

## Escape Velocity in Canadian Tech

Last year, growth stocks, especially high growth tech stocks, performed extremely well. Later in 2020 and into early 2021, we saw a shift (or what we refer to as a “rotation” in finance parlance) into cyclicals and other value stocks. During this rotation, we saw a valuation reset for growth names, enabling us to opportunistically add to selected positions at attractive levels and potentially laying the groundwork for a truly rewarding second half of 2021. We believe the cyclical trade is temporary, inspired by one-time pandemic issues while the tech trade is on the cusp of a decade-long curve of dramatic growth. As the third quarter unfolds and big tech stocks such as Google, Facebook, Apple and Amazon achieve new all-time highs, the rebound in large cap growth stocks will lead to strength in mid cap growth stocks, which will then propel small cap growth stocks.

The [April 2021 edition of the ROE Reporter](#) examined various factors (cost, speed, availability and acceptance) driving the tech sector into a period of exponential growth, where we will see certain technologies achieve escape velocity. Having thoroughly addressed the “Why”, this edition will dive into the “Where”, “When” and “How”.

### Where: Oh, Canada!

While we are geographically agnostic between Canada and the US, most of the tech companies grabbing our attention are based in Canada. No longer associated solely with maple syrup, Justin Bieber or Justin Trudeau’s perfectly coiffed hair, Canada has become a global tech hub as public and private investment continues to flood Canada’s tech sector.

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**LATEST CBRE REPORT SHOWS CANADA HAS SOME OF  
THE FASTEST-GROWING TECH TALENT POOLS IN NORTH  
AMERICA**

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In fact, Canadian companies raised more than \$3.8 billion in venture capital in Q2 2021, smashing the previous quarterly record of \$3.2 billion set in Q1 2021.<sup>1</sup> Just a couple hours away from our office, the Waterloo region tech community hit its own milestone with \$1.1 billion of public and private investments in a recent 30-day stretch – the ecosystem’s most impressive four-week run to date.<sup>2</sup> For context, this is more than half of the \$2 billion in venture capital raised over the entire decade from 2010 to 2020!<sup>3</sup> In early July, we participated in RBC’s inaugural private tech company conference. RBC had 35 companies participate in this virtual private company conference. This event provided excellent insight into what is in the pipeline.

KITCHENER

## June 'richest month' for region's tech industry as \$1.1B invested in local companies



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We are seeing a reverse brain drain as Canada continues attracting the brightest minds in tech and the world's largest tech firms at a record pace. Home-grown firms and international companies have been setting up shop and expanding in Canada's major cities but also in smaller markets where the tech industry is being properly cultivated. This is driven by:

- *Education system:* Canada’s world-class public universities and colleges, many of which have ramped up their STEM and business programs and have helped produce a steady parade of strong talent for the sector.
- *Immigration policies:* Over the last five years, Canada’s policies (including a unique startup visa program) have become more conducive and welcoming to immigrants, just as policies in the US have become more restrictive. This has encouraged talent abroad interested in North America to end up in Canada.
- *Salary costs:* Due to a weaker Canadian dollar (relative to the USD), Canadian talent is viewed as more affordable. As such, rapidly growing tech companies have opened offices across Canada.
- *Tax credits:* Canada supports innovation and entrepreneurship through the Scientific Research and Experimental Development (SR&ED) Tax Incentive Program, which provides tax incentives for the direct in-house costs of performing eligible R&D work in Canada.

<sup>1</sup> Globe & Mail. “Booming Canadian tech sector set to smash venture capital records after ‘ridiculous’ run of megadeals” (June 25, 2021).

<sup>2</sup> CommuniTech. “Tech Roundup for June 2021” (July 4, 2021).

<sup>3</sup> CommuniTech. “Tech Roundup for June 2021” (July 4, 2021).

- *Standard of living:* Around the world, Canada has a reputation for being an ideal place to live and to have a family for many reasons, including access to healthcare and education, a steady economic and a stable democratic government.

According to CBRE’s “Scoring Canadian Tech Talent” report, Toronto has added more than 81,000 tech jobs since 2015, representing nearly 43% growth.<sup>4</sup> The city is home to more than 270,000 tech employees, ranking it third overall after San Francisco/Bay Area and New York.<sup>5</sup> Furthermore, 10.2% of Toronto’s total workforce currently works in tech roles, a concentration similar to San Francisco, where 10.9% of all jobs are tech jobs.<sup>6</sup> The report also notes that Vancouver added over 24,000 tech jobs during the same period, an uptick of more than 36%.<sup>7</sup> The city now boasts a total of 91,000 tech jobs, placing it above Detroit (which has a similarly sized population) and just behind Houston (which is over 2x more populous).<sup>8</sup> Tech employees represent about 8% of the overall labour pool in Vancouver.<sup>9</sup>

We are seeing firsthand a continued shift of the younger generations pursuing career paths in tech rather than industries that used to be highly coveted, such as finance and consulting. Working for one of the tech giants like Amazon, Google and Apple have become the most sought-after positions in the world. This is driving even more innovation as the best & brightest apply their abilities and many people in the GTA are not even aware that we are living right in the center of the action.

