PENDER
SMALL / MID CAP DIVIDEND FUND

THE MANAGER'S COMMENTARY – JUNE 2020

In last month's update, we talked about a couple of our portfolio companies providing mid-quarter updates with a noticeably more positive tone, compared to the outlook given with Q1 earnings just 30 days prior. So, what changed in that one month to cause the change in positivity?

What we have gathered through our conversations with these companies is that the worst of the shut-downs was felt in the last week of April and the first two weeks in May. Although the economy was closed for April and began opening again in May, there was a lag to both its impact and recovery. Orders that were booked continued to ship into April, but once those shipments were completed they were not replenished until after the economy opened back up.

Q1 earnings were reported right in the middle of this gap between orders being shipped and new orders being placed. This was when the impact was at its worst and commentary outlooks for Q2 reflected this. However, within weeks of this the recovery started. The recovery seems to be faster than most were expecting. Below is an excerpt from the Intertape Polymer press release.

The Company estimates that its revenue is approximately $267 million for the three months ended June 30, 2020, compared to the outlook range communicated on May 13, 2020 of $235 million to $250 million. With the out-performance of revenue, management also expects adjusted EBITDA to be greater than the top end of the outlook range of $34 million that the Company communicated on May 13, 2020 as well.

Intertape's stock rallied nicely from the April lows with the updated guidance; however, it still remains 40% below its pre-COVID levels. There are still stocks that we believe continue to reflect a long drawn out recession in their valuations. Our belief is that so long as there is no permanent impairment to these businesses, there remains considerable upside potential for many small cap companies in Canada.

Case Study: Mullen (a Misunderstood Stock)
Mullen is an interesting case of a misunderstood stock and we are going to spend the rest of this note discussing why. The first thing people think when they hear Mullen is energy services. It is true that it used to be predominately an energy related services company. But today energy-related revenue represents less than 30% of the overall, while the other 70% (and growing) is coming from trucking and logistics. Despite this, they still get lumped in with the energy service stocks and even remain in a couple of energy indices.

With the energy complex remaining out of favour for the past five years, this has similarly caused Mullen to remain out of favour with investors. The energy business provided the company with strong cash flow for many years and was a great business while the price of oil remained high. With the downturn in energy prices in 2015, the management team saw the ability to generate returns from that revenue stream diminishing and so started to direct more of their growth capital towards the trucking and logistics segment.

This brings us to the second reason we believe Mullen is misunderstood. In still perceiving Mullen as an energy services company, investors have not yet valued-in the growth opportunity of their trucking and logistics business segment. The segment has actually performed well through the pandemic, but this positive outcome has been masked by weakness in the energy sector. Looking only at Mullen's consolidated financials you would see that EBITDA peaked in 2014 at around $200 million, coinciding with the energy peak, and today it is $165 million. With no apparent growth for the past five plus years, what is there to get excited about here?

If you dig deeper and look at the segmented results, you will see that while the energy business EBITDA is down around $125 million from its peak, the trucking and logistics segment is up around $50 million during the same period. Investors will probably not take notice of this until the consolidated results start showing growth again. We think that this could have happened this year if it were not for the COVID-related impact.

The reason is that we believe their energy related revenue is at or very near a bottom. Their drilling related services have fallen to virtually nothing, having been on a decline for the past five years. What is left is primarily pipe hauling (large pipeline projects) and fluid hauling (related to oil production), both of which are less cyclical than drilling and have a decent outlook. With the energy segment bottoming, we believe the growth from the trucking and logistics segment will begin to stand out on its own merit. In fact, in January, before COVID hit, Mullen's guidance for 2020 was $220 million in EBITDA.

Their trucking and logistics assets are well established. They have distribution and warehousing assets (mostly owned) from BC to Ontario, including a large transloading centre located in Edmonton that is a hub for rail goods moving across the country. They provide shipping for Shoppers Drug Mart, warehousing for numerous eCommerce companies, trucking for alcohol distribution and logistics for Dollarama. It is a diverse operation, providing a necessary service to many small communities across Canada. With this facility base in place across most of the country Mullen is now looking to grow by leveraging this platform.

Earnings Season

Second quarter earnings releases are just around the corner. There will be a lot of data from the earnings releases to digest. What we will be paying particularly close attention to is how businesses were able to adjust to the shut-down as well as a monthly cadence of sales now we can see the path to recovery from pre-COVID levels. The risk of another economic step back remains, given COVID infections are back on the rise so we will want to own only businesses with management teams that are showing they can successfully navigate the shut-downs. As we say in each of our notes, we continue to invest with discipline and remain mindful of the heightened risks.

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