July 22, 2020

Dear Partner:

In the quarter ended June 30, 2020, the fund recorded a net profit of 10.7%. At quarter end, the fund's equity exposure was 107.4% long and 44.9% short for a net equity exposure of 62.5%. In addition, the fund was 1.1% long and 8.8% short fixed income securities for a net fixed income exposure of -7.7%. The top five positions constituted 23.0% of equity capital and the top ten positions constituted 38.0% of equity capital.

**Review of the Quarter**

The fund generated a net profit of 10.7% in the quarter. Long equity positions generated a +25% return on capital, hedged long equity positions generated a +3% return on capital, short equity positions generated a -29% return on capital and fixed income positions generated a +4% return on capital.

The fund had four winners in the quarter greater than 100bps, our long positions in Brunswick Corporation (224bps), BMW (131bps), Facebook (123bps) and Insperity. (112bps). I discussed our views on Brunswick, a manufacturer of marine engines, in our first quarter 2019 letter. Following a significant decline in the first quarter, Brunswick's stock rallied sharply in the second quarter as industry demand has begun to benefit from consumers embracing boating as a socially-distant recreational activity. We continue to view the shares as attractively valued given the company's strong competitive position, sizable cost reductions and opportunities for further market share gains following two recent contract wins in the U.S. and Europe. I discussed our updated views on BMW in our most recent letter, and the stock increased meaningfully in the second quarter, bouncing off a heavily-discounted valuation of just 60% of tangible book value in March (implying *negative* value for its automotive business). With the stock still trading below 80% of tangible book value and roughly 5x normalized earnings, we continue to see tremendous upside driven by the recent rebound in China auto sales, improving U.S. auto sales and a potential recovery from depressed levels in Europe. Shares of Facebook rallied during the quarter as the business proved more resilient to coronavirus headwinds than expected. Despite a tough macro backdrop, Facebook reported flat April advertising revenue compared to a year ago, and we believe the business has accelerated since then. With increased expense discipline, we think Facebook could have higher earnings power than we previously forecasted once the economy recovers. Earlier this year the fund initiated a position in Insperity, an outsourced human resources company. During the quarter, the company's stock recovered from extremely dislocated levels reached in late March, helped by solid first quarter results and a constructive outlook for the remainder of 2020. I discuss our detailed thesis on Insperity further below. The fund had no losers greater than 100bps in the quarter.

## Thoughts on the Market Environment

Today's market environment is unlike anything I have seen since the second year of my career in 1999. Coming into this year, much ink had already been spilled discussing the remarkable outperformance over the past decade of highly-valued growth and momentum stocks compared to more mundane value stocks. In 2020, this trend has only accelerated as the coronavirus crisis disproportionately affected companies with near-term cash flows. In the first half of 2020, shares in companies that lost money in 2019 *rose* 47% on average while shares in companies trading below 12x next year's earnings *fell* 21% on average.[1] This level of divergence is utterly remarkable. We acknowledge that low interest rates and rapid technological shifts have benefited many growth-oriented companies, and we are likewise well aware of the economic headwinds facing many traditionally cash-generative companies, but it strikes us that the pendulum has swung way too far in recent months. A mentality has firmly set in that if a company has prospects for growth, you simply can't lose. The higher the price of the stock, the more appeal it seems to have. Conversely, it seems no matter how low the price, it's hard to win with a stock lacking a good "story." You can almost see the market shake its head and roll its eyes as you try to entertain what a stock may actually be worth.

And, if you've just been watching the major equity indices of late, you would be excused for concluding the market environment appears rather benign. It may seem investors are relatively complacent, if not completely dismissive of the risks posed by the coronavirus. But I caution that like no other time in recent history, these indices provide a misleading picture of the typical U.S. company and the typical U.S. stock. The three largest publicly-traded U.S. companies (Apple, Microsoft and Amazon) now account for nearly $5 trillion of market capitalization, *more than twice* the value of all the companies in the Russell 2000 Index combined. By comparison, ten years ago, the three largest publicly-traded U.S. companies (Exxon, Apple and Microsoft) were worth less than 70% of the Russell 2000. It also happens that the largest U.S. companies today are in the technology industry and are perceived safe havens in this uncertain economy, creating unprecedented dispersion between the major indices and individual stocks.

