LIONGUARD
CAPITAL MANAGEMENT INC.

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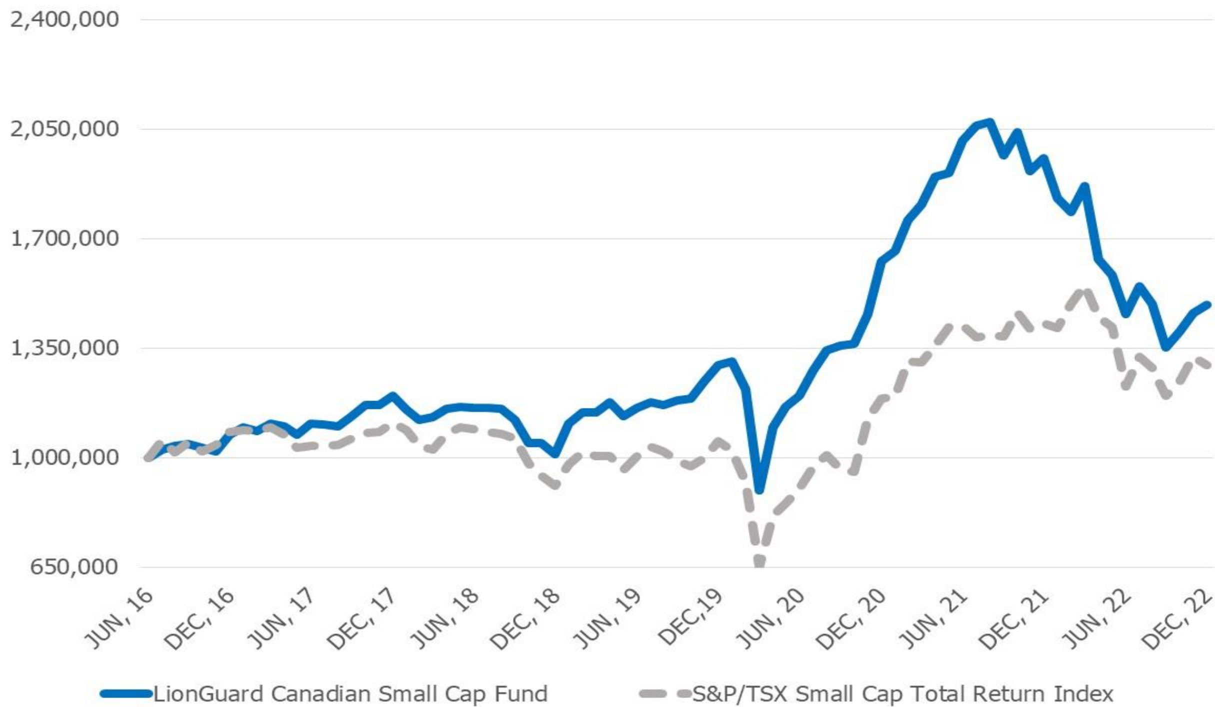
LIONGUARD CANADIAN SMALL CAP FUND
YEAR 2022 REPORT

Performance

LionGuard Canadian Small Cap Fund ("Fund") performance vs. S&P/TSX Small Cap Total Return Index



Commentary

Historic Market Environment

It was a very tough year for global equity markets. S&P 500 Index delivered a return of -19.4%, NASDAQ -33.1%, Dow Jones Industrial Average -8.8%, and Russell 2000 Index -21.6%. Canadian market indices fared much better, due to the massive outperformance of energy stocks (benefitting from the devastating war in Ukraine). To put the performance in perspective, it was the 7th worst year for the S&P 500 Index since 1929.

