October 16, 2019

The TSX outperformed its global peers with an increase of 2.5% this quarter.

Following a strong first half of the year, equities experienced moderate returns during the third quarter. The S&P/TSX Composite Total Return Index (TSX) outperformed its global peers with an increase of 2.5% this quarter. The S&P 500 Total Return was up 1.7%, ahead of The United Kingdom's FTSE 100 (-0.2%) and the MSCI World 1.1%. Small cap stocks underperformed in both the US and Canada with the Russel 2000 and the S&P/TSX Small Cap Total Return Indexes down (-2.4%) and (-1.2%) respectively.

While we have seen impacts of tariffs in the forms of higher costs and slower capital spending, the North American economy appears resilient. Continued strong employment trends in both countries are helping to absorb these headwinds albeit with slower, but still modest growth. Given accommodative interest rates, we still feel positive on the long term outlook for equities.

The North American economy appears resilient in being able to absorb these headwinds albeit with slower, but still modest growth.

As always, we remain disciplined in our fundamental investment approach. At Seymour, we invest in well-managed companies with attractive business models and sustainable competitive advantages that are well positioned to navigate through business cycles and world events. By owning businesses with a long-term time horizon, strong, experienced, and well-aligned management teams have the ability to execute on their strategic initiatives and adapt to their ever changing environment.

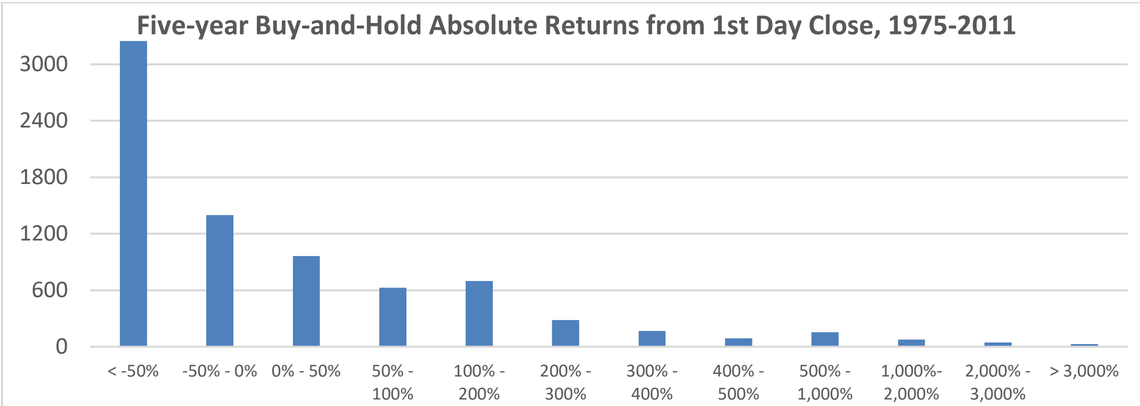
Below, we dive into an example of our bottom-up approach in one particular industry garnering headline attention: technology. We walk through why Initial Public Offerings (IPOs) are historically not fertile ground for investors, and what guiding principles we use to help us identify the long term winners out of the noise.

<u>Evaluating Technology Businesses</u>

Technology has been a strongly performing sector over the past several years. However the market's focus on owning the newest Unicorn (a private company worth >$1B), no matter how short the track record or how much cash the company burns, seems to echo the late 90's. How do we try to sort through what may be a flash in a pan or a disruptive market leader?

It pays to be selective. Technology is unique in that new companies can spring up seemingly overnight. These "disruptive" technology companies are often run by impossibly bright visionaries with share price valuations to match. While the urge to speculate on what will be the next revolutionary idea sounds rewarding, a study by UBS (slide below) looked at IPOs over the last 30 years and found that the average 5 year return lagged the market. Moreover, >60% of IPOs provided investors with a negative return over that time period.

Appendix 1: Five years after IPO, a few extreme positive and a majority negative returns



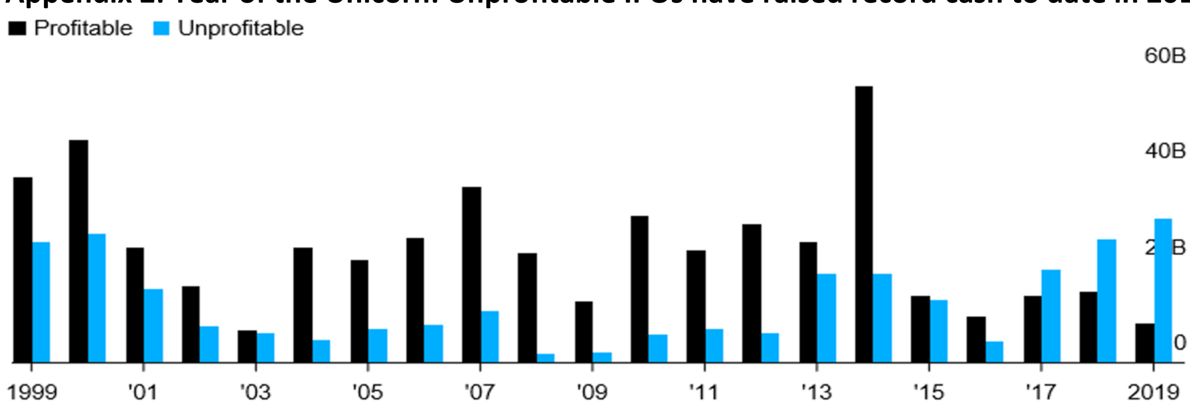
Source: Jay Ritter, UBS as of 31, March 2019

