

LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

28 February 2022



Dear Lakehouse Investor,

Firstly, our thoughts go out to everyone impacted by the recent flooding across Queensland and New South Wales. We know some of our fellow investors were directly impacted: we hope that you and your families are safe, and our thoughts are with you for the recovery ahead.

Turning to equity markets which experienced a further step up in volatility through February as tensions between Russia and Ukraine broke out into a full-blown war. Markets were whipsawed by the uncertainty of war in Europe, the evolving impact of economic sanctions, the resulting spike in energy and commodity prices which added to already-elevated inflation concerns, among various other anxieties. In the words of Nassim Taleb, "History doesn't crawl; it leaps." That certainly rings true as we live through this volatile period of modern history, where global energy policies are being rewritten to reduce a decades-long creeping dependency on Russia, and globalisation has gone into reverse. These events made for the most volatile ASX reporting season we have seen in recent memory for the Small Companies Fund.

In terms of performance, it has been a tough month: in fact, our third toughest since inception. The Fund returned -12.6% net of fees and expenses during the month compared to a 0.0% return for the benchmark. Over the last 12 months, the Fund has returned -21.4% compared to 5.0% for its benchmark. Since inception in mid-November 2016, the Fund has produced a net total return of 108.4% compared to 61.0% for the benchmark. In annualised terms, the Fund has returned 14.9% per year since inception compared to 9.4% per year for the benchmark.

	1 Month	3 Month	1 Year	3 Year (p.a.)	5 Year (p.a.)	Inception (p.a.)
Lakehouse Small Companies Fund	-12.6%	-25.7%	-21.4%	9.6%	17.2%	14.9%
Benchmark	0.0%	-7.7%	5.0%	7.7%	9.4%	9.4%
Excess Return	-12.6%	-18.0%	-26.4%	1.9%	7.8%	5.5%

*** 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 (46.0% of total capital), financials (15.6%) and healthcare (11.3%) while the benchmark's largest allocations are to materials (20.6%), real estate (15.8%) and consumer discretionary (13.8%). It is worth noting we do not hold any exposure to

energy and commodities, which have been among the best performing sectors in recent months. This recent change does not impact our long-term view that those sectors are typically capital-intensive, and price takers, with limited long-term structural advantages.

As highlighted in previous letters: Lakehouse embraces a fundamental, bottom-up investment process that focuses on businesses we believe possess superior economics that are likely to win out over the long-term. Specifically, our investing process 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. technology, healthcare, consumer products) while are rarely found in others (e.g. commodities), hence our continued differentiation.

We remain committed to executing our concentrated, high-conviction investment strategy in pursuit of long-term outperformance.

Company News

Turning to specific companies, the Fund’s most significant contributor to performance during the month was **PEXA Group** (+2.9%), which reported a strong half. The biggest detractor was **Tyro Payments** (-31.5%), which disappointed investors with its higher cost outlook. We’ll discuss both in more detail below.

The Fund’s five largest holdings as of the end of the month accounted for 36.0% of the portfolio and are named in order of the Fund’s allocation: **Netwealth, EML Payments, Bapcor, Nanosonics** and PEXA Group.

Fund Metrics	
Companies Held	21
Cash Allocation	5.6%
Top 5 Portfolio Holdings	36.0%
Net Asset Value per Unit (mid)	\$1.615
Fund Net Asset Value	\$295.1 million
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

Tyro shares were sold down after the company reported its first half results, where revenue and payments volume grew 30% and 31%, respectively, despite merchants in NSW and ACT being affected by COVID-related disruptions. The market was more focused on Tyro’s cost growth, particularly relating to higher employee expenses as the business further invests in improving its technology offering. The company also noted that it delayed a pricing adjustment to support COVID-impacted merchants, which negatively affected margins by roughly 2 basis points. This price increase has since been put through and its impact will be evident in the full year results.

On the brighter side, the company’s operating metrics reveal a healthy business, with merchant and transaction churn at 10.1% and 9.0%, respectively. Tyro continues to attract new merchants, ending the half with 61.5k merchants, up 68% year-on-year. Further, the company announced that it signed an exclusive partnership with Telstra, which is similar to the [Bendigo Bank partnership](#), and is looking for more. This partnership will leverage other companies’ salespeople to help Tyro scale faster and in a more efficient way, which will contribute to future profitability. Lastly, the company is in a good position to re-accelerate its payments volume growth as Australia finally moves on from COVID. We remain patient holders of Tyro.

