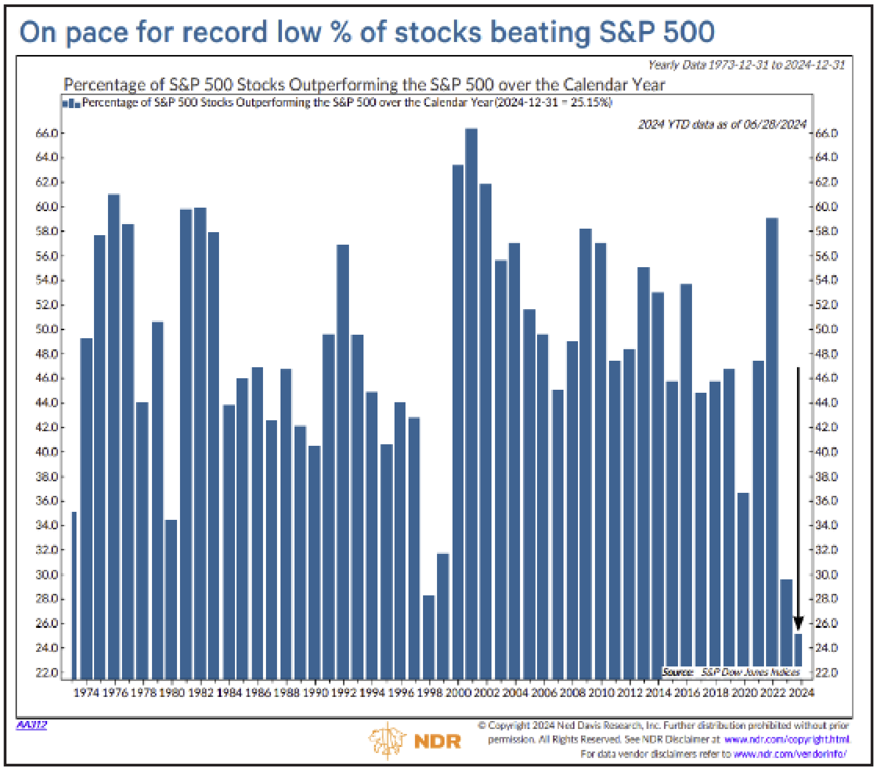
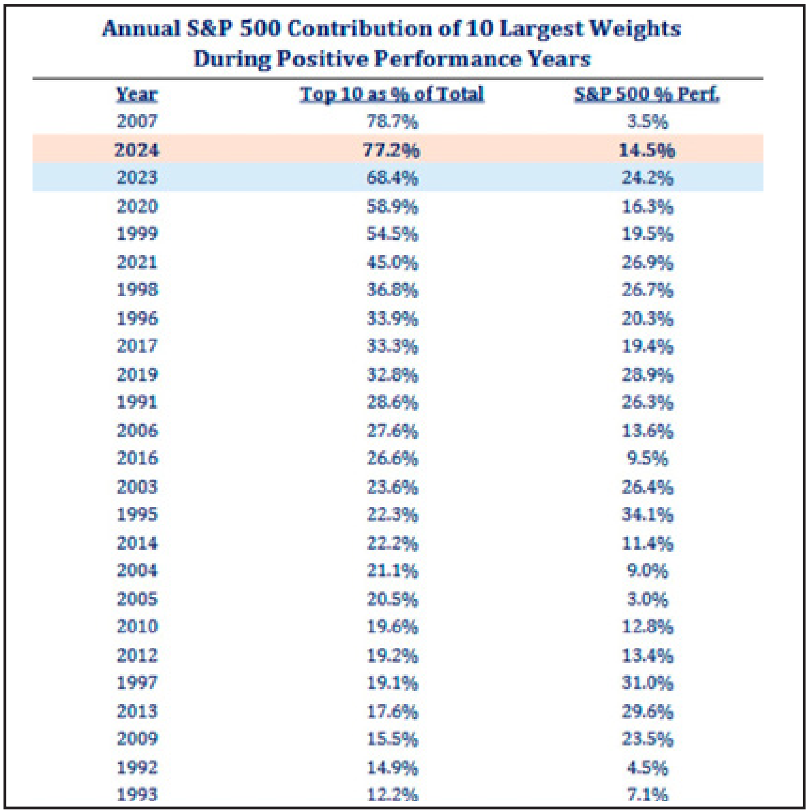
Breadth Remains Weak

We talked last month about the lack of breadth in the markets, and the money flowing to select names. The below charts highlights just how narrow the breadth is. Only 25% of the stocks in the S&P 500 are beating the index for the year. This is a record going back to the mid-70s.



