LAKEHOUSE SMALL COMPANIES FUND
MONTHLY LETTER
30 April 2022

Dear Lakehouse Investor,

April was a tough month for global and domestic equity markets. This is particularly true for small caps and the growth orientated names within it. While the more cyclical resource and energy sectors benefited from elevated commodity prices and supply constraints, the technology names and growth companies we seek continued to be hit by macro headwinds and global sentiment.

It's important to remember that while extreme bouts of volatility might unnerve short-term speculators, for the long-term investor, periods of panic provide opportunity. At times like this Charlie Munger's 2009 interview with the BBC springs to mind, where he talks about that period being the third time he and Warren Buffett have seen their holdings in Berkshire Hathaway go down, top tick to bottom tick, by 50%. It's recommended watching when you have a spare 10 minutes.

To put some historical context around the current market, we can look to the Nasdaq index as a bellwether for both global and domestic growth stocks. The Nasdaq posted a -13% loss in April, marking its worst monthly return since the Global Financial Crisis in 2008, and it has now lost -21% so far this calendar year: its worst start to a year, ever.

It's worth re-reading those facts and putting them in the context of equity market history, per the histogram below. Milestones like that should grab long-term investors' attention as, throughout history, periods of negative returns have often been a precursor to periods of strong investment returns.

NASDAQ Composite Yearly Return Buckets	2008	2000 1974 2002 1973	2001	1990 1984	1987 2018 1981 1994 2011	2005 2015 1986 1977 2016 2004 2006 2007	1978 2014 1993 1988 1992 2012 2010 1972 1982 1989 1983	2021 1997 1996 1976 1979 2017 1975	1985 1980 2019 2013 1998 1995	2020 2009	2003 1991	1999
% Return Buckets	-50 to -40	-40 to -30	-30 to -20	-20 to -10	-10 to 0	0 to 10	10 to 20	20 to 30	30 to 40	40 to 50	50 to 60	more than 60
Distribution of each Return Buckets	2%	8%	2%	4%	10%	16%	22%	14%	12%	4%	4%	2%
% of Positive Return vs Negative Return					26%	74%						

Source: *Factset, Lakehouse Capital*.

(Note*: This above histogram organises the historical annual returns of the NASDAQ Composite from 1972-2021 into "return buckets". It shows that historically negative returns have occurred 26% of the time, and positive returns 74% of the time.*)

As concerning as it is for investors to see the value of the Fund fall – and we acknowledge that our growth investing style is deeply out of favour at present – we view the current market as a very attractive set up for future investment returns for long-term, growth-focused investors. To that end, we have been taking

advantage of share price weakness, reallocating capital toward a number of our existing high conviction holdings as valuations have become increasingly attractive on a relative basis.

We have established five new positions in the last 12 months, and note that the Fund's cash position has decreased from 10.8% to 5.6% over the same period. Our portfolio represents a collection of businesses exhibiting market leadership, superior underlying economics and growth potential, and clean balance sheets. In our view, these businesses are in a very strong position relative to the majority of other businesses, whether they be considered 'growth' or 'value', and we believe they will continue to thrive regardless of whether the global economy races or stumbles forward.

The team's primary focus for the month was on a number of portfolio companies that provided trading updates and quarterly cashflow reports. We'll speak more about results from key holdings shortly but, big picture, we continue to be considerably pleased with the collective fundamental performance of our businesses as they continue to affirm our long-term theses. Despite all the headlines of doom and gloom that have impacted the Fund to the extent it is down 32% since the beginning of 2022, we note that the fundamental performance of the portfolio remains strong with revenue growing over 28% year-on-year (on a weighted-average basis through the latest reporting period), and according to Factset, is set to compound at over 22% over the next 3-5 years.

