LAKEHOUSE SMALL COMPANIES FUND

ANNUAL LETTER

30 June 2023

LAKEHOUSECAPITAL

Dear Lakehouse Investor,

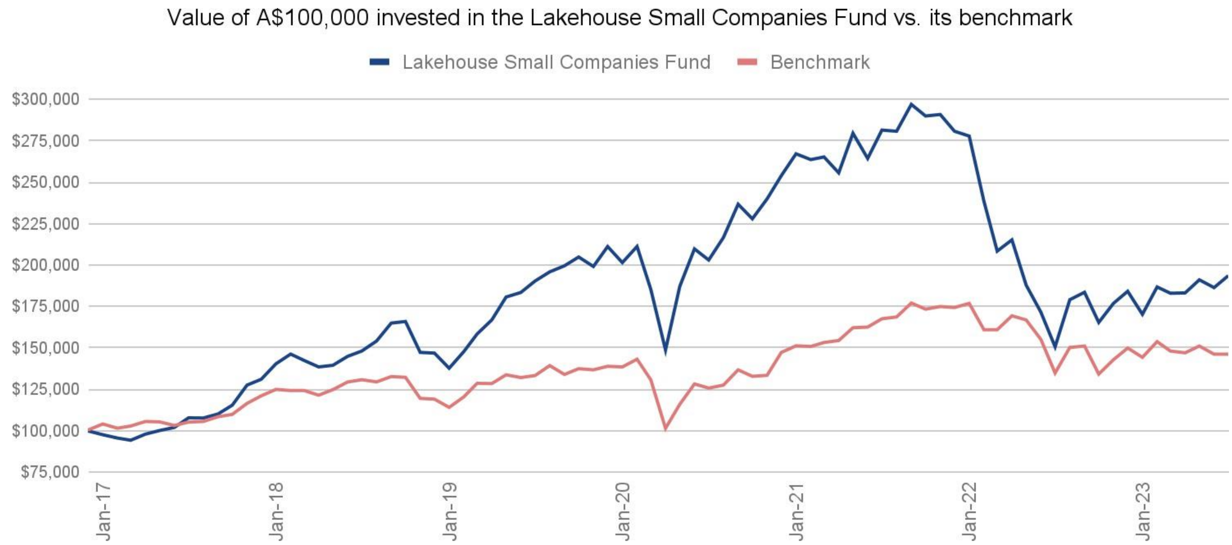
The Fund performed well in the 2023 financial year, returning +28.5% net of fees and expenses compared to +8.4% return for its benchmark. Since inception in mid-November 2016, the Fund has delivered a net total return of 93.6% compared to a 46.3% return for its benchmark. In annualised terms, the Fund has returned a net 10.5% since inception compared to 5.9% for its benchmark.

Fund metrics	
Companies Held:	20
Cash Allocation:	8.7%
Top 5 Portfolio Holdings:	37.8%
Net Asset Value per Unit:	$1.3493
Fund Net Asset Value:	$220.4 million
Benchmark:	S&P/ASX Small Ordinaries Accumulation Index

We are pleased with the Fund's progress toward long term outperformance, however as the chart below highlights, the compounding of wealth in equity markets doesn't follow a straight line. The last two years serve as a reminder of this and the importance of having a long investment horizon. Our ability to remain focused on fundamentals and committed to our philosophy and process throughout changing markets ultimately lay the foundation for long term outperformance.

	3 Months	1 Year	3 Years (p.a.)	5 Years (p.a)	Inception (p.a.)
Lakehouse Small Companies Fund	5.7%	28.5%	-1.6%	5.5%	10.5%
Benchmark	-0.5%	8.4%	5.2%	2.3%	5.9%
Excess Return	6.2%	20.1%	-6.8%	3.2%	4.6%

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.



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

Over the last twelve months, investor concerns were again dominated by inflation, interest rates and the potential for a global recession. Whilst we consider and appreciate the risks of each, particularly the possibility of a significant economic slowdown given the recent rapid rise in interest rates around the world, our passion and strength lies in analysing businesses, not predicting (largely unknowable) macroeconomic outcomes. Hence, for the most part we stay in our lane and stick to seeking businesses that we believe can thrive over the long term regardless of whether inflation proves stickier than first thought or the global economy enters a full-blown recession.

Having said that, it would be naive of us not to let our market observations influence our thinking, particularly as it relates to portfolio construction. We'll speak more to sources of return and our portfolio companies later, but first, let's dig into the year that was and Lakehouse's investing approach moving forward.

