



MASSIFCAPITAL

Friday, January 11, 2019

Dear Friends and Investors,

For the quarter ending December 31st, 2018, the core portfolio was down -24% net of all fees and expenses compared to -13% for the MSCI All Cap World Index. Since inception in June 2016 through the end of the first quarter 2018, the core portfolio has returned -3% net of all fees and expenses compared to 19% for the MSCI All Cap World Index. Returns in separately managed accounts may differ from the core portfolio based on the initial investment date. In the first eight trading days of the year, the core portfolio has regained significant ground and YTD we are up 7.9% vs. the MSCI ACWI which is up 3.7%.

High-level 2018 Review

We are undoubtedly disappointed in our yearend results. The combination of an ongoing US-China trade dispute, an unpredictable US political environment, and a historically fast sell-off in oil was damaging to the near-term price action of our portfolio. At present, we are confronted with a market that appears to be trading on daily geopolitical news with little regard for underlying company fundamentals or company specific context. Given this environment our politically and economically sensitive portfolio will experience significant volatility, much of which, if not all, is value agnostic.

Despite the selloff in our portfolio positions, we are pleased to have entered this uncertain period holding approximately 40% cash. Our approach to portfolio construction in 2018 has been a mix of strong decisions and less than ideal decisions. As we have discussed in several previous letters, we have long held a belief that we are coming to the end of this current market cycle, and as such few companies were priced such that they met our high standards and return hurdles. The result is that we have maintained a high level of cash that we can now begin to deploy into assets with significantly lower prices than just a few weeks ago.

At the same time, we decided to move in an overly aggressively fashion to build positions in the companies we liked, unfortunately even strong companies with rock-solid balance sheets trading at discounts to intrinsic value sold off in the fourth quarter, especially those in the oil sector. Maintaining high levels of cash was an active decision, as was building large positions in select companies. To date, one decision has worked out well; the other is a yet to be fully resolved matter that in the short term produced quotational losses.

Below, we will outline our strategy for the year ahead. We are enthusiastic about our research pipeline and look forward to lowering our cost basis on several existing positions. Before delving into a review of the portfolio, we would like to address some of our lessons learned in 2018 and restate our conviction on core holdings through the lens of operational results. We will also briefly comment on the historic trading patterns observed in December and our broader view on the real economy as we look towards 2019.

A Unique December

Looking at the fourth quarter of 2018, there is clear evidence of wholesale selling on a level rarely seen. The month of December saw investors pull \$94 billion from equity funds, more than double the previous record set within four weeks. The third week of December saw an average of more than 40% of securities trading on the NYSE and NASDAQ hit a 52-week low – a rare event that has only been matched twice in the last 35 years, the 1987 crash and 2007 preceding the recession. 73% of the S&P 500 financial stocks hit a 52-week low in the third week of December,

exceeding all days during the 2007-2008 financial crises.¹ Since 1990, the only two days to exceed that reading were September 24th and September 27th, 1990.

Stocks suffered one of the largest and swiftest pullbacks in 70 years with a 17% loss in four months.² While perhaps unnerving, this is historically not the type of decline that either precedes or follows an economic recession. The sample size is extremely limited (6 occurrences since 1980), but negative moves of this velocity have typically reversed themselves rather quickly. The average one-month return following a >17% down move in less than four months is 7% while the average return six months later is 21.4%. Indeed, the day after Christmas the S&P 500 had the most positive day since 1990 with 404 out of 505 stocks finishing higher.

Lessons Learned – Position Sizing

In conducting our yearend review, we decided that our approach to accumulating stock in favored positions has been overly aggressive for where we believe we are in the market cycle. When we look at a new investment we think of each as having four phases: (1) a research phase, (2) an initial purchase decision, (3) a holding/adding phase and (4) a sell decision. The research phase is our strength, clearly, room for improvement, as there always is, but certainly the strongest aspect of our investing process. In both the initial purchase phase and the holding/adding phase, we have identified weaknesses though, and these weaknesses are most evident in our four largest positions: Diamond Offshore (DO), Teekay Offshore (TOO), Graftech (EAF) and Lucara (LUC).

