April 29, 2019

> "Travel is fatal to prejudice, bigotry, and narrow-mindedness, and many of our people need it sorely on these accounts. Broad, wholesome, charitable views of men and things cannot be acquired by vegetating in one little corner of the earth all one's lifetime."
>
> - Mark Twain, *The Innocents Abroad*

Dear Client,

What a difference three months make. For the full year 2018, every primary asset class was negative: the S&P 500 lost 4.6%, commodities were down 13.9%, long-dated US Treasury bonds were down 1.6%, and gold gave up 1.9%. Contrast that with the first quarter of 2019 – every one of those assets was up! The S&P 500 rallied 13.5%, commodities were up 13.8%, long-dated US Treasury bonds returned 4.5%, and gold managed to finish just barely positive – up 0.6%.[1]

As we discussed in our last quarterly letter, historically reliable indicators of investor sentiment such as credit spreads and market breadth suggested the October through late-December equity sell-off was more likely a short-term panic than the start of a full-fledged bear market. As such, we used the opportunity to add equity exposure which we described in that letter.

During the early part of the first quarter, we increased our equity exposure further. In early January, we initiated a position in Facebook (FB). We used the opportunity created by generally negative market sentiment, as well as the negative sentiment toward Facebook specifically, to purchase shares at approximately $138. Facebook grew revenue at over 30% in 2018, with expectations for continued growth over 20% for several more years. Yet, at $138/share the stock traded at a price to earnings multiple of just 16x 2019 earnings.[2] At that price, we felt issues around user data privacy were more than priced in. We also increased our exposure to the online travel segment. More on that below.

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[1] The market (or asset class) returns are measured on a total return basis using index exchange traded funds (ETFs): SPY for the S&P 500, GSG for the S&P GSCI Commodity Index, TLT for 20+ Year Treasury Bond index (i.e. "long-dated" US Treasury bonds), and GLD for gold.

[2] This multiple is ex-$14/share in excess cash and uses a consensus expectation of $7.57/share in 2019 earnings.

While we now have only minimal cash positions in both equity and fixed income accounts, our overall exposure is still relatively balanced. We maintain significant positions in "safe-haven" assets such as long-dated Treasury bonds and gold, as well as, meaningful exposure to the more defensive healthcare sector.

Online Travel

We continue to find the online travel industry a compelling source of investment opportunity. We made our first investment in Booking.com (BKNG), then named Priceline (PCLN), back in July of 2015 when that stock traded at $1150/share and had already established itself as an industry leader. After four more years of significant growth, the market opportunity today remains large for the best-positioned companies. The leisure travel booking market is currently $1.6 trillion and growing at a 5% annual rate – supported by increasing global wealth and discretionary income. Online market penetration for travel bookings is still just 44% (that's right, over half of leisure bookings are still made offline). Additionally, the two largest online travel agencies, Booking.com and Expedia (EXPE), each have a modest 6% share of total travel bookings. Putting that all together, it is reasonable to expect the overall travel market to continue to grow, online to continue to take share from offline, and the best positioned and largest players in online travel to use their leadership to take more and more share from competitors.

Expedia stock has recently been under more pressure than peers as they have worked to integrate their Orbitz acquisition, experienced some challenge from the more competitive US hotel market where they are the largest player, and spent money to grow market share overseas. We purchased an initial position in Expedia using cash, as well as, funds from trimming Booking.com and further cutting TripAdvisor (TRIP) by about half.[3] While Booking.com is the industry's 800-pound gorilla with the largest market share in the best geography (Europe, where hotel ownership is far more fragmented), both Expedia and TripAdvisor command leadership in large and profitable segments. Expedia dominates in North American market share and TripAdvisor is the leader for in-destination activities (tours, museums, etc.). At today's prices, we want to own all three.

Despite the secular tailwinds from travel growth and online share gains, the entire sector trades at very reasonable multiples compared to growth and our perception of long-term competitive advantages. From 2016-2019, BKNG grew EBITDA[4] at a 14% annual rate, yet it trades at 14x

[3] We had sold a significant portion of this investment in the fourth quarter after the third quarter earnings announcement drove shares into the high $60s and up almost 125% on a twelve-month basis.
[4] EBITDA is earnings before interest, taxes, depreciation, and amortization. It is a crude, but handy, measure of operating profit.

EBITDA. TRIP grew EBITDA at a 12.4% annual rate, yet trades at 13x EBITDA. EXPE grew EBITDA at a 11% annual rate, yet trades at 8.6x EBITDA. Commenting on CNBC recently, Joel Greenblatt indicated that at today's price, you can purchase Booking.com, a business whose fundamentals are meaningfully better than the average S&P 500 company, at a "40% discount to the S&P."

Jefferies Financial Group (JEF)

Jefferies is our largest individual equity position at just over 12%, comparable in size to our online travel basket. The only other positions that are similar in size are more diversified index fund exposure to momentum (MTUM, 10%) and long-dated Treasury bonds (TLT, 10%).

