April 11, 2017

INVESTMENT LETTER

DOES EXCITEMENT ALWAYS BRING PROFITS?

SNAP, INC. (NASDAQ: SNAP)

One challenge a money manager faces is to keep a curious and energetic viewpoint, eager to embrace untested concepts, willing to dig deep to learn about any company that he or she believes is undervalued or underpriced. Pursuing such a challenge can be intellectually stimulating and, as we have seen in the case of Universal Display (NASDAQ: OLED), can produce investment rewards. But there are two sides to the issue of mispricing: a company may be overvalued, having been the subject of extravagant but empty promises, promises out of touch with reality, and that pose danger to the investor, just as dramatically underpriced companies with substance and powerful competitive advantages offer great rewards to the investor.

The tug of war that money managers must deal with every day—the struggle between the forces of excitement and reality—had me in its grasp when I was reviewing Snap, Inc.'s preliminary prospectus, filed on February 2, 2017 with the Securities & Exchange Commission.

The Snap story, which had been accompanied by effusive praise from the underwriters for the company's prospects and for its software, had been in the news for months: it was almost impossible not to be aware of Snap's imminent offering and almost impossible not to be curious, and maybe skeptical, about the company's implied boast that its products were uniquely valuable, meeting a consumer demand that no other company could meet.

Who could not be interested in a company that had received powerful, sophisticated promotion, with stories appearing for months before the company's scheduled going public sale in March? Who could ignore the stories about Snap that appeared almost daily in publications with national reach, such as *The Wall Street Journal*, *The New York Times*, *USA Today*, and interviews of Snap management with Jim Cramer, CNBC, ABC, and other influential media, especially when the subject of all this publicity was a company acclaimed by Wall Street analysts to have created software that could revolutionize the way people communicated through picture transmission, that claimed by implication that its products were revolutionary?

As exciting and promising as the Snap story was, I forced myself to remember that it is also the job, the investment manager's fiduciary duty, to protect his (her) clients by avoiding commitments in companies where risk has been obscured or camouflaged by heavy promotion or by the promotion of a service or product that seems exciting or sexy. A sexy product could also easily turn out to have abbreviated permanence and questionable lasting power, leaving promises unfulfilled.

Snap completed the filing of its final prospectus on March 1. Underwriters fixed the selling price at $17.00 a share, but only the underwriting group's most favored clients were able to get that price. (The lead underwriter for Snap was Morgan Stanley which sold 60,484,615 shares. In the underwriting group, with less of a commitment but still an important role in selling Snap to their clients were SunTrust Robinson Humphrey, Inc. and Goldman Sachs.)

The public's first opportunity to buy shares came on March 2 at $24.00. The next day, shares traded at $29.44, the high of the day, and so far, the all time high. From $17.00 a share to $29.44 in less than a week is a remarkable ascent. Such an ascent was bound to at least arouse the curiosity of even the most jaded investor, an ascent whose power was propelled by a story about the Snap offering on ABC's Evening News on March 3, the second day the shares traded, as well as other shrewdly placed stories about the company's offering in the two week period before and after March 2.

For months, I had been following the Snap story, and I had made it a point to devote several hours to studying the February 2 preliminary prospectus. On page one of this document, Snap noted that it "…is a camera company...," a statement that puzzled me, given my understanding that the company produced software, an intangible product, and not tangible products, such as a camera that might be a physical part of an Apple or Samsung phone. What message was the company trying to convey, I wondered? What did the company seem to suggest when it implied that it was a hardware company as well as a software company? The company's curious statement, filled with mystery, begged for clarification.

Snap does not design or manufacture cameras, in fact, nor any other product for that matter. What Snap has done, is to create an ingenious software messaging system that allows a Snapchat member to load a picture into a software package and then transmit the picture to another Snap devotee. If someone is taking a selfie using Snap, the Snap software can make and deliver a seductive promise: after a picture is received, it will often disappear in a short time.

Young people, mostly in the eighteen to thirty-four age demographics, had given Snapchat rave reviews, and at first glance, at my first reading of the preliminary prospectus, the numbers backed up these reviews.

> Our advertising business is still young but growing rapidly. For the year ended December 31, 2016 we recorded revenue of $404.5 million, as compared to revenue of $58.7 million for the year ended December 31, 2015, representing a year-over-year increase of more than 6x (page 4, Snap preliminary prospectus of February 2, 2017.)

