

October 21, 2014

Third Quarter 2014 Investor Letter

Review and Outlook

The Third Quarter was moderately volatile for the markets and Third Point's portfolio. In a quarter in which it was difficult to gain traction, July's losses offset August's gains, while September was essentially flat. Equities produced profits, mortgages continued their impressive outperformance, and credit suffered primarily from losses in a single investment, Banco Espirito Santo. Throughout the Quarter, we continued to optimize position sizes to increase portfolio concentration, which has been a key focus this year. We also took advantage of stronger tapes to exit or reduce positions including AIG, Hertz, Softbank, LNG, LNG AU, and Sony, which is discussed in more detail below.

Before October, both market corrections and rallies back had been quick and dramatic this year. We feared that there had been a paradigm shift until the last few days, but it now seems the market may be continuing this established pattern. Pinpointing the cause of the initial sharp market movement downward is conjecture at best. Daniel Kahneman, the Nobel Laureate Economist and expert in heuristics, has written extensively about the dangers of our tendency to attribute causation to associated events. Keeping his research in mind, we caveat our explanations for October's correction and volatility.

In early October, a confluence of events transpired in relatively short order, including weaker economic data, political uncertainty, a potential global plague, and bureaucratic meddling, which caused fear to spike, sentiment to decline, and investors to de-leverage. The month got off to an especially rocky start for hedge funds when a court dismissed a claim in connection with the Fannie Mae/Freddie Mac GSE complex. Many investors were oversized in this trade and their forced selling kicked off the "de-risking" cycle. Next, oil prices declined sharply and many funds who had large positions in E&P companies suffered enormous losses. Then last week, AbbVie halted its announced inversion transaction with Shire, inflicting great pain on the arbitrage community. Opaquely blaming mysterious "meetings with the Treasury Department", AbbVie walked away from an entirely lawful deal that it had touted as enormously accretive and strategic as recently as two weeks ago, incurring a substantial \$1.6 billion break-up fee. A rational conclusion is that instead of a legislative solution that might require comprehensive tax reform, this Administration has decided to unilaterally curb inversions using whatever means are available. Needless to say, this regulatory uncertainty (along with prior detours from the

rule of law) will be a wet blanket on top of investors until transparency and a level playing field are restored to the markets.

Amidst this unwind, our analysis showed us that while some fear was warranted, some was exaggerated, and so we took steps to mitigate volatility and simultaneously take advantage of the market mayhem. Over the past week, after initially reducing our exposures, we realigned our portfolio by lifting hedges, taking on new positions, and re-establishing investments in companies we had previously exited at much higher prices.

Going forward, we expect that the US will remain the best place to invest, credit opportunities will stay slim, and large cap opportunities with a constructivist angle will become more promising. Although consensus has shifted to lower growth, slower inflation, modest rates, and continued monetary expansion, we think the markets will resume an overall upward trajectory in the US through year-end.

Amidst this volatility and performance dispersion, we struggle with our instinct that it is a good time to short stocks with the reality of the past few years of short-selling carnage. We were intrigued by investment legend Julian Robertson's recent comments that, "we had a field day before anyone knew anything about shorting. It was almost a license to steal. Nowadays it's a license to get hosed." There is no doubt that the complexities around single name short selling have increased massively following 2008 – partly as a function of government regulation and intervention, partly due to negative rebates being the norm – but we have slowly been getting back in to the shallow end of the pool.

Quarterly Results

Set forth below are our results through September 30th and for the year 2014:

	Third Point Offshore Fund Ltd.	S&P 500
2014 Third Quarter Performance*	0.1%	1.1%
2014 Year-to-Date Performance*	6.0%	8.3%
Annualized Return Since Inception**	17.5%	7.5%

*Through September 30, 2014. ** Return from inception, December 1996 for TP Offshore Fund Ltd. and S&P 500.

Select Portfolio Positions

Equity Position: Amgen

Since its founding in 1980, Amgen ("the company") has been a pioneer in the biotechnology industry, successfully discovering, developing, and marketing therapeutic agents that have meaningfully impacted human health. From 1989 to 2002, Amgen grew five revolutionary biologic drugs into billion dollar blockbuster products in oncology, nephrology, and

inflammation. Today, Amgen is a \$105 billion market cap company with annual revenues of nearly \$20 billion and annual net income of over \$5 billion.

