

# LAKEHOUSE SMALL COMPANIES FUND

ANNUAL LETTER

30 June 2021



Dear Lakehouse Investor,

2021 was a very good year for the Lakehouse Small Companies Fund despite significant economic, political, and medical uncertainty. The Fund returned 38.6% net of fees and expenses in fiscal 2021 compared to a 33.2% return for its benchmark. The Fund has delivered a net total return of 181.4% since inception in mid-November 2016 compared to a 67.6% return for its benchmark. In annualised terms, the Fund has returned a net 25.1% since inception compared to 11.8% for its benchmark.

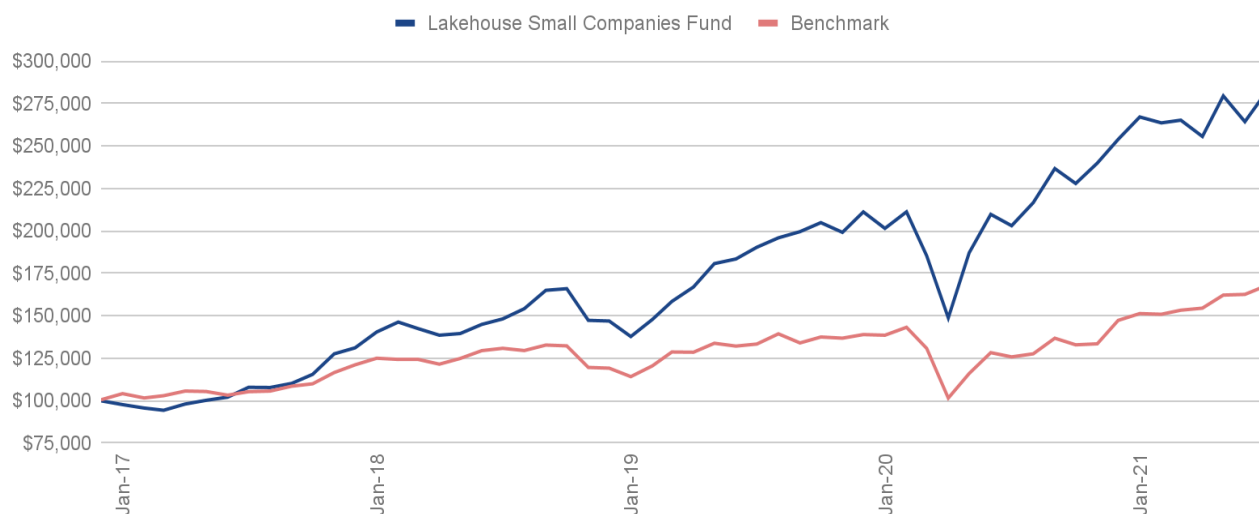
<b>Fund Metrics</b>	
Companies Held:	21
Cash Allocation:	6.1% (or 10.9% inclusive of reinvested distributions)
Top 5 Portfolio Holdings:	36.2%
Net Asset Value per Unit:	\$2.1810 (after a 15.85 cent distribution)
Fund Net Asset Value:	\$403.6 million (after a \$29.3 million distribution)
Benchmark:	S&P/ASX Small Ordinaries Accumulation Index

	<b>FY17*</b>	<b>FY18</b>	<b>FY19</b>	<b>FY20</b>	<b>FY21</b>	<b>Inception (p.a.)</b>
Lakehouse Small Companies Fund	7.9%	37.3%	28.5%	6.7%	38.6%	25.1%
Benchmark	5.3%	24.2%	1.9%	-5.7%	33.2%	11.8%
Excess Return	2.6%	13.1%	26.6%	12.4%	5.4%	13.3%

*\*Inception on 30 November 2017. Past performance is not indicative of future returns.*

We are pleased with the Fund's progress towards its goal of long-term outperformance and to have outperformed during such a volatile period for shares of high-growth companies. The year was not without its challenges -- we'll speak to some investments later that haven't worked out as we'd have liked -- but on the whole we think the end result for the year speaks well to our dogged commitment to our philosophy and process. Ultimately, our 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.

