October 20, 2014

Dear Partners:

In Q3 we were fortunate to receive two additional capital contributions to the Fund (a ~28% increase in capital under management), and eagerly put most of the capital to work. Accordingly, the Fund finished Q3 2014 with YTD returns of 12.66%, net of fees and expenses. By comparison, the S&P 500 index finished the quarter with YTD returns of 9.30%.

Although we detailed much of our investment thesis for Apple (AAPL) and Verisign (VRSN) in last quarter's investment letter, given the size of both positions (AAPL continues to be our single largest holding), a quick update is in order:

Verisign: At several points throughout the quarter, VRSN - led by its .com monopoly - was our top performer (on a percentage basis). The new domain extensions (gTLDs) have proved underwhelming[1] to say the least, and VRSN reported great results for Q3 2014.

Apple: Just in case anyone was living under a rock during Q3, AAPL used their September event to gift the world three new products: the latest and greatest iPhone, the Apple Watch, and Apple Pay. While the potential of Apple Watch is hard to determine at this point, the continued dominance of the iPhone is undeniable. During AAPL's most recent earnings call, management announced that the initial sales of the new iPhones - despite only being available for a few weeks at the end of Q3 - were well ahead of internal expectations. Amazingly, Q3's gangbuster sales of the new iPhones did not even include demand from China, where just the pre-orders were rumored to exceed 20 million![2] Needless to say, AAPL shareholders also received a gift of their own: better than expected earnings for Q3.

The real star of Apple's show, however, was the introduction of Apple Pay, Apple's solution to mobile payments. While skeptics are correct that Apple Pay is only compelling IF consumers use it, and IF retailers accept it, this could be a real profit rocket and we believe the stars have never been better aligned for Apple Pay's success:

Compelling For Merchants

- Upcoming Terminal Refresh Cycle: As of October 2015, merchants must use the more secure payment terminals (those that accept cards embedded with a chip). Should they fail to do so, the merchants (not the banks!), will be liable for any fraudulent charges. Many of these new terminals will also include NFC technology - a requirement for Apple Pay.
- Fraud Now = Monetary *and* Reputational Costs: Target's hacking scandal sent store sales and the stock price tumbling, has cost the company its reputation, its CEO his job, and ~$150 million in hacking-related expenses so far. Yet, Target is not alone: there have been 579 data breaches this year, a 27.5 % increase over the same period last year.[3] We suspect executives at large merchants are likely to be especially receptive to anything that helps them dodge the speeding bullet of fraud and point the finger elsewhere.
- It's Free: Apple Pay - according to the Q3 2014's earnings call - does not impose any charges on either the merchants or customers, which is likely to sound much more appealing to merchants than expensive (and uncertain) investments in IT and other security-related technology. We suspect early resistance to Apple Pay

[1] For those wondering, the top three new gTLDs (as of 10/16/2014) were: .xyz (614,000 registrations), .berlin (140,000 registrations), and .club (121,000 registrations). All in, the new gTLDS have resulted in a lackluster ~2.7 million domains across 425 new extensions.

[2] MacRumors: iPhone 6 Pre-Orders in China Top 20 Million Through Carriers and E-Commerce Site JD

[3] Washington Post: Home Depot and JPMorgan are doing fine. Is it a sign we're numb to data breaches?

by some retailers (Walmart and CVS are notable examples), will eventually subside when retailers (or their shareholders) realize they are retailers, not technology specialists . . . The odds on Walmart transforming the payment space is not a bet we wish to make!

Compelling For Banks

- $10 per Card: At an average cost of $10 per card, banks spent ~$200 million dollars after the Target fiasco just on replacement cards alone! Importantly, that $200 million only covers the cost of the newly issued plastic and does *not include* the (presumably much larger) tab for any fraudulent charges made on the compromised cards![4]
- The Holy Grail of Authentication: Signatures are rarely checked, and even then can easily be faked. Pin numbers, card numbers, zip codes, the three numbers on the back of the card, or any other data points, are only as secure as the weakest database storing them - simply put: that is a big problem! Thus, the holy grail for banks is an authentication method that mitigates the flaws of forgery and security at any one database. In this regard, there is little doubt that Touch ID combined with AAPL's control of software *and* hardware offers a fortress level of security well beyond current alternatives. For this reason - above all others - it should be no surprise that more than 500 financial institutions have already embraced Apple Pay.
- Horse & Buggy Insurance: While Apple Pay *does* impose (an undisclosed) charge on the banks, it works within the existing banking network, addresses one of their main costs (i.e., fraud), and - if successful - assures their enduring relevance and profitability in the payment space.