Central banks rapidly increased interest rates throughout the year to dampen demand and curtail inflation. The US Federal Reserve moved its short term interest rates from 1.75% to 5.25% over the year. Locally, the Reserve Bank of Australia increased interest rates in 10 out of 12 months, taking the cash rate from 0.85% at the start of the financial year to 4.10% by year end.

This rapid move in interest rates has yielded some benefit in the fight against inflation. In the US, headline CPI to June slowed to 3.0% after peaking at 9.1% twelve months earlier, while core CPI came in at 4.8%. In Australia, headline CPI dropped to 5.6% in May from a peak of 8.4% in December, and core CPI fell to 6.1%. There's still much to play out as core CPI remains more stubborn than headline CPI but inflation expectations appear to have moderated.

Economists, bankers, investors, politicians, retirees and mortgage-holders, among others, are busily predicting when interest rates may peak. While we at Lakehouse are not seeking to make a point estimate, it is probable that we are close to the end of the current interest rate hiking cycle. Though we should remember: a change in interest rate policy will come at the cost of a weaker economy.

The risk remains that central banks find out in hindsight that they have been too restrictive, resulting in a recession. We invest with this possibility in mind.

Are we going to have a recession this year?

The short (and honest) answer is we don't know. As it stands today, uncertainty is high and we have conflicting signals on each side. On one hand, leading indicators, such as the inverted yield curve, suggest a high likelihood of a recession in the year ahead. On the other hand, lagging indicators such as labour-market data – and until recently, retail data – continue to surprise and suggest potential resilience in earnings and economic growth. There's a whole lot of noise and data out there to satisfy whatever view people seek to justify.

The fact is we have just experienced one of the steepest monetary tightening cycles in history. Given the speed and magnitude of the move in rates, and the lag effects associated with them, we believe there is a meaningful probablity that some economies could tip into recession. (For what it's worth, Goldman Sachs had the odds of a U.S. recession at 25% in early July, and recently reduced it to 20%.)

If a recession were to occur then corporate earnings growth would slow – or reverse. However, this will not mean the world is ending. We are confident that if such a scenario comes to pass, our portfolio companies are well placed to not only weather the storm, but perform in a relative sense.

Investment strategy

Our day to day focus is not on short-term performance or the latest economic data point, but the consistent application of a process that emphasises quality and patience. Doing so puts time on our side. We're very specific about the traits we seek in businesses we own. Namely, we look for:

Strong positions in growing markets. Industry leaders capture an outsized share of industry profits, and growing markets put the wind at their backs. This is all the more true in the winner- take-most markets for which we have a particular fondness.

Durable competitive advantages grounded in scale, strong brands, network effects, or high customer loyalty. We have an appetite for businesses with wide and widening moats. In particular, we're fond of businesses with extremely loyal customers and highly visible recurring revenue streams. Indeed, 18 of the Fund's 20 holdings today have models explicitly built upon recurring revenue streams.

Pricing power with customers and suppliers. Pricing power is the financial distillation of a business' competitive position. Little wonder that many of the world's most successful businesses are price setters while laggards are price takers.

Aligned and experienced management teams with strong track records of capital allocation. The importance of management increases exponentially next to a company's growth and reinvestment rate. As it happens, our portfolio companies are collectively growing very quickly, so we make it a point to get to know the people leading our companies and their track records.

Conservative balance sheets. A well capitalised business will almost always live to see another day. One better, it can play offence while others play defence. We're not dogmatic on owning businesses without debt – some businesses are more valuable to shareholders when a prudent amount of leverage is applied – but we have a strong bias towards balance sheets with untapped capacity.

Attractive valuations that afford upside to our estimate of fair value. Valuing the types of high- growth companies we prefer can be an exercise in false precision. Nonetheless, while we're not slaves to spreadsheets, we strive to pay prices that we think boost the odds of a favourable outcome.

It's unusual to find opportunities that tick a few of those boxes at a time. In our experience, though, they tend to most often be found in software, healthcare and consumer markets. That's why, despite our being generalists with a range of experience across multiple sectors, these areas are a particular focus for us.

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

First, the Fund's cash position started the year at 4.7% (inclusive of reinvested distribution) as we saw an attractive opportunity to be close to fully-invested in the face of very negative investor sentiment. Throughout the year the cash level averaged around 6.7% – albeit skewed by a large injection following the Nearmap takeover, which temporarily took it to 12.6% – and finished at 8.7%. 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 continue to target a cash allocation of 5% to 15%.

Second, on distributions, we note that the Fund did not pay a distribution this year. 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. Total distributions paid to unitholders since inception amount to 58.71 cents per unit. We're pleased for these distributions to have been paid out to those investors who elected not to reinvest, however, we remind investors that we manage towards long-term total returns, not current income, and that we expect the ultimate distribution sizes to bounce around considerably from year to year, as they have done this year.

