DKAM DONVILLE | KENT asset management inc.

ROE REPORTER

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INVESTMENT ISSUES • STRATEGIES • INSIGHTS FROM DONVILLE KENT

On The Cusp

From time to time we sit down and chat with other fund managers and investors. This can be a useful exercise especially when someone has a contrasting opinion. Roughly 13 years ago a well-known investor came into our office. This investor truthfully believed that three of the major Canadian banks were going to go bankrupt in the coming months and he had sold all his investments. For perspective, this is on the heals of US banks like Lehman Brothers, AIG & Bear Stearns effectively going bankrupt just months earlier. Plus, the unemployment rate was rising and stock prices were sinking. Point being, times were DIRE in late 2008 and early 2009 and most investors were forecasting much of the same for 2009 mainly based on emotion. Now we all know that the Canadian banks handled the great recession extremely well and that type of pessimism from our colleague was unwarranted.

This provided a major lesson because investor sentiment got too negative and stock valuations got too cheap. It became quite apparent that during drawdowns it's human nature to do the wrong thing at the wrong time.

Donville Kent Asset Management
200 Bay Street – Suite 3120
Toronto, Ontario
M5J 2J3

416-364-8505
www.donvillekent.com

"Although we are not top-down (macro) investors, we expect that 2009 will be a good year for investors for several reasons. …we believe that at some point in the not-too-distant future the market is going to rise and we expect it will do so in a significant way." DKAM'S ROE Reporter from January 2009

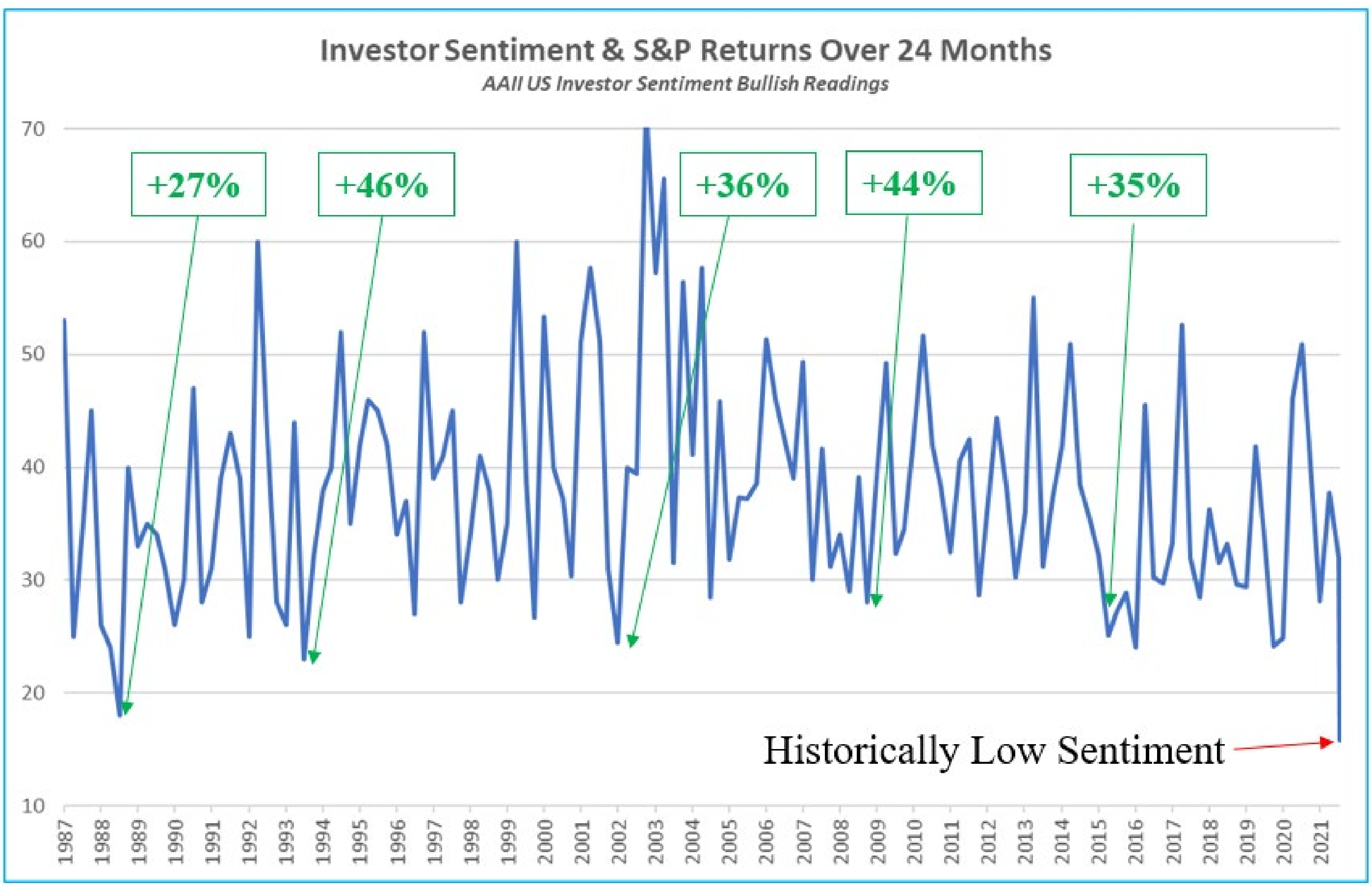
2009 turned out to be a phenomenal year to invest. The Capital Idea's Fund was up 88.17%[1] in 2009 and up 113.04%[1] in the twelve months following the bottom in 2009. Investors are even more pessimistic now than they were during the great recession of 2008/2009 and profitable small cap stocks[2] are cheaper now than they were then. Many of our portfolio investments seem to be trading solely based on investor psychology versus real fundamentals.

