LAKEHOUSE SMALL COMPANIES FUND

ANNUAL LETTER

30 June 2024

Companies Held:	22
Cash Allocation:	5.7% ^
Top 5 Portfolio Holdings:	38.8% ^
Net Asset Value per Unit:	$1.6815 ^
Fund Net Asset Value:	$245.9 million ^
Benchmark:	S&P/ASX Small Ordinaries Accumulation Index

^ Note: all figures are net of the 30 June 2024 distribution; equal to $0.0297 per Unit, or $1.25 million total net at the Fund level.

The Lakehouse Small Companies Fund performed well in the 2024 financial year, returning +26.8% net of fees and expenses, compared to +9.3% return for its benchmark.

It was pleasing to have the performance acknowledged by Livewire -- which recently named the Fund as the seventh best Australian equity fund for the year to 30 June -- however, we remind investors our investment horizon is much longer than 12 months.

Lakehouse is into its eighth year of operation. Since inception in mid-November 2016, the Fund has delivered a net total return of 145.6% compared to a 60.0% return for its benchmark. In annualised terms, the Fund has returned a net 12.5% since inception compared to 6.4% for its benchmark.

	1 Year	3 Years (p.a.)	5 Years (p.a.)	Inception (p.a.)
Lakehouse Small Companies Fund	26.8%	-4.4%	5.2%	12.5%
Benchmark	9.3%	-1.5%	3.7%	6.4%
Excess Return	17.5%	-2.9%	1.5%	6.1%

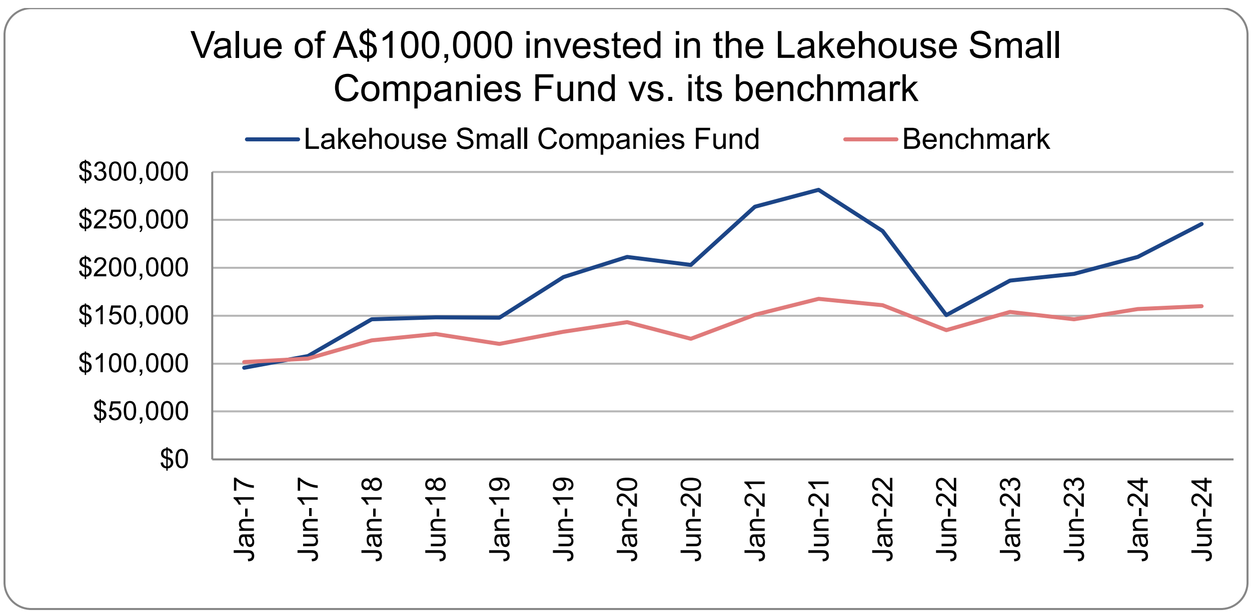
Performance calculations are based on the month end exit price with distributions reinvested, after fees and expenses, since inception in mid-November 2016. Benchmark: S&P/ASX Small Ordinaries Accumulation Index. Returns greater than one-year are annualised. Past performance is not indicative of future returns.

