DKAM
DONVILLE | KENT asset management inc.
ROE REPORTER
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INVESTMENT ISSUES • STRATEGIES • INSIGHTS FROM DONVILLE KENT

Things are about to get a lot better

Suffice to say, it's been a year unlike any other. Despite the turbulent rollercoaster of 2020, the DKAM Capital Ideas Fund (the "Fund") has rebounded significantly. Since the end of March 2020, the Fund has risen by 35.51%[1], while the S&P/TSX Total Return Index has increased by 22.51%[2]. We believe that we are well-positioned to deliver a strong return by year end.

As we write this newsletter, most of the world is in the throes of a second wave of COVID-19. To further exacerbate our anxieties, the federal government of the US, the world's most influential economy, is days away from holding an election involving one of the most divisive incumbent presidents we have ever seen. Like we said, it's been quite a year. In spite of this, we anticipate that the next 12 months will be much more pleasant than the past 12 months. Our optimism is propelled by the promising progress of COVID-19 vaccines, dovish central banks, and the continuing economic recovery, which should drive equity markets higher.

At this time, there are more than 165 COVID-19 vaccines in various stages of development. These pending vaccines are backed by some of the most trusted pharmaceutical behemoths, including Pfizer, Johnson & Johnson, Astra Zeneca, and Moderna. More than 10 of these vaccines are in Phase 3 trials, which is the final phase before regulatory approval. The first successful vaccine could reach the finish line by November 2020 and five companies (four US and one British) should have their results ready by the end of January 2021. If a couple of these vaccines prove to be effective and safe by then, public distribution could begin in early 2021. As the general population becomes vaccinated, testing technology improves, and the world adapts to the "new normal", society's focus will continue shifting towards living rather than merely surviving.

There is substantial, pent-up demand for the things we've longed for during the pandemic, as well as unprecedented fiscal stimulus plans around the world, low interest rates, unexpectedly high personal savings rates, and favourable demographic trends. Once our lives regain some semblance of pre-pandemic normalcy, we will see a massive burst of optimism and economic activity, and we forecast that there will be a huge market rally. Thus, we believe 2021 will be a great year for the stock market.

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The long-term case for technology

Technological evolutions typically stretch over long timeframes, but catastrophic events such as recessions, wars, natural disasters, and pandemics can suddenly drive a sharp acceleration of these advancements. We have observed this phenomenon firsthand as society's continued digitization ramped up dramatically over the past year, triggering a major transformation in how society functions. These changes will have significant, lasting implications for investors for years to come. Please refer to our July newsletter, "Industry 4.0", for an in-depth look at specific fast-tracked trends and infrastructure advancements.

How does one invest in technology?

Traditionally, we have strived to invest in high return on equity ("ROE") stocks, using ROE as the primary measure of value creation, and the price-to-cash earnings ratio ("P/CE") as the primary valuation method. How does a high ROE investor reconcile this approach with the high revenue growth, low profit model emerging in the technology industry? Is this the right framework to look at technology stocks? The answer is yes, but slight adjustments to the framework need to be made.

First, let's take a look at the ROE element of stock investing. Historically, we have invested in companies that earn an ROE of at least 20%. For example, in the past we would have been drawn to a trucking company with $200M of revenues that could generate a profit of $20M on an equity base of $100M, therefore achieving an ROE of 20%. At year end, the company would invest its $20M of profits in additional trucks. Presumably, this expanded fleet would enable the company to push sales to $240M in the next year, generating a profit of $24M on an equity base of $120M, and so on. This illustrates the magic of compounding that we have discussed on previous occasions.

Next, let's examine a hypothetical software-as-a-service ("SaaS") company. Assume it has the exact same financial performance as the trucking company: revenues of $200M and a profit of $20M on an equity base of $100M. However, unlike the trucking company, the SaaS company does not have to purchase any additional hard assets at year end in order to boost sales because SaaS companies scale extremely efficiently. The adage in the software sector is that SaaS companies build only once and sell it a million times. These businesses derive most of their economics from attracting and retaining new customers, who will typically remain customers for many years (referred to as lifetime value). As such, the cost of acquiring that client will be paid back handsomely in subsequent years if the cost of servicing that customer is minimal.

