VOSS CAPITAL

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January 25th, 2015

Dear Partners,

The Voss Value Fund returned 11.25% net of fees for calendar year 2014. This compared to a 13.69% total return for the S&P 500, 4.90% for the Russell 2000. Realized alpha on the year was 11.5% and is 16.2% annualized since inception. The Value Fund's 3-year annualized return to Partners net of fees stands at 21.9% versus 19.8% for the S&P 500 over the same timeframe. Net exposure averaged 67.3% on the year, and only 28.4% on a Beta-adjusted basis. Our top 10 long positions make up 62.9% of the portfolio, the highest concentration we have had since inception. Our top 10 short positions make up 27.2% of gross exposure. Contribution from the long book in 2014 exceeded the Russell 2000 returns by 15% at 20.15%, or +20.56% when considering bullish oriented options strategies. Shorting and hedging (includes bearish oriented options trades) cost the fund 0.7%. One short alone cost the fund over 5% so our "hit rate" was high but one large loser and poor risk control prevented shorting from having a meaningful positive impact on returns. Also, negative currency translation due to an increasing concentration in Canadian Dollar denominated positions had a material negative impact of -3.5%. The expense ratio was slightly less than 1%.

Voss Value Fund, LP

ESTIMATED NET MONTHLY PERFORMANCE | 2014

PERIOD	VVF (Net)	VVF (Gross)	S&P 500 TR
JANUARY	-1.24%	-1.15%	-3.46%
FEBRUARY	-0.16%	-0.08%	4.57%
MARCH	6.16%	7.43%	0.84%
1st QUARTER	**4.68%**	**6.11%**	**1.81%**
APRIL	6.70%	8.37%	0.74%
MAY	-0.20%	-0.17%	2.35%
JUNE	-2.20%	-2.60%	2.07%
2nd QUARTER	**4.15%**	**5.37%**	**5.23%**
JULY	-4.47%	-5.39%	-1.38%
AUGUST	0.43%	0.62%	4.00%
SEPTEMBER	-3.82%	-4.64%	-1.40%
3rd QUARTER	**-7.73%**	**-9.23%**	**1.13%**
OCTOBER	0.94%	1.26%	2.44%
NOVEMBER	2.69%	3.44%	2.69%
DECEMBER	6.69%	8.35%	-0.25%
4th QUARTER	**10.59%**	**13.49%**	**4.93%**
YEAR TO DATE	**11.25%**	**15.19%**	**13.69%**

We were lucky to finish on a strong note on what could be considered the "bell lap," but like Smarty Jones' near miss in winning the Triple Crown in 2004, we are only two-for-three in beating the S&P 500 net of fees and expenses in the past three calendar years.

The once translucent stream of reason that recently ran through corporate America continues to be muddied by the forced misallocation of capital after six years of zero-bound short term interest rates. While I am thankful for the delusional optimists and those peering through rose tinted spectacles among us as they are necessary to fund the businesses that expand the bounds of human progress, they don't make for conservative long term equity investors and their time in the limelight (though longer than usual this cycle) will ultimately prove ephemeral as it always does. Our own prognosis remains tinged by a generous dose of skepticism and our investment decisions are grounded in quantifiable empirical evidence combined with a militant discipline in paying ridiculously cheap valuations and shorting over-hyped, overvalued cash incinerators.

The median valuation of public companies in the US continues to march beyond the level witnessed in the 2000 peak, which is the de-facto new benchmark for any market valuation discussion. One obvious difference this go-around is that this deep into the cycle central banks are hardly even considering a removal of their collective lead foot from the accelerator as the risk of deflation remains palpable around the globe—partly from their own misguided, yield curve flattening Quantitative Easing endeavors.

