LionGuard Capital Management Inc.
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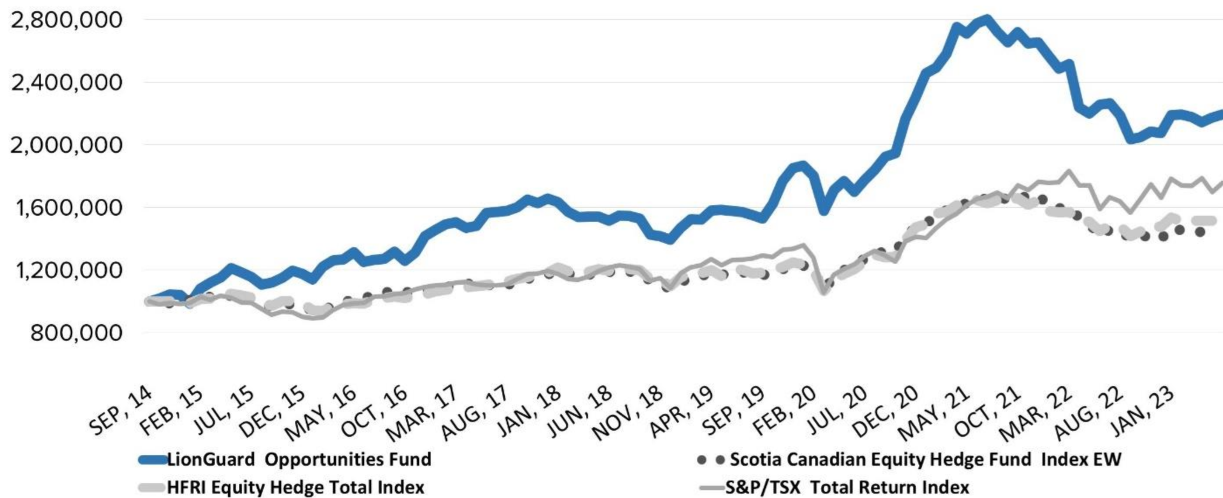
LIONGUARD OPPORTUNITIES FUND
Q2-2023 REPORT

Performance

LionGuard Opportunities Fund ("Fund") performance vs. S&P/TSX Total Return Index, Scotia Canadian Hedge Fund Index EW and HFRI Equity Hedge Total Index



During the quarter ended June 2023, LionGuard Opportunities Fund had a net return of 0.78%. Since inception, its compound annual net return amounts to 9.40% and cumulative net return to 119.52%. This compares to 6.65% and 75.64%, respectively, for S&P/TSX Total Return Index.

	LionGuard Opportunities Fund Net Return	S&P/TSX Total Return Index
2014 Since Inception (Oct-Dec)	4.11 %	(1.47) %
2015	13.07 %	(8.32) %
2016	20.30 %	21.08 %
2017	17.00 %	9.10 %
2018	(15.90) %	(8.89) %
2019	32.88 %	22.88 %
2020	24.32 %	5.60 %
2021	15.37 %	25.09 %
2022	(21.84) %	(5.84) %
2023 YTD (Jan-June)	5.77%	5.70 %
Cumulative Since Inception	**119.52 %**	**75.64 %**
Compound Annual Return	**9.40 %**	**6.65 %**

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Commentary

Market Commentary

First half of 2023 has seen major indexes overcoming numerous challenges, powering higher in spite of global economic concerns and worries about the trajectory of interest rates. Even a banking crisis and debt-ceiling standoff in the U.S., along with fears of recession in Europe, were not enough to stop the S&P 500's rise this year. European markets are also up, with France's CAC 40 hovering near all-time highs.

However, this performance is not broadly based but heavily dependent on a select few heavyweight stocks. Tech dominance, particularly by U.S. companies, has been a recurring trend over the past few years. This dominance has strengthened recently with eight of the largest tech and growth companies in the U.S., including Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Tesla, and Nvidia, now accounting for 30% of the S&P 500's market capitalization. This is a marked increase from about 22% at the beginning of the year. A stark illustration of the narrowing can be seen by the staggering 10% year-to-date outperformance by the S&P 500 compared to its equally weighted counterpart.