Despite significant recent business progress, at $20.25, JEF trades at just 80% of tangible book value. In a market where the S&P 500 index trades at a 3.34x price to book value multiple (*inclusive* of goodwill and intangibles, not tangible book), the JEF multiple implies a deteriorating business. Even investment banking "peers," currently under pressure from an inverted yield curve, trade at much higher valuations. Morgan Stanley trades at 1.28x book value and Goldman Sachs trades at 1.02x book value. Advisory focused Evercore trades at 6.26x tangible book value.[5]

We have followed JEF since well before the merger between Leucadia and Jefferies in early 2013. Just before the merger occurred, we made our first purchase in JEF. The past four years have seen challenges and the *appearance* of business stagnation. Between 2015 and 2016, there were two very significant business difficulties within two of Jefferies' biggest subsidiaries: one in fixed income trading and another in beef processing. These difficulties caused the company's two largest segments to be unprofitable. Combined with a lack of subsidiary portfolio sales, business appeared to stagnate. At the end of 2013 (just after the merger), tangible book value was $21.10. At the end of 2016, tangible book value was slightly lower at $20.16. Many of those who owned JEF prior to the merger and consistently awarded it a 2x book value multiple left. Those who owned Leucadia prior to the merger and were willing to patiently wait for lumpy returns that compounded at 20% for several decades left too – it was all just taking too long and there were many reasons to doubt.

[5] Stock prices as of 4/24/19 close, book values as of 12/31/18 financial reports.

Yet, since late 2016, JEF has seen a dramatic turnaround and the monetization of progress that was actually occurring all along:

- Sales of a portion of National Beef, Garcadia, and Conwed demonstrated that the (inherited) Leucadia merchant bank portfolio was as robust as it was historically. These transactions netted well over $1 billion.
- Current management's successful new investments include Knight Capital Group and FXCM, demonstrating *their* ability to operate profitably the merchant banking segment. Another investment, HRG Group, should still prove very successful when Spectrum Brands rebounds – the hard work of unwinding HRG is done.
- Jefferies (the investment banking business) has returned to profitability and has surpassed historic highs, generating EBIT of $410mm in 2018 and adjusted net earnings of $324mm.
- National Beef too is operating at historically high revenues and profitability. Run-rate distributions for JEF's now (much more reasonably sized) 31% ownership of National Beef are close to $100mm annualized (on an investment marked at $654mm.) With a long cattle cycle, current herd levels indicate the cycle turn is still several years away at the earliest.

Tangible book value is now $25.21[6] implying a 5-year return of 5.4% annualized (inclusive of dividends) since current management assumed control. Not stellar, but far from a deteriorating business.

Further, Chairman Joe Steinberg, CEO Rich Handler, and President Brian Friedman are aligned with shareholders – they each have large equity stakes and compensation that is directly tied to return on equity AND shareholder return. They are also aggressively working to improve shareholder return. THE COMPANY REPURCHASED 50MM SHARES IN 2018 OR 13% OF FULLY DILUTED SHARES OUTSTANDING. THE AVERAGE PRICE WAS $22.86/SHARE, SO THEY CLEARLY BELIEVE THE STOCK IS WORTH MUCH MORE THAN THE CURRENT QUOTE. The company authorized an additional $500mm share repurchase on January 10, 2019.

It is also worth noting that between 2000 and 2012 (just prior to the Leucadia and Jefferies merger), Jefferies stock (with CEO Rich Handler and President Brian Friedman at the helm) was the best performing investment bank stock. JEF was up 159% for the period. Goldman Sachs was the only other investment bank with a positive stock performance at 30%. JP Morgan was DOWN 20% over that period. In addition, Jefferies required no government assistance in 2008/9. The leadership team has proven to be nimble survivors.

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[6] As of the end of Q1 2019.

Going forward, we think the businesses should generate at least 8%/year in book value growth without significant transactions. With a continued increase in Jefferies' (the investment bank subsidiary) return on equity and meaningful, but sporadic, transactions in the merchant banking portfolio, Jefferies Financial Group should be able to grow book value in the low double digits going forward. This warrants a price to book multiple between 1.25x and 1.5x. At $25.40 book value and 1.35x book JEF is worth $34/share today. Given the broad diversity of the new Jefferies Financial Group, modest leverage at the investment bank[7], a price well below tangible book value, and a management team aggressively buying back stock, we think the downside is limited too. The significant upside, combined with the limited downside is why we believe the stock warrants a large position in the portfolio.

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As of late-April 2019, credit spreads, gold, and other measures of broad market sentiment indicate a relatively risk-neutral investment environment. Given the fourth quarter 2018 equity sell-off, we did take advantage of several opportunities to invest cash during that period – in most cases this has already proven fruitful. Today, we hold minimal cash positions in both risk-oriented (i.e. weighted toward equity) accounts, as well as fixed income accounts. Nonetheless, we still maintain some exposure to safe-haven assets such as long-dated US Treasury bonds and gold – this is keeping with the relatively neutral investment environment.

Mark Twain reminds us travel is fatal to narrowmindedness. That idea certainly supports the growth in global travel and our interest in the online travel sector. The idea is also relevant to investing – a generalist approach (i.e. an approach that seeks ideas in multiple sectors, geographies, and asset classes) allows the investor to borrow the best techniques from multiple disciplines while also, like migrating birds flying to where weather is best, shifting portfolios as opportunities develop.

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

Sincerely,
Grey Owl Capital Management
Grey Owl Capital Management, LLC

[7] JEF is levered at about 10x equity at the investment bank compared to Morgan Stanley which is closer to 16x, yet still earned a comparable ROE in 2018.

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