THE NELSON EXCLUSIVE

Confidential

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Letter to Members: How Buffett Felt in 1999

How things have changed since we penned the inaugural letter to readers in the Nelson Exclusive July 2016.

At that time, market conditions looked bleak for incremental money. Valuations across the US stock market were stretched, concerns were running rampant in Europe thanks in part to Brexit uncertainty, and interest rates were hovering near all-time lows. Consumer staples equities, the most stable variety of business models, had been trading at nosebleed levels, with many fetching multiples north of 20 times forward earnings, and cyclicals were garnering peak multiples on peak earnings, the latter a classic sign of bubble-like tendencies in any market. The investment-decision landscape was as complicated as it has ever been for all types of investors. I said at the time that the next few years would be among the most difficult witnessed since the Great Recession.

Fast-forward six months, and things are now even more difficult. News of Donald Trump's election victory has sent stock investors on a buying binge, scooping up almost everything across the board, perhaps on hopes that "this time will be different." The financials sector has led the charge during the past few months thanks in part to a steepening yield curve and a 10-year Treasury that has rallied to 2.6% by mid-December (now leveling off at ~2.4%). By market participants' own euphoria, the global financial system is now on sturdier ground and, thanks to ongoing chatter by OPEC and improved discipline from shale-oil producers, crude oil prices have finally found some relief. Consumers are grumbling again about how high gas prices are at the pump.

These are not normal times, my friends.

The forward price-to-earnings ratio for companies in the S&P 500 is 17.1 times, above its 5-year average of 15.1 times and 10-year average of 14.4 times. Notably, the 5-year and 10-year average multiples had a foundation of earnings that were much lower than today's levels. Almost seemingly with little care to intrinsic value estimation, corporations are buying back their own stock hand over fist. Perhaps they themselves are the ones driving most of the pricing advance? Dividend growth investors and indexers, two strategies in vogue today, are not selling, helping to create the classic self-perpetuating condition of "more buyers than sellers." At no time in history has indexing been a more popular strategy. The top investment banks are even aware of the ominous situation, but they still say, "buy, buy, buy." From Goldman:

> "[N]ow we have crossed into the 10th decile of valuations: US equities have been more expensive than current levels only 10% of the time in the post-WWII period...Yet we continue to recommend staying the course. We are duly aware that this recommendation is long in the tooth, particularly given such high valuations and the unusually high level of policy uncertainty." (Source: Goldman Sachs, "Outlook," January 2017)

According to FactSet, analysts are expecting earnings-per-share on the S&P 500 of $132.92 for 2017, a huge leap from the near-$119 per share mark in calendar year 2016, amounting to the biggest per-share step change in earnings since the very beginning of the recovery from the Financial Crisis (2009 → 2010). We're skeptical. Donald

Trump's plans to modify the tax code could be the biggest reason for this, with shrinking share counts as a result of corporate buybacks helping, but it's hard to stake one's long-term capital on a permanent reduction in the tax code, which may or may not come to fruition. Even if normalized earnings are reset higher to, let's say, $140 per share (well north of expected 2017 levels), a 15 times forward earnings multiple on that number equates to 2,100 on the S&P 500. The S&P 500 closed at about 2,277 on Friday, January 6, 2017. The risk-reward situation will remain a perilous one in the next few years, in my view. I feel a little like Warren Buffett in 1999.

But despite the market's advance since the release of the inaugural Nelson Exclusive edition, I have been downright impressed by our hit rate for short idea considerations, with 5 of the first 6 highlighted in this very publication working out, from highlight price to announced closing price. We've now closed Seritage Growth Properties (SRG). Even though we still believe shares are trading on euphoric expectations and its ties with Sears Holdings (SHLD) present more risks than opportunities, dividends and timing will start to work against this position. The "win" follows Lands' End (LE), Vivint Solar (VSLR), Lloyds Banking (LYG), and GoPro (GPRO) in a line-up of short idea considerations that have worked out in a strongly-advancing market. That's really saying something. We hope that we can continue this streak, though Royal Bank of Scotland (RBS), the December short consideration, has rallied against us out of the gate thus far.

Overall, 11 out of 18 ideas have worked out thus far (generated positive performance), a 60%+ record and one that I believe is quite appealing for any long-short investor. I'm very proud of the performance overall. However, going 6 for 12 out of the gates with long-only ideas in an up market isn't as impressive. Certainly, income ideas in the Nelson Exclusive have been raising their payouts quite nicely, which is why they have been highlighted, and a number of capital appreciation ideas have done well, but I want to keep getting better. It's still very early, of course, and a strengthening US dollar has worked against our non-US ideas, but you are our best customer, and I want you to have the best. We release 36 new ideas for consideration in each yearly edition of the Nelson Exclusive, and after the January release, we'll be a little past halfway for this year. We won't know just how good our picks have been until many years in the future, consistent with their respective time horizons.

Just a quick note: as outlined in our goals set forth when we launched the Nelson Exclusive publication, we will continue to highlight ideas that fall outside our expansive coverage universe, as each have been thus far. I had sent out a survey a number of weeks ago inquiring whether we should consider bringing companies we cover into this publication, but I have decided against it. The Nelson Exclusive will remain purely incremental, and its ideas will fall outside the vast coverage of ideas currently available at www.valuentum.com, as marketed. It makes things more challenging, but I'm up for it, and I'm set on delivering what you ordered. If you have any questions, comments, concerns, or ways that we can continue to make the Nelson Exclusive the best it can be, please email me at brian@valuentum.com.

Thank you,

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Highlight Date	Company (symbol)	Highlight Price	Current or Close Price	Div's Received	Realized Gain	Realized Annualized Gain	Time Horizon	Notes
Income Ideas								
Jul, 16	Universal Corp (UVV)	57.74	64.10	1.60	-	-	0-30 yrs	Announced 46th consecutive yearly dividend increase November 8. Stock still rallying.
Aug, 16	B&G Foods (BGS)	51.54	43.50	0.885	-	-	0-2 yrs	Raised its dividend November 4 by ~11%, to $1.86 per common. Very disappointed in performance as of late.
Sep, 16	Maxim Integrated (MXIM)	41.12	39.74	0.33	-	-	0-10 yrs	Solid net cash position, strong free cash flow -- ~3.5% yield. Weighed down by general tech malaise.
Oct, 16	Douglas Dynamics (PLOW)	31.94	32.85	0.235	-	-	0-20 yrs	Insider buying. Stock has rallied back after Q3 results, but could do better. Yield of ~3%.
Nov, 16	Ennis Inc. (EBF)	14.60	16.30	NA	11.6%	605.5%	Closed -- 11/12/2016	Captured more than 2 years' worth of income via capital appreciation in one week. Not being greedy.
Dec, 16	Watsco, Inc. (WSO)	150.57	147.83	-	-	-	0-20 yrs	Investors assessing impact on demand from HVAC price hikes at key customer Carrier (UTX).
Capital Appreciation Ideas								
Jul, 16	Bloomin Brands (BLMN)	17.87	19.28	0.07	8.3%	22.6%	Closed -- 11/12/2016	Taking what the market gives us. May re-open idea again. We still believe in long term. Stock very cheap.
Aug, 16	Healthcare Srvs Group (HCSG)	38.91	38.83	0.369	-	-	0-20 yrs	Nice streak of consecutive quarterly dividend increases. Very strong end market -- about even on idea.
Sep, 16	Grupo Aeroportuario (ASR)	157.87	142.13	-	-	-	0-20 yrs	The strength in the US dollar is hurting. We still love the long-term picture though. Travel to Cancún not going away.
Oct, 16	Swedish Match (SWMA.ST)	314.80SEK	292.00SEK	-	-	-	0-20 yrs	Tobacco (snus) demand is about as resilient as it gets through the economic cycle. Currency is hurting shares.
Nov, 16	Symrise AG (SYIEY)	16.25	14.97	-	-	-	0-20 yrs	EBITDA margins don't get much steadier than Symrise's (18-22% from 2006-2015). Down in sympathy with peers.
Dec, 16	Tootsie Roll (TR)	37.80	38.65	0.09	-	-	0-20 yrs	A fantastic company with excellent financials. Potential big dividend growth story with takeout catalyst as a growing possibility.
Short Idea Considerations								
Jul, 16	Lands' End (LE)	16.76	16.10	NA	3.9%	10.7%	Closed -- 12/2/2016	We were worried Eddie Lampert may start buying more heavily. Very volatile equity. Not being greedy, so closed position.
Aug, 16	Vivint Solar (VSLR)	2.94	2.85	NA	3.1%	10.8%	Closed -- 12/2/2016	Stock wasn't acting right despite an ongoing negative solar backdrop. We locked gain in as a result.
Sep, 16	Lloyds Banking (LYG)	3.31	2.78	NA	16.0%	96.1%	Closed -- 11/4/2016	We didn't like Lyolds' leverage and were worried about Brexit. We picked our spot to take profits.
Oct, 16	GoPro (GPRO)	16.68	11.12	NA	33.3%	400.0%	Closed -- 11/4/2016	This was a big winner. We continue to have concerns, and the stock keeps falling. We're not looking back, however.
Nov, 16	Seritage Group Properties (SRG)	44.31	42.13	-0.25	4.6%	26.8%	**NEW:** Closed - 1/6/2017	The REIT continues to trade on euphoric expectations, but we're going to close this for a gain. Div's work against us as it relates to short performance. Buffett is watching.
Dec, 16	Royal Bank of Scotland (RBS)	4.91	5.72	-	-	-	0-2 yrs	The stock is rallying alongside financials peers. A steepening yield curve, and Trump optimism is running rampant.
	Average Realized Annualized Gain %					**167.5%**	Varies	**Overall:** I don't think we could do better with our short ideas (5-6), but our long ideas (6-12) aren't panning out as well as we would have hoped thus far. We continue to exercise patience.