Searching for high-quality, yet mispriced businesses

In our relentless pursuit of undervalued yet high-impact investment opportunities, we prize entities that showcase clear strategic vision, robust financial fortitude, and an effective command of either differentiation or cost leadership strategies. The linchpin of our investment selection process is a company's Return on Invested Capital (ROIC)—a potent financial metric that measures a company's proficiency in converting capital investments into lucrative returns. Unraveling ROIC into its constituent components—NOPAT margin and invested capital turnover—grants us profound insights into a company's strategic underpinnings. Firms with a high NOPAT margin are generally proponents of a differentiation strategy, justifying higher prices for their unique products or services. Conversely, a significant invested capital turnover signifies a company's adherence to a cost leadership strategy, vying for a competitive edge through superior operational efficiency and aggressive pricing.

As the business milieu continues to place more emphasis on intangible assets such as brand value, patents, and intellectual capital, we meticulously refine our ROIC computation to encapsulate these less visible investments. This process entails capitalizing and amortizing these intangible assets, which enables us to recalibrate the NOPAT and invested capital variables, thus realigning the overall ROIC metric.

Our investment philosophy takes into account the relentless gravitational force of Regression Toward the Mean (RTM) in corporate financial performance. RTM implies that the outperforming high-ROIC companies of today may not retain their golden performance indefinitely, and similarly, today's underperformers may rebound. However, those standout entities that persistently defy this norm and uphold high ROICs are those that have successfully erected formidable "moats" around their business models. As part of our rigorous investment due diligence, we pay considerable attention to the industry-specific ROIC dynamics and corresponding RTM rates, as these variables exhibit substantial variance across sectors. Firms that consistently generate high ROIC over extended periods particularly pique our

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interest—these are often indicative of effective and durable differentiation strategies, corroborated by their high NOPAT margins.

A key cornerstone of our investment philosophy lies in assessing a company's Total Addressable Market (TAM). Grasping the magnitude of a firm's TAM allows us to gauge the scale of potential opportunities that a company can tap into and is often a critical determinant of sustained high ROICs. A large TAM suggests ample room for growth and expansion, mitigating concerns of market saturation. This is particularly crucial for companies espousing a differentiation strategy—if the differentiated product or service caters to a substantial market, the prospects for superior returns are magnified. Conversely, for companies committed to a cost leadership strategy, a large TAM offers the volume required to achieve economies of scale, thereby enhancing their invested capital turnover.

Additionally, the return on incremental capital, deployed either organically or through Mergers & Acquisitions (M&A), is another pivotal element in our investment analysis. This return is a testament to a company's capacity to judiciously allocate supplementary capital and spawn profits from new investments. For organic investments, it involves gauging the company's efficiency in deploying its retained earnings or additional capital to fuel growth, innovation, or operational improvements. Essentially, it's an indicator of a company's aptitude to transmute reinvested earnings into augmented earnings.

When it comes to M&A, the return on incremental capital assesses a company's acumen in pinpointing, acquiring, and integrating businesses that add positively to its bottom line. A successful M&A strategy can substantially bolster a company's competitive positioning and its ability to preserve a high ROIC over the long term. If the acquired entities align seamlessly with the company's strategic direction—be it differentiation or cost leadership—and produce a high return, this signals the company's capital allocation and execution prowess. Consequently, we are more inclined toward companies that exhibit a high return on incremental capital, interpreting it as a hallmark of sagacious capital management and a potential harbinger of sustained superior performance. Invariably, a comprehensive appraisal of returns on incremental capital, when applied to a sizeable TAM, serves as a reliable barometer of an investment's long-term performance potential.

Contributors

During the quarter, some of our largest contributors included EQB (EQB CN), goeasy (GSY CN) and Mattr (MATR CN).

- **EQB (EQB CN)** – EQB stands out as a long-term compounder, continually delivering value to its stakeholders. Its disciplined business model has consistently achieved a 15%+ Return on Equity (ROE), showcasing resilience even amidst periods of global banking stress. The bank's robust deposit growth, driven by successful customer acquisition strategies, digital enhancements, and targeted marketing campaigns, are testament to its steady growth trajectory. Furthermore, EQB's resilient credit metrics and sound risk management practices underscore its ability to weather market fluctuations and provide consistent returns.

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This long-term growth view is complemented by the bank's recent stellar performance. As Canada's 8th largest bank, EQB has exceeded expectations due to a stronger-than-anticipated Net Interest Margin (NIM) and robust non-interest income. The bank's high liquidity levels and deliberate funding diversification strategies have proved effective, with deposit growth slightly surpassing loan growth. Even as arrears increase, they remain relatively low, and credit is normalizing.

