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Goodwood Capital Fund Class A and Class F May 2019 Commentary

Having officially been appointed to lead Portfolio Manager of the Goodwood Capital Fund (the "Fund") (https://www.newswire.ca/news-releases/goodwood-inc-appoints-gajan-kulasingam-as-lead-portfolio-manager-of-the-goodwood-capital-fund-899160546.html) I'm pleased to pen the inaugural monthly commentary for the Fund under my tenure at Goodwood Inc. Given it's my first commentary, it's a bit longer than I would've liked, but if you bear with me, hopefully, it will give you some insight into our thoughts and process, and you'll find it to be of value.

Year-to-date and for the month of May 2019, the Fund generated net returns of +8.02% and +1.35% versus the S&P/TSX SmallCap TR Index of +5.82% and (-4.16%) respectively. While I whole heartily admit both data points are ridiculously short term in nature, we view the Fund's performance as an important output of our investment process. Which I will walk you through in this letter. While it's true that short term performance is almost indistinguishable between luck and skill; in the long run, an investment manager's actual value is achieved by implementing a successful investment process and having the ability to be unwaveringly disciplined through the ups and downs of the market.

Year in review and market outlook (using S&P 500 as a market proxy)

Fool me once, shame on you. Fool me twice, shame on me. We've all heard/or used George Horne's proverb but, as we sit here today and think about the markets, we can't help but think about this saying as we compare 2018 to the start of 2019. January 2018 started with a bang, and the market took off in a straight line, continuing where 2017 left off. Then February 2018 happened (some low volatility fund or ETF blew up) and we got a nice, quick 10% market correction. Markets nicely shrugged that mini correction off and subsequently marched upwards and onwards to reach new highs until October 2018. Then Federal Chairman Jerome Powell opened his mouth and said two very dreadful words, "auto-pilot". These two little words, along with an aggressive interest rate hike trajectory in the face of what appeared to be a slowing global economy, sent the markets spiraling downwards over the next three months. And we all remember Christmas Eve! Seeing the massacre in the financial markets (despite a relatively stable global economy) Chairman Powell capitulated (aka Powell Pivot) and said, "sorry didn't mean to say auto-pilot, and there will likely be no rate hikes in 2019, and maybe 1 in 2020" (we paraphrase here). Markets said "cool, thank you very much" and roared right back to all-time highs. Then this funny thing called tariffs started to escalate (even though this threat's been in the market for the past year) and the market decided it was time to de-risk, and here we are today. So that's 6 material directional changes in the market over the past 17 months, but what's really different or new about today versus January 2018? Seems to us, all that investors got over the past 17 months was a lot of volatility and nothing to show for it. Technically, that's not true. The S&P 500 in USD would've given you about 2% before dividends and buybacks!

In terms of the outlook for the market, first and foremost, we don't make any predictions. We believe that's a pointless exercise. Instead, we analyze the facts as we know them today, assess the forward return expectations by prudently underwriting our investments to determine if such returns are adequate to compensate us for the risks (known and unknown) we're taking. Going into the second half of 2019, we continue to focus on what we believe are the critical factors for the markets: i) interest rates, ii) earnings growth, iii) leverage/credit risk, iv) liquidity and v) valuations. At any time, all or a combination of these factors could be a tailwind or a headwind to the markets. The markets are never static. It's always in a constant motion swinging from side to side like a pendulum. Moreover, depending on what side of the pendulum the market is on, it's either time to be offensive and aim to achieve maximum returns; or, to be defensive and avoid paying a high price to simply play risk. When investors think about the market outlook, we generally view the market through a probabilistic prism. However, what's important is not the probability of an event, but the magnitude of the outcome. If we apply this framework to the trade wars, there's maybe a 50/50 odds (who really knows) that it either gets resolved or escalates to dangerous levels. Now let's think about the magnitude of the outcomes; if there's a resolution, the markets will no doubt rally and march onwards (but remember, if this risk is off the table, the Fed most certainly becomes less dovish). So, we think the rally has a low ceiling. On other hand, if trade wars escalate to the point it triggers a global recession, we believe the downside could be very severe in magnitude and duration. And yes, in this case, the Fed will mostly certainly cut interest rates and inject further liquidity into the market, but we would question the efficacy of this move at this stage of the cycle. I mean, if $4 trillion of liquidity isn't enough, what's another few basis points of rate cuts? Broadly speaking, we believe the risk-reward is skewed to the downside. As such, the Fund continues to be defensively positioned, and will look to opportunistically deploy capital where we discover investments that exhibit the following characteristics: i) have the ability to compound intrinsic value at a greater pace than the broader markets, ii) have pristine balance sheets, better protecting the portfolio from potential risk of permanent loss of capital in a downturn, iii) trading at valuations below market levels, but offering what we believe is better upside potential, and iv) businesses with company specific catalyst events that have the potential for shareholder value creation.