The table above is provided for the sole purpose of transparency, to allow readers to track the ongoing performance of Nelson Exclusive ideas in a way that they feel is most appropriate. Ideas within the Nelson Exclusive are not constructed as a portfolio, nor should they be viewed as a model portfolio, and performance returns are hypothetical. Realized annualized returns cannot be achieved and are provided for the sole purpose of rightsizing each idea to a common measurement period (one year), to compare ideas closed within one year to ones held longer than one year, taking into account capital efficiency. A reader, for example, may view a 20% return over a period of five weeks as much better than a 20% return over a period of five years. Whereas both represent 20% returns, annualized performance is much different under each case. Readers may have different views and time horizons. To retain independence, neither Valuentum nor Brian Nelson own any shares, nor do they plan to own any shares, of any companies highlighted in the Nelson Exclusive. Importantly, shorting stocks involves a number of abnormal risks, including theoretically the infinite loss of capital, and is not for everyone. Valuentum is a financial publisher not a financial advisor. Please contact your personal financial advisor to determine if any idea in the Nelson Exclusive may be appropriate for you.

About Your Editor

Brian Nelson is the president of equity research and ETF analysis at Valuentum Securities.

He is the architect behind the company's research methodology and processes, developing the Valuentum Buying Index rating system, the Economic Castle rating, and the Dividend Cushion ratio. Mr. Nelson has acted as editor-in-chief of the firm's Best Ideas Newsletter and Dividend Growth Newsletter since their inception.

Before founding Valuentum Securities in early 2011, Brian worked as a director at Morningstar, where he was primarily responsible for training and methodology development within the firm's equity and credit research department. Prior to that position, he served as a senior industrials securities analyst covering aerospace, airlines, construction, and environmental services companies.

Before joining Morningstar, Mr. Nelson worked for a small capitalization fund covering a variety of sectors for an aggressive growth investment management firm in Chicago. He holds a Bachelor's degree in finance and a minor in mathematics, magna cum laude, from Benedictine University. Brian has an MBA from the University of Chicago Booth School of Business and also holds the Chartered Financial Analyst (CFA) designation.

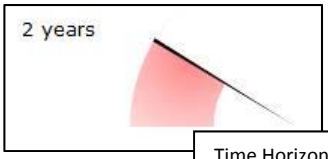
Highlights:

Brian is frequently quoted in the media and has been a frequent guest on Nightly Business Report, Bloomberg TV, CNBC, and the MoneyShow.

Mr. Nelson is very experienced valuing equities, developing discounted cash-flow models used to derive the fair value estimates for companies in the equity coverage universes of two of the largest independent investment research firms.

Brian worked on a small cap fund and a micro-cap fund that were ranked within the top 10th percentile and top 1st percentile within the Small Cap Lipper Growth Universe, respectively, in 2005.

Mr. Nelson led the charge in developing Morningstar's issuer credit ratings, creating and rolling-out one of the firm's proprietary credit metrics, the Cash Flow Cushion.



Time Horizon: Short-term

Star Gas Partners (SGU)

"At the end of the day we know our overriding priority is to produce sustained long term value for our investors, and in that vein during the past twelve months we also repurchased 1.4 million common units and were able to sustain our distribution through solid management of the business." -- Star Gas Partners Quarterly Conference Call Dec. 7, 2016

Thesis

What if I told you there was a master limited partnership whose distribution was covered several times over by traditional free cash flow and supported by a net cash position, resulting in an unadjusted Dividend Cushion ratio above 3 to go along with a distribution yield well over 3.6%? Now what if I told you that same MLP was trading at less than 12.5 times fiscal 2017 (ends September 30) earnings estimates? You might think it sounds too good to be true, as I did when I first began digging into Star Gas Partners, but it is merely proof that not all MLPs are created equal. Investors concerned about the tax implications of MLPs may want to steer clear, but this idea is not your average MLP.

Corporate Profile

Star Gas Partners, L.P. is a home heating oil and propane distributor and services provider that provides home and building heating services to residential and commercial customers in the Northeast, Central, and Southeast US regions. The firm is structured as a master limited partnership. It was founded in 1995 and is headquartered in Stamford, Connecticut.

(in thousands, except per unit data)	Fiscal Years Ended September 30, 2016	2015	2014	2013	2012
Per Unit Data:					
Basic and diluted net income per unit (a)	$ 0.70	$ 0.59	$ 0.57	$ 0.47	$ 0.40
Cash distribution declared per common unit	$ 0.395	$ 0.365	$ 0.340	$ 0.320	$ 0.310
Balance Sheet Data (end of period):					
Current assets	$ 294,858	$ 271,479	$ 296,465	$ 305,880	$ 301,519
Total assets	$ 692,970	$ 685,508	$ 685,107	$ 632,504	$ 639,347
Long-term debt	$ 76,300	$ 90,000	$ 124,572	$ 124,460	$ 124,357
Partners' Capital	$ 301,493	$ 289,886	$ 273,245	$ 259,281	$ 260,145
Summary Cash Flow Data:					
Net cash provided by operating activities	$ 101,957	$ 136,853	$ 95,155	$ 18,492	$ 105,828
Net cash used in investing activities	$ (19,631)	$ (30,385)	$ (107,318)	$ (6,960)	$ (44,517)
Net cash used in financing activities	$ (43,646)	$ (54,959)	$ (23,895)	$ (34,566)	$ (40,009)
Other Data:					
Earnings from continuing operations before net interest expense, income taxes, depreciation and amortization (EBITDA) (b)	$ 113,934	$ 111,198	$ 101,490	$ 83,308	$ 74,654
Adjusted EBITDA (b)	$ 95,717	$ 140,526	$ 108,056	$ 90,083	$ 66,105
Retail home heating oil and propane gallons sold	302,517	382,834	360,972	324,797	277,204
Temperatures (warmer) colder than normal (c)	(17.8)%	5.0%	4.9%		

Image Source: Star Gas

Let's jump right into the attractive cash rich nature of Star Gas Partners' business; after all, the effective management of its solid free cash flow generating capacity is what sets it apart from its debt-riddled MLP brethren. As of the end of fiscal 2016, the firm had a net cash balance of nearly $47 million, not exactly a fortress-like balance sheet, but healthy nonetheless. What's more is the MLP's significant coverage of its distributions with traditional free cash flow generation. In the past three fiscal years (2014-2016), Star Gas has averaged nearly $102 million in annual free cash flow generation, covering annual run rate cash distribution obligations of ~$23 million many times over.

