May 6, 2015

Cable Car Capital LLC Q1 2015 Letter

Dear Friends,

The Cable Car Composite returned +12.0% net of fees during an eventful first quarter of 2015. In this letter I will mostly discuss what happened to a few large positions shown on the attribution table below.

Performance

Worldwide equity markets, as measured by the MSCI All Country World Index (ACWI), rose +2.3% during the period. The composite ended the quarter with approximately 9% fixed income exposure, 70% net equity exposure, and 115% gross equity exposure.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov*	Dec	Year
2013											+4.2	-0.3	**+3.8**
2014	-3.3	+3.9	+1.9	+1.6	+3.3	-0.5	-1.6	-0.5	-6.2	+4.7	-1.6	+5.8	**+7.2**
2015	-3.8	-0.9	+17.5										**+12.0**
Annualized since inception (*November 8, 2013)													**+17.2**

Fee-paying client returns ranged from +9.4% to +16.1% for the quarter. The variation was due primarily to differences in fee arrangements and the disproportionate impact of an option position on small accounts. Because the bulk of Cable Car's initial clients do not pay incentive fees, please note that the difference between gross and net returns during periods of significant outperformance may be larger in the future. Had all clients qualified for Cable Car's standard incentive-only fee model and been above their previous high watermarks, net returns in the quarter would have been about 9%.

Attribution

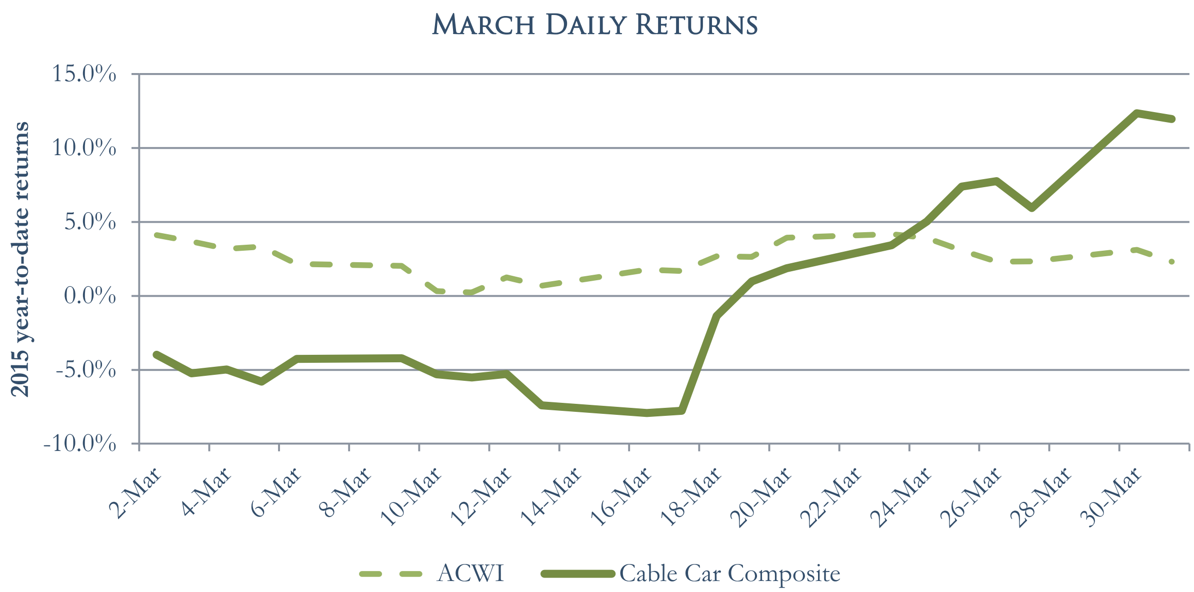
As of March 31, the five largest long positions, which together comprised 83% of net assets, were NetDragon Websoft (777 HK), Insignia Systems (ISIG), Retrophin (RTRX), Intercontinental Exchange (ICE), and ADT (ADT). The most significant performance impact by issuer for a representative account was as follows, with contribution to return in basis points (bps) computed on beginning-of-period assets:

Contributors		**Detractors**	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long RTRX	+1128	Long PANL	-549
Long 777 HK	+509	Long ISIG	-393
Long ADT	+136	Short Company B	-113
Short EXAS	+93	Short Company C	-41
Long ICE	+80	Short CVS*	-18

*Denotes closed position. Please see the last page of this letter for important disclosures.

