



April 15th, 2016

March was one of the Dark Horse's better months in the past few years. We achieved this despite maintaining a net exposure that was substantially similar to what we've maintained since early last year (between 35-45% net long). One change we have made over the last few months has been a reduction of our USD exposure. This tactical move has assisted us of late as we've seen the loonie regain some of its lost ground to the greenback. While the generally upward move in equities in the month helped the fund, the majority of the performance was driven by outsized gains in a couple names. Typically, for our fund to move more than 2.5-3.0% in any given month it requires some heavy lifting from individual positions. That was clearly the case in March.

The buyout of **Axia Netmedia (AXX:TSX)**, which we discussed in last month's letter, was a major contributor to the month's performance. In addition, **Forestar Group (FOR:NYSE)** caught a bid as investors finally took notice of the significant progress the Board and management have made in divesting non-core assets. Forestar, which we added materially to in late February and early March, was up 33% during the month providing as big a boost to the Dark Horse's performance as Axia did. These efforts continued into April with the announcement that the company has now reached an agreement to sell substantially all of its remnant oil & gas operating assets.

The divestiture of the Bakken assets officially closes the books on the company's disastrous foray into oil & gas. It also likely marks the last time you'll see the word Bakken in one of our letters. While the company maintains the mineral rights on hundreds of thousands of acres throughout the southeast, they no longer have any material capital at risk. We applaud the efforts of the Board and management to atone for the sins of their predecessors. It is our anticipation that Forestar will soon return a material amount of capital to shareholders, in some form or another, while continuing to monetize its remaining asset base.

March also closes the books on the Dark Horse's seventh year. We are now the longest-tenured hedge fund in Toronto, east of the DVP. Seriously though, seven years is nothing to scoff at. Self-deprecation aside for a moment, we are very proud of what we have achieved over this time and are very excited about what the next seven years will bring. We would like to take a moment to thank all of you for your support in helping us get this far.

Now, onto this month's missive...

The Next Valeant: How dare you say that about my daughter?

Context is critical. Imagine you're at a hockey rink watching your daughter play. She speeds down the ice, cuts in on her off-wing and whistles a wrist shot over the goalie's shoulder. Another parent turns to you and says, "Wow, she really looks like Phil Kessel out there". Put aside what you may think about Mr. Kessel's work ethic and let's agree this is quite a compliment. Now imagine you are at a party before prom night. The kids, including your daughter, are all dressed to the nines prepared for the

biggest night of their teenage lives. That same parent turns to you and says, “Wow, she really looks like Phil Kessel out there”. This clearly falls far short of being a compliment.



Similarly, context is very relevant in the capital markets. Not long ago, investors and bankers yearned for the “Next Valeant” – the next great company that would take the markets by storm, buy everything in sight and grow, grow, grow. Today, if you were to refer to a company as the “Next Valeant”, you’re likely to be sued for slander or libel.

We have chosen to discuss **Valeant Pharmaceuticals International Inc. (VRX:TSX)** despite the fact that we were never directly involved, either long or short. We were, however, keen observers of both the company and the hype machine surrounding it. Our suspicion was that Valeant, for all its fanfare, was simply another in a long line of aggressive acquisition-driven promotes. Such stories are far too prevalent in the Canadian capital markets. There will certainly be others and the vast majority will end in tears. By looking at such a notable blow-up in retrospect, perhaps we will all learn something about identifying the next one and ensuring we all avoid it. Remember those videos you had to watch back in grade school that showed some creep trying to lure kids into a van? This is Broadview’s version of those videos – a lesson in being able to spot danger ahead of time.

Valeant was Bay Street’s golden goose from 2013 until the middle of last year. The stock price expanded more than five-fold during its run, providing much needed performance for equity managers and fees for investment bankers. Much of this period coincided with the crash in the commodities complex making that performance and those fees ever more precious. In addition, Valeant’s run sponsored a number of copycats that, for a time, also showered followers with riches.

