

THERE'S NO SUCH THING AS 'COVENANT-LIGHT' DEBT

Instrument (Inception)*	May 2016 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	-0.6%	-4.5%	12.6%
Venator Partners Fund (July 2014)	-1.1%	-5.1%	-0.9%
Venator Investment Trust (September 2007)	-0.9%	-4.9%	8.9%
Venator Income Fund (August 2008)	1.5%	7.8%	12.5%
Venator Select Fund (September 2013)	1.9%	4.3%	20.1%
S&P/TSX Total Return (March 2006)	1.0%	9.5%	4.8%
Russell 2000 (March 2006)	2.3%	2.3%	6.0%
S&P Toronto Small Cap (March 2006)	-0.3%	21.6%	1.4%
S&P 500 (March 2006)	1.8%	3.6%	7.2%
Merrill Lynch High Yield Index (August 2008)	0.7%	8.2%	8.5%

Over the last several years, with interest rates sitting near zero, many companies have accumulated debt under favorable terms for various uses. Probably the four most common reasons for debt raising activities are stock buybacks, dividends, acquisitions, or rolling old debt into more favorable terms. Many of the companies in our hedge funds and income fund have taken advantage of these debt opportunities over the last several years including:

- **Nathan's Famous Inc. (*long the bond*):** completed a large debt issue in order to payout a large one-time dividend;
- **Concordia Healthcare Corp. (*long the bond & the stock*):** completed a large bond issue to finalize its AMCO acquisition;
- **Apple Inc. (*recently closed short position*):** Issued debt in order to buy back stock (the company could have done it with internal funds, but most of it resides offshore);
- **Iconix Brand Group Inc. (*long the bond*):** Recently completed a debt issue in order to redeem current convertible bonds that were maturing.

Between 2011 and mid-2015, debt markets were very favorable. Along with lower rates came low security on these bonds, also known as 'covenant-light' bonds. In recent history, some of the best bonds (from an investor's standpoint) were issued in 2009, when the bond markets re-opened for business post-crisis, and companies with near-term maturities were eager to extend due dates, issuing some very oppressive high coupon debt secured by specific assets. Suffice it to say, there aren't too many of these left out there as most have been "called" and replaced by lower rate debt (although Entercom's 10.5% bonds, which we own, are conspicuous by their presence).

Conversely, some of the worst bonds were issued in the 2011-2014 period, when the market was on fire and covenant light 'high yield' debt was being issued below 6%. I can still remember when Iron Mountain announced in 2012 that they were converting to a REIT. They then proceeded to call their 2016, 6.625% bonds and replaced them with 2024, 5.75% bonds (they have since issued some 2021, 4.375% bonds). So even though by virtue of their conversion to a REIT they would be effectively using all of their free cash flow to pay the distribution to shareholders, rather than being able to use it to pay off bondholders, they were able to ask for more term and lower rates from their bondholders, which is completely counter-intuitive.

When we look at stocks, we often look at the debt structure. This can be a helpful exercise on both the long side and the short side, which we talked about in March. One of the smokescreens companies use, especially on the private equity side, is the defense of the debt structure as being "covenant light". This means that debt is not secured by any assets, senior debt can be issued in front of it, and the financial ratios are generous and subject to non-GAAP adjustments. But the reality of the situation is that all debt shares one covenant-heavy characteristic: it eventually matures. No matter how generous the terms of debt that was issued at better times for a company, if the company's fundamentals or the debt market's receptiveness has changed for the worse, that company is going to have a tougher time rolling that debt into a new issue, or achieving the same terms, or replacing it.

XPO Logistics Inc. is effectively a private equity-like transportation and logistics company based in the US. I say private equity-like because it was effectively relaunched when Bradley Jacobs (who has a very successful roll-up history) took control of the company in 2011 after making a large investment with the intention of bringing XPO into the big leagues with future material and transformative transactions. With roughly \$2 billion of subsequent financial backing from several high profile investors, including the Ontario Teacher's Pension Plan, the company is a much bigger and transformed entity today after a series of acquisitions:

XPO Logistics Inc.	2011	2016E
Revenue	\$ 177.1	\$15,183.3
EBITDA	\$ 4.1	\$ 1,250.0
CAPEX	\$ 0.8	\$ 530.0
Interest	\$ 0.2	\$ 370.0
Shares	8.2	135.0
Price	\$ 8.50	\$ 30.00
Market Cap	\$ 69.7	\$ 4,050.0
Debt	\$ 5.0	\$ 5,370.0
Enterprise Value	\$ 74.7	\$ 9,420.0
Analysts	<3?	16

After the first large equity infusion made by the consortium led by Teachers in 2014 we bought XPO 2019 bonds in our Income Fund. At that point the company was an asset-light logistics business with a clean balance sheet and some strong financial backers. But these attractive characteristics changed in a big way in 2015. The company made an initial and material foray into Europe acquiring their way into a more asset-heavy business, and moving their net debt to over \$5 billion in the process. This changed the whole equation, and our view of the debt structure and the stock (which we had no position in prior to the 2015 acquisitions).

While we continue to hold the debt (largely because our tranche comes due in 2019, while the vast majority of the debt comes due after 2020), the rest of the capital structure, including the stock, didn't sit right with us. The company has come under fire for shifting to an asset heavy model which surprised the Street (even though all but one analyst rates the company a "Buy"). We would note that with 16% of the float sold short, we are not the only ones thinking this way. The company advertises that only 3% of total revenues goes to capex, but we would note that this is a low margin business, and that their over \$500 million of capex represents over 40% of EBITDA. In fact, between capex, interest expense and taxes, we expect only 20% of EBITDA (or 1.25% of revenues) to flow through to shareholders on an adjusted basis. That \$250 million in adjusted free cash flow (note actual free cash flow is expected to amount to a mere \$130 million this year) looks rather puny next to over \$5 billion in total debt.

Admittedly, our palms get sweaty when we start seeing stocks whose debt exceeds 10x free cash flow (to say nothing of 20x), so this represented a major red flag for us. Eventually, that debt needs to be refinanced (most of it is scheduled to mature in 2022), at which time they will likely still be above that 10x free cash flow bogey that we like to see in order to consider a company investible. Anything over 15x free cash flow is considered short-able territory to us.



We acknowledge that if the company were able to reach its 2018 goal of \$1.7 billion in EBITDA without any additional issuance of debt or equity, it would be able to get down to around 10x debt to free cash flow. But this is now a geographically complex, higher leveraged, and more economically sensitive business. The risk, in our view, is to the downside, and any slippage in the fundamentals could cause a precipitous decline in the stock.

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

A handwritten signature in black ink, appearing to read 'B. Osten'.

Brandon Osten, CFA
CEO, Venator Capital Management Ltd.

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