That being said, we understand that one of the greatest challenges facing high growth tech companies is a tough hiring environment. At the rate these companies are growing at, there simply is not enough qualified tech talent, leading to high compensation packages for many of these young and talented software engineers and developers. Recently, we had dinner with a tech founder who almost couldn’t launch his new startup due to his struggle with finding and affording a CTO and development team. Keeping an eye on the hiring environment, company culture and employee satisfaction are underfollowed data points but definitely worth taking into account.

## **When: No Time Like the Present**

The simple answer is now. Below is a snapshot of recent IPOs we have reviewed over just the past quarter.

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<sup>4</sup> CBRE. “Scoring Canadian Tech Talent” (July 2021).

<sup>5</sup> CBRE. “Scoring Canadian Tech Talent” (July 2021).

<sup>6</sup> CBRE. “Scoring Canadian Tech Talent” (July 2021).

<sup>7</sup> CBRE. “Scoring Canadian Tech Talent” (July 2021).

<sup>8</sup> CBRE. “Scoring Canadian Tech Talent” (July 2021).

<sup>9</sup> CBRE. “Scoring Canadian Tech Talent” (July 2021).



Data analytics



Digital lending



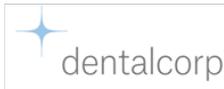
Entertainment



Data infrastructure



Cloud database



Healthcare



Telemedicine



Digital media data and analytics



Smart water metering



Digital farming solutions



Background checks



High-value payments



AI marketing platform



VR/AR



Cash management



Digital mental health & well-being



Investigative tech



Pharmaceuticals



Marketplace for financial services



Data analytics



Digital banking



Education (K-12)



Investor relations



Reach: E-commerce payment provider



E-sports and sports betting



Smart solutions for homes



IT infrastructure



Website platform for creators



Digital outsourcer



Telecommunications



Platform for online courses



Advertising tech



Robotic process automation



Platform for online enthusiast communities



Industrial parts marketplace

According to data from a Morgan Stanley CIO survey, only 23% of workloads are running in the cloud today.<sup>10</sup> This indicates that we are still in the early aughts of a long runway for cloud software and we anticipate that macro tailwinds will only intensify.

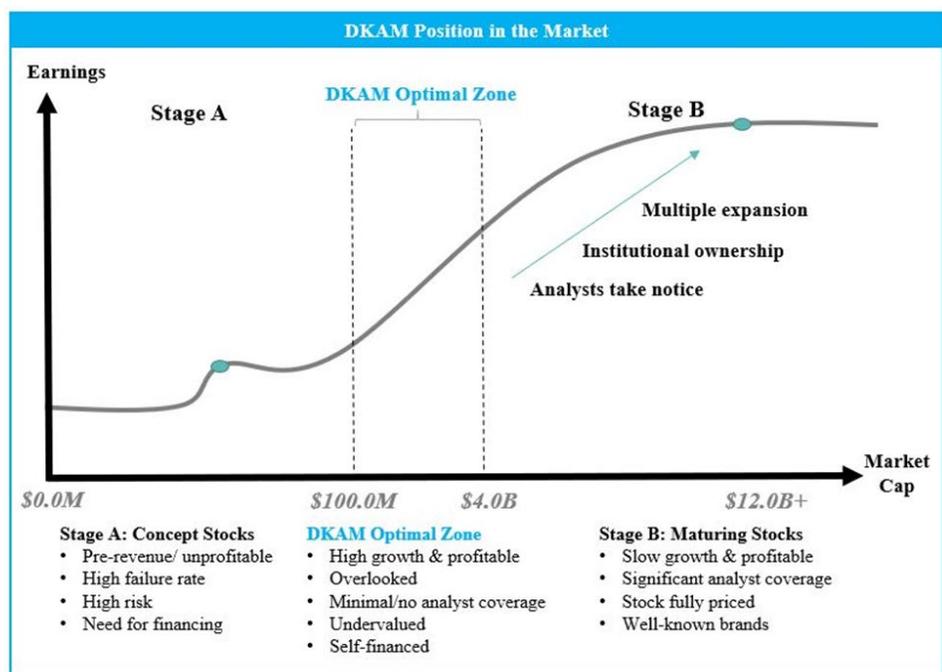
## **How: Balancing Growth & Value of SaaS Businesses**

So, how are we analyzing these investments? First and foremost, we are focused on the numbers and we'll share with you some of the most important metrics to follow. In general, we examine a company's unit economics, return on investment and runway for growth and compare this data with a company's valuation based on its price-to-adjusted-earnings ratio. From there, we use our proprietary model to rank all investment options, helping us objectively determine the best growth-to-value trade-offs. Our philosophy is that we would prefer to invest in companies that are taking their earnings and investing them back into the company to fuel further growth (growth companies) as opposed to companies that are prioritizing dividends, stock buy-backs and neglecting innovation (value companies) – essentially engineering their financial results to feed short-term investor demands.