Performance review

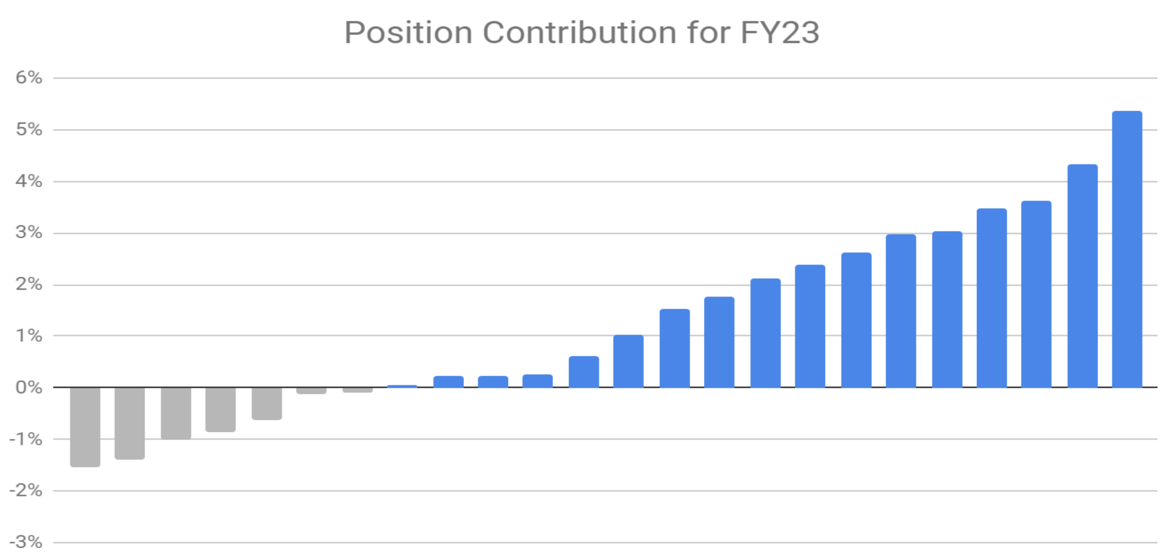
Let's get back to our favourite subject: the businesses we own.

The Fund's largest holdings to finish the year, which made up 37.8% of the portfolio, were Netwealth, Nanosonics, Pinnacle, Xero and Altium. Each should look familiar to investors as four of the five positions were in our top 5 positions at the end of last year, plus we've discussed each of them in previous investor letters.

The Fund still owns 16 of the 20 companies it owned twelve months ago, making for a position-level implied holding period 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.

The Fund exited 4 of the 20 holdings with which it started the year, opened stakes in 4 new ones, thus ending with 20 holdings. The positions exited during the year were; Dubber, EML Payments, Nearmap and Whispir. Nearmap was subject to a takeover by private equity, which we will discuss later. The other three exits resulted from broken investment theses, causing a cumulative -3.0% drag on performance, with EML accounting for over half of that. More on EML later as well.

Digging into performance. As can be seen in the chart below there was a broad contribution across the portfolio. In fact, 71% of the 24 positions held during the year made a positive impact, which is the broadest contribution in a financial year since inception of the Fund.



The biggest contributors to performance were Nearmap, Cettire, and Nanosonics in order of contribution. We'll discuss each in turn. (Note that the chart above shows the total returns to the portfolio contributed by position, which reflect total returns and average position sizing during the year.)

Nearmap's share price rose 103.9% during the year as an astute and opportunistic private equity buyer took advantage of the tech sell-off and an already-bruised board. Fundamentally, we thought the business was tracking well, had a bright future relative to the prevailing price and, ultimately, we would have preferred the business remain listed.

Indeed, we spoke a great deal about Nearmap in investor letters throughout the year, including in July, August, October, November, and December. We also rallied publicly to apply pressure to the board and encourage other shareholders to reject the deal. We think our October 2022 investor letter, in the depths of the tech sell-off, put it well:

> *We remain of the view that the current $2.10 [per share] takeover offer remains well below fair value for the company, and note it is below the midpoint valuation in the independent expert's report. In our opinion, too much focus has been put on the share price prior to the release of full year results to justify the deal. We are of the view that prior to accepting Thoma Bravo's bid price, and agreeing to break fees, the Nearmap board ought to have released the company's strong annual results to the market, especially the expectation that the company will reach cash flow breakeven by the end of the current financial year with a pro forma cash balance of $66 million to $71 million. There was no opportunity for this information to be reflected in the share price ahead of the board agreeing to break fees and recommending the $2.10 takeover price. It should come as no surprise that the Fund voted its shares AGAINST the proposed scheme as we believe material upside remains from the company remaining listed as it rapidly approaches profitability, even if a higher bid does not materialise.*

The scheme of arrangement vote ultimately passed on 25 November 2022 with 78.5% in favour, narrowly ahead of the required 75% threshold for the takeover to proceed. The sale temporarily increased the Fund's cash position from 4.7% to 12.6%, but we moved swiftly to reinvest the funds in other opportunities.

