



10<sup>th</sup> of January, 2017

Dear Clients and Friends,

After one of the worst starts in history, the S&P 500 rallied to end the year up 11.9% in 2016. Stocks jumped after the election on the expectation that President-elect Donald Trump will quickly enact a growth-oriented economic agenda, including tax cuts, regulatory relief, and economic stimulus. Some investors believe these policies will result in profound economic shifts that could ignite animal spirits, attract productive capital, and send the economy and stock market much higher for years to come.

While upward market momentum is an encouraging signal for a strong market in 2017, we believe some caution is warranted. According to Investors Intelligence, 60.2% of investors are bullish versus only 18.4% bearish, a historically challenging level of enthusiasm. Such optimism has sent median P/E valuations to 23x, roughly 35% above the 50-year average. Lastly, according to InsiderScore, corporate insiders intensified their selling of stocks, particularly in the banking sector where more than 700 insiders sold roughly \$1.5 billion worth of stock in the fourth quarter alone. In such an environment, we think investing in special situation opportunities and companies with outstanding management teams will be particularly important to generating good returns going forward.

We have been taking profits and selling down many of our core bank holdings including QCRH Holdings (QCRH), Pacific Premier Bank (PPBI), Horizon Bancorp (HBNC), and Agriculture Mortgage (AGM). All of these companies have great management teams, used their competitive advantage to grow EPS and book value at 10%+, and were purchased below tangible book value. We love these companies, but now have the high-class problem of having to sell them due to their share prices rising above fair value and in some cases above the price which management has told us they would sell the whole company. We still find the banking industry attractive, particularly in view of potential deregulation, lower taxes, economic stimulus, and rising interest rates. It has just gotten harder to find stellar banks at a price that gives us upside potential as well as downside protection. Fortunately, we still hold many banks and are even buying a couple more that meet such criteria. We're confident such banks will deliver attractive returns going forward.

We are laser focused on achieving great returns in 2017 and we have deep list of exciting new investment ideas. Along with "special situation" investment ideas like the Brookfield DTLA I will outline on the next page, a common theme you hear from us relates to investing in companies with great management teams who promote outstanding corporate cultures. World class cultures emphasize motivating and rewarding employees, exceeding customer expectations, and generating industry leading value for shareholders.

On the next page, I have outlined the rationale for a few of our new investments. We are excited about these opportunities and the many more to come in your portfolios. Thank you for business and confidence and we look forward to a great 2017.

Sincerely,

Tom Eidelman, CFA  
Managing Director

## **New Purchases**

### **Allergan - Price: \$210**

Allergan (AGN) is a leading pharmaceutical company whose blockbuster drugs include Botox and Restasis, a treatment for dry eye. AGN received a buyout offer from Pfizer valued at \$360 share back in October, 2015, but shares collapsed below \$200 per share when regulatory changes deterring tax inversions forced Pfizer to walk away from the deal. The future is still very bright for Allergan. In November 2016, CEO Brent Saunders bought over \$1 million of AGN stock personally and AGN trades at just 13.9x forward earnings, a discount to the healthcare sector and S&P 500 despite its strong management, drug pipeline, and double-digit earnings growth prospects. At a healthcare industry average multiple of 16x '18 non-gaap EPS estimates of \$18.20 per share, AGN shares would be worth \$300 per share, a 43% premium to the current price.

### **First Solar - Price: \$32.10**

First Solar (FSLR) is a leading provider of solar energy solutions. It makes Photovoltaic (PV) solar modules and systems as well as provides maintenance services to utilities and independent power producers. The dramatic sell-off in the company's shares seems to be concern over the financial impact of excess supply in the market. While most analysts expect the overcapacity to last through 2017, we think the future looks bright with worldwide solar capacity estimated to increase between 10-20% for the foreseeable future. We love FSLR's technological advantage, which allows its products to outperform in extraordinary hot and humid climates. With \$1.6 billion of net cash and no debt, we think FSLR will ride out the overcapacity storm, emerge stronger, and ultimately return to its former levels of profitability. While FSLR will be just be marginally profitable in 2017, it has earned between \$3.50 and \$5.50 per share in EPS the last few years and trades at a significant discount to tangible book value of \$56/share. We think FSLR should be worth at least tangible book value of \$56, a 75% premium to the current price.

### **Brookfield DTLA (Downtown Los Angeles) Preferred – Price: \$21.65**

Brookfield DTLA preferred is a preferred stock of a company with commercial real estate assets in downtown Los Angeles. DTLA used to be called MPG Office Trust preferred. DTLA has a par value of \$25 per share with a 7.625% coupon or a dividend of \$1.90 per share. MPG Office Trust got into financial trouble in January 2009 and stopped paying dividends and started accruing the interest to be paid out later when it was capable. In 2013, Brookfield Office Properties, a stronger real estate conglomerate, acquired MPG Office Trust. While we thought this acquisition would result in the immediate redemption of this security at par plus back interest, it turned out Brookfield didn't need to immediately redeem it as it was still inadequately secured by the value of the underlying downtown Los Angeles commercial real estate. A lawsuit was filed and settled for \$2.25 per share, but in his sworn affidavit in 2015, Mark Brown of Brookfield stated "it is highly likely that Brookfield DTLA will begin paying the accrued and unpaid dividends on the preferred stock within the next eight years" and later said that is a "conservative" estimate and "not unrealistic" that they would pay sooner. Since then, downtown Los Angeles commercial property values have increased substantially and Brookfield Office Properties marked up these properties on their balance sheet. With a cumulative value of roughly \$38 per share, we think DTLA preferred shares could appreciate 72% when Brookfield Office Properties redeems the DTLA preferred plus accumulate an additional 7.6% annual coupon while we wait.