LIONGUARD
CAPITAL MANAGEMENT INC.

LionGuard Capital Management Inc.
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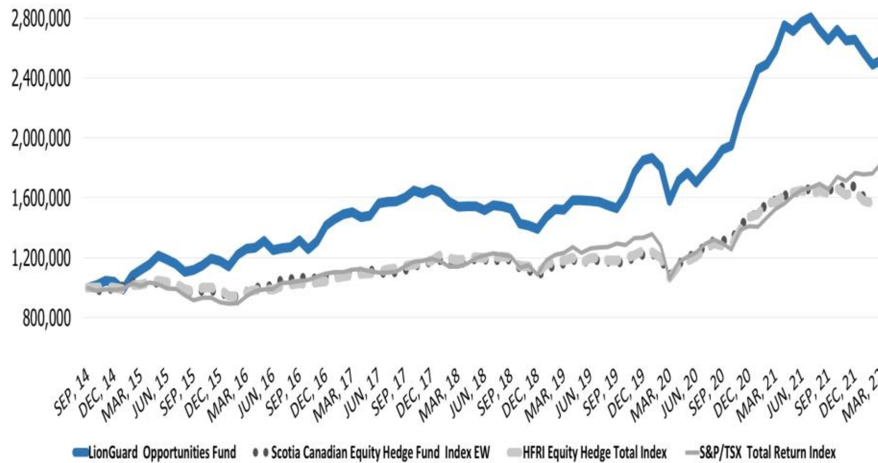
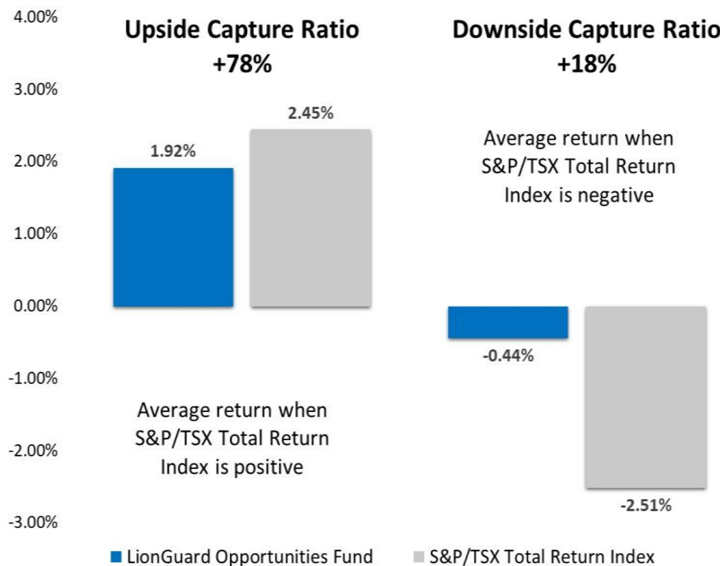
LIONGUARD OPPORTUNITIES FUND
QUARTERLY REPORT – MARCH 2022

Dear Investors,

During the quarter, LionGuard Opportunities Fund ("Opportunities Fund") had a net return (after all fees and expenses) of -5.17%. Since the Opportunities Fund's inception, its annualized net return amounts to 13.10%.



As compared to the broad market index (S&P/TSX Total Return Index), the Opportunities Fund's since inception upside capture amounted to 78% while its downside capture to only 18%.



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In addition to the industry-leading downside capture ratio, we outperformed the S&P/TSX Total Return Index by 4.70% per annum while maintaining an average net long exposure of 61% and holding an average of 9% of the Fund's assets in cash.

Also, the annualized net return of the Fund divided by its largest drawdown since inception amounts to 0.82. This ratio is frequently used by sophisticated allocators to gauge funds' return profiles relative to the amount of risk they take.

