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EP91 | Playing the plan: Mawer's Canadian small cap portfolio

Disclaimer:	00:25	This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.
Andrew Johnson:	00:40	All right, welcome back to the podcast, everyone! Today we are welcoming back Jeff Mo. Jeff is the lead portfolio manager for the Canadian small cap strategies here at Mawer. Welcome back, Jeff!
Jeff Mo:	00:51	Thanks Andrew, great to be on again.
Andrew Johnson:	00:53	We did an episode around this time last year on the Canadian small cap portfolio, but we had your co-manager Samir on at that time. So, believe it or not Jeff, it's been over two years since we've had you on the podcast. I'm excited you're here and to talk about how you and the team are doing with the portfolio.
	01:10	I really wanted to lead off the conversation with something I'm sure many of our listeners are curious about, and that's the IPO market so far in 2021—and especially for tech companies. And just for context for our listeners, according to CPE analytics, if you exclude SPACs—so these are special purpose acquisition vehicles—the TSX saw 25 IPOs totalling almost $6 billion in the first half of this year. And just for further context, in all of 2020, the TSX had just 10 IPOs for a total of $4.4 billion.
	01:44	And we're seeing similar activity in the U.S. I believe Q2 was also the most active quarter for IPOs there, since 2000. So help us make sense of where the demand for these businesses is coming from—including the demand for the equity in these companies that the market clearly has a lot of recently.

Jeff Mo: 02:02 You're right. This has been a very active year in Canada and across the globe for IPOs, especially for technology companies. And this has been a long time coming, Andrew. I mean technology at one point—i.e., during the dot-com bubble—was the largest sector in the market. But since then…I remember at one point back in the mid-2000s, at least for the TSX SmallCap, technology was maybe a 2% weight or something like that for the index. And so certainly it was in the doldrums and it's come back over the last decade.

Jeff Mo: 02:38 I think if you look at the economy, a lot of the areas that have been adding value or creating productivity gains have been through technology companies: software, even hardware; things like Tesla changing how we commute, how we drive.

What has been the disconnect though, in technology, has been between private market valuations and public market valuations.

03:03 So, technology is a little bit different than the traditional industries that we're used to dealing with. In fact, I would argue our accounting rules still haven't caught up.

For example, a traditional company, like a manufacturing company, when they want to grow, they would build a second factory. And so when they build the factory, they would buy the materials and build a factory, and that would be considered capital expenditures (CapEx). That would be capitalized on the balance sheet. Now, these new technology companies, they don't invest that way. They invest by hiring engineers, programmers, developers. They might grow without a very large sales force, spend money on marketing…all of that under traditional accounting rules is expensed. And one would say, "oh, well, you know, it's just dusty accounting rules." But I actually think for a very long time, especially in Canada, that was very important for investors—that companies showed profits on an accounting basis.

03:57 So none of these technology companies did, even though everyone thought that, hey, they have great competitive advantages, they're run by excellent management teams, and they are growing very, very quickly. And so the valuations actually, arguably look reasonable. Technology traditionally was funded by venture capital and other private vehicles like growth equity capital. And so companies like that would be very open to companies with accounting losses, because that's what they're used to dealing with. I mean, in venture capital [laughs]…pretty much every company you invest in is losing accounting money. If they're not, you'll probably doing something wrong as a venture capitalist.

04:35 I'll tell you a story...I'm trying to think...five/six years ago, so there's a company in Vancouver called Hootsuite. I think they're still private today, but they are a social media aggregation company. And so they were looking to raise some capital and we got contacted by a couple of banks saying—I don't remember the reason exactly—but they had wanted a Canadian investor for that round of financing—something to do with the number of shares controlled by foreigners, or there's some rule about that.

Jeff Mo: 05:06 And they had several offer sheets from various U.S. investors out for more than twice the valuation they were offering to Canadian investors. And it was completely crickets on the Canadian side. Nobody wanted to touch this company because they didn't have accounting profits.