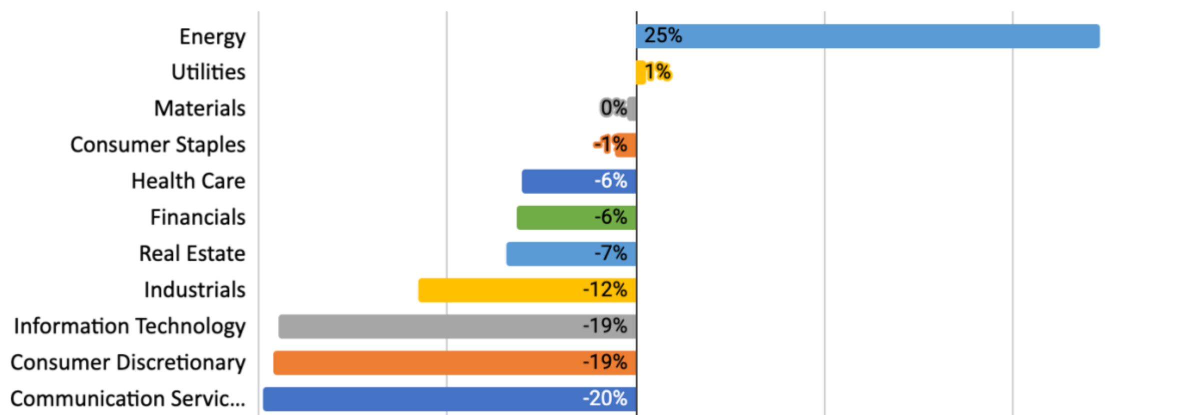
Turning to a breakdown of Fund performance. The Fund returned -12.7% net of fees and expenses during the month compared to -1.5% return for the benchmark. As we'll discuss later, a single stock was responsible for around 40% of the monthly drawdown. Over the last 12 months, the Fund has returned -32.8% compared to 2.9% for its benchmark. Since inception in mid-November 2016, the Fund has produced a net total return of 87.9% compared to 66.9% for the benchmark. In annualised terms, the Fund has returned 12.3% per year since inception compared to 9.8% 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	-12.7%	-21.2%	-32.8%	1.3%	13.4%	12.3%
Benchmark	-1.5%	3.7%	2.9%	7.6%	9.6%	9.8%
Excess Return	-11.2%	-24.9%	-35.7%	-6.3%	3.8%	2.5%

*** 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 (45.8% of total capital), financials (16.6%) and healthcare (12.3%) while the benchmark's largest allocations are to materials (25.3%), real estate (14.7%) and consumer discretionary (13.0%). The energy sector in particular has done well in 2022. The chart below shows the degree of energy's outperformance year to date relative to all other sectors,

which is in stark contrast to the mediocre 5% per annum return it delivered over the past 5 years (inclusive of energy's most recent boom).



Source: *MSCI, Lakehouse Capital*.

In light of the performance of commodities, we have fielded questions from a few investors about whether we should be changing our investing approach. To that, our answer is consistently: "no" and not without good reason. We have conviction that our focus on quality growth companies is the best way to compound wealth over the long-term. No investment style leads over every short-term period, but we remain confident that our strategy will outperform over rolling 5-year periods.

Company News

Turning to specific companies, the Fund's most significant contributor to performance during the month was Bapcor (+6.4%), which ticked higher on no material news. The biggest detractor was EML Payments (-46.8%), after the company downgraded its full year earnings guidance. The Fund has been bludgeoned by EML over the past 12 months, but more on that shortly.

Fund Metrics	
Companies Held	21
Cash Allocation	5.6%
Top 5 Portfolio Holdings	35.5%
Net Asset Value per Unit (mid)	$1.4563
Fund Net Asset Value	$260.5 million
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

The Fund's five largest holdings as of the end of the month accounted for 35.5% of the portfolio and are named in order of the Fund's allocation: Netwealth, Nanosonics, Xero, EML Payments and Pinnacle Investment Management.

The Fund's largest holding, Netwealth, provided a business update during April. In spite of elevated market volatility throughout the March quarter the business added $2.6 billion in net flows: up 16% versus the corresponding period last year. While this is a deceleration versus recent quarters, it is a pleasing result given volatile markets were undoubtedly a big

distraction for many of Netwealth's financial planner clients in transitioning to Netwealth's platform. According to Plan for Life's recent data, Netwealth continues to be the fastest growing platform provider by net fund flows in Australia, adding around 1.2% in market share in 2021, taking total share to 5.5%, with plenty of runway for future growth.

Zooming from quarterly out to a 12-month view; Netwealth's total funds under administration grew 37.6% to $57.6 billion, and that's despite a -$1.7 billion negative market movement headwind during the quarter. We remain attracted to this strong underlying organic growth, delivered by a deeply aligned and long-term-focused management team. Add to this growth thesis the earnings buffer that capped-fees provide against falling equity markets – as was highlighted during the COVID-selloff of 2020 – and also that Netwealth stands to benefit from rising Australian interest rates. At the time of writing the RBA had announced a 0.25% rise in the cash rate, its first in 11 years, with more rises expected throughout 2022 and into 2023.