Source: Ned Davis Research

This can be seen another way, with the total percent of index performance driven by the 10 top names. 2024 is nearly a record, with only 2007 as a period of greater performance concentration.



Annual S&P 500 Contribution of 10 Largest Weights
During Positive Performance Years

Year	Top 10 as % of Total	S&P 500 % Perf.
2007	78.7%	3.5%
2024	77.2%	14.5%
2023	68.4%	24.2%
2020	58.9%	16.3%
1999	54.5%	19.5%
2021	45.0%	26.9%
1998	36.8%	26.7%
1996	33.9%	20.3%
2017	33.3%	19.4%
2019	32.8%	28.9%
1991	28.6%	26.3%
2006	27.6%	13.6%
2016	26.6%	9.5%
2003	23.6%	26.4%
1995	22.3%	34.1%
2014	22.2%	11.4%
2004	21.1%	9.0%
2005	20.5%	3.0%
2010	19.6%	12.8%
2012	19.2%	13.4%
1997	19.1%	31.0%
2013	17.6%	29.6%
2009	15.5%	23.5%
1992	14.9%	4.5%
1993	12.2%	7.1%

Source: Geiger Capital, https://x.com/Geiger_Capital/status/1808157461116838391/photo/1

Another Eye Rolling Potential Takeout in our Portfolio

Having been around small cap Canada for the last 30 years, we've seen a lot of different changes in that space. For example: wild swings in investor sentiment, speculation, cheap compounders, hidden gems, promotional activity that makes you laugh, deep value and hyper growth. But nothing is more exciting than a takeover. Takeovers come in all shapes and colours, but in the last number of years, we feel like we've had the carpet pulled from under our feet numerous times.

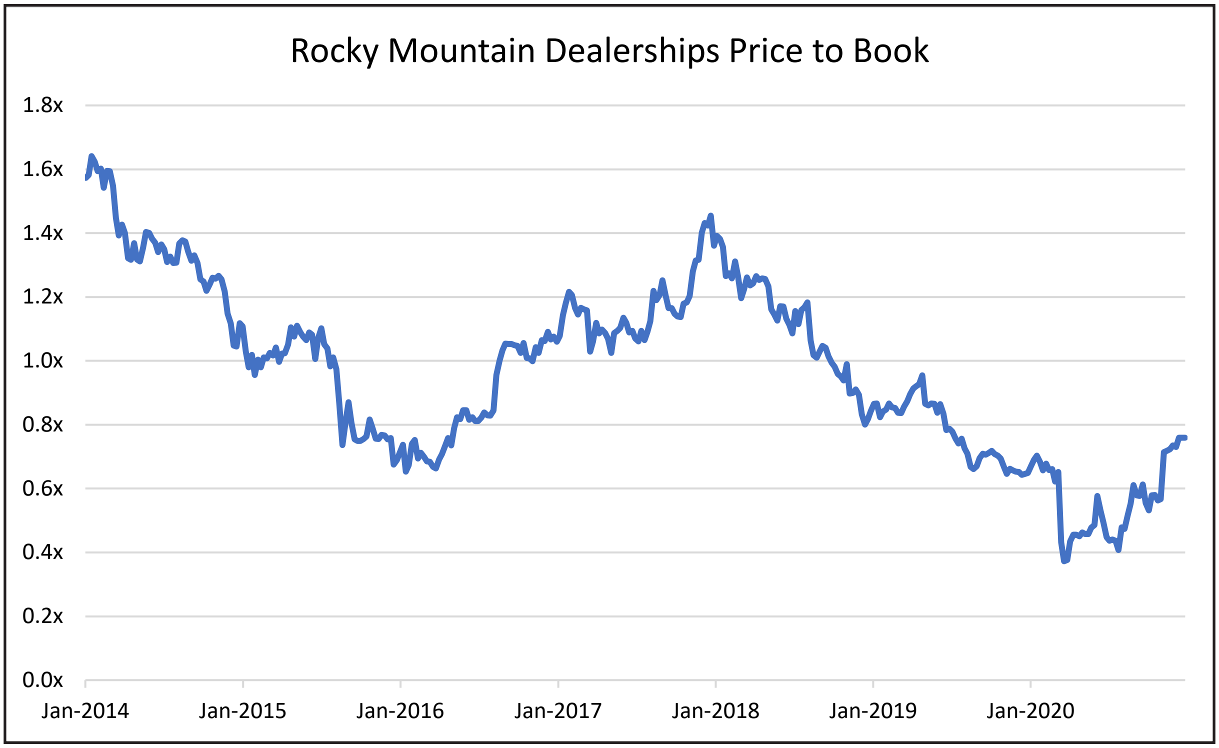
Why are these takeouts a problem? As investors, our problems in 2025-2027 will be the same as our problems in 2024. As a result, we need to find attractive risk/reward investments which provide an appropriate rate of return for our risk. Part of solving our 2025-2027 problems means doing work to find multi-year compounders today. When a takeout happens for one of our portfolio holdings it often means selling that holding today for a 30-35% premium, a return that essentially brings forward 1.2 to 1.5 years of returns. The problem then becomes about redeploying that capital into equivalent quality compounders at similar risk/reward set-ups where we have similar conviction.

