July 7, 2014

Dear Partners:

A long time in the making, Pomeroy Capital Partners, L.P. (the "Fund") finally became a reality as of May 1, 2014 when our first partner - my mom - committed to invest in the Fund. In the two months since our start, the Fund finished the 2nd quarter of 2014 with returns of 5.97%, net of fees and expenses. By comparison, the S&P 500 index increased by 5.23% during the same time (despite the benefit of an additional month).

As our first partnership letter, I thought a little history might be in order: I was first introduced to investing by my late grandfather who patiently shared his insight, investing experiences, and reading materials (including annotations) with his young grandson. Guided by my grandfather - and our research - I was hooked after making my first investment at age 13.

Over the next several years, an interest in the markets and Grandpa's investing lessons became the bond we would share until his passing during my sophomore year of high school. From there, the subscriptions were put in my name, and I eagerly - and nervously - assumed the role of family nerd in search of investment ideas.

In the years that have since passed, much has come and gone, but an interest in investing has remained the one constant in my life. While I have since learned that many of Grandpa's investing principles were not necessarily original, they have nonetheless remained an enduring and profitable road map through the ups and downs since his passing (far more profitable, thankfully, than all the baseball cards we so eagerly collected together).

Like many of history's best investors, Grandpa emphasized the importance - first and foremost - of investing in quality businesses. Although somewhat subjective, at the core of every quality company is a competitive advantage that is both profitable and sustainable. Seeking companies with actual profits and "big moats" (to quote Warren Buffett) generally keeps us plenty safe from *speculating* in "momentum" stocks which tend to rise and rise . . . until they simply stop rising and the "momentum" moves elsewhere.[1]

Of course, the holy grail in trophy hunting is to stumble upon a high-quality business selling at low-quality or reasonable prices. To quote Benjamin Graham, the father of value investing: "Price is what you pay, value is what you get." Accordingly, we would be hard pressed to offer two better examples of such high-quality opportunities than our two largest holdings as of the quarter end:

Apple

Through both well-designed and innovative products Apple Inc (AAPL), has quickly become one of the largest and most successful technology companies in the world. From 2004 to 2013, revenues have rocketed up by just under 2,000% (or an impressive ~ 40% per year). Earnings per share (something us old-fashioned investors still appreciate) have grown even faster, from just $0.36 in 2004 to a whopping $39.75 in 2013 (and an even better $43.25 estimated for YE 2014).

Although much of the peanut gallery would have you believe that the passing of Steve Jobs and the near-term lack of a blockbuster product is proof that AAPL's glory days are a thing of the past, we continue to believe AAPL offers much to be bullish about. Consider the following:

[1] camera company GoPro - now worth ~ $6 billion after the recent IPO - is looking like this week's prime example

Product

- Upcoming iPhone Refresh Cycle: Accounting for more than 50% of AAPL's sales, the iPhone continues to be the main driver in AAPL's investment story.[2] Despite this strength, the detractors continue to point to the iPhone as a perfect example of where AAPL has lost course, arguing: the phones aren't cheap enough, the screens aren't big enough, and ultimately fretting that the iPhone is quickly losing its competitive edge against the growing stampede of Android powered and cheaper alternatives. However, we believe smartphones are increasingly becoming "must-have" accessories in the busy lives of many consumers. These consumers expect top quality products, and not surprisingly are increasingly willing to pay top quality prices. Evidence of this consumer behavior can be found in a recent report by Morgan Stanley which found that 56% of US iPhone owners on Verizon, 42% on AT&T, 47% on Sprint, and 35% on T-Mobile are still using either iPhone 4 or 4S.[3] In our view, the takeaway here is two-fold:
    a. The abundance of older model iPhones still in use speaks to both the durability of the products, and continued usefulness despite newer technology and competing options.
    b. For 10 straight studies by J.D. Power and Associates[4] - that's every study since the first iPhone was introduced - the iPhone has been ranked highest in customer satisfaction. In other words, the press isn't the only ones impatiently awaiting a new iPhone . . so are the millions of loyal customers still happily using previous iterations of the iPhone.
- The Next Big Thing(s): Scarcely a day passes without some speculation about AAPL releasing some sort of fitness / health tracker, a long-rumored TV product, possible innovations in the payment space,[5] or any number of other rumored products. Apple's executives have fueled the fire by publicly expressing their excitement for the upcoming product pipeline ("Later this year, we've got the best product pipeline that I've seen in my 25 years at Apple"[6]) and publicly stating that a "new product category" will be introduced this year.[7] Ultimately, we view continued speculation as confirmation of ongoing customer loyalty / excitement, and future products - in whatever form - as an added bonus in the overall investment thesis.

