BronteCapital

Amalthea Fund

10 September 2015

Investors' Letter for August 2015

The market got into a funk this month and many funds (including funds we admire) have had a rough time.

As the results below show our performance was fine. We beat global indices by more than 4 percentage points and during a rough period the value of your holding increased by 0.88% net of all fees and charges. Although it is by no means a sensible benchmark for this global fund it is notable that the Australian market (ASX 300) index was down 7.7% over August.

Our longs did not hurt us in any unexpected way. Many of our shorts made us good money. On the big down days our funds went down but well under half the market. Alas on the big up days we underperformed somewhat. There were no big surprises. Because the gains were mostly on the shorts our leverage levels generally declined during the month and our flexibility is increasing.

Newspapers have been calling this an "historic" sell off. It is not. Market funks like this happen every few years on average. The last few years however have been benign and so people are surprised.

We do not think the sell off has been large enough to make stocks cheap and there is no substantial change to our positioning. We expect worse. We just don't know when.

The Sun Edison complex

The markets have not fallen very far – and we do not think generally that it is time to go looking for "bargains". In the oil space (where the falls have been large) plenty of companies we regard as frauds and promotes have not yet failed. <u>It is unlikely there will be true bargains (particularly in the energy space) before the big bankruptcies begin</u>.

However there is one cluster of stocks which have been hit remarkably hard – Sun Edison and its related companies. We talked about these stocks in our last letter and they are the signal collapse of this little interlude of stock market history.

Sun Edison develops huge and highly capital intensive solar and wind project where the power is largely pre-sold and where separate financing is developed for each project. These projects are then sold to ["dropped down to"] semi-captive yield companies sold to mostly to yield sensitive investors.

There are several issues. Big solar projects are massively capital intensive – think of utility scale power generation where you have to pay for the next 25 years of fuel up-front. The projects have huge debt but also reliable high margin cash flow.

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Secondly there is a pretty obvious conflict of interest in the “yield co” dropdowns. We have successfully shorted a few companies where we think that overpriced assets were being dropped down. And those stocks went badly wrong but it took time.

Thirdly, because of the related parties and the copious amounts of different types of debt these companies have complex and even scary accounts. John thinks himself a quite dab hand at accounting and has trouble getting to grips with it. In a meaningful fashion Sun Edison is a “trust me” story.

Whatever, the problems Sun Edison and its yield cos have been smashed. Once fairly obscure solar developers have become a major topic of discussion on Wall Street.

It has taken a while to understand why they have fallen so hard (and hence created the opportunity in the stock). The argument comes down to complex accounts, lots of debt and a peculiar acquisition of multi-level-marketing scheme (Vivint) that invites scrutiny.

But there is also more than the usual amount of rumour and innuendo. On Twitter—surprise!--there are arguments we know to be wrong and arguments that are simple fear-mongering (calling Sun Edison “Sun Enron” is one such appeal). Sure the company is highly levered and complex but it is almost certain that the past deals have been good deals. Any solar farm deal you put in place 3-5 years ago has worked out. Both solar panel prices and interest rates are lower than you would have baked into your cash flow models. <u>We would be enormously surprised if the past deals of Sun Edison did not work out</u>.

Whether the future deals work out is however an open question. Low solar panel prices and low interest rates are not exactly a secret – and the funding cost for solar panel farms has risen with this panic.

We have read an enormous amount about this company lately and most of it made little to no sense. However we are not beyond plagiarism where we find good ideas well explained <u>and where the ideas test out against facts we know</u>. Plagiarism is a perfectly acceptable investment strategy as long as you do enough work to know you are plagiarising good ideas.

And here we will plagiarise the anonymous Nemo's blog (by “Nemo Incognito”). Nemo has an acute and we believe accurate description of the company. Nemo analyses Sun Edison as a non-bank financial. To quote:

> There is a deeper problem with the way these companies [yield cos and their parents] see themselves and communicate with investors. That comes down to the fact that many have their roots in semiconductors where operating leverage is everything. You disclose your costs, your variable versus fixed, capacity expansion and so forth because if you make solar modules, wafers or chips that stuff matters a very great deal to your business. Investors use and demand that information because simply put, it matters and drives the profitability of the business.

A yieldco is a completely different business – it is a financial company.

Nemo later notes that non-bank financials "blow up" for one of three reasons, (i) credit risk, (ii) duration mismatches and (iii) and unstable funding. If you want to assess TerraForm Power (Sun Edison's yield co) you need to assess whether the credit risk on the projects (the counter-party) is okay, how the contract and funding is (eg floating/fixed etc) and all the ways in which project development funding is able to roll into long-dated funding.

Nemo once in his professional capacity put this to a yieldco and the management balked at providing that level of project detail. His response: "well, are you Northern Rock?[1]"

And that is the guts of the issue and the market fear. However Nemo has (in a past career) arranged construction funding for yieldcos and the funding could be rolled into long dated project finance (sometimes at disadvantageous rates). We can't see all the funding (the disclosure is complex) but the bits we have seen have this character. We did some checking and the facts match Nemo's assertion.

The funding can't be called, the company can't have a "run on the bank" and the Northern Rock outcome of a quick smash is unlikely.

Now of course we have not seen and understood all of the finance deals. Only the ones we can find. But that is sufficient to know we are *probably right*.

