

2016 THIRD QUARTER INVESTOR LETTER

October 20, 2016

As the third quarter drew to a close, investors momentarily turned their attention away from interest rates and towards the rapidly approaching presidential election, perhaps not that dissimilar to how a driver stares at a multi-car accident at the edge of a freeway. We see little benefit in mixing politics with investment commentary, but we want to make a couple of quick observations after catching part of one presidential debate. We were struck by how confident the two candidates sounded on the best/only way to fix/improve a \$18 trillion economy in their two-minute responses. As some have noticed, we find investment discussions on a single company name can stretch for forty minutes!

Additionally, in our Q1 letter we noted how two IMF researchers (Hites Ahir and Prakash Loungani) detailed how professional forecasters (many of whom presumably have PhDs from somewhere other than Trump University) were nearly perfect in their inability to predict 2008-2012 recessions one year in advance. For this reason, we have trouble taking political soundbites too seriously and we think people should generally be weary of simple cause/effect explanations for complex and often unpredictable economic events. Additionally, we put little stock in reports which suggest better performance for one political party over another, since many of these studies fail to adjust for less than trivial details like whether markets were statistically cheap or expensive at the beginning of a new administration. Over longer periods of time, the US has found a way to grow and markets have advanced, despite some truly horrible headlines and rather mediocre presidents (Our sneaking suspicion is the latter will again be tested regardless of the outcome).

Discovery: Hated Because of US Cord Cutting...But International Assets/Possible Sale Offer Protection

Now that we've covered politics for the next four years, we wanted to give a couple of portfolio updates. In our Q1 2015 letter, we briefly described our initial purchase in Discovery Communications (DISCA). We owned Discovery after its initial 2005 spinoff, but we sold too quickly following the financial crisis (shares increased over 330% from 2009-2013). Having long been an investor darling, Discovery's shares are now a pariah after falling nearly 45% since the start of 2014. As shares fell to \$23-\$24 during the third quarter, we increased our position.

Discovery finds itself in the middle of widespread debate about cord cutting/cord shaving as millennial viewers often are not watching linear television (i.e. *The Big Bang Theory* on CBS at 8pm on Mondays), but instead choosing to watch Netflix, YouTube or other content online. Additionally, cable bills have increased more than inflation rates for years, and many consumers have simply decided they don't need to pay for hundreds of channels they often don't watch. The number of video customers has fallen from roughly 100 million at the end of 2013 to roughly 96 million by June 30, 2016. But, will this cord cutting accelerate from the current 1-2% rates or stay roughly constant? This is the unknown and the source of consternation across the entire media industry.

As we have discussed in past letters, we own larger positions in distributors (Charter via Liberty Broadband/Liberty Ventures and Liberty Global), as we believe consumers will continue to demand faster broadband connections even if the pace of cord cutting accelerates. While we would acknowledge the range of outcomes for content names is wider for DISCA's business versus the aforementioned cable companies, we think the company's moderately priced content, recent distributor renewals and international exposure (nearly 50% of its business comes from overseas) differentiate the company from other content owners. We also believe that DISCA might be a likely acquisition target as the content industry consolidates and the company's John Malone affiliation provides comfort for a shareholder-friendly resolution.

As DISCA CEO David Zaslav loves to discuss, DISCA currently accounts for roughly 12% of US cable TV viewing but receives only 3% of total affiliate fee revenue. Many DISCA skeptics claim that the company's channels do not possess the "must-have" sports content to be part of cheaper ("skinny") cable offerings. But, DISCA appears protected in a couple of ways. First, according to multiple surveys (Digitalsmiths/Solutions Research Group/MoffettNathanson), Discovery's flagship channel often ranks just behind the four broadcasters in terms of the most desired channel to be included in a skinny bundle. Additionally, the bulk of DISCA's economics (80%+) come from its top five channels and therefore make DISCA additions easier in a world where fewer channels will be included in video offerings going forward. Finally, DISCA has substantial visibility on roughly 50% of its US revenue following recently signed distribution deals with Comcast (2015) and AT&T (2016), with the contracts believed to include mid-single-digit increase escalators. Zaslav has also noted that current contracts restrict skinny offerings that do not include DISCA channels.

