

July 20th, 2016

Dear Partners:

The Fund finished the first half of 2016 up 8.68%. Since inception (in May of 2014), the Fund has grown by 41.40% as shown below:

	Q1 2016	Q2 2016	1st Half 2016	Since Inception
Fund ¹	12.79%	(3.65)%	8.68%	41.40%
S&P 500 Total Returns	1.35%	2.46%	3.84%	16.70%

The markets began 2016 concerned with a slowing Chinese economy, low oil and commodity prices, and the expectation of four rate hikes from the prognosticators of such things. By the end of the first half, China's problems remained largely unresolved, oil's freefall had stabilized somewhat, and Britain's vote in favor of a so-called "Brexit" surprised the world and wiped out more than \$3.0 trillion in paper wealth within just two days. Throughout the first half, quick swings towards pessimism were soon followed by equally rapid rebounds in price, optimism, and continued faith in the world's central bankers: by June 30th, \$12.7 trillion (over 1/3 of the \$35 trillion in total sovereign debt) yielded *less than zero*, while another \$14.5 trillion boasted only slightly more generous yields of between 0%-1%.

Amid abundant macro worries and investors starved for yield, market commentators vacillated between proclamations of "risk on" and "risk off" as elevated volatility became the norm throughout the first half. Yet, for those of us who invest with a risk *always* on mindset, risk is *best* managed by understanding what you are buying, what it is worth, and being disciplined enough to wait until it sells for less. In this sense, volatile markets are often the friend of patient investors - presenting opportunities to buy companies we studied long ago, at prices well below our best estimate of value.

With the S&P 500 down ~8% just ten trading days into 2016, several companies on our watchlist had fared even worse - prompting us to add both LSB Industries (LXU) and Quotient Technologies (QUOT) to the portfolio. These well-timed purchases boasted whiplash-worthy gains of ~92% at QUOT and ~162% at LXU by the end of Q1. However, not even a further increase of ~26% at QUOT could shelter Q2's results against declines of ~12% at Apple (AAPL) and ~31% at American Airlines (AAL).²

During the first half, we also:

- Added positions in 1347 Property Insurance Holdings (PIH), Macy's (M), and Trinity Industries (TRN),
- Trimmed our position in LXU by 50%,
- Exited our Civeo Corporation (CVEO) position entirely (more below),
- Finished the first half with ~6% of the Fund in cash, and
- Remained (patiently) invested in AAL, AAPL, Entravision (EVC), Verisign (VRSN), and Zynga (ZNGA).

¹ All performance numbers are calculated before allocation (no management fee, performance fee of 1/4 of gains in excess of 6%) to the General Partner.

² As one example of price volatility within our portfolio, AAL shares are already (just 13 trading days into the second half) ~27% above their first half closing price.

Broken Record

As our largest holding, APPL's ~12% decline in the second quarter reduced total first half performance - for the Fund - by nearly 4%. At the risk of singing the same old tune on repeat, we continue to believe APPL's market price remains disconnected from the substantial value we see in everything from APPL's management team and financials, to its best in class products and throng of loyal customers. While we recognize few companies are followed as exhaustively as APPL, we remain convinced the bulk of APPL's followers continue to miss the forest for the trees in their endless fixation on macro speculation, product gossip, and general tea leaf reading.

Although it seems all but certain that iPhone sales will fluctuate for any number of reasons going forward, we believe APPL's continued focus on keeping both customers and developers happy is ultimately *the* time-tested recipe for making shareholders happy too. Thus, whether it is worries of a Chinese (or global) economic slowdown, lowered expectations for the upcoming iPhone 7 (now rumored to include only incremental improvements - and thus, preemptively declared a flop), or some other passing concern, the prevailing view that APPL's best days are behind it, is *not* one we share.

Calling CVEO

In what is now considered the costliest disaster in Canadian history, the Fort McMurry wildfire began on May 1st and would spread its devastation for nearly two months across nearly 1.5 million acres in Alberta and Saskatchewan, before finally being declared under control in early July. The fire's proximity to several of CVEO's camps sent CVEO's stock soaring as the market eagerly fantasized about the possibilities to transform crisis into profit.

Given CVEO's already-constrained reality, we were surprised to see the enthusiasm with which the market welcomed such news. Despite the obvious demand for CVEO's rooms left empty by the oil slowdown, common sense indicated most of this demand would be from evacuees in need of shelter, safety, *and charity*. While such charity was indisputably the right thing to do amid such devastation, it seemed evident the (uncertain) costs of doing so - at least initially - would be borne by CVEO. Accordingly, we reached out to investor relations in search of what (if anything) we might be missing in our analysis.

After a day of radio silence, we called back and were soon transferred to someone who - abandoning any pretext of phone manners - seemingly belched a curt: "What?" In fairness, perhaps "what?" was the relevant - albeit blunt - question. As in:

- WHAT were we thinking (when we *again* invested in CVEO)?, or
- WHAT exactly compelled us to remain shareholders going forward?