Unfortunately for Valeant and its legions of fans, the company’s glorious run has come to a swift and crushing end, as most of you undoubtedly already know. A stock that once approached C\$350 a share has plunged to as low as C\$35 – representing a breathtaking decline of nearly 90% in less than 8 months. More stomach-churning is a loss of more than C\$100,000,000,000 dollars in market capitalization....and no, the author didn’t just fall asleep on the “0” key. That’s what \$100 billion looks like. To give you some context, that is enough money to write a cheque to every Canadian citizen for \$28,000 or to buy a house in a decent school district for every member of the Vancouver Canucks.

Let’s start by going back to when Valeant was something that people wanted to talk about, not just bash on twitter. The story, *and there’s always a story*, was that Valeant was run by the only smart “business guy” in the pharmaceutical industry, Mike Pearson. Every other Pharma executive was some geek in a lab coat who cared far more about filling up test tubes than filling the pockets of investors. Pearson, and his disciples, were able to buy the orphaned cast-offs from these bumbling pharma behemoths and substantially increase profits through cost-cutting and more aggressive sales tactics.

Pearson's McKinsey-bred genius was the "secret sauce" that allowed Valeant to rise from the ashes of Biovail to become, for a brief time, our nation's largest publicly-traded company. Only Pearson, or so went the story, had the insight to raise prices on acquired drugs as the previous owners were all too stupid or wimpy to charge more for their products. Plus, Valeant paid next to no taxes and obviously this would be the case forever. Whoever heard of a company utilizing aggressive international tax strategies ever getting into any trouble? According to its cheerleaders, Valeant's model was the new gold standard for healthcare, if not all industry. It was repeatable and eternally fundable with receptive equity markets and all the cheap debt the company could ever want.

Put more succinctly, the story was comprised of these three parts:

- a) **The Orphan Angle.** Buy orphan drugs that are being ignored and/or managed by idiots/not for profits. Fire everyone. Earnings go higher.
- b) **The Price Angle.** Immediately jack the prices of the acquired drugs. Earnings go higher.
- c) **The Tax Angle.** Stop paying taxes. Earnings go higher.

Thankfully for our investors, the *story* never added up to us¹. Perhaps we err on the side of being too skeptical, but in our minds none of these angles held up to even the slightest bit of scrutiny. At best, they were temporal opportunities that would be competed away or outgrown. At worst, they were simply untrue – existing only in the minds of investment bankers and momentum investors. Let's start with the orphan angle.

We could see the logic in say, acquiring a \$5 million revenue drug from a \$10 billion company and getting a good deal. It's not a stretch to believe that such a drug may have been overlooked inside a vast, bureaucratic organization. On the other hand, this angle becomes far less believable when, for example, Valeant bought Bausch & Lomb for \$9 billion with the seller being a major private equity firm. Presumably such a seller has some profit motivation and experience in reducing costs. As such, the promised cost synergies (usually in the form of gutting R&D) were either exaggerated or likely to result in a long-term impairment to earnings power.

In addition, the acquired assets were clearly substantial enough to warrant attention as opposed to the theoretical \$5 million revenue afterthought. As another example of how far the truth was from the story, Concordia Healthcare, the largest (and perhaps ugliest) of Concordia's offspring, jumped the shark when it announced a \$1.2 billion acquisition from Cerberus Capital Management (yes, *that* Cerberus). No offense intended, but if we have to guess who's winning a deal between Cerberus and a couple of guys in a boardroom in Oakville² we're going to go with the multi-billion dollar firm with over 20 years of experience named after the multi-headed dog that guards the underworld.

The price angle (or price-gouging as its now more commonly referred to), which was usually touted as the most guaranteed of synergies, left us equal parts suspicious and uncomfortable. While this may sound like our inner-Tommy Douglas coming out, it really is just a simple matter of Economics 101, not politics. The price of popcorn at the movies can go up every year by a meaningful amount and nothing will ever happen to change that. The government isn't going to step in, competition won't emerge (because competitors can't get into the theatre) and while consumers may grumble, it's not as if they'll band together to march on their nation's capital, demanding price caps on golden topping.