Key Statistics	
Last Close	$11.21
52-week range	$7.27 - $11.30
Market Cap	$630 M
Avg Daily Vol (30 wks)	35,487
Annual Dividend Yield	3.66%
Trailing Dividend Payout Ratio	59%
Trailing P/E	16.0
Net Cash (LFY)	$47 M
Net Debt/EBITDA (LFY)	N/A

Income investors will also be pleased to see Star Gas Partners' debt maturity schedule in coming years. A meager total debt load of $92.5 million as of the end of fiscal 2016 breaks down into the following maturity schedule: $16.2 million in fiscal year 2017, $10 million in fiscal 2018, $10 million in fiscal 2019, and $56.3 million in fiscal 2020. While we acknowledge the potential for additional capital to be raised via debt in coming years as Star Gas searches for growth in its declining industry, the MLPs current debt maturity schedule allows for ample financial flexibility when considering recent free cash flow generation and other capital needs.

The home heating oil industry is expected to decline in the foreseeable future due to the increasing popularity of natural gas and other alternative energy sources in home heating. As a result, Star Gas Partners will have to turn to acquisitions to grow its core business, in addition to growth efforts in its other service-based offerings. The MLP estimates that between 1.3% and 2.4% of its customers have converted to natural gas for heating per year over the past five years, and it expects such a trend to continue as natural gas has become a more cost efficient option on an equivalent BTU basis. Also, legislative and regulatory efforts in several states are encouraging homeowners to use natural gas for heating purposes. As of 2009, when the most recent Residential Energy Consumption Survey was published by the US Department of Energy, the Northeast and Mid-Atlantic regions accounted for 83% of the total households in the US where heating oil is the main space heating fuel, and 28% of the homes in those regions used heating oil as their main heating fuel.

Due to such dynamics, we're looking to Star Gas Partners as a stable source of income over a short-term time horizon. The heating oil industry's poor outlook is concerning, but the firm's free cash flow generation and balance sheet are healthy enough, in our view, to maintain a strong payout in the near term. While the majority of the company's revenue is generated via heating oil and propane sales (~63% of total sales in fiscal 2016), installation and repair services account for nearly 22% of total sales, and sales of other petroleum products (diesel fuel, other gasoline products) account for roughly 15% of total sales. It would take a substantial collapse in free cash flow generation in a short period of time to materially impact the health of Star Gas' distribution over our selected time horizon.

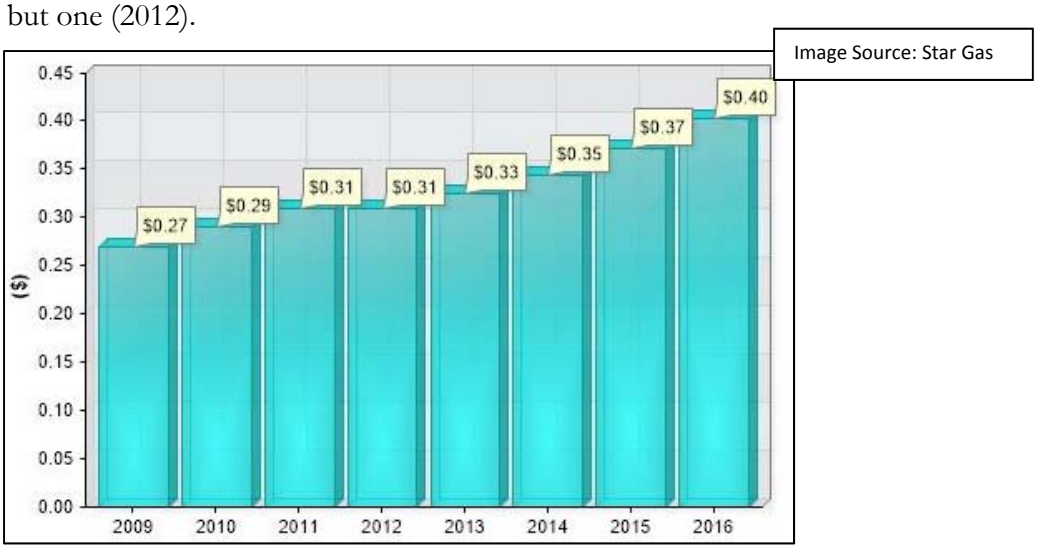
Star Gas' scale advantages will help it in its battle against a shrinking, fragmented market. Management believes it is the largest distributor of home heating oil in the US despite having only 5.5%+ market share. Such a scale advantage allows the firm the ability to offer better than average customer service as well as more extensive installation, maintenance and other ancillary services to customers than the much smaller, independently owned and operated local distributors. Its size should also provide a benefit when it comes time to pursue inorganic growth. Other players in the industry will likely be looking to expand as well, and we think Star Gas having more extensive capital resources in comparison to most, if not all, other players in the industry will enable it to be effective in acquiring some of the industry's higher quality assets.

Image Source: Star Gas

(in thousands, except per unit data)	Fiscal Years Ending September 30, 2016	2015	2014	2013	2012
Statement of Operations Data:					
Sales	$ 1,161,338	$ 1,674,291	$ 1,961,724	$ 1,741,796	$ 1,497,588
Costs and expenses:					
Cost of sales	768,841	1,203,588	1,555,300	1,388,668	1,199,811
(Increase) decrease in the fair value of derivative instruments	(18,217)	4,187	6,566	6,775	(8,549)
Delivery and branch expenses	276,493	309,025	282,646	250,210	217,376
Depreciation and amortization expenses	26,530	24,930	21,635	17,303	16,395
General and administrative expenses	23,366	25,908	22,592	18,356	18,689
Multiemployer pension plan withdrawal charge	—	17,796	—	—	—
Finance charge income	(3,079)	(4,756)	(6,870)	(5,521)	(4,393)
Operating income	87,404	93,613	79,855	66,005	58,259
Interest expense, net	7,485	14,059	16,854	14,433	14,060
Amortization of debt issuance costs	1,247	1,818	1,602	1,745	1,634
Loss on redemption of debt	—	7,345	—	—	—
Income before income taxes	78,672	70,391	61,399	49,827	42,565
Income tax expense	33,738	32,835	25,315	19,921	16,576
Net income	$ 44,934	$ 37,556	$ 36,084	$ 29,906	$ 25,989