The Russell 2000 collectively is at over 17x EBITDA—a full 40%+ higher than the 12x trailing multiple in 2006 that preceded the downturn. Small cap earnings are expected to grow by 20.7% for 2015, which is coincidentally the exact same growth rate I cited in our Q4 2013 letter that was expected for 2014 at about this time last year (source: Bank of America Merrill Lynch, Small-Cap Monthly Chartbook, January 7th, 2015). Compare this to the actual earnings growth for the Russell 2000 for 2014 (using some Q4 estimates-not all cos have reported) at -13.5%, or +5.7% if you exclude those companies with negative earnings. To give you some sense of how little idea the sell side has of earnings and how far off these predictions tend to be, just one month ago the energy sector's 2015 earnings growth was expected to be 33.1%, versus -9.3% now (source: Bank of America Merrill Lynch research). The energy sector currently accounts for ~8% of S&P 500 market cap, ~11% of S&P 500 earnings and a disproportionately large percentage of capital expenditures, at ~33% (source: Goldman Sachs report "Crude math of Energy and Earnings" January 9th, 2015). Increased cap-ex helps to boost corporate profits as the spending is another company's revenue and earnings that gets booked immediately, yet capital expenditures are amortized over a long period. With the coming energy cap-ex collapse the prospects for overall S&P 500 earnings growth this year are dimming, which could make the market multiples even higher on a go-forward basis. The decline in oil being an immediate boon to consumer spending was disproven as retail sales unexpectedly declined in December. Despite this and other conflicting pieces of evidence, the narrative continues that the gasoline decline will support above average consumer spending growth.

Capacity utilization across the entire economy is back above 80%, a level consistent with an inflection point in inflation, and a level that should start to force companies in other sectors outside of energy to ramp up capital expenditures. Yet this is also a point where the incremental operating margins and profits will be lower from revenue growth as the maximum benefits of operating leverage are behind us.

Biotech

The S&P 500 Biotech index has now tallied up a 53.8% CAGR since that start of Q3 2012. This is a full 32.3% *per year* better than the S&P 500 during what has been a historically an incredibly strong bull market in both duration and magnitude. We were undeniably and embarrassingly early in turning heavily bearish on the space early last year when we called biotech the most one-sided positive sentiment extreme in the market's history. Biotech was up another 34% in 2014 (small caps taken by themselves were up over 50%) and the greatest one sided sentiment extreme of all time has stretched even more. A very large net short in Health Care overall continues to be the bane of our portfolio returns. Combing through 25 years of historical industry returns shows that Biotech's relative outperformance over the broad benchmarks over the last 3.25 years puts it in a category all its own. Checking many of the periods with tremendous industry returns we could think of, no other industry has outperformed the benchmarks by such a wide degree over a sustained 3+ year timeframe (at least within the last 25 years). Using quarterly return data starting from 1994, the spread (cumulative outperformance) of the NASDAQ Biotech Index over the S&P 500 is a 4.3 standard deviation move. *If* financial market returns were actually distributed normally, this level of cumulative industry outperformance should happen only once every ~7,889 years. This fact alone tells us nothing about future returns other than the odds should favor a massive reversion to the mean--defined as multiple years of future underperformance. For all we know, the current once-in-a-hundred-lifetimes-outperformance of biotech could continue for another three years and blow-out further from here. These sorts of record breakings of historical precedent no longer surprise us.

Too much of a good thing can sometimes be bad thing in capital markets and investment bankers will eventually ruin the party with too much supply. As of mid to late January biotech firms have been raising equity at close to a billion dollars a day pace. What helped mark the top of biotech in early 2000 were three massive equity offerings by Genentech in short succession: $1.94b in June 1999, $2.87b in October 1999 and then another $2.82 billion in early March 2000. Equity deal count in both 2013 and 2014 was over 90% higher than the 2000 peak with the overall dollar amount raised about 40% higher in 2014 than in 2000. These raises consist of more small deals, so the positive breadth and euphoria is generally more wide-spread in small and mid-cap names, compared to the 1999/2000 genomics bubble which was a subset of the greater large cap tech bubble. While the amount of capital raised is certainly a rounding error in the grand scheme of global market cap, it is large relative to existing Biotech market cap. We are just 27 days into 2015 and Biotech has had more IPOs this year than the entirety of 25 of the last 36 years. Even with a large cash M&A component taking biotech equity supply out of the market, supply will eventually swamp demand at this record breaking run-rate.

