PENDER

SMALL CAP OPPORTUNITIES FUND

THE MANAGER'S COMMENTARY – DECEMBER 2022

Fellow unit holders,

The Pender Small Cap Opportunities Fund returned 9.7% in the fourth quarter, bringing returns in 2022 to -28.5%[1]. The Fund had a nice recovery in the fourth quarter, especially in the context of a challenging year overall for equity markets (and financial markets more broadly). These challenges have been particularly acute in small/micro-cap and technology companies – areas where we focus and that have added significant value over the long term in this strategy.

While the recovery is well received, we are being asked a lot whether we think this recovery is sustainable as we enter 2023. The short answer is that we don't know, but what we do know is that there are compelling opportunities with long runways to compound and an attractive setup for small caps going forward.

Valuation in small caps is appealing as we start 2023. The S&P 600 Index closed the year trading at 13.5x NTM earnings, which compares to 17.4x NTM P/E for the S&P 500 – nearly a four-turn discount. The S&P 600 actually traded at a premium to large caps for much of the last decade, which reversed in the last few years. While forward earnings expectations have been coming down — with that trend likely to continue in 2023 — valuations have undeniably had a healthy reset from >20x NTM P/E in early to mid-2021. Further impacting the drawdown in small caps in 2022 was aggressive tax loss selling at the end of the year. It was particularly noteworthy and among the worst years we have experienced, with widespread drawdowns and a lack of investor appetite for small caps. As the calendar rolled over to 2023 and with tax loss selling behind us, one of the headwinds has been removed and company fundamentals are back in the spotlight.

The multiple compression we saw in 2022 was a main contributor to the bear market performance, and while valuation alone is not an investment thesis, it is an important starting point to compounding returns over the long term. Looking at past bear markets, the recovery in small caps over the ensuing year has been impressive, in our view. Looking at the Russell 2000 as an example, since the early 1980's the returns following a bear market over the following year have averaged gains of 53.7%. Although every cycle plays out differently, the starting point following a correction and the valuations we are seeing in companies across our investment universe are attractive.

Encouragingly, we have also started to see strategic buyers take notice of the valuation discounts in high-quality companies, with M&A activity positively impacting the portfolio in the fourth quarter. Maxar Technologies Inc. (TSX: MAXR) is an example of recent M&A activity. The company was a top contributor to the portfolio in the quarter after private equity firm Advent International made a bid to acquire the company at a large premium. Maxar was a long-term holding in the portfolio and we had been adding to our position during 2022. The company provides earth intelligence and space infrastructure solutions around the world and is a leader in earth imagery and satellite solutions for commercial and government customers. We had built it up to a large weight in the portfolio as we believed the company operated rare assets that were critical to the US and Canadian governments and that it was approaching a free cash flow inflection point.

[1] Class F of the Fund. Other classes are available. Fees and performance may differ in those other classes.

Also contributing positively to the portfolio in the quarter were positions in Magnet Forensics Inc. (TSX: MAGT) and Spartan Delta Corp. (TSX: SDE). Magnet Forensics delivered strong quarterly results, generating 41% revenue growth, including 50% growth in annual recurring revenues. The company also raised its full-year revenue and EBITDA guidance. Magnet Forensics continues to invest in growth but can sustain that growth through internally generated cash flows, and maintains profitability.

Spartan Delta continues to perform well and with its recent quarterly results, reported that production and cash flows had exceeded expectations. In its earnings release, the company also announced a $0.50 special dividend, and with significant cash flow generation and low leverage, the company is positioned to return material capital to shareholders. The company also announced a formal process to evaluate strategic repositioning, potentially resulting in an outright sale of the business. Spartan Delta has been outperforming expectations and is expected to generate nearly $500 million in free cash flow – a 20% FCF yield. It will evaluate ways to maximize shareholder returns before going forward with a new capital return and operational plan and expects to make an announcement by the end of Q1 2023.

Holdings that also contributed positively to performance in the quarter include Copperleaf Technologies Inc. (TSX: CPLF) and Sylogist Ltd. (TSX: SYZ). Both companies were added to the portfolio in 2022 at attractive levels.

A new holding that we added in the quarter was the preferred shares of Glass House Brands Inc. (OTCMKTS: GLASF). The company is a vertically integrated cannabis operator with cultivation, retail and wholesale distribution that offers a portfolio of branded products. It is well positioned to be the largest and lowest cost cannabis cultivator in California, the largest cannabis market in the world. As the market matures, we believe that scale and low-cost operations will be key to developing a sustainable competitive advantage in the industry. Glass House Brands is also well-positioned to be a key beneficiary of federal decriminalization or legalization of the industry. We see this as additional potential upside optionality in our investment thesis, but it is not required for growth with the preferred shares alone offering an attractive yield, downside protection and upside optionality.

As 2023 gets underway, we are encouraged with the setup for small-cap companies. We are finding attractively valued opportunities to invest in businesses that continue to grow and compound value for shareholders at impressive rates. We see many potential catalysts on the horizon, including a possible improvement in macro sentiment, mean reversion back to historical ranges and renewed M&A activity, which began late in 2022. While timing is always difficult to predict, we are seeing multiple paths to close the discount between our estimate of fair value and intrinsic value in many of our portfolio holdings.

Thank you for your continued support.

David Barr, CFA and Sharon Wang
January 18, 2023

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PenderFund Capital Management Ltd.

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