Compelling For Consumers

- Consumers = The Big Unknown: While an estimated 40% of Americans consumers have experienced card theft within the last five years,[5] it remains an open question just how excited consumers really are to replace their wallets with their phones at the checkout. Accordingly, we suspect Apple Pay may present a more compelling use case for online shopping (Touch ID has now been added to iPads), as consumers will no longer have to leave the couch to find their wallets. Either way, the use case on the consumer front is admittedly less than certain at this point. That said, the formidable marketing muscle of both AAPL and the card issuers will undoubtedly put their collective best foot forward.

In keeping with last quarter's format, we thought we would detail two investments added to the Fund during the quarter. While both of these positions were positive contributors to Fund performance at various times throughout the quarter, recent market volatility left both positions in the red as of quarter end. Nonetheless, both companies retain significant value in excess of current market prices, and we continue to believe there is much to like in both companies.

Entravision

Entravision (EVC) is a Spanish-language media company. Founded in 1996, EVC is the creation of current Chairman & CEO Walter Ulloa (a lawyer and TV guy) and current board member Philip Wilkinson (a radio and sales guy) who convinced three other investors - all TV station owners - to combine their interests into one company (an additional investment of $10 million came from Spanish-language broadcaster Univision[6]). By the fall of 1998, EVC was already the proud owner of eleven Univision-affiliated TV stations, three Spanish-language radio stations, and the first (of many) net losses.

Just two years later - and still unprofitable - EVC would raise ~$800 million via an August 2000 IPO. Apparently fearful that the new money would burn a hole in their pockets, EVC quickly got to work acquiring. Through a variety

[4] WSJ: What Did the Target Hack Really Cost? The Numbers Trickle In
[5] http://www.businessinsider.com/apple-pay-has-one-big-problem-2014-10
[6] In return for the option of later converting their investment into a 25% equity interest in EVC. Incidentally, Univision would go on to make additional investments in EVC (at one point owing ~30% of EVC) until forced by the Department of Justice and FCC to divest their stake down to no more than 10% of EVC - an investment Univision maintains today.

of acquisitions - some pre-negotiated and contingent on their IPO windfall - EVC would add more than 50 radio stations, 1,200 billboards, and a newspaper to their portfolio of Spanish-focused media properties.

Unfortunately, a fool and his money are soon parted, and this time was no different. The radio business has been progressively slimmed down to today's remaining stations, and the billboard business was divested in 2008. Even worse, EVC was hit especially hard by reduced ad spending (most notably by the automotive industry) during the most recent financial crisis, resulting in the "impairment"[7] to the carrying value of the radio assets by an astounding $735 million between 2006 and 2008.

Thankfully, things are a bit quieter at EVC nowadays. Management has managed to keep acquisitions to a minimum. Advertisers are both spending again and increasingly mindful of the Hispanic community's growing spending power. EVC's portfolio now consists of 58 TV stations and 49 radio stations that it owns and/or operates in "densely-populated and fast-growing Hispanic markets in the U.S." Specifically, EVC operates media properties in 14 of the 20 highest-density Hispanic markets, and 10 of the 15 fastest-growing US Hispanic markets. Given the limited supply of broadcasting licenses, and EVC's impressive holdings in crucial Hispanic markets, it is safe to say that EVC owns some real gems.

Even so, this beauty isn't without a wart or two, and perhaps the biggest of these warts is EVC's debt. Currently, EVC spends nearly ~18% of operating income to service the interest on their ~$360 million of total debt (~50% of enterprise value).[8] While debt is certainly a bad word, it doesn't have to be a fatal or final word. Accordingly, we remain confident in the ongoing earning power (and resulting debt service capability), and are further reassured by management's proactive management of interest rate exposure. Incidentally, debt covenants and the watchful eye of creditors are likely to do an excellent job of tempering any future acquisition itches.