Only 10 stocks out of the crop of ~150 Biotechs funded from 1999/2000 have returned over 300% since 1/1/2000 (or a later date in 2000 if their IPO was after this). The starting pool of candidates considered was any IPO from 1999 or 2000 firm that did a Wall Street backed equity offering. Over a 15 year period this is actually only a 9.68% CAGR in total shareholder return--and these are the small fraction of winners. Celgene has been by far the single biggest winner and outlier from the '99 era and its total shareholder return has underperformed its revenue CAGR by 13% (28% versus 41%) due to its starting valuation and share dilution. A German company called Morphosys was also a frequent exploiter of the US equity markets' generosity during this era. Its Enterprise Value peaked in Q1 2000 at $1.05 billion versus the current $1.8 billion (and hit a low of $6 million in 2002, but survived). Shares outstanding have gone from 10.3 million to 26.5 million for a 6.5% CAGR. Share price peaked 2/29/2000 of $100.67 and now $74.68 for a -2% compound annual return for the last 15 years while the market cap is actually up 2x over the same time.

The median return for biotech stocks from that era is -100% as the majority of them ground down to zero. The Pre-commercial Bloomberg Biotech index at this point in the cycle is already up over 9x since 2008. The positive breadth going forward in biotech will be terrible. When some of the names from the current crop are down 50-95% there will be some good long ideas that emerge. It is likely that there will only be a few very big out-sized winners 5-15 years from now if someone is buying at today's prices, and even those winning stocks will severely under perform their fundamentals (as measured by revenue growth in this instance as there are no earnings for a while) because the starting valuation bakes a lot of growth in and shareholders will inevitably endure massive dilution as they burn ungodly amounts of cash along the way to long term business success.

Often in the same breath Biotech is cited as both a high-beta speculative play and an economically insensitive safe haven with pricing power, the only conclusion therefore is that it cannot go down. It is becoming all things to all people, much like gold was in 2011. For now we continue to brace ourselves for the high likelihood that the extremes and euphoria will continue for the foreseeable future.

New short idea: Royal Caribbean

One way we choose to mitigate the risk of an uncertain and unpredictable world is by avoiding extreme concentrations and finding ideas that will benefit from the world's inherent volatility. One of many new ideas in the Fund that will benefit us from the uncertainty of the world is our short in Royal Caribbean (RCL).

RCL has a 25 year history of adding capital inefficiently. The company's return on invested capital has slowly regressed under their cost of capital over the years. As this happens the Enterprise Value of a capital intensive business should trend towards the book value of invested capital. RCL shares, however, trade at over 2x book value. Direct competitor and trading comp, Carnival (CCL) is at 1.46x book value (which is still expensive) despite having an identical return on invested capital (5.33% versus 5.58%).

The cruise industry has had a nice lull in deliveries of new ships after the Great Recession from 2010-2014 and now will have a wave of deliveries of new generation ships. There is expected to be 16.3% growth in total available berths between 2014 and 2018 in what is already characterized as a price-taking industry (e.g. commoditized and well supplied). RCL is amongst the worst businesses we are aware of that are solidly perched at 52-week highs. We like an RCL short here for a plethora of reasons.

- Operational outcomes for the cruise industry have an inherently negative asymmetry, with many more negative contingencies than positive ones.
- RCL is back at or near all-time high valuations as measured by a variety of metrics.
  - The stock has a history of booms and busts in the equity valuation due to leverage and cyclicality.
  - The other multiple peaks were followed by 50-80% equity drawdowns.
    - 16x EBITDA peak in 1999: 78% drawdown from Q4 1999 to Q3 2001.
    - 14.8x EBITDA peak in 2004: 86% drawdown from Q4 2004 to Q1 2009.
    - 13x EBITDA peak in 2010: 59.6% decline from Q4 2010 to end of Q3 2011.
    - Current multiple is 15.1x trailing EBITDA, surpassed only in 1999.
    - Current multiple on forward EBITDA estimates is 12.0x, surpassed only in 2010 at 13.07x.
- RCL has tallied negative $4.1 billion in cumulative FCF since 1991.
  - Since 1991 debt has gone from $1.017 billion to $8.074 billion.
  - Dividends paid out over this time equal $1.792 billion.
  - Net new equity issued over this time equals $1.304 billion.
- Cap-ex has outpaced depreciation in every single year except for one.
  - RCL requires constant reinvestment into ships.
  - Cap-ex as a % of sales has ranged from 7.2% (9.7% currently) to over 40% in many years and a peak of 55.2% in 2001.
- RCL is at 29.7x trailing free cash flow, despite just having its best FCF year since 1993.
  - Current run-rate only due to depressed cap-ex.
  - EBITDA – cap-ex is cumulatively negative since inception.
- RCL is 4.2x levered as measured by net-debt-to-EBITDA.
- Since 1998 RCL's asset growth has outpaced revenue growth by a cumulative 200%.
  - There is no operating leverage or scalability as the ships are immediately deployed and typically filled. RCL must grow assets as quickly (or in the last 17 years) or quicker than it can grow sales.