Value of A\$100,000 invested in the Lakehouse Small Companies Fund vs. its benchmark



*Note: Fund performance is net of fees based on monthly ending NAV and includes distributions. The benchmark for the Fund is the S&P/ASX Small Ordinaries Accumulation Index.*

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.

We spend a considerable amount of time getting to know current and potential portfolio companies, which not only enhances our understanding of them but gives us greater confidence to hold on through downturns. Our team has held 340 meetings with our current group of 21 portfolio companies and a total of 834 meetings with current, former, and potential portfolio companies since inception.

The Fund still owns 12 of the 19 companies it owned two years ago, making for a position-level implied holding period of about five 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 will speak more to sources of return later but, first, let's talk about what our team views as the most impactful risks in markets today and our current positioning. The elephant in the room is Covid-19, which is the dominant force driving economic, social, and foreign policy. Our view on the present and future of Covid-19 is a balanced one.

The war against Covid-19 has largely gone well for Australia. The virus has been far more contained within our borders and inflicted far less direct damage than almost anywhere else. The pace of vaccination is also picking up, our knowledge of the virus and how it spreads has grown, and the capacity of our hospitals to handle surging case loads has collectively much improved. And, considering that equity markets experienced their steepest-ever drawdown during the first wave of Covid-19, the economy itself seems to have held up reasonably well.

All that said, we're writing this letter whilst under lockdown and odds are good that you're in the same boat, so it's pretty clear that the war isn't over. In fact, a stubborn reality is that some version of Covid-19 is very likely to remain endemic. The slow vaccine rollout in Australia and much of the rest of the world has left many people at risk for longer than was necessary and allowed the virus to fester and mutate. Compounding matters is vaccine hesitancy -- roughly 1 in 4 adults in the US and Australia say they may not get vaccinated -- which risks our collective ability to reach herd immunity.

Australia's political leaders have largely staked their reputations on low-to-zero community transmission of Covid-19, which has some very practical economic implications. The first is that we must all endure lockdowns in fits and starts until we reach a level of vaccination that is high enough for Australian leaders to accept the risks that come with living with the virus.

The second implication is that we can expect loose fiscal and monetary policy in response. We view Australian interest rates as likely to stay structurally lower than their pre-GFC days given the slow rate of growth heading into this crisis and that household debt as a share of income has climbed to 180%, which doesn't leave much wiggle room for interest rates to move higher before becoming a major drag on consumption or property prices. Meanwhile, we note that an Australian government which prided itself on fiscal prudence not so long ago has become much more relaxed about deficit spending -- a habit that is easy to start and hard to break.

A resulting concern of ours from low rates and ongoing deficits is inflation, however, we have some in-built protection against this risk as pricing power is a trait we seek in our portfolio companies. Further, if inflation or interest rates were to increase because of strong economic growth, we would likewise have a natural hedge as a robust economy is welcome news for long-only investors such as ourselves.

Another implication of a fits-and-starts reopening is that many of the changes to how we live, work, play, and spend have hardened into permanent habits. For example, while MasterCard reports that ecommerce sales in the U.S. were only +8.3% in June 2021 compared to June 2020, the cumulative growth from June 2019 to June 2021 was +95.0%. Granted, this is U.S. data, but

the directional trends are much the same. We remain confident that the pull-forward in demand we've seen during Covid-19 in the growth of businesses that offer superior value and convenience for consumers and businesses is very much structural, not cyclical.

We're rooting for a fast-paced recovery -- and vaccine rollout, for that matter -- but take comfort knowing that our philosophy and process should continue to serve the Fund well if a fits-and-starts reopening continues into next year. It helps that our portfolio companies are growing strongly -- revenue was collectively up 21.1% year-on-year in calendar 2020 -- and that 87% 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 with 19 of the Fund's 21 portfolio companies holding more cash than debt.

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 (56.7%), financials (16.9%) and healthcare (11.8%) and compared to the benchmark which is led by materials (21.2%), consumer discretionary (16.3%), and financials (14.5%).

