Old West Investment Management, LLC

July 14, 2017

Dear Investor:

The first half of 2017 has been remarkably similar to the past several years, with stock and bond markets at all-time highs, and volatility (more about this later) near all-time lows. As you can see in your enclosed statement, we had a difficult second quarter and we under-performed the market in the first half of the year. However, there have been several signs that have popped up just the past few weeks, which lead me to believe there is a rotation coming when money will flow from growth to value stocks. We have been anxiously waiting for this rotation to occur, as our portfolios are full of ignored companies with tremendous upside potential.

This past month was the tenth anniversary of the beginning of the first signs of the great recession. Two Bear Stearns hedge funds blew up in June of 2007, and that was the start of what would have become a worldwide financial crisis. The ensuing twenty months would see Bear Stearns disappear, Lehman Brothers go under, and major banks all over the world hang by a thread. The stock market would fall 56%, hitting a bottom in March of 2009.

As you know, economic cycles are a fact of life. Markets go up and markets go down. Markets of late seem like they'll stay up forever, but we know they won't. The current bull market run is the second longest in post-World War II history, having run 100 months and counting. The longest ever is 113 months, from 1990 to 2000.

What would end the current run? I'm not sure, but here are a few "canaries in the coal mine". The recent bankruptcy of Puerto Rico could be the beginning of a string of state/county/ city bankruptcies. Illinois, New Jersey, Connecticut, Massachusetts and Kentucky are all in desperate financial condition, having made promises and obligations they will not be able to keep. In recent letters I have expressed my concern over the amount of debt in the world. Global debt has risen to $217 trillion, which is 330% of the global GDP. This debt amount has risen 50% since 2007. US Corporate debt is at its highest level in 20 years, having risen $8T since 2010. Even though interest rates are extremely low, companies' ability to service their debt is at its lowest point in 10 years.

I have stated many times in the past that debt is a retardant to growth. Excessive debt levels and aging populations throughout the developed world are major reasons GDP growth has been anemic for many years. However, the stock market has been acting like GDP growth is robust. A new class of stocks have been named the "super caps", which would be companies with market caps in excess of $300B (Apple, Google, Microsoft, Amazon and Facebook). These companies added $600B of total market cap in the first half of 2017. Apple alone has added $300B of market cap in the past year, while their revenue growth was negative 8% and net income growth was negative 10%.

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Besides the super caps appearing to be running out of steam, the lack of volatility also has me concerned. The well know VIX index, a popular volatility gauge over the past 20 years has only closed below 10 on eleven days. Seven of those days were this June. When the VIX Index is a high number it means stocks are trading with great uncertainty and volatility. During the '08 recession the VIX was a high 90, and as I stated, it hit a record low of 10 recently. Although this might seem counter intuitive, when the VIX is high investors are panic stricken, which is a good time to buy, and when the VIX is low, investors are complacent, which means you should be ready to run for cover.

My list of worries include the aforementioned length of the current bull market and low volatility, a potential credit bubble in the world's second largest economy, China, a 33 year old nut job at the controls in North Korea, and many more.

There are a lot of positive things happening in our country and the world. I do believe President Trump and the Republican controlled Congress will pass tax legislation in the near future, and hopefully by year end. This will include a dramatic lowering of corporate taxes, which will be positive for financial markets. However, the market has already priced this in for the most part. The Trump team has done a terrific job of reducing needless regulation on business, and this will add to corporate profits and help capital spending.

So how do we at Old West protect your hard earned assets from a market correction? By sticking to our investment process and stress testing every company in our portfolio to be sure there is a margin of safety. With a margin of safety there is room for negative surprises and outlier events that weren't anticipated when we did our research. So many stocks today are priced for perfection, but not in our portfolios. As expensive as I believe the overall market is today, interesting that we are fully invested across our portfolios. There are 4,000 publicly traded companies to choose from, and we are finding plenty of opportunity.

Regarding my earlier comment that we're looking forward to a rotation from growth to value, I don't want to give the impression we're not looking for growth. We own plenty of companies that are growing rapidly, including Formula One, IDW Media, Air Lease, Keryx Pharmaceuticals and NMI Holdings. What sets us apart is these are companies we uncovered through our investment process, not stocks we feel a need to own because everyone else owns them. Trillions of dollars have flooded into index funds and ETFs, where deep research and individual stock selection have been deemed obsolete.

