PENDER
SMALL / MID CAP DIVIDEND FUND

THE MANAGER'S COMMENTARY – SEPTEMBER 2020

After several consecutive months of equity markets moving steadily higher, September saw a return to volatility. As the COVID case count started to rise again, there were fears of a second wave and containing its spread and the likelihood of some sort of government intervention which will again have an impact on the economy.

With this in mind, we thought we would discuss the stability of the dividends in the portfolio and review how our companies managed their dividends through the first wave in the spring. We also added a new company to the Fund in the month, which we will discuss later in the commentary.

Dividend Sustainability

Given the Fund pays an external yield to shareholders, dividends play a key role in what we are looking to invest in. They are not the only characteristic, but a key characteristic all the same. The Fund was designed to provide a combination of yield and growth. We can and do own some non-dividend paying companies but the majority of what we own are dividend payers.

The first wave of COVID in the spring caused every company to review their dividend policy and even suspend it until they had gained better clarity of the impact to their business. As things stabilized, we had five companies lower their dividend with the current range of reductions being between 15-50%. The primary reason for the reductions was the economic fall-out from the government imposed shut-downs and the uncertainty around the recovery, but there were also some nuances worth highlighting.

For Mullen Group Ltd (MTL) and Evertz Technologies Ltd (ET), part of the reason for the cut was to eliminate any perception that the subsidies they received were in any part funding the dividend. Otherwise there is the risk of an audit and a potential requirement to repay the subsidy. Computer Modelling Group (CMG) cut their dividend by 50% due to weakness in oil and gas. Like Evertz, they decided to retain their difficult-to-replace employees and sacrifice the dividend instead. Comparatively, their larger competitor has laid off more than 50% of their workforce since the fall-out of oil and gas in 2015.

The other two companies that cut their dividends were Diversified Royalty Corp (DIV) and Alaris Equity Partners (AD.UN). Both companies had the highest payout ratio in the Fund, meaning more of their cash flow was required to fund the dividend. Alaris acted fast to cut their dividend although the impact of COVID to their business has been less severe than initially anticipated. Today their payout ratio sits below 70%, well below the near 100% payout ratio they had coming into the pandemic. This is a more sustainable payout ratio, giving them flexibility against any further economic fall-out.

The Fund today has a combined payout ratio of dividend paying companies below 50%. This means that cash flow would have to fall in half before it no longer covers the dividend. This acts as a nice cushion against the risks posed by a second wave and another government intervention to slow the spread, with the caveat being the severity and longevity of the pandemic. But at this point we are not expecting any further meaningful dividend reductions from companies in our portfolio.

Despite the current second wave, conversations with management have shifted from defensive to offensive. Having survived the initial wave in the spring, they are looking to grow instead of protect their business. The low payout ratio of the portfolio today helps to protect against this second wave, as well as giving these companies excess cash flow to invest and grow.

Waterloo Brewing
We added a position to Waterloo Brewing Ltd. (WBR) to the Fund in September. The company is a producer of alcoholic beverages in Ontario and manufactures for its own brands and also has co-packaging agreements with companies such as Carlsberg, Hiram Walker and Loblaws Liquor Stores. They are currently benefitting from the drink-from-home trend but it is their growth potential over the next couple of years that is what really attracts us. They are in the midst of a large expansion, increasing their production capacity by more than 50%.

The company is a good example of the yield and growth balance we look for. Their current dividend policy is to payout 25% of the EBITDA through dividends. As they fill this new capacity of the coming years, we believe we could see both higher earnings and an increasing dividend as a result.

Closing remarks
We believe the volatility we saw in September is likely here for the time being. In conjunction with the rising COVID case count, investors will be dealing with the looming US Presidential election and the start of third quarter earnings. There will be a lot to digest over the next couple months. We have our heads down, looking to navigate through this second wave. But more importantly, we hope you stay healthy and virus free. We thank you for your continued support.

Don Walker, CFA
October 26, 2020

PENDER
PenderFund Capital Management Ltd.