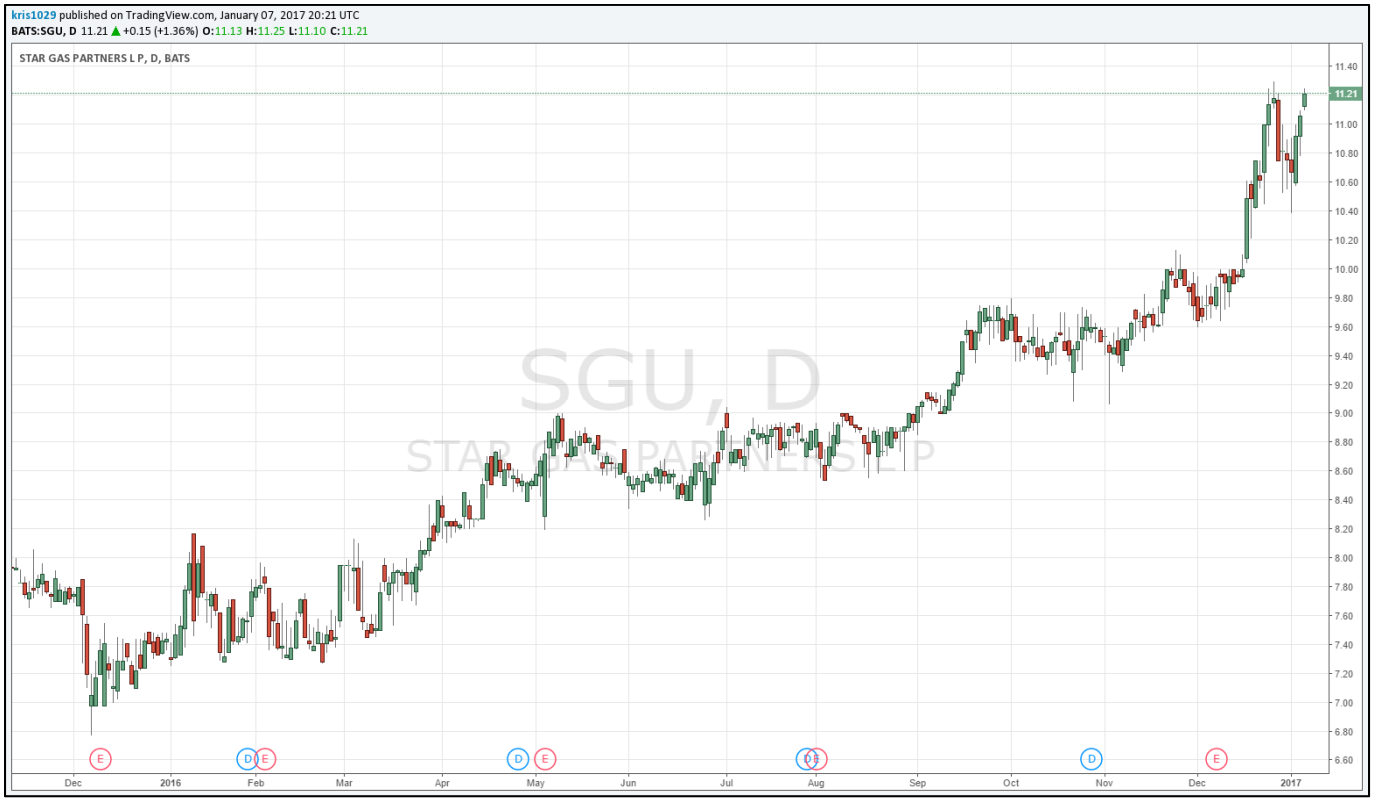
Star Gas Partners' scale also enables it to offer various pricing options to its customers. The MLP currently offers variable and price protected payment programs to its customers, with the majority (~55%) of its customers using the higher-margin variable pricing program. Approximately 96% of the company's customers have automatic deliveries scheduled, and roughly 37% of all residential customers--residential customers account for 96% of all customers--use a balanced payment plan, in which estimated annual oil purchases and other service contract fees are paid in equal monthly payments. The offering of such a payment plan helps Star Gas protect against the impact of potential customer credit issues, a particularly relevant issue when considering the seasonality of the heating oil business. The firm estimates that roughly 30% of its total volume of heating oil and propane is sold in the fiscal first quarter (calendar fourth quarter) and approximately 50% is sold in its fiscal second quarter (calendar first quarter).

Though Star Gas does not have an immaculate dividend track record--it suspended its distribution in 2004 due to a combination of massive amounts of financial leverage and weakness in its heating oil business--such a characteristic may actually be a positive for income investors in this instance. In a market environment where massive debt loads have become increasingly common, coupled with the expectations for interest rate hikes in 2017 and beyond, we think a firm that has felt the impact of its own imprudent capital management in the past is less likely to do so again. Star Gas Partners' balance sheet and cash flow statement support that notion. Since being reinstated in 2009, the company has grown its annual distribution in every calendar year but one (2012).



In addition to shares of Star Gas Partners trading at attractive earnings multiples, we think shares are attractive on a discounted cash flow basis as well. Our fair value estimate for the firm currently sits at $14, an estimate that incorporates conservative estimates for margin expansion and top-line growth. In fact, our $14 per share fair value estimate includes a 0% mid-cycle revenue growth assumption in addition to slowing gross margin expansion compared to recent years.

We love the financials of Star Gas Partners, and we think taking a shorter-term time horizon approach may prove to be an effective strategy in avoiding being potentially hurt by the contracting home heating oil industry. Annual cash distribution obligations amount to less than one-quarter of the firm's average annual free cash flow generation over the past three years, reassuring us that even with hypothetical material declines in its business, the company will be able to maintain its recent trajectory of dividend growth. Debt maturities over our selected time horizon do not materially impact our thesis, and a net cash position on the balance sheet helps put our mind at ease.



Kris Rosemann contributed to this article.

TEXAS CAPITAL

Texas Capital Bancshares (TCBI)

"We are extremely pleased with our third quarter results, highlighted with continued improvement in core earnings and efficiency," said Keith Cargill, CEO. "Proactively managing credit is an ongoing focus and key to our continued success. Our ability to attract and develop great talent as well as partner with exceptional clients will drive future risk-appropriate growth in earnings and ROE and solidifies our outlook for a bright future." – Source: Texas Capital Results for Q3 2016

Thesis

The "Trump rally" has sent shares of banks surging of late, and mostly because the publication is a new one, the Nelson Exclusive has been lacking bank ideas for readers. We're going to fix that in this edition.

Though we have strong reservations about the resilience of the banking business model and its ability to generate economic value (ROE less COE) through the course of the economic cycle, the table is set for better times to come as a result of 1) expectations for rising interest rates, which translate into net-interest-income opportunities as the yield curve steepens, and 2) a more favorable regulatory environment that may soon come during President Trump's early years in office. Most banking equities have surged ahead as a result of the Trump victory already and are unfortunately technically extended (they've run far past their bases), but this one's book of business in the improving energy arena gives investors a number of ways to be right with shares.

Corporate Profile

Texas Capital is a fast-growing commercial bank headquartered in Dallas, Texas. The company serves middle-market businesses, professionals and entrepreneurs in Texas. Texas Capital has experienced strong loan growth and favorable loss experience despite challenging market conditions in the energy sector and the Texas economy. It commenced banking operations in 1998.

Key Statistics	
Last Close	$78.05
52-week range	$29.78 - $81.25
Market Cap	$3.8 B
Avg Daily Vol (30 wks)	463,512
Book Value	$34.25
Tangible Book	$33.82
Price/Book	2.28x
Price/Tangible Book	2.31x
Price/Earnings	22.43x

Enter Texas Capital Bancshares, a commercial bank that serves much of Texas, including Austin, Dallas, Fort Worth, Houston, San Antonio and beyond. The company has deep experience when it comes to energy lending, and while its energy portfolio represents just less than 10% of its loan book, we think the recent rise in energy resource prices has helped to improve the credit quality of its overall portfolio, almost across the board, in our view. But while most banks have been rallying almost entirely as a result of optimism surrounding potential improvement in banking sector-driven dynamics, we don't think Texas Capital Bancshares has yet to receive the added, incremental boost from improving geographic (Texas) and energy-sector related dynamics. The bank is also quite resilient, too. For example, during the toughest energy market conditions in more recent history, arguably through much of 2015, Texas Capital produced record levels of net income as it grew total loans over 20% during the year.

