PATHFINDER

Pathfinder Small Cap

Quarterly Report

September 29, 2023

The Pathfinder Small Cap mandates investment in high-torque, early-stage companies that have the potential to generate superior returns.

Pathfinder Partners' Fund

The Partners' Fund had a net return of -6.5% in the third quarter of 2023. This compares to the TSX Venture Exchange's return of -10.10%. Our annualized 10-year return is 14.9% compared to the TSX Venture Exchange's return of -5.1% over the same period. The table below provides the performance summary.

Performance: September 29, 2023

	3M	6M	1 Yr	3 Yr	5 Yr	10 Yr	Incpt. *
Pathfinder Partners' Fund[1]	-6.5%	-6.3%	2.8%	8.7%	10.0%	14.9%	6.6%
S&P/TSX Venture	-10.1%	-11.9%	-5.9%	-7.5%	-4.7%	-5.1%	-10.9%

	2022	2021	2020	2019	2018	2017	2016
Pathfinder Partners' Fund[1]	-20.6%	19.6%	50.6%	26.3%	-17.0%	36.6%	40.3%
S&P/TSX Venture	-39.3%	7.3%	51.6%	3.7%	-34.5%	11.6%	45.0%

[1] Performance based on Class C Master series, please see disclosures below

*Inception Date: March 2011

Our top contributors for the quarter were **Terra Firma Capital Corp. (TSXv:TII)** and **Vitalhub Corp. (TSX:VHI)**, while our main decliners were **Eupraxia Pharmaceuticals Inc. (TSX:EPRX)**, **Spectra7 Microsystems Inc. (TSXv:SEV)** and **Imaflex Inc. (TSXv:IFX)**.

Positive trends in the first half of the year related to tech stocks (boosted by AI) were generally reversed in Q3 as the market's performance more closely mirrored expectations of a high interest rate environment. In a single year, Canada's interest rate has moved from 1.5% to 5%, and while these rate hikes should be slowing growth as capital becomes more expensive, what we've seen instead is a fragile optimism buoyed by robust consumer demand. Optimism aside, interest rate hikes are only just beginning to work their way into the real economy and consumers are exhausting their excess savings that were amassed during the pandemic.

We believe that a wide valuation gap exists between small and large public companies, with small caps trading at a notable discount to large caps on a variety of metrics. It is difficult to determine if or when this valuation gap may close, but we have seen some encouraging signs over the past few weeks. While investors have not yet stepped in en masse to buy small caps at these low valuations, there has been positive activity from corporates and private equity regarding recent M&A announcements. In early October, **Neighbourly Pharmacy Inc. (TSX:NBLY)** announced that they were getting acquired for over $900 million, representing a 47% premium to its share price. Similarly, **H2O Innovation Inc. (TSX:HEO)** announced that they would be acquired for $395 million at a 68% premium to the share price. One week later, **OpSens Inc. (TSX:OPS)** was acquired for $253 million at a healthy 50% premium to their closing price.

While these specific stocks were not part of our portfolio, we believe that similar potential exists among our holdings. As M&A continues to unfold and deals are finalized, there is the possibility that investors will redirect their transaction proceeds into other promising small companies. One of our large holdings, **Terra Firma Capital Corp. (TSXv:TII)** announced that they are being acquired and we are eagerly awaiting the closing date to re-deploy the proceeds into attractively priced stocks. In our opinion, there are compelling investment opportunities in the marketplace today.

The volatility of the last three years has presented us with opportunities to find cheap businesses in more traditional industries. "Old world" businesses, which typically carry higher inventories and require large capital expenditures, such as refineries and manufacturers, over-earned after the pandemic as customers stockpiled inventories to reduce supply-chain risk. The excess inventory purchased throughout 2021 and 2022 was often at elevated prices compared to historical norms, but pricing pressures have begun to normalize, and companies no longer look to carry as big an inventory buffer.

As pricing normalizes and customer orders decline, the once "over-earners" have become "under-earners" with compressed margins and deteriorating earnings, leading to share price declines. Businesses exposed to this type of cyclicality provide us with the opportunity to invest in strong cash flowing companies at discounted valuations. If we can correctly determine the "normalized" earnings power, likely somewhere between the over-earning highs and the under-earning lows, then we hope to find opportunities with oversold businesses. We have initiated several new investments in this category anticipating that earnings power will increase during 2024, leading to a positive re-rating.

While the past two years have been extremely difficult for small cap equities, there is a silver lining. Many stocks are severely mispriced with seemingly unlimited sellers and no buyers. Historically, we have seized such opportunities and purchased some of our largest winners during times of distress. We believe the portfolio is positioned to outperform going forward and thank our investors for their continued trust.

Pathfinder Resource Fund

The Resource Fund had a net return of –5.4% in the third quarter of 2023. This compares to the benchmark which had a net return of +1.4%. Since inception (July 16, 2018), the Resource Fund has returned +11.9% annualized versus the benchmark's return of +5.6%. The table below provides the performance summary.

Performance: September 29, 2023

	3M	6M	1 Yr	3 Yr	Incpt. *
Pathfinder Resource Fund[1]	-5.4%	-11.0%	4.1%	8.3%	11.9%
Benchmark	1.4%	-4.7%	8.8%	12.5%	5.6%

	2023 YTD	2022	2021	2020	2019
Pathfinder Resource Fund[1]	-11.0%	-18.7%	23.6%	69.9%	15.6%
Benchmark	-4.7%	12.0%	19.8%	6.0%	19.0%

Benchmark: 75% S&P/TSX Capped Materials Index, 25%, S&P/TSX Capped Energy Index *Inception Date: July 16, 2018

Our top contributors for the quarter were **Sprott Physical Uranium Trust (TSX:U.UN)**, **Orogen Royalties Inc. (TSXv:OGN)** and **Athabasca Oil Corporation (TSX:ATH)**, while our main decliners were **Pan Global Resources Inc. (TSXv:PGZ)**, **Geodrill Limited (TSX:GEO)**, and **Ophir Gold Corp. (TSXv:OPHR)**.

