Q3 2017 Partnership Letter

Dear Partners,

It's been fascinating to watch the disruption that has been occurring in the retail environment over the past few years. Interestingly, the sea change that's been taking place seems to have only come to the forefront of investors' minds this year.

On one hand, retail spending in the United States has been growing at a solid clip, 4.4% in the past quarter. This is identical to the average annual retail spending increase of 4.4% since 1993[1]. However, online retailing, a relatively recent phenomenon (considering the Internet has only been operating commercially for a few decades) has grown at an incredible pace. Recently, the U.S. Census Bureau cited online retail growth at an impressive 16.2%. Since overall spending growth has remained constant, this online retailer success is clearly coming at the expense of some brick-and-mortar retailers.

According to a recent retail bankruptcy study, 19 retailers with over $50 million in liabilities have filed for bankruptcy so far in 2017, versus 20 that filed in all of 2008 – the height of bankruptcies during the financial crisis[2]. We find this to be odd considering the relative health of the economy and consumers today. Investors have certainly taken note, sending retail stocks down 8.0% in the U.S. since the beginning of the year, underperforming the broader market indices by a wide margin[3]. Which leads us to ask ourselves: if the broad retail environment is so healthy, why are so many retailers failing, and why is everyone so adverse to investing in the space?

Today, online retailing makes up just 8.9% of total retail spending in the U.S. – a small but growing figure[1]. Who loses market share to online retailing is at the heart of the question as to whether an investment opportunity exists – and the answer is quite complicated. For instance, we suspect department stores are increasingly likely to go the way of the dodo bird. These brick-and-mortar retailers are nothing more than walk-in fulfillment centres, and differentiation between them is hazy at best. On the flip side, retailers that are selling their own products or where customer service is crucial to the purchase will have a far better chance of succeeding. We also get the distinct impression that retailers whose customers visit them frequently and spend small amounts at a time, or those selling goods that are generally difficult to purchase online, are also better positioned in this new environment.

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[1] US Census Bureau
[2] Alix Partners Retail Bankruptcy Study (Oct. 2017)
[3] Returns according to the SPDR S&P Retail ETF

More generally, we're skeptical of the market's overriding sentiment that existing retailers cannot adopt to a changing environment by offering an online experience. As we dive deeper into the industry, we're finding many conventional retailers with a significant online presence. They also have well-formed plans to invest more into their direct-to-consumer initiatives. We're even seeing some of them shift from playing defense to playing offence against the 800lb Amazonian gorilla in the room.

Lately, we've focused more of our time on identifying retailers that are suffering from the perception of being an obsolete business model, when their future actually looks bright. This has taken us into various forms of the automotive market, and discount retailers of all types. Since we engage our research process with an open mind, what new investments may ultimately come of our industry examination is unknown at this early juncture. However, we're intrigued by the many great businesses we've explored to date.

<u>Performance Before and After the Bell</u>

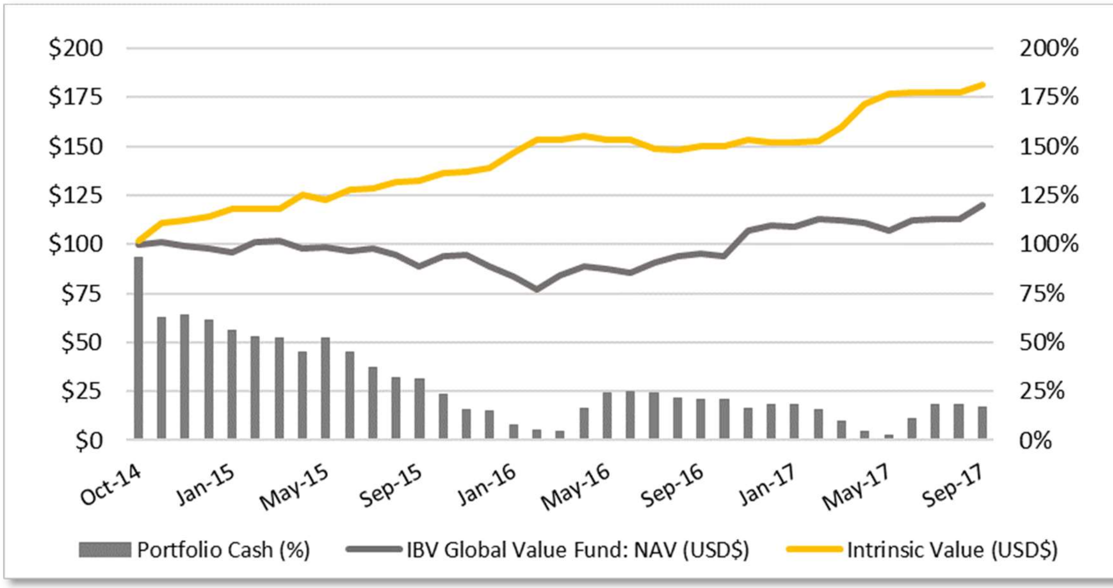
The market value of our IBV Capital Global Value Fund increased by 6.6% in the third quarter of 2017. Importantly, the intrinsic value of our portfolio advanced 2.5% during the quarter. For comparative purposes, during the third quarter of 2017, the MSCI World Index increased by 4.8%.

