

Cycles on Cycles

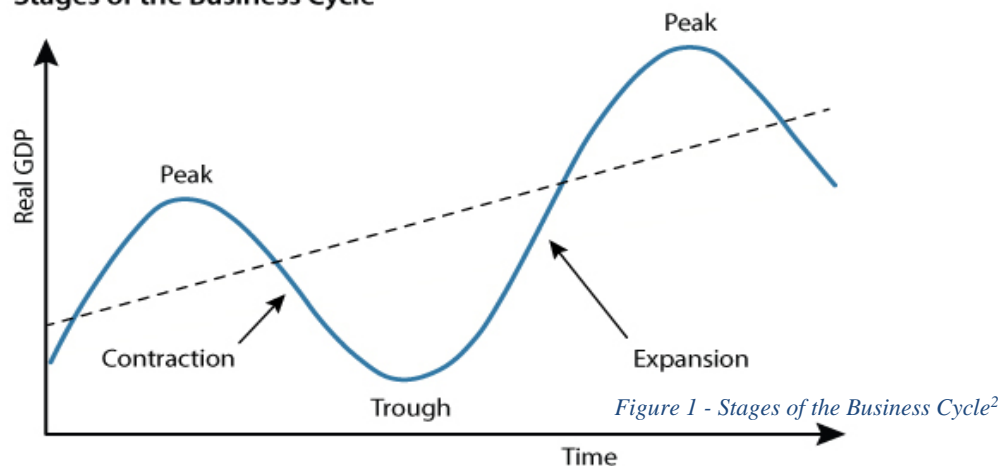
A year ago, we wrote [*When History Rhymes*](#)¹, where we focused on the “What” for the stock market. It has been one of our most popular newsletters because the small cap opportunity, the “What”, was made clear and shown with useful examples. The concept that history doesn’t repeat itself but it rhymes is rooted in the notion that basic human nature doesn’t change. Time and circumstances change but the causes and responses are all bound by human emotion. With this in mind, this letter will add to the previous conversations and try to tackle the questions of “Why” and “When”.

In this newsletter, we will go over the phenomenon of market cycles, the current cycle, the impact on stock valuations, and inflation implications. The table of current PE multiples for small caps should be of particular interest, especially when combined with the data on how small caps perform in recessions. We’ll make a few stock-specific comments, most notably with an interesting development in the Reitmans’ investment scenario.

Cycles

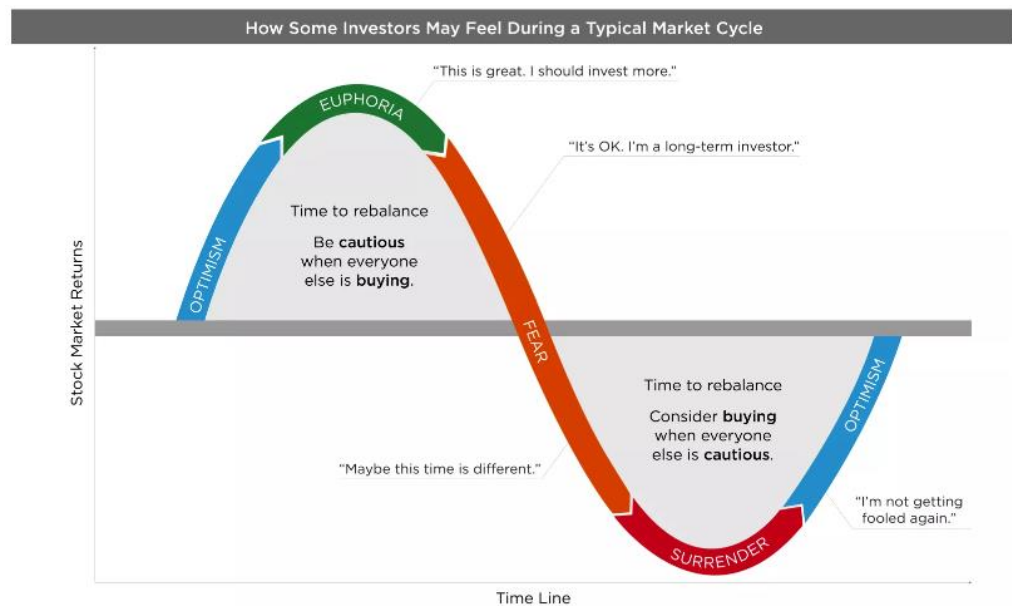
For the economy as a whole, there is a long-term natural growth rate as the population expands and productivity improves. There are however fluctuations around this long-term trend. There are expansions and contractions (also known as recessions). Cycles are not as obvious as the generic chart below but the idea of a continuous cycle of rise, peak, dip, trough has been a recurring pattern since we’ve been able to track human output.

