

Software at an Inflection: Weighing AI's Earnings Potential vs. Margin Pressure

The DKCI Fund was down -1.07% in August (-2.60% YTD & +18.36% trailing twelve months).¹ Our software investments underperformed during the month, which is the main topic of this newsletter.

Our most recent newsletter was one of our most widely read and circulated. If you missed it, you can read it [HERE](#). In that newsletter we focused on the valuations of small caps versus large caps and mentioned that the catalyst for small caps to rebound is interest rate cuts. Historically, small caps outperform large caps after 50-150 bps in cuts, so counting the cut in 2024, the catalyst should be September 2025-early 2026. There are currently 2 more rate cuts predicted for the rest of 2025.

In this edition of the newsletter, we will address the two most common questions we've received recently plus provide summaries of Q2 earnings and portfolio moves.

Artificial Intelligence and Impact on Software

The most popular question recently has been how will AI impact traditional Software as a Service (SaaS) companies. People have been concerned as of late because many software stocks have been weak due to the narrative that AI will negatively impact their business.

There are two parts to this argument:

- 1) AI makes it cheap, fast, and easy to build and sell a software app. The argument being this creates more competition and potential price pressure.
- 2) AI makes it easier for companies to develop their own software in-house, leading to less demand for software from vendors.

There is a certain level of legitimacy to both these points, but like most things, the value is in the details.

Our fund's exposure to software investments is mainly through VitalHub (VHI) and Constellation Software (CSU). Both of these stocks, along with almost all software stocks, have declined fairly significantly recently based on the AI

narrative. It is important for our investors to understand why we think these two companies will do well in this environment while at the same time explaining why some software companies will be in trouble.

To start, we will focus on argument #1. The cheap and fast AI app development is being referred to as “vibe-coding”. This is a relatively new concept but the examples of where it works versus where it doesn’t is starting to become fairly apparent.

A recent Pitchbook article, titled *The Dangerous Vibes Powering VC’s Favorite Start-Up Category* explains the main issue.

“Vibe coding soared to prominence on the premise that a person with just an idea and no software skills could create new applications using instructions in plain English. But a growing number of hacks and security vulnerabilities is raising concerns about these tools.”²

As the recent article from PitchBook highlights, many of these vibe-coded software apps lead to massive cyber incidents. This makes sense, because the basis around constructing this way is to do it as cheaply and quickly as possible. This leads to massive oversights, underinvestment, and lack of ongoing maintenance on the cyber front.

Due to the lack of investment in security and the associated security risks with these tools, the AI argument #1 falls apart when dealing with software that handles sensitive data with lots of users. These vibe-coded apps are far away from being able to receive SOC 2, DoD, or HIPAA compliant certifications, meaning traditional software companies in healthcare, finance, and defense have a moat here.

Vibe coding can be useful for simple tasks. It can make sense as a “first draft” with technical oversight and reviews, which is what most software companies are already doing. This is what is allowing them to grow revenues without increasing their development teams, which is why we’re seeing increasing profit margins of many tech companies.

The legitimacy for argument #1 comes to software applications where the use case is less regulated and security is less of a priority. The traditional software companies that are probably in trouble are in sectors like customer service, digital media, content creation, website creation, marketing, etc. Companies that come to mind that will probably face a lot of competition and hence business pressure, will be companies like Adobe, Enghouse, Salesforce, WIX, GoDaddy, Trade Desk, etc.

Now let’s look at argument #2, which focuses on using AI to accelerate in-house software development and forgoing software companies. This is definitely a valid point, especially for larger companies who usually shift to more

customized software as they scale. The cost to continually maintain, modernize, and secure software can be significant, especially if it isn't your expertise and you lack scale. Using these AI tools makes sense for large companies that have the resources to continually maintain the software they generate. If a company is large enough and sophisticated enough, there is a good chance they reduce their spending on traditional software as a service applications.

Where this argument falls short is for end customers that are either too small, too risk averse, or where their software spend isn't significant enough (relatively) to make the change. If a company is spending a low percentage of their operating expenses on software, and that software is integral to running their business, then taking the risk to save a small dollar amount doesn't make sense. Similar to the above argument, large and expensive software systems like ERP systems & HR software can run into the tens to hundreds of millions of dollars per deployment. These price tags could give the customer ample motivation to try and use new AI tools to internally develop software instead.