As we pondered such questions, CVEO's investor relations was actively calling shareholders, but only to "remind" them to vote their shares in the upcoming shareholding meeting. Such a priority might seem odd until you realize that among the proposals shareholders were "reminded" to vote on, were requests to:

- dilute existing voting threshold requirements from a percentage of total shares *outstanding* to a percentage of shares *voted* (an easier hurdle), and
- to increase the number of shares in the "equity participation plan" more than 3 fold (from 4 million to 14 million) as well as change the minimum vesting period from 3 years to a mere 1 year.

Ultimately the disparity regarding *what* management was doing ("reminding" shareholders to vote) versus *what* we thought they should be doing (communicating with shareholders about the fire - and its implications - in a proactive and forthcoming manner) was the straw that broke this camel's back. By the time we were able to speak with management, we had already answered the "what" question for ourselves, and exited the position entirely.

A ROI of 6,779.5%

After increasing ~41% in the second half of 2015, VRSN's stock price took a well-earned breather during the first half of 2016. Nonetheless, we remain as bullish as ever on VRSN's prospects, and shared our bullishness as an entry to the recent Sohn Investment contest (a copy of which is included with this letter). While the winning idea advocated shorting DexCom (a trade that hasn't been pretty to date), we enjoyed the chance to re-examine / revisit our investment thesis, and continue to think a long-lasting monopolistic toll booth on all.com registrations remains a no-brainer.

On a (slightly) related note, we were unexpectedly reminded of the value of good domains while reading a recent Wall Street Journal (WSJ) profile³ of a young fund manager - Geoffrey Abbott - of GCA Capital (more on this later). As it turns out, Mr. Abbott bought his domain (gcapital.com) from yours truly in 2013 for \$765.00. That is, \$765.00 dollars for a domain registered (with a coupon) for \$2.95 in 2012 and later renewed in 2013 for \$8.17 - a profit of 6,779.5%. Even so, VRSN (mostly) missed the party thanks to regulated pricing still in effect - likely pocketing a relatively puny \$23.55 in registration fees.⁴

Although our bullish view on VRSN does not rely on (nor include) pricing in the domain aftermarket, we believe such aftermarket pricing is yet another indicator of the large gap between market prices and those set by regulators.

QUOT

In 2015's year-end letter, we explained our bullish thesis for QUOT, concluding: "If retailers are as slow to remove QUOT's products from their all-important point-of-sale platforms as they have been to add them . . . QUOT is well-positioned to benefit. Although we harvested our losses at year-end, don't be surprised if QUOT returns to the portfolio."

And return to the portfolio it did! Better yet, by the end of the 30 days required by the IRS's wash sale rule, QUOT had decreased another ~20%. At odds with the bearish sentiment (and declining price), our conviction remained unchanged as QUOT continued its steady (and slow) rollout of RetailerIQ. Via their continued relevance with consumers, product manufacturers, and grocery retailers, we believe QUOT has painstakingly assembled the necessary pieces for the Rolls Royce of all moats: the network effect.

Accordingly, we considered ourselves well prepared (and very lucky given the additional discount) to once again add QUOT to the portfolio. With (unrealized) gains of ~142% at the end of the first half, we continue to believe QUOT's snowball is only just beginning its slow roll down a very large - and lucrative - hill.

When It Rains, It Pours

LXU first popped up on our radar in a Barron's article in April of last year. Back then, LXU was in the (unrelated) businesses of making fertilizer and building large heating, ventilation, and air-condition (HVAC) systems for commercial and industrial buildings (i.e., various hotels, Rockefeller Plaza, etc). The investment thesis was fairly straightforward: 1) a separation of the two businesses would yield a sum-of-the-parts value well beyond the market price, 2) the board had said a separation "may be a step for consideration" upon the completion of a plant expansion in 2016, and 3) the presence - and 7.3% ownership - of an activist shareholder (already aggravating for change and board seats) would provide the catalyst to unlock hidden value.

With fertilizer and HVAC systems solidly outside of our circle of competence, we filed it in our subconscious until we again read about LXU in the July 2015 Market Commentary published by Horizon Kinetics. As an LXU

³ 4/1/2016 WSJ: "It's Time for Investors to Re-Learn the Lost Art of Reading."

⁴ \$15.70 (\$7.85 x 2 years of registration under my ownership) + \$7.85 (upon registration in Mr. Abbott's name).

investor, Horizon emphasized: 1) an owner operated company, 2) with an impressive track record of growing book value, and 3) a plant expansion underway with compelling implications upon completion. And boy were there some implications! Once completed, the plant expansion was expected to increase LXU's capacity by 70% while also eliminating their need to buy ammonia as a feedstock. From Horizon's letter, LXU's "published estimates are for a \$90 million increase in operating cash flow (EBITDA) based on a normalized production at El Dorado and its associated benefits in the production of other product . . . Less a rough estimate for increased depreciation and income tax expense, net income could be \$50 million higher." With just ~23 million shares outstanding and (as Horizon pointed out) "average earnings for the past 10 years" of \$37 million, an additional \$50 million is real money.

