

## THE NEXT BIG THING IS HELPING IN A BIG WAY

Instrument (Inception)*	January 2018 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	6.7%	6.7%	12.2%
Venator Investment Trust (September 2007)	7.0%	7.0%	8.9%
Venator Income Fund (August 2008)	0.0%	0.0%	11.7%
Venator Select Fund (September 2013)	11.2%	11.2%	18.5%
S&P/TSX Total Return (March 2006)	-1.4%	-1.4%	5.7%
Russell 2000 (March 2006)	2.6%	2.6%	8.1%
S&P Toronto Small Cap (March 2006)	-2.2%	-2.2%	2.4%
S&P 500 (March 2006)	5.7%	5.7%	9.2%
Merrill Lynch High Yield Index (August 2008)	0.7%	0.7%	8.8%

It didn't take long for us to identify the next '*big thing*' in capital markets: the reverse take-over. Two of our multi-year core holdings, Skyline Corporation (SKY) and Entercom Communications (ETM) are beneficiaries of this trend.

On January 5<sup>th</sup>, Skyline Corporation announced plans to merge with Champion Homes (a Bain Capital portfolio company) in a reverse takeover transaction. Some of our followers might recall our letter from April 2016, discussing how the quickest buck can be made as companies transition from potentially insolvent, to profitably thriving (mining investors know that the highest torque is felt among the highest cost producers). Our call was that the "going out of business trade, to the staying in business trade would be a profitable one".

Looking back, the path to this positive outcome with Skyline Corporation was bumpier than we would have preferred. Skyline had a bit of setback in early 2017, as it closed two unprofitable plants, leading to disruption in both revenue growth and profitability, which sent the stock price down by roughly 50%, to under \$6. A mere two quarters later, the profitability of the remaining plants shone through and the stock rebounded to \$12. In early January 2018, the Company (now on stable footing), agreed to be acquired by Champion Homes in a stay public takeover (Skyline shareholders will end up with about 15% of the combined company), which sent the stock price north of \$20. We would note that a takeover by either #2 industry participant Champion Homes, or #3 industry participant Cavco Industries (CVCO), who had previously attempted a takeover of Skyline, was always part of our investment thesis. Looking forward, we will continue to hold the position primarily because we believe that the stock still represents good value at current levels, and we really like the outlook for the manufactured housing sector, currently growing in excess of 15%. As an aside, the largest player in the industry, (Clayton Homes), is controlled by Warren Buffett, so we aren't alone in our bullish view.

Skyline Corporation and Entercom Communications (taken over a few months ago by CBS Radio – described in detail in our letter from October 2017) are great examples of the big trend we are expecting to see in corporate finance activity this year: large private companies going public through the takeover of smaller public companies (and their stock listing in the process), as opposed to the traditional IPO route.

While the market has generally focused on the benefits of the new tax regime with earnings increases of roughly 15% for full taxpayers in America, not all Corporations benefit equally. One of the negative provisions of the new tax regime is that *interest on debt is not deductible beyond 30% of EBITDA*. Many businesses owned by private equity have used the old interest tax shield to the max by leveraging all their profitability away, and these

firms are now faced with the distinct possibility of paying income tax on unprofitable businesses. This situation will only get worse if a Company's debt needs to be refinanced down the road at higher interest rates.

There are essentially three ways out of this conundrum. First, you can find a cash rich buyer for the business who can de-lever it themselves. Second, you can de-lever by raising equity through either a private equity round or an IPO. Third, you can buy a smaller under-valued company, hijack its public listing, raise equity quickly in the context of the market and benefit from synergies.

In Skyline's case, Champion Homes didn't have any debt, so their owners were looking to kill four birds with one stone in acquiring an undervalued asset, buying market share, benefitting from synergies and going public. This week we also saw Green Mountain Coffee announce a reverse takeover of Dr. Pepper, and now there are rumors of Dell Computer doing the same with VM Ware. Including CBS Radio's reverse into Entercom in lieu of an IPO, this amounts to over \$4 billion worth of transactions in recent months. If you then factor in all the SPACs with closing transactions, it's clear that the reverse takeover model is becoming a material alternative to the more expensive and time consuming traditional IPO route.

Identifying businesses that stand to benefit from the reverse takeover model isn't as easy as one would think, as it requires some working knowledge of the private equity space. Essentially, you need to identify a small public company that has a large private company peer, that would like to take it over as a means of going public, and/or to de-lever the balance sheet. Ideally, it's preferable if the smaller company has a relatively clean balance sheet, while the larger company has a little too much leverage. This is a departure from the norm as, historically, hunting for takeover candidates has worked the other way around. This does, however, play into an area of strength for us here at Venator, given our focus on small to mid-cap undervalued companies. We have already begun to layer in additional analysis of each portfolio company and its private equity owned peer group, to help identify the next round of potential beneficiaries of this new trend.

To end on a positive note, I'm proud to report that, as of the end of January, each of our Funds is at its respective all-time high. This essentially means that every investor who has capital with us is up on their investment, to varying degrees. Furthermore, over the last twelve months, all our Fund mandates are beating their benchmarks. We've managed to begin 2018 on a good note, and we will continue to work diligently to keep the performance of each Fund moving in the right direction. Value investing is not like momentum investing; you don't get to move with reliable correlation to the markets, as our Skyline position has demonstrated. Quite often, these contrarian investments take time to play out, and in the end the destination makes the journey worth the wait. Thank you to all our existing investors for your patience.

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



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