There's a lot of value being generated, and I think eventually the Canadian market crossed that threshold—very tentatively. I would actually say the IPO of Shopify was that moment when things started to shift for Canadian public investors.

05:37 So, traditionally, Canadian public investors have always been more conservative than their American peers. Whether it's how they think about accounting and profits, or things like debt to EBITDA, debt to capital ratios. If you look at Canadian markets (excluding some of the commodity companies, which are viewed from a slightly different lens), if you just look at standard...kind of main street economy businesses, Canadian companies tend to have lower leverage as well.

06:03 So... Canadian investors have been more conservative. But with Shopify, here's was a case of a company that was growing very quickly, they dominate their markets, but they didn't show accounting net income. And they had a, I guess at that time, especially by tech standards, a pretty tentative IPO. Actually, it was one we missed. It was tentative, not, I mean, on the first day the stock went up a lot, but I meant tentative from a standpoint of the valuation they were asking. And we missed it because we had the same mentality as all the other Canadian investors at that time, which is, hey, they didn't show accounting net income, this is a high risk situation, this is probably not for our clients. And it was all of one day that Shopify was a Canadian small cap company [laughs]. Unfortunately, we missed that opportunity for investors.

06:49 Sadly, of course, we know where Shopify is trading at today—one of the largest companies in Canada on a market cap basis. But I think Shopify really kind of broke down that door. And then since then you've seen Lightspeed [POS Inc.], Docebo [Inc.], and a couple other of these high-growth tech companies that didn't show accounting net income.

Jeff Mo: 07:09 So, what gradually shifted was, in the past when companies like Hootsuite maybe were getting more than twice the valuation [in] private markets, slowly that gap started to close in Canadian public markets. And investors said that's very different. They started to recognize the value that these companies were creating—the competitive positions that these companies had. In fact, we are one of those investors [laughs] that had to kind of go through that learning curve, in terms of recognizing that yeah, that these companies do fit our criteria.

07:39 They are wealth-creating companies. They are often run by founders and excellent management teams who have the energy and the drive to push the companies forward. And the final question of, well, did they trade at discount to intrinsic value? And when we started using the same tools we always had—our discounted cash flow tools—we realized that yeah, in a lot of scenarios, they were trading at a discount to intrinsic value. And so that's why I think we've come over the hump.

08:08 Other Canadian investors have come up over the hump as well. And so I think the inflection is sometime in the probably mid-[to]-late 2020. This is just my sense, but I think that public market valuations for these companies started becoming higher than the private market valuations. And so you've seen this raft of IPOs.

A bit of a long answer to maybe a simple question, but I think that's why we're seeing so many IPOs and specifically so many tech IPOs.

Andrew Johnson: 08:34 No, that was exactly what I was looking for. And it takes me in the direction where I wanted to go next, which is, as you mentioned, we've changed our mentality, we've learned about this through time. We've also participated in some of these IPOs recently.

So, I wanted to understand—take me through the process of evaluating a business prior to it becoming public. What is involved in that? And perhaps what is unique compared to the investment process that we have in place for companies that have been public for some time?

Jeff Mo: **09:03** That's a very interesting question when you frame it that way. I would say that the nuts and bolts of it are still the same. We filter it through our investment philosophy. So, we're looking for a wealth-creating company, with excellent management teams trading at a discount to intrinsic value. And the tools and the frameworks by which we evaluate each of these pieces have remained the same. So, we still go through our competitive analysis, Porter's Five Forces. We'll still use our management assessment framework and ranking management teams on our investment matrix. We'll still use our discounted cashflow tools.

Jeff Mo: **09:36** What's different is the length of time and information that you can get. And so you're right, there's been a couple of times when we have evaluated companies even before they have filed their prospectus. The team has worked very hard to develop these relationships with some of these companies we think are going to come to market.

09:57 And I think Samir probably on the last podcast talked about Dye and Durham and the relationship we built with management over two years, which ultimately led to Canadian small cap getting a full allocation on an IPO that was 8x oversubscribed.

