October 15, 2019

Dear Partners,

Petoskey Capital Fund, LP returned (1.1%) net of all fees and expenses in the third quarter of 2019[1]. This compares to the S&P 500's 1.7% total return. Year to date, the Fund's net return is 11.1%, compared to 20.6% for the S&P 500. The third quarter was the rough equivalent of watching paint dry and feeling very slightly dissatisfied with the final color. In each of the quarter's three months, the Fund either lost or made approximately 1%. To be concise, not much happened.

Throughout the quarter we maintained a defensive posture and kept our net long exposure below our long-term target of 50%. Furthermore, we believe that our long portfolio is currently quite defensive and should hold up better than the overall market in the event of a correction, which should mean that our downside risk is lower still than our net long exposure implies. I should stress that this is only our belief, not a guarantee, but our experience managing long-only portfolios for individual clients underpins that belief.

In fact, we have spent most of 2019 hunkered down preparing for a potential market decline. There have been a few volatile moments this year, but the market has always bounced back near its all-time highs. Overall, our defensive posture has proven somewhat disadvantageous in 2019. In the first two quarters of the year, our stock picks generally beat the market by an interesting—if not wildly exciting—amount, which gave us something fun to talk about in these letters. In the third quarter our stock picking failures slightly outweighed our successes. We would like to have done better, but we realize that occasional slow quarters will happen on the long road to success.

One of the worst things a manager can do is try to create their own excitement when the market is not offering many opportunities. This is how funds drift from their strategies and surprise limited partners with big drawdowns out of the blue. There is a temptation to manufacture fireworks when things feel uncomfortably quiet, especially for startup funds whose managers desire to make a name for themselves in a crowded field. Don't get us wrong—we want to make a name for ourselves—but we are content to play the long game. As always, we thank our limited partners for your trust in us, and in the case of Q3, your patience. Often the best tactic is to wait. As the old saying goes, "Don't just do something, stand there!"

[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 September 2019, all partners qualify for the reduced Founders Fee structure of 1% and 15%.

At the end of September, the Fund held 19 long positions and 16 short positions. Our largest long position represented 10.2% of capital, while our largest short position represented -4.4% of capital. At the end of the reporting period, the Fund's top five long positions were:

Company Name	Ticker	% of Capital
Air Lease Corp	AL	10.2%
Gilead Sciences	GILD	7.5%
The Walt Disney Co.	DIS	7.3%
Alphabet Inc.	GOOG	5.8%
IAA Inc.	IAA	5.5%

The Fund's top five short positions were:

Company Name	Ticker	% of Capital
Tesla Inc.	TSLA	-4.4%
CONMED Corporation	CNMD	-4.3%
EBIX Inc	EBIX	-4.1%
Yeti Holdings	YETI	-3.4%
JAZZ Pharmaceuticals	JAZZ	-3.3%

Overall, our short portfolio did a hair better than our long portfolio. Some major contributors to performance were:

Long Galapagos NV

We previously mentioned this Belgian pharmaceutical company in our Q1 letter, when the stock added approximately 2% to overall fund returns thanks to positive Phase III trial data for its drug addressing inflammatory diseases. Galapagos helped us again in Q3, contributing another 2% to overall Fund returns after announcing a revised partnership with Gilead Sciences which we would characterize as a quasi-buyout of Galapagos, although the company remains nominally independent. At a high level, Gilead traded cash for a combination of Galapagos stock, future warrants to acquire more stock, an economic interest in Galapagos' existing development pipeline, plus an option to become the majority owner of any new drugs Galapagos develops in the future.

The market initially loved the deal, sending GLPG shares up from a quarter-end price of $129 to as high as $191. We agree that the deal was generally positive, but we found the terms awkward for GLPG shareholders. The cash received from Gilead will leave Galapagos grossly overcapitalized, with no clear outlet to reinvest its cash for the benefit of its non-Gilead shareholders. We can only assume that the company's board must eventually pay a sizeable one-time dividend to rationalize the balance sheet. If we were a much bigger fund we might be tempted to try to engage with the board and push for what we consider the obvious course of action. Instead, we simply took our profits and plan to keep watching the company closely in case another buying opportunity emerges. We almost can't help but continue watching Galapagos closely because we increased our investment in its partner Gilead during the quarter. You can see in the chart above that Gilead is currently our second-largest holding. From Gilead's perspective, this deal adds some sorely-needed development stage assets to a drug portfolio long on near-term certainty but a little short on long-term upside.

Short Lending Tree

Our short position in Lending Tree contributed 0.8% to the Fund's return this quarter. The company helps banks source retail customers for financial products. For most of the year, investors leaned into the stock on the presumption that lower interest rates would lift its moribund mortgage business. While that appears to be happening to some extent, mortgage is only about 20% of total revenue, and most of the remaining businesses are weakening. The company hoped that highly-profitable personal loans would grow 30%-40% this year, but second quarter growth was only 14% and slowing due to intensifying competition. TREE's businesses in deposits, home equity loans, and credit cards are also slowing. The company reduced guidance for second half results (particularly the fourth quarter), which is never a good sign for a supposed growth stock.

Of greater concern is the fact that management is moving the goalposts. The company measures success using a made-up metric called Variable Marketing Margin (VMM), and until the second quarter used to brag that it would only invest as long as a transaction yielded positive VMM. This was already a low bar, but the company lowered it further and now measures profitability based on the "lifetime value" of a customer. This allows the company to justify spending more to acquire a customer, including negative VMM transactions. Customers aren't suddenly becoming more profitable, but TREE is now spending more to get them. A worsening business outlook is generally the cause of shifting metrics. We remain short the stock.

Long Dropbox

Our biggest long detractor was Dropbox, which was added to the fund in March. The investment had a promising start, gaining 11% through the second quarter. However, in the third quarter shares dropped 19% on concerns of slowing conversion of free to paid users and roughly flat pricing, as Average Revenue Per User (ARPU) declined 1%.

Two significant product releases have great potential to accelerate paid user growth. The first is a new Dropbox workspace intended to boost team productivity through cross-platform integration, while maintaining ease of use, for common applications like Microsoft Office, Google G-Suite, Zoom for video conferencing, Slack for messaging, and Artisan for workflow. Second, Dropbox will integrate tools from its recent HelloSign acquisition. Its existing user base of 600 million people worldwide should quickly discover a variety of use cases for this digital signature technology.

Long KAR Auction Services / IAA Inc.

We talked about KAR Auction Services in our second quarter letter. At the end of June, KAR completed the long-planned spinoff of its salvage auction business, IAA, into a new publicly traded company. Since completion of the spinoff, the market seems to be struggling to find the appropriate price for each individual company, as seen by sizeable price swings for KAR and IAA.

This often happens with spinoffs, which makes them particularly interesting investment opportunities. With KAR, we were able to take advantage of some of the fluctuations in price intra-quarter to produce a positive contribution to Fund performance even though the stock itself was essentially flat during the quarter. IAA shares were up nearly 8%, as its first earnings report as a standalone company was well-received. IAA contributed more than 1% to overall Fund returns. We sold out of KAR but retained a position in IAA. We expect both stocks to remain volatile and will look to be opportunistic.

Conclusion

At the end of the third quarter, the Fund's total capital was $17 million. We continue to manage the Fund to deliver on our objective of beating the S&P 500 over a full market cycle, net of all fees and expenses.

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 confidence in us, and we very much hope to reward your trust with strong investment results.

Sincerely,

Miles G. Putnam, CFA

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