LionGuard Capital Management Inc.
1010 rue Sherbrooke Ouest, Suite 2350
Montréal (Québec) Canada, H3A 2R7
www.lionguardcapital.com

LIONGUARD CANADIAN SMALL CAP FUND
QUARTERLY REPORT – MARCH 2022

Since inception Returns:

During the quarter ended March 31, 2022, LionGuard Canadian Small Cap Fund ("Small Cap Fund") gross returns were at -4.62% comparing to the S&P/TSX Small Cap Total Return Index ("Benchmark") that ended the quarter with a return of 8.41%. Our 5-year annualized return compares favorably to the benchmark with a return of 10.98% for our Fund whereas Benchmark had a return of 7.15%. **Since inception the Fund delivered 11.49% annualized returns which also compares well with the Benchmark at 7.93%.**

Views on the market:

The current market environment presents both numerous challenges and great opportunities. Fundamental investors need to adjust their forecasts to account for higher interest rates (but how much higher?), supply chain disruptions (how long will those last & are we at the worst of it?), inflationary pressure on labour and raw materials fronts (unlikely to resolve any time soon), etc.

And if that was not enough, there are also heart-breaking geopolitical matters affecting the lives of millions of Ukrainians and the resulting sanctions on Russia that have dislocated global transportation routes and lead to supply/demand imbalances (in some cases to an extreme degree) for numerous critical inputs into the interconnected global ecosystem.

On a positive front, we are talking less and less about Covid (despite new lockdowns in China and elsewhere) as people are returning to working from offices (all the research pointing to this being crucial for mental health) albeit mainly on a hybrid schedule.

With so much confusion out there, more and more stock prices, especially for small and medium-capitalization companies, do not reflect their businesses' intrinsic values, which is, of course, great news for investors who can spot said large dislocations.

In our own investment operations, we make sure to stress test the discount rates to account for higher interest rates. We also analyse in detail the companies we invest in to determine the extent of their pricing power. We remain of the view that investing in high-quality free cash flow generating businesses with excellent pricing power is one of the best ways to circumvent the hurtful effects of inflation. Refer below to our discussion on **Softchoice (SFTC CN)** – one of our top ideas – to see how they gain from labour cost inflation for IT professionals.

Q1-2022 Investment Performance:

LionGuard Canadian Small Cap Fund ("Fund") underperformed the S&P/TSX Small Cap Total Return Index ("Benchmark") during the first quarter of 2022, returning -4.62% against the Benchmark's 8.41%.

The sectors where the Fund performed best in comparison to the Benchmark were Materials with 184 bps of relative outperformance and consumer staples with 48 bps of relative outperformance. Sectors where the Fund underperformed vs the Benchmark included Energy with -502 bps of relative underperformance and Industrials with -494 bps.

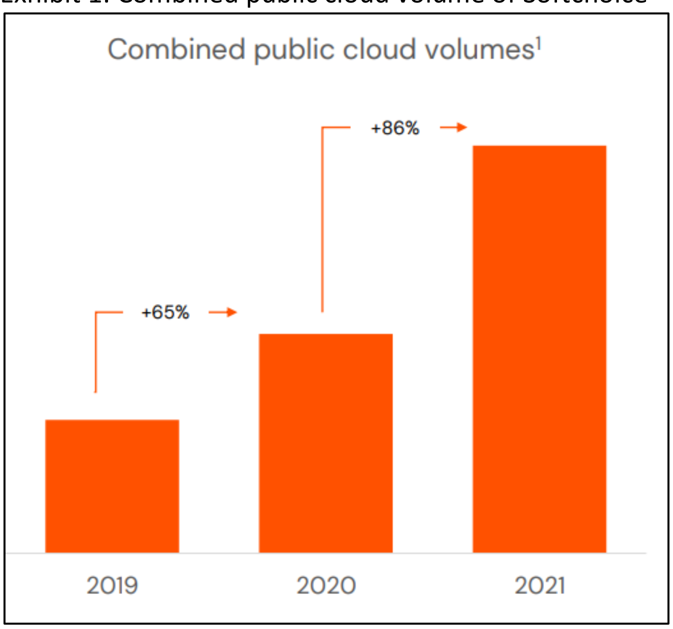
Our largest relative contributors came from being overweight in **Softchoice corp** (SFTC CN) and **Major Drilling Goup** (MDI CN)**.** At the same time, being overweight in **Dirtt Environmental Solutions** (DRT CN) and **Sangoma Technologies** (STC CN) has cost us relative to the Benchmark.