We believe that the sizing of our initial purchases has been too large, and our averaging down occurred on price drawdowns that were not significant enough for where we are in the market cycle.

The question we now find ourselves asking more frequently when thinking about portfolio construction, and specifically portfolio construction late in a market cycle, is do we want to explain to you our investors that:

- 1) We accumulated stock aggressively because there was value, but it has now traded down significantly, and we have little room to add more before the position becomes too large as a percentage of our portfolio for our risk appetite, or...
- 2) We did not accumulate a full position of company X before it moved up significantly, so the position made money, but its impact on the portfolio overall is less than we would have liked.

Our preference would be explaining to you the second, not the first.

Moving forward, you can expect, and in fact should demand, an increased dialog on how the macroeconomic environment may affect our portfolio. **It's critical to note that any macroeconomic outlook we may have will not dictate our security selection.** Rather it is important for us to ask:

- Are our views of the economy consistent with the macroeconomic risks our security selection and position sizing expose us to?
- What geopolitical scenarios do we think our portfolio will thrive in and do we believe those scenarios are likely, or not, in the coming years?

In addition to company-specific operational updates which provide a clear view into our rising or falling conviction on an investment thesis, the relative health of the macroeconomic landscape and the market cycle must be a tool we use to help us size positions. The world oil markets provide an illustrative case which we will discuss below. Although we would have preferred a more insightful execution of our ideas, our high hurdle rate has prevented us from deploying significant capital this year as few businesses met the standard. As such, we are now in a situation to add to many

¹ Among S&P 500 stocks, the last six straight trading days of 2018 saw zero 52-week highs, the longest stretch of that metric since 1990.

² As of January 9th, 2019, two weeks into a recovery from a major decline, the S&P 500 has made back more than 40% of its losses. This is the best ever retracement only two weeks in a rally.

positions, which in a few cases have reduced our average purchase price by as much as 8%. This will serve us well in the long-run even if the unrealized losses and volatility in the short run are painful.

Turning back to the portfolio, we closed out one position and added one position during the fourth quarter. Also, we are very pleased with some of the recent operating results and will be looking to add to select positions. At the current time, we are remaining patient, the extent and speed with which the market has sold off warrants continued patience. At the time of writing, we have already added to our position in LUC and are reviewing TOO for a potentially sizable add.

Graftech (EAF)

EAF has suffered this past quarter from being closely associated with trade and steel. The steel industry internationally has sold off all year, with US steel focused indices down 24% and international steel focused indices down 27%. Despite the association with the industry, we believe several company-specific traits isolate the business from the vicissitudes of actual steel producers. For starters, 65% to 70% of total firm production of Graphite Electrodes are sold at fixed prices on long term take-or-pay-contracts.

Fully 60% of the businesses revenue for the next four years is already determined by these contracts, which are spread across nearly 100 different customers, significantly reducing counterparty credit risk. Additionally, the electrodes that Graftech sells are a critical component into the steel manufacturing process for any Electric Arc Furnace Steel Manufacturer. Substitutes for the electrodes do not exist, and the process of swapping one brand for another is expensive and time-consuming, according to our conversations with buyers at US Steel producers. The result is that most producers have a choice between buying electrodes or shutting down a facility.

During the 4th quarter, EAF management continued to execute their stated objective of returning significant cash flow to shareholders in the form of a \$0.70 special dividend, which at the time it was announced amounted to a 5% return of capital. Although we are unsure of what nature the ongoing capital return will take in upcoming years, we are confident it will continue. Next year looks likely to be a record free cash flow year with between \$800 million and \$1 billion being generated. At these levels, the firm is trading at roughly 3.75x and 3x free cash flow. This is occurring while supposedly asset lite high free cash flowing business-like Facebook are trading at between 20x and 21x free cash flow. Asset lite is nice but buying at mouthwatering prices is better.

At the time of writing this letter, our plan for the upcoming year regarding EAF is as follows: our current position in EAF is a 10.7% position with an average price of \$17.80. We have two put option positions that expire in April of this year (2019) and which we expect will result in shares of stock being put to us. Should the stock be put to us, it will be put to us at a weighted average cost of \$12.82 or 4% below the current open market price.