The most recent example of an eye rolling takeover attempt in our portfolio is with Ag Growth International, which at the time of writing is 11.5% of the fund's NAV. As highlighted in a recent Globe & Mail article, the company saw a proposal from a "industry rival" with an implied offer at a 35% premium to the recent share price but no premium to where it was a few weeks prior. We strongly believe this premium to be materially below Ag Growth's intrinsic value and we worry about another case of poor corporate governance and lack of shareholder discipline.

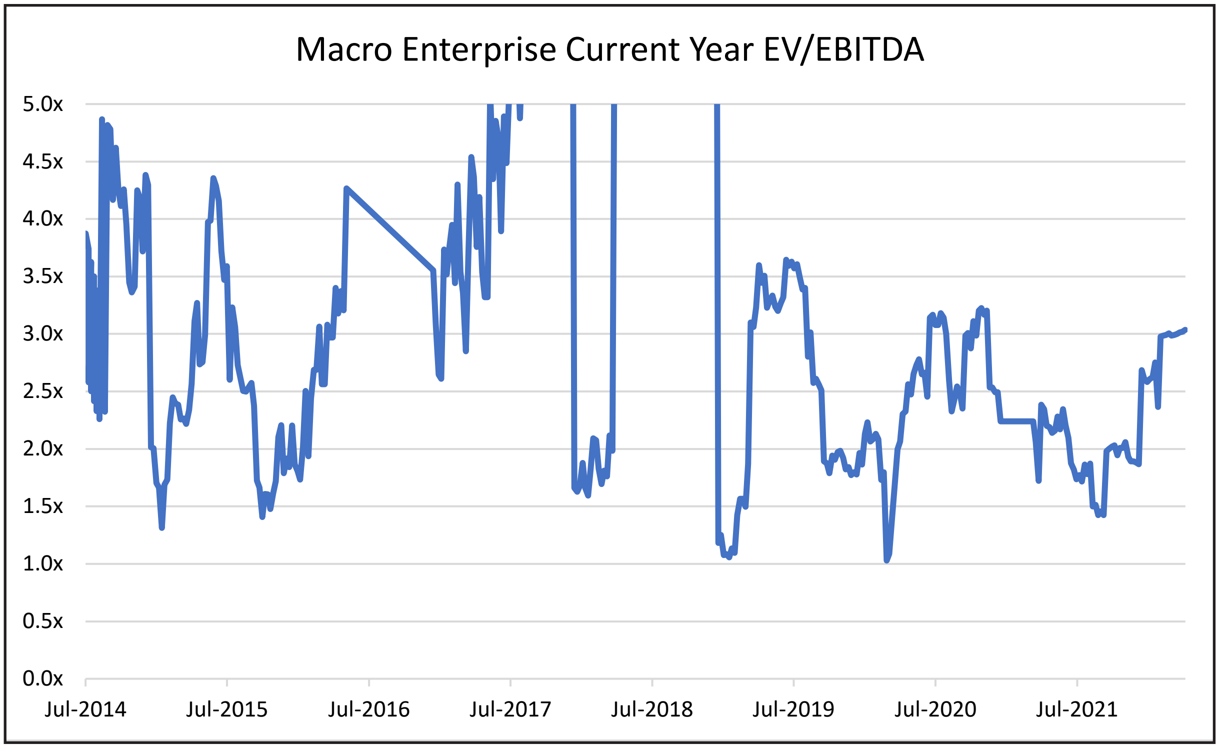
This takeover attempt of Ag Growth reminds us of the a few takeovers:
1. Macro Enterprise's management buyout done at 2.7x forward EBITDA on the cusp of increased profitability due to Transmountain Expansion costs overruns and the LNG pipeline build.