Stages of the Business Cycle



The natural question is why do markets have these fluctuations? A textbook will include answers like changes in demand, supply, debt, etc. These answers are true, but they are also the accumulation of the daily choices made by humans. Human emotions are volatile. The long-term trend of a company's revenue and earnings could be consistently growing but the stock price will most likely fluctuate much more than the fundamentals, because the price is a function of human emotion.

A cycle is in essence a study of emotions. As you can see from the chart below, the peak, contraction, trough, and expansion are replaced with the emotions that dominate the stock market.



Source: Edward Jones

Figure 2 - Business Cycle Emotions

Emotions get tied to stock prices and will usually have a snowball effect. Selling begets selling, and anxiety turns into fear, which turns into panic. The opposite is also true when buying begets buying, and hope turns into optimism, which turns into euphoria. This rollercoaster of emotions impacts stock prices on a day-to-day basis but has little impact on the daily operations of those businesses. Remember, a stock is a piece of ownership in a business. Day-to-day operations of a business do not fluctuate like emotions do. A good CEO isn't making operational decisions based on his stock price, and employees aren't producing less or more based on the stock price.

Over the course of years, a good business grows revenues, increases profits, and becomes a more valuable asset. The stock *price* on the other hand will usually fluctuate considerably around the long-term trend in asset *value*. Investors fail to see the underlying trend in fundamentals and focus on the

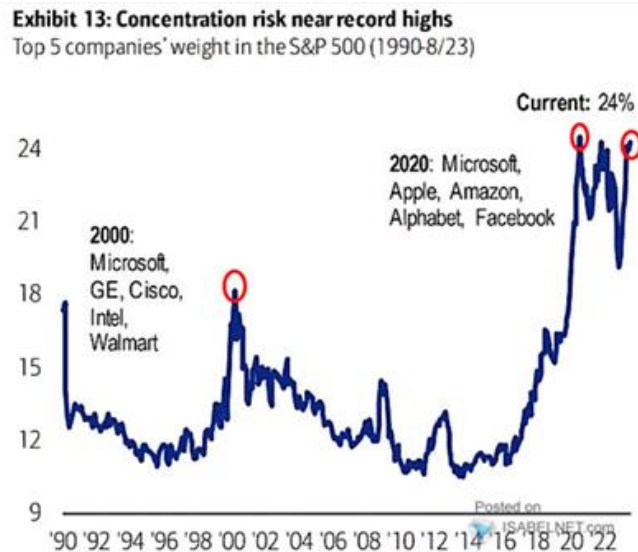
short-term price action. Humans decide on when to buy and sell, so human emotion plays a role in overall stock prices, *in the short-term*.

When you're inside of this, it will feel random and chaotic. At the bottom you become emotionally fatigued. Many investors sell everything that's not working and go to safe assets. In this sense, you're losing twice. You've rode the wave down and now have given up on the rebound. Humans are behaviourally programed to buy high and sell low. To chase returns. To get caught up in the excitement but also become overly depressed and pessimistic. Let's stay analytical and hopefully we can alleviate some of this stress.

Current Cycle

Where are we in the extent of this cycle, or in other words, what is the dominating emotion? For small caps, we are at the cheapest level we could find in recent history, meaning investors have sold small caps down to the cheapest valuations we have seen. Blackrock is the largest money management firm in the world, with over \$10 Trillion in assets under management. Yes Trillion. Blackrock's CEO, Larry Fink, began his professional career in the early 70's and at the end of September he just said, *"I see more fear than any time in my business career."* We are not trying to scare anyone here. The point is actually quite the opposite. The damage has been done. We're in a trough and the opportunity is in front of us.

Anyone who points to the "stock market" being near highs, is missing the point of what the "stock market" really is and what the true investor is feeling. The graph below shows a historic concentration in the largest stocks. The "Magnificent Seven" stocks have accounted for essentially all the market gains so far this year. It appears like all the capital has left the small-medium stocks and is historically concentrated in just the largest companies.