The option positions will take our average price down to \$16.31 and result in a position size of between a 10% and 15% depending on the price of EAF in the open market at the current time we are comfortable with building EAF to a 15% position. Come April, if we find ourselves in a position where the stock is not being put to us, but EAF is still well below our initial purchase price, we will look to add to the position in a sizable way.

Lucara Diamond (LUC)

Turning to LUC, we believe it remains poorly understood by the market. The last five quarters of operations at Lucara appear subpar. The reality, however, is that management has executed on the mine plan which they laid out in 2017 very efficiently, despite struggles related to a change in the mining contract which delayed progress but did not prevent progress.³ The Lucara situation is one we envision experiencing many times over in the future as we pursue our real asset strategy. The reason for this is that Lucara, although increasingly a multifaceted business, is first and foremost a project company. By that, we mean their business is executing a single, specific mega-project. As with all large or mega-scale projects, there are ups and downs. This is true of any business of course; the difference is that with most

³ More commentary on operational progress as it relates to an investment thesis can be found in our 2018, Third Quarter Letter.

businesses the execution of one large scale project is not the entirety of the business. As such with project companies, the rhythms of the project execution become the rhythms of the stock itself.

So, the questions the market should be asking are: what is the project plan, where in that plan is the company currently, and what kind of results can we expect from the project at this point in its lifecycle? Initially, the firm had access to three interconnected diamond-bearing kimberlite pipes, with more limited access to the primary pipe. To access the primary pipe the open pit mine needed to be reworked. This work was initially planned to start between 2019 and 2020. That plan, however, was made before a spade even hit the ground (circa 2012-2013). In the intervening five years, management has had an opportunity to see the quality, quantity, and character of the diamonds the mine would produce. The superior results from the mine warranted a change to the long-term plan.

In 2017 management started to execute on that new plan which brought forward in time the firms access to the core kimberlite pipe. As a result, the past six quarters of mining have been more focused on waste stripping then on ore mining. This was a necessary trade-off, another hallmark of project companies. Unlike, for example, a company like Exxon Mobil, that makes capital allocation decisions between two projects behind the scenes such that investors don't necessarily see the tradeoffs management is making, with a project company the tradeoffs are front and center. In the case of Lucara there are only so many machines and so many people to operate them, thus to prioritize stripping ore to access a particularly rich part of the kimberlite pipe, machines and people had to be redirected from mining ore, and hence the results are impacted.

We believe the company is coming to the end of the stripping process, and now resources are being redirected away from waste stripping and towards ore mining. This shift is apparent in the numbers, specifically when comparing ore mined vs. waste mined. The shift to the core kimberlite pipe which is the richest source of diamonds at the mine is also apparent in the carats recovered:

	Q3-2017	Q4-2017	Q1-2018	Q2-2018	Q3-2018
Tons of Ore Mined	386,906	624,749	630,242	702,825	1,217,016
Tons of Waste Mined	5,540,139	4,745,609	3,991,648	4,416,361	3,850,225
Average Grade Processed (Carats Per Ton)	10.6	10.2	12.6	11.7	17.5
Carats Recovered	62,425	64,477	75,698	81,507	127,031

The change in CapEx on a quarterly basis (which is higher when waste stripping is high) and operating cost per carats sold (which is also higher when waste stripping is high) both support this argument as well. Over the next couple of quarters and in the long-run, we expect the free cash flow generated by the business to grow significantly and are optimistic we may see a return to the free cash flow profile of the company in 2013 and 2014.

Additional positive take-away's from the quarter include:

- Continued growth of 10.8+ carat diamonds as a percentage of total carats recovered; the company is on pace for 2018 to be a record year.
- The balance sheet remains rock solid with no debt and plenty of cash.
- On-going feasibility and technical studies for the underground life of mine extension are progressing. Initial results earlier in the year were favorable.
- Inaugural diamond sales via Clara occurred in November with good results. Prices received on diamonds sold during this limited test run were 8% above the expected market price. We currently view Clara as an interesting unpriced option but do not yet assign any value to it. For those unfamiliar with the product, it is an online diamond sales platform that utilizes proprietary analytics to match diamonds with jewelers who have

specific needs. What this means is that a jeweler that needs a rough diamond of Quality "X" that can be cut into a diamond of shape "Y" and Size "A" can find precisely the stone he or she needs.