2. Rocky Mountain Dealership Inc's management buyout done at 0.8x tangible price to book right on the cusp of a strong agricultural cycle

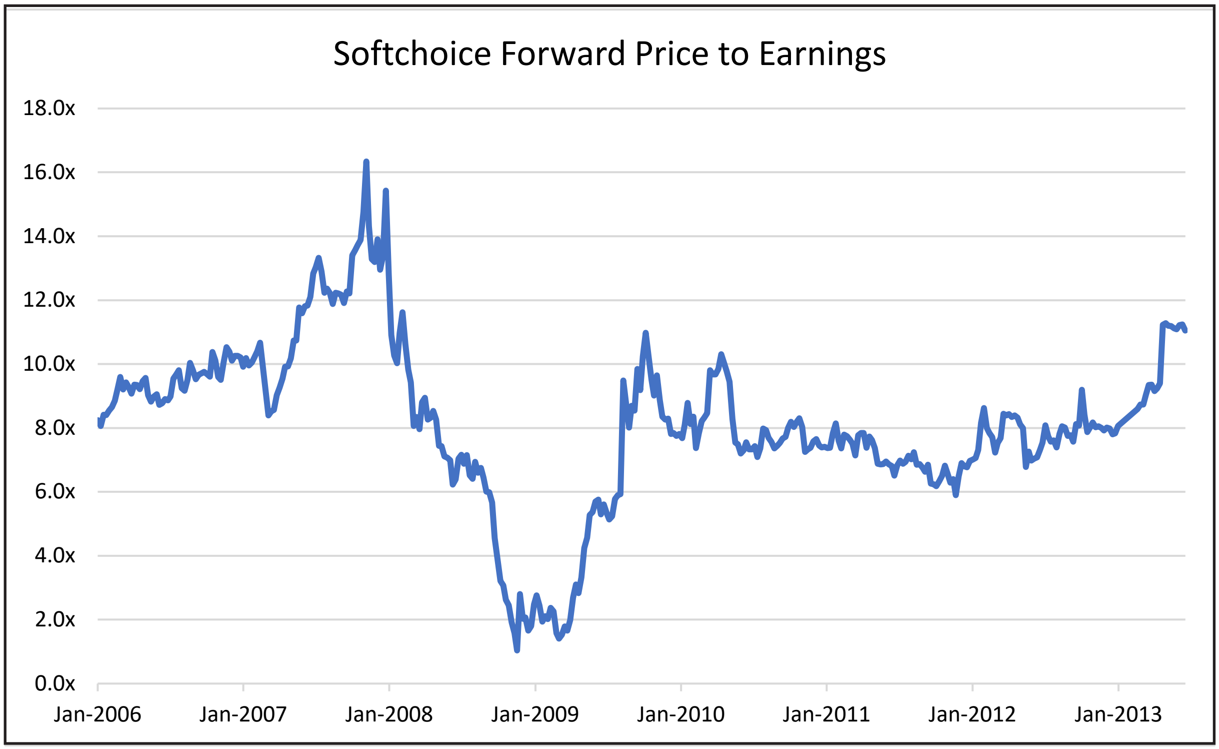
3. Softchoice's private equity buyout in 2013 which was done at 11x forward price to earnings, with the company IPO'ing at more than double that valuation in 2021.



