

LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

31 August 2021



Dear Lakehouse Investor,

August was a busy and fruitful month for the Fund as it marks the full year reporting season for the majority of companies in our investment universe. The team digested a deluge of new information as it held 54 meetings with current and potential portfolio companies. Notably, the team is now close to having held 1,000 such meetings since inception, most of which entailed at least two of us attending.

The Fund also initiated a new position during the month, exited two others, and trimmed and topped-up numerous other holdings. As is our

usual practice, we will not disclose the new position while we continue to build out our stake. One of the positions we exited was Afterpay, which we touched on in [last month's letter](#), and the other was RPM Global, which we will discuss later. The net result of the Fund's activity was that the cash position increased to 14.6%.

The Fund returned 5.8% net of fees and expenses during the month compared to a 5.0% return for the benchmark. Over the last 12 months, the Fund has returned 25.4% compared to 29.5% for its benchmark. And, since inception in mid-November 2016, the Fund has produced a net total return of 196.9% compared to 77.1% for the benchmark. In annualised terms, the Fund has returned 25.5% per year since inception compared to 12.7% per year for the benchmark.

Fund Metrics	
Companies Held	20
Cash Allocation	14.6%
Top 5 Portfolio Holdings	34.4%
Net Asset Value per Unit (mid)	\$2.3006
Fund Net Asset Value	\$445.8 million
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

	1 Month	3 Month	1 Year	3 Year (p.a.)	Inception (p.a.)
Lakehouse Small Companies Fund**	5.8%	12.3%	25.4%	21.6%	25.5%
Benchmark*	5.0%	8.9%	29.5%	10.1%	12.7%
Excess Return	0.8%	3.4%	-4.1%	11.5%	12.8%

** 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 (47.8% of total capital), financials (14.1%) and healthcare (9.7%) while the benchmark's largest allocations are to materials (21.3%), consumer discretionary (16.0%), and financials (14.9%). 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 process 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 **Pinnacle Investment Management** (+32.4%) which reported strong full year results and a strong start to fiscal 2022. The biggest detractor was **Bapcor** (-9.8%) which disappointed the market with their cautious outlook for the year ahead. More on both shortly.

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**, **EML Payments**, **Nanosonics**, Pinnacle Investment Management and **Tyro**.

Turning back to the Fund's most significant contributor, Pinnacle Investment Management. The company was first out of the blocks in our reporting line-up and we provided our take [last month](#). One postscript comment we would add after having met with the management team is that we are more enthused about their long-term plans for the international business and its potential for significant growth. The shares continued to rally through the month and we took the opportunity to trim our position.

Netwealth had a solid result marred by a collection of impacts: A big haircut in interest income, a big drop in fee income from a well-telegraphed reduction in pricing, and an increase in investment for fiscal 2022. The market also appeared to be underwhelmed by management's guidance for \$10 billion net fund flows for the year ahead, a modest 2% increase on the financial year just ended. We are mindful that the guidance is net of any large institutional wins that could land, and also note founder-led company's track record of conservatism that typically precedes upgrades throughout the year.

In terms of the financials, revenue grew 16.9% and net profit after tax grew 23.9% to \$54.1 million as the business continued to benefit from significant operating leverage. The fact that 37 cents from each dollar of revenue turns into net profit underscore the profitability of the business. Despite capturing the largest share of flows across the industry, the business still has less than 5% market share. Given Netwealth's industry leadership and the size of the opportunity we remain fully supportive of management's plan to accelerate R&D spend throughout the year ahead and keep the platform at the leading edge.

Moving on to EML. The company reported a good fiscal 2021 result with revenue and EBITDA growing at 60% and 65% year-on-year, respectively, with a heavy contribution of growth from the PFS acquisition. The

gift and incentive business is recovering from Covid-related weakness and the general purpose reloadable business continues to win gaming, salary packaging and government programs. Management noted a strong and growing pipeline of deals which, at maturity in 3 to 4 years, would contribute an estimated \$10.5 billion in gross debit volume (GDV).

The company also shared an update on the ongoing regulatory issue with the Central Bank of Ireland (CBI), which was pretty much in-line with what we wrote about in our [May letter](#). EML is working closely with the regulator in its remediation process and investing more in people, systems, and controls. The company expects to complete a substantive part of the remediation process and the remaining elements by March 2022. EML also set aside \$11.4 million for costs, including a potential fine, associated with this matter. The silver lining for shareholders is that this expense is incurred by the PFS business, which directly affects the earnouts payable on the acquisition, lowering the acquisition price by roughly \$80 million. Further, the company noted that no customer contract was cancelled due to this matter. In hindsight, the roughly \$800 million drop in EML's shares price in response to the CBI appears to have been a gross overreaction.

The CBI issue will lead to higher ongoing regulatory costs and there is a temporary slowdown in client onboarding, however, taking the long view, we see a business with a sticky base of customers with whom EML grows, a large and growing market opportunity, management that have a track record and skin in the game, and a \$141 million cash pile. We remain patient investors despite the short term challenges to the business.

