

PENDER

SMALL / MID CAP DIVIDEND FUND

THE MANAGER'S COMMENTARY – MAY 2020

Staying Sensible (Keeping Emotions in Check)

What a roller coaster ride. From the most severe correction in North American equity markets right into the fastest 50-day rally of all time. The Canadian major indices have rallied hard off their bottoms, but still remain a fair distance from where they started the year. At the time of writing, the TSX Small Cap Index is still down around 15% year to date but up over 50% from where it bottomed in April.

Investors went from panic to euphoria in a matter of months. It is nearly impossible not to have an emotional reaction to such dramatic moves, but it is important to remain disciplined. Momentum alone should not be an investment strategy. It is a dangerous game when the investment strategy becomes “what hasn't moved yet”. During these periods, it is extremely important to own stocks for the right reasons, irrespective of market dynamics. Despite the rally in equity markets, we acknowledge that risks remain elevated.

Portfolio Updates

For the Pender Small/Mid Cap Dividend Fund, we did most of the heavy lifting in March and April, positioning the portfolio for companies that we believed would be able to survive the shutdowns and have strong upside potential on the other side. When May came around and markets started to rally, we continued to assess our theses against new data points and remained comfortable with these positions.

Most of the trading we did in the portfolio was more at the margins than wholesale shifts. We sold our positions in three companies in May. One was due to disappointment with management and the other two rallied back to pre-COVID levels and we felt we could reinvest the proceeds into companies with better upside potential. We also added two other securities which I will detail at the end of this note.

Two portfolio holdings released mid-quarter updates in early June. The first was Hardwoods Distribution (HDI) which announced that sales were down 23% in April but bounced back 16% in May and continue to recover in June. They were also cash flow positive during this period. The other update was from Mullen Group (MTL) which also announced a dip in revenue of around 20% for April and May and that EBITDA was down around 15%. EBITDA falling less sharply than revenue implies that they were able to increase margins, despite the fall in revenue. This is a dialed-in management team that reacted quickly to right size operations. Furthermore, after wage subsidies from our generous government, they are expecting EBITDA to return close to last year levels for the second quarter.

We viewed the updates as positive with both companies emerging in good shape: with no apparent lasting impairment to the business or capital structure, and end markets starting to recover. These companies have been stress tested through the forced shut-downs and their businesses performed sustainably. These are the companies we want to hold in the portfolio. In [our last commentary](#) we talked about companies that are looking to go on the offensive through this. These are the dialed- in management teams that we believe are ready to add value through the next business cycle.

New Portfolio Additions

The first company we added to the portfolio was IBI Group, an architecture and engineering firm. The company has a 16-month backlog of work and will also be a benefactor of the expected fiscal infrastructure stimulus. While most of the publicly traded firms in the industry are focused on growth by acquisition, IBI has focused on growth by developing technology solutions. They have a segment called Intelligent Solutions that develops and maintains software programs including security systems, toll road

systems and weather telematics and analytics. The beauty of this segment is that it generates recurring revenue and has high margins. Today the segment is around 20% of revenue and 40% of EBITDA, and has grown at around 5-10% per year.

The company trades at around half the multiple of large cap peers in Canada, due in-part to the size of the company and lack of following.

The second addition to the portfolio was Colliers Group which is a commercial real estate brokerage. Most of their exposure is to office and industrial buildings, with smaller exposure to retail space. Ten years ago, they were primarily a transactional based company (sales and leases) but now around 50% of their revenue is from recurring sources such as property management and advisory services. Looking back at the previous downturn in 2009, it took the company a year and a half to recover to previous peak EBITDA levels.

The sentiment towards commercial real estate turned extremely negative with the exodus to remote working, resulting in a lot of uncertainties in the outlook. As a broker, Colliers does not own the real estate but instead helps to facilitate transactions and manage the assets. The weak sentiment allowed us to buy what we view as a high-quality company at depressed valuations. Over the past five years they have grown EBITDA by 20% per year through organic growth and diversifying away from transactional based revenue streams.

With North America in the early phases of re-opening, we are likely to get more data points in the coming weeks both on the economy in general and company specific news. The straight down and back up trajectory of equity markets over the past three months is likely to be the shape of things to come and we can expect more volatility as investors digest and recalibrate this new data. Our hope with our next update is that there is a continued progression towards a recovery to close out the second quarter and that the North American economy is more firmly on the path forward. In the meantime, we continue to manage the portfolio through our disciplined approach aimed at balancing both the upside potential and the downside risk.

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