Full Steam Ahead (Growing the Moat)

- From Zero to Hero in Enterprise: Just a few years ago, AAPL was largely shunned by corporate IT departments content with commodity PCs hobbled together by the likes of Dell and HP. Fast forward to today, and you will find eye-popping adoption of AAPL's products in the enterprise space: iPhones are now used in 97% of the Fortune 500 and 91% of the Global 500, and the iPad is used in 98% of the Fortune 500 and 93% of the Global 500. As if those numbers weren't impressive enough: 90% of tablet activations in corporations are now iPads.[8] Pundits attribute much of this growth to a trend dubbed "bring your own device" (or BYOD) wherein enterprise adoption of consumer technology - such as the iPhone and iPad - is primarily driven by cost constraints and employee preferences (translation: the loyal fan base strikes again!).
- International Growth: AAPL's biggest international market is quickly becoming China, where revenue has already topped $18 billion dollars in just the first half of 2014. Amazingly, much of this revenue was achieved despite only *limited* contributions from iPhone sales through China Mobile, China's largest mobile carrier. To put this in perspective, China Mobile has a whooping 750 million subscribers, but technology constraints by China Mobile have limited the initial rollout (beginning in January of 2014) to just 16 cities. Although it is still early days in the China Mobile partnership, we expect sales to pick up considerably as

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[2] By itself, the iPhone generates more revenues (and is growing faster) than Microsoft's *entire* business.
[3] This Is The Chart That Has Apple Analysts Drooling About The iPhone 6
[4] Apple Smartphone Devices Rank Highest among Tier 1 Wireless Carriers
[5] Apple currently has more than 800 million credit cards on file (~4 times the number of cards held by Amazon)
[6] Apple's Eddy Cue touts 'best product pipeline' in 25 years coming this year
[7] Applle Repurchases $14 Billion of Own Shares in Two Weeks
[8] Q1 2014 Earnings Conference Call Transcript

China Mobile continues to rollout 4G functionality to 340 cities by the end of 2014. Clearly, international growth, both in China and other countries, continues to look very promising going forward.

Strong Bench & Steady Hands

- No News Is Good News: Despite being in the middle of a product refresh cycle (i.e., new iPhones are expected in September), and without any other big product announcements, AAPL continues to perform like a gem: earning ~ $37 billion over the last 12 months (slightly down from $42 billion as of YE 2012). This earning power translates to some impressive cash generation, AAPL finished the most recent quarter with approximately 26% of its market cap in cash. While the stock has gone up ~18% YTD, the stock continues to trade at a P/E multiple of ~ 15.5x[9] which is not only cheaper than the overall market multiple, but is also even cheaper when available cash is subtracted from total market value. Needless to say, there is still ample room before we get anywhere near drunken optimism.
- Music To Our Ears: As if everything above weren't enough, on April 23, 2014 AAPL announced their intention to return over $130 billion dollars to shareholders by increasing their dividend payment (now yielding just over 2%), and implementing a humongous stock buyback program ($90 billion - the *largest* single share repurchase in history[10]). For good measure, AAPL also announced a recent 7-1 stock split. While stock splits are largely cosmetic,[11] we suspect a 7-1 split (rather than a 2-1 or some other combination) was likely management's subtle means of suggesting their stock was underpriced. Perhaps another example of management's confidence - or outright savvy - was on display in the two weeks after Jan 27, 2014, the day after AAPL reported lower iPhone sales than projected. Additionally, management warned that revenue in the current quarter might decline from the same period a year ago. Unsurprisingly, Wall Street was not impressed and AAPL shares went down 8%. Instead of panicking, AAPL's CEO would later tell the Wall Street Journal that he took the opportunity to be "aggressive" and "opportunistic": over the next two weeks AAPL purchased $14 billion of their stock. To put this in perspective, AAPL's $14 billion was actually more than what all but three companies (excluding AAPL) spent on buybacks for all of last year - and they did it in just a two week period.[12]

