PEMBROKE
Serving Private Clients and Institutions

October 2017

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On the Road Again

At Pembroke, we are ever vigilant to remain up-to-speed on companies within our investable universe. Investment decisions are dynamic; an idea that doesn't warrant capital at a given point in time can become interesting through an improvement in fundamentals or a share price correction. As such, we are big believers in the discipline of constantly revisiting ideas and retesting our theses.

Our recent investment in **Ballard Power Systems** ("BLDP") provides a good example of the value and importance of proactively revisiting ideas. Ballard is a Vancouver, British Columbia based company focused on designing, developing, manufacturing, and selling fuel cells. Fuel cells use hydrogen to generate electricity via an electrochemical reaction with oxygen, and produce water as a waste by-product. The company was founded by Geoffrey Ballard in 1979, and completed its initial public offering in 1993.

The merits of adopting fuel cell technology have long been understood: no greenhouse gas emissions, higher efficiency than diesel or gasoline engines, long operating times, and simpler maintenance as there are fewer moving parts in a system. Investors in the past eagerly embraced the transformational potential of fuel cells and Ballard's shares peaked at $192 and enjoyed a market capitalization of over CAD $17 billion in March 2000. Promising relationships were formed with major automotive and industrial partners, and there was great optimism about the commercialization prospects for the technology.

The initial enthusiasm regarding fuel cells proved premature. Commercialization was a slow and arduous process, and the firm's cash burn mounted. As the market fervor towards fuel cells waned, investors were left with losses and disillusionment from their involvement in Ballard.

BALLARD®

Ballard's history and challenges were well known to the Pembroke team, so it was with some natural scepticism that we met with management in the spring of 2017. We came away, however, with our interest piqued, and followed up the initial meeting with two site visits to Ballard's headquarters and manufacturing facilities in Vancouver, a meeting with management in Montréal, and attendance at the company's investor day event in New York City. Through these interactions, we had the opportunity to meet with Ballard's senior management, members of the board of directors, members of the research and engineering staff, and the head of one of Ballard's key customers and joint venture partners.

Our due diligence convinced us that the perception of Ballard in Canadian equity markets was quite different than reality. While the market perceived Ballard to be an undercapitalized, cash-consuming R&D firm whose main technology had been surpassed by lithium-ion batteries, we saw a company with a strong balance sheet, on the cusp of profitability, with credible industry partners, new and engaged management, and a tantalizing addressable market. With no institutional analyst coverage in Canada and only a handful of analysts covering Ballard in the United States, we believe the process of rediscovery is still in its early stages. The discipline of revisiting ideas from the past is important as it can surface investment opportunities overlooked by others in the market.

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
September 30th, 2017

Company	Q3 Price Change (CAD)	Revenue Growth, Current Fiscal Year	EBITDA Growth, Current Fiscal Year	Revenue Growth, Next Fiscal Year	EBITDA Growth, Next Fiscal Year
Gildan Activewear Inc.	-2%	0%	4%	6%	7%
DHX Media Ltd.	-9%	54%	95%	6%	12%
Stella-Jones Inc.	9%	1%	-5%	3%	15%
Solium Capital Inc.	5%	6%	-4%	18%	39%
Canadian Western Bank	24%	24%	22%	7%	10%
Average	**5%**	**17%**	**22%**	**8%**	**17%**

Top Five U.S. Holdings
September 30th, 2017

Company	Q3 Price Change (USD)	Revenue Growth, Current Fiscal Year	EBITDA Growth, Current Fiscal Year	Revenue Growth, Next Fiscal Year	EBITDA Growth, Next Fiscal Year
HMS Holdings	7%	14%	9%	13%	16%
BofI	20%	18%	16%	14%	14%
Carbonite	1%	18%	28%	10%	33%
J2 Global	-13%	31%	29%	8%	12%
GTT Communications	0%	55%	104%	27%	25%
Average	**3%**	**27%**	**37%**	**14%**	**20%**

Source: Consensus and Pembroke estimates

Overview of the Quarter

Introduction

Global equity indices moved higher in the third quarter of 2017. Even in Canada, which has struggled with low energy prices, the major benchmark rose over the past three months. Central banks have begun positioning for tighter monetary policy, but their initial rate increases and more hawkish messaging have been overpowered by strong economic data, from employment to manufacturing. Concerns about growing tension with North Korea have been largely dismissed by investors, with any dips proving to be buying opportunities. The US dollar also weakened against many global currencies, which will provide a tailwind for US corporate earnings growth should it remain at current levels or keep falling. In Canada, the opposite is true, and Pembroke has been carefully adjusting its forecasts for its holdings based on the 7% rise in the Canadian currency since the beginning of the year.