By the time we read the annual report in mid October, the stock had already fallen by more than ~55% from its trading levels at the time of Horizon's letter. Even so, we decided to pass due to our difficulty in confidently valuing two cyclical businesses outside of our circle of competence, as well as all of the risks inherent in any sort of debt funded expansion in terms of delays, cost overruns, or both.

Then in mid-November, the company announced the sort of bad news that quickly transforms scared investors into former investors: not only was the plant expansion going to take longer . . . it was also going to cost (much) more than originally planned. Given the sudden gap between projections and reality, additional financing was secured and a new management team was put in place to right the ship. Despite interest rates at unprecedented lows elsewhere, the terms for LXU's financing looked more like a kick in the gut than a life saver:

- \$50 million in senior secured debt with a 12% interest rate,
- \$210 million in preferred stock with a 14% annual dividend and an economic participation right equal to 2% of the outstanding common stock before the transaction,
- Warrants to purchase 17.99% of the company with an exercise price of \$0.01 per warrant and a ten year term,
- Voting rights equal to 19.99% of the common stock before the transaction, and
- 3 board appointees.

Not even the Golsens (the founding family) were spared; the terms of the financing not only required the Golsens to maintain ownership of at least 75% of their stock, but also required the newly issued preferred shares to be senior to those held by the Golsens. In short, the bankers took a pound of flesh (and then some), LXU apparently lacked any better options, and shareholders heard the message loud and clear as they dumped their shares. By January, LXU was selling for an enterprise value (market value + net debt) of just ~\$660 million dollars - a drastic discount to the value of their assets.

Mindful that risk is both a function of *what you buy* and *what you pay*, we took great comfort in the disconnect between the market price and even the most simplistic valuation of their assets. For example, not only were they in the process of topping off a nearly ~\$830 million investment in the expansion of one plant, they also had 3 additional chemical facilities. Additionally, there was the entire HVAC business, which we suspected could reasonably fetch \$170 million - at least - by itself.

With much of the bad news behind it, LXU has spent the first half of 2016 quickly getting things back on track. By May, they had sold the climate business for \$364 million (more than 2x our crude valuation), started production at the expanded plant, and limited unexpected outages at other plants. By the end of the first half, the Fund had realized gains of ~170% on 50% of our position, and unrealized gains of ~139% on the remainder of the position.

Taxi!

Although we briefly mentioned Mr. Abbott above, it was his goal - rather than his domain purchase - that earned him the WSJ's spotlight. In an article titled, "It's Time for Investors to Re-Learn the Lost Art of Reading," the WSJ shared Mr. Abbott's goal of perusing "the annual report from each of the 3,000 largest companies in the U.S." in part, by reading the letter to shareholders written by each company's CEO. To illustrate the apparent rarity of such efforts among investors nowadays, the profile offered some interesting evidence:

- "Timothy Loughran, a finance professor at the University of Notre Dame who studies corporate disclosure, has analyzed computer records for the Securities and Exchange Commission's filings website. He says only 29 people a day download the average annual report when it comes out. Even General Electric's annual report was downloaded from GE's website only 800 times in 2013, according to the company."

While it may not be terribly shocking that an annual report clocking in at 146 pages⁵ wasn't exactly popular reading in a year when the masses were clamoring to read *50 Shades of Grey*, it does make one wonder what investors no longer "willing to do that sort of digging anymore," are doing instead? In one word: **marketing**.

According to a May WSJ article,⁶ many of "the most famous minds in investing" journeyed to Vegas for an "annual celebration of the hedge-fund industry." The 3-day SALT conference is a "staple of the hedge fund circuit, famous for attracting heavyweight investors, celebrities, and politicians." Yet, the reality of clients disappointed by lackluster returns and a (billionaire) fund manager lamenting "whether it made sense to continue on after redemptions from his firm" apparently weighed heavily on the festivities. Even worse, the mood was apparently so dampened that one major "investment bank told clients they would have to hail cabs to a nightclub venue because the bank would no longer cover limousine service of years past . . ."

In a world of *mostly* efficient markets - where price and value are aligned *most* of the time - *most* investors don't beat the market. Underlying this truism are the realities articulated in the above articles, namely: *most* fund managers simply aren't willing to do *most* of the slow work - read, think, rinse, repeat - that smart investing requires. And even if they were, the resulting fund would lack *most* of the sex appeal, marketing gibberish, and (perceived) predictability desired by *most* institutional investors.

Thankfully we aren't like *most* fund managers, and you aren't like *most* investors. Instead, we are delighted to spend our days thinking, reading, and searching for new opportunities - one page at a time. We also benefit from the trust and freedom bestowed upon us by our partners, whose long-term patient approach to investing almost certainly makes even the "most famous minds in investing" shudder with envy!

As always, please feel free to email or call with any questions or concerns.

⁵ Dwarfed by the 222 pages of GE's 2015 annual report.

⁶ 5/12/2016 WSJ: "Hedge Fund Star: We Are 'Under Assault'"

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