Netwealth's half year result was largely pre-announced with their quarterly update which we covered [last month](#). To recap, the business is growing funds under administration at 46% as it continues to capture over a third of net inflows across the industry against Netwealth's current market share of around 5.5%. Despite this, and the management team upgrading full year guidance, the market was disappointed by Netwealth's cost increases. In our view, the market is overlooking the founding family's conservative approach to fully expense research and development costs as they invest in expanding the long-term prospects of the business. For instance, Netwealth invested in building out its mobile app and non-custodial platform, both of which will help expand future revenue streams even if there is a temporary mismatch between the spend and the revenue.

Turning to EML, which reported a tough half for the business. Negative rates weighed heavily on interest revenue, and the Central Bank of Ireland (CBI) issue increased the cost of compliance and slowed client onboarding in its Irish subsidiary, PFS. Further, management noted that the gift card business was negatively impacted by the Omicron outbreak during the holiday season. Despite that, EML was able to increase revenue by 20% and is expecting an improvement in the second half. The company happily reported that client churn rates remain low, at less than 1% over a 3 year cycle, despite the CBI issue – this customer stickiness, in our view, is not well understood by investors.

On a more positive note, EML continues to work with the CBI and management expects the remediation process to be substantially complete by June of this year. Further, the Bank of England raised interest rates by 40 basis points during the last few months which is already having a positive impact on EML's interest revenue, with similar moves by other central banks on the horizon. The company's pipeline remains healthy, with deals estimated to account for \$13.6 billion of gross debit volume (GDV) in 3 to 4 years. All these developments are expected to contribute to the second half and put the company in a strong position to accelerate growth in the future. And a final point on the topic of EML: our covering senior analyst, Erwin Tan, discussed EML's half year result in his recent interview with [Livewire Markets](#) if you'd like to read more about our view on the company.

Moving on to Bapcor which reported results in line with expectations: revenue was flat for the half year but profits down 15% due to the various impacts of COVID on its supply chain and intermittent shuttering of its businesses across various states. This was the first time we heard from the newly minted CEO, Noel Meehan, and it was a decent result given many states were under lockdown for over twice as long as the same period in the prior year. An increased focus on technology and integration of systems across the business stood out as a key focus for Meehan.

The company managed to largely pass on increased costs but margins were still impacted from not standing down staff during the lockdowns. There are still temporary issues relating to the supply chain and this is driving up capital intensity as the company is carrying higher-than-usual inventory, however product availability has helped it hold strong on pricing with customers. Its private-label push has also been placed on hold as a result of the supply chain challenges. Over the medium term, we expect margins to benefit from the increasing share of private label products, and consolidation of distribution centres. Looking ahead, the company has maintained guidance that FY22 earnings will be at least at the level of FY21 while it invests in technology, people, supply chains and logistics.

Turning to Nanosonics, which was heavily sold down by the market in the lead up to, and following, the half year results, largely on account of uncertainty around its new sales agreement with GE Healthcare, which we'll discuss further shortly. As background, GE customers represent 55%-60% of Nanosonics installed base in North America. It's fair to say we have a different view here versus others in the market: we see

this change as a logical evolution of Nanosonics business that will raise margins and enhance customer relationships and control as the business moves through the Trophon upgrade cycle in North America.

If we flash back through Nanosonics history to 2014, distribution for both the capital equipment and consumables product was exclusively through GE, then it went non-exclusive around 2015, and in 2019 there was a further change to the consumables model allowing direct sales and margin improvement for Nanosonics. At the time, Nanosonics would have happily taken the full direct customer relationships but GE wanted to retain them. However, this is now changing to align with other similar agreements Nanosonics has, for example with Phillips, where Phillips makes a margin on the capital equipment but doesn't have to hold any inventory and the customer passes directly to Nanosonics.

Regarding concerns about Nanosonics ability to meet GE's scale, it's worth noting that currently around 60% of the newly installed Trophons through GE in North America are referrals that originate from Nanosonics itself, another 20% are bundled with GE ultrasound equipment sales, and the balance are from GE's sales team, which is focused on selling Trophon and supporting GE equipment sales. GE has already provided customer lists to Nanosonics and the core GE sales team responsible for Trophon is being restructured -- we anticipate a number of those employees will re-emerge as part of Nanosonics' own expanded sales team and sales infrastructure. This transition is slated to cost \$13 million to \$16 million in the second half, and we view it as a logical step in expanding Nanosonics' long-term margin opportunity and sales infrastructure to fulfil its growth ambitions.

