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June 2011 Report

Dear Friends,

Motiwala Capital began operations in April 2011 and this is our first quarterly letter to our clients. The primary focus of these letters will be two fold – discuss our value investing philosophy and recent portfolio decisions.

Eat our own cooking: As a fiduciary, one of the main responsibilities is to do what is in the best interests of our clients. We take this responsibility seriously and invest your capital as if it were ours. My personal portfolio is invested alongside my clients' portfolios. We do not receive any commissions for selling any products. We are an independent fee-only firm and we receive a fee for managing your assets. If your portfolio does well, then we do well.

Value Investing: The basic premise of "Value Investing" is to buy an asset or security below its estimated true worth or intrinsic value. Two golden rules of investing are: Rule # 1 - Don't lose money and Rule # 2 - Don't forget Rule #1!! We have put up a presentation on our website or email us to receive a copy.

Blog: Occasionally we share our thoughts on a recent investment or provide an update on an existing position. Our blog also contains a lot of excellent educational material (www.motiwalacapital.com/blog). In order to receive updates automatically, please subscribe to our blog.

Position Sizing: Given the size of our initial accounts, we favored a 10 stock portfolio with a 10% allocation to each idea. In a short time frame, we realized the volatility that comes from having such a concentrated portfolio and the potential to have a huge haircut if we are wrong / unlucky or are too early in an investment. After our initial positions were put on, we decided to move towards a 20-25 stock portfolio. Such a portfolio is concentrated enough while providing a reasonable level of diversification at the same time.

Cash: At the end of June 2011, most accounts had significant levels of cash (>20%). Our cash level increased after we received cash from the tender offer. This should change as we find opportunities to deploy this cash in the coming months.

Portfolio

When we began the quarter, the US stock market as indicated by the SP 500 index had almost doubled since the scary lows of March 2009. We do not attempt to time the markets and wait for a correction before investing, but at the same time we were cautious. We started investing the accounts with 4 positions **- Microsoft (MSFT), Western Digital (WDC), GameStop (GME) and**

Aeropostale (ARO). Our detailed thesis on these companies is available on our blog. We provide a short summary below:

Western Digital (WDC) is the largest manufacturer of hard disk drives in the world. In FY 2010, sales were $9.8 billion with FCF of $1.2 billion. WDC trades at 10 times earnings and had $2.9 billion in excess cash. With an enterprise Value of $4.6 billion, WDC traded at 4-5x trailing twelve month (TTM) FCF.

GameStop (GME) is the largest video game retailer in the world and sells new and used video game software, hardware and accessories for video game systems from Sony, Nintendo and Microsoft. At our average purchase price $20, GME was trading at 8 times earnings. In FY 2010, GameStop had $9.5 billion in sales and produced $400 million in FCF.

Aeropostale (ARO) is a mall-based specialty retailer of casual apparel and accessories. ARO has grown sales from $568 million in 2002 to $2400 million this past year. We purchased shares at an average price of $24.5 and a P/E of 10. ARO has been aggressive in returning excess capital to share holders and has reduced share count by 35% since IPO.

<u>Why is it attractive?</u> Cotton prices had more than doubled towards the end of last year and analysts forecasted that this would be a major impact to gross margins of clothing retailers. We felt that a lot of the pessimism was priced into the stock price at 10 times earnings while comps were trading at 15 to 25 times earnings. Many seasoned investors such as Tweedy Browne and Michael Price have recommended relying on private market values as a valuation method. We noted that a few acquisitions in the retail space in the early part of the year such as Jo Ann Stores, Gymboree and J. Crew. The average multiple paid on these deals was 8x EBITDA and ARO was trading at 4x EBITDA.

Portfolio performance

ARO took a hit on weak Q1 earnings and much lower Q2 guidance. Most of the problems were with a fashion miss with women's apparel and excess unsold inventory. Gross margin came out very weak and quarterly EPS more than halved year over year. The next couple of quarters could be rough with higher cotton prices also impacting them and we are going to watch for signs of improvement. Unless we feel the business has permanently deteriorated, we intend to hold this position. This large position which went against us hurt performance in this quarter.