

Manager's Commentary

David Barr, CFA

Fund Performance

The Pender Value Fund continued to perform well, returning 12.6% in the fourth quarter and bringing 2024 returns to 55.9%¹. The performance in the quarter outpaced the S&P/TSX Composite Index which gained 3.8%, as well as the S&P/TSX Small Cap Index which gained 0.7%. While broad small caps continued to trail large caps, the performance of the portfolio has outpaced both large and small companies. This is encouraging and demonstrates the waning investor appetite for small caps over the last few years which has left these smaller companies ripe for fundamental research and stock pickers like us. We expect security selection to drive performance in the portfolio and the past quarter and year were no exception.

We still see good value in the companies we own, although not at the extremely depressed levels of a year ago. The Trump administration is also likely to be supportive of small caps as a more pro-business White House should see reduced regulations, and M&A continue to re-accelerate. With this transition in US government, there is also the potential for a more inflationary environment. Fiscal spending is showing no sign of slowing and tariffs are likely to go higher, both of which are inflationary. As part of our ongoing process to review our holdings, we are analyzing the potential impact of tariffs. We see the portfolio impact as minimal given tariffs tend to be focused on hard goods vs. our portfolio which is tilted more heavily to software and services.

Portfolio Drivers in the Quarter

The top contributor to performance in the quarter was Kraken Robotics (TSXV: PNG), one of the top holdings in the Fund. Kraken is a marine technology company that offers subsea sensors, batteries, remotely operated vehicles and robotics services for defense and commercial applications. Their sonar and battery technology has been embedded in many leading autonomous underwater vehicle platforms. The company has benefited from strong product-market fit, as one of the few mission-critical componentry suppliers in the marine defense technology market, combined with favourable industry tailwinds. NATO navies are prioritizing the modernization of their fleets amidst heightening geopolitical tensions, where autonomous and robotic systems offer productivity benefits and significantly lower operating costs. We believe this is the early innings of secular demand picking up and Kraken participating in sizable navy contracts, like autonomous underwater vehicles.

These attractive tailwinds have translated into revenue growth that has compounded at ~60% per annum since 2018 and EBITDA margins that are now in the 20s and, we think, can expand further. This should lead to positive free cash flow generation which they have yet to demonstrate more consistently. Despite the stock moving significantly higher in 2024, we still believe the shares are attractive and continue to own the company as one of the largest holdings in the portfolio.

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.

Dye & Durham (TSX: DND) also positively contributed to performance during the quarter. This was a headline driven stock in 2024 that was under pressure from activist investor, Engine Capital. Engine successfully won their proxy fight resulting in a new Board of Directors and kicking off a search for a new CEO. We are highly encouraged by these results as DND has the potential to generate significant free cash flow and, with proper oversight from an independent board, we believe we will see capital allocation decisions that will be value accretive to shareholders. We continue to own DND in the portfolio and see it as a core holding.

Portfolio Activity

We added three companies to the portfolio during the quarter, one of which is Hexcel Corp (NYSE: HXL). Hexcel is a global aerospace composite manufacturer, deriving over 60% of their revenues from commercial aircraft programs and about 30% from aerospace and defence customers. They are a leading, sole source supplier in their key markets resulting in an attractive competitive positioning with high barriers to entry. The company is attractively valued relative to their growth and cash flow potential, in our view. They are in the process working through supply-chain challenges at their customers, which gives them visibility to ramping growth and rising capacity utilization at their manufacturing facilities. This growth is supported by a multi-year backlog. This bodes well for revenue growth, margin expansion and free cash flow generation, which combined should drive better returns for their overall business as capital investment needs are relatively low.

Positioning for 2025

The strong performance in our portfolio in the last year has been the result of our contrarian nature. As we look forward into 2025, we remain optimistic about the prospects for the companies in our portfolio, but less so in the overall markets. With high equity market concentration in large caps, narrow leadership and expensive valuations relative to history, we are expecting increased volatility as we go through 2025, albeit from a low base. As a result, we have been trimming well-performing stocks and rebalancing, effectively moving our large position sizes down to protect against volatility.

We continue to identify compounders with structural tailwinds in areas such as AI, Enterprise Software, Energy Transition and companies benefiting from the shifts in the geopolitical environment. While our shorter-term positioning reflects our cautious view, we are constructive over the mid- to longer term based on the quality and compounding potential of the underlying businesses in our portfolio. There are also macro catalysts that could support a re-rating in small caps over the medium term that include improvements in M&A activity, the IPO market, along with general sentiment attracting flows back into small caps.

With the many cross currents in the economy and geopolitical environment on display as we enter 2025, we continue to focus on our investment process and the bright futures of the businesses we own, which keeps us optimistic about the years ahead.

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