THIRD POINT

July 29, 2013

**Second Quarter 2013 Investor Letter**

**<u>Review and Outlook</u>**

Third Point's opportunistic approach and robust framework allow us to search globally for attractive event-driven equity and credit opportunities and occasional "macro" trades. Our broad mandate has made it increasingly essential to study economic trends and attempt to identify key areas to dedicate our resources. Over our eighteen years, this flexibility has given us the ability to avoid (or short) asset classes that become overvalued, such as tech stocks in the bubble of the late '90s or credit leading up to 2007, and to press bets in areas that become oversold. As a result, our portfolio is built not only by reacting to special situations that arise, but also from top down insights.

At our Investor Presentation in February, we outlined four key developments we expected would lead to interesting investment ideas in 2013: a) increasing allocations to equities as a consequence of a more benign macro environment; b) a re-rating of stocks due to improving global economic growth; c) a resurgent Japan; and d) an increase in merger and acquisition activity reflecting rising corporate confidence. More than halfway through the year, all of these developments have played out as expected, and a majority of our profits have come from event-driven investments in American and Japanese equities.

Remaining opportunistic and responsive to scenarios that materialize – and those that do not – has been the key to generating positive performance in 2013. After a profitable first five months, many of our positions reached their price targets and we began to sell them near their highs in May and early June before the market began to correct sharply. We had reduced long (and unfortunately short) exposure meaningfully by the first week of June, and while our portfolio was not immune to the correction, we were insulated enough to be buyers rather than sellers near the lows. We remain optimistic about growth and the markets overall, and expect both gross and net exposure to increase during the third quarter.

Despite our fairly constructive view, June's "taper tantrum" in the US and the sell-off in Japan reminded us why we stay liquid and move quickly when circumstances change. Throughout the panic over Chairman Bernanke's remarks, we believed that the market misunderstood his data-driven prescription for reducing the Fed's extraordinary liquidity measures. Our view is that the Fed is betting the U.S. economy is getting close to escape velocity and soon will be growing at ~3%, but at the same time it remains acutely aware of the perils of derailing the still-fledgling recovery. If we finally see accelerating growth rates, yields should normalize from the unusually low levels we have seen recently. The playbook for investors in that scenario is to focus on assets that will benefit from US growth while avoiding investments that are hurt when real yields rise, such as gold, emerging markets, and fixed income – all areas where we have very little exposure today. Indeed, we sold our long-held gold position early in the second quarter at approximately $1,450.

**<u>Quarterly Results</u>**

Set forth below are our results through June 30 and for the year 2013:

| | Third Point Offshore Fund Ltd. | S&P 500 |
|---|---|---|
| 2013 Second Quarter Performance | 3.3% | 2.9% |
| 2013 Year-to-Date Performance* | 12.6% | 13.8% |
| Annualized Return Since Inception** | 17.8% | 6.6% |

*Through June 30, 2013. ** Return from inception, December 1996 for TP Offshore Fund Ltd. and S&P 500.

The funds are hard closed to all investors and not accepting any new capital.

**Select Portfolio Positions**

**<u>Equity Position: Sony Corporation</u>**

Third Point acquired a significant stake in Sony Corporation ("Sony") earlier this year, and in May, we unveiled a proposal to increase value by partially listing Sony's Entertainment ("Entertainment") business in the U.S. Our investment thesis is that Sony – composed of Electronics, Finance, and Entertainment – is not well understood by investors and is therefore significantly undervalued. Sony's Entertainment division has leading franchises in movie and television production and distribution via Columbia Pictures and Sony Pictures Television, and is one of the top recorded music and publishing companies in the world. Sony also has coveted global cable network assets, including a strong position in the fast-growing Indian market. Electronics is best known for its struggling televisions and VAIO computers but its true value lies in its strong semiconductor and video game console divisions, and its resurgent smartphone business. At the time we made our initial investment, we believed that at our purchase price we were acquiring Entertainment at an attractive value while receiving Electronics nearly for free, giving us a substantial margin of safety.

