LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

31 May 2022

Dear Lakehouse Investor,

Macro factors and investor nervousness continued to weigh on equity markets through May, with 'bearish' investor sentiment becoming increasingly entrenched. According to the American Association of Individual Investors survey[1] , investors are about as bearish as they were during the depths of the Global Financial Crisis in 2008 – when housing foreclosures were running at record highs and banks were collapsing – and the 1990's recession.

To be clear, this does not reflect that the survey is right, but highlights just how deeply fearful some investors are at the present time and that the technology sector continues to be ground zero for negative investor sentiment. According to a recent Morningstar note[2], '*Right now, based on Morningstar's metrics, technology stocks are the cheapest they have been since March 2009, when markets were beginning to recover from the global financial crisis*'.

We continue to see this negative sentiment reflected in the local market performance, and further in that of the Fund given its focus on long-term growth opportunities, corresponding overweight to technology companies, and zero exposure to the resources sector compared to the ASX Small Ordinaries benchmark. The Fund returned -8.7% net of fees and expenses during the month compared to -7.0% return for the benchmark. Over the last 12 months, the Fund has returned -35.1% compared to -4.6% for its benchmark. Since inception in mid-November 2016, the Fund has produced a net total return of 71.6% compared to 55.2% for the benchmark. In annualised terms, the Fund has returned 10.2% per year since inception compared to 8.3% per year for the benchmark.

In contrast to current negative sentiment and the decline in share prices, we received a number of updates from portfolio companies during May, which highlighted solid fundamental performance of the businesses that we discuss below. This serves to further highlight our view that bouts of volatility, like this, offer up opportunities to discerning long-term investors. Or as famed investor Warren Buffett says: "*The stock market is a device for transferring money from the impatient to the patient*." We think that appropriately summarises what is currently happening.

[1] American Association of Individual Investors, https://www.aaii.com/sentimentsurvey. AAII Sentiment Survey offers insight into the opinions of individual investors by asking them their thoughts on where the market is heading in the next six months and has been doing so since 1987.

[2] Morningstar: Lessons from 2022's tech stock collapse, Tom Lauricella, 17 May 2022.

	1 Month	3 Month	1 Year	3 Year (p.a.)	5 Year (p.a)	Inception (p.a.)
Lakehouse Small Companies Fund	-8.7%	-17.7%	-35.1%	-2.2%	10.9%	10.2%
Benchmark	-7.0%	-3.6%	-4.6%	5.5%	8.5%	8.3%
Excess Return	-1.7%	-14.1%	-30.5%	-7.7%	2.4%	1.9%

*** 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 (44.8% of total capital), financials (18.0%), and healthcare (12.7%) while the benchmark's largest allocations are to materials (24.6%), real estate (14.5%), and consumer discretionary (12.5%).

As we frequently remind investors, our investment process seeks out and emphasises Investment Fascinations, that is businesses with extremely loyal customers, network effects, and unique and enduring intellectual property. Most of those businesses tend to be more concentrated in specific sectors (e.g., technology, financials, healthcare) while are rarely found in others (e.g., commodities).

Company News

Turning to specific companies, the Fund's most significant contributor to performance during the month was **Audinate** (+8.3%), which continued to rally following a trading update late last month. The biggest detractor was **Catapult** (-28.3%), which fell after the company pointed to ongoing investment in its recent full year results. More on both shortly.

The Fund's five largest holdings as of the end of the month accounted for 38.1% of the portfolio and are named in order of the Fund's allocation: **Netwealth**, **Nanosonics**, **Xero**, **EML Payments** and **Pinnacle Investment Management**.

Fund Metrics	
Companies Held	21
Cash Allocation	6.5%
Top 5 Portfolio Holdings	38.1%
Net Asset Value per Unit (mid)	$1.3297
Fund Net Asset Value	$229.3 million
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

Turning to **Audinate**, which provided a trading update in late April (also covered in last month's letter). The pandemic was a very tough period for Audinate but fast forward to today, and green shoots are emerging. The business managed to redesign some of its products using available chips and is working through clearing the order backlog that could see them print around 6 months of revenue in the final four months of the year. Recent share price performance relative to its technology peers suggests more of the market agrees that the tide may be turning for Audinate.

We're looking forward to sitting down with the company in early June to dig deeper into its long-term plans to proliferate the Dante ecosystem, in particular as they relate to the newer Dante video software offering and the recently launched in-field enablement strategy (Dante Ready), along with the pending Dante Cloud offering. 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 and our investment thesis.

Catapult's recent full year report pointed to an acceleration in growth, reduction in churn, and a continuation of the company's strategy to invest in growing the business. It was the latter point that upset the market given current sentiment against technology companies investing in growth initiatives with paybacks years out from today. Part of Catapult's recent investment was to combine its wearables and video offerings to deliver a product that contextualises players' physical attributes with events and performance on the field. The result is a luxury for coaching staff, with time savings of up to 90% in producing game analysis and strategic actions week-in and week-out. It's pleasing to see the company having some early sales success with the product – German Football Association, VfB Stuttgart, NASCAR – ahead of the key North American selling season from May to September.

Digging into Catapult's results; the company has been on a long and financially painful journey to transition away from capital sales to full subscription, and that is now largely complete with 92% of revenue over the last financial year coming from subscription. Despite the headwind of a mix shift away from upfront capital sales toward recurring subscription, total organic annualised contract value (ACV) grew at a healthy 23% to $65.6m (32% including the SGB acquisition). Although prices were increased in some products, and some customers were forced off capital sales to subscription, churn fell to 3.5% (down from 4.1% at the half year).