So in these cases, how do we do the evaluation?

10:15 I think it's largely around finding that information. So just being more creative with researching in the public domain. And so there's a lot more information today—whether it's alternative sources like Twitter and social media, investment blogs, or just even the newspapers. I think there are some really good writers out there who do a good job of interviewing these up-and-coming private tech companies.

Another piece is traditional research work. So, Phil Fisher, back in the 1950s coined the term "scuttlebutt," which is his way of saying, just go talk to the companies, customers, suppliers, employees, former employees—people who know the company at the ground level.

11:00 We do this for all of our investments in all our public companies. You can do the same thing for private companies. And so we just really have had to roll up our sleeves and pursue that scuttlebutt on these private companies. The final thing I think that's been an enhancement to our process over the last couple of years is we've started utilizing expert networks, as well.

So, in situations where we find it very difficult or it's a sensitive situation where we can't directly talk to some people, we'll go and utilize the power of these expert networks to find the right person to speak with.

On the flip side, the shorter end of the portfolio, the shorter end of the duration, valuations are also more attractive. No surprise in less sexy businesses like mining and banking.

Andrew Johnson: 11:34 Excellent. That's the second time that Phil Fisher has been mentioned in the last few podcast episodes that we've aired, so I think we're going to have to dig a little deeper on that into an episode at some point in the future.

But you've just taken us through one way to allocate capital, which is directly investing into our portfolio. Another way that our clients benefit from strong capital allocation is through the management teams of the companies that we own.

11:57 In some of the conversations that I've had with you and Samir recently, it's been noted that mergers and acquisition activity has also been elevated this year. Can you speak to some of the examples to help illustrate the kind of deals that our companies are making? And maybe more generally speaking, just the importance of management teams that have a strong track record of capital allocation?

Jeff Mo: 12:19 Absolutely. So, M&A is definitely elevated in the market as well. I think generally, going back to the IPO question, markets are strong. And I shouldn't say that all the IPOs (I think 25 you quoted year-to-date so far) is because of technology getting its heyday. Definitely it's a bull market; valuations are up; asset prices are up; people are doing deals, whether they're going public, whether they're buying a company. So, [in] Canadian small cap we've been on both sides of the coin.

12:48 Obviously the largest kind of M&A in the Canadian markets is the Rogers and Shaw deal. But even in the small cap side, we've had three companies in the portfolio this year be subject to takeover offers and get taken over. And a fourth one in our portfolio is currently in the process of potentially getting taken over as well. That's certainly on the high end for us. I'm trying to think this...especially if we analyze this and assume that it becomes eight on a full-year basis, I think would be the second highest number in the time that I've been with the funds and with the portfolio since 2008.

Andrew Johnson: 13:25 I can imagine that in some cases, Jeff, that's a bittersweet moment. Where, like you said, if it's being valued, you're going to get a good premium likely on the shares that we own. But at the same time, we think much more longer term than that in most cases, and perhaps we would have wanted to hold onto those companies for a longer period of time.

Jeff Mo: 13:45

It is certainly Andrew. So, we have a pretty concentrated portfolio here in this strategy. We have 49 holdings and across Mawer, as you know, we always run concentrated portfolios. And for us, it's hard to find a good company, a good capital allocation management team. And so when they leave, it's a loss, but that's, I guess why our clients hire us. We go and we find the next one. And I think we've come across a lot of great capital allocators in Canada. Whether it's Jay Hennick, with FirstService and Colliers; whether it's Steve Sadler with Enghouse. Obviously, we can't have a conversation of great capital allocators in Canada without mentioning Mark Leonard at Constellation Software, no longer a small cap, but at one point was the largest position in our fund.

And yeah, if you look at each of these managers, they continue to do what they do best—which is make tuck-in acquisitions. Companies that fit with their strategies of buying companies that are part of other existing business, or very related to the existing business at undemanding valuations, and then bringing those companies operationally into the core of the main publicly listed entity.

