An Overview of Why I'm Long Micron Technology & the Airlines

Whitney Tilson

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KASE CAPITAL

Kase Capital Management
Is a Registered Investment Advisor

Carnegie Hall Tower

152 West 57th Street, 46th Floor

New York, NY 10019

(212) 277-5606

info@kasecapital.com

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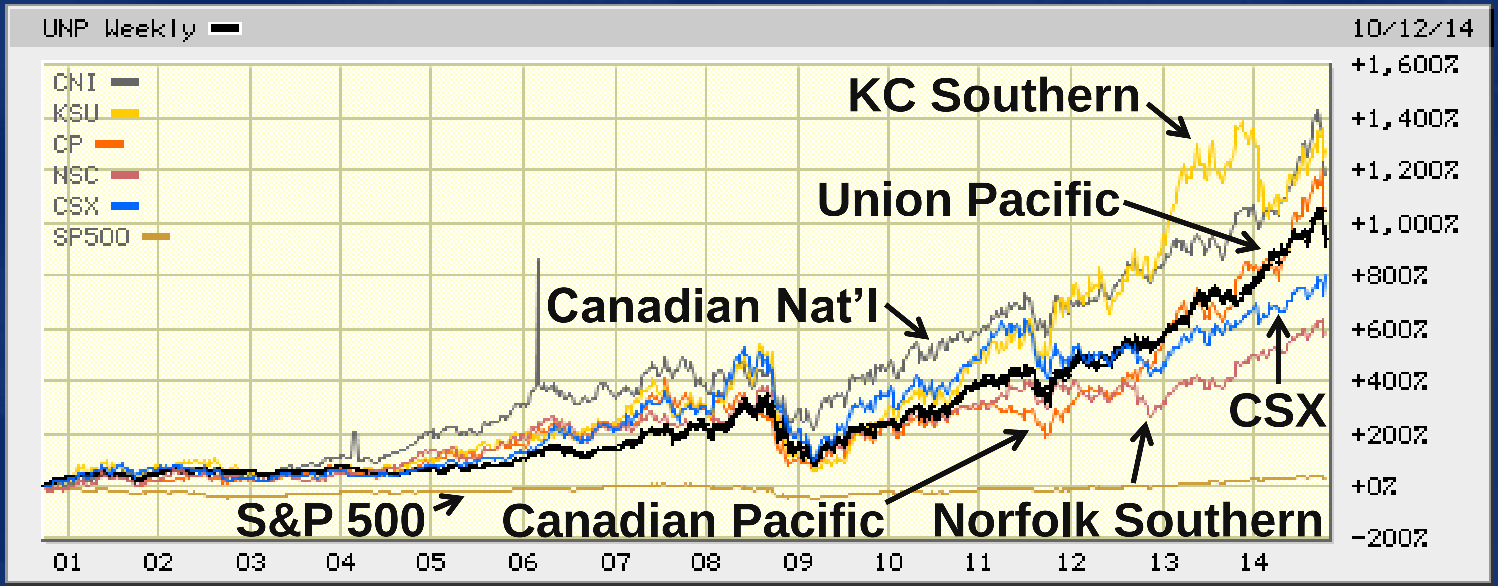
The Three Most Dangerous Words in Investing: "I Missed It"

- The "I Missed It" phenomenon is the emotional mistake of looking at a stock that's moved up a lot and, sometimes subconsciously, saying to yourself, "Rats, I missed it," and doing no further work on it
  - I know people who looked at Berkshire Hathaway, after it had run from $100 to $1,000 (and $1,000 to $10,000, and $10,000 to $100,000) who fell into this trap
  - I've talked to many people who started doing research on Netflix after my presentation two years ago, but then when Carl Icahn filed on the stock a few weeks later and it ran from the low $60s to almost $80 in two days, they fell into the "I missed it" trap and didn't buy
- Therefore, anytime you hear yourself saying "I missed it," STOP! Re-do your work, ignore the historical price, and focus on the only question that matters: is the stock, at today's price, an exceptionally attractive investment? If so, BUY IT (or short it)!
- I am going to present a number of stocks today, some of which have made big moves
- Despite this, I not only own them, but have been adding to most of them at current prices and if I were starting a new portfolio from scratch today, I would put on all of these positions

The Railroad Industry: What Can Happen When an Industry Consolidates

- The semiconductor, U.S. airline, and auto rental industries today remind me of the railroads a decade or so ago: a lousy, capital-intensive industry – characterized by cut-throat competition, low margins, low returns on capital, and high debt levels – consolidates and slowly turns into a much better industry
- When this happens, there can be a decade-long tailwind of strong top-time growth combined with improved pricing, margins, and returns on capital, leading to rapidly rising earnings
- This, combined with investors awarding these earnings a higher multiple, can lead to tremendous long-term stock returns (the *worst* performer is up 7x!):



The Two Big Ideas I Got From Last Year's Robin Hood Conference: 1) Micron

(Thank you David Einhorn!)

