April 8, 2019

Q1 2019 Investor Newsletter

Wolf Hill Partners, LP and Wolf Hill Offshore Fund, Ltd were officially launched on February 1st. For our first abbreviated quarter under our new fund structure we are pleased to report that the funds posted a net gain of 6.33% versus a total return of 5.22% for the S&P 500 over the same time frame.

WOLF HILL CAPITAL FUNDS Q1 2019 RESULTS

	Feb 2019	Mar 2019	Q1 2019 [2]	YTD 2017 [1]	YTD 2018	YTD 2019 [2]	ITD [1, 2]
Net Returns	4.38%	1.87%	6.33%	20.19%	35.86%	6.33%	73.64%
S&P 500	3.21%	1.94%	5.21%	14.85%	-4.40%	5.22%	15.52%

[1] Performance through December 31, 2018 represents the asset weighted net returns of separately managed accounts (Wolf Hill Composite Index) managed by Wolf Hill Capital Management, LLC. Client accounts were liquidated in early January 2019 to facilitate the reinvestment of client capital into Wolf Hill Partners, LP in advance of the February 1, 2019 launch date. Performance beginning February 1, 2019 and beyond represents net performance of Wolf Hill Partners, LP.

[2] Net returns for the abbreviated period from inception of the new Wolf Hill Capital Fund structure as of February 1, 2019; S&P 500 returns excludes results from January 2019 to reflect the same investment period as the Wolf Hill Capital Funds.

The stock market rout that began last October due to concerns over the economic disruption of a brewing trade war and an overly hawkish Fed left many stocks trading at historically cheap valuations at year end. As we had anticipated, President Trump's fixation on the stock market and his perception that the stock market serves as a barometer of his Presidency (as long as it goes up) foreshadowed a positive outcome for trade negotiations with our Chinese trading partners. While a final trade agreement has yet to be agreed upon, all signs point to an ultimately favorable resolution to what could have been a disastrous economic outcome. To further boost risk-taking animal spirits, Fed Chair Powell has done a 180, adopting a far more dovish policy outlook that has allayed concerns over rising rates acting as a break on economic growth. In response to these positive developments, the S&P recorded its strongest quarter in 10 years.

Q1 Portfolio Review

As we began to put capital to work in February, we were leery of chasing many of our favorite long ideas at prices that had rebounded 20+% off their December lows. Fortunately, the market melt-up created attractive entry points to initiate meaningful positions in several high-conviction short ideas while we opportunistically deployed capital into core long ideas. For our abbreviated quarter, the fund generated 303 bps of net performance on our short book and 330 bps of net performance on our long book. Notable contributors on the short side of the ledger were Westshore Terminals, WageWorks, Pearson, and AK Steel.

Westshore Terminals (WTE CN) short

Westshore operates a coal export facility on land leased from the Vancouver Fraser Port Authority ("VFPA") located approximately 30 km south of Vancouver. Its terminal is the largest coal loading facility on the West Coast of the Americas. Westshore's historical earnings have grown in a steady and highly

predictable manner as the company has deployed capital to steadily increase the coal handling capacity of the terminal. Westshore operates the business on a throughput basis and is simply paid a handling charge based on contractual volumes secured by long-term “take-or-pay contracts” from key customers. While market conditions(1) may affect the competitiveness of Westshore’s customers and the volume of coal handled by Westshore – the company’s earnings have been highly consistent. The predictability of the company’s earnings has allowed Westshore to consistently return cash to shareholders via buybacks and dividends. As a result, the company has attracted a relatively conservative, yield-focused investor base.

However, despite its history of steadily growing earnings, Westshore is anything but a “safe” investment as customer concentration risk poses an existential threat to Westshore’s forward earnings power. Westshore relies on one customer, Teck Resources, for 60% of its volumes; and another, Cloud Peak Energy, for ~15% of its volumes. Importantly, the take-or-pay contracts with these customers (and others) that support the company’s predictable earnings stream were signed under a dramatically more robust commodity backdrop and no longer make economic sense for their customers. We estimate that Teck and others are currently paying Westshore ~$12/ton, while “market” is closer to $7/ton. Importantly, the Teck contract expires in March 2021 - and Teck has already deployed tens of millions of dollars to expand its own port, Neptune (which sits near Westshore in the same harbour) to prepare for the post-contract world. Westshore has acknowledged this reality in their most recent annual report. Our industry sources are unanimous in their belief that there are insufficient alternative volumes to replace Teck, nor are there alternative uses for the port.

