MADIRON CAPITAL

October 22, 2018

Dear Esteemed Clients,

At the end of the third quarter, our portfolio has gained 10.4% , providing a YTD return of 20.8% and a cumulative return of 83.9% since inception. The portfolio is positioned more defensively with a cash position of 28%. As I write this letter, the overall market has given back the majority of its returns. In the nine months of 2018, we did see a fair share of volatility. I like to embrace volatility, it provides prudent entry points and premium exits. Embracing volatility is easier in theory than in practice. Whenever I find my emotions taking hold and need realignment, I read my favorite authors on investing and psychology. Recently, I have been gorging on a newly discovered author, Nassim Nicholas Taleb. If you enjoy reading practical philosophy and psychology, I recommend reading his books.

In the following pages, I will discuss this quarter's largest contributors to performance and our investment in GameStop [ticker: GME].

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

	Q1	Q2	Q3	Q4	YTD	S&P 500[1]	ACWX[2]	Cash Exposure
2018	(2.56%)	13.00%	10.39%	-	20.8%	10.4%	(3.1%)	28%
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	**83.9%**	77.9%	30.8%	24%

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.

Largest Contributors to Performance in Q3

Pandora Media [ticker: P]

Pandora stock is up another 21% at the end of the third quarter and just about doubled to the price of $9.50/share. Pandora agreed to be acquired by Sirius XM (ticker: SIRI) in an all stock deal for $10.14 per share in late September. While the deal validates my investment thesis, I am not particularly thrilled with the price paid. An all stock deal now means Pandora's stock will ultimately be pegged to the performance of Sirius XM's stock until the deal closes. Management expects the merger to close with approval in Q1 of 2019. This a great deal for a SIRI shareholder and I do believe the merger will create synergies where, 1 + 1 = more than 2.

Pandora shareholders are set to receive 1.44 shares of SIRI stock. What the deal is missing is combination of cash and minimum conversion guarantee until the merger closes. A conversion guarantee would require SIRI buck up more shares if their stock fell between the offer and the closing of the merger. Similar to what was done recently with Discovery/Scripps and TimeWarner/AT&T deals. The lack of provisions makes me leery of the deal's acceptance without any resistance from Pandora shareholders.

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Viacom [ticker: VIAB]
Viacom is up 13% at the end of the Q3. This is still a largely undervalued company and we are waiting for the market to get this one right. Viacom is making great strides in its turnaround. It's film division, Paramount Studios, will be having its first profitable year in many years and there is a great pipeline of movies coming in 2019. In addition to Paramount's movie production, they have emerged as a quality content producer for premium TV, something that was abandoned after the CBS/Viacom demerger. Paramount TV studios is now developing and selling content for Netflix, Amazon Prime, and it's own flagship networks. The flagship five cable networks (MTV, Comedy Central, Paramount Network, Nickelodeon, and BET) have done moderately well, illustrating robustness.

There is still quite a bit of drama surrounding the prospects of CBS and Viacom reuniting. More so now that CBS CEO, Les Moonves, has been removed as CEO of CBS this September. Ultimately, I think it will mean a merger of CBS & Viacom, with Viacom's, CEO Bob Bakish, taking charge of both companies. This would be a great thing for both companies in the long term. Unfortunately, I cannot predict how the market will respond in the near-term.

Discovery Communications [ticker: DISCA] &
Scripps Networks [ticker: SNI]
Discovery Communications and Scripps Networks announced a merger last year that closed this March. At the time, we were shareholders of Scripps Networks and enjoyed a very pleasant premium for the buyout. Combined, the company would command 20% of cable TV viewership in the USA and lucrative international business. Then chaos broke out. Discovery's share price dropped from ~$25 to $16. We took advantage of this inefficiency. We added shares of SNI and bought shares of Discovery at an average price of $21 per share.

I extend my 'old' media thesis (the death of cable TV and its content is being grossly exaggerated) to any quality media company that comes our way. I would like to thank the market for the bargain prices. We enjoyed a 50% return on this investment and closed out at $32/share.