Turning to its results. A key metric to track is the underlying growth of the Trophon installed base as it is followed by an annuity stream of higher-margin consumable revenue. COVID-19 continues to create a lot of noise around installed base growth, which is up +12% over the last 12 months, only +5% during the last six months, accelerating to +14% in the second quarter. Over the long-term we expect to see growth in the teens-to-twenties for the core product, which will be complemented by the addition of further products.

Looking beyond the installed base growth, half year revenue grew +41% to \$60.6m (slightly ahead of consensus) as capital sales rebounded and the higher-priced Trophon 2 upgrade cycle in North America started to take effect. Nanosonics continues to pour cash back into research and development, and scaling the business, which depresses the true earning power of the existing business. This dynamic will continue, and possibly accelerate, as the company is moving to a larger Macquarie Park facility which offers 3x R&D capacity of their current site. Nanosonics remains focused on becoming a global, multi-product company in infection prevention and remains well funded with no debt and \$92m in cash.

Now to the newly disclosed position, PEXA Group. The core PEXA Exchange product is an important piece of digital infrastructure in the Australian property market that has (mostly) replaced the previously-paper-based Torrens Title property settlements process which has existed since the 1800s. PEXA is the result of a decade-long collaboration to build a cloud-based platform that integrates with Land Titles Offices and State Revenue Offices, over 160 financial institutions, over 9,000 practitioner firms (lawyers & conveyancers), the Reserve Bank of Australia, and the Australian Taxation Office, to enable the complete digital lodgement and settlement of most property transactions. In fact, PEXA Exchange handles over 84% of all property transfers in Australia and over 90% of refinancings. Due to its dominance, PEXA Exchange pricing increases are largely limited to CPI, so most of the growth will come from transaction volumes and market share gains.

Australia is the only country in the world to have a fully-digitised property settlement process and PEXA is looking to export its capability abroad. The 'magic' of digital settlement means properties can settle faster

and with a lower error rate, people can move in (or out) of their property faster, and refinancings can happen more quickly and easily. Interested parties such as banks can unlock debt faster and mortgage brokers can claim their commissions faster. There are many winners right across the property transaction value chain. PEXA provides a step change in reliability and productivity for an incredibly large asset class, and is a revered platform for property markets across the world but only currently available in Australia.

While the Australia-focused PEXA Exchange product is the profit engine, the business is investing heavily to expand into the United Kingdom property market, build a Data Insights business, and also has a Ventures arm for ancillary investments. While there's no guarantee of success in the UK, we are encouraged by the progress the company has made, including: testing their payment solution with seven UK banks and the Bank of England during the half, with a further four testing slots booked for October, and PEXA has signed agreements with Her Majesty Land Registry and the Bank of England. As we have seen in Australia, connecting the centuries-old components of the property industry can be akin to herding cats, though a large first-mover advantage awaits whoever gets there. No firm is as advanced as PEXA in the UK market, and given PEXA is the only business to operate a fully-digitised property settlement platform globally, and the need to invest \$100 million over three years to build a minimum-viable product, we do not anticipate to see a wide field of competition from here.

Turning to its results. Transaction volumes grew +37%, revenue +46% to \$145 million for the half, and EBITDA +76% to \$83 million. We saw some strong positive jaws unfold as PEXA Exchange put incremental market share gains through a largely fixed cost base. PEXA has further market share to gain in Queensland and Western Australia, plus it only recently launched in ACT, and is yet to launch in Tasmania and NT. These are smaller markets, but will serve to cement PEXA's dominance as the national platform. Management also increased full year guidance (relative to the June 2020 prospectus) by 7%-11% at the revenue line. While it's still early days, it was also pleasing to see PEXA Insights launch its first two products during the half, and the first investment being made under PX Ventures. Overall a pleasing start to our relationship with the company.

Looking Ahead

Throughout March the investing team will continue digging through the recent half year results and wrap up the tail of management team meetings we have booked in. With the recent heavy sell-off of growth equities, we are focused on turning over stones in search of compelling investment opportunities to add to the portfolio: that is the silver lining of current market uncertainty.

As always, thank you to all our investors for your time and trust.

Best Regards,

[Lakehouse Capital](#)

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