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3-SIGMA VALUE

Q3 2018 In Review

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For the quarter ended September 30, 2018, 3-Sigma Value, LP (the "Partnership") had an estimated loss of 20.3% with average gross exposure of 169.2% and net exposure of positive 12.9%. Given the stock market's sharp correction in October and 3-Sigma Value's stated goal to provide protection in a down market, we believe it is important to report October's return of +14.4%. Year-to-date through October 31, 2018, the Partnership is down 2.0%.

	Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18	YTD
Gross Return	6.3%	10.1%	1.1%	-6.5%	1.6%	-5.7%	-5.0%	-12.5%	-2.8%	14.4%	-2.0%
Long Attribution	3.4%	-3.1%	-1.0%	-3.2%	0.7%	0.7%	-4.9%	-1.3%	0.2%	-1.0%	-9.3%
Short Attribution	3.0%	13.2%	2.0%	-3.3%	0.8%	-6.3%	-0.1%	-11.2%	-2.9%	15.6%	8.2%
Long Exposure	81.3%	70.9%	71.9%	82.3%	91.2%	93.9%	90.0%	90.2%	92.8%	90.8%	85.5%
Short Exposure	94.4%	88.5%	86.8%	82.5%	79.2%	80.7%	80.5%	78.4%	75.5%	70.1%	81.7%
Gross Exposure	175.8%	159.4%	158.7%	164.8%	170.4%	174.6%	170.5%	168.6%	168.3%	160.9%	167.2%
Net Exposure	-13.1%	-17.6%	-15.0%	-0.2%	12.1%	13.2%	9.5%	11.9%	17.2%	20.7%	3.9%
# of Longs	18	17	16	18	18	18	18	18	18	19	
# of Shorts	18	17	18	20	20	20	20	25	18	19	

In total, 3-Sigma Value, LP is invested long 19 companies, and short 19 companies. Our investment approach is global in scope, yet, at this time, North American equities constitute the vast majority of our gross exposure.

As long-short investors focused on delivering positive returns on your investment regardless of market conditions, we are heavily focused on managing the portfolio's correlation to the overall equity markets (or "beta"). In fact, we are more concerned with correlation than volatility because volatility is the natural result of any deep-value investment strategy, and therefore we accept a certain level of shorter-term volatility that is only "risky" to emotionally driven or illiquid market participants when it guides their buy/sell decision-making.

Managing the beta of a value-driven equity portfolio, in any market climate, is an inherently tricky undertaking. Much like the disclosure maxim that "past performance is no guarantee of future results", the historical correlation of portfolio returns with market returns is only valid to the extent future performance and perception of risk remains consistent with the recent past.

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As value investors frequently targeting companies facing rapidly changing operating performance and/or market perceptions, this continuity between the past and future is tenuous at best. Notwithstanding the caveat, we generally seek overall market agnosticism in the construction of the portfolio as reflected in a target range of net exposure between negative 25% and positive 25%.

Because our efforts are focused on identifying and exploiting a very scarce set of truly egregious valuation discrepancies rather than a broader set of more common (and muted) ones, we believe it inherently produces weaker long-term market correlation for two reasons. First, the "correction" of such mispricing upon catalyzing events generally occurs irrespectively of the strength of the market – i.e. a company that is 50% or more undervalued will not remain so even in a weak market. And second, the downside protection we demand in the context of our risk/reward criteria is generally provided in the form of either strong asset coverage, durable earnings power or both. Conversely, the positions in our short book, many of them targeting industries facing weak macro fundamentals, tend toward higher market correlation than those in our long book.

With performance bouncing back in October (up 14.4%), we view the 20% drawdown in Q3 as a normal function of volatility in a concentrated portfolio. As value investors driven by industry and company fundamentals, we consider risk to be the probability that portfolio investments fail to deliver anticipated returns over our investment horizon (generally 1-3 years). We are not active traders but long-term investors; however, a significant share of our alpha generation derives precisely from being able to exploit this short-term volatility through trading around our long-term holdings.

When analyzing a drawdown, we split it into two parts – (1) permanent loss of capital, and (2) volatility. Permanent loss of capital represents the final accounting of a mistake. In contrast, volatility is not a final anything. Volatility is not the end, but a means, the means to a higher level of profitability. Volatility presents more opportunity than it represents risk. The financial industry's obsession with reducing volatility and conflating it with risk is the single biggest factor underlying the rise of passive investing and questions about the viability of active investing. In general, most fund managers under-perform the S&P 500 and always have. Yet, I know plenty of successful active managers with superior long-term track records.

What if I can show you a fund that has generated a 10% annual return over the past 12 years with a zero% beta (a.k.a. zero correlation to the market). The best year was +30% (2011), the worst

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year was -15% (2008) – representing 2-to-1 reward versus risk. Furthermore, this fund is invested in liquid securities that are marked-to-market daily.

Sounds like a great addition to a diversified investment portfolio, no?

The problem is that in today's marketplace there is an obsession with volatility, a fear based on the false premise that volatility equals risk. Thus, the fund with the 10% annual return and zero% correlation is no longer an attractive investment vehicle because it has a monthly standard deviation of 5%, which according to conventional wisdom is high.

If risk was instead defined more appropriately as the probability of permanent capital loss – a truer measure over the long-term than the statistical meaningless of monthly volatility – then investor focus would shift to what is clearly most important when managing money, that is the long-term preservation of capital.

When I am asked about 3-Sigma Value's goals or purpose, the answer is always first and foremost to preserve capital. The answer is not to reduce volatility. If so, I would have chosen to study under the tutelage of Ralph Cioffi and the Bear Stearns High Grade Structured Credit team, or if I had been truly obsessed with eliminating volatility then maybe I would have ended up at Bernard L. Madoff Investment Securities.

