BROADVIEW
Capital Management Inc.

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The Dark Horse registered another positive month in July. While capital markets continue their TINA[1]-driven march higher, we actually found one stock that went down and did so dramatically. Thankfully, we were short this stock which went a long way to ensuring we were up on the month. That stock was Alaris Royalty Corp (AD:TSX).

Alaris Royalty: The day the cheerleading died…

We have been vocal critics of the Alaris model since late 2013 and have been short the stock for most of the past two and a half years. Our view, as it has appeared in these pages more than once, is that Alaris is a "sausage stock" – a collection of inferior cuts made palatable by the juicy casing of a dividend yield. Given that many of you are on summer vacation, there is no need for us to go on another ranty reiteration of our case against Alaris. For those interested, please check out our letters[2] for our thesis on all we believe to be wrong with the company and how it is valued.

Just before July ended, Alaris reported a quarter so bad that Prime Minister Trudeau may issue a formal apology in the coming years[3]. In short, ample evidence was presented that much of what we believed would eventually catch up with the company is catching up with the company. Partner companies are struggling to cover the cost of their high interest capital, competition is making it difficult for Alaris to deploy new capital and problem investments are continuing to worsen despite management's assurances that every issue is only temporary. With the release of the company's Q2 2016 financial results on July 26th, the sausage's casing has been peeled off and investors are being forced to look at exactly what they are being served. The reviews have been savage. Over the three days following the disastrous quarter, the stock plunged 21%.

The single biggest detractor in the quarter was Alaris' investment in KMH Cardiology ("KMH"). Alaris disclosed what we had long suspected – no deal has yet been reached to cure or divest this troubled investment. With this news, the company has further written down the value of the investment and taken another substantial hit to its book value. KMH, however, is only one of the many issues ailing the company. The company disclosed continuing or new issues with five of the eleven investee companies that it has funded pre-2015. A casual observer would look at that figure and logically ask "what sort of distressed businesses make up a book with such terrible credit metrics?" Our answer would be, the kind that have to borrow money at 16%.[4]

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[1] TINA is the acronym for "there is no alternative". This is increasingly the explanation given as to why the equity markets continue to move higher. Given the lack of yield/returns offered elsewhere there is no alternative for investors other than plowing money into the equity market. It has nothing to do with Tina Turner, though much like Proud Mary, the markets do just keep on rolling.
[2] Dec. 2013, Feb. 2015, Apr. 2015, Oct. 2015
[3] See Americans, we can make fun of our guy too.
[4] Alaris charges 14-16% on capital it invests with partner companies.

We think it is illustrative to take a longer look at Alaris' investment in KMH, specifically in how the problems were, or were not, disseminated to the investing public. It is our belief that this exercise will paint of picture of a company that either a) has very little insight into the financial health of companies it invests tens of millions of dollars in, or b) willingly obfuscates in order to prop up its stock price. We also suspect that this drawn out pattern of increasingly bad news will likely be repeated with one or more of the five current problem investments. Instead of using our words to describe this tale of misery, let's go direct to the source and use Alaris'. All of the following italicized quotes have been taken directly from Alaris press releases.

Alaris first signaled problems with KMH at the bottom of a January 2nd, 2015 press release filled with much sunnier highlights. *"Short-term cash flow constraints"* was the explanation given to a partial deferral of payments. Basically, this was the company saying, "nothing to worry about" and that the problem would be addressed in short order. This press release was issued more than nineteen months ago!

Then in March investors got the following update, *"the fixed portion of the distributions have been less than expected, resulting in a $1.66 million reduction in the fair value of our units in KMH to $52 million."* Uh oh, sounds like something to worry about now. The $53.7 million investment Alaris had in KMH was now looking somewhat in danger.

Now we get to the May 5th, 2015 Q1 release and we read this. *"The Corporation continues to work with KMH on a long term solution to improve cash flow. The timing of collections from KMH's US business and decreased performance from and closures of some of KMH's US clinics has resulted in a continuing cash flow constraint that has prevented KMH from paying any material distributions in 2015."* Wait, so you haven't received *any* material distributions? I guess the "less than expected" reference in March was actually zero. Not entirely sure why this wasn't mentioned earlier, but we're sure this will all get cleared up soon.

