Manager's Commentary

David Barr, CFA

The Pender Value Fund had a strong start to the year, gaining 17.3%[1] in the first quarter of 2024. This result compares with gains of 6.6% in the S&P/TSX Composite Index and 7.9% in the S&P/TSX Small Cap Index. In the US, the Russell 2000 Index (CAD) returned 7.5%. The strength in overall equity market performance was a continuation from the fourth quarter of last year, with broad based risk appetite returning for investors. Monetary policy and the macro interest rate environment were cues for the rally, kicked off by signaling from the Fed that interest rates had peaked, and cuts were coming in 2024. Although expectations of interest rate cuts were pushed out and repriced by financial markets during the quarter, market consensus has shifted squarely to expectations of a soft landing, which has supported the positive momentum in equity markets.

While macro events and headlines have significant influence on investor sentiment, we of course remain focused on the underlying fundamentals of the companies in our portfolio that we believe can win in a range of macro scenarios. When looking at the underlying companies, we continue to see an attractive set up for small and mid-sized companies. We see the reversal of both short-term and long-term trends providing potentially powerful catalysts to these companies.

Stepping back, a long-term headwind has been the flow of capital away from Canadian small cap companies. In the Canadian small cap mutual fund categories – a proxy for investor interest – those assets are down over 50% in the last decade. These assets have flowed into other asset classes like private equity as an example, with PE dry powder sitting at $3.9 trillion[2] at the end of 2023.

Another long-term trend that we have previously discussed in this commentary is the attractive valuations in small caps on both an absolute and relative basis. This has not changed and remains a long-term tailwind for small caps as mean reversion in valuation levels bring these relationships back closer to historical averages. As an example, the small cap S&P 600 Index finished the quarter trading at ~16.2x forward earnings compared to the S&P 500 Index at ~21.8x. This is the largest discount for small caps compared to large caps since the early 2000's at around a 5.5x discount[3]. For most of the last couple of decades, small caps have traded at a premium!

There are also shorter-term trends that could provide future tailwinds to small caps. Technology company M&A activity slowed to multi-year lows in 2023. After a challenging year in 2022, tech companies focused internally on driving operational efficiencies and we could see their focus

[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.*
[2] *Source: Global Private Equity report 2024, Bain & Company.*
[3] *Source: Capital IQ.*

shift back to external M&A to drive growth in 2024. With buyer and seller expectations adjusting to the new valuation and interest rate environment, we will likely see an uptick in strategic M&A this year, albeit off low levels.

Portfolio updates

We have seen some signs of this already with one of our portfolio holdings, Truecontext Corp. (TSXV: TCXT), being acquired in the first quarter. The company, previously called ProntoForms, provides software to transform paper forms into mobile forms to enable the collection and analysis of field data. They have a predictable and high margin recurring revenue with an expanding enterprise customer base. On March 13, Truecontext announced it would be acquired by an entity controlled by Battery Ventures for $1.07 per share or $150 million, a ~40% premium to the previous closing price. The deal is supported by major shareholders representing 76.4% ownership and values the company at 4.5x 2023 revenue or 3.8x 2024 expected revenue. Our position in Truecontext was the largest contributor to overall portfolio performance in the quarter. We believe this is a positive signal of the M&A market opening up and further deals in the small and microcap technology sector.

Other key contributors to the portfolio in the quarter were Sangoma Technologies Corp. (TSX: STC) and Kraken Robotics Inc. (TSXV: PNG), with both stocks up nicely. Sangoma is a one stop shop provider of unified communications solutions. We see them as a high-quality business with a large portion of their revenues recurring – 81% as of most recent quarter. They have a new management team in place to accelerate revenue growth by implementing substantial operational and go-to-market strategies. We are encouraged to see early signs of success and believe that the business can continue to generate cashflows to support deleveraging and that we will see valuation re-rating over time.

Kraken Robotics Inc (TSXV: PNG) was another key contributor. This is a relatively new addition to the portfolio after we first initiated a position late last year. They are a marine technology company that offers subsea sensors, batteries, remotely operated vehicles and robotics services for defense and commercial applications. We believe Kraken has a strong product-market fit as one of the few mission-critical component suppliers in the marine defense technology market. We expect this market will see significant industry-wide demand over the coming years as NATO navies are increasingly adopting for autonomous defense technologies, given the productivity benefits and lower operating costs. The company provided an update in February such that they think they can achieve at least +30% Y/Y revenue growth in 2024, growing revenue off an expected +68% in 2023[4]. With adjusted EBITDA margins that could expand into the 20% range, we believe Kraken is on a path to sustaining positive FCF generation as the firm scales.

These are examples of where we continue to find attractive opportunities in small and mid-sized companies in North America where we see a disconnect between the intrinsic value and the underlying fundamentals of businesses. Our weight in Canadian equities stood at ~71% at the end of the quarter, with ~29% in US equities and a small ~3% allocation held outside North

[4] *Source: Kraken Robotics Inc and Capital IQ.*

America. Across these geographies, our small cap weight represented ~51% of the portfolio at the end of the quarter, with ~24% in mid-caps, ~21% in large caps and ~5% in micro caps.

This positioning is driven by our fundamental analysis and where we are finding the best opportunities. We believe the potential returns in small cap over the next three to five years remain attractive as the intrinsic value of the companies becomes apparent. This is an exciting time for small cap investors as the tide may finally be turning with headwinds of key trends we have been monitoring finally turning to tailwinds.

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