

January 18, 2012

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# Palos Weekly Commentary

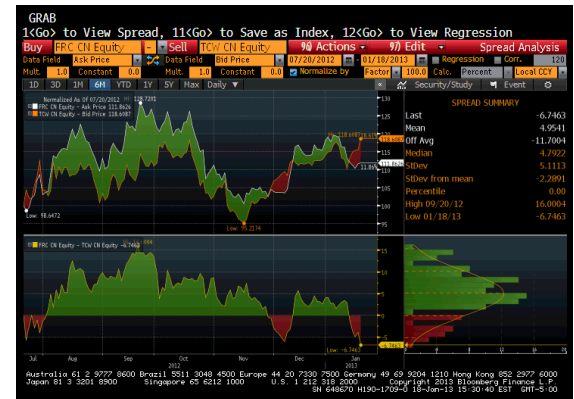
## Palos Income Fund

By Charles Marleau

### Pair Trade in the Pressure Pumpers

Pressure pumpers are companies that offer fracturing and chemical stimulation services to enhance oil and natural gas production. There are three Canadian publicly listed companies that provide these services: Trican Well Services (TSX: TCW), Canyon Services (TSX: FRC), and Calfrac Well Services (TSX: CFW). The three companies usually trade in tandem. However, a trading opportunity has occurred among two of them: long FRC versus short TCW. There are two reasons why Palos thinks this trade is very compelling:

1) The trade looks very good statistically and on the historical spread:



2) The fundamentals also look very compelling:

- TCW trades at 9.6x 2013 EV/EBITDA, FRC trades at 7.0x 2013 EV/EBITDA,
- TCW trades at 2.4x 2013 Debt/EBITDA, FRC trades at 0.0x 2013 Debt/EBITDA, and
- TCW trades at 44.6x 2013 P/E, FRC trades at 16.5x 2013 P/E.

Chart 1: Palos Domestic Funds\*

	FundServ	NAVPS	5D Returns	YTD Returns
Palos Income Fund L.P.	PAL 100	CA \$8.98	0.89%	2.47%
Palos Equity Income Fund - RRSP	PAL 101	CA \$6.94	0.74%	1.77%
Palos Merchant Bank L.P. (Dec 31, 2012)	PAL 500	CA \$8.18	---	---
Palos Majestic Commodity Fund L.P. (Jan 17, 2013)	PAL 600	CA \$10.69	0.65%	0.68%

Chart 2: Market Data\*

	Value	5D Returns	YTD Returns
S&P TSX Total Return Index	36,568.35	1.01%	2.44%
S&P 500 Total Return Index	2,611.55	0.96%	4.28%
S&P TSX Venture Index	1,235.32	-0.39%	1.17%
MSCI All Countries World TR Index (CAD)	3,472.86	0.95%	4.30%
US Government 10-Year	1.84%	-0.03%	0.08%
Canadian Government 10-Year	1.92%	-0.02%	0.12%
Crude Oil Spot	US \$95.56	\$2.00	\$3.74
Gold Spot	US \$1,687.00	\$26.40	\$11.20
US Gov't 10-Year/Moody BAA Corp. Spread	191 bps	1 bps	0 bps
USD/CAD Exchange Rate Spot	US \$1.0084	-\$0.0071	\$0.0032

\* Period ending Jan 18, 2013

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Furthermore, TCW has more exposure to the slowdown in drilling activity in Canada. We are expecting TCW's fourth quarter revenue to decline the most among the three. After analyzing the stats and the fundamentals of both companies, Palos believes that this trade is compelling on a risk/reward basis.

## ■ Palos Merchant Fund

*By George Kaneb, Cameron McDonald*

IOU Financial Inc.\* (IOU) continues to build momentum as an online lender, having now surpassed \$70 Million in loan applications and having funded \$14.5 Million in loans.