In addition to its appealing valuation, we believed Sony would benefit from the economic tailwinds created by the First and Second Arrows of Prime Minister Shinzo Abe's economic plan, *i.e.*, a weaker currency and fiscal stimulus would immediately benefit Sony's margins and drive earnings per share. But it was not until we became familiar with Abe's Third

Arrow that we became confident Sony was an ideal candidate to benefit from the type of structural reform recommended by his administration. Following recent victories in the Upper House, Premier Abe is now well-positioned to begin enacting his much-anticipated reforms to modernize Japan's economy and corporations. Like the rest of the world, we are eagerly awaiting these changes, which should benefit Japanese companies like Sony.

Finally, the Sony management team installed last April seems to have broken a long string of challenged leadership and has started to make some difficult decisions in the Electronics business by reducing overhead and cutting the number of products offered. Highly-regarded CEO Kazuo Hirai deserves plaudits for the green shoots increasingly visible in Electronics. Sony's Xperia Z smartphone is a hit, and new product momentum has built meaningfully over the last few months while competitors have been losing ground. Sony is introducing an array of new Xperia models, including a large screen "phablet" device, the Xperia Z Ultra, and new Xperia C and SP devices for China Unicom and China Mobile. The launch of Sony's refreshed Xperia line has been a success in Japan, where Sony has overtaken Apple as #1 in smartphone market share, and in Europe, where Sony has risen to #3 in smartphone share. The upcoming launch of the Honami smartphone and other products in China and the U.S. should offer further opportunities for Sony to gain share in smartphones.

Strong momentum in the smartphone business has been accompanied by a perfectly executed introduction of the PlayStation 4 ("PS4") platform. The PS4 is set to gain share versus its competitors – the Wii and Xbox – with better hardware performance, new title breadth, and attractive launch pricing. Sony's consumer-friendly approach also stands to benefit investors with better initial hardware margins than PlayStation 3, increased market share and the growth, revenue and profit contributions of the PlayStation Network.

The visible improvement in Sony's new products has caused us to rethink our approach to valuing Electronics. The Game and Mobile Products divisions are now poised to join the Devices business as meaningful profit contributors, while the Television business is becoming only a marginal drag.

Putting these encouraging gains into perspective, they are modest in light of the longer-term challenges facing Sony and the Japanese electronics industry. Drastic – rather than incremental – action is required. Third Point's proposal to partially list Entertainment should not only increase overall profitability but also provide capital to accelerate restructuring at Electronics, against a backdrop of increasingly fierce global competition.

Turning to another challenge: unlike Electronics, Entertainment remains poorly managed, with a famously bloated corporate structure, generous perk packages, high salaries for underperforming senior executives, and marketing budgets that do not seem to be in line with any sense of return on capital invested. We were surprised that after Entertainment's highly-touted big budget summer film releases – *After Earth* and *White House Down* – bombed spectacularly at the box office, CEO Hirai, speaking at the Allen & Co. Sun Valley conference a few weeks ago, brushed off these failures, saying:

*"I don't worry about the Entertainment business, it's doing just fine"*

We find it perplexing that Mr. Hirai does not worry about a division that has just released 2013's versions of *Waterworld* and *Ishtar* back-to-back, instead giving free passes to Sony Pictures Entertainment Co-CEO's Michael Lynton and Amy Pascal, the executives responsible for these debacles. Unfortunately, Mr. Hirai's remark is consistent with accounts we have heard repeatedly from key industry players and others: under Mr. Lynton and Ms. Pascal's leadership, Entertainment's culture is characterized by a complete lack of accountability and poor financial controls. To us, these latest blunders are *prima facie* evidence of our thesis that Entertainment's U.S.-based business is being ineffectively overseen and needs its own governance structure led by a board whose job it will be to worry about such troubling results.

We are also surprised that Sony's CEO does not worry that Entertainment continues to generate profitability levels far below those of its competitors. Based on publicly-available peer data as of March 31, 2013, Entertainment has trailing twelve month EBITDA margins that are 700 basis points below peers in the Pictures division and 380 basis points below peers in the Music division, despite the fact that each is an industry leader in revenue terms. If Entertainment achieved peer margins, EBITDA could increase nearly $800 million to just over $2.0 billion.