That brings us to June of 2015. *"KMH and Alaris continue to evaluate strategic alternatives that include, but are not limited to, a full repurchase of Alaris' preferred units (the "KMH Units"), the rolling of all of Alaris' KMH Units into a strategic entity and a combination of a partial repurchase of the KMH Units and rolling the remaining KMH Units into a strategic entity. Alaris expects a conclusion to the process within the next 90 days".* This press release appeared 417 days ago – Spoiler alert: the process has not yet concluded.

In September came this. *"Due to the length of the strategic process underway at KMH, the Corporation has further reduced its expectations of fair value to approximately $35 million. That results in a $15 million reduction in the current period, but because this is viewed as a permanent impairment, another $5.4 million is recorded in the quarter that relates to provisions made in prior periods. "While we're disappointed with the length of the KMH process, our expectation is that we receive cash at closing as well as some level of long term revenue stream from a strengthened Partner."* This $35 million was referred to on the accompanying conference call and in financial filings as a "liquidation value". You can't get less than liquidation value, can you?

Now we get to 2016. The year-end results come with this reassuring language that this terrible ordeal is finally behind the company. *"KMH has taken much longer than anticipated but the Corporation has recently reached an agreement in principle with KMH management on a transaction that would see Alaris receive approximately $35 million in value for its preferred units consisting of between $15 and $20 million in cash and the remainder in a note payable or some other form of negotiated future compensation."* Thank God that's over with.

Scratch that. It's not over with. From the recent Q2 results: *"The decrease in net earnings is due to the impairment of the KMH, Limited Partnership ("KMH") units as the Corporation continues to negotiate a repurchase of its units with the goal of obtaining more up-front cash on the pending repurchase rather than leaving a long-term note payable with KMH".* The company has now taken a further $7 million impairment on KMH bringing the total impairment, *so far*, to over $27 million. This update provided a surprising answer to the question posed two paragraphs ago. Yes, apparently you can get less than liquidation value.

To this lexicon of ever increasing distress we would add one note that Alaris never included in a press release. We found this little nugget buried deep in the 2015 MD&A.

"KMH ceased paying regular distributions to the Corporation in November 2014."

If you'll scroll up you'll see the date on the press release stating that KMH would be partially deferring payment was January 2015. Unless our understanding of the linearity of time is off, and God knows we make mistakes too, January 2015 is two months after November 2014. Given that distributions from partners are made monthly shouldn't this have been disclosed earlier? Perhaps it wasn't a disclosure issue and Alaris simply hadn't realized until January that payments weren't made. If we were investors we're not sure which scenario we would find more alarming.

Finally, no deal has yet been finalized and no timetable for an end to this nonsense has been established. Given previous management comments on this matter we wouldn't be convinced a deal was done until all paperwork was signed and cash was in the bank. So far, phrases with such supposedly definitive connotations as "agreement in principle" and "liquidation value" have been thrown around without much regard for what they actually mean.

Even if the KMH fiasco is concluded with no further impairments, why should investors have any faith that the issues with investee companies SMi, Kimco, SCR Mining and Agility Health aren't going to snowball into material writedowns and impairment to future cash flows? The verbage used to describe the problems with these four companies all sound very similar to what was said about KMH early in its travails. As of now, none of the aforementioned companies are currently making any cash distributions to Alaris.

The funny (or sad, we're not sure which) thing is that none of this may have ever mattered. The misleading statements from management, the eight figure write-offs and the deteriorating creditworthiness[5] could have all been swept under the carpet by the fee-hungry brokerages[6] had the music just kept playing. It is our belief that had Alaris found ways to deploy more capital it would still be able to count on Bay Street to trumpet the stock and promote it to its less-discerning clientele.

When Alaris management mentioned that they were having trouble deploying new capital they opened themselves up for scrutiny. With even an ounce of scrutiny, the flaws in the business and the problems with the current crop of investments are impossible to overlook. Had the company been successful in investing capital into new partner companies it would have soon gone back to the equity markets to raise new capital. With equity raises come fees for the brokers.

[5] To say nothing of the CRA issues and potential selection bias as the best credits graduate from Alaris' high-cost capital offering.