Source: Bloomberg, FactSet, BofA US Equity & Quant Strategy *Figure 3 - Concentration Risk*

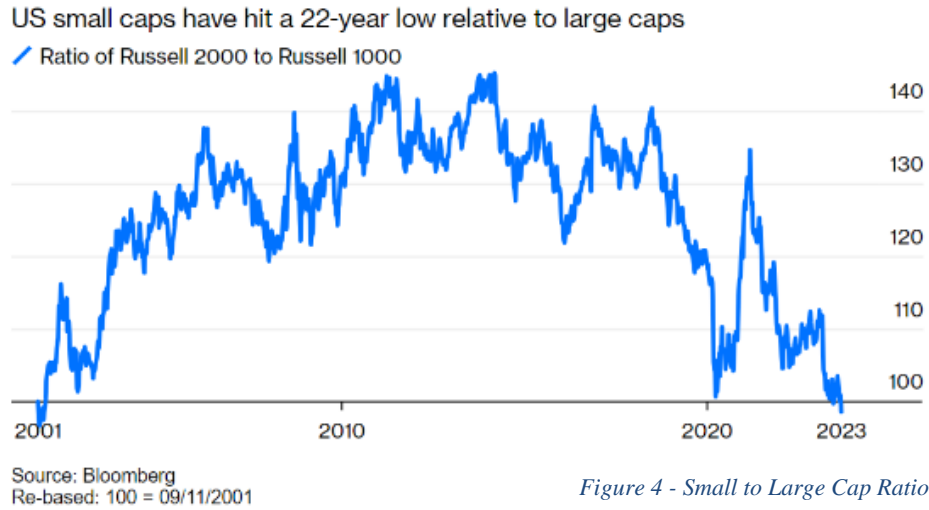


Figure 4 - Small to Large Cap Ratios

The narrative at the moment is that these large businesses are safe havens and can't lose propositions. We agree that these are great businesses. They didn't get to their scale and notoriety without doing a lot of things right. The issue from an investment perspective is that future investment returns are a function of fundamental growth and multiple expansion/contraction. Meaning buying something cheap and quickly growing will outperform something in the long-term that is expensive and growing more slowly.

This is the particularly interesting point where we compare large cap growth and valuations against our list of preferred small caps.

Current Large Cap Fundamentals & Valuations				
Company	2024E Revenue Growth	2024E Earnings Growth	2024E PE	EPS Growth/PE
Microsoft	12%	12%	30.1	0.40
Apple	-3%	-1%	26.6	-0.04
Alphabet (Google)	12%	16%	19.7	0.81
Nvidia	49%	58%	24.6	2.36
Amazon	12%	28%	30.9	0.91
Meta (Facebook)	13%	24%	18.0	1.33
Tesla	24%	32%	52.0	0.62
Berkshire	5%	5%	24.6	0.20
Costco	5%	5%	36.2	0.14
Walmart	4%	10%	22.5	0.44
Pepsi	5%	7%	19.7	0.36
United Health	7%	12%	19.1	0.63
Eli Lilly	17%	30%	46.8	0.64
Exxon	-4%	-2%	12.0	-0.17
J&J	4%	7%	14.1	0.50
Average	11%	16%	26.5	0.61

Figure 5 - Large Cap Fundamentals and Valuations³

Current Small Cap Fundamentals & Valuations

Company	2024E Revenue Growth	2024E Earnings Growth	2024E PE	EPS Growth/PE
Reitmans	6%	5%	2.3	2.17
Sangoma	7%	12%	3.3	3.64
RediShred	16%	18%	3.6	5.00
Propel	34%	77%	4.1	18.78
Converge Technology	8%	14%	4.1	3.41
GoEasy	21%	22%	6.8	3.24
Zedcor	36%	46%	7.2	6.39
Nuvei	17%	26%	7.5	3.47
VitalHub	20%	21%	8.7	2.41
SSC Security	12%	38%	9.7	3.92
Hammond Power	10%	11%	9.8	1.12
Decisive Dividend	21%	37%	11.1	3.33
Average	17%	27%	6.5	4.74

Figure 6 - Small Cap Fundamentals and Valuations³

We think this is the best way to illustrate the current state of the market. The large cap stocks have lower growth rates both for revenue and earnings but trade at 26.5x earnings³. The small caps listed grow the top and bottom line faster and only trade on 6.5x earnings³. The furthest column on the right takes earnings growth and divides by the earnings multiple. This equates to how much earnings you're getting per unit of valuation. For large caps you're getting 0.61 and for small caps you're getting 4.74x³! That is almost an 8x difference and the largest spread we have been able to find in the investments we have tracked.