Entertainment's poor relative performance has been a chronic phenomenon extending back to the famously profligate Guber-Peters regime, suggesting the current configuration of these businesses – far from offering synergies to shareholders – is in fact undermining Sony's value potential. Keeping Entertainment underexposed, undervalued and underperforming is not a strategy for success. Sony's investors today would be hard-pressed to explain the composition of Entertainment or the key value drivers at work. While management goes to great lengths to explain the strategy for Electronics, it treats Entertainment like its "red-headed stepchild", addressing it in only three slides in a twenty-six slide analyst day presentation made just a week after Third Point announced its proposal. At a moment when Entertainment was of paramount interest to investors, management barely addressed its significance, business strategy or profitability expectations. Given Entertainment's perpetual underperformance, perhaps Sony's reluctance to discuss it candidly stems from (understandable) embarrassment.

From a creative point of view, we are concerned about Entertainment's 2014 and 2015 slate, which lacks lucrative "tent pole" franchises. Anecdotally, we understand that its development pipeline is bleak, despite overspending on numerous projects. We are also disappointed to see that Sony's television business lacks new material and instead relies on old Merv Griffin Productions workhorses like *Jeopardy* and *Wheel of Fortune*. Entertainment has no hit network television shows, only one major syndicated network show – the *Dr. Oz Show*, and has missed the market for unscripted television.

Meanwhile, our research continues to reveal Entertainment's hidden value. We believe the Pictures unit profitability is anchored in higher margin (and higher multiple) international cable networks and television production, with the film business offering negligible profitability. This makes apples-to-apples comparisons with peer film studios (which lack the benefit of cable networks in those segments) even more unflattering. Nevertheless, we believe the film unit possesses considerable library cash flow value, currently masked by poor new production profitability, as well as significant asset value in its Culver City lot. Beyond the hidden value in the film business, we see meaningful value in the Music division, particularly in VEVO and GraceNote.

Absent a major improvement in transparency and accountability, Entertainment's fortunes are unlikely to change and Sony's full potential will remain unrealized. We are continuing to study Entertainment's businesses, uncovering opportunities for improvement in strategy, culture and operations that bolster our view that it would benefit significantly from our proposal. The suggestion that the status quo of opacity, underperformance and under-management is superior to transparency, management accountability and distinct leadership seems to be based on the misguided notion that the status quo strategy has worked over the last two decades. By contrast, our proposal for a public listing of Entertainment provides investors with a compelling opportunity – offering focused leadership, direct exposure to high-value international cable networks, significant margin improvement head-room, structural catalysts, hidden asset values and capital return. The status quo offers Sony and its shareholders only more of the same unfulfilled potential.

While CEO Hirai focuses on Electronics, Entertainment is in desperate need of proper supervision. We believe Sony's Board, which we understand continues to consider our suggestions, has plenty of reasons to worry about Entertainment and should enact our partial listing proposal quickly. A resurgent Electronics combined with a well-managed, publicly-listed Entertainment business would make for a stronger Sony and offer tremendous value for shareholders.

**<u>Equity Position: CF Industries</u>**

CF Industries is North America's largest nitrogen fertilizer manufacturer and one of the lowest-cost producers globally. CF currently trades at an unwarranted discount to fertilizer and commodity chemical peers. We believe its structural cash flow generation strength is misunderstood and that management should deliver a much larger dividend to its shareholders. Such a dividend would highlight the sustainability of its cash flow generation and lead to a substantial re-rating.

