LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

31 August 2022

Dear Lakehouse Investor,

Fund Metrics	
Companies Held	22
Cash Allocation	6.4%
Top 5 Portfolio Holdings	42.4%
Net Asset Value per Unit (mid)	$1.2790
Fund Net Asset Value	$232.5 million
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

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. Updates on the businesses and their growth strategies led the Fund to initiate two new positions during the month in companies we have been following for some time. We also trimmed and topped-up a few holdings as new information was digested. We discuss results from our largest portfolio holdings in more detail below. As is our usual practice, we will not disclose the new positions while we continue to build out our stake.

Turning to global markets, where there continues to be no shortage of volatility as investors weigh the uncertain geopolitical and economic environment, including implications of recent interest rate increases. We continue to take a balanced view of the current economic backdrop and remain focused on finding and backing businesses that we believe have the potential to weather economic challenges and prosper over the long-term.

On to performance, the Fund returned 2.5% net of fees and expenses during the month compared to 0.6% return for the benchmark. Over the last 12 months, the Fund has returned -38.2% compared to -14.7% for its benchmark. Since inception in mid-November 2016, the Fund has produced a net total return of 83.6% compared to 51.2% for the benchmark. In annualised terms, the Fund has returned 11.1% per year since inception compared to 7.4% 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	2.5%	7.0%	-38.2%	-2.7%	10.7%	11.1%
Benchmark	0.6%	-2.6%	-14.7%	4.1%	6.9%	7.4%
Excess Return	1.9%	9.6%	-23.5%	-6.8%	3.8%	3.7%

*** 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 (45.2% of total capital), financials (18.3%), and healthcare (13.9%) while the benchmark's largest allocations are to materials (23.1%), real estate (14.4%), and consumer discretionary (13.3%).

As we frequently remind investors, our investment process seeks out and emphasises Investment Fascinations; businesses with extremely loyal customers, network effects, and/or unique and enduring intellectual property. Most of those businesses tend to be more concentrated in specific sectors (e.g., technology, financials, healthcare) and 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 Nearmap (+49.6%), due to a takeover offer. The biggest detractor was **Nanosonics** (-12.5%), which pulled back after a 40.2% share price rise in July leading into the full year results. More on both companies shortly.

The Fund's five largest holdings as of the end of the month accounted for 42.4% of the portfolio and are named in order of the Fund's allocation: **Netwealth**, **Nearmap, Nanosonics, Pinnacle Investment Management** and **Altium**.

Netwealth reported a pleasing result despite multiple headwinds: reduced interest income, rolling over a reduction in pricing, increased investment in fiscal 2022, and difficult industry conditions in the second half – including market volatility and adviser regulatory requirements – which distracted advisers from migrating platforms. The market appeared to be underwhelmed by management's guidance for $11 billion to $13 billion in net fund flows for the year ahead, however, we note the founder-led company's track record of conservatism that often precedes upgrades throughout the year.

Based on the company's $60 billion of funds under administration (FUA) as of 19 August, we estimate the business is tracking around 10%-15% ahead of the top end of full year guidance after the first seven weeks of the financial year. We also note that management's guidance to the market focuses on FUA, not earnings, yet we see earnings materially benefiting from recent increases in cash rate by the RBA and revenue from the new non-custodial administration.

In terms of the financials, revenue grew 19.6% but net profit growth was more muted at 2.7% as the company continued to invest in its technology, administration and support that it fully expenses. Despite capturing the largest share of flows across the industry, the business still only has around 6% market share and plenty of runway to grow. Given Netwealth's industry leadership and the size of the opportunity, we remain fully supportive of management continuing to invest throughout the year ahead to keep the platform at the leading edge.

Nearmap delivered a strong full year result with Annual Contract Value (ACV) up 25% to $160 million, and customer retention steady at 93%. Despite the business continuing to reinvest heavily, cash burn came in at $20 million – well below guidance for $30 million – and the business remains well funded with $94 million in cash, and no debt.

The North American business was the stand out: ACV grew 45% and gross margins widened by 4% to 54%, all while the capture program was expanded to include an additional 9% of the population, with the end result being $22 million free cash flow from the segment. North America is now both the largest part of the business, and the fastest growing. The recent result further highlighted the operating leverage as the North American business continues to scale, which will be amplified by improving unit economics following the imminent HyperCamera3 rollout.

The strong result makes the next topic even more painful: the takeover offer by Thoma Bravo at $2.10 per share, which to our disappointment has been accepted by the Nearmap board. It's worth calling out that management guided toward the business reaching positive free cashflow next financial year, and achieving that milestone with $66 million to $71 million cash in the bank, while continuing to grow top line at over 20%. For our part, we would prefer to remain invested in Nearmap and capture the long-term benefit of its vast growth runway, improving unit economics, strong operating leverage, and significant reinvestment potential given it has a strong balance sheet to support it, but it appears disappointingly the board has decided on a different course of action after a tough couple of years in the market.

Turning to Nanosonics, which preannounced their strong year end result and landed it as our top contributor in July. Fundamental growth of the Trophon installed base grew a healthy 12% to almost 30,000 units, globally. Revenue increased 17% over the year to $120.3 million, driven by a 41% increase in capital sales and 8% growth in consumables. We expect capital sales will continue to dominate as hospital access improves with COVID impacts normalising, and as the upgrade cycle gathers pace. Cost growth accelerated during the period as the company shifted to a direct sales model in North America and moved into a new, larger office and research premise in Sydney.

During the results presentation, management called out the attractive economics of the North American Trophon business: $100 million in revenue growing at around 20% per year, and generating a 55%-60% operating profit margin. We look forward to the Trophon business continuing to add 2,800 to 3,000 new units per year in North America, complemented by over 1,000 annual upgrades and incremental growth from Europe and Asia. Longer term, the company is expanding its product suite and has made further progress on the CORIS platform for endoscope instrument reprocessing, with introduction to the Australian and/or European market in 2023.

Altium posted a solid set of results with revenue up 23% to US$221 million, and well ahead of consensus, driven by 85% growth in electronic and industrial parts search engine Octopart. Sales in the core Design business benefited from lower promotional discounting as well as a growing proportion of higher valued seats, with average revenue per subscriber up 13% to US$2,170. Pro and Enterprise revenue was a standout, up 73%, as the value proposition of the 365 platform and digital sales model look to have hit an inflection point.

Octopart benefitted from the global parts shortage and the company expects this to continue into the new financial year and beyond as the US and Chinese economies further diverge in terms of electronics supply chains. Net profit grew by 52% as the company leveraged its cost base, though management pointed to lower margins in the year ahead, as it continues to invest in the business in its pursuit for US$500 million in revenue in fiscal 2026.

The transition from perpetual to term-based licence is still ongoing: recurring revenue is now 75% of total revenue versus 65% in the prior year. This transition has been a headwind to top-line growth, in exchange for stickier revenue streams, but the company has guided to a healthy 15-20% growth outlook for FY23 notwithstanding. We continue to be impressed by the management team who are executing well to extend Altium's lead in printed circuit board design software.

Looking ahead

The team will continue to digest results and meet with management teams throughout September in search of new investment opportunities, and build out the positions initiated in August in the face of market volatility. We're also gearing up for our Annual Process Review whereby all our analysts come to the table with ideas on how to incrementally refine and enhance the sound, repeatable process that our team has executed since inception of the Fund.

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

Best Regards,

Lakehouse Capital

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