Apart from physical uranium and oil, weakness persisted across the commodity sector during the third quarter. Despite apathy in the market, we continue to maintain diversified exposures, with a primary focus on our high-quality core positions. These companies provide us liquidity and downside protection as we wait for market dislocations to present an opportunity to rotate into higher torque exploration companies. The market is still driven by new discoveries, thus half of our portfolio is centered on exploration stage companies, many of which will be delivering results over the upcoming months.

Common themes that we have outlined over the past year have been underinvestment in supply and more recently, destocking of inventory. We believe these fundamental factors are still "in play" and will lead to supply constraints that will fail to meet demand, resulting in stronger commodity prices offering positive returns.

In 2020 and 2021, the commodity sector outperformed other markets, but the rally was short-lived as global economies, particularly China, faced challenges in resuming normal operations. These demand concerns have persisted throughout this year, exerting downward pressure on equities, despite little change in the long-term supply and demand fundamentals—a reason why we remain optimistic about the sector's future prospects.

One theme we highlighted in a previous quarterly report (3Q22) regarding uranium supply constraints has materialized, propelled by overfeeding and diminishing inventories, resulting in the sector's outperformance.

Another theme gaining traction is the pending demand for fertilizers, driven not only by soil degradation but also the shift towards lithium-iron-phosphate (LFP) batteries. LFP batteries dominate the market outside of North America (NA) but as companies like Stellantis NV and Volkswagen AG look to build battery plants in NA, domestic supply for these battery metals will become critical. **Itafos (TSXv:IFOS)**, a core position in our Resource Fund, is a vertically integrated phosphate producer located in Idaho that is ideally situated to meet this emerging demand. We believe there is significant dislocation between IFOS's company fundamentals and market valuation. For example, over the last eighteen months, IFOS has paid down C$245 M of net debt with free cash flow while only being valued at a market cap of C$243 M. The company has announced a strategic review and we view it as a natural acquisition candidate based on the company's current valuation and continued successful execution. The replacement cost of ITAFOS's assets including infrastructure is over a billion dollars, and as new and existing entrants look to enter the market, we believe that they would prefer to purchase Itafos rather than invest in new greenfield capacity.

In other market segments, inflation continues to persist, prompting us to increase our exposure to royalty companies. Royalty companies provide financing to other entities in exchange for a share of project production or top-line revenue, thereby insulating us from cost inflation. **Orogen Royalties Inc. (TSXv.OGN)**, another core holding, is a precious metals royalty/project generator company with positive cash flow. Unlike other junior exploration companies that continually struggle to raise money, OGN has a 2% net smelter royalty (NSR) on First Majestic Silver Corp's producing Ermitaño mine. This offers a continuous revenue stream, which covers costs and supplements the project development side of the business. Orogen also holds a 1% NSR on AngloGold Ashanti's newly discovered Silicon-Merlin deposit in Nevada. AngloGold Ashanti recently published a resource of 4.22 Moz gold on the Silicon project and had commenced a preliminary economic study (PEA) to rapidly advance the project towards production. However, due to a new discovery named Merlin, the company halted the PEA because Merlin appears to be an even better target than Silicon. The company is guiding that Merlin's resource is expected to be 6-8 Moz at 0.8-1.0 gpt Au. In our opinion, Silicon-Merlin is a cornerstone royalty on a world class asset that more than drives the current valuation of the company. OGN is trading at ~0.7x NAV without taking into consideration additional upside at Silicon-Merlin or offering much value to Ermitaño or the project generation business. Orogen is a scenario where the sum of parts offers a valuation greater than the whole, which is being overlooked.

While some of our macro themes are yet to unfold, we appreciate your patience as we continue to focus on downside protection. In the near-term, we will continue to strengthen our high-quality core positions while maintaining exposure to exploration companies that we believe will generate torque for the portfolio on the back of discoveries.

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Disclosure

National Instrument 31-103 requires registered firms to disclose information that a reasonable investor would expect to know, including any material conflicts with the firm or its representatives. Doug Johnson and/or Pathfinder Asset Management Limited are an insider of companies periodically mentioned in this report. Please visit www.paml.ca for disclosures.

* All returns are time weighted and net of investment management fees. Returns from the Pathfinder Partners' Fund are presented based on the Class C Master series except prior to its inception in July 2011 when the Class A Master series was used. Inception returns include the 10 months from inception in March 2011. Returns greater than one year are annualized. Returns from the Pathfinder Resource Fund are presented based on the Class C Master series since its inception in July 16, 2018. The S&P/TSX Venture Composite Index (C$), the S&P/TSX Venture Composite Index, the S&P/TSX Capped Materials Index and the S&P/TSX Capped Energy Index provide general information and should not be interpreted as a benchmark for your own portfolio return. Further details of the Partners' Fund are available on request.

Changes in Leverage. We are increasing the liabilities ceiling to 2.0 times the market value of equity for Pathfinder International Fund and Pathfinder Real Fund to be consistent with Pathfinder Partners' Fund and Pathfinder Resource Fund.

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