LAKEHOUSE SMALL COMPANIES FUND

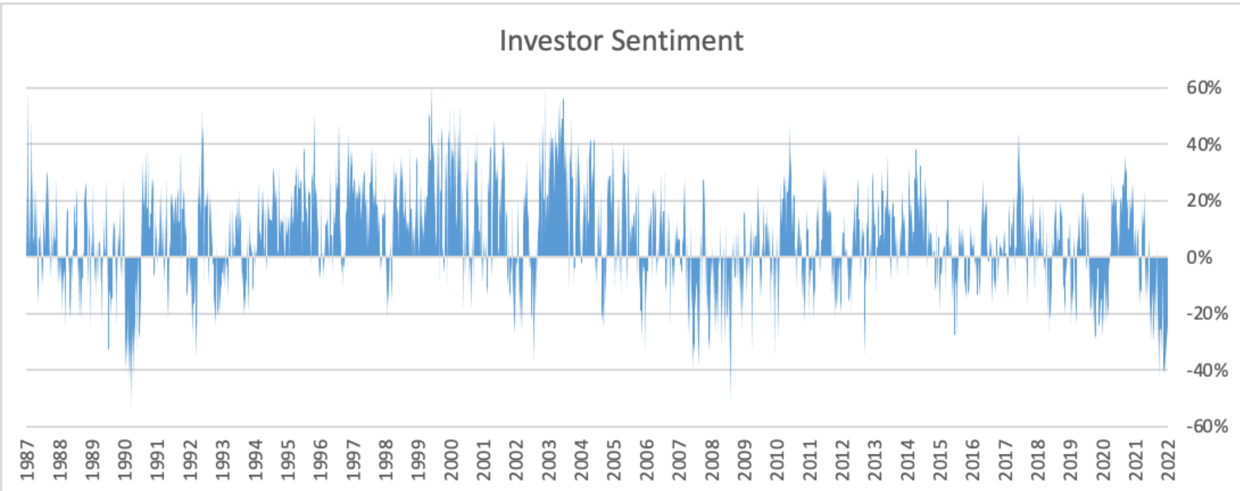
ANNUAL LETTER

30 June 2022

Dear Lakehouse Investor,

The financial year 2021/22 was challenging for the Lakehouse Small Companies Fund underscored by conflating macroeconomic and geopolitical events. Share prices of small cap growth businesses that we invest in were among the hardest hit by a rapid shift in interest rate policy, which saw the Fund return -46.5% net of fees and expenses compared to -19.5% return for its benchmark. The key factors behind this were our overweight positioning to technology, and underweight exposure to materials and energy companies which we will discuss further shortly. The Fund has delivered a net total return of 50.7% since inception in mid-November 2016 compared to a 34.9% return for its benchmark. In annualised terms, the Fund has returned a net 7.6% since inception compared to 5.5% for its benchmark.

Central bank rhetoric to contain inflation with rapid rate hikes began weighing on share prices in the third quarter of 2021. The uncertainty and inflationary pressure was exacerbated when two of the world's largest commodity producing nations (Russia and Ukraine) went to war in February of this year, and China's rolling lockdowns over recent months only served to tighten supply chains and stoke inflation. This cocktail of concerns pushed volatility higher, and investor sentiment lower, in fact, to levels seen during the GFC and the 1990's recession[1].



Source: *American Association of Individual Investors, https://www.aaii.com/sentimentsurvey*

The previous chart provides perspective of current sentiment in the context of time (since it first started being measured 35 years ago). The reality is that bouts of negative sentiment are not new, always seem to feel worse than last time, but only punctuate the more abundant optimism over time. It also serves to remind us even when sentiment and markets are at their greatest despair, the swing to more positive outlooks and performance is often swift and sustained. While history seldom repeats it often rhymes.

[1] According to the American Association of Individual Investors survey, investors are about as bearish as they were during the depths of the Global Financial Crisis in 2008 – when housing foreclosures were running at record highs and banks were collapsing – and the 1990's recession. Further survey details are available from American Association of Individual Investors, https://www.aaii.com/sentimentsurvey. The AAII Sentiment Survey offers insight into the opinions of individual investors by asking them their thoughts on where the market is heading in the next six months and has been doing so since 1987.