No business is without risk though. In the case of Lucara, the elephant in the room now is lab-grown diamonds. No question they are a risk, but how significant a risk? We would argue that lab-grown diamonds are less of a risk to Lucara than other diamond miners, the reason is the nature of the diamonds Karowe produces. For starters, there are currently limitations to how big a lab-grown diamond can get and still be economical. The record (as far as we know) for a lab-grown diamond is 10.02 carats. However, it was not economically grown; it was an experiment. Generally, lab-grown are economical at 1.5 carats or less. So Karowe still produces a product that can't be replicated.

Most of us are not buying diamonds greater than a few carats let alone ten though, so there remains a risk to most of the production from Karowe by volume but not a risk to production by value, but it is still early days. We would argue that the emerald market is a good comparable to look at. Lab created emeralds came out in the '90s and now you can buy 1+ carat lab grown emeralds that are chemically identical to the real thing from JC Penny for less \$100. The result though was not the destruction of the natural emerald market but a bifurcation into a market for high-end jewelry, where a premium still exists on natural emeralds, and costume jewelry.

Another critical question to ask is why do people buy diamonds, and will the reason people buy diamonds be satisfied by buying a lab-grown diamond from JC Penny that costs a couple of hundred dollars? We can't answer this question for everyone, but at least for our wives, the answer is a resounding no.

Oil Markets

Two of our remaining big four positions are tied to the offshore oil market. We find ourselves presented with a unique buying opportunity in a market that continues to improve structurally while the cost of buying into the market continues to decline. In this most recent sell-off, Brent Crude fell 41% in three months. The fall in price is not consistent with the underlying supply/demand economics. Current concerns regarding global demand are overstated. Global growth will likely taper in 2019, but that does not mean that oil demand will contract, as the magnitude of the sell-off would suggest, the more likely outcome is slowing growth. Oil market volatility will likely continue in 2019 and be driven by key political events.

Oversupply concerns are often misguided and, in some cases, empirically inaccurate. No OPEC country outside of Saudi Arabia, Iran and Venezuela have spare capacity greater than 0.4 million b/d.⁴ We have low expectations either country can utilize that spare capacity over the next year and think Saudi Arabia has more incentives to not use their spare capacity than they do to use it. The 2019 Saudi Arabia federal budget, recently released, requires an \$80 per barrel price of oil to balance the books.⁵ Bloomberg economist Ziad Daoud expects that Brent crude would need to rise another to \$95 a barrel for the Kingdom's oil to sell at a price north of \$80 and thus have the budget balance.

Saudi Arabi is now experiencing their 6th consecutive budget deficit in a row. Nevertheless, the King has noted that the country will continue paying public sector cost of living allowances for citizens and will boost spending to stimulate growth, even as they try and close their deficit. To fund these programs, Saudi Arabia needs oil prices materially higher.⁶ Although no longer the biggest producer in the world, or the swing supplier, Saudi Arabia remains a key player in international oil markets, and have a clear need, desire and motivation to encourage supply-side constraint and higher oil prices.

⁴ It is worth noting that Iran and Venezuela have spare capacity, and Saudi Arabia does as well but the extent and persistence of that spare capacity is an open question. A proper audit by a reliable outside third party has not been conducted on Saudi oil reserves since the 1960s or 1970s. The most complete picture of the current Saudi Oil reserves was completed in 2005 and even that review was based on secondary sources, principally technical reports in industry journals.

⁵ According to the Kingdom, the government expects oil revenues will grow by nearly 10% from 607 billion riyals in 2018 to 662 billion in 2019. To hit 662 billion riyals in oil revenue, they must produce 10.2 million b/d sold at an average price of \$80 per barrel.

⁶ If the budget is not balanced, concerns of taking on further debt, spending their petrol-dollar reserves and theoretically, at some point, introducing austerity measures may become a reality they will likely try to desperately avoid.