The second massive disconnect, after the valuation gap, is that these small cap companies are reporting record revenue and record earnings. The long-term trend is positive. Their stock prices have not been indicative of the actual underlying performance of the business. All of these small cap companies listed (besides Reitmans – read more below) are on track for *record 2023 and projected record 2024 results*¹. Fear has led to the current trough, but these companies continue to perform.

Small Cap and Recessionary Cycles

*“Investors may ask themselves if now is the time to skew equity allocations to more liquid large caps. From an emotional perspective this feels like a logical investment strategy. The data on investment returns, however, suggests quite the opposite.”*⁴

An article published by Shroders⁴, used historical data and examples to explain why small caps actually outperform in recessions. It makes sense at the moment because there is such a large valuation difference between small and large. Small caps have been hit extremely hard in anticipation of a recession. Now that the damage is done, it makes sense that they could greatly outperform from here.

“...the market tends to sell small companies heading into a recession in favour of more liquid large cap stocks. The selling, however, gets overdone. We’ve all seen footage of a herd of animals turning on a dime to avoid danger, and it’s a similar picture with the rush of capital away from small caps heading into recession.”⁴

“Once we’re in recession, however, and as the market begins to discount recovery, there is an equally forceful rush of capital back into small caps. Investors are now anticipating benefiting from the sensitivity of small cap earnings to the recovery.”⁴

With the spread between large cap and small cap valuations being so vast, we would expect the future outperformance to be on a similar scale. The chart below depicts the small cap outperformance coming out of 2000-2002, the last time there was heightened concentration in the largest cap stocks.



Figure 7 - S&P Small Cap 600 vs S&P 500⁵

These cycles have and will continue to persist. The strategy of buying the cheap and discarded stocks may be hard emotionally, but has shown to be the successful strategy over time.

Inflation Cycle

Inflation and therefore interest rates, the tool used to fight inflation, have been more entrenched than we expected. This has negatively impacted the multiples on stocks, most notably on small cap stocks. As inflation has lasted longer than expected, the impact has been an elongated trough in this small cap cycle.

The full impact from rising rates hasn't been felt through the economy and is probably taking longer than usual because of the high fiscal support, but we would argue it has been more than factored into the prices of stocks. For those that think rates will stay higher for longer, we would push back with the reasons why rates consistently declined for 40 years before Covid hit – population & technology.



Figure 8 - US 10-Year Yields⁵

The working age population growth from 2008-2019 was less than 1/3rd the growth experienced in the 70-90's. Take a look at the graph below of the world working population growth and compare it to the interest rate graph above. The working age population (15-64), which is the population that spends, that builds, that invests, exploded after WWII. However, based on current birth rates, the growth rate continues to plummet and is expected to go negative.