We have a strong preference towards businesses 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, the Fund does not target sector allocations but rather specific business models and investment traits regardless of sector.

Two more things before we move to discuss performance in detail. First, the Fund's cash position averaged around 12% during the year and finished at 6.1%, or 10.9% 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 in fiscal 2020.

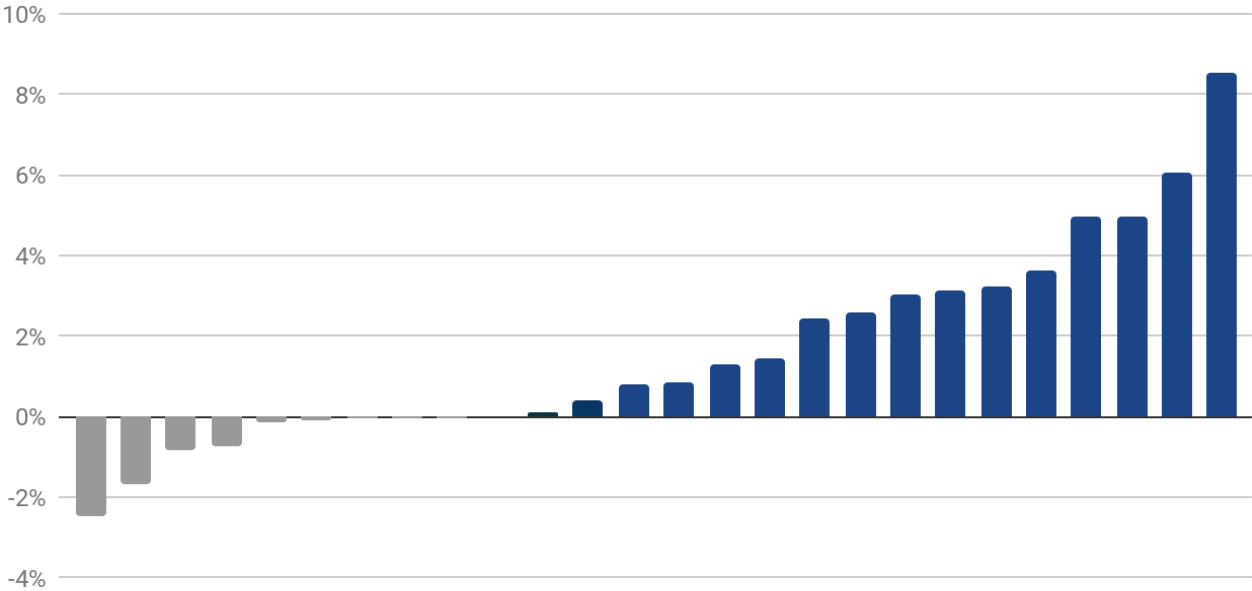
Second, on distributions, we note that the Fund's low turnover and emphasis on capital appreciation can make for a lumpy income stream. The final distribution of 15.85 cents per unit brought the total distributions paid to unitholders to 46.96 cents per unit since inception. We're pleased for these distributions 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 Review

Let’s get back to our favourite subject: stocks. The Fund’s largest holdings to finish the year, which made up 36.2% of the portfolio, were [Netwealth](#), [Pinnacle Investment Management](#), [Tyro](#), [Nanosonics](#) and [EML](#). Each should look familiar to investors as we’ve discussed them in previous [investor letters](#).

Turning to performance, it wasn’t so much that the Fund had a sterling strike rate in terms of positive contributors, albeit 65% of holdings contributing positively isn’t bad, but rather that 46% of the Fund’s investments increased by greater than +50% during the year. Indeed, the Fund had five investments that more than doubled and it certainly didn’t hurt that our largest average holding, Netwealth, returned +93.5%.

Position Attribution for FY21



The biggest contributors to performance were Netwealth (+93.5%), [Pro Medicus](#) (+122.8%), and [Pinnacle Investment Management](#) (+214.3%) in order of contribution. Note that the table above shows the total returns to the portfolio contributed by position, which reflect total returns and average position sizing during the year, while the percentage shown after each name listed above reflects the total return for the year of the individual share. We’ll discuss each in turn.