Andrew Johnson: 14:58

Great overview. And let's move back to the capital allocation by you and the team. Our listeners have heard us talk about the matrix meetings that our teams have on a regular basis. And you mentioned it upfront in this episode. Maybe you can just quickly remind our listeners what the matrix meeting is and the role that it plays in portfolio construction, and then we can move on from there.

Jeff Mo: 15:18

The last step for us before a company makes it into the portfolio is called the investment matrix. And it's a two-by-two matrix where on one axis (or a two-dimensional matrix, I should say) we rank the potential return that a company can give to us. And on the other axis, we evaluate the company's quality. And we look for high-quality companies, which we define as companies with strong competitive advantages run by excellent management teams that have higher-than-an-average return potential. And that would be kind of the "holy grail" of investing.

15:57

Typically, markets are efficient, so high-quality companies with great management teams tend to be trading at valuations which would have lower future return potential and vice versa. Lower quality companies tend to have slightly higher return potential, all else being equal. And so when we analyze a new company, we plot its position on this investment matrix against all the other companies in our portfolio.

Jeff Mo: 16:25 And then once a quarter, we'll go back and re-rank our companies. So, just based on new news, based on new developments, or even if there's no new developments, often the stock price has changed so the return potential has shifted. And so it's a living dynamic document or a matrix, and these companies are constantly shifting their positions on the matrix. And usually at least quarterly we re-rank everything on the matrix and decide if the portfolio needs to perhaps shift slightly to still be the most optimal portfolio in our minds for our client.

Andrew Johnson: 16:57 I presume, Jeff, that that is an incredibly important tool for you as the lead manager. I mean, you would admit that one person can't have as robust of a view on things as multiple individuals with a diverse set of backgrounds and experiences and viewpoints. And even though you're all speaking the same language—in other words, you're all viewing things through the lens of our investment philosophy—you are speaking in different ways and it's that diverse thinking that really puts you in a position to make the best decision you can with our client's capital.

Jeff Mo: 17:27 Absolutely. I really value all of our teammates and being able to get that diverse viewpoint. But as you know, and as probably many of our listeners know as well, Mawer has a very clear accountability structure: it's leader decides with input. And so I do have to make that final call, but I think without that input, I can't make a very good one. The matrix is that distillation of everyone's collective knowledge. It could be people on the Canadian small cap team, it could be people outside the Canadian small cap team. So we have some overlap holdings with our Canadian large cap team. We can get their views on the matrix as well, but occasionally we have other team members come in. I've seen our U.S. team members sometimes rank their views on a Canadian company because it competes with one of their companies. Or the global small cap team sometimes will come into Canada and they have a couple of holdings here that they also occasionally look at; some other opportunities as well.

18:29 All of those opinions get boiled down into the five categories we use for the matrix to determine quality. We score out of five what the business model is, what the management team is ranked at, and what we think the risk rating is. And for valuation, we look at what we think the return potential is and then something called skew, which we view is sort of the long-term upside versus downside potential of the company.

Jeff Mo 18:57 So companies with very large growth runways may have a positive skew, for example. And so for a lot of these companies, I might have 3, 4, 5 different viewpoints to draw from, and we'll have those conversations in our matrix meetings with those people. Okay, I ranked the management team a 3.5, someone else ranked the management team 3.0, let's have that discussion. And I find those discussions invaluable to help me understand where the opinions and differences are on the team, and how I, as lead manager should ultimately make that adjustment, if at all, to our weighting and my view of our holding.

Andrew Johnson: 19:33 Okay, so the most recent matrix meeting for you in the Canadian small cap team was about a month ago. Were there any themes that arose from then that prompted any shifts in the portfolio?

Jeff Mo: 19:44 Yeah, so it was almost exactly a month ago, I think June 14th. (So, month to the day that we're recording this anyway, for our listeners.) I'd say more of the same. I think out of every matrix meeting we have a few companies or maybe several companies that we think are slightly mis-weighted based on the sort of opinions of the team.