So there you have it – some good, some bad, and nobody knows where the market is headed. I firmly believe it is a time to use caution, and similar to the years following the bursting of the tech bubble of 2000, it's a great time to be a value investor.

In my quarterly letters I like to highlight one or more of our holdings, and this quarter I'll explain the investment thesis behind Keryx Biopharmaceuticals.

KERYX BIOPHARMACEUTICALS (KERX)
KERX is a Boston based company focused on bringing innovative medicine to people with renal (kidney) disease. The company's long-term vision is to build a leading renal company. They have an approved drug on the market, Auryxia® which is an orally available, absorbable, iron-based medicine. It is approved in the U.S. for the control of serum phosphorous levels in patients with chronic kidney disease (CKD) who are on dialysis. Phosphorous is a mineral found in your bones. Along with calcium, phosphorous is needed to build healthy bones, as well as keeping other parts of your body healthy. Normal working kidneys can remove extra phosphorous in your blood but when you have CKD your kidneys cannot remove phosphorous adequately. Having too much phosphorous can cause body changes that pull calcium out of your bones, making them weak. High phosphorous and calcium levels also lead to dangerous calcium deposits in blood vessels, lungs, eyes and heart.

Auryxia® is also approved in Japan and is sold under the brand name Riona® and is marketed by Torii Pharmaceutical. The drug is approved in Europe and under the brand name Fexeric®. The company also hopes to expand the use of Auryxia® to the treatment of iron deficiency anemia, or IDA in adults with non-dialysis dependent chronic kidney disease (CKD). If the use expands to non-dialysis patients, the sales numbers will grow dramatically. KERX's version of building a leading renal company includes expansion of their product portfolio with other medicines that help patients with kidney disease.

As we all know, the world is facing an obesity epidemic. Overweight people are multiplying at a rapid rate all over the globe, and one consequence of being overweight is diabetes. Diabetes is the leading cause of CKD. Today in the U.S., there are 450,000 people with CKD requiring dialysis including 350,000 adults currently taking a phosphate binder. The KERX sales team is calling on nephrologists and their associated dialysis centers with steady and increasing sales numbers. If the drug is approved for the expanded use by patients with iron deficiency anemia, there are an additional 650,000 people in the U.S. being treated by nephrologists. No oral iron medications are currently FDA approved to treat IDA. The company expects FDA approval for treatment of IDA later this year.

How did our investment team come across KERX? All investment managers are required to disclose their holdings quarterly with the S.E.C. in what is called a 13-F filing. There are some twenty money managers whom we hold in very high regard, and Seth Klarman of the Baupost Group is at the top of our list. Baupost is the largest shareholder of KERX, owning 26,000,000 shares which is 24% of the company. One of Klarman's long time research analysts is David Abrams, who left Baupost after many years to start his own firm, Abrams Capital. Abrams owns 5.7 million shares of KERX and is the third largest shareholder. Although Abrams doesn't have the fame and notoriety of his former boss Klarman, we regard him as one of the upcoming superstars of investing. The fact that Baupost and Abrams are two of the top three holders of KERX forced us to take a close look.

In analyzing a company we always want to see management be heavily invested in their company. We like it when management has more to gain from their ownership in the company than their cash compensation. KERX CEO Greg Madison is highly regarded and owns 1.4 million shares, which today has a market value of $10.8 million. His annual cash compensation is $540,000, so his stock holdings in KERX is truly his pot of gold at the end of the rainbow.

Auryxia® was first approved by the FDA for use by dialysis patients in late 2014. After some start up manufacturing glitches, the sales effort is now in full gear. The company is forecasted to do $65 million in sales this year, which is a 100% increase over last year. Revenue is forecast to grow 50% per year for the next several years, and the company should become profitable in 2019. Given the prevalence of diabetes all over the world, we believe Keryx Biopharmaceutical is a timely and opportunistic investment. Our average cost basis across our portfolios is $5.90 per share, and the stock is currently trading at $8.20 per share and the current market cap is $890 million. We would not be a bit surprised if KERX is bought by a larger drug company, but if not, we think the future is very bright.

Thank you for your continued support and loyalty, and we look forward to a strong second half of the year.

Sincerely,

Joseph M. Boskovich, Sr.
CEO and Chief Investment Officer

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