PENDER
SMALL / MID CAP DIVIDEND FUND

THE MANAGER'S COMMENTARY – APRIL 2020

First Survive, Then Thrive

At the time of writing this note, first quarter earnings are wrapping up. The reported earnings for the quarter were not overly relevant as the economy was, for the most part, still functioning. But they did give some important insight into the initial impacts of the shut-down in mid-March. Most companies also gave increased disclosures around operations and performance in April when the shut-downs were in full effect.

The good news from the quarterly conference calls was that April took by far the worst of the impact and in May things had started to thaw. This mirrors conversations I have had with management teams. A month ago, it was about surviving through a potentially prolonged shut-down. Now the focus is shifting to operations on the other side. Although there are still a number of questions remaining regarding the speed of the recovery, lasting impacts and what the world will look like six months from now, the focus has moved from survival to recovery.

The more dialed-in management teams are not satisfied with simply returning operations back to previous levels. They are looking for ways to emerge from this in better shape. As their end markets recover and their operations return to pre-shut-down levels, they want their company to be bigger, stronger and more profitable than before. GDI Integrated Services is looking to develop cleaning solutions for their janitorial business. Pollard Banknote is aggressively marketing their iLottery business to state run lotteries in the US. K-Bro Linen is looking to increase their market share with hotels and long-term care facilities for laundry services. These companies do not just want to reach their previous earnings peak, they want to quickly eclipse it and grow through the next business cycle.

The Valuation Reset

Every earnings season is bound to give some surprises and it is so much nicer when the surprise is positive. Richards Packaging, a distributor of packaging products, reported a very strong quarter with organic growth of 25%. They have three reporting segments (food & beverage, health care, cosmetics) each of which contributed to the positive organic growth. Their cosmetics segment reported a whopping 85% increase in sales for the quarter, with the majority of the increase coming in the last two weeks of the quarter. The strength was from an increase in demand for their pumps and sprays for sanitization products. There are questions regarding the longevity of this higher demand, but the strength has continued into the second quarter.

Richards Packaging has always had M&A as part of their strategy to grow. Every year in their annual report they document the number of acquisitions that occurred in the past twelve months and the average multiples they transacted at, for the packaging industry as a whole. You can see from the chart below how the multiple expanded through the last business cycle.

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Number of Acquisitions	165	226	274	278	152	187	269	294	307	205	143
Avg EV/EBITDA Multiple	6.0	7.0	6.8	6.8	7.0	8.2	8.2	8.0	8.9	10.5	10.0

Most packaging companies convert between 40-60% of their EBITDA into free cash flow, which means paying 10 times EBITDA equates to paying around 20 times free cash flow, implying a 5% after tax free cash flow yield (the inverse of 20 times). With all the risks inherent with an acquisition this is not a very attractive return profile. The culprit of the increasing acquisition multiple was private equity using cheap financing and high leverage to bid up valuations. Public companies had a difficult time competing as they couldn't increase their leverage in order to make the math work.

Richards Packaging sat back watching and waiting for multiples to correct, completing only one acquisition in the past 10 years. Thinking like owners of the business, the company would rather retain cash than make acquisitions at unattractive valuations. But as valuations are looking to reset, they are again actively searching, focusing on niche distributors such as dental products. The dental business has good long-term fundamentals but was effectively shut-down with some distributors having too much debt. This is another reminder of the importance of retaining a good balance sheet. Because of their financial discipline, we believe Richards Packaging is in a good position to take advantage of valuation multiples resetting.

Is It Small Caps' Time To Shine?

Reviewing the portfolio through first quarter earnings had me thinking about why small cap companies generally perform well coming out of a slowdown. The first reason is that multiples generally correct more for small caps than for large caps. Effectively, small caps tend to start the next cycle with a lower valuation on their normalized earnings. The second is earnings growth. Small cap earnings tend to be more sensitive to the economic cycle and so are impacted more when things slow but also grow more during the recovery.

The third is a reset in valuations which allows companies to deploy capital on acquisitions at significantly more accretive returns. The benefits of this are similar for companies of all sizes but our experience is that they tend to favour smaller companies. In the case of Richards Packaging, a larger peer will not be looking at smaller, suffering dental distributors because it is not worth their time. They are looking instead for larger acquisition candidates which will be more impactful on their earnings. The set up for Richards Packaging is the ability to deploy capital now at valuations that meet their return hurdles which by themselves might not be overly material but when combined can be significant value creators.

Without knowing all the answers to the impact of COVID and how the economy will recover, we have been positioning the portfolio in strong cash generative businesses and management teams with the "thrive" mentality. Volatility is likely to remain high, but we take comfort in the businesses we own and the valuations they are trading at, on normalized earnings.

Don Walker, CFA
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