Pembroke is encouraged by several potential drivers for its portfolio, from an expected multi-year recovery in the building of US single family homes to the innovation that is taking place in the automotive sector. The devastating hurricanes that struck the US in September will buoy several Pembroke industrial and consumer holdings as individuals and the government start spending on the rebuilding process. Healthcare remains another area of excitement, as technology continues to provide opportunities to improve care and reduce the cost of delivery. The repeal of Obamacare has failed for now, and Pembroke's hope is that the status quo will give hospitals the visibility they need to buy new information-technology systems and medical equipment. While our investment team believes such purchases are inevitable, the lifting of the regulatory cloud might reaccelerate decision making.

While the economic backdrop is strong and the pace of innovation is impressive, Pembroke remains vigilant on valuations and balance sheets. The portfolio managers have been reducing positions that have run too far too fast, and redeploying the capital where the combination of growth and valuation is more attractive. Should a market correction provide the opportunity, expect certain holdings to be built back to higher weights. The firm's pipeline of new ideas is robust and the investment team

continues to travel extensively (including recent trips to Vancouver, Oklahoma, Philadelphia, San Francisco, Massachusetts, New Hampshire, Indiana and London England) to meet with existing holdings and identify new potential investments.

US Commentary

Pembroke's US growth portfolios delivered robust absolute performance in the third quarter of 2017. While the results trailed the Russell 2000 slightly over the past three months, the performance through the first three quarters remains well ahead of the benchmark.

From a sector perspective, the most meaningful contribution came from the firm's consumer discretionary holdings, which include companies exposed to autos, home building, and recreational vehicles. The only negative sector over past three months was healthcare, which gave back some of its gains following a strong first half of the year. Importantly, the most recent attempt to repeal and replace Obamacare failed at the end of September, which should eliminate a significant uncertainty overhanging some of Pembroke's healthcare holdings.

The investment team has been risk-managing the portfolio, taking weight out of several holdings that have jumped higher. While these holdings still offer long-term upside, the underlying valuation expansion limits the opportunity for outsized gains in the near term. At the same time, proceeds from these sales have been allocated to existing holdings with more upside potential and to several new holdings from a range of industries. Importantly, the investment team believes that the top ten US portfolio holdings still offer significant upside over the next year as well as over the longer-term.

During the third quarter of 2017, shares in **Boingo Wireless** ("WIFI") surged after the company delivered exceptional financial results and offered a strong outlook. Revenue rose 256% and adjusted EBITDA margins jumped from 24% to 33%. WIFI is benefitting from rising data consumption on mobile devices. As smartphones proliferate, and consumers increasingly use them to check social media, watch videos, FaceTime with friends, and post or send photographs, telecom companies' network speeds are slowing. Slow download times lead to consumer dissatisfaction and higher customer losses. In areas of high congestion, such as sports stadiums and train terminals, carriers are looking to WIFI to build networks that handle high volumes of data. The company's success is leading to more carrier relationships and opportunities to "densify" networks in highly-trafficked locations.

The shares of **BOFI Holding** ("BOFI"), a branchless bank that has enjoyed impressive growth in its core mortgage offering and new business lines, rose from depressed levels in the quarter. The company has spent more than two years fending off unfounded attacks from short investors. Recent disclosures have helped clear the controversy, and position BOFI's stock to perform in line with its fundamentals rather than around baseless rumours. In fact, the company's strict lending standards have led to improving rates of non-performing loans, which already stood at industry-leading levels. The Pembroke team believes that BOFI's consistent performance and branchless model, which allows the firm to invest in data analysis and new services rather than old-line branches, offers significant long-term upside. Over the near term, if BOFI can simply close the valuation gap with its peers, the stock should move materially higher.

The portfolio enjoyed a small benefit from the acquisition of long-time holding **Actua** ("ACTA"). ACTA had three main operating segments and announced the sale of all three of them in separately negotiated transactions. Each segment had significant potential but two of them had struggled to find their footing as small software companies that were torn between driving growth and delivering near-term profit. As owners of over 11% of the equity, the management team and board of directors were well aligned with shareholders and decided that a sale was the best way to realize ACTA's value rather than to continue as a public company with three interesting, but very independent, business lines.

