HAYDEN CAPITAL

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April 27, 2017

Dear Partners and Friends,

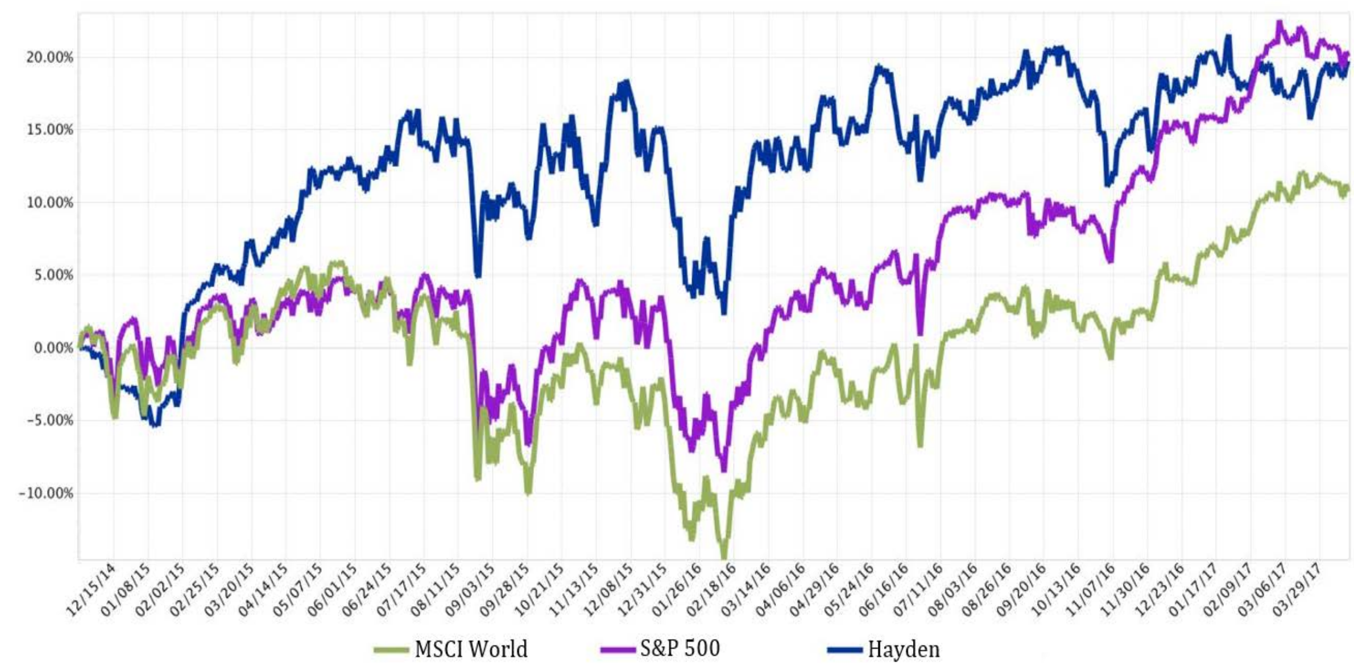
There's no sugarcoating it – the last two quarters have been tough. The so-called "Trump Rally" continued during the first two months of 2017, during which we underperformed. From November 7, 2016 to March 1, 2017 the S&P 500 rallied 16%, while our portfolio rose only 7%. Over the first quarter of 2017, our portfolio at Hayden Capital gained 0.96% compared with the S&P 500's return of 6.07%.

We would never base the success or shortcomings of our process on 5 months of data. It certainly doesn't reflect the fundamental value of our investments. Additionally, as noted last quarter, we believe this recent rally is mostly based on hope and expectations for change (i.e. "soft data"), rather than concrete improvements to the economy. Lately, the "Trump Trade" has started to reverse course, as investors start to doubt his ability to push through tax and healthcare reform as quickly as they had hoped for, which caused the market to lose confidence and reset the market's expectations.