Discussion

In almost every letter so far I've written about the impact of portfolio concentration on the volatility of returns. Volatility is something to embrace if the underlying security selection proves correct, but in the short term it can make quarterly updates feel premature at times. I thought I would take the unusual step of sharing the daily evolution of the composite in March to further emphasize this point:



As you can see, the content of this letter might have been very different if it had been written in mid-March. Dramatic outperformance from two significant long positions over the last few weeks outshone an otherwise mixed quarter. While results in March were spectacular, both the possibility of asymmetric returns and the magnitude of the preceding drawdown are to be expected from a concentrated approach.

The short book had a high 'hit rate' in the period, with positive contributions from ten short positions that were not individually large enough to disclose. Collectively, short selling contributed an aggregate of 240 bps to returns and 70% of short positions were profitable in the quarter. With the benefit of hindsight, several of these positions were covered prematurely or should have been sized more aggressively.

Cable Car sold its long-held position in Walgreens Boots Alliance (WBA) in February as shares traded above estimated fair value. Walgreens remains a fantastic business with strong management and generally appealing prospects, but the market price increasingly ignores potential reimbursement headwinds while taking uncertain margin expansion and speculative industry consolidation activity for granted. I hope to someday have another opportunity to own the franchise at a more appealing valuation.

Pangaea Logistics (PANL)

Rather than just take a victory lap on positions that have appreciated in recent weeks, I want to describe what went wrong and provide a detailed update on PANL, which has been Cable Car's worst performer since inception. PANL is a dry bulk shipping services provider with a current market cap of about $80 million. It is 90% insider-owned after coming public in October through an abortive reverse merger with Quartet (QTET), a special purpose acquisition company.

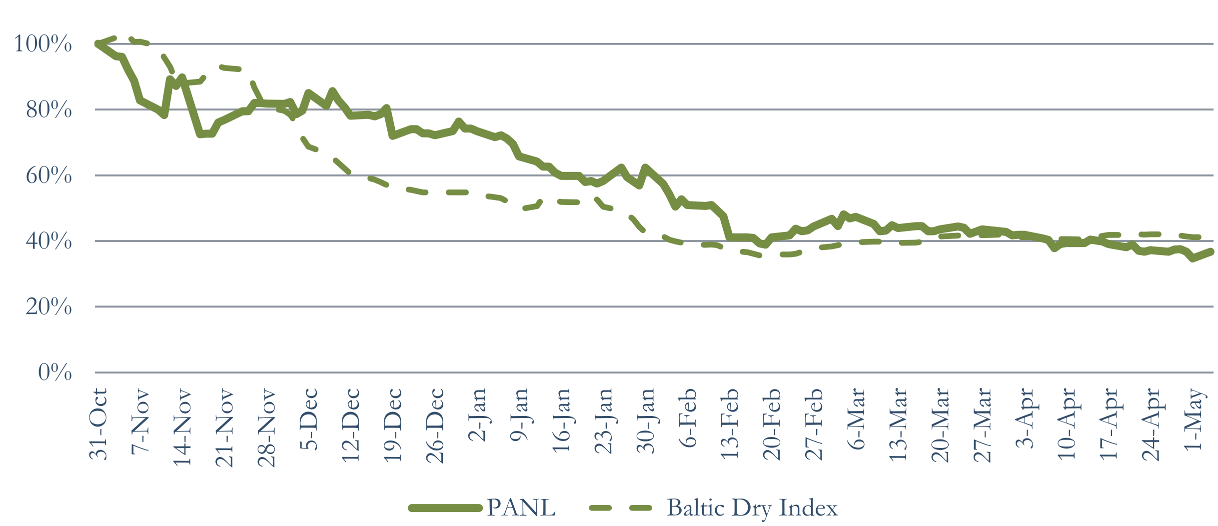
PANL declined 44% during the first quarter and as of this writing last traded 78% below the initial public valuation established last fall and 56% below the weighted average cost basis of the composite. While I am well aware of the potential for misaligned incentives at blank check companies and have even written about them on the blog, in this case I have spoken extensively with both the sponsors and management and believe they acted in good faith. The acquisition simply had unfortunate timing.

Due to weakness in the dry bulk shipping industry, illiquidity, and the complexity of its business, PANL is marked well below my downside estimate at the time of investment and what I believe would be a reasonable liquidation value for the business. It remains a meaningful, though smaller position. PANL now offers an opportunity to capitalize on having a longer time horizon than most market participants.