More importantly, however, is DISCA's substantial exposure to overseas markets, which provides the best hedge for a difficult US market. Sharks and monkeys tend to travel better versus other American content, and DISCA has used its substantial distribution to secure channel placement in multiple international markets. DISCA programming often has full distribution in markets with a much smaller number of available channels than those found in the US. As we have noted in past letters describing Liberty Global, cord cutting pressure is often far less extensive in overseas markets given substantially reduced cable bills. Additionally, local broadcasting channels often receive the vast majority of advertising dollars and therefore small movements in cable channel market share can greatly benefit content owners like Discovery.¹

DISCA has also expanded its content beyond its traditional nonfiction content and moved aggressively into sports content after its investment in Eurosport, which reaches over 160 million subscribers across Europe and Asia. Eurosport has generally avoided bidding wars for soccer rights (which rival US football for their price increases) and instead focused on more niche sports such as skiing, hockey, cycling and tennis (Yes, people actually watch and some are passionate about these events). Eurosport will also have exclusive European broadcast rights for the four Olympic games from 2018-2024 as well as certain German professional soccer league matches (Bundesliga) for the next four years.² DISCA has used its local distribution teams to sell Eurosport alongside its other channels. Eurosport investment has hurt international margins, but it likely opened significant growth opportunities for the company. Zaslav's comparison of Eurosport to ESPN in the mid-nineties is more than a bit hyperbolic, but we do believe DISCA can build a pan-continental sports offering and use its popularity to continue DISCA's international expansion. Additionally, unlike previous owners who sold advertising on a pan-European basis, Eurosport is creating local channels and using sales and distributions already in place which currently support nearly 10 channels per country. Eurosport would appear to be the Discovery property with the best chance of offering a successful direct-to-consumer offering. DISCA is targeting double-digit constant currency growth internationally, but this growth is hidden by a strong US dollar that has hurt reported results. While many predict US dollar strength will continue (which would be negative for DISCA), we certainly believe these forecasts are far from infallible and suspect a reversal is entirely possible. DISCA's international assets offer

¹ DISCA has used this international distribution to gain other channel placements, including the top kids network in Latin America. Despite facing one of the worst economic environments in decades, DISCA noted at its 2015 investor conference that Brazil revenue growth was 50-70% in 2014/2015. Even this growth, DISCA channels still accounted for less than 10% of cable advertising despite accounting for over 30% of total viewership.

² Eurosport does have soccer rights for certain soccer rights in foreign markets. Additionally, Sky bought Bundesliga rights for £4.6 billion, but German regulation prevented one buyer from owning all the rights, and therefore Eurosport will broadcast roughly 40 live matches over the next four years for an undisclosed amount (£100 million annually according to *The Financial Times*).

far better growth opportunities than the US market, and therefore differentiate the company from other US content providers.

And this leads to the final point with DISCA. Despite Mr. Zaslav's assurances that everything is wonderful with DISCA, we suspect the company's days as an independent company are numbered. It seems inevitable following a round of distributor consolidation (Charter buying Time Warner Cable, AT&T buying DirecTV, Altice purchasing Suddenlink and Cablevision) that US content companies will need further scale to push back on distributor muscle. In the US, DISCA is smaller than its peers and could face pressure during the next round of contract negotiations 3-5 years from now if ratings pressure continue and/or cord cutting accelerates. While DISCA continues to boast some of the highest US margins (nearly 60%) and the recent contract renegotiations provide visibility, we think DISCA's recent investments demonstrate its attempt to grow outside of the US as quickly as possible – a very reasonable choice in our opinion. While some speculate that DISCA will purchase Scripps Networks or another asset to increase its size, we suspect the far more likely outcome will be a sale. We foresee a couple of possibilities. First, we believe that a large content company could gain additional international exposure through DISCA and better utilize DISCA's international distribution to gain exposure for other content assets. We also believe that such an acquirer would be in a better position to further grow Eurosport and potentially justify entering the bidding frenzy for soccer rights (which would arguably make the ESPN comparison more plausible). Certainly, many names might make sense, but Fox or Disney could be possibilities. In some ways, the biggest constraint for the deal would be the combined 46% voting interest held by John Malone and Advance/Newhouse. With the pending merger of Starz and Lionsgate, Dr. Malone has already begun some content consolidation, and DISCA would be a welcome addition to their business mix, especially considering the substantial tax synergies.

