LionGuard Capital Management Inc.
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# LIONGUARD CANADIAN SMALL CAP FUND
# QUARTERLY REPORT – SEPTEMBER 2022

Since Inception Returns:

During the quarter ended September 30, 2022, LionGuard Canadian Small Cap Fund ("Small Cap Fund") returns amounted to -7.21% versus S&P/TSX Small Cap Total Return Index ("Benchmark") return of -2.48%. Our 5-year annualized return of 3.62% compares favorably to that of the Benchmark at 2.43%. **Since inception the Fund delivered 4.97% annualized returns versus that of the Benchmark at 2.93% for value added of 2.04% per annum.**

Federal Reserve Resolve:

The inflation problem is as real as it gets, and we cannot disagree with the Federal Reserve's resolve to address it head-on. However, it takes quite some time to see the effect of policy actions on the economy. Therefore, our best guess is that we will see a pause to further increases at the beginning of 2023. Federal Reserve committee members must also be cognizant of the elevated systemic risks caused by the abnormally high back-to-back interest rate increases. Having said so, we do not expect to see lower interest rates unless there is a). a confirmation of a lower core inflation trajectory and/or b). a temporary dysfunction of market operations.

BIG Re-Pricing:

While we do not have a crystal ball on where long-term interest rates will settle in the aftermath of the "Fed vs Inflation" battle, we are of the opinion that we are unlikely to see prior remarkably low interest rates for quite some time. At higher interest rates, there are now more alternatives to putting the capital to work in the stock market. To justify an investment in the stock market, there needs to be a sufficient market premium embedded in the expected long-term return. The only way to accomplish this is to have a lower market multiple. It is therefore perfectly logical that the overall market is under pressure as it re-sets its earnings multiple to be more competitive vis-à-vis fixed income alternatives.

In the environment of "BIG Re-Pricing", we caution investors against relying on past valuation multiples as means to value securities. Prior levels of P/E, EV/EBITDA, and other commonly used valuation multiples have nothing to do with the fair value of businesses under a different interest rate regime.

The best approach to properly value any business remains the discounted free cash flow (DCF) methodology. The good news is that DCF can easily incorporate the higher discount rate required of an investment when rates are higher. With the renewed focus on profitability, it looks like many of the prior high-flying technology companies are starting (and some we believe are already) being valued based on DCF.

The Hidden Cost of "Upgrading" & Impact on Smaller-Cap Equities:

With geopolitical tensions nowhere close to abating and abnormally high back-to-back interest rate increases causing re-pricing of assets and mounting risks of systemic shocks, it is not a surprise that equity investors are trying to desperately (and in a hurry) "upgrade" their portfolios. The hidden cost of "upgrading", however, is that it creates a false sense of security. It often leads investors to abandon the assets they know well in exchange for assets they are less familiar with.

This "flight to *supposed* quality" exacerbates movements across asset classes and even more so among individual securities. As a result, the disconnect between fundamental values and market quotations can reach historical proportions. Making said changes to managed funds is a safe short-term bet for many managers who are afraid of a career risk during periods of market turbulence.

As it relates to smaller capitalization equities, desperate "upgrading" of managed funds leads to no real marginal buyers and quite a few sellers of many smaller capitalization stocks. Overall, small-cap equities as a group currently trade at one of the cheapest valuation levels relative to larger-cap alternatives. Within that group, some high-quality businesses trade at levels that are greatly disconnected from fundamentals.

## Seizing Assets on The Cheap:

During the broad-based selloffs, like we are currently experiencing, with some companies' market quotations falling greatly below their fair values, those willing to "steal" companies on the cheap are certain to show up. Strategic buyers, management buy-outs, and private equity players can often "pull the trigger" at the right price. For private equity participants, even with higher prevailing interest rates, the math can still make sense depending on how cheap the asset has become.

Most boards of directors recognize the disconnect between market quotations and the true value of the businesses they oversee, yet often fail to take action to lower the probability of a take-out on the cheap. Best boards, however, are never asleep at the wheel and take proactive actions to take advantage of the environment. If the company is operating with an excessive cash level (or even an under-levered balance sheet relative to the quality of the business adjusted for the business environment), usage of cash must become a strategic priority. Typical alternatives include Dutch Auctions, Normal Course Issuer Bids, and acquisitions of other businesses on the cheap. Many of the businesses we invest in today are doing a fantastic job at using their excess cash to take advantage of this environment. Several of the companies we invested in have been acquired this year and some are in the process of a strategic review at this time (see below for details). Clearly, highly mispriced assets cannot stay cheap forever.

## Q3-2022 Investment Performance:

LionGuard Canadian Small Cap Fund ("Fund") underperformed the S&P/TSX Small Cap Total Return Index ("Benchmark") during the third quarter of 2022, returning -7.21% against the Benchmark's -2.48%.

The sectors where the Fund performed best in comparison to the Benchmark were Consumer Discretionary with 56 bps of relative outperformance and Communications with 21 bps of relative outperformance. Sectors where the Fund underperformed vs the Benchmark included Technology with -332 bps of relative underperformance and Health Care with -129 bps.

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Our largest relative contributors came from being overweight in **IBI Group (IBG CN)** and **TFI International (TFII CN).** At the same time, being overweight in **HLS Therapeutics (HLS CN)** and **Sangoma Technologies (STC CN)** has cost us relative to the Benchmark.

Q3-2022 Contributors:

During the quarter, one of our largest contributors was **IBI Group (IBG CN)** and **TFI International (TFII CN)**. On the opposite side, our detractors of note included **Sangoma Technologies (STC CN)** and **HLS Therapeutics (HLS CN).** Please see comments on these businesses below.

**Sangoma Technologies (STC CN)** now trades at a 21% free cash flow yield. Adjusted for the reclassification of a revenue line item, STC's guidance for fiscal 2023 calls for an organic revenue growth rate of 6%. This is after a record year for hardware sales, which benefitted from excellent supply chain management in 2022. With management expecting more normal level of sales for hardware, an overall 6% organic growth rate guidance bodes very well for the growth rate of recurring software operations. There is no fundamental rationale for the stock to trade at these levels other than short-term fund flow dynamics exacerbated by the current state of the overall market.

**HLS Therapeutics (HLS CN)** is a Canadian pharmaceutical company with an established drug in Clozaril that is highly cash generative, and a new drug in Vascepa that is a potential blockbuster. LionGuard normally stays away from pharma investments, however HLS is de-risked in that Vascepa is approved and has agreements in place that address 80% of the Canadian population. While HLS is small, they are utilizing Pfizer's sales representatives to reach a broader audience, something we think de-risks the story further. Despite the market growing impatient with the ramp of Vascepa sales (which is occurring), we see a doubling of the share price from these levels under our base case DCF. Further patience might be required given market conditions but with strong cash flows and results that are uncorrelated with the market we have the patience to wait.

Closing Comment:

We look forward to continuing to compound our investor's capital by taking advantage of structural inefficiencies available within small and medium-capitalization equities. Despite a higher than we would like to see mark-to-market impact so far this year, stock market volatility (and especially indiscriminate often forced selling activity for smaller-capitalization equities) provides us with opportunities to buy great businesses at highly attractive prices. Time and time again, this has proven to be a winning recipe to compound our investors' capital at higher rates of return and with a lower level of risk-taking than investing in the overall market.

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)