Time Period	Hayden (Net)[1]	S&P 500	MSCI World (ACWI)	Avg. Cash Exposure[2]
4th Quarter[3]	(4.92%)	1.29%	(0.91%)	55.22%
2014	**(4.92%)**	**1.29%**	**(0.91%)**	**55.22%**
1st Quarter	11.16%	0.95%	2.60%	37.79%
2nd Quarter	6.70%	0.28%	0.22%	23.32%
3rd Quarter	(6.00%)	(6.44%)	(9.27%)	23.92%
4th Quarter	5.14%	7.03%	4.82%	20.34%
2015	**17.23%**	**1.37%**	**(2.22%)**	**26.31%**
1st Quarter	(0.23%)	1.35%	0.43%	22.53%
2nd Quarter	1.23%	2.46%	1.63%	27.64%
3rd Quarter	5.04%	3.85%	5.10%	32.60%
4th Quarter	(2.06%)	3.82%	1.05%	21.07%
2016	**3.90%**	**11.95%**	**8.40%**	**26.03%**
1st Quarter	0.96%	6.07%	6.91%	18.75%
2017	**0.96%**	**6.07%**	**6.91%**	**18.75%**
Total Return	**16.92%**	**21.92%**	**12.29%**	**25.78%**
Annualized	**6.78%**	**8.67%**	**4.99%**	**-**

[1] Hayden Capital returns are net of actual fees. Individual client performance may differ based on fee schedule and date of funding.
[2] Includes Cash and Inverse S&P 500 ETF, which allows us to decrease our long exposure without paying taxes on profitable positions.
[3] Hayden Capital launched on November 13, 2014. Performance for both Hayden Capital and the indexes reflects performance beginning on this date.

Since Inception



All this aside, it's still encouraging that as of this writing, things are starting to look brighter. A few weeks into the second quarter, our performance since inception has once again surpassed that of the S&P 500. I certainly hope for continued performance, but recognize short-term price movements are largely out of our control. Rather, the most productive course of action we can take is to continue to get smarter every single day, study more business models, read voraciously, and ultimately trust this process to lead to an actionable insight.

Over the past year, we have found more opportunities in Europe and Asia, as valuations in the US grow stressed. Because of this, you may notice the MSCI World (ACWI) index has been added to our comparison table. Keep in mind, these indexes are merely meant to be indicators and a representation of the opportunity cost for our investors. Our portfolio construction significantly differs from these indexes, and thus these are not true "benchmarks" (at least in the way traditional asset managers use it). Rather, we believe these are alternative, low-fee opportunities our clients may invest their capital in instead of Hayden.

Does Sentiment Matter?

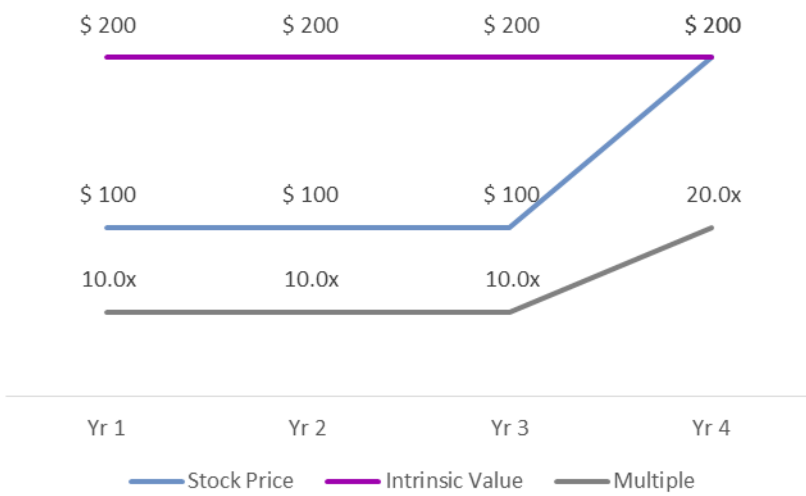
Over the past year, I have increasingly been thinking about the nature of sentiment, its effect on multiples, and how much it influences performance. As fundamental investors, we are often taught to ignore what everyone else is doing. Just buy what is cheap, and eventually the market will realize the value and push up the stock's price.

The irony is though, that once the stock is in the portfolio, the investor *needs* other people to realize its value too for the stock to "work".