CF's access to low-cost North American natural gas – the primary input in nitrogen fertilizer production – gives the company a structural, sustainable margin capture relative to global peers with higher input costs. These same competitors provide a floor for the nitrogen fertilizer price, because they idle production when the price nears their cost ("the cost floor"). The spread between CF's production cost and that of the higher cost producers is a sustainable stream of cash flow for CF, with limited volatility. Using an onerous set of assumptions for this spread ($5 Henry Hub/natural gas input cost and $275 per ton nitrogen fertilizer price), we estimate that this cash flow stream would be ~$1.2 billion annually (operating free cash flow less maintenance CapEx, post expansion). On today's equity value, that would mean CF is currently trading at an 11% free cash flow yield using these onerous assumptions. Given the low-risk profile of this portion of CF's cash flow, it should receive a bond-like multiple (*e.g*. 7 - 8% yield), which alone implies significant upside to the current share price.

CF management has the ability to highlight the value of this stable cash flow stream by paying a significant portion of it as a dividend. A high dividend payout would still leave CF's leverage well below the 3x debt to EBITDA criteria that Moody's recently established as adequate to maintain their current debt rating of Baa2.

Additionally, when the nitrogen price rises above the "cost floor," which often happens when demand exceeds supply (2012 average price $408/ton), CF generates cash flows incremental to the stable cash flows discussed above. Even using a 4x cash flow multiple for this more volatile earnings stream suggests an additional $15 of value per share for every $25 change in nitrogen price above the cost floor. Finally, we believe that executing the remaining $2.25 billion of CF's share buyback authorization could be ~20% accretive to the estimates detailed above.

CF has been underperforming recently despite the emergence of several positive indicators, including reduced Chinese plant operating rates, reports of capacity idling in Eastern Europe, and the shelving of two plant expansions in North America. This underperformance reinforces our view that a dividend strategy based on CF's stable cash flow stream would lead investors to reassess the company's valuation.

(Note: All nitrogen prices are Urea on a fob Black Sea basis in metric tonnes.)

**Equity Position: Yahoo**

Last week, we sold approximately two-thirds of our stake in Yahoo. In addition, the three Third Point nominees to the company's Board of Directors – Daniel Loeb, Harry Wilson, and Michael Wolf – submitted their resignations as required by the settlement agreement ending our proxy contest in 2012. We continue to hold approximately 20 million shares and the investment's IRR is just over 50% since inception.

Since Third Point initiated its position, over $15 billion of value has been created, growing the company's market cap from $15 billion to $30 billion today, while over $5.2 billion of cash has been returned to shareholders. Since Third Point made "The Case for Alibaba" in our original investment presentation, our Fourth Quarter 2011 Investor Letter, and on our valueyahoo.com shareholder advocacy website, consensus Wall Street estimates for Alibaba's value have increased from $20 billion to over $80 billion. In addition, and consistent with our views on Japan, Yahoo Japan's value has also more than doubled during this period.

In governance and leadership terms, Yahoo's Board is far stronger, with over 90% new members. This Board's hire, Marissa Mayer, has done an outstanding job transforming the company and has surrounded herself with new, high-caliber leaders. Yahoo has increased engagement and seen a surge of talent return to the company. Momentum around new products – particularly for mobile – has increased dramatically.

We are pleased with our contribution to Yahoo since we became involved and believe the company will continue to thrive under Ms. Mayer's leadership.

**Business Updates**

**New Addition to the Analyst Team**

We welcome last summer's MBA intern Christopher McCoy back to Third Point, where he will be a generalist analyst. Before completing the MBA program at the Graduate School of Business at Stanford University, he was an associate at The Carlyle Group, focusing on private equity investments. Previously, he was an analyst at Evercore Partners in its Mergers and Acquisitions group. Chris received a BA in International Relations *magna cum laude* from the University of Pennsylvania.

Sincerely,

**Third Point LLC**

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All performance results are based on the NAV of fee paying investors only and are presented net of management fees, brokerage commissions, administrative expenses, and accrued performance allocation, if any, and include the reinvestment of all dividends, interest, and capital gains. While performance allocations are accrued monthly, they are deducted from investor balances only annually (quarterly for Third Point Ultra) or upon withdrawal. The performance results represent fund-level returns, and are not an estimate of any specific investor's actual performance, which may be materially different from such performance depending on numerous factors. All performance results are estimates and should not be regarded as final until audited financial statements are issued.

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