Softchoice Corporation (SFTC CN) – Softchoice is a leading software-focused information technology solutions provider that helps clients through their digital transformation journey. Its main practice areas are 1) Hybrid multi-cloud integration & optimization, 2) Digital collaboration, and 3) Software/IT asset management. The company generates most of its profit from its high margin Software & Cloud segment (60%), with the balance in Services (9%) and Hardware (31%).

We believe the company presents an extremely compelling investment opportunity for the following reasons:

- **Secular demand drivers –** Digital transformation remains a key priority for companies of all sizes as the COVID-19 pandemic has drastically changed the way companies operate around the world. To ensure business continuity and capture the benefits from what modern cloud technology has to offer, IT spending on cloud adoption is bound to continue its growth trend for years to come. According to our internal research, only 15% of all enterprise workloads are currently deployed on the cloud in 2021, therefore, there is plenty of growth left in the cloud migration trend. SFTC has seen explosive cloud usage from its existing client base, its public cloud volume grew 86% from 2020 to 2021, above the industry growth rate of 30-50%.

Exhibit 1: Combined public cloud volume of Softchoice



Source: Investor Presentation

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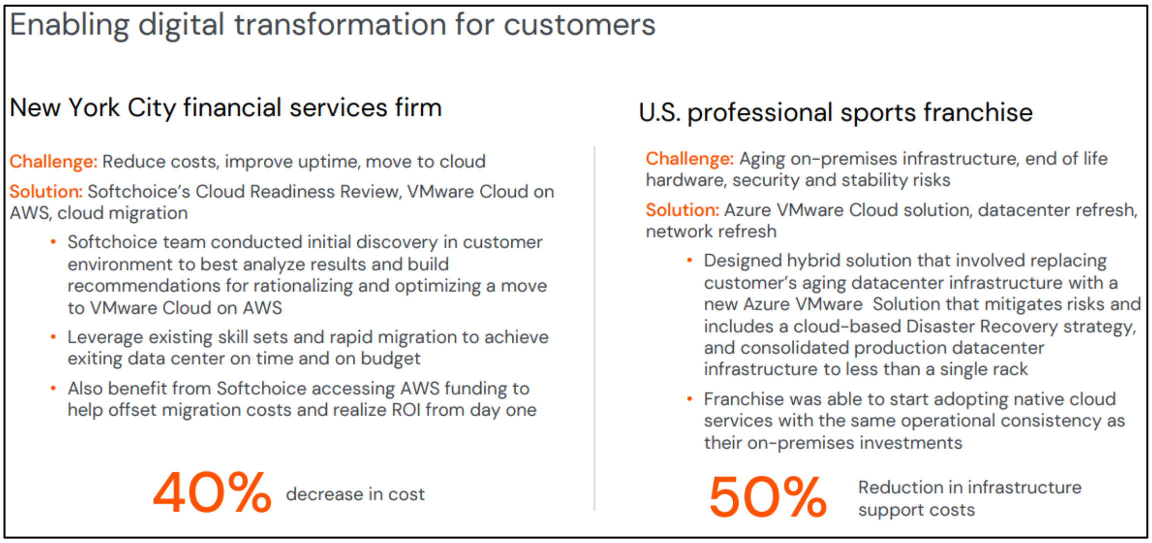
- **Inflation is a tailwind –** A key offering of SFTC is to help clients optimize their IT spending. With rising costs across the board, optimizing IT cost structure is becoming imperative. Recent engagements with 2 of STFC's clients have led to cost reductions of 40% and 50%. Given that skilled IT professionals remain in short supply, the value proposition of outsourcing IT functions to companies like SFTC has never been stronger.

Exhibit 2: SFTC customer case study



Source: Investor Presentation

- **Strong recurring revenue provides stable earnings and is a solid foundation for growth –** With over 70% of gross profit coming from sticky revenue streams, net revenue retention of 113%, and rising gross profit per customer, SFTC has demonstrated solid execution and increasing penetration within its customer base. It is not surprising, given SFTC's strong reputation, that the company recently won the prestigious 2022 VMware Partner of the Year award. This accolade highlights the outstanding competitive positioning of SFTC.