Turning back to Catapult's heavy investment. This is a continuation of the strategy CEO, Will Lopes, laid out following his appointment some 2 years ago. As former Chief Revenue Officer of Amazon-subsidiary Audible, Will comes from the Amazon school of thought: reinvesting hard with a long-term focus. He has surrounded himself with other Amazon-thinkers and clearly laid out his ambition to 10x the business in the years ahead. We estimate 15% of the addressable market is penetrated, with Catapult holding roughly two-thirds of that whilst being 5x the size of the nearest competitor, we see a vast opportunity ahead. Although market sentiment has shifted, we maintain a small holding given Catapult's growth potential, that the business is operating cash flow positive and has US$26.1 million in cash as it continues to scale with an increased suite of products.

Nanosonics also provided an update on its transition to a more direct sales model in North America, and a general trading update which guided to consensus revenue growth of 12.0% for the full year. Overall, the company looks to have made good progress in moving GE customers directly to Nanosonics, and with a healthy level of continuity across customer relationships as Nanosonics has hired a number of executives from GE, including the former head of the GE High Level Disinfection team. Also, the warehousing and distribution hub in Indianapolis is set up, operational and has ample capacity to handle increased volumes. We accept this transition will create some short-term financial pain in terms of increased costs and reduced revenue as GE runs down its inventory and moves to a drop-shipping model, but we have not lost sight of the long-term gain of higher margins and increased control over the Trophon upgrade cycles.

Xero reported strong full year results with revenue growth accelerating back to pre-COVID trends (+30% yoy in constant currency). This was driven by its core accounting business (+23% yoy) and increasing contribution from its platform business, which includes Planday and Xero Payroll, (+113% yoy, +43% yoy organic) which now makes up 11% of total revenue. Overall subscriber metrics remain sound with total subscriptions up 19% to 3.27m; however, on a regional basis the UK was slightly disappointing due to industry-wide softness. Nevertheless, the company stated that performance picked up in Q4 and the long-term fundamentals of the UK market remain solid.

Zooming out, UK cloud accounting penetration is still very low compared to Australia and New Zealand. With a leading product and over 1,000 app integrations, we believe Xero will continue to gain share in this market. Additionally, its stickiness and pricing power can be highlighted by its stable churn rates, despite raising prices throughout the year across its premium plans in all of its markets (the price increase accounted for most of the 7% uplift in Average Revenue Per User) lifting up customer lifetime value. And with customer acquisition costs rising at a much lower rate, Xero's unit economics remain very attractive.

The disconnect in the performance of the share price and Xero's business arises from current market sentiment favouring companies to generate free cash flow instead of investing in future growth. Xero's management team have stated their clear preference is reinvesting cash generated into growing its global small business platform to drive long-term shareholder value – a strategy we strongly support given the company's typical 6x payback on that investment. In essence, this increases the company's future value and durability of the business, which meets our long-term goals but not the shorter-term desires of many investors in the current market. Xero has shown in the last couple years that it can generate free cash flow and while the opportunity remains large and underlying economics are attractive, we as shareholders can remain patient and continue to favour management teams who – much like us – talk, think and act long-term.

Pinnacle provided a trading update during the month for the period to 31 March 2022: the three-quarter mark for the 2022 financial year. Despite choppy equity markets, Pinnacle's aggregate funds under management (FUM) have grown a modest 2.2% since June 2021, and have only fallen -2.4% since the half year results on 31 December 2022. The business has been bolstered by diversification across asset classes in recent years. In particular, the fixed interest asset class – notably, Credit Metrics and Coolabah Capital – have been performing well. The combination of investors' flight to safety and rising base interest rates (due to their floating rate exposure) is driving significant operational leverage in these businesses.

We are encouraged by continuing positive net inflows into Pinnacle's affiliates, despite the drag of lower equity markets, and the recycling of institutional FUM into higher margin strategies '*with the result that the contained annual revenue impact of net institutional flows to 31st March 2022 has been significantly positive*'. Based on our estimates, this institutional FUM recycling is leading to 2-3x fee uplift on that FUM. We also note that the majority of strategies are still eligible to earn performance fees, even in down markets. In summary, we continue to believe current market sentiment is weighing on the share price, underappreciating the long-term organic growth, operating leverage and earning capacity of the business.

Finally, we also received updates from two other holdings during the month, Bapcor and Nearmap. Bapcor indicated that year to date group revenue, to the end of March, was up 3% led by an 8% increase in Specialist Wholesale and held back by a 4% decline in Retail, and reiterated its guidance to deliver earnings at least at the level of last financial year. A sound result given the impact of COVID lockdowns earlier in the year. Nearmap narrowed its full year ACV guidance to $155 million to $160 million, which is at the upper end of its previous guidance, and implies full year ACV growth of 22.9%. Another pleasing fundamental performance that in our view is disconnected from the share price.

Looking Ahead

As we head into June financial year end, many of our companies will start to batten down the hatches to focus on closing out the year and ruling off their books. It also means Lakehouse is moving toward ruling off another financial year and preparing to release our investors annual statements and our annual letter. We anticipate both the annual letter and annual tax statements being available later in July.

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

Best Regards,

Lakehouse Capital

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

---