The other factor that seems to give investors (especially short-term investors) some pause is EVC's earnings volatility. As a media company, EVC's revenues are primarily the result of both general marketing spending, and the percentage of such spending focused on Spanish-speaking audiences. While some lumpiness is simply inevitable, there is a lot to like if you are a marketer:

- Eyeballs: The Hispanic population of the United States (US) numbered ~54 million people, or ~17% of the total US population.[9] Already a large part of the American demographic, Hispanics accounted for nearly *half* of US population growth (~2.3 million people) between July 2012 and July 2013. This growth is so robust that Latinos are expected to compose 40% of the net new US households over the next 10 years, and grow to 31% (~128.8 million) of the US population by 2060.[10]
- Spending Power / Influence: The buying power of the Hispanic consumer is expected to rise from $1 trillion in 2010 to $1.5 trillion by 2015. While Latinos make fewer trips to the store than the average non-Hispanic consumer, they spend more per trip than average ($52 vs $47).[11] In the wake of their impact on the 2012 elections,[12] Hispanics are also becoming increasingly relevant to political advertisers.[13] Incidentally, while

[7] Accounting speak for these assets are no longer worth as much as we once thought
[8] Interest expense and operating income based on last 12 months as of Q2 2014. Debt as of Q2 2014. Enterprise value as of the end of Q3 2014.
[9] As of the most recent US Census Bureau on July 1, 2013
[10] infoplease: Hispanic Americans By the Numbers
[11] Nielsen: The State of the Hispanic Consumer
[12] CNN: Latino Vote Key To Obama's Re-Election
[13] Political advertising is an example of how Spanish-language marketing dollars are not yet on par with the amounts received by English-language broadcasters. While ~20-25% of the revenue for English-language broadcasters will be driven by political ads during the runup to an election, only 9% of EVC's revenues were driven by political advertising in the last election cycle of 2012.

Hispanics remember English-language commercials as well as the general population, their ad recall increases by as much as 30% when shown the same commercial in Spanish.[14]

- Relevance: On the TV front (~70% of revenues), Entravision is the largest affiliate group of the Univision television network with TV stations in 20 of the nation's top 50 U.S. Hispanic markets. In filings, EVC aptly describes Univision as "top-ranked," and they aren't embellishing: the all Spanish network has ranked ahead of all major networks - i.e., ahead of giants such as ABC, CBS, FOX, and NBC - in the important July sweeps for the last two years and counting![15] Accordingly, EVC celebrated their 11th consecutive quarter in Q2 2014 in which EVC's TV revenue growth exceeded revenue growth seen across the broader TV industry. Although less profitable than the TV assets, 48 of EVC's 49 radio properties are located in the top 50 US Hispanic markets (broadcasting to nearly 40% of the US Hispanic population), and continue to hold their own (revenues increased 8% in Q2 2014).

Even if you remain unconvinced of growth within the Hispanic community, unimpressed by EVC's media assets and partnership with Univision, or simply don't believe EVC will be able to capitalize on an improving advertising environment, consider this:

- EVC's broadcasting assets are currently carried on the balance sheet at values ***below*** - some far below - current market prices due to a more favorable marketing environment and those deep impairment charges of 2006-2008.[16] While these impairments may have been justified when they were made, they are almost certainly not an accurate reflection of current asset values, and - per accounting rules - can only be revalued if/when the assets are either further impaired or offered for sale. Thus, absent a sale, these assets will remain on EVC's books at values reflecting the turmoil of 2006-2008. Needless to say, with an enterprise value just over $700 million, we remain confident there is much more value here than first meets the eye.

Zynga

Founded in 2007, Zynga (ZNGA) would quickly became the quintessential "social gaming" company by leveraging a close relationship with Facebook (the "social" in "social gaming") to drive eye-popping growth in their games. An example of this explosive virality can be found in the quick growth of their popular game Farmville. First launched on Facebook (FB) in June of 2009, Farmville would achieve 10 million daily active users within just six weeks. The formula was simple, lucrative, and ZNGA was at the forefront of the new gold rush: 1) make game, 2) flood FB and its newsfeed with said game, 3) receive millions of players overnight, and 4) count money.

Of course, all good things must come to an end, and this time was no different. FB began limiting game-related spam in the newsfeed (dampening the virality of ZNGA's games), and smartphones quickly moved gaming growth from desktops to mobile where ZNGA was no longer a dominant force. The transition from golden-child to yesterday's news has - unsurprisingly - been a bit rough for ZNGA, but they are far from giving up the fight.

