Bronte Capital
Amalthea Fund

9 March 2016

Investors' Letter for February 2016

We had a good month in a stressful market. Our performance is usually good in a weakly downward market and it was during February (+1.8%).

The market recovered fairly rapidly in the last week in February (and the first week of March). We usually do poorly during rapid market spikes, however in February the market spike did not hurt us and left us with positive results for the month.

Prior to the spike we benefited from a well-received earnings report from Rolls Royce and later in the month Herbalife reported results which we thought were merely adequate but which the market liked. Meanwhile our short position in Valeant worked well as Valeant stock continued to erode. We discuss all of these below.

The market surge in the first week of March has been less kind to us. We normally don't report positive intra-month performance but negative intra-month performance warrants a mention. We are down a low single-digit percentage during the first week of March our worst relative week for many months.

We are not worried about being down a few percent in early March – but it does take the shine off an excellent February. For reasons described at the end of this letter we think our early March losses will be reversed.

Rolls Royce

Rolls Royce, the maker of jet engines, was one of the most problematic stocks in our portfolio. We have discussed this at length in previous letters.

They have the most fuel-efficient jet engine on the market (the Trent XWB) for the most fuel-efficient plane on the market (the Airbus A350). This plane should sell a lot of copies (especially if the oil price rises).

If the plane sells a lot of copies Rolls Royce should make a lot of money on maintenance over the next thirty or so years.

However there has been some difficulty in Rolls Royce getting to the "promised land". The company has incorrectly estimated cash usage and has considerable capital expenditures in ramping up production. We have been uncertain as to whether Rolls Royce can meet those capital expenditures without tapping equity markets for more money.

Rolls reported results that were uneventful. They cut their dividend (as expected) but the management seemed sanguine about their capital needs. The stock rose from just above 5GBP per share to just above 7GBP per share.

Bronte Capital Management Pty Ltd (AFS License: 334325, IARD No. 151222)
Suite 1703 Tower 2, 101 Grafton Street, Bondi Junction, Australia.
Phone: +61 2 9389 3293 • Email: investor.relations@brontecapital.com

The Herbalife results

We have done some study of Herbalife's European business. The business model is a very long way from the business model described by Herbalife's main critic. The pattern on the ground is not even to mention the "business opportunity" until the customer has had a notable change in body shape from the weight loss routine.

Recruitments in this business are lower but retention is much higher and the average recruit does better. This is a stable growing business.

This regime has been in place in much of Europe for some time. And the numbers show it – volume points (a good measure of sales volume) in Europe rose 15 percent. This was the best for any region other than China.

The business methods in Europe are being transitioned over the globe. As this happens we expect short-term volume falls in countries which are disrupted, followed by long term stable growth.

The volume falls in transitioning markets were a feature of late 2014 and were the main reason why the stock was weak in the second half of 2014.

In most countries the transition is now over a year old and growth should be resuming. And it did resume – and the market was pleased.

We were less pleased.

We expected growth in volume points in the transitioned countries to be higher. We were particularly disappointed with the US result where volume points remained at minus 7 percent year on year and were dead flat in the fourth quarter versus the fourth quarter of last year.

Unless this growth comes our eventual target for the stock lowers to about $80 (it trades at about $55 currently).

We think European type growth might come to the rest of the world – but we would prefer seeing it before we believe it. If the European growth globalises then Herbalife will wind up above $200 per share. That is not our base case – but very strong upside is possible here.

The FTC settlement

The big news in the results however was new language in the 10-K filing about them being in discussions with the FTC to settle outstanding issues.

Herbalife made several changes to their business model after the short-seller attack on the company. We expect the company to settle with the FTC for a fine and for provisions making permanent the new company rules. How big the fine is is an open question but

anything less than $100 million will be a big victory for longs in the company provided it does not come with substantial changes in the way the business operates today.