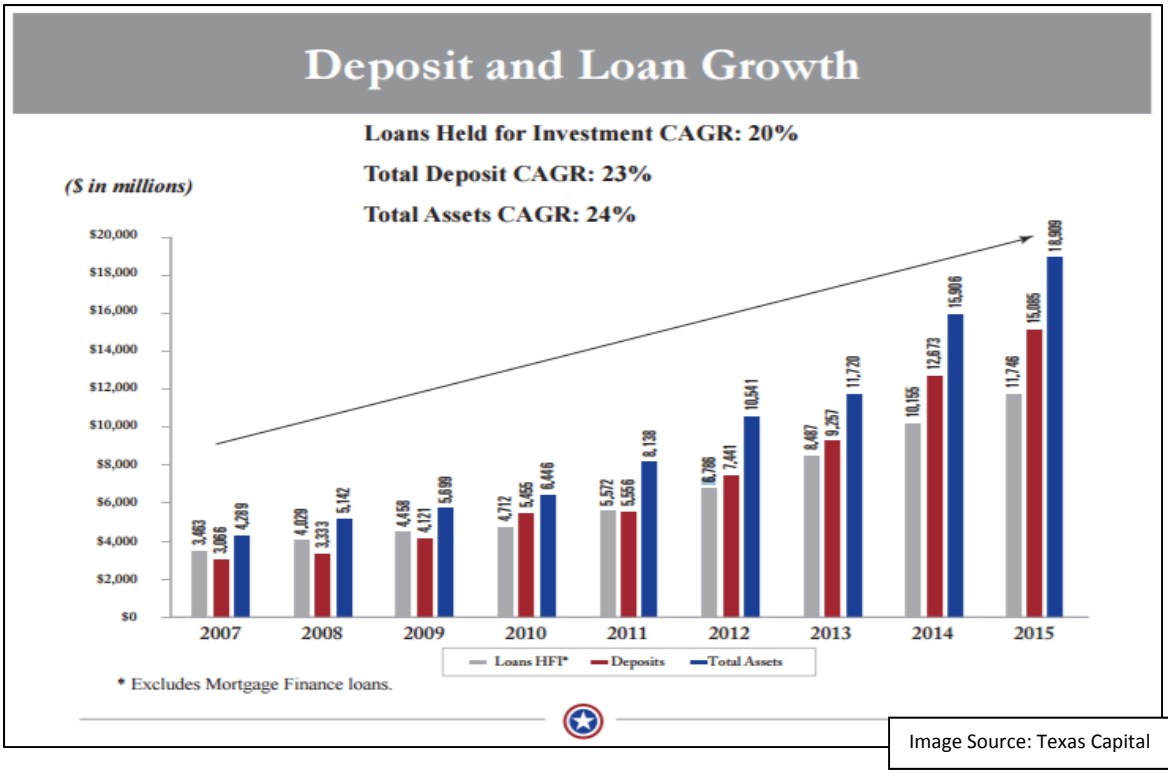


Image Source: Texas Capital

Though we like the idea in part because of its exposure to the recovering Lone Star State, management is quick to highlight that over the past few years, the bank has become more and more diversified, both by lending vertical and geography, with now more than 50% of its loans located outside of Texas. That still leaves a lot left in Texas, of course, for the bank to benefit from the ongoing recovery, but it also reduces it from being what we call a pure-play to the region. When it comes to the cross section of energy and banks, it's the type of idea that I like—one that has some exposure to improving commodity prices and local/regional economic health, but not of the boom or bust variety. Texas Capital is also doing a great job continuing to build its fee-income generating businesses, which are helpful boosts to ROE, and we have high hopes for its Private Wealth Advisors group when it comes to contributions to its bottom line. But regardless, loan growth at Texas Capital has simply been phenomenal (read right to left).

Image Source: Texas Capital

	2015	2014	December 31, 2013	2012	2011
Commercial	$6,672,631	$5,869,219	$5,020,565	$4,106,419	$3,275,150
Total real estate	4,990,914	4,223,532	3,409,427	2,630,390	2,241,670
Construction	1,851,717	1,416,405	1,262,905	737,637	422,026
Real estate term	3,139,197	2,807,127	2,146,522	1,892,753	1,819,644
Mortgage finance	4,966,276	4,102,125	2,784,265	3,175,272	2,080,081
Equipment leases	113,996	99,495	93,160	69,470	61,792
Consumer	25,323	19,699	15,350	19,493	24,822

In light of such growth, it's hard to say that Texas Capital is not one tough rival, even as we say that the Texas market is a competitive one. Some of its main lending foes are headquartered outside the state, and we believe that there's something to be said about it being best able to serve middle-market companies, professionals, and entrepreneurs in Texas as predominantly a Texas organization itself. The bank is in tune with local and regional trends, and based on performance during 2015 when energy resource pricing was tumbling, its

profitability remained healthy, even as it took large loss reserves on its energy book of business. Of course no bank will get every loan right, but lending expertise in key energy areas and established community ties make the bank a staple in Texas, translating into a competitive advantage difficult for even the largest banks to infiltrate. Warren Buffett may describe Texas Capital as "moaty."

Let's cover a few risks. First, Texas Capital is a bank, and banks themselves are always exposed to abnormal risks. Until the day that banks hold a dollar in house for every dollar they lend out, they will always be exposed to a run-on-the-bank dynamic. You may think that this is absurd for me to bring up, but Washington Mutual, less than 10 short years ago, fell prey to a modern run-on-the-bank situation during the depths of the credit crunch. It can and will happen again to another big bank, the timing the only uncertainty. We're not worried too much about this right now, but we have to mention it. After all, it's part of the reason why we don't like banking business models, in general--their future is based extensively on market confidence, something completely beyond their control. Counterparty risk cannot be ignored either.

But what about its loan book? Well, about 40% of Texas Capital's book of business (loans held for investment) consists of commercial loans, which tend to be of larger size, and a significant portion of its loan portfolio is tied to commercial and residential real estate, about 30% of it. Less than 10% of its loans are tied directly to reserve-based exploration and production companies, royalty owners, and midstream operators. While that doesn't seem like a lot, reverberations from these loans, should they become non-performing, are likely to spill into other lines of its business, given geographical concentration. However, improving energy resource pricing and recovering economic conditions in Texas are only enhancing the credit quality of its loan book, in my view. Even during tough market conditions for energy, the bank has been able to drive net income higher in the face of a near-tripling of credit loss provisions in 2015 (as shown below).

Image Source: Texas Capital

	At or For the Year Ended December 31,				
	2015	2014	2013	2012	2011
	(In thousands, except per share, average share and percentage data)				
Consolidated Operating Data(1)					
Interest income	$ 602,958	$ 514,547	$ 444,625	$ 398,457	$ 321,600
Interest expense	46,428	37,582	25,112	21,578	18,663
Net interest income	556,530	476,965	419,513	376,879	302,937
Provision for credit losses	53,250	22,000	19,000	11,500	28,500
Net interest income after provision for credit losses	503,280	454,965	400,513	365,379	274,437
Non-interest income	47,738	42,511	44,024	43,040	32,232
Non-interest expense	326,523	285,114	256,729	219,881	188,327
Income before income taxes	224,495	212,362	187,808	188,538	118,342
Income tax expense	79,641	76,010	66,757	67,866	42,366
Net income	144,854	136,352	121,051	120,672	75,976
Preferred stock dividends	9,750	9,750	7,394	—	—
Net income available to common stockholders	$ 135,104	$ 126,602	$ 113,657	$ 120,672	$ 75,976

Let's cover some bank-specific metrics, starting with leverage.

At the end of 2015, assets to equity stood at about 11 times ($18.9 billion/$1.62 billion), which is elevated, in my view, but nowhere near those of some of the more leveraged institutions across the globe. Tangible book value

stood at $31.69 per share at the end of 2015, so shares are trading at a multiple of book on a trailing basis (almost 2.5 times), but the bank is growing rapidly. Earnings multiples aren't much more palatable, and while return on average equity has faced pressure in recent years, falling to 9.7% in 2015 from as high as near-17% at its near-term peak in 2012, we're expecting considerable improvement in 2017 thanks in part to improving energy-related performance. It's hard to find many banks that are growing as fast on the bottom line, even if all they faced were good times. Texas Capital has had challenges, and net income has still leapt to $135+ million in 2015 from just under $76 million in 2011, two years after the credit crunch.

