



April 2018

PEMBROKE AT 50

2018 marks the celebration of an important anniversary for Pembroke. The company was founded in 1968, making this our 50th anniversary.

For 50 years, we have invested in entrepreneurial growth companies and served the investment needs of our clients. More than the simple passage of time, 2018 is an opportunity to reaffirm and celebrate our core values, our consistent investment philosophy and, most importantly, what we have achieved for our clients.

We have witnessed tremendous change and innovation over the past half century and we have invested in many wonderful companies that have created, significant wealth for their shareholders. We have also learned some tough lessons along the way. The wisdom gained every year has helped us focus on what matters; creating wealth for our clients over the long-term.

We thank all of our clients for having confidence in Pembroke, and we all look forward to celebrating our 50th anniversary with you as we continue the journey.

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ON THE ROAD AGAIN

Pure Storage Inc. (“PSTG” or “Pure”) is a relatively new holding for Pembroke, having entered the portfolio in October of 2017. PSTG is the leading vendor of “all-flash” data storage products for enterprises, governments and educational institutions. “All-flash” refers to the storage medium PSTG utilizes in its systems; the hard disk drives that characterized the last three-decades of information storage are being replaced by solid-state flash drives (“thumb drives”), which provide faster and more efficient access to data.

To say that PSTG is simply swapping out hard disks for flash memory doesn’t do the company’s solution justice. Pure is disrupting the traditional data storage industry through its unique hardware upgrade model and its proprietary software capabilities. Historically, storage vendors like EMC and NetApp made money by selling systems that required major upgrades every three to four years and costly annual maintenance programs. PSTG’s systems can last over ten years, require no annual maintenance contracts, and benefit from a software stack built for the ‘cloud’. As a result, Pure’s total cost of ownership is dramatically lower than legacy systems and has enabled them to capture a leading share in the all-flash market.



As active technology investors, Pembroke believes it is critical to visit Silicon Valley and have on-the-ground interactions in the most dynamic tech region in the world. Indeed, we typically load up our schedules and meet with a dozen or more companies over the course of three to four days. We have visited PSTG’s Palo Alto headquarters twice in the past six months, most recently in March. We have met with Pure’s president, head

of sales, CFO, lead artificial intelligence product engineer, and investor relations team.

Our visits deepened our appreciation of the company's technology advantages, particularly its competency serving the artificial intelligence (AI) and machine learning markets. PSTG's new PureBlade, and AI Ready Infrastructure products are optimized for the speed, performance, and vast data size requirements inherent in AI workloads. In fact, Pure is becoming the de facto standard storage solution in the autonomous driving sector, perhaps the largest current AI use-case. While the company doesn't break-out revenue by product, we believe Pure has the most exposure to AI of any small cap tech company we follow.

Our Silicon Valley trips also helped us gain insight into PSTG's data storage competitors. We visited NetApp, Nutanix, Cisco, VMWare and several private data storage providers and venture capitalists, which helped fill in our mosaic of understanding in the segment and furthered our conviction in Pure's proprietary technology.

Despite gains of almost 30% from our initial purchase, we remain confident about Pure's potential. In fact, we believe the stock has clear "double-play" potential – the company can benefit from both earnings growth and earnings multiple expansion. With a \$35 billion market opportunity, double digit industry growth rates, a sustainable competitive position and under-appreciated operating leverage in the model, there is real potential for long-term growth.

JUST THE FACTS

Before providing qualitative comments on the quarter, we present some quantitative information regarding our top five Canadian and U.S. holdings.