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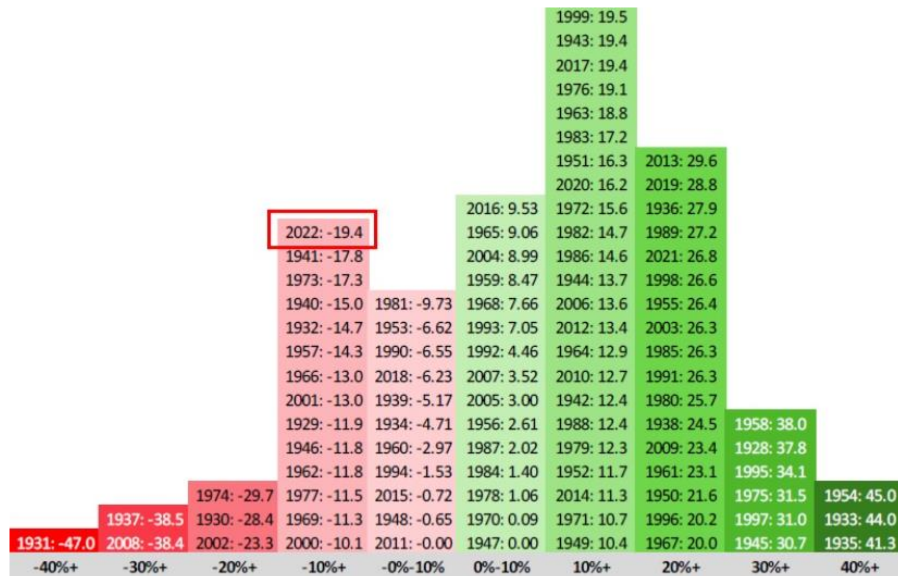

What is even more staggering is that fixed-income instruments did not fare well resulting in one of the worst performances in history for a 60/40 (60% stocks and 40% fixed income) portfolio.

Canadian Small Cap Fund Performance

During the quarter ended December 2022, LionGuard Canadian Small Cap Fund had a gross return of 10.06%. For 2022, Fund's gross return amounted to -23.96%. Since inception, its compound annual gross return amounts to 6.33% and cumulative gross return to 49.00%. This compares to 4.09% and 29.79%, respectively, for S&P/TSX Small Cap Total Return Index.

During 2022, the sectors where the Fund performed best in comparison to the Benchmark were Consumer Staples with 64 bps of relative outperformance and Materials with 326 bps of relative outperformance. Sectors where the Fund underperformed vs the Benchmark included Technology with -822 bps of relative underperformance and Energy with -646 bps.

Despite a higher than we would like to see mark-to-market impact last year, stock market volatility (and especially indiscriminate often forced selling activity for smaller-capitalization equities) provides us with unique 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.

Excessive Irrationality Leads to Takeouts

We strongly believe that excessive mark-to-market irrationality for high-quality businesses cannot persist for an extended period. One piece of evidence in support of this assessment is the high number of takeouts we experienced last year - several companies in our portfolio were bought out in 2022. This provides firm evidence that strategic buyers are stepping in to take advantage of highly attractive pricing levels currently offered by the market.

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Seizing Assets on The Cheap *(from Q3/22 write-up)*

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), the 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 of using their excess cash to take advantage of this environment. Several of the companies we invested in were acquired last year and some are in the process of a strategic review at this time. Clearly, mispriced high-quality assets cannot stay cheap forever.

Businesses You Own

As we examine our top holdings, we see a group of businesses with broadly the following characteristics:

- Business quality: very high insider ownership, excellent management teams, high organic growth rates, solid pricing power, high return on invested capital, ability to reinvest earnings at very high rates of return, large addressable markets, high levels of free cash flow conversion, flat to expanding margin profiles, high balance sheet flexibility, little requirements for capital expenditures, etc.

- Business valuation: high free cash flow yields to enterprise value, high upsides using conservative DCF assumptions.

We feel confident in knowing that we (and you!) own high-quality businesses managed by properly incentivized individuals. Such businesses are commonly referred to as compounders. We also feel privileged to be able to own them at highly attractive prices.

Closing Valuation Gap

Here is how we think about timing when the market quotation will likely close the gap (or at least most of it) with intrinsic value. First, there are two extremes:

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- Patient approach – Wait for the market to get it right. The rule of thumb here is a 3-year window. In a very high percentage of cases, assuming the valuation work is done correctly, the market quotation shall revert closer to intrinsic value. If within a 3-year window it did not materialize, it is very likely that an investment thesis needs to be re-examined.

- Almost immediate outcome – Business is getting actively "shopped around" and in the current market environment it should get the recognition it deserves. Thus, there is an immediate catalyst at play and there is no impediment in place why the transaction value should be materially different from the intrinsic value.