Cable Car first invested in PANL as part of a merger arbitrage with QTET. As mentioned last year, other than difficulties maintaining the short leg of the trade in a few accounts, the arbitrage was nicely profitable. When shares declined sharply after the transaction was consummated, I thought I saw an opportunity to own a well-managed underlying business with growth prospects and leadership in several niche shipping segments including ice-class trade through the Arctic Ocean, which the company pioneered. Many investors who tried to take advantage of the same arbitrage were unable to short QTET and sold at a loss after the transaction closed. I believed this selling pressure was not fundamental in nature and provided an attractive entry point.

That may have been the case, but unfortunately the industry's fundamentals deteriorated dramatically thereafter. The Baltic Dry Index (BDI), a benchmark of spot day rates for cargo vessels, has declined about 60% over the past six months to multi-decade lows. Due to the duration mismatch between near-term demand fluctuations and the several years required to order, build, and deliver new supply, the BDI is notoriously volatile. With recent price declines in several major bulk commodities and concern over decelerating demand growth in China, new vessel deliveries scheduled in more optimistic times have outpaced trade growth. The dry bulk industry is currently in a state of moderate oversupply that appears unlikely to ameliorate in the near future. PANL has declined virtually in lockstep with the BDI:

Trailing 6 Month Indexed Price Performance



In my opinion, this reflects complete misunderstanding of Pangaea's business and should not have happened. Pangaea was and is appealing in large part because its business has limited exposure to fluctuations in day rates. Approximately two-thirds of Pangaea's fleet at any given time is chartered in on a very short-term basis to respond to the specific needs of its customers, who are major commodity producers. This is a spread business that in principle should be profitable in any rate environment. Pangaea is not taking on rate risk directly, although the business suffers when overall industry activity is low, since there are fewer cargo opportunities available.

Pangaea also owns a fleet of 14 vessels, which may be the source of most market confusion. Owning a ship is analogous to a long position on spot day rates. If rates decrease, the value of the vessel decreases and vice versa. Whereas most ship owners start with a vessel and then try to obtain the highest available rate, Pangaea does not purchase ships speculatively. The company only purchases vessels after securing long-term contracts. One-third of Pangaea's revenues are generated from multi-year contracts of affreightment (COA), fixed-price agreements with commodity producers to carry a certain amount of cargo. A COA is thus analogous to a short position on day rates. If rates fall, the COA becomes more valuable as it provides the ability to earn more per day than a ship could obtain in the spot market. If rates rise, the COA is a liability because it obligates the vessel owner to earn less than spot rates. Vessel ownership and COAs are thus natural hedges, and Pangaea's owned fleet is fully hedged.

Unfortunately, only the vessels are recorded on a company's balance sheet, not the COAs. Pangaea's already very-complicated balance sheet does not reflect the true economic reality of its exposure. This is similar to how boxed short* positions on a Form 13F are sometimes misinterpreted as a hedge fund being long a declining business. Only the long side of the trade is disclosed! Importantly, while market prices for vessels have declined, every ship in Pangaea's fleet has a market value in excess of its debt burden, and the COAs provide sufficient cashflow to cover required fixed charges.

As a matter of philosophy, I prefer to avoid investments that are dependent on the performance of an underlying commodity whose price is difficult to forecast. For example, Cable Car currently has no direct exposure to oil prices, long or short. However, where a company has underappreciated hedges in place or has been mistakenly lumped in with the rest of a volatile industry, opportunities may arise.

PANL trades at less than 3x management's 2015 earnings forecast at the time of the transaction, and they have won new business since. While the slowdown in chartering activity means the forecast will not be achieved, that earnings power remains intact once activity – not necessarily the BDI – recovers. I could go on at length detailing why I believe Pangaea is unlike the rest of the shipping industry. My diligence suggests Pangaea's corporate governance is superior to industry norms and that its long-term producer and banking relationships will help it weather the current downturn. I think it likely that the market will continue to misprice PANL so as long as investors remain wary of the shipping industry. However, I believe the operating performance of the fleet will demonstrate the true value of the business over time.

