July 15, 2015

Cable Car Capital LLC Q2 2015 Letter

Dear Friends,

I am pleased to report an extraordinary second quarter of 2015. The Cable Car Composite returned +22.7% net of fees, with significant contributions from both long and short positions.

With two higher-profile short positions in the news recently, I'll do things a little differently this quarter and start with a discussion of Cable Car's recent activism on the short side, followed by performance reporting and attribution.

Short Activism

As regular readers know, in May I published a twelve-part short thesis on Plus500 (PLUS LN), a UK-listed contract for difference broker. The impact was above and beyond my expectations; Cable Car may perhaps now be better known in the UK than in the US. Thanks to media coverage, shares were briefly halted after the initial report, and the analysis has been well-received within the investment community. I will provide an update on PLUS in a moment, but first I want to thank many of you for your words of encouragement. It has been a heady last few months, and I feel fortunate for the many productive conversations and new relationships that have arisen out of the publicity. While I still have some reservations about disclosing short positions, I appreciate the attention and opportunity it created to connect with all of you.

For those who are new to Cable Car, a few words about my philosophy on publicity may be in order. Although I use the word activism to describe some of my work, I hope to avoid the label of 'activist investor.' The bulk of Cable Car's investment activity is and will remain passive security selection based on potential return on capital and the belief that other market participants will eventually come to similar investment conclusions. That said, I have written before about the benefits of 'soft activism' – publishing a detailed, accurate, and original research report, long or short, can sometimes accelerate price discovery and improve an investment's internal rate of return. The Internet makes it easy to share opinions, and I intend to continue sharing mine when I believe I can help correct misinformation in the marketplace or persuade others of my point of view.

As a partial owner of a business, I believe it would be irresponsible not to communicate with management when opportunities for value creation become apparent. However, Cable Car is unlikely to follow the traditional model of activist investing and noisily agitate for change at its portfolio companies. I am more inclined to sell a mismanaged company short than buy shares hoping to effect change without a control position. For example, an activist recently published an angry letter to the Board of Directors of a company Cable Car is short; in the letter, they surprised me by publicly articulating several aspects of my own short thesis: management has materially misrepresented the liquidity position of the business, engaged in self-dealing, and entrenched itself through poor corporate governance.

On the short side, my approach to publishing research is nuanced. I am mindful of the fact that there is still a great deal of misunderstanding regarding the role of short sellers in the market. We are often unreasonably vilified. Short selling is not always a moral judgment, and Cable Car's short positions are not necessarily intended as indictments of companies and management teams. Theses based on fraud or malfeasance are the exception, not the rule. Cable Car's portfolio remains long-biased.

However, given the time required to publish a detailed report, it is personally far more satisfying to help expose wrongdoing or contribute to a public policy aim rather than just correct mispricing. I will not be shy about publishing research if I believe I can contribute meaningfully to the market's understanding of a business, but I will be considerably more likely to do so when there is an ethical dimension to the work.

Along these lines, I believe it is extremely important to maintain the highest standards when publishing research on either the long or the short side. That means fully disclosing my positioning and attendant bias, clearly distinguishing fact and opinion, and avoiding the kinds of exaggerations that have sometimes been associated with short sellers in the past. I think there is ample space for short-biased commentary that does not attempt to 'short and distort.'

Three different short positions illustrate my varying approach to advocacy as a short seller. Plus500 I have written about in detail due to the rationale just described. By contrast, another short position I have publicized is Exact Sciences (EXAS), where I have been much less critical of the overall business. I believe the basic goal of increasing colorectal cancer screening is laudable, but I think EXAS is overvalued, estimates are too optimistic, and the current reimbursement level for Cologuard is excessive. My efforts to persuade CMS to reconsider the payment level for Cologuard are based on objective research into the cost-effectiveness of different screening alternatives. Researching EXAS led me to the conclusion that Cologuard should have a lower reimbursement level, but absent the short position, I would hold the same opinion as a taxpayer. CMS is expected to reach a determination on the reconsideration request in October.