And that is the case for buying. The old projects are good and they should run off at something more than the current share price. [Our guess – and it is very back-of-the-envelope – is about double the current share price.] Wall Street has a fantasy about the company "blowing up" and we think the fantasy is wrong. And whilst it is not certain that the company will be able to generate substantial value with future projects it is also not certain that the company won't. Profitable future projects offer considerable upside.

<u>The Vivint Acquisition</u>

Sun Edison management are not blameless in this panic. They did something wrong.

That something was the brave (that is foolhardy) acquisition of Vivint.

Vivint is a multi-level marketing scheme (an MLM) like Avon or Herbalife that sells solar panels door to door.

Customers signed up for solar panels don't get a bad deal. They put the solar panels on their roof and their power bills go down. Whether the solar panel is owned by the household or some corporate structure what is effectively going on is a loan to the householder where the householder will repay the loan by splitting the utility bill saving with the solar company. Things can go wrong in this deal – but those things are not very likely.

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[1] A British bank that faced a "run" and was nationalised by the British Government in 2008

That said, there are good reasons why roof top solar is less attractive than utility scale solar farms. The main one is that rooftop solar gets under-priced use of the grid. The grid is essential here – unwanted solar is sold to the grid and the grid provides electricity when the sun doesn't shine. Simon – being a past utility CEO has an instinctive skepticism of rooftop solar. He thinks – correctly – that people with rooftop solar underpay for grid services.

In Northern California this is becoming explicit. Pacific Gas and Electric is proposing changes which explicitly charge households with solar panels more to access the grid. Whilst we have no view on the size of the charge the direction is probably right.

This will become a trend and make roof top solar less attractive in the future.

But even that does not explain what is causing the Sun Edison stock price collapse. The issue is that Vivint is an MLM. MLMs – even honest MLMs – invite regulatory scrutiny. We have been living that scrutiny with Herbalife. MLMs regularly trade at a discount because there are regulatory risks associated with them. Moreover any MLM must rigorously guard against fraud. Herbalife has over 300 thousand distributors who average about $10,000 a year in sales. That is a small city.

In a small city you will find both saints and sinners. Every MLM has had rogue distributors though the good ones have made some effort to control distributor behaviour. However even the best MLMs will invite scrutiny.

Alas this sort of scrutiny is poison for a highly levered finance company. The last thing a finance company needs is regulatory entanglement.

This doesn't speak well for the management of Sun Edison. They were originally semi-conductor guys. They wound up running a financial institution and they did not change the decision making to meet the new reality. Whilst we are comfortable owning a well-managed MLM we are deeply uncomfortable combining that sort of regulatory risk with high levels of leverage. We think the market shares our concern.

We suspect some solution will be found. Either the Vivint deal does not close (at a meaningful break fee) or Vivint is stripped and spun out or – more likely – Vivint originated solar panels are kept separate from the rest of Sun Edison – and the main parts of the company are structured to be "Vivint remote". Modern project finance allows this.

Whatever – the acquisition of Vivint was stupid. And it is here we differ from Nemo's blog. Nemo thought that the deal could be broken easily. That is probably untrue.

Our trade

This month we swapped the relatively low risk position in Terraform Power (the yield co) for a higher risk position in the parent (Sun Edison). Sun Edison is cheap and the reasons it is cheap are manageable. However we now have a position to rival Herbalife and Senomyx for day-to-day volatility. On many days a small position is either our biggest winner or biggest loser.

If we did not have the large Herbalife position (and hence plenty of MLM risk) we would be buying more. But there is a limit to how many times we can accept that risk. And because we have done more work (and hence have more conviction) we prefer taking our MLM risk at Herbalife. Moreover Herbalife has simple accounts and the cash generation is obvious. Sun Edison accounts are really complicated and leverage is really high. It is unlikely we could ever get comfortable enough with Sun Edison for a large position.

Spear Phishing

We recently received an email from simon@brontecapitall.com. Note the second "l" in the email. Someone is impersonating us presumably to try and extract money or personal details from us. This sort of fraud is known as "spear phishing".

We have set mail rules to block all emails from that address and notified our outsourced back office. We expect them to be similarly vigilant. We have also alerted our securities regulator and various internet agencies (including the registrar of the typo-squatting domain). We do not think there is any way that they could know who our clients are so it is unlikely you will receive similar emails. However it is not just small caps in the stock market that are laced with fraud – it is a rough world out there and there are people who want to take your money.

Please be alert to this stuff generally. It matters more than it should.

Thanks again

The Bronte Capital Team

Performance (Net of all fees) [unaudited and pre end of year distribution]

Last 12 months	26.9%
Since inception (annualized)	19.7%
Largest Monthly Gain	6.1%
Largest Monthly Loss	(3.7%)
Max. consecutive Gain	15.7%
Max. Drawdown	(6.0%)

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	YTD
FY13											5.4%	1.3%	6.8%
FY14	6.0%	-2.5%	0.4%	3.6%	5.7%	4.3%	-3.7%	0.2%	-2.6%	0.9%	3.4%	-0.8%	15.2%
FY15	-0.9%	-1.6%	2.7%	1.7%	3.4%	4.9%	2.3%	-0.1%	1.7%	-1.7%	4.4%	-1.7%	15.6%
FY16	6.1%	0.9%											7.05%