Now let's take a look at our two main software investments that fit into this ecosystem.

VitalHub provides mission critical software mainly to the healthcare industry in Canada and the UK. Their clients are the UK and Canadian governments. They handle extremely sensitive patient data, have the required certifications and have a pristine cyber security record. We don't think their government clients have the risk appetite or budget constraints to shift their business to cheap start-up alternatives or develop software internally.

From our viewpoint, healthcare is usually the last to adopt "new" technology, which is why VHI is winning and implementing software today. They are literally just now getting doctors' offices to replace fax machines with software solutions. Speaking with healthcare professionals, cyber and service are the highest priorities when selecting a product. Not price.

Constellation Software hosted a call for investors on September 22nd that strictly focused on AI. You can access the replay of the call on their website. They provided a lot of great examples of how they are utilizing AI and how knowledge about customers' processes and workflows is proprietary. We would suggest listening to the call to better understand the argument we are making above.

Constellation is home to more than 1,000 separate software solutions. They are the definition of niche software. They have a structural advantage, which isn't just diversification, but also knowledge of processes and workflows. For many of these software solutions, they have many years, even multiple decades, of experience in that specific niche. Dealing with customers over decades provides data and critical insights into customer workflows and processes. This allows companies like Constellation (& VitalHub) to create solutions for clients'

problems instead of building AI tools that are in search of a problem (many new AI apps would fall in the latter category). The domain expertise can't be overlooked and should be the first question when measuring AI disruption risk. The size of these customers also points to the lack of scale and resources to build and maintain software internally, most of which is mission critical and hard to rip and replace. (Just as a note, Healthcare is also Constellation's largest vertical market).

There are also internal benefits and opportunities here. VitalHub and Constellation, have their own AI initiatives which allow them to do more with less and you're seeing it play out in their profit margins. It is early on for both these companies, but many software companies are starting to use AI themselves as a tool to be more efficient. They're able to automate the more menial tasks and focus their internal talent on more important tasks.

The recent pullback in software stocks due to this general narrative provides the opportunity to invest in the companies that will benefit while avoiding the companies that actually have disruption risk. We think this sector wide sell-off is an opportunity if you can distinguish between the winners and losers. We have been adding to VitalHub and Constellation.

Details on Valuations

Besides inquiries on AI/Software, the second most common question we have received recently, which stems from our last newsletter, is where are these cheap small caps? The issue is that potential investors will look specific stocks up on Yahoo finance or their trading platform and take whatever numbers they see at face value.

For example, one of our largest investments is Zedcor (ZDC), which we forecast is growing revenue 91% this year and 79% next year while cash earnings are growing 167% this year and 94% next year (without factoring in potential Z-Box success or enterprise client wins).³ We forecast the stock is trading on 14x 2026 cash earnings.³ If the company executes anywhere near this, the stock will do extremely well.

Now the issue for those that asked about not finding these cheap companies is where they go for information is either unreliable or the methodologies/accounting treatment is incorrect. This is usually the case for small companies as there aren't many, if any, analyst projections.

Below is a summary table for Zedcor and the different P/E valuations one might find on the internet (as of September 5th). This example can be applied to how the internet values other companies as well like Constellation and VitalHub.

Summary Table		
Source	Metric	Value
StockAnalysis.com	Trailing P/E (as of early Sep 2025)	234.13×
Yahoo Finance	Trailing P/E	209.50×
Yahoo Finance	Forward P/E	41.84×
MarketWatch/Barron's	Trailing P/E (w/o extraordinary items)	187.17×
Barron's	P/E current	250.43×
Barron's	P/E (with extraordinary items)	278.56×
Investing.com	LTM P/E	206.5×
Investing.com	Alternative LTM P/E	142.6×
Stockopedia	Forward P/E	59.56×

This is where the risk and opportunity are for investors. Can you get to the right numbers? We have Zedcor on 14x next year's P/E while Yahoo has it on 42x and Stockopedia has it on 60x.

Since 2008, we have written many times about how IFRS/GAAP reporting guidelines are fairly strict and the need to make adjustments to get to cash earnings. This is where most of the discrepancy above comes from. Doing your models/projections and focusing on cash earnings is important. We have included a summary of our model on Zedcor below. A detail that might seem unimportant but isn't in our view, is that maintenance capex was ~\$500k in the first half of this year, while true free cashflow that is invested into new towers is the cash earnings amount. One can nit pick our numbers in the model, but it would be hard not to see the stock as being cheap and nowhere near as expensive as some might think.