Shares in **Teligent** ("TLGT"), which manufactures generic drugs, declined in the third quarter of 2017 as investors grew frustrated with the rate of new drug approvals. TLGT has a robust pipeline of new products and guided investors to expect another ten approvals before the end of 2017. Since that guidance was issued, only three drugs have been approved. Pembroke is focused on the multi-year opportunity, as the success of these approvals is probable and the management team has a good execution track-record. Whether the approvals come in the next three, six, or nine months, has little bearing on the long-term opportunity for Teligent to grow its revenue and turn significantly profitable. Several of the approvals expected in the foreseeable future target large market opportunities and would help drive significant 2018 revenue growth. If this happens, the market should wake up to Teligent's growth and to the value of its expanding generic drug pipeline.

Shares in **j2 Global** ("JCOM") declined following the company's release of second quarter 2017 results. Pembroke's investment team was surprised by the negative reaction and increased its holding in JCOM at lower prices. In 2016, JCOM announced the acquisition of **EverydayHealth** ("EVDY"), a leading online provider of health information to consumers and physicians. Pembroke's investment team recently met with EVDY

management and agreed with JCOM's assessment of the business; that is, EVDY could have been run more profitably and that two of the company's five divisions are not strategically important and should have been sold. JCOM is optimizing the income statement by ending unprofitable contracts and has sold one of the two non-core divisions. The progress is not yet captured in JCOM's financial results because they are spending to rationalize EVDY's bloated expense base. As we proceed through the second half of 2017, the profit margin potential at EVDY should become more evident; further, 2018 should see EVDY return to growth but at a much higher level of profitability. JCOM has a strong record of acquiring businesses like EVDY and restructuring them for profits and cash flow. Pembroke does not believe this case will be any different. The stock trades at a reasonable valuation and offers exciting upside for investors willing to look past this brief period of integration and cost cutting.

CANADIAN COMMENTARY

Canadian equity markets rallied in the third quarter of 2017, largely driven by strength in financial stocks and a rebound in the energy sector. Over the period, Pembroke's Canadian equity portfolios posted positive absolute returns that trailed the S&P/TSX Composite Index. The fund benefited on an absolute basis from gains in its energy, information technology, and industrial holdings, though real estate and health care investments were a drag during the quarter. Compared to the S&P/TSX Composite Index, the consumer discretionary, real estate, and financial sectors were the most significant detractors from performance. Several stocks declined significantly and weighed on performance.

DIRTT
Build better.™

Shares in **DIRTT Environmental Solutions** ("DRT"), a technology-driven manufacturer of customized building interiors, declined in the third quarter after seasonally weak interim results and in reaction to a change of personnel at the CFO position. Despite these short-term headwinds, we believe the outlook for DIRTT remains encouraging. The company is enjoying sales momentum that will drive margins and earnings in the coming quarters and years.

Shares in **Colliers International Group**, ("CIGI"), a global real estate company offering a full range of services to tenants, owners, and investors, declined in the third quarter after a strong start to the year. Nonetheless, quarterly results were ahead of expectations and the company's outlook remains robust. Given that the global real estate service industry remains fragmented, Colliers has significant runway to grow its business through a combination of organic and acquisition-driven initiatives.

Two noteworthy stocks made significant positive contributions to returns in the third quarter. Shares in **Canadian Western Bank** ("CWB"), a deposit-

taking financial institution serving both commercial and personal clients, performed well during the period as investors reacted positively to interim results and credited the company with being a beneficiary of a rising interest rate environment. CWB had been negatively affected in the past two years by a slowdown in western Canada resulting from depressed energy prices. Recent results suggest, however, that credit quality is on the upswing and that acceleration of loan growth is afoot.

Shares in **Westport Fuel Systems** ("WPRT"), a developer of low-emission natural gas engines to displace conventional fuel engines, performed well during the period as investors recognized that commercialization of one of the company's key technologies was imminent. The company has spent many years and significant capital developing this technology, so commercial sales will be a major milestone. The company is poised to benefit from the secular shift away from high-emission diesel engines to cleaner burning alternatives.

Balanced Fund & Dividend Commentary

Pembroke's balanced portfolio, the **GBC Growth and Income Fund**, generated a modest positive gain during the third quarter of 2017. This result added, in both absolute and relative terms, to the strong performance already reported in the first six months of the year. The result came from a few stocks with strong contributions, a large group of holdings that made smaller positive contributions, and the absence of any holdings that made meaningful negative contributions. Although the fund trailed the benchmark slightly during the quarter, its returns remain positive and well ahead of the benchmark in the year to date.

The asset mix did not change materially during the period with approximately 29% of the portfolio invested in fixed income at the end of September 2017. This component is primarily invested in securities rated "A+" that, on average, have a collective yield to maturity of 2.1% and an adjusted portfolio duration of 4.8 years.

