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February 5, 2017

Dear Partners and Friends,

The last quarter of 2016 was certainly interesting. The election of President Trump to the White House caught many off guard. However even more surprising may be the hope-filled "Trump Rally" that ensued in the following weeks - especially after dire warnings by pundits in the weeks before. Between November 7th and year-end, the S&P 500 rallied over 5%.

Notably, this recent rally is driven by multiple expansion, as investors became ever more excited about the business prospects and tax reforms under the new administration. Since businesses are expected to earn more next year, investors bid up the price they're willing to pay today, and thus priced in these lofty expectations. The risk is these reforms may take longer to implement than the market expects, and the Trump administration may lack the "political capital" to get some of their agenda passed (especially if they continue to alienate core fiscal Republicans).

During this period, our portfolio lagged the broader market. This shouldn't be of concern, as our portfolio value is structured to rise in-line with the fundamental value growth of our underlying businesses (normalized earnings power growth), rather than multiple expansion (the market's willingness to pay a higher price).

Especially in today's market where interest rates have likely bottomed, it's apparent that multiples will have a hard time expanding going forward and that intrinsic value growth will matter much more in coming years (I talk about this in-depth below). Expecting other market participants to pay more for the same company tomorrow vs. today will be a dangerous game to play.

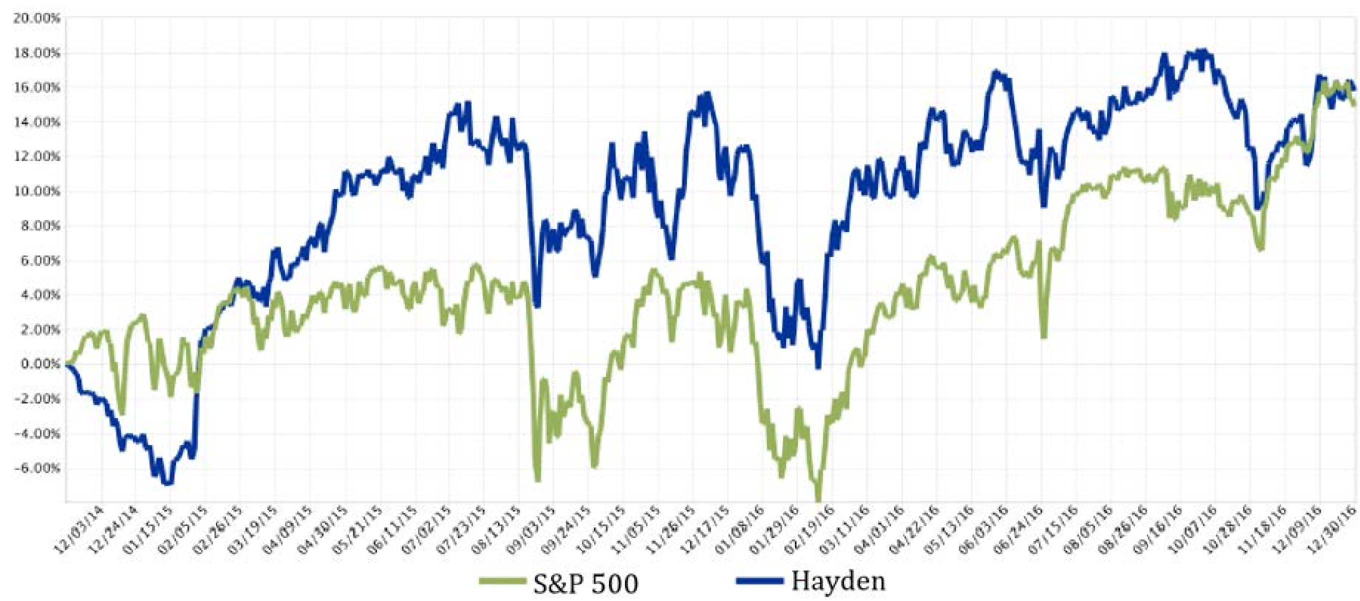
During 2016, we estimate our underlying companies grew their earnings power by 12.5%. However, this was offset by the multiples the market was willing to pay for our firms declining -4.2%. Combined with the "cash drag" due to our average 26% cash position, we had returns of 3.90% for the full year of 2016. Over the fourth quarter of 2016, our portfolio at Hayden Capital declined by -2.06% compared to a 3.95% gain in the S&P 500.

