

LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

28 February 2023



Dear Lakehouse Investor,

February was a busy month for the Lakehouse team as most of our portfolio holdings reported half-yearly results. Despite the uncertain economic environment, we were pleased with the fundamental performance of the vast majority of our portfolio of businesses. We will delve into key results below but as a high-level snapshot the portfolio delivered 27.4% revenue growth over the past 12 months and sits on sound financial footing with very low net debt of 1.2% relative to the portfolio market capitalisation¹.

Turning to performance, the Fund returned -2.1% net of fees and expenses during the month compared to -3.7% return for the benchmark. Over the last 12 months the Fund has returned -12.2% compared to -8.0% for its benchmark. Since inception in mid-November 2016, the Fund has produced a net total return of 83.0% compared to 48.1% for the benchmark. In annualised terms, the Fund has returned 10.1% per year since inception compared to 6.4% per year for the benchmark.

Fund Metrics	
Companies Held	22
Cash Allocation	6.3%
Top 5 Portfolio Holdings	40.5%
Net Asset Value per Unit (mid)	\$1.2749
Fund Net Asset Value	\$219.4 million
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

	1 Month	3 Month	1 Year	3 Year (p.a.)	5 Year (p.a.)	Inception (p.a.)
Lakehouse Small Companies Fund*	-2.1%	-0.7%	-12.2%	-0.4%	5.1%	10.1%
Benchmark**	-3.7%	-1.2%	-8.0%	4.2%	3.6%	6.4%
Excess Return	1.6%	0.5%	-4.2%	-4.6%	1.5%	3.7%

* Performance calculations are based on exit price with distributions reinvested, after fees and expenses, since inception in mid-November 2016. Returns greater than one year are annualised. Past performance is not indicative of future returns

** Benchmark: S&P/ASX Small Ordinaries Accumulation Index.

¹ According to Factset as of 28 February 2023.

The Fund's largest sector allocations remain information technology (42.9% of total capital), financials (17.2%), and healthcare (16.0%) while the benchmark's largest allocations are to materials (24.1%), consumer discretionary (14.5%), and real estate (13.5%).

As we remind investors each month, 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).

We remain focused on investing in strong businesses in growing markets, with durable competitive advantages and pricing power, that are led by founders or well-aligned management teams, and with strong balance sheets.

Company News

Turning to specific companies, the Fund's most significant contributor to performance during the month was **Tyro** (+11.1%), as a bidder returned for a third time. The biggest detractor was **Pinnacle Investment Management** (-11.3%), as sentiment toward markets waned. More on both shortly.

The Fund's five largest holdings as of the end of the month accounted for 40.5% of the portfolio and are named in order of the Fund's allocation: **Netwealth**, **Nanosonics**, **Altium**, **Pinnacle Investment Management**, and **SiteMinder**. We will discuss each in turn below.

Payments provider, Tyro, had a particularly eventful month, but first to their results. Revenue grew 45% to \$216.6 million and gross profit was up 40% to \$95.2 million. The company turned its maiden profit as a publicly listed company – a modest \$1.1 million – and was also marginally cash flow positive as CEO, Jon Davey, delivered on [his mandate](#) to cut costs and shift the business to consistent profitability. There is further to run in Tyro's rejuvenation but it is notable that, among the cost cutting, the company successfully launched new product (Tyro Go and beta testing of Tyro Pro), launched automated on-boarding, and expanded its distribution partnerships (Telstra and Australia Post) which should continue to aid growth even as the post-COVID surge in spending and high inflation tailwinds begin to moderate.

During the month, the company also reached an agreement to settle the class action in relation to the terminal connectivity issue dating back to January 2021. While the agreement still requires Federal court approval, if approved, it removes a lingering issue for Tyro allowing a clearer path for the company, or potential acquirer, to move forward. Which leads to the next point: Potentia private equity returning for a third time. The Tyro board granted a four week non-exclusive due diligence period *'to enable Potentia to develop a significantly improved proposal'* relative to their \$1.60 per share offer in December 2022. At the time of writing, nothing further had been announced, though we note an update from the company is likely imminent given the due diligence period is due to end on 10 March. With the business growing at fundamentally strong rates, soundly executing a cost out plan to drive profitability, and selling for less than four-times gross profit, we remain patient regardless of the Potentia outcome.

On to the biggest detractor for the month, Pinnacle Investment Management, which we covered in some detail last month:

The business delivered a solid result with net profit up 32%, beating consensus profit estimates by over 10%. Despite this, shares have fallen as Pinnacle has leveraged exposure to falling equity markets due to its underlying investment management businesses.

Unpacking the results, Pinnacle's profit growth was driven by a 42% rise in base fees, but held back by a -58% fall in performance fees as it rolled over a high comparable period. Funds under management (FUM) grew by a modest 5% over the last six months to \$89.4 billion, and was impacted by a large institutional outflow. However this masks the addition of \$3.5bn in retail inflows. In our view, the combination of a low proportion of performance fees and higher retail FUM improves both the upside potential and quality of revenue across Pinnacle affiliates.

