PENDER
SMALL CAP OPPORTUNITIES FUND

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Manager's Commentary

David Barr, CFA and Sharon Wang

Fund Performance

What a way to start the year! Our Fund had a very strong quarter, up 18.9%[1] compared to the S&P/TSX Composite Index that was up 6.6%, and small cap markets in Canada and the US that were up 7.9% and 7.5% as measured by the S&P/TSX Small Cap Index and the Russell 2000 Index (CAD) respectively. We were encouraged to see small caps continuing their rally from the fourth quarter last year, while noting a change in the performance drivers in the Fund so far this year. As well as participating in the broad rally in small caps, the excess returns we experienced this quarter were driven by company-specific performance.

We've highlighted our focus on company fundamentals and are encouraged that these underlying drivers are getting recognized. As an example, 55% of the companies held in the portfolio reported record high revenues when we look at the year-end results in the small cap portfolio. We believe this is a sign of things to come and that we are now in the early innings of the rebound in small cap technology companies from the major selloff we saw in 2021 and 2022. The spring is coiled tight.

M&A is here to stay

We've previously written about the historically slow M&A market we saw for the technology sector last year. It looks like they're back! Long time portfolio holding TrueContext Corp (TSXV:TCXT) (you may remember them as ProntoForms) entered into an agreement to be acquired by an entity owned by Battery Ventures for $1.07 per share. This represents almost a 39% premium to the $0.77 it was trading at the day before the deal was announced. Join me in congratulating the founder Alvaro Pombo for doing a great job for us unitholders!

With M&A, transactions don't usually die, but instead they are put on hold. With a stabilized interest rate environment, we expect both strategic and financial buyers to be highly active this year. Deals that were discussed but not completed and new transactions will be consummated as large cap and private equity backed companies look to revitalize their growth rates through the acquisition of very attractively priced small cap companies.

Headwinds turning to tailwinds

With an anticipated rebound in M&A, we are also watching some long-term headwinds to small cap performance that are bottoming or even showing signs of reversing. Capital flows have persistently moved out of Canadian public small caps over the last 10 years. As a proxy for investor interest in Canadian small caps, we looked at the Canadian mutual fund category assets which are down almost 50% in the last decade. These assets have flowed into other investments – like global categories, alternatives, private equity, to name a few. Ultimately though, it will be the fundamentals of a business that will matter in driving value creation and

[1] *All Pender performance data points are for Class F of the Fund. Other classes are available. Fees and performance may differ in those other classes.*

with small caps still trading at attractive valuations relative to their history and to large cap companies, we are encouraged that company fundamentals are coming back into focus.

Portfolio Activity

Since the downturn in small caps in mid 2021 we have actively rotated our portfolio into high quality growth companies in our investment universe. Our objective was to be well positioned entering the next small cap cycle and ride the underlying fundamental performance of these companies while having the tailwind of a multiple rerating. That rotation to position the portfolio was effectively complete last year, while this quarter was more about trading around the edges than any major adjustments to the portfolio.

During the quarter, we completed the exit in several small positions, companies we had been selling down over time. The only major change occurred when we exited our position in Aritzia Inc (TSX: ATZ) for a nice gain.

"The spring is coiled tight."

We did initiate a position in an emerging compounder, Kneat.com, Inc. (TSX: KSI). Kneat provides purpose-built software to the life sciences industry to digitize validation life cycle management and testing. Most of the top 20 global pharmaceutical companies use Kneat's SaaS platform for quality management. Kneat generates recurring revenue from a sticky customer base with a powerful 'land and expand' business model, evidenced by an impressive 138% net revenue retention in 2023, with a large and growing addressable market. We have been watching this company grow from $4 million revenue in 2019 to $34 million in 2023 (four-year CAGR of 72%) and believe Kneat is at an inflection point to achieve profitability in the near future. We believe the company can continue to deliver impressive revenue growth and is supported by a healthy balance sheet.

After sitting on the sidelines for most of last five years since cannabis was legalized in Canada, we initiated a position in the industry during the quarter. Our focus is south of the border, with an election year and new developments to legalize the industry providing several catalysts which we believe could unlock value in the US cannabis sector. Despite a growing number of states legalizing its use, cannabis is still federally illegal and considered among the most dangerous Schedule 1 drugs available. Companies that produce and distribute cannabis operate in a grey market and this uncertain status results in them listing on OTC or foreign stock exchanges, making it more challenging for these companies to access financing. This materially impacts their cost of capital and does not allow them to deduct normal expenses, penalizing them with a high tax burden. The tide may be turning with the US Department of Health and Human Services, many US regulators, politicians and the Vice President calling for the Drug Enforcement Agency to reclassify cannabis and ease restrictions. While the timing of federal legalization is difficult to predict and uncertain, the rescheduling and removal of some of the regulatory burden through legislation like the SAFE Banking Act could materialize this year. We see these as catalysts for the nascent industry and initiated a basket position in nine US cannabis companies.

We were actively trimming and adding to positions in the portfolio during the quarter. With the strong performance, some of our companies went beyond our target weight, so we trimmed those to redeploy into positions that we saw as better opportunities. We continue to find compelling businesses with attractive fundamentals and are encouraged to see that headwinds could be turning to tailwinds, creating an attractive set up for small caps.

David Barr, CFA and Sharon Wang
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