

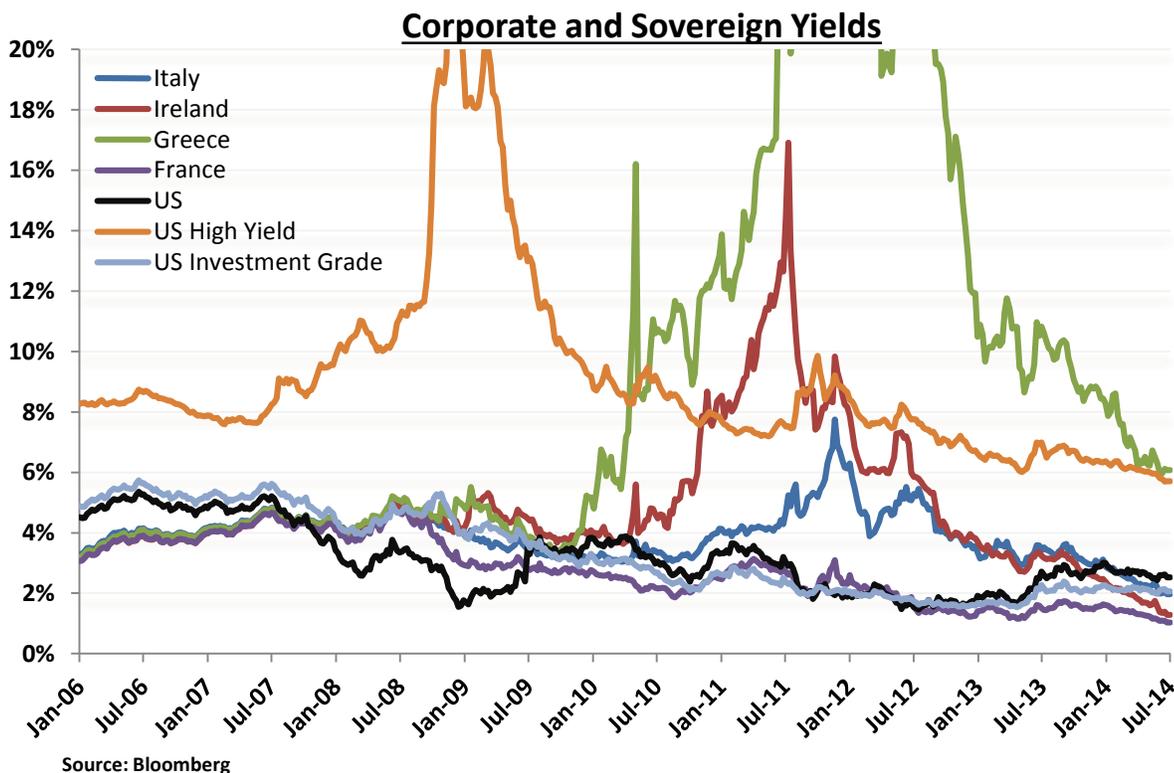
Credit is what counts ... Not leverage

Q2 2014 Commentary

With the passing of June, the Fulcra Focused Yield Fund has reached its 5 year anniversary. Thank you to investors, friends and family for your investment and support throughout this period.

Looking back to the summer of 2009, most investors and business owner / operators were still concerned about the availability of **credit** – the contractual agreement between a borrower (company) and lender (bank and/or credit investor) in which the borrower receives capital today and agrees to repay that capital at a future date, with interest payments paid over the term of the contract.

Today, however, the availability of credit is not a concern and is in fact abundantly accessible by even the riskiest of corporations and countries. With the exception of outliers like Greece, yields for most issuers are well below pre-crisis levels.

