VENATOR
CAPITAL MANAGEMENT LTD.

THE QUICKEST BUCK

Instrument (Inception)*	April 2016 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**1.8%**	**-3.8%**	**12.8%**
Venator Partners Fund (July 2014)	**1.9%**	**-3.9%**	**-0.3%**
Venator Investment Trust (September 2007)	**1.8%**	**-3.9%**	**9.1%**
Venator Income Fund (August 2008)	**3.0%**	**6.4%**	**12.4%**
Venator Select Fund (September 2013)	**5.7%**	**2.3%**	**19.9%**
S&P/TSX Total Return (March 2006)	3.7%	8.4%	4.7%
Russell 2000 (March 2006)	1.6%	0.0%	5.8%
S&P Toronto Small Cap (March 2006)	12.4%	21.9%	1.5%
S&P 500 (March 2006)	0.4%	1.7%	7.1%
Merrill Lynch High Yield Index (August 2008)	4.0%	7.4%	8.5%

A quick look at the chart above shows a pretty significant standout: the TSX Small Cap Index. Not only is it up an astounding 22% on the year, but it is up a more astounding 42.6% from its 2016 bottom (late January). Of course the TSX Small Cap Index is still 25% off of its all-time high achieved way back in the summer of 2007 (and off 18% from its two-year high); earlier this year it was 50% off of that same high. So this was a great move for the market timers, but not so great for the buy-and-hold crowd.

The two sub-sectors that have driven this move have followed the same pattern with more eye-popping results. The gold index (TSX:XGD) is up 86% from its 2016 bottom, but it's still 50% off its fall 2011 high. The oil and gas index (TSX:XEG) has made a similarly amazing 50% move but still sits 60% below its summer 2008 high (and off 45% from its two-year high). Similarly, a stock that's up over 100% from the bottom may still be down over 50% from the top as we can see in the case of Barrick Gold which is up 160% from its recent low, but still down 65% from its all-time high; and Encana, which is up 155% from its low, but is still down 85% from its all-time high.

I am certain that none of our readers would be pleased to be up 22% this year if it means that they are still down 20% since 2007, or 2011 for that matter. But that's often where the biggest near-term gainers come from: last season's biggest losers. I would imagine that most of the top fund managers this year are gold bugs, but I would also imagine that the three and five-year track records of those funds are not enviable. And lest the oil and gas expert say "I told you so", ask about their three or five-year track records.

Turning back to stocks, one of our Rules of Investing to which we revert every now and then is that there is no faster way to multiply your money than with a good turnaround. There are massive gains to be made as a company crosses from the threat of insolvency to staying in business. This was basically a third of the market back in 2009. Being in or out of business in the gold sector is often the difference between $1100 gold and $1200 gold, which is why you have seen 100%+ moves in stocks despite a lesser 23% move in gold (for a Canadian producer the gold price move has only been half of this US-dollar quoted price thanks to the sudden appreciation of the Loonie, but the gold market doesn't like little things like currency movements to get in the way of a good narrative). Sometimes, a financing connected to a potential turnaround is enough to self-start the turnaround by taking a company out of debt trouble, as we saw with Manulife in 2009, among others.

Of course, it's always important to remember another one of our rules: the market is pretty much perfect when it comes to forecasting what it thinks will happen, but has a poor track record at predicting what will actually happen. The market is an anticipatory animal, but not an accurate fortune teller. With regard to oil, the market thinks US supply will fall off, or OPEC

will freeze supply, or demand will grow with global GDP, or China won't suffer a hard landing; and is pricing these possibilities into the oil price accordingly with crude up 60% off of its recent lows. We don't think that any of these assumptions will prove correct because the facts seem to run counter to the hopes. We saw this with the latest production freeze rumours, which sent oil prices up 20% in several days, but the deal did not happen. We are fully aware that our current bearish stance in some of the more volatile parts of the market means that we aren't going to keep up with some of these resource specialists and narrow indexes over the short term, but we also think it means that we will continue to outperform them over the long term.

This brings us to a more recent investment in Skyline Corp., an underfollowed (no analyst coverage) company in the manufactured/modular housing business. Although, as a subset of the housing industry, Skyline could be considered cyclical, its sales are increasing at a healthy pace (although margins have been bouncing around quite a bit). Fortunately, with a clean balance sheet, the company was able to weather losses over the past eight years and has now turned free cash flow positive with over $200 million in NOL's (net operating losses, which are past operating losses that can be used to reduce future tax bills).

In the mid 1990's, as an industry, the manufactured housing market used to sell close to 400,000 units per year. The housing collapse, coupled with adverse changes in mortgage lending for these types of houses, dropped the industry down to 50,000 units per year by 2009 (a possible reclassification for mortgages is a free option at this point, but we are not betting on a return to older lending standards). However, from this 2009 bottom, the market has expanded every year since, with Skyline's sales in the past six months being up 20% over the prior period. As is typically the case in manufacturing, with greater scale comes greater margins, and we believe that Skyline, with no interest expense, minimal CAPEX (its only at 60% capacity), and no taxes for years to come, is capable of earning free cash flow of $16 million on its current revenue base. With a current market value of $75 million, the stock appears to be exceedingly cheap.

Bringing this full circle to the stock price, we note that the stock has already tripled from its recent lows, but is down over 60% from its five-year highs despite industry and company sales, as well as margins, being up from the sector trough that continued to 2011. If Skyline's sales continue to increase, and margins continue to scale, the ultimate potential for this company at capacity (the "rose coloured glasses view") is revenues of $300 million and free cash flow of $30 million (assuming 40% taxes), which could result in a tripling of the stock price. So we are currently moving from the 'going-out-of-business trade' into the 'staying-in-business trade'. The next trade will hopefully be the 'we-are-actually-doing-well trade'.

As always, we reserve the right to change our mind!

Brandon Osten, CFA

CEO, Venator Capital Management Ltd.

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requirements for the purchase of shares. All stated Venator returns are net of fees. It is important to note that past performance should not be taken as an indicator of future performance.