LionGuard Capital Management Inc.
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LIONGUARD U.S. SMALL CAP FUND
QUARTERLY REPORT - MARCH 2022

Dear Investors,

LionGuard U.S. Small Cap Fund underperformed its benchmark, the Russell 2000 Total Return Index ("Benchmark") during the first quarter, with a return of -10.01% as compared to a -7.53% return for the Benchmark.

The sectors where the Fund performed best in comparison to the Benchmark were Communications with 139 bps of relative outperformance and Healthcare with 83 bps of relative outperformance. Sectors where the Fund underperformed vs the Benchmark included Technology with -162 bps of relative underperformance and Industrials with -135 bps.

Market Commentary:

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.

Q1-2022 Contributors:

Our largest drivers of our outperformance came from positions in **Houghton Mifflin Harcourt (HMHC)** and **Currency Exchange (CURN)**. At the same time being long **Purple Innovation (PRPL)** detracted from our performance relative to the Index.

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We take this opportunity to discuss **Houghton Mifflin Harcourt (HMHC)** as well as **Franklin Covey (FC)**, one of our largest holdings**.**

Houghton Mifflin Harcourt (HMHC US) – is our largest contributor for the quarter. What has been historically perceived as a cyclical lumpy business (prior to the recent GROSSLY undervalued take-over announcement by Veritas Capital for $21/share or just 7.5x 2024 unlevered free cash flow), is in fact a business in the mid stages of an ambitious yet successful transition to a Digital-first, more reoccurring, higher margin model. Despite HMHC being our top contributor for the quarter, we are disappointed to see this company being sold for an unreasonably low value.

Through a number of highly effective restructuring initiatives including divestiture of a non-core segment for ~13x EBITDA, rapid acceleration of Digital billings (~45% of billings), and cost and real estate footprint optimization, this leading global education provider with a presence in ~90% of school districts and 10% market share in a $10Bn TAM (30% market share in Core Curriculum and 10% share in Extensions), has transformed itself from a cash breakeven business to a cash cow expected to generate over $300M in unlevered free cash flow (UFCF) by 2024 given the company's significant operating leverage with EBITDA to FCF conversion of ~65%.

With all KPIs trending in the right direction, the restructuring paying off with substantial FCF being generated, an industry in its trough stage of the cycle, and a balance sheet with a net cash position, why would anyone tender their shares to Veritas at $21/share or 7.5x 2024 UFCF valuation when all precedents (including the recent McGraw Hill 11x EBITDA multiple) point to at least $25/share?

When we took a position in HMHC, our base case intrinsic value pointed to a stand-alone upside of at least $27/share. This excluded any incremental improvement in the business / stronger than historical mid cycle billings. Our base case LBO generated ~$26/share valuation yielding ~18% IRR for a potential acquirer with just 10% FCF improvement. We often conduct an LBO analysis for companies with a high probability of a takeout, which serves as a cross-check to our stand-alone intrinsic value calculations (based on discounted free cash flow). Thus, the takeout offer at $21/share severely undervalues the company and its prospects.

Franklin Covey (FC US) – Please refer to previous letters for a detailed discussion of FC. Despite yet another phenomenal quarter and an increase in EBITDA guidance for the year (now expected to grow ~38% at the mid-point), the stock retraced ~8.0% on the day of reporting.

Having examined various factors and the trajectory of key KPIs, including ~30% growth in subscription revenue and subscription services, continued signs of operating leverage with EBITDA to grow 25%+ in the near-future, and long-term revenue growth in the 20s%, we attribute the weak share price reaction post the quarter primarily to short-term, immaterial, non-fundamental factors. We think market participants are just too focused on the Q3 EBITDA guidance of LSD growth Y/Y (lapping a very strong comp), cautious comments on Japan/China (<10% of revenue) due to COVID-19, and some increased OpEx investments. Despite those factors, <u>the company continues to guide for 30% - 40% revenue to EBITDA flow-through, leading us to believe that their H2 EBITDA guidance is conservative and expect FC to beat its guidance by double-digit % in the second half of the year.</u>

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Now that we covered our understanding as to why the stock reacted the way it did (clear case of market inefficiency as short-term oriented speculators do not understand true value-creating drivers of the business!), we move on to the fundamentals and what we believe should be the intrinsic value of this business.

First, subscription and subscription services revenue grew 31% in Q2 and 32% YTD driving overall revenue growth of 18% in Q2 and 22% YTD. On a two-year stack, subscription and subscription sales grew 38% while total revenue grew ~6.0%.