Source: Bloomberg


Macro Enterprise Current Year EV/EBITDA

Source: Bloomberg

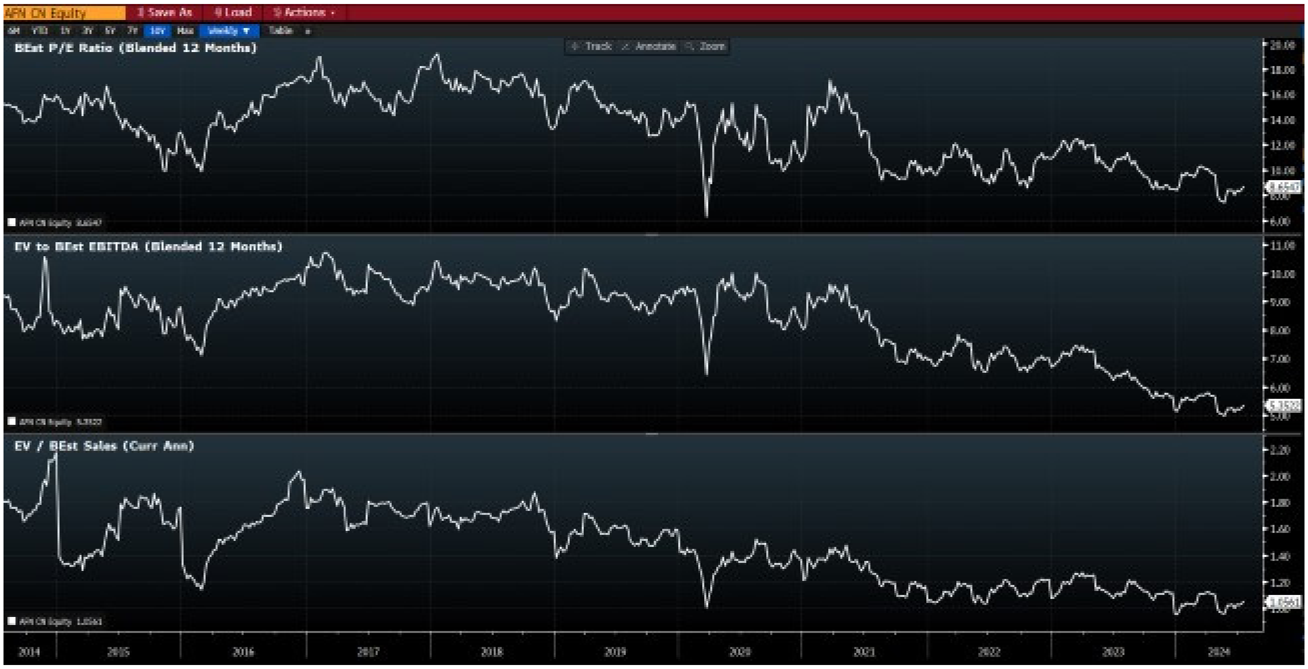

Softchoice Forward Price to Earnings

Source: Bloomberg

In all of these instances, shareholders were robbed of their opportunity to participate in the full upside potential of these companies. In each instance, as you can see above, multiple expansion opportunities were apparent and/or the takeout multiple was just plain simply very low. And all the while, company fundamentals were often right in the sweet spot.

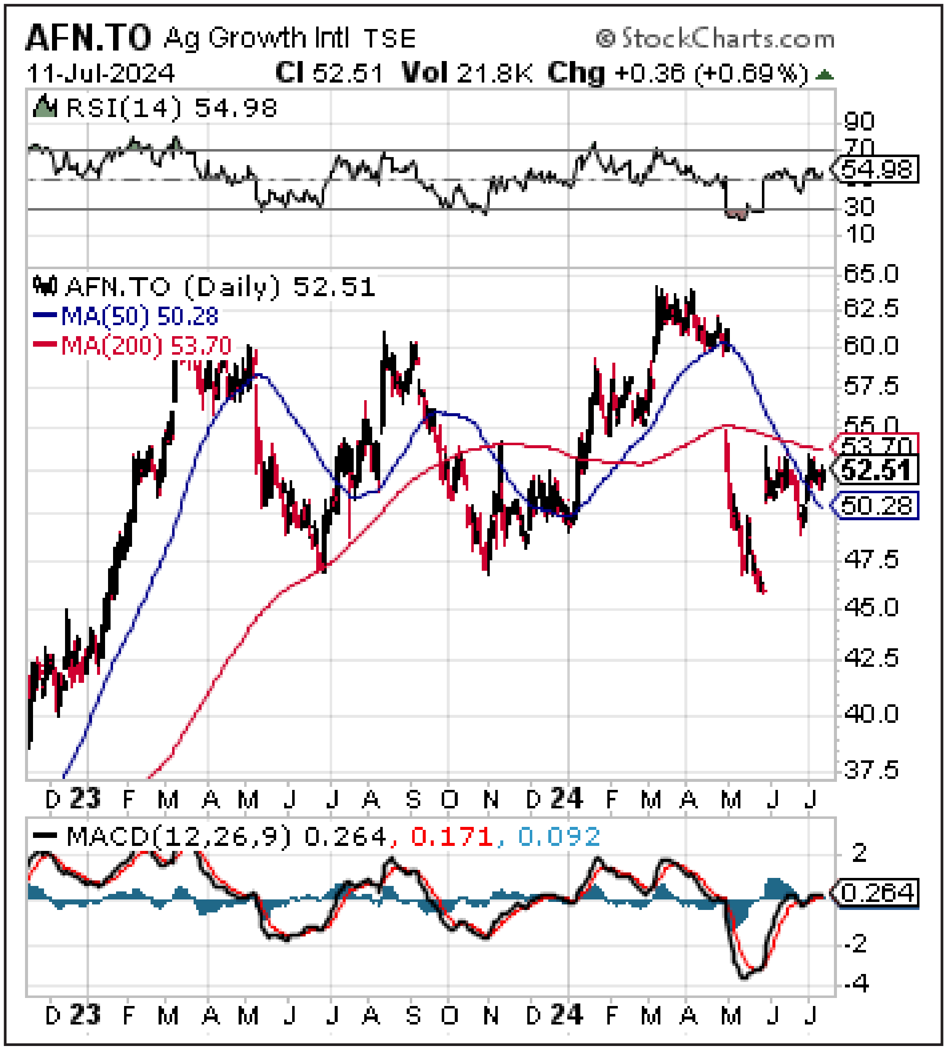
Fundamentally, over the last 4 years Ag Growth has become a much stronger business. They have de-levered the balance sheet to a reasonable level (net debt to EBITDA is 2.9x), and they have diversified away from farm (which is driven by farmer income and steel) to now having a larger commercial presense as well as presence in fast growing international economies such as India and Brazil, where agricultural infrastructure is behind the western world. The ebbs and flows of farmer income in a specific geography are less impactful than ever before on the bottom line of the business, reducing volatility in performance. Ag Growth's best days are ahead of it and that is the fundamental opportunity today.

