



July 15th, 2016

So ends the first half of 2016. What was turning out to be a surprisingly resilient six months for the global equity markets came to a crushing end with Brexit – the shocking UK vote to leave the EU. This sent markets...wait, what? Most major equity indices ended June flat? That can't be right?

Looks like all that worry was about nothing. Apparently, the relief rally on the expectation that Brexit wasn't going to happen, was similarly unwarranted. Let's just recap that. Markets trade down on supposed worry of Brexit. Then, in the days and hours leading up to the vote, markets rally as odds point towards a win for the stay campaign. Brexit actually happens and then a week later most major markets are all back at all-time highs. Bad news is bad news, good news is good news and then bad news is good news.

According to the financial press, markets rallied yesterday on the back of the Bank of England *not* raising rates. A mere week ago, prices spiked as Bank of England Governor Mark Carney signaled stimulus would be forthcoming. In reality, markets went up because they were open that day and capital had nowhere else to go. The explanations attributed to the daily gains were simply coincidences, not causalities. One could have just as accurately said, the markets traded higher today because Mark Carney is a handsome man. While Mr. Carney's dreaminess is not in doubt, there is certainly no relation between that fact and stock prices moving higher.

These days it appears the best way to determine whether markets will go higher is to ask yourself whether the day ends in "y". Central banks have decided that global economies are not capable of dealing with even the slightest discomfort. The first signs of correction are met with more liquidity and more support for prices. While the talk seems to be of "Helicopter money", our thoughts tend more toward "Helicopter parents".

The markets are being treated like pampered children. *Economic data is a little disappointing?* Let's not hike rates and start floating the idea of negative rates. *Poor little Hudson scraped his knee playing soccer?* Oh, better take him off the field, buy him some Fro-Yo and ban all balls from the schoolyards.

Appeasing the markets, just like appeasing a child, is the path of least resistance and certainly represents the easy way out. Lee and Anthony are all too aware of this truth, having six children under the age of 10 between their two families. Intellectually they know, however, that this is not the best way to raise children. Bubble wrapping kids and preventing them from experiencing the slightest disappointment is a formula for ensuring they grow up unable to cope with the real problems they will inevitably face. Similarly, shielding markets from volatility has potentially left them incapable of dealing with a real shock. While parents may have a limitless reserve of tender loving care to support their children, Central banks have some limit to the amount of support they can offer.

So what, if anything, can actually cause the equity markets to trade meaningfully lower? Earnings could disappoint, but then again multiples already seem stretched so why not stretch them further? November could see the love child of Veruca Salt and an Oompa Loompa elected as the world's most

powerful person. Oh well, just think of what the mass exodus north will do to Canadian real estate prices – buy on the dip! Perhaps the market is simply invincible, having reached some sort of post-gravity financial nirvana. Our suspicion, and our continued cautious positioning, indicates otherwise. We remain deeply concerned that a propped up market could be one or two shocks away from reacting like a sheltered, home schooled kid during frosh week. No amount of Frozen Yogurt will be able to clean up that mess.

WesternOne Inc. the Sequel: WesternTwo

Despite our less than enthusiastic view of the market, we are still finding select opportunities to deploy capital. We have been adding to our position in the WesternOne Inc. debentures (WEQ.DB and WEQ.DB.C) and have now made the position our largest, with an approximate 7% weighting in a combination of the two tranches.

After the close on June 30th, it was announced that WesternOne would be equitizing the near-dated debentures due in 2018. Equitization is the act of paying back debt with newly-issued equity. Companies do this as a last resort, as it is extremely dilutive to existing shareholders. This is not, or at least should not be, a step that is taken lightly given that the move effectively hands control of the company over to debtholders. Conversely, for other creditors such a move is typically good news as it removes a liability and an interest burden thereby improving the overall creditworthiness of the entity.

We understood that this event was a real possibility and had attempted to balance our positioning in both the near-dated 2018s (WEQ.DB.C) and the long-dated 2020¹s (WEQ.DB). While we are excited about the prospects for the equity stake WEQ.DB.C holders will receive, we view the move as neutral to slightly positive to our long-term view on the recovery of that paper. The long-dated converts, however, have seen an immediate and material improvement in their relative standing. Trading in the subsequent few days was erratic, much of which we would attribute to investors not properly reading and understanding WesternOne's press release². Prices have since settled down to more reasonable levels with the near-dated debentures trading down slightly and the long-dated debentures having traded up around 25%. We continue to see good value in both.