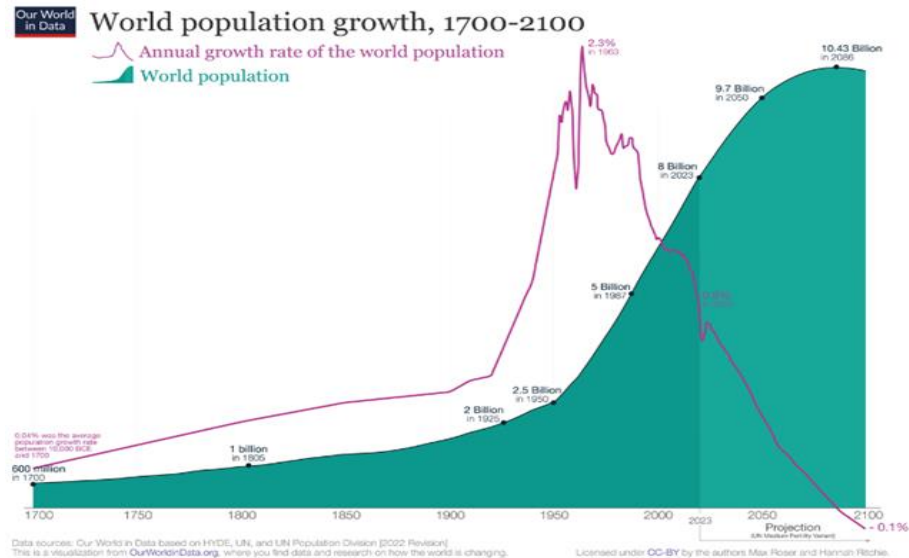
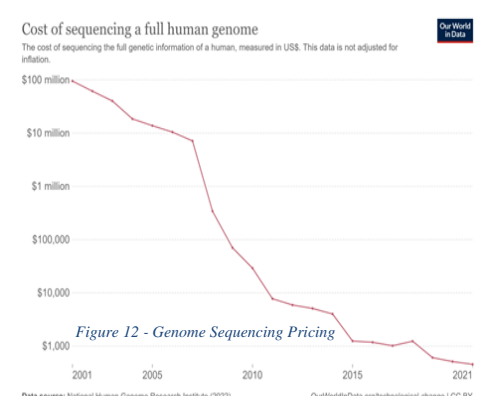
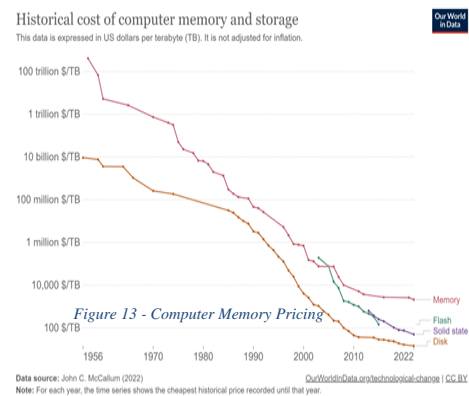
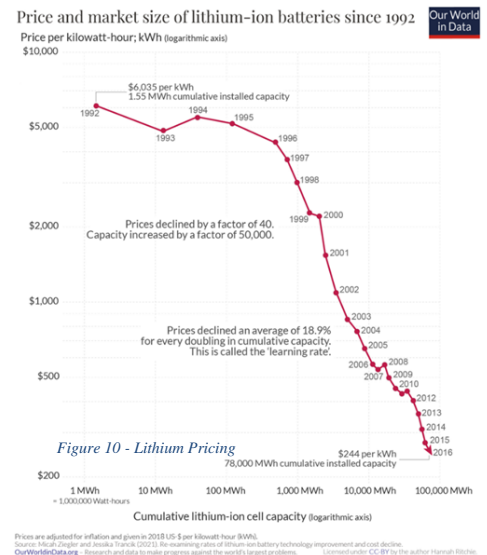


Figure 9 - World Population Growth

Technology is the second of the two major deflationary forces. We've included 4 examples below of massively declining cost curves, but this is the technological phenomenon being felt across the world.



For inflation to be more entrenched than expected, there would have to be a factor of inflation that keeps it high that wasn't in place for the last 40 years. The undersupply of real estate in Canada definitely doesn't help, plus geopolitical tensions and impact on energy prices are also inflationary. These are factors to watch, but secular decline in population growth plus continued deflation from technology will be hard forces to fight against.

Reitmans (RET & RET/A)

We originally wrote about and included our analysis on Reitmans in our [January 2023 newsletter](#)⁶. Recently the stock sold off after their reported quarter because of difficult year-over-year comparisons. This is a flawed way of approaching the results. The quarter was actually in line with our model and expectations. The main point to take notice of is that there were \$20m of compensation costs expensed in 2023 that was based on performance in 2022.

By simply comparing year-over-year results, you're not comparing apples to apples. We would suggest following the cash. Operating cashflow in the quarter was \$37m and total cash increased \$27m. The market cap is only \$127m with \$100m of cash on the balance sheet.

Considering the recessionary storm clouds, another assumption is that a clothing retailer is a risky investment. Reitmans is a value brand, and they have had resilient revenue because of the value they offer. In 2008-2009, during the worst recession in recent history, sales remained consistent, and profits were stable. If you were to apply how much they made per store in the 2009 recession to their store count now, the stock is trading on 3x earnings. Now they are even more streamlined, have a high percentage on online sales, and a rock-solid balance sheet.

