

RULE #73: IF THEY CAN'T SELL IT, YOU DON'T WANT TO BUY IT

Instrument (Inception)*	May 2014 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	-0.4%	10.0%	14.8%
Venator Income Fund (August 2008)	0.0%	6.6%	16.2%
Venator Select Fund (September 2013)	6.6%	16.0%	-
S&P/TSX Total Return (March 2006)	-0.2%	8.5%	5.7%
Russell 2000 (March 2006)	0.8%	-2.0%	6.9%
S&P Toronto Small Cap (March 2006)	-1.7%	10.3%	2.6%
S&P 500 (March 2006)	2.4%	5.0%	7.3%
Merrill Lynch High Yield Index (August 2008)	1.0%	4.7%	11.3%

When we first launched the Founders Fund we always wanted to preserve our ability to make meaningful investments in early stage companies – those with market values under \$100MM. We also knew that the day would come when, in order to preserve our ability to do this we would have to close the Founders Fund to additional investments. That day has come. June will be the last month we accept new subscriptions into the Founders Fund. We appreciate all the support you have given us in order to get to this point in our evolution.

The Venator Partners Fund will be our newest investment vehicle. This fund will have a high degree of overlap with the Founders Fund (we estimate over 90%) but will not be initiating investments in companies until their market values reach \$100MM. This Fund will be launched by August 1st.

As for the Venator Investment Trust, up until now it sole investment has been in units of the Venator Founders Fund. Going forward, new money coming into this fund will flow into the Partners Fund giving investors a blended exposure to both funds. This may cause some deviation from the results of the Founders Fund but given the overlap between the two funds we do not believe this variation will be substantial.

Keep in mind that the Founders Fund has historically carried very little exposure to sub-\$100MM companies. Even big winners like Boyd Group, initially purchased under \$5.00 with a \$50MM market cap, crossed \$100MM at \$10.00 and currently sits at \$40.00, meaning that the Partners Fund would have still enjoyed 80% of the move, when the weight was larger and we had more comfort and conviction in their business plan. The reason for this limited exposure is that we typically do not buy companies that we believe will be small-caps forever, or pre-revenue companies.

Getting back to our 2014 theme, this brings us to:

Rule #73: Avoid Pre-Revenue Companies: If they can't sell the product, you don't want the stock!

We also call this the "no revenues, no interest" rule when getting pitched pre-revenue companies by brokers. It's not that such a company can't be successful, it's just that there is no way of knowing. We are fairly strict on this rule although there may be a few instances where one can at least listen to the story:

- **Resource companies:** specifically in mining where revenue can be years off, but at least the asset, while still in the ground, if economic is valuable.
- **Biotechnology:** we don't really play in the biotech R&D/FDA trial space often due to a keen self-realization of our limitations in this field. But if that's the sandbox you play in, pre-revenue companies are a viable investment.

That being said, one must remember to avoid the no revenue head fake: the company with a backlog or revenue commitment, but that still has no revenue. You would be amazed how often we ask: "what were their revenues last quarter?" and are answered "their revenues are going to be \$15MM next year!". I am not sure if this is the result of the pitchperson reading off a script, a lack of understanding of past and future tense, a lack of understanding of the difference between fact and forecast, or a function of not listening to the question being asked. Of course, we wouldn't be doing our job if we didn't at least ask "how do you know?". The answer is invariably related to a customer commitment or some measure of backlog or pipeline conversion. Now remember this: *if the customer doesn't make good on their purchase commitment, and you can't sue them for breach of contract, is it not really backlog...it is bulls..t!*".

Now there is a corollary here to Rule 73 and it is:

Rule #124: If the company disappeared would anyone care?

This is why we generally treat any company doing less than \$2.5MM in quarterly revenue (\$2MM if they are growing quickly) as "pre-revenue", even if this isn't technically correct. You are not "mission critical" to Wal-Mart if they are only paying you \$1MM per year for your product/service. There are too many small companies out there doing small things for their customers; whereby these customers would have very little problem continuing their business as usual if the vendor were to disappear tomorrow.

SPHERE 3D CORPORATION

This brings us to Sphere 3D Corporation, a recent short sale in the portfolio. Sphere 3D was brought to my attention about a year ago when the stock was trading at about \$1.00 (currently around \$9.00). It was explained to me that they had a software product (Glassware 2.0) that was essentially able to "appify" other software programs making them available on mobile devices. This is basically what a very large company called Citrix does; the applicable buzzwords are "virtualization" and "mobile cloud computing". Apparently, people following the stock were claiming Sphere 3D had, for one reason or another, a superior solution to Citrix's. Now, we have been following Citrix for several years and have met with management in the past, and from what we could gather, this was unlikely (but not impossible) to be the case. That being said, they had managed to secure a supposedly impressive large partner called Overland Storage (the CEO of which was on Sphere 3D's board) that had \$50MM in revenue. *Overland Storage - remember this as it will become important later on.*

The problem was that according to their financial statements they had never sold a single dollar worth of product. Really, if the product is so great, why can't you get anyone to pay for it? So to the extent they had this great product, how could anyone ever know? Sure they have shown people demonstrations of Glassware 2.0 in a controlled environment (note no one appears to have purchased Glassware 1.0 either), but without a customer in an unbiased environment, that demo could effectively be the equivalent to a scripted movie or

video game for all I know, as opposed to a dynamic demo (known as the "pay no attention to the man behind the curtain" demo). Again, it's not that we were certain whether the product worked or not, it was that "if you can't get someone to buy the software, we aren't going to buy the stock".