While the loss of their largest customer would be reason enough to be bearish on Westshore, perhaps a more pressing near-term issue is the impending bankruptcy of Westshore’s second largest customer, Cloud Peak Energy. In February, WTE sold off 20% when Cloud Peak announced that it elected not to make the coupon payment on their bonds as a prelude to a Chapter 11 filing. Per Cloud Peak’s recently filed form 10K, *“logistics export pricing declined in the fourth quarter of 2018 to an uneconomic level.”* As part of Cloud Peak’s restructuring, we expect Cloud Peak to reject their take-or-pay contract with Westshore. This will either lead to a total loss of these volumes if Cloud Peak is liquidated or a new contract with Cloud Peak on far less economically friendly terms. Ultimately, we believe that Westshore’s steady-state earnings power will prove to be about 50% of what the company reported in 2018 due to the dearth of alternative coal producers available to replace these lost volumes.

WageWorks (WAGE) short

During March, we re-initiated a short position in WAGE after a greater than 30% one-day rally in response to the company becoming current on its long delinquent SEC filings. We have been following WAGE since June of 2017 when a significant red flag (former CEO Joe Jackson sold a majority of his shares in a secondary stock offering along with primary shares with no apparent use of proceeds) piqued our interest. Subsequent to the stock offering, the company was forced to restate years of historical financials due to accounting irregularities that ultimately resulted in the firing of CEO Joe Jackson, the CFO, General Counsel, along with the resignation of WAGE’s audit firm.

For years, WAGE grew earnings at a steady clip due to robust employment growth and its dominant market position as a provider of Flexible Spending Accounts (FSA’s) to employers. The stock traded at a growth multiple due to the strength of WAGE’s market position in FSA’s along with the promise of

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[1] For example, Cloud Peak’s contracts reflect the Kalimantan 5000 GAR index price. We calculate Cloud Peak’s breakeven economics at ~$55 Kalimantan relative to the Kailimantan at $46 in January ’19.

parlaying these customer relationships into the nascent market for Healthcare Spending Accounts (HSA's). The growth narrative that was articulated by Joe Jackson (as he was shovelling stock out the door) was predicated on WAGE being able to quickly penetrate the HSA market while continuing to gain share in the mature FSA market. However, it is our view that at today's valuation WAGE is a compelling short as the company will be challenged to grow earnings due to cyclical headwinds from peak employment and substantial structural headwinds from the rapidly changing industry landscape.

The business of administering FSA's to employers is essentially a melting ice cube as the market is increasingly moving towards Healthcare Spending Accounts (HSA's). The rapid growth of HSA's has had a dramatic effect in reshaping the industry. Importantly, employees cannot have both an FSA and an HSA, so the growth in HSA's are directly cannibalizing FSA's as this is a zero-sum game. HSA's are a better mousetrap than FSA's. In the FSA model, employees set aside a set amount of pre-tax income to be used for healthcare spending – which is "use it or lose it" with no employee matching. In the HSA model, 70% of employers match employee pre-tax contributions and balances can be rolled forward indefinitely. Over the past several years there has been a land grab for HSA market share among health insurers and large financial institutions. Unfortunately for WAGE, that ship has sailed, and WAGE is stuck with a measly 2% market share. Our industry channel checks suggest that the market for FSA's could shrink by as much as 50% over the next several years as employers increasingly switch to the HSA model. As the FSA market continues to shrink, the implications for WAGE are dire and completely at odds with the medium-term earnings guidance the company recently issued.