We have updated our valuation tables and added the recent Chico's women's clothing takeout by Sycamore Partners that was announced in September. Private equity firm Sycamore Partners is paying \$938m, which equates to 11x PE multiple. Reitmans has higher gross profit, operating margins, net margins, plus a better balance sheet

Retailer Earnings Multiples

<u>Retailer</u>	<u>2023 PE</u>
Reitmans	2.3x
Nordstrom	6.8x
Guess	7.4x
Dillard's	8.5x
American Eagle	13.6x
Abercrombie	14.1x
Roots	15.7x
The Gap	16.4x
TJX (Winners)	24.2x
Aritzia	25.9x
Average	13.5x

Figure 14 - Retailer Multiples³

Reitmans Valuation Potential

<u>Valuation Method</u>	<u>2023 PE Multiple</u>	<u>Value per Share</u>
Average competitor multiple	13.5x	\$13.84
Closest Canadian Competitor	15.7x	\$16.09
Chico's takeout multiple	11.1x	\$11.38
Average Reitmans multiple 2002-2013	15.0x	\$15.38
Average	13.5x	\$14.17

Figure 15 - Reitmans Valuation³

From current prices⁷, this suggests +500% upside and doesn't take into account the large cash hoard, the completely owned office building and distribution center. *The delta between where the stock trades and its intrinsic value is so large that it begs the question if something else is holding it back? **To that end, we have sent a letter to the board because we believe the business is being run well operationally (day-to-day) but not at the board level (this letter can be found as an appendix to this newsletter).***

Their approach to the capital markets and treatment of minority shareholders is poor and outdated. We believe by consolidating into a single class share structure, thus eliminating the no coattail clause issue, plus uplisting to the TSX and becoming more shareholder friendly will undoubtedly help close the gap.

We continue to buy both classes of shares.⁸

Reitmans is one of the most straight forward examples of the value that is available in this environment. We expect to be active in many more scenarios like this where companies should be taking advantage of the environment we are in and maybe need a little push to do so.

If you are a Reitmans investor, please feel free to reach out. We would be interested to hear points of disagreement or potential other strategies to unlock value.

Converge Technology (CTS)

On October 19th Converge released preliminary Q3 results which surprised to the upside. They lead with the title “Q3-2023 Performance to be Stronger than Expected”. Gross profit will be up ~22% vs 2022 and EBITDA will be up ~29% vs last year. They also included, “Cash generated from operating activities improved significantly in Q3, resulting in positive free cash flow and a reduction in net debt”. The stock is currently up ~20%⁷ since the release and we expect the stock to do even better as the true earning ability of this company shines through.

RediShred (KUT)

RediShred reported a record quarter at the end of August. They then announced two more acquisitions and guided to completing more before year-end. The stock on the other hand declined quite a bit. The stated financials, with forex and a fluctuating paper price, may hide the true profitability, but the company continues to reinvest at high rates of return. The profitability of shredding trucks is much higher than one might expect. We continue to believe in this management as they execute like they say they are going to.

For both CTS & KUT, we focus on cash earnings versus other metrics like free cashflow or EBITDA etc. We believe both companies are investing in *growth* CAPEX at high rates of return, which is what you want to see. These are two investments that we expect to jump considerably as the cycle turns.

Conclusion

Going through a trough is hard and it is emotionally draining. One way to approach this opportunity would be to try and put your emotions aside. Change the narrative in your head. Approach it analytically and say to yourself “What stocks are cheap?”, “What stocks are poised for a comeback?”, “When the cycle turns where should I be?”

Human emotion is hard to fight against. We have to fight against the buy high and sell low mentality. We're conditioned to be pessimistic and optimistic at precisely the wrong times. For example, getting scared out and selling during 2008 and missing the large rebound in 2009. Or the Covid crash in March 2020 and missing the massive rally that ensued in the months thereafter. The notion of repositioning into small caps now is becoming more and more common in our daily discussions with investors. Small caps outperform in recessions and investors from what we've seen are grossly over exposed to the very large caps.

There will be opportunities when this cycle turns. We remain focused on owning companies that are growing revenues, growing profits, have solid balance sheets, and especially now, trade at extremely cheap prices. We will leave you with some context, in that our current top 10 investments are all on pace for record revenue and earnings in 2023.

