LionGuard Capital Management Inc.
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LIONGUARD CANADIAN SMALL CAP EQUITIES FUND

QUARTERLY REPORT – MARCH 2020

Since Inception Returns:

LionGuard Canadian Small Cap Equities Fund ("Small Cap Fund") gross returns, as of March 31, 2020, can be summarized as follows:

Time period	LionGuard Canadian Small Cap Equities Fund	S&P/TSX Small Cap Index	Value Added
YTD	-31.13%	-38.64%	7.51%
1 year	-21.82%	-37.06%	15.23%
2 year (annualized)	-10.94%	-22.36%	11.42%
3 year (annualized)	-6.83%	-18.07%	11.24%
4 year (annualized)	-1.04%	-8.67%	7.63%
Since Inception (annualized)	**-2.49%**	**-9.58%**	**7.09%**

Triple Crisis – Healthcare, Economic & Energy:

What started as a local virus issue in Wuhan, China, has very quickly evolved into a global pandemic of unprecedented proportions. In the interest of saving millions of people's lives and not overwhelming local healthcare systems, almost all governments elected to shut down their economies by enacting the now-famous "social distancing".

With the unprecedented collapse of the economic activity and little clarity as to the timing of the "shutdown", global stock markets endured some of the fastest and most violent corrections on record. For the quarter, S&P/TSX Composite Index recorded -21.59% and S&P500 Index -20.00%. As expected, smaller capitalization indices were hit hardest with S&P/TSX Small Cap Index at -38.64% and Russell 2000 Index at -30.89%.

Having learned from the still recent financial crisis, central banks and government officials responded by providing extraordinary levels of fiscal and monetary stimulus. Unlike during most recessions, however, this time there is no tangible moral hazard case against bailing out struggling companies and industries.

In addition to Covid-19 healthcare crisis and the economic crisis due to the purposeful shutdown of the economy, stocks were largely impacted by the dispute between Russia and Saudi Arabia on oil production cuts. Big increases in oil production levels at exactly the wrong time, given the global economic slowdown,

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led to a 66.5% drop in oil prices during Q1-2020 (from $61.06/bbl to $20.48/bbl). With no clear timeline on when the dispute may resolve, and oil stockpiles quickly filling up, numerous equities including those exposed to Western Canadian economy were severely punished.

Some of the typically highly defensive stocks saw their prices fall by more than 40% as their operations were not labeled "essential" during the shutdown period and/or as their business operations were severely impacted one way or another. With the duration of the crisis under question, numerous investors panicked and sold off said quality businesses to record low valuation levels as determined by the multiples on their "normalized" earnings power.

Numerous companies also sold off as investors were "upgrading" their portfolios at any cost by reducing smaller capitalization stocks and buying larger ones. With no marginal buyers stepping in to defend most stocks, we witnessed some of the most volatile daily trading sessions seen over the last 50+ years. This dynamic, as expected, was especially intensified for the smaller capitalization equities, which correct the most during broad-based market selloffs and subsequently (typically) recover the most.

In addition to fundamental investors' worries, market movements were exacerbated by the fact that so many investment decisions these days are made by machines. Also, with record amounts of capital, pre-crisis, flowing to passive investment vehicles, it is no wonder that the disconnect from fundamentals (on an individual securities' basis) during times of market stress is severely elevated.

ZOOMing In On Fundamentals:

We are of the view that this environment presents great opportunities for long-term investors who have solid fundamental research orientation. Rather than trying to predict the overall market direction (very rarely a good idea) or relying on quantitative decision-making tools (with often unreliable input variables under even more normal market conditions), this is the most obvious time to focus the efforts on fundamental research.

When analyzing businesses in such an uncertain environment, there are three main elements to focus on:

1. **Assessing Balance Sheet Strength**

Balance sheet strength is determined by the Company's level of net debt (or net cash), debt maturities schedule, debt covenants levels, number of banking syndicate members, the strength of banking syndicate members (their capital ratios, their credit rating, whether they are "too big to fail", etc.), location of cash in relation to debt facilities (within the same banking institution or otherwise), etc.

2. **Stress-Testing Free Cash Flow Generation Under Multiple Scenarios**

Given uncertain timing and depth of the crisis, multiple scenarios must be performed (using financial models) to evaluate free cash flow capabilities and their impact on the strength of the company's balance sheet. The only way to do so with a reasonable degree of accuracy is to have an excellent understanding of the company's operations including its ability (and senior management and Board of

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Director's willingness - which can be assessed based on past behavior, quarterly and annual commentaries, quarterly conference calls transcripts, etc.) to cut costs.

Note: Businesses with flexible cost structures typically fair well under such stress-test analysis, although this can also be quite misleading given government interventions, changing sensitivities at varying levels of the impact, all too common blunders by management teams and others. This analysis also becomes ever more complex for businesses with varying lines of business and operating jurisdictions.

3. Computing Upside Potential Under <u>Same Multiple Scenarios</u>

When computing the upside under each scenario, unlike most Wall Street pundits, we shy away from valuing businesses on a famed EV/EBITDA and P/E ratios and instead allocate practically all the weight towards DCF (discounted free cash flow) analysis.