Disrupted but not Dead Investment

GameStop [ticker: GME]
GME is the largest retailer of video games, gaming devices and accessories in the United States. The bear argument for GME's demise is that physical games will be completely replaced by digital downloads, gaming subscriptions, and streaming. Their business will decline into the retail brick & mortar abyss. I know what you are thinking. The next Blockbuster or Radio Shack. There are comparisons to draw for such a thesis. This ugly narrative has led the company's stock to be heavily shorted (speculators who hope the stock goes $0.00) and priced remarkably cheap.

While the narrative is ugly, the financials of GME are not. It will generate over $300 million in free-cash-flow in 2018 (FY Jan'19) and a fat FCF yield of 20%. From that, GME rewards shareholders with a $150 million worth of dividends equating to a 10% dividend yield. The dividend is covered 2:1. Before GME becomes the next Blockbuster, it needs to stop making money.

The market must be right!? How else could GME be so underpriced in this bull market? As we know from our investment endeavors, the market at times can be very inefficient and overly pessimistic (and just wrong). When it's both, we have the recipe for a winning investment.

GME Key Stats: *(as 10/12/18)*

Current Share Price:	$15.00	Shares Outstanding:	101 million
Est. 2018 Revenue:	$8.80 billion	ROIC:	16.7%
Earnings Yield:	19%	Dividend Yield:	10.0%
Market Cap:	$1.5 billion	Total Debt:	$819 million
Price to Book Value:	0.6x	Book Value per share:	$21.00

Power to the Player

'Power to the Player' is GME's slogan, brilliant in so many ways. If money is 'power', then GME is providing that to its customer base. Kids between the ages of 5-18 don't have much money, with their physical video games, they have an asset. At GME, a video game or system is an asset that can be instantly monetized to purchase newer games and equipment. GME has a thriving secondary-market that provides currency, hence power to the player. The pre-owned segment is GME's bread and butter. It generates 30% of its revenue and responsible for a majority of the profits. GME believes it owns nearly 50% of the pre-own market which means there is still room for growth to offset a shrinking market. With their loyalty rewards programs, GME customers have lots of incentives to go to them.

GME's gaming business is declining slowly. Games sales are moving digital but not all games and not at equal velocity. There are certain gaming categories that have lost significant market-share to digital downloads, most notably the FPS (first-person-shooter) category. FPS are big money makers for game-developers and have massive multiplayer followings. These games typically get played for long periods of time due to the multi-player dynamic (there is no beating this game, it continues on and on). They also require updates for bugs, maps, and after-market upgrades. Digitally downloading these types of games makes sense to many hard-core gamers. Also, the FPS gamer happens to skew older, 17+, who have more discretionary income and don't care of about the underlying value of owning a physical game. Any enterprising minor, (the unentitled ilk) values the physical game. Sports games (Madden, NHL, NBA) is another category that will naturally go to digital or even a streaming subscription. Sports games typically have a shelf life of a year and don't retain trade-in value. A digital model makes sense in the future. Time will tell!

Tradition & Special Edition

Gifting traditions play a favorable role for GME. Kids receive a majority of their new games during the holiday season and on birthdays. Families want to give a physical gift not a virtual one. GME is doing their part to promote physical game purchases. They have made a smart move into the gaming collectibles and special edition releases. This provides added value to the gamer when a game is bought physically. Most of the top games come from the best franchises and have cult followings. This dynamic creates a need for collectibles, toys, and special editions on releases. Gaming releases are a big thing, think of Apple iPhone lines, kids(and adults) wait on lines for big game releases.

Gaming traditions can play important roles as well, think of gaming tastes being passed down to their kids like religion. Gaming franchises like Super Mario are being renewed with today's technology. Parents will buy their kids games with brands they are familiar with and trust. For years all major titles have been available for download on the Nintendo/PS4/Xbox systems. Behavioral purchasing patterns, lack of plastic (credit cards) by a large customer base, and trade-ins play a key role for the slow decline. If not, GME would be shrinking at lager rates. For now, value and behavioral patterns trumps convenience in the gaming business.