Some of our cash was deployed into our newest investment, Zooplus (ETR: ZO1), bringing our average cash level down to 21%. However, we continue to wait for better opportunities to deploy the remainder of our cash "war chest".

Over the next year, we estimate our portfolio companies to grow their earnings power by over 17%. If our estimates are correct and company multiples stay the same, we can expect a portfolio return within this range.

Time Period	Hayden (Net)[1]	S&P 500	Relative Performance[2]	Avg. Cash Exposure[3]
4th Quarter[4]	(4.92%)	1.33%	(6.25%)	55.22%
2014	**(4.92%)**	**1.33%**	**(6.25%)**	**55.22%**
1st Quarter	11.16%	0.88%	+10.28%	37.79%
2nd Quarter	6.70%	0.21%	+6.49%	23.32%
3rd Quarter	(6.00%)	(6.42%)	+0.42%	23.92%
4th Quarter	5.14%	7.03%	(1.89%)	20.34%
2015	**17.23%**	**1.25%**	**+15.98%**	**26.31%**
1st Quarter	(0.23%)	1.33%	(1.56%)	22.53%
2nd Quarter	1.23%	2.46%	(1.23%)	27.64%
3rd Quarter	5.04%	3.78%	+1.26%	32.60%
4th Quarter	(2.06%)	3.95%	(6.01%)	21.07%
2016	**3.90%**	**12.00%**	**(8.10%)**	**26.03%**
Total Return	**15.81%**	**14.91%**	**+0.90%**	**28.01%**
Annualized	**7.12%**	**6.73%**	**+0.39%**	**-**

Since Inception



[1] Hayden Capital returns are net of actual fees. Individual client performance may differ based on fee schedule and date of funding.

[2] Relative performance compared to S&P 500 (Total Return).

[3] Includes Cash and Inverse S&P 500 ETF, which allows us to decrease our long exposure without paying taxes on profitable positions.

[4] Hayden Capital launched on November 13, 2014. Performance for both Hayden Capital and the S&P 500 reflects performance beginning on this date.

The Magic House

Over the past five years, the S&P 500 has risen 98%. Of this, only 23% of the gains have come from earnings growth and 10% were from dividends. The remaining 64%, or two-thirds, was from multiple expansion. The S&P 500 companies didn't become twice as profitable over this period. Rather, investors were simply willing to pay a 64% higher price for the same company five years later (the forward P/E ratio for the S&P 500 rose from 12x to 18x from year-end 2011 - 16).

Low interest rates meant that the yields offered by bonds were often insufficient to meet investor needs, and thus capital moved to higher risk equities to provide these returns. As with any market, if there are more buyers for the same number of stocks, the price will go up[5].

With most investments, there are two components of what an asset will sell for – the fundamental value (the future earnings stream) and the price you're willing to pay today for each dollar of future earnings (the P/E multiple)[6].

To better illustrate this concept, the example I give to clients is that of a "magic house"[7]. Let's imagine that you buy a 1,000-sqft house for $1 million (we're talking NYC / SF prices…). This equates to a price of $1,000 per square foot. However, homes in this alternate universe are special, and the house is able to magically "grow" 15% a year. Thus, next year the house will expand to 1,150-sqft, and 1,323-sqft the year after that.

Now let's imagine that in this universe, there is no change in housing stock (no homes being built or destroyed, since the homes last forever). There's also no inflation, and no population growth (deaths-to-births = 1). Because of this, all things equal, the price per sq ft should remain constant (there's no natural tailwind from inflation or population growth)[8].

However, the pricing does change with people's moods and their feelings about their economic situation. Looking at historical pricing, you know that when everyone is feeling good and flush with cash, homes sell at $2,000 per sqft. And in bad times, they go as low as $500 per sqft. The average in the past few years has been $1,250 per sqft. As such, you're feeling your purchase at $1,000 per sqft is a very fair price.

Plus, the house (and thus its value) is compounding at 15% a year. If pricing remains stable, your investment will appreciate at this rate every year.

However, homebuyers are not rational. In any given year, the price per square foot homebuyers are willing to pay will change (i.e. a different multiple), depending on their economic situation.

For example, the local bank may be launching a promotion this year, and offering home loans at 0% interest rates (i.e. Yay, Free Money!). Realizing a great opportunity, buyers take out loans and can afford to start bidding up the prices to unprecedented levels of $5,000 per sqft.

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[5] The number of publicly listed companies was 3,605 in 2012, and 3,700 in 2015 (LINK).