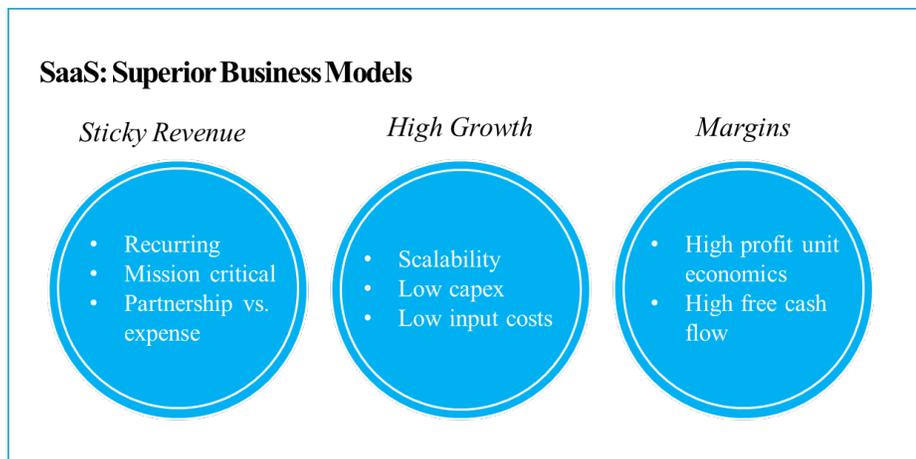
From a high level, we start by focusing on small and underfollowed companies that have grown past the concept stock stage (Stage A) and are now producing real revenue and earnings. This allows us to have a higher batting percentage of winners but we're still getting to the companies early enough that they can have significant returns for our shareholders. We believe this is the optimal combination of potential upside return and downside protection.

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<sup>10</sup> Morgan Stanley. "Technology Eating the World – Top Trends Post COVID-19" (June 2020).



When it comes to tech investing specifically, we focus on software-as-a-service (“SaaS”) over other sectors in tech, such as hardware. SaaS businesses have superior business models, as outlined below.



As an investor, what you are trying to discern is if the unit economics of the business are attractive: can the business invest in acquiring assets (customers) at an attractive return with the ability to scale revenues quickly and attain significant size? When investing in SaaS there are key metrics to prioritize and different strategies to approach the market, as discussed in the [October 2020 edition of the ROE Reporter](#). Below are additional thoughts to take into account when analyzing how a software business is positioning themselves in the market.

## Business to Business (B2B) vs. Business to Consumer (B2C)

As mentioned, there two markets for SaaS businesses as a company can sell directly to: (i) consumers (e.g. Netflix and Spotify); or (ii) other businesses (e.g. Salesforce and Hubspot). We always prefer investing in a B2B software business over a B2C software business. Businesses view most software as an investment and partnership that helps their business become more efficient and effective, ultimately leading to greater success. As such, they have a higher willingness to pay and a higher lifetime value. B2B subscriptions usually grow as the businesses they are selling to grow and the more people using the product, the more immersed and sticky it becomes. On the other hand, B2C businesses face the challenges of higher churn and lower lifetime value, and it's harder to convince a consumer to upgrade.

## Enterprise vs. Small & Medium Businesses (“SMB”)

The next point of distinction is a little less clear. Within B2B, we have found success with companies that focus on either SMBs or enterprises as customers. Think of enterprises as some of the most massive companies in the world. MediaValet continues to have success with selling to large companies like Universal Studios, similar to how Boardwalk Software's success with selling to Facebook. These enterprises sign huge deals and have higher retention rates.

To be clear, we are not making a blanket statement that selling to enterprises instead of SMBs is always the optimal path as there are so many underserved small businesses at the moment. SMBs have less buying power but there are a lot more of them and they are the early adopters. At Donville Kent, we have a history of successfully investing in companies like Sangoma and Wishpond that focus on selling to SMBs (note: Sangoma is moving up market with their acquisition of Start2Star). Overall, selling to enterprises generate the best ROI but SMBs allow for faster scaling and momentum. We believe investors can be rewarded in both strategies.

## Proprietary ranking model

We are often asked, “How do you balance a company's growth with its value?” Our fund participates in the highest risk-to-reward section of the curve by avoiding the most speculative, money-burning companies while investing in the small, up-and-coming businesses with great unit economics and large addressable markets. Our ranking process balances the appropriate amount of profit today and forecasted growth in relation with valuation.