Given our large position in AAPL, we are finally able to answer a confident and resounding "yes!" when we ponder that rhetorical question posed in every Allstate commercial: "Are you in good hands?"

Verisign

Founded in 1995, Verisign (VRSN) was initially a "certificate authority" or issuer of "digital certificates,"[13] but sold this part of their business in 2010 to focus on a far better line of business, one that would usually be described as a "monopoly." Of course, VRSN is far too prudent to use the m-word, and instead prefers "registry services" as the title for the line of business responsible for nearly all revenues and profits. But, as you will soon see, "registry services" is really secret code for "the internet won't work without us, and we have contracts that ensure our ongoing monopolist opportunities will continue to fill our pockets."

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[9] as of July 1, 2014

[10] Apple More than Doubles Capital Return Program

[11] Ten $1 bills are equivalent to one $10 bill

[12] Just How Big Was Apple's $14 Billion Buyback?

[13] Digital certificates serve as a trusted third party in cryptography to enable secure connections over the internet. For example, if two parties (ie you and me) are seeking to securely transact or communicate over the internet, a method is needed to verify each party is representing themselves truthfully. As a third party, trusted by both parties, a certificate authority serves as the verifier to each party that 1) both of us are who we say we are, and 2) the transaction is thus valid and secure.

Before delving into the details of VRSN's business and those contracts, it is important to understand something called top-level domains (TLDs). TLDs are the last part of every internet domain, examples of common TLDs would be .com, .net, .org, etc. Each time anyone - anywhere in the world - goes to a website of their choosing, they do so by typing a name (e.g., cnn, google, facebook, etc) followed by a TLD (e.g., cnn.com, google.com, etc).[14]

In the digital world, VRSN is the "*authoritative directory*" of all .com domain names AND "the *exclusive registry* of domain names within the .com" generic top-level domain (gTLDs).[15] As a registry, VRSN maintains "the master directory of all second-level domain names in these TLDs"[16] (e.g., johndoe.com, example.com, facebook.com, etc). To fully comprehend the significance of these terms, consider the following examples:

- As the "authoritative directory" VRSN ensures that the web address "amazon.com" directs all internet traffic to the famed web retailer (instead of a page dedicated to the Amazon rain forest), or that "cnn.com" directs all internet traffic to a site filled with "breaking news" rather than the homepage for Charles Nicholas Nelson (i.e., someone, or something, with the initials of CNN). The technical name for this function is Internet Assigned Names Authority (IANA) and involves control of something - *also* controlled by VRSN - known as the "root zone." A full explanation of this responsibility is addressed a bit later in this letter, and will - of course - require several more acronyms.
- Better than a directory - even when it's an *authoritative* directory - is an "exclusive registry." Exclusive registry simply means that every .com (or any other TLD for which VRSN is the exclusive registry) must - without exception - always pay VRSN when they 1) first register a domain and 2) when the domain is renewed every year thereafter. While consumers are free to buy and keep their domains at any registrar of their choice,[17] no domain for which VRSN is the "exclusive registry" is issued or renewed without first paying VRSN and its humble shareholders.