After month end on Herbalife

After month end Herbalife put out a truly shocking correction to their results where they indicated the number of new active distributors was grossly overstated. They claimed this was due to a coding error in their (mostly laudable) Oracle database system. Here is the mea-culpa as in the SEC filing:

> On March 1, 2016, Herbalife Ltd. (the "Company") identified errant information regarding the Company's new "Active New Member" metric that was provided on certain of the Company's 2015 earnings calls, as outlined in greater detail in the tables below. The Company began tracking this non-financial metric in 2015 in connection with certain marketing plan changes and discussed it for the first time on its second quarter 2015 earnings call. However, database scripting errors led to both (i) the errant inclusion of additional categories of data in calculating the metric for parts of 2015 which were not included in the 2014 and prior period calculations and (ii) quarterly aggregation issues which created variances from period-to-period depending on when the greatest level of activity occurred during the relevant period. The Company did not discover these errors earlier because it had limited visibility into the likely rate of change in this metric upon its first use. The Company has taken corrective action regarding these issues. No information regarding this non-financial metric has been included in any of the Company's periodic reports filed with the Securities and Exchange Commission and the errors do not impact the Company's historical consolidated financial statements.

Some of the changes were ugly. For instance global active new members excluding China went from 16.7 percent to 3.0 percent growth.

We have agonised about this error. Nobody likes mistakes, but they are twice as painful for companies operating under exacting public scrutiny. It was sloppy but we have – on balance – decided we believe the honest-error explanation. And it did not affect reported earnings numbers or cash balances.

It is worth explaining why we believe the sloppy error explanation when we so readily conclude that other companies' misstated accounts are fraudulent.

Double-entry accounting is a beautifully self-correcting system. If you want to fake your earnings you are overstating your revenue or understating your expenses. This means that pretty rapidly your balance sheet will show cash or other assets that simply are not there. When you do the reconciliation the absent cash (or the fake asset) will be detected - eventually.

To fake your earnings requires two sets of fakery. It requires you to fake your profit and to fake your asset balances. [It can be done directly through revaluation of assets through the profit and loss statement but the general conclusion does not change.]

Incorrect earnings do not generally happen by accident because double-entry accounting is self-correcting. It is unlikely you will accidentally have two offsetting incorrect numbers.

If there had been an adjustment to earnings and cash balances we would not be so sanguine. Honest mistakes in accounting are the exception by the time you have an audited balance sheet.

However the number of distributors that a company (say Herbalife) has is not self-correcting. Operational reporting systems sometimes contain errors. There is no double entry and hence no automatic check of the numbers. An error can go undetected for a long time.

It is for this reason we are willing to accept the honest-error explanation.

Here are the adjusted numbers as published by Herbalife.

Active New Members

	Q1 YOY	Q2 YOY	Q3 YOY	Q4 YOY	2015 YOY
Regions					
North America	-26.9%	-15.4%	1.8%	31.3%	-8.2%
Mexico	0.8%	21.7%	29.1%	34.1%	20.4%
South & Central America	0.9%	7.6%	25.1%	9.4%	10.4%
EMEA	13.0%	23.3%	10.2%	17.7%	16.2%
Asia-Pacific	6.6%	-0.6%	-0.9%	-18.2%	-3.8%
Total Company (excluding China)	-1.7%	3.7%	8.7%	3.2%	3.4%
Additional Information					
Brazil	9.8%	69.5%	71.9%	17.1%	37.7%
United States	-27.1%	-16.0%	0.8%	30.7%	-8.9%
APAC (excluding Korea)	2.6%	11.7%	37.0%	30.4%	20.2%

These are not bad numbers at all <u>even after they are corrected downward</u>.

The sharply negative numbers followed by the sharply positive numbers (particularly in the USA) is the transition in business model as described above. So far the lift in active new members has <u>not</u> led to a spike in sales.

If it does our price-target for Herbalife will get adjusted up a great deal. We are hoping but not holding our breath.

We also credit Herbalife for reporting the error quickly in an 8-K filing. For our non-US audience, this is a method of keeping the market informed of potentially material information.

Valeant Pharmaceuticals

We don't usually discuss shorts but Valeant is not a normal short. This was one of the most popular stocks on Wall Street with a panoply of famous funds managers having oversized positions.

We don't usually short such things. We don't think we are smarter than a huge array of extremely competent Wall Street Managers. But we are smarter than - or at least more diligent than - at least some market participants. We prefer foolish, ill informed or better – deceived – counterparties for our shorts. Betting against smart, informed managers with access to management is not something we do lightly.

That said our research has been OK. While we had looked into Philidor before it wound up on the front page of the *Wall Street Journal*, we did not fully comprehend its operations before its public expose by able journalists. (It was in the business of exploiting loopholes in the drug cost claim reimbursement processes of US medical insurers and Valeant announced its closure because the insurance companies would no longer deal with it.) We have found more than a couple of other red flags.