At \$23-\$24 purchase prices, DISCA was trading at slightly under 10x our 2017E free cash flow per share, even assuming further currency headwinds. For 2015-2018, DISCA is targeting EPS and free cash flow per share growth of "low teens or better." In a rather un-Malone-like fashion, DISCA has repeatedly noted its intent to maintain its investment grade credit rating. That said, DISCA will likely use the majority of its free cash flow for share repurchases and we assume shares outstanding decline by roughly 7-8% annually over the next 4 years. At an assumed valuation of 12-13x free cash flow (corresponding to approximately 10x EBITDA), we believe DISCA can generate standalone IRRs of 15-16%. These returns roughly correspond to the mid-teens IRRs that DISCA believes it generates from current repurchases. If we assume that DISCA's tax rate was cut to approximately 15%, IRRs would jump to nearly 20% (via a possible Lionsgate acquisition). Again, a third party would need to offer a substantial multiple for DISCA to consider a deal, and we believe Malone/Newhouse would want stock to defer taxes. Clearly, this is a complication, but not an insurmountable one. Given the strong visibility into future share repurchases, DISCA (similar to several other Liberty entities) really looks like a public leveraged buyout with the key difference that current public investors do not have to pay a control premium (or performance fees) for the possibility of earning private equity-type returns.

Clearly, there are risks. We think the biggest risk would be the US advertising portion of DISCA's business, equating to roughly 25% of 2017E revenue. Recently, there has been some movement of advertising dollars back to television following some concerns about the integrity of some online advertising spend. Additionally, reports/company commentary have indicated a much stronger scatter/upfront advertising market. That said, these recent movements could certainly reverse, especially if 2016 rating weakness continues. And, we certainly think it is possible that US video losses could accelerate. This threat must be taken seriously, and we would not invest in DISCA were it not for the international story and the Malone stewardship, regardless of how low the underlying valuation. But, despite some challenges, DISCA's

revenue visibility remains quite high for the next several years and the company has some truly unique global assets and growth avenues.

QVC: Aberration or Secular Issue?

In early August, QVC's stock declined nearly 20% after announcing that sales had declined at a mid-to-high single-digit rate in June, with the weakness continuing into July and early August. Previously, QVC had only suffered this type of revenue decline during the Great Recession, so investors naturally wondered whether the long successful business model was finally succumbing to some of the secular problems faced by other retailers. These worries were magnified by weakness in the previously strong fashion category and this soft spot followed Amazon's March debut of its 30-minute program on fashion trends. We concede that it will take time to fully know whether this bump is a temporary setback or a more permanent change, but we do not believe that this recent weakness represents secular deterioration.

Why do we believe this? First, Amazon's programming would unlikely cause such immediate changes in QVC's business. QVC's US business had been growing at 4-5% in the first five months of the year prior to the June weakness, and Amazon's offering would more likely cause a gradual erosion of sales versus the drastic month-over-month decline experienced by QVC. It would also be reasonable to believe that Amazon's fashion offering would first pick off QVC's least frequent shoppers, but lower frequency shoppers have increased their purchases with QVC. As we have previously discussed, QVC customers have long over-indexed towards Amazon/Amazon Prime versus the general population, so Amazon product offerings are not a novelty. Secondly, QVC's international business continues to perform quite well, including varying degrees of strength in the German, Italian and the UK businesses (The last is surprising considering Brexit uncertainty). While one could argue that US retailing is more competitive than Europe's, few would characterize the European environment as easy. QVC experienced some uneven results in the UK and Germany during the past several years, but both operations have shown meaningful improvements over the past several quarters. QVC also suffered an outside impact from a drastic decline in its Wen hair care business. Wen had particularly strong sales in June 2015, but sales plummeted after revelations the product caused balding for certain users. Wen's problems may have accounted for 25-30% of June sales weakness. While we are willing to own QVC, we will be less willing to lather up with Wen after reading certain online reviews.