Please take a listen to our most recent podcast and if you like to set-up a call or meeting, please feel free to reach out.



<http://t.ly/OJR8w>

“Most people get interested when everyone else is. The time to be interested is when no one else is. You can’t buy what is popular and do well.” Warren Buffett

Feel free to reach out with questions or comments,

J.P. Donville & Jesse Gamble

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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 – Article can be found at <https://donvillekent.com/wp-content/uploads/2022/11/DKAM-ROE-Reporter-November-2022-Final-1.pdf>

2 – Chart sourced from <https://www.nature.com/articles/488024a>

3 – Per DKAM internal estimates

4 – Shroders article can be found at <https://www.schroders.com/en-us/us/individual/insights/do-small-caps-or-large-caps-perform-better-in-recessions/>
5 – Per Bloomberg

6 – January 2023 newsletter can be found at <https://donvillekent.com/wp-content/uploads/2023/02/DKAM-ROE-Reporter-January-2023-Final-1.pdf>

7 – As of October 24th, 2023

8 – As of October 24th, 2023, DKAM Capital Ideas Fund LP owns 1,314,100 of RET.A shares, and 620,600 RET shares.

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DONVILLE KENT ASSET MANAGEMENT
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October 12th, 2023

The Board of Directors
Reitmans Ltd
250 Sauve Street West
Montreal, Quebec
H3L 1Z2

Attn: Chairman Stephen Reitman

Attn: Daniel Rabinowicz, Samuel Minzberg, David Kassie, Bruce Guerriero, Theresa Yanofsky, Anita Sehgal, Gillian Reitman, Andrea Limbardi

Dear Mr. Reitman and Members of the Board:

We are writing to you as strong supporters of the company but also as concerned shareholders.

We are firm believers in the brand value at Reitmans, RW&CO and Penningtons. After speaking with customers, employees and investors, the resiliency of the brands is obvious, which supports the resiliency of revenue and earnings for the business. The executives and staff of the business appear to be doing an excellent job with costs being contained and proper investments being made. We would not have invested in the company if we thought it didn't have a bright future.

That being said, we see far more value in the business than is currently reflected in the Company's stock price. The stock appears to be undervalued by a factor of 2.5-3x. After considerable research and many conversations with investors, we believe this discrepancy is largely due to the company's share structure and attitude towards capital markets versus the fundamentals of the operating business. More specifically, many potential investors are hesitant to invest based on the dual class share structure, the non-voting shares having no coattail provision and especially the fact that the stock now trades on the TSX Venture Exchange.

We have provided a multi-step proposal below. We believe our proposal tackles the issues that are currently suppressing shareholder value and implementing each step will unlock this value and set the company up for long-term success.

Proposal - Simple Acts to Create Substantial Value

1. **Eliminate Dual Class Share Structure**
 - a. **Settles No Coattail Clause Issue**
2. **Buyback**
3. **Uplist Shares**
4. **Investors Relations**

Step 1 – Elimination of dual class share structure

The company is approaching its 100-year anniversary and times have definitely changed. From an onlooker standpoint, the business has appeared like a fiefdom up to this point. With the passing of longtime CEO Jeremy Reitman and the announcement of the first ever non-Reitman family CEO, we believe this ushers in a new era for the company. The typical argument for keeping a founder or visionary in control with dual class shares no longer prevails.

This is necessary and in the best interest of shareholders because it is the first step in uplisting the shares from the TSX Venture Exchange to the TSX Stock Exchange. We have spoken to specific groups, but there are many more that will not invest in companies that are listed on the junior exchange. In addition to investors, the majority of Sell-Side Analysts and Index Providers solely focus and allocate to the main exchange.

This reorganization into a new class of share will also solve the current issue of the shares not having a coattail provision, which is necessary to be listed on the TSX Stock Exchange. With Reitman shares being one of the remaining few who were grandfathered in when this rule was implemented decades ago, it is now time to move ahead and resolve this issue.

We have provided information from when Magna International Inc eliminated their dual class share structure in 2010. The Class B shares had effective control of the business and did not contain any protections for holders of Class A shares and there wasn't a coattail provision. We think Magna is an appropriate example of the specific details but also an example of the board acting in the best interest of all the shareholders and fulfilling their fiduciary duty.

