LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

31 March 2021

Dear Lakehouse Investor,

The last month marked the anniversary of the rapid global spread of COVID-19. It was a time of massive panic, underscored by unknown health risks, school and office closures, the shuttering of borders, and the steepest drawdown in the history of global equity markets.

And, yet, March 2020 proved the best buying opportunity in more than a decade with the Fund up 71.8% net of fees and expenses over the past 12 months. Although Australian small-caps had fallen by 32%, there were plenty of reasons for optimism: social distancing had taken off and was proving effective, private enterprise had thrown its considerable weight behind finding and creating treatments and vaccines, and governments and central banks had unleashed unprecedented fiscal and monetary stimulus.

The crash proved a powerful reminder of the value of a long-term mindset and the importance of sticking to one's approach even during challenging times -- *especially* during challenging times. It's much easier to talk about a long-term mindset than it is acting upon one, yet we were pleased and proud that our investors tipped more money into the Fund on a net basis in March 2020. We are fortunate and grateful to have such an aligned group of investors.

Turning back to more recent performance, the Fund returned -3.6% net of fees and expenses during the month compared to a 0.8% return for the benchmark. Over the last 12 months, the Fund has returned 71.8% compared to 52.1% for its benchmark. And, since inception in mid-November 2016, the Fund has produced a net total return of 155.6% compared to 54.5% for the benchmark. In annualised terms, the Fund has returned 23.9% 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	-3.6%	-4.3%	71.8%	22.6%	23.9%
Benchmark	0.8%	2.1%	52.1%	8.3%	10.5%
Excess Return	-4.4%	-6.4%	19.7%	14.3%	13.4%

The Fund's largest sector allocations are to information technology (54.2% of total capital), financials (13.4%) and healthcare (12.7%) while the benchmark's largest allocations are to materials (21.2%), consumer discretionary (17.3%), and financials (13.3%). 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

Turning to specific companies, the Fund's most significant contributor to performance during the month was mining software and consulting leader **RPM Global** (+21.7%) after a strong start to the second half for its software business. Meanwhile, the biggest detractor was **CleanSpace** (-67.2%) which provided a horrid quarterly trading update following its strong half-year report. We'll discuss both companies in more detail shortly.

The Fund's five largest holdings as of the end of the month accounted for 35.2% of the portfolio and are named in order of the Fund's allocation: **EML Payments**, **Netwealth**, **Pro Medicus**, **Pinnacle Investment Management** and **Tyro**.

Fund Metrics	
Companies Held	23
Cash Allocation	12.8%
Top 5 Portfolio Holdings	35.2%
Net Asset Value per Unit (mid)	$2.1254
Fund Net Asset Value	$392.0 million
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

RPM Global is a company we last mentioned in these letters in January 2019 when it was our biggest detractor, so it's nice to see a role reversal for its second appearance. The core of our investment thesis remains the software business which we are happy to report is gaining steam, particularly the valuable recurring component. Indeed, annual recurring revenue and total contract value are up +22.8% and +61.4% respectively since the end of December 2020. The market enthusiasm was further supported by another brokerage firm initiating coverage on the company.

RPM management continues to execute well on its strategy to build an enterprise platform to service miners and is reaping the rewards of having invested against the commodities cycle. Recent accelerated demand for cloud services from customers has seen RPM step up its R&D spend, which will likely continue at an elevated pace for the next 18 months. With a profitable business, more than 10% of its market capitalisation in cash, and a commercial leader at the helm, the business remains well placed to expand its market position.

Turning to our biggest detractor, CleanSpace, where we initiated a small position in the months following the company's October 2020 IPO. CleanSpace designs, manufactures and sells high-level respiratory protection equipment for healthcare and industrial markets. The innovative masks were developed by an ex-ResMed biomedical engineer whose big idea was to miniaturise a positive pressure mask and filtration system. Our investment thesis focused on the longer-term fundamentals for adoption for CleanSpace's superior product, where the adoption curve had been accelerated by COVID-19.