- The stock had more than tripled in the previous year
- How many people would have looked at this chart and said to themselves: "I missed it"?

Source: BigCharts.com.

But You Hadn't Missed It: The Stock Is Up 50% Since Then

Source: BigCharts.com.

To Evaluate Micron Today, You Only Need to Answer One Question

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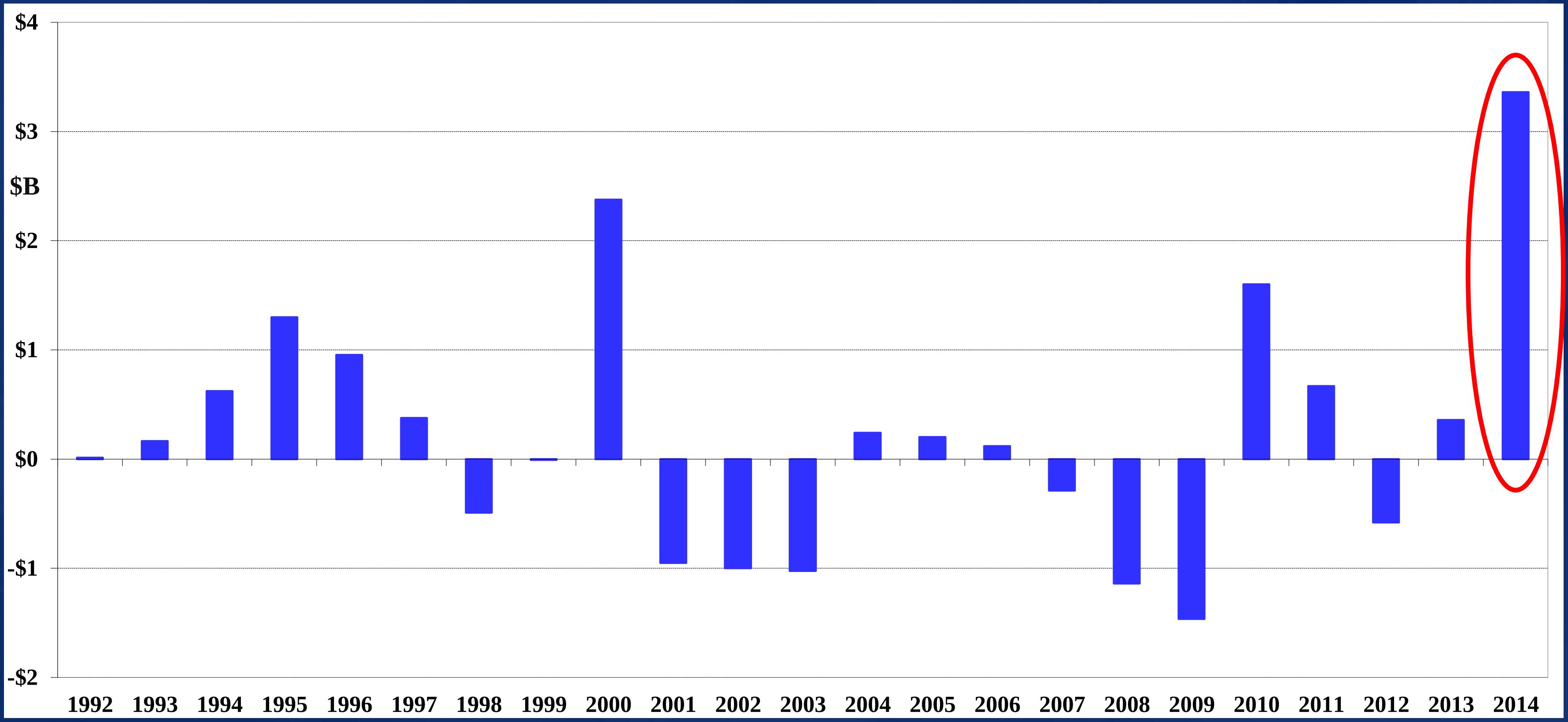
- Are the record earnings over the past year the top of yet another cycle or does it reflect a long-term fundamental change in the industry?

Annual Operating Income



Source: CapitalIQ.