Top Five Canadian Holdings

March 31st, 2018

Company	Q1 Price Change (CAD)	Revenue Growth, Current Fiscal Year	EBITDA Growth, Current Fiscal Year	Revenue Growth, Next Fiscal Year	EBITDA Growth, Next Fiscal Year
Solium Capital	2%	21%	21%	18%	88%
Colliers International	18%	15%	21%	8%	10%
The Descartes Systems	3%	21%	29%	10%	15%
Canadian Western Bank	-15%	20%	17%	10%	10%
Badger Daylighting	-5%	12%	16%	11%	13%
Average	1%	18%	21%	12%	27%

Top Five U.S. Holdings

March 31st, 2018

Company	Q1 Price Change (USD)	Revenue Growth, Current Fiscal Year	EBITDA Growth, Current Fiscal Year	Revenue Growth, Next Fiscal Year	EBITDA Growth, Next Fiscal Year
Bofl Holding	36%	18%	21%	13%	26%
Carbonite	15%	28%	485%	12%	15%
National General Holdings	24%	1%	144%	13%	18%
HMS Holdings	-1%	8%	35%	7%	9%
WNS Holdings	13%	20%	37%	10%	3%
Average	17%	15%	144%	11%	14%

Source: Consensus and Pembroke estimates

OVERVIEW OF THE QUARTER

INTRODUCTION

We are at an interesting juncture in this unloved bull market. The recent volatility of the markets in early February, and subsequently at quarter end, provided an indication of how vulnerable the markets are to a change in sentiment. Given the renewed general interest in equities and high valuations, the backdrop set up perfectly for a small sell-off. In February, the calm of the previous year was upset by the spectre of higher inflation and many investors ran for the door. In late March, the fear of a trade war between the US and China set off another round of selling. It is not unreasonable to assume that recent market moves were exacerbated by trend followers and the high-frequency traders, but the change in sentiment was striking.



Investor behaviour in fixed income and equities has been influenced by 30 years of declining interest rates. Low interest rates and excess liquidity have fueled asset inflation in many forms beyond just rising stock prices, including:

- Falling capitalization rates in real estate
- Rising takeout multiples in private equity
- House price appreciation in major urban markets
- Rising prices of collectibles
- A long-term bond bull market

The positive side of all the stimulation, fueled further by business-friendly tax cuts and regulatory rollbacks in the US, is that we are in a period of self-sustaining economic expansion. While we expect a slow normalization of interest rates, some tightening is not a concern if it reflects healthier economic and business conditions.

If this normalization is gradual, then the stock market should weather the transition and small cap companies with high earnings growth rates should be able to move forward despite the mild headwind that rising rates will pose. Clearly though, if this scenario unfolds, some areas will be challenged by the changing conditions. These include but are not limited to:

- Mortgage originators

- House builders
- Long bonds
- Long duration equities
- REITs and non-growing dividend equities
- Highly levered companies
- Indebted consumers

The question, then, is how Pembroke is reacting to these conditions. From a high-level perspective, the team is carefully:

1. Evaluating how much of our gains have come from expanded valuations
2. Singling out the companies whose business models were fueled by the easy money and managing their weights in the portfolio appropriately
3. Managing our exposure to companies vulnerable to a rising cost of capital:
 - ✓ Interest sensitive industries
 - ✓ Levered balance sheets
 - ✓ Highly valued equities with no near-term earnings support
4. Reviewing all the holdings and confirming the following characteristics:
 - ✓ Long runways for growth
 - ✓ Strong balance sheets
 - ✓ Attractive returns on invested capital
 - ✓ Self-financing business models

In the short term and medium term, Pembroke remains positive. The fourth quarter earnings reports from our companies were very strong, and their management teams generally provided impressive 2018 outlooks. Tax reform in the US will help reported earnings and spur capital investment. Including the lower tax rates, valuations are not unreasonable compared with those of the past twenty years and we remain confident about the climate for equity investments.

There will have to be an adjustment in investor behaviour as interest rates rise further, and portfolio managers will have to manage their sector exposures accordingly. The small-cap growth stock universe should be a fertile hunting ground as the underlying growth in earnings should offset the potential compression in valuation caused by rising rates. Clearly, the prevailing conditions in the marketplace do not point to a cyclical bear market; nevertheless, the jumpiness of the past month is leading us to keep

our pencils sharp, to be ready when the market gives us a chance to add to our favourite holdings and to add new positions that meet our parameters for quality and growth.

US COMMENTARY



Pembroke's US equity portfolios had a solid start to 2018 on both an absolute and relative basis. While volatility in February and March brought first quarter returns back to earth, the fund nevertheless delivered positive returns for the first three months of the year and outperformed both the Russell 2000 and S&P 500 indices. From a sector perspective, financial, consumer staples, and technology stocks led the way, while the firm's sole holding in the materials space faced a short-term setback.