Netwealth was a very strong contributor in 2021. Funds under administration increased by 49.6% year-on-year to \$47.1 billion thanks to a mix of asset growth, new client wins, and new assets from

existing clients. Also helping is that the market came to appreciate that negative interest rates were an unlikely risk to Netwealth. Practically speaking, we're confident that a business with multiple pricing levers that is trusted with tens of billions of dollars by advisors who have built their customer relationships on top of this platform won't struggle to find ways to monetise those relationships even if interest rates do go negative.

We think Netwealth has a longer growth runway ahead than the market fully appreciates. The business has gained more in net flows to its platforms than any other platform in the market for four straight years, moving from the tenth-largest platform to the 6th, and yet still only has around 5% market share. We don't see any reason for Netwealth's market share gains to slow down either given the increasing market preference towards independent platforms and as Netwealth has a platform so well regarded that *Investment Trends* has rated it #1 for overall satisfaction among primary users for the ninth year in a row.

The consensus view is that Australian wealth platforms will continue to face pricing pressure in the years to come, which is true in some senses but also ignores the incredibly sticky nature of existing clients, network dynamics, and the optionality around price increases as Netwealth scales. For example, not only does a growing client base attract a larger pool of investment managers who want to get their funds on the shelves, the pricing power that platforms have with those managers rises exponentially with scale.

Netwealth ticks so many boxes for us: Product leadership, rapid market share gains, extremely loyal customers, increasing optionality, and all run by a founding family with considerable patience, discipline, and skin in the game. We never know what the future holds but we very much like the long-term range of outcomes.

Pro Medicus had a big year by landing seven notable contract wins including its [largest-ever deal](#). The company's flagship product, Visage 7, remains a market leading platform in healthcare informatics and the accelerated shift by the healthcare industry to embrace cloud software tilted the landscape further in their favour. The long-standing 'patient data privacy concerns' barrier was weakened through Covid-19 -- a lot of concerns are made to look very minor by pandemics -- and Pro Medicus' proven capability in the cloud was borne out as four of the notable seven contract wins were for public cloud. We anticipate Pro Medicus' competitive strength as a proven cloud operator will continue to build from here.

The investment has been a significant winner for the Fund since inception having contributed 38 percentage points to gross performance. CEO and Co-Founder Sam Hupert has done an excellent job of steering the ship, winning new business, growing relationships, meeting clients' high expectations for implementations, and innovating new products and capabilities. All that said, we also appreciate the implementation risks that come with all these new business wins and that the

recent unprecedented string of new contract wins likely isn't sustainable. We've maintained a small position given our confidence in the core business, opportunity, strong financial position, and leadership team, but taking profits here recently appropriate given the range of outcomes no longer skews so obviously positive as when we first invested.

**Pinnacle Investment Management** also delivered strong fundamental performance in fiscal 2021 off the back of continued distribution momentum and broad asset price appreciation. Growth in total affiliate funds under management (FUM) accelerated in the second half as the \$11.8 billion added in the first half was eclipsed by \$14.4 billion in just four months to the end of April. Zooming out, total FUM ended April 2021 at \$84.9 billion, +44.6% higher than the prior financial year end. We anticipate full year FUM growth will print at over +50% when the company releases its full year results on the 5th of August.

Alongside the strong growth, liquidity in the shares and business quality also continued to improve through the year. Pinnacle has executed well on tilting toward an increasing revenue mix from retail clients and performance-centric strategies whilst also diversifying its earnings base by asset class, investment style and geography. This strong growth and broadening of the earnings base saw over \$1.5 billion of value added to Pinnacle's own market capitalisation.

Pinnacle has established offices in Japan, the UK, and the US in recent years, opening the door for distributing Australian investing IP and applying the Pinnacle model of backing promising boutiques in those markets as the firm recently did with a London-based emerging markets manager. International will be a slow burn as building out distribution takes time but we think the optionality in those markets is very much real and promising.