If the technology company can acquire new customers through marketing efforts at attractive economics (i.e. the lifetime value of a customer is multiples higher than the cost to acquire a customer), the company would be motivated to increase its marketing budget by $20M as opposed to spending $20M on hard assets like the trucking company. However, from an accounting perspective, the entire $20M marketing expense will flow through the income statement in the year it is incurred, reducing the company's profit to zero. In contrast, the trucking company's investment in additional trucks will flow through the income statement and the balance sheet, ultimately being treated as a capital expenditure ("CAPEX"). The $20M trucks purchase will be expensed over time during the trucks' 10-year life as a depreciation expense on the income statement. Both companies are making rational capital allocation decisions to further grow their businesses, but in terms of their respective financial statements, the companies look quite different from each other. Setting aside valuations, both companies are extremely promising, but the key differentiator is that the trucking company seems to be quite profitable whereas the technology company appears to be barely breaking even.

In today's digital economy, many technology companies are doing exactly what we described in the example above. Value-creating technology companies show evidence of their value creation solely through the income statement whereas the traditional ROE model implies that evidence of capital allocation and value creation are found in a combination of the income statement and the balance sheet.

The Rule of 40

As illustrated in the example above, many value-creating technology companies can achieve exceptional revenue growth while showing modest profitability. One popular method for assessing the balance between a technology company's revenue growth and profitability is the Rule of 40. This concept is typically used to evaluate software companies and is increasingly being applied to a range of digitized businesses. The Rule of 40 indicates that a SaaS company's combined revenue growth rate and profit margin should be at least 40%. For a tiny SaaS company, this can be a relatively easy number to hit but as a company grows, only truly exceptional companies will exceed 40%. In figure 1 below, we highlight selected companies in Canada and the US that look compelling strictly based on the Rule of 40.

Figure 1. The Rule of 40

Company	Ticker	Market Cap ($M)	2021 Expected Rev Growth*	EBITDA Margin*	Rule of 40
Dye & Durham	DND	1,113	63%	56%	**119%**
Kneat	KSI	168	105%	-4%	**101%**
Nuvei	NVEI	5,515	28%	38%	**66%**
VitalHub	VHI	83	46%	19%	**65%**
Adcore	ADCO	26	21%	38%	**59%**
Veeva	VEEV	44,002	28%	29%	**57%**
Sangoma	STC	300	40%	15%	**55%**
Etsy	ETSY	15,872	35%	19%	**54%**
Enghouse	ENGH	3,809	21%	33%	**54%**
Crowdstrike	CRWD	29,525	60%	-6%	**54%**
Adobe	ADBE	235,789	16%	35%	**51%**
Constellation	CSU	30,275	17%	32%	**49%**
Kinaxis	KXS	5,710	21%	27%	**48%**
Digital Turbine	APPS	2,996	30%	15%	**45%**
Appfolio	APPF	5,190	27%	14%	**41%**
Datto	MSP	5,152	20%	20%	**40%**
Dyantrace	DT	12,063	20%	19%	**39%**
Chegg	CHGG	10,626	26%	13%	**39%**
Datadog	DDOG	30,012	35%	4%	**39%**
Crexendo	CXDO	108	23%	15%	**38%**
ServiceNow	NOW	97,299	26%	10%	**36%**
Altigen	ATGN	48	12%	19%	**31%**
Shopify	SHOP	125,787	35%	-5%	**30%**
Docebo	DCBO	1,196	39%	-11%	**28%**

**DKAM Estimates - Rule of 40 combines Revenue growth and EBITDA margin*

What about valuation?

Given the unique way in which technology companies create value, where most or all of its profits are reinvested via the income statement to grow sales, we need a more robust metric than earnings to assess the valuation of these companies. At a high level, there are two simple approaches to this issue: (i) price-to-sales ("P/Sales"); and (ii) normalized earnings.

Price-to-Sales (P/Sales)

The simplest way to value a technology company is to examine its P/Sales multiple rather than its P/CE multiple. This is a popular, straightforward method and it can be a powerful tool, particularly when looking at homogenous technology companies. Sometimes sales or sales growth can be misleading, but

there are other techniques for assessing the quality of a company's sales and sales growth that we will discuss another time. Nonetheless, the P/Sales multiple is a quick and generally effective way to investigate how expensive a tech company is.

