



## Second Quarter 2020 Investor Letter

August 6, 2020

Dear Investor:

During the Second Quarter, Third Point returned 10.8% in the Offshore Fund. Following further gains last month, we have substantially reduced losses incurred during the First Quarter, bringing year-to-date losses for the Offshore Fund to -3.7% through July 31. Returns for the Second Quarter were divided nearly equally between equity and credit.

|                                 | Q2*   | YTD   | ANNUALIZED RETURN† |
|---------------------------------|-------|-------|--------------------|
| THIRD POINT OFFSHORE FUND, LTD. | 10.8% | -7.2% | 13.8%              |
| CS HF EVENT-DRIVEN INDEX        | 9.8%  | -7.6% | 6.4%               |
| S&P 500 INDEX (TR)              | 20.5% | -3.1% | 8.2%               |
| MSCI WORLD INDEX (TR)           | 19.6% | -5.5% | 6.7%               |

\*Through June 30, 2020.

† Annualized Return from inception December 1996 for TP Offshore and quoted indices.

Third Point's successful shift to working from home during the COVID-19 pandemic was a testament to our robust technological infrastructure and the team's grit in adapting to this new model. However, we never lose sight of the fact that while some parts of the economy have managed to survive and even thrive over the past few months, the loss of life and livelihoods for some is incalculable. Events of this year have laid bare many inequities in our society. As we have for many years, we will fight for educational opportunity, work diligently to repair our broken criminal justice system, and encourage our employees to find ways to make meaningful differences in their communities. As we discuss the investment environment below, we never forget the human suffering underlying the economic declines and market disruption.

On June 1, Third Point marked 25 years since its founding. I am grateful to our investors and my team, who have been instrumental in achieving this milestone. Third Point's longevity and growth have been underpinned by a strict adherence to our core values and an ethos of embracing change and evolution. These values include integrity, collaboration, transparency, and constant personal and organizational improvement, or *kaizen*. While our values are evergreen, our investment style is characterized by flexibility in shifting market conditions. Over the years, we have demonstrated this approach by moving assets between equity and credit as the opportunity set dictates, including by adding structured credit – which quickly became a core strategy – over a decade ago.

I believe the Second Quarter was one of many important inflection points over the past 25 years. My disappointment with some elements of recent performance led me to adjust certain parts of our strategy and investment process. One step was to take full control over the portfolio and resume my role as sole CIO. Another was to drive ideas to the team that better reflect the current environment of disruption and dramatic dispersion between winners and losers. These changes to the organization and our process are having the impact I desired: significantly increasing the volume and quality of actionable ideas and thereby creating a more dynamic and diversified portfolio with improved performance.

In 2010, I remember sharing with investors at our annual event the quotation attributed to John Maynard Keynes: “When the facts change, I change my mind. What do you do, sir?” Categories are important and central to how our minds make sense of a complex world by structuring and holding disparate information in our brains. Third Point was founded originally as an “event-driven, value-oriented” strategy<sup>1</sup> that specialized in both credit and special situations such as spin-offs, demutualizations, and post-reorg equities. Over time, we developed the additional skill of creating our own events through activism. By structuring our funnel of ideas around these categories, we could easily prioritize our research process toward companies that were undergoing or could be catalyzed into making some sort of financial or operational “event”. As markets have changed, I have realized that while event-

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<sup>1</sup> To this day, the best book on this topic is [You Can Be a Stock Market Genius](#) by Joel Greenblatt.

driven is still an essential investment lens (clearly, as our two largest investments, Pacific Gas & Electric and Prudential plc, are both event-driven situations that together comprise nearly 20% of our exposure), today, *quality*<sup>2</sup> is also an essential screen.

This investment environment is characterized by breakneck technological innovation and sluggish growth which has only been amplified by COVID-19. Considering this, it is essential to find companies with great leadership and unique products in growing end-markets in which they are gaining share and achieving high topline growth and strong margins. These factors drive robust earnings and free cash flow growth supported by high returns on existing invested capital. However, when investing in a quality or “compounder” company, it is critical to find an entry point at which an investment is attractive since most of these businesses trade at relatively high multiples.

