VENATOR
CAPITAL MANAGEMENT LTD.

RULE #45: LOOK FOR THE FREE OPTION

Instrument (Inception)*	October 2014 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**1.7%**	**23.1%**	**15.6%**
Venator Partners Fund (July 2014)	**-0.1%**	**5.3%**	**-**
Venator Investment Trust (September 2007)	**1.7%**	**22.9%**	**11.7%**
Venator Income Fund (August 2008)	**-0.4%**	**9.6%**	**15.6%**
Venator Select Fund (September 2013)	**4.7%**	**33.8%**	**46.9%**
S&P/TSX Total Return (March 2006)	-2.1%	9.9%	5.6%
Russell 2000 (March 2006)	6.6%	1.9%	7.1%
S&P Toronto Small Cap (March 2006)	-8.3%	-1.9%	1.2%
S&P 500 (March 2006)	2.4%	11.0%	7.6%
Merrill Lynch High Yield Index (August 2008)	1.1%	4.7%	10.6%

One of the things we look for in an investment is a free option on a future event that may or may not happen. In other words, we are getting good value for what the business is today, but there is something potentially big in its future, the value of which is currently not built into the stock price (as explained below, there are lots of potential options on future events, but most aren't free and often they are overpriced). We have a few "free options" in the portfolio today. By my count we have approximately $50 million invested in companies with "free options", not including several convertible bonds owned in the Income Fund (if you think the bond component is fairly priced, then the conversion feature constitutes a free option). One of our current favourites in this category is ICAD Inc.

ICAD is our prototypical kind of name. It has a $160MM market cap meaning that there is adequate liquidity for us to build a substantial weight in our equity funds. It has a current annualized revenue run rate of $50MM, meaning that this is an established company with a saleable product that paying customers value. It has less than three sell-side analysts covering it meaning that this company has yet to be discovered by "the street" in any meaningful way. And finally, it has an established stable business that provides a floor under its valuation and two options that could potentially result in a more than doubling of the stock in the intermediate term.

ICAD's legacy, or base, business is in providing Computer Aided Detection (CAD) software to medical imaging device manufacturers (think GE Medical Systems) for inclusion in their hardware platforms. Basically, this is software for cancer detection. As a business, this is actually a fairly mature market segment, offering stability with limited potential for longer-term growth (kind of like the low growth profile for ultrasound and MRI machines). That being said, there is some near-term growth coming as the market converts to 3D Tomosynthesis over the next five years. It's a pretty big shift, but quite frankly this is only a $20-$30MM per year business, capable of earning maybe $5-$7MM per year, and worth maybe the $100MM market value that the company had when we first bought the stock. So that's the base business, likely fairly valued at our time a purchase several months ago.

Now the "free options" are far more interesting. This is the company's therapy division. The company's first product was for post-lumpectomy breast cancer radiation treatment. Basically, this technology allows breast

cancer patients to avoid months of post-op radiation therapy in that it has proven to be an effective quick, post-op, sub-15 minute therapy session. It's also cheaper than months of radiation therapy. While this technology looked promising two years ago it ran into an unfortunate, but foreseeable problem: doctors/hospitals make much more money from 35 radiation sessions than one post-op session, and this fact has presumably caused this technology to dramatically underperform initial growth expectations. As a result, this product is still in its market infancy stage and represents a future free option on the stock.

Fortunately, the same technology can be applied to non-melanoma skin cancer. This is basically a non-surgical alternative, in-office treatment that is quick, effective and leaves minimal scarring. Most importantly for the business case, this application makes financial sense for the dermatologist vs. the surgical alternative. Best of all, this segment is growing at a fairly rapid pace and therapy revenues are now 60% of the total business as they begin to dominate overall company performance. With a market value of $160MM, one could argue at this point that the previously “free option” is now priced at $60MM and is no longer free. However, we believe that with an established proof of concept on the skin-cancer side, which at this point in its evolution we believe to be worth $100MM on its own, the promising breast-cancer therapy product is still a free option in that technological proof of concept has been established, even if the business model needs some adjustment.

A caveat: Rule #46: Most Options aren't free - just because it's not in the financials doesn’t mean it isn't already built into the stock price. When you see a company that is going to see its growth rate increase, but the stock is trading at 20x earnings, that growth increase is not "free", it’s built into the stock. When you see a "turnaround" trading at 15x two years out estimates based on a successful turnaround, then the turnaround is built into the price already (in fact this is probably a good short sale candidate as a successful turnaround is never assured and is often unlikely to succeed to expectations). Often we find that the “option” is 80% built into the stock price even though it only has only a 20% chance of actually happening.

For example, in the case of Amazon.com, you are currently paying 80x 2015 earnings. I would suggest that you are not getting their 18% growth rate for "free" and generally the investment community understands this. However, the bull case rests on Amazon.com eventually achieving EBITDA margins of 9%, something Amazon has never achieved before. This goal, based on expected 2015 revenues would amount to earnings of roughly $4.7 billion (assuming $4 billion in CAPEX/Depreciation and a 35% tax rate) or approximately $10.00 per share. Therefore, if Amazon.com were to continue to grow at 18% and were to achieve its hypothetical EBITDA potential you would still be paying almost 30x earnings for Amazon.com, suggesting that neither the growth nor the margin expansion constitutes a "free" option; you are paying handsomely for both of these assumptions.

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

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