We did not add a new investment name during the quarter. This isn't uncommon for us, especially when market valuation levels are elevated, in a reasonably good economic environment, and with interest rates likely to rise in most developed economies around the world. This is not to say we're *not* doing lots of work to find pockets of value. We have quite a few interesting ideas in the hopper.

During the quarter, our investments in Bank of America and Citigroup experienced meaningful gains, bringing them closer to their intrinsic value. If you recall, we invested in these two great companies during the market turmoil when Greece was leaving the Eurozone for the third time, and again at the start of 2016 when oil prices were in freefall and China's economy was stalling.

We also received very good news during the quarter from Trinity Industries, our largest investment. In particular, minutes after the closing bell on the last trading day of the quarter, it was announced that a $663 million whistleblower lawsuit against the company, the largest award in the United States False Claims Act's 153-year-old history, was overturned. This had an immediate material impact on the underlying fundamentals of the company, unlocking much of their cash to be allocated to value-enhancing initiatives. Accordingly, we immediately revised our intrinsic value upward. Since this news came after the quarter's trading had officially ended, it did not impact our third-quarter returns – just our portfolio's intrinsic value. Instead, the share price increased meaningfully on the first trading day of October, so the actual benefit of the news will be accrued to our investors in our fourth-quarter returns.

For those of you who have been following us since our inception, a pattern of idiosyncratic returns should be evident by now. Many of our investments have catalysts that we have identified but are not yet apparent to the markets. Unfortunately, the timing of when these catalysts are realized can't always be determined. However, when the unveiling does occur, we get to experience moments of abrupt positive returns that are uncorrelated with the market. The nature of how these returns are earned emphasises the importance of our intrinsic value gap. For instance, due to the portfolio changes we share in this letter, the gap between the intrinsic value of our portfolio – what we think our portfolio is worth – and the market value of our portfolio, now stands at 51.4%.



In addition to the meaningful increase in market value, we experienced a shift in our portfolio over the course of the quarter into cash. Today, our cash position stands at 17.0%. This is due in part to selling our stake in Scripps Networks Interactive. In the past, our elevated cash position has protected us against market turmoil and provided us with ample investment resources for when that turmoil arises – so we're quite pleased with where it stands today.

<u>Lone Star State Lawsuits and Foodie Television Buyouts</u>

If we were to ask you which U.S. city plays the most outsized role in global commerce, which one would you choose? Would it be New York, Chicago, or maybe even San Francisco? They're all good choices. However, what if we told you that Marshall, Texas, with a sleepy population of 24,000, is one of the most important cities in America – and possibly the world – for shaping the direction of global commerce?

Marshall's claim to fame is its recently restored 117-year-old courthouse. Within the walls of this monument to law, nearly 30% of all patent cases in the U.S. are heard and judged on each year. Why? In short, because of their reputation for having a "rocket docket."

Decades ago, a local judge constructed a framework for legal proceedings that limited the number of pages lawyers could submit in court filings, thereby favoring speedy court resolutions. In the 1990s, Texas Instruments, now a large technology conglomerate, realized it could have its patent cases heard and decided on quickly – just two and a half hours from its head office in Dallas. So, they began filing their case load there. Other companies quickly followed suit, and by the 2000s the word was out – and Marshall became a hotbed of litigation activity. Today, the citizens of Marshall, of whom only 20% have a university degree, are responsible for presiding over some of the world's largest and most complex corporate lawsuit cases.

As it happens, the little town of Marshall has had an enormous impact on our largest holding, Trinity Industries. In 2012, Joshua Harman brought forward a large whistleblower case against Trinity Industries in Marshall. Mr. Harman claimed that the highway guardrails that Trinity manufactures were malfunctioning and injuring people instead of saving them. We studied this case before we made our investment, and have watched closely as the legal proceedings have unfolded. While the case would experience many twists and turns, one thing remained constant: an appreciation for the unpredictable nature of this legal jurisdiction, and our deep skepticism on the merits of the lawsuit.

Mr. Harman's history with Trinity will help you understand why we've been so skeptical of the case. Mr. Harman was a former Trinity employee. After he left the company, he started his own firm, where he bought and installed Trinity guardrails. Then, he stole Trinity's guardrail designs to manufacture his own, and was sued by Trinity for patent infringement. He lost the lawsuit, and soon after filed for bankruptcy. By all accounts, and certainly from our vantage point, the whistleblower case against Trinity was simply Mr. Harman's chance to get back at Trinity for bankrupting his company.

In a courtroom drama reminiscent of a Law & Order episode, it came to light that Mr. Harman was in the process of raising money to refinance his old guardrail business. However, this time, as his investor pitch deck showed, he would be far more successful because he would benefit from having to replace all of Trinity's "defective" guardrails, once he won his lawsuit against them. His company would also be better financed because he could use his whistleblower reward (all $199 million of it) to capitalize his company.