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. 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 Contributors:

During the quarter, some of our largest contributors included **Houghton Mifflin Harcourt (HMHC US)** and **Softchoice (SFTC CN)**. Please see discussions of both companies below. On the opposite side, our detractors of note included **Dirtt Environmental Solutions (DRT CN)** and **Sangoma Technologies (STC CN)**. We already discussed at length our views on DRT and STC businesses – for details refer to our prior quarterly reports. We take this opportunity to highlight once again one of our highest conviction ideas, **Franklin Covey (FC US)**, as the market irrationality when it comes to valuing this business is becoming increasingly disconnected from reality.

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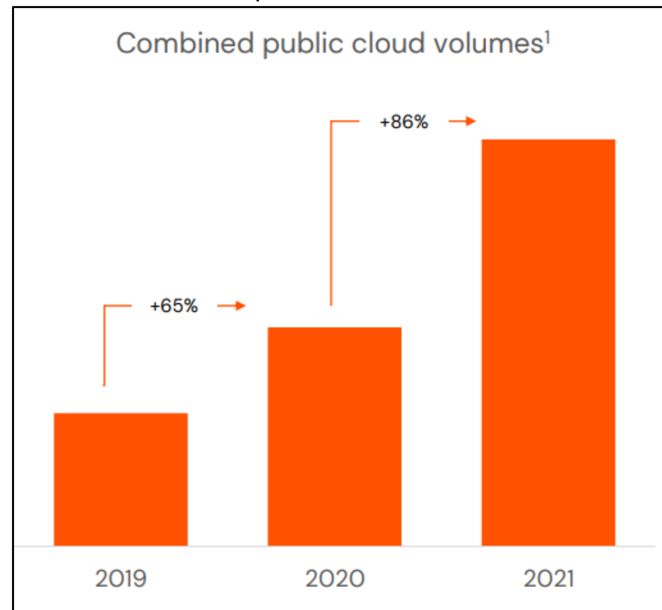
Softchoice Corporation (SFTC CN) – Softchoice is a leading software-focused information technology solutions provider that helps clients through their digital transformation journey. Its main practice areas are 1) Hybrid multi-cloud integration & optimization, 2) Digital collaboration, and 3) Software/IT 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. <u>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%.</u>

Exhibit 1: Combined public cloud volume of Softchoice



Source: Investor Presentation

- **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. <u>Recent engagements with 2 of STFC's clients have led to cost reductions of 40% and 50%.</u> Given that skilled IT professionals remain in short supply, the value proposition of outsourcing IT functions to companies like SFTC has never been stronger.

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Exhibit 2: SFTC customer case study

Enabling digital transformation for customers

New York City financial services firm

Challenge: Reduce costs, improve uptime, move to cloud

Solution: Softchoice's Cloud Readiness Review, VMware Cloud on AWS, cloud migration

- Softchoice team conducted initial discovery in customer environment to best analyze results and build recommendations for rationalizing and optimizing a move to VMware Cloud on AWS
- Leverage existing skill sets and rapid migration to achieve exiting data center on time and on budget
- Also benefit from Softchoice accessing AWS funding to help offset migration costs and realize ROI from day one

40% decrease in cost

U.S. professional sports franchise

Challenge: Aging on-premises infrastructure, end of life hardware, security and stability risks

Solution: Azure VMware Cloud solution, datacenter refresh, network refresh

- Designed hybrid solution that involved replacing customer's aging datacenter infrastructure with a new Azure VMware Solution that mitigates risks and includes a cloud-based Disaster Recovery strategy, and consolidated production datacenter infrastructure to less than a single rack
- Franchise was able to start adopting native cloud services with the same operational consistency as their on-premises investments

50% Reduction in infrastructure support costs

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.