Zedcor Financial Projection Summary

	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025E</u>	<u>2026E</u>	<u>2027E</u>	<u>2028E</u>
# of Towers	265	506	825	1337	2700	4800	7300	10100
Growth YoY	70%	91%	63%	62%	102%	78%	52%	38%
Revenue (\$M)	14	22	25	33	63	113	177	245
Growth YoY		63%	13%	33%	91%	79%	57%	38%
Gross Profit	8	13	16	24	47	84	133	186
Gross Margin	57%	58%	63%	73%	74%	74%	75%	76%
G&A	4	6	8	12	24	41	61	83
Lease Payments	2	2	2	4	4	5	6	7
Adj. EBITDA	2	5	5	8	19	38	66	96
EBITDA Margin	17%	23%	20%	25%	30%	34%	37%	39%
Interest Expense	2	1	1	2	1	4	6	7
Tax Expense	0	0	0	0	1	1	6	9
Maint Capex	0	0	1	0	1	2	3	4
Cash Earnings	1	4	3	6	16	31	51	77
Growth Capex	6	9	13	21	49	70	82	92

*DKAM Estimates

Zedcor Projected Valuation Metrics

<u>Valuation</u>	
Stock Price	\$4.15
Market Cap	\$437
2026 x EBITDA	11.4
2027 x EBITDA	6.6
2028 x EBITDA	4.5
2026 P/Cash Earnings	13.9
2027 P/Cash Earnings	8.6
2028 P/Cash Earnings	5.7

*DKAM Estimates

Another way of looking at valuations and the opportunity in small caps versus large caps goes beyond their PE valuations.

A quick example is VitalHub. Their Novari acquisition gets them to \$120M in revenue and they probably do another \$35M in acquired revenue within a year which gets them to \$175M in sales including organic growth.³

Based on the above and factoring in their organic growth, they should get to +\$200M in revenue in short order and streamline acquired companies' profit margins to ~35% EBITDA margins (probably even higher).³ This equates to

~\$70M of EBITDA which leads to an implied market cap of ~\$1.6B, or about \$28/share which is 150% more than where the stock is trading today.

This is also another example of why looking at the trailing earnings multiple isn't very informative since the earnings grow over 200% when comparing the trailing twelve months versus 2 years out.

We would argue this table is the most informative for how we view future performance of our fund versus the rest of the market. The Bloomberg consensus estimates for the large indexes below (S&P 500, TSX 60, Nasdaq 100) show ~7% revenue growth, ~11% earnings growth, while trading on ~22x earnings. The S&P 600 small cap index trades significantly cheaper at 14.3x with much higher earnings growth at 19%. However, when we refer to cheap stocks, we view it as relative to how much growth you get per unit of price you have to pay. Our projections show much higher revenue and earnings growth with these companies trading on the cheapest valuations. Combined with the catalysts of declining rates, which we spoke about in our last newsletter, we think the portfolio is poised to do very well from here.

2026 Growth & Valuation Metrics					
	DKCI Fund	S&P 500	TSX 60	Nasdaq 100	S&P 600
2026 Revenue Growth	34%	6%	5%	9%	5%
2026 Earnings Growth	47%	12%	8%	13%	19%
2026 Cash P/E	13.2x	21.7x	16.8x	26.2x	14.3x

**S&P 600 is the small cap index that only includes profitable companies.*

Update on Q2 Earnings

VerticalScope (FORA) – We were waiting to see how quickly VerticalScope could address the changes to the Google algorithm before we made a definitive decision. During the last month we sold our position in FORA and used the proceeds to buy more VitalHub, Enterprise, and Constellation, as each of these positions pulled back in the month.

MDA Space (MDA) – On September 8th, EchoStar announced cancellation of their \$1.8B contract with MDA. That contract was just announced in August. The stock sold off +25% on this news after initially reacting close to +20% on the original announcement of getting the contract. Their Q2 results were a record for the company and they now have a ~\$5B backlog and \$13B pipeline with potential contract wins with Eutelsat/OneWeb, Apple/GlobalStar, Artemis, and Radarsat replacement. The market reaction after announcing the EchoStar deal and then losing it was understandable but we're still early in the secular growth of space commercialization and MDA is reporting significant earnings growth. We expect them to announce more satellite constellation contract wins.