Nanosonics was one of the highlights of the 'small cap' companies reporting season. The biggest news was that the company (finally!) revealed its new product platform after years of badgering by analysts at every opportunity. The new platform addresses automated high-level disinfection for flexible reusable endoscopes that are commonly inserted into the human body where the sun don't shine. A lack of total cleansing of reusable endoscopes is a significant issue within the medical profession and has received significant Main Street attention including an inquiry by the U.S. Senate.

Commercial launch of the product is still some time off, currently slated for calendar 2023, but the fact that the company has registered the Coris trademark, and is in the process of lining up external clinical assessments to accompany its FDA application speaks to management's confidence from their internal testing. We are optimistic given the company's established distribution, product leadership in disinfection with its flagship Trophon product, and the scope and nature of the problem Nanosonics is aiming to solve with Coris.

The other significant news was the 50% increase in the company's estimate of the total addressable market (TAM) for Trophon in North America, the company's largest and most penetrated market. The company's previous estimate was some 8-years-stale and a combination of increased ultrasound procedures and use cases over that time contributed to the step change. It was amusing to see financial models across the market move in unison on the update. The company continues to understate the TAM for Trophon for the

'rest of the world', but given it is only around 4% penetrated, there's little point in re-evaluating the TAM at this time. Don't be surprised if we see another similar move in the years ahead.

Diving into Nanosonics financial results. Revenue grew 12% (in constant currency) over the year, thanks to an impressive acceleration to 50% growth in the second half following an -11% decline in the first half. One of the key metrics we keep an eye on is growth in the installed base as it precedes the high-margin consumables annuity stream. The installed base grew 13% over the year which we consider a strong showing considering the tough first half and that hospital access has been tightened throughout the Covid-19 era. Management has pointed to declining gross margins in the year ahead, which was cause for concern for investors with a shallow understanding of the business but we note actually reflects an acceleration in installed base growth which means an increase in the high-margin consumables annuity in future years. Overall it was a strong result and we are pleased to see Nanosonics grow its way back into the Fund's top 5 holdings.

Tyro delivered a strong result in what was a tough year featuring widespread lockdowns and then an outage of a big chunk of its terminals early in the calendar year. The company reported a gross profit of \$119.5 million, up 27.8% compared to the prior year, with gross margins continuing to increase due to a mix shift towards debit cards. What was more impressive was that Tyro reported \$14.2 million of EBITDA, up more than four times from fiscal 2020, with a 60% EBITDA margin on each incremental dollar of revenue. Merchant churn remains low at 11.3% despite the outage and the jarring impact of rolling lockdowns on the hospitality and retail industries. Tyro continues to repair its relationships with its merchants following the outage and reported that roughly 85% of the 3,000 merchants that registered for remediation for the outage have been settled.

Tyro ended the fiscal year with 58,200 merchants, up 81% compared to the previous year, as Bendigo Bank merchants were onboarded. We believe that Tyro will continue to win similar partnerships from banks who do not consider payments a core competency, and find additional ways to acquire new merchants at scale. Growing scale will improve unit economics, drive greater profitability, and make Tyro an increasingly attractive strategic partner. Overall, Tyro continues to win market share but only has a 3.8% slice of the total card spend in Australia. We believe there are multiple levers where the business can continue to grow.

As referenced before, Bapcor was a major detractor for the month despite delivering strong full year results with revenue growing 20.4% and net profit 46.5%, both slightly ahead of market expectations. We were also pleased that EBITDA margins expanded across the group and that leverage is in hand with net debt relative to EBITDA sitting at just 0.74x. However, the negative impact and uncertainty of rolling lockdowns across Australia and New Zealand, particularly for Bapcor's retail-facing stores, weighed on investors' minds. Bapcor guided 'to deliver earnings at least at the level of financial year 2021, dependent on the extent of lockdowns and other government imposed restrictions', which underwhelmed investors. We remain enthused about the business and think the shares are reasonably priced at around 19 times consensus earnings estimates for this year in light of the steadiness of the business and management's history of underpromising and overdelivering. We remain patient holders.

And finally to the companies we bid farewell to. Afterpay was covered [last month](#), which leaves the focus on RPM Global. RPM has only appeared in these letters twice despite being a holding and meaningful contributor to the Fund's performance since the Fund's inception in November 2016. Despite its long tenure, RPM was only first mentioned in [January 2019](#) as the Fund's biggest detractor, and again in [March this year](#) as the Fund's biggest contributor. Appearances ranging from the gallows to glory, some may say. Despite the stock generating a 29.2% internal rate of return since we invested, the company's tight share register and growth occurring in fits-and-starts prevented us from growing to a larger position throughout this time.

We have long been fans of CEO Richard Matthews who has a strong commercial acumen and enviable track record of capital allocation buying, integrating, and selling software companies. The recent sale of RPM's orphan division GeoGas for \$500,000 was disappointing, though, amounting to a fraction of its carrying value, the price offered previously by willing buyers, and the value we had attributed to it. Through the lens of hindsight, the outcome was akin to leaving fruit to die on the vine. Between the GeoGas outcome denting our confidence and an elevated market price for the shares, we wished the company well and decided it was time to move on.

Looking Ahead

The flurry of company meetings and new information throughout reporting season has armed us with a number of new investment ideas that we are working through our usual process. We will keep you updated as they bear fruit.

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

Best Regards,

[Lakehouse Capital](#)

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