A side effect of elevated uncertainty is that it shortens the time horizon of the market, seemingly to only a few months, and leads investors to seek refuge in more liquid names, which can mean disproportionately more selling of smaller capitalisation companies as are held by the Fund.

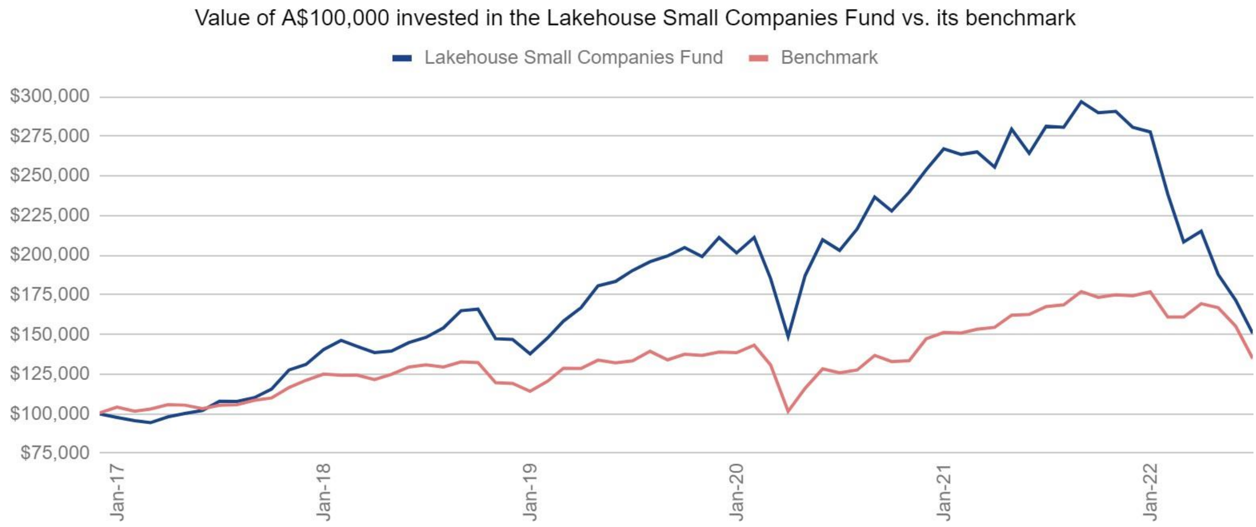
Equity markets have never moved in a straight line. Which is unfortunate in that it can cause unease, and inevitably means periods of strong outperformance will be followed by periods of underperformance at some point. Of course on the flip side, it is this very unpredictable, irrational behaviour of markets that allows us as active managers to add value over time. This is particularly true for those, like us, who take a longer-term view, do not try to time these often erratic movements and instead seek to take advantage of the volatility rather than simply chasing and following the noise. We therefore, remain comfortable in the realisation this will also be the case for the Lakehouse Funds: there will be zigs and zags in the portfolio over time.

Zooming out puts in context the Fund's performance, by financial year since inception, into perspective.

	FY17*	FY18	FY19	FY20	FY21	FY22	Inception (p.a.)
Lakehouse Small Companies Fund	7.9%	37.3%	28.5%	6.7%	38.6%	-46.5%	7.6%
Benchmark	5.3%	24.2%	1.9%	-5.7%	33.2%	-19.5%	5.5%
Excess Return	2.6%	13.1%	26.6%	12.4%	5.4%	-27.0%	2.1%

**Inception on 16 November 2016. Fund performance is net of fees and includes distributions. The benchmark for the Fund is the S&P/ASX Small Ordinaries Accumulation Index. Past performance is not indicative of future returns.*

And the cumulative performance of the Fund, since inception:



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.