Regardless of Mr. Harman's obvious conflict of interest, the case would proceed and Mr. Harman would pull out all the stops to try to win it. First, he sought to strengthen his case by asking the Federal government's whistleblower prosecutors to join him in his lawsuit against Trinity – they declined because they didn't feel he had a case. So, he proceeded without them – effectively suing Trinity on behalf of the U.S. government without having the U.S. government's support.

Given Marshall's long-standing reputation for irrational and lopsided verdicts, it should have been no surprise that the jury didn't see the case through the same lens as these Federal prosecutors. Instead, they sided with Mr. Harman, dismissing the fact that the Federal Highway Administration (FHWA) persistently stated that the guardrails worked as intended – meaning most States were still able and willing to purchase them with Federal infrastructure dollars.

We suspect this verdict could have been avoided entirely if the jury waited until federally regulated crash tests were conducted on the guard rails, to determine if the new modified guard rails were within safety and performance standards set out by the FHWA. When the crash test was finally conducted, *after* the verdict had already been handed down, it showed that the guardrails passed all criteria, and were deemed safe for installation. When the 5th Circuit of Appeals court in New Orleans overturned the lawsuit on Sept 29th, we were vindicated in our research that this case was rather frivolous, and represented a catalyst that wasn't being correctly viewed by investors. We're looking forward to Trinity using this newfound financial flexibility.

In other good news, during the quarter we sold our stake in Scripps Networks Interactive (SNI) – locking in a lucrative return. We purchased our shares of SNI during the fourth quarter of 2015, when investor sentiment in the sector was particularly dire. At the time, everyone was worried about the impact of cord-cutting and cord-shaving in the cable television industry.[4]

Cord-cutting and shaving was – and still is – a legitimate worry. With the advent of Netflix, Hulu, Pick and Pay TV, not to mention skinny bundles, a lot is changing in the industry, and at a rapid pace. In the case of SNI, we chose to proceed because our detailed analysis identified that their dominant networks – HGTV, Food Network and Travel Channel – were insulated from the effect of cord-cutting and shaving for several reasons. Most importantly, SNI counts affluent women between the ages of 25 and 54 as their core customer base. Interestingly, this demographic is least likely to "cut the cord" or pare down their cable package to save on their bill. They also represent the most attractive customers to advertisers. It became evident to us that this sticky and desirable customer base was translating into SNI networks being included in all Tier 1 skinny bundles, further protecting the company from reduced spending on cable packages by consumers.

For these reasons and others, we felt their affiliate fees – what cable providers pay them to broadcast their networks – were protected, and enjoyed considerable room for growth. Their advertising revenues were also healthy, and likely to remain that way because of their high ratings – something we anticipated continuing due to the growing trend towards sharing life experiences like food and travel. Combined, this was all-important for the stability and growth of their North American business.

Globally, their lifestyle format was also performing well. SNI was investing heavily to grow this business, which was acting as catalyst for revenue growth but a drag on current earnings. We liked the growth trajectory and thought this would eventually be highly beneficial to earnings. In the end, we were pleasantly surprised when SNI purchased TVN, Poland's premier commercial television network, accelerating their international expansion.

We compared the market's sentiment for SNI's potential growth against our own assessment of the growth opportunities the company was enjoying, and found comfort in its long-term trajectory. This comfort was furthered by the company's sound margins, strong balance sheet and good management team. SNI's long-time CEO, Kenneth Lowe, was a capable capital allocator and was aggressively repurchasing shares to improve shareholder returns. For all these fundamental reasons, we were comfortable making a reasonable-sized investment in SNI.

Our due diligence was rewarded in July when rumours swirled that Discovery Communications, a company partially controlled by famed media investor John Malone, was bidding for SNI. This wasn't the first time a potential tie-up was in the works between these two companies – a fact we considered before investing. However, with the recent bout of consolidation in the cable space, along with the expiry of the Edward W. Scripps Trust in 2012, the possibility the union would be consummated was vastly improved this time around. When Viacom, owner of Nickelodeon and Paramount Motion Pictures, joined the bidding process, SNI's stock price surged quickly to within our intrinsic value range.

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[4] Discussed at length in our Q1 2016 Partnership Letter

We maintained our discipline and immediately sold our entire stake for $86.20, realizing a 59% gain in 22 months. The suspense was lifted in August, when a deal was announced that Discovery Communications would buy SNI for $90 per share in a cash and stock offer. Indeed, we left some returns on the table; since we were pleased with the price and there was a risk a deal wouldn't be announced – a by-product of the ownership structure of the three parties involved – the risk/reward profile of the investment had changed dramatically, and we no longer saw the need to be involved. While we're a bit biased, we think John Malone, a CEO we greatly admire, purchased a wonderful company for a fair price, and we look forward to seeing how he uses the company to transform his media empire.

Sincerely,

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