In addition, we ought to recognize that Canada's record population growth offers a further optimistic lens through which to view EQB's prospects. This population surge directly translates into increased demand for housing and upward pressure on real estate prices. In a scenario where residential property values continue to rise, EQB stands to benefit significantly given its significant exposure to the Canadian housing market through its mortgage portfolio. Notably, the bank's business model emphasizes sound risk management and boasts a loan-to-value ratio of 65% in its uninsured single-family mortgage portfolio, offering a layer of protection against potential market downturns. Therefore, this demographic trend aligns well with EQB's strategic focus, potentially bolstering its long-term growth and profitability.

- **goeasy (GSY CN)** – goeasy Ltd., with its impressive track record of growth, has solidified its position as a long-term compounder in the financial services sector. Its effective business model, underscored by a high reinvestment rate, has led to consistent returns and steady expansion over the years. A notable aspect of goeasy's recent performance is its excellent Q1/FY23 results.

  Recently, investors had been apprehensive about the potential impact of the Canadian government lowering maximum permissible rates on goeasy's profitability. However, the company's recent results and outlook have largely mitigated these concerns, suggesting that the impact of the rate cuts was not as severe as was initially portrayed by the stock price reaction. Excessive concerns provided a significant buying opportunity for a multi-year compounder at a great price, which we have taken advantage of. Moreover, goeasy has been purposefully reducing its yield over the years. This transition puts the company's average interest yield at around 30% today, 500 basis points below the proposed 35% rate cap. Also, as the new proposed legislation would only impact new loans, the effect will be gradual across the portfolio. Additionally, goeasy noted its ability to raise the rates of some loans currently under the new cap, which further demonstrates the company's resilience against market dynamics. The company's ability to adapt and thrive amidst potential regulatory changes, further bolstering its poisoning as one of the two leaders in the country, reinforces our view of this business as a long-term compounder.

  Our reflections cannot be concluded without drawing attention to recent governmental actions. As keen observers of this industry over many years, we assert that these government-induced rate cuts are indeed counterproductive to the broader interests of Canadians. By introducing a cap on interest rates, the government is actively stifling the vibrancy of marketplace competition. This interventionist policy paves the way for a hostile environment for smaller players. Furthermore, rather than providing the intended relief, these regulations disengage the most financially vulnerable from much-needed financial services, including by limiting their ability to rebuild their credit histories. It is critical that we earnestly scrutinize these potential adverse

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outcomes and champion for policies that ensure consumer protection and promote a competitive and accessible financial ecosystem.

- **Mattr (MATR CN)** – Mattr's strategic approach to business transformation has steadily reshaped the company into a focused player within the industrial, automotive, water, and energy sectors. The management team, led by Michael Reeves since March 2021, has judiciously implemented a plan centered around optimizing the company's operational efficiency, which has manifested in a notable surge in Mattr's share price.

  An important aspect of this strategy is the divestment of non-core businesses, allowing for greater allocation of resources towards strategic and high-return investments. This emphasis on strategic sell-offs underpins the management's foresight in recognizing the potential to enhance shareholder value. As part of this plan, Mattr has been clear in its ambition to become a leader in specific value-added products, enhancing its profit margins and stabilizing cash flows. The upcoming divestment of its PPS segment by mid-2023 is expected to generate considerable proceeds, further enhancing the company's capacity to reinforce its core business segments.

  As Mattr trims its portfolio to enhance its performance, the company is expected to showcase improved financial indicators by 2024. This includes an increase in Return on Equity (ROE), Return on Capital Employed (ROCE), gross margins, and EBITDA margins, compared to prior years. Furthermore, the company is projected to be in a net cash position by this time, indicating a strong financial base for executing future growth strategies.

  Mattr's strong financial position also offers it the flexibility to make strategic moves such as organic capital investment, M&A, or share repurchases. The company's recent capital investment announcement, which implied around a 3-year payback, showcases an attractive internal rate of return on these investments.

  Despite its impressive strides in strategic transformation and attractive financial projections, Mattr remains largely undiscovered by institutional investors. This dynamic is, however, set to change in the coming quarters as the company's refined focus, improved profitability metrics, and strong balance sheet become increasingly evident.

Focused on Performance

We are excited about our ongoing commitment to compound our investors' capital through strategic investments in high-quality mispriced businesses.

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

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