PENDER
SMALL / MID CAP DIVIDEND FUND

THE MANAGER'S COMMENTARY – MARCH 2020

And this too shall pass
Pender is entering its fourth week of working from home. There have been some adjustments to our new reality, but we have been extremely fortunate to so far be free of any health issues and we sincerely hope you are staying healthy as well.

As I take long walks in the evening both to get some exercise and to clear my head, my mind is constantly shifting from the near-term impact of the shutdown to the longer term potential of the recovery. The near term is all about risk mitigation, while the longer term is about the upside potential. We are positioning the portfolio for this balance; aiming for a portfolio of companies that will be around with no permanent impairment in order to participate in the eventual recovery.

Over the last couple of weeks several companies have issued press releases updating operations. The impacts have ranged from seeing a significant decline to business as usual. The consumer facing businesses have been the first to see a revenue decline while several manufacturing and industrial companies have yet to see a slowdown as they work through a backlog of orders. As this gets completed, they too will likely start feeling some pain.

A strong balance sheet and a flexible business model will be key to surviving this. A liquid balance sheet is probably the greatest asset today. There must be sufficient cash available in order to continue paying fixed costs above those covered by government subsidies, such as wages, interest expenses, lease payments etc. Not having enough liquidity will likely be what forces companies to restructure their balance sheet or enter bankruptcy.

Some business models can adapt better to an abrupt slowdown and this comes from having a greater percentage of costs variable versus fixed. Variable costs allow a company to adjust operating costs to match revenue very quickly. For example, the janitorial operations of GDI Integrated Services have the majority of their operating costs related to staff carrying out cleaning duties. They are able to adjust their staffing levels immediately to the amount of work. While we are cognizant for GDI, and many other companies we own, that 'variable cost' translates directly to 'people losing their jobs', it is part of the analysis that we must do in order to aid in the best decision making for the portfolio.

We have spent the last few weeks speaking on the phone with senior management of portfolio companies, discussing these topics and how they have been preparing for this societal shutdown. We believe that the companies in our portfolio will be able to survive this. Eight companies in the portfolio today have a net cash balance sheet, meaning they essentially have no net debt. The bigger weighted companies in the portfolio have more of the flexible business models.

While risk is top of mind right now, we are also thinking about the upside potential and positioning the portfolio for an eventual recovery. Several stocks are trading at discounts which seem to assume little recovery from the shutdown. Here are two portfolio holdings which outline this return potential in the current market environment.

Badger Daylighting
Badger provides hydrovac services throughout North America. A hydrovac is used to expose pipeline and other buried infrastructure in a non-destructive way. It is used by municipalities, utilities, general construction and oil & gas customers. Despite being deemed an essential service and able to operate through the shutdown, Badger is seeing scheduled jobs pushed out, so they too are being affected.

However, they have a highly variable cost model where operating costs consist mainly of the labour needed to operate the vehicle, fuel and repairs, all of which vary with the time they are operating the vehicle. Even the labour costs are an hourly wage for time served. So, like GDI, if Badger has no jobs to complete, they have a greatly reduced cost of goods sold. They also have a strong balance sheet with a Debt to EBITDA ratio of around 1 times and ample liquidity.

Badger issued a press release at the end of March updating operations. Among other items, they pulled their 2020 guidance citing too much uncertainty related to the impact, but they maintained their target of doubling the US operation in the next three to five years. As we think about their business, it is an essential service and we believe it will continue to be needed as we recover from this pandemic, so our view is that we don't see any long-term permanent impairment as a result of the shutdown.

Hardwoods Distribution

Hardwoods, as its names states, is a distributor of hardwood throughout Canada and the US. Their end markets include new builds, renovations, commercial and industrial customers. They too are deemed an essential service and able to operate through the shutdown. As a distributor, their balance sheet naturally creates liquidity through a slowdown. As inventory gets sold it does not have to be replaced and can convert to cash. The company has no long term debt and this should provide them the liquidity to survive a prolonged slowdown.

As of the end of March, Hardwoods has not seen any slowdown to their business, as announced in a press release. However, things will likely slow for them. There is a lack of near-term visibility but at 6 times 2019 earnings, the stock price seems to be basically implying earnings will be cut in half and never recover. Over this past business cycle, the company grew its revenue from $190 million in 2009 to $1.2 billion today. At the valuations on the current earnings, we believe this is a good entry point to a business that management was able to grow fivefold through the last cycle.

There is a lot of negativity in the news today and stock prices are reflecting that. The portfolio is invested in strong cash generative businesses with good balance sheets, which we believe can weather this storm. As we look out past the near term, we are optimistic about the upside potential of small cap stocks, especially given the valuations we are able to buy these companies at. We will continue to maintain a disciplined approach in balancing both the implications of this pandemic on our holdings with the longer term upside potential on the other side.

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April 9, 2020

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