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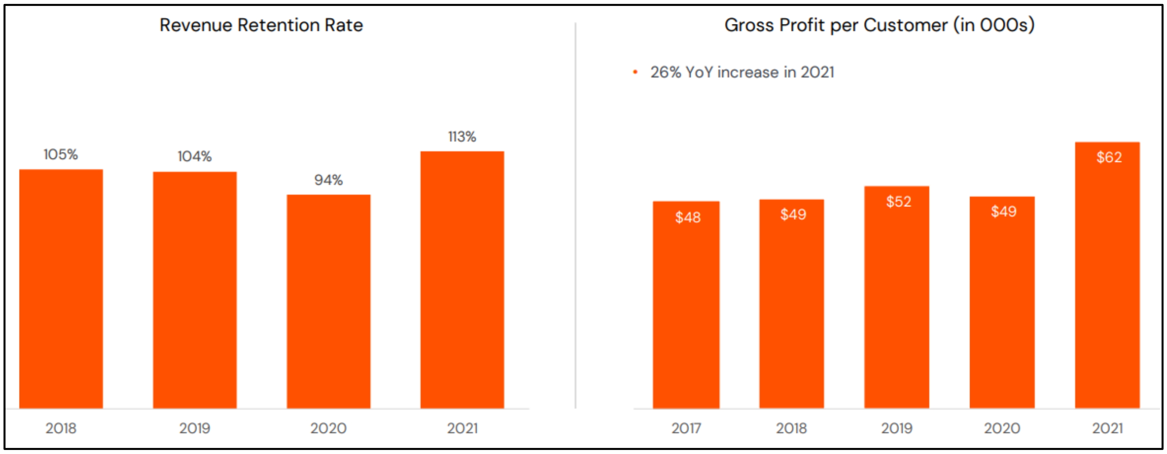
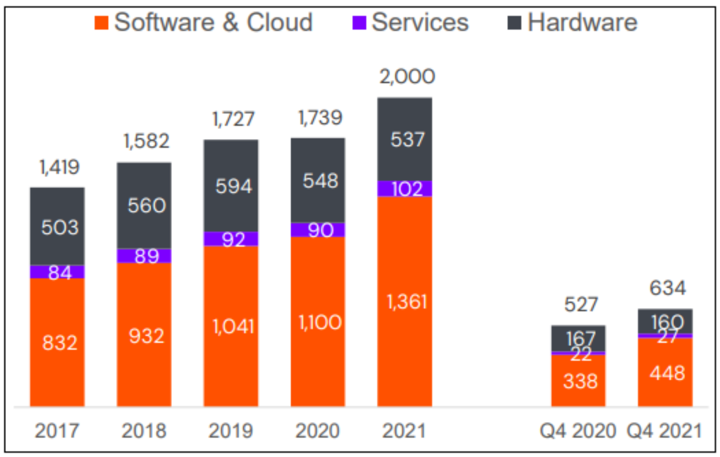
Exhibit 3: Financial Performance



Source: Investor Presentation

Exhibit 4: Revenue mix progression



Source: Investor Presentation

- **EBITDA margin expansion –** Given the inherent operating leverage of the business and the management team's strong execution, the EBTIDA margin increased from 20% in 2017 to 24% in 2022. Also, with the latest Q4/21 earnings release, <u>the company raised the FY2022 guidance from $300M of gross profit to at least $320M, and EBITDA margin (as a percentage of gorss profit) to 30% (from 24% in 2021)</u>. We believe the margin expansion story does not end here. We are confident that margins will continue to expand (BY A LOT!) on the back of high operating leverage, strategic initiatives aimed at improving efficiency, and the harvesting of recent investments and economies of scale. The best-in-class companies in this industry have an EBITDA margin of 40%. Based on our research, we believe there is no structural difference between the best-in-class peers and SFTC , and thus, there is a path for SFTC to reach an EBITDA margin that is in the high 30s. Assuming the company can achieve best-in-class margins, <u>SFTC can deliver an EPS CAGR of 20-25% over the next 5 years.</u>