Second, gross margin improved from 75.8% LTM to 77.7%, and EBITDA margin expanded from 10.6% last year to 14.2% this quarter as the shift to subscription revenue accelerates, with management targeting >90% of revenue to come from subscription and subscription-related services in the next few years, with expected EBITDA margin to exceed 20% in the near-future (implies yet another year of double-digit growth in EBITDA F2023E).

Third, as Franklin Covey continues to ramp its sales force (expected to add 30 Client Partners this year which will be, according to the CEO, "kind of the new floor and then we build from there" Q2-2022 call; please note that assuming 0 client partners added this year, we expect revenue to grow ~13% from the increase in Client Partners from previous years), management has guided for long-term revenue growth of 20%. This excludes any price increases which we think is highly likely to happen in this inflationary environment with AAP having strong pricing power attributes.

We have established that management and the Board have done a spectacular job transitioning the business form a cyclical one to a highly recurring, high margin one. We own a subscription business growing double digits organically, with >90% revenue retention, consistently growing its AAP size (from mid $30K to $46K LTM with 57% attachment rate) and experiencing sizeable margin expansion implying at least 20% EBITDA growth for the foreseeable future. Yet, the company trades at 2.3x sales or <13.5x F2023E EBITDA for a proven content business with a rare combination of revenue and margin expansion at accelerated rates.

One must wonder, when will the street start to appreciate all of these attributes? The flywheel effect is clearly showing in their KPIs, and the company's overall fundamentals have started to mirror SaaS-like fundamentals. Eventually the stock will re-rate and move even if it is simply a function of getting 25%+ EBITDA growth Y/Y with a flat multiple which is HIGHLY UNLIKELY for a fast-growing recurring business.

Note that the company has a $45 million net cash position (7.5% of market capitalization or $3.20 net cash/share) and we conservatively expect the cash balance to grow to ~$14/share or $200 million (30% of market cap) by 2024! We highlight this given FC's history of buybacks and the CEO and CFO's commentary on the call to have a "more formalized and discussed plan" to return cash to shareholders while re-investing in the business organically and via M&A over time. With a strong balance sheet and commendable FCF generation (~9.4% FCF yield on 2023), we view FC as a very compelling take-out candidate.

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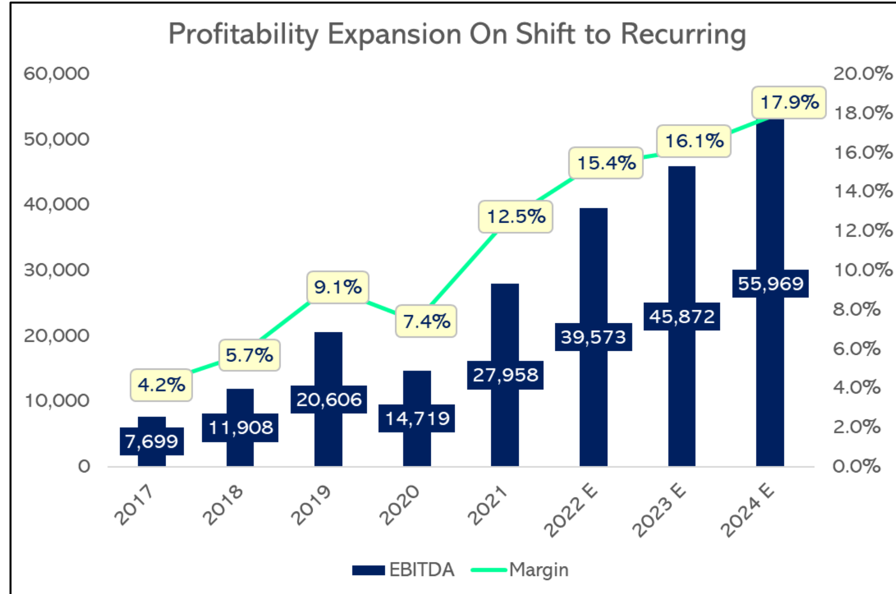
Exhibit 1: EBITDA margin expansion including internal estimates



Source: Company Filings, LionGuard Capital Management

<u>Franklin Covey remains one of our highest conviction investments with its intrinsic value pointing to an over 100% upside from current levels.</u>

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

Yours sincerely,

Andrey Omelchak, CFA
President, CEO & Chief Investment Officer
Co-Portfolio Manager, LionGuard US-SC Fund
(on behalf of LionGuard Capital team)

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