BARRANTAGH Investment Management | 1995 2020 25 Years

Q2 2024

TRADING ACTIVITY

BARRANTAGH INVESTMENT MANAGEMENT
Canadian Small Cap Equities

The second quarter provided choppier performance for equities in increasingly narrow lead markets. Globally, AI-enthusiasm drove larger-cap tech winners to all time highs with respect to share prices and market concentration. Positive economic data points in the U.S. pushed out interest rate cut expectations and small caps lagged top-heavy large-cap benchmarks. Canadian equities also lagged during the period, outside of commodity names which were an area of strength. On both sides of the border, stock price performance was wildly differentiated depending on where you aligned on the prevailing market narratives.

Taking a step back, this current "peak rate" environment has been largely supportive for Canadian small caps and Portfolio returns. Since markets bottomed last October, the Portfolio is up almost 18%, trailing the benchmark marginally over this eight-month period. This largely overcame a large relative headwind from materials, which contributed 40% of the market returns. During one three-month period (Mar-May) small cap mining stocks (which make up ~28% of the benchmark) were up 40%. The Portfolio currently has zero exposure to mining and our "commodity-light" approach has been a significant headwind to relative performance in the short run. The Portfolio has made sizeable gains elsewhere though (Financials, Industrials, Technology, Staples), offsetting almost all of this drag. In the long run we believe focusing on quality value names with less cyclical exposure provides stronger risk-adjusted returns over the economic cycle.

Another resource area that has seen large gains over the last few years is energy and one such winner in the Portfolio, ARC Resources (ARX), was sold during the period. Given strong execution on the back of the large strategic Seven Generations acquisition, ARX grew to 350,000 barrel per day producer, $14B market cap and realized ~230% return (~40% CAGR). Alongside, the valuation multiple re-rated higher, closing the gap to large cap best-in-class peers. These proceeds were cycled into NuVista Energy (NVA), which also has a sizable position in the condensate-rich fairway of the Montney resource in Western Canada. They are less than one quarter of the size of ARX but growing faster and carry very little debt. NVA trades at a material discount to larger-cap peers (~40%) despite a de-risked 5-year plan targeting annual double digit return profile (production growth plus share buyback) within cash flow on current commodity prices.

Halfway through 2024, we believe there are multiple levers for small caps to outperform. Interest rates are a big one – in a steadying/declining interest rate environment earnings and cash flows rise (lower debt service burden) and valuations lift (time-value of money). Most importantly, sentiment can shift, which we saw late in 2023 and once again in June, as market participants start to look outside the crowding in small pockets that have been driving overall market returns. Market sentiment can be summed up in valuation and, not surprisingly, valuation opportunity differentials between large caps and small caps is stark. Looking at the benchmark, outside of mining/energy, all nine sectors are trading at double-digit discounts to five year average trading multiples (avg: -17%). This margin of safety offers downside protection and optimism for future mean reversion higher. This compares to the TSX-60 (as a proxy for large caps), where there are just two sectors trading at a large discount (rate-sensitive telcos and REITs), with the remaining eight sectors trading at just a 1% discount to five-year average multiples. Markets move in cycles and the current setup looks quite attractive for smaller cap names going forward.

BUYS

Headwater Exploration (HWX)

Headwater Exploration is an intermediate oil producer in the highly economic Clearwater play with a strong management team from Raging River/Wild Stream (Chairman - Neil Roszell). They've had outstanding historical returns growing production base organically from 10,000 bpd to 20,000 bpd. The stock has an attractive outlook (double-digit production per share growth; TMX pipeline service) and attractive valuation.

NuVista Energy (NVA)

NuVista Energy is a liquids rich natural gas/condensate producer in the Montney region. Currently, producing 80,000 BOE (Barrel of Oil Equivalent) and growing production ~10% annually. They have a solid management team with strong assets, derisked growth and a share buyback strategy and very little debt. The stock is trading at an attractive valuation versus larger cap peers, only starting to get appreciated for the quality of the asset in the market.

Sleep Country Canada (ZZZ)

Sleep Country Canada is a leading specialty mattress provider in Canada with ~40% market share. They have a solid long-term track record of growth and an experienced management team who successfully navigated the shift to an omni-channel approach. They came through a 2-year challenging period of industry contraction with good growth potential. It has an attractive valuation on cyclically low earnings and a strong upside to our $45 price target.

Trican Well Service (TCW)

Trican Well Service is a leading Canadian pressure pumper with ~25% market share. It is a right-sized business with a strong return of capital track record buying back 45% of shares outstanding since 2017. It has a strong management team lead by CEO Brad Fedora who is well respected in the industry. Fundamentals are setting up well with LNG export, Montney growth and increasing frac intensity in the basin. The stock has an attractive valuation on current activity levels with strong torque to increased producer spending, no debt and a growing dividend.

SELLS

ARC Resources (ARX) and MTY Group (MTY).

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