20:06 And while I certainly have the "leader decides with input" ability to override any of our team's decisions, I think we often will come out of these by saying, yeah, here's a few companies that probably deserve a slightly higher weight, and here are a few that maybe deserve a lower weight. And occasionally we might say there's a few companies that deserve to no longer be in the portfolio. And in this most recent matrix meeting, we actually chose to exit four companies, which sounds like a lot, especially when you consider we only hold 49. But in each case it was following our sell discipline.

20:49 So, the sell discipline is the opposite of our buy discipline. The most important thing we look for when we buy a company is that it's a wealth-creating company. And so, if a company we've deemed is no longer wealth-creating going forward, we act quite quickly to sell that company.

21:07 The second most important thing for us is an excellent management team. And then we start having doubts about the management team, we move the second quickest. And the one that causes us to move the slowest is the third one, which is trading at discount intrinsic value. And the reason that is so, is because as many of our listeners already know, we value companies not just based on a share price target, which I think is very traditional in the investment industry. Rather, we build our 15-year discounted cashflow model on our forecast for our companies and then we put lots of statistical parameters around things like growth rates and margins, and then we simulate that using Monte Carlo simulation.

21:48 So, we come out with a wide, often a pretty wide range on the fair value of the share price that we think the company should trade at. And so when companies and stocks move up in price, we have the least amount of conviction. For that reason alone, we should exit the company from the portfolio. However, matrix meetings are when sometimes those conversations can get crystallized a little bit more. And so most recently we chose to exit our positions in Badger Infrastructure Solutions; in Tecsys, which is a software company in Montreal; in WPT Industrial REIT; and in actually a recent IPO, Neighbourly Pharmacy.

22:30 And all four companies were already smaller weights in our portfolio because we had already felt that on the basis of those matrix rankings they were more marginal ideas compared to some of our other holdings. And the most recent matrix meeting made us realize that there were probably better opportunities elsewhere based on the combination of their current valuation and return potential, as well as their quality versus some of the other[s].

Andrew Johnson: **23:01** All right. Well, just to wrap things up, I always like to ask our guests to walk through some of the holdings just to illustrate and bring to life our investment philosophy and our process. And I've got a couple of stocks in the portfolio that I'm curious to hear your thoughts on. I wanted to start with TerraVest. This is a relatively new name for the portfolio; we've held it for about a year and a half, I believe. And we've recently added to the position slightly. So just take us through your thoughts on TerraVest.

Jeff Mo: **23:25** TerraVest is a manufacturer of…call it energy infrastructure. And that sounds, I guess, risky in the sense that we've seen where oil prices have gone, but they're actually very much involved more so in the downstream aspects. Their largest market is actually manufacturing the tanks for heating oil.

So, most of North America is heated with natural gas through furnaces and pipelines. But there are places—usually remote areas, smaller towns—that don't have central connection to the utility grid. And so for those homes and buildings, they're heated with heating oil. And so TerraVest is [the] largest manufacturer in North America of heating oil tanks. It's a small, slowly declining market, but they continue to add value by finding more efficiencies to manufacture these heating tanks. And they're still able to grow their profits on that business. They're also involved in building the tanks and vessels that go onto the trailers for transportation of propane and other natural gas liquids.

Jeff Mo: **24:36** And they do have some other kind of vessels that are used in oilfield services and drilling, but as you can imagine with energy prices having been weaker over the last five years, that business has gone down. So, it's what I would call a typical Mawer business, kind of very boring… no one gets out of bed in the morning saying, "I'm excited to make a heating oil tank today," but it's a business that's necessary. People who don't have a connection, they need this or else they're freezing in the winter. And so having reliable, high-quality product is very important for those that rely on these products. And what excites us most though, is not just the little niches that this company is very strong in, but also the management team there. And they're actually sort of a quasi-spinoff from a company called Clarke Inc., which is another kind of noted company in Canada in terms of capital allocation.

