February 17, 2016

Cable Car Capital LLC Q4 2015 Letter

Dear Friends,

Overall, 2015 was a fantastic year. Nevertheless, there were significant missteps that detracted from returns in the fourth quarter. While it is easier to write about successes, I find it far more interesting to read investor letters that include an element of self-flagellation. In the spirit of continuous improvement, after "doing the numbers" this letter focuses on a few recent learning experiences.

Performance

The Cable Car Composite returned +1.1% in the fourth quarter and +38.5% in calendar year 2015. Worldwide equity markets, as measured by the MSCI All Country World Index (ACWI), returned 5.0% in the fourth quarter. The ACWI declined by 2.4% including dividends in 2015.

CCC	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year	ACWI
2013											+4.2	(0.3)	**+3.8**	**+3.9**
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**	**+4.2**
2015	(3.8)	(0.9)	+17.5	+4.6	+25.0	(6.1)	(2.9)	+4.5	(1.6)	+3.5	+1.9	(4.2)	**+38.5**	**(2.4)**
Annualized since inception (November 8, 2013)													**+22.4**	**+2.6**

In 2014, net returns for accounts that were funded for the full calendar year ranged from 6-10%, with a median of 7% and standard deviation of 2%. In 2015, net returns for accounts that were funded for the full calendar year ranged from 22-55%, with a median of 40% and standard deviation of 10%. As a reminder, the Cable Car Composite contains all accounts managed by Cable Car on a fully discretionary basis. Although accounts are managed proportionally using a common strategy, significant differences arise from variations in fee structure, timing of deposits and withdrawals, and position eligibility and availability limitations. The lowest returns in 2015 were realized in IRA accounts that cannot hold short positions.

At year-end, the Cable Car Composite represented approximately $4.4 million in 25 accounts. Cable Car's total assets under management were $6.2 million, which includes a passive mandate from a client subject to ERISA diversification requirements. Assets managed by Covestor Ltd pursuant to a licensing agreement are not included in Cable Car's assets under management.

Attribution

Average exposure for the representative account during 2015 was 95% long and 30% short. For the full year, the long portfolio including arbitrage positions generated a gross return of approximately 35% on average capital employed. Short positions returned approximately 19% on average capital employed.

As of December 31, the five largest long positions, which comprised 66% of net assets, were Insignia Systems (ISIG), Retrophin (RTRX), NetDragon Websoft (777 HK), Pangaea Logistics (PANL), and The ADT Corporation (ADT). The most significant performance impact by issuer for the representative account in the fourth quarter was as follows, expressed in basis points (bps) on beginning-of-period assets:

Contributors		Detractors	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long ISIG	+269	Short KBIO*	(594)
GBSN Arbitrage*	+240	Long PANL	(171)
Long 777 HK	+234	Short PLUS LN	(158)
Short EXAS*	+109	Short ATHN	(65)
Long ADT	+91	Short WRLD	(59)

*Denotes closed positions. Please see important disclosures on the last page of this letter.

Exercising warrants against a short position in Great Basin Scientific (GBSN), which completed the Capital Structure Arbitrage A discussed in last quarter's letter, contributed to returns in December and detracted slightly from returns in January on a mark-to-market basis. The arbitrage freed up capital at a welcome time. Gross exposure for the representative account at year-end was 96%. Net exposure was 58%.

Discipline

I am satisfied by Cable Car's recent performance through a tricky market environment. Continuing the strong results in 2015, as of this writing the Composite is up slightly in 2016 despite broad market volatility. Cable Car benefited from this week's announcement of the proposed acquisition of ADT by Apollo Global Management. With committed financing, a large reverse termination fee, and the possibility of a superior proposal, the deal spread is attractive and ADT remains a significant position.

Good things notwithstanding, I want to explore a recent loss in some detail. As regular readers know, these letters are intensely personal and are intended in part to chronicle my continuing evolution as an investor. I am still in the process of earning my stripes and "battle scars" as a short seller. While I do not mean to dwell on one bad outcome, I hope to do someone, somewhere a mitzvah by thoroughly describing a difficult experience that I believe has made me a better investor.