On valuation, we agree with whoever tried to acquire the company. The multiple is low and attractive on both a relative basis to historic levels as well as on an absolute basis. This low valuation provides both margin of safety and significant flexibility on the need to be exactly right on the timing of our fundamental forecast – even if there is a small cut to guidance, the stock remains very inexpensive with a low likelihood of underperformance.



Source: Bloomberg

Recent share price movement: prior to the proposed acquisition, the company had recently sold off on the back of missing Q1 result expectations as well as due to (we believe) the exit of many event and momentum driven investors (these investors were hoping the company would be added to the TSX Composite Index in turn driving a short-term boost to the share price).



Source: Bloomberg

The recent underperformance in the stock price, in our view, is the stock price reacting to buyer-seller mechanics and have resulted in a material undervaluation of the company. We are not the only investors who think the company is undervalued, in fact, an informed entity thought it was a great investment opportunity to buy the entire company at $62-65 per share.

The opportunity: A triple digit share price is needed today, i.e. 10x this year's EBITDA, a level the company has previously traded at. If this occurs, then we'd be able to walk away from Ag Growth and be able to find similar risk-reward alternatives that could be the equivalent of a $150-$200/shr when compounded over the course of 4-5 years. As the business continues to perform positively, in turn driving multiple expansion, the company will then very likely be a candidate to join the TSX Composite Index. This would likely be an upside liquidity event and could bring the stock well into the $70s within less than a year, in our opinion.

Something we don't talk about too much in our discussions with investors is our opinions on ESG practices – which stands for Environmental, Social, and Governance. In small cap Canada, "governance" can at times be seriously lacking. We've never been activists, and today isn't the day we start, but without proper risk alignment through at-risk shareholdings (i.e. investing board member's own money, not given shares in lieu of service), we consider any board as being sub-optimally formed. Ag Growth could be considered a contender for sub-optimally formed board in that respect. We have, along with other shareholders, encouraged the board to consider increasing personal ownership as well as to engage with investors to help highlight the full potential intrinsic value Ag Growth can deliver for all current shareholders.

Portfolio Positioning

Alluding to our opening comments regarding the narrowing breadth in the market, it seems like the majority of people are doing the same thing with a focus on a singular company or topic (private equity, private credit, AI & magnificent 7). This signals to us that there is a huge downside risk that is building up. This becomes even more apparent when everyone is 'all-in' on the trade. When the flow of money stops, that downside risk is often present. It is also important to note that some of these tech names who have experienced rapid multiple expansion and the ever-expanding private equity/credit business have yet to be tested in a recessionary environment.

We believe that we are in a fairly clear set-up for a large decline in the economy and equity markets. The inflation fatigued consumer, elevated government debt, and all-time high markets with narrowing breadth all point to this. While volatility is at a low, it points to potential set-up for shorts to work in the market. We continue to reduce exposures and remain focused on our highest conviction ideas.

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