A third short position is "Company D," disclosed as a detractor in the attribution table later in this letter. Unlike PLUS and EXAS, I have chosen not to write extensively about Company D, although some readers may recognize it as a company I have been profitably short in the past. I have chosen not to publicize Company D in part because the position is relatively illiquid and difficult to borrow. Yet the main thing holding me back, however, is the desire not to have the strongest aspect of my argument be character assassination. I think the management of Company D may have engaged in misdeeds that I cannot prove, and I strongly suspect Company D's revenue has been inflated through channel stuffing. Unfortunately, I do not have sufficient evidence of sell-through to prove this suspicion right or wrong. What I have been able to independently verify are several red flags from a basic background check on a new board member whom many shareholders mistakenly believe will be a force for positive change at the company.

This individual misrepresented his undergraduate degree program in the company's proxy statement, which I have confirmed with the university's registrar; he was arrested on felony domestic violence charges in 2003; and he failed to properly report OTC transactions in the company's securities. The activist angle I have taken with respect to Company D is to apprise FINRA of the trade reporting omission through their whistleblower process. I think the new director is of a feather with the company's executive management and expect their character to continue to be reflected in the financial results.

Plus500 update

In what must win an award for awkward timing, I released parts 11 and 12 of the series on June 1, just hours before the company announced it had received a 400p takeover proposal from Playtech, a gambling technology firm. While Plus500's lack of substantive response to my analysis and the potential takeover are disappointing, the experience has been satisfying on the whole. While it was at one point a much greater contributor, Plus500 was still the best-performing short position during the quarter. If the acquisition is completed, it will mark the first time in my career a short position has been bought out below my cost basis.

In the absence of any response to the bulk of my assertions, I believe I am correct to assume that the company obtains a substantial proportion of its revenue from jurisdictions where it operates without a license. This appears to be confirmed by the level of continued revenue generation reported during last month's account freeze affecting the bulk of Plus500's European customers. It is therefore not a question of whether or not Plus500 has violated the law by, for example, accepting customers in Singapore, Hong Kong, and Taiwan, but a question of whether or not the local regulatory authorities will do anything about it. Shareholders agitating for a better offer, having already disregarded misstatements, incomplete disclosures, and evidence of illegal activity, must be deeply cynical to believe such activities will be able to continue indefinitely.

It has become apparent that Plus500's strategy since October 2014 has been to transfer as many European clients out from under FCA supervision at Plus500UK to its Cyprus subsidiary and CySEC supervision as possible. This is now happening forcibly to a significant number of previously frozen accounts, representing a disturbingly blatant attempt at regulatory arbitrage.

With the recent Eurogroup satyr play in between the tragedy of successive Greek bailouts returning attention to the future of the Eurozone, Plus500 throws one of the unintended consequences of political and economic integration in Europe into sharp relief. The regulatory passporting mechanism under MiFID surely did not contemplate enabling a pan-European company to switch regulators the moment it encountered complications in one jurisdiction. If Plus500's AML procedures were insufficient to meet FCA standards, how can they satisfy the authorities in Nicosia?

Plus500 remains Cable Car's largest short position, and I believe it now represents an even more appealing risk/reward calculus. I consider the most likely scenario to be that the acquisition is completed as proposed, in which case Cable Car will lose the 3-4% spread to the takeover price. I expect Plus500 shareholders to approve the transaction tomorrow. However, Playtech has left itself the right to walk away in the event of a Material Adverse Change to the business. In such a scenario, there remains over 80% downside to my price target.

It's all up to regulators now. From past experience, I have learned that regulatory authorities rarely act quickly enough to serve as a reliable catalyst, which tempers my expectations. However, Plus500 has confirmed that it remains under intense regulatory scrutiny. It is vanishingly unlikely that the recently completed Skilled Person Review in the UK is the only active regulatory investigation into the company, or even that it is the only Skilled Person Review. It remains entirely possible that one or more of Plus500's supervisory authorities will ultimately decide to sanction the company, refuse to approve the change of control, or potentially even suspend the company's license.

