LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

31 May 2021

Dear Lakehouse Investor,

May was a tough month for the Lakehouse Small Companies Fund with high-growth companies swinging out of favour and a pair of company-specific issues dragging on overall performance. The volatility didn't keep us from getting on with business, though, as our team held 27 meetings with current and prospective portfolio companies, topped up existing holdings, and exited two tiny investments in which circumstances changed before we built a full position. More on the company news later in the letter.

The Fund returned -5.4% net of fees and expenses during the month compared to a 0.3% return for the benchmark. Over the last 12 months, the Fund has returned 26.0% compared to 26.7% for its benchmark. And, since inception in mid-November 2016, the Fund has produced a net total return of 164.3% compared to 62.6% for the benchmark. In annualised terms, the Fund has returned 23.9% per year since inception compared to 11.3% per year for the benchmark.

	1 Month	**3 Month**	**1 Year**	**3 Year (p.a.)**	**Inception (p.a.)**
Lakehouse Small Companies Fund	-5.4%	-0.4%	26.0%	22.2%	23.9%
Benchmark	0.3%	6.1%	26.7%	7.9%	11.3%
Excess Return	-5.7%	-6.5%	-0.7%	14.3%	12.6%

The Fund's largest sector allocations are to information technology (53.7% of total capital), financials (14.3%) and healthcare (13.5%) while the benchmark's largest allocations are to materials (21.2%), consumer discretionary (17.2%), and financials (13.9%). Our preference to shy away from cyclical, capital-heavy sectors and companies has contributed to recent short-term underperformance but has rewarded the Fund well since inception. As you would expect, we have no plans to shift away from our long-term, quality-driven approach that emphasises businesses with extremely loyal customers, network effects, and unique and enduring intellectual property simply because commodity prices are hot right now.

Company News

Turning to specific companies, the Fund's most significant contributor to performance during the month was **Bravura Solutions** (+21.6%) after reiterating their full year guidance and the biggest detractor was **EML Payments** (-41.9%) who came into the crosshairs of the Irish financial services regulator. Both companies should be familiar to investors from previous letters. We'll discuss each in more detail shortly.

Fund Metrics	
Companies Held	21
Cash Allocation	11.8%
Top 5 Portfolio Holdings	34.4%
Net Asset Value per Unit (mid)	$2.1970
Fund Net Asset Value	$406.5 million
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

The Fund's five largest holdings as of the end of the month accounted for 34.4% of the portfolio and are named in order of the Fund's allocation: **Netwealth**, **Pro Medicus**, **Tyro, Pinnacle Investment Management** and EML Payments.

Now to the Fund's most significant contributor, Bravura Solutions, which rallied following confirmation of their full year guidance in early May. The market was pleased to receive the confirmation 10 months through the financial year given the 80% skew in earnings to the second half, and that it leaves less room for disappointment from a company that has been in a downgrade cycle for the past 12 months. As an enterprise software provider to the financial services industry in the UK, Bravura was heavily impacted by both Brexit and then COVID-19 as customers waited for certainty before proceeding with large upgrades or wholesale new implementation, which typically require a high level of on premise work.

Bravura's pipeline has been severely impacted by the double-whammy of uncertainty but in a sign of renewed confidence, management guided for a return to top-line growth relative to the first half and reiterated guidance for net profit after tax of $32 million to $35 million. The business is selling for roughly 22 times Brexit- and COVID-19-impacted earnings, which strikes us as a very fair price, and we believe is poised for growth following the company's tilt toward cloud services, increased customer demand for digital engagement with clients, and Bravura's Sonata Alta marquee win to be the service provider for the client ecosystem of Australia's second largest super fund. With $56.4 million in net cash, a pent up pipeline of work for mission critical software upgrades and implementations, and rebounding economies, we think Bravura has better roads ahead.

Turning to the pair of company specific issues which relate to EML Payments and Nearmap. Both events served as yet another good reminder of the volatility inherent in investing in fast growing small companies, which we expect our investors have become as accustomed to as we are, and highlights why the Fund typically holds 15 to 30 investments at a time rather than just a handful.

We'll start with EML as it was the Fund's biggest detractor on the back of being last month's biggest contributor. The stock fell in response to EML's announcement that its Irish-licenced subsidiary, PFS Card Services, had received correspondence from the Central Bank of Ireland (CBI) raising significant regulatory concerns with the company's anti-money laundering and counter-terrorism funding risk (AML/CTF) and control frameworks and governance. The release went on to note approximately 27% of EML's revenue was derived from programs operating under that Irish license, which the market apparently read as being entirely under risk of disappearing as the shares fell 46% on the day of the announcement.