IMO 2020 Theme and Product Tankers (Long)

In our Q3 2018 letter I highlighted an emerging theme tied to IMO 2020 and the impact this is likely to have on product tanker earnings. IMO 2020 refers to the International Maritime Organizations requirement that ship owners reduce sulfur emissions from 3.5% currently to 0.5% by January 2020. To comply, shipowners have a choice of installing expensive "scrubbers" to continue to burn high sulfur fuel oil (HSFO), or, switching to low sulfur fuel oil (LSFO). Compliance with IMO 2020 will clearly have highly beneficial implications for the environment and from an investment perspective has the potential to be incredibly disruptive to many different links to the shipping industry supply chain from crude oil producers, crude tankers, refineries, and product tankers. Product tankers are vessels that transport refined petroleum products from refineries to terminals. Despite being guilty of premature accumulation during last year's second quarter, we believed then, as we do now, that IMO 2020 will have significant ramifications for the product tanker market as higher demand for LSFO increases the distance between production and consumption, driving increased ton mile demand for refined product.

As we get closer to the implementation of IMO 2020 next January, the product tanker industry finds itself on the cusp of what we believe will be a significant cyclical inflection point in earnings as high scrapping activity among older vessels and several years of underinvestment in new tankers are beginning to manifest in higher charter rates. From a demand perspective, we are beginning to see the first signs of bunker fuel supply chains adjusting as refineries are producing increasing quantities of low sulfur fuel oil so that shipowners can test to see if their vessels are running properly prior to the actual implementation of IMO 2020.

We have elected to express our view through two product tankers – Scorpio Tankers (STNG) and Ardmore Shipping (ASC). Scorpio has a more levered balance sheet, but with the industry's most modern fleet of vessels, while Ardmore has a slightly older fleet but with a far less-levered balance sheet. Both stocks are

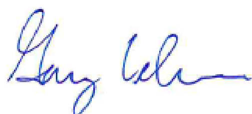
currently trading at ~60% of NAV, providing margin of safety and tremendous upside optionality to a cyclical mean-reversion of product tanker earnings. We find the asymmetry of both stocks to be highly compelling and anticipate growing these positions meaningfully as we get closer to the implementation of IMO 2020.

Portfolio Positioning and Parting Thoughts

I have to admit to being somewhat caught off guard by the vengeance with which stocks have rebounded to begin the year – especially in light of net year's S&P earnings estimates getting slashed, tangible weakness in European economies, domestic job creation that is seemingly as good as it gets, and economic malaise being signalled by the recently inverted U.S. yield curve. Perhaps 2019 will be remembered as the year where all asset classes rallied in unison - where US rates are anchored lower by global interest rates near zero, a dovish Fed, and a resurgent Chinese economy leading to a goldilocks environment of steady domestic growth and earnings multiple expansion? Surely anything is possible, but I'm not hanging my hat on that blue-sky scenario continuing to play out over the foreseeable future. We continue to cautiously underwrite current positions and new ideas from the perspective of this being the 8th inning of the economic cycle. Our base case remains that corporate earnings are peaking with margin pressure likely to become more acute in coming quarters due principally to tight labour market conditions. Signs of late-cycle excesses are everywhere - from lax credit underwriting conditions, deca-billion dollar IPO's of cash incinerating technology businesses, resurgence of bitcoin, cannabis stock euphoria, and perhaps most ominously - this week's cover of Barron's titled: "Is The Bull Market Unstoppable?".

As the second quarter begins, our portfolio remains conservatively positioned with gross exposure of ~160% and net exposure +/- zero. Despite our negligible net exposure and our current perspective on peak economic conditions, the current stock picking backdrop could not be more favourable for our "targeted shots on goal" approach towards portfolio construction. Our core long ideas are underpinned by significant margin of safety by virtue of idiosyncratic value drivers, impossibly cheap valuations, significant hard asset value, and concrete catalysts that we believe will serve to change the narrative around these names to unlock significant hidden asset value. On the short side, several of our ideas are tied to our "peak employment" theme, while others give us exposure to businesses that are perceived to be safe and defensive, but in actuality are being disrupted by emerging technologies and new entrants. We are extraordinarily excited by our current portfolio and pipeline of ideas that we are monitoring and look forward to sharing the results with you next quarter. In the meantime, feel free to reach out with any questions or comments.

Regards,



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