January 22, 2019

Dear Partners,

Since inception in early March, Petoskey Capital Fund, LP has performed about as expected, returning -0.6% compared to the -6.1% return for the S&P 500 for the 10-month period.[1] Over a full market cycle we want to exceed the S&P 500 while experiencing only about half the downside risk.

The Fund returned -8.4% net of all fees and expenses in the fourth quarter of 2018.[1] This compared to the -13.5% return for the S&P 500, the worst quarter for the index since 2011. The Fund slightly missed its objective of falling about half the level of the S&P 500, held back by weakness in our single largest long and also the biopharmaceuticals industry generally (discussed later).

Throughout the quarter the Fund remained approximately 90%-100% gross long and 50%-55% gross short, about the same ratios as the third quarter. The result is that our net long exposure (long minus short) remained roughly at our stated target of 50%. Even at lower valuations, we continue to see long candidates that are more expensive than we would like to pay for their growth prospects, particularly those names that rely on international markets that are notably slowing, such as China. Meanwhile, there still seems to be an abundance of bad companies out there. We are not struggling to find interesting short opportunities.

At the start of the new quarter, the Fund held 17 long positions and 13 short positions. Our largest long position represented 11.4% of capital, and our largest short position represented -5.3% of capital. The Fund's top five long positions were:

Company Name	Ticker	% of Capital
Air Lease Corp.	AL	11.4%
KAR Auction Services Inc.	KAR	9.1%
Booking Holdings Inc.	BKNG	7.8%
Comcast Corp. Cl. A	CMCSA	7.0%
CarMax, Inc.	KMX	6.3%

[1] Results are unaudited. Individual returns may vary based on fee structure and timing of investment. Refer to administrator statements for individual returns. Quoted returns assume a management fee of 1.5% and a performance fee of 15%. As of January 2019, all partners qualify for the reduced Founders Fee structure of 1% and 15%.

The Fund’s top five short positions were:

Company Name	Ticker	% of Capital
Tesla Inc.	TSLA	-5.3%
Cimpress N.V.	CMPR	-4.4%
Keurig Dr. Pepper Inc.	KDP	-4.3%
Jazz Pharmacueticals plc	JAZZ	-3.5%
AngioDynamics, Inc.	ANGO	-3.5%

During the quarter our long and short portfolios declined in about the same proportion relative to the overall market. This symmetry in each portfolio resulted in net underperformance to our benchmark because our long portfolio is about twice as large as our short portfolio. We will spend some time discussing the quarter’s largest detractors and contributors to give you a flavor of what worked and what didn’t during the quarter. We want partners to know what drove the Fund’s investment results, and we also want to provide a window into our thinking and overall execution of the Fund’s strategy.

Long Air Lease

We were surprised that our largest position, Air Lease, didn’t perform well in 2018, as 2019 is expected to be the best year of growth in its history. On top of that, its valuation went from quite attractive to absurdly cheap, so it wasn’t like it was an overpriced stock going in. Air Lease purchases new aircraft from Boeing and Airbus, and then leases them out to airlines all over the world.

From the fourth quarter of 2018 through the end of 2019, Air Lease will take delivery of 102 new aircraft. These aircraft are 96% placed on long-term leases with customers, as are the majority of planes scheduled for delivery in 2020. Its senior managers have decades of experience in all kinds of operating environments. They seem to know everything about aircraft manufacturers and airlines around the world.

Part of the reason why the stock market sold off in the fourth quarter was that investors began to doubt global economic growth, particularly outside the U.S. Air Lease is very much a global company, and investors may have worried that demand for aircraft might decline. Global air travel has been rising at a 6%-7% pace in recent years, and the challenge for Air Lease has been to keep up with customer demand. We remain optimistic about Air Lease and took advantage of weakness to add to our position when its forward P/E ratio was a ridiculously cheap 5. It remains our largest holding.