Our adherence to the very specific set of traits we seek in investments did not realise the returns during the year that we would expect over the longer term. This is disappointing and it never feels good to deliver negative returns to our investors over any period but, as we've written about in prior monthly letters, we view the current market set-up as favourable to patient long-term investors, which we are. Fundamental growth of the type of businesses we own has not materially slowed (portfolio revenue growth for 12 months to 31 December 2022), yet valuations of small cap companies vs the rest of the market have significantly been sold down.

When the Federal Reserve changed stance to aggressively fight forty-year high inflation in the third quarter of 2021 – indicating it would raise rates further and faster than the market had been expecting – share prices of tech companies became ground zero. Yes, market pricing of some technology stocks – particularly in relation to crypto, NFTs and web 3.0 – were stretched at the time, but valuations have changed dramatically over the past 9-10 months. We do not think current share prices reflect the underlying fundamentals of many of the businesses in the Fund, and we know that will not remain the case.

We have consistently held a larger allocation in technology than the benchmark, and to give a sense of where valuations are presently: *ASX small-cap software is trading on a next-twelve-months Enterprise Value to Revenue multiple of 3.9x, which compares to a 7.2x multiple for the US software peer group. The ASX small-cap software multiple is at its lowest point since the COVID-19 panic selloff in March 2020, and roughly -25% below its 7-year average which captures a more normal interest rate cycle. Source: Factset, Shaw and Partners*

Our commitment to our growth-focused philosophy and process has resulted in negative investment returns for our investors, particularly in the back half of this financial year, as we continued to avoid the temptation to invest in capital-intensive, price-taker materials and energy businesses, which have been the best performing sectors this year. Despite this pain, we still do not believe we possess any edge in forecasting commodity prices, and nor do we wish to invest in businesses exposed to such highly cyclical external forces, or try to time such cycles. Instead, we will continue to stick to our knitting as patient, fundamental bottom-up business analysts working towards more probable outcomes.

Ultimately, our philosophy is all about a long-term mindset and approach, backing our best ideas with conviction, and seeking out asymmetric opportunities where we think we have multiple ways to win and few ways to lose. We search for companies that have strong positions in growing markets, durable competitive advantages that provide pricing power with customers and suppliers, aligned and experienced management teams with strong track records of capital allocation, conservative balance sheets, and attractive valuations that afford upside to our estimate of fair value.

We spend a considerable amount of time getting to know current and potential portfolio companies, which not only enhances our understanding of them but gives us greater confidence to hold on through downturns like we have experienced over the most recent half. Our team has held 149 meetings with our current group of 20 portfolio companies and a total of 1,224 meetings with current, former, and potential portfolio companies since inception.