Our fund hasn't performed well over the past 8 months. We have been disappointed with our performance but not necessarily our process and stock picks. We have been surprised by the severity of this sell-off, especially in small cap growth stocks. The disconnect between fundamental business performance and stock price performance has been persistently frustrating over the last few months. Companies' reported sales, margins and earnings have been great and for many, their forward momentum is accelerating. We remain focused and committed to generating superior returns for our investors and progressing back to and above our previous highs. Similar to March 2009 and March 2020, we're now at historical lows in both investor sentiment and valuations. Combine both these factors with continued earnings growth and we believe our investments will be back to new highs sooner than most anticipate.

Preparing for a recovery in confidence

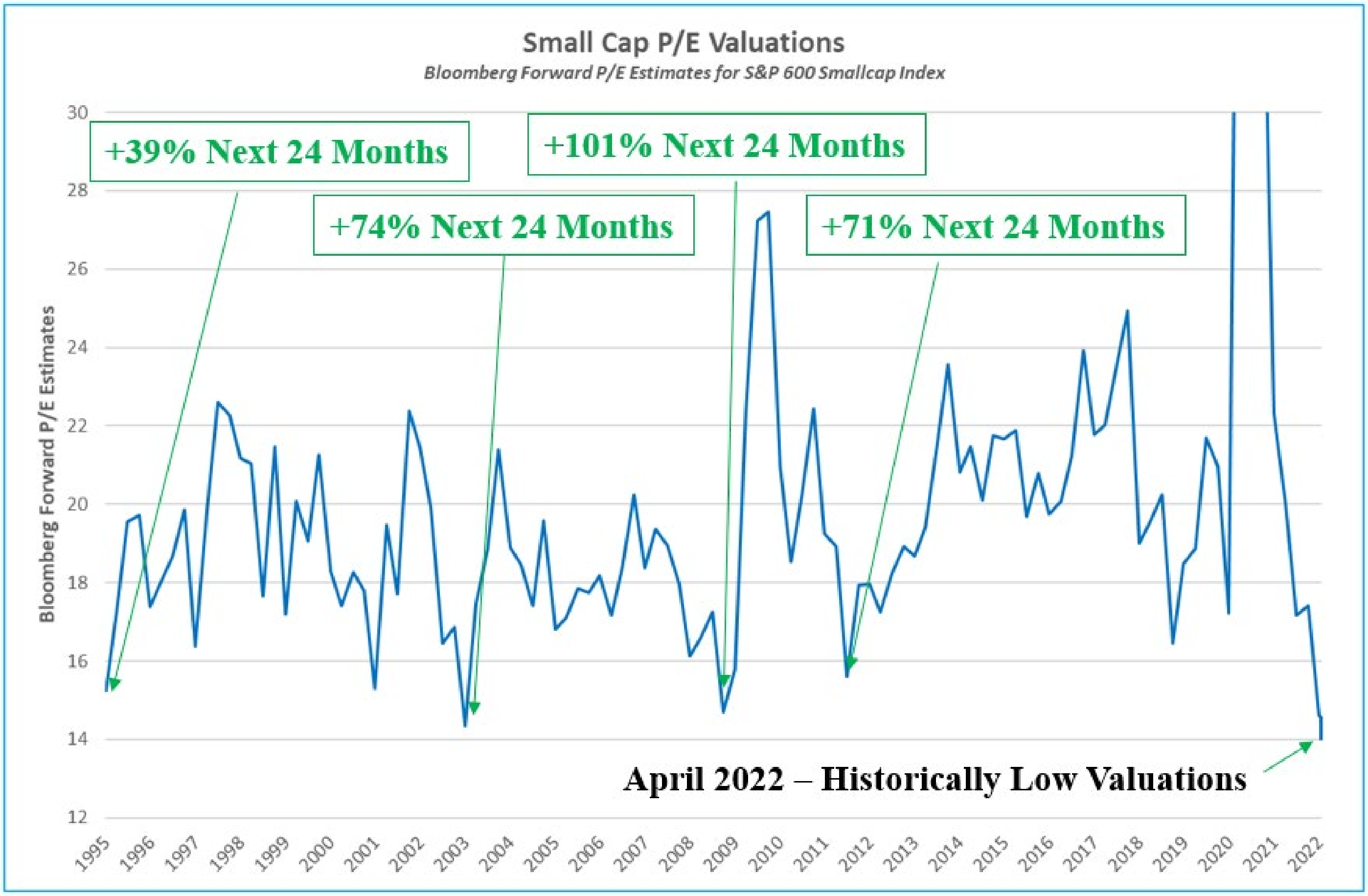
Looking back at 2021, stocks sold off when the Federal Reserve changed its stance on inflation. Interest rate hikes were back on the table and what followed was a sector wide sell-off in growth stocks, especially small cap growth stocks. Combine this with a war in Ukraine, Covid lockdowns in China, and a slowing housing market and investors' attitudes are now extremely negative. Investor sentiment indexes, like the one below, aim to track these attitudes and the current sentiment is at an **all-time** low[3]. Sentiment is now lower than the market bottom in March 2020, the market bottom in March 2009, the bottom in October 2003, and even the bottom in 1987[3].

Like in 2009, investors are too negative and we now expect psychology to reverse. Investors' mindsets now, like in 2009, will go from Chicken Little, expecting the sky to fall, to Warren Buffett, treating these cheap valuations as an opportunity. As you can see, the 24 month returns off past bottoms have been impressive. Combine this with our next point on valuations and the idea of wanting to buy small cap stocks here should be quite evident.



Why is valuation so important?

A stock's future performance can be broken down into a combination of factors that add up to its total return. In the simplest terms, a stock's return consists of the capital appreciation of the stock and the dividends received. However, we can take a stock's capital appreciation and break it into two pieces, namely the change in its earnings and the change in the multiple at which the stock can be bought and sold. Thus, if a stock's earnings double and the P/E multiple that it is valued at stays the same, then the capital appreciation is equal to the earnings growth and thus there has been no multiple expansion. However, if the stock has risen faster than its earnings, we can say that there has been multiple expansion, and conversely if the stock rises slower than its earnings, we can say that there has been multiple contraction. Ideally, investors seek to identify markets and stocks that will enjoy strong earnings growth and multiple expansion.