While we are not in the business of forecasting commodity prices, we are firm in our belief that the structure of the supply side of the oil market supports price appreciation over the next few years. Not only are OPEC producers supportive of higher prices but the lack of conventional oil field discoveries, in non-OPEC countries over the last decade means that much of the supply growth the market needs to remain in balance is expected to come from continued growth in U.S. shale. We believe there is ample evidence to question this assumption as most market prognostications seem to assume a continuation of the shale growth trend of the last few years, sometimes the future looks just like the past, but not very often. It is also worth noting, and this is little discussed, that the reliance on shale to fill global demand is supportive of higher oil prices, not lower, as shale is a more expensive method of production than conventional production. Should global demand continue to grow, and non-OPEC conventional oil field exploration continues to lag, offshore looks to increase in importance to the oil markets. We will be releasing a white paper in January which will elaborate in detail on our prevailing oil market view.

Teekay Offshore (TOO)

Revenue for the third quarter was in keeping with the second quarter and up 19.7% year over year. Gross profit was up 20%. The only unusual item on the income statement was a \$55.4 million loss related to debt repurchase of which \$31.5 million was non-cash. After considering cash taxes payable vs. the book tax expense and the non-cash component of the debt repurchase, TOO flipped from having a net loss of \$39 million to positive net income for the quarter of \$2.5 million. A minor win for the company, but a win none the less, and not the only one during the quarter.

- \$623 million in debt due next year was moved to 2022.
- Management settled a dispute with Petrobras related to a terminated charter contract; the settlement resulted in a \$96 million payment to TOO.
- Management secured a new contract for the Petrojarl Varg FPSO. The contract starts in 2020 and is for seven years although is expected to be used the entire life of the field it is being deployed.
- The company sold two used shuttle tankers, one twenty years old, the other seventeen years old, for a combined \$19.2 million and a gain on sale of \$3.0 million.
- TOO has extended the contract for the Voyageur Spirit FPSO an additional 12 months.

We are often asked what we are paying for shuttle tankers, FPSO, FSO and towage ships when we discuss Teekay with investors. It is hard to determine exactly, but we have the following approach we believe is reasonable. We take the Market Cap of the company and allocate that Market value to each segment according to the percentage of revenue each segment produces. We then add in debt pro-rata. Next, we divide that number by the number of ships. It's quick and dirty, but we think it is reasonable. The latest quarterly data suggests you are buying ships at the following costs:

Shuttle Tankers	FPSO	FSO	Towage	Conventional
\$47.9 mil	\$219.6 mil	\$61.4 mil	\$21.1 mil	\$25.9 mil

The new Shuttle Tankers that TOO is buying run around \$120 million. FPSO's can cost up to a billion. We will be looking to add to our position at these levels.

Diamond Offshore (DO)

Diamond Offshore has executed strongly throughout the downturn but has not been left unscathed. Heading into the fourth quarter, rig utilization increased to 54% from 46% in 2017, with the average day-rate falling to \$333,000 from \$357,000 in 2017. ⁷ Revenue increased 6.5% with operating losses falling by 55%. The health of the offshore industry remains critical for the long-term success of the company.

⁷ Higher day rate contracts are beginning to expire bringing down the weighted average.

Demand for drilling and well services is growing, with more than 72,000 wells set to be drilled and completed in 2019.⁸ Well completion hit local lows in 2016, dropping 44% in two years. It has rebounded 30% since then as oil prices appreciate. The complexity of offshore development continues to present challenges. We believe the North Seas is driving floating rig growth while Brazil and West Africa appear to assist demand in the more medium term. Purchases of services look to grow on average by 9% leading through to 2021.⁹

While the price action in oil has likely extended the timelines associated with both Diamond Offshore and Teekay Offshore, we don't believe it has necessarily extended the timeline to where the position fails to meet our internal yearly hurdle rate (we look for all our long positions to be trading at a discount sufficient that on a year to year basis a 12% CAGR would result from appreciation to our low price target). We will be adding to Teekay, principally due to its business model strength and contracted revenue. Regarding Diamond, we will look to increase the position beyond its current level once we see positive news either in a shift of capital allocation to offshore by the majors, or a more developed picture of supply constraints, specifically structural weakness in the U.S. shale basins.