While the aforementioned market dynamics have undoubtedly proved frustrating, it presents an enormous opportunity set for us. We have always employed a disciplined, flexible approach that we believe should deliver attractive results independent of market conditions. Until recently, the fund has largely been successful in this endeavor even as the market environment was generally not conducive to our value-oriented style. But, to our dismay, this year has thus far been about as unfavorable for our approach as I can envision. We believe this is likely to change. The interest rate support for richly-valued stocks has largely run its course (mathematically speaking, rates simply are not going much lower and certainly have plenty of room to go higher), many out-of-favor stocks are already heavily discounted for near-term uncertainty and shares in many of the most dubious of companies are trading at inflated levels on a scale not seen in a generation, largely driven by retail and momentum investors, emboldened by recent successes. I

[1] Portfolio consists of U.S. stocks which traded for the entire period indicated with a market capitalization exceeding $1 billion.

know we had to bear some pain to get to this point, but I do not recall a period in our thirteen year history where the potential returns on our long and short positions were simultaneously as high as they are now.

**Some New Ideas**

As I mentioned above, we have a tremendous opportunity set. Below, I share our thoughts on our long positions in First American Financial, HD Supply, Insperity and Athene Holding (first mentioned in our fourth quarter 2018 letter) and our short positions in Ballard Power Systems, Simulations Plus and Sorrento Therapeutics.

*First American Financial (Long)*

During the March sell-off, the fund initiated a position in First American Financial, the second largest provider of title insurance in the U.S. We believe the stock's 50% decline at the lows in March allowed us to purchase a high-quality business with stable competitive dynamics at a deeply discounted price. While First American often gets grouped with financial and insurance stocks, we believe the company is more akin to a capital-light service business deserving of a premium multiple.

First American's title business, which provides title insurance for residential and commercial real estate purchases or refinancings, accounts for 93% of its earnings while a small specialty insurance business accounts for the remaining 7%. First American issues title insurance directly as well as through a network of independent agents. Between both its direct and indirect channels, First American accounts for roughly 25% of the total U.S. title insurance market (with the top four players accounting for approximately 85% of the market).

Trends for First American's core residential title business are favorable with new home purchase applications returning to strong levels after the initial lockdown period and industry refinancing volumes recently soaring 100% vs. 2019 levels due to the low rate environment. While First American makes approximately 2.5 times as much on a new home purchase compared to a refinance transaction, the refinancing tailwind will nonetheless help underpin financial performance for the remainder of 2020 even if new home purchase activity is more muted given the economic backdrop. We also believe First American will be in a great position to capitalize on the better-than-expected activity levels since the company chose to largely avoid making substantial workforce changes during the initial lockdown period.

In addition to volumes coming in better than originally feared, we also think industry losses will remain subdued given improved underwriting and resilient housing prices. As we saw with other financials in March, the knee-jerk reaction of the market was to look back to what happened during the financial crisis. Back then, the title insurance industry suffered loss rates of up to 10% compared to 4% to 5% during a typical year (largely due to the pervasive fraud that existed during the housing bubble). With improved underwriting at both the mortgage originators and the title insurers, we do not foresee

losses returning to financial crisis levels, especially given the recent stability of housing prices.

We expect normalized U.S. mortgage activity to be in the low- to mid-$2 trillion range per annum, a bit higher than the $2.1 trillion in 2019 but still well below the 2001 to 2007 average of $2.8 trillion. At margins similar to the average of the past few years, we expect First American to generate around $5.70 of 2022 earnings. We value the stock at 14x earnings, similar to where it has traded for much of the past ten years, resulting in a total value of $82 per share (including dividends), roughly 50% above recent levels.

*HD Supply (Long)*

During the quarter, the fund initiated a position in HD Supply, a leading industrial distributor focused on two separate markets, facilities maintenance and non-residential construction. We believe the upcoming spin-off of its more cyclical, non-residential construction business will highlight the company's attractive facilities maintenance business, providing significant upside from the stock's discounted valuation of under 9x last year's consolidated EBITDA.