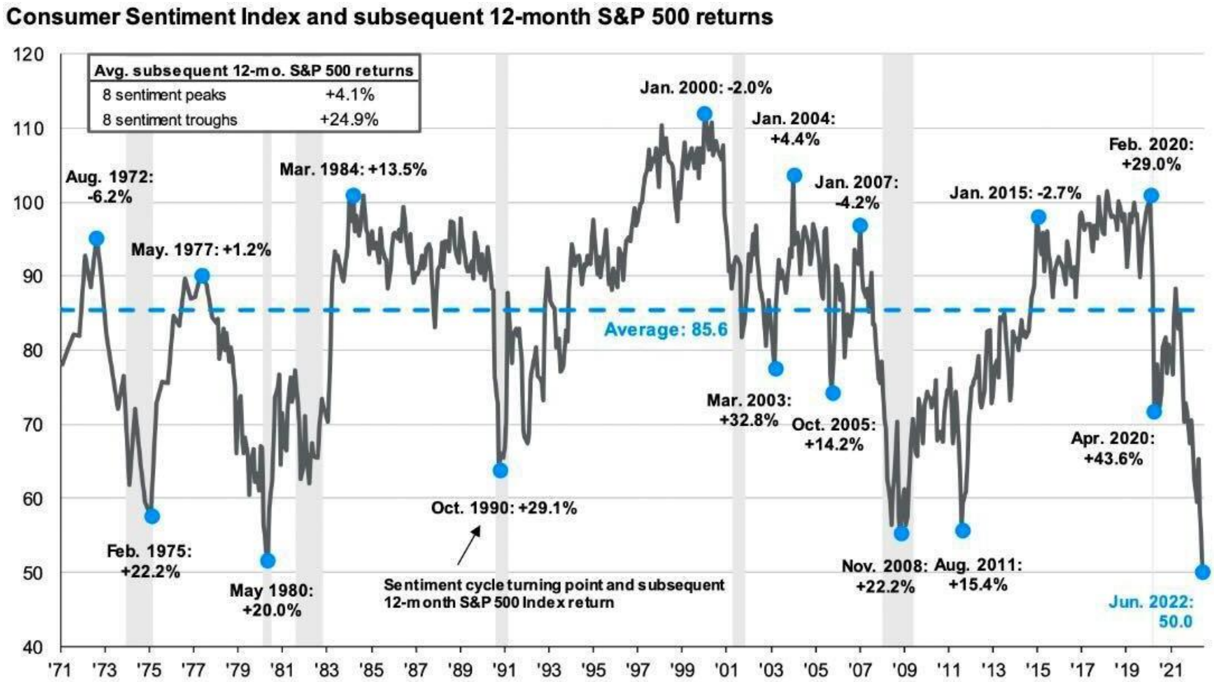
The Fund still owns 12 of the 19 companies it owned two years ago, making for a position-level implied holding period of about five years. This aligns with our long-term holding orientation and the reality that a high proportion of smaller companies don't pan out. That is not to say we have been static in those names, we regularly reassess opportunities in absolute terms and relative to the portfolio with many of those holdings moving in and out of the top 10 as we actively manage our exposures based on valuations and business fundamentals.

Before we dive into discussing individual businesses, we'll talk about what our team views as the most impactful risks in markets today and our current positioning. Last year the focus was on COVID-19, but this year the elephant in the room is persistently high inflation, and central banks' (blunt) tool to combat it: higher interest rates.

We have long held the view that historically low interest rates would not persist over the long-term. Firstly, since inception, we have shielded the portfolio from higher short-term interest rates by owning businesses that have minimal, or ideally, no debt. This remains a key strategic pillar within our investment philosophy.

Another key attribute in this environment and all environments, in our view, is seeking out businesses with strong competitive positions that afford pricing power, and/or extremely loyal customer bases. Inflation can be a death knell for companies when they are unable to pass on rising input costs to customers. Companies that have the ability to raise prices and keep their customers are able to comfortably navigate inflationary periods and grow at stronger rates for longer.

A more tactical way we have positioned the Fund for the current environment is we have sought to own businesses that possess strong fundamental growth, but whose profits grow directly from higher short-term rates: like Netwealth and EML Payments. However, it was the lift in the entire interest rate curve that crunched the share prices of our growth businesses as markets discounted future profits with less certainty and at higher cost of capital. That said, at the time of writing concerns of a US recession are growing, particularly given in the US consumer-led economy consumer sentiment has reached levels rarely seen in the past 50 years.



Source: *JP Morgan, Guide to the Markets®, 3Q 2022*

The US recession concerns have pulled longer-term interest rates down, energy and materials prices have drifted lower, and technology stocks have rallied higher. It is unclear to us whether this is the bottom.

A big theme for our businesses at the half year reporting were costs. In many cases costs came in above expectations, of which the contributing factors being tight employment markets pushing wages higher, rising input costs, partly due to supply chain shortages, and change in approach from companies to carry higher levels of inventory. As we said in last year's annual letter with respect to monetary and fiscal response to COVID-19:

A resulting concern of ours from low rates and ongoing deficits is inflation, however, we have some in-built protection against this risk as pricing power is a trait we seek in our portfolio companies. Further, if inflation or interest rates were to increase because of strong economic growth, we would likewise have a natural hedge as a robust economy is welcome news for long-only investors such as ourselves.