Difficult as it may be to regulate a company operating in many jurisdictions worldwide, this is not idle speculation on my part. I can confirm that Cable Car's research and several customer complaints have been independently submitted to a number of regulatory authorities worldwide. Visitors with network addresses matching all three primary regulators have spent time on Cable Car's website. Hong Kong and Singapore civil and criminal authorities have been notified of potential unlicensed activities within their borders. The United States CFTC has been informed of unregistered derivatives based on regulated US futures markets and US persons acting as affiliate marketers for Plus500. UK filings discrepancies have been reported to the Insolvency Service and the Financial Reporting Council.

Whether or not any these regulators have chosen to investigate further is not a matter of public record until their work is completed. The transaction is supposed to close by September. That does not give authorities a lot of time, but I wait with interest to see how they respond. In the meantime, Plus500's remaining customers continue to complain about withdrawal difficulties, poor support, and possibly abusive expiry procedures on several forums. In late June, Plus500 revealed on a Facebook thread that it had voluntarily exited from the Canadian market, where it had been operating without a license.

Lastly, there is hope for Cyprus (and the European project?) yet. The Definitive Merger Agreement between Playtech and Plus500 on inspection in London included the previously unreported disclosure that Plus500 received an initial request for information from CySEC on Friday, May 29.

Performance

	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	+4.6	+24.9	-6.1							**+37.4**
Annualized since inception (*November 8, 2013)													**+29.6**

The Cable Car Composite returned +37.4% net of fees during the period from January 1-June 30. Worldwide equity markets, as measured by the MSCI All Country World Index (ACWI), rose +0.3% during the second quarter and +2.7% in the year to date. The composite ended the quarter with approximately 64% net equity exposure and 125% gross equity exposure.

Attribution

As of June 30, the five largest long positions, which together comprised 75% of net assets, were Insignia Systems (ISIG), Retrophin (RTRX), NetDragon Websoft (777 HK), Intercontinental Exchange (ICE), and Pangaea Logistics (PANL). For a representative account, return attribution in basis points (bps) computed on beginning-of-period assets was as follows:

Contributors		Detractors	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long 777 HK	+1554	Long ISIG	-295
Long RTRX	+757	Long ADT	-189
Capital Structure Arbitrage A*	+181	Short Company D	-115
Short PLUS LN (Company C)	+175	Short EXAS	-110
Long PANL	+156	Short TSLA	-56
Short FXCM*	+118	Long PRW LN	-55
Short WRLD	+90	Long ICE	-43
Short 1063 HK*	+68	Long GNL	-39

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

Discussion

Due to the unusually strong quarter, I thought it would be productive to disclose all eight positions that detracted from performance during the quarter, which has the benefit of enabling me to disclose three short positions that might have made the top five in another period. The dramatic returns from NetDragon and Retrophin discussed last quarter continued into Q2, but it would be a shame if they completely overshadowed performance from some smaller positions.

Remarkably, all four Hong Kong-listed short positions in the basket described in last quarter's letter contributed to performance. Suncorp Technologies (1063 HK) was the highlight; the unprofitable distributor of landline handsets briefly achieved an astonishing valuation of over USD $3 billion on the strength of an equity raise and a press release announcing plans to develop a mobile payments app. I covered after a sudden, unexplained collapse in the share price in mid-June. 1063 HK remains significantly overvalued, but shares are no longer available for borrow.

These more egregiously overvalued stocks largely sold off prior to the recent meltdown in mainland Chinese markets; frustratingly, there was little to no borrow availability on the securities I was most interested in during the recent extension of the selloff in A-shares to Hong Kong. For better or for worse, some market participants have begun to refer to NetDragon as a 港 A 股 – a so-called "Hong Kong A-share," indicating its popularity among mainland speculators. This presents challenges for the long term-oriented investor. The sad irony of recent volatility – which exhibited signs of forced selling – is that overleveraged retail investors who have been stopped out or margin-called on speculative positions are in my opinion likely to have been exactly right about the long-term prospects for NetDragon's education business. With perfect hindsight, I wish I had trimmed more at the top and added more this month, but the thesis remains intact and I look forward to reporting on the company's progress in future quarters.

