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CIO'S COMMENTARY – PART 2 – FELIX NARHI

What now?

"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." – William Arthur Ward

Like most, we watched the early advancement of the coronavirus outbreak in China with shock. But other than selling a few holdings like WYNN when the casinos in Macau were shut down, we mostly stayed the course. Perhaps like others, we were comforted by the fact that other recent epidemics like SARS and Ebola had been contained regionally. *Unfortunately, this time was different*. This particular outbreak became a global pandemic. We have been navigating our way through the crisis like everyone else. As the facts changed, we changed our minds on many holdings. Earlier this month we outlined at a high level some actions we took first to protect capital and second to grow capital over time. Assessing catastrophic risk is paramount to our investment process. We undertook a deep dive into each holding as we reassessed the risks considering the quickly deteriorating outlook for most companies. Below are a few examples from Pender portfolios of *the Good, the Bad and the Ugly (for now).*

The Good

Some holdings are performing well in this new environment. One example is Winpak (TSX:WPK) which provides essential packaging services for food and beverages, consumer staples, household products and the healthcare industry. All of its manufacturing plants remain operational and it has benefited from a spike in food and pharma demand. In our opinion, it is a high quality, founding family-controlled business that generates ample, persistent free cash flow and has a cash rich balance sheet.

JD.com (NASD:JD), sometimes referred to as "the Amazon of China", is benefiting from a demand surge as consumers switch to more online buying, especially in groceries and healthcare products. It has gained significant goodwill from customers relying on its dependable delivery of life's necessities during the lockdown. JD's partners are mostly larger enterprises which tend to be more resilient to the downturn than smaller businesses. Electronics and appliances is a major category that has been impacted by the outbreak. That said, it is still seeing growth thanks to the demand for small kitchen appliances as people are cooking more at home, as well as computers for students required to take more online classes.

The Bad

Several businesses we owned that were well-positioned and resilient in the "old normal" are suddenly facing greater potential downside than any bear case we previously envisioned. We exited a number of such holdings.

For example, we sold our entire Middleby stake (NASD:MIDD). While we believe Middleby is a great company, we could not ignore what we believed to be its elevated business risk which, combined with its balance sheet risk, puts the company in a potentially precarious position. Middleby has three business segments, the most important being Commercial Food Services which sells equipment and services to restaurants and accounts for most of the firm's sales and profits. Almost every restaurant in the US has Middleby equipment in their kitchens. The restaurant industry has been very resilient in the US. According to the National Restaurant Association, the industry has grown almost every single year since 1971. This almost uninterrupted trend of industry growth will come to an abrupt halt in 2020 and we believe it could be years before financially strapped consumers return to previous levels of eating out. We believe many restaurants will go out of business and many of the survivors will need time to repair their balance sheets. Interest in new kitchen equipment, which usually lags demand, is unlikely to be a priority in a recovery. Finally, Middleby will need time to repair its own balance sheet which suddenly looks shakier. In our view, Middleby will not be unscathed by the brutal conditions we see the industry facing. At minimum, we believe it makes sense to switch to other stocks that have less near and medium-term risk.

The Ugly (for now)

Many companies fall into a category best described as "ugly (for now)". There is no doubt that many companies will be negatively impacted in the near term, but we believe some will be favourably set up to rebound and, in some cases, even thrive in a post COVID-19 world.

After hitting an all-time high a few months ago, the Zillow Group (NASD:ZG) has taken a huge coronavirus-related hit since then. It is hard to complete a real estate transaction in a city that is in lockdown. Even as cities emerge from lockdown, we suspect far fewer people will be interested in holding or visiting open houses due to health concerns. The number of real estate agents is likely to decline and the surviving agents may have less business over the near-term. Right now this is terrible news for Zillow's legacy business of selling leads to real estate agents to connect with consumers. This is even worse news for Zillow's nascent iBuying business which has been put on hold for the time being. While the near-term outlook is not great for Zillow, it is catastrophic for many less well capitalized peers as potential losses soar and VC funding is curtailed. Initial industry layoffs are already gathering momentum which could sap morale and impair competitiveness down the road. We suspect many competitors will go bust or be left in a significantly weakened state by the Great Lockdown.

The silver lining is that Zillow has been built to survive thanks to a large capital raise last September on very favourable terms. Looking forward, we believe many industries will be permanently reshaped by COVID-19 related forces, including real estate. We are thinking more about the many potential industries that could see a paradigm shift. Indeed, this crisis could very well accelerate a technology-driven re-platforming and digitization of the industry that was already gathering momentum. Web traffic stats following search trends are already indicating Zillow's resilience relative to peers. Consumers are returning to Zillow in greater numbers than to competitor portals. In addition, virtual tours are gaining traction amidst shelter-in-place decrees. Zillow has substantially ramped up its internal engineering efforts to produce 3D virtual tours, becoming the only company to provide this feature for all homes and rentals with online listings. Zillow's deep pockets have so far allowed it to weather the storm and keep the core team together, giving it a potential advantage in the coming recovery.

PAR Technology (NYSE:PAR) was another holding that hit an all-time high earlier this year, but has since slumped. The company is a leading all-in-one cloud-based restaurant point of sale solution provider to the restaurant industry. Like Zillow, PAR could benefit from a re-platforming of the restaurant industry as digitization accelerates. In our opinion, PAR has a strong balance sheet, a capable management team and is well positioned to thrive in a world where the immense value of integrating online ordering, third party delivery apps and digital payments is being highlighted.

While we believe the next few quarters will be grim, we believe both companies will survive and are relatively well positioned to emerge stronger.

Please do not hesitate to contact me, should you have questions or comments you wish to share with us.

Felix Narhi
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