Turning to the portfolio, our companies are growing strongly -- revenue was collectively up 28.1% year-on-year through their latest reporting period -- and 80% of the Fund's invested capital backs companies with business models explicitly tied to recurring revenue. Our companies are also typically better capitalised than most small companies with 15 of the Fund's 20 portfolio companies holding more cash than debt.

We have a strong preference towards businesses with high and persistent returns on invested capital (e.g. software and household products) and away from those that are capital intensive (e.g. materials and energy) and highly competitive (e.g. retail and transportation). For that matter, the Fund does not target sector allocations but rather specific business models and investment traits regardless of sector.

Two more things before we move to discuss performance in detail. First, the Fund's cash position averaged around 9% during the year and finished at 4.6% (inclusive of distributions that reinvested on 1 July). We seek to manage the cash balance relative to the attractiveness of opportunities available. The cash balance ended last year at 10.9% (inclusive of reinvested distribution) and grew to a peak of 14.6% in August 2021, when valuations were stretched and attractive investment opportunities were more scarce, only to be reduced to 4.7% at the end of fiscal 2022 where we are seeing attractive opportunities.

Second, on distributions, we note that the Fund's low turnover and emphasis on capital appreciation can make for a lumpy income stream. The final distribution of 11.75 cents per unit brought the total distributions paid to unitholders to 58.71 cents per unit since inception. 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.

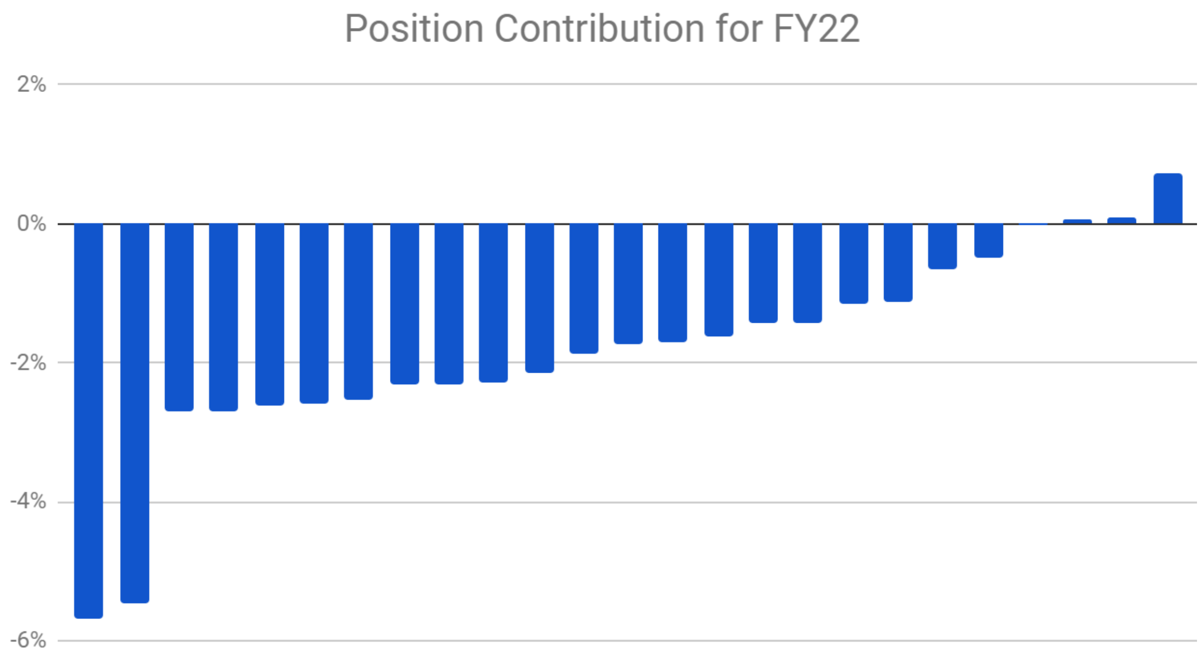
Performance Review

Let's get back to our favourite subject stocks. The Fund's largest holdings to finish the year, which made up 40.1% of the portfolio, were Netwealth, Nanosonics, Xero, EML Payments and Altium. Each should look familiar to investors as three 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.