Equity markets can be remarkable wealth compounders for patient investors. What would be even more remarkable, is if those returns were delivered evenly across time, but – unfortunately -- markets don't compound wealth in a straight line. Instead, they move around daily -- sometimes wildly and irrationally -- as investors compete on the fast-paced flow of mostly short-term information.

At Lakehouse we seek to slow our thinking down, and not focus on short-term noise or the latest economic data point, but instead the consistent application of a process that emphasises long-term growth, quality and patience. Doing so puts time on our side.

The below chart plots the journey of the Fund, and benchmark, since inception.

One will quickly observe neither etch a straight line. The market gyrations of recent years -- the COVID pull-forward of returns as interest rates were hacked to zero, followed by the post-COVID recovery with rampant inflation and interest rates -- serve as another reminder of the importance of patience and a long investment horizon for equity market investors.



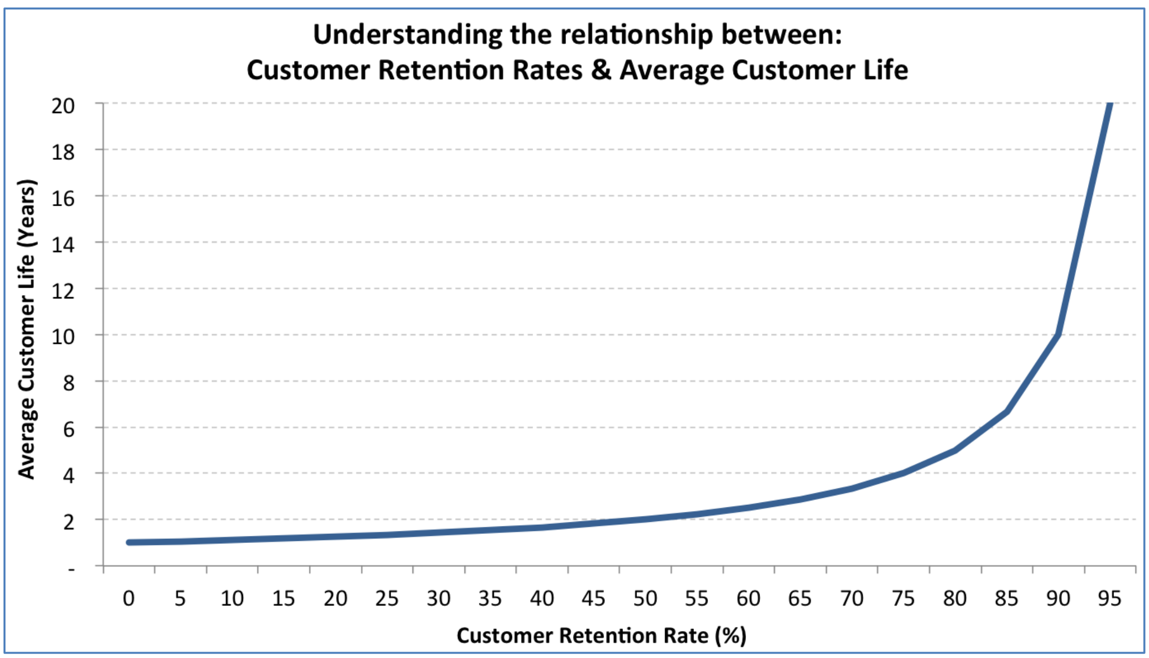
Note: Fund performance is net of fees based on six monthly ending NAV and includes distributions. The benchmark for the Fund is the S&P/ASX Small Ordinaries Accumulation Index.