Considering this track record, Amgen's long-term underperformance relative to its biotech peers is surprising. The company has a compelling mix of long-duration, high-margin mature products like Neulasta and Enbrel, and a number of exciting high growth assets, including recently launched blockbusters like Prolia and Xgeva along with innovative late-stage pipeline assets like evolocumab. Yet, using nearly any valuation metric, the Company trades at a substantial discount to peers. Amgen even trades at a discount to the US pharmaceutical sector, despite superior revenue and earnings growth rates. Amgen's current discount to fair valuation – and the lack of structural hurdles to closing this gap – make it an attractive investment opportunity. Third Point is now one of the company's largest shareholders.

Amgen has all the hallmarks of a hidden value situation, one of our favorite investment themes. The company does not receive proper credit from investors for either the cash generative potential of its mature products or the coming financial impact of its growth assets. In the mature products segment, we believe revenues will be sustainable and concerns about potential erosion are overstated. With respect to Amgen's pipeline, we believe the market underappreciates how disruptive some of its new products will be. Our conviction about the company's growth pipeline has been bolstered by our discussions with Third Point's newly created Scientific and Medical Advisory Board ("SMAB") led by renowned oncologist Dr. David Agus. Dr. Agus has helped us assemble a world-class team of scientists and physicians to assist in our evaluation of therapeutic companies and their clinical assets.¹

We believe the obscured fundamental value and investor skepticism that have led to Amgen's valuation discount can be easily unlocked. Throughout our due diligence and discussions with sell-side analysts and other investors, it became clear that the market has penalized Amgen for several key reasons: 1) its historical lack of R&D productivity; 2) more than a decade of flat operating margins; and 3) the suspension of its share repurchase program in 2013 following its \$9 billion acquisition of Onyx Pharmaceuticals.

First, on R&D productivity, our analyses confirm that Amgen's R&D efforts have been more costly and less efficient than those of its biotech peers. Despite investing a cumulative \$32 billion in R&D since 2002, over 75% of Amgen's current revenues still come from products

¹ Other SMAB members include Dr. Geoff Ginsberg, the founding Director of the Center for Genomic Medicine at Duke University, and Dr. David Parkinson, a former pharmaceutical and biotech executive and the former chairman of the FDA's Biologics Advisory Committee.

introduced before that year. Amgen also appears to spend significantly more money on its late-stage pipeline assets than any of its biotech peers – both in absolute terms and relative to the number of development projects. Given this sparse output versus investment, we believe improvements are needed in Amgen’s R&D evaluation process, a hypothesis supported by members of our SMAB.

Second, the market has rightfully punished Amgen for having flat operating margins since 2002 despite a 3x increase in revenues, a failure we attribute to excessive spending. For starters, the bloated cost structure is troubling given that Amgen competes in specialized therapeutic areas which require small, highly focused sales and marketing efforts, and generates the majority of its revenues from just a few well-established, popular drugs. Another puzzle is that while the biotechnology industry has seen substantial improvements in manufacturing efficiency, Amgen has not demonstrated any of the obvious economies of scale (e.g., procurement, sourcing) that should have been realized. Against this backdrop, the company’s lack of operating margin leverage over this period is doubly surprising. Given its revenue growth, we are convinced that Amgen should have seen meaningful operating margin expansion since 2002, a shortcoming which we believe management has now acknowledged. We believe recent efforts to trim costs do not even scratch the potential opportunity.

Third, in 2013, Amgen’s management made a questionable capital allocation decision: the company purchased Onyx Pharmaceuticals at a 40%+ premium for \$9 billion in cash while halting its own share repurchase program. At the time, the company said that its buyback would remain halted until 2016. Based on corporate filings, during the deal negotiations, Amgen had concerns about Onyx’s lead compound, Kyprolis, and renegotiated to reduce the price. Since the acquisition closed, Amgen has disclosed that while the ASPIRE trial for Kyprolis met its clinical endpoints, its sister FOCUS trial failed to show clinical benefit and introduced potential concerns over renal-adverse events. Instead of the Onyx purchase, Amgen could have accretively repurchased over 10% of its shares outstanding, at the depressed valuation of just 4x sales. Beyond Onyx, we question whether the return on Amgen’s \$17 billion in M&A spending since 2002 (on top of the aforementioned \$32 billion in R&D spending) has been economically justified, both in absolute terms and also relative to other transactions in the sector. We are challenged to identify any “home-run” acquisitions and, while still early, believe that most of these transactions will turn out to show mediocre returns.