GOPRO (NASDAQ: GPRO): A SOBER STORY OF A ONCE HIGH FLYING COMPANY THAT ENCOURAGED SELF ABSORPTION AND ULTIMATELY FELL PREY TO REALITY

GoPro (NASDAQ: GPRO) is another company that appeals to the egocentric personality, permitting transmission of a video of the picture taker performing an impressive athletic feat.

GoPro made its debut on June 26, 2014 at $24.00 a share and quickly rose to $31.34 a share on the first day of trading activity. As of the close of trading on Nasdaq on Friday, April 7, 2017, an investor could get all the GoPro shares he wanted at $8.55 per share.

Some people say that Snap is following in the footsteps of GoPro, offering instant gratification and shallow connection for the self-absorbed. The creativity of GoPro and Snapchat is impressive, but you have to wonder whether there might be too many entrants in the game of selling self-recognition, self-promotion, and instant gratification.

I was getting excited, bullish, optimistic about the numbers in the Snap prospectus, but I told myself to temper my euphoria as I recalled the story of Icarus, a prominent character in Greek mythology who built two wings, attached these wings to his body, thinking that his wings were heat proof and that he could fly close to the sun without having to worry that the sun's power could melt his wings and send him hurtling to the sea and to his death.

Icarus apparently did not want to confront the dynamic of psychological escalation, a force that says that once you have committed to a belief, idea or thesis, it becomes more difficult to be objective, to challenge your assumptions, and to change course and face a dreary and often dangerous reality, even if a negative reality becomes increasingly in conflict with your hopes and fantasies. With psychological escalation, you can mold reality any way you like and postpone the confrontation with reality until it is too late.

Was there a conflict, a tug of war between what I now wanted to believe about Snap's prospects and the reality of its financial achievements?

I told myself not to make the mistake that Icarus made—that is, forming an opinion and not permitting yourself to consider facts that could make the opinion worthless or dangerous.

Sending messages was not new and did not require a patent application, but sending messages that were designed to have a short life and to disappear quickly from the recipient's phone was certainly a novel development. But I wondered how valuable such a feature was? Was this feature a fad, or something more durable, and were there other companies that boasted similar offerings, thus narrowing the competitive advantage that Snap might claim?

These thoughts took me back to some of my conversations with people in the eighteen to thirty four year old age group as I listened to their expressive and effusive praise about Snap, praise as you would expect, that was embellished with words such as "fantastic" "amazing," and "incredible."

Those words alone made me sit up and take notice, and think about how strong the company's competitive position actually is.

Snap faces, in fact, much competition from companies which deliver pictorial and text messages from one person to another. Instagram, for example, which Facebook acquired in April 12, 2012, paying a billion dollars in cash and stock, offers a convenient and attractive message service with appeal to the young demographic that Snap prizes. Instagram can boast of more than one hundred million users, with ninety per cent of these people under thirty five years of age. Instagram pictures do not disappear, they are part of a permanent record. Instagram offers unique filters to make their photos exceedingly attractive and, like Snapchat, Instagram's photos are easy to take.

Because Snapchat photos disappear after seconds, it could be argued that Snapchat can deliver photos of a more sensitive nature than Instagram, as the Snapchat users do not have to worry about unwanted undesirable permanence of the content they deliver. You could say the Snap product gains a competitive advantage over Instagram because the Snap product is transitory. For the Snapchat user, there is little to worry about when it comes to the accumulation of meaningless, insipid, and worse, embarrassing content. However, it should be noted, this disappearance can be negated by a recipient of a Snapchat photo simply taking a screen shot of a Snapchat message or photo.

Snapchat is like the discounting mechanism of the public securities markets. These markets always look into the future, considering the past as weak history, events that mean little, events that serve only as a rough, highly limp or anemic guide to the future. Snapchat's most loyal demographic lives in the present, worshipping instant gratification, disdaining the lessons of history, but wanting and needing to experience excitement and novelty in the present. What better way to do this than to send a picture, made alluring and powerful by its animation, especially when the picture contains sexual content, and a picture that will also soon disappear without any incriminating consequences? What could be more exciting than to send a picture that is meant for only one person, and yet because the picture has a short life, there is little risk of putting the sender into marital jeopardy, or any other compromising position?