In Cable Car's very first letter, I made a commitment to openness that now bears repeating: "I seek situations with favorably skewed risk/reward dynamics and have established position limits so that mistakes are survivable. I fully expect that even after careful analysis, I will make mistakes. I pledge to be transparent with clients and learn from every investment, successful or not." In retrospect, Cable Car's investment in KaloBios Pharmaceuticals (KBIO) did not exhibit favorable risk/reward characteristics. Although the investment turned out poorly, aspects of the situation were well managed. I will address the initial decision to short KBIO, the decision to cover, and position sizing in turn.

KBIO is a clinical-stage developer of oncology therapeutics that exhausted its financial resources last year without successfully bringing a drug to market. In early November, KBIO announced a reduction in force and pursuit of strategic alternatives, including the potential sale of the company. On November 13, the company announced that it planned to liquidate after the process ended without viable expressions of interest. During the following trading session, KBIO more than tripled intraday on abnormally high volume after initially falling sharply on the news. Inaccurate estimates of the company's liquidation value based on outdated financial reports were circulating online, which caught my attention. The sudden increase in price and interest from short-term traders resembled a classic pump-and-dump manipulation of a small, neglected

security. When sized conservatively, short positions in such situations may offer attractive returns and contribute to the efficient functioning of capital markets.

I estimated the net liquidation value of KBIO at the time of the announcement to be less than $1.00 per share based on its most recently reported fiscal position and burn rate. I incorrectly assumed that the failure of the strategic alternatives process indicated a lack of real economic interest in the company's assets and limited the fundamental downside of a short position. Cable Car later turned out to be among several professional investors and fund managers (unfortunately joined by a number of under-margined day traders) who had independently come to the same conclusion.

On November 18, Cable Car obtained a pre-borrow for the representative account and opened a short position in KBIO at an average price of $1.82. Unexpectedly, that same afternoon a buyer group announced it had accumulated a supermajority stake in the company, dramatically reducing the available float. In the resulting short squeeze, KBIO traded as high as $24.55 in pre-market trading. (See appendix for price charts). On November 19, I covered the entire position at an average cost of $11.13, incurring a permanent loss of more than five times the initial capital committed to the position. The cost to the Composite was limited to about 400 basis points because no other accounts were able to locate shares.

If there were any silver lining to the outcome, which is hopefully the worst loss in percentage terms Cable Car will ever experience, it was that I reacted deliberately despite disappointment. I waited to trade until regular market hours and correctly recognized the potential for buy-ins to further increase the share price. I firmly believe that the decision to cover was the right one from both fundamental and risk management standpoints. The buyer group's involvement invalidated the short thesis. Instead of liquidating, the company would raise additional capital and restart its development program. Skeptical as I was about the prospects of the oncology pipeline, the potential for further trials and an equity raise at an inflated price increased the company's valuation. In addition, the cost to carry a short position skyrocketed to a 200% annual fee rate.

Sure enough, KBIO continued to rise, reaching an intraday high of $45.82 on November 23 in part due to the deliberate withdrawal of shares from the stock loan market by the buyer group. Maintaining even a small short position through a further four-fold increase in price would have been unacceptable. KBIO acquired a potentially valuable Chagas disease treatment and issued new shares priced as high as $29.32 per share prior to suddenly filing for bankruptcy protection in December due to an unrelated criminal indictment.

I approach sizing a potentially volatile short position in part by working backwards from the amount of capital I would be willing to have committed to a position in the event of an extremely adverse mark-to-market scenario. In principle, my goal is to size short positions conservatively so that it is not necessary to capitulate solely due to near-term price volatility. Previously, I considered a rule-of-thumb extreme scenario to be an unjustified two- or three-fold increase in price. In the case of KBIO, which had already risen significantly, I allocated about one percent of the representative account to a short position I believed traded at double its fundamental value. Hypothetically, if it were to have been temporarily marked up to three times higher, it would have represented a three percent position with over 85 percent downside potential. Importantly, that downside could be captured in a well-defined timeframe through liquidation. Although this logic may have been sound, I got the range of potential outcomes wrong. I did not foresee a fundamental increase in the company's value or an overnight 13-fold increase in share price from my basis!

My basic error in judgment was shorting a liquidating asset that had a market capitalization of only $8 million, no matter that its fundamental value may have been lower. I failed to account for the intangible value and replacement costs of a public listing, which can be significant even in a liquidation scenario. I did not fully appreciate the attractiveness of the shell alone and its vulnerability to an acquirer in the open market. KBIO short sellers conceivably have a colorable fraud on the market claim arising from the manipulative cornering and withdrawal of borrowable inventory, but I make no excuse for my failure to anticipate the possibility that increased trading volume represented an acquisition attempt.

