PENDER

SMALL / MID CAP DIVIDEND FUND

THE MANAGER'S COMMENTARY – OCTOBER 2020

October was a shaky month. The risks seemed to outnumber the potential rewards and the broader markets ended on a down note. All eyes were on a looming presidential election and a rising COVID case count. Investors were understandably jittery.

We also saw a couple of false starts during the month in the rotation from the COVID "winners" into the COVID "losers". Businesses benefitting from the pandemic and the stay-at-home mandate have become a hedge against the ability to discover a vaccine. The two sides pitted against each other and a rotation predicated on finding a vaccine. The "haves" against the "have nots".

The "haves" hover near 52-week highs, while the "have nots" remain below where they started the year. For the "haves" to keep moving higher, they need an ever-rising COVID case count, keeping people in their homes. The "have nots" need a vaccine before the government subsidies run out.

Most of the companies in our portfolio do not fit neatly into either group, rather somewhere in the middle. There has been some impact caused by COVID to their earnings, both positively and negatively, but it is more at the margin than wholesale changes to their business.

K-Bro Linen has been the most negatively impacted. They provide laundry services to hotels and hospitals and their hotel business has obviously been hurt through this and would surely benefit from a vaccine with a return to normal occupancy. But we believe the company will survive even without one.

The Beauty of Watching a Company Hitting its Full Stride

PFB Corporation (PFB) has seen little impact from the pandemic. But if you were to look at the stock charts you would think they were in the "winners" camp. Their stock is up over 40% so far this year, reaching all-time highs.

PFB manufactures structural insulation products used for residential, commercial and geotechnical applications. The main input for their product is styrene, which is an oil derivative used to make resin-based products. Historically, one of the biggest uses for styrene was to manufacture single use consumer products such as white Styrofoam coffee cups which have been banned in many countries recently. So, a sizable portion of styrene consumption has disappeared permanently which implies these lower costs for PFB should be sustained.

Another area where they are seeing margin improvements is simply operating efficiencies. In April when the pandemic hit, forcing most employees to work from home, they looked internally at how they could operate more efficiently. They were able to shed a couple of percent off of their cost structure.

Third quarter operating earnings were a record for the company, up over 100% compared to the same quarter last year. The increase was not due to pulling forward revenue or stay-at-home trends that will reverse with a vaccine. Instead, the record earnings were generated through operating efficiencies and the lower input costs which should be sustained with or without a vaccine.

The move in the stock price this year coincides almost identically with the increase in earnings for the first three quarter of the year. The company started the year trading at four times their enterprise value to EBITDA and they are currently still trading at four times. Despite the very strong earnings and cash flow, there has been no multiple expansion like we have seen with many of the work-from-home winners and PFB continues to trade at what we believe is a discounted valuation.

Eventual Vaccine?

We do not own any stocks in our portfolio where the thesis is predicated on discovering a vaccine. We own no companies in our portfolio where we can say three years of revenue was pulled into three months. We do not own any companies where the development of a vaccine is required for corporate survival.

We think this is a pretty good place to be as we are not making a bet on how long the pandemic will last or the discovery of a vaccine. Of course, a vaccine would be helpful for a handful of companies in our portfolio, but it is not the primary reason we own them.

Instead, we own these companies because we like the business, the cash flow they are generating and management's ability to allocate the cash generated. Whether it is news of a rising case count or development of a vaccine, our view is that we do not need to make any major adjustments to our portfolio. We are comfortable with the companies we own, under either scenario.

Don Walker, CFA
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PenderFund Capital Management Ltd.