I returned my thinking to the concept of the deliberate destruction of a picture. Was this a clever version of planned obsolescence? The idea of erasing historical evidence puzzled me, probably because, as a member of a demographic markedly older than Snap's target market, I was trained to believe that pictures, and paintings for that matter, often reflected much effort and much sentiment, and therefore begged to be retained and archived, and not eliminated arbitrarily. You don't put a lot of effort, my conditioning said, into something and then destroy it.

I was able to reconcile my apparently outdated view of communication and artistry, however, by recalling a phrase that the Las Vegas Nevada Convention and Visitors Authority had made famous: "What Happens in Vegas, Stays in Vegas." If you lead an upright, straight arrow life, characterized by probity, communication without guile, and you make your car payments and mortgage payments on time, conduct your friendships and other important relationships without deception and complication, but with good intent and kindness, and generally follow the golden rule, you may wonder about the value of a feature that automatically makes a picture disappear or go blank after a very short period.

But then you may be the type, instead, that goes to Las Vegas looking for illicit experiences and other thrills. If that is the case, he idea of making history disappear or rewriting history may appeal to you and you might find disappearing ink, or in this case disappearing pictures, to be of great value.

My mind was spinning. Was there any way to bring objectivity to the investment worth of Snap?

If the Snapchat medium emphasized impermanence, something transitory, something of a short life, with emphasis on the here and now, could the Snapchat phenomenon itself, be transitory, its services a fad? Snap's offerings might be highly creative, maybe even ingenious, but did the company have the staying value that companies like Apple, Google and Amazon did? These companies are meeting important if not indispensable needs. These companies have something that is unique, giving them significant competitive staying power. But many companies, such as Instagram and Facebook, offer the ability to transmit pictures, whether permanent or impermanent. So, what was so unique about Snapchat? I was looking for the proof in the pudding, and the numbers would tell me just how good the pudding was.

The numbers do not tell a kind story about Snapchat. What is the reality of Snapchat, especially its financial position? I had set a time limit to make a decision on whether to consider Snap, and I was about to reach that time limit.

Below are comparative income statements for the fiscal and calendar years ended on December 31, 2015 and December 31, 2016. (page 10, Snap preliminary prospectus of February 2, 2017.)

Summary Consolidated Financial Data

The following table summarizes our consolidated financial data. We have derived the summary consolidated balance sheet data as of December 31, 2015 and 2016 and consolidated statements of operations data for the years ended December 31, 2015 and 2016 from our audited consolidated financial statements included elsewhere in this prospectus. Our historical results are not necessarily indicative of our results in any future period. You should read the following summary consolidated financial data together with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements and the related notes included elsewhere in this prospectus. The summary consolidated financial data in this section are not intended to replace our consolidated financial statements and the related notes and are qualified in their entirety by the consolidated financial statements and related notes included elsewhere in this prospectus.

	Year Ended December 31, 2015	2016
	(in thousands, except per share amounts)	
Consolidated Statements of Operations Data:		
Revenue	$ 58,663	$ 404,482
Costs and expenses:		
Cost of revenue	182,341	451,660
Research and development	82,235	183,676
Sales and marketing	27,216	124,371
General and administrative	148,600	165,160
Total costs and expenses	440,392	924,867
Loss from operations	(381,729)	(520,385)
Interest income	1,399	4,654
Interest expense	—	(1,424)
Other income (expense), net	(152)	(4,568)
Loss before income taxes	(380,482)	(521,723)
Income tax benefit (expense)	7,589	7,080
Net loss	$ (372,893)	$ (514,643)
Net loss per share attributable to Class A and Class B common stockholders and Series D, E, F, and FP preferred stockholders(1):		
Basic	$ (0.51)	$ (0.64)
Diluted	$ (0.51)	$ (0.64)
Pro forma net loss per share attributable to Class A, Class B, and Class C common stockholders(1):		
Basic		$ (0.51)
Diluted		$ (0.51)

(1) See Note 15 of the notes to our consolidated financial statements included elsewhere in this prospectus for a description of how we compute basic and diluted net loss per share attributable to Class A and Class B common stockholders and Series D, E, F, and FP preferred stockholders and pro forma basic and diluted net loss per share attributable to Class A, Class B, and Class C common stockholders.

As Jack Webb, the businesslike hero known as Detective Friday in the television series called Dragnet would say:

JUST THE FACTS, MA'AM, OR JUST THE NUMBERS, SNAP.