Our [Pinnacle investment thesis](#) is anchored by the company's domestic and international growth strategy. We continue to see sound progress with existing affiliates both growing organically and standing up new strategies, as well as the creation of new affiliates. North America remains a key growth opportunity for Pinnacle given its unique model of taking minority positions in businesses alongside investors with strong track records, and is supported by solid fund infrastructure and strong distribution capability. The business remains well funded to execute on its growth plans with \$135 million in dry powder, as it continues to expand its portfolio of businesses with large asymmetric payoffs skewed to the upside.

There has been no material change in our long-term view. The business is selling for 21 times forward earnings – a 25% discount to its five year average forward earnings multiple – which looks undemanding given its growth prospects and the operating leverage inherent across their business.

Moving on to Netwealth which reported 19% growth in half year revenue to \$108 million, and 10% growth in funds under administration despite softer flows across the industry. Profit margins shrank during the half as management continued to invest in building out new tools and features, but as the business emerges from this investment phase we see a path to expanding margins in the months and years ahead. We look forward to the imminent launch of Netwealth's non-custodial product and mobile platform, which should help both attract and retain customers. The company continues to benefit from rising interest rates, and is well positioned for long-term structural growth as it captures around 47% of incremental flows against its 6.3% market share.

Turning to Nanosonics, who saw half year revenue lift 35% as higher pricing from the transition to a direct sales model flowed through. Trophon installed base growth came in at a modest 4% over the half (11% over last 12 months) and it has become evident that much effort is being put behind Trophon 2 upgrades which has potential to be a \$100m sales opportunity over the next few years. It was notable that sales momentum accelerated into the second quarter, setting the business up for a strong second half.

Management also updated that the endoscope reprocessing platform, Coris, is steadily tracking toward a launch in Europe or Australia later this calendar year. Coris should have a smoother path to market than Trophon as all markets already reprocess endoscopes and the platform significantly exceeds existing guidelines, with the potential to set new, higher, industry standards.

Altium battled a number of headwinds during the half – exiting Russia, COVID lockdowns in China, negative currency movements – but managed to deliver a 17% lift in revenue (22% in constant currency). The business is being buoyed by increasing average price per seat as customers upgrade subscriptions, driving profitability higher with earnings per share up 29% over the half.

Altium 365, the company's cloud-based collaboration platform, continues to grow at a healthy clip – up 36% since August 2022 to 33,500 – whilst management remains patient about its monetisation. Further, management called out potential to utilise their US\$200 million war chest to accelerate the growth of Altium 365 through M&A; signalling far greater investment may come. They believe there are winner-takes-most dynamics at play, as the ratio of users to accounts continues to climb (now 2.8x) and are focused on mass user adoption. With the core business tracking well and positioned to benefit from China coming out of lockdown, management continues to promote an aspirational target of doubling the revenue of the business over the next 3 years.

Finally, on to SiteMinder, which we provided a high-level overview of the business in the recent webinar. It's a relatively new holding for the Fund, having started buying in November 2021 and has grown into one of our top five positions.

SiteMinder is a cloud-based hotel channel manager that allows hotels to connect to different distribution channels, like Booking.com or Expedia, to automate the management of the listings in real-time. Hotels that are connected to multiple online channels find the task of constantly updating and adjusting availability, rates and inventory a complex administrative burden. SiteMinder automates and simplifies this process by integrating with various sales channels and internal software tools that hotels use. SiteMinder is integrated with 1,350 partners internationally, from hotel systems, hotel apps, distribution and marketing channels, working with 36,600 properties around the world and an addressable market opportunity of 1 million properties.

The company is a leader in its field but still has a long runway ahead. Further, the company has worked on expanding its product suite to become a hotel commerce platform, adding various functionalities such as rate management, a booking engine, website builder, offering insights, and processing payments.

Like many of our investments in software, SiteMinder exhibits strong customer loyalty and unit economics, reporting a relatively low 1.1% monthly revenue churn and life-time-value (LTV) to customer-acquisition-cost (CAC) of 3.6 times. Though already pretty positive, we suspect that unit economics still have room for further improvement, as travel returns to full swing and newer products taken up by new and existing clients.

The company is led by ex-Xero CFO and COO Sankar Narayan, who coincidentally also has the required experience in the travel space, previously being the CFO of Virgin Australia. He possesses alignment with shareholders, having a 2.6% stake in the overall company. Sankar and the team have executed well even throughout COVID, with FY21 revenues down only 5.7% despite worldwide travel restrictions. We're happy to back the team and are confident that they will be able to capitalise on the opportunities ahead.

Looking Ahead

We will continue to meet with management teams throughout March with a number of meetings already in the calendar which we look forward to updating you on in future letters.

We thank all our investors for their continued support and trust.

Best Regards,

[Lakehouse Capital](#)

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