- Long term earnings targets have continually been overly optimistic. For example, at the start of 2011, consensus 2014 adjusted EPS for RCL were $6.19 and the stock was at $50. Assuming Q4 2014 is on target, actual adjusted EPS is now slated to be $3.49 and the stock is at $84. So the multiple went from 8x FY4 forward EPS estimates, to 24.3x trailing EPS.

While there is rarely a "surprise windfall" for RCL, there has been one recently that we're all aware of and that is the collapse in oil prices. Over the course of its history RCL has spent on average 9.7% of sales on fuel costs. We estimate the decline in fuel cost for RCL will add about 45-50 cents of 2015 EPS, but this will be offset by a negative effect from a stronger US Dollar by ~15 cents, therefore the net effect of oil's decline for RCL's bottom line is only about +30-35 cents. If this EPS boost were capitalized at 17x (RCL's current forward P/E multiple) that's an additional ~$6 of added value for RCL shares. The multiple of earnings should be capitalized at a maximum of 10-12x, in my opinion, meaning RCL's shares should be worth $3.50-$4.20 more. Meanwhile the stock has actually gone from $53 to $85 since the mid-October oil meltdown, which is up 9.1x the $3.50 amount.

As alluded to above in terms of operational asymmetry, it is no secret that RCL has to shorten and cancel voyages quite frequently for random, uncontrollable mishaps, such as a steel fishing net beneath the surface of the water in the Tokyo shipping channel damaging a propeller, or the oil spill from a cargo ship collision in the Gulf of Galveston that shut the port down, etc. This is an industry and business model that is highly prone to randomness and susceptible to negative geopolitical events, economic shocks and pandemic scares. Except for one day during Leap years, never will they miraculously be able to cram more voyages into their schedule and increase asset utilization. Even if the jockey were good, the horse is so bad it hardly matters. Management has grown adept at hyping the latest class of new builds while always citing a new scapegoat for poor operating performance and missing earnings estimates—be it the timing of maintenance expenditures, one-time restructuring costs, negative industry publicity, tough comparables, inflationary pressures, Ebola, SARS, the weather, etc. They are equally as eager to pat themselves on the back for positives or attribute them to "brand strength." After going through every kind of operating condition possible—periods of rising net yields per available berth, falling net yields per available berth, rising oil prices, falling oil prices, etc., one would think that 25 years of history is enough to figure out this is a terribly capital intensive business model that is incapable of generating free cash flow over a cycle. Unlike other industries like Homebuilding or Oil and Gas exploration that generate no cumulative free cash flow due to reinvestment and the firms trying to grow their NAV, if RCL were to stop investing in new ships it would not all of a sudden morph into a cash cow. There is a higher level of necessary maintenance cap-ex and expenses on the ships that is required to keep attracting passengers and keep the assets operational, as opposed to an E&P that can collect a long tail of cash flows from its existing production while not drilling new wells or a homebuilder that simply liquidates all of its existing inventory and stops reinvesting in new lots and homes. Even if we assume RCL all of a sudden will spend *only* 7% of sales on cap-ex as a normalized maintenance level (7.2% is the lowest in its history in 1993), then investors are still paying a 23.3x multiple (or receiving a 4.3% FCF yield) in a best case bare-bones cap-ex scenario for a FCF stream that would inevitably decline from here as competition keeps chugging ahead with newer, nicer ships while RCL's fleet ages, eroding any kind of pricing premium that RCL may be able to enjoy now (over say Carnival).