[6] Credit where credit is due, RBC Capital Market's Ben Holt caught on to many of the issues we had (restatements of coverage ratios, unwarranted premium to book value, similarities to BDCs) with his June 29th initiation. That report was one of the better pieces of research we've read in some time and easily the top Alaris sell-side piece published.

The possibility of a hefty commission would have caused the brokers (or at least the majority of them) to immediately cast aside that pesky scrutiny and move into full-throated promote mode. The seemingly obvious problems would be ignored in favour of some ethereal fluff about a "great management team" and "dividend growth excellence".

How can this be, you ask? How can a risky investment with such obvious warts continue to be championed by the sell-side? The answer lies not in some spreadsheet or stock chart but rather in the imperfections of human nature.

Objectivity and truthfulness are both absolute virtues. While both wonderful things, neither provide tangible rewards that are derived from them and them alone. The incentive provided by tangible benefits – whether they be monetary or otherwise – can therefore dissuade individuals from exercising these two virtues. With our Alaris example, and countless others, we can see how the incentive of commission and advisory fees can overwhelm the objectivity of the analyst community.

While the pursuit of pure objective research is wonderfully virtuous, it makes for a terrible business model, particularly when compared to simply being upbeat and promotional. The analyst that is entirely objective and truthful may find him or herself out of work. There is simply not sufficient profit to be generated for the bank or brokerage from trading commissions to make up for lost revenue from capital raising and advisory fees. "Calling a spade a spade", unfortunately, will often eliminate that analyst's firm from consideration for the lucrative cash flow streams associated with raising capital.

This dynamic is not solely limited to the brokerage industry. Certainly there are instances in academic research where the interests of a wealthy patron or commercial sponsor may influence, or even drive, the ultimate findings. For a more topical example, let's take a look at the windswept dumpster fire of a campaign we're witnessing south of the border. The mental gymnastics displayed by pundits and politicians in maintaining support for the GOP nominee despite months of increasingly bizarre, immature and offensive behaviour seem reminiscent of how analysts have maintained strong buy ratings on Alaris throughout the KMH fiasco. Now that Trump's hopes of being elected seem to be circling the drain, we see partisans "boldly" break ranks and denounce him. This also seems familiar to anyone who read the downgrade notes post Alaris' second quarter release. It's certainly easier to be objective and honest when there's no cost to being so.

So, did we just equate Alaris Royalty to Donald Trump? I guess we did.

Is it unfair to compare a publicly-traded company to *Dick a L'Orange*? Maybe. Then again, this company has benefitted from unwavering fawning for so long that perhaps it is overdue for a dose of hyperbole-tinged criticism. While early, our doubts about this company's sustainability are proving to be well founded. To use a popular Trumpism, *many people were saying* we were crazy when we first questioned the supposed bulletproof dividend back in December 2013. Now that Alaris hasn't generated sufficient cash flow to cover its dividend in six quarters and is in breach of its standard debt covenants[7], our beliefs no longer seem so far out there. If something drastic doesn't happen soon to turn around Alaris' fortune, its 2016 may end very much like Mr. Trump's. That would be good news for investors in the Dark Horse, not to mention all good people the world over.

Until next month,

Anthony Hammill Lee Matheson

[7] Alaris has a 90 day waiver that allows it to avoid a technical breach. It assured investors on the conference call that it will be back onside within that 90 day window. As we have seen, the company is currently 0 for 1 when it comes to correctly predicting what can happen in 90 days.

Series	June 30, 2016	July 31, 2016	Monthly Return	YTD Return	Annualized Return Since Inception (April 3, 2009)
Master – Class A	$245.23	$246.58	0.55%	2.51%	13.1%
Series 5 - June 2015 – Class A	$245.06	$246.42	0.56%	2.55%	
Series 1 - Feb 2016 – Class A	$242.66	$244.00	0.55%	6.03%	
Series 2 – Mar 2016 – Class A	$242.89	$244.24	0.55%	5.42%	
Series 3 – Apr 2016 – Class A	$244.96	$246.32	0.56%	2.11%	
Series 4 – May 2016 – Class A	$245.22	$246.58	0.56%	1.36%	
Series 5 – June 2016 – Class A	$242.73	$246.39	0.56%	1.51%	
Series 6 – July 2016 – Class A	$245.23	$246.60	0.56%	0.56%	

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

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

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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