Investment strategy

Many of the companies held in the Fund have business models built upon extreme customer loyalty by virtue of great products, service, and execution. We think extreme customer loyalty is a trait sorely underappreciated by most investors because of the difficulty in conceptualising retention rates, the ability of such firms to cross-sell, their pricing power, and the failure of accounting standards to appreciate that booking income and creating wealth are not one and the same.

Consider two familiar companies from the same point in fiscal 2019: Xero, which has an annual customer retention rate of ~90% in its ANZ market, and their once formidable competitor MYOB, who's retention came in at ~80%[1]. The fundamental difference between the two looks small, however, Xero and its 90% retention has an average customer life of 10 years compared to just 5 years for MYOB at 80%.

Average customer life becomes exponential as retention rates move closer to 100%. Though both were considered relatively good businesses, the difference in performance over a long-time horizon has been significant.



[1] Note: for illustration purposes we are using approximate figures from the 2019 financial year, for similar geographies, prior to MYOB delisting. We acknowledge there is more context to what was happening in each of the businesses, but it is a suitable example to illustrate the significant impact of seemingly small differences in customer retention rates. One final point; the Fund never owned MYOB despite many market participants arguing it was 'cheap'. Conversely, the Fund has owned Xero since inception.

Thanks to its superior retention rate, and accounting for the time value of money, Xero could roughly afford to outspend MYOB by about 50% on marketing, customer onboarding, and product development while still achieving a comparable return on investment. All else equal, odds were good that Xero would climb to a clear and sustainable leadership position.

The appeal of such a model is not obvious from looking at income statements, though, because much if not all the investments made to develop and market services are expensed in the year they're incurred. The mismatch makes for an ironic effect: Current-year profits and intrinsic value move in opposite directions because the short-term cost of customer acquisition is dwarfed by the long-term value of the extremely loyal customer.

MYOB's financial statements appeared stronger, even though Xero had a more loyal customer base. This is because MYOB was growing its customer base at a slower pace with fewer customer acquisition costs to expense. Conversely, Xero was growing its customer base faster and at higher retention rates, thereby to the untrained eye: losing lots of money.

While MYOB boasted better-looking financial numbers in the short term, Xero was steadily growing its intrinsic value over the longer term. We prioritize companies that focus on building long-term value, even if it means sacrificing some short-term profits.

Cash levels & distributions

Two more things before we move to discuss performance in more detail.

First, the Fund's cash position started the year at 8.7%, inclusive of reinvested distribution. Throughout the year the cash level averaged 7.0% – albeit skewed by a large injection following the Altium sale, which temporarily took cash to 13.4% – and finished at 5.7%.

We value having some dry powder and flexibility, particularly given our high-conviction approach, and we have made good use of it during the downturns in late 2018, early 2020 and more recently in the 2022 bear market. We will continue to target a cash allocation of 5% to 15% going forward.

Second, on distributions. This year the Fund paid a distribution of 2.97 cents per unit, plus 0.47 cents per unit in franking credits. We'd like to remind investors that the Fund's low turnover and emphasis on capital appreciation can make for a lumpy income stream, and distributions are an outcome, not a target, of the way we invest.

It is also worth noting;

- i) capital appreciation is more tax effective than income distributions to many investors, and
- ii) investors can always 'manufacture' their own distribution by selling some of their units.

Total distributions paid to unitholders since inception amount to 61.68 cents per unit, plus franking credits of 2.44 cents per unit. We're pleased for these distributions to have been paid out to those investors who elected not to reinvest; however, we will always manage towards long-term total returns.

Portfolio overview

Let's get back to our favourite subject: the businesses we own.

The Fund's largest holdings to finish the year, which made up 38.8% of the portfolio, were **Netwealth**, **Pinnacle**, **SiteMinder, Pro Medicus** and **Xero.** Each should look familiar to investors as three of the five positions were in our top five positions at the end of last year, plus we've discussed each of them many times in previous investor letters.

