

Dear Esteemed Clients and friends,

In the first quarter of 2019, our fund returned 6.3%. We kept a conservative cash position of 25% in the portfolio and added two significant positions in stocks that I categorize as merger arbitrage opportunities. Lastly, two major positions were closed, Corning and Pandora.

In the following pages I will discuss:

- My thoughts on the US stock market utilizes a new chart
- Our new Merger Arbitrage investments (Celgene & RedHat)
- An update on GameStop
- Closing our positions in Corning & Pandora

MADIRON EQUITY FUND PERFORMANCE (GROSS-OF-MANAGEMENT FEES)

Year	Q1	Q2	Q3	Q4	YTD	S&P 500 ¹	ACWX ²	Avg. Cash
2019	6.3%				6.3%	13.2%	10.31	25%
2018	(2.56%)	13.00%	10.39%	(17.27%)	3.6%	(4.4)%	(14.5%)	20%
2017	8.97%	1.39%	1.14%	6.72%	18.2%	21.8%	27.2%	20%
2016	7.08%	0.14%	10.91%	4.96%	23.1%	11.9%	4.5%	23%
2015	8.41%	(2.85%)	(14.67%)	4.96%	(6.6%)	1.4%	(5.7%)	18%
2014	2.23%	8.82%	(3.58%)	2.57%	10.0%	13.7%	(3.9%)	21%
2013	-	(0.76%)	9.83%	9.30%	18.4%	18.7%	11.8%	28%
				Total	73.0%	76.2%	29.7%	22%

¹ **S&P 500**: The SPDR® S&P 500® SPY ETF Trust seeks to provide investment results that, before expenses, correspond generally to the price and yield performance of the S&P 500® Index. SPY cumulative performance of quarterly SPY TR results provided by Morningstar.

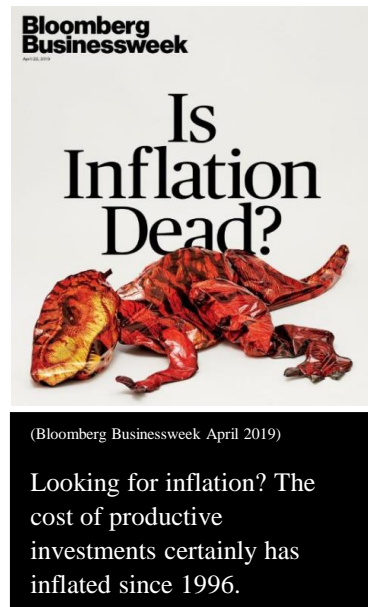
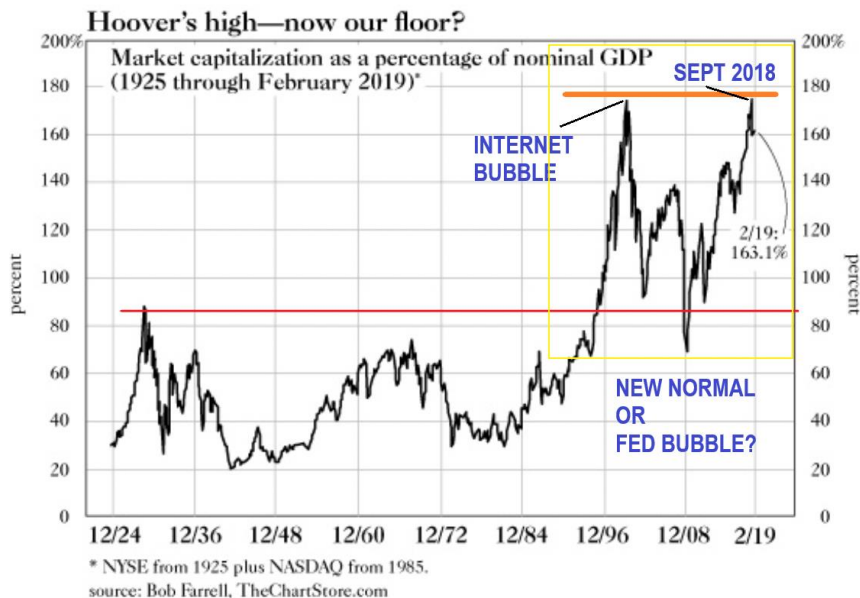
² **ACWX**: The iShares MSCI ACWI ex U.S. ETF seeks to track the investment results of an index composed of large- and mid-capitalization non-U.S. equities.

Market Commentary and Future Prospects

In my last letter, I referenced [Shiller's P/E](#) as a yard stick to help us assess the US stock market. To cross-examine Shiller's indicator, I am presenting this next chart; Market Capitalization to Nominal-GDP. This chart is a favorite for one of Wall Street's best minds and technicians, Bob Farrell.