Our view on the situation, based on our own research, experience, and a discussion with an Irish lawyer with deep experience engaging with the CBI on regulatory issues, is that the most likely scenario is that EML works closely with the regulator to establish a controls solution and pays a modest fine. We expect a fine in the ballpark of A$5 million, or 10% of the 27% of group revenue linked to the license, with the business taking on marginally higher costs in order to improve its approach and systems around AML/CTF. Such an outcome is in the realm of how the CBI has handled similar situations in recent years.

The market has reacted to the situation as though a suspension or revocation of the license is probable, however, that is an extreme outcome and not the angle from which the CBI would be starting. Keep in mind that the CBI wants to foster growth and innovation in financial services, not regulate it into oblivion, and so collaborating with PFS to solve the issue is the more pragmatic jumping off point. Also note that businesses and consumers inside and outside of Ireland would be impacted by a license suspension or revocation, which are battles the CBI likely wouldn't want to instigate without incredibly serious concerns. After all that, even if PFS ran into a permanent licensing issue, it isn't obvious to us that EML couldn't pivot its European operations to a different European license.

We did not grow our position in EML on the drop despite our view that the market was overreacting given our emphasis on not averaging down on bad news. It's possible this could drag on for longer than we'd like, more issues may come to light, or perhaps the business really does suffer through a suspended or revoked license. All that said, we think those concerns are more than properly accounted for in the current valuation based on what we know today. We will continue to watch the matter closely and note that it's possible all this could be resolved in a matter of weeks, which would be welcome news to investors.

Moving on to Nearmap, which upgraded guidance in early May following an acceleration in growth in the second half toward 22.2% for fiscal 2021. The company also revealed lower-than-expected cash burn should leave the business with over $120 million in net cash at year end. The market was pleased and the stock rallied 15%. The rally was short-lived, though, as news broke hours later that US-mapping rival EagleView had brought legal proceedings against Nearmap claiming patent infringement, leading Nearmap's stock to fall by a quarter.

The more than $300 million the market has shaved off Nearmap's valuation strikes us as harsh given this legal dispute will likely play out over years, not weeks, and that Nearmap may well prevail. For that matter, we note that Nearmap's US business is fundamentally gaining steam and that any impacts to the business in terms of legal costs and revenue impact are already likely well reflected in the current share price. Again, we did not top up given our emphasis on not averaging down on fundamentally bad news, and we did not sell any shares either.

The Nearmap products potentially impacted by the case contributed around 17% of first half revenue, and amount to some US$20 million cumulatively to the end of December 2020 since Nearmap started selling them. If Nearmap is found to have willfully infringed on EagleView's patents, which is not our expectation, our read is they could be up for a penalty of three times the cumulative revenue, plus legal costs, which combined is a fraction of what the market has priced in.

The legal case is clearly an unwelcome distraction for management and could potentially give US customers some pause and impact demand for those products, but overall we think the market is exaggerating the risk. Notably, the shares sell for around 54% below their highs and for an enterprise-value-to-forward-revenue multiple of 5.6 compared to an average of 9.1 over the last 3 years. Meanwhile, Nearmap has returned to growth in North America, is cashed up, remains on track to commence rollout of HyperCamera3 next financial year, has further geographic expansion up its sleeve, and continues to invest in premium content to entrench their value to customers. We acknowledge the risks but remain comfortable long-term holders.

Looking Ahead

The Fund successfully completed its change of Responsible Entity vote during the month. We'd like to thank all our investors for their support and making it such a smooth process. Our Operations team is in the process of making the required changes, which include an updated Product Disclosure Statement and some changes to the application forms in the weeks ahead.

June means we are fast closing in on the end of the financial year for most of our portfolio companies which means we enter black-out as companies focus on ruling off their books and preparing their annual report cards. This usually sees the cadence of meetings slow and the pace of IPOs pick up to take advantage of the void.

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

Best Regards,

Lakehouse Capital

P.S. Next month's letter will be our annual one and will arrive in late July. Expect a detailed look-back on performance, key contributors and detractors for the year, our views on core holdings, and our outlook.

For more information call us on +61 2 8188 1510, email investorsupport@lakehousecapital.com.au or visit www.lakehousecapital.com.au

---