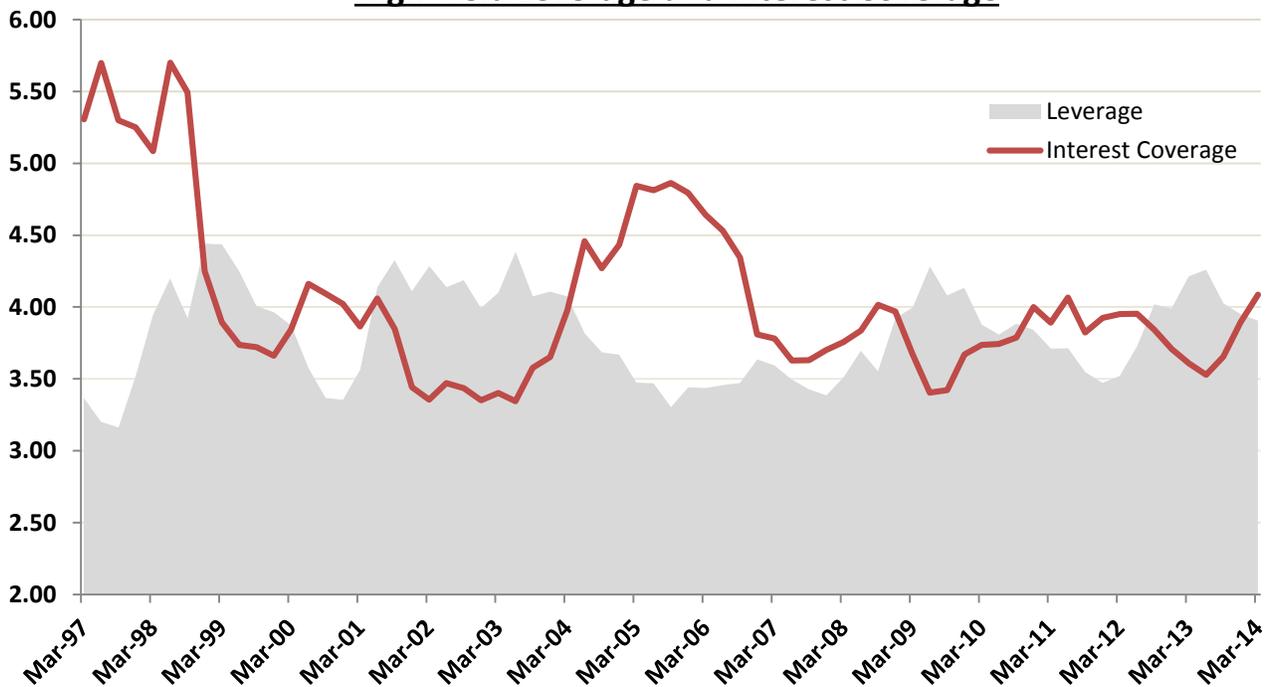


The low level of yields today and the abundance of credit creates the potential for excessive leverage. **Leverage** is capital that is borrowed to make an investment with the expectation that the profits made on the investment will be greater than the interest payable.

However, when corporations and investors use the availability of credit too aggressively and increase leverage the outcome can lead to at the very least unfavorable credit metrics and inevitably an uptick in bankruptcies.

While high yield credit metrics may suggest you shouldn't head for the hills, we are concerned about an important component used in calculating both leverage and interest coverage. **Cash flow** margins over the last two years have been higher than those over the previous fifteen. This abets lower leverage ratios and higher interest coverage ratios. While positive for high yield companies today, a drop in cash flow margins and / or an increase in interest rates will drive risk premiums (spreads) significantly higher.

