

### ROLL UP NATION (BUILDING VS BUYING)

Instrument (Inception)*	February 2015 Return	Year-to-Date Return	Compound Growth
<b>Venator Founders Fund</b> (March 2006)	<b>1.8%</b>	<b>2.4%</b>	<b>15.5%</b>
<b>Venator Partners Fund</b> (July 2014)	<b>1.6%</b>	<b>2.2%</b>	-
<b>Venator Investment Trust</b> (September 2007)	<b>1.7%</b>	<b>2.4%</b>	<b>11.8%</b>
<b>Venator Income Fund</b> (August 2008)	<b>2.7%</b>	<b>3.7%</b>	<b>15.4%</b>
<b>Venator Select Fund</b> (September 2013)	<b>5.7%</b>	<b>-3.2%</b>	<b>34.3%</b>
S&P/TSX Total Return (March 2006)	4.0%	4.6%	6.0%
Russell 2000 (March 2006)	5.9%	2.5%	7.4%
S&P Toronto Small Cap (March 2006)	3.2%	3.7%	1.5%
S&P 500 (March 2006)	5.8%	2.6%	7.9%
Merrill Lynch High Yield Index (August 2008)	2.3%	3.0%	10.2%

Thanks to Burger King's recent purchase of Tim Horton's, Canadian shareholders are unlikely to be "rolling up the Tim's" in the stock market for much longer as this Canadian gem likely goes the way of Lululemon towards an eventual sole-US listing. Fortunately, Canadian companies, at the behest of their shareholders, have been "rolling up" for a couple of years now, as this has become the de facto value creation tool of our otherwise growth-starved corporate landscape for years.

We have become a corporate finance driven nation. No longer is internal growth the metric by which we judge the quality of a management strategy and for which we award premium multiples. Operating excellence has been usurped by corporate finance expertise where the most valued management teams are those that can play numerical shell games with their balance sheets. Today's management teams are awarded for using cheap debt to acquire profitable companies (because everything is accretive to earnings per share until the debt needs to be refinanced at a higher rate). Basically, we are playing multiple arbitrage with valuations rather than judging the prospects of the future of an operating company.

Financial engineering has become the preferred value adding method of choice as it's easier to lay out \$100MM to buy \$10MM in earnings when the only expense on the income statement is \$5MM in interest (not even that if you have excess cash). At 20x earnings using \$100MM of debt or cash creates an instant \$100MM of incremental stock market value at 20x that \$5MM, while the \$100MM cost of that acquisition is quickly forgotten if noticed at all.

This has resulted in a market where the justification for every company out there that is trading at a high multiple (over 12x EBITDA or 17x earnings) despite a sub-5% internal growth rate is that they are going to make an acquisition. Even better, management teams are unafraid to admit to their less-than-mediocre growth/operating skills freely stating expected organic growth rates of 0-3%. We have even heard comments from other money managers stating that certain companies are in the business of making acquisitions, and knowledge of their products, customers, suppliers and competitors is secondary if it is relevant to the investment at all!

## **BUILDING VS BUYING**

***The Builder (organic growth):*** This is the old fashioned way of doing things, where you spend some money on sales, marketing, research or equipment in order to increase sales and generate a return on investment. Contrary to popular belief, this is the cheaper way to grow. To use the software industry as an example, when you spend \$100 dollars on sales/marketing you are generally expected to achieve \$200-300 of revenue. It can also be less risky because the amount you spend on growth initiatives is variable and can be reduced if things aren't working out.

***The Buyer (acquire a company):*** This is the current preferred way of doing things in Canada. This is where you buy a revenue and earnings stream (you acquire another company), using largely debt or existing cash, in order to create immediate and possibly material EPS gains (because interest rates are so low so there is very little income statement offset to the increased operating earnings). Again using software as an example, the spending would work in reverse whereby you need to spend approximately \$200-\$300 to acquire \$100 in revenue. Furthermore, these new revenues come with additional operating costs since you need to take on a good chunk of the acquired company's expenses as well. This method can be a little riskier in that if things don't work out you can shut the acquisition down, but you will still have spent this great sum of money and have less cash or owe creditors.

There is no doubt at this point in the interest cycle that the "buyer" model is the preferred route in Canada whether we are talking about software, auto dealerships, specialty pharma or any other industrial concern. But why should this be the case? Doesn't it make more sense to spend \$100 to gain \$200 in sales rather than spend \$200 to gain \$100 in sales?

***The Accounting (follow the cash flow):*** The reason why the current market considers it better to buy than to build is simple. We value companies based on earnings (or EBITDA if we are lazy) and these are calculated off of the income statement. Spending money on sales and research is an expense that serves to reduce reported earnings. Spending money on an acquisition bypasses the Income Statement and shows up on the cash flow statement and balance sheets; you have effectively transferred the cost of growth off of the Income statement! While those organically growing "builder" suckers are reporting "inefficient" operating margins, the model of choice "buyers" all-in cash flows are inferior because they spent multiples of money to acquire their growth.