There has been no paradigm shifting change now that will create a permanent inflection in future free cash flow prospects. Rather what has happened is that the momentum market has simply floated RCL's boat to all time high valuations, on both a forward and trailing basis (being in **146** different ETFs certainly helps). This is more the rule than the exception lately. With poor returns on capital that are consistently below the cost of capital, the shares should trade below invested capital. Don't expect the captain(s) to go down with the ship--in the last six months insiders have cashed out over $495 million worth of their stock (a lot from one director on the open market). When the euphoria inducing fog that is clouding people's judgment eventually burns off we expect RCL shares to take on water and sink back towards book value, which is over 50% lower from here.

Conclusion

Engaging in what seems is an increasingly anachronistic undertaking of peeling back the layers of an investment onion and deriving a view that deviates from consensus can frequently lead to tears. This is due to lack of reward for such immense effort and either being wrong, or having the feeling of fighting a seemingly endless supply of capital myopically focused on price momentum and struggling to delineate between the two. If we have been accurate in our original analysis and valuation estimates then both our long and short book "return pipelines" are fully loaded with future returns from our many laggards and losers that have earned a full portfolio weighting. Incremental capital inflows into the Fund will go into these names, allowing us to continue to average in in moderation.

It is difficult, if not impossible, to compare our decisions and actions in our lives to alternative decisions we could have made without actually having lived through the subsequent chain of events and unknown consequences. In other words, there is no sure way to know how an alternate decision might play out throughout life and it is hard to judge past decisions properly. However, in public equity portfolio management *we can* accurately and objectively compare alternate decisions by viewing the return impact an alternate decision would have made on our portfolio (ignoring any case of being able to influence the outcome, e.g. activism campaign).

Price/return histories allow us to evaluate our decision making track record in earnest and use regret accumulation to try and avoid repeating mistakes. This mindset must be moderated somewhat (by looking through the windshield and not only the rear-view mirror) in order to minimize emotional and decision fatigue that often paralyzes our minds during trying times when we should be more pro-active. By starting with strict valuation criteria and targeting a long-term time frame (and thus low portfolio turnover), what we can do is limit our major moves to a very small sub-set of capital allocation decisions that are systematically poised to outperform by avoiding the folly of over paying for assets and engaging in fruitless hyper-activity within the portfolio.

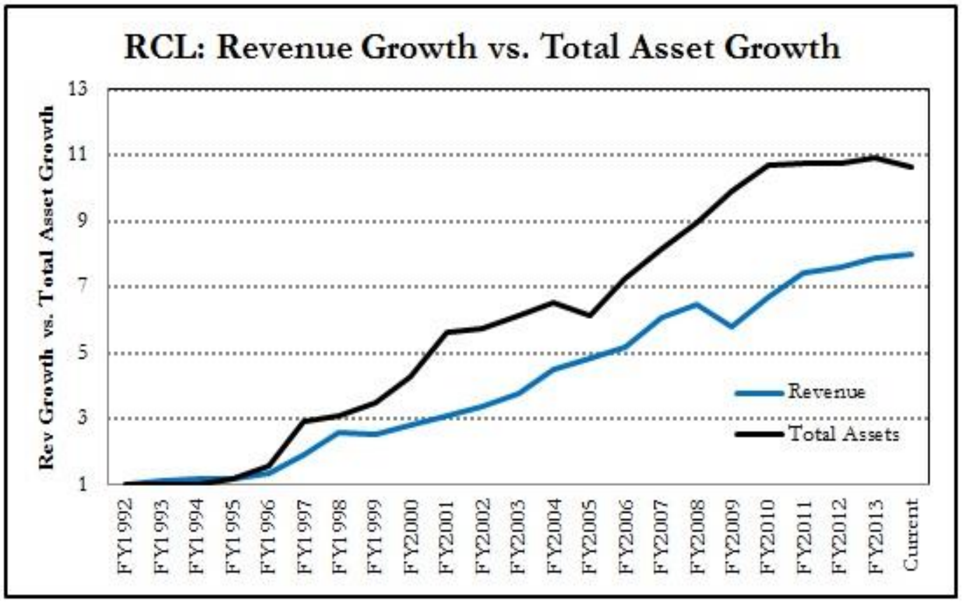
I recently read a story about a guy who joined a Buddhist monastery. He began to live in a small cabin a short walk down a winding path from the main temple within the complex. He asked one of the monks who had lived there for 15 years if he ever got sick of walking the trail connecting the residences to the building. "I'm only just starting to learn it," the monk replied. After tens of thousands of hours studying investments and capital markets we continue to think like a beginner by constantly revisiting the fundamental basics. Challenging what we think we know and believe. Challenging what others think they know and believe. We ignore and often shun conventional wisdom and constantly seek the brutal truth for ourselves in hopes of discovering a better paradigm in equity portfolio management. It's a short, easy path to beta…but a long, winding, and arduous road to alpha. We are only just starting to learn it.