Note: Some of the best managed and strongest companies do not generate positive free cash flow, as their managers choose to invest in growth CAPEX with high rates of return. Assessing management's ability to create shareholder value via growth CAPEX initiatives is one of the key jobs of fundamental research professionals. When faced with such cases, we do not shy away from investing in said businesses as they can be some of the best long-term investment opportunities (just think of Amazon). In those cases, we apply Modified DCF analysis, which segments run-rate cash flow generating ability of the business under Maintenance CAPEX scenario and the expected return from Growth CAPEX initiatives. Of course, different discount rates are applied to each, as may be warranted.

In our own scenarios, we probability-adjust such diverse cases as a "miracle drug" all the way to a very gradual opening of the economy coupled with a "second wave" of the virus plus the liquidity crisis and "run on the bank". We stay short of social unrest and even more sensational proclamations and it is warranted to point out that our analysis at this time indicates a low probability of this evolving into a financial crisis.

Multiple stress-test scenarios provide us with much-needed comfort to separate temporary mark-to-market fluctuations from cases when a capital position may be permanently impaired. When done properly, this kind of research can lead to materially improved risk-adjusted returns for the Fund as a whole.

In many respects, prudence is still warranted as we have yet to see the full impact of the economic shutdown and because we are quite unlikely to see the same level of economic activity as we did before the crisis in the near-term. It is also unclear whether European and North American economies can successfully "open up" without incurring a new spike in Covid-19 cases. It may not be appropriate to extrapolate from the Chinese experience, as the same levels of monitoring cannot be implemented in economies with stricter individual privacy laws.

At the same time, however, we believe that it makes great sense to acquire on the cheap pieces of businesses with solid balance sheets, which will continue generating positive free cash flow during the "shut-down" (or have a minimal adverse impact on the current balance sheet under severe scenarios) and which will come out stronger than their competitors in the end. Among those securities, we currently

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come across a healthy number of businesses with large long-term upside potentials under even severe and long-lasting adverse economic conditions.

Q1-2020 Investment Performance:

LionGuard Canadian Small Cap Equities Fund delivered on its mandate and significantly outperformed its benchmark, S&P/TSX Small Cap Index ("Benchmark") during the Q1-2020. During this period, Fund returned -31.13% as compared to Benchmark at -38.64%.

The sectors where the Fund performed best in comparison to the Benchmark were Energy with 340 bps of relative outperformance and Industrials with 270 bps of relative outperformance. Sectors where the Fund underperformed vs the Benchmark included Financials with -71 bps and Materials with -58 bps.

Our largest relative contributors in Q1 were Kinaxis Inc (KXS) and Morneau Shepell (MSI). At the same time, being overweight in Sangoma Technologies (STC) and not owning Real Matter (REAL), Ballard Power (BLPD) and Semafo Inc (SMF) cost us relative to the Benchmark. Please see our comments below on Sangoma.

Sangoma Technologies (STC) - Please refer to our prior quarterly reports for a detailed discussion of the company. Given the precipitous decline in the company's share price, we believe it is fair for investors to ask for our view on this investment.

In our opinion, recent stock price correction (due partially to the company-specific transitory issues and mostly to the broad-based market sell-off) has nothing to do with the "real" value of the business. As a result, we have been taking advantage of the much lower stock price to become notably larger shareholders of the company.

On the transitory issues front – The management team has communicated openly that growing the recurring revenue stream remains a key priority, and as a result, the company is ready to allocate a greater amount of resources to this segment.

With that understanding in mind, the weaker than expected revenue in Q2-2020 was as expected. At the same time, recurring revenue showed almost a 5% growth quarter over quarter. According to our estimates, the company's service revenue has been growing organically in the mid-teens range for quite some time. Given low UCaaS (unified communication as a service) penetration, we believe that this growth rate is sustainable.

We subjected Sangoma to the same stress tests as other companies (refer to the section on "ZOOMing on Fundamentals" for details) and confirmed that we are comfortable with its balance sheet, cash flow generation and the upside potential. Some of the conclusions of that analysis are the following:

- STC does have some debt, however, given its sizeable recurring revenue base and flexible cost structure we do not see this as a concern.

- About 50% of its revenue is recurring and generates a high margin. Services they provide are essential to ensuring the well-functioning of numerous enterprises. In many respects, the benefits of UCaaS are further highlighted by the current "work from home" environment.

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- Company's management team has an excellent track record of cutting costs. We, therefore, have full confidence in their ability to do so, if needed, of up-to $8-10M per year.

- We see strong upside potential from these levels (under all scenarios in question) either as a stand-alone entity or as a result of a takeout by private equity or a strategic buyer. In our opinion, Sangoma remains a key takeout target.

Corporate Updates:

Despite temporary yet dramatic healthcare and economic challenges, LionGuard remains committed to growing our dedicated team and expanding our operations. To that end, in March 2020, we hired Wei Lin as a Senior Associate, Operations. We welcome Wei to the team and wish him great success at LionGuard.

May you have any questions, please contact us at any time.

Yours sincerely,

Andrey Omelchak, CFA
President, CEO & Chief Investment Officer
(on behalf of LionGuard Capital team)