Only Sure Things Are Death, Taxes . . . and Domain Registration Fees

It is VRSN's role as the exclusive registry for .com that is by far the largest contributor to revenues and profits. Fortunately, there are only a few factors to consider when thinking about the .com registry and any potential impact this may have on VRSN's success going forward:

- <u>Active Domains</u>: VRSN makes money when either new .com domains are issued or old .com domains are renewed. As of YE 2013, VRSN reported a total of 127.2 million active .com and .net domains,[18] representing a 5% improvement from the year before.[19] While the active domain counts *does* seem to ebb and flow based on trends outside of VRSN's control (e.g., economic condition, registrar promotions, etc), growth in active domains over the last five years has ranged from 5-9%, and better than 70% of all .com and .net domains are renewed each year.
- <u>Continuity, Exclusivity, and Profitability of .com Registry Agreement</u>: In 2000, VRSN acquired the core registry functions that would form the basis for VRSN's registry services division.[20] The .com Registry

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[14] If drawing an analogy to the physical world, the name might be the street address, while the TLD might be the state or country of such address. Either way, *both* the name and the TLD are necessary to avoid getting lost in both the physical and digital worlds.

[15] From Wikipedia: "a gTLD is one of the categories of TLDs mained by the Internet Assigned Numbers Authority." "The core group of generic TLDs consist of the .com, .info, .net, and .org domains."

[16] While a much smaller part of their business, VRSN is no one-trick pony, it is also the exclusive registry and authoritative directory for .net, .cc, .tv, .name, .gov, .jobs, and .edu domain names.

[17] popular registrars include GoDaddy, Network Solutions, and eNom to name a few

[18] As of YE 2013, VRSN reported 112 million .com domains and 15.2 .net domains.

[19] http://www.verisigninc.com/assets/domain-name-report-april2014.pdf

[20] The operations for .com, .net, and the .org TLDs were acquired in VRSN's acquisition of Network Solutions. VRSN would later divest the retail part of Network Solutions (ie the domain name registrar), while retaining the wholesale domain name registry that is now their main line of business.

Agreement (Agreement) is a periodically renewed contract between VRSN, ICANN, and the United States Department of Commerce. The last iteration of the Agreement was signed on November 29, 2012 and provides the following key points:

- VRSN will remain the *exclusive* registry operator for domain names in the .com TLD through November 30, 2018.
- The price of a .com domain name shall *not* exceed $7.85 for the term of the Agreement.[21]
- Just in case the other terms weren't favorable enough, VRSN and their lawyers have seemingly managed to effectuate this Agreement into perpetuity with the following legalese: "The 2012 .com Registry Agreement provides that it shall be renewed for later terms unless it has been finally determined by an arbitrator or court that the Company has failed to cure a fundamental and material breach of certain provisions of the 2012 .com Registry Agreement and, following the decision of such arbitrator or court, the Company[22] fails to comply with such decision." Thus, VRSN's exclusive monopoly on .com registration will remain in place unless 1) a court or arbitrator rules that VRSN has defaulted on their part of the Agreement; AND 2) despite said ruling, VRSN still fails to take steps necessary to fix their default! Maybe John Rockefeller was on to something when he said "competition is a sin."

The Less Favored Children

We sleep well at night when we think of .com's dominance, and believe you should too. Even so, it is worth noting that VRSN does provide the registry for a variety of other TLDs including .net, .name, .tv, .cc, and others. But, for brevity's sake we will simply note that VRSN's other registry operations are generally based on terms even more favorable (especially in terms of pricing) than those found in their .com Registry Agreement.

Additionally, ICANN is in the early stages of introducing a whole slew of new gTLDs possibilities including such "blockbusters" as .today, .ninja, .company, and .tips![23] While much has been made of this new "land-rush" of domains, .ninja hardly seems like a plausible threat to the long establish standard of .com or any of the alternatives already available. Nonetheless, it is always good to be prepared. Accordingly, should any of the new gTLDs prove more popular than anyone expected, VRSN stands to benefit as applicants for approximately 200 of these new gTLDs are already in contract with VRSN to provide back-end registry services.

