

PENDER

SMALL / MID CAP DIVIDEND FUND

THE MANAGER'S COMMENTARY - JULY 2020

With this month's commentary we have hit a key milestone for the Pender Small Mid Cap Dividend Fund. The Fund is officially six months into its mandate and while it's been a wild six months, we are grateful for the early buy-in to our investment strategy. Thank you.

Stocks continued their recovery through July. Small caps performed particularly well in the month with many stocks back to, or above, their pre-COVID levels. In many cases this equates to returns in excess of 100% from the lows. The initial rally in April and May was a bounce from the aggressive panic selling at the onset of the pandemic in March. More recently though, we believe the strong returns are from a recalibration of expectations moving significantly higher. Or put another way, the impact from the COVID-related shutdowns appear to be far less severe than initially expected.

We wrote [last month](#) that we thought expectations for the second quarter were too low. With more than half of the companies in our portfolio having now reported their second quarter earnings, the results exceed even our higher expectations.

For one, revenues appear to be recovering faster than anticipated. Equally impressive have been the reported margins. When revenues were falling fast in April, costs were cut in similar fashion but have been slower to recover. This combination of revenues being "less bad" and a leaner cost structure is producing impressive results.

Some of the quarterly results have actually been astounding. Both Hardwoods Distribution Inc ("HDI") and PFB Corporation ("PFB") reported record EBITDA and margins for the quarter, despite revenue falling around 10% in both cases. To think that the economy was shutdown for an entire month, yet companies are reporting their best results in corporate history is mind boggling.

We fully expect a portion of the margin improvement to reverse in the coming quarters for many companies. Cost structures are arguably artificially low at the moment, and while companies have learned to do more with less, things like discretionary spending halts, capex cuts, tax deferrals and travel bans will eventually be withdrawn or return to normal levels. In other instances, government subsidies are helping to pay employee wages deepening the artificially low overhead structure (though we should note that neither PFB nor HDI received any government assistance). So, there is a bit more noise than usual in this quarter and we are scrubbing reports to determine what we believe the normalized cash flow generation will be on the other side of the shutdown.

In summary, we have been very pleased with the quarterly results for our portfolio companies. The headline numbers are far exceeding expectations but require additional analysis to split out what's artificial and short term from what is likely to be the new normal and long-term. The remaining companies in our portfolio will be reporting in the next couple weeks, after which time we will be doing deep dives in each portfolio company to determine how much of the positive news we are seeing this quarter is sustainable.

Portfolio Update

Through March and April we were adding to positions in companies which we felt had the balance sheet and business model to survive a prolonged shutdown. With the share price of some of these companies returning to pre-COVID levels, we have trimmed the weights from 5-6% of the Fund back to a core weight of 3-4%. The proceeds were then used to either increase weightings in existing names that have lagged or to invest in new additions. Three existing names we were increasing last month were Information Services Corp. (ISV), IBI Group Inc. (IBG) and GDI Integrated Facility Services Inc. (GDI).

We added Major Drilling Group International Inc (“MDI”) to the portfolio which services mining companies and is one of the largest drilling companies in the world. With gold prices currently at all time highs and a number of mining companies raising capital during this strength in gold, demand for drilling services is set to increase. MDI is currently operating at around 40% utilization; we expect the company to benefit from both increased utilization and prices for their service.

We were also fortunate to participate in the Dye & Durham Ltd (DND) IPO last month. The company provides registry data services to law firms. It has a recurring, transactional based business model producing very high margins and strong free cash flow. The company attempted to go public twice in the past couple years. Each attempt seemed to broaden the audience and demand for their stock so that when they finally went public in July, the demand far outreached the supply of stock available.

We have been surprised by the strength in small caps stocks over the past couple months and impressed by our portfolio of companies’ ability to navigate this period. In many cases, they are emerging in what we believe to be better shape than when they entered it.

The last of our portfolio companies will be reporting over the next couple of weeks. We plan on discussing some of the more value enhancing activities and outcomes for our investee companies that have emerged from COVID and the related shutdowns in next month’s update. In the meantime, thank you for your continued support and stay healthy.

Current Price: \$11.14¹

Don Walker, CFA
August 18, 2020



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¹ Class F, August 14, 2020.