Current Thoughts on Micron

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- Micron has pulled back 15% in recent weeks, yet the company and industry fundamentals remain excellent:
  - Demand is very strong
  - Spot and contract pricing is stable/up
    - Little evidence for the bear thesis of a collapse in DRAM pricing
  - Capacity discipline and stabilization, in which growth is in line with demand
    - Micron has no plans to add any capacity
- Less than a month ago, Micron reported a very strong quarter (revenues rose 49% year over year and operating income quadrupled) and gave excellent guidance
- Industry leader Samsung, in an otherwise dismal Q3 update, said: “Earnings for the Memory business improved on-quarter led by continued strong seasonal demand momentum, including PCs and servers, price stabilization under tight market supply and demand conditions”
  - While Samsung is building a new chip plant, production won’t begin until 2017 and the CEO dismissed concerns of a price war, saying “there definitely will not be any game of chicken”
- Inotera also reported solid numbers for September

What About Microchip Technology's Earnings Warning?

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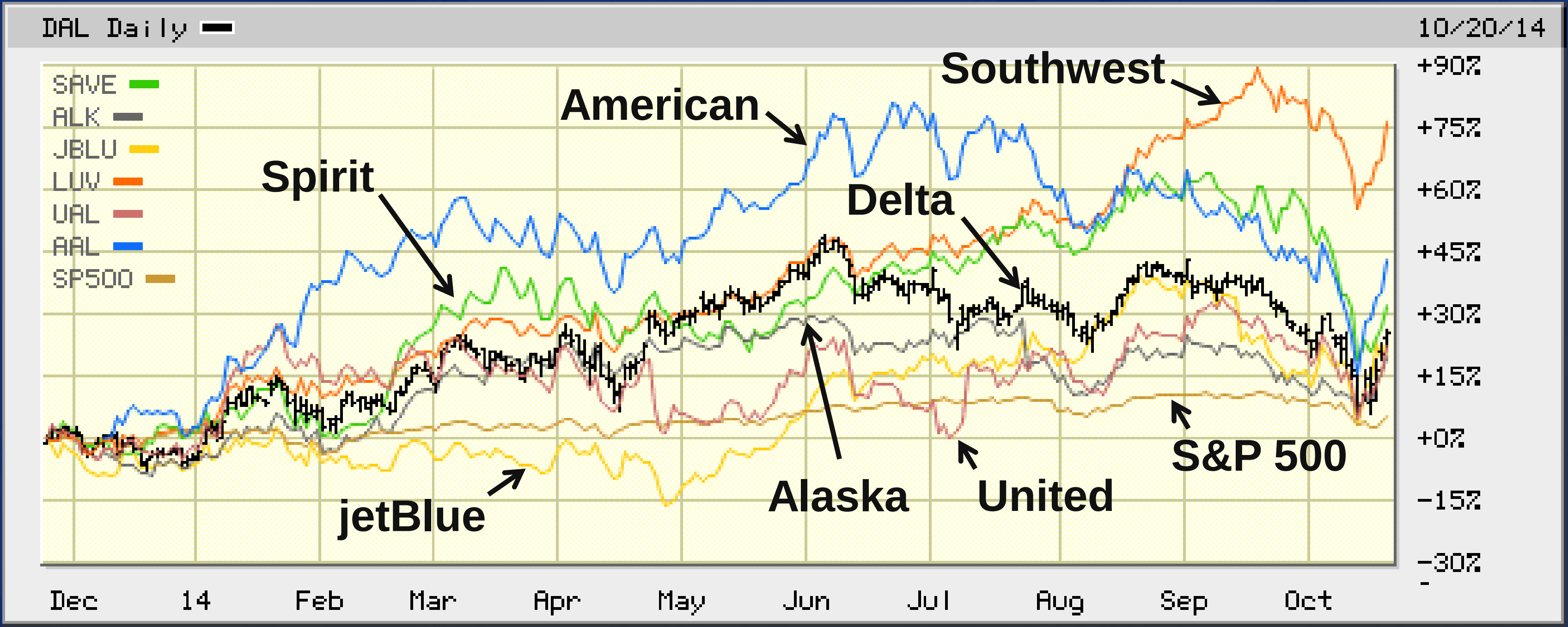
- Microchip Technology (MCHP) recently announced an earnings miss, during which the CEO said: "Microchip often sees the turn of the industry ahead of others in the semiconductor industry…We believe that another industry correction has begun and that this correction will be seen more broadly across the industry in the near future."
  - While Microchip has been an early indicator in the past, I think the CEO is mostly making excuses for his company's poor performance
    - Microchip is integrating two acquisitions
    - It likely gave overly aggressive guidance
    - In late July the CEO sent a letter to customers encouraging them to place orders soon because the company was running short of manufacturing capacity, which may have caused distributors to build up more inventory than customer demand warranted
  - MCHP has less than 1/8th the revenues of Micron and is in very different businesses (microcontrollers for autos, appliances, remote controls, etc.)
  - In contrast, Micron derives most of its revenue from DRAM DDR3 chips, which are in shortage and fully booked up by Apple, Samsung and Chinese smartphone and tablet vendors as well as PC and server vendors