[6] Except in asset-based or liquidation scenario investments.

[7] I find the concept easier to explain with the tangible nature of real estate, as individuals are often more familiar with this market, than dealing with abstract numbers and ratios in stock investing.

[8] There are more factors not mentioned at play, which affect housing prices. However, for the sake of this example, we'll ignore these aspects for now.

Alternatively, there may be a slow-down at the local diaper factory, which is the primary employer in the city. The recent election of an eccentric Mayor has caused uncertainty for the future, which has resulted in drastically fewer people wanting to start families this year.

There are rumors there will be lay-offs, and no one wants buy homes in the area anymore. Home prices subsequently plummet to $500 per square foot.

Eventually however, the bank promotion is going to end, as this is a business after all and they can't lose money forever. The free money faucet will close, and borrowers will no longer be able to pay as much as they did before.

Similarly, families will become more comfortable under the new administration, and baby making will return to previous levels. Diapers will once again be in demand, and the factory will need to hire those laid off employees back. When these events happen, housing prices will find equilibrium again, and the multiples will mean-revert.

Even if it doesn't, our downside risk (or the risk of losing your initial investment) is low, so long as we're confident in the "Magic House's" ability to continue growing more valuable each year. For example, even if prices drop 50% to the low-end of $500 per sqft, it will only take 5 years before we break-even on the investment.[9]

However, it's highly likely that over time, the multiple will revert back to a "fair" multiple.[10] Therefore as long as our "house" continues to expand at 15% a year, this is the return we would expect to realize over the long run.

Portfolio Impact

I give this example, to illustrate the way I think about public markets investments. It's tough to predict what other people are going to be willing to pay for an investment tomorrow or next year. There is simply too much noise in the markets to predict sentiment accurately – betting on other investors' willingness to pay more or less in the future.

I believe it's more productive to simply try to make our purchases at a "fair" multiple or below, based on today's normalized earnings power, and let fundamental growth drive the majority of our expected returns. In this way, our margin of safety lies in getting the growth of the company for free. Our aim is to purchase these high-quality, growing companies at a "no-growth" multiple, and benefit as the company proves the market wrong with a longer than expected runway.

If other market participants choose to pay a higher price per $ of earnings when we sell the investment, we'll take it. However, it's not something our portfolio is reliant upon in order to make attractive returns.

This year, other market participants chose to pay a lower price for our investments than the previous year. For example, the P/E ratio (trailing twelve month) for our portfolio declined from 22.6x to 21.6x (-4.2% decrease). Meanwhile, the S&P 500 multiple expanded 10.7% - from 23.1x to 25.5x.

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9 At a 15% annual growth rate, the house will be 2,011 square feet in 5 years. If we sell this house at $500 / sqft, this equates to a value of $1,005,678 – slightly more than our purchase price.

10 And if it doesn't, it's likely I misjudged the quality of the business and thus has caused the market to permanently impair the multiple.

Hayden Capital Performance Drivers
For 2016; Versus the S&P 500 Index

	1/1/2016	12/31/2016	Chg Y/Y
P/E Ratio (ttm)			
Hayden Capital	22.6x	21.6x	(4.2)%
S&P 500	23.1x	25.5x	10.7%
Est. Growth (fwd. 1yr)			
Hayden Capital	12.5%	17.1%	4.6%

Source: Hayden Capital; Standard & Poors; Robert Shiller

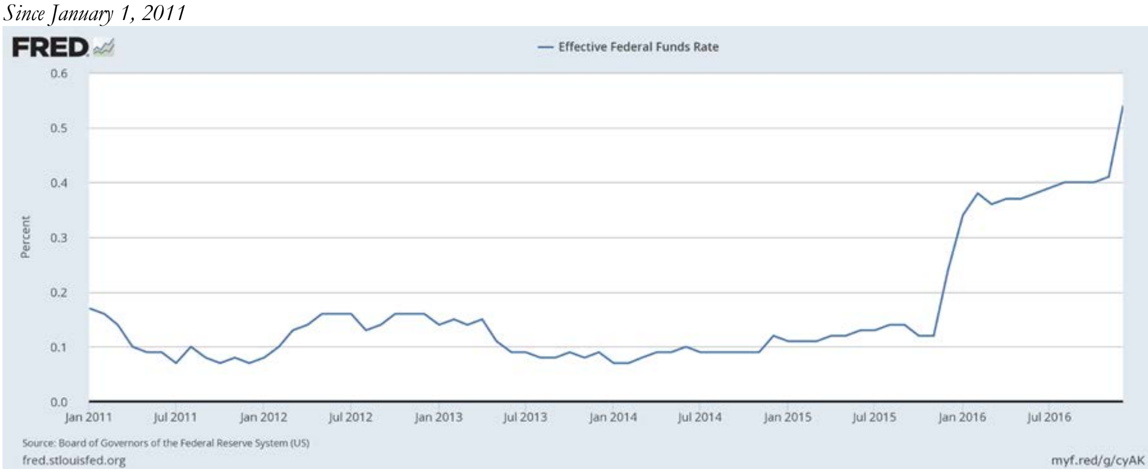
However, I am very comfortable with this, as our investment horizon is much longer than the typical investor's time horizon, and I know we paid a below-fair multiple for our investments. Like the "Magic House", I'm confident the multiple will soon return to normalized levels.