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* A "short sale against the box" is a tax deferral technique in which a manager holds offsetting long and short positions in the same security. Instead of netting the position, each leg is considered a separate investment. As long as the box is "opened" (i.e. by closing one leg and taking on market risk) for 60 days during each year, a manager can delay recognizing large taxable gains on an appreciated position. Cable Car does not currently box positions, as it requires opening a duplicate account for each client and makes end-of-year tax reporting considerably more complicated. This is an obscure example of a way in which a pooled vehicle can be more tax efficient than separate accounts.

Retrophin (RTRX)

The performance of PANL was more than offset by positive developments at RTRX during the quarter, and I similarly want to explain what happened in some detail. It was a rare example of an investment thesis playing out almost exactly as hoped, and I believe the company remains underappreciated by the market.

With valuations in the biotech sector getting frothy, fellow value investors might be surprised to learn that one of Cable Car's largest long positions is a controversial pharmaceutical company focused on developing and commercializing therapies for rare diseases. Unlike biotech specialists gambling on the odds of drug approval, I prefer to invest in biotech only when the potential value of the drug development pipeline is in my opinion not reflected in the share price. I believe there are occasional opportunities to purchase a portfolio of proven commercial assets at a discount to fair value, along with a free or very inexpensive call option on new approvals. That is how I viewed RTRX during periods of management change and business transition that provided an initial entry point last year, and it is still how I view the company today. I do not think Retrophin’s valuation reflects the current biotech euphoria.

I value RTRX solely on the basis of the recurring earnings from its existing commercial portfolio. RTRX revenues today are primarily generated through the sales of two commercial products, Thiola and Chenodal. Thiola is a medication for a condition that causes recurrent cystine kidney stones, and Chenodal is an off-label treatment for a rare bile acid disorder. My research effort has focused on understanding the two diseases and treatments, the therapeutic alternatives, and the potential markets. In brief, my research suggests that patients are reliant on Retrophin's products, medical opinion leaders value the treatments highly, and there are meaningful barriers to competition. Because Retrophin's drugs treat very rare diseases, insurers have consistently been willing to pay six-figure amounts per patient for an annual course of treatment, yielding very high gross margins. In addition, there is potential for RTRX to identify new patients and increase the penetration of both therapies among under-served populations. Combined, these factors contribute to substantial recurring gross profits with significant growth potential.

In January, RTRX scored a coup by purchasing the rights to cholic acid (Cholbam), a treatment for other bile acid disorders. Cholbam had not yet been approved by the FDA, and RTRX paid only $5 million upfront for an option to acquire the full rights for up to $73 million in the event of approval and subsequent milestones. On March 17, the FDA approved Cholbam with a very broad label allowing use in several pediatric bile acid conditions with a much larger addressable market than Chenodal. Unexpectedly, the approval also provided RTRX with a transferable Rare Pediatric Disease Priority Review Voucher. Prior sales of similar vouchers have exceeded the entire purchase price for Cholbam; in effect, Retrophin acquired a potentially very significant new source of revenue for free. The timing of the Cholbam approval was especially fortuitous, as Retrophin was marketing a secondary offering at the time. The offering was oversubscribed, priced about 40% higher than initial indications, and raised nearly $150 million.

I believe the value of the income stream from Thiola and Chenodal alone justified the market capitalization prior to these events. Remarkably, when I add similar calculations on the potential patient population and pricing of the Cholbam, I arrive at a very similar enterprise value to sales multiple as before. Even after accounting for dilution from the secondary, RTRX still appears inexpensive on the basis of likely product sales over the next few years. Excluding discretionary R&D investments, I think RTRX trades at an inexpensive multiple of operating earnings on an absolute basis.

Prior to the secondary, the biggest risk factor facing the company in my view was its balance sheet. RTRX took on a significant amount of high-interest rate debt to finance the purchase of Thiola and Chenodal, and it had limited covenant headroom. In establishing Cable Car's position in the company, my primary concern was that if for some reason my assessment of the products were wrong, the company lacked financial flexibility. In order to limit the risk of permanent capital loss in this downside case, I expressed the majority of Cable Car's notional position in RTRX through at-the-money call options. My reasoning was that a few quarters of product sales would either prove the investment thesis correct or result in a major liquidity shortfall at the company. Instead of purchasing a very large position outright, I sacrificed some of the potential upside and capped the downside risk to the premium paid. This enabled Cable Car to add aggressively without placing an undue amount of capital at risk.

Retrophin has now transitioned to a far less risky business with a net cash position and significant operational flexibility. With material upside potential from any positive developments in the pipeline, similar valuation, and dramatically reduced downside risk, it warrants a larger portfolio allocation than before.