Fortunately, I ended up learning how to invest from an old-school value investor who measured wealth creation in terms of decades not quarters. My father Milton Weinger was a stock broker at Oppenheimer for over 30 years, and more importantly a proponent of facing reality. In terms of risk management, he said it is harder to sell then it is to buy, and therefore you have to close positions faster than you open them, as soon as you realize you've made a mistake.

During Q3, I realized two mistakes – being long Criteo (CRTO) and short Atlassian (TEAM) – both featured in 3-Sigma Value's 2017 Review / 2018 Outlook[1]. In addition, the top detractors to performance in the third quarter of 2018 were primarily on the short side; they were Carvana (CVNA), Credit Acceptance (CACC), Gogo (GOGO), and the portfolio of cannabis shorts as described in our Q2 2018 letter. On the long side, Shutterfly (SFLY) and Scientific Games (SGMS) were significant detractors.

[1] Available at www.3sigmavalue.com.

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Scientific Games (SGMS)

In a classic case of "buy the rumor sell the news", ever since the Supreme Court struck down the ban on U.S. sports betting in May 2018, SGMS has dropped for no fundamental reason from $60 to $20. Meanwhile, SGMS is the best positioned company to win in sports betting in the U.S. after making the key acquisition of NYX Gaming Group (the OpenBet platform). Intense competition for the end customer is likely to be won by big brand names like the Tier 1 casinos. Differentiation and value add derive from technology. Outside of U.S. sports betting, new sources of demand for gaming equipment include Brazil lottery privatization and casino legalization, and Japan legalizations. In terms of valuation, SGMS has a market cap of $2.0 billion and $8.5 billion of net debt (no significant maturities until 2022) for an enterprise value of $10.5 billion. 2018 EBITDA ~$1.34 billion = 7.8x. However, SGMS should generate ~$1.9 billion of FCF over the next three years (Base Case operating scenario), which lowers net debt to $6.5 billion. At the same time, EBITDA should grow to ~$1.6 billion (net debt-to-EBITDA of 4.2x by 2021).

In terms of credit risk, we find a material disconnect between the stock market's perception of risk and actual credit risk. The key debt covenant is a net first lien leverage test, which stepped down from 6.0x to 5.5x on 6/30/18 and will step down again to 5.0x on 6/30/19. Meanwhile, with $4.3 billion of Senior Secured Credit Facilities due 2024, actual net first lien leverage is only 3.1x.

SGMS is worth 10x EBITDA. While M&A deals in the gaming equipment sector often price higher than 10x, the best comp is Gtech's 2014 acquisition of International Game Technology (IGT) for $6.5 billion enterprise value (including the assumption of $1.7 billion debt), equal to 9.8x LTM EBITDA. Gtech renamed itself IGT.

Scientific Games (SGMS) Summary Valuation			
Price at 10/31/18			$22.26
Shares Out			91
Market Cap			2,035
Debt @ 9/30/18			8,782
Cash @ 9/30/18			114
Equity Investments @ 9/30/18			206
Enterprise Value			10,497
	Upside	Base	Downside
Revenue - 2021	3,768	4,104	4,459
EBITDA - 2021	1,784	1,621	1,470
Worth 8x - 10x	10.0x	9.0x	8.0x
PV of Terminal Value	14,838	12,138	9,781
3 yrs of FCF (2019-2021)	2,289	1,962	1,652
Pro Forma Net Debt	6,173	6,500	6,811
Pro Forma Equity Value	8,665	5,637	2,970
Target Price	**94.80**	**61.68**	**32.50**
% Upside (Downside)	**326%**	**177%**	**46%**

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Shutterfly (SFLY)

In January 2018, Shutterfly, the leading online retailer of personalized photo-based products, acquired Lifetouch, the leader in school photography, for $825 million, equal to 8.25x NTM EBITDA of $100 million ($935 million revenue). Both companies are vertically-integrated (cost synergies). Lifetouch reaches 10 million households and adds a million kindergarten households each year. Cross-selling personalized photo-products during important milestones of these school children is a fresh opportunity that will add substantially to Shutterfly's active base of 10 million customers. In sum, Lifetouch lowers Shutterfly's customer acquisition costs (revenue synergies). $1.2 billion of SFLY revenue ($1 billion consumer + $200 million business) plus $935 million of Lifetouch revenue = $2.1 billion of pro forma revenue. EBITDA margin will also expand, from ~20% to ~25%, as a result of identified cost savings on top of the revenue opportunity.

Since peaking at $100 per share in the wake of the Lifetouch acquisition, SFLY has cleaved in half to $50. While blame is assigned to weakness in the consumer business, management did not change its guidance and the stock reaction appears overblown. Based on comparable ecommerce M&A comps, SFLY is on sale at 5.8x 2020 EBITDA.

Shutterfly (SFLY) Summary Valuation	
Baseline 2018 Adjusted EBITDA:	
Shutterfly	270
Lifetouch	100
Total	370
Baseline Growth in 2019 and 2020	5.0%
Incremental Baseline EBITDA	38
Revenue and Cost Synergies	50
2020 Adjusted EBITDA	458
Worth 10x	10.0x
Enterprise Value	4,579
Debt @ 9/30/18	1,106
Cash @ 9/30/18	205
Equity Value	3,678
FD Shares Out	35
Target Price	**105.07**
Price at October 31, 2018	**50.00**
% Upside (Downside)	**110%**

Please contact me with any comments or questions.

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