Many long/short managers have established arbitrary market cap or traded float thresholds of $50 million, $100 million, or $1 billion, below which they will not short stocks under any circumstances. These limits are often dictated by a firm's assets under management, though it is worth noting that on a much larger capital base the small quantity of KBIO shares I was able to locate would not have resulted in a material loss. Other managers establish trading rules based on liquidity, which likely would not have excluded KBIO in any case. Cable Car has no hard-and-fast size and liquidity rules, though both are important considerations.

Nevertheless, after this experience, it is fair to ask whether it ever makes sense to short a microcap security. My somewhat unsatisfying answer after a great deal of thought is a heavily qualified "sometimes." Most, but not all, smaller companies are unattractive short candidates to begin with due to illiquidity, margin requirements, lack of borrow availability, and the risk of acquisition by larger competitors. However, just as the absence of larger market participants and published security analysis can create long opportunities in off-the-radar securities, short selling opportunities can exist in companies of all sizes. There is no shortage of stock promotion, dilutive financing schemes, and capital destruction among small public companies. Attractive situations may arise as an event such as a delisting, recapitalization, or bankruptcy filing approaches. However, an added degree of caution is appropriate in these circumstances.

I am not of the school of thought holding that capitalization alone provides much of a margin of safety for short sellers. The Volkswagen short squeeze of 2008 is the canonical example of how even large companies can be subject to extreme price movements due to technical factors. However, it is clear that smaller companies are more frequently vulnerable to manipulative trading activity and extreme price volatility. That volatility is both a source of risk and a source of attractive returns when prices adjust quickly. The primary means of risk mitigation short sellers have is conservative position sizing.

From past experience, I had already established lower size limitations for short positions in microcap companies than in larger-capitalization securities. I now incorporate a wider range of possible adverse price movements into my sizing determination. I am more alert to the risk that trading volume could represent an attempt to obtain control, and Cable Car now avoids situations altogether where the value of the public listing is significant in context of the company's market value.

I believe it is extremely important for clients and prospective clients to understand the risks inherent in short selling. Hopefully this extreme example, which I will obviously do my best to avoid in the future, helps make the risks less hypothetical. For my fellow investors, I hope you found this situation instructive. If so, I would love to hear it.

Other Lessons

KBIO was not the only frustrating short position in the fourth quarter. The proposed acquisition of Plus500 by Playtech collapsed under regulatory scrutiny in November as predicted in these pages. Disappointingly, the share price did not react as anticipated. Plus500 now trades above the mooted acquisition price. For the time being, investors appear to be overlooking the company's continued customer churn, wholly unaddressed misrepresentations, and extrajudicial operations. Cable Car reduced its position size for risk management reasons during the fourth quarter (a larger position was appropriate when the upside risk was capped by the acquisition). Plus500 remains an active position, but it has been an object lesson in the limits of short activism. I can shout disclosure irregularities from the rooftops, but it is ultimately up to other investors and regulators to take action.

I stand by Cable Car's research but will likely have little more to say barring major developments. One unfortunate consequence of publicizing the position has been that Plus500 has become much more difficult and expensive to borrow. For future activist campaigns by Cable Car, I have learned to be more willing to take advantage of short-term trading opportunities. Though I take great pride in publishing research that is thoroughly substantiated, it is perhaps foolish righteousness not to cover a profitable short position just because a company has not addressed allegations or a price target has not yet been met.

For better or worse, we live in a world in which entire businesses are valued on the basis of the marginal transaction. This form of collective insanity is precisely what creates opportunities to buy and sell assets at prices that do not reflect fundamental value. The fourth quarter provided a few valuable reminders that the sword I live by can cut both ways.

During the fourth quarter, I also learned a great deal more about the operational complexities of the stock transfer process than I ever cared to know through the GBSN arbitrage. It is scandalous how much a Deposit/Withdrawal at Custodian (DWAC) transaction costs, and as my clients know it was quite an adventure processing warrant exercise requests through separate accounts. Cable Car may well be alone in attempting this kind of capital structure arbitrage through a separately managed account platform, and due to the time investment required, I will be very selective about future situations. Due to borrow limitations and lessons from processing GBSN, Cable Car passed up similar opportunities in securities brought to market by the same underwriter.