Biopharmaceutical Longs

During the fourth quarter three of our four biopharmaceutical investments held back Fund returns. The sole positive contributor was Corium International, which in October agreed to a takeover at approximately 50% above its previous closing price. Corium was a small position for us, less than 2% of Fund capital, and its contribution to overall Fund returns was therefore less than 1%.

Meanwhile, our other three long positions in the space had their prices slashed between -18% and -41% in a market that became suddenly averse to anything with a hint of risk. The weakest performer was Aerie Pharmaceuticals, which is launching an exciting new glaucoma drug. We think the ultimate market opportunity should be greater than $1 billion in annual sales, which would easily justify the price we paid. Nonetheless, the share price came down 41% during Q4. We did not own the stock throughout that entire slide, but the position still inflicted a meaningful loss on the Fund. We can only speculate as to why the damage was so harsh. The first few months of a new drug launch are a sensitive time for investors. Launch data tends to be limited and noisy. Early indications of a drug's success or failure in the market are only that—indications—but investors live and die on every early datapoint. From what we see, the company's launch seems to be going about as anticipated. We don't know whether investors are disappointed in the early data or whether they are simply paranoid that other investors may become disappointed. Such is the nature of a "risk-off" environment like we saw in Q4.

The other two smaller detractors dropped for largely mysterious reasons as well. We don't mind the market punishing worthy companies from time to time—that's where our opportunities come from. However, it sure felt like the market overdid things in Q4. We are pleased to see all three of these positions bouncing back in the New Year.

Healthcare Shorts

In Q4, the Fund's strongest short return came from a heavily-indebted equipment and supplies company called Invacare Corp. Simply put, Invacare has very little going for it, and we struggle to see how the company's operations can support the debt load it has accumulated. We believed its stock price was being propped up by a market that was overenthusiastic about healthcare equipment companies. The market suddenly woke up to the truth in Q4. Invacare shares declined 70%. We participated in much of that decline, and the position added about 2% to overall Fund returns. Another sizable healthcare short, Jazz Pharmaceuticals, also contributed as shares dropped 26% during the quarter.

Long Ulta Beauty

We made money with our long position in Ulta Beauty in the quarter. We view the company as a strong performer that continues to gain share in a fragmented space. The company's comprehensive services offering, including hair, skin, brow, and makeup services, helps it differentiate itself and gives customers a reason to visit the store. The company also continues to do an admirable job adapting to an omnichannel retail world.

Ulta shares were down generally in line with the overall market in the quarter, but we were able to make money by being nimble—exactly the kind of situation for which the fund is well-suited. Shares had rallied going into the company's earnings report in early December and we saw an unfavorable risk/reward tradeoff going into the earnings release. As a result, we sold our position ahead of the quarterly results. Shares did decline after the report, more than we felt was warranted, and we subsequently repurchased a position.

Short WageWorks

WageWorks provides supplemental employee benefits like Health Savings Accounts (HSAs), Flexible Spending Accounts (FSAs), post-employment health insurance known as COBRA, and commuter benefit programs. Early in the fourth quarter, the company announced that it was still unable to provide quarterly financial results. It has been unable to do so since October 2017. WageWorks' senior management left the company last spring and half its board has been replaced.

An additional catalyst emerged in the fourth quarter: the company replaced the respected Big Four audit firm of KPMG with BDO, a firm a fraction of the size. Even more puzzling, it chose a tiny accounting firm to audit results for a period when accounting shenanigans are alleged to have taken place. Appearing to run away from trouble is not the way to inspire investor confidence. Under these circumstances, it isn't surprising that WageWorks has been one of our most successful short bets during each of the past two quarters.

Short Luxoft

Last quarter we mentioned that our short position in Luxoft, an IT services provider, went against us as the market believed management's expectation that new business from financial services and automotive customers would offset continued weakness from its two largest customers, UBS and Deutsche Bank.