We believe that Amgen management can directly address all three sources of legitimate investor frustration and, based on our discussions to date with management, we believe that they will. While we applauded Amgen’s first steps in July to target the company’s inflated cost structure by rationalizing its US facilities footprint and creating centers of

R&D excellence in San Francisco and Boston, we believe much more can and should be done. Immediate actions Amgen can take to create shareholder value include: 1) Focusing its R&D efforts; 2) Providing long-term margin guidance demonstrating a commitment to reducing a bloated cost structure; and 3) Creating clarity on additional shareholder returns.

We have also asked the company to seriously consider a more radical option, one first proposed by Geoffrey Porges at Sanford Bernstein. It is well-established that disparate business units generally benefit from operating separately due to distinct corporate cultures, superior efficiencies, and a greater focus for employees and management alike. Given the diverse nature of its assets – cash-generative Mature Products and R&D-intensive Growth Products – we believe that Amgen could benefit from a separation into distinct operating units with separate financial statements and should seriously consider separating into two companies (e.g., a MatureCo and a GrowthCo). Internally, each business would have different priorities: MatureCo would focus on efficiency and cash flow, while GrowthCo would emphasize product development and innovation. Externally, each business would be valued with different metrics: MatureCo on a dividend yield and GrowthCo on a peer-based sales or earnings multiple. Our own extensive diligence suggests that a break-up of Amgen is feasible and that purported constraints such as tax strategy and supply chain management can be managed.

A separation of Amgen into MatureCo and GrowthCo would likely be very well received by investors. We expect that MatureCo would receive a valuation based on its dividend yield while GrowthCo would be valued, like peers, on a high growth multiple on earnings, reflective of the burgeoning pipeline. Importantly, however, we believe that a separation would not just be good for shareholders, but that it is a more effective way of running each business. In particular, we believe that the benefits to GrowthCo would be the most meaningful: talent retention, more rapid decision making, and ultimately, accelerated development of new therapies to improve countless lives. We urge Amgen management and a committee of independent directors to conduct their own in-depth evaluation of this strategic option and share their findings with investors.

We believe there are three ways to win in Amgen, depending on the path management takes from here. If Amgen is simply valued at one turn below its pharmaceutical peers at 17x earnings – a change we expect to be driven by management’s current restructuring plans – the stock should be worth \$189 per share by the end of 2016. If Amgen fully seizes the opportunities outlined in our recommendations to focus its R&D, announce structural expense reductions, and accelerate capital deployment, we believe 2017 EPS will reach \$12.82 (versus consensus of \$11.12 currently), implying a share price of \$218 on the same multiple. We see the most upside, however, in the scenario where Amgen strategically separates into two standalone business, as we have encouraged management to consider.

In two years, we expect that such a separation could create almost \$249 per share in total value, over 80% upside to the current share price.

CEO Bob Bradway and his team have been open-minded and receptive to our ideas to date and we firmly believe that the company is at an inflection point. The company's upcoming Analyst Day presents an excellent chance for Amgen management to take bold action and provide clear direction for the company, its investors, and its employees. We hope to maintain our constructive dialogue with management as the company moves towards closing its valuation gap.

Equity Position: eBay

We established a significant position in eBay during the Third Quarter. While eBay's challenges were well-mapped – including multiple years of minimal value growth, a weak execution track record, and high employee turnover – we sensed it had arrived at a critical inflection point and gained new focus. A meeting with CEO John Donahoe this summer left us impressed by his process-driven approach to optimizing the business.

We were pleased when Mr. Donahoe announced in September that eBay would split into two by spinning off its PayPal unit. Our work on Alibaba since 2011 had persuaded us of the power of the marketplace model in e-commerce and our work on AliPay convinced us that PayPal was an incredibly well-positioned global brand with the potential to become a leading player in mobile payments. Following the spinoff, eBay/PayPal will offer two appealing growth, relative value, and capital return profiles for investors.

eBay/Marketplaces

eBay is one of the world's ten largest retailers, with strong margins, limited capex, global reach, and consistent high-single to low-double-digit growth. While eBay's sales growth may appear underwhelming when compared to Alibaba or Amazon, the company is growing sales 2-3x faster than the Home Shopping Network (which trades at 10x 2015E EBITDA) and Wal-Mart (which trades at 8x 2015E EBITDA), and enjoys a much more attractive margin and free cash flow profile.