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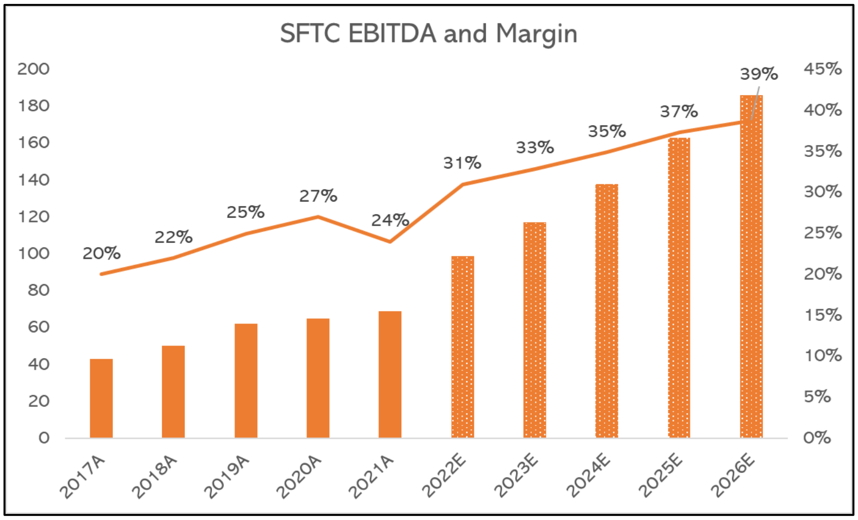
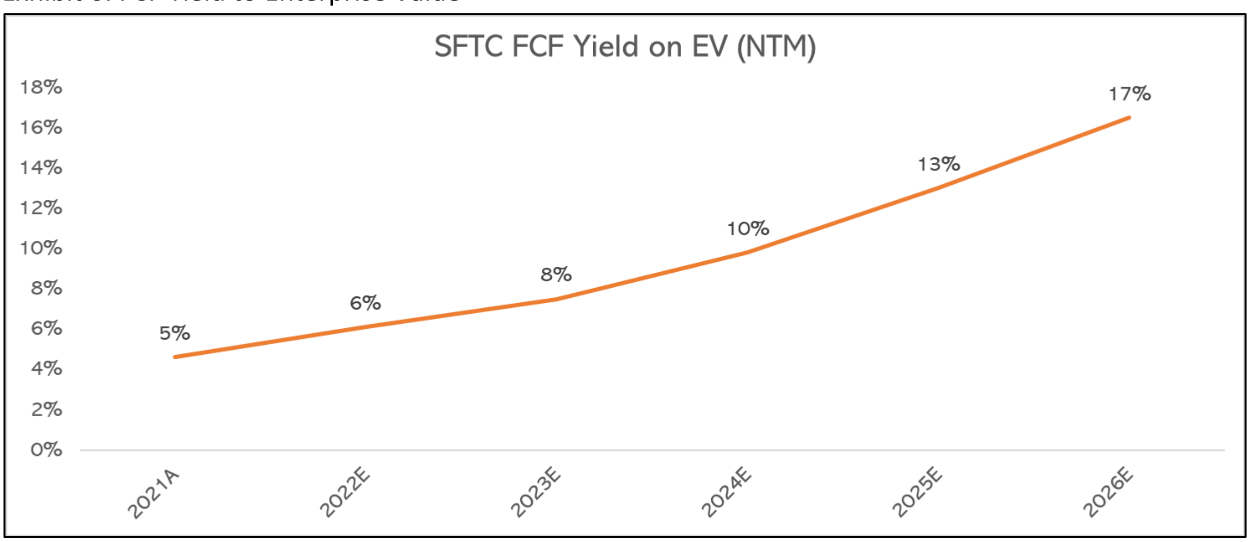
Exhibit 5: Margin progression including internal estimates



Source: Company Filings, LionGuard Capital Management

- **Cash flow machine** – Given its asset-light business model and high ROIC (~30% range), SFTC generates a large amount of cash per year. Although the company still has a small amount of debt on its balance sheet, we expect it to be debt-free by the end of the current fiscal year and thereafter will be in a good position to return the capital to shareholders in a more material way (substantial issuer bid and special dividends are both on the table). The company recently announced a 5% NCIB, which reflects the management and board's optimism on the business prospects for years to come.

Exhibit 6: FCF Yield to Enterprise Value



Source: Company Filings, LionGuard Capital Management

- **Excellent management team with good alignment of interest –** Insiders own around 50% of the shares outstanding, which ensures strong alignment of interest with minority shareholders. The senior leadership team has demonstrated a high level of expertise in both operational business matters as well as when it comes capital allocation decisions.

In summary, we believe Softchoice will continue its high organic growth trajectory given very favorable industry dynamics and the business' competitive positioning (exposed to the fastest growing verticals). It is a high and growing free cash flow operation with a clear path towards margin expansion. Most of the business is stable and reoccurring with no real risk of disruption. The management team is of top quality, is shareholder friendly, and is committed to returning excess capital back to shareholders, all of which bodes well for shareholder value-creation. <u>We are of the view that Softchoice is one of the best undiscovered and under-owned compounders in Canada! Our base-case DCF points to an upside of more than 150% from the current levels.</u>

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)