The silver medal contributor was Cettire, whose shares rose seven-fold during the year. As a young, rapidly-growing company there remains a wide range of outcomes for this business and we continue to size our position accordingly. Cettire is not widely known, and less widely understood in the investment community, so we'll quickly recap.

Cettire is a fast growing ecommerce portal focused on branded and luxury fashion. The business operates a capital light drop-shipping model, which means, unlike traditional retail businesses, the company does not hold inventory. In fact, the business operates a negative working capital balance where they are paid by their customers up to 60 days before having to pay their suppliers. This efficient funding model allowed founder, Dean Mintz, to boot-strap the business from its founding in 2017 to $85 million in annualised sales at IPO without any outside funding.

This capital-light business model also allowed Dean to own 100% of the fast-growing business up until he sold a third of it through the IPO in December 2020. He has subsequently sold down to a 45.9% holding, which is still significant but has been a jarring experience for the market. For our part, we don't begrudge a founder reducing their exposure to their single largest asset. Indeed, an eventual sell down was a consideration in our investment thesis, it will diversify the shareholder base and add to liquidity over time.

Cettire has grown at an extraordinary rate since listing, with sales tracking toward a 17-fold increase over the last three financial years. To give a sense to Cettire's scale, the company has a selection of more than 400,000 products across 2,500 brands, that it sells across 53 markets to 314,000 active customers and is run-rating at close to $400 million of sales for the fiscal year.

Generally speaking, we remain cautious on consumer-dependent businesses given elevated inflation and higher interest rates are proving a headwind. So whilst we are positive on the business, our caution is managed via position sizing, with Cettire ending the year as a modest holding in the Fund. We are also mindful that the business has been scrutinised for its escalating customer acquisition costs, calling into question the company's profitability. But this needs to be balanced with the fact the company is continuing to invest in its ecommerce platform, rapidly pushing into new markets, and spending ahead of attracting customers in those markets.

We remain enthused by what the business has achieved in six short years, Dean's strong focus on optimising for profitable long-term growth, and that Cettire continues to self-fund and grow at high-double-to-triple-digit rates, with a long runway ahead.

Coming in third place was Nanosonics. The shares rose 41.1% in fiscal 2023 following new information on a couple of fronts.

Firstly, the benefits of transitioning to a direct sales model in North America started to flow through. We observed both a step up in pricing, but also greater access to the underlying (formerly-GE) customers with improved ability to sell Trophon upgrades. The upside of improved pricing is obvious, but enhanced customer access is more nuanced.

By way of background, GE customers represented approximately 55%-60% of Nanosonics installed base in North America. If we flash back through Nanosonics history to 2014, distribution for both the capital equipment and consumables product was exclusively through GE, then it went non-exclusive around 2015, and in 2019 there was a further change to the consumables model allowing direct sales and margin improvement for Nanosonics. At the time, it is our understanding that Nanosonics would have happily taken the full direct customer relationships but GE wanted to retain them.

However, the direct sales model now aligns with other similar agreements Nanosonics has, for example with Phillips. Phillips makes a margin on the capital equipment but doesn't have to hold any inventory and the customer passes directly to Nanosonics. This enhanced customer access allows additional effort to be put behind Trophon 2 upgrades which has potential to be a very large sales opportunity over the next few years.

Secondly, the company expanded on plans for its new product platform, Coris. As a reminder, the new platform addresses automated high-level disinfection for flexible reusable endoscopes that are commonly inserted into the human body. These are intricately technical and fairly expensive medical devices. A lack of total cleansing of reusable endoscopes is a significant issue within the medical profession and has received significant Main Street attention including an inquiry by the U.S. Senate.

Commercial launch of the Coris product is slated for later this calendar year, though we remain pragmatic that this could (again) be nudged out. More importantly, through conversations with endoscope experts we remain optimistic about the opportunity. The company's established distribution, product leadership in disinfection with its flagship Trophon product, and the scope and nature of the problem Nanosonics is aiming to solve with Coris is a promising combination. We can see a smoother path to market than Trophon as all markets already reprocess endoscopes and testing results to date suggest the platform significantly exceeds existing guidelines, with the potential to set new, higher, industry standards.

