VENATOR
CAPITAL MANAGEMENT LTD.

BOND & STOCK DIVERGENCE = OPPORTUNITIES (TO THOSE WATCHING)

Instrument (Inception)*	March 2016 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**5.9%**	**-5.5%**	**12.8%**
Venator Partners Fund (July 2014)	**5.6%**	**-5.7%**	**-1.3%**
Venator Investment Trust (September 2007)	**5.7%**	**-5.6%**	**9.0%**
Venator Income Fund (August 2008)	**4.7%**	**3.3%**	**12.1%**
Venator Select Fund (September 2013)	**10.5%**	**-3.2%**	**18.0%**
S&P/TSX Total Return (March 2006)	5.3%	4.5%	4.4%
Russell 2000 (March 2006)	8.0%	-1.5%	5.7%
S&P Toronto Small Cap (March 2006)	7.4%	8.5%	0.3%
S&P 500 (March 2006)	6.8%	1.4%	7.1%
Merrill Lynch High Yield Index (August 2008)	4.4%	3.3%	8.1%

As many of you know, we've managed both an Income strategy (the Venator Income Fund) and an Equity strategy (the Venator Founders/Partners/Investment Trust) for the past several years. Some people have suggested that trying to do two things at once is a distraction spreading our research attention too thin. We have always considered it to be a strategic advantage to have both a bond and stock perspective and recent market volatility is bearing this out.

Oddly enough, we have found that "bond guys/gals" don't pay much attention to the stock market, and stock analysts don't pay very close attention to what is happening to companies' corporate bonds. We are often surprised when we speak to analysts with a "buy" rating on a stock who have no idea that the same companies' bonds are trading at 70 cents on the dollar (implying a high-ish probability that the stock should be closer to $0.00 than to wherever it's trading). Conversely, we are often surprised when we see very high yielding bonds with face values in the hundreds of millions backed by stocks with equity values in the billions. This dichotomy can represent an opportunity to buy the bond as there is often a lot of equity value backing the bond to $1000 par value.

I thought this would be an appropriate time to talk about some of the divergences we have witnessed in recent months between stocks and bonds of the same issuers that we have taken advantage of.

Precision Drilling 2020's: This has been a core bond holding of ours as well as an on-and-off stock holding. Our investment thesis has focused on the replacement value, auction value, and book values of the Tier 1 rigs, cash and real estate of the business. Our view has always been that the bonds were more than covered to par based on the auction value of the Tier 1 rigs, which we understand to be an average of about US$8 million per rig vs. US$20 million in book/replacement value. When the stock bottomed earlier this year amid weak oil prices the equity value of the company dropped to C$1.1 billion, while the total debt was US$1.6 billion at par and fell to about $1.0 billion at market (we calculate the auction value of the assets at US$2.2 billion, so call this 2x asset coverage at market). At this point we started looking for more bonds to buy as they were yielding a very rich 18% annual return to a 2020 maturity. Then something interesting happened: the oil price rebounded and so did the equity value of the stock. In fact, the stock gained 50% to give it a market cap of C$1.6 billion, which was more than the market value of the bonds which didn't move much at all. Now if the stock is indeed worth C$1.6 billion, and assuming the stock market is correct in at least the future solvency of the company, the bonds should have been much closer to $1000 than $700, after all the only way we don't get $1000 at maturity is if the stock goes to zero. This

presented a great opportunity to buy the bonds at a massive discount when the stock market was saying "this one should be fine".

Canexus Convertibles 2021's: Here is another investment opportunity that looked good enough to put in all of our funds. By way of background, Superior Plus, a company we know quite well, has made a takeover bid for Canexus. This deal will see the combined company control a significant amount of its industry and there are questions as to whether the trade commissions will allow the deal to go through (we think they will). This created two opportunities: one in the stock and one in the bond. In terms of the stock, clearly the market was skeptical the deal would go through as the arbitrage spread (the return of going long Canexus and short Superior Plus) was over 25% for a six-month target period. The bond market was also pessimistic given it was offering in excess of a 13% nominal yield over six months (you can "put" your Canexus bond to Superior if the deal closes due to "change of control" provisions). Both of these looked like sensible investments to us on fairly short time horizons. But then something interesting happened: the stock arbitrage "closed" to 8% while the bonds were still offering 10%+ nominal yields (20% annualized). This is odd as you would rather own a bond for a given return in an arbitrage situation over a stock as you are now looking at a rare situation of greater upside with less downside. We took this opportunity to close the stock arbitrage and maintain our bond position which has strengthened of late.