So here are the facts, the indisputable numbers:

> For the year ended December 31, 2016, net cash used in operating activities was $611.2 million as compared to $306.6 million for the year ended December 31, 2015. For the year ended December 31, 2016, our Free Cash Flow was $(677.7) million as compared to $(325.8) million for the year ended December 31, 2015. For a description of how we calculate our revenue, ARPU, Adjusted EBITDA, and Free Cash Flow, and factors that may affect these metrics, see "Management's Discussion and Analysis of Financial Condition and Results of Operations." (page 1, Snap preliminary prospectus of February 2, 2017.)

As I plowed through the prospectus, other facts alarmed me. Other excerpts show a company bleeding cash but also a company whose top executives have taken much of their profits and have structured the common shares into three classes with these executives being empowered to run the company without any real checks or balances.

> As a result of the Class C common stock that they hold, Evan Spiegel, our co-founder and Chief Executive Officer, and Robert Murphy, our co-founder and Chief Technology Officer, will be able to exercise voting rights with respect to an aggregate of 215,887,848 shares of Class C common stock, which will represent approximately 88.5% of the voting power of our outstanding capital stock immediately following this offering. As a result, Mr. Spiegel and Mr. Murphy, and potentially either one of them alone, have the ability to control the outcome of all matters submitted to our stockholders for approval, including the election, removal, and replacement of directors and any merger, consolidation, or sale of all or substantially all of our assets. (page 4, Snap preliminary prospectus of February 2, 2017.)

The two founders control 88.5% of the stock and all of its voting power and therefore can, with impunity, ignore the interests or subvert the interests of the public shareholders.

Such a situation is unprecedented:

> Although other U.S.-based companies have publicly traded classes of non-voting stock, to our knowledge, no other company has completed an initial public offering of non-voting stock on a U.S. stock exchange. (page 5, Snap preliminary prospectus of February 2, 2017.)

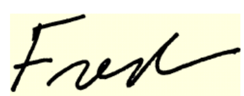
As I read on, I imagined that many investors had not read the prospectus or had decided upon reading to ignore additional warning signs such as the following.

> We have a short operating history and a new business model, which makes it difficult to evaluate our prospects and future financial results and increases the risk that we will not be successful. (page 6, Snap preliminary prospectus of February 2, 2017.)

Yes, the company's operating history was short, but as I mentioned earlier, alarmingly, its financial position had dramatically worsened in 2016. **From 2015 to 2016 the loss from operations grew from $381,000,000 to $521,000,000.**

When the hype fades away and when things get rough, when reality collides with fantasy and promotion, we may see some investors, who believed that doing their homework was a waste of time, discover that getting rich was as elusive as finding a needle in a haystack. Desperately searching for a miracle, these investors may learn a tough market lesson, as succinctly and articulately put by Warren Buffett, when writing about the collapse of the internet bubble in 2002, as follows: "After all, you only find out who is swimming naked when the tide goes out." Or, to put it another way: when the chips are down, that is when you find out that the emperor has no clothes.

Sincerely,



Fredric E. Russell
Fredric E. Russell Investment Management Co.
918.743.5959
www.ferimc.com

****

Fredric E. Russell has a B.A. from Swarthmore College in Swarthmore, PA and an M.B.A and an M.A. from Washington University in St. Louis, MO. He also holds the CPA certificate and, in his previous life, he taught accounting and finance at three universities, as well as history and literature at one university. He believes that his love for writing and his usually correct grammar come from spending four years learning the English language at Deerfield Academy in Deerfield, MA, and from spending countless hours in the Swarthmore College library on Saturday afternoon studying great writers in history and philosophy while wishing he were at a big university, such as the University of Oklahoma, watching a football game on Saturday afternoon with women who enjoyed partying as well as studying, a dual dynamic missing at Swarthmore. He likes to read anything well written that he can find. He does not enjoy fiddling with an iPhone but prefers to use his work and spare time studying and collaborating with his driven, sharp colleagues to produce letters that are informative and easy to read. BUT MOST IMPORTANTLY OUR JOB IS TO MAKE MONEY WITH AS LITTLE RISK AS POSSIBLE FOR OUR CLIENTS. We are appreciative of a wonderful client base and I am appreciative of being able to come to work each day and be with highly intelligent and pleasant coworkers.

****

For further information, please contact Ying Qi via email at yqi@ferimc.com or call her at 918.743.5959.

Our web site: www.ferimc.com has loads of information about the firm including an archive of Investment Letters.

This letter is not a recommendation of purchase or other action.