MDA Reported Q2 Earnings

Revenue \$373m +54%
Adj. EBITDA \$76m +57%
EBITDA Margin 20%
Net Income \$48m +106%
\$420m Net Cash
Current backlog over \$6B

VitalHub (VHI) – As covered earlier, VitalHub’s stock has been weak due to the AI narrative. They reported a record Q2 and have significant capacity to be opportunistic with +\$120M in cash and no debt on the balance sheet.

VitalHub Reported Q2 Earnings

Revenue \$23.9m +47%
ARR \$79.6m +55%
14% organic growth
Adj. EBITDA \$6.3m +50%
EBITDA Margin 26%
Cash Earnings 5.1m +132%
Cash Margin 21%
Novari acquisition closed after the quarter end
Including Novari the ARR increases to \$91.6m
Sitting on +\$120m of Cash and no debt currently

Constellation (CSU) – After listening to their AI call on September 22nd, we expect them to be net beneficiary from an efficiency perspective as well as adding additional revenue streams.

Constellation Reported Q2 Earnings

Revenue \$2.84B +15%
5% organic growth
Operating Cash flow \$433m +63%
Cash Earnings \$619m +34%
Cash Margin 22%
Deployed \$469m on acquisitions in the quarter
Deployed \$320m in Q3 so far
Higher margins with lower % staff expenses

Zedcor (ZDC) - Zedcor continues to impress. Canada is supposed to be its mature market, and they still grew in Canada by 39% with 63% EBITDA margins. They plan on expanding into Quebec and cities like London, Ontario. As they mature in the US, their margins should get to Canadian operating levels. All their branches in the US are now fully staffed so margin improvement should

happen quickly. Our model (above) doesn't fully factor in this margin improvement or potential Z-Box growth or large enterprise customer wins.

They continue to reinvest cashflows into the business at very high IRRs. This leads to an extremely reliable, high ROE. We've increased our estimates.

Zedcor Reported Q2 Earnings

Revenue \$13.5m +84%

Canada +39%

US +478%

Adj. EBITDA \$4.9m +83%

EBITDA Margin 36%

Cash Earnings \$3.6m +100%

Cash Margin 27%

0.7x Debt/EBITDA

Canada gross margins 80%

63% EBITDA margins in Canada

US gross margins 72% (should improve as they scale)

Added 316 towers to the fleet (+20% vs. last quarter)

ZBox units reached 115

Utilization rates above 90%

Expanded into 10+ new cities

Enterprise (E) – We think they will be successful shifting to a full-fledged power company, mainly because these turbines are already proven to be a better source for energy. As shown by the deployment in an Alberta Rec Center, the turbines power all their electricity and heat while saving 849 tons of carbon dioxide per year and reducing energy costs by \$336k/year.

As the energy grid becomes increasingly stressed, companies will need alternative power sources that don't rely on the city's electrical grid in order to get their builds approved, but will also need it to be secure and reliable.

We used the recent pullback in the stock to add to our position. When looking at this company, their financials should be viewed on an annual basis due to the timing of spring break-up and shifts in activity. We expect 2025 to end up being a great year for Enterprise and 2026 to accelerate that trend.

We're looking forward to them signing deals outside of drilling, including mining, data centers, and utilities. Their recent partnership with Plum Gas Solution is the first step. We've been adding at these levels because this is the bottom from both a seasonality perspective but also a natural gas activity perspective.

Enterprise Reported Q2 Earnings

Revenue \$6.5m -16%

Operating Cashflow \$5.1m +2%

Operating Cashflow YTD \$10.1M

Closed the acquisition of Flex Canada on May 7th

Add Long-term rental/long-term maintenance contracts

Pre-Synergies acquired Flex at 4.2x EBITDA

Strategic partnership with Plum Gas Solutions

On pace to have a record year for revenue and earnings

Tornado Infrastructure (TGH) – Tornado had a great quarter, and they are winning business over Badger. We expect the high margin equipment finance segment to grow quickly.