One market where we find this accounting treatment to be exceptionally egregious is in the specialty drug business, which is very prominent in Canada thanks to the success of Paladin Labs and Concordia Healthcare. We saw one company that was paying 5x EBITDA for drug marketing rights that expired in less than three years; the stock was trading in excess of 7x EBITDA. The rationale for this nonsense was that stocks in the sector were trading in excess of 10x EBITDA so it was all worth it on a multiple arbitrage basis. My response was to offer the CEO a deal: the company should give me \$1MM and in return I offered \$200k per year for three years after which we would call it even; unfortunately this person didn't take up the offer even though this was essentially the math behind their acquisition strategy. The market is willing to accept this shell game because what would show up as research and development on Merck's income statement is conveniently buried in the cash flow statement of an acquirer of specialty drug rights and these companies are valued on the basis of EBITDA with no regard to the amount paid for the acquisition.

***The Outcome:*** The stock market tends to forget about past transactions and looks to the future. That being said, the past isn't necessarily the past as we remember it. For example, one beloved "cash flow machine" in

the software sector has reported free cash flow in excess of \$130MM over the last five years, but has actually spent \$118MM in acquisitions; so I don't really know if the reputation is warranted. Nor do I buy into the valuation in excess of 15x EBITDA (that's about 20x taxed earnings) that puts this company on par with other great organic growth companies that are free use their cash for buybacks, dividends or organic growth initiatives (this company readily admits that its internal growth rate is sub-5% because why set a high bar for yourself when you don't need to?). There are at least four software companies in this country exhibiting these characteristics, one of which we are long and one of which we are short.

One Builder we are long (and this one has admittedly not worked out very well for us ... yet) is Halogen Software, a company whose biggest problem is that it wears its growth investments on its Income Statement. Halogen admittedly spends too much on Sales and Marketing (50% of sales) and General and Administrative expenses (20% of sales) to justify its growth rate (about 20%, all organic). But this extra spend makes it the highest organically growing publicly traded pure-software company of any meaningful size in Canada. Unfortunately, it loses money to the tune of negative \$9MM in EBITDA last year; we think it should be breaking even given its 20% growth rate, hence our previous comment regarding them spending too much. If Halogen were to stop growing and start cash flowing it would need to freeze spending here and let the revenues grow for several more years into its current cost structure and then give up on growth. By our estimation this would get Halogen to \$125MM in revenues and \$25MM in earnings. If the Canadian zero growth, high earnings, high multiple market were to persist, and if management could convince investors that there are acquisitions to be made, we could have a \$500MM valuation on our hands which would be a triple from current levels (that being said, if the market reverted to a more normal 10-13x earnings for low growth software companies the stock would only go up by 50%). Frankly, I would rather they kept growing because organic growth is a scarcer commodity a premium to an eventual acquirer.

## **OUR APPROACH**

Lest you get the wrong impression, I am not opposed to acquisitions in general. When you can pay fair value for a serial acquirer where, at under 15x earnings, future acquisitions are not currently built into the valuation that is something we are interested in, which is why we own Open Text. When acquisitions are additive to an existing growth model, we like that too which is why we continue to hold Boyd Group who can build their way to a 10%-plus growth rate if they can't find anything to buy.

I just don't like paying for acquisitions that haven't happened yet, and when you pay more than 20x earnings for an otherwise no growth company that is exactly what you are doing. This is why we own Open Text but not Constellation Software. If Open Text doesn't make an acquisition for the next two years it might drop about 10%, putting its valuation on par with Oracle (to name another low growth consolidator); the same scenario played out with the aforementioned Constellation Software would send that stock down over 30%.

I also don't like it when companies pay more to buy something than the cost of building it internally, especially when time is not of the essence. Facebook's purchase of Oculus for \$2BB is a good example. Here is a product that was two years away from being commercial and I can't imagine that Facebook, if they really believed in the future of goggle-based virtual reality, couldn't have thrown \$200MM at this technological problem and built a product just as good at 10% of the cost of buying it and gotten it to market at about the same time as an independent Oculus with a bigger marketing budget (even Google managed to rip off the iPhone iOS inside of six months and grab some serious market share). The cost of an acquisition such as Oculus should be a Research and Development expense, not tucked away in the Cash Flow Statement.



## IN SUMMARY

So all else being equal (and it never is), at Venator we prefer organic growth to corporate finance driven growth. We will buy corporate finance driven growth at a *slight* premium, but we believe the valuations should be weighted towards the organic growth rate.

- Organic growers are not dependent on their own valuation (multiple arbitrage). They do not need to lay out large amounts of capital to execute on their business plans. Many consolidators “growth” models fall apart if their stock valuations aren’t high.
- Organic growers aren’t dependent on acquisitions for growth (in order to justify their growth models). Boyd Group can continue to grow at approximately 10% per year without acquisitions. Many high multiple consolidators cannot, and a prolonged pause in their acquisition strategies could send these stocks down 20%-40%.
- As noted before, growing organically is generally cheaper, even if it takes a little more time. This is because you often expect incremental sales and profits above their salaries for each salesperson or lab rat hired. Acquisitions cost multiples of the acquired incremental sales and profits, and you have to take on the targets cost structure anyways.

**A dollar spent is a dollar spent, regardless of whether it shows up on the Income Statement or goes around it through the Cash Flow statement to the Balance Sheet. If there is one thing to take away from this letter, that is it.**

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

A handwritten signature in black ink, appearing to read "BO", is positioned above the typed name.

Brandon Osten, CFA  
CEO, Venator Capital Management Ltd.

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