Below is a message from the CEO of IOU and a link to his interview on PBS Television:

"I am pleased to report that IOU had a busy past couple of months. Following are several highlights:

- On December 28, 2012 we press released that we had closed on the first leg of our previously announced \$5.0 million private placement for total gross proceeds of \$3.1 million.
- On January 17, 2013 we press released that since the launch of our site through December 31, 2012, IOU surpassed US\$70.0 million in loan demand (loan applications) and had funded (originated) US\$14.5 million in loans.
- Late last year, we were mentioned in a "USA Today" article about the rising alternative lending space and I did an interview on "PBS Television".

Please find below a link to the "PBS Television" interview I did with Robert Scully on the "Scully: The World Show". The "PBS Television" interview explains how IOU is harnessing the power of the internet to provide small businesses access to capital. I hope you enjoy it.

Here is the link to the "PBS Television" interview:

[http://www.youtube.com/watch?feature=player\\_embedded&v=SLART7Y0-kk](http://www.youtube.com/watch?feature=player_embedded&v=SLART7Y0-kk)

Regards,

Phil Marleau  
 IOU Financial Inc.  
 Chief Executive Officer"

\*The fund and principals of Palos have significant ownership positions in IOU Financial Inc.

## ■ Risks, Hedges and Opportunities

*By Adam Smalley*

### Ice Cream

Wells Enterprises, Inc. sold \$235 mm in 6.75% senior secured notes (B2/B+) due 2020 this week. The book was rumored to be 5x oversubscribed but Palos was able to get a meaningful allocation. The portfolio managers at Palos like this company and this bond.

Wells is the third-largest ice cream manufacturer in the US with sales and EBITDA of \$975 mm and \$106 mm, respectively. The Company sells branded products (Blue Bunny), licensed brands (Weight Watchers, Yoplait, Cadbury), and private label.

While the use of proceeds in the transaction, a dividend to owners, was a bit distasteful from a credit perspective, the pro forma capitalization and credit profile are impressive. Pro forma for the deal, the company will have total debt of \$255 mm versus EBITDA of \$106 mm, resulting a leverage ratio of 2.4x. Although Wells' stock is not publicly traded, it is family-owned, food companies generally trade at 6-8x EBITDA, providing significant equity cushion to the debt. Moreover, the bond compares well to the Shearers Foods bond that the fund bought in October 2012 and still owns.

Shearer, a manufacturer of salty snacks, issued bonds in connection with its LBO at around 6x leverage. Those bonds came at 9% and today trade at a dollar price of 107 (7.4% yield). To us, the Wells bonds looked cheap at 6.75% due to significantly lower leverage and higher ratings than Shearer (B3/B).

The Wells bonds ended the week 103.75 bid to yield 6.0%. We think there is a little more room for the bond to run until it achieves fair value.

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## ■ What is New on the Macro Level?

By Hubert Marleau

### The Point of Inflection

Last week, I argued that the Federal Reserve gave itself an escape clause to change monetary policy. The Fed knows that it can't grow its balance sheet forever without incurring longer term negative consequences. There are many examples that show that unprepared investors can end-up with an injured portfolio if they are not prepared for the approaching point of inflection. Dennis Lockhart, president of the Federal Reserve Bank of Atlanta, gave us a warning on Wednesday. Palos is closely monitoring the composition of the Misery Index which is the sum of the unemployment and inflation rates. Currently, the Index stands at 9.5 (1.7% for inflation and 7.8% for unemployment). Put simply, inflation represents 18% of the index. In our judgment anything over 25% for inflation could trigger the anticipated point of inflection for monetary policy.

*If you have any questions about the weekly commentary, the securities that we follow, or investment ideas, please contact us at [info@palosmanagement.com](mailto:info@palosmanagement.com)*

**Chart 3: Palos International Fund\*\***

	Last	5D Returns	YTD Returns
Palos International Equity Income Fund PLC - CAD	CA \$5.21	0.54%	1.04%
Palos International Equity Income Fund PLC - EUR	EUR 6.97	-1.23%	1.02%
Palos International Equity Income Fund PLC - USD	US \$6.77	0.90%	2.28%
S&P TSX Composite Total Return Index - CAD	36,321.56	1.13%	1.75%
S&P TSX Composite Total Return Index - USD	36,904.65	1.41%	2.86%

\*\* Period ending Jan 15, 2013