Capital structure arbitrage, among other things, would be easier to accomplish in a pooled vehicle. I hear from time to time from prospective clients who would prefer a traditional LP structure over a managed account. Sometimes I would too, but for the time being my focus remains on maintaining the lowest possible costs for clients. Cable Car will consider launching a pooled vehicle in the future if the initial capital commitment would fully cover the added administrative expenses of the fund.

Cash Shells

Mindful of the value of a public listing, Cable Car has recently invested excess capital in a small handful of potentially liquidating or merging cash-rich companies at significant discounts to net current asset value. In a market where there appears to be newfound disagreement about the right multiple to place on a future stream of cash flows, I find myself gravitating to the relative certainty of balance sheet analysis.

Particularly among microcap securities in areas that have fallen out of favor, there are a few valuation disconnects available in 2016 that I have not observed since the financial crisis. Note that these situations exclude companies with a history of accounting irregularities or concern over access to their cash resources.

One dollar of after-tax cash does not always have a market value of one dollar. It trades at a range of justifiable discounts when there is uncertainty when and if it will be returned to shareholders. Bonds trade at a discount to par; it makes sense that equity claims on asset value should too, but indiscriminate selling can cause excessive discounting. The discount to cash has an appealing tendency to widen just when the potential opportunity set for accretive acquisitions expands.

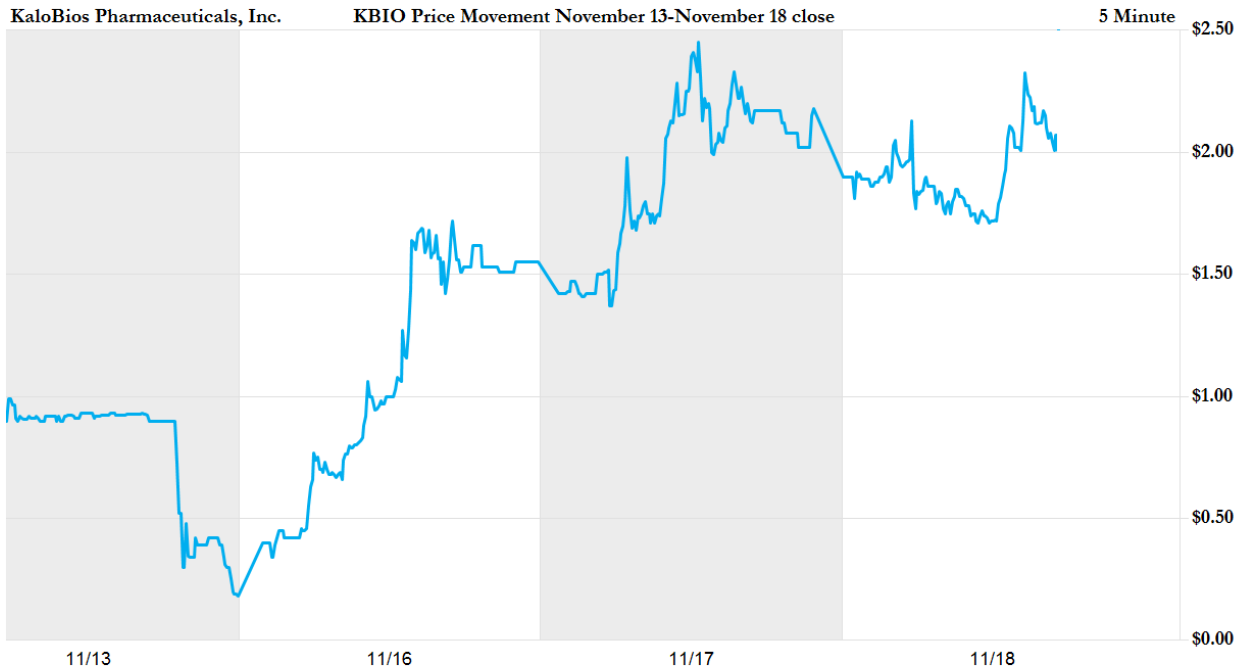
Cable Car's recent positions trade at discounts of as much as 50% to the estimated value of their net cash and tax assets. Among others, Kobex Capital, discussed last quarter, remains a compelling near-term opportunity, with management having stated intentions to return capital to shareholders if a suitable business combination that would monetize the company's tax assets is not proposed by the end of March. A former diagnostics business controlled by shareholders with access to deal flow and a history of good capital allocation has roughly $23 million of cash and $10 million of unrecognized tax assets, yet sports a market value of only $19 million. A third situation may present an opportunity to engage constructively with a board presently evaluating strategic alternatives.