I am always on the lookout for interesting ways to monetize prior research. When NetDragon announced a possible bid for Promethean (PRW LN), a UK-listed education technology business, I read up on the company and was excited by what I saw. Promethean has struggled with the shift from its lower-margin education hardware roots to more recent attempts to develop education software. It has been capital-constrained and hampered by more experienced competition. However, it has a well-established sales channel into thousands of school districts worldwide and existing manufacturing relationships with Chinese vendors. Given NetDragon's financial resources, the potential strategic benefit of a pre-established sales channel and foreseeable synergies with NetDragon's software capabilities, I considered a deal to be quite likely and the 17% risk arbitrage spread to be very attractive. Cable Car is long a small position in PRW LN, and NetDragon's bid became definitive on July 10.

RTRX has continued to perform ahead of expectations, as the company sold the Priority Review Voucher discussed last quarter to Sanofi for a record $245 million, more than double its book value. I attended a cystinuria patient symposium in June that left me with continued confidence in the growth of Retrophin's marketed products. I continue to believe the valuation reflects very modest expectations for the growth of Thiola, Chenodal, and Cholbam, while entirely disregarding the pipeline opportunities despite the present biotech boom.

The capital structure arbitrage involves a long and short position in a recently listed security. The short leg is very difficult to borrow, and after a bounce, the position has only been partly reinitiated in recent days due to limited availability. If I'm able to locate enough shares to matter, I will hopefully be in a position to discuss it next quarter.

PANL reported a profitable first quarter shortly after being profiled in last quarter's letter. There were some one-time benefits due to seasonality and the timing of fuel hedges, but I believe the thesis was largely validated by the results and look forward to future reports from the company.

In May, Cable Car closed the FXCM short position discussed in Q4. While the market value has approached, but not quite reached, a reasonable estimate of the remaining equity value, shares have continued to exhibit extreme volatility upon the announcement of asset dispositions and other news. While it is possible shares will ultimately receive little or no recovery, they currently exhibit option value dependent upon the future performance of the business. While sustained improvement remains unlikely, FXCM shares may present better valuation opportunities in the future.

Cable Car holds a 2.4% stake in Insignia Systems that I do not yet feel would be beneficial to discuss at length. I was disappointed by the resignation of CEO Glen Dall last week. Along with incoming CEO (current CFO) John Gonsior, Glen did a fantastic job leading a turnaround effort in 2012 that initially attracted me to the business. I have a great deal of respect for both individuals and look forward to what John and his colleagues accomplish going forward.

As an author of short-biased research myself, I am not immune to the effects of other analysts. ADT declined during the quarter following a report from Off Wall Street, a firm I hold in very high regard. ADT is a small, contrarian position, and I believe the concerns raised in the report largely rehash previous short arguments that have not been proven correct. ADT's accounting is complex, and its management team has not done a great job of communicating the company's value proposition to investors. Yet in this case, Off Wall Street and I fundamentally disagree about the true cash earnings potential of the business.

Thank you as always for reading and for your continued support.

Jacob Ma-Weaver, CFA

Important advertising disclosures

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 GIPS guidelines regarding advertising disclosure and SEC guidelines regarding references to past specific recommendations.

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.

Cable Car Capital LLC ("Cable Car" or the "firm") is a limited liability company with principal place of business in San Francisco, CA. The Cable Car Composite reflects the performance of the firm's concentrated, hedged value investing strategy. The composite contains all fully discretionary accounts managed by the firm, and it is the firm's only composite. Cable Car claims compliance with the Global Investment Performance Standards (GIPS). To obtain a compliant performance presentation and composite description, contact Jacob Ma-Weaver at jacob@cablecarcapital.com or (415)857-1965. Verification and performance examination reports are also available upon request.

ACWI is a trademark of MSCI, Inc. "The MSCI ACWI Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets." ACWI total returns are presented including dividends net of withholding taxes. Composite returns are presented net of all expenses and fees, including accrued but unpaid performance fees. Returns are expressed in USD. The ACWI returned +3.9% for the period from November 8 through December 31, 2013, +4.2% in 2014, and +6.6% annualized for the period since inception.

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.