This is particularly true in the case of slow growth, mature companies ("cigar-butts", where intrinsic value and earnings growth is stagnant), which are often disguised as multiple "re-rating" stories. Even in the case of faster growth companies (compounders), a change in multiple can often influence performance much greater than operational performance in a given year. A 10x P/E stock being bid up to 15x P/E in the span of 3 months (50% gain), is much more lucrative than waiting for earnings growth of 15% per year.

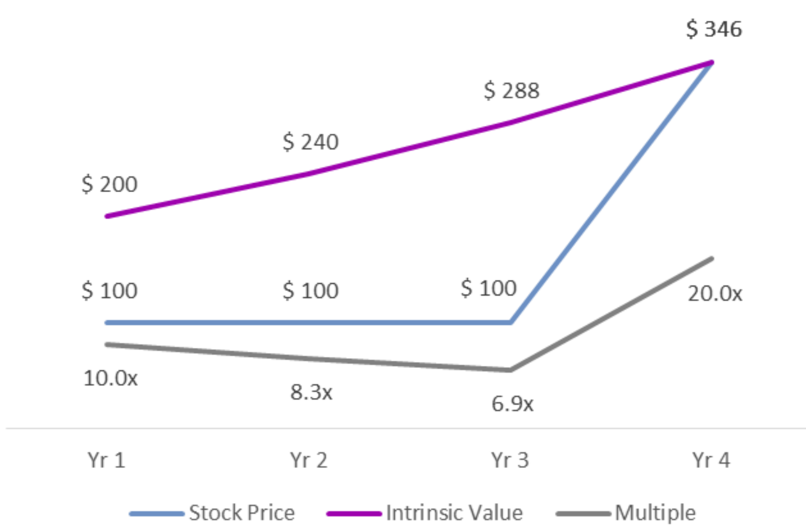
In the context of performance, the CAGR of an investment matters. Let's say there's a stock selling at $100 but the intrinsic value is $200 (your proverbial 50 cent – dollar). If it takes 4 years for other investors to realize the bargain situation (i.e. price stays flat for 3 years, then doubles in year 4), this equates to a 19% CAGR (still a great return). However if you buy a stock for $100, after which other investors immediately recognize the value and bid the shares up, that's a +100% CAGR.

"Cigar-Butt" Investment
Illustrative Example



Source: Hayden Capital

"Compounder" Investment
Illustrative Example



Source: Hayden Capital

As you can see, the best time to buy a stock (even an extremely undervalued one) is 1 second before other investors start to take notice. In this way, your money won't be sitting idle for 3 years and can be used for other investments in the meantime (resulting in an even higher return with the same amount of capital).

The tricky part is – how do you predict *when* this change in sentiment will take place? Is it better to be 3 years early, or should you invest only after it's clear other investors have caught on[4]? Or should you do a mixture of both – take a starter position and "flex up" the position only after the valuation gap has begun to close?

Also if it's so lucrative, why don't we hear about this aspect of investing more? My guess is because it's very hard to do and there's few methods to use hard data or analysis to get the timing right (it's based mostly on "feelings" or gut instinct). Like a trader looking at momentum indicators to gauge which way the market will break in the next hour, so too is predicting what will move a stock over the next month. Understanding who the incremental buyer will be, what the "story" that draws them to the name will be, how they will find out about the stock, at what price they'll be willing to pay up till (i.e. how high the multiple can go), and most importantly *when* they'll start buying are all extremely hard to predict.

Sometimes it's possible though. For example, I know all of our investments extremely well (such is the nature of owning only 8 positions). At times, I can recognize their trading patterns and literally feel shifts in sentiment. At conference cocktail hours, several investors will mention it in passing as their "latest idea". It will be discussed more frequently on Twitter. You see it popping up in other financial publications and investment letters. The shift in sentiment is palpable if you pay attention.

Furthermore, I believe the industry doesn't talk about this facet of investing much because it isn't noble. If the company's intrinsic value is flat, the "pool" of available capital is fixed and it turns into a zero-sum game. An investor betting on multiple "re-rating" is essentially "front-running" the market, with the idea of selling to other buyers who were late, once the price is bid up[5].