Interestingly, our most successful activist investments have been in companies that embody these very characteristics, where we were able to find appealing entry points when companies were changing positively in measure of quality. Our investments in Baxter and Nestlé were made at transition points in margin, ROIC and earnings growth. Our investment in Yahoo! was also driven primarily by our interest in buying a high-quality business, Alibaba, in which Yahoo! held a substantial stake at an extremely attractive price.

Investing in “quality” companies or “compounders” is not a new endeavor for us but a long-time category. Some of our most successful investments that have doubled or tripled during the lengthy periods of our ownership including S&P Global, Visa, Danaher, Adobe, Salesforce and Sherwin Williams can rightly be described as such. To be clear, investing in compounders and event-driven situations are not mutually exclusive activities. It has been our experience that our event-driven focus provides us with a unique window into the creation or evolution of a quality company, since they are often born out of corporate events or management changes. As we discuss in the equity section below, recent market dislocations have created several unique opportunities for us to acquire more of these kinds

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<sup>2</sup> For an excellent overview of quality and compounding, see [Quality Investing: Owning the Best Companies for the Long Term](#) by Cunningham et al.

of companies at bargain prices. We anticipate selectively adding to this long-term portfolio when opportunities present themselves.

### **Equities**

In Q2, the equity book returned ~9% on average net exposure of ~56%, with a 15% return in long equities offset by losses from short positions. Equities made up 5.4% of the firm's 11.4% gain.

Driving the equity portfolio's gains were a series of well-timed entries into new positions since the market bottom including in Alibaba and JD.com, Amazon, and Disney, as well as by bounce backs in several core positions including S&P Global and Prudential plc. During the quarter, we also initiated an equity position in Pacific Gas & Electric through a PIPE transaction. We discuss these investments below.

#### *Alibaba & JD.com*

During the quarter, we took advantage of jitters about China's relationships with Hong Kong and the U.S. that created an air pocket in trading of Chinese-related shares to establish new positions in e-commerce leaders Alibaba and JD.com. As we have articulated in prior letters<sup>3</sup>, our outlook for Alibaba and the broader Chinese e-commerce market is bright. We believe online gross merchandise value ("GMV") will grow at a mid-teens CAGR over the next five years, propelled by both (1) rising consumption per capita, as the Chinese retail market is equal in size to the U.S. despite four times as many consumers, and (2) increased penetration of retail by online, a trend which we believe has been structurally accelerated by the COVID-19 pandemic.

As the e-commerce market matures, we believe Alibaba & JD will leverage scale and growing repositories of transaction data to increase monetization of their platforms through targeted advertising to improve revenue yields (revenues as a percentage of GMV) from a starting point of less than 4% today. As a point of comparison, brick-and-mortar retail store rent

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<sup>3</sup> See Q4 2011 & Q2 2017 investor letters.

expenses in China are greater than 10% of sales on average, which provides a significant umbrella for online marketplaces to take a greater share of GMV through a combination of commission and advertising spending as online retailer cost structures converge with brick-and-mortar retail.

Finally, we continue to be excited about the latent potential in some of Alibaba's businesses beyond the core e-commerce marketplaces – particularly the cloud computing business, Aliyun. China's cloud computing industry remains nascent but is growing nearly 3x faster than its developed market counterparts through a combination of rising IT intensity, rapid cloud penetration, and a gradual moderation in software piracy. Within that market, Aliyun is increasingly dominant (with nearly 50% market share) and will generate dramatic profit growth as margins expand with scale. As one reference point, Aliyun today resembles Amazon's AWS business five years ago; this is an encouraging comparison given that today, AWS' operating profits (and estimated enterprise value) exceed Alibaba's business in its entirety. Ant Financial – in which Alibaba holds a ~30% stake that is worth roughly \$70 billion – has announced its intention to go public later this year. Alibaba shares will benefit further should they become accessible to mainland Chinese investors through inclusion in the Southbound Connect.