25:35 And so the management team at TerraVest—Dustin Haw, the CEO, and Mitch Gilbert, the CIO—they were kind of trained in that kind of capital allocation school of thought. And so these two individuals…I imagine they're still kind of in their late thirties, early forties, so, young, lots of runway, lots of energy and passion. They continue to identify these kind of niche manufacturing niches, where they can buy up these businesses and with their scale, add value to the businesses and generate a very attractive return on invested capital. And all of this trades at a low to mid-teens free cashflow multiple, which we think is very attractive in this market. And when we model out our discounted cashflow, it trades at a discount to our estimate of intrinsic value.

Andrew Johnson: **26:24** Excellent. Another one that I wanted to hear more about is a much longer term holding and it's one of the higher weights in the portfolio, and that's FirstService. If I recall Jeff, you can correct me if I'm wrong, but we've held this for a long time. I think it's been in the portfolio for over 10 years, which takes it back to when you worked alongside Martin Ferguson on the portfolio.

Jeff Mo: **26:43** That's right Andrew. In fact, it goes back a bit further than that. I think I was a company summer student in 2006 and I remember looking at FirstService [laughs]. It was one of my projects then. So, FirstService is a great Canadian success story. They are the North American leader in residential property management. So, for those of us who may live in a larger city, if you go to the downtown core, you might notice a lot of condo buildings will say "managed by FirstService Residential." That's about half of their business. And the other half of their business is a grab bag of home improvement and home restoration brands. These would be things like California Closets, CertaPro Painters ®, Paul Davis Restoration for if you have flooding damage. And most recently they bought a commercial restoration company called [FIRST] ONSITE and these are all what are called "essential property services."

27:40 So that's what FirstService is about, but they have a very unique and innovative acquisition model that Jay Hennick, the chairman of the company, set up back in the day. And so FirstService actually sees itself at least at the corporate level as just a capital allocation group. I think they have less than 20 people at head office. So what they do is they partner with entrepreneurs and they'll buy their business, but allow the entrepreneur to keep 15, 20, 25% of the equity in that business to continue to motivate them to grow their business, but they can also bring in central support in terms of sharing of best practices, systems, and as well kind of negotiating prices. So for example, with FirstService residential home insurance and property insurance, often it's a very big expense for things like a condo board. And so they're able to negotiate better rates for all their customers because of their large scale.

28:33 And so this is a company that today because of their large scale and dominance—almost all of their brands are number one or number two in the markets they operate in—they have strong competitive advantages.

Jeff Mo: **28:44** And because of Jay Hennick and his team—today's CEO, Scott Patterson, CFO, Jeremy Rakusin—they've done a great job of pushing that entrepreneurial culture throughout the organization and allocating capital at still very attractive rates of return. We estimate that the unlevered IRRs for most of their acquisitions are in the low to mid-teens, which especially when you also use a little bit debt, that's a very high rate of return. And FirstService had a great track record of, I think over 20 years of compounding their share price in that kind of mid-to-high teens rate.

Jeff Mo: **29:19** In fact, they used to also own Colliers, which they actually spun out. And so these are two kind of best-in-class real estate services businesses that are now standalone, but both are great holdings. We also still own Colliers. And we think that the potential continues to be very strong for FirstService in the markets they're in.

Andrew Johnson: 29:41 Excellent. Thanks, Jeff. We covered all of the main points of our investment philosophy throughout this episode. We talked about the importance of wealth-creating businesses and especially those ones that have durable competitive advantages, just like you outlined with both TerraVest and FirstService. [We] talked about the importance of management teams and strong capital allocation, in particular with those management teams that we're entrusting our client's capital with. And of course the importance of the price that we pay for the final investment that we put into the portfolio.

So, this has been a great conversation. I get to talk to you often and hear that how these things are going, but this was great to finally get you back on the podcast after a couple of years. We'll try not to wait so long next time. Thanks again for taking the time to chat today.

Jeff Mo: 30:23 Thanks for having me, Andrew. And great to chat with our listeners again.

Andrew Johnson: 30:27 All right. Take care.