Image Source: Texas Capital

	Amount	Percent of Total
Geographic region:		
Dallas/Fort Worth	$1,361,596	32.8%
Houston	1,029,999	24.9%
San Antonio	428,773	10.4%
Austin	374,477	9.1%
Other Texas cities	325,720	7.9%
Other states	615,986	14.9%
Total market risk real estate loans	$4,136,551	100.0%

A steepening yield curve should help to reverse net interest margin compression, and a more favorable regulatory environment may serve to reduce overhead, if only by a few basis points. Capital ratios could be better, with Texas Capital's Tier 1 capital ratio standing at ~8.8% at the end of 2015, but recent equity price performance speaks to considerable capital resilience and a market that is willing to support the equity, even if incremental capital is needed (it issued a secondary offering in November). Investors in Texas Capital need to pay more attention to its share price than anything else, as in many ways, a bank's financial risk is better reflected in the price (and movement) of its equity price than any GAAP fundamental considerations, in my view. What others—dealers, customers, counterparties, etc—think of the bank will be reflected in its share price, and that confidence is what keeps Texas Capital in business and thriving. Evaluating technical considerations (or monitoring the company's pricing chart) was one of the only few red flags that kept investors from losing big during the last Financial Crisis.

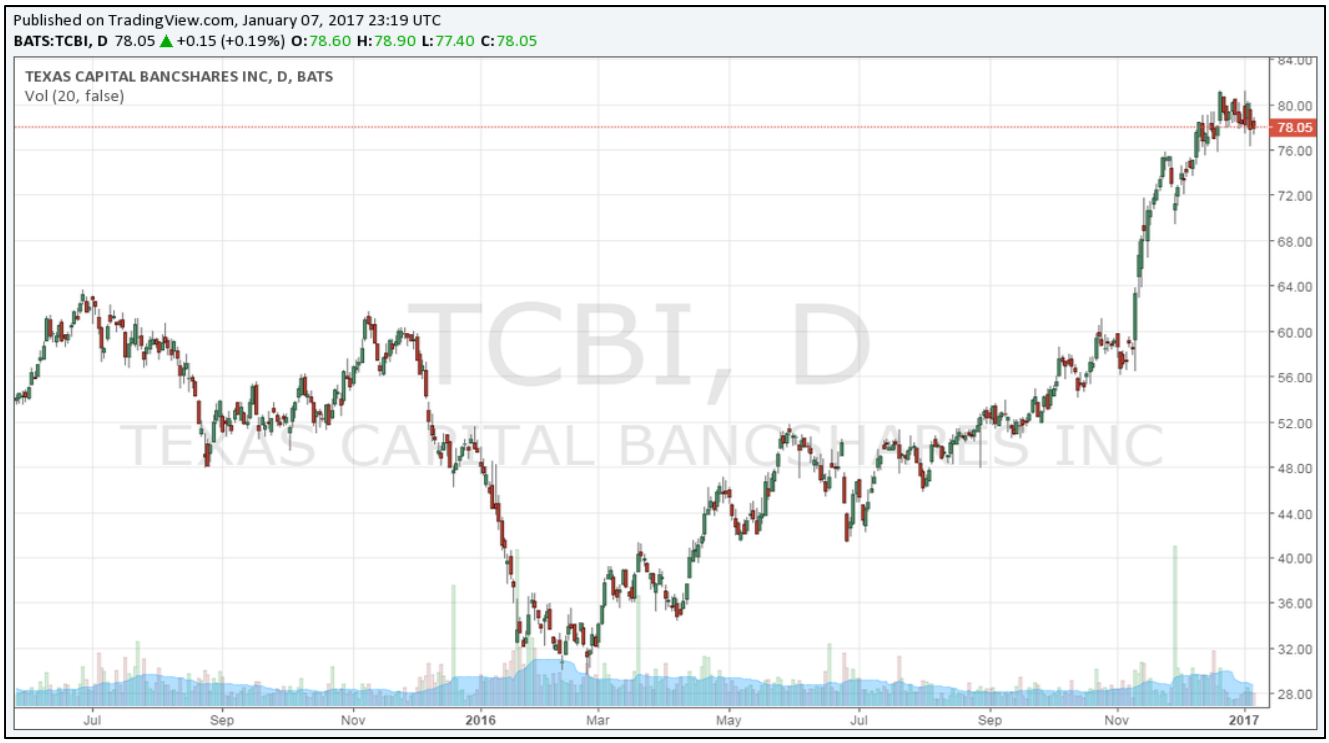
We've previously dropped coverage of Texas Capital on our website, but in previous iterations of our data sheet for regional banks, Texas Capital received poor marks for ValueCreation and Relative Value, but we think times are changing for the better at the bank, with the former in particular. During the third quarter of 2016, for example, Texas Capital's ROE came in above the 10% threshold to earn a good mark for ValueCreation, while diluted earnings per share advanced 16% in the period. Tangible book value continues to advance steadily, too. Relative value comparisons will always remain difficult, but Texas Capital has more going for it than the average banking entity.

Texas Capital has effectively doubled interest income and driven net income to substantial gains since 2011, despite a challenging market backdrop, and for that, we think a price-to-book multiple of 2-3 times is appropriate for this fast-growing, "moaty" bank, which puts fair value for shares in the range of $67-$100, or about 17 times this year's expected earnings at the low end of the range. We know that's an aggressive valuation, but if energy and Texas come roaring back, as they have done time and time again, Texas Capital is going to be there to reap the rewards. Shares are currently trading at $78 each.

Image Source: Texas Capital

PERFORMANCE RATIOS (%)	TCBI	PEER MEDIAN	PEER AVERAGE
ROAA	0.70	0.87	0.88
ROAE	8.53	8.25	8.21
Net Interest Margin	3.09	3.09	3.15
Efficiency Ratio	54.96	61.82	60.38
Loans / Deposits	97.13	80.60	80.82
ASSET QUALITY RATIOS (%)			
NPAs / Assets	0.85	0.71	0.71
NCOs / Avg Loans	0.18	0.28	0.25
Reserves / Loans	0.99	1.37	1.26
Reserves / NPAs	95.91	100.66	110.14
CAPITAL RATIOS (%)			
Tier 1 Capital	8.80	11.34	11.25
Tangible Equity / Tangible Assets	7.69	8.97	8.97
Total Equity / Total Assets	7.77	10.45	10.46
MARKET RATIOS			
Price / Earnings (x)	27.48	22.52	23.66
Price / Book (%)	227.89	171.96	183.95
Dividend Yield (%)	0.00	1.76	1.82

Note: Investors have to watch the technicals on this one closely, and a move back to the $60s or lower may happen before a move to $100. Please be careful with this idea. Banking ideas are generally more risky than most, and the "Trump trade" has pushed the sector to hefty valuations. We've often preferred diversified exposure to the banking sector in the form ETFs such as the Financial Select Sector SPDR ETF (XLF) or the SPDR S&P Regional Banking ETF (KRE), both holdings in the Best Ideas Newsletter portfolio. Texas Capital is one for your radar, in any case.


Published on TradingView.com, January 07, 2017 23:19 UTC
BATS:TCBI, D 78.05 ▲ +0.15 (+0.19%) O:78.60 H:78.90 L:77.40 C:78.05
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Vol (20, false)
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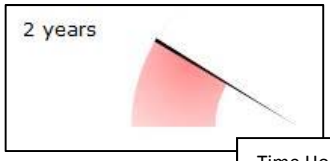


Time Horizon: Short-term

sequential brands group

Sequential Brands Group (SQBG)

Thesis

The broader US retail space has been pummeled in recent quarters, and Sequential Brands Group has not been spared the pain. The holiday season in 2016 did very little to help the plight of traditional US retailers, and weakness in fashion apparel and accessories has become a common theme. The retailer expects to transform its revenue breakdown to have at least 15% of its sales come from international avenues and at least 15% of its brands sales to be made online by the end of 2018, meaning it is *significantly* exposed to the fate of the traditional US brick-and-mortar retail as it exists at this point in time.

Though the 'athleisure' trend--the growing popularity of a cross between athletic and leisure wear--may provide a boost for some of Sequential's brands, such as AND1 and Avia, we think the firm being tied to traditional US retail is a major risk to the success of its brands in coming years. The spending habits of millennials have been a hot topic of discussion of late, and experiential purchases and value-focused consuming have become common themes with the generation. While some of Sequential's brands may offer some potential for the value-focused consumer, the fact that the firm's e-commerce presence currently makes up less than 15% of its overall sales limits its potential with the generation that is growing its purchasing power by the day.