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Gaming Industry

When you see people in their 50s, 60s, and 70s playing games on their smart phones, its obvious the gaming industry has grown their base. This is something you would have never saw the before the smart phone. Now I can't get my mother-in-law off Words with Friends or Candy Crush. To generalize gaming behavior and the business models behind them is a mistake. The gaming business is now big enough to break apart into categories and cohorts.

GME's niche is distributing games for traditional home and mobile gaming consoles. Evolving with the industry and retaining control of its core niche business will be challenging but doable. If one of the top 3 platforms makers exit (Nintendo, PlayStation, Xbox), emerging VR platforms could fill the void. GameStop is a fantastic distribution partner to have. Unfortunately, they are not in control of their destiny because it will be dependent on how the top game developers decide to distribute their hit titles in the future. One trend that is in favor of the GameStop's future prospects is the success of the Nintendo Switch. This is a hybrid gaming platform that acts as a mobile gaming system and a traditional home-console in one. When Nintendo has hit systems, PlayStation and Xbox tend to follow suit. I wouldn't be surprised if Sony and/or Xbox release a hybrid system in their next big platform refresh in 2019/20. If so, this will help secure GameStop's circulation of pre-owned systems and software for another 7 years. I believe the risk of the next generation of systems not having physical cartridges or discs is small. The spirit of any gaming system would be in jeopardy if the system only operated properly with a high-speed internet connection, games weren't mobile from system to system, and friends couldn't borrow games from each other. It needs to serve a global audience and have robust qualities.

There is a specific velocity required behind every platform release for GME to do well. Nintendo's Wii U flop in 2013 hurt GME's business for 5 years. Nintendo's gamers skew younger which helps GME's pre-owned business. The continued success of the Switch and Nintendo titles will generate the required velocity of trade-ins and generate more profitable pre-owned sales. Healthy platforms sales from Nintendo, PlayStation, Xbox equate to healthy sales for GME. GME's pre-owned business lags behind successful platform launches and gaming titles. The success of the Switch platform will not material for another 6 months in pre-owned market. An emerging platform that has yet hit mainstream is virtual reality (VR). For GME, these platforms will also create a healthy pre-owned marketplace in the future.

Lastly, I want to discuss the essence of technologies/gadgets/processes that have been around for awhile. Things that have been around for awhile, tend to have lasting power. The classic things never leave us, arguably the best tools in a chef's kitchen have been around and unchanged for thousands of years. Vinyl music records have out-lived its expiration date by forty years yet people are still buying them. One computer-age example is the QWERTY keyboard. It was intentionally made in order to slow the typist in order to avoid jams! It holds zero reverence in today's world yet it has survived. So before you presume the death of anything, human behavior is not always rational or logical Spock!

The video gaming console is approaching its 35 years anniversary when it comes to mass adoption. Are we seeing signs of lasting power? Absolutely. A great example is the relaunch of Nintendo's 1st hit gaming title, NES (released the late 80s). In the last two years, it has sold millions of a technologically outdated gaming device. A gamer can still sell systems/gaming titles for decent sums of money that are 15 years old. It is obvious there is a healthy market for them. Nostalgia and entertainment are not beholden to logic or rational.

GME Valuation:

With all of the above discussed, GME is one of the cheapest stocks in the market. If my thesis proves to be correct, GME could have a slowly shrinking but healthy business for another 10-15 years. If the market doesn't appreciate its value, it will not be a publicly traded issue for long.