Figure 2. Price to Sales

Company	Ticker	Market Cap ($M)	2021 Expected Rev Growth*	Rule of 40*	**Price/Sales 2021E***
Sangoma	STC	300	40%	55%	**1.6**
Adcore	ADCO	26	21%	59%	**2.4**
VitalHub	VHI	83	46%	65%	**4.4**
Constellation	CSU	30,275	17%	49%	**5.1**
Crexendo	CXDO	108	23%	38%	**5.2**
Altigen	ATGN	48	12%	31%	**5.3**
Enghouse	ENGH	3,809	21%	54%	**6.0**
Etsy	ETSY	15,872	35%	54%	**7.7**
Datto	MSP	5,152	20%	40%	**8.0**
Digital Turbine	APPS	2,996	30%	45%	**9.3**
Dye & Durham	DND	1,113	63%	119%	**10.5**
Kneat	KSI	168	105%	101%	**13.0**
Nuvei	NVEI	5,515	28%	66%	**13.1**
Appfolio	APPF	5,190	27%	41%	**13.2**
Chegg	CHGG	10,626	26%	39%	**13.9**
Docebo	DCBO	1,196	39%	28%	**14.0**
Dyantrace	DT	12,063	20%	39%	**14.8**
Adobe	ADBE	235,789	16%	51%	**15.8**
ServiceNow	NOW	97,299	26%	36%	**17.4**
Kinaxis	KXS	5,710	21%	48%	**19.7**
Crowdstrike	CRWD	29,525	60%	54%	**20.6**
Veeva	VEEV	44,002	28%	57%	**23.3**
Shopify	SHOP	125,787	35%	30%	**35.3**
Datadog	DDOG	30,012	35%	39%	**38.0**

**DKAM Estimates*

Normalized Earnings

By exploring the income statement of a technology company, the sales and marketing expenses can be adjusted or normalized to gauge how profitable the company is. It's not uncommon for a technology company to spend more than 50% of its revenue on sales and marketing. In comparison, a company outside of the technology sector might spend only 15-20% of revenues on sales and marketing expenses. By normalizing the sales and marketing expense for a technology company with rapidly increasing revenues, we can quickly identify

which companies have the strongest potential to be highly profitable tomorrow if they slowed down their sales and marketing spend.

Figure 3. Stocks Ranked by Normalized Earnings

Company	Ticker	Market Cap ($M)	2021 Expected Rev Growth*	2021E Normalized Earnings Margin*	**2021E Normalized Earnings Valuation***
Adcore	ADCO	26	21%	40%	**5.9**
Sangoma	STC	300	40%	16%	**9.0**
Dye & Durham	DND	1,113	63%	58%	**14.6**
Altigen	ATGN	48	12%	25%	**14.9**
Enghouse	ENGH	3,809	21%	34%	**15.8**
Constellation	CSU	30,275	17%	32%	**17.9**
VitalHub	VHI	83	46%	23%	**19.3**
Crexendo	CXDO	108	23%	21%	**25.0**
Etsy	ETSY	15,872	35%	30%	**26.0**
Datto	MSP	5,152	20%	27%	**29.4**
Adobe	ADBE	235,789	16%	47%	**33.6**
Nuvei	NVEI	5,515	28%	41%	**33.7**
Dyantrace	DT	12,063	20%	39%	**38.0**
Digital Turbine	APPS	2,996	30%	23%	**40.8**
ServiceNow	NOW	97,299	26%	34%	**51.1**
Kinaxis	KXS	5,710	21%	34%	**58.0**
Appfolio	APPF	5,190	27%	18%	**72.5**
Veeva	VEEV	44,002	28%	31%	**75.0**
Crowdstrike	CRWD	29,525	60%	27%	**76.2**
Docebo	DCBO	1,196	39%	13%	**107.6**
Chegg	CHGG	10,626	26%	11%	**126.3**
Datadog	DDOG	30,012	35%	25%	**152.2**
Shopify	SHOP	125,787	35%	6%	**556.3**
Kneat	KSI	168	105%	2%	**648.5**

**DKAM Estimates - If Sales & Marketing is >15% of sales, Normalized Earnings adjusts Sales & Marketing to 15% of sales*

In our past newsletters we explain why combining high ROE and low cash earnings multiple get you a better sense of the growth to value trade-off. In general terms, a lot of the highest growth companies in the market are overvalued while the cheapest stocks are cheap for good reason. Ranking growth versus value does a good job to weed out the extremes. In this example, we will combine figure 1 and figure 2 to get a better sense of what stocks look attractive.

