DONVILLE | KENT
asset management inc.

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MAY 2023 – MONTHLY COMMENTARY

After a strong month in May, many of the factors supporting a large comeback for small-cap stocks seem to be coming to fruition. There are two main points to speak to in this monthly commentary. The first being some particular company earnings plus a quick comment on inflation and bond yields.

The last two years have been abysmal for small-cap stocks as a whole. The sell-off in this category was across the board and what we call a high-correlation drawdown. This is how we could have all our largest investments have record revenues and record earnings in 2022 but have their stock prices not reflecting this performance. Now that we have seen Q1 2023 results, we are still projecting even higher revenues and earnings in 2023. Stock prices are down over the past 2 years and with earnings continuing to increase, this means that these stocks continue to get cheaper and cheaper.

What has changed? For the last two years it has been quiet. No one has wanted to speak on small-cap stocks. That changed in the last 4-5 weeks. We're now getting calls from investors and other portfolio managers. They're asking what they're missing when they look at some of these small caps on 3-, 4-, and 5-times earnings. The small cap indexes have seemed to be coming back to life and the opportunity we see may be starting to become more prominent.

COMPANY EARNINGS

Reitmans (RET/A & RET) – Mentality Shift

- Reitmans reported their Q4 earnings in April, which showed revenue growth of 11%, of which e-commerce revenue accounted for 34% of the total revenue. After adjusting for tax adjustments, they reported $22m in cashflow in the quarter, with $106m in cash and zero debt on the balance sheet. This continues to be the best value stock we have seen in years. Factoring in cash, earnings, and real estate, it is astounding it is still at a ~$150m market cap. Please refer to our January newsletter for the full write up but we are confident in our forecast based on recent competitor earnings, continued population growth, less USD headwinds, declining commodity prices like cotton, declining shipping costs, lessening wage pressures, but most importantly, the shift in corporate mentality[1]. Speaking with the company, the mentality has shifted from empire building, which got them into trouble, to sustainable profitability. This is signalled by the fact that their compensation structure is now based on per store profitability. This is in-line with the Charlie Munger quote, "Show me the incentive, and I will show you the outcome." They just announced a new CEO, the first non-Reitman to run the business, plus further turnover on the board.
- They report earnings the second week of June followed by their AGM the next day where we anticipate speaking with the new CEO. From a trading perspective, we still think it is prudent to hedge some of the overall retail exposure by shorting a basked of weaker retailers. Many of

[1] January newsletter can be found at the following link: https://donvillekent.com/wp-content/uploads/2023/02/DKAM-ROE-Reporter-January-2023-Final-1.pdf

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which are carrying significant debt and still trading at much higher valuations. From a risk perspective, there are two risks worth noting. First, their business is seasonal where almost all the profits are made in Q2 & Q3, so investors may be expecting more out of Q1 than will occur (this is what happened after the Q4 release). We also don't expect any imminent announcement on share buybacks or dividends, but we have put management in contact with a local third-party office building valuation expert, as well as supplying the pros and cons and research on up-listing to the TSX, we believe this is the low-hanging fruit with capital allocation decisions to come later this year. A final risk to note is that they will have paid out the one-time bonuses earned in 2022 during Q1 which will lower the overall cash amount.

RediShred (KUT) – Misunderstood Business Model

- RediShred reported a very strong Q1 with revenues growing 36% and free cashflow growing 48%. They are starting to see driver wage inflation subside, and diesel prices – one of their largest costs – are down over 30% from their peak in 2022. The misunderstood aspect of their business is around paper. First, the use of physical paper has slowly been declining for a long time, however the amount of paper being recycled is increasing which has led to stable per unit tonnage for RediShred. The amount RediShred gets for their recycled paper (their "commodity paper price") has also been in focus as its currently near historic highs; it has a decent correlation with other commodities like diesel. Second, they have done a great job implementing bailing their own paper in their five largest locations which improves margins significantly and has a great return on capital. More importantly, using the complete range of paper prices, lows to highs, the business has great unit economics. They announced their first stock buyback which we think is just the first step in how they can unlock value here.