Exhibit 3: Financial Performance

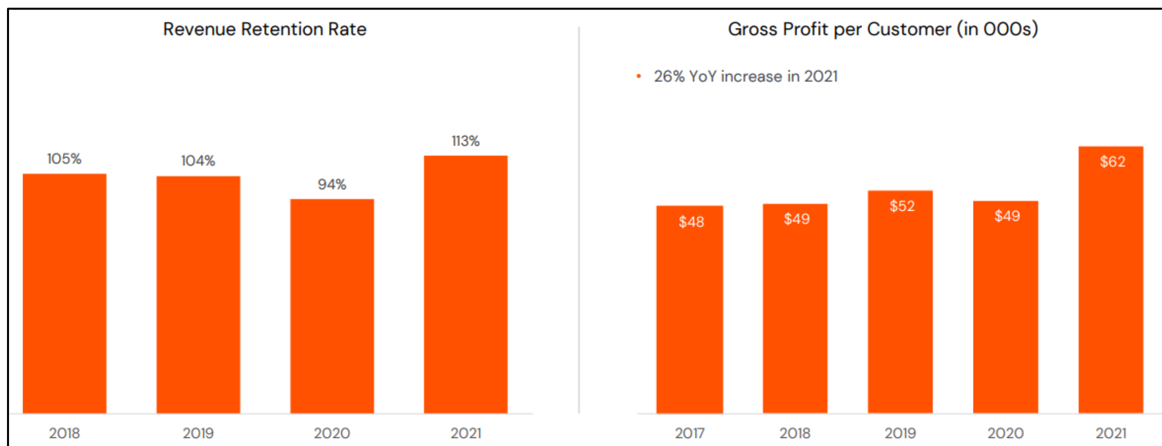

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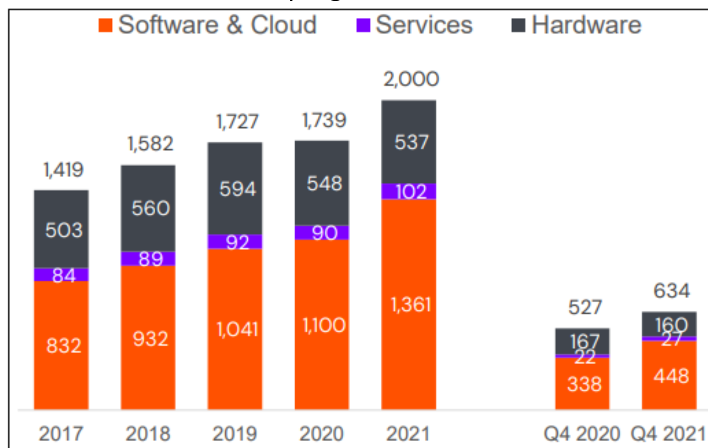
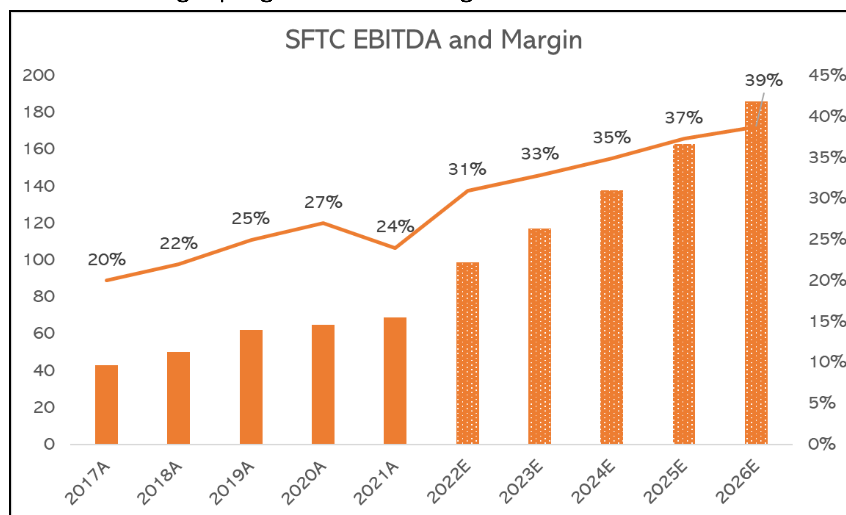
Exhibit 4: Revenue mix progression