BOFI Holdings ("BOFI"), an online bank, posted another strong quarter of loan growth and continued to deliver robust credit metrics, demonstrating the company's strict discipline and use of complex data when making business or mortgage loans. BOFI's management has continued to diversify and strengthen its funding sources as well. BOFI has risen significantly but remains attractively priced versus its quality growth bank peers. Importantly, BOFI enjoys a higher return on capital than many of its competitors because its business model does not require a heavy investment in bricks-and-mortar branches. Pembroke believes that BOFI is on the leading edge of what banking will look like in the future – a branchless system in which banks compete based on deposit rates, services, and online usability.

Pembroke's investment in **Paycom Software** ("PAYC") continued to perform well due to the company's rapid growth and high profit margins. During the fourth quarter of 2017 the company reported 30% top-line growth, reflecting strong execution as well as a large addressable market.



PAYC is winning share within the payroll software market, often displacing legacy providers such as ADP. PAYC's software is cloud based, easy to install, and offers a range of fully-integrated products that work seamlessly with each other. PAYC's proven growth strategy (carefully opening regional offices run by proven internal sales people), its strong product and large market, give us confidence that the company's high rate of growth can persist for at least the foreseeable future.

In March of this year, **CommerceHub** (“CHUBA”), a Pembroke holding since November 2016, announced that it was being acquired. CHUBA is a high margin software company spun out of Liberty Media. Pembroke identified the opportunity at CHUBA early, before the company was covered by sell-side analysts or understood by many buy-side investors. The company was helping large retailers compete with the likes of Amazon and boasted an impressive lineup of customers, including Home Depot and most recently, Macy’s. Given the company’s strong competitive position, high profit margins, and robust balance sheet, Pembroke was disappointed with the purchase price. The investment in CHUBA nevertheless generated positive returns for the firm’s clients; Pembroke started buying the stock below \$16 per share and the company is being acquired for \$22.50 per share.

Installed Building Products (“IBP”), an installer of insulation and other building products in residential and commercial buildings, declined 7.3% in the quarter. Despite nearly 30% year-over-year revenue growth, and nearly 20% year-over-year earnings growth, the company’s margin performance missed investor expectations. Labor and employee benefit cost inflation outpaced the company’s ability to pass these costs through to their customers. IBP fully intends to pass all its cost inflation, and more, onto customers throughout the course of this year. In the meantime, the company’s core market – US single-family home construction – remains below normalized demand levels and poised to contribute to IBP’s expected double-digit topline growth and ~40% earnings growth in 2018. We see a very compelling risk/reward setup for the stock and are confident about its place among our top ten US positions.



Ferroglobe (“GSM”), a vertically integrated producer of silicon metal, ferrosilicon, and silicon-manganese, declined 17% in the fourth quarter – largely in the last week of the quarter. The stock was hit when the US International Trade Commission reversed its preliminary decision to levy tariffs on silicon metal from four countries. Despite this disappointing news, we retain our confidence in GSM and bought more stock during this downturn in the shares. Silicon metal demand remains brisk with compelling long-term growth trends, there is no new supply expected to enter the market, and GSM’s dominance in the US and Western Europe remains unchanged. Indeed, the stock is on sale and carries a high free-cash-flow yield and a low valuation multiple.

CANADIAN COMMENTARY



Canadian equity markets declined in the first quarter of 2018, with most industry groups in negative territory for the period. Pembroke's Canadian equity portfolios were not immune to the downdraft, and posted returns that trailed the S&P/TSX Composite Index for the quarter. The primary drivers of the fund's declines were holdings in the industrials, financials, materials, consumer discretionary, and energy sectors. Compared to the S&P/TSX Composite Index, the portfolio's industrial, financial, and material investments were underperformers during the period.

On an individual holdings basis, two stocks posted significant declines that weighed on performance.

