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Second Quarter 2017 Investor Letter

Review and Outlook

During the second quarter of 2017, Third Point earned +4.6% in the Offshore Fund, bringing total returns for the year to +10.7%. We have generated alpha through good stock picking in an environment that has proven unpredictable, but favorable for our opportunistic style.

In our January letter to investors, we shared our view that 2017 would be a year characterized by reflation globally, an end to central bank easing, and a US economy juiced up by the Trump administration's increased fiscal spending and tax reform. So far, none of these predictions has come to pass. In April's investor letter, we noted that actions out of Washington would be delayed or even denied, but explained that we remained fully invested because we believed that the emergence of synchronized global growth was more important than the fading "Trump Trade".

We were correct on this point and during the second quarter, we reduced investments in bank financials, exited reflationary macro trades, and reoriented the portfolio towards investments in companies that benefit from low inflation. Europe, which we highlighted as a source of opportunity in our Q1 Letter, has been a bright spot. Our exposure there is higher than it has been since 2010, led by our recently announced investment in Nestlé. Our portfolio is well balanced across equity sectors but with declining exposure to credit strategies.

Looking ahead to the second half of the year, we still believe that central banks will be important drivers of action. While it might be too early to say that the key central banks have turned hawkish, their tone is changing and they are well past the point where any hiccup in the market will prompt increased accommodation. In the US, current weak levels of inflation and poor CPI and retail sales reports present a quandary for the Fed. Based on her recent remarks, Janet Yellen does not seem likely to advocate drastic action. However, we do believe that the Fed will begin balance sheet reduction shortly but that the next rate hike will be on hold until growth and inflation accelerate.

Economic growth in the US has been generally disappointing, particularly relative to expectations. Markets, on the other hand, have been helped by better performance globally, which also explains why non-US market performance has been strong. We believe that US growth will pick up in the second half, driven by seasonality and other factors. However, the US economy will continue to have an overhang until Congress and the President show they can get major legislation passed this year. With substantial corporate tax reform promised but not delivered, companies are sitting on their cash hoards and their M&A plans, waiting for clarity.

Despite the market run-up, we continue to find compelling investment opportunities, particularly with global growth intact. However, not all stocks that have appreciated are trading at fair value and accordingly, we are also finding opportunities to hedge the portfolio with single name shorts that we believe are overpriced.

Quarterly Results

	Third Point Offshore Fund Ltd.	S&P 500
2017 Second Quarter Performance	4.6%	3.1%
2017 Year-to-Date Performance*	10.7%	9.3%
Annualized Return Since Inception**	15.8%	7.8%

*Through June 30, 2017. ** Return from inception, December 1996 for TP Offshore Fund Ltd. and S&P 500.

Equity Investment: Baxter International Inc.

Two years ago, we initiated a 9.9% position worth over $1.5 billion in Baxter. An under-earner in the medtech industry with margins trailing its peers, Baxter was about to spin out its biopharma business, Baxalta. Shortly after the spin-off, Baxter's long-time CEO announced his intention to retire. We believed these two major changes at the company presented an opportunity to create a more focused Baxter, cure its under-earning problem, and even make it an industry leader in operational performance – if the company took the right steps. Third Point's Munib Islam joined the Baxter Board of Directors in September 2015. Munib also participated on the search committee that successfully recruited former Covidien CEO José "Joe" Almeida as Baxter's new CEO starting on January 1, 2016.

Mr. Almeida's sweeping changes to Baxter's business over the past 18 months have created meaningful shareholder value. His tenure thus far is a case study on how leadership and cultural change can be transformational. Prior to his arrival, Baxter had guided to 2016 operating margins of 10%, growing to 14% by 2020. Under Mr. Almeida's leadership, Baxter delivered 2016 operating margins of 13.6% and in May 2016, updated 2020 guidance to 17-18% operating margins. Due to continued strong operational performance, Baxter subsequently upgraded its 2020 guidance to ~20% operating margins on the Q2 2017 earnings call. The increases have been driven by multiple factors including:

- **Cost cutting initiatives**: Mr. Almeida instituted a Zero-Base Budgeting process that had an immediate impact: SG&A spend declined over 10% in 2016 vs pro forma 2015 levels, while R&D spend also declined year over year in absolute dollars.
- **Addition by subtraction:** As part of an extensive portfolio review, Mr. Almeida made decisions to exit certain unprofitable product lines/markets and legacy R&D projects with negative expected value.
- **Focus on high gross margin businesses**: Baxter supplemented its generic injectable drug pipeline through three transactions and strategic partnerships (including the proposed acquisition of Claris Injectables). As the pipeline matures and products are approved, the high gross margin products will naturally improve Baxter's underlying operating margin.

