LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

30 September 2022

LAKEHOUSE CAPITAL

Dear Lakehouse Investor,

September was a choppy month in global equity markets as macroeconomic and geopolitical events continued to dominate headlines and dampen investor sentiment. Long-dated bonds gyrated with US 10 year Treasuries starting the month at 3.2%, topping out at 4.0% before winding back to 3.6% at the time of writing. Locally, our 10 year bonds started the month at 3.6%, and peaked at 4.1% before plumbing to 3.7% at the time of writing. These are extraordinary moves, in a short amount of time, for the long-dated rate from which most assets are priced. It underscores the uncertain and volatile environment we are in.

Fund Metrics	
Companies Held	21
Cash Allocation	5.6%
Top 5 Portfolio Holdings	42.5%
Net Asset Value per Unit (mid)	$1.1523
Fund Net Asset Value	$208.5 million
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

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.

It was a busy month for the Fund as the team continued to meet with management teams following recent full year results. We completed the exit from one position early in the month - more on that later - and continued to build out a few other positions. We are seeing a number of very attractive opportunities present in the current environment as investors become increasingly risk averse on account of heightened recession concerns.

On to performance, the Fund returned -9.9% net of fees and expenses during the month compared to -11.2% return for the benchmark. Over the last 12 months, the Fund has returned -42.9% compared to -22.6% for its benchmark. Since inception in mid-November 2016, the Fund has produced a net total return of 65.4% compared to 34.2% for the benchmark. In annualised terms, the Fund has returned 8.9% per year since inception compared to 5.1% 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	-9.9%	9.8%	-42.9%	-6.9%	7.4%	8.9%
Benchmark	-11.2%	-0.5%	-22.6%	-0.8%	4.1%	5.1%
Excess Return	1.3%	10.3%	-20.3%	-6.1%	3.3%	3.8%

*** 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 (46.1% of total capital), financials (17.9%), and healthcare (13.5%) while the benchmark's largest allocations are to materials (23.4%), consumer discretionary (13.6%), and real estate (12.9%).

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 **Tyro** (+6.6%), due to a takeover offer. The biggest detractor was **Pinnacle Investment Management** (-19.4%), on elevated equity market concerns. More on both companies shortly.

The Fund's five largest holdings as of the end of the month accounted for 42.5% of the portfolio and are named in order of the Fund's allocation: **Netwealth**, **Nearmap, Altium, Nanosonics** and Pinnacle Investment Management.

Tyro received a takeover offer at $1.27 per share from a consortium of private equity investors early in September, which the board quickly rejected on account of it significantly undervaluing the business. We were not surprised by the takeover offer in light of our views published in June letter:

> *We find it hard to make sense of the current share price which implies roughly 2x Enterprise Value to Gross Profit on FY22 estimates. A lot of bad news has been priced-in and the company looks like it is priced lower than private market valuations. The full year results point out that what the market will be looking for is greater cost control and a demonstration of operating leverage. Based on the company's current valuation, it would not be a surprise to us if Tyro became a takeover target, especially since consolidation is normal in an industry where scale is important.*

We caught up with Tyro chair, David Thodey, during the month to better understand the boards' thinking in rejecting the offer and a sense of the path ahead. We agree with the board that the Potentia offer significantly undervalues the business and respect that the board has dug-in to deliver a better outcome for investors.

Jon Davey was appointed as the new Tyro CEO during the month and has a clear mandate to control costs, whilst maintaining topline growth. Topline growth is tracking well given transaction volumes grew at 59% in the first quarter of fiscal 2023, which sets the business up to deliver material operating leverage in the year ahead assuming the company can get costs under control.

There's little doubt the business is running with higher headcount following rectification of the 2021 terminal outage, and as of 30 June was employing over 100 IT contractors to support its development efforts. This speaks to part of the opportunity that private equity investors see and we expect Jon will be similarly more aggressive on cost controls. We note at the time of writing, Tyro shares are trading materially above the offer price as speculation of an alternate bid/s circles and we anticipate there is more water to go under the bridge yet.

Pinnacle Investment Management's share price fell during the month on no material news. Investor sentiment toward Pinnacle shares is closely tied to equity market movements despite the business diversifying into non-listed-equity asset classes in recent years. In a similar vein, gyrations in bond markets toss around the implied value of the company's funds under management (on which it earns revenue) which is often magnified in Pinnacle's share price performance.

The Fund completed its exit from EML Payments during the month. EML has faced steeper-than-expected challenges since its Irish-licenced subsidiary, PFS Card Services, came into the crosshairs of its regulator in May 2021. The ongoing issues have been well documented in these monthly letters over the past 16 months. We won't rehash the issues other than to remind investors the Fund has been exiting its stake since July on the back of the CEO and de facto founder, Tom Cregan, resigning along with continuing issues with the Central Bank of Ireland.

Reviewing the recent annual report reveals the ongoing issues resulted in over a quarter of staff leaving the business in fiscal 2022 and the employee engagement score falling to 60% from 70% in 2020. We admittedly underestimated the time and cost of remediating the Irish regulatory issues, and allowed the company (and investment thesis) too much rope as the regulatory issue dragged on.

We've learned some tough lessons on this one, and will keep companies facing regulatory scrutiny on a much shorter leash going forward. EML has detracted 2.8% from the Fund since inception, and accounted for around a third underperformance relative to the benchmark over the last 12 months. We are pragmatic about the challenging path back for the business from here. We would not be surprised if the company put the for sale sign up as the earliest possible remedy.

Looking Ahead

As we approach AGM season, the team have arranged meetings with board representatives from a number of the Fund's holdings, and we have more planned. We look forward to engaging with a number of our portfolio holdings at the board level to provide feedback on the past 12 months, discuss the Fund's voting intentions and understand areas of focus for the business for the years ahead in light of the challenging economic environment.

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

Best Regards,

Lakehouse Capital

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