Shares in **DIRT Environmental Solutions** ("DRT"), a technology-driven manufacturer of customized building interiors, declined in the first quarter as the market reacted to unexpected changes to the company's senior management team. DIRT continues to offer an innovative product line poised to disrupt the office construction and renovation business, but investors are viewing executive turnover and governance practices with a heightened degree of caution.

Shares in **Westport Fuel Systems**, ("WPRT"), a developer of low-emission natural gas engines aimed at displacing conventional fuel engines, declined in the first quarter following strong 2017 returns that still failed to meet expectations. The company has made impressive headway in commercializing its proprietary technology, with Volvo rolling out its engines in Europe and with initiatives in the Chinese market starting to come to fruition. There is considerable momentum driving substitution of diesel engines from the marketplace, and Westport is well positioned to benefit from this trend.

On the positive front, two stocks made significant additive contributions to returns in the first quarter.

Shares in **Colliers International** ("CIGI"), a global real estate company providing a wide array of services to commercial real estate occupiers, owners, and investors, performed well in the first quarter as the company posted robust operational results that were well ahead of market expectations. Colliers is augmenting solid organic growth with opportunistic acquisitions, while generating strong free cash flow and high returns on capital. We feel that Colliers has an attractive runway for growth via continued market share gains and consolidation of a fragmented industry.

Shares in **Avigilon** (“AVO”), a designer and manufacturer of video surveillance software and equipment, reported strong returns in the first quarter as the company announced it was being acquired by Motorola Solutions at a premium valuation. Avigilon had been successfully winning market share and developing its video analytics capabilities, making it an attractive target for larger suitors.

BALANCED FUND/DIVIDEND COMMENTARY

Pembroke’s balanced portfolio, the GBC Growth and Income Fund, recorded negative returns in the first quarter of 2018, driven by declines in the equity portion of the portfolio. The fixed income portion of the fund, represented by the GBC Canadian Bond Fund, posted a small positive return in the first quarter in a challenging environment for fixed income investors.

Two stocks were significant detractors to performance in the first quarter of 2018.



Shares of **Collectors Universe** (“CLCT”), a leading provider of third-party authentication and grading services for high-value collectibles such as coins and trading cards, declined substantially in January. The company reported disappointing quarterly results with weak coin grading volumes affecting overall profitability and cash flow generation and management lowered the dividend payout ratio. With no net debt, high returns on capital, and high free cash generation, the company’s current allocation of capital to dividends is conservative.

Shares of **Lucara Diamond** (“LUC”), the owner and operator of the Karowe diamond mine in Botswana, were weak in the first quarter as the company announced a CEO transition and an investment in a supply chain technology company undertaken to streamline and digitize the rough diamond sales process. While Lucara has a pristine balance sheet, strong cash flow generation and a consistent record of paying out regular and special dividends, the executive change and the foray into a newer line of business was viewed with caution by the markets.

Two stocks stood out as outperformers for Pembroke’s dividend mandate in the first quarter.

Shares of **Pollard Banknote** (“PBL”), a supplier of instant tickets and related services to the lottery industry, performed strongly during the first quarter driven by market share gains and opportunistic M&A activity. Pollard is reaping the benefits of past investments made to bolster production capacity, and is expanding margins as these facilities are filled. A recent equity issue puts Pollard in good position to act on additional acquisition opportunities as they arise.

Shares of **Morneau Shepell** (“MSI”), a provider of human resource consulting and outsourcing services, performed well in the first quarter. Morneau’s business is recurring and capital-light in nature, allowing management to allocate funds to organic and acquisition-driven growth strategies while simultaneously funding a healthy dividend. Recent momentum has been driven by Morneau’s initiatives to expand in the US market; these initiatives are now bearing fruit and driving impressive revenue growth.



Income in the balanced fund is generated from a combination of dividends and interest. The equity portion of the fund has a current annualized gross yield of 3.5%, while the fixed income segment of the fund is primarily invested in securities rated “A+” that, on average, have a collective yield to maturity of 2.8% and an adjusted portfolio duration of 4.7 years. The asset mix of Pembroke’s balanced mandate did not change materially through the year, with approximately 30% of the portfolio invested in fixed income securities at March 31, 2018.