In the last six months of calendar 2020, the business delivered numerous hospital-wide rollouts, and was added to the standards of care for a number of hospital networks, increasing its sales 5-fold compared to the prior corresponding period. U.S. healthcare providers, in particular, scrambled to adopt the product in response to the pandemic. But roll forward a few short months and the music stopped as the focus in the U.S. moved to rapid rollout of the vaccine. We were not surprised by a slowdown but the steepness was more than we and the market expected with the shares falling over 50% in a single day.

In hindsight, we were too optimistic for the short-term prospects for the product and likelihood for COVID-19 to linger longer and drive continued adoption and heightened pandemic preparedness. Management has also created a credibility issue for themselves by not being more direct with investors about the scope of the slowdown when they updated the market in late February. Fortunately, we did not compound this mistake by topping up our position following the half-year results on account of a soft outlook statement. Our strong preference is to average up where an investment thesis is working out, not averaging down when fundamentals are weakening.

We are not pulling the plug on this now small investment, though, as the business remains well capitalised with over 30% of its market capitalisation in net cash, is operating around breakeven at the reduced sales volume despite an expanded distribution effort, and has a market leading product which we expect will see wider global adoption once post-pandemic reviews are completed and standards of care and preparedness are updated. The company could also find itself an acquisition target given its well-received products, clean balance sheet, small size, and the potential for a strategic buyer to enhance value via an already established global sales network.

Netwealth also had a tough month as the company announced that its current (favourable) arrangement with ANZ Bank, to earn 0.95% above the overnight cash rate on its cash deposits, will end in March 2022. This is an unsurprising change in the current climate as competition for funding is tilted in the banks' favour and thus the margins on this portion of the profit pool will shrink for Netwealth.

The market had a brutal response to the news, with the shares falling 15% on the day. We thought the reaction was overdone and took the opportunity to grow our position in a business that continues to gain market share. Ironically, this news happens with the backdrop of global interest rates having increased and Netwealth a net beneficiary of that trend. Our conviction behind the thesis remains strong as founder-led Netwealth remains highly profitable, debt free, and with many levers it can pull across the business to grow revenue as it continues to gobble up market share.

Zooming in to our newly disclosed holding, Tyro Payments, which the Fund has held since early February. Tyro is a company that we've followed since its IPO in late 2019 but felt that the price was not right. The negative publicity from a recent outage created an opportunity for the Fund to initiate a position, though, as we expected current and potential clients would quickly look past the issue. Indeed, Tyro has since provided strong weekly payments volume updates and the market's worst fears about the outage have already been put to bed. The share price appreciated and Tyro grew its way into our top five positions.

Tyro Payments is a merchant acquirer and banking solutions provider in Australia. The company accepts and processes $21 billion in card transactions annually in store and online. Tyro is active in the retail, hospitality, and healthcare space, having deep integrations with more than 300 point-of-sale (POS) software providers. The deep integrations, along with the mission-critical nature of accepting payments, creates sticky and loyal customers. The company retains 90% of its merchant clients and 92% of transaction volume annually, which is a great recipe for a business to continue to grow over time. We estimate the company creates $4 in gross profit in present value terms for every $1 it spends acquiring customers, which is already strong, but has room for upside when the economy fully reopens.

Tyro has a long runway for growth, being used at only 7% of the payment terminals in Australia, taking market share from large incumbent banks that do not see this market as core to their overall business. We are also excited about recent partnerships with Bendigo Bank and Me & U as these will accelerate the company's overall growth and help acquire scale. The company recently hit EBITDA profitability and we estimate that 38% of incremental gross profit translates to additional EBITDA. Further, Tyro has $130 million in the bank, which can help it weather any minor setbacks or costs related to the outage.

Looking Ahead

April will be busy as usual for our team as we turn over new rocks, meet with current and potential portfolio companies, and digest updates from pre-profit companies reporting their quarterly 4C cash flow statements.

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

Best Regards,

Lakehouse Capital

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