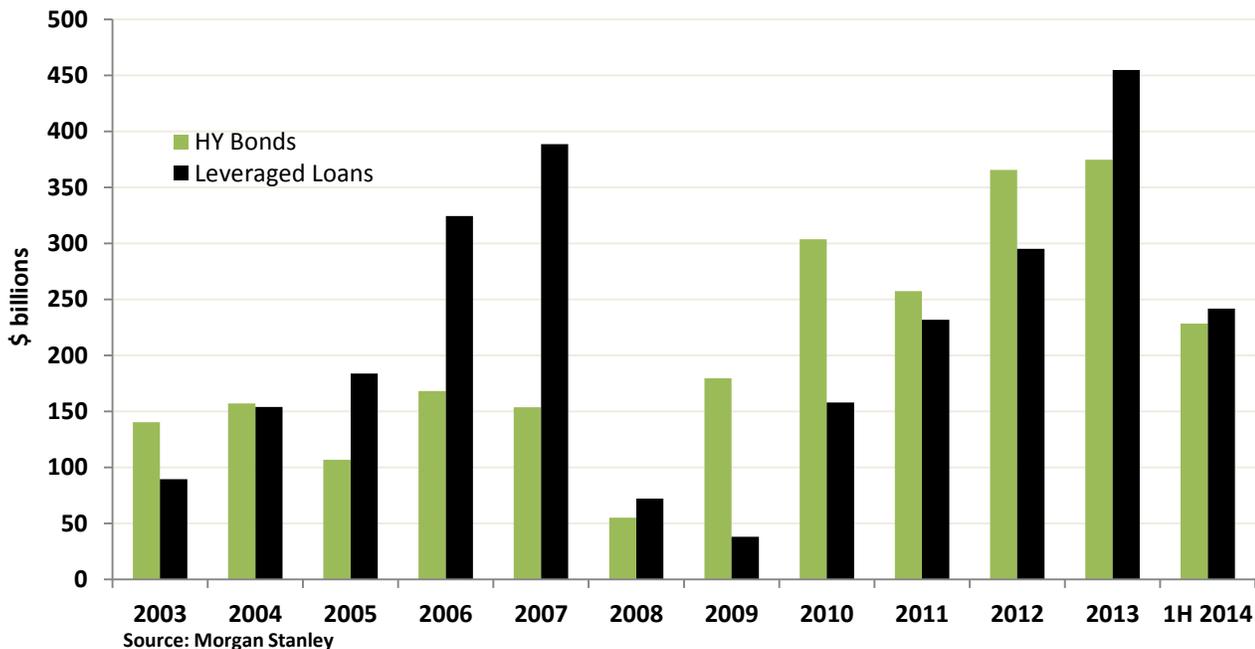
High Yield Leverage and Interest Coverage



Source: Morgan Stanley

In the meantime, however, low interest rate volatility and, at the very least, sanguine equity markets will continue to drive robust corporate bond demand. As can be seen in the graph below, high yield bond issuance has been growing ever higher over the last several years. And if the first half of 2014 is any indication, loan and bond issuance by high yield companies will be second to none in 2014. Furthermore, according to Barclays, 25 percent of June high yield bond new issuance was upsized and over 85 percent priced at or through the original price talk (coupon).

High Yield Loan and Bond New Issuance



What will be the catalyst to crack this over valuation? ... An interest rate rise and /or equity market pull-back are obvious threats but you can now add geo-political risk to the equation. What is clear, however, is that it won't take much given that the high yield market hit its all-time low yield of 4.85 percent in June.

To avoid the obvious longer duration, tight credit spread, index like risks, we are focused on finding opportunities like Gentiva Health Services' 11.5 percent bonds due September 2018. Gentiva operates in the very fragmented home health, hospice, and community care services sector in the United States. We first discovered Gentiva, in September 2013, when it was raising money in the loan market to fund an acquisition. While we did not buy the loan, we continued to follow the company.

The industry was facing revenue headwinds due to Medicare reimbursement rate cuts and regulatory uncertainty regarding the validity of physician referrals. However, we see the importance of home health and hospice services to the US health care system, due to their cost savings compared to the in-patient fees of the hospital alternative.



Then this past May, Kindred Healthcare made a hostile bid for Gentiva. This was the catalyst that attracted us to the Gentiva bonds. Kindred's \$533mn bid for Gentiva's equity was a supportive statement about the valuation of Gentiva's business, and it increased our confidence that Gentiva could refinance its 11.5 percent bonds in the near-term.

The yield for three months to the September call date was 4 percent, but there is upside for our investment if an acquisition process postpones the refinancing. The longer the bond stays outstanding, the higher our return. Recently, Gentiva received a higher bid from another party which Kindred said they are willing to match. As Gentiva sorts through this auction process, it is possible the 11.5 percent bonds will stay outstanding into early 2015, which would earn the fund an 8 to 9 return over 6 to 9 months.

Best Regards,

Matt Shandro
President, Fulcra Asset Management Inc.