In our view, Netwealth's profit growth has been held back recently as the company continues to take a conservative approach to fully expense its long-term growth investments. In particular, we look forward to the imminent launch of the non-custodial administration service to deepen relationships within the high-net-worth and ultra-high-net-worth market, as well as continued refinements to its mobile app. We believe both growth initiatives will add to long-term client retention, and profits, for the company. Our conviction behind the thesis remains strong as founder-led Netwealth remains highly profitable, debt free, and with many levers it can pull across the business to grow revenue as it continues to gobble up market share and benefit from rising interest rates.

Turning to EML Payments, which switched from being the Fund's biggest contributor last month, to the biggest detractor this month due to a profit downgrade. (In fact, EML alone contributed around 40% of the Fund drawdown for the month, which is a good reminder of how concentrated portfolios can move in either direction.) We have written about EML and its ongoing remediation process with the Central Bank of Ireland (CBI) in every monthly investor letter since the matter first presented in May 2021. We will not rehash all the details again given all past investor letters are available here.

The downgrade amounted to a relatively modest -8% versus the consensus midpoint earnings, but it was too much for some investors after what has been a challenging 11 months for the company. Management pointed to four contributing factors:

- Higher-than-expected costs due to the CBI issue eating into earnings,
- Foreign exchange translation on US cards adversely impacting earnings,
- Delays in CBI approval to earn interest on some of its European float, and
- Slower-than-anticipated European program launches, partly due to the CBI maintaining a conservative view toward certain programs.

It was profoundly disappointing news to receive the downgrade only two months after management reiterated full year guidance during half-year results. We viewed the recent announcement of a few sizable programs in Europe as signalling a thawing of the CBI's restrictions on EML's European business. However, the downgrade in FY22 expectations suggest that the CBI is still cautious when it comes to determining which specific programs go ahead until the remediation program concludes, and regulatory approval for actions such as bond investments can take longer than usual. So far, we've been wrong about how long the CBI issue would drag on.

Ultimately, we continue to hold our investment in the company because we believe that the CBI issue will pass. At its core, the company has a sticky client base with program churn of less than 1% over a 3-year

cycle, a growing pipeline of deals despite recent regulatory constraints in Europe, and positive interest rate exposure through float on its card balances. Recent interest from private equity firms validates that the company has the potential to turn the ship around when Irish regulatory pressure eventually eases and also points to the prevailing market price sitting at a large discount to where it should be.

Moving on to **Nearmap** to quickly add to our update last month. The company has commenced commercial production of its next generation camera technology, HyperCamera 3, which we have long seen as a precursor to entering new geographies due to the efficiency benefits it offers to any new capture program. While the company hasn't made any formal announcements, we noted mention of a "European roll-out" in a recent company presentation.

Growing at mid-20%, with almost 20% of its market capitalisation in cash, global cash flow positive operations (before reinvestment into AI and 3D premium content), expanding margins and a growing global market opportunity, we see a favourable set up for Nearmap at around 4x forward gross profit while its share price continues to be weighed down by the ongoing patent challenge with Eagle View.

Finally, turning to **Audinate** which also provided a trading update during the month. The pandemic delivered a double punch to Audinate: initially end demand was crushed by lockdowns – which we discussed as returning to its pre-COVID trajectory around the middle of last year – but the company was subsequently hit by the global chip shortage which constrained its ability to meet customer orders.

Fast forward to today, and pleasingly Audinate has managed to redesign some of its products using available chips and is working through clearing the backlog that could see them print around 6 months of revenue in the final four months of the year. We are pleased to see these green shoots, though remain mindful that the global chip shortage is likely to persist for longer, plus manufacturing and supply chain constraints will be negatively impacted by the rolling COVID lockdowns in China.

On a more positive note, Audinate recently released its first Dante video software product which is now available as a free trial. Audinate has done a great job of winning the audio market, and continues to cleverly expand the ecosystem through initiatives like in-field enablement, and is taking the same long-term approach to the video market. While market conditions have not favoured the company over the past 2 years, the management team continues to steadily deliver on its long-term growth strategy.

Looking Ahead

We're planning one-on-one catch ups with many of our portfolio companies throughout May, and will also attend a number of small cap conferences and investor days to deepen our research on existing portfolio companies, and continue the search for exciting new opportunities shaken out by market volatility. While the economic environment feels uncertain to many investors, we continue to execute on our investment process and position the portfolio for long-term growth.

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

Best Regards,

Lakehouse Capital

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