LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

31 July 2021

Dear Lakehouse Investor,

Fund Metrics	
Companies Held	21
Cash Allocation	12.4%
Top 5 Portfolio Holdings	33.1%
Net Asset Value per Unit (mid)	$2.1753
Fund Net Asset Value	$420.8 million
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

July was a busy month for the team despite rolling lockdowns as we dug into quarterly reports, wrapped up the annual letter, hosted a client webinar and rolled into full year reporting. The team held 7 meetings with current and prospective portfolio companies during the month on account of many companies being in blackout until their results are released.

Also, even though it happened after month-end, it would be remiss of us to not acknowledge the announced acquisition of **Afterpay** and reveal how we have responded. More on that later including 6 lessons learned from an investment that increased 57-fold from the date of our first purchase four years ago.

The Fund returned -0.3% net of fees and expenses during the month compared to a 0.7% return for the benchmark. Over the last 12 months, the Fund has returned 29.6% compared to 32.3% for its benchmark. And, since inception in mid-November 2016, the Fund has produced a net total return of 180.7% compared to 68.7% for the benchmark. In annualised terms, the Fund has returned 24.5% per year since inception compared to 11.8% per year for the benchmark.

	1 Month	**3 Month**	**1 Year**	**3 Year (p.a.)**	**Inception (p.a.)**
Lakehouse Small Companies Fund**	-0.3%	0.4%	29.6%	22.1%	24.5%
Benchmark*	0.7%	4.1%	32.3%	9.2%	11.8%
Excess Return	-1.0%	-3.7%	-2.7%	12.9%	12.7%

*** Performance calculations are based on exit price with distributions reinvested, after fees and expenses, since inception in mid-November 2016. * Benchmark: S&P/ASX Small Ordinaries Accumulation Index. Past performance is not indicative of future returns.*

The Fund's largest sector allocations are to information technology (54.4% of total capital), financials (15.2%) and healthcare (8.9%) while the benchmark's largest allocations are to materials (22.4%), consumer discretionary (16.0%), and financials (14.2%). 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 **Audinate** (+22.5%) following a positive trading update early in the month. The biggest detractor was **Netwealth** (-8.8%) which appears to have been modestly impacted by a broker initiation report.

The Fund's five largest holdings as of the end of the month accounted for 33.1% of the portfolio and are named in order of the Fund's allocation: Netwealth, **Pinnacle Investment Management**, **EML Payments**, **Tyro** and **Xero**.

Turning to the Fund's most significant contributor, Audinate, which rallied after announcing a strong recovery with full year revenue up 23% in constant currency terms. The strong acceleration in the final quarter, where revenue was up 75% year-on-year, was even more impressive and a strong sign that global demand for the professional AV-industry has returned to its pre-COVID trajectory. The company also noted positive feedback on Dante video products recently launched into the market by Audinate's customers, Bolin Technology and Patton Electronics. As a reminder, Audinate has established Dante as the dominant digital networking platform in audio but video is more akin to a greenfield opportunity. It is pleasing to see Dante with finished video products in the market allowing AV professionals to exclusively use Dante networking for both video and audio distribution.

But it wasn't all good news for Audinate. The company again flagged uncertainties in global supply of computer chips and electronic components, which has been colourfully explained as the corporate equivalent to toilet paper hoarding. Audinate and its customers have suffered some under-delivery of raw materials, increasing lead times, and requests from chip manufacturers for up to 12 months in forward orders. The shares have more than recovered from their pre-COVID days and short-term risks are elevated but we remain long-term optimists.

Pinnacle Investment Management released its full year report after month end, but before publishing the monthly letter, so we'll take the opportunity to cover it briefly in a timely manner. In short, the Aggregate funds under management (FUM) were up 52% on fiscal 2020, with net profit up 108%. Overall the results were ahead of consensus expectations and the starting FUM for fiscal 2022 is 23% higher than the average throughout FY21, setting the business up for a strong start to the new financial year. The market responded positively with the stock up over 15% since reporting on the 4th of August.

