PENDER
SMALL / MID CAP DIVIDEND FUND

THE MANAGER'S COMMENTARY – AUGUST 2020

Reported earnings for the second quarter ended as strong as they started. Through a combination of better-than-expected revenue and reduced costs, basically every company in our portfolio either met or handily surpassed our expectations.

In last month's update we noted that a portion of the stronger than expected earnings was likely unsustainable. Discretionary spending and travel expenses that were put on hold for example would return. However, there were a number of positives for our portfolio companies that could be sustained.

GDI Integrated, a janitorial service company, saw their margins in their Canadian segment double for the quarter. Revenue was impacted by building closures for a short period but additional cleaning services more than made up for this. Customers are now asking the company to disinfect, not just to clean for appearances, and these additional services will likely continue.

Pollard Banknote, which provides products and services to government lottery agencies around the world, saw a large upswing in usage for their internet-based lottery platform, iLottery. In fact, revenue for this income stream doubled in the quarter and other lottery jurisdictions, which don't have an internet-based lottery offering, have taken notice. We will discuss this in further detail below.

While we were happy with how our companies navigated through the second quarter, we are starting to look towards the third quarter. There was a lot of noise in the second quarter around the impact of government subsidies. Next quarter should be a cleaner quarter and give us a better indication of operations on a go-forward basis. We are not out of the pandemic yet, but we have a high degree of confidence that our companies should be able to continue navigating through this positively.

Industrial with a Tech Focus
Technology companies have been all the rage for the past five years and the stay-at-home mandate has only increased this. Investors have come to love the business model of technology companies. They are high margin, asset light and scalable. Tech companies have been rewarded for these advantages with high multiples. Hi-tech companies generally trade off multiples of revenues while industrial companies trade off their earnings, which includes all the costs of operating the business.

Ideally, it would be great to find companies with the business model of a tech company while trading at the valuation of an industrial company. Two companies in our portfolio are predominately industrial based but both have a technology related strategy aimed at growth: Pollard Banknote through their iLottery segment and IBI Group through their Intelligence Solutions segment. For both companies there is the potential for earnings growth and multiple expansion as investors take notice of their growing tech offerings.

Pollard manufactures physical scratch and win tickets as well as offering online lottery service, iLottery, to government agencies. While iLottery has been available for the past five years, adoption has been slow. Michigan, a Pollard customer, were ahead of their time and were the first state in the US to adopt iLottery. It's been a huge success, contributing $116 million in lottery revenue in 2019 for the state, where the proceeds are primarily directed to school funding. The neat part for Michigan is that as good as the success for iLottery has been, physical ticket sales also outpaced national averages. iLottery has been shown to be an additive source of revenue at a time when many US states are looking for new sources of revenue to help fund deficits.

Pollard has around a 50% market share for iLottery in the US, which is the largest lottery market in the world. Today only nine states have an iLottery offering, but most other states will likely have an offering within the next five years. Pollard's iLottery platform is very scalable as it requires little ongoing costs for additional customers once it has been developed it. This segment is at the inflection point in terms of profitability. We believe cash flow should begin ramping up with both more customers and increased transactions.

IBI Group provides architecture and engineering services. This is a difficult business to scale because the revenue generating assets are primarily the skilled labour. With natural employee turnover it can be difficult to hire and train staff fast enough to offset this, let alone grow. Most firms instead turn to M&A in order to acquire the employee numbers to grow. The challenge is that there is a shrinking pool of acquisition targets, causing multiples to continue creeping up.

However, instead of focusing on acquisitions to grow, IBI's strategy is to build out a technology platform through their Intelligence Solutions segment. They have a shelf of fully funded programs they have designed for customers in the past which they are now looking to offer to other customers on a subscription basis. Examples of their programs include toll road systems, traffic management and urban city analytics. These products have significantly higher margins compared to engineering and architecture services and are much easier to scale.

For both companies, we believe the potential of their technology strategies are not widely understood by most investors. The large cap tech giants have garnered a disproportionate amount of investor attention recently, but underneath this layer are a number of smaller, not well followed companies. They are high quality, cash generative businesses with a strategy aiming for growth at attractive returns. These are the companies we look to own in our portfolios.

The broader markets have staged a remarkable recovery from their bottoms in March, yet we feel there still exist compelling opportunities, such as Pollard and IBI, because small caps in general are simply not getting the same attention from investors as the large cap tech companies.

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September 28, 2020

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