Figure 4. Stocks Ranked by Growth & Value

Company	Ticker	Mkt Cap ($M)	2021 Expected Rev Growth*	EBITDA Margin*	Rule of 40*	P/S 2021E*	**Overall Ranking**
Sangoma	STC	300	40%	15%	55%	1.6	**33.8**
Adcore	ADCO	26	21%	38%	59%	2.4	**25.0**
VitalHub	VHI	83	46%	19%	65%	4.4	**14.7**
Dye & Durham	DND	1,113	63%	56%	119%	10.5	**11.4**
Constellation	CSU	30,275	17%	32%	49%	5.1	**9.6**
Enghouse	ENGH	3,809	21%	33%	54%	6.0	**9.0**
Kneat	KSI	168	105%	-4%	101%	13.0	**7.8**
Crexendo	CXDO	108	23%	15%	38%	5.2	**7.2**
Etsy	ETSY	15,872	35%	19%	54%	7.7	**7.0**
Altigen	ATGN	48	12%	19%	31%	5.3	**5.8**
Nuvei	NVEI	5,515	28%	38%	66%	13.1	**5.0**
Datto	MSP	5,152	20%	20%	40%	8.0	**5.0**
Digital Turbine	APPS	2,996	30%	15%	45%	9.3	**4.9**
Adobe	ADBE	235,789	16%	35%	51%	15.8	**3.2**
Appfolio	APPF	5,190	27%	14%	41%	13.2	**3.1**
Chegg	CHGG	10,626	26%	13%	39%	13.9	**2.8**
Dyantrace	DT	12,063	20%	19%	39%	14.8	**2.6**
Crowdstrike	CRWD	29,525	60%	-6%	54%	20.6	**2.6**
Veeva	VEEV	44,002	28%	29%	57%	23.3	**2.4**
Kinaxis	KXS	5,710	21%	27%	48%	19.7	**2.4**
ServiceNow	NOW	97,299	26%	10%	36%	17.4	**2.1**
Docebo	DCBO	1,196	39%	-11%	28%	14.0	**2.0**
Datadog	DDOG	30,012	35%	4%	39%	38.0	**1.0**
Shopify	SHOP	125,787	35%	-5%	30%	35.3	**0.9**

**DKAM Estimates - Overall Ranking divides Rule of 40 (Growth) by Price to Sales (Value) x 100*

The ultimate goal of stock market investing is to uncover companies that create significant value in a consistent and recurring manner. Such companies, if successful, will be worth substantially more in 5-10 years than they are today. While the Fund does not invest exclusively in technology companies, we are seeing some incredibly promising technology companies in Canada and the US that we feel are trading at attractive valuations. Please refer to the glossary for a list of more nuanced terms and metrics commonly used for evaluating software businesses.

Tech ideas

The following stocks represent some of our best technology ideas in Canada and the US:

Market Cap $35M

2021 Cloud Growth 20%

2021 Price/Sales 5.3x

DKAM Estimates

Altigen Communications (ATGN) is a leading Microsoft Cloud Solutions provider, delivering fully managed Cloud-based unified communications services based on the Microsoft platform. The company acquired an additional cloud-based platform to supplement its Microsoft Teams solution. The stock has performed well and we expect even more upside as the growth of cloud revenue accelerates.

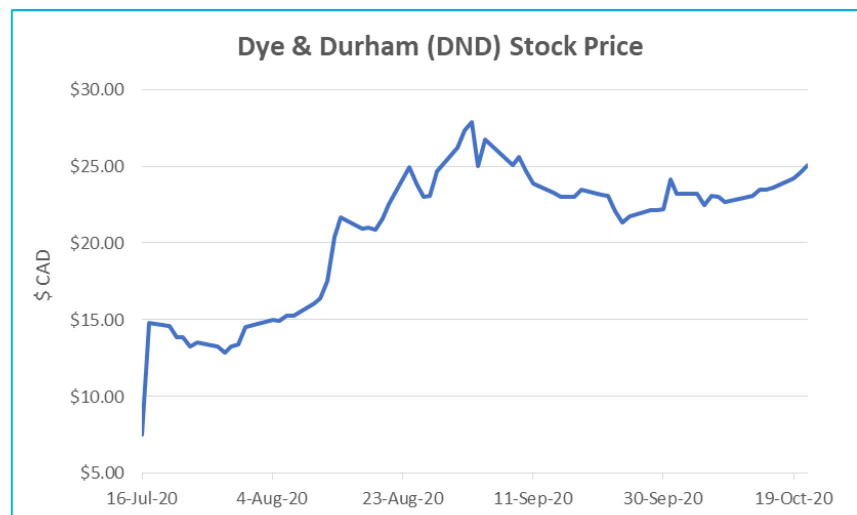
Market Cap $1.1B

2021 Revenue growth 56%

2021 Earnings Growth 74%

DKAM Estimates

Dye & Durham (DND) is a leading provider of cloud-based software and technology solutions designed to improve efficiency and increase productivity for legal and business professionals. The company reported its first quarterly performance as a public company and blew expectations away while also announcing the acquisition of Property Information Exchange, and bullish guidance for the next quarter.