Hanger 2018's: This situation was unlike any I had seen before. Years ago we owned a large position in this stock on the back of some interesting technology that didn't pan out due to reimbursement pushback from Medicare. Well after we had sold the stock a subsequent audit uncovered some inventory issues in their accounting. Both the stock and the bonds weakened and we took the opportunity to acquire the bonds given our positive predisposition to their market dominant healthcare service business. Last month it was revealed that the Company's inventory issues were more complex than originally thought, spilling into bad debt expense, and that the Company would not be able to file its end of year financials for both 2014 (revised) and 2015. This announcement prompted the NYSE to delist the stock . . . banished to the Pink Sheets for Monday's open (the news came out Friday after the close). The stock closed Friday at around $12.00 per share. With limited information available to me that was published for the bondholders to satisfy the indenture, we surmised that the Company was likely earning over $1.00 per share. When the market opened on Monday, institutional shareholders that couldn't own "pink sheet" stock starting dumping shares. When the stock was down 50% to $6.00, the bonds had barely moved, indicating to us that the move was largely forced selling, as the bondholders (of which we were one) weren't panicking out of the name. At one point the stock hit $2.00, down over 80%, representing a multiple of under 2x earnings for a company that we still believe is not a bankruptcy risk. We started buying at this point for our equity funds (apparently along with KKR who now owns over 9% of the company) and the stock has quickly tripled from that point (it would have been a bigger position but we couldn't get hold of the Company until after market close at which point we continued to buy at $3.00 the next day).

Concordia Healthcare 2022's: We have a history with Concordia that stretches back to its IPO. We enjoyed an over 10-fold run in the stock before the one-two punch of Turing Pharma and Valeant knocked the whole healthcare sector to the mat. Since then, Concordia has been hit by shrapnel every time Valeant reveals some new previously unknown scandal. For various reasons, we remain positive on Concordia's prospects, most notably that it is not Valeant, and over 60% of its business is conducted outside North America where the regulatory environment is not as contentious. What's interesting again is the contrast between its stock price and the junior bonds (which we own at a handsome 10% yield). While the stock trades at a very depressed 4x earnings/free cash flow, the bond trades at 97 cents on the dollar, indicating that the bond market is confident in the company's ability to stay solvent and not trip debt covenants all the way to 2022. If this were to happen, then presumably the Company would have paid off over $1.5 billion of it's debt, reduced its interest expense by over $100 million per year and, assuming the business stayed flat as a pancake, come out earning over $400 million per year, or $7.70 per share, with modest leverage of under 3x EBITDA (this would be extra modest given the company has minimal Capex and pays minimal taxes). Additionally, assuming that the non-US portion of the business is higher than 70% at that point, and that the political overhang of an election year has blown over, we would expect the stock to trade at a minimum

of 12x earnings or a today price of US$92.00 per share, a 270% gain from here. Even discounting this number by 5 years at 10% we would arrive at a today price of US$54.00, a more than 100% increase from current levels. Of course, we think the company will increase its business and can quite possibly get a higher multiple than 12x under this scenario, but the point is that if the bond market is right, then the stock market is wrong and there is an opportunity here.

In all four of these situations, keeping one eye on the stock market and one on the bond market gave us informational advantages in the investment opportunity and gave us some great insight that an investor who only watches one of these markets would have missed. I am amused when the dramatic actors on CNBC talk about Valeant missing their annual financials filing deadline, thereby tripping reporting covenants and technically putting the company in default, as though there is a material risk to the Company on that basis alone. I myself have talked to investment professionals and talked them off the ledge on issues like this, while at the same time buying Valeant's 2018 bonds at 90 cents on the dollar (I don't know where the stock is going, but I don't think it's going to zero). After having zero experience in the bond market for my first decade-plus in this business, I have grown to appreciate it. Another tool at our disposal in the fight for market-beating profitable returns.

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

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