July 25, 2014

Cable Car Capital LLC Q2 2014 Letter

Dear Friends,

I am pleased to share Cable Car's second quarterly update. Q2 2014 marks the first full quarter of performance since the firm's initial client accounts were funded. I continue to onboard new clients regularly and welcome anyone with interest to contact me for further information.

Performance

The Cable Car Composite returned +4.5% net of fees for the quarter ended June 30. Worldwide equity markets, as measured by the MSCI All Country World Index (ACWI), rose +5.0% during the period. The Cable Car Composite has returned +7.0% year-to-date and +11.1% since inception on November 8, 2013. As a reminder, my goal remains to outperform the nominal cost of equity overall a full market cycle.

In other words, the business is off to a good start, although I caution readers not to read too much into a single period's returns. I expect future returns to be lumpy due to the level of concentration in the portfolio. With that said, performance for the second quarter was satisfactory, particularly given relatively low net and gross exposures. I continue to feel that a cautious stance is appropriate in the current market environment. In addition to helping protect capital, maintaining conservative exposure levels provides flexibility to participate in special situations. The composite ended the quarter with approximately 39% net exposure and 103% gross exposure, well below its 200% maximum leverage guideline.

	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							**+7.0**
Since inception (*November 8, 2013)													**+11.1**

ACWI is a trademark of MSCI, Inc. Client portfolios are not managed with reference to any particular benchmark, and performance is not comparable to and likely to diverge significantly from the performance of any given index. The above performance statistics are preliminary and unaudited. Returns are presented net of all expenses and fees, including accrued but unpaid performance fees. Approximately 7% of the composite's assets are non-fee-paying. The Cable Car Composite includes all accounts Cable Car manages on a fully discretionary basis, which represented approximately 62% of firm assets as of quarter-end. It is important to note that 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 fee arrangement, and the availability of investment opportunities for each account may lead to divergence from composite returns.

Portfolio discussion

As of June 30, the five largest long positions were mostly unchanged from the prior quarter, and consisted of Intercontinental Exchange, Inc. (ICE), Walgreen Company (WAG), Insignia Systems (ISIG), NetDragon Websoft (777 HK), and The ADT Corporation (ADT). During the second quarter, the top contributors to and detractors from performance for a representative account were as follows, with contribution to return in basis points (bps) computed on end-of-period assets:

Contributors		Detractors	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long INXBW/GLRIW	+347	Short GLRI	-208
Long WAG	+166	Short Company A	-97
Long ISIG	+105	Long ICE	-69
Long ADT	+68	Short STB	-53
Long GCVRZ	+63	Short EXAS	-46

Important information regarding past specific recommendations

I find it instructive to perform attribution analysis, and I consider it an important element of my fiduciary duty to examine the reasons for detraction from performance, even when it is not the easiest thing to write about. I hope it is interesting to you as well. Please be aware that because this letter is shared with non-clients, it may be considered an advertisement under Rule 206(4) of the Advisers Act. It is therefore subject to certain guidelines regarding references to past specific recommendations, including that 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, and I will gladly provide detailed computation methodology and a list of all holdings' contribution to the account's performance upon request. The holdings identified above do not represent all securities purchased or sold for advisory clients, and past performance is no guarantee of future results.

Contribution highlights:

- WAG rose 12.7% during the quarter including dividends, contributing +166 bps.
- Cable Car exited a long position in Infinity Cross Border Acquisition Corp warrants (INXBW), which converted into Glori Energy warrants (GLRIW) during the quarter. I described the situation in a series of blog posts. Net of a short hedge in the underlying, Glori Energy (GLRI), the warrant investment contributed +138 bps.
- The contingent value right created by Sanofi's acquisition of Genzyme (GCVRZ) rose 61% during the quarter on news that Sanofi had resubmitted its previously denied FDA application for approval of Lemtrada. GCVRZ is a small, more speculative position. According to my analysis, the CVR has the potential to achieve a $2.00 milestone payment from international sales even if Lemtrada is not approved in the United States. GCVRZ contributed +63 bps of mark-to-market performance.

Contribution lowlights:

- Cable Car's short position in Company A was adversely affected by the announcement of an acquisition proposal, detracting 97 bps. Cable Car remains short Company A on the basis that its core product faces ongoing regulatory risks and the proposed transaction may not be consummated.
- ICE declined during the quarter and subtracted 69 bps. Cable Car increased its long weighting in ICE modestly during the quarter.
- Cable Car's short position in Student Transportation Inc. (STB) cost 53 bps during the quarter including dividends. STB is an expensive short position to carry due to its 8% dividend yield; however, I believe it remains significantly overvalued.

In brief, the STB short thesis is predicated on my belief that the company has an unsustainable financial structure, with too much debt and operating costs rising faster than revenues. STB is by all accounts a competent school bus contractor, but it operates in a highly capital-intensive industry and does not generate positive free cash flow. The company nevertheless has attracted a yield-seeking shareholder base through an artificially high dividend funded by debt borrowings. I believe the share price would be significantly lower if not for the dividend. STB is likely to reach the limits of its borrowing capacity soon. I anticipate that it could violate debt covenants and/or be forced to reduce its dividend within 12-18 months.

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. Position descriptions in this and other communications from Cable Car represent my opinions and should not be considered statements of fact or investment advice, nor are they intended to be a complete assessment of the risk factors and potential considerations for any investment thesis.