Micron's Low Valuation

- Micron trades at only 7.7x run-rate earnings
  - EPS was $0.96 last quarter
- I see EPS in 2015 north of $4.00
- If Micron demonstrates reasonably stable earnings over time, it will likely re-rate to a 10-12 multiple, or a $40-$50 stock
- Conclusion: The long-term industry consolidation story is still intact and has many more years to run. <u>You haven't missed it</u>
- I bought more Micron last week

The Two Big Ideas I Got From Last Year's Robin Hood Conference: 2) Airlines

- The seven largest U.S. publicly traded airline stocks have all handily outperformed the S&P 500 since last year's conference:

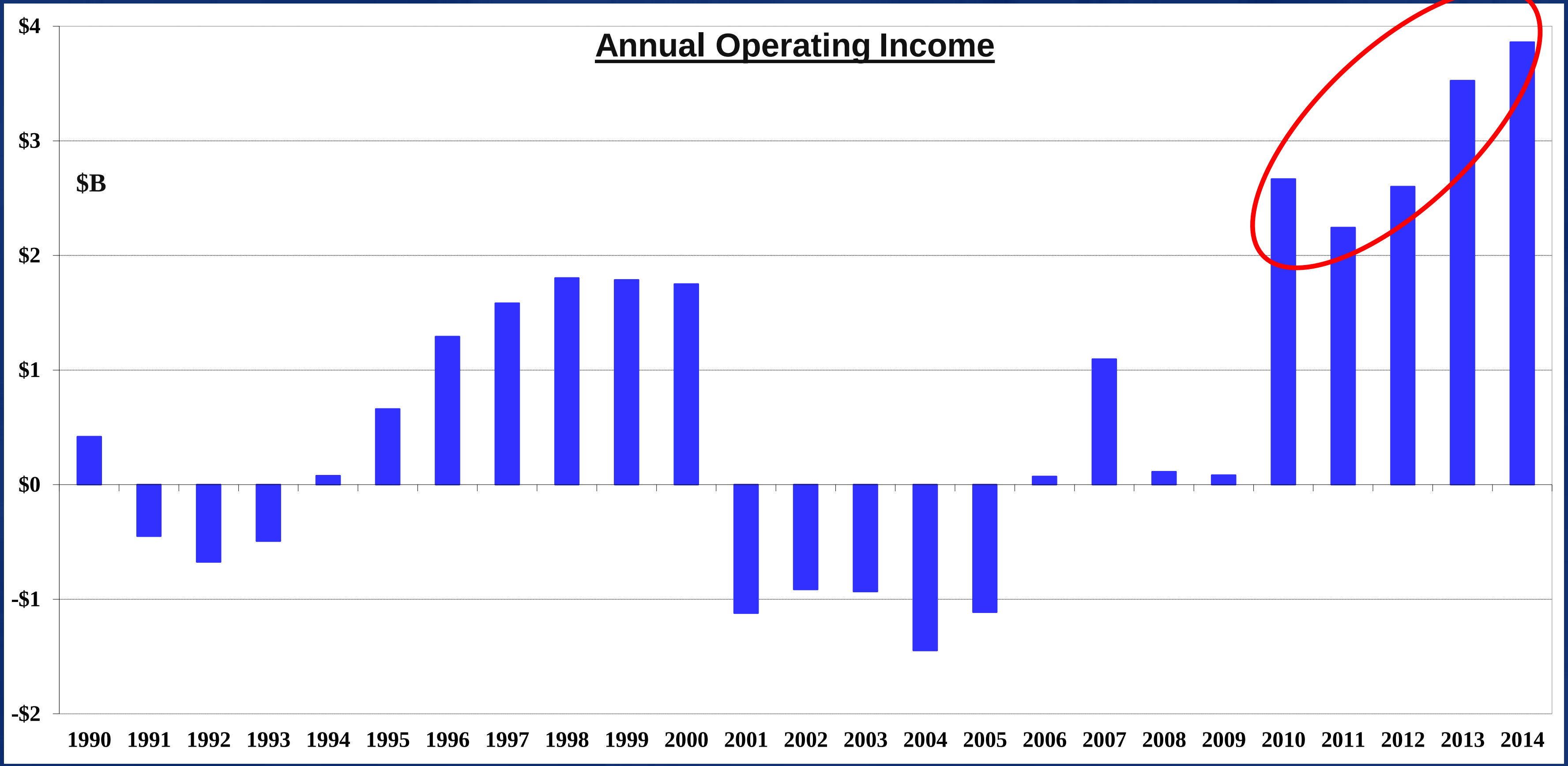


- I have invested 10% of my fund in four airline stocks (in descending order of size): Delta, jetBlue, United & American

Source: BigCharts.com.

To Evaluate the Airlines Today, You Only Need to Answer One Question

- As with Micron: Are the record earnings over the past few years the top of yet another cycle or does it reflect a long-term fundamental change in the industry?



Source: CapitalIQ.

Current Thoughts on Airlines

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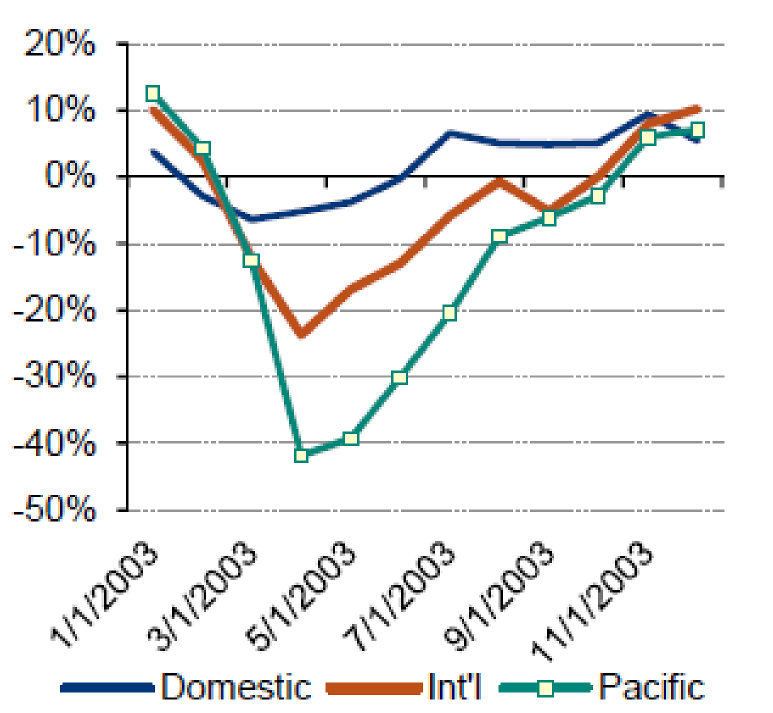
- There's been a sharp pullback in the sector in the past two months due to concerns about increased capacity and slowing growth internationally, the stronger dollar, Ebola and (perhaps) the unwinding of a crowded hedge fund trade
- Yet the fundamentals remain excellent (as Tom Wagner showed yesterday):