Tornado Infrastructure (TGH)

Revenue \$45m +31%

Gross Profit \$9m +45%

EBITDA \$5.6m +49%

Cash Earnings \$3.6m +36%

Cash Margin 8%

Acquired CustomVac for \$28m May 15th

Cipher Pharmaceuticals (CPH) – Cipher is now starting to show the results of acquiring and integrating Natroba. Cipher has a lot of opportunity in front of them with licensing Natroba in Canada, out-licensing globally, plus adding more products to their dermatology line-up.

Cipher Reported Q2 Earnings

Revenue \$13.4m +152%

Gross Profit \$10.9m +159%

Adj. EBITDA \$7.6m +148%

EBITDA Margin 57%

Net Income \$5.9m +97%

Bought back \$2.1m shares

Natroba trending well above expectations

Continue to work on licensing Natroba into Canada

Continue to work on out-licensing Natroba globally

Looking to add to dermatology line-up with M&A

Tantalus Systems (GRID) – Tantalus spent years developing TruSense and the results from that investment are just starting to materialize. They are modernizing the electrical grid and providing the utilities with the data they need.

Tantalus Reported Q2 Earnings

Revenue \$13.1m +22%

ARR \$13.3m +11%

Adj. EBITDA \$510k

Operating Cash Flow \$759k

Net Cash

Secured initial orders from 45 utilities for TruSense
(up from 33 last quarter)

Propel Holdings (PRL) – Propel continues to execute and their integration of Quidmarket appears to be going well. Their opportunity for LaaS loans is significant, which should support growth and an increase in margins.

Propel Reported Q2 Earnings

Revenue \$143m +34%

Loan Book \$520m +33%

Net Income \$19.2m +16%

ROE 32%

Revenue in-line with estimate, Net Income better

Maintained 2025 guidance (34% ROE)

Increased dividend 9%

GoEasy (GSY) – GoEasy reported a strong quarter with a 23% ROE and reiterated their 2025 guidance. Of note, there was a short report issued on September 22nd. The stock declined from \$204 to \$175 as a result. We believe the report misrepresents many points, mostly around the accounting impacts as GoEasy has significantly grown their asset-backed lending business. There are also other scare tactics in the report like flagging insider selling but not highlighting that it was just 208 shares. If anyone wants more details on the short report and our detailed thoughts, please feel free to reach out.

We had trimmed ~60% of our GoEasy investment around \$205/share the preceding month as we added significantly on the last sell-off and it rebounded well. We may be looking to add after this pullback as well.

GoEasy Reported Q2 Earnings

Loan Originations \$904m +9%

Loan Growth \$313m +9%

9% above initial outlook

Loan Portfolio \$5.1B +23%

Revenue \$418m +11%

Net Charge Off 8.8%, down 50 bps YoY

(better than Q1 '25 & lowest rate since Q4 '23)

Low end of outlook 8.75%-9.75%

Loans 90 days overdue 2.81% vs. 3.36% in Q1 '25

ROE 23.2%

Reiterated full year guidance

Conclusion

Many stocks performed extremely well in 2024, and it isn't uncommon for them to "take a breather" before continuing their climb higher. We would put stocks like Zedcor, VitalHub, Propel, Cipher, Constellation, and Tornado in this category. That being said, the underlying companies continue to grow, generate cash, and re-deploy it back into their businesses at high rates of return. Combining continued profitable growth and low starting valuations, we foresee a strong next leg higher.

We would again like to highlight our fund's weighted average revenue & earnings growth plus its valuation.

DKCI Fund Growth & Valuation Metrics

<u>Fund Metrics</u>	<u>Weighted Average</u>
2026 Revenue Growth	34%
2026 Earnings Growth	47%
2026 Cash P/E	13.2x

**DKAM Projections*

Finally, we will be hosting a Webinar on October 23rd at 1:00PM EDT, where Jason and Jesse will discuss their market outlook, specific portfolio investments and answer Q&A. You can register using the link below.

https://us06web.zoom.us/webinar/register/WN_xUMnL3WIR-GMcJD982RT0Q

Sincerely,

Jason & Jesse

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¹ Time weighted return, net of fees and expenses

² https://pitchbook.com/news/articles/dangerous-vibes-powering-vcs-favorite-startup-category?utm_medium=newsletter&utm_source=daily_pitch&sourceType=NEWSLETTER

³ Internal DKAM estimates