HD Supply's facilities maintenance business, which accounts for over 60% of its EBITDA, is the market leader in distributing maintenance, repair and operations (MRO) products to multifamily, hospitality, healthcare and institutional facilities. This business has historically been very stable, as demand is largely driven by repair needs. Moreover, customers generally need to have these products urgently to complete a job, giving HD Supply a strong competitive advantage as the company offers next-day fulfillment that e-commerce and smaller competitors are unable to match. This attractive competitive positioning and resulting share gains have driven organic revenue growth of about 5% annually since 2013. Recently, investors have focused on the segment's exposure to the travel market, which has been severely impacted by the COVID pandemic. However, the vast majority of earnings comes from the more insulated multifamily and healthcare markets as hospitality accounts for just 20% of segment sales and has lower-than-average margins. While the overall business was impacted materially in April as even normal maintenance was deferred due to COVID-related restrictions, activity has already begun to normalize, and we would expect this trend to continue throughout the remainder of the year.

HD Supply's other core business operates under the brand White Cap, providing a one-stop solution for non-residential construction products including concrete accessories, safety equipment, tools, building materials and fasteners. White Cap is the largest player in this fragmented market with a high-single digit percentage market share and predominantly competes with smaller "mom and pop" alternatives. Due to its scale, White Cap has significant advantages in the breadth of products it can provide to customers and depth of inventory to ensure on-time delivery, which are both important factors to builders given the significant costs of unutilized labor when waiting on materials. As a standalone company, White Cap will have the ability to pursue its acquisition strategy more aggressively and further consolidate the market. Buying

smaller companies, extracting synergies and leveraging its superior purchasing power should prove to be a powerful driver of White Cap's future financial performance.

Following the spin-off of White Cap (which should occur later this year or early next year), we believe that each individual business should eventually trade at better multiples than the market currently applies to the consolidated company today. We believe the stability, attractive growth profile and high returns on capital of the facilities maintenance business will hold broad investor appeal and should garner a multiple of 12.5x EBITDA (a slight discount to Grainger, an industrial MRO business). We value White Cap at 9x EBITDA, which is in line with other more cyclical distributors. In sum, this equates to an 11x blended EBITDA multiple, resulting in a price of almost $60 per share, around 65% above current levels.

*Insperity (Long)*

Earlier this year, the fund initiated a position in Insperity, a provider of outsourced human resources for small- and medium-sized businesses. We began purchasing shares in February as the stock declined significantly following disappointing earnings and guidance related to an unusual spike in employee benefit costs. Subsequent share price declines during the March stock market sell-off, primarily due to concerns about the health of the company's core customer base, allowed us to purchase additional shares in a high-quality, growing and cash generative business at an extremely discounted valuation.

Insperity operates what is called a Professional Employer Organization (PEO), whereby it serves as the co-employer for around 240,000 worksite employees (WSEs) across almost 9,000 companies. Insperity provides a wide range of human resources offerings to its clients and uses its position as a large "employer" to negotiate lower benefit pricing (including health insurance and workers' compensation) than its clients would be able to obtain individually. This model has proven remarkably successful, with Insperity growing WSEs by 9% annually since 1999, while expanding gross profit and EBIT during the same period by 11% and 15% per annum, respectively. We believe there is a long runway for growth ahead as the penetration rate of the co-employment model in the small- to mid-market workforce is only about 5%.

Despite its long history of strong operational and financial performance, Insperity has been under pressure for the past year due to elevated employee benefit costs. Over short periods of time, Insperity is exposed to fluctuations (both good and bad) in benefit costs as it effectively self-insures across its large employee base. Following particularly good results in 2018, the company saw an anomalous amount of large healthcare claims from a small subset of employees in 2019, which had a substantial negative impact on earnings. As we researched the business and analyzed the 2020 outlook, it seemed unlikely that anything in the company's financial model or margin profile had structurally deteriorated. We believe that there is significant upside to Insperity's earnings through either a normalization in benefit costs or a proactive repricing of problem clients should the issue persist.