INTERNATIONAL EQUITY COMMENTARY




The GBC International Growth Fund benefited from favorable style tailwinds during the quarter, as higher quality, growth-oriented companies outperformed. Relative to the MSCI ACWI ex-US Small Cap Index, stock selection within industrials was a key contributor. Brazil-based car rental company **Localiza's** ("RENT3 BZ") share price was bolstered by quarterly earnings results that were significantly ahead of consensus expectations, driven by increases in rental days and cars sold. Consumer staples stock selection also contributed positively, supported by strong fundamental business trends at Japanese cosmetic companies **Kose** ("4922 JP") and **Pola Orbis** ("4927 JP"). UK-based **Fevertree Drinks** ("FEVR LN") was another notable contributor, driven by solid sell-through trends at existing accounts in addition to distribution gains as retailers added more shelf space for higher margin premium mixers.

Partially offsetting these positive contributors were consumer discretionary stock selection and the underweight exposure to real estate. Within the consumer discretionary sector, Sweden-based **Evolution Gaming** ("EVO SS") was a notable detractor from performance during the quarter. Evolution is a leading business-to-business (B2B) provider of live casino solutions with more than 100 customers, including a majority of the tier-1 online casino operators in Europe. Its share price was hampered by investor disappointment with the company's modest 2% earnings beat during the quarter, although fundamentals remained strong with 48% revenue growth and a 45% EBITDA margin. Indian automotive components company **Motherson Sumi Systems** ("MSS IN") also detracted from performance amid broad Indian market weakness and concerns about near-term margin pressures resulting from plant start-up costs.

From a geographic perspective, relative performance was positively impacted by the overweighting exposure to Latin America and Japan, and the underweight position in developed Asia ex-Japan markets and Canada. The positive drivers were partially offset by weak stock selection in the emerging Asia region.

The fund's allocation to health care was increased through new positions and higher weightings in existing holdings. The fund's consumer discretionary sector exposure was also increased during the quarter. These increases were primarily offset by reductions in the financials and materials sectors. Geographic positioning was mostly unchanged during the period. The fund maintained overweight positions in Europe and the UK, offset by continued underweight positions in developed Asia ex-Japan and the emerging Asia region.

FIXED INCOME COMMENTARY



Equity markets struggled with higher interest rates, tariff scares, and a Facebook led tech sell-off in the quarter as the US Federal Reserve raised rates again citing continued strength in the labour market and moderate economic growth. The Federal Reserve clearly wants to see interest rates higher, especially given the huge stimulus coming from US tax cuts. The Bank of Canada followed suit with its own hike in January but now appears to be more cautious about further increases. Bond market returns were negative as a result early in the quarter, however yields settled back somewhat in March so that the FTSE TMX Canada Universe Bond Index came in at a slightly positive return. Corporate bonds modestly underperformed Canada bonds as spreads widened, especially in higher quality issues. Very large corporate bond issuance was a contributor to the spread widening experienced in the quarter. There were over \$15 billion in new issues in March, making it the third most active month ever. Evidently, corporate issuers are attempting to lock in low yields.

The GBC Canadian Bond Fund earned a positive return for the quarter, outperforming its benchmark, the FTSE TMX Canada Universe Bond Index. With almost a quarter of the Fund invested in floating rate notes at the end of the quarter, the GBC Canadian Bond Fund remains well positioned if rates continue to rise in 2018. Canso Investment Counsel continues to believe this stance is prudent, as investors are not adequately compensated for duration risk with long Government bond yields at 2.3%.

A LUNCHEON WITH US SMALL-CAP INVESTMENT STRATEGIST, JAMES FUREY

Well-known small cap strategist Jim Furey joined a Pembroke luncheon last month to talk about the US small cap market. Among other trends, Furey analyzes the way policy makers respond to challenges in the economy and asks – are these policies bullish or bearish for financial assets? Furey argues they have been bullish for a decade and continue to be. Below we share a summary of his comments.

James Furey is bullish on US small cap stocks. Here are the four reasons why.