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>

Exhibit 5: Margin progression including internal estimates



Source: Company Filings, LionGuard Capital Management

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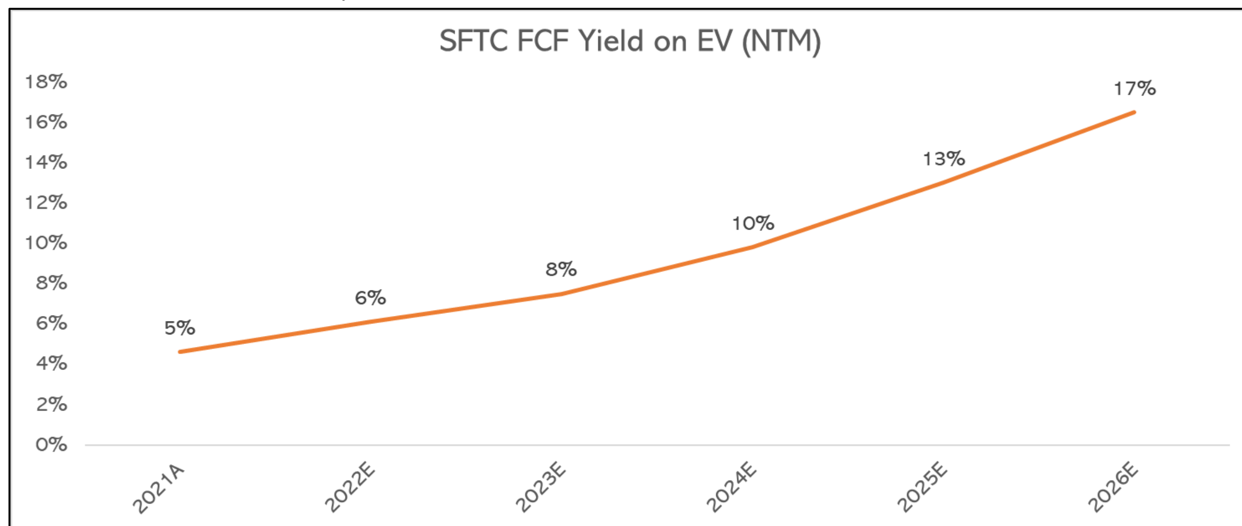
- **Cash flow machine** – Given its asset-light business model and high ROIC (~30% range), SFTC generates a large amount of cash per year. Although the company still has a small amount of debt on its balance sheet, we expect it to be debt-free by the end of the current fiscal year and thereafter will 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>

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,

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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>

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.

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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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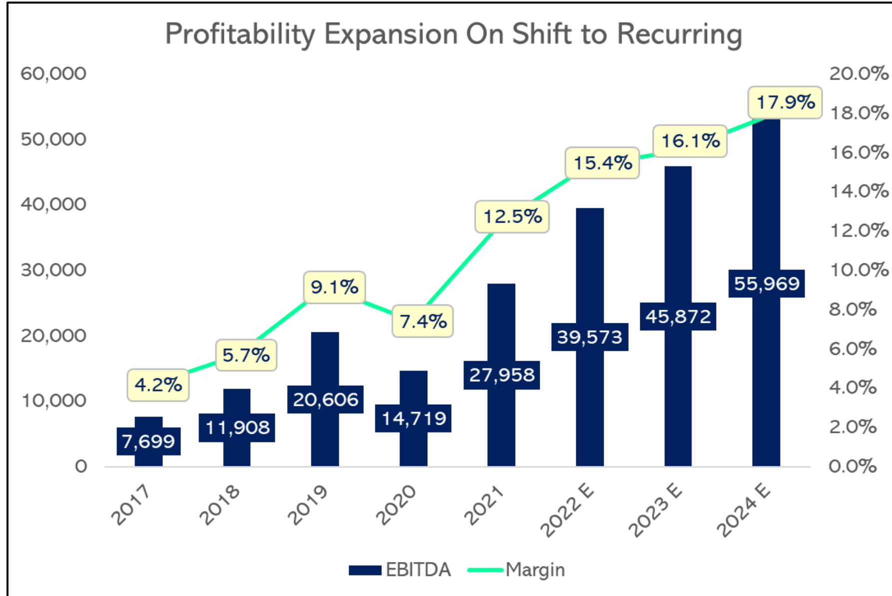
Exhibit 7: EBITDA margin expansion including internal estimates



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
(on behalf of LionGuard Capital team)

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