No Good Deed Goes Unpunished

VRSN's role as "authoritative directory" - while fundamental to the daily functioning of the internet - involves a slightly complicated web of contracts and organizations: At the very foundation of the internet is a role called Internet Assigned Numbers Authority (IANA) which is the right and responsibility to assign names among domains.[24] Because the original architecture of the Internet was developed in the United States, this responsibility was initially managed by the US government. However, since the 1990s, the US government has offloaded much of the IANA responsibility to a non-profit group known as the Internet Corporation for Assigned Names and Numbers (ICANN). ICANN was essentially created for the purpose of being able to contract *out* the running of the IANA function - a power given to them (and periodically renewed since) by a contract from the National Telecommunications and Information

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[21] except that VRSN will have "the right to increase the price of a .com domain name during the term . . . due to the imposition of any new Consensus Policy or documented extraordinary expense resulting from an attack or threat of attack on the Security or Stability of the Domain Name System (DNS) not to exceed 7% above the price in the prior year."

[22] in both cases, Company is VRSN

[23] On June 13, 2012, ICANN announced it had received 1,930 applications for over 1,400 unique new gTLDs.

[24] (amazon.com = online retailer, *not* a site about the rain forest)

Administration (NTIA).[25] While ICANN manages the IANA function under contract to the NTIA, the actual work of maintaining the core list of gTLD domains and their operators is handled by something known as the "root zone." The technical work of maintaining the root zone is managed under a cooperative agreement between the US Department of Commerce[26] and VRSN.

The reason the above detail is important to understand is that recent market pessimism for VRSN seems to indicate that most investors simply misunderstand - or are too lazy to even try - the dynamics of the non-registry part of VRSN's business. This became especially clear - and all the more important - given the government's recent noise-making:

- In March of 2014, mainly in response to pressure from revelations made by Edward Snowden about the National Security Agency and its spying activities, the NTIA announced that the US would relinquish federal government control over "the administration of the Internet." The government plans to relinquish this control by simply not entering into another contract when the current contract[27] expires in 2015. Instead of renewing the contract with ICANN, the US government plans on simply surrendering the IANA function to ICANN going forward. Because nothing is ever clear or easy when it comes to government actions, ICANN will have to meet a list of currently ambiguous specifications, and our elected officials will need plenty of time to pontificate one way or the other. Thus, no one really knows when - or if - this change will actually happen.
- Nonetheless, investors spooked by these developments seem to be unaware of the following:
    - The contract to manage the root zone is separate (i.e., 100% unrelated) from the contract with ICANN that stipulates VRSN's ongoing role as the exclusive registry of .com domains (officially known as the ".com Registry Agreement," unofficially known as the monopoly money printing machine).
    - The role of managing the root zone - something ICANN may or may not renew post transition - is currently provided by VRSN ***<u>for free</u>*** *"as a service to the internet and the world."*
    - Given the continued importance of a functioning and reliable internet to the global economy, we suspect ICANN is unlikely to make flippant changes to key parts of the underlying infrasture - especially when such infrastructure is maintained for free and without problems . . .

Ultimately, an investment in VRSN is a bet on the future of the Internet, and VRSN's continued role as a stable and reliable provider of several core functionalities. Developments related to the NTIA's departure may provide some near-term turbulence, but we suspect any turbulence will largely be noise and misunderstandings. Either way, we are confident that VRSN's dominant position will remain intact, and may even rise stronger whenever the dust settles. At just 14 times earnings, we suspect manning the .com toll both may be significantly more promising and enduring than current market consensus seems to think.

In Closing

As always, thank you for entrusting us with your investment.

Please feel free to email me at stephen@rltcapital.com or call at (415) 894-5406 if you have any questions.

Sincerely,
RLT Capital, LLC

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[25] The NTIA would actually "let out for bid" the contract for the management of the IANA function. However, the contract has historically been written in such a way that there was only one entity, ICANN, that could realistically win the contract.

[26] of which the NTIA is a component

[27] between the NTIA and ICANN

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