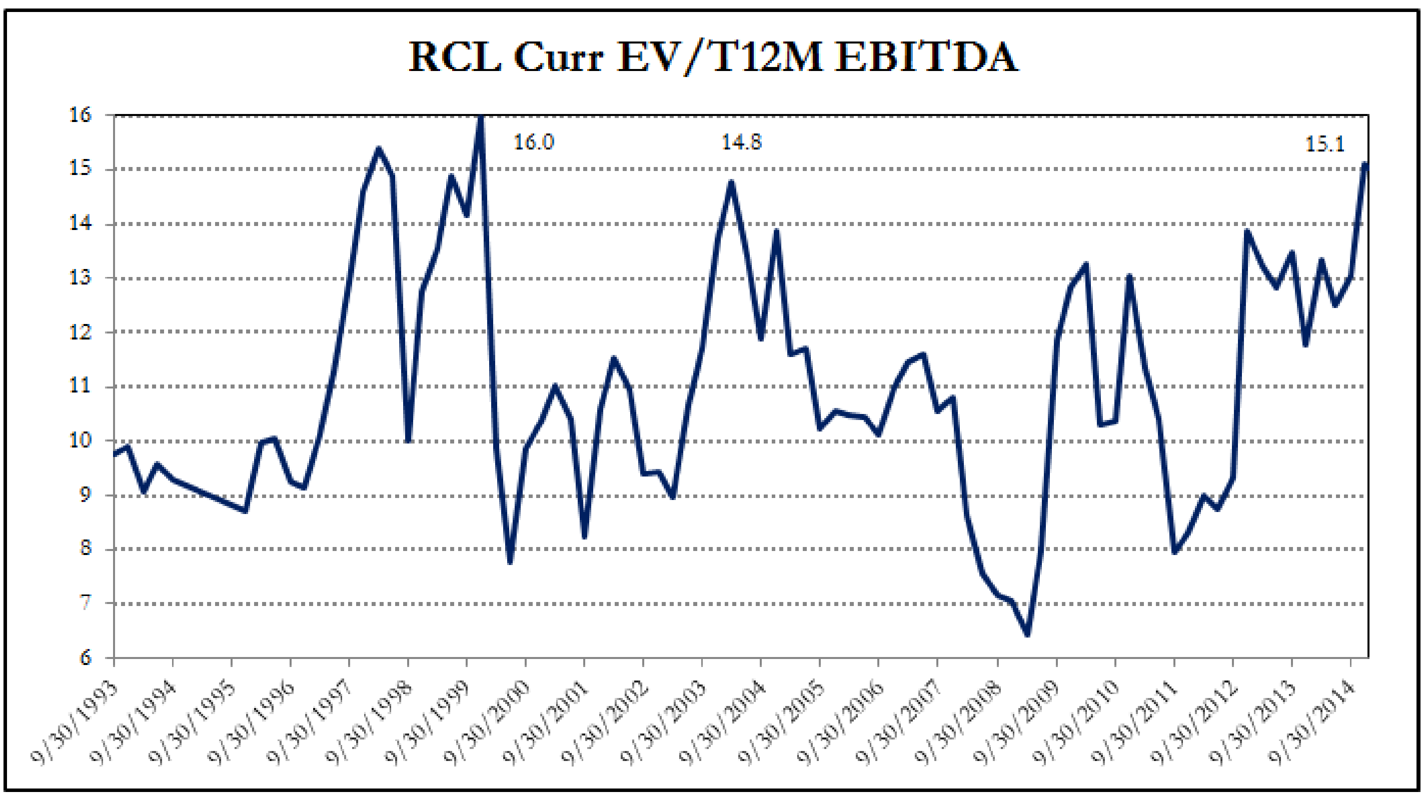
Sincerely,

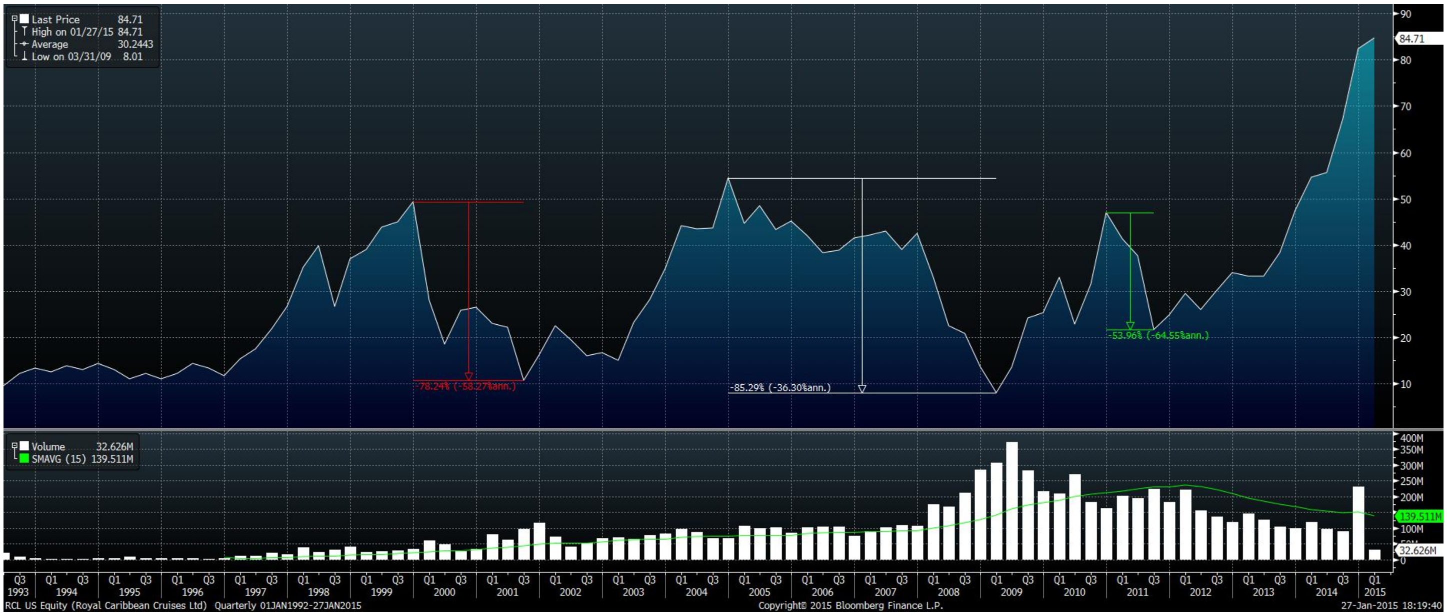
Travis

RCL Chart Appendix:

		Free Cash Flow
Current TTM	$	852,779,008
FY2013	$	648,291,008
FY2012	$	90,235,000
FY2011	$	282,112,992
FY2010	$	(524,169,984)
FY2009	$	(1,632,668,032)
FY2008	$	(1,152,279,040)
FY2007	$	(48,687,000)
FY2006	$	(232,072,992)
FY2005	$	681,462,016
FY2004	$	446,320,992
FY2003	$	(171,727,056)
FY2002	$	180,478,944
FY2001	$	(1,103,781,888)
FY2000	$	(582,333,056)
FY1999	$	(389,123,040)
FY1998	$	(30,095,032)
FY1997	$	(672,092,992)
FY1996	$	(422,874,976)
FY1995	$	(202,904,992)
FY1994	$	72,073,000
FY1993	$	136,806,000
FY1992	$	(95,768,984)
FY1991	$	(318,925,984)
	$	(4,188,946,088)







