VENATOR
CAPITAL MANAGEMENT LTD.

WRONG FOR A YEAR TO BE RIGHT FOR A DAY

Instrument (Inception)*	June 2013 Return	Year-to-Date	Compound Growth
Venator Founders Fund (March 2006)	**0.9%**	**18.2%**	**13.8%**
Venator Income Fund (August 2008)	**-0.8%**	**9.1%**	**16.4%**
S&P/TSX Total Return (March 2006)	-3.8%	-0.9%	3.4%
Russell 2000 (March 2006)	-0.5%	15.9%	5.5%
S&P Toronto Small Cap (March 2006)	-4.5%	-6.8%	-0.3%
S&P 500 (March 2006)	-1.3%	13.8%	5.4%

*Estimated Performance

One of the questions we get from those in our industry is "why do you bother shorting stocks since it is so difficult to make money in a rising market?". Indeed, this 2009-present increase in US stock markets has made shorting difficult. In addition, our lack of resource exposure has not allowed us to materially benefit from the collapse of the mining sector in Canada.

From our own internal analysis we estimate that the Founders Fund has lost 1.5% in aggregate from 2006-2012 shorting individual stocks, and we lost 5% shorting ETFs over the same timeframe. Since we have averaged a 34% short equity balance over that timeframe, our short portfolio is up 20% (assuming we were 100% short equities) vs. a market rise of 24%. However, with more than 50% of our short equity exposure being individual stocks, we estimate that our individual stock short positions are up less than 9% vs. that market gain of 24%. Put another way, we are generating that elusive "alpha" on the short side, but we still aren't making any money off of it; and clearly we are better off shorting individual stocks than ETFs.

VENATOR FOUNDERS FUND SHORT ESTIMATES (2006-2012)					
	Losses	Weight	100% Weight	Market	Alpha
Individual Shorts	-1.5%	17%	-8.8%	23.5%	14.7%
ETF Shorts	-4.9%	17%	-28.8%	23.5%	-5.3%
Total Loss	-6.4%	34%	-18.8%	23.5%	4.7%

There are some counterbalancing arguments as to why we short sell/hedge our Fund that I think are worth mentioning:

- Firstly, this is not a good time to measure the potential benefit of short selling given the multi-year run in US markets. Indeed, if you questioned me on the benefits of short selling at the end of 2008, I would have pointed to a three year 12% benefit from shorting (or 44% if we were 100% short equities vs. a market drop of 28%).

20 Eglinton Avenue West, Suite 1004, PO Box 2073 Toronto ON M4R 1K8 T 416.628.8198 F 647.477.2529 www.venator.ca

- Secondly, we have a disciplined hedging strategy that we believe helps normalize our long-side investments for risks such as valuation, economic sensitivity, and market sensitivity. Put another way, hedging allows us to make some investments in 'macro sensitive' businesses (i.e. cyclical companies, high valuation technology companies) that we might otherwise not make.
- Thirdly, sometimes we just see the opportunity to make money on the short-side while reducing risk/overall market exposure at the same time.

We always tell ourselves that we need some patience when shorting as you have to be willing to be wrong for a year to be right for a day. Generally, companies put out good news all the time, but only put out bad news once a year. Cheerleader analysts, Fund managers in the press, new customer contracts, competitor takeovers (always viewed as validation of the space but never viewed as a negative in the form of a more formidable rival), competitor earnings beats (the space is strong), competitor misses (we are gaining market share), management strategic initiatives that are believed to be just as easily said as done, takeovers, takeover rumours; there is always positive spin until an earnings miss.

REDKNEE

This brings us to a little company called Redknee, which we have followed for several years, but have only recently initiated a small short position in our Fund. Without getting into too much product detail, Redknee supplies technology to the telecommunications industry. Redknee, which has not shown any material growth in four years, has recently acquired a large division of Nokia Siemens ($225MM in revenue vs. Redknee's $50MM) which is shrinking by over 10% per year and has been struggling to maintain profitability as it chases employee headcount reductions in line with revenue deterioration. The "plan" is that Redknee will halt the revenue declines at $200MM leaving the combined company with $250MM in revenues, and manage to post after-tax margins of roughly 10% leaving the company with 25 cents in earnings per share within the next several years. With the stock currently at $3.30 per share, this supposedly represents good value at 13x eventual theoretical earnings as compared to other "recurring revenue/SAAS" companies that trade at 6x revenues.

It's a simple enough story when we look at it this way, so why would we be inclined to short the stock? Basically we have chosen to diverge from the Street view on the following points:

- We believe that the reported earnings quality of the base business has deteriorated over the past several years, as demonstrated by a substantial increase in "Unbilled Receivables".
- We believe that the decline in the acquired business will not be easy to halt.
- We do not believe that a no/low growth company whose recurring revenues constitute mainly support revenues will receive the premium valuation attributed to "sexier" SAAS stories.