In the meantime, this gave us the opportunity to increase our portfolio's intrinsic growth rate at this lower multiple. Based on our analysis, I expect our portfolio companies to grow 17% more valuable a year from now, versus 12.5% growth last year. Additionally we continue to search for those 70-cent dollars, which we believe will grow to $5[11].

End Of The Multiple Expansion Era

It's unlikely that multiple expansion will be the driver of market returns for much longer. Over the last five years, multiples expanded 64% (from 12x to 18x) due to the unprecedented amount of money that had been pumped into the US monetary system. This kept 10 year treasury rates at ~2% for much of the period (compared to the long-term average of ~6%). Similar to the example of the Magic House, when borrowing money is free, investors will be willing to pay more for the same assets.

Effective Federal Funds Rate
Since January 1, 2011



Source: Federal Reserve Bank of St. Louis

[11] Warren Buffett famously coined the investment metaphor of buying $1.00 for $0.50. Once the market realized the investment was worth $1 and it traded up to "fair-value", he would sell it and put it into the next $0.50 investment. However, this strategy implied that the company's value was static, and would never be worth more than the $1 value.

In contrast, I would much rather pay a little more for a high-quality, growing franchise business. In this way, we aim to purchase a high-quality business that's worth $1 today for $0.70 – if we know that $1 value today will grow to $5 in just a few years. I believe this type of situation offers a superior return on our investment.

However, the days of free money are coming to an end. The Fed Funds Rate (the rate at which banks lend money to each other overnight) hasn't been at these levels since the financial crisis. This rate is the underpinning on which all interest rates are determined. For example, if the Fed Funds Rate rises, you can expect your mortgage rate to rise too.

So far, the Federal Reserve has hiked interest rates twice since December 2015. As the markets hit all-time highs, the pace of interest rate increases will accelerate. Investors are expecting 1 – 2 more hikes this year alone.

What this means is that the cost of borrowing money is going to rise, which in turn means people will not be able to pay as much for assets. Multiples will have a tough time driving returns going forward.

> *"The market was up because quantitative easing [central banks' asset-buying programs] effectively lowered the discount rate applied to earnings and cash flow. It had a profound impact. The election was an inflection point, as we can see from the postelection rise in bond yields.* ***P/E ratios now face a serious head wind. It can be overcome with accelerated earnings growth, and tax reform will be a part of that, if it happens…***
>
> *The index-fund trend has been turbocharged in the past five years.* ***When most of the market's return owes to multiple expansion, indexing is an ideal way to win. If we have entered a new regime, with earnings and dividends starting to drive total return, the opportunities for active management are only going to get better.*** *Lower correlations are good for active management."*
>
> *– Bill Priest, CEO of Epoch Investment Partners* [1]

Portfolio Updates

Zooplus (ZO1): We purchased our newest investment, Zooplus (ETR: ZO1), during the fourth quarter. We made the purchase at an average price of $126.23. The company is headquartered in Munich, traded on the Frankfurt Stock Exchange, and only operates in Europe. Sales were €950M in 2016, which is expected to grow 26% in 2017 to ~€1,200M.