Baxter's free cash flow generation has benefited from the improved operational efficiency. The prior free cash flow guidance was for $400 million in 2016 growing to $1.1 billion by 2020. Under Mr. Almeida, Baxter reported $935 million in 2016 free cash flow that is forecast to grow to ~$2.0 billion by 2020. Through the Zero-Base Budgeting process, the company has cut capex spending by nearly $200 million to $720 million in 2016 and forecasts continued reduction in capex through 2020.

In addition to continued margin expansion and improving free cash flow generation, there is renewed anticipation about how Baxter might deploy its pristine balance sheet. Since the spinoff, Baxter successfully monetized its Baxalta retained stake and currently sits at a zero net debt position; this contrasts with medtech peers who carry 1-2 turns of net leverage. Mr. Almeida has significant capacity to create value for shareholders through a combination of business development, share repurchases, and potential dividend increases.

Investors have clearly approved of Mr. Almeida and Baxter's improved performance. Between January 1, 2016 and June 30, 2017, Baxter delivered a Total Shareholder Return (TSR) of 61%, nearly 3x the S&P 500 return of 22.4%. Despite the 18 month outperformance, Baxter's forward EV / EBITDA multiple has remained largely unchanged at 12.5-13.0x; stock appreciation has been driven almost exclusively by an increase in Baxter's underlying earnings power. Looking forward, we are confident that Mr. Almeida can combine operational efficiency with an unlevered balance sheet to drive continued earnings growth which – even absent any multiple expansion – should drive strong returns for Baxter shareholders.

Equity Investment: Alibaba Group Holding Ltd.

We have reinitiated an investment in Alibaba, a name which we have owned directly and via our positions in Yahoo and Softbank over the past six years. Since we initially laid out "The Case for Alibaba" in our Q4 2011 investment letter, Alibaba has consistently surpassed our growth estimates for GMV (gross merchandise value), revenue, and earnings and today, the company has achieved scale (~$550 billion GMV last year, equal to ~5% of

Chinese GDP). Alibaba is currently at a positive inflection point after rolling out significant changes over the past year to its advertising platform, which currently generates the majority of the company's revenue. We view these changes as an important catalyst for meaningful revenue acceleration over the next few years. Combined with an attractive multiple, we believe now is the time to own Alibaba again.

- **Launch of personalized advertising:** In September 2016, Alibaba launched its first advanced ad targeting tools, allowing merchants to better personalize ads based on its users' data profiles and browsing histories. Since launching this new ad personalization initiative, Alibaba has seen a steady increase in CTR ("click-through rate") on ads, creating a growing tailwind to revenue growth as demonstrated in its recently-issued full-year fiscal 2018 revenue growth guidance of 45-49%. Alibaba's ad personalization initiative is still at a very early stage relative to Google and Facebook; because Alibaba has a highly engaged user base with strong purchase intent, along with extensive transaction data from its users' purchase history (both online and offline), we believe Alibaba's targeting capabilities will eventually surpass its global competitors. Alibaba should continue growing ad revenue at rates substantially higher than underlying GMV growth.

- **New ad tech for brand advertisers:** Despite operating the largest advertising business in China, Alibaba historically has captured little revenue from large brands, relying instead on small merchants. Unlike Baidu and Tencent, which we estimate earn 1/3 of their ad revenue from brand advertising, we believe only ~5% of Alibaba's revenue comes from large brands. Earlier this summer Alibaba launched "Uni-Marketing", a new ad-buying software platform designed with large brands' marketing needs in mind. Uni-Marketing should allow Alibaba to not only capture a higher share of large brands' ad budgets, but also create new revenue streams from ad inventory sold on third-party platforms.

- **Latent revenue potential from higher ad load:** Another important revenue driver for Alibaba is the "ad load", or the number of ads shown per page of content.

Alibaba last increased ad load on Taobao in September 2015, which led almost immediately to an acceleration in ad revenue growth (from +46% in calendar Q4 2015 to +54% two quarters later). Today we estimate that ads represent only ~10-15% of content units on a typical mobile Taobao search page, versus ~30-50% for commercial searches on Google and Baidu. Over time, we see significant room for Alibaba to increase the ad load on Taobao, resulting in higher monetization, similar to what has occurred at Google over the past three years.[1]

- **Mobile monetization gap now closed:** As the share of Alibaba's GMV from mobile devices grew over the past three years (from ~25% in early 2014 to ~80% by mid-2016), Alibaba initially generated a much lower "revenue yield" (i.e. revenue per unit of GMV) on mobile than on desktop, resulting in a drag on revenue growth as more GMV shifted to mobile. However the mobile revenue yield has steadily risen and by late 2016 the monetization gap between mobile and desktop had fully closed. Calendar Q1 2017 marked the first quarter in which the mobile revenue yield significantly exceeded the desktop revenue yield.

- **Low revenue yield indicates long monetization runway:** If we compare ecommerce marketplaces globally, Alibaba's current revenue yield is much lower than peers, at less than 4% versus 6-15% for all other large platforms (e.g. Amazon marketplace, JD marketplace, EBay, Rakuten, and MercadoLibre). While this comparison ignores some important differences across platforms, it nonetheless illustrates that Alibaba's current monetization is low in absolute terms with potential for future upside. Alibaba's revenue yield has already begun expanding over the past two years (from ~2.5% in calendar 2015 to ~3.5% in calendar 2017) and we believe this trend will continue.