The policies pursued by the Trump administration are aimed at promoting economic growth. With policy makers' focus on jobs, deregulation and the economy, pent-up consumer demand is being unleashed and will push profits higher. The administration passed a large-scale tax reform that is expected to add a 15% boost to earnings. The labor participation rate is still low so there is also room for job creation.

Fiscal policy and monetary policy will support strong economic growth.

Continuing easy monetary policy is now being combined with accommodative fiscal policy. Central bankers are managing the US dollar down as the United States normalizes rates; China's renminbi is pegged to the dollar. These conditions of a falling dollar and gradually rising rates create a "risk-on" environment globally. Approximately \$300B in fiscal stimulus is planned and, with this added fiscal stimulus, the economy should continue to experience strong growth. The most important economic development to watch for is inflation (currently between 1-3%). Inflation will be on the rise and policy makers cannot curb entitlements and spending. Despite the direction and trend, current inflation rates are only just nearing target ranges and should be met with steady and gradual interest rate increases rather than abrupt or aggressive hikes.

Small cap stocks have historically performed well in healthy, rising rate environments like today's.

Some of the best small-cap returns occurred when rates were on an upward trend (1949 to 1979). Rising rates could, however, create a bear market for bonds and we are entering an environment in which active management and small-caps are poised to outperform. As interest rates rise, the environment should remain conducive for equities until rates hit 4-4.5%. Furey believes there is still a lot of room for the real rate to increase before it starts hurting the economy.

Valuations appear high but will moderate as powerful earnings growth accelerates.

The stage is set for earnings to accelerate rapidly. For profitable companies, net profit margins as a group are near record highs but this picture is somewhat distorted by the inclusion of the banks and financials. Not including banks and financials, net profit margins are still near recession levels. Corporate profits have been essentially flat for years as capital spending has been low and held back productivity. Not only is the denominator in the index's PE ratio understated, it is distorted by the inclusion of many loss-making companies (approximately 32% of companies within the index are loss-making). As earnings growth accelerates, Furey believes, the index will not look expensive.

Whether we are in the 9th year of a bull market that began in 2009 or an earlier year of a bull market that began later, a high-quality portfolio is a great defense against weak markets. If you want to learn more about investment opportunities, or discuss your asset allocation, please contact your Pembroke representative.

--James Furey is Managing Partner & Chief Investment Strategist at Furey Research Partners

BUSINESS UPDATE: PEMBROKE IS GROWING – MEET DOMINIC COSTANTINI



A personal attribute that Dominic's past clients and colleagues reference when speaking of him is his capacity for listening – both to what is said and to what is implied. Perhaps that's why his career, spanning 20 years in finance and investments, helping family offices, pension funds and foundations has been so rewarding. Dominic brings this approach to the Pembroke team in his new role as Senior Vice President, Business Development, effective March 12, 2018. Dominic holds an MBA from Western University, is an alumnus of McGill University in Montreal and serves on the Board of the Montreal General Hospital Foundation where he chairs the investment committee.

ALIGNMENT *of* INTERESTS

THE FIRM

Pembroke Management Ltd. was founded in 1968 and is based in Montreal. Pembroke's business and investment philosophy is rooted in the concept of ownership. Owners do what is in the long-term interests of their customers and stakeholders to maximize their own wealth. For this reason, Pembroke will, more often than not, back management teams that either own significant stakes in the companies they manage or whatever they own represents a significant part of their personal wealth. Furthermore, Pembroke tries to not take unnecessary risks in its investment portfolios because the Pembroke partners are large shareholders in the firm's funds. The result is a powerful alignment of interests.

Pembroke is registered as an Investment Advisor in Quebec, Ontario, British Columbia, Alberta, Manitoba, the United States, Denmark and Ireland. The firm manages segregated portfolios for institutional and high net worth clients. Pembroke Private Wealth Management is a subsidiary of Pembroke Management and is a mutual fund Manager and Dealer for the GBC family of mutual funds and the Pembroke family of pooled funds.

PEMBROKE PRIVATE WEALTH CONTACT

For additional information regarding Pembroke Private Wealth Management please call us in Montreal at 514-848-0716 or 800-667-0716 or in Toronto at 416-366-2550 or 800-668-7383, or refer to our website www.pml.ca.

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