While COVID-related declines in employment will be a clear near-term headwind for the business, we think this environment has also given Insperity the opportunity to reinforce the value it provides to its clients. During the lead-up to the recently passed CARES Act, Insperity built all of the detailed reporting capabilities needed by its clients to apply for Paycheck Protection Program loans. These actions allowed about two-thirds of its clients to run the necessary reports the first day banks began accepting applications and provided a further benefit to Insperity by ensuring its client base received government aid to keep staff retained (and therefore remain co-employed by Insperity).

Given the depressed near-term margin and earnings level and the company's significant long-term growth potential with low capital intensity and high cash generation, we value the shares using a discounted cash flow analysis and a 9% cost of capital (likely conservative in the current rate environment). Two years from now, we believe the stock will likely be worth around 20x earnings or $115 per share (including dividends), representing 70% upside from the current share price.

*Athene Holding… Revisited (Long)*

We previously discussed our long position in Athene Holding in our third quarter 2019 letter, and the stock performed well over the next several months as management continued to execute on its competitively advantaged strategy in retirement services. However, Athene's stock was punished by the pandemic-related sell-off, and at 60% of tangible book value, we believe it has the potential to double over the next 18 months.

While investors are justifiably concerned about future credit impairments, we think they are unlikely to amount to more than 10% of its tangible book value of $10 billion. Given that Athene typically generates pre-tax profits of nearly $1.5 billion, the company should still grow tangible book value in 2020. Athene has also capitalized on the significant disruption in the marketplace to improve its competitive position and increase its return profile. In June, the company, along with its co-investment vehicle ACRA, announced an accretive transaction with Prudential's Jackson business, whereby it would reinsure $27 billion of fixed annuity and fixed indexed annuity reserves and acquire an 11% stake in Jackson's remaining business. This deal will increase Athene's earnings by nearly 10% and add 100bps to overall returns on equity by 2022. We estimate that Athene is paying just 3x pro forma earnings for this business, underscoring its unique ability to acquire complex assets at incredibly attractive prices. Furthermore, Athene continues to have significant dry powder to do additional deals, comprised of over $3 billion of excess equity capital on its balance sheet and nearly $2 billion of excess third-party capital in ACRA.

We are also encouraged to see KKR (a previous Lakewood long) recently announce that it is acquiring Global Atlantic, an Athene competitor (that is more levered but generates similar returns on equity) for 1x tangible book value. Applying the same valuation to our estimate of Athene's book value at the end of 2021 yields nearly 100% upside in the shares over the next 18 months. At that level, the shares would be trading at just 6x forward earnings.

*Ballard Power Systems (Short)*

In recent months, fuel cell stocks have once again become one of the latest market crazes, with investors flocking to the sector despite the industry's history of many disappointments, poor financial performance and undifferentiated technologies. The fund is short Ballard Power Systems, a consistently loss-making and cash-burning Canadian company that has recently seen its market capitalization swell to a remarkable $4.5 billion (up eight-fold from the end of 2018). We have tracked Ballard Power (and several other fuel cell stocks) for the past decade, and on five separate occasions, investors bid up the shares in a frenzy only to be left holding the bag months later when they came crashing down to earth.

Ballard Power, born in the height of the tech bubble twenty years ago, is a supplier of fuel cell "stacks," which are layers of energy-producing units that are combined to generate power. The stacks are sold to original equipment manufacturers and systems integrators for applications such as transportation (bus, truck and rail) and material handling. A quick peek at Ballard's financials reveals just how challenging selling fuel cell energy stacks to vehicle manufacturers can be. The company generates just over $100 million in annual revenues and has never earned more than $40 million in annual gross profit. 2019 revenues were actually 12% *below* what the company generated in 2017, and annual EBITDA losses and cash burn have averaged about $15 million and $25 million, respectively.

