IRONVINE
CAPITAL PARTNERS, LLC

To: Ironvine Capital Partners Investors

From: Matt Barnes and Ryan Mendlik

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Subject: First Quarter 2016 Letter – **Lessons Learned**

Our portfolios have contracted in value by nearly 18% over the last year. From inception in April of 2012, our capital has compounded at an average annual rate of 8.4% after fees and expenses, resulting in a cumulative gain of 38.2%. The data below is presented on a total return basis, and is shown net of all fees and expenses.

Cumulative Returns	Since Inception[1]	3 Year	2 Year	1 Year	YTD[2]
Ironvine[2]	38.16%	17.51%	(5.16%)	(17.95%)	(11.17%)
S&P 500	59.34%	39.82%	14.74%	1.78%	1.35%

Average Annual Returns	Since Inception[1]	3 Year	2 Year
Ironvine[2]	8.42%	5.53%	-2.61%
S&P 500	12.35%	11.82%	7.12%

[1] Composite inception 04/01/2012. Please refer to the Important Disclaimers at the end of this document.
[2] Ironvine Capital Partners performance data is presented net of all fees and expenses and includes reinvestment of income.

We look forward to the day that these letters are at last liberated from discussion about the soap opera our investment in Valeant Pharmaceuticals has evolved into. In the meantime, we're going to revel in this mortal purgatory for a short time longer, as with each passing day of servitude, the defenses it's helping us build against our own idiocy grow more fortified. Our relationship with Valeant has been well-documented in these letters, so we'll try not to belabor you with too much historical context and just jump right in. However, if you're unfamiliar with the story, give us a call if you have a few hours to kill and we'll take you through it in great detail.

<u>What happened to Valeant in March?</u>

Valeant's circumstances escalated from troubling to near perilous on the morning of March 15th when the company issued a much-anticipated press release outlining preliminary results for fiscal 2015, revenue and profit guidance for fiscal 2016, and "normalized" guidance for the four quarters ending March 31st of 2017. Though the outlook was reduced from estimates reiterated by the company just ten weeks earlier, it provided helpful qualitative commentary, was put forth with what appeared to be a healthy dose of conservatism, and it established that the company expected to remain highly cash generative. However, in the prepared remarks of the conference call that followed the press release, Valeant confirmed that by further delaying the filing of its 2015 annual report (10K) due to the ongoing review of now closed mail-order pharmacy Philidor, the company would soon enter a state of technical default with its bond holders and bank lenders. When pressed as to whether the company would have its 10K filed by April 29th, 2016—action that would cure the default in all respects and preclude Valeant's lenders from demanding immediate repayment on its $31 billion in debt—Valeant's CEO, Mike Pearson, could provide nothing resembling assurance. Then, as the question and answer session progressed, management was asked to clarify why an important figure in the presentation slides posted to Valeant's website was approximately $500 million lower than the same measure found in the press release. When it became clear that the company had transposed some numbers in error, Valeant was forced to issue a corrected press release during the conference call, and what little confidence remained in Mike Pearson at the time vaporized, along with another 50% of Valeant's equity market value.

Where did we go wrong?

Despite repeated bouts of debatable decision-making, inept and tone-deaf communications, and blatant incompetence, Valeant has failed to put us out of our misery just yet (more on this later). Nevertheless, the company's ultimate fate isn't necessary for us to offer a review of the mistakes we made managing this investment. We offer an abridged version of these below.

- As we continue to study our decisions over the last year, we keep returning to a single, dominant theme: **We put too much faith in the wrong people.** Although he did a number of great things during his tenor at Valeant, somewhere along the way, Mike Pearson lost his decision-making compass and strayed outside the lines of acceptable behavior. And the company's board seemingly lost control of him. Questionable choices like covertly setting up a mail order pharmacy and taking outrageous price increases on two life-saving drugs were warning signs we saw but failed to do anything about.

- **We ignored deviations in Valeant's once-disciplined acquisition criteria.** After exercising discretion in abandoning a bid for Allergan in 2014, Valeant paid an unusually steep price for Salix Pharmaceuticals. Moreover, Salix' value was rooted in intellectual property (patents) and a pipeline of near and mid-term products—two bets (patent durability and science) that Valeant had avoided paying for in prior deals. Then Valeant paid $1 billion for Sprout. Sprout was not only the first drug of its kind, requiring Valeant to create a market for it, but it hadn't generated a dollar of sales when the company agreed to buy it. *Important side note:* As fathers of five, you might question how we didn't immediately recognize a female libido drug that couldn't be taken with alcohol was destined for failure.

- **We were too lenient with Valeant's use of cheap debt.** Very few businesses have the durability required to employ elevated levels of debt. Valeant's excessive use of leverage turned a deteriorating but solvable situation into full pandemonium. "They can grow into their capital structure" is a sentence that necessitates sprinting in the other direction the moment you hear it. Having enjoyed the fruits of Valeant's early successes, we stayed put when tectonic shifts in the economics of the company's business model were clearly underway. When the pressure increased, Valeant's leverage turned euphoria into despair very quickly.