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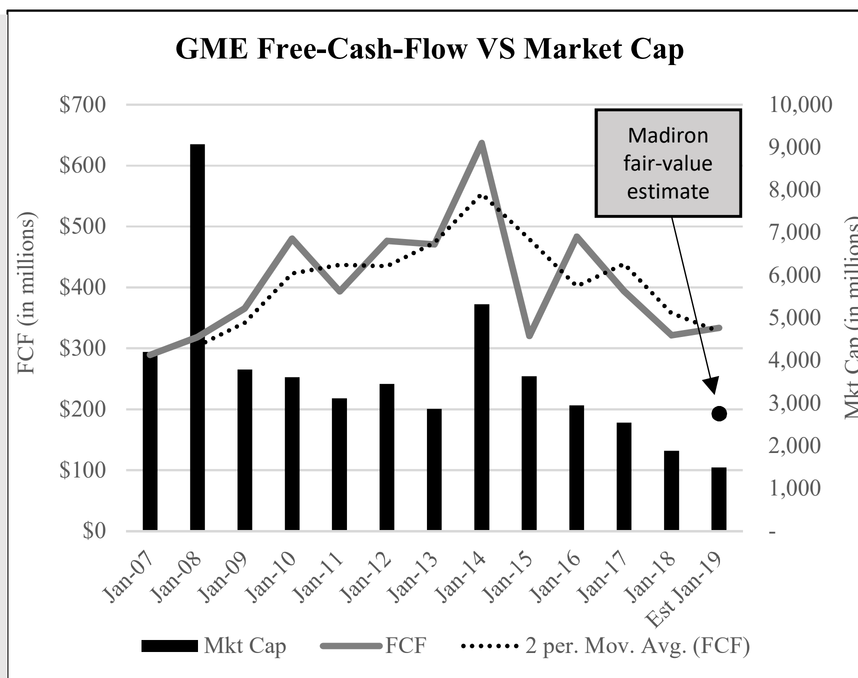
I believe the decline of FCF since 2014 was largely due to the failure of Nintendo's Wii U console rather than digital downloads.

The 2008-2014 period had three successful gaming platforms (Nintendo Wii, PlayStation3, Xbox 360). This created a healthy market for GME.

In 2013/14, a new generation of gaming consoles were released. PlayStation and Xbox platforms had healthy sales. However, Nintendo's Wii U console was a failure, selling only 14 million units word-wide from 2013-2018. Nintendo released the Switch in Mar 2017 and has already sold 20 million units word-wide. This is a great start for the next generation of console releases and GME.



GME's earnings power should fairly value the company at a 8x-12x earnings multiple, **a price range of $24 - $32 per share**.

GME is in a curious situation, an Interim CEO has been hired from the board as they look at strategic options. Since long-time GME CEO, Paul Raines, resigned due to illness last year, there has been a revolving door at the executive level. The stock has suffered dramatically from the lack of leadership while chicken little antagonists declare the sky is falling in the video game business.

This leads me to believe that GME is being setup to be sold to private equity. Something I am not opposed to since the pe firm would find more enterprising ways to invest GME's hefty and consistent free-cash-flow. GME's recent diversification efforts in wireless stores and electronics do no have the stellar prospects or economics. It does not While the collectibles business looks to have added value to its core business, the wireless and electronics segments may have erased some.

I'm looking for signs of a potential sale like shedding non-core business segments and/or selling their international video game stores in Europe and Australia. In doing so, GME would simplify its operations and make itself more appealing for takeover. Not to mention, cash from sales could repay most of the outstanding debt.

Private Market Valuation

Sycamore Partners purchased Staples in 2017 for $11 per share. Staples suffered from comparable forms of disruption yet still had a very solid cash generating business. The buyout multiple equated to an EV/FCF of 11x and an EV/EBITDA of 5.7x

Utilizing these multiples would value **GME between, $25.50 -$28.50 per share**. I believe there to be an upside starting at 60% plus dividends.

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Closing Remarks

Please checkout our newly designed website at www.madironcapital.com. You will be able to find all of our previous letters and investment literature.

I will be traveling down to Southern Florida for business and some pleasure from Nov 10th to 24th. For anyone in the Florida area, I would love to grab a coffee. *As always, the highest compliment I can receive is a referral.* In the spirit of Thanksgiving and the upcoming holidays, I would like to send my warmest wishes and gratitude.

Sincerely yours,

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