VENATOR
CAPITAL MANAGEMENT LTD.

VALUATIONS DON'T MATTER (until they do!)

Instrument (Inception)*	May 2017 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**-2.5%**	**-5.2%**	**11.4%**
Venator Investment Trust (September 2007)	**-2.5%**	**-5.2%**	**7.7%**
Venator Income Fund (August 2008)	**0.0%**	**3.3%**	**12.1%**
Venator Select Fund (September 2013)	**-3.1%**	**-8.3%**	**12.5%**
S&P/TSX Total Return (March 2006)	-1.3%	1.5%	5.5%
Russell 2000 (March 2006)	-2.0%	1.5%	7.2%
S&P Toronto Small Cap (March 2006)	-4.0%	-4.6%	2.1%
S&P 500 (March 2006)	1.4%	8.7%	8.1%
Merrill Lynch High Yield Index (August 2008)	0.9%	4.8%	9.1%

I wanted to take the opportunity this month to write about valuation and its importance when investing given that companies such as Facebook, Amazon, Apple, Microsoft, Google (yes, I know it's called Alphabet now), Netflix and Tesla are all the rage among individuals and institutions alike. We are, in a way, partying like its 1999 when it comes to technology. The NASDAQ is outpacing the S&P 500, with these large-cap, growth tech names representing over half the broader market move year to date. These stocks, and other tech names, are why the performance chart above shows some serious lag between the S&P 500 and the other North American indices, where technology is comparatively under-represented.

From a money flow perspective, it makes sense. Retail investors actively buy products sold by these companies (iPhones, Microsoft OS, Google search, Facebook accounts, Netflix, Amazon, etc.), and the financial news media tells us how great they are (we have noted in the past that the stock market is the only economic market where people prefer paying more for product than less). Active money managers will often take the same macro/narrative view, as it's hard to get any informational edge on companies like Amazon and Tesla. Similar to what took place in the early 2000's, the media has allowed the narrative to overtake the fundamentals, and risk factors have been lost in the shuffle. For example, little attention is paid to the fact that Microsoft's EBITDA/profitability is lower than it was four years ago, while its trailing 12-month revenue is also lower than it was three years ago. Many are unaware that current year sales for Apple are expected to come in 3% below where they were three years ago. Or that over the last 12 months, Apple's revenues and earnings are down year over year. Or that one of the primary reasons why the iPhone 8/10 is expected to be so successful is that the 6S/7 were huge revenue disappointments, creating what I would call artificial pent-up demand. These types of things are discussed only when stocks are down. In the interest of full disclosure, the Venator Funds do not have a position in either Microsoft or Apple.

Despite all of this, I would suggest that fundamentals and valuation still matter in the end. There are lessons to be learned from the past, which are often forgotten in the euphoria of the present. To illustrate:

- Microsoft was a great stock from its IPO through to 1999, however, it's worth noting that the stock rarely traded above 20x adjusted EPS over that time frame, despite carrying an EPS growth rate well over 30%. Great returns were had, in part, because its valuation was never that high, which allowed compounding growth to fuel returns, rather than multiple expansion.

- Amazon has been a stellar stock since permanently breaking through a split adjusted $100 in late 2009. However, investors were only breaking even at that point had they purchased the stock in early 1999, and that's after losing over 90% of their money following the tech sell-off!

- The ultimate cautionary tale of valuation relevance is Cisco Systems. At one time considered the 'highest' of all high-flying stocks, everyone today thinks of it as a struggling relic since 2000, which is hardly the case. As summarized in the table below, Cisco has tripled its business, on a per share basis, since 2000 (Microsoft has only marginally exceeded Cisco's per share growth, clocking in just above 300%, yet its stock is hitting new all-time highs). However, because investors overpaid for the stock in 2000 at 100x EBITDA, they lost a lot of money (in contrast, investors paid 55x EBITDA for Microsoft at the same time, and its stock only exceeded its late 1999 price of $60.00 late last year).

CISCO SUMMARY *(then vs. now)*

	2000	TODAY	GROWTH
Revenue *($ in millions)*	$ 18,928	$ 49,247	160%
EBITDA *($ in millions)*	$ 5,471	$ 14,838	171%
Cash	$ 5,525	$ 65,767	!!!
Shares Outstanding	7,438	5,088	-32%
Revenue per Share	$ 2.54	$ 9.68	280%
EBITDA per Share	$ 0.74	$ 2.92	296%
Stock Price	$ 80.06	$ 31.50	-61%
Market Capitalization *($ in millions)*	$ 557,000	$157,000	-72%
Enterprise Value	$ 553,000	$122,000	-78%

While we aren't looking to put out any warning signals for stocks at today's levels, we are simply pointing out the need to be mindful of valuation risk. On a positive note, the naysayers who today point out Tesla being worth more than companies like GM and Ford reminds me of similar comments made about Amazon being worth more than companies such as Borders and Barnes & Noble, roughly 17 years ago. Tesla probably has the best big picture growth prospects out there among large cap companies, and if the upcoming Model 3 launch propels the company to 2020 EPS of $20, the stock will probably move well through $400 over the next couple of years. Similarly, a $50 EPS number for Google two years out would justify a $1000+ stock price. In the case of a company like Salesforce.com, its sub-5X, two-year revenue projection is quite reasonable, relative to other companies in Cloud computing, or the valuations of slower growth peers such as Oracle and Microsoft. In the interest of full disclosure, the Venator Funds currently have positions in Google, Salesforce.com and Tesla's convertible bonds.

In our opinion, there continues to be attractive value opportunities to be found outside the tech sector, where the air has been sucked out of less high-profile industries, leaving many industrials in a veritable vacuum. Not all companies outside of cloud computing, internet retail, digital media and social media are secularly challenged. From our vantage point, the market landscape is starting to resemble the opportunistic situation that was available to non-tech investors in 2000, or non-resource investors here in Canada in 2006, where some of the neglected companies of the day went on to become the stars of tomorrow.

To summarize the performance of the Venator Funds last month, I'll begin with our long/short mandate (Founders Fund & Investment Trust). The strategy experienced its 14th month of effectively alternating positive and negative returns (except for last November, where it broke even). Hopefully, that bodes well for June. The decline in May was largely due to the continued short selling activity in Entercom Communications, which fell for 10 consecutive days to start the month. When the smoke cleared, the stock had moved from just over $13.00 per share to just under $10.00, down nearly 25%, as short interest spiked from 2.5 million shares at the beginning of the month, to roughly 5 million shares by month end. The bleeding finally stopped when the Field family (founders of the business) started aggressively buying shares in the open market. While we are frustrated with the share performance year to date, we remain enthusiastic about the company's outlook because its fundamentals are in excellent shape, the stock trades at a significant discount to its peers, and the merger with CBS Radio is scheduled to close in Q3.

Venator Income Fund, on the other hand, was down slightly in May, but is up roughly 3% year to date. We're pleased with the results being generated by the Fund, and its *'Yield Plus'* investment approach continues to serve investors quite well.

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

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