# LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

30 November 2021

Dear Lakehouse Investor,

| **Fund Metrics** | |
|---|---|
| Companies Held | 21 |
| Cash Allocation | 8.9% |
| Top 5 Portfolio Holdings | 35.4% |
| Net Asset Value per Unit (mid) | $2.1749 |
| Fund Net Asset Value | $418.0 million |
| Benchmark | S&P/ASX Small Ordinaries Accumulation Index |

November was another volatile month for global equity markets as the COVID-19 Omicron variant spread and the US Federal Reserve positioned itself to take action against structurally higher inflation sooner than the market anticipated. For our part, we took the opportunity to initiate a new position and top up positions that we viewed as compelling to patient investors, shrinking the cash allocation from 12.1% to 8.9%. We remain comfortable with the portfolio positioning to perform through higher inflation and interest rate scenarios, particularly due to our focus on investing in strong businesses in growing markets, with durable competitive advantages, pricing power and strong balance sheets. We look forward to digging into this further in our investor webinar on Thursday 16 December -- which you can register for here.

The Fund returned -3.5% 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 10.5% compared to 18.4% for its benchmark. And, since inception in mid-November 2016, the Fund has produced a net total return of 180.7% compared to 74.4% for the benchmark. In annualised terms, the Fund has returned 22.7% per year since inception compared to 11.7% per year for the benchmark.

Our concentrated, growth-focused investment strategy means at times the portfolio will zig while the market zags, and this month was such an example. Our focus remains on generating long-term outperformance and the consistent execution of a process that blends hustle (we've held 323 company meetings in the last year) with patience (the Fund still owns 15 of the 21 companies it owned 12 months ago). We are pleased with the progress made toward this goal.

The Fund's largest sector allocations are to information technology (45.7% of total capital), financials (14.8%) and consumer discretionary (11.2%) while the benchmark's largest allocations are to materials (21.0%), consumer discretionary (15.0%), and real estate (13.7%).

We embrace a bottom-up process that seeks out and emphasises businesses with extremely loyal customers, network effects, and unique and enduring intellectual property. Most of those businesses tend to end up in some specific sectors (e.g. IT) while are rarely found in others (e.g. materials), hence our continued differentiation.

| | 1 Month | 3 Month | 1 Year | 3 Year (p.a.) | 5 Year (p.a.) | Inception (p.a.) |
|---|---|---|---|---|---|---|
| Lakehouse Small Companies Fund** | -3.5% | -5.5% | 10.5% | 24.1% | 22.9% | 22.7% |
| Benchmark* | -0.3% | -1.5% | 18.4% | 13.5% | 11.7% | 11.7% |
| Excess Return | -3.2% | -4.0% | -7.9% | 10.6% | 11.2% | 11.0% |

*** 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.*

## Company News

Turning to specific companies, the Fund's most significant contributor to performance during the month was EML Payments (+22.0%), which shifted from being last month's largest detractor after an update relating to ongoing issues with the Irish regulator. The biggest detractor was Tyro (-28.7%), which provided a trading update at its AGM. More on that later.

The Fund's five largest holdings as of the end of the month accounted for 35.4% of the portfolio and are named in order of the Fund's allocation: EML Payments, Netwealth, Pinnacle Investment Management, Bapcor and Xero.

EML provided a positive update regarding the issues the Central Bank of Ireland (CBI) has taken with EML's European subsidiary, PFS. Overall, the CBI loosened its restrictions on PFS including dropping the imposition of broad-based limit controls on programs and allowing PFS to sign on new customers and new programs while operating within growth restrictions. The release also outlined a more clear path out of the regulatory review, with the potential for growth limitations on Total Payment Volume to end earlier than the prescribed 12 months (if a third party verifies the remediation plan has been effectively implemented). While the situation is ongoing, we are pleased with how it is playing out relative to our initial assessment and look forward to the company officially moving past this speed bump and back to firing on all cylinders.

As highlighted last month, we remain enthused about EML's prospects as it... *is in a good position to benefit from economies (and malls) reopening, and is another portfolio holding that benefits from a rising interest rate environment given the $2 billion of float on its balance sheet. Further, the company has other levers to grow the business, such as offering account-to-account payment functionality from its recently acquired business, Sentenial. We remain patient investors despite short term challenges*.

Turning to Tyro, who published a trading update at its AGM on 3 November. The company reported Total Transaction Value (TTV) and gross profit up 25% and 14% year-to-date, respectively. This change between TTV and gross profit growth rates was mainly due to the new profit sharing arrangement with Bendigo Bank when that large relationship was transitioned across in June 2021. The market -- incorrectly, in our view -- reacted negatively to the update. The way we see this situation is simple: The business grew 14% during the lockdown and is growing at roughly double that rate coming out of it. With roughly 60% incremental EBITDA margins, we will likely see strong profitability growth in the coming years.

Meanwhile, Tyro continues to attract new merchants, averaging 1,259 new merchant applications per month, up from an average of 1,000 in the previous financial year. Management also shared that the company is exploring similar large partnerships to Bendigo and is undertaking a pilot with Telstra. We see these partnerships as efficient ways to scale the business and improve its profitability. On top of the solid growth, we are attracted to the payments toll-booth model as odds tilt toward an economic reopening in the midst of a potentially inflationary environment. Overall, we are happy with how the business is tracking.

Finally, it would be remiss of us not to comment on the odd situation unfolding at Bapcor. We've long admired CEO Darryl Abotomey, his 'under-promise and over-deliver' approach, and his ability to incrementally drive business improvement while also creating step change through capable capital allocation. Unfortunately, Darryl's relationship with members of the Board has materially deteriorated since February and we are seeing this play out in an uncharacteristically public manner, including his tenure at the company ending as the situation, according to the board, became 'untenable'.

Following feedback from a large Bapcor trade customer, we don't believe the current situation will impact the trade business, and even less so as far as retail customers go, at least in the near term. Darryl's immediate termination is aimed at a quick resolution to the underlying differences, though the Board has a case to answer for the poorly managed situation. For now, we remain patient as we continue to like growth prospects for the business, and the differentiated and defensive attributes it brings to the portfolio.

## Looking Ahead

Another friendly reminder that we're hosting a client webinar on Thursday 16 December and look forward to answering questions from Lakehouse investors. You can register here.

The Lakehouse Small Companies Fund quietly celebrated its fifth birthday in mid-November. While it doesn't impact anything in our day-to-day process, we are pleased with the progress we've made toward long term outperformance. We're also grateful that most of the Fund's original investors are still invested, which shows a genuine long-term commitment and degree of trust that we'll continue to do our best to honour.

One final thing for 2021, we hope you and your loved ones have an enjoyable and relaxing break over the holding period.

Best Regards,

Lakehouse Capital

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For more information call us on +61 2 8294 9800, email investorsupport@lakehousecapital.com.au or visit www.lakehousecapital.com.au

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