On the day of the firm's fiscal second quarter (calendar third quarter) earnings announcement in mid-November, the company reported that UBS and Deutsche Bank are continuing to cut back more rapidly than expected while new financial services business has failed to materialize. Automotive work is proceeding on plan but growth comparisons for the Digital Enterprises segment will be challenging. As a result, Luxoft lowered its earnings guidance, causing shares to drop 14%.

Luxoft's price drop flipped our short position from a loss to a nice gain. We decided shortly after the earnings announcement to close the position as shares had dropped to a valuation that matched the firm's reduced outlook.

We were pleased to be out of the short by year end because in early January Luxoft agreed to be acquired by DXC Technology, another IT services firm, for $59 a share in cash, roughly double what shares had been trading for on the open market. Acquisition risk is always a danger to short positions, and we won't always avoid a hit to the Fund as was done here with Luxoft. However, we feel our valuation discipline should help mitigate acquisition risk in most cases.

Short Cimpress

One short position that deserves special mention is Cimpress NV, a custom printing company with a fanatical investor base and a mixed record of delivering profitable growth. The company's stock has defied gravity for a long time but dropped 24% in Q4. We are short Cimpress mainly due to valuation, although one could equally say that we are short because we don't find management's growth plans credible.

At first blush, we can almost see why many investors are so enamored with Cimpress. Over the past ten years, the company has grown its total sales fivefold while also reducing its share count by about 25%. A shareholder today has claim on about six times as much business volume as a shareholder ten years ago did. Sales aren't what you take to the bank, however, profits are; and profit growth has been hard to come by. Adding more sales volume has not helped the bottom line. This company just grows to get bigger. To paint a picture of steady improvement, management has relied on an increasingly imaginative series of "adjustments." Cimpress earned about as much ten years ago as they will earn this year. Why should the stock price be materially higher?

We could be wrong. Analyst estimates call for a spectacular ramp in profitability over the next few years. We expect the timing of that ramp to get pushed out indefinitely, but if the ramp is eventually achieved then the shares are currently quite cheap relative to future prospects. There are some companies for whom spectacular success is always just around the corner. We don't see how Cimpress turns that corner.

Short Tesla

Our Tesla short detracted from performance as the company improbably delivered a profit in Q3, aided meaningfully by the sale of regulatory credits. Elon Musk has indicated his expectation the company will be profitable every quarter going forward—time will tell if this is correct. While there are many reasons to be bearish on Tesla, we believe not enough attention has been spent on potential demand issues for the company.

Tesla attracted approximately 450,000 reservations for the Model 3 before the vehicle went on sale, which was the good news for the company. The bad news for Tesla is these were reservations only and not firm orders. Furthermore, the reservations were for a vehicle that was originally marketed with a price of $35,000. To date, the company has been unable to deliver on the initially-promised price, with the minimum available price $45,000. Options typically bump the cost well over $50,000. With vehicles only available at higher price points, this raises the question as to the true level of demand for the "mass market" Model 3.

To make things even more challenging, buyer tax credits are rolling off. In response, Tesla has tried to counteract this with a $2,000 price cut in the U.S. Tesla stopped reporting its Model 3 reservation number two quarters ago, but the company has given enough information to make it clear that reservations still number in the hundreds of thousands. If these are legitimate customers at current prices and demand is truly robust, why cut price at all? This will be worth watching closely in the coming quarters, especially as competition intensifies.

Conclusion

At the beginning of January, the Fund's total capital was $13.9 million, and there were 33 limited partners including members of the General Partnership and employees of the Investment Manager. The number of partners continues to grow steadily.

We are pleased that the Petoskey Capital Fund delivered on its goals in its launch year despite a soft fourth quarter. The Fund will experience ups and downs in the future. We will have reporting periods in which we fail to meet our goals, and hopefully many more in which we exceed them.

We extend our thanks to all our limited partners for your belief in this new venture, and we very much hope to reward your trust with strong investment results.

Sincerely,

Daniel J. Boyle, CFA

DJB/pjp

Disclosures

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