When you're selling life-saving drugs, however, prices simply can't be raised without some consequences, regardless of patents. Historically, Pharma companies were able to explain (though not

¹ Yes, we should have shorted it, although that would have been an extremely painful process before it actually began to pay off.

² We have nothing against Oakville. It's where former Buffalo Bills All Pro placekicker Steve Christie went to high school.

necessarily justify) price increases given their massive R&D budgets. Valeant prided itself on slashing R&D, thus losing this part of the argument.

To us, it all came down to a very simple question. If success in pharmaceuticals was simply driven by jacking up prices, would the sellers not have already tried this? As we established earlier, these sellers were sophisticated operators, so if massive price hikes were more than just a short-term boost why wouldn't they already have been enacted?

Any of you who have picked up a newspaper or heard the name "Martin Shkreli" are probably aware that drug pricing is finally coming under attack. The drug companies, particular the orphan drug peddlers, seemed to have pushed drug price hikes too far and now face real and sustained pressure to roll-back prices. While the image of the detestable Mr. Shkreli was splashed across the media it was likely the actions of Valeant and its peers that finally convinced the politicians to act. Regardless of what caused the crackdown, the days of simply acquiring someone else's drug and forcing through exorbitant price increases without consequence have come to an end. This destroys a central tenet of the Valeant model.

Finally, there was the tax inversion angle. Valeant and its brethren all paid very little in the way of taxes. This was a result of complex structuring that ran the majority of earnings through subsidiaries and associated entities domiciled in tax friendly jurisdictions. Valeant was able to pass on this good fortune to any acquired company. Company A makes \$1.00 in earnings. That company is acquired and *presto*, through the magic of tax inversions that company now makes \$1.25. This "tax synergy" is realized before a single scientist is fired or a single cancer patient's medication becomes unaffordable. No one's ever going to do anything to try and stop this, right?

Wrong. Inversions are finally now being shut down, hopefully for good. This concerted effort by government to close this loophole was likely accelerated by the profile of such large companies as Valeant. Simple tax arbitrage will no longer be the sure thing it once was and as such deals will no longer be accretive simply based on the jurisdiction of the buyer.

It has now become abundantly clear that the Valeant model is not sustainable and the gains it derived post acquisitions were fleeting and illusory. The company has been exposed as just another version of "the roll-up" undone by the inherent limitations of that strategy (along with some overly aggressive accounting thrown in for good measure). Roll-ups may work on a small scale but eventually outgrow the legitimate opportunity. In the case of Valeant and its ilk, we say "Good riddance". Having our nation's largest publicly-traded company be little more than a tax-havened, R&D slashing, "hike the price on Nanna's pills"³ pseudo-company is not exactly something we should be proud of. Surely we can find a more useful model for Canada's entrepreneurs and MBAs to emulate.

So the next time someone comes to you breathlessly promoting the *next this* or the *next that*, take a second to consider the context. Will this ultimately prove to be a compliment or an insult? In the case of the *next Valeants*, had investors objectively and honestly thought about what the current Valeant was and how it wrung such massive growth and profits from the cast-offs of others, perhaps they would have passed, saving much hardship. The same would go for other such "winners" and their copycats. We would point you to Amaya and the Next Amayas and, perhaps one day, Alaris and the Next Alarises. When we hear something pitched as the next whatever, our impulse is usually just to say, "Next".

Until next month,

³ Fun fact: Anthony's Nanna and Valeant's soon to be Ex-CEO Mike Pearson are both from London, Ontario.

| Series | Feb 29, 2016 | March 31, 2016 | Monthly Return | YTD Return | Annualized Return Since Inception (April 3, 2009) |
|---------------------------------------|--------------|----------------|----------------|------------|---|
| Master – Class A | \$231.6825 | \$241.2253 | 4.12% | 0.28% | 13.4% |
| Series 5 - June 2015 – Class A | \$231.4423 | \$240.9752 | 4.12% | 0.28% | |
| Series 1 - Feb 2016 – Class A | \$231.4628 | \$238.9719 | 3.24% | 3.84% | |
| Series 2 – Mar 2016 – Class A | \$231.6825 | \$239.1995 | 3.24% | 3.24% | |

**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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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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