Our Philosophy and Process

Our goal at Goodwood is to provide investors with access to investment products that are; differentiated and highly value add, exposed to inherently inefficient parts of the market, are un-replicable by passive or quantitative strategies, and provide an idiosyncratic return profile. The Goodwood Funds are also where the majority of the Managers' net worth are invested. We're not managing our careers. We're managing the future wealth generation of nearly all our personal capital. We are 100% aligned with our investors!

We will tell you we are value investors, which then leads to the question of "how do you define value investing?". We believe that value investing is best viewed as a holistic philosophy versus a rigid set of parameters. To us, value investing isn't about investing in cheap companies as defined by a set of static constraints such as P/E, P/BV, etc. Instead, we view value investing as the ability to underwrite an investment using conservative assumptions, and then buying at a discount to the underwritten intrinsic value of the business. Investing in its most basic form is simply underwriting an unknown future outcome. The question is, are you underwriting a prediction or an observation? We think growth investing entails a lot more of a prediction; whereas, value investing is rooted in observations. If we can conservatively underwrite a high-quality investment with a 15-20% IRR, we would view that as a great investment opportunity. The single most important factor that determines the future outcome of an investment, is the price you pay!

To better illustrate our philosophy and process, we will walk you through 3 portfolio holdings which we broadly define as: i) capital compounders, ii) deep value, and iii) special situations

CCL Industries Inc. ("CCL") – Capital Compounder
CCL Industries Inc. is a global leader in label packaging solutions for large corporations and small businesses. CCL has a broad portfolio offering that's diversified both by end markets and geography. To give you a sense of why we classify CCL as a capital compounder, please see Exhibit 1, which highlights some of the key metrics that makes CCL an exceptional business.

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Exhibit 1

	10 Year CAGR 2009-2018	10 Year Average 2009-2018
Share Price	27.50%	
Revenues	17.61%	
Gross Profit	21.72%	
GP Margin		26.55%
EBITDA	27.89%	
EBITDA Margin		17.75%
EBIT	24.13%	
EBIT Margin		12.30%
CFO	19.95%	
CFO Margin		14.85%
EFCF	25.75%	
EFCF Margin		8.29%
EFCF/EBIT Conversion		70.38%
BV/Share	15.89%	
Dividends/Share	18.00%	
Dividend Payout Ratio		22.00%
Net Debt/EBITDA		1.50x
Net Debt/Total Cap		19.00%
ROIC - Total Capital		13.65%
ROIC - Tangible Capital		26.29%

Financial results such as these don't happen by accident. They're a function of a good business run by an exceptional management team. Obviously, the data above is backward looking and available to everyone, so where did we see an opportunity that the market was mispricing? After a sustained period of outperformance, calendar Q2-Q4 2018 saw the stock decline from the highs of nearly $67 per share to the lows of roughly $48.50 per share, a near 28% contraction. We believed the market was focused too much on short term issues such as rising input costs, a weak quarter from one of its divisions and the difficulty CCL was facing in lapping tough comps in some of its other segments. However, if you took a step back and took a broader view, it was clear that these short-term issues could abate over time and fundamentally, the business was still performing very well. We started buying CCL in the Fund in the mid $50s. Sometimes rather than trying to figure out what a company is worth, it's a better exercise to reverse engineer what the market is pricing in about the prospects of the business. We find this to be a particularly useful exercise for high quality businesses that have consistently generated good results (i.e. high-quality observation data). In the case of CCL, if we modelled 8-9% equity FCF growth for the next 10 years, tapered that down to a 2.5% terminal growth rate, and discounted all those cash flows back at an equity IRR of 10%, that valued CCL in the mid $50s. So, the question we asked ourselves was, based on what we know about the company, it's industry, management team, and historical track record, do we think CCL can deliver results better than what we think is priced into the stock? Obviously, we said yes. As a value investor, our thesis was that we didn't think the fundamentals of the company will perform as badly as the market thinks it will. Conversely, a growth investor most likely believes that fundamentals will be better than what's priced in.