Income generated by the portfolio comes from a combination of dividends and interest. The portfolio's annualized gross yield is currently 3.3%. The growth component of the portfolio stems primarily from the 45 dividend-paying holdings whose share prices are expected to appreciate. Eighteen of these names, representing 41% of the equity exposure, are also held in Pembroke's standard growth portfolios. The holdings that are unique to this portfolio are generally expected to be less volatile as they pay a substantial dividend and are expected to grow their earnings at a more moderate but stable rate. Companies are selected for inclusion in the fund based on having an attractive, well-funded,

sustainable dividend as well as reasonable growth opportunities. Management quality and alignment with shareholders are also key investment considerations. The equity holdings in the **GBC Growth and Income Fund** are the same as the holdings in the **Pembroke Dividend Growth Fund**.

The **Pembroke Dividend Growth Fund** outperformed the S&P/TSX Dividend Aristocrats Index and underperformed the S&P/TSX Composite Index during the quarter, and remains comfortably ahead of both indices on a year to date basis.

During the third quarter of 2017, performance was aided by several stocks that made strong positive contributions. This is not surprising in a measurement period as short as three months. Over a sufficiently long period of time, the goal of managing this portfolio is to have a much broader collection of the holdings contributing meaningfully to returns. From a relative perspective, the top two holdings had much higher contribution than the largest two detractors. At the top of the contribution list were **Pollard Banknote** ("PBL") and **Canadian Western Bank** ("CWB"). Pollard Banknote, based in Winnipeg, is one the largest global providers of instant-win scratch tickets and the largest vendor of lottery products in Canada. Early in the quarter, shares rallied following the company's acquisition of Innova Gaming, a provider of instant-ticket vending machines and other alternative gaming products in North America. We believe this to be a highly strategic and financially accretive deal given the price paid for the asset. Furthermore, second quarter results came well ahead of expectations due to a greater mix of higher margin scratch tickets and improved manufacturing efficiencies from their new printing press. Pollard Banknote is a large position in the portfolio because of the long-term opportunity for the business to grow organically and through further acquisitions.

Shares of Canadian Western Bank rallied in the third quarter as the company delivered financial results that were viewed positively by the equity markets. Investors were encouraged by the loan growth and improving credit trends posted during the quarter. Moreover, the bank is poised to benefit from a rising interest rate environment which will bolster its net interest margins. After several years of headwinds caused by depressed energy-sensitive economies, the operating environment for Canadian Western Bank is becoming more favourable.

The two stocks that detracted the most from performance were **Tricon Capital Group** ("TCN") and **Sleep Country Canada** ("ZZZ"). Tricon Capital Group is an asset manager and investor in North American residential real estate. Operating results were solid and did not contain any surprises, however, shares have declined during the quarter because of two

macroeconomic, non-company-specific, issues. First, the translation effect of a strengthening Canadian dollar impacted the company's US-denominated earnings. Second, regulatory scrutiny over valuation practices of an appraisal firm that Tricon and other companies use has negatively impacted sentiment towards the industry. Neither of these give us reason to change our view on the fundamental outlook of the company.

Sleep Country Canada is a mattress retailer with an eponymous brand across Canada (except for Quebec where it markets itself under the Dormez-vous name). This holding has been included in past quarterly commentary given its strong contribution to the portfolio's performance. During the past three months, the shares pulled back slightly due to investor concerns related to the growth rate in accessory sales and the Toronto and Vancouver housing markets. Investors expected margins to gradually increase due to a higher mix of accessory sales. This trend was questioned during the most recent quarter when sales growth of accessories slowed. Management expressed confidence that the slower quarter was anomalous and cited a sales push in the year-ago period which created a tough comparison. We have managed the weight in this holding but continue to believe the business has a sustainable long-term growth opportunity.

Although the fund did not keep pace with the benchmark during the third quarter, it generated a strong absolute return and remains comfortably ahead of benchmarks on a year to date basis. We have increased the number of positions in the portfolio as we continue to process a pipeline of promising ideas across various sectors.

INTERNATIONAL EQUITY COMMENTARY

The fund benefited as higher quality, growth-oriented companies with good earnings trends and share price momentum outperformed the MSCI ACWI ex-US Small Cap Index benchmark. Stock selection within the industrials sector was a key contributor to the fund's outperformance. Japanese factory-automation holding **Daifuku** was the leading performer within the sector, supported by consensus-beating quarterly financial results arising from accelerating demand from its electronics and e-commerce customers. Holdings in the consumer discretionary sector also contributed positively, bolstered by strong fundamental business trends at hotel operator **China Lodging Group**. Within consumer staples, UK-based **Fever-Tree Drinks** 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 the selections in the materials and information technology sectors. Within materials, Japan-based **Hitachi Chemicals** detracted from relative performance despite the company reporting solid operating trends on rising demand for semiconductor consumables and electronic vehicle battery materials. Within the information technology sector, Swedish online casino game software company **NetEnt**'s share price weakened in September amid investor concerns about potentially softer growth trends in the second half of the year.