Despite continued favorable feedback given in customer surveys by "super shoppers," the ones buying 15-20 purchases per month, QVC claims the recent weakness is driven by slightly reduced purchases from this group (If readers of this letter happen to be in this shopping crazed cohort, please put down this letter immediately and tune into QVC to buy something). Is this a sign of economic weakness, a sign of stale QVC product selection, or simply noise as shoppers are distracted from the Olympics/election coverage/other news? We really do not know and will not know for several quarters. But, we were encouraged to hear that customer retention rates/viewership levels have not decreased and we were pleased to hear QVC CEO Greg Maffei note during a September conference that QVC had already seen some "green shoots" from QVC, suggesting a stabilization of negative trends.

Interestingly, the QVC weakness has occurred while the recently acquired zulily business has reported outstanding results. Sales accelerated to 23% year-over-year growth following 16% growth in the first quarter. Zulily's 8%+ operating margins are already approaching levels that we assumed were multiple years out, and this improvement has occurred before many of the cost synergies with QVC have fully taken effect. In short, the zulily deal looks to be an outstanding fit within QVC.

Clearly, the recent weakness in QVC's US business is a negative development, and the company needs to stabilize or investors will abandon the company regardless of valuation. That said, since the original LINTA/LCAPA tracker creation in 2006, we believe the biggest chink in QVC's armor has actually been on

the capital allocation side. Near-term maturities which partially funded ill-timed share repurchases forced QVC to deleverage rather than repurchase stock in 2008-2010, when its stock traded at ridiculous levels.³ Currently, the sales slowdown at QVC occurred when debt levels were elevated following the zulily deal, but current levels are much lower than those prior to the financial crisis. QVC senior debt/bank drawings currently stand at roughly 2.6x trailing EBITDA, and QVC has promised the rating agencies that debt levels (QVC's senior debt carries an investment grade rating from 2/3 rating agencies) will return to 2.5x. We believe QVC will continue to use all available free cash flow to repurchase shares, but QVC will unlikely issue additional debt to take advantage of share weakness in order to maintain an investment grade rating on the senior debt. Given the bullish tone of Maffei and the entire QVC leadership team at the company's May 2016 analyst day, we believe the sudden weakness in QVC sales was a complete surprise. Without question, the timing is unfortunate, given the higher debt levels post zulily. That said, QVC's current valuation (9-10x 2017E free cash flow per share adjusting for HSN stake) likely implies at least a partial impairment of QVC's business.

To be clear, QVC's US operations need to return to growth, and without this step our entire thesis in QVC would need to be reexamined. That said, we also believe that QVC would be immensely helped by becoming an asset backed security. Investors who are attracted to QVC often want little to do with the Liberty Ventures' cable/venture capital investment no matter how attractively priced it is. Even assuming a bounce in QVC's operating results, QVC will unlikely see meaningful multiple improvement until it becomes a separate standalone company. We think this view is supported by QVC's discounted valuation prior to its recent sales weakness. As we described in previous letters, the exchangeable bonds attributed to Liberty Ventures (which are the obligation of parent company Liberty Interactive) make an asset backed security more difficult since the exchange holders want to be near a cash generating asset. But, as we learned at Liberty's annual meeting, it would be possible to move the exchangeables if QVC/LVNTA were recombined (the so called "Smush" strategy). As a standalone company, QVC would likely be an easier name for many investors to own and would likely attract more sell-side coverage, with reports highlighting the business model and discounted valuation versus other retailers. Liberty's management team surely understands this, and we do believe will take steps to enhance value but, admittedly, they will follow a path/timing perhaps different than what we would prefer. However, history suggests the simplification will eventually happen. While QVC has long been viewed a neglected name within the Liberty empire, Dr. Malone and Greg Maffei have a substantial financial interest in its success, since the two own shares worth \$560 million and \$179 million, respectively.

Leucadia Update: Beef Turned...Jefferies Starting to Earn?