The chart is quite remarkable. It illustrates the market hit a quasi-ceiling in September of 2018 which was established by the Internet bubble of 2000. We live in a world dominated by monetarism, fiat currency, and low interest rates. If the status-quo prevails, so will this paradigm. (see next page)

source: Grant's Interest Rate Observer



According to this chart, we are in a danger zone. For bear market conditions to prevail, the credit cycle needs to be in dangerous territory as well. This is where the FED's interventionist hand comes in. The FED has retreated from its hawkish stance in Q4. I guess you can thank the FED for Q4 nosedive and Q1 recovery. The FED giveth and taketh. This type of tinkering works, until it doesn't.

Merger Arbitrage Opportunities

Celgene (ticker: CELG)

We purchased shares of Celgene (CELG) between \$83-\$85/share after Bristol-Myers Squibb (BMY) made an offer to buy Celgene. BMY has offered Celgene shareholders \$50 a share in cash, plus one share of its stock for each share that Celgene shareholders own. In addition, BMY will give Celgene shareholders a contingent value right worth \$9 a share, which we would receive upon FDA approval of three Celgene drugs (Ozanimod, liso-cell, and bb2121). The deal, worth about \$74 billion, values Celgene stock at \$102.43 a share. The speculation that created the rich arbitrage opportunity was the significant doubt that Bristol-Myers shareholders would approve the merger. On April 12th, both shareholders of both companies of Bristol-Myers and Celgene approved the combination. Shares of Celgene trade at approximately \$94/share which significantly closed the spread between the value on the transaction.

I count on BMY shares to remain somewhat stable (typically a low volatility stock) therefore provide a holding period return (HPR) of approximately 15% in eight months. The merger is on pace to close at towards the end of the third quarter of this year.

Red Hat (ticker: RHT)

We purchased a large position in Red Hat (RHT) between the prices of \$181-182/share. Red Hat's pending merger with IBM is on track to close in the second half of 2019. IBM will pay RHT shareholders \$190 per share in cash, a deal valued at \$34 billion. The merger has been approved by shareholders on both sides and should successfully clear regulatory review in the coming months. This investment will generate a holding period return of only 4.3% but an annualized rate of return of 12.3% (if closed in July). The annualized rate of return could decline to as low as 5.5% if the merger doesn't close until December.

GameStop Update

GameStop (ticker:GME) is down over 40% since I discussed it in the Q3 2018 letter.

Management concluded its strategic review in February with the sale of its Wireless division (November), hired a new CEO (late March), and announced that terms to successfully sell the company were not met. The Board of Directors also announced an increase of \$130 million to their share buyback program, totaling \$300 million.

GME completed the sale of its Wireless division for \$700 million and will pay off its 2019 debt. Currently, the stock is trading at a \$93 million Enterprise Value. It will generate \$150+ million in FCF and is trading as if it is on the brink of bankruptcy. Management has not cut the dividend either which now is yielding 17%. GME is by far one of the cheapest names in the stock market.

2019 looks like it will be a trough year with a weak gaming release line-up coupled with an aging PS4/Xbox One console cycle. New gaming consoles are expected to role out in 2020. My research indicates these next generation consoles will have discs or cartridges which is a positive sign for GME's prospects.

This does not mean traditional gaming consoles won't be challenged. Google announced Stadia; a cloud based streaming gaming platform in March. Apple announced a subscription gaming service and Amazon is expected to release a gaming platform soon. The battle for next-generation gaming will be fierce and competition should create some great entertainment products. This is where creativity wins. Placing games on a cloud doesn't make better entertainment products, it just provides better access to it. For the new platforms to succeed they will need exclusive franchises to draw gamers. The incumbents will be in trouble if their new competition executes well on both. Currently, there has been no pricing information released on cloud gaming subscriptions.

Will GME be acquired?

It is very possible GME is acquired because of its stellar cash generation despite weakening business fundamentals. My research indicates GME will dispose of its European and Australian operations prior to a PE buyout.

Figure 2 (next pg.) is a chart of the 20 largest private equity retail acquisitions in the last 15 years. The common denominator is that all these retailers were large US chains. None of these retailers had significant store footprints around the world when they were acquired. (i.e., Staples sold off most of its foreign ops prior to a buyout)

(Continued on next page)

An alarming fact presented in Figure 2 is the number of Ch. 11s. 25% of these retail LBOs failed. The PE formula looks to be broken in the age of Amazon. Maybe the companies made aggressive assumptions and/or overpaid while issuing too much debt.

The news surrounding GME continues to be ugly. In the second half of 2018, GME took over \$1 billion in non-cash charges to write-off goodwill from acquisitions in 2005-2006. This simply reinforces the already known fact that the business has shrunk.

US Console and handheld systems units sold dropped from ~164 million units from the last cycle (2005-2012) to ~92 million units in this current cycle. Nintendo was responsible for majority of the decline in the current cycle. Nintendo only sold 39 million units in the current cycle (Wii U, Switch, 3DS) VS. 85 million units in the last cycle (Wii & DS). I believe for GME to have a healthy business; it will require US console/device unit sales of 75+ million in the next cycle.