Fund Metrics	
Companies Held	20
Cash Allocation	4.7% (including reinvested distributions)
Top 5 Portfolio Holdings	40.1% (including reinvested distributions)
Net Asset Value per Unit (mid)	$1.0498 (after a 11.75c distribution)
Fund Net Asset Value	$192.3 million (after $5.6m net cash distribution)
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

The Fund also exited a small remaining stake in Bravura. A change of CEO in September 2021 did little to inspire us around the company's strategy and was followed by a change in CFO in March 2022. We had been trimming the position for some time and exited the small remaining stake in June. We note the business had a further change in CEO after we completely exited our stake.

Turning to performance. There was almost nowhere to hide among our typical growth investment universe with the 'best contributors' coming from positions we exited during the year. A paradoxical phenomenon when markets crater.



The biggest contributors to performance were Audinate, Afterpay, and RPM Global in order of contribution. Note that the table above shows the total returns to the portfolio contributed by position, which reflect total returns and average position sizing during the year. We'll discuss each in turn.

Audinate. We do not profess to be market timers, or wish to be, but the timing of our decisions on this one were proven right. When Audinate was trading at $10, we could clearly see the semiconductor chip shortage was building and stood to negatively impact Audinate's business. The shares rallied strongly to what we viewed as elevated prices, despite potential issues lingering. We sold our shares earlier in the financial year and have been buying back our stake in the business in recent months.

Afterpay. Back in August of 2021 it was announced that Afterpay was being acquired by American digital payments giant Block Inc (previously Square) in an all-stock deal. As we said at the time, we were not shocked as we have long thought that an acquisition by Square or PayPal would make great sense for either business as they could immediately enhance the value of Afterpay by flipping on new distribution with both users and merchants as well as leveraging their structurally lower costs of capital.

We decided to exit our Afterpay position in the days following the announcement at roughly $129 a share as we thought that holding a stake in a US$160 billion company was outside the spirit of our mandate. That decision turned out to be the right one as shares of Block went on to fall 76% post the acquisition announcement.

RPM Global. RPM has only appeared in our letters twice despite being a holding and meaningful contributor to the Fund's performance since the Fund's inception in November 2016. Despite its long tenure, RPM was only first mentioned in January 2019 as the Fund's biggest detractor, and again in March 2021 as the Fund's biggest contributor. Appearances ranging from the gallows to glory, some may say. Despite the stock generating a 29.2% internal rate of return since we invested, the company's tight share register and growth occurring in fits-and-starts prevented us from growing to a larger position throughout this time.

We have long been fans of CEO Richard Matthews who has strong commercial acumen and an enviable track record of buying, integrating, and selling software companies. The recent sale of RPM's orphan division GeoGas for $500,000 was disappointing, though, amounting to a fraction of its carrying value, the price offered previously by willing buyers, and the value we had attributed to it. Through the lens of hindsight, the outcome was akin to leaving fruit to die on the vine. Between the GeoGas outcome denting our confidence and an elevated market price for the shares, we wished the company well and decided it was time to move on.

There were a number of names in the portfolio where our investment thesis was challenged. The biggest detractors to performance were EML Payments, Tyro Payments, and Whispir. We'll discuss each in turn.

Two of our largest detractors in the Fund were in the payments sector, which sold off based on various market concerns throughout the year. General concerns around payments were the potential disruption of the four-party model of Visa and Mastercard, expectations around general economic weakness, buy-now-pay-later (BNPL) becoming a feature and not a standalone category, competition driven by increased fintech funding, and Apple attacking the market more aggressively. We share the same sentiment for some of the concerns but not so much for others.