This brings us to another observation we have made over the years, once a "concept stock" gets above a \$200MM market cap, you can start short selling the stock. In Canada, it is difficult to maintain momentum beyond a certain level without a reputable institutional following; retail and fast money hedge funds can only carry a stock so far. So when the stock went above \$7.50 per share we started short selling.

Now recall that Sphere 3D had this established partner Overland Storage that was going to support them in their move to the big time (to be fair they have also partnered with Corel, although to our knowledge no dollars have changed hands there). Now when we looked up Overland (OVRL) it happened to be a day when the stock was collapsing after a missed quarter. What we saw was a company whose revenues were in seemingly perpetual decline in a secularly declining market with a net negative cash position and that was burning cash. With a market value of less than \$100MM and going lower, I wasn't sure how they would be able to materially help Sphere 3Ds business enough to justify its \$200MM market cap.

But in a plot twist as well disguised as Rocky Balboa beating Ivan Drago on Christmas Eve, last month Sphere 3D announced that it was going to put its \$200MM market cap to good use by acquiring Overland for approximately \$60MM. That's right, their big time partner effectively got bailed out by them. It's a bait-and-switch. The market was baited into thinking Overland was a big impressive partner (for anyone who couldn't bother to look up the market value of Overland), and Overland switched to the smaller partner to be bought by impressive \$250MM market value Sphere 3D.

At this point we know what the market valued Overland at prior to the acquisition (about \$50MM), and we doubt there is any benefit to putting the two together as Sphere 3D has not had a lot of success selling Glassware 2.0 (they claim to have sold some product in the March quarter but we suspect these sales are related-party sales to Overland). So the combined company is likely worth something close to what Overland was worth on its own: \$50MM, or \$1.25 per share after the smoke settles on their shares count. Interestingly, Overland's stock value is suggesting that Sphere 3D should be trading significantly lower than its current value, a testament to the abilities of the cheerleaders that own Sphere 3D to hold it up.

For shareholders who got into Sphere 3D early, this is good news, as Sphere 3D won't go back to zero, which is probably what it was worth prior to the acquisition. For short sellers, this is also good news as the hype of Sphere 3D will be buried deep in the deteriorating business that is Overland Storage. Without the sizzle, the steak looks pretty low grade to us. Target price: \$1.50.

REDKNEE SOLUTIONS FOLLOW-UP

Now I know what you're thinking: isn't this the same guy that was shorting Redknee in the low-\$3.00s (now around \$5.00)? Yes we are. Our thesis was that Redknee was way behind in its collections for accounts receivable which is always a huge red flag in my experience. Now, as of the last reported quarter, pretty much everything we viewed as a huge risk with Redknee came true. Their total receivables have skyrocketed – they claim that the Days sales outstanding is a manageable 110 days vs our 179 calculation - but that's because they use a bizarre calculation that excludes unbilled receivables from the numerator, yet includes unbilled revenues



in the denominator - here is an idea: if the street is willing to buy into this creative calculation, and doesn't care how much cash they burn through, Redknee should simply never bill any of their customers, make all receivables unbilled and report an unheard of zero Days Sales Outstanding, claiming the best collections practices in the history of software). But I digress . . .

Last quarter Redknee announced that their holy grail, recurring revenues, declined \$7MM (20%) sequentially, pretty much unheard of in the software maintenance world. Furthermore, despite trailing 12 month EBITDA of close to \$20MM, they have somehow managed to burn through around \$40MM in cash, nearly \$20MM in the last quarter alone (this is easy to do when you report big unbilled revenue on the income statement, but don't collect on that revenue which shows up on the cashflow statement and balance sheet).

So what we ended up with is a company with one of the worst-in-class total receivables relative to total revenues, a recurring revenue base declining at an abnormally high pace, and hemorrhaging cash. In fact, at one point their net cash position was dangerously close to going through zero, potentially bringing business continuity issues into question. By all rights this stock should have been below \$3.00 after the quarter was announced but for one small snafu: in mid-March Redknee managed to raise \$64MM in a share issue. Note that Redknee's March 31 balance sheet showed cash of \$115MM, loans of \$47MM and money still owed for the acquisition of \$10MM, leaving the company with net cash of \$58MM, which would have been negative \$5MM without the share issue.

In our view, this financing bought Redknee some time, but that's about it. All of our concerns about the business, in our view, have been proven correct. Had they waited a few weeks to raise the money they desperately needed, the stock may have been cut in half. This would explain why they were so eager to do a financing at \$5.85 when the stock had been trading at \$7.60 three months earlier.

For analysts and shareholders claiming that Redknee is executing to plan, I can guarantee that the plan did not call for declining support revenues, a \$40MM plus cash burn, and the dilutive raising of \$60MM because they were effectively out of cash.

(To end on a more positive note, this group would be better off revisiting Open Text, with a more stable revenue base, a higher proportion of recurring revenues (and unlike Redknee's, they aren't declining, meaning they actually recur), a history of free cash flow that confirms its EBITDA and profitability, a dividend, and a cheaper multiple (12x what I think they will earn next year, vs over 15x what the street thinks Redknee will eventually earn).)

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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