Before concluding, we want to give a quick update on Leucadia (LUK) which just hosted its 2016 investor day. We can already hear the collective groans when we mention this name and note that we increased our position as shares fell. Over the past two years, Jefferies's results have suffered following both industry wide pressure (meaningfully lower fixed income trading results) and some company specific issues (Bache commodity business which was ultimately sold and some overexposure to energy trading positions). Some of our early LUK purchases clearly did not anticipate the scope of these problems. We would concede that Jefferies needs to earn closer to a 10% return on tangible equity or investors will not ascribe any franchise value. Jefferies has shrunk its balance sheet, shed costs and posted improved results in its third quarter (ending in August). A higher rate environment would likely help the entire industry, but recent third quarter results from some of the larger banks (JP Morgan, Citigroup and Goldman Sachs) give hope for a continued rebound in trading activity. Additional pullbacks from European banks, which seem to improve

³ In late 2008, the market value of Liberty Interactive's (LINTA) equity investments and cost value of its e-commerce stakes was 15-20% greater than LINTA's market capitalization, implying little or negative value for QVC.

their stock price every time they announce moves away from US investment banking, would also help. Calling any bottom is impossible, but we suspect investment banking's future outlook might be better than many project.

Interestingly, CEO Richard Handler again mentioned the possibility of selling a minority interest in Jefferies to a foreign buyer in the years ahead. With investment banks rivaling presidential candidates in terms of popularity, we believe many readers might wonder why anyone would want to buy into such a difficult business. But, the sun has a funny way of rising, even in cyclical businesses. There are few global banking platforms remaining, and a potential Asian investor wanting exposure to a global banking platform (a platform free of systemically important financial institution regulators) might find an investment in Jefferies quite attractive. While such a deal is far from assured, we think several firms might consider an investment now and a larger number if the US market shows additional improvement. A deal would likely be done at significant premium to tangible book value, could open new business opportunities for Jefferies and possibly be viewed favorably by rating agencies. With shares trading at roughly 84% of estimated current value (assuming Jefferies is only worth tangible book value), it is not difficult to foresee such a deal acting as a game changer for the stock.

Certainly, a minority sale of Jefferies is not the only way LUK shares could move higher, and there have been some positive developments at other subsidiaries. Perhaps the most meaningful has been the immense improvement at National Beef. The business has moved from negative EBITDA in Q4 2015 to near record results as a shortage of cattle has given way to a glut, allowing National Beef to post nearly \$130 million EBITDA in the third quarter and \$267 million EBITDA year-to-date. While we expect LUK to exit the beef business sometime during this upturn, the company could hold the business longer than originally anticipated, as the oversupply conditions could continue for the next 1-2 years. We anticipate LUK will try to find a buyer willing to pay a peak multiple for near peak profits, and we believe both parts of the equation will ultimately prove much higher than what we believed at this time last year. Importantly, the recent strength at National Beef will flow to Leucadia tax free given the still large deferred tax asset and these cash flows will allow further investments or share repurchases. Simultaneous weakness at Jefferies and National Beef prevented larger share repurchases earlier this year, but this situation will hopefully look meaningfully different over the next 12-18 months.

We will not fully detail all developments at Leucadia subsidiaries. We would note, however, that FXCM has shown further signs of business stabilization/continued asset monetization, while HRG has benefited from the continued strength at Spectrum Brands. Leucadia continues to believe that HRG will close on the sale of its insurance business, and we would anticipate that HRG might explore a tax efficient merger with Spectrum Brands post sale. While such a transaction would not be straightforward, Liberty's experience for the past 40 years suggests that creative solutions are possible. We believe both of these investments will ultimately create substantial value and their ultimate monetization, combined with the "float" from Jefferies and (until sold) National Beef, will allow further investments going forward.

Our concluding statement is that despite the deep unpopularity of DISCA, QVC, LUK, we believe there are compelling reasons to own these names. We applaud readers who made it through this entire letter and we understand those who instead adopted presidential debate listening protocol: pay attention to the beginning and end and take a well-earned snooze during the middle. Feel free to call us directly with questions – we promise the moderator will not strictly enforce response times.

Thanks for your continued support.

Patrick Brennan

Contact information

Patrick Brennan, CFA
Brennan Asset Management
patrick@brennanvalue.com
T: (707) 738-5654

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