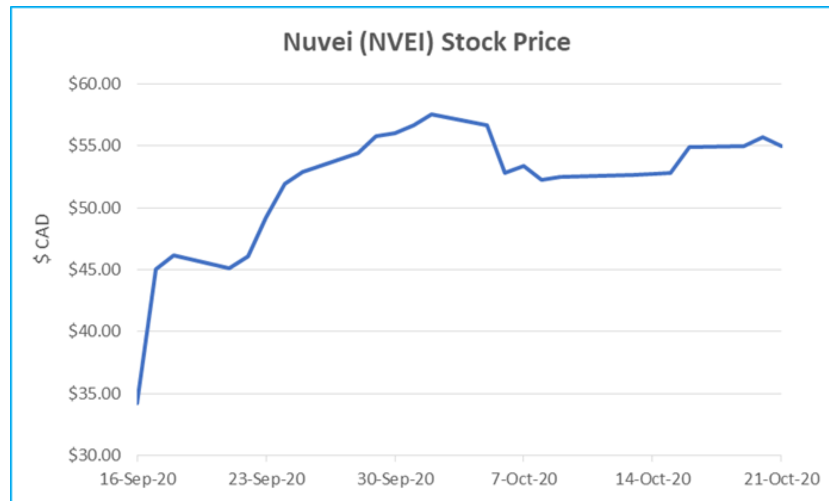
Market Cap $5.5B (USD)

2020 Revenue Growth 43%

2020 Earnings Growth 109%

DKAM Estimates

Nuvei Corp (NVEI) is a global electronic payment processor that went public last month. The company has a proprietary platform which offers direct connections to all major payment card schemes worldwide, solving payment issues for complex transactions in over 150 different currencies using 450 alternative payment methods. Nuvei partners with point of sale and online businesses within high growth digital segments such as online gaming, gambling and sports betting, retail, network marketing, and digital goods & services.



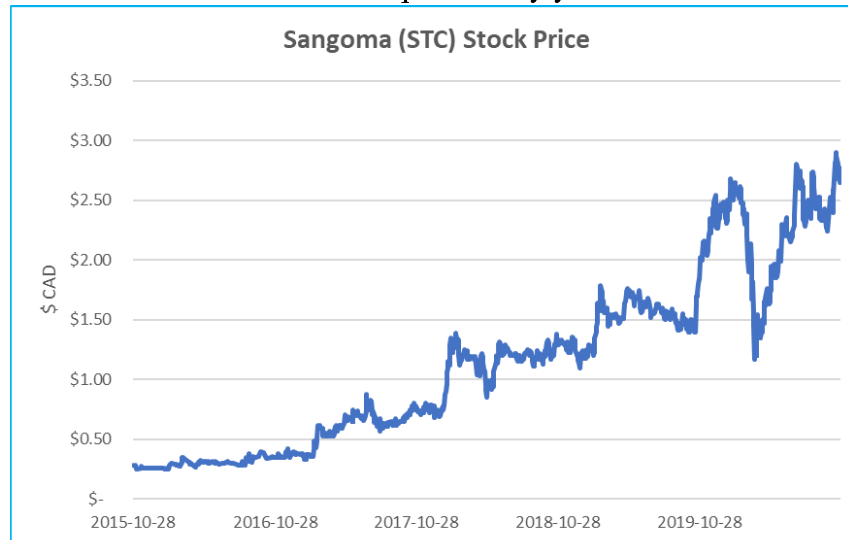
Market Cap $300M

2021 Revenue Growth 40%

2021 Earnings Growth 51%

DKAM Estimates

Sangoma Technologies (STC) is a Unified Communications as a Service provider (UCaaS). A rare combination of high organic growth (+30% last quarter), high and improving earnings margins and trades at a cheap valuation. Recurring revenue continues to trend higher, now over 55% of total revenue, but the stock still trades as if it is a hardware business. One of our highest conviction names as they have roughly $52m in net cash and we expect them to announce a sizable acquisition by year-end.