Last but not least, early in August it was announced that Afterpay is being acquired by American digital payments giant **Square** in an all-stock deal. We were not shocked as we have long thought that an acquisition by Square or **PayPal** would make great sense for either business as they could immediately enhance the value of Afterpay by flipping on new distribution with both users and merchants as well as leveraging their structurally lower costs of capital.

We made the difficult decision to exit our Afterpay position in the days following the announcement at roughly $129 a share as we thought that holding a stake in a US$160 billion company was outside the spirit of our mandate. We say 'difficult' as Afterpay was long the Fund's largest holding and an enormous contributor to performance having increased from around $2 on our first purchase.

It's rare to have an investment deliver the scale of return as Afterpay has done with the Fund, let alone in only four years, so we thought it might be illustrative for investors for us to reflect on what made this such a successful investment.

1. Massive growth. Afterpay was rolling off the December 2016 quarter in which underlying merchant sales had roughly 20X'd year-on-year when the Fund first invested in February 2017. Sure, that was off a small base, but considering the business had already leapt to having 15% share of all Australian apparel ecommerce sales it stood to reason that the company could execute and had product/market fit. Indeed, growth remained consistently north of 100% year-on-year and underlying merchant sales went on to increase by roughly 54-fold from December 2016 to December 2020. We don't think it's a coincidence that the eventual gain in the price was directionally similar to the underlying growth of the business.

2. Patience. Hanging onto Afterpay for more than four years wasn't always easy. The business had no shortage of critics, real risks did rear their heads along the way, and the shares fell by more than 25% six different times since Afterpay's merger with Touchcorp closed in 2016. Many speculators or investors who lacked conviction were shaken out along the way. And, yet, since the merger of the two companies, the shares returned around 43-fold. Patience pays.

3. Focusing on unit (transaction) economics and the future, not today's P&L. The discussion around Afterpay's financials always focused on the present bottom line rather than its transaction-level economics, which always struck us as solid and likely to improve over time as Afterpay's costs of capital fell, bargaining power improved, analytics engine improved, and the user base seasoned. The losses could have been a problem if Afterpay struggled to get funding but companies growing organically by triple-digits almost never struggle to raise capital. For that matter, when you got under the hood, it became clear over the past couple of years that the most mature market (ANZ) was already solidly profitable on an underlying basis despite rapid growth, which bodes very well for eventual profitability across the group.

4. Getting to know the people. We spent a fair bit of time getting to know Afterpay's leadership team via 21 meetings over the span of four-plus years. It became very clear to us early on that not only were co-founders Nick Molnar and Anthony Eisen a strong, capable, complementary duo but that they also were optimists and true believers in Afterpay's ability to help merchants and consumers. Having conviction in the team and their own vision for the business certainly helped to ride out the periods where regulatory uncertainty was front and center.

5. Focus on the data. Afterpay has broad appeal today in Australia today with more than 3 million active customers but in its early days the business focused heavily on Millennials and fashion brands. We ourselves did not understand the initial appeal -- after all, credit cards had been around for a long time and digital payments weren't new -- but the data clearly showed there was a strong appetite for Afterpay from shoppers and merchants. Letting that data steer the conversation rather than our initial sniff-test proved valuable.

6. Appreciating optionality. Businesses with scalable products, product/market fit, and large, growing customer bases who love and regularly use the product have immense optionality. Indeed, Afterpay methodically expanded the business into brick-and-mortar stores, new verticals, new geographies, and new products. We expect much more is on the way. Our conviction grew as each additional step proved sure-footed, and we remain very focused on finding businesses with real and growing optionality.

Looking Ahead

With reporting season upon us, we are looking forward to hearing more from the management teams of our portfolio holdings, and prospective companies, and their plans for the future.

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

Best Regards,
Lakehouse Capital

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

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