While eBay will invest in branding efforts during the balance of this year, we anticipate favorable comparisons to drive renewed momentum in 2015. We are also intrigued by efforts to emphasize structured data in ways that will benefit consumer engagement and merchant visibility. Finally, eBay is highly cash-generative and has relatively limited capital needs. It has shown an interest in buying back its stock and a willingness to take on debt to do so. With the split of eBay and PayPal, we believe eBay's capital return strategy will be more pronounced and structurally, new eBay would be positioned to buy back

roughly a third of its float within two and a half years (and almost half its float within 4 to 5 years). We believe core eBay could be worth more than double its implied pre-split value, assuming high single-digit topline growth, modest margin improvement, and a consistent buyback policy.

PayPal

PayPal is a high-growth business with significant opportunities to expand its existing market and margins while pursuing new paths in financial services for consumers and merchants. With significant scale and an attractive funding mix, PayPal generates high incremental margins on payment volume increases which it can use to fund sustained growth.

Apple's entry into the payments space dampened investors' enthusiasm for PayPal, creating an interesting entry point. We think the market is missing the fact that ApplePay is primarily an offline mobile solution focused on the Point of Sale (POS) opportunity which represents a small fraction of PayPal's current business. When we break down the applicability of ApplePay to PayPal's business mix, we find that ApplePay will compete directly with only 1.5-2% of PayPal's total payment volume (TPV).

We believe that Apple's entry into the mobile payments space could ironically be a net positive for PayPal. Mobile payments have been "the next big thing" for almost five years but have failed to ramp. In part, this is because one needs buy-in from financial institutions, merchants, and consumers in order for a payment technology to gain acceptance. With no pressure to catalyze a decision, the different incentives of these groups have not proven to be sufficiently aligned to overcome their inertia and come to an agreement. MCX, Google, and PayPal now need partners to compete with Apple and we think multiple win/win deals exist. PayPal's current POS business is *de minimis*, allowing the company to price disruptively while creating substantial value.

Finally, PayPal's value will be better reflected in a smaller, more nimble entity. PayPal has the option to go-it-alone, sell to one of many potentially interested parties, or to open itself up to partnerships with other key online players (e.g. Google, Facebook, Amazon, Alibaba, Apple) and become a neutral, online payments network (essentially becoming "the Visa of the Internet"). The market is currently valuing PayPal at approximately 11.5x-14.5x x 2015 EPS (assuming an 8-9x EBITDA multiple for eBay) which seems too cheap for a company growing sales 20% with significant strategic optionality and a strong chance to shape the future of payments.

Equity Position: Alibaba

In our Quarterly Letter two and a half years ago, we argued “the Case for Alibaba.” At the time, Alibaba held a leading market position that it was just beginning to monetize (the company had less than \$75 million in LTM earnings). Today, the Company has continued its exponential growth, demonstrated significant margin leverage, and is expected to earn over \$5 billion this fiscal year. Our enthusiasm for the Alibaba story has underpinned multiple investments at Third Point and now that the company is public, we have established a significant direct investment in Alibaba shares.

Third Point has met with management several times and is confident that Alibaba can generate long-term value in its core markets and compete in new ones, making it a compelling potential multi-year investment. The company has a substantial network effect that creates several large moats around its business, generating significant free cash flow for re-investment and expansion as well as an unrivaled amount of data on Chinese consumers. We see continued end market growth in Chinese consumer spending and e-commerce (as well as global e-commerce) and continue to believe that Alibaba has considerable additional monetization potential.

The success of Alibaba’s IPO shows that we are not alone in our view that the company is positioned as China’s e-commerce juggernaut. Alibaba’s metrics should appeal to growth, GARP, and value investors. We are most focused on Alibaba’s multiple hidden assets that represent under-appreciated sources of value, including:

Aliyun / Alibaba Cloud Computing is Alibaba’s Infrastructure as a Service (IaaS) business (effectively the AWS of China). The unit can leverage the robust infrastructure Alibaba has in place to handle spikes in demand around the 11/11 sales holiday (which has ~9x the traffic of the average day). Since Alibaba only uses 12% of its peak capacity on an average day, the company can lease out its infrastructure to other businesses at extremely competitive costs. Our research suggests that Alibaba has the best IaaS platform in China and competitors are ceding the market to them. Gartner suggests that this will be a \$5 billion RMB market in three years and it is Alibaba’s to lose.