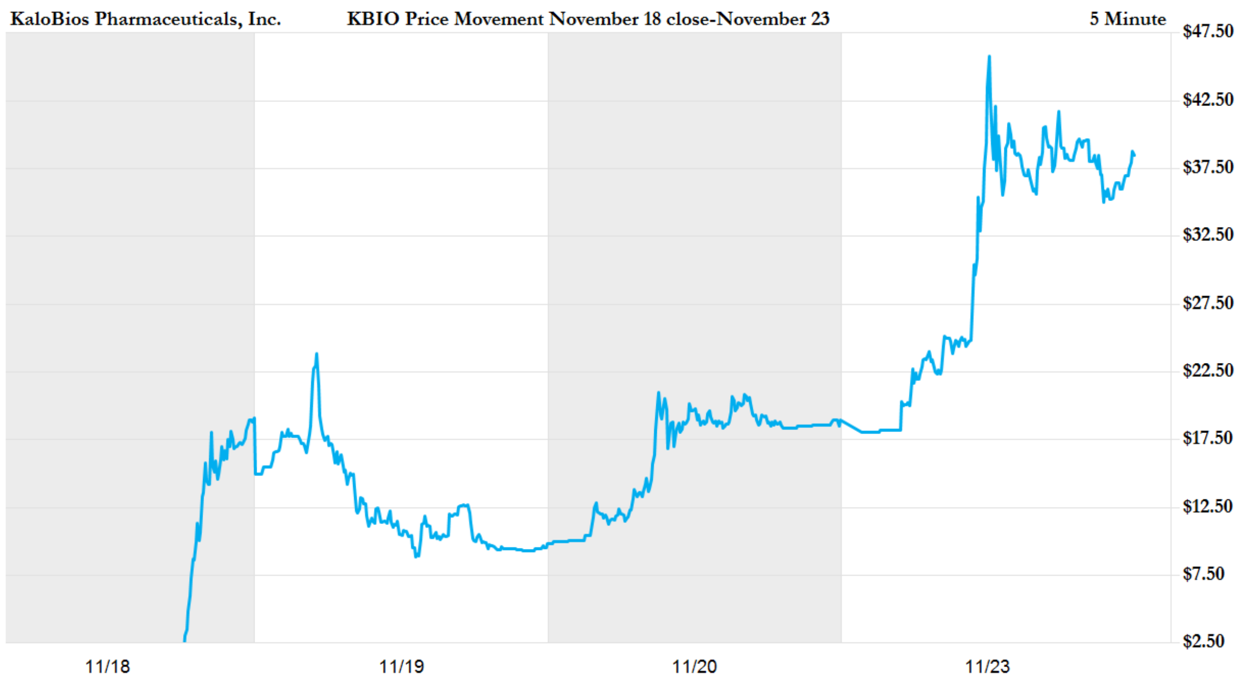
To close with one additional business update, Cable Car's membership in the National Futures Association and registration as a Commodity Trading Advisor with the Commodity Futures Trading Commission became effective in December. Registration was required for Cable Car offer commodity interests to qualified eligible persons through managed accounts. The expanded instruments available to Cable Car will enable more cost-effective hedging and implementation of certain positions. Incorporation of the occasional commodity interest position does not represent a change in strategy.

Thank you as always for your time, attention, and feedback.

Jacob Ma-Weaver, CFA

Appendix: KBIO Price Charts





Note the difference in y-axes! Source: FactSet.

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Please note that Cable Car maintains a selective public disclosure policy regarding positions that may be competitively sensitive, difficult to borrow, or otherwise unlikely to benefit from 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.

Cable Car implements its strategy in part through short sales and makes limited use of derivatives 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 availability of investment opportunities for each account may lead to significant divergence from composite returns. In 2014, net returns of accounts funded for the full year ranged from 6-10%. In 2015, net returns of funded accounts ranged from 22-55%.

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.