We outlined our Zooplus thesis in a 24-page investment report, published on January 10th ([LINK]). For those interested, I would highly recommend giving it a read. An excerpt of the investment case is below:

> Zooplus is the leading online retailer of pet food and supplies in Europe, with 50% of the online market share. Generally, in a commoditized market such as selling pet food, the lowest cost provider with the best customer service has the "right to win".
>
> I believe Zooplus will be this winner, given its structural cost advantage versus its competitors. Additionally, customer satisfaction is extremely high, and we can clearly see customers' appreciation for the company's value proposition, as evidenced by the 94% sales retention rate. The company has grown at a 31% sales CAGR since 2010, and the company is still only at the early stages (it has ~3.5% of total industry market share).
>
> I believe the market is underestimating the long-term earnings power of the firm and consequently significantly undervaluing the company. For instance, the stock is currently trading at 0.9x 2016 sales while comparable acquisitions have taken place at 2 – 6x multiples. Additionally, we believe at maturity, the business will have normalized operating margins of 8 - 10%, implying a valuation of ~10x normalized EBIT.

This is an extremely cheap for such a dominant company, with a clear and growing advantage versus competitors, and profitable growth of 20 – 25% per year going forward. Zooplus also benefits from economies of scale, resulting in lower cost of goods and shipping costs per order as it gets larger, and widens its "moat".

Going forward, I estimate the company will compound its intrinsic value and earnings power at a rate similar to its top-line growth, resulting in a return of ~19 - 22% per year (with the added possibility of multiple expansion too).

Note: In late December, the CEO of Zooplus (Cornelius Patt) purchased $220K worth of shares at ~$119. During the same period, other board members also purchased $140K worth of shares at similar prices. This is the first time he has purchased shares in the open market since 2012, when shares were ~$33. As the old saying goes, there's many reasons for insiders to sell stock… there's only one reason for them to buy.

Credit Acceptance (CACC): During the fourth quarter, I increased our position in Credit Acceptance, after it reported earnings. The company disclosed that October unit volumes would experience a decline year-over-year, which surprised the Street. The stock subsequently fell ~12% the next day.

After speaking with dozens of auto dealerships, I learned that the likely reason for the decline was due to CACC beginning to tighten pricing on their loans. CACC saw a deterioration in the industry coming, and was becoming more conservative in their lending practices because of it (which is a great thing).

All indications pointed to this decline being due to a conscious business decision, rather than an impairment of the fundamental business, and gave me conviction to "flex up" the position beyond our "core" weighting. The stock subsequently increased from ~$165 after earnings to a high of $220. We managed to sell the "flexed up" portion of our position over several tranches, at an average price of $198.20.

While this type of short-term trading isn't our typical mandate, I am comfortable occasioning increasing our positions when the opportunity arises. At the purchase price, the valuation was very attractive, and I was confident we had downside protection from the company's historical share repurchases at similar levels. Additionally, short interest hit abnormally high levels in the weeks after, which I felt would reverse (there are actually more shares short than the non-institutional float). We had seen this happen several times prior with the stock.

Going forward, investors should expect more volatility in the name over the next 12-24 months. Since 2014, I've indicated that the subprime auto industry was due for a correction, and that Credit Acceptance would be a beneficiary as a result (see our Q2 2016 and Q3 2016 Investor Letters). This recent quarter is likely the beginning of an industry inflection.

In the short-term, I predict negative industry news will offset positive news of Credit Acceptance gaining market share from competitors (i.e. industry multiples will probably decline, while CACC's earnings will grow), leading to higher volatility as investors shift focus between the two stories.

However, this volatility will be worth the trouble, and I expect Credit Acceptance to be in a much stronger position coming out of the cycle. For example, in what was a very competitive and "bad" year, Credit Acceptance was still able to grow earnings by 14% y/y in 2016. I expect this rate to accelerate in future years, as the company captures share in the coming industry slowdown.

Conclusion

On the operational front, I would like to welcome our newest member of the team – Josh Raj. Josh is currently studying Finance and Computer Science at New York University's Stern School of Business (which I consider as the top undergraduate business school in the world… mainly because it's my alma mater).

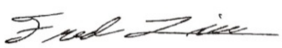
As a research intern, he will be a valuable addition to our research process. The analytical power he brings will help us conduct research on our ever-growing pipeline of potential ideas much more quickly. We welcome Josh to the Hayden Capital family.

Over the last few months, I have had the pleasure of being introduced to many great individuals, who share an appreciation for our investment philosophy. Thank you for spreading the word about the work we're doing at Hayden. I always enjoy meeting interesting people, and am always open to any introductions to investors who may be a good fit or would like to learn more about our investment philosophy.

Lastly, 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. I am always happy to chat via email, phone, or over some good coffee.

Sincerely,



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