# LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

31 May 2023

Dear Lakehouse Investor,

This month concerns about the looming deadline to raise the US debt ceiling grabbed headlines. Our pragmatic view led us to make no changes to the portfolio in response. For some perspective, we can turn to the US Department of Treasury's own website:

> *Congress has always acted when called upon to raise the debt limit. Since 1960, Congress has acted 78 separate times to permanently raise, temporarily extend, or revise the definition of the debt limit – 49 times under Republican presidents and 29 times under Democratic presidents. Congressional leaders in both parties have recognized that this is necessary.*

| Fund Metrics | |
|---|---|
| Companies Held | 20 |
| Cash Allocation | 7.4% |
| Top 5 Portfolio Holdings | 39.5% |
| Net Asset Value per Unit (mid) | $1.2990 |
| Fund Net Asset Value | $215.1 million |
| Benchmark | S&P/ASX Small Ordinaries Accumulation Index |

More recently, the debt ceiling was raised a total of 7 times under George W Bush's presidency, and 11 times under Obama's, who both served 8 year terms. Markets rallied in early June in response to the issue being resolved, and serves as a reminder of the constant noise for investors to filter in financial markets.

Moving on, May was a busy month for the team as a number of portfolio companies reported half or full-year results, others provided trading updates ahead of their 30 June financial year end, members of the team attended a small cap conference and an investor day, and the Fund participated in an equity placement. More on that later.

Turning to performance. In terms of broader movements, small caps drifted lower and are reportedly trading at their biggest discount to large cap stocks in two decades. The Fund returned -2.5% net of fees and expenses during the month compared to -3.3% return for the benchmark. For the financial year to date, the Fund has returned 23.7% against 8.4% for the benchmark. Since inception in mid-November 2016, the Fund has produced a net total return of 86.4% compared to 46.2% for the benchmark. In annualised terms, the Fund has returned 10.0% per year, net of fees and expenses since inception compared to 6.0% 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% | 1.9% | 8.7% | -3.9% | 5.2% | 10.0% |
| Benchmark** | -3.3% | -1.3% | -5.8% | 4.5% | 2.5% | 6.0% |
| Excess Return | 0.8% | 3.2% | 14.5% | -8.4% | 2.7% | 4.0% |

** 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.*

The Fund's largest sector allocations remain information technology (36.8% of total capital), financials (19.6%) and healthcare (18.9%), and while the benchmark's largest allocations are to materials (25.9%), consumer discretionary (16.1%), and real estate (13.1%).

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).

## Company News

Turning to specific companies, the Fund's most significant contributor to performance during the month was Xero (+17.8%) on the back of reporting solid full year results and a stronger focus on profitable growth going forward. The biggest detractor was Tyro Payments (-25.3%), as the long-running potential takeover process ultimately fell over. More on both companies shortly.

The Fund's five largest holdings as of the end of the month accounted for 39.5% of the portfolio and are named in order of the Fund's allocation: Nanosonics, Netwealth, Altium, Xero and Pinnacle Investment Management.

Moving on to Xero. Full year revenue grew 25% (in constant currency), while annualised monthly recurring revenue lifted 26% to NZ$1.6 billion, and monthly revenue churn held steady at 0.9%. Revenue was driven by a combination of a 14% increase in subscriber numbers, and an 8% increase in average revenue per subscriber (in constant currency) as the company pushed prices higher. Going into the result, the market held concerns about subscriber growth in light of the weaker economic environment, and given subscriber numbers fell short of market expectations in the first half results (when Xero was the portfolio's biggest detractor). However, Xero has demonstrated greater economic resilience than the market anticipated and the re-acceleration in subscriber growth in the United Kingdom, in particular, was a welcome lift following a slow down in the first half.

The key takeaway from the result was confirmation of the strategic shift to profitable growth under newish-CEO, Sukhinder Singh Cassidy. Shortly after becoming CEO in February, Sukhinder was quick to put her stamp on the business, announcing a cost reduction program in March that saw Xero shed around 15% of its workforce. While the full impact of these savings won't be evident until the half year results are reported in November this year, early signs, including steep write downs of previous acquisitions and management commentary, make the renewed focus consistent and more clear. The company is taking a more disciplined approach to reinvestment of cash and generating shareholder value.

Turning to the biggest detractor, Tyro. After multiple approaches over the past nine months, Potentia's third attempt – which included an extended period of due diligence – failed to produce a revised offer. We observed that under Jon Davey's leadership, the business had started to perform some of the cost-improvement work the private equity bidder likely had in mind. In light of this view, and that the process was dragging on, we trimmed the Fund's position. Though, it appears other challenges emerged that collectively led to scuppering the deal; the process and timelines involved in dealing with APRA on the banking licence appeared more challenging than perhaps the bidder expected, and the economic environment softened with Tyro revising down its total translation value guidance for the financial year, negatively impacting top line growth.

Truth be told, Tyro's trading update was a mixed bag. Although transaction value was revised down -1.2% at the midpoint, gross profit and EBITDA were revised up 2.1% and 8.0%, respectively (also at the midpoint). We see a future of growing profitability ahead under Davey's leadership and retain a moderate holding in the portfolio.

Finally, we discussed Impedimed in last month's letter when it was the Fund's biggest contributor. During May the company raised $20 million via an institutional placement, in which the Fund participated. Seeing the first medical policy published by a regional insurance payor added confidence to increase the Fund's position. Notably, the policy specifically names Impedimed's product, and defines use of the product and underlying methods as medically necessary in the detection, diagnosis or surveillance of breast cancer related lymphoedema. While this is the first published policy, there are many more in the pipeline, with Impedimed indicating expectations for 'nearly 50%' of private payors to publish coverage by the end of 2023, and 'nearly all' by 30 June 2024.

At the time of writing, another regional payor under Blue Cross Blue Shield (BCBS) – Florida Blue – announced a policy change to include Bioimpedance Spectroscopy (BIS) as medically necessary, specifically referencing Impedimed's technology. The announcement holds additional gravity as BCBS is one of the largest private payors in the US – its association of 34 companies collectively insure 1-in-3 Americans – and Florida Blue's move has the potential to positively impact medical policy decisions by other BCBS companies and stimulate the rest of the payor market to have a view on BIS in lymphoedema.

While it is still early days for the company's execution following NCCN's updated guidelines, we expect both prices and volumes to accelerate materially as more payors adopt the updated guidelines and add Impedimed's product to their reimbursement list. Once broad coverage for BIS testing for lymphedema is achieved for breast cancer, the longer-term potential remains for Impedimed to expand its addressable market into other areas of oncology.

## Looking Ahead

As we head into the final month of the financial year, Lakehouse funds are preparing to release investors' annual tax and distribution statements which, along with the annual letter, we anticipate being available to investors later in July.

As always, we thank all our investors for their continued support and trust.

Best Regards,

Lakehouse Capital

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

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