Closed positions - Barnes and Noble Education (BNED)

We closed out one position in the fourth quarter of 2019, Barnes and Nobles Education. BNED has long been an outlier in our portfolio. It was researched and added to the portfolio in the early days of Massif Capital before we had narrowed our industry focus to materials, energy, and industrials. It nevertheless was maintained as we believed that significant value existed in the form of a brick and mortar store network on college campuses that would be difficult for any newcomer to replicate.¹⁰

Although that thesis has not proven incorrect, other issues have arisen that threaten the company in a significant way. In particular, we underappreciated the potential significance of reduced textbook prices on revenue. Fast-forward to the most recent quarter and what we observed is that a small drop in textbook prices, with pricing largely determined by publishers, resulted in a large drop in revenue. BNED is selling a similar volume of books as they have every school year for the last five years, but the continued erosion in textbook pricing is quickly shrinking the revenue pie. Given this reality, we sold out of the position, unfortunately not before BNED reported results during the fourth quarter. The results put this risk on display and prompted a one day 30.7% sell-off in the stock. This was a significant one-day sell-off, the magnitude of which we had not previously experienced.

We believe the shortcoming in our process that allowed for us to miss the significance of the textbook pricing risk was a result of not exploring what was going wrong with the business during the quarters we owned the company, and instead focusing on what was going right. What was going right was of only half the story. Our approach to the management of a position once in the portfolio has typically included a quarterly reevaluation of the business and the investment thesis. That reevaluation is not complete though if it just focuses on what is going right at a company. We have now expanded our quarterly review checklist to include questions about what is going wrong and whether those issues are more significant to the business overall than what is going right. By doing this, we believe we will force ourselves to confront shortcomings in business models of our investments more regularly, and thus avoid this error in the future.

Remaining Portfolio Activity

- 1) We reduced our position in Haw Par from an 8% position to a 2.5% position. We did this not because our conviction in the company and our investment thesis has changed but because we had a minor gain in the

⁸ Rystad Energy.

⁹ Ibid.

¹⁰ BNED has maintained a network of more than 700 physical college campus bookstores, that we believed, when combined with a growing digital education business created a stable and highly profitable business for many years to come.

position and the odds seemed in favor of it trading down in the near term creating an opportunity to reestablish the full position at a lower average price. To date, the strategy is working.

- 2) We established a position this quarter in Barrick Gold. We established an initial 2.5% position on the Friday before the firm announced its pending merger with Randgold. The stock has done nothing but go up since then. We believe the merger is a boon for the company and the gold industry in general, perhaps establishing a new paradigm for consolidation within the industry, the merger was completed without a premium. We will look to add to the position at lower prices or if our assessment of the new firm's potential significantly boosts our intrinsic value estimate such that the margin of safety is at least 30% from the current price, which is 20% above our initial purchase.
- 3) Our short position in Norwegian Cruise Lines continues to pay off, not only because of the decline in the market but also because of industry weakness arising from falling demand, as noted by Carnival Cruise Lines when they last reported results. At the current time, the price of Norwegian has fallen roughly 25% from our initial purchase price, and we believe we have another 35% to go before we exit the position.
- 4) We have established a 2.5% position in Kazatomprom (KAP). All investors will receive a detailed investment report in the coming weeks. KAP is the largest uranium producer in the world (responsible for ~23% of the global primary supply in 2018) and is the lowest cost producer in the industry. At the current time, the firm operates or has an equity interest in, nine of the eleven lowest cost mines in the world. Due to the firms' complex structure, which includes ten asset level partnership with equity interests of between 30% and 65%, significant balance sheet value is obscured by IFRS (International Financial Reporting Standards) equity method accounting rules for JVs. At current Uranium spot prices, and at a 10% discount rate, the mines the firm operates or has an interest in are trading at a 22% discount to intrinsic value. This valuation ignores significant industry tailwinds; the firms dominate position within the industry and a dividend of up to 75% of FCF going forward. As such we believe a more realistic valuation is between \$22 and \$24 a share, suggesting the firm is currently trading at a discount to intrinsic value of between 38% and 43%.

As always, we appreciate the trust and confidence you have shown in Massif Capital by investing with us. We know that entrusting hard-earned capital to a young emerging fund is difficult and hope that you will never hesitate to reach out if you have any questions or concerns about what we are investing in.

Best Regards,



Will Thomson



Chip Russell

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