More generally, Valeant has terrible GAAP numbers and is priced at an absurd multiple of GAAP earnings. And the GAAP earnings may fall. But it is priced at a low single digit multiple of its non-GAAP (aka "cash") earnings as promulgated by the company. We have enough evidence to question the company's stated non-GAAP earnings but we do not have enough data to work out the real sustained earnings power of the business going forward. And that makes us slightly less comfortable in the short, given where the stock is today relative to where we started.

We still think bankruptcy is the likely outcome. We find too many warts and they are too easy to detect. The numbers require a degree of trust, and the company has not demonstrated as of late that such trust is well placed. That said – we have covered a little more of our short.

February and early March was particularly nice to us on this stock. The company did not make a planned earnings call and is currently unable to present audited accounts. They plan on giving "preliminary" numbers in mid-March which implies audited accounts will not be available.

There are several covenants that are triggered by terrible results. There are other covenants that are triggered by failure to provide audited accounts. Breaches of these covenants (mostly) do not result in debt acceleration but prohibit future borrowing and create cash-traps.

A rapid bankruptcy is possible but is not our modal outcome.

Walking dead oil companies

We have been short many oil companies (some of which are frauds) that we believe have no reasonable hope of survival unless the oil price rises above $70 within the next

18 months. (And for a few, that will only delay what we believe will be the eventual outcome.)

A few (but by far the minority) have already filed bankruptcy. One, Miller Energy, had senior executives charged with accounting fraud by the regulators after the bankruptcy filing. The SEC charges were entirely consistent with our original short thesis.
There are many more that are going to disappear and we expect some may also result in similar prosecutions.

We have however been worried about a bounce in this sector. We discussed the issue at length in our January letter and we have struggled to find a reasonable hedge with which we were entirely happy.

Alas the bounce happened in late February and early March. It is the main reason we are down in the first week of March.

For instance, Chesapeake – a giant and important gas company announced in January that it was suspending dividends on their preferred stock. This is only done in times of extreme financial stress. The stock has bounced from $1.50 to $5.73 and has many billions of dollars of market cap. We have no position but it is a pretty obvious bankruptcy candidate before and after this bounce. The bounce looks like a short-squeeze.

Linn Energy (a stock we shorted in quantity and John wrote about) has announced that they are seeking a restructuring of their debt (which almost certainly means filing bankruptcy). LinnCo has risen from 14c to almost $2. We covered our short on the way down at $4 because it looked a little crowded to us. The bounce however makes no sense outside a short-covering rally.

We are short a few stocks that have more than doubled in this rally. Positions are small and the aggregate "draw-down" is only low single digits. But it is painful.
Importantly our positions started and remain <u>much</u> smaller than most of our short selling competitors so as to manage the risk of such squeezes. And all these stocks will go down as the short-covering rally ends.

The draw-down is painful but we believe (for good reason) that it is temporary.

Currency

We remain short the Australian dollar. It is not a huge position but the relatively strong Australian dollar will mean Australian dollar returns for almost all Australian dollar denominated international funds will be weak. As we carry a net short ours will be weaker still – although included in the early March loss previously described.

Conclusions

Having spelt out the negatives lets end with some positives. We have done very well in the market hiccups, somewhat offset by a single bad week in March 2016. We think most of the problems in early March 2016 will go away.

We are confident (within the usual constraints of market prediction) that our results will continue to be better than adequate.

Thanks again

The Bronte Capital team

Performance (net of fees)	
1 Month	1.8%
Calendar YTD	2.3%
Financial YTD	10.4%
Since Inception (Annualized)	17.3%
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	FYTD
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%	-0.2%	3.8%	-1.3%	-1.4%	0.5%	1.8%					10.4%

Portfolio Analytics	
Sharpe Ratio[1]	1.4
Sortino Ratio	3.2
Annualised Standard Deviation	9.5%
% Of Positive Months	65%

Fund Features	
Investment objective	Maximise risk-adjusted returns with high double-digit returns over 3 year periods.
Inception	May 2013
Minimum investment	$100,000 (for qualifying investors)
Applications/Redemptions	Monthly
Distribution	Annual
Management Fee	1.5%
Performance Fee	20%
Administrator	Citco Fund Services
Auditor	Ernst & Young
Custodian/PB	IB LLC

[1] Sharpe and Sortino ratios assume Australian risk free rate of 2.5%