NetDragon (777 HK)

Last but not least, several clients and friends have reached out to ask how I have reacted to the recent surge in 777 HK, which appears to have gotten caught up in a sudden wave of mainland Chinese interest in small-cap Hong Kong-listed stocks. Thank you for your kind comments. I wish I could say that the market has validated my investment thesis, but I think technical factors may be the primary reason for the price increase. The Shanghai Composite has doubled over the past twelve months and many mainland investors have sought out better opportunities to the south. Mainland Chinese mutual funds were allowed to invest in certain smaller Hong Kong issuers for the first time in March, and there is widespread speculation that the Shanghai-Hong Kong Stock Connect Program will be broadened to include smaller companies, including NetDragon, later this year.

At one point last month, NetDragon rose so far that it briefly breached the thirty percent maximum position size guideline I have established. While that standard is admittedly arbitrary, I thought it prudent to trim about one-third of the position to allow for the possibility that I may be able to repurchase shares again at a lower price in the future. Several members of the company's Board have done the same. In case the enthusiasm dies down as suddenly as it arose, I have also begun to establish a handful of very small (<1%) short positions in some of the more egregiously overvalued Hong Kong-listed stocks. I am short a property developer that quadrupled on acquisition rumors, above any sensible privatization price, a heavily promoted regenerative medicine company at 3x the price of its equity raise mere weeks ago, and a well-known solar company experiencing net outflows from the Stock Connect Program after negative reporting in the domestic press. While I have no wish to swim against a massive tide of speculative mainland sentiment, I think a basket approach and manageable position sizing will prove profitable over the long run.

I am still just as sanguine about NetDragon's long-term prospects as before. Calibur of Spirit, the company's new web-based League of Legends clone, has been performing well under its license to Tencent, and I estimate it could contribute over RMB 100 million in net revenue this year. It has been one of the top three games on the QQ platform continuously since January. NetDragon continues to make progress on its education venture, and I expect a broader launch late this year or in early 2016. While the undervaluation is now less dramatic, I believe the current price continues to completely ignore the value of the company's real estate, assign a low multiple to the growing game franchise, and underappreciate the potential of online education.

The first quarter's performance provided a nice shot in the arm. I am mindful of the fact that returns will likely continue to be lumpy, but I am confident in the portfolio's positioning and looking forward to business updates from the companies we own.

Cable Car recently passed a milestone, reaching $5 million in assets under management and over $3 million in the composite. The increase since this time last year has come primarily from performance, but I am slowly starting to market the business more actively. In June, I will attend my first capital introduction conference at the Context Summit in Dallas. If you've been reading these letters and would like to learn more about Cable Car or know of someone who might have interest in what I'm doing, I welcome opportunities to speak with capital allocators of all types. Please don't hesitate to reach out.

To all my clients and readers, thank you for your continued support.

Jacob Ma-Weaver, CFA

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The SEC requires that references to past specific recommendations, including attribution calculations, be based on a reference account and that at least ten holdings be disclosed. Cable Car's largest account serves as the reference account. Detailed computation methodology and a list of all holdings' contribution to the account's performance are available upon request. The holdings identified in this letter do not represent all securities purchased or sold for advisory clients, and past performance is no guarantee of future results.

Please note that Cable Car maintains a selective public disclosure policy regarding active short positions that may be competitively sensitive, difficult to borrow, or otherwise unlikely to benefit from broad publicity. Clients retain complete portfolio transparency, and Cable Car will disclose the subject securities to non-clients upon request.

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Cable Car implements its strategy in part through short sales and makes limited use of derivatives, primarily options contracts, and leverage. Gross exposure is generally limited to 200% and portfolios maintain a net long bias. Additional disclosures regarding the risks associated with the firm's investment approach are contained in the firm's brochure on Form ADV. The firm's list of composite descriptions and additional information regarding valuation policies, performance calculation, and performance presentation is available upon request.

The performance of individual client accounts can vary significantly from the performance of the composite. The timing of cash flows, the size and type of account, the account's base currency, the fee arrangement, and the feasibility and availability of investment opportunities for each account may lead to significant divergence from composite returns. While the composite is benchmarked against the ACWI in order to compare performance to broad market equity returns, client portfolios are not managed to any particular benchmark, and performance is likely to vary from the performance of any given index.