Tucows (TC) – Pivot Point

- Tucows held their first AGM and it was well attended and valuable. The main emphasis being that the business has now reached a turning point with all three business segments hitting their stride while also solving their balance sheet issues. The stock sold off on their quarterly results which are messy but recovered extremely quick and the stock is near 3-month highs. In recent weeks there have been reports that Amazon is in talk with DISH to offer mobile services to their Prime users. Tucows' SaaS product Wavelo, handles the backend for all DISH mobile clients. Please refer to our last newsletter for the full analysis[2].

VitalHub (VHI) – Resilient Compounder

- VitalHub reported a very impressive quarter with 17% organic growth and annual recurring revenue growing 65%. They are still sitting on a lot of cash, and we expect acquisition announcements later in the year. Sales are now starting to pick up in Canada and profit margins continue to expand. The business is proving to be resilient, and we expect continued compounding.

[2] Our last newsletter from April can be found at the following link: https://donvillekent.com/wp-content/uploads/2023/05/DKAM-ROE-Reporter-April-2023-Final.pdf

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Sangoma (STC) – Left for Dead

- Sangoma reported a strong Q1 with revenue increasing 18% with 19% EBITDA margins. Their SaaS revenue grew 10% organically and now represents 81% of total revenue. They are confident they can maintain this level of organic growth. The stock is extremely cheap with one broker publishing a note titled "Left for Dead". They are expected to announce a new CEO soon and there has been some interesting shareholder activism with their competitors.

Converge Technology (CTS) - Uncertainty versus Risk

- In May they reported +38% Net Revenue growth with +39% Adjusted EBITDA growth and their backlog continues to increase. They are now paying a dividend and focused on buying back "as many shares as we can at these prices." Their buyback seems to have put a price floor in for the stock and we think the amount of cashflow produced in the coming quarters will surprise the market. There has been some short-term volatility around topics like CTS's index inclusion and their strategic review outcome, all of which doesn't impact their fundamental value which we believe is significantly higher than today's prices.

GoEasy (GSY) - Sell-off & Recovery

- The stock sold off in March & April on the Federal Budget headlines about capping interest rates. This knee-jerk reaction was extreme and an overreaction. They have since updated their guidance and forecast 21% ROE and improving operating margins going forward which is phenomenal given where the stock is trading today. In May they reported 29% revenue growth, 58% loan growth and a 24% ROE. They lowered their expected net charge-off amount and have enough funding capacity in place to reach their 2025 forecast.

INFLATION AND BOND YIELDS

Inflation

We mentioned Truflation in our last newsletter[3]. As seen below, we have plotted the last 3 years of Truflation against reported US Consumer Price Index (CPI). The argument being, Truflation tracks thousands of real-time price indicators versus CPI using outdated and stale data[4]. One can argue the pros and cons of each, but as the graph shows, Truflation highlighted rising inflation in 2022 much earlier and to a higher degree. Following this metric would have alerted to the Fed earlier to inflation and would have signaled the significance in a more accurate manner in our opinion.

[3] Our last newsletter from April can be found at the following link: https://donvillekent.com/wp-content/uploads/2023/05/DKAM-ROE-Reporter-April-2023-Final.pdf
[4] Truflation's methodology can be seen on their website, at https://truflation.com/methodology