EARNINGS QUALITY CONCERNS

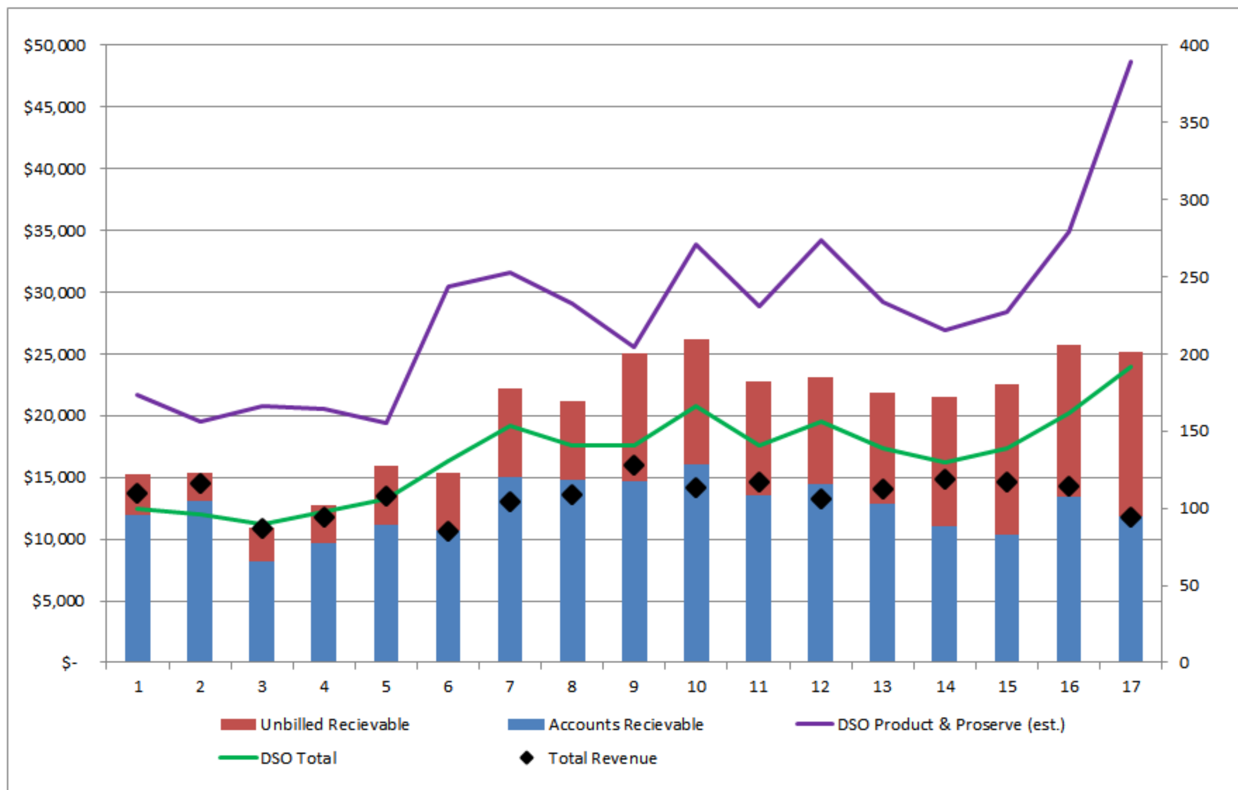
What do we mean when we say "earnings quality"? While financial statements are signed off by the company's auditors, there are certain practices that are in line with IFRS/GAAP but can signal underlying stress

in the business. One of the primary red flags can be a rise Accounts Receivable relative to Revenues. This is what we would call deterioration in earnings quality.

While Redknee's Accounts Receivable has actually been steady, what got our alarm bells ringing is the account on their balance sheet called "Unbilled Receivables". These basically represent revenues that have been recognized, but the customer has not been billed. Because Redknee does much of their integration on what is known as a percentage-of-completion basis, they estimate how much work they have done for a client and record it as revenue for future billing when certain milestones are completed.

From the chart below, one can see what has happened to Unbilled Receivables over the past 17 quarters (note we did have to adjust the most recent quarter down to account for the $8.3MM in Unbilled Receivables acquired in the NSN transaction). The balance has increased from $3.2MM to $13.3MM despite no commensurate increase in Accounts Receivable or Revenues. So while Accounts Receivable has remained stable, the amount of reported revenues that have actually been collected has declined precipitously.

To gain a different perspective we have included the broadly followed measure of "Days Sales Outstanding", or DSOs, in the chart below. This indicates how long it takes a company to collect on reported revenues (both Accounts Receivable and Unbilled Receivables are considered revenues that have been reported but remain uncollected). While there are some exceptions, we would generally expect a no/low growth, support revenue heavy company like Redknee to report less than 80 DSO. In fact, Redknee's reported DSO is closer to 200. Furthermore, assuming that support revenues are generally not receivable (but rather pre-paid in Deferred Revenues), a worst case assumption could be that product and professional service revenues reported are running close to 400 DSO, possibly indicating that a portion of reported historical revenues have not been collected in over a year.