In previous editions of the ROE Reporter, we ranked stocks using our growth-to-value methodology. This is just a beginning step in our process but it is always interesting to see when new companies enter the list and as the new ranking

below shows, there are several large, up-and-coming Canadian growth names with many more in the pipeline.<sup>11</sup>

Highest Rule of 40 Scores			Growth Balanced with Valuation		
Ticker	Company	Growth Score	Ticker	Company	Growth to Value Score
DND	Dye & Durham	230%	DND	Dye & Durham	4.0
NVEI	Nuvei	117%	TIXT	Telus International	3.2
SHOP	Shopify	100%	NVEI	Nuvei Corp	1.8
PAY	Payfare	99%	TOI	Topicus	1.5
TOI	Topicus	81%	STC	Sangoma	1.5
LSPK	Lifespeak	80%	CSU	Constellation	0.8
THNC	Thinkific	79%	LSPK	Lifespeak	0.5
TIXT	Telus International	78%	MAGT	Magnet Forensics	0.5
CARE	Dialogue Health	69%	DSG	Descartes	0.4
DCBO	Docebo	61%	SHOP	Shopify	0.4

The above ranking is a high-level breakdown and we set the market cap minimum at \$500 million. A higher growth-to-value score means you are getting more “growth units” per “unit of value”. Investors should own high growth companies but avoid overpaying for that growth. Additionally, it is essential to evaluate non-GAAP adjustments. Having a deep understanding of accounting is more important now than ever. A specific issue in tech investing is how the acquisition of customers appear in financial statements. For software businesses, customer acquisition costs run through the income statement while other businesses include investments on the balance sheet. Across all industries, we always adjust earnings to determine cash earnings and when we invest in tech, we make similar adjustments as outlined in the [October 2020 edition of the ROE Reporter](#). Being able to normalize all business models to compare apples and apples and rank appropriately is a critical tool.

Many investors like to hear about the smallest companies we follow and so we’ll highlight a couple here.

**Plurilock (PLUR)** provides identity-centric cybersecurity for today’s workforces. The company has signed more than 15 contracts since May 2021. Contracts signed include: (i) US\$500,000 contract with a California state utility resource organization; (ii) US\$1.7 million order with the US Department of Defense as part of National Aeronautics and Space Administration’s (NASA) Solution for Enterprise-Wide Procurement (SEWP); and (iii) US\$1.9 million contract with the US Department of Defense.<sup>12</sup> Most of these sales are from the VAR the company acquired at the end of March 2021. The strategy is to use the low margin VAR sales and connections to upsell their proprietary high margin

<sup>11</sup> Companies with market caps exceeding \$500 million. Based on DKAM estimates.

<sup>12</sup> Per company press releases (July 2021).

SaaS product. PLUR was spun-out out of the University of Victoria after significant R&D and we are extremely impressed by the product demo. We believe there is a large addressable market for PLUR's high margin cybersecurity software and the low margin VAR sales connections should help the company scale at a good pace.

**NowVertical (NOW)** is a big data analytics company that helps businesses solve problems by using that company's data and high-end analytics. The company's software offering is similar to the software provided by Palantir. The difference is that while Palantir focuses on enterprise customers, NowVertical focuses on smaller companies. From an investing standpoint, we feel Palantir is expensive and NowVertical provides exposure to big data analytics without the rich valuation. We feel this story will evolve quickly since the market is very fragmented and NOW appears to be on the cusp of least three acquisitions that will bring significant scale to the business all while remaining profitable.

## **Final thoughts**

Over the past decade, Donville Kent has cultivated a reputation of being long-term capital partners and as such, we have become partners of choice in the pre-IPO/going public equity raises of companies in the past. We can play a collaborative role on future raises and help companies gain exposure along the way. We use this newsletter to keep our investors informed but to also bring attention to ideas we think are important. Along those lines, we think it is important for up-and-coming technology companies to know that we are flexible, long-term focused and can provide strategic insight in many situations. If you are a small growth business in need of strategic capital, please feel free to reach out.

Plenty of sectors are still lagging behind in terms of embracing technology and we intend to stay immersed in those fields in order to discover up-and-coming disruptors. Currently, we have our eyes set on a handful of IPOs coming up later this year and we look forward to sharing the details.

During the third and fourth quarters, which are typically the more seasonally strong times of the year, we believe small cap tech stocks will bounce back and actually reflect the actual fundamentals and strong performance playing out at the company-level. A handful of the largest companies' stocks have been driving the market higher but the broader market has been in a consolidation and correction mode since March of this year. As described in the last edition of our newsletter, investing in the technology sector right now is the equivalent of holding a beachball tightly underwater. The sector is on the cusp of an exponential ascent and that beachball definitely will not be held down for very long.

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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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