The pendulum of what investors are willing to pay for earnings (the multiple) swings back and forth over time, and from time to time it will greatly overshoot in both directions. This is because at market bottoms and tops the price of stocks is controlled by human emotion instead of financial fundamentals. As one can see from the graph above, small cap stocks[3] have swung to being the cheapest since this index was created over 27 years ago! The green text boxes illustrate the returns of small cap stocks[3] over the next 24 months after hitting valuation lows. We now have many stocks trading at cheapest valuations in our history. We don't know the timing of when these stocks will bottom, but when market psychology begins to shift these stocks should rebound impressively.

Where are the opportunities?

Well, let me start by saying that we are not top-down investors for a reason. We continue to believe that it is much easier for investors to identify strong companies and reasonably priced stocks than it is to predict the future direction of interest rates or inflation. As such, even though we believe the market is attractively priced at a macro level, we can protect ourselves by making sure that the investments we own are priced at low multiples of earnings and/or are growing at rates that are significantly higher than the market.

At Donville Kent, we believe that companies such as Constellation Software, Colliers, Topicus, and Redishred, just to name a few, are outstanding companies today and we can say with a high degree of certainty that they will continue to be outstanding companies next year, the year after that, and the year after that. Below are a few others that appear to be highly opportunistic buys at these levels.

GoEasy (GSY) – GoEasy's stock is currently down 47% from its high in September 2021 and a main contributor to our negative performance. Like we have mentioned before, this company is very misunderstood by the market and looking back on how it traded in March 2020 illustrates this point well. During the Covid decline in 2020, GSY declined 70% in short order. Management did a good job not only operating the business but speaking to investors about what was happening in the business. GoEasy's stock would **increase 831%** from the Covid lows. This business doesn't get enough credit for its technology, experience, and resiliency. The stock currently has a +3% yield, is buying back stock and is trading on less than 7x earnings[4]. We believe this current decline, even though painful for short-term performance, is setting up to be a great long-term opportunity.

Givex (GIVX) – Givex is new to the public markets, but the company is over 20 years old and has been profitable since day 1. Their new point-of-sale solution, GivexPOS, is gaining good momentum and can be found at Second Cup, Barburrito, Milestones and many more locations. They just launched GivexPay, their payment processing solution and their core loyalty solutions continue to gain market share. We forecast +30% revenue growth, 14% operating margins and have the stock trading on 4.8x EV/EBITDA. The stock is currently trading ~$0.75/share and just based on announced deals and growth rates, we think the stock should be valued closer to $2.25/share.

VitalHub (VHI) – VitalHub's management team continues to execute extremely well. We expect them to report record Q1 results that will support +20% organic growth for 2022. Even though the company has been executing for a few years now, the stock still doesn't get the attention it deserves. Once they announce and integrate an anticipated large acquisition, we foresee the stock getting to +$6/share.

Converge (CTS) – CTS management has executed their growth plan just as they explained the first day we met in 2018. The business has now turned a corner, and management has indicated that the business is throwing off enough cash that they will be able to execute on their deal pipeline plus start returning capital to shareholders. The stock deserves a large multiple re-rating plus there are multiple catalysts including imminent acquisitions in early 2022. We think CTS is one of the best stocks to own when the market rebounds.

Final thoughts

We would argue that although the news is bad, it is for the most part known and priced in. We have spent the last few months concentrating the portfolio in our highest conviction investments that should perform extremely well when sentiment turns.

We're currently seeing the best combination of growth rates, profit margins and valuations in the history of our fund. To get to this point we've had to endure a painful decline but like in past corrections, the tables turn quickly and with little notice.

I would like to thank our team for remaining committed and passionate to generating returns for our investors. I would like to thank our long-term investors for their support and trust in the process.

– Jason Donville, President & CEO

Feel free to reach out questions or comments,

J.P. Donville & Jesse Gamble
info@donvillekent.com

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

2 – The S&P 600 Smallcap Index is a capitalization-weighted index that measures the performance of selected U.S. stocks with a small market capitalization. The forward earnings estimates are provided by Bloomberg.

3 – Measuring market bottoms using quarterly data and history of the index back to 1987

4 – DKAM estimates based on 2022 earnings