MAXAM
CAPITAL MANAGEMENT

Maxam Diversified Strategies Fund – Q2 2017 Commentary

The second quarter of 2017 was a successful and eventful quarter for the Maxam Diversified Strategies Fund. The fund delivered a positive return while the Canadian market moved lower, and we reached a significant milestone. First some quick comments on the milestone and then on to the business end of the commentary.

Time flies when you're having fun.

June 30, 2017 marked the eight-year anniversary for the Maxam Diversified Strategies Fund. *Launch day* feels like yesterday, and an eternity ago at the same time.

As the well-known saying goes, "*time flies when you're having fun*" – a quick Google search on this generally accepted phenomenon suggests that when you are bored your mind is more likely to wander and you'll check the clock more frequently with thoughts on how long until you can move on to something more appealing. Conversely, when you are busily engaged in a stimulating activity or venture, you don't worry about time because you are enjoying the moment – especially if focused on a goal.

When I think back to the fund's launch day, it really does feel like yesterday. This is testament, I believe, to the nature of an entrepreneurial pursuit, the daily grind of the investment business and mostly, of course, because we love what we do.

Grind. Stay humble.

We are very proud of the strong results we have generated for clients over the past eight years. Our track record, of course, has not been absent of some *downs* with the *ups*. Such is the nature of the investment business that I believe one must be comfortable with, otherwise one may not have the fortitude to endure through to success.

We've had our fair share of experiences, both good and bad, and learned a few lessons along the way. Our ongoing endeavour is to learn valuable lessons from both the good and the not so good, and to apply that cumulative experience to future situations and opportunities. It is a privilege to be entrusted with managing other people's money – one we do not take for granted. We enjoy the grind and are thankful for the opportunity.

Back to business.

The Maxam Diversified Strategies Fund[1] gained +1.2% in the month of June, +0.7% for the second quarter and +5.1% through the first six months of 2017. We're pleased with the fund's solid start to the 2017 calendar year, especially when considered relative to what the Canadian market has offered investors.

YTD as at June 30, 2017	
Maxam Diversified Strategies Fund[1]	+5.1%
S&P/TSX Composite	-0.7%
S&P/TSX Total Return Index	+0.7%
S&P/TSX Small Cap	-5.3%
S&P/TSX Venture	+0.6%

Some notable successes have helped drive our returns so far this year. The first quarter of 2017 started off well with TIO Networks and RDM Corporation, two of our long-time holdings in the Technology sector, announcing that they had agreed to be acquired by PayPal Inc and Deluxe Corporation, respectively.

Sandvine Corporation, a provider of data and bandwidth management technology, disappointed investors with poor financial results and stock price performance in 2016. With our conviction in holding the name being tested, we asked ourselves: is this technology company – a business trading at about a 5x EV/EBITDA

multiple, paying a 3% dividend yield, cash representing ~50% of its market capitalization and with no debt – a *value trap* name or a *value with a catalyst* name?

We stayed long Sandvine with the conviction that their leading technology, attractive valuation and fortress-like balance sheet would eventually attract acquirers. In late May it appeared that our patience would be rewarded when a global private equity firm, Vector Capital, announced that they had reached an agreement to acquire Sandvine for $3.80 per share. While above our cost and the stock's recent trading range, we were somewhat underwhelmed by what we thought was a low bid.

Interestingly, the transaction details included a 42 day go-shop period during which Sandvine could actively solicit superior bids. When we received the information circular outlining the details behind Vector's $3.80 bid we were pleased to see that other parties had historically offered to acquire Sandvine for superior consideration. *Game on!*

Enter Francisco Partners – another private equity fund who had previously purchased a Sandvine competitor, Procera Networks, in 2015. When Francisco acquired Procera they paid a higher valuation than Vector was offering for Sandvine – which was a key supporting data point in our thesis for owning Sandvine. A bidding war ensued: Vector offers $3.80 – Francisco offers $4.15 – Vector exercises their matching rights at $4.15 – Francisco offers $4.40 and wins the prize[2].

While the path wasn't necessarily smooth, we're pleased with the outcome on our investment in Sandvine. It's a great example of our focus on risk/reward, and our search for *value with a catalyst*.

Another successful name for us in Q2 was Norsat International – a provider of unique and customized communications solutions for remote and challenging applications (think radar and satellites). Our thesis on Norsat, which we outlined in our Q1 commentary, shared some similarities with Sandvine – an attractive valuation with a catalyst. Norsat's largest shareholder, Privet Fund Management, started the bidding process with an unsolicited acquisition offer at US$10.25 per share. Fast forward to the end of June, Norsat had reached a definitive agreement to be acquired by Hytera Communications for cash consideration of US$11.50 per share.

Other notable holdings providing positive performance attribution for the fund in Q2 included long positions in Polaris Infrastructure, Sunopta, Blackline Safety and Boyd Group, and five of our short positions.

Lest you think all of our holdings were acquired for substantial premiums during the first half of the year… they weren't.

Notable holdings which provided negative performance attribution in Q2 for the fund included long positions in Medicure and Bird Construction, and four of our short positions.

On Bird Construction, it looks like we jinxed ourselves when, in our Q1 commentary, we wrote:

"Bird Construction is one of our newer holdings in the fund, and while it is still early days, its shares are already moving in the right direction (I wish that was always the case!)." – Travis Dowle, Maxam Q1 Commentary.

Ye investment gods have smote me! Just a little lightning strike, a reminder not to be too confident.

In our Q1 commentary we also discussed Bird's rock-solid balance sheet (no debt and half of its market cap in cash), an improving project backlog and potential upside from Mr. Trudeau's promised infrastructure spending. Shame on us for celebrating a positive move in the stock too early (we're roughly at our cost base now). We believe our thesis still holds.