China Smart Logistics is Alibaba’s logistics JV (Alibaba holds 48%). The Company’s logistic partners delivered 6.1 billion packages in China for the twelve months ended 6/30/14. This was 38% more packages than UPS delivered *globally* in that time period. Courier businesses are competitive in China and packages can be delivered for anywhere from ~5-22RMB. Taking the lowest delivery prices we have heard, applying that to 6.1 billion parcels and growing the unit numbers 30% annually suggests that the delivery portion of Alibaba’s logistic ecosystem will be a \$17 billion business in 5 years. Applying this math to average delivery prices suggests a \$33 billion business. Once warehousing and logistics is added in, the industry could be closer to \$50 billion annually. Our belief is that

while Alibaba doesn't want to enter the courier business directly, they would work through the JV to help the ecosystem manage data to make logistics more efficient and intelligent. It isn't hard to imagine this becoming a multi-billion dollar income stream over time.

AliPay is an escrow payment service the company developed to ensure users felt safe transacting on the platform. Alibaba has indirect exposure to AliPay via its 33% interest in Ant Financial, which also includes merchant finance, insurance and consumer finance businesses. AliPay has grown into one of the most important financial companies in China and has over 300 million users (twice the number of PayPal) and 190 million mobile users. The average AliPay user transacts over 80 times per year. While almost 80% of transactions on Alibaba are paid for via Alipay, Alibaba only represents 30% of AliPay's business. AliPay runs their Alibaba volumes at zero margin and makes money on the off-Alibaba portion. This portion is growing faster than the Alibaba portion of the business, allowing revenue to grow faster than TPV and profits to grow faster than revenue. If we apply Visa's TPV multiple to AliPay, it would imply the unit is worth \$80 billion and is almost 10% of the company's current valuation. The Chinese payments market is evolving quickly and the regulatory environment can be fluid but AliPay is one of the most innovative companies in China and is structured to be very nimble. Bank of America Merrill Lynch estimates AliPay will earn over \$2 billion in 2017 and argues for a \$60 billion valuation for the unit (or an NPV of \$7 per Alibaba share). Local brokers have made the case that AliPay could be a \$200 billion USD business by the end of the decade.

The common factor in all three hidden assets is that they are underappreciated relative to Alibaba's core free cash flow machine because they are only beginning to make money. We have seen Alibaba's pattern for growing businesses and believe that they are inclined to focus on share over profits until they reach enormous scale. Once a business achieves ubiquity, profits can ramp very quickly. We believe that Alibaba's \$200 billion enterprise value (adjusted for public stakes) suggests we are getting valuable call options in Aliyun, China Smart Logistics and AliPay/Ant Financial for free.

Equity Position Exit: Sony

In May of 2013, Third Point announced a significant stake in Sony and suggested to the company's CEO, Kazuo Hirai, that he should seriously consider spinning out 15-20% of the company's undervalued, American-based Entertainment business. At the time, we explained that partially listing the Entertainment segment would have three positive effects: 1) highlighting its profitability; 2) increasing investor transparency, thereby allowing the market to properly benchmark the company against its global media peers; and 3) incentivizing Entertainment's management to run the company more efficiently by engaging in cost cutting and laying out clear earnings targets.

While, regrettably, the Company rejected our partial spin-out suggestion, they made some changes that were consistent with our goals. In the Entertainment business in particular, Sony has cut costs, improved its dialogue with investors, and undertaken key management changes. In Electronics, Mr. Hirai's team deserves credit for transitioning away from personal computers this year and improving television profitability in 2015. They have also improved investor transparency. Still, they have a long way to go and we continue to believe that more urgency will be necessary to definitively turn around the company's fortunes.

A key tenet for us in making constructivist investments is our margin of safety. While we are most focused on the potential upside available to shareholders if management undertakes changes, we are unlikely to make a significant investment in a situation where constructivist-driven change is the chief catalyst unless we see minimal downside. Sony was exactly the type of investment where the risk/reward ratio was skewed in our favor. Thanks to this investment principle, despite enduring profit warnings nearly every quarter we were invested, incurring worse news about Electronics than we expected, and suffering from market disappointment at the pace of Japanese macroeconomic reforms, we still managed to generate nearly a 20% return on this investment before exiting.

Sincerely,

Third Point LLC

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