Polaris Infrastructure Inc. ("Polaris") – Deep Value, but not necessarily high risk

Polaris is a Toronto-based company engaged in the operation, acquisition and development of renewable energy projects in Latin America, with majority of its assets in Nicaragua. Given the unrest in Nicaragua, understandably so, Polaris' shares experienced significant volatility over the past 18 months. However, the company continues to drive operational improvement and cash flow growth supported by the 2018 drilling program and recent M&A. The recent M&A also helps Polaris diversify out of Nicaragua and into Peru, which is a more stable region. The company also just closed on a $25 million convertible debentures offering, which we think provides Polaris with adequate dry powder to deliver further M&A outside of Nicaragua as the company continues to de-risk and diversify its cash flows. At today's valuation, Polaris is trading at roughly 5.2x 2020 EBITDA vs its larger and more diversified peers trading at 10-12x. Now we're obviously not underwriting a thesis where we think Polaris should trade at 10-12x. But we certainly believe as Polaris continues to deliver on its current organic growth plan, execute a diversification M&A strategy and de-risk the business, it is worth significantly more than 5.2x EBITDA (or 15% EFCF yield) today. So, while Polaris grows and de-risks, investors are being rewarded with a near 6% dividend yield (at a 30% payout ratio) and 20% positive intrinsic value carry (15% current EFCF yield + conservatively a 5% EFCF growth over the next 5 years). While we understand and acknowledge the potential risks to our investment, we believe we are more than adequately compensated to underwrite such risks.

KLXE Energy Services Holdings Inc. ("KLXE)– Special Situations, a spinoff off a spinoff (try saying that fast 10 times), all figures in USD

KLXE provides products and services to onshore oil and gas producing regions of the United States. The company operates in three segments determined on a geographic basis: Southwest Region (Permian Basin and Eagle Ford Shale), Rock Mountains (Bakken, Williston, DJ, Unita, Piceance Basins and Niobrara Shale), and Northeast (Marcellus and Utica Shales). KLXE offers some of the most advanced and broadest set of product portfolios related to completions, productions and interventions. KLXE is also a recent spinoff, from a company that itself was a spinoff (don't see that too often). Without going into all the details, here's a quick snapshot of how KLXE became the company it is today:

- The CEO and Chairman of KLXE is Amin Khoury. Mr. Khoury co-founded B/E Aerospace in 1986. Over time, B/E Aerospace (BEAV) grew organically and via acquisitions from a single product line business with $3.0MM in revenue to become the leading aircraft cabin interiors equipment company in the world with $3.5BN in sales.
- In 2014, BEAV announced it would spin off its Aerospace Solutions Group (ASG) which was focused on airplane parts (fasteners, bearings, seals, etc.) and services, and its Energy Services Group (ESG), which was focused on oilfield services, into a new company call KLX Inc. The spin-off occurred in December 2014 and traded under the ticker KLXI. Mr. Khoury became the Chairman and CEO of the new company KLXI.
- In December 2017 KLXI announced that it had received interest from numerous parties and would conduct a strategic review to explore options to maximize shareholder value.
- As a result of the strategic review, KLXI announced that Boeing was interested in purchasing KLXI's ASG business (at 14.3x EBITDA), and spinning out its energy services business to create KLXE Energy Services.

Spinoffs happen all the time, and some of them turn out to be terrible businesses, while others turn out to be the beginning of a great new venture. What's interesting about the KLXE spinoff is that Messrs. Khoury and McCaffrey (CFO) will not only be running KLXE, but they are not taking any cash compensation. Instead, they have elected to receive only equity remuneration for the first 4 years of the Company's life. So, you have a management team that has a strong reputation of building companies through organic growth and acquisitions, then monetizing their businesses at attractive valuations, who have elected to receive 100% equity compensation. That's a very intriguing alignment of incentives.

So, what do we like about KLXE (other than management and incentive alignment)? Afterall, oilfield services (OFS) businesses are often viewed as super cyclical terrible businesses. Which on broad generalization probably isn't an inaccurate characterization. But, therein lies the opportunity. In our opinion, what really makes cyclical business dangerous are leverage and a poor management team that doesn't know how to navigate the cyclicality. We believe KLXE has neither of those risks. We think KLXE can not only organically grow (which they've already been doing by taking market share), but also become a consolidator of an industry that's often inadequately capitalized and prone to booms and busts. Interestingly, while a weak commodity tape (crude and natural gas) will be negative for KLXE in the short term. In the long run, we think this sets up KLXE well to roll up its competitors for pennies on the dollar. If you go into a cyclical downturn, you want to own the best managed company as it will not only survive but come out of the downturn bigger and stronger.