Not everything went to plan in the portfolio this year, though. The biggest detractors to performance were **CleanSpace** (-77.5%), **Bravura Solutions** (-20.0%), and **Nearmap** (-17.3%). We'll discuss each in turn.

CleanSpace has been a terrible performer for the Fund. Fortunately, it was only an average-sized position at its peak and we did not compound our mistake by averaging down into fundamental weakness, but the mistake stings nonetheless.

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.

The business did very well in the second half of calendar 2020 with sales up 5-fold year-on-year as the business delivered numerous hospital-wide rollouts and was added to the standards of care for a number of hospital networks. Roll forward a few short months, though, and the rapid deployment of vaccines in the US led to a dramatic slowdown in demand for CleanSpace's products. 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 about the stickiness of recent sales growth, though we will note that the recent increase in new cases in many countries supports our general view that Covid-19 would linger and drive continued adoption and heightened pandemic preparedness. Compounding an already bad situation was that management 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.

We have reduced the Fund's stake in the business, which is now the Fund's smallest position, reflecting reduced confidence in management and the broader thesis. We do still have confidence that CleanSpace has a market leading product, however, and that the company could 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.

Bravura Solutions did not have a great year. The enterprise software company struggled as its UK-based financial services customers were heavily impacted by both Covid-19 and the extensions to the Brexit-transition framework. Customers waited for certainty before proceeding with large upgrades or wholesale new implementation, which typically require a high level of on-premise work. UK workplace restrictions, meanwhile, put the brakes on the project work and system upgrades that usually contribute significantly to revenue.

The first-half impact in the UK contributed a \$21.1 million revenue reduction, equivalent to almost 8% of fiscal 2020 full year revenue. The company was tracking toward an even weaker fiscal 2021 outcome, as we found management's February guidance for an 80% skew in earnings to the second-half hard to digest. Fortunes turned marginally with the confirmation of full-year guidance in early May and a return to top-line growth relative to the first-half.

Bravura 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 to one of Australia's largest super funds. We think the business has a better next couple of years ahead thanks to reopening



economies, a pent up pipeline of work for mission critical software upgrades and implementations, and \$56.4 million in net cash that ensures financial comfort.

Nearmap had an eventful year: solid fundamental business performance was marred by a controversial [short report in February](#) and [legal proceedings from a competitor in May](#). We have discussed both of these stock-specific events in previous letters, and direct investors to those commentaries rather than rehashing them again here.

Fundamentally, Nearmap had a strong year as accelerating growth beat upgraded guidance and lower cash burn left the company in a stronger than expected financial position. The company's preliminary results show Annual Contract Value (ACV) increased +25.8% in fiscal 2021 driven by +54.5% ACV growth in North America. Growth in North America was (and remains) a central tenet of our investment thesis, and we're pleased to see it playing out as it now represents 46% of group ACV and looks set to surpass the ACV contribution from ANZ within the next year.

Nearmap also recently announced that a prototype of their next generation image capture technology, HyperCamera3, has been tested in flight and the imagery run through the existing processing software. HyperCamera3 will deliver higher resolution imagery captured from the same altitude as their existing technology, or may lower image capture costs by allowing current resolution capture from a higher altitude reducing flight time. In any case, we are pleased to see the multi-year R&D investment coming to a head and excited to see the commercial rollout out in fiscal 2022 as it also brings forward the prospect of expanding into new geographies.

We acknowledge that the US legal proceedings will likely linger for a number of years, however, we remain comfortable with the company's long-term growth prospects supported by a recurring revenue model, very sticky customers, ongoing investment in image capture technology and premium content, and a \$123.4 million cash balance.

## **Thank You**

Thanks to all our investors for your time and trust. We are extremely grateful and continue to reinvest in our own business to honour that trust. The Lakehouse team has grown from seven to thirteen over the past two years as we bolstered our capabilities in investing, operations, client services, and distribution.

Again, on behalf of everyone at [Team Lakehouse](#), thank you. We can't promise that next year's performance will look like prior years but, regardless, we'll stick to our playbook and keep on with our process.

Joe Magyer,  
Chief Investment Officer

Donny Buchanan,  
Senior Analyst

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