While I do not find it constructive to write at length about every position, giving an idea more complete treatment in writing can be a helpful forcing mechanism to sharpen my reasoning. This year, FactSet and the buyside networking website SumZero are sponsoring an investment idea competition that motivated me to do a long report on NetDragon Websoft. The pitch was named one of the runners-up in the first round of the contest. In the future, I may use these letters to discuss current investments in more detail. However, rather than devote the remainder of this letter to NetDragon, I encourage you to download the full report from Cable Car's website.

Position analysis

On the subject of Chinese companies, I would like to share the outcome of an unsuccessful investment that highlights an element of my approach to short positions. Cable Car's largest short position at quarter-end was Yongye International, Inc. (YONG), a Chinese manufacturer of crop nutrients. I initiated the short position in YONG after the announcement of a revised going-private proposal, which ultimately closed on July 3. The reference account sustained a loss of 39 bps, including 18 bps during the second quarter.

While I was disappointed by the outcome of the YONG investment, the position had a compelling *ex ante* risk/reward, which justified a large allocation. In contrast to most short positions, which have theoretically unlimited loss potential, proposed acquisitions with small spreads sometimes represent attractive short candidates because the potential for loss is limited to the merger consideration or a superior proposal. Shorting takeover targets – essentially the inverse of a merger arbitrage strategy – is not a profitable approach in the aggregate; however, the market sometimes misprices the risk of individual transactions failing to close. In the case of YONG, the gross spread to the acquisition price was as low as $0.01 per share during the month of June. Even after the company reported difficulties with escrow logistics, raising speculation that the transaction might fail, the potential loss for a short position was only about 3%. Against this, prior trading history suggested YONG could fall at least 25-30% in the event the transaction were not completed. 10:1 or better potential return per unit of risk was and remains appealing.

Just as long exposures in the portfolio create optionality in the event of unexpected positive news, I find it valuable to maintain some negative optionality as well. There are many unforeseen circumstances that can derail an acquisition, including changes in market conditions and loss of financing, in addition to adverse changes at the company itself. Among US-listed Chinese companies, complications have been relatively common. A survey of proposed going-private transactions at US-listed Chinese companies by Houlihan Lokey last year counted 7 cancellations, 15% of the total, among 46 transactions in the preceding three years.

YONG was part of a wave of US-listed Chinese companies that originally came public through a reverse merger. Many reverse mergers did not undergo the same scrutiny as the IPO process, and there have been a number of accounting scandals and cases of fraud among them. Multiple short sellers raised fraud allegations against YONG that in my opinion were never fully refuted. Without dwelling on the details of the allegations and my subsequent research, I was unable to independently verify the company's purported sales figures and distribution network, and I could not reconcile the size of its reported shipment volumes of crop nutrient with my knowledge of the market. For example, the company's stated 2013 production tonnage was unreasonably high in relation to the product itself – YONG would have had to sell over 500 million bottles of liquid crop nutrient, far more than its small neighborhood retail outlets could possibly have handled. In addition, YONG's reported earnings and capital allocation decisions made little sense in the context of its capital structure and unusually high working capital balances.

In any case, I am not so naïve as to believe that overstated financial statements automatically disqualify a company from being acquired, especially in China. Nor is it reasonable to rely on the SEC to intervene, given its limited resources. Whatever the real economics of the business at YONG may be, they were attractive enough for the buyers, who had access to private information. There are numerous examples of US-listed Chinese companies with questionable SEC filings completing going-private transactions, several of which have been the subject of widespread debate among short sellers (e.g. FSIN, FMCN). However, other proposed buyouts have collapsed, such as AMBO. In general, I believe the odds of a transaction not being consummated are higher when financial statements may likely been misrepresented.

Going forward, Cable Car may invest in similar situations if the right combination of limited risk and high potential return presents itself. Not all proposed acquisitions are attractive. For example, I currently have no position in Montage Technology Group (MONT), although I am following closely. Some short sellers have alleged fraud at MONT, while others have claimed its unusually high profit margins are due to black market activity. Cynically, if the latter interpretation is correct, the transaction is still very likely to close. Given the relatively high 6% gross spread to the proposed buyout price, I am unlikely to short MONT unless the spread narrows substantially or I develop a significantly differentiated viewpoint.

My hope in discussing investment performance through these letters and on the blog is to encourage feedback and refine ideas. Please do not hesitate to contact me with comments or suggestions.

Business Updates

During the quarter, Cable Car launched a model portfolio on Covestor, an innovative online multi-manager platform. Pursuant to a non-exclusive licensing arrangement, Cable Car provides Covestor with trading data for its liquid US-listed equity positions, and Covestor replicates positions as part of a core-satellite approach for its investors. I am excited to join Covestor's platform, which I view as an appealing additional distribution option for retail investors who desire exposure to multiple active managers. More information about the relationship is available on Cable Car's website.

Cable Car also recently engaged a third-party verification firm. My goal is to present performance results that comply with the Global Investment Performance Standards (GIPS) by my next letter.

Last and least, I finally joined Twitter this month. So far, it has proven a useful tool for keeping up with the investment community. However, I clearly have some work to do when it comes to brevity.

Thank you for reading.

Jacob Ma-Weaver, CFA