### *Amazon*

Historically, Amazon was a company we admired that traded outside our valuation range. In March, we initiated a 5% position and although shares were flat on the year, we believed they were significantly undervalued due to the acceleration of the adoption of e-commerce and cloud computing in the pandemic. We saw that e-commerce penetration as a percent of total retail sales had nearly doubled and that Amazon was fully participating in that growth. Even as shopping patterns normalize, we believe that e-commerce penetration has structurally ratcheted up and that Amazon's share gains will be sticky. The COVID-19 pandemic is also helping to accelerate the adoption of Amazon's cloud computing services because they are a critical enabler of remote work, a trend that will similarly outlast the virus.

Amazon possesses all the key characteristics of a great “compounder”, including one of the highest cash returns on capital invested (“CROCI”). Shares are up significantly since March, but our attractive entry price enables us to continue to benefit from the company’s compounding of value as the twin engines of e-commerce and cloud computing are expected to drive strong growth well into the future.

### *Disney*

During Q2, we initiated a long position in The Walt Disney Company when shares traded down on fears that closures of theme parks and movie theaters due to the coronavirus pandemic would cripple the company. A slew of sell-side analysts had recently downgraded the stock but we believed they failed to grasp that the pandemic also provided Disney with an important opportunity – to accelerate a plan to bring its blockbuster content directly to the consumer via streaming, which will further elevate Disney’s position as the world’s pre-eminent media company. Streaming is Disney’s biggest market opportunity ever with potentially \$500 billion of revenue spread across over a growing market of 750 million current broadband homes globally ex-China, dwarfing the size of Disney’s current addressable markets (roughly \$100 billion between global box offices and theme parks). Disney’s dominant position in the global media landscape sets up the company to take a meaningful chunk of the growing DTC streaming market, shown by the early success of Disney+. In less than nine months, Disney+ attained 60 million global subscribers, a milestone that took Netflix over seven years to meet.

On August 4<sup>th</sup>, Bob Chapek addressed the market after his first full quarter as Disney’s CEO. We were pleased that he views DTC as Disney’s “top priority” and believe his decision to premiere a tentpole film like *Mulan* through Disney+ is a defining moment. We encourage Disney to continue leveraging its new digital platforms to further connect fans with their iconic content and brands and, as Mr. Chapek said, “take full advantage of the opportunity” available to Disney today.

### *Pacific Gas and Electric PIPE*

Third Point's involvement in PG&E began in late 2018, when the Company's bonds traded to distressed levels following the tragic Camp Fire. The Company's bankruptcy filing was prompted by the need to access liquidity and settle outstanding wildfire claims in an organized manner. We believed PG&E's core business remained in a strong position reflecting a classic "good business/bad capital structure" restructuring and made it the firm's largest distressed position. By early 2020, the company reached an agreement to restructure the business and as part of that exit plan, the company needed to raise approximately \$26 billion in new capital including \$9 billion in new common equity. The exit financing was used to settle insurance and victims' claims relating to the 2017 and 2018 wildfires, repay some pre-and post-petition creditors, and contribute to the new Wildfire Fund.

Third Point participated in the common equity offering as a cornerstone PIPE investor. PG&E is the 6<sup>th</sup> largest U.S. utility by rate-base and has no unregulated exposure. The bankruptcy addressed the company's outstanding legacy liabilities and repositioned the balance sheet for investment and growth. PG&E's fundamentals position it at the high end of the utility industry, with equity rate base growth of approximately 8% and EPS growth of 8-12% driven by strong investments in infrastructure to serve customers safely and reliably while also reducing the company's carbon footprint and providing customers with energy choice. Yet PG&E's valuation is a fraction of its peers: it trades at under 8x 2022 earnings versus the regulated utility peer set at 18x. The shares have traded poorly (down ~5%) since exiting bankruptcy due primarily to technical factors that are extremely common in these situations. We expect this sharp discount to diminish as the company goes through the normal process of finding an institutional shareholder base, as well as hires a permanent CEO and continues to address prior operational deficiencies.