The source of recent excitement appears to center on the potential for Ballard Power to be a major supplier to the transportation industry as the demand for "green" energy sources increases. We are skeptical. We view fuel cell stacks as a low value-add product that is relatively commoditized. If the sale of these products ever became materially profitable for Ballard Power, we believe an equipment manufacturer could insource the technology relatively easily or simply switch to one of Ballard Power's numerous competitors. With just $45 million of PP&E and an R&D budget of about $25 million, Ballard Power lacks the manufacturing infrastructure or technological expertise that would ever result in a sustainable and profitable competitive position. For example, Cummins, one of the largest global diesel and natural gas-powered engine manufacturers, acquired one of Ballard Power's competitors in 2019 (for less than $300 million) and is already spending over $100 million in annual R&D on fuel cell, hydrogen production and hybrid power systems investments.

As the current euphoria wears off, we expect the reality of Ballard Power's poor business prospects to once again set in as the company continues its long history of disappointing financial results. Setting a price target on a perpetually loss-making business with murky prospects like Ballard Power can be a challenge, but if its market capitalization merely settled at the level of prior peaks, the stock would be down over 80% from current levels. As one former senior industry participant told us, "I just can't get my head around the valuation, it's just crazy… Ballard doesn't even have a story."

*Simulations Plus (Short)*

In recent months, the valuations for hyper-growth software companies have surged to extraordinary heights. Amidst all this excitement, we have seen some lower-quality companies that have been reporting attractive headline growth mistakenly pulled along for the ride, creating a number of interesting short opportunities. The fund is short Simulations Plus, formerly a small-capitalization software company with limited sell-side coverage. Far from a hot start-up, Simulations Plus is actually a fairly mature 25 year-old company with the majority of its growth coming from a lower-margin consulting business and acquisitions. After getting caught up in the recent software rally, Simulations Plus was added to the S&P SmallCap 600 Index in June, sending its stock price up over 50% in a matter of weeks. Consequently, the company now trades at nearly 30x revenue with just mid-teens organic revenue growth of questionable quality.

Simulations Plus sells license software for pharmaceutical research and development, and its core product, GastroPlus, simulates the mechanics and interactions of drug compounds. While GastroPlus is by all measures a quality, leading product, its addressable market is fairly limited, with revenues growing to just around $20 million since its launch in the mid-90s. Over the past several years, the company began a series of acquisitions which meaningfully accelerated reported growth. In 2014, Simulations Plus acquired a company called Cognigen for $7 million at a valuation multiple of roughly 1x revenue, expanding into consulting services for pharmaceutical companies. Since then, the company acquired two smaller software and consulting competitors, both at low-single digit revenue multiples. In total, Simulations Plus has spent just over $30 million to acquire businesses accounting for nearly half of current revenue, in stark contrast to the company's current market valuation of $1.2 billion.

The company's consulting business now accounts for nearly half of its $40 million in annual revenues. In the most recent quarter, consulting revenues grew over 30% while software revenues grew 7% organically. While the consulting business has proven to be a success at the top line, results at the bottom line have been more mixed with margins steadily compressing over the last few years as the company has been forced to add headcount to support growth. Despite adding $10 million of company-wide revenue over the last two years, reported pre-tax income increased by only $2 million (even with an acquisition). While many high-growth companies show limited operating leverage as they aggressively invest in new products, this does not appear to be the case at Simulations Plus with annual R&D expense of just *$2.5 million*.

While we understand the basis for early-stage, subscription software companies to be valued off of revenue multiples, we believe it is more appropriate for Simulations Plus to be valued off of its earnings levels since, after all, Simulations Plus is not early stage, subscription-based or even entirely software. With the index addition now complete, we expect the stock to converge back toward its historical average multiple of 30x forward earnings (instead of 30x *revenue*). We forecast that the company will generate just over $0.60 of EPS next fiscal year, and at a multiple of 30x earnings (in line with its historical average despite the higher mix of the lower-quality consulting business today), the stock would trade at $18 per share, representing approximately 70% downside.

*Sorrento Therapeutics (Short)*

We recently initiated a short position in Sorrento Therapeutics, a biotechnology company with a checkered history that is now opportunistically claiming to have the cure for COVID-19. We have followed Sorrento for a while, and after years of shady transactions, shameless promotions and staggering losses, the stock appeared to finally reach the end of the road in early 2020. By March, Sorrento was down to $22 million of cash with $285 million of debt and a few hundred million dollars of market capitalization.