[1] Moreover, several of the most popular content pages within the Taobao app (for example, the Weitao newsfeed) currently have little to no paid advertising. These content pages are a key driver of Taobao's strong user engagement: Taobao's average daily user opens the app ~8 times per day and spends ~25 minutes per day using the app, which puts Taobao in a league of its own relative to other global ecommerce apps. (For comparison, a daily average user on Amazon's mobile app spends ~7 minutes per day on the app according to third-party tracking data). While Taobao's content channels have been highly effective in driving user engagement, we believe they are effectively un-monetized today, creating a significant opportunity for revenue upside in the future.

Alibaba trades at 18x P/E on our calendar 2019 estimate for non-GAAP EPS. If we exclude the value of Alibaba's expected net cash at year-end 2017 ($7 per share), its stake in Ant Financial at the latest private valuation ($8 per share) and our current estimate for the value of its Aliyun cloud business ($16 per share), we estimate that Alibaba's core business is currently valued at $121 per share, or 15x our calendar 2019 EPS estimate of $8.20, while growing earnings in excess of 30% year-on-year.

We believe that Alibaba is among the best business models in the global internet sector, and is the clear winner in the consolidated Chinese ecommerce market. Alibaba owns the customer experience from commercial engagement through transaction (online and offline). Its core business, along with its cloud and payments subsidiaries, should sustain 20%+ revenue growth into the next decade. As the company continues to execute, we believe its valuation multiple can approach other best-in-class high growth businesses, namely Tencent, which trades at 32x consensus 2018 EPS, making us believers in the 2017 "Case for Alibaba".

Equity Investment: BlackRock, Inc.

BlackRock is the world's largest asset manager, with $5.7 trillion in AUM. In a classic scale industry, BlackRock is an asset-gathering machine, with organic net inflows of over 7% annualized[2]. Coupled with a tailwind from rising markets, AUM grew 17% year-over-year in the second quarter, which remains a key input for earnings power. Yet we see BlackRock as far more than an asset manager dependent on market movements. It is increasingly becoming a network or index-like business, with earnings power driven by ETFs (via iShares) and data & analytic services (via Aladdin). These are oligopoly businesses with faster growth and much higher incremental margins than traditional asset management – and thus deserve much higher P/E multiples over time. With shares at less than 15x our 2019 EPS forecast, and an outlook for consistent mid-teens EPS growth, we think BlackRock is a misunderstood franchise that is just beginning to inflect.

[2] Based on organic growth for the rolling last 3 and 12 months. Unless noted, we refer to asset growth & performance based on "Long-term Net Flows", which excludes cash management & advisory AUM.

BlackRock's iShares business has over 38% global market share in ETFs, and rising. It took in a record $74 billion of net flows in 2Q – a 21% organic growth rate – and had nearly as many inflows in the first half of 2017 ($138 billion) as all of last year. In the US, iShares had more inflows in 1H17 than the next 10 competitors *combined*. We think this acceleration in ETFs is just getting started, as regulatory change globally pushes lower-cost, transparent investment products, and institutional investors use ETFs as investment solutions, particularly in fixed income – an area where BlackRock has an even higher global market share for ETF products (~50%). We see iShares delivering mid-teens topline growth over the next 3 years and producing over half of BlackRock's earnings by 2019. More importantly, this is a business with significant operating leverage as it scales, with far less variable costs from compensation and benefits, which limit the margins of traditional asset managers.

BlackRock's Aladdin business is a data, analytics, and risk management platform originally built for internal use that now services over 25,000 external users. Historically, Aladdin was focused on institutional investors and corporates but we see a huge opportunity to bring it directly to retail financial advisor networks. This new product, called Aladdin Risk for Wealth Management, will link the world's biggest asset manager and ETF provider directly to the desktops of thousands of financial advisors and their customers. As with other data and analytics providers in which we have made investments, these services become sticky, must-have products for users, with upside from ancillary fees. We see Technology and Risk Management revenue, which became a new line-item on BlackRock's P&L in 1Q17, continuing to grow at 12-15%, and delivering 20% of incremental operating income growth in 2019.

BlackRock is valued like a traditional asset manager but it has much greater potential for structural revenue growth and operating margin expansion. Previous headwinds like USD strength have now become tailwinds, helping recent performance, but we are much more excited that higher-margin, higher-multiple businesses like iShares and Aladdin will become almost 2/3 of BlackRock's earnings power within 3 years. This evolution in business mix should deliver 20x+ forward P/E multiples for the stock as well as faster, more consistent mid-teens EPS growth – a combination which drives ~40% total return potential for shares over the next 2 years.

Sincerely,

Third Point LLC

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