Alternatively, some attribute the extreme discount to peers to potential wildfire risk but the regulatory regime has substantially changed since PG&E filed for bankruptcy. In addition to restructuring the balance sheet and addressing past liabilities, emergence from bankruptcy allows PG&E to fully access the elements of the enhanced wildfire-related regulatory

framework under AB1054. The largest component of this is the new Wildfire Fund, which provides all investor-owned utilities in California an insurance policy to address future catastrophic wildfire claims in a timely fashion. Funded to withstand 10+ years of potential wildfire liabilities, the Wildfire Fund provides a three-year rolling cap on shareholder liability estimated by PG&E at around \$2.4 billion, which only applies if the utility fails to act prudently.

Most important, however, is PG&E's focused commitment to an investment in wildfire safety. The company is spending approximately \$3 billion per year to reduce wildfire risk through system hardening, vegetation management, and enhanced inspections. The company has also invested in weather stations and cameras to spot potential fires early and sectionalized the grid to reduce customer disruptions caused by the Public Safety Power Shutoff process. In addition, the company has started to adopt state-of-the-art technology such as drones provided by Third Point Ventures' portfolio company PrecisionHawk and is partnering with Palantir to use AI for further risk mitigation and network efficiency. On a positive green note, the company also recently announced a partnership with Tesla to build a lithium-ion battery storage system. These investments and PG&E's commitment to ESG best practices should reduce environmental risk over time, while the Wildfire Fund should protect the state's investor-owned utilities who act responsibly on climate change.

#### *Prudential plc Update*

Prudential plc stock performed well in the Second Quarter, gaining 18% as concerns over Prudential's U.S. business, Jackson National, waned and management proved the efficacy of Jackson's robust hedging program. However, the volatility in the shares over the past few months has confirmed our view that accurate price discovery by the market will prove elusive unless Jackson National is held in a separate corporate entity from Pru Asia.

We were pleased by the Board's recent announcement of a combined equity investment and reinsurance transaction between Jackson and Athene, a leading annuities company affiliated with Apollo Global Management. Athene will reinsure Jackson's \$28 billion fixed and fixed indexed annuities portfolio, as well as make a \$500 million anchor equity investment in



Jackson in exchange for an 11.1% economic stake. We believe that this transaction is an important step towards full separation of Jackson and Pru Asia. It increases capital levels at Jackson to be more in-line with standalone publicly traded peers, a critical consideration for regulators and ratings agencies when evaluating an independent U.S. business. It also puts a floor valuation mark on Jackson equity from a respected market player ahead of a standalone listing.

We continue to advocate for expeditious action in our constructive dialogue with management and the Board. We are confident that an independent Jackson can unlock significant value by closing the still-large complexity discount in the stock. When Prudential's fast-growing Asia business becomes a pure-play, investors will better appreciate this high-quality business, leading to significant multiple expansion. We look forward to an update on the company's restructuring plans on its August 11 earnings call.

#### *S&P Global Update*

Another winner in the quarter was S&P Global, an investment we initiated four years ago. The company looks forward to decades of growth supported by increasing global debt issuance, data consumption, and the shift from active to passive investing. Over the past few years, we have watched the market react to multiple debt issuance pullbacks including the oil price shock in 2014, the Brexit panic, China slowdown fears, and, most recently, the COVID-19 crisis and, in each case, these dislocations have all proven fleeting and credit markets have come roaring back. This proved true once again in Q2 2020 with record setting issuance across U.S. investment grade and high yield as well as European investment grade, resulting in S&P Global stock rising +35% in the quarter. We believe that cheaper access to liquidity with near-zero interest rates, a growing refinancing wall in non-investment grade credit, and nascent huge opportunities in China will continue to drive demand for S&P Global's essential services. Management's stewardship remains excellent, with a focus on cost control, prudent reinvestment, and capital allocation. These elements strengthen our view that S&P Global is a highly defensive, long-term compounder.

