools. With $129 million in cash on the balance sheet and a primary competitor in the US who is debt-strapped and owned by private equity, we think Nearmap is well placed to defend its position at home and win more share abroad.

Pinnacle Investment Management is a company we have followed for several years but only built a stake in the middle of last year when equity markets were racked with COVID uncertainty. The shares have performed well since and the position has grown into our top 5 holdings. The company owns stakes in a collection of boutique funds management businesses with Pinnacle's share ranging in size from 23.5% to 49.9%. There are many strings to the business, but Pinnacle's key value proposition to affiliate investment managers are their marketing and distribution capabilities, evidenced by 21% organic compound annual growth in funds under management (FUM) over the past decade. The business has continually invested in growing its core distribution capability in Australia, and more recently has established offshore offices in the UK, US and Japan.

The business historically owned a smaller number of stakes in mostly equity-focused fund managers with a heavy reliance on FUM from institutional clients. Management's strategy has broadened this base markedly in recent years, and our investment thesis is centred around the strength of the distribution network domestically and growth internationally, an increasing mix of retail and performance funds, and the addition of further affiliate investment managers across a broadening suite of asset classes to capture fund movements in dynamic markets.

The business handed down a strong recent half year result with aggregate FUM growing 14% to $70.5 billion and ordinary net profit (excluding performance fees and investments) growing 39%. With $51.4

million in cash and investments, against a modest debt balance of $30 million, we think this capable management team is well placed to continue growing its affiliates, their investment strategies across asset classes, and distribution capability to reach and serve an increasing number of global investors.

Now to the **LiveTiles** exit. LiveTiles is a long-held position established through a capital raise in 2017 and one of the Fund's smallest holdings by cost. We first mentioned the company in March 2019 when it was our biggest contributor, and provided an overview of the investment thesis in April 2019, which we described as being akin to a venture style investment. Growth, however, has slowed materially since then, and share price followed as the business continued to burn cash in pursuit of hyper-growth, and breaking our thesis in the process. For much of the past 12 months the stock has traded sideways at a conventionally-cheap multiple of 3 times forward sales to enterprise value, with high gross margins and high customer retention, and we were lulled into overstaying our welcome.

At the start of this year the position had shrunk to 1.4% of the portfolio and was on a short leash, but the final straw came after the founder put out the 'for sale' sign for private equity buyers and Microsoft released a competing product. The reliance on Microsoft's ecosystem has always been LiveTiles' achilles heel, and with Microsoft Viva modules overlapping LiveTiles products it tipped our hand to allocate the capital elsewhere. While we hope things work out well for the company, we are not an event-driven fund and didn't see merit in waiting around for a private equity suitor to potentially emerge.

Looking Ahead

With half year reporting behind us, we continue to trawl through company reports and meet with management teams for updates on their longer-term strategy to expand our universe of potential portfolio holdings.

Thanks again to all our investors for your time and trust.

Best Regards,

Lakehouse Capital

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