Corporate Profile

Sequential Brands Group markets and licenses a portfolio of consumer brands, providing products in the fashion, home, and lifestyle categories, among others. Its brands include the likes of Martha Stewart, Jessica Simpson, AND1, Avia, and Ellen Tracy. Its products are available via various distribution channels, including retailers, wholesalers, and distributors. The firm was incorporated in 1982 as Old Sequential and is headquartered in New York, New York.

Key Statistics	
Last Close	$4.62
52-week range	$4.10 - $9.14
Market Cap	$289 M
Avg Daily Volume (30 wks)	238,209
Shares Outstanding	62.47 M
Float	38.92 M
Shares Short	5.44 M
Short Ratio	27.51
Short % of Float	14.0%
Shares short (prior month)	5.81 M

	Years Ended December 31,				
	2015	2014	2013	2012	2011
	(in thousands, except share and per share data)				
Consolidated Income Statement Data:					
Net revenue	$ 88,262	$ 41,837	$ 22,653	$ 5,274	$ 547
Operating expenses	58,611	29,806	16,845	11,812	172
Income (loss) from operations	29,651	12,031	5,808	(6,538)	375
Income (loss) from continuing operations	2,416	(646)	(11,142)	(7,394)	239
Loss from discontinued operations, net of tax	—	—	(6,244)	(1,780)	(6,219)
Consolidated net income (loss)	2,416	(646)	(17,386)	(9,174)	(5,980)
Net (income) loss attributable to noncontrolling interest	(5,287)	(422)	(588)	49	3,643
Net loss attributable to Sequential Brands Group, Inc. and Subsidiaries	$ (2,871)	$ (1,068)	$ (17,974)	$ (9,125)	$ (2,337)
Basic and diluted (loss) income per share:					
Continuing operations	$ (0.07)	$ (0.04)	$ (0.66)	$ (3.04)	$ 0.11
Discontinued operations	—	—	(0.35)	(0.74)	(1.08)
Attributable to Sequential Brands Group, Inc. and Subsidiaries	$ (0.07)	$ (0.04)	$ (1.01)	$ (3.78)	$ (0.97)
Basic and diluted weighted average common shares outstanding	41,177,523	29,964,604	17,713,140	2,413,199	2,400,171

Image Source: Sequential Brands

Sequential Brands also faces an uphill battle with respect to the public opinion of Martha Stewart as it significantly increased its debt load to bring the brands of Martha Stewart Living Omnimedia into its portfolio in late 2015. The success of such a move is tied to the public perception and marketability of Ms. Martha Stewart, who has served jail time related to convictions of obstruction of justice, securities fraud, and other smaller crimes and is currently one of the subjects of an Amended Class Action Complaint brought about on behalf of Martha Stewart Living Omnimedia shareholders. The complaint makes claims against Ms. Stewart for a "breach of fiduciary duty" and against Sequential for aiding and abetting Ms. Stewart. Not only does the complaint have the potential to bring about substantial monetary damages, but the marketability of Martha Stewart could be meaningfully impaired should the plaintiffs be successful, which may make the acquisition of Martha Stewart Living Omnimedia a value-destructive move.

Acquisitions are a core part of Sequential Brands Group's growth strategy, and such a growth strategy introduces additional risks compared to a firm that is growing organically. In addition to the risks associated with the impact on financial leverage brand acquisitions have had, an acquisition-focused growth strategy brings on material integration risk, which increases with each additional acquisition made as the business grows increasingly complex. For example, Sequential has increased its forecasts for SG&A expenses in 2016 and 2017 due in part to higher than anticipated costs associated with the integration of Martha Stewart Living. The impact of cost overruns goes beyond the obvious impact they have on reported results as they also veer from the assumptions made during the evaluation of the acquisition and change the level of value creation of said acquisition.

Following the $353 million acquisition of Martha Stewart Living Omnimedia in late 2015, and the mid-2016 acquisition of GAIAM Yoga Brand for $146 million, Sequential's net debt load has ballooned. As of the end of the third quarter of 2016, the firm had ~$628 million in net debt, but it expects to end the year with a net debt balance of ~$640 million, **which will be good for a net debt-to-adjusted EBITDA ratio of nearly 7.5x when using the midpoint of the firm's 2016 adjusted EBITDA guidance range of $83-$88 million.**

	As of December 31,				
	2015	2014	2013	2012	2011
			(in thousands)		
Consolidated Balance Sheet Data:					
Cash	$ 41,560	$ 22,521	$ 25,125	$2,624	$ 243
Working capital (deficiency) from continuing operations	49,594	23,584	17,745	(524)	(4,401)
Intangible assets, net	872,277	303,039	115,728	4,293	392
Total assets	1,297,772	526,363	153,605	8,977	2,188
Long-term debt, including current portion	550,000	175,500	57,931	3,502	1,750
Total equity (deficit)	525,649	264,900	81,169	(48)	(5,416)

Image Source: Sequential Brands

What's more concerning is the likelihood that such a lofty leverage multiple is not going away anytime soon. In fact, management is targeting a net debt-to-adjusted EBITDA ratio of roughly 6x at the end of 2017 as it projects adjusted EBITDA to be in a range of $100-$105 million in the year and net debt to be ~$600 million. The firm has also set 2017 free cash flow guidance at $50 million, and it already plans to use $28 million of that cash to pay down debt. This leaves only ~$32 million in cash available for other initiatives, including the very important growth strategies of international expansion and a growing online presence.

Also, in accordance with the covenants on Sequential's current credit agreements, the firm can only request additional term loan facilities if it would not cause its consolidated total leverage ratio to exceed 6x, the firm's target for year-end 2017 leverage. Growth capital will be hard to come by for the company in the near term, and the impact rising interest rates will have on debt service costs in coming years should not be ignored.

What may be reassuring investors is that Sequential does not have any material debt maturities over the next five years. However, the firm is fighting an uphill battle in terms of the current operating environment in the US retail market, and its current cash flow generating capacity does not appear to be leaving management much margin for error in terms of execution. Though we like what we've seen from the company in terms of free cash flow generation through the first nine months in 2016 and its projections for 2017 look promising, it has failed to generate positive free cash flow in each of the past three years, including 2015, when it had positive free cash flow generation through three quarters, only to report negative free cash flow and cash flow from operations for the full year. An apparel brand company underperforming during the holiday season does not sit well with us, and we're not ready to place a high degree of confidence in Martha Stewart Living, which had seen its sales fall to $142 million in 2014 from $231 million in 2010 as a standalone that included publishing and broadcasting operations, to reinvigorate things.

Sequential also has a degree of customer concentration risk in its business. As of the end of the third quarter of 2016, the company had two licensees that accounted for 10% of its total net revenue, as well as two licensees accounting for a combined 25% (14% and 11% individually) of its total accounts receivable balance. Concentration risk in the firm's ownership is prevalent as well. As of April 15, 2016, Tengram Capital Partners Gen2Fund owned more than 12% of shares outstanding of common stock, Carlyle Galaxy holdings owned more than 10%, and Martha Stewart owned ~13%. The firm's chairman of its board of directors, William Sweedler, is a principal of Tengram, Rodney Cohen, a director, is a principal of Carlyle, and Martha Stewart is a director in addition to her role as Chief Creative Officer.

Our most pressing concerns with Sequential Brands Group are its substantial ties to the traditional US retail market and its massive financial leverage, which will make the continuation of its acquisition growth strategy difficult in the near term. Such leverage coupled with the uphill battle that is organically expanding free cash flow generation in the current retail environment does not provide for a rosy outlook in coming years, in our opinion, regardless of whether or not the firm has afforded itself some breathing room with respect to its debt maturity schedule.