## **Credit**

In Q2, Corporate Credit returned ~16.4% on average exposure and Structured Credit returned ~8.6%. Corporate Credit returns were driven by timely purchases of high-grade bonds near market lows including in Boeing, Kraft, and Ford. On the non-performing side, our investment in Pacific Gas & Electric (which we added to near market lows) was also a material contributor, adding 90 bps to fund performance. In Q2, we took profits on some of the investments we made late in Q1 as High-Yield and Investment-Grade spreads tightened considerably and we reduced exposure to corporate credit from roughly 23% to 17% of Offshore NAV. I give extra praise to our credit team, who have spent their careers investing in distressed and high yield bonds, for decisively seizing the brief opportunity that we saw in investment grade debt. We expect additional opportunities in credit as the current economic situation disproportionately affects certain industries, offering opportunities for us to facilitate financing and restructurings and allowing companies to make it through this difficult period.

In Structured Credit, many of the investments we made during the panic and forced selling we saw in March appreciated in value during Q2. We are constructive on residential mortgages and consumer assets as interest deferral and forbearance plans are starting to work. Over the coming quarters, we believe opportunities in structured credit will emerge alongside deteriorating fundamentals in commercial real estate and corporate credit. From March through May, we saw a significant dislocation in the secondary markets with new issue securitizations largely on hold. In June, well before TALF was officially launched, the bid for senior portions of the capital structure increased dramatically. We have remained flexible during this period, alternating between investing in securities and loans when a strong funding opportunity presents itself. We are bearish on commercial real estate financials given a confluence of concerns around occupancy and cash flows (e.g. lower rents, required capex, excess capacity, pricing power) potentially impacting asset values. After the forbearance period, we are closely watching potential re-defaults and liquidity options for many of these properties.

## **Outlook and Updates**

To say that markets have climbed a massive wall of worry since they bottomed on March 23<sup>rd</sup> is an understatement. There is still plenty to be worried about between a pandemic that seems to have re-accelerated around the world; diminished prospects for normal school openings in the fall; whole swaths of the economy, especially SMB's, decimated by the economic fall-out; a highly volatile November election looming, with many unknown and market-moving outcomes; and continued tensions with China. The market's recovery has been more fragile than it appears, led by a few pandemic "winners" urged on by Fed policy, which flooded the market with capital and led to historically low interest rates, ongoing fiscal stimulus, and expectations of a vaccine by year-end.

As challenging as things seem today, we have spent significant time with scientific experts to better understand evolving treatments and vaccines and have confidence that several will be effective and available later this year, which should lead to the next phase of market recovery in coronavirus-affected companies. Our equity portfolio is balanced between companies that are doing well now, and later stage recovery names in aerospace, entertainment, and retail which are still trading near their March lows and should benefit when there is a move back into these sectors. Our net exposures reflect not so much a rosy market outlook as an abundance of new ideas that we believe will prosper in our current scenario analyses. But, like Keynes and consistent with our last 25 years in business, we always reserve the right to change our mind as new information presents itself.

## **Business Updates**

I am pleased to announce that Scott Leslie, who will continue in his roles as energy analyst and coordinator of our activist efforts, has also agreed to assist me as Director of Equity Research. In this role, he will also help with talent recruitment and development, drawing on his decade plus of experience working with all teams across the firm.

Jessica Pellegrini joined Third Point in June as a Managing Director of Investor Relations and Marketing. She graduated from Harvard University with a B.A. in Sociology. She was previously Head of Marketing and Investor Relations at Engle Capital, an \$800 million

long/short equity hedge fund and a Vice President in the Prime Services Division at Barclays. Through her previous roles, she is familiar with many of our investors and will soon connect with those of you she has not yet met during over a decade spent in the hedge fund industry.

Please contact Investor Relations at [ir@thirdpoint.com](mailto:ir@thirdpoint.com) or at 212.715.6707 with questions.

Sincerely,



**Daniel S. Loeb**

**CEO & CIO**

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