The Fund still owns 18 of the 20 companies it owned twelve months ago, making for a position-level implied holding period well in excess of five years. This aligns with our long-term holding orientation but is not to say we have been static in those names.

We regularly reassess opportunities in absolute terms and relative to the portfolio as we actively manage our exposures based on new information, valuations and business fundamentals relative to our investment thesis.

Exited positions

The Fund exited 2 of the 20 holdings with which it started the year, and opened stakes in 4 new ones, thus ending with 22 holdings. The positions exited during the year were **Altium** and **Cettire**.

Altium was subject to a takeover bid by $50+ billion market-cap Japanese semiconductor manufacturer, Renesas Electronics Corporation, which we discussed at some length in our February letter. Lakehouse had owned Altium since launching in 2016 -- and generated compound returns of over 20% per annum -- but those healthy returns were certainly not delivered in a straight line.

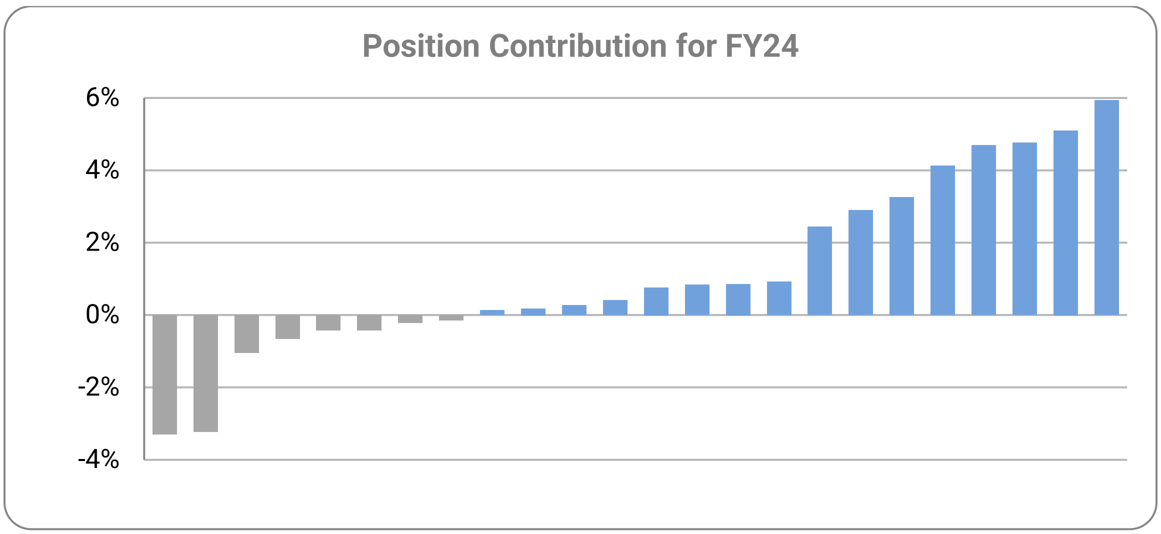
The stock fell from its highs by more than 25% six times, and by over 40% on three occasions during our investment period. The biggest drawdown was over 44% in the depths of the tech stock selloff in May 2022. Remaining patient and taking a long-term view of the value being created within Altium was, ultimately, handsomely rewarded.

Turning to Cettire. The business represented less than 1% of the Fund at the time of exit in April as the Fund had been a heavy seller following the half year results. We were attracted to the extraordinary growth the business achieved in its short life, its ability to self-fund that growth with a long runway, however we never held strong enough conviction to allow the position to grow to significant size.

An elevated share price against a backdrop of observed weakening luxury spend in global peers (through the Lakehouse Global Fund), followed by an expanding list of distractions for the management team, led us to fully exit. At the time of writing, the Cettire share price had fallen -54.3% relative to our average exit price.

Best performers

As can be seen in the chart below there was broad contribution across the portfolio. In fact, 67% of the 24 positions held during the year made a positive contribution.