In fact, ZNGA's renewed fight is led by CEO Don Mattrick who formerly ran - and made profitable - Microsoft's Xbox division. Press reports have mostly focused on Mattrick's personal wealth and overly generous[17] compensation package at ZNGA. Even so, Mattrick the manager is known as a "hard-ass" who has little patience for people that don't deliver.[18] In a company that hasn't done much "delivering" in a while, Mattrick appears to be taking many of the hard steps necessary to stabilize the ship and once again deliver.

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[14] Nielsen: The State of the Hispanic Consumer
[15] Huffington Post: Univision Trumps English-Language Network Giants, Again
[16] Per the 2013 10-k, EVC management estimates that fair value exceeded carrying values by the following amounts: 215% for the TV reporting unit, 35% for the radio reporting unit, between 50% and 500% for their TV FCC licenses, and between 26% and 75% for their radio FCC licenses.
[17] Just under $58 million for 2014. CNBC: ZNGA's Stock Is Lackluster But CEO's Pay Is Not
[18] Fast Company: Meet Former Xbox Boss Don Mattrick

Fast forward to today, and one can begin to see faint signs that the bad news blues *may* finally be a thing of the past: headcount has been slimmed, the balance sheet has (so far) remained fairly strong, and management continues to invest in the type of game development that - ideally, at least - will restart ZNGA's growth story. Accordingly, some stabilization and faint growth is now visible in several of ZNGA's key metrics.[19] Even more exciting is the growth shown in metrics that benefit from the most loyal (or free spending) of ZNGA's user base: both Average Bookings Per User (ABPU) and payer conversion are now on the upswing. All three of ZNGA's core game franchises (Casino, Farmville, and Words With Friends) continue to remain strong franchises while also delivering increased "bookings."[20]

Despite initial progress, there is no avoiding the fact that revenues continue to slump downwards, leaving many to fear the worst. In contrast, we believe many of the systemic problems that initially led to ZNGA's slump (i.e., mobile weakness, FB reliance, etc) are now issues that are both well-known, and actively addressed by management in their efforts to stabilize the decline. Even so, systemic issues pale in comparison to the impact of future game popularity on revenue growth. At its core, ZNGA is a "hits-based" business, and "hits" take investment and development time - something management continues to provide.

Nonetheless, you don't have to speculate on the future success of any one game to get excited about ZNGA. In fact, even the biggest ZNGA bears seem to agree that if ZNGA only did one thing right in the last several years it was the ~$961 million raised via a 2011 IPO at just about the precise moment - you guessed it - when everything looked its rosiest. Better yet, a big part of that IPO cash, remains on the balance sheet, and when combined with a valuable piece of San Francisco real estate, adds up to a sizeable downward safety net.

Conservatively calculated,[21] the math works like this: Cash ($135.63) + Short-Term Investments ($591.61) + Long-Term Investments ($421.97) + HQ Building ($228[22]) - Debt ($0) = Safety Net of $1.38 billion (~$1.54 per share). By ignoring the value of any other assets (as well as any multiple that might be applied to the operating business), the above calculation is admittedly overly simplistic and conservative - and therein lies the beauty. Nonetheless, it is always a good sign when you can readily identify ~70% of a company's book value ($2.21 per share as of Q2 2014) with just four line items.

Despite obvious value, ZNGA has - so far - not been kind to our portfolio with an average cost basis of $2.91 per share. However, we continue to believe market sentiment on ZNGA is overly negative. The risk vs. reward was compelling when we made our initial investment, and has since become even more compelling at recent prices. That said, we intend to let the peanut gallery focus on the doom and gloom of ZNGA's past mistakes, and continue in their speculation around the ultimate popularity / profitably of current and future games. Our thesis, on the other hand, remains unchanged: while some games will be hits, and others will be flops, patient investors need only concern themselves with one thing - the stability (and size!) of ZNGA's safety net.

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[19] Including Daily Active Users (DAU), Monthly Active Users (MAU), and Monthly Unique Users (MUU) as of Q2 2014

[20] A non-GAAP financial measure that is equal to revenue plus any changes in deferred revenue. Deferred revenue primarily captures the sale of virtual goods and mobile downloads which are later recognized as revenue over the estimated average payer life or as the virtual goods are later consumed.

[21] In millions as of Q2 2014

[22] Purchased in 2012, and likely worth more than purchase price today

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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