EML is a business we own because of its sticky revenue streams and is a beneficiary to a rising interest rate environment, which we are seeing play out at the moment however it has been a serial source of disappointment for the Fund this year. The fact it has been a large position for the Fund puts more sting in the outcome. We've talked about EML extensively in our monthly letters regarding the company's ongoing issues with the Central Bank of Ireland. EML is still in its remediation process and has affected the timing of program launches and approvals for bond purchases. The business provided a satisfactory update at the half year, but took a surprising turn when the management downgraded the full year guidance reiterated only 6 weeks earlier.

In hindsight, we overestimated how fast the remediation process would be resolved. We were too optimistic about the company launching 23 programs at the end of December 2021 and signing a material contract with Up Spain as a sign that the CBI was starting to soften its stance. The downgrade confirmed that there were still some issues that EML needed to iron out with its regulator. At the moment, EML continues to compete for new programs, but is limited to programs that would be deemed low risk from a CBI compliance perspective. Recently, the company announced an expansion of its contract with Correos to distribute Spanish Government stimulus funds worth roughly A$320 million.

The Fund's stake in the business has reduced considerably since the start of the year, but as many other positions also shrank, the position remains in our top 5, reflecting our view that the industry dynamics and fundamentals of the business remain attractive over our investment horizon. However, we have continued to reduce our stake in the company during the start of FY23 following the announcement of the long-term CEO stepping down.

Tyro also had a somewhat forgettable year. COVID lockdowns severely impacted business, customers were dissatisfied due to the recent terminal outage, cost pressures increased due to a war for technology talent, topped off with the announcement of the CEO stepping down.

On a positive note, Tyro still has good bones. The business retains 90% and 91% of its merchant clients and transaction values, respectively. The company's net promoter score has improved significantly since the outage and should help with reducing churn moving forward. Further, the company has put in place various initiatives to control costs and optimise pricing. We also expect to see more partnerships similar to Telstra and Bendigo Bank to efficiently scale the business and improve profitability.

In FY22, Tyro processed $34 billion of total payment volume, up 33.9% from FY21. 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.

Whispir was our third largest detractor over the year as the business continued to spend and scale into the large North American market. Some solid fundamental business performance and customer wins were overshadowed by the market's desperation away from cash burning companies.

Fundamentally, Whispir had a strong year as accelerating growth beat upgraded guidance, though cash burn continues to weigh on investors' minds. Preliminary results for the three quarters to the end of March 2022 show Annual Recurring Revenue of A$62.4m, up 24.1%. The company has seen growth in three of its key markets, ANZ, North America and Asia. In Australia, Whispir has shown continued progress in winning government related contracts.

However, North America remains the focus as investors are wary that the direct distribution model carries a higher risk and investment than through partner channels. Management was happy to share that the deal size and quality of the pipeline continue to improve in its US operations. Finally, the company's Asian segment is starting to see an uptick, as it slowly recovers from COVID related weakness. There is also expanding optionality in Asia as the company landed a marquee deal with Singtel that will open up opportunities for the company, similar to its Telstra partnership in Australia in its early days.

Thank You

Thank you to all our investors for your time and trust through what has been a truly challenging year. We remain committed to our growth-focused investment philosophy, and focused on executing our process, despite the humbling reminder the market has delivered this year.

We are extremely grateful for our investors' support and continue to reinvest in our own business to honor that trust. The team has grown from two to twelve over the past five years as we bolstered our capabilities in investing, operations, client services, and distribution. During FY22, Lakehouse upgraded to top tier partners across its operations, including:

- Responsible entity: ASX-listed Equity Trustees,
- Fund accounting, administration and registry: Apex (formerly Mainstream),
- Custody: Apex (formerly Mainstream), with JP Morgan as sub-custodian,
- Fund auditor: Ernst & Young

A further development that we look forward to sharing the details of is that Lakehouse is in the final stages of appointing its first non-executive director: an industry veteran who brings great insights and perspective for Lakehouse and our clients. We look forward to sharing further details in the coming weeks.

Again, on behalf of everyone at Team Lakehouse, thank you. We look forward to a prosperous new financial year and hope you can make the upcoming webinar on 5 August 2022

Best regards,
The Lakehouse Capital Team

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