Medicure has been a very strong performer for the fund since we acquired our initial position in mid-2015, but it was a notable drag on performance during the second quarter of 2017. This relatively unknown Canadian specialty pharmaceutical company focuses on the development and commercialization of therapeutics for the U.S. hospital market in the area of acute cardiovascular care. We were attracted to the valuation and growth profile of Medicure itself, but were particularly intrigued by what appeared to be a significant hidden asset: Medicure's fixed-price option to acquire a business called Apicore.

Apicore is a New Jersey based developer and manufacturer of specialty Active Pharmaceutical Ingredients ("APIs") and pharmaceuticals. With two FDA approved facilities, Apicore specializes in the manufacture of difficult to synthesize, high value and other niche API's for many U.S. and international generic and branded pharmaceutical companies. In late 2016 Medicure's shares moved higher on news that it had exercised a portion of its option to acquire a 64% interest in Apicore.

We believe Medicure's share price moved lower in the second quarter of 2017 for two primary reasons. First, its Q1 results were not received well, which we think was largely due to a lack of communication and understanding regarding the seasonality of the Apicore business. And second, because of some investor uncertainty with respect to whether or not Medicure would exercise their right to acquire additional ownership in Apicore before their fixed-price option expired. Why exercise the option to acquire 64% of the business and then, only a few months later, allow your remaining options to expire worthless? Investors were puzzled.

It turns out investors didn't need to worry, Medicure did exercise its remaining fixed price option to acquire Apicore[3], and a significant part of our original thesis on the name is now in the process of playing out. We're excited about the catalysts on the horizon for Medicure and Apicore.

"There is always something to do. You just need to look harder, be creative and a little flexible."
– Irving Kahn (1905-2015)

The above quote from Irving Kahn is one of my favorite investing quotes – although it can apply to a lot more than just the pursuit of investing. Kahn was dubbed the oldest living active investor, active until the age of his passing at 109! The quote is also the title of the well-known investing book on value-investor Peter Cundill, "There's Always Something to Do"[4].

I've always liked this quote because it encapsulates why I love the investment management business and it ties into many of the important attributes of Maxam's investment philosophy. We believe that catalysts and events occur in a variety of market environments – and if you look and work hard enough, there really is always something to do.

Active. Opportunistic. Flexible.

In our Q1 commentary we discussed our views regarding ongoing investor complacency in the face of geopolitical discord, rising protectionism, uncertain government policy outcomes and rising interest rates. And while we have continued to see decent economic growth and solid corporate financial results in the U.S. and Canada, we still believe some market participants may not be appropriately pricing risk.

Using the VIX – the S&P 500 volatility index – as a measure of risk, or fear, in the marketplace, we have recently been witnessing some historic extremes. Twenty of the lowest thirty VIX closes since the series' inception in 1990 have occurred this year (nine of those have been in July alone). We're also seeing similar multi-year volatility lows in bonds, gold and emerging market equities – all of which have our attention. We continue to believe that some discretion is warranted.

In Canada, the economy continues to deal with a range bound oil price and a consumer that by all counts is increasingly stretched. Canadian real estate prices, most notably in Vancouver and Toronto, have continued to defy traditional metrics – moving higher on a seemingly endless flow of funds and #FOMO. Calling a top in Canadian real estate prices and shorting related securities has been a losing thesis for many over the past few years.

Recent developments have us wondering if we have now seen the peak for Canadian real estate prices. The Bank of Canada recently raised interest rates, Canadian banks followed suit by increasing mortgage rates and market expectations are factoring in at least one more rate hike. The Canadian dollar has rallied higher making our real estate, and other goods, more expensive for foreigners. New policies from several levels of government have been put in place that will certainly impact demand. We've seen a dramatic increase in listings in the Greater Toronto Area since the Ontario government unveiled their 16-point plan in April to try and cool their red-hot housing market. Meanwhile, in BC we have a new NDP/Green party coalition government that was elected, at least in part, on a platform that promised to take action on BC's high real estate prices. All this at a time when Canadian consumer debt continues to reach record levels… and not the good kind of record levels.

We've been actively positioning the fund to both prepare for a potential increase in market volatility and, most importantly, to take advantage of it. Over the last several months we have exited some positions that we considered to be non-core and we've opportunistically added to some of our favourite names. We continue to add some incremental short exposure to the fund and our cash position has increased – in part due to a few of our holdings being acquired and some merger arbitrage positions successfully closing out.

In the Maxam Diversified Strategies Fund's very first commentary eight years ago I posed the question: "*Why should one invest in an environment where the near-term prospects are so uncertain?*" While clearly a different market environment back then versus now, my answer is similar today. With an active, flexible and opportunistic investment strategy we believe we can take advantage of the compelling investment opportunities that become available during periods of change and volatility. A more volatile environment means increased opportunities for our active strategy, which, in-turn, sows the seeds for future returns.

As we have over the last eight years, we continue to invest with a bottom-up, value-focused, active, opportunistic and flexible investment approach. We are excited about how we are positioned.

Thank you for your investment and your continued trust. We'll get back at it now… there's always something to do.

Sincerely,

Travis Dowle, CFA
President & Fund Manager
Maxam Capital Management Ltd.

[1]Returns are for Series F Units, and are net of fees and expenses.
[2]Vector had the right to match Francisco's $4.40 bid until July 14, 2017 … and match they did not.
[3]Medicure closed the acquisition of additional interests in Apicore on July 12, 2017.
[4]There's Always Something to Do: The Peter Cundill Investment Approach, by Christopher Russo-Gill