October 31, 2015

## Cable Car Capital LLC Q3 2015 Letter

Dear Friends,

Investors celebrated Halloween early this year, banishing animal spirits for a spell. A flash crash in August and ghastly headlines in the healthcare sector spooked market participants. While Cable Car's long portfolio was not immune from a few frighteningly steep declines, the Composite finished the third quarter with a net return of -0.2%. The remainder of this letter will refrain from torturing the metaphor (and you, my dear readers) any further.

## Performance

Worldwide equity markets, as measured by the MSCI All Country World Index (ACWI), declined by 9.4% during the quarter. Cable Car's hedged equity approach performed broadly as intended, with short positions declining significantly more than long positions, on average, during the period.

| | 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 | +25.0 | -6.1 | -2.9 | +4.5 | -1.6 | | | | **+37.2** |
| **Annualized since inception (*November 8, 2013)** | | | | | | | | | | | | | **+25.1** |

For the representative account, average exposure during the quarter was 89% gross long and 32% gross short. Adjusted for exposure, the long portfolio generated a loss on capital employed of approximately 14%, while the short portfolio returned approximately 20% on capital employed during the quarter. The balance of gross returns was attributable to a capital structure arbitrage and other special situations.

## Attribution

As of September 30, the five largest long positions, which together comprised 70% of net assets, were Insignia Systems (ISIG), Retrophin (RTRX), NetDragon Websoft (777 HK), Pangaea Logistics (PANL), and the warrant component of Capital Structure Arbitrage A. The most significant performance impact by issuer for the 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)* |
| Capital Structure Arbitrage A | +615 | Long RTRX | -623 |
| Short Company D | +240 | Long 777 HK | -497 |
| Short WRLD | +183 | Long ISIG | -158 |
| Short EXAS* | +157 | Long ADT | -82 |
| Long PRW LN* | +101 | Long PANL | -47 |

*Denotes closed positions as of the date of this letter. Please see page 5 for important disclosures.

## Discussion

Despite the market volatility, there are relatively few major updates to share this quarter. Cable Car sold one core long position to make room for more attractive opportunities, added aggressively to another, and recycled capital through several compelling short positions. Qualitatively, individual equities appear to have exhibited less correlation in recent months, creating interesting long and short candidates.

I am somewhat ambivalent to report that I sold IntercontinentalExchange (ICE) during the quarter. It was the only core long position that did not decline in the period, and it became the sacrificial lamb to accommodate several shorter-duration special situations with more attractive risk-reward characteristics. I did not wish to significantly increase portfolio leverage in an unusually volatile market environment. In my opinion, ICE remains an undervalued business with a truly visionary management team. The company's strategy of rethinking market structures, globalizing its clearing house presence, and shifting away from transaction-based revenues is the right approach, but I believe its market data/analytics and IPO revenues may prove more cyclical than anticipated. With the bulk of its cost savings program already realized and continued uncertainty relating to MiFID II implementation on the horizon, it is difficult to perceive a margin of safety in the event of a sustained downturn in the capital raising environment.

As a reminder on the subject of MiFID II, Europe will impose a customer-appropriateness requirement on CFD brokers beginning in 2017. It remains unclear how exactly Playtech and other brokers plan to certify the suitability of 200:1-leveraged gambling on financial instruments for retail individuals. Plus500 remains Cable Car's largest short position, with a little over 100 basis points at risk if the proposed acquisition is completed and substantially more potential return if it falls through. The fate of the transaction, which has already been delayed once, now rests in the hands of the Financial Conduct Authority, who are reviewing the transfer of Plus500UK's license. If Playtech's section 178 paperwork was submitted in a timely manner after shareholder approval, the FCA's decision is due within weeks.

Needless to say, I do not believe the change in control should be approved, but I have no particular insight into whether or not it ultimately will be. Interested observers may wish to read up on the activities of other Israeli trading technology businesses and consider whether the relationships among Aviv Talmor, Amots Zvik, Dror Sordo, and the acquiring parties have any bearing on the question of whether Playtech is "fit and proper."

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The highlight of the period was the capital structure arbitrage mentioned briefly in last quarter's letter. As there remains some risk in realizing the mark-to-market returns, I will save some details for future commentary. The arbitrage involved creating warrants of an early-stage molecular diagnostics company significantly below a fixed-value floor by shorting common stock and purchasing units consisting of preferred equity and the warrants. The market largely missed the floor value and ratchet features of the warrants. The contribution to the representative account resulted from a 15% gross and 3% net position in the issuer's securities.

My interest in molecular diagnostics initially led me to meet with the company to discuss its technology and go-to-market approach, which show some promise. I only discovered the potential arbitrage by delving into the company's filings later. The units may be the worst securities from an issuer's perspective that I have ever encountered. The first clue was the convertible preferred component of the units, which was convertible into shares of common stock with no additional preference features. This is a fairly transparent attempt to circumvent SEC rule 105, which prevents short selling in connection with a public offering. The units were underwritten by a questionable Boca Raton outfit that I believe took advantage of a financially unsophisticated management team. Incredibly, even excluding the value of the preferred component, which notionally exceeded the offer price on the date of issuance, the units were offered to the public at 45% of the floor value of the warrants.