Note: the chart above shows the total returns contributed to the portfolio by position, which reflect total returns and average position sizing during the year.

The biggest contributors to performance were, in order, Pro Medicus, Altium, and **Audinate**. We'll discuss each in turn.

Pro Medicus delivered another strong year and contributed 5.9% of the Fund's return. It signed a record $245 million in minimum total contract value (TCV) for the year, including a monster $140 million 10-year deal with Baylor Scott & White Health – the largest in the company's history. This compares strongly to the $104 million in minimum TCV signed last fiscal year.

A particularly pleasing feature of the contract wins is that most were for the full stack of Visage 7 products, demonstrating strong traction across the product suite and resulting in larger contract sizing, and all are to be implemented in the cloud. Demand for cloud implementations have accelerated in recent years – partly due to pandemic lockdowns, and in part due to the acceptance that cloud is more secure than on premise -- helping extend Pro Medicus' market leadership as its rivals are yet to deliver a full cloud implementation.

The business is debt-free and incredibly profitable, with about two-thirds of each incremental dollar of revenue falling to pre-tax profit. This strong profitability has seen the net cash balance[2] swell beyond $130 million, providing it with great optionality including for new product development and M&A. The business has a strong existing competitive position, expanding pipeline beyond its traditional client base, a growing product offering and remains less than 8% penetrated in its core North American market providing a very long runway for growth in the years ahead.

The Fund has held Pro Medicus since its inception. We have held firmly as it has steadily grown to become one of the highest quality businesses on the ASX -- and is now priced as such. We continue to manage the position size in light of the elevated market price, balancing it with our mantra to ‘let winners run’.

The silver medal contributor was Altium which we’ve already covered above. In its swansong year Altium contributed 5.1% to the Fund.

In third place was Audinate, which frequent readers may have noticed has been a top detractor in our recent monthly updates. Nonetheless, the business remained a top 3 contributor for the year, with shares up 41.1%, contributing 4.8% to the Fund return. Within the year, we capitalised on some strong price movements trimming our stake, but it remains a significant holding for the Fund.

Zooming out, Audinate executed well on its long-term growth: continuing to proliferate its Dante network while remaining profitable and positioning the business for future growth. The Dante ecosystem is stronger than ever, with over 4,000 Dante-enabled products available and many more in development. The video segment and software services for AV users are still in their early stages but provide Audinate with significant growth runway. While short-term economic headwinds could dampen demand for AV products, we remain focused on the longer-term industry transition from analogue (copper cables and ponytails) to digital connectivity (ethernet cables and remote cloud management).

Although the combined network AV market is estimated to exceed $2 billion, Audinate currently holds a low single-digit market share. Achieving success in the video segments is important, we are particularly excited about the long-term vision of implementing Dante as a software solution as this transition away from single-sale hardware dependency promises higher-quality recurring revenue.

[2] Pro Medicus last reported its cash balance in February 2024, it has likely grown further.

Audinate is profitable and well-capitalised after a $70 million capital raise in September 2023, aimed at supporting its next leg of growth. The funds were intended to accelerate development and pursue potential acquisitions to strengthen its position in the video segment. While no acquisitions have been finalised, management has diligently vetted opportunities. We support the strategic direction and commend the board and management on their patience in finding the right opportunity and price. Meanwhile, the search for a replacement CFO continues, but between the company's dominant market position, growth runway, strong balance sheet and standing as an ASX200 company we expect the business will attract a talented, capable individual.

Worst performers

There were a number of names in the portfolio where our investment thesis was challenged. Coincidentally, all within healthcare. The biggest detractors to performance, in order of impact, were **Nanosonics**, **Impedimed** and **Cogstate**. We'll discuss each in turn.

Nanosonics stands as another reminder of the volatility that can persist in listed markets over short periods; it swung from being a top contributor to a top detraction in 12 months. The share price declined -36.9% in fiscal 2024 resulting in a -3.3% drag on Fund returns. We don't believe the long-term fundamentals, nor the intrinsic value, have moved to the extent of the share price.