From a geographic perspective, stock selection in Japan was the largest contributor to second quarter performance, followed by stock selection in Europe (ex-UK). These effects were partially offset by weak UK and Latin America stock selection.

From a sector perspective, the allocation to financials was increased through higher weightings in existing diversified financials holdings, and new positions in European and UK capital markets companies. The information technology sector exposure was also increased during the quarter. These increases were primarily offset by reductions in the consumer discretionary 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

Commentary on GBC Canadian Bond Fund

Although the **GBC Canadian Bond Fund** posted a negative return for the quarter, it managed to slightly outperform its benchmark the FTSE TMX Canada Universe Bond Index.

After essentially pre-announcing interest rate increases in the second quarter, the Bank of Canada matched their words with actions in the third quarter. They increased their target for the overnight rate to 0.75% on July 12th and to 1% on September 6th. This reversed the "insurance" cuts the Bank made back in 2015 in response to the drop in oil prices. The Bank pointed to better than expected recent economic performance in justifying their decision but they also appear to be a bit confused about why inflation has not also moved higher.

Higher yields have translated into broadly negative returns in the bond markets for the most recent quarter and year. Short term yields increased more than long term yields, and Government bond yields have risen more

than corporate bond yields. As a result, the yield curve has flattened and the latest quarter's return on broad market indexes was negative. Longer duration Provincial bonds did worse while spread narrowing and higher running yields mitigated the damage in corporate bonds. They outperformed the broad market but were still negative for the quarter. The Canada Index returned -1.8% in the quarter.

With over 23% of the Fund invested in floating rate notes at the end of the quarter, the **GBC Canadian Bond Fund** is well positioned in the event that rates rise further. The position in floating rate notes was already a benefit to the Fund as short-term yields rose in the quarter. Many short-term bonds such as Ontrea Inc (RBC Centre) and the Eurofima bond maturing in 2019 also outperformed. Canso Investment Counsel continues to believe that investors are not adequately compensated for the risks of owning many longer-term bonds.

Commentary on Pembroke Corporate Bond Fund

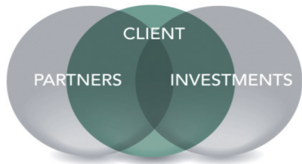
The **Pembroke Corporate Bond Fund** posted a positive return for the quarter to outperform its benchmark FTSE TMX Canada All Corporate Bond Index.

Higher yields have translated into broadly negative returns in the bond markets for the most recent quarter and year. The Canada Index returned -1.8% in the quarter. In the corporate sector credit spreads actually declined in most cases so that corporate bonds outperformed the broad market in the short, mid, and long term. Although the Corporate Index had a negative return for the quarter, it managed to outperform the overall market as it had a lower weight in long term bonds. The contributing drivers of the negative 1.3% return for the Corporate Index was the weight in the long Infrastructure sector and the longer duration A rated index returning -2.9% and -1.7% respectively.

The Fund's sensitivity to the negative effects of higher interest rates is quite low relative to the broad market. One of the main reasons for this is the Fund's over 30% weight in floating rate notes. Since the coupon payments of these rise when interest rates rise, they did well in the recent environment. Bombardier bonds were down roughly 5% however this was more than offset by gains in Postmedia, Yellow Pages, and Black Press. Canso Investment Counsel continues to believe the potential returns from most high yield bonds are very low versus their inherent risk. As a result, they continue to position the portfolio in higher quality names.

OUTLOOK & CONCLUSION

Pembroke's clients know that we spend more time analyzing our current holdings, potential investments, and their opportunities than prognosticating on the market or the economy. The stock market can be bumpy, the global economy is unpredictable, and few companies execute their plans in a linear manner. The firm's long-held view is that growth companies, run by sound capital allocators, working on behalf of shareholders, will generate sufficient long-term progress in earnings per share to compensate for changes in overall market valuations. Patience is the key. We continue to uncover new ideas in the US and Canada that we do not believe are appropriately valued by the market. Further, we are optimistic about the potential in each portfolio's top-ten holdings, and our accuracy on that front will be a critical driver of future performance. We are balancing our optimistic outlook for our holdings and the strong economic backdrop against the risks of a stock market correction by closely monitoring valuations and balance sheets. While we are not forecasting a correction, we would welcome the opportunity to buy compelling businesses at lower prices. In the meantime, we are constructing portfolios that responsibly balance growth and valuation.



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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