Interestingly, because Accounts Receivable have remained stable this is not a collection problem. It is the Unbilled Receivable account that has given rise to our concerns. They would seem to indicate that the Company has possibly relaxed its billing schedules in order to placate potential customers, or that the Company's view of its progress towards certain progress goals for its customers is inconsistent with its customers' views or payment commitments. *Surprisingly, we have not seen this rather simple DSO analysis disclosed as a risk factor in any broadly disseminated sell-side research reports.*

NOKIA SIEMENS (NSN) DIVISION ACQUISTION

Let's move onto the acquired NSN division, which will likely represent 75%+ of the business going forward. This division has a lot of customers (130+) and a lot of employees (1,200), not surprising since it was once of a division of Nokia Siemens. Its revenues also declined 10% last year, also not surprising as it was a division of Nokia Siemens! The division lost $25MM last year after losing $50MM the year before (although it did make $14MM in its seasonally strong Q4). We would also note that it reduced headcount in prior quarters which likely contributed to both the annual loss (in the form of restructuring charges) and fourth quarter profit. Fortunately, this division carried very little Accounts Receivable, which will serve to bring down the overall reported DSO, but that doesn't alleviate the risk in the original, and only profitable, business as mentioned above.

While the Company only paid $5MM for this $225MM business (with a possible €25MM earn-out) we aren't convinced that Redknee got a bargain. Technically, they acquired a money-hemorrhaging headache with Nokia Siemens keeping the earn-out option in case this thing can get turned around. The headache is in the form of managing a declining revenue stream, which means managing down employee headcount (expensive and onerous in Europe), which results in annual restructuring charges. Redknee may be focused on "recurring revenue", but they will also be possibly looking at "recurring restructuring" charges as they manage this business down to a sustainable level.

Redknee might be saying all the right things in terms of updating/upgrading technology, cross-selling and pricing updates, but it's more difficult than people think to a) convince a Nokia Siemens (well known) customer to port to Redknee (relative unknown) products; b) raise pricing for support on a legacy platform that customers are weaning themselves off of; and c) manage a declining business that is bigger than your prior business while still tending to your prior business which is struggling to grow. Basically, stopping the business decline and getting earnings up to 10% after tax is hardly a slam dunk.

THE OUTLOOK FOR VALUATION

As noted above, if management can meet their stated intermediate term goals for the business (which we believe is a stretch) of $250MM in revenues and 10% in after-tax earnings, or 25 cents per share, we would envision an eventual stock price of $2.50 or less. The reason we think 10x earnings is appropriate is that we think that combining a no growth business with a shrinking business is unlikely to result in a growing business, which in technology is only worth 10x earnings, at best.

Where people get excited about this business is the focus on "recurring revenues". The problem is that not all recurring revenue is created equal. Premium valuations of 6x revenues-plus are afforded to those that sell software on a subscription basis such as Halogen Software, Salesforce.com and SPS Commerce to name a few.

Less interesting valuations of 8-13x earnings are given to those lower growth companies whose recurring revenues are based on support revenues for software sold years ago such as Open Text or Oracle (frankly there aren't a lot of support focused companies out there anymore).

I would also note that while the Street tries to focus on the valuation potential of a recurring revenue business, it is still expected to be less than half of the company's overall revenue base and possibly declining (question: if recurring revenue is declining is it really 'recurring'). We already know that the product/service revenue base, the company's only potential source of growth, is experiencing some issues matching its revenues with collections. So what part of this business would anyone want to own anyways?

Lastly, we believe that Nokia Siemens was shopping this division for some time and was unable to find any other buyers willing to pay more than Redknee. Given that this business is now over three-quarters of the combined business, we don't believe that anyone would want to acquire Redknee in the near future, taking away the single largest risk in shorting stocks. This should buy us some time.

I would note that my opinions regarding the potential outcome of the integration of the NSN acquisition and the ultimate valuation of the Company is just an opinion, albeit a fairly educated one. My analysis of the Company's Unbilled Receivable balance and DSO is based on fact, pulled directly from the financial statements of the Company. However, my speculation with regard to the possible causes of the escalation in Unbilled Receivables is also only an educated guess based my own fifteen years of experience with software industry accounting standards.

As a matter of full disclosure, like the vast majority of our single company shorts, this is a relatively small weight for the Fund. We would look to add to the position should the stock move higher, and likely close the position in the $2.00 range.

We reserve the right to change our mind,

Brandon Osten, CFA
CEO, Venator Capital Management Ltd.

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