    - Pricing is strong (Delta pushed through a fare increase last week, which gained full industry support over the weekend, the first time this has happened since April)
    - Fees are high
    - Planes are full
    - Capacity growth is restrained
    - Labor relations are good
    - The price of jet fuel has fallen by ~15% since the beginning of September
        - A 10-cent decline in fuel prices boosts industry earnings by 10%
    - All four major U.S. carriers are returning capital to shareholders
    - Fully-taxed P/E multiples for the three network carriers are now <9x
- Delta reported strong earnings and guidance last week and United recently gave strong guidance
    - American, United, Southwest, Alaska and JetBlue report results on Thursday
- The nine publicly traded U.S. airlines have a total market cap of $105 billion; Union Pacific alone has a $95 billion market cap
- Conclusion: The long-term industry consolidation story is still intact and has many more years to run. <u>You haven't missed it</u>. I bought more Delta and jetBlue last week

But What About Ebola?
We've Seen This Story Before

- SARS was much more deadly and contagious – but ultimately had no lasting impact on airlines – or the world:

Chart 1: SARS impact to revenues in 2003



Source: A4A, BofA Merrill Lynch Global Research

Exhibit 1: US airline stock price perf

*Note: Bloomberg US airline stock index, Jan 2003-Dec 2003

Source: Bloomberg, BofA Merrill Lynch Global Research

Source: BofA/Merrill Lynch analyst report, SARS shows Ebola not good excuse to sell airlines, 10/13/14.