On the plus side, the arbitrage provided a source of incremental capital at an opportune time. Cable Car added to its position in RTRX after an unjustified selloff on drug pricing-related headlines. The RTRX thesis is unchanged and my conviction is supported by additional confirmatory due diligence from conversations with patients and physicians in the cystinuria and bile acid synthesis disorder communities.

## Exact Sciences (EXAS)

After three years of varying degrees of involvement in EXAS, I covered Cable Car's short position in mid-October following a gratifying statement by the United States Preventative Services Task Force that echoed many of the concerns about Cologuard raised by Cable Car and many other commentators. Initial confusion regarding the interpretation of the task force's draft guidance provided a welcome opportunity to increase exposure, but at the current valuation, further downside potential is limited by the company's significant net cash balance. While a financial distress scenario at EXAS cannot be completely ruled out given the current burn rate, incremental test sales should demonstrate significant operating leverage, and I believe there is meaningful excess sales and marketing and administrative expense that could be reduced if the company wishes to emphasize profitability.

While I will accept some small measure of credit for influencing public perception of Cologuard's cost-effectiveness (and perhaps also the task force), Cable Car's effort to reduce the excessive Medicare reimbursement rate has thus-far proven unsuccessful. Cable Car had significantly more exposure to EXAS through put options prior to the preliminary CMS determination not to adjust the payment level. Had the task force issued its recommendation one week earlier, the effect on the Cable Car Composite would have been even more salutary.

Other than that missed opportunity, Cable Car's overall experience with EXAS was satisfactory. I remember asking Kevin Conroy about the implications of the CISNET study's cost-effectiveness conclusions at the J.P. Morgan Healthcare Conference in January 2013. The intervening tripling of the share price and subsequent ~75% decline only serve to illustrate the difficulty of timing for short sellers and the critical importance of conservative position sizing.

Since covering the position, Cable Car submitted a final public comment on the reconsideration request, which proposes a compromise crosswalk based solely on test methodology. CMS determined that they will only base the crosswalk on methodology, not the various other public choice considerations Cable Car proposed. Objectively, Cable Car's newly suggested test code of 81288 in lieu of 81315 should be a far better comparator for the methylation component of Cologuard, but it is very late in the process.

Technically, Cable Car is not a "hedge fund," but I was pleased to be mentioned in Exact's last few securities filings. As CMS reaches a final determination on the reconsideration request, investors are advised by the company: "A hedge fund has submitted a request that CMS reconsider its reimbursement rate for Cologuard, which was presented at a CMS public meeting on July 16, 2015. CMS has issued a preliminary determination maintaining the current reimbursement rate. After a public comment period, CMS will issue a final determination in November, 2015. We can provide no assurance that CMS will not negatively alter its coverage or reimbursement rate based on this request or otherwise."

## Kobex Capital (KXM CA, KBXMF)

To close with a new position, I thought I would mention one of the most straightforward special situations I have seen in a while. KXM is a microcap cash shell listed on the Toronto Venture Exchange that is the subject of a proxy contest initiated by Kingsway Financial. Market cap is only C$24 million, so the mispricing may only be available to smaller funds and personal accounts, but it represents an obvious example of how larger entities can create value through shareholder activism. I rather wish I had noticed and thought of it first, but in this case I am happy to ride Kingsway's coattails. Not to jinx it, but the proxy contest offers an easily quantifiable margin of safety and clear catalyst for return of capital.

KXM holds a portfolio of cash and one equity position worth about C$0.70 per share. It last closed at C$0.53. It is a dollar literally trading for 75 cents, a much larger discount than a typical closed-end fund in the current market environment. KXM also has tax assets that could be worth another ~50% in an M&A transaction. Cash shells like Kobex can languish for many years and are not always great investments, but Kingsway's stated intention after the proxy contest is to return capital through a share buyback at C$0.65 before attempting to invest the remaining cash and monetize the tax asset over time. In the event Kingsway is unsuccessful at the November 17 special meeting, shareholders who purchase shares after the October 1 record date will have the opportunity to weigh in at the next annual meeting and hold an asset purchased well below liquidation value in the meantime. Provided Kingsway follows through on its stated intention to return capital, there will be an opportunity for liquidity in the very near term.

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In September, NetDragon was recognized as the best performing idea in SumZero's 2014 best ideas contest. With the education launch underway and completion of the acquisition of Promethean, NetDragon appears positioned to offer another bite at the apple after the Chinese market euphoria earlier this year.

The Cable Car Composite marks two years since inception next week. I am grateful 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 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% from November 8 through December 31, 2013, +4.2% in 2014, -7.0% in the first nine months of 2015, and +0.3% 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.