GME's will now be running their business on a ~\$2.5 billion asset base. If the economics are stable here, I expect the business to generate a 10%-15% ROIC in the next cycle. This target assumes GME's pre-owned inventory is in good shape and GME sustains a healthy velocity of trade-ins.

As we wait and see how the gaming industry evolves, I look forward to hearing from the new CEO and collecting a safe dividend in 2019.

I don't believe anything unless I understand it inside out. And even if I understand something, it is not uncommon that I disagree with accepted view (even if it's a Nobel laureate).

— Michael Burry —

Largest private equity acquisitions

Figure 2

Retailer	Price	PE Buyer	Year	Ch. 11
PetSmart	\$8.7 billion	BC Partners	2015	N
Dollar General	\$6.9 billion	KKR	2007	N
Staples	\$6.9 billion	Sycamore	2017	N
Toys R Us	\$6.6 billion	Bain, KKR, Vornado	2005	Y
Neiman Marcus	\$6 billion	Ares Capital	2013	N
Michaels	\$5.8 billion	Bain, Blackstone	2006	N
Neiman Marcus	\$4.9 billion	Leonard Green	2005	N
Petco	\$4.6 billion	CVC Capital	2015	N
Mattress Firm	\$3.8 billion	Steinhoff	2016	Y
Claire's Stores	\$3.1 billion	Apollo	2007	Y
J. Crew	\$3 billion	Leonard Green	2011	N
Belk	\$3 billion	Sycamore	2015	N
BJ's	\$2.8 billion	Leonard Green	2011	N
Party City	\$2.7 billion	Thomas H. Lee	2012	N
Bass Pro	\$2.4 billion	Pamplona Capital	2016	N
Nine West/Jones	\$2.2 billion	Sycamore	2014	Y
Burlington	\$2.1 billion	Bain Capital	2006	N
Gymboree	\$1.8 billion	Bain Capital	2010	Y
Savers	\$1.7 billion	Leonard Green	2012	N
Petco	\$1.7 billion	Freeman Spogli	2006	N

Source: Debtwire, Pitchbook, Bankruptcydata.com, AlixPartners, Retail Dive

It takes an iron stomach to hold a 'dog' while the investment declines and digesting mostly negative information (mostly noise). Second-guessing yourself is part of the exercise.

I found some solace while scraping through some filings of value/contrarian investment firms. Michael Burry, the acclaimed investor who profited from the financial collapse in 2008 and made famous from the book/movie, *The Big Short*, started a large position in GME in Q4 of 2018.

If I'm wrong about GME (and I've been wrong many times), at least I will be in good company. Note that I'm well aware of the implied confirmation bias here.

Major Positions Sold

Corning (ticker: GLW)

GLW has been held since the fund's inception and provided market beating returns of 207% vs the S&P 500's 76%. We sold Corning at a great price and believe sitting on the sideline until we see more applications emerge on their high margin glass business is prudent. I believe there will be some pressure on sales and earnings growth in a few critical segments. The LCD panel glass business has been resilient and outperformed thanks to screen size growth and slower price degradation. The business is still declining, and the technology commoditized.

Their Specialty Materials segment also outperformed in 2018 thanks to their glass being adopted on both sides of smart phones. Apple's material slowdown in China and the maturation of the smartphone market in total will slow sales growth. Corning does have an opportunity to offset the slow down with higher double-sided glass adoption with other phone makers. However, glass on the backside of phone should not be relied on for long term stability since form-factors and design are constantly changing.

Many of the investments in the past couple of years (through acquisitions) has driven top-line growth is in the optical communications business. This business has lower margins and is commoditized. I don't suspect these investments to drive ROIC in mid-to-high teens like its other business units. Lastly, I feel executive management has been very promotional as we come to the end of their capital allocation plan implemented in 2015. I have enjoyed the ride and respect this management team very much, however, the global trade climate should incite some conservatism.

Pandora (ticker: P)

We closed on the entire Pandora position after the Sirius XM merger was completed. This investment generated a 91% return for the portfolio vs. S&P 500's 11% return in the comparable time period (Nov 17 to Feb 19).

In this merger, Sirius XM (ticker: SIRI) issued 1.44 shares for every Pandora share. I believe SiriusXM's management are fantastic operators, however, I view the stock as richly valued. I prefer more downside protection given the evolving business fundamentals. Many of SiriusXM's competitors (Apple, Google, Amazon) don't care to make a profit in this business. This means pricing pressure followed by profit degradation. Its only independent streaming competitor is Spotify. Spotify has a tight grip around a younger consumer and has yet to turn a profit.

SiriusXM has done a great job of blocking and tackling. This is thanks to their vast partnership development with carmakers and used-car dealers. Their premium content offering (most notably Howard Stern) is also a large driver of sales and retention. I am keeping a close eye on the company and industry since we hold inter-related businesses in Vivendi (largest catalog of music rights with Universal Records) and traditional radio broadcaster (ticker: ETM).

Sincerely yours,



Ted Rasa Jr.