For fiscal 2019, we anticipate KLXE to generate around $700-800mm in revenues, $180-$200mm in adjusted EBITDA (25% mid-point margin) and 20% ROIC, assuming WTI $50-$60/bbl. This puts KLXE's mid-point valuation at 0.66x 2019E P/S and 3.3x 2019E Adj. EBITDA. We think that's far too cheap for a company run by a strong management team, with a clean balance sheet, generating strong margins/ROIC, can grow organically and through acquisitions and commodity prices near the lows of the cycle. While we can't predict commodity prices and market cycles, we're confident KLXE will be a more valuable company in the future. Lastly, when dealing with cyclical businesses, it's not only important to know what to buy, but also when to buy and when to sell. Owning cyclical investments is not a simple buy, hold and forget strategy.

As always, we have no idea how the markets will perform in the short term. What we do know is that the Fund currently owns a collection of businesses where the downside appears to be limited by some combination of balance sheet strength, business quality, catalyst events and valuations. The upside we believe, will be a function of mean reversion of our companies' true earnings power. In cyclical world, people often erroneously take a linear view.

If you have any questions or comments, please feel free to reach out to us anytime.

Happy Hunting!

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Disclosure:
Standard performance data has been calculated for the Goodwood Capital Fund. As of May 31, 2019, the 10, 5, 3 and 1 year periods for Class A units are: +4.09%, +0.62%, +2.23%, and -10.13%. Class F units have been distributed since July 8, 2016 and therefore annual compound returns for that class for 3, 5 and 10 year periods are not available. The 1 year and since inception returns as of May 31, 2019 are: -9.11% and +3.95% respectively.

The indicated rates of return are the historical total returns over the periods noted, including changes in unit value and reinvestment of all distributions. These indicated rates of return are net of all management fees, expenses and performance incentive fees and do not take into account any redemption charges that may have been payable by redeeming unitholders, which would have reduced the returns of redeeming unitholders in certain circumstances.

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Performance returns above are calculated for the founding Class of Units for the Goodwood Capital Fund - Class A Units. Please refer to the Prospectus for details and other important information. In addition, performance data represents past performance and is not indicative of future performance. Performance data from certain market indices (S&P/TSX Small Cap TRI, S&P 500 Index) are provided in this commentary for information purposes only. A comparison of the Fund's performance to such market indices is of limited use because the composition of the Fund's portfolio may contain other securities not found in the market index. As a result, no market indices are directly comparable to the results of the Fund. The opinions expressed are based upon our analysis and interpretation of these particulars and are not to be construed as a solicitation or an offer to buy or sell the securities mentioned herein. This communication is not a product of any research department. Goodwood Inc. does not publish research. The opinions expressed should not be construed as research or a recommendation but rather commentaries of the Goodwood Capital Fund's holdings and hypothetical performance. The Goodwood Funds and/or the principals, officers, directors, employees of Goodwood Inc. may have a position in the securities mentioned herein and may make purchase and/or sales of these securities from time to time. Our valuations may contain forward-looking information which is subject to change. Actual results or performance may differ materially from those expressed or implied in this document as a result of unforeseen events and their effects on our valuations and opinions. The Goodwood Capital Fund is offered by Prospectus, which contains important information about the fund, including management fees, other charges and expenses and should be read carefully before investing. Mutual funds are not guaranteed, their values change frequently, and past performance is not indicative of future performance and may not be repeated. Any views and/or commentary in this communication is by the Author (Portfolio Manager of the Goodwood Capital Fund). This commentary is not a recommendation and does not take into account whether any product or transaction is suitable for any particular investor.

CONFLICTS OF INTEREST: Principals of Goodwood Inc. may, from time to time, accept officer positions and/or directorships from and/or have other relationships with companies unrelated to Goodwood Inc. In this circumstance, that company would be considered under relevant securities law to be a "connected issuer" to Goodwood Inc. Currently, there are no "connected issuer" in respect of Goodwood Inc. Furthermore, Goodwood Inc., or an affiliate of Goodwood Inc., may provide services to and receive compensation from issuers in which the Funds are invested. The Manager has entered into a four year consulting agreement with Medexus Pharmaceuticals Inc. ("Medexus Pharmaceuticals") dated October 16, 2018 pursuant to which the Manager receives cash compensation from Medexus Pharmaceuticals for providing strategic advisory services. In addition, Goodwood Management Services Ltd. ("GMSL"), an affiliate of the Manager, has entered into a six year consulting agreement with Polaris Infrastructure Inc. ("Polaris") dated May 13, 2015, as amended, pursuant to which GMSL receives cash compensation from Polaris.