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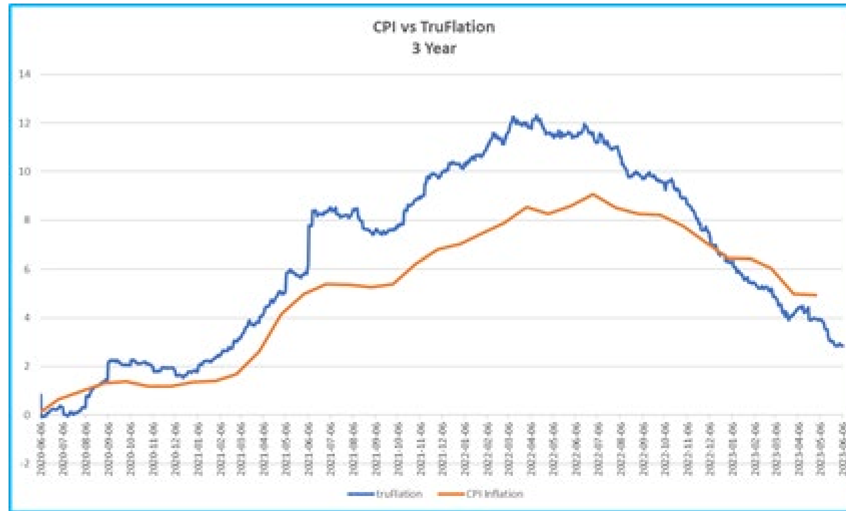

Figure 1 - 3 Year CPI vs TruFlation

This is important to highlight now because CPI is dropping, but real inflation appears to be dropping more quickly (1 year chart below). For this reason, we think recent interest rate hikes are a mistake and if federal bankers remain focused on outdated methodologies, they will stay too restrictive too long just like how they were overaccommodating for too long.

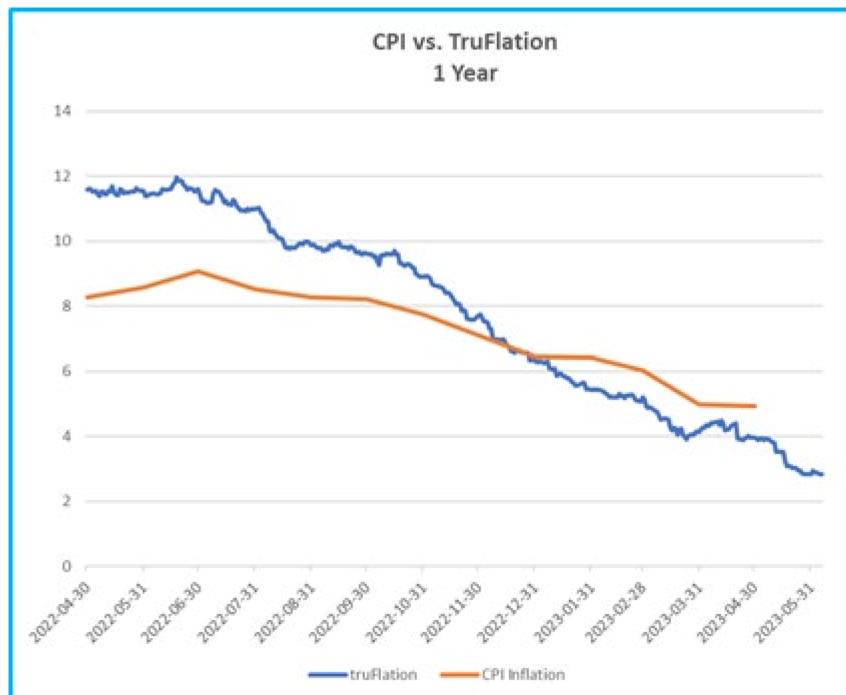

Figure 2 - 1 Year CPI vs TruFlation

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Bond Yields

Peaking bond yields coincide with increasing earnings multiples. As mentioned, many small-cap companies continue to grow and remain profitable. With peaking rates, as investors you'll not only get growing EPS but also an increasing earnings multiple on those earnings, the 'double whammy'[5].

It is likely that stocks will front-run an inevitable Fed easing or have already started to. The obvious risk to this scenario being stubborn inflation due to the current tight labour market.

We believe we're coming out of the longest small-cap bear market in 40 years, and historically cheap small caps have a *long* way to run.

Feel free to reach out questions or comments,

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[5] We dove deeper into this 'double whammy' effect in our July 2018 newsletter. This newsletter can be found at the following link: https://donvillekent.com/wp-content/uploads/2023/06/DKAM-ROE-Reporter-July-2018.pdf