IPOs over the last 30 years demonstrate the average 5-year return lags the market

Lofty tech valuations can be justifiably earned. There are unique attributes in tech that *potentially* make companies worth more than your average widget manufacturer. Consider two different firms, one manufacturing car parts and one selling software online, both growing quickly. For the manufacturer to continue to grow each year, it will need to continually invest millions into new manufacturing capacity, inventory and labour to keep up with demand. Comparatively, the cost and effort to sell another copy of software online is virtually zero!

This efficient use of capital means less cash needs to be reinvested in the business leaving more cash flow for shareholders, justifying a higher valuation. The caveat is that many tech companies whether through competition, changes in the industry, poor management or an unviable business plan, never reach a stage where they become profitable at all. As detailed by the graph below, an increasing number of IPOs are not profitable, nor expect profitability for some time.

Appendix 2: Year of the Unicorn: Unprofitable IPOs have raised record cash to date in 2019



Source: Bloomberg

For companies to have longevity, they must generate cash flow

Based on experience, we've found the following guiding principles as key factors for long term success and have provided some examples from our portfolio holdings.

Cash generation is king. While above market growth rates and the promise of a large addressable market are common selling points for potential investors, at the end of the day, for companies to have longevity, they must generate cash flow. A key criteria is solid and growing free cash flow generation, which enables a company to continually invest in sales, research, and potentially acquisitions. This allows it to outpace its peers who may not have the same financial resources. Over time, as the company matures, cash flow can be directed toward share buybacks and increasing dividends.

OpenText, a leader in Enterprise Information Management, has historically used its growing cash flow to acquire competitors to become the #1 player in its market. OpenText continues to have strong acquisition opportunities, and a long track record of increasing dividends.

A standard setter has a highly defensible, profitable and valuable business

We want companies that set the standard. When a new market opens, many companies come up with novel ways to attack the opportunity. When personal computers entered offices and homes, you may recall a multitude of spreadsheet programs such as Lotus 1-2-3, Quattro Pro and Excel all competing for market share. Over time, a focus on interoperability, innovation, and ease of sharing led Excel to dominate all others. By being the standard, a company has a monopoly like hold on customers, offering the ability to takeover adjacent areas (like Microsoft has with word processing, email and presentations) and discourage competition. As long as a company treats its customers fairly and continues to innovate, a standard setter has a highly defensible, profitable and valuable business.

Altus Group, a real estate software firm, provides software for owners, brokers and potential buyers to value real estate assets. With a new suite of products, Altus continues to win major real estate asset owners including BlackRock and major pension funds, forcing those that deal with them to also use Altus. With continued execution, we believe Altus can become the standard for the real estate industry.

We look for companies with strong value propositions for prospective clients

We want customers to win. Selling new technology to customers is difficult. Any prospective client is risk adverse, worried about how implementing a new system may impact their customers, employees and their bottom line. We look for companies with strong value propositions for prospective clients; happy clients stay for a long time and advocate on their behalf, growing the addressable pool of opportunities.

Kinaxis developed a transformational technology for supply chain management called Rapid Response. We consistently hear feedback that Kinaxis customers see drastic operational improvements and save many multiples the value of what they pay Kinaxis annually. Kinaxis won Ford as its first automotive client a few years ago, whose strong results have convinced Toyota, Nissan and Honda to also adopt Kinaxis. While sales cycles for Kinaxis can take years, we think the company's strong value proposition will continue to drive customer adoption.

At Seymour, we're willing to miss a few high flyers and believe a disciplined approach to identify long-term winners is best.

The tech sector holds the allure of high returns, but historically many fail to deliver on the promises made. At Seymour, we're willing to miss a few high flyers and believe a disciplined approach to identify the long-term winners is best. We apply this discipline to all our investment decisions with the confidence that a dedicated, fundamental, bottom-up approach will provide superior long-term investment returns.

As always, please reach out to any member of the Seymour team with any questions.

Sincerely,
The Seymour Team