Let's get back to explaining how WesternOne got into this mess and how we got involved. Then we can discuss how we believe this will ultimately be resolved. WesternOne was created as an income fund. These, and other such silly instruments, were designed to capitalize on the Canadian retail investors' insatiable appetite for yield. A combination of tax loopholes and undiscerning buyers allowed corporations to magically transform moribund assets into highly-valued publicly traded securities. This is just another flavour of the "sausage stock" we have belittled numerous times in the past - the juicy casing of a dividend yield masking what's really inside.

WesternOne was one of the best (or depending on your viewpoint worst) examples of this fad. To us, it appears that the company's founders thought they could simply create a vehicle and fill it with other people's assets thereby creating a distribution stream that investors would fawn over. It was a rather crude incarnation of a REIT, but with industrial assets as opposed to real estate. Even today, the

¹ 2018 and 2020 are the maturities of the debentures.

² It appears as though some took the release as an indication that the company would be redeeming the notes in cash at their full face, plus accrued. This would equate to \$100.77 of face value for debt that previously traded at \$58.51. These securities spiked to a high of \$79.90 before the truth seemed to sink in. They are now trading back to the mid-\$50s. Investors, please read press releases in full before transacting. PR guys, please don't try and hide the fact your company is diluting shareholders by burying it at the bottom of a long-winded and confusing press release.

company website's second tab is entitled "For Business Owners"³ and makes the case why other people should vend their businesses into WesternOne.

As WesternOne Equity Income Fund⁴, the company cobbled together two unrelated business lines, WIS and Britco. WIS is an equipment rental business based in B.C. and Alberta while Britco is a manufacturer of modular buildings. Neither of these business units were horrific businesses, just cyclical. Unfortunately, the capital structure was built as if the underlying businesses were regulated utilities with zero volatility in cash flow. The company had a huge payout ratio, onto which they layered an extreme amount of leverage. There was, in retrospect, no margin for error for either business. So, how do you think this all worked out for the company? We'll give you a hint, the "Western" in WesternOne refers to Western Canada.

Long story short – the price of oil crashes, the dividend gets cut and the equity gets annihilated. Much of the company's operations were not directly related to oil and gas, but enough were (Britco in particular) to essentially bring down the company. A stock price that topped \$8.50 in the fall of 2014 collapsed to sub 30 cents by the end of 2015. Let this be an important reminder, *meh* businesses with terrible balance sheets do not typically work out well for equity investors.

The Dark Horse's involvement began in mid-2015 when we saw the publicly traded debentures fall to severely impaired levels – less than 50% of par. By this point the company had been able to reduce debt levels to slightly more palatable levels, at least when considering the convertible debt at market prices. They had also shut off the acquisition engine and were generating significant free cash flow by running off working capital. After much analysis, we came to the belief that while the equity was likely worth little, if anything, the discounted debentures represented good value. At that point we started building our position.

The true value of the underlying businesses could be realized in any number of ways. The company could have restructured its senior debt, tendered for some of the debentures, raised equity from a strategic investor or, as has now happened, equitized one or both tranches of the convertible debt. Any one or some combination of the above would have resulted in a balance sheet better suited to the realities of the two underlying businesses. That is where we find ourselves now.

With the equitization of the first and largest tranche of debentures, the company has now bought itself some time. There is no looming debt maturity and the remaining interest burden is easily covered by current cash flow. At the same time, the Board may be handing the keys to the company to a group (debenture holders) that are not natural equity holders and may look to monetize sooner rather than later. There are certainly strategic and financial buyers that would be interested in both lines of business. The 2018 debentures, with the change of control provisions that they contained, acted as a bit of a poison pill that may have dissuaded interested parties from making a bid⁵. The equitization has removed that barrier to a transaction.