“Magna has also done things to reward its shareholders, such as boost the dividend and buyback shares – things it didn't bother do when their votes didn't matter.” MacLeans, 2014.

Magna announced the intention to eliminate dual class share structure May 6, 2010, and the shares immediately increased in value by over 20%.

- June 28th, 2010
- Special meeting for the reorganization of Magna that would result in the elimination of Magna's dual class share structure by way of a court-approval plan of arrangement
- Immediately following the Arrangement, Magna would have a single class of voting equity securities with each vote getting 1 vote per share
- Magna believes the Arrangement, if approved, has the potential to unlock significant share value for its shareholders and establish a stronger foundation for its continued and long-term success. Among other things, the Arrangement is expected to:

- reduce or eliminate any trading discount of Magna’s Class A Subordinate Voting Shares associated with Magna’s dual class share structure;
- enhance the liquidity and marketability of Magna’s shares;
- address the concern expressed by some holders of Class A Subordinate Voting Shares as to the alignment of interests of all shareholders;
- allow each shareholder to have a voting interest that is proportionate to the holder’s equity ownership interest;
- eliminate the ability of the holders of Class B Shares to sell control of Magna without any consideration being paid to the holders of Class A Subordinate Voting Shares

We have attached the Magna Circular for their special meeting from 2010 for reference.

Obviously, the ability to vote is valuable and as a result of modifying that power, the conversion should occur at a premium. We suggest that each current voting share is converted to the new class at a 50% premium.

Step 2 – Share Buyback

Roughly speaking, post conversion there would be ~55.5m shares with the Reitman family controlling ~21%.

In order for the Reitman family to regain control, the company would need to buyback 32.4m shares under this specific example. We think this would be a great use of capital considering the current valuation and strength of the balance sheet and cashflows. We suggest completing that size of buyback over the next 3-4 years, but the breakdown could be as follows.

1. Buyback \$16m/year over 5 years
2. Buyback \$20m/year over 4 years
3. Buyback \$26m/year over 3 years
4. Buyback \$40m/year over 2 years
5. Buyback \$79m in 1 year

Retail businesses obviously had a hard time during Covid and the decision and process of entering CCAA would have been extremely difficult. Understanding the current strength of the business, like the resilient earnings ability of the current stores and especially the strength of the balance sheet, paired with the current valuation of the shares leads to a historic opportunity.

In the past, the company has bought back shares on many occasions but non like this. We believe some of those past buybacks were most likely a mistake, paying too high a multiple and spending too much at one time. From a capital markets perspective, having a continual daily buyback is much more impactful and much more flexible than single large issuer bids, like the large one completed for \$45m in 2019.

Reitmans has made over \$50m in earnings over the last 12 months, is sitting on \$100m of cash and has a \$115m market cap. Just last quarter, cash increased over \$27m. While we understand the benefits of

being conservative, there is a difference between being careful and being incapacitated. The macro economy is obviously uncertain, and we're not advocating for a large buyback or anything aggressive. We don't think a buyback of less than half of yearly earnings, paired with the current cash balance, will preclude the company from making any of the necessary operating investments or undermine the balance sheet.

Step 3 – Uplist to the TSX Stock Exchange

We believe many boards and management teams don't understand the importance of being on the TSX main board. Many institutional investors will only invest on TSX listed companies, usually due to imposed risk management mandates. Additionally, being considered for index inclusion is vitally important and so is liquidity. With a single class of share and the complications of coattail provisions behind us, we believe uplisting is a low hanging fruit to increase shareholder value.

Step 4 – Investor Relations

Since publishing our research on Reitmans almost a year ago, we have become the defacto source of information for investors. We get calls and emails asking questions about the business that could and should be asked and answered on earnings calls or by sell-side analysts. Comparable public companies not only have earnings conference calls but also provide regular investor presentations as well as seek analyst coverage. We believe better engagement and communication with shareholders will help the market understand the great investment opportunity that is Reitmans.

We believe this process should start immediately and suggest creating an independent committee to assess the required actions. As shareholders, we trust that the Board has our best interests in mind and will comply with their fiduciary responsibilities.

We thank the Board for their consideration and welcome any questions directly from any members of the Board.

Sincerely,



Jesse Gamble

Sr. VP & Portfolio Manager

Donville Kent Asset Management

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