Last Price 84.71
High on 01/27/15 84.71
Average 30.2443
Low on 03/31/09 8.01
-78.24% (-58.27%ann.)
-85.29% (-36.30%ann.)
-53.96% (-64.55%ann.)
Volume 32.626M
SMAVG (15) 139.511M
RCL US Equity (Royal Caribbean Cruises Ltd) Quarterly 01JAN1992-27JAN2015
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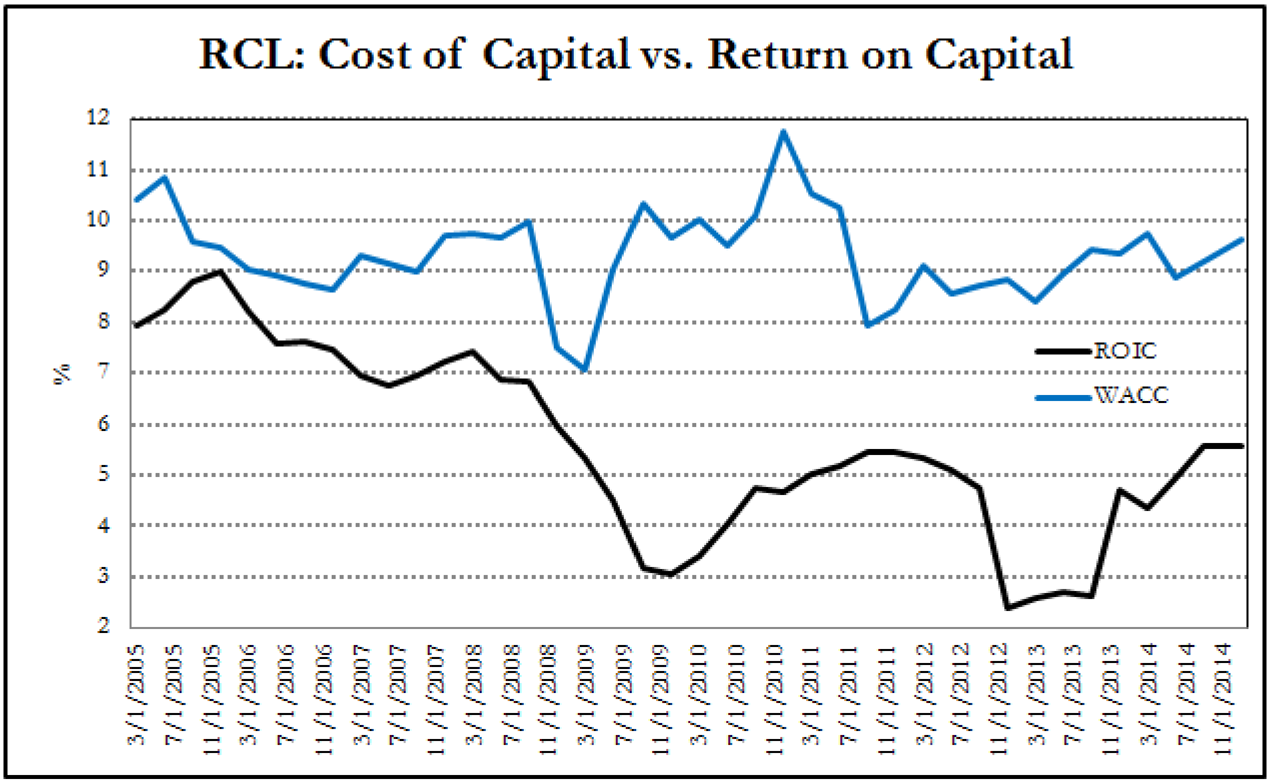

RCL: Cost of Capital vs. Return on Capital
%
ROIC
WACC

Disclosures and Notices

All YTD performance figures are unaudited, estimated, and may be subject to subsequent adjustment. A limited partner's actual returns may vary from published fund returns based on the timing of capital and fee arrangements. This statement represents information based on the policies of the fund's managers and general partner. Please contact Travis Cocke, Managing Partner of Voss Capital, LLC, with any inquiries.

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