Of course, there is an infinite number of in-between possibilities. Some of the examples include new large shareholders stepping in as investors, an increase in the liquidity of security (a leading indicator of a multiple expansion), high short interest relative to the average daily trading volume (high odds of a short squeeze as shorts' thesis falls through), very sought-after assets by private capital participants (much higher odds of a takeout), the very savvy management team (watch out for Dutch Auctions, large NCIBs, non-core assets divestitures, highly accretive strategic acquisitions, etc.), and many more.

An ability to realize the upside sooner leads to much higher annualized returns. Therefore, catalysts that can close the gap sooner need to be accounted for when it comes to position sizing within the Fund. Any such catalysts however can never come at the expense of the quality of the investment and the degree of certainly offered by a patient approach over a 3-year investment horizon. Note that our focus businesses with top management teams, who have interests aligned with minority shareholders, naturally lead to various positive catalysts that are especially apparent during volatile market environments.

The Fallacy of Market Timing *(from Q2/22 write-up)*

A great majority of investors engage in the practice of market timing. Despite all the evidence to the contrary, they believe that they can predict when "the market will turn" or that "there will be better buying levels".

The fallacy of systematically overestimating their market timing abilities often precludes even the most astute professionals from selling overpriced securities when they are more than favored by the market and taking advantage of seemingly obvious investment opportunities during market corrections.

Rather than allocating the capital towards activity where they have high predictive ability (such as buying a quality business at a cheap price), investors are usually betting on something where they have very little odds of getting it right (market timing). Over the longer term, the practice of market timing ends up being a very costly exercise.

Contributors

For the year, our largest relative contributors came from being overweight in **IBI Group (IBG CN)** and **Boyd Group Services (BYD CN).** At the same time, being overweight in **Sangoma Technologies (STC CN)** has cost us relative to the Benchmark. We also take this opportunity to highlight several additional take-outs, namely **Home Capital Group (HCG CN)** and **Points International (PTS CN),** that took place during 2022.

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- **IBI Group (IBG CN)** - Received an offer to be acquired by Arcadis for $19.50/share, or 30% premium to the pre-announcement closing price. We believed the offered price was too low and would have preferred for the company to remain public entity.

- **Boyd Group Services (BYD CN) –** Led by a strong management team, the industry continues its recovery path. Both labor and inflation-related cost increases continue to improve, which should position the company to deliver great financial results over the near and medium term. BYD CN remains to be a great compounder in our view.

- **Home Capital Group (HCG CN)** – Received an offer to be acquired by Smith Financial Corporation for $44.00/share, or 63% to the pre-announced closing price. We are not surprised by the announcement given how disconnected the market was relative to the company's long-term fundamentals, and with this acquisition, it further highlights how mispriced Equitable Group (EQB CN) is relative to its underlying fundamentals.

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➢ **Points International (PTS CN) –** Received an offer to be acquired by Plusgrade for $32.21/share, or 43% to the pre-announced closing price. We believe the price offered for the company was a fair one.

➢ **Sangoma Technologies (STC CN)** – Company's stock price corrected tremendously despite solid execution and high levels of free cash flow generation. In our opinion, current trading levels are largely disconnected from business fundamentals. At this point, we would not be surprised to see a management buyout and/or other forms of value-unlocking developments.

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Perfectly Aligned + Focused on Performance

I am extremely fortunate to work alongside bright, passionate, and committed individuals. What is especially fulfilling is the common sense of purpose that unites us, as we are determined to deliver the best possible value for our clients while being good global citizens.

Last summer Josh Wilson joined our team as Chief Compliance Officer. Josh has over 25 years of experience in Compliance and Risk Management. After starting his career in various Compliance roles with the Financial Industry Regulatory Authority (FINRA) in the US, he became a trainer at the FINRA Examiner University and Advanced University. Subsequently, he became Director of Examinations at the National Stock Exchange (NSX) where he led the member audit program. After moving to Canada, Josh worked for global financial institutions acting as Chief Compliance Officer for their US and Canadian operations and was the regional head of compliance for up to six jurisdictions.

We take this opportunity to thank our committed clients who entrust us to compound their capital over a long period of time. In the same way, as top management teams have high insider ownership, we have our own capital invested alongside yours. Our interests have always been and will always be perfectly aligned.

We are utterly focused on taking advantage of numerous prevailing market opportunities and much look forward to reporting on our progress.

Sincerely,

Andrey Omelchak, CFA
President & Chief Investment Officer
LionGuard Capital Management

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