This is something that I've been thinking of more recently – however I don't have a clear answer to these questions yet. For now, we'll stick with our tried and true method of investing. But the beauty of this profession is that we're required to continuously learn, to always incorporate new methods into our process in the pursuit of better results. Hopefully as I develop this more and with additional contemplation, this facet of the investment "game" will be another edge to draw upon.

Portfolio Updates

While there were no major changes in our portfolio this quarter, I just wanted to give an operational update on one of our key positions.

Zooplus (ZO1): Over last few months, there have been some exciting developments with our investment in Zooplus. The most meaningful of these was last week's announcement that Petsmart is acquiring Chewy.com for $3.35BN[6]. At such a valuation, this equates to a ~2.23x forward EV / Sales multiple.

This acquisition is important, as it finally gives us an indication of what rational private market buyers are willing to bid for an online pet supply retailer (and in an industry with few comparables). Additionally, this wasn't simply an overzealous buyer paying too much. The backer is BC Partners (the private equity firm that owns Petsmart), which is one of the most sophisticated financial buyers in the market.

[4] If the latter, you will likely miss the first 20% of the move. However, the positive tradeoff is that your capital wasn't tied up for an indefinite amount of time.
[5] I wonder who coined the term "multiple re-rating"… it makes the act sound much more sophisticated that it actually is. I guess "taking money from dumb investors" is less catchy.
[6] According to Recode's sources (LINK). We have heard that the valuation may actually be higher.

Notably, Zooplus and Chewy are remarkably similar companies, only with one operating in Europe and one in the United States. Both have 50% market share of the online pet food market, have Amazon as their largest competitors, are rated highly by customers, and are of similar size (Chewy had $901M of sales in 2016 and projected to do $1.5BN in 2017. Zooplus did €952M of sales in 2016, and we project will do €1.2BN in 2017). The only difference is that Chewy is still unprofitable (Zooplus has been profitable since 2013), but has higher growth (which ironically is why it's unprofitable).

Zooplus is currently trading at a 1x EV/S multiple. If we were to apply Chewy's take-out valuation, it would indicate a ~€360 price per share (or +120% upside). Even assuming a lower "fair" multiple to account for the take-out premium and slower growth (let's call it a 1.8x multiple, or a 20% discount), this would still equate to a €290 price (76% upside). It's rare to see such a large valuation discrepancy in the market.

In other developments, Zooplus announced their full year 2016 earnings. Revenue grew 28% y/y, while net income was up 44%. More importantly, orders per customer and basket size both increased (7% y/y and 6.5% y/y respectively), indicating that customers are increasingly finding value in the product.

The company also completed its first ever 3-hour Investor Day in March (LINK). By 2020, management expects to reach €2 billion in sales or more than double current revenue in 4 years (22% CAGR).

Lastly, a key drawback of the investment has been the lack of liquidity in the name. I've spoken with many investment managers who expressed interest in the company, but noted the current liquidity (~$2M a day) makes it hard to establish a meaningful position[7]. More events such as the recent Investor Day should bring attention to the stock, and help increase liquidity over time.

Conclusion

Next week, I will be at Berkshire's Annual Meeting. Every year, investors of all disciplines flock to Omaha, Nebraska to hear the godfather of investing speak. After many years in the markets, I am embarrassed to say this will be my first year among them. There are numerous events hosted around the event, and sharing ideas and meeting like-minded investors is all part of the weekend fun. If you are going to be in Omaha, please reach out.

As always, I'd like to thank our investors for their continued support and trust for managing their hard-earned assets. While in the short-term our results may occasionally be volatile, I know our profits over time will be worth the volatility.

Please feel free to reach out if there is anything I may help with. For more frequent updates, I also communicate regularly on Twitter. Our posts center around what we're currently looking at and find interesting throughout the quarter (LINK). If you'd prefer to chat the traditional way, I am always reachable via email, phone, or over a few old fashioned's.

Sincerely,

Fred Liu

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[7] The general "rule of thumb" we use is 15% of average daily volume, to ensure a buyer's orders to not push up the stock price (how much you buy in a day should not be more than 15% of the total volume). If a firm wished to establish a $10M stake in the stock (relatively small by industry standards), it would take them 33 trading days (1.5 months) to build the position.

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