There were a number of names in the portfolio where our investment thesis was challenged. We have already mentioned the exits of Dubber, EML Payments and Whispir. The biggest detractors to performance, in order of impact, were EML, Frontier Digital Ventures, and SiteMinder. We'll discuss each in turn.

We were attracted to EML due to its sticky revenue, global growth profile and positive exposure to a rising interest rate environment. Instead, it has been a serial source of disappointment for the Fund, including falling -48.8% in the fiscal year. The fact it was a large position over the past few years put more sting in the failed investment thesis which, after months of selling, we fully exited in September 2022.

We've written extensively about EML's issues since it came into the crosshairs of the Irish regulator, the Central Bank of Ireland (CBI), in May 2021. Even now, more than two years on, EML is still working through its remediation process which has constrained program launches and approvals for bond purchases from which it earns interest. In hindsight, we were wrong on the range of outcomes from the regulator's actions, underestimating the time and cost of remediation, and allowed the company (and investment thesis) too much rope as the regulatory issue dragged on.

We erroneously extended our holding period by being too optimistic about the fact the company hadn't lost any customer contracts, had launched 23 programs at the end of December 2021 and signed a material contract with Up Spain as a signal that the CBI was starting to soften its stance. The thesis waned for months, but the departure of the CEO and de facto founder, Tom Cregan, in July 2022 was the final nail ending our involvement.

To highlight the extent of the damage, last years' annual report revealed that over a quarter of staff left the business and the employee engagement score fell to 60%, versus 70% in 2020. Subsequent to our exit, EML has lost customer contracts and endured yet another change in senior management.

If growth businesses morph into turnarounds, rather than keeping them on a short leash, the default decision should be to move decisively to exit and watch from the sidelines.

Frontier Digital Ventures also had a forgettable year with the shares declining -44.0%, though position sizing limited the portfolio impact. While inflation in developed markets reached high-single-to-low-double-digit levels, in emerging and frontier markets it was a magnitude higher and this had an outsized impact on their fragile currencies. FDV's most valuable asset, Zameen, has been significantly affected by the issues in Pakistan. Having a dominant market position and being led by a capable management team is not enough to compensate for a precarious economic situation and political instability. We are questioning whether growing dominant classifieds businesses and attractive valuation have the ability to compensate for whip-sawing currencies.

The quarterly release weeks after the capital raising presentation was not taken well by the market, and was interpreted as a downgrade. This perhaps dented management's reputation and led to further investor selling and share price weakness. All of these factors pushed FDV's share price to all time low revenue multiples despite the significant progress since its IPO in 2016.

We continue to hold a small position in the business. Fundamentally, the business emerged from COVID lockdowns in good shape and management is executing on their plan to strengthen the competitive position of its 15 classifieds businesses. Although the current macro environment is challenging in FDV's markets, we can also see opportunities when these issues start to ease. With FDV selling at around 2x revenue to enterprise value for a portfolio of leading classifieds, being cash flow positive at a group level and with over 10% of its market capitalisation in net cash, we're giving this thesis more time.

Turning to SiteMinder, which is one of few pre-positive cash flow businesses in the portfolio, and endure a -16.8% share price decline. The business has strong fundamentals, being the largest player in the accommodation channel management space and has the opportunity to leverage this position to offer adjacent transactional services. The company features attractive unit economics, with monthly revenue churn of roughly 1% and generating a 3.6x LTV/CAC ratio that is projected to further improve as travel reverts to normal levels. Due to the substantial increase in interest rates, caution around consumer spending and potential weakness in travel spending has weighed on the share price. But we are mindful how well the company weathered COVID, which saw a complete travel lockdown.

While the business is still burning cash, it is close to a fundamental inflection point of becoming cash flow positive. The third quarter results have shown a 5.5 percentage point quarter-on-quarter improvement in margins and we expect further progress, as cost controls fully contribute. We see a path to the business reaching breakeven within the 2024 financial year, and are confident market sentiment toward the company will change significantly once it crosses that important milestone.

Thank You

Thank you to all our investors for your time and trust investing alongside us. We are confident that staying the course with our business-focused, growth-oriented investment philosophy will yield satisfactory results over the long term.

Again, on behalf of everyone at [Team Lakehouse](), thank you. We are excited about the prospects of the businesses we own in the year ahead and wish you a prosperous new financial year.

Best regards,
The Lakehouse Capital Team

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