



April 28th, 2017

Fulcra Credit Opportunities Fund

Q1 2017 Commentary

Just when you thought quarterly investment fund commentary season was over, Fulcra decides to issue its first of 2017. Maybe our tardiness can be attributed to the exciting first round of the NHL playoffs (Go Oilers Go), or the desire to reduce the time a competitor can copycat our investments. Either way, we think it has some meat on the bones, so please enjoy (or at least try) and, as always, please send us any questions and comments.

As communication is the hallmark of any strong relationship (i.e. marriage), we thought it would be useful to use this first quarterly commentary as an opportunity to both refresh and introduce investors to the investment process at Fulcra.

When looking at potential investment candidates for the Fund, we first analyze the investment risks and merits of owning the debt (bonds/loans) of a company. If we like the company and find that the senior bond offers an attractive enough return, without the resident interest rate risk inflicted by many an “index”/ long duration bond, then we will target it for purchase. However, in cases where there isn’t a fixed income investment that, in our opinion, provides enough return potential and/ or protection against rising interest rates, we may consider securities lower in the capital structure.

Due to our credit focused ways, we are most concerned about the return of capital as opposed to the return on capital. As a result, we often find ourselves retreating from dropping too low in the capital structure (i.e. stock) as it pulls us away from this capital preservation focus.

When we do find an opportunity to invest in an “equity” like security, it is because we view it as a very low priced option on the fundamentals of the business improving and/ or the market subscribing a low enterprise valuation on the company. In our experience, this “discount” can arise more frequently and with greater tenor with small to medium-sized enterprises.

Due to the higher frequency of “cheaper” securities existing amongst small and medium-sized businesses, Fulcra is keenly dedicated to hunting for companies in this size range. While the definition may vary amongst market prognosticators we think of small to medium-sized companies as having



enterprise values between \$200 million and up to \$10 billion. Our sweet spot is certainly in the bottom 1/3 of this range.

While focusing on smaller companies provides differentiation and the potential for discounted valuations, we also look for potential catalysts that will - in the case of bonds - ensure that our capital is returned at or prior to maturity, and together with stocks will surface the valuation discrepancy that can exist. This combination of cheap valuation and catalyst creates a margin of safety which we believe is critical to preserving capital.

Convertible bonds (busted) - Temple Hotel converts

We met the founder/ CEO of Temple 3 years ago. While the company has some interesting assets, the convertible bonds weren't particularly attractive at the time and the Founder was too "promotional" for our liking. Fast forward a few quarters later, the company eliminates its dividend, the stock and convertible bonds drop in price, and Morguard Corp advantageously buys stock. We took these credit friendly signals as an opportunity to do more work, concluding that the convertible bonds represented very good value. We still own the bonds today as they are short in maturity, have a very attractive cash yield and don't require a High Interest Savings Account to fund (... an attempt of levity).

Deep value credits - CNG Holdings bonds

CNG is a private consumer finance company that operates in the US. They started as a payday lender but have migrated their business over the last several years to more of an installment based model, which has allowed them to attract a higher quality customer base. CNG also owns a point of purchase financing business- the clients of which are some of the largest big box retailers in the US. While retail stores are generally seeing same store sales declines, businesses like CNG's are all the more important. We believe this business represents that "catalyst" to satisfy the take out of the bonds we own. In addition, the core business generates a substantial amount free cash flow while the bonds trade at 1 times the total loan receivable value.

Credit Ratings arbitrage – Navistar bonds

In the fall of 2016, VW announced that they were acquiring a 17% stake in Navistar for approximately \$260 million. VW and Navistar are rated A3/ BBB+ and Caa1/ CCC+ respectively by Moody's and Standard & Poors. While we did not own the Navistar bonds before the VW announcement, we had



been following the company, and shortly after this announcement bought the Navistar bonds after determining there was negligible deal risk.

While you may think this is a precursor to a VW take out... you are absolutely right! Over the past few years, VW has acquired the commercial truck businesses of Scania and MAN. However, before taking full control, VW bought a minority stake in each first. Our view is that VW will eventually acquire Navistar outright. If this happens before the bonds mature in November 2021, VW will have to bid us \$101 as per the change of control provision. If they don't, we continue to clip our 8.1 % current yield.

At Fulcra, we pride ourselves on providing a fundamental bottoms up and contrarian approach to investing. The fund's mandate is absolute return focused, not benchmarked against any fixed income index, employs NO leverage, and possesses a flexible distribution policy by only paying out what it earns from investments.

Best regards,

Fulcra Asset Management Inc.

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