Revenue fell -2% in the first half of the financial year as the business faced a tougher selling environment with hospitals running tighter budgets and delaying equipment upgrades. Following a recent update, conditions look to have meaningfully improved in the second half. Moving forward, the opportunity for the company is to further penetrate its customer base, expanding use of the Trophon across hospital departments and completing the upgrade cycle to the new generation machines. Further, geographic expansion in Europe, the Middle East and throughout the Asia Pacific markets are still in its early stages, offering further growth for the Trophon platform.

Management had to navigate alternate ways to sell in a more budget-constrained environment, whilst also investing in the platform to commercialise their long-anticipated CORIS product. This automated endoscope cleaning system tackles a significant challenge and based on studies to date, has the potential to unlock a substantial market opportunity for the business.

Impedimed had a bumpy year as the company endured a shareholder-led overhaul of the board and management team. The net impact of the share price decline was -3.2% at the Fund level. The board and management changes were a very big distraction for the business, and sales efforts suffered. The company is young, not yet cash flow positive, and its thin balance sheet has put it in a race against time to accelerate topline growth to cover costs and avoid (another) highly dilutive capital raise.

On a more pleasing note, the business continues to make progress building out its sales ecosystem. Despite facing challenges, the company's highly effective solution, boasting a 97% device retention rate, allowed them to persevere. As of the end of the third quarter, the company had signed up private payors covering 42% of the U.S. population, including over 80% coverage in 16 states.

We remain comfortable with the progress to be added to reimbursement policies and are excited that the payor landscape could look very different for the company at the end of calendar 2024, which should serve to accelerate sales growth. The opportunity for Impedimed is attractive, with execution being a key determinant of success from here, but a wide range of outcomes remain, and the position is sized accordingly.

Cogstate is a new and previously undisclosed position which dragged Fund performance down by -1.1%. The business is a leading provider of computerised cognitive tests used as key measurement endpoints in clinical trials for Alzheimer's disease. Put very simply, Cogstate are a provider of ‘picks and shovels’ for Alzheimer’s treatment research.

Alzheimer's disease is a neurodegenerative condition currently affecting over 55 million people worldwide, the number of people impacted expected to roughly double every 20 years. It remains a significant cause of death, and only recently have there been US FDA-approved treatments that have proven to slow the rate of cognitive decline in patients. But the disease remains an unmet medical need, and the aging population will only increase the patient pool, presenting a significant challenge for society and an opportunity for pharmaceutical companies.

We expect the recent breakthrough drug discovery to act as a catalyst for further investment into research. This has been the case for other conditions such as multiple sclerosis, and we see no reason why history will not repeat itself with Alzheimer's disease as well, particularly given the growing scale of the problem.

Back to the earlier analogy of viewing an investment in Cogstate as a ‘picks and shovels’ approach; it offers a means of gaining exposure to this growing thematic without the binary risks of drug development. Cogstate is a company we have followed for several years, but held off on investing until more concrete developments in regulatory and reimbursement pathways were clearly defined. With these hurdles now resolved and two approved drugs from different pharmaceutical companies on the market, we believe this creates a favourable environment that supports a pipeline of continual drug development.

The lack of uptake in clinical trial contracts for now, coupled with lower levels of liquidity, has resulted in it being a main detractor for the Fund. However, this investment thesis is still in its early stages for the Fund, we believe the company has a bright future in the years ahead as it helps to solve a generational societal problem.

Thank you

Thank you to all our investors for your time and trust investing alongside us. We are pleased with the Fund's progress toward long term outperformance and are excited to watch the investment cases of our portfolio businesses unfold in the years to come.

Best regards,
The Lakehouse Capital Team

For more information call us on +61 2 8188 1510, email investorsupport@lakehousecapital.com.au or visit www.lakehousecapital.com.au