Post the anticipated August equitization, we would expect there to be aggressive interest in all parts of WesternOne. The new equity holders being largely comprised of distressed convertible buyers

³ <http://www.weq.ca/business-owners/why-business-owners-look-to-weq.htm>. We would encourage those interested to take a moment and absorb the message the company is sending with this page. We would summarize it as "We'll buy your business for a high price regardless of what it is. We won't get involved in running it. We don't do any due diligence. We can do this because the Canadian retail investors and banking sector offer us a ridiculously low cost of capital and will finance it all. Who do we make the cheque out to?"

⁴ The company dropped the income fund status and converted to a corporation at the end of 2012.

⁵ In a change of control, debenture holders would be due their full principal, plus a small premium and accrued interest.

(Broadview included) will likely be very involved in the process and will play a big role in determining how, and in what form, the company proceeds. Rest assured, there will be a significant amount of scrutiny on management and the future Board of Directors to ensure that the path forward is a sensible one. Needless to say, the burden of proof required to justify anything other than a timely liquidation of all the company's assets will be high.

With that said, there is a scenario in which the new WesternOne is an absolute homerun from here as a public company. We would refer to this sequel as *WesternTwo*. The debenture holders receiving equity are getting a controlling stake in a more suitably funded company. WIS, in particular, is a better than average business that has a well-established footprint and is relatively insulated from the vagaries of the energy market⁶. Britco, while certainly more exposed to oil and gas, has now been right-sized from a cost point of view and is operating at a cyclical low. Any recovery from here will accrue to the new shareholders. In addition, Britco's modular manufacturing has many applications outside of energy. Management has begun focusing the business into these new verticals in both Canada and the U.S. If these efforts bear fruit, the benefits will flow to the new shareholders, as will those from any cyclical upturn.

The "upside optionality" of either a cyclical recovery or success in taking Britco's expertise into new markets is not something that is given any value at current valuations. Said slightly differently, 2018 debenture holders are being awarded free options on either scenario coming to fruition. At Broadview, we love free options and look to accumulate them wherever and whenever we can. Typically we acquire them when investing in beaten-up stocks. The slight variation here is that this time they have come attached to beaten-up debt.

Down the road, a newly reborn WesternOne could conceptually re-initiate a dividend, start making acquisitions and work its way back towards sausage status. We're not sure if there is a precedent for re-sausagefication so perhaps this could be the first. Regardless, it would be at this point that Broadview would likely move on, having already enjoyed our homerun trot.

Broadview's investment in WesternOne has generated solid returns to date and we are confident it will continue to do so, even under a very conservative scenario. *WesternTwo*, if everything falls into place, could end up being the rare sequel that actually surpasses the original.

Until next month,

Anthony Hammill

Lee Matheson

⁶ WIS rents a large portion of its equipment to the film industry in BC as well as for general construction purposes.

Series	May 30, 2016	June 30, 2016	Monthly Return	YTD Return	Annualized Return Since Inception (April 3, 2009)
Master – Class A	\$242.73	\$245.23	1.03%	1.95%	13.2%
Series 5 - June 2015 – Class A	\$242.48	\$245.06	1.06%	1.98%	
Series 1 - Feb 2016 – Class A	\$240.39	\$242.66	0.94%	5.44%	
Series 2 – Mar 2016 – Class A	\$240.62	\$242.89	0.95%	4.84%	
Series 3 – Apr 2016 – Class A	\$242.66	\$244.96	0.95%	1.55%	
Series 4 – May 2016 – Class A	\$242.64	\$245.22	1.06%	0.80%	
Series 5 – June 2016 – Class A	\$242.73	\$245.03	0.95%	0.95%	

**From inception return used for series launched during the year*

All numbers reported after fees and expenses. See subscription confirmations for your Series.

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About Broadview Capital Management Inc. and the Broadview Dark Horse LP:

Broadview is the manager of the Broadview Dark Horse LP (“The Dark Horse”), a fundamental-based long/short investment partnership. Broadview utilizes its relatively small size, contrarian nature and willingness to perform extensive due diligence to deliver strong risk-adjusted returns for its investors. The managers concentrate on going where others can’t or won’t to find investment opportunities.

The firm is run with the philosophy that it will manage “as much money as it deserves to manage” and that a dedication to working hard for existing clients is the best way to grow the business in a sustainable fashion. It is not Broadview’s intention to take on additional investment mandates for the foreseeable future beyond the Dark Horse LP. Broadview was founded in October of 2008 and the Dark Horse was launched in April of 2009.

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