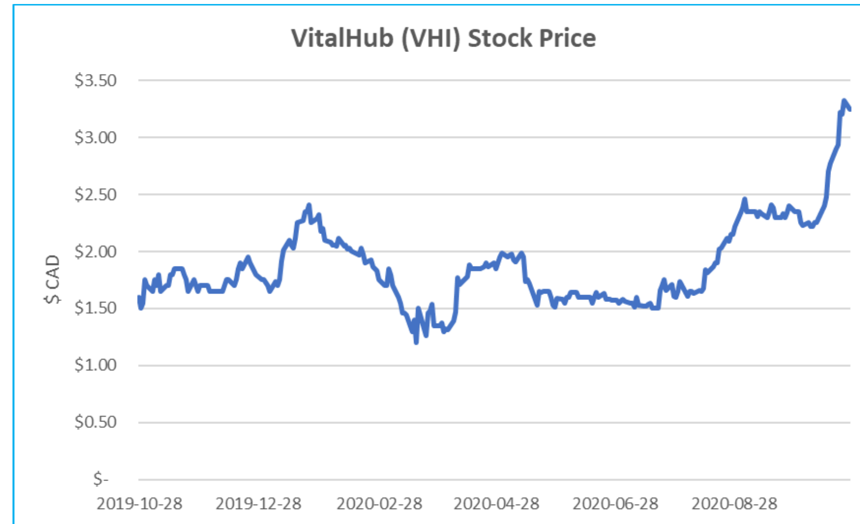
Market Cap $83M

2021 Revenue Growth +46%

2021 Earnings Growth +53%

***DKAM Estimates**

VitalHub (VHI) provides software to hospitals, focused on electronic medical records as well as patient flow efficiency. Recently acquired two businesses and announced multiple customer wins. We expect their growth rate to surprise to the upside. This under the radar business is starting to get the attention it deserves and will continue to climb the market cap curve.



Final Thoughts

As the year draws to an end, we have visibility into a much clearer and brighter 2021. Stay tuned for our appearance on BNN's Market Call in the coming weeks where we will be fielding questions on North American technology stocks. Additionally, we are pleased to announce that Donville Kent has moved into new office space at Royal Bank Plaza. We are thrilled about the expansion and look forward to hosting our investors once the pandemic calms down. In the meantime, we are always happy to host virtual meetings with investors. We encourage you to reach out with any questions or concerns. Thank you for your continued support of Donville Kent.

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Glossary

Customer acquisition cost (CAC): The amount of spending required to acquire a new customer, calculated as the cost of sales and marketing divided by the number of new customers acquired. This figure should be a fraction of the lifetime value of that customer to the company, ideally around 1/3 to 1/5.

Lifetime value (LTV) of a customer: The estimated value of a customer to the company, based on the projected spend of a customer over the course of their relationship. This figure takes into consideration factors such as subscription terms, churn rates, and lifespan, and should be 3-5x more than the cost to acquire a customer.

Land and expand: The strategy of signing a customer to a small initial contract (land) and over time increasing the value of that contract (expand) either through more seats, additional departments, or more products & services.

Net dollar retention: The percent of revenue that a company successfully retained from the prior year. Ideally, this figure should consistently be at least 100% if the company has good churn rates as well as strong land and expand growth.

Annual recurring revenue ("ARR"): The current annualized value of a company's subscription revenue they expect to receive from their customers. This figure is used as a leading indicator of predictable recurring revenue.

All estimates, projections, and calculations have been generated by DKAM. This does not constitute advice for personal investments but rather a breakdown of how Donville Kent approaches stock analysis.

1 Time weighted rates of return for Class A Series 1, net of all fees and expenses as of September 30th, 2020.
2 S&P TSX Composite Total Return Index is the Net Total Return version of the S&P/TSX Composite Index.

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The S&P/TSX Composite Total Return Index, the S&P 500 Total Return Index, and the Russell 2000 Total Return Index ("the indexes") are similar to the DKAM Capital Ideas Fund LP ("the fund") in that all include publicly traded North American equities of various market capitalizations across several industries, and reflect both movements in the stock prices as well as reinvestment of dividend income. However, there are several differences between the fund and the indexes, as the fund can invest both long and short, can utilize leverage, can take concentrated positions in single equities, and may invest in companies that have smaller market capitalizations than those that are included in the indexes. In addition, the indexes do not include any fees or expenses whereas the fund data presented is net of all fees and expenses. The source of the indexes' data is Bloomberg.

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