But, in the second quarter, the company's fortunes suddenly turned. Sorrento announced plans to sell stock to two different entities, Alliance Global Partners and Arnaki Ltd. Alliance Global Partners has a long history of raising money for failed and fraudulent companies, and Arnaki Ltd. is an opaque British Virgin Island company linked to Globus Maritime and DryShips, both stocks that fell 99%. Shortly thereafter, Sorrento began issuing press releases related to COVID-19, culminating in a widely circulated May 15th Fox News article where Sorrento's CEO Dr. Henry Ji claimed, "We want to emphasize there is a cure. There is a solution that works 100 percent." Dr. Ji went on to claim the treatment could be available before a vaccine. Multiple journalists have pointed out that this story was widely shopped and rejected by more reputable publications, but nonetheless, Sorrento's stock was off to the races, rising from $2 per share to over $8 per share, equating to an enterprise value of close to $2.5 billion.

Sorrento's approach is to use an antibody to target COVID-19, which is generally considered an inferior solution to the multiple vaccine solutions that are currently progressing in human trials. If there ends up being a role for antibody treatments, at least a dozen other antibody solutions are significantly ahead of Sorrento, including more promising prospects from Eli Lilly and Regeneron. Further, Sorrento is making these bold claims despite only conducting tests in a petri dish (i.e., Sorrento has not even conducted tests in animals, much less humans at this point). And, even the petri dish results have not been published or peer reviewed.

Investors would be well advised to treat Dr. Ji's statements with skepticism. Sorrento has been successful at little more than burning investor cash while repeatedly changing its story to the current biotech flavor du jour (from cannabidiol to CAR-T to non-opioid pain relief). Since the 2009 reverse merger that brought Sorrento public, the company has lost money every year, including $450 million over the last three years. Also, this is not the first time Sorrento has attempted to pump its stock around an equity raise. Most recently, in November 2019, Sorrento announced it received an unsolicited non-binding proposal to acquire the company for a significant premium from an unnamed buyer. In January 2020, the company claimed to receive an even higher offer from another unnamed buyer. Sorrento "rejected" both anonymous offers, instead deciding to raise a combined $116 million in equity.

If all that is not enough, management's track record also warrants caution. Dr. Ji was on the board of a publicly-traded company called NantKwest, which at one point fell 96% from its IPO price and engaged in some questionable related-party transactions with

Sorrento. Sorrento is also on its third CFO since the reverse merger with the current CFO also sitting on the board of a publicly-traded company called Kaixin Auto Holdings, which is down 92% since going public via a SPAC last year. This is not going to end well.

**Operational Update**

During the quarter, Matt Lota departed the firm. Matt had been a trader at Lakewood, and we thank him for his contributions over the years and wish him well in his future endeavors.

**Conclusion**

Thank you for taking the time to read this lengthy letter. This unique market environment has presented many attractive investment opportunities, and we look forward to the rest of 2020.

We remain incredibly grateful for your support and confidence. As always, please feel free to reach out to us at any time with any questions or comments.

Sincerely,

Anthony T. Bozza

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Returns disclosed are for Lakewood Capital Partners, LP ("Lakewood Capital"). Lakewood Capital Offshore Fund, Ltd ("Lakewood Offshore") invests directly into Lakewood Capital, and therefore, the returns of Lakewood Offshore are similar to those of Lakewood Capital. All exposure information is calculated on a delta-adjusted basis and excludes any currency, standalone U.S. Treasury bills, notes and bonds and sovereign debt as well as derivatives on any of these instruments.

Performance results are presented on a net-of-fees basis and reflect the deduction of among other things: management fees, brokerage commissions, administrative expenses and accrued incentive fees, if any. Net performance includes the reinvestment of all dividends, interest and capital gains. Depending on the timing of a specific investment, and eligibility with respect to participation in "new issue" investments, net performance for an individual investor may vary from the net performance as stated herein. Performance data and other information contained herein are estimated and unaudited.

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