- **We fell for one of the oldest tricks in the book—cognitive dissonance—and did what any deranged investor would do: we justified our rationale and added to the investment as the price fell.** This was perhaps our biggest mistake of all. There's a difference between sticking with an idea when your thesis is intact, and being stubborn. It's subtle, but Valeant's economics *were changing*, and we could have preserved capital by exercising patience until the company's circumstances were understood.

<u>Where does that leave us today?</u>

Fortunately—or perhaps unfortunately for those of you who have grown ill reading about Valeant every day—this story is far from over. In fact, it has evolved materially since our last correspondence. Just days after the company's disastrous call on March 15th, one of Valeant's largest shareholders joined the board and almost immediately changed the posture of the company from defense to offense. In one fell swoop, the board announced that:

- A search to replace Mike Pearson as CEO would commence immediately
- The Ad-Hoc Committee reviewing Valeant's accounting for Philidor was nearing its completion
- The Committee's ongoing review hadn't identified additional items that would require financial restatements beyond the previously disclosed $58 million revenue recognition error
- The tone at the top of the organization and performance-based culture at the company may have contributed to the company's improper revenue recognition
- Valeant intended to file its 2015 10K on or before the important April 29th deadline

Subsequent to this announcement, on April 5th the Ad-Hoc Committee announced that its review of Philidor and related accounting matters was indeed complete, and that no additional accounting misstatements had been identified. Valeant has also reiterated its intent to file its 10K on or before April 29th on several occasions. To be conservative, the company also obtained a 30 day extension from its bank lenders to make the filing. Finally, on the evening of April 21st, we learned that the board was working to finalize a contract that would make long-time pharmaceutical veteran and then current Chairman/CEO of Perrigo, Joe Papa, the next CEO. These rumors became fact this Monday morning (April 25th) when Valeant announced the appointment of Mr. Papa as its Chairman and CEO, and that he would start in early May.

Valeant has made critical progress in a very short period of time. This is a different company that it was just months ago. However, the board and new management have their work cut out for them, and investors are by no means out of the woods. Valeant has yet to file its 10K (although we expect it imminently). They also need to report results for the quarter ending March 31st (we expect those numbers to be ugly) and file a 10Q for the quarter by July 31st. The company is saddled with an enormous amount of debt that needs to be addressed quickly. It's possible that Joe Papa will distance himself from guidance given just two weeks ago, leaving investors to assume that the company will trip its leverage covenant and be pulled back to the table with its lenders to seek relief. The company is also under intense scrutiny by payors (insurance companies and pharmaceutical benefit managers) and regulators and is the subject of several investigations—notably those by Congress and the SEC. Valeant will undoubtedly face a number of fines for its transgressions, and the volume of press the company receives will remain high for some time (and it will often be written with contempt). There is a chance—albeit remote—that Valeant is forced into bankruptcy and we lose what remains of our investment. A more likely outcome is one that sees its workforce stabilize, and its brands thrive under new leadership. Valeant is a highly cash generative business with leadership positions in dermatology, eye health, and gastroenterology that should be able to deleverage—slowly at first, then more rapidly. We anticipate the cadence at which debt is reduced to be augmented with non-core asset sales. As the company deleverages, each dollar used to pay down debt will accrue to equity holders. And as new management seasons with Valeant's assets, employees, and stakeholders, the credibility of the company will be restored, and its share price will begin to recover. We don't know the final outcome of this investment yet, but through March 31st, Valeant's troubles have resulted in mark-to-market losses ranging anywhere from 5% to 20% of your *original* invested capital (depending on when you invested with us).

Valeant is a fraction of its former self in our portfolios today. What was until recently a $90 billion company with aspirations of becoming one of the largest pharmaceutical companies in the world is now an $11 billon dollar equity stub. With excess cash flow that could potentially reach 30% - 40% of today's equity valuation, our position in Valeant is effectively a call option on the company's solvency with no expiration date.

Going forward

The list of valuable lessons we've taken away from our experience with Valeant is long. We misjudged someone, and that mistake introduced a number of psychological biases we failed to guard against. In light of business durability that proved to be more fragile than the company led on, it's clear we erred in letting Valeant grow to such a large portion of our portfolios. Adding to the position when the entire pharmaceutical ecosystem was coming under siege bordered on stupidity. Going forward, you can expect to see us redouble our focus on quality. You can also expect to see a more crotchety, skeptical, pair of analysts guarding your capital from management teams, and the human biases we all carry.

Important Disclaimers

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Ironvine Capital Partners claims compliance with the Global Investment Performance Standards (GIPS®). To receive a description of Ironvine Capital Partners' composite and a presentation that adheres to the GIPS standards, please contact Ryan Mendlik, rmendlik@ironvinecapital.com, 402.715.5224, or write Ironvine Capital Partners; 9290 W. Dodge Rd, Ste 203; Omaha, NE 68114.

The Ironvine Composite *includes all accounts over which Ironvine deems to have discretion and that follow the composite strategy. Ironvine seeks to earn above average returns by investing primarily in a concentrated portfolio of global issuers in all facets of capital structures, including but not limited to common and preferred stocks, debt instruments, & convertible securities.*

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