However, the company's debt maturity schedule does play into how we are looking at it in terms of our time horizon for this short idea to work out. There is a very real possibility that this will be a short term idea when considering the massive let down the retail space endured in this most recent holiday shopping season, but we are also allowing for a potentially longer time horizon in the event it is able to effectively navigate the broadbased weakness. We do not expect the firm to retain what little financial health it may have once its creditors come calling, barring a material, unforeseen expansion in cash flow generation capacity. We think a short term time horizon is reasonable, but we have an even more difficult time envisioning a healthy Sequential Brands Group existing as its debt begins to mature. Importantly, the company has no plans of paying a dividend in the foreseeable future, so short sellers will not be required to cover any dividend payments.

Image Source: Sequential Brands

5% Beneficial Owners:		
Martha Stewart Family Limited Partnership[3]	8,032,910	12.9%
Tengram Capital Partners Gen2 Fund, L.P.[2]	7,619,178	12.3%
Carlyle Galaxy Holdings, L.P.[9]	6,369,812	10.2%
Blackrock, Inc.[10]	4,484,617	7.2%

Kris Rosemann contributed to this article.

July 1, 2016

Inaugural Letter to Members

Dear Valued Member,

Welcome! You are one of a very limited number of members that will ever bear witness to the pages that follow.

The launch week of the Nelson Exclusive coincided with news that Britain has voted to leave the European Union. The decision, while sending the European banks tumbling violently, does little to muddy the context setting the background of the inaugural edition of this publication.

Broader stock market valuations are at frothy levels, and interest rates continue to hover near all-time lows. The investment-decision landscape is more complicated today than ever before for all types of investors, from those seeking long-term capital appreciation to those that are targeting certain income goals. Cyclicals today are trading at peak multiples on peak earnings, and even consumer staples equities have reached valuation levels that may be more appropriate for aggressive growth equities, not mature operators. *Said differently, the market has laid down the gauntlet.*

The next few years in the markets may be among the most difficult witnessed since the Great Recession. Even a broader market pullback 20% from current all-time highs wouldn't be abnormal given that the collective market valuation of S&P 500 companies has effectively tripled from the March 2009 panic bottom. The launch of the Nelson Exclusive in such conditions can be considered perilous as broader market performance inevitably will act as ballast to the returns of ideas surfaced. In this spirit, I want to remind you that not all ideas in this publication will be successful, and some that are eventually may encounter tough sledding over extended periods of time. As a swimmer cannot achieve his best time swimming against the current, a stock selector cannot achieve his best performance in a down market. Regardless, the value placed on a steady hand during challenging times is priceless.

Let's first cover what the Exclusive is and then we'll talk about what it is not. As you know, the Valuentum investment coverage universe is vast, and what we're seeking to deliver in this publication is ideas that fall outside its reach. We're breaking down the traditional barriers of equity coverage to identify underfollowed gems across the investing spectrum, delivering in each monthly edition one idea for income investors, one idea for readers seeking long-term capital appreciation, and a bonus idea for those looking for a "short" consideration (1). Underfollowed doesn't mean obscure, however, and the ideas that we're targeting will be investable ones, avoiding thinly-traded instruments and penny stock "traps." We'll clearly define our expected time horizon for each consideration, and where applicable, we'll update our theses in subsequent editions. We'll keep score, tracking performance over time.

Let's talk about what the Exclusive isn't. The Exclusive does not constitute individual investment advice, and the ideas within it are not personal recommendations. Each of you reading should always work with your

personal financial advisor who knows your individual goals and risk tolerances. I do not. Only you and your personal financial advisor know what's best for your life circumstances. The personal financial advising markets and what we do at Valuentum via financial publishing are two different verticals in the same industry, but they are different nonetheless. I just want to be very clear about this because I can never tell you to buy or sell anything at any time, even if this may be what you want. It's not that I don't have conviction in my work – it's the rules of the business.

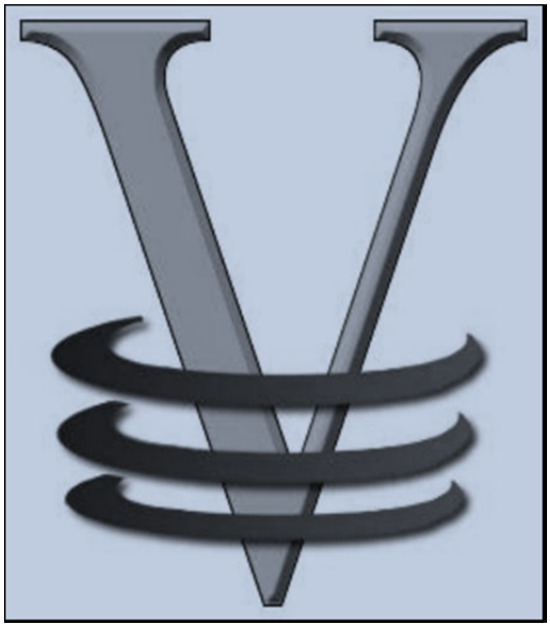
Within the twelve editions of the Nelson Exclusive each year, we'll be highlighting in total 36 ideas for consideration with varying investment parameters. That's a lot. Depending on the time horizon set forth with each idea, fantastic performance might mean a success rate of 60%, great performance might be 55%, average performance might be 50%, while anything below that mark may constituent a poor showing. Obviously, I'm aiming for a 100% success rate, but I also have to be realistic. The great Joe DiMaggio may have hit safely for 56 consecutive games in the last baseball season before the United States was thrust into World War II, but he "only" hit .357 that year. That season of '41, the great Ted Williams would be the last player to hit .400, meaning that one of the best hitters in baseball…ever…was still called out ~60% of the time.

The greatest investors face a similar paradigm. Stock selection is a process where there will be homeruns and strikeouts. You know me. The Exclusive is not a "get-rich-quick" product, and you should keep a close eye on your wallet if you encounter anyone promising anything of the sort. In the inaugural edition of the Nelson Exclusive, I'm going to take 36 swings – they are going to be hard and through the zone, and I'm not going to pull my shoulder out or take my eye off the ball. Market conditions are expected to be stormy in coming years as "reversion-to-the-mean" dynamics rain down, and a crafty lefthander with great "stuff" may be on the mound, but we're stepping up to the plate and digging in.

Batter up!

Sincerely,

Brian Nelson, CFA
President, Investment Research & Analysis
Valuentum Securities, Inc.
brian@valuentum.com



P.S. On a very personal note, I wanted to thank you for your continued support. Without you, neither the Nelson Exclusive publication nor Valuentum would exist. This fact is not lost on me. I thank you deeply.

The Nelson Exclusive: Volume 2, Issue 1

The Nelson Exclusive is published monthly. Contact us at info@valuentum.com for more information.

(1) From the SEC's website: A short sale is the sale of a stock that an investor does not own or a sale which is consummated by the delivery of a stock borrowed by, or for the account of, the investor. Short sales are normally settled by the delivery of a security borrowed by or on behalf of the investor. The investor later closes out the position by returning the borrowed security to the stock lender, typically by purchasing securities on the open market.

Investors who sell stock short typically believe the price of the stock will fall and hope to buy the stock at the lower price and make a profit. Short selling is also used by market makers and others to provide liquidity in response to unanticipated demand, or to hedge the risk of an economic long position in the same security or in a related security. If the price of the stock rises, short sellers who buy it at the higher price will incur a loss.

Brokerage firms typically lend stock to customers who engage in short sales, using the firm's own inventory, the margin account of another of the firm's customers, or another lender. As with buying stock on margin, short sellers are subject to the margin rules and other fees and charges may apply (including interest on the stock loan). If the borrowed stock pays a dividend, the short seller is responsible for paying the dividend to the person or firm making the loan (Source: SEC https://www.sec.gov/answers/shortsale.htm)

Short selling is not for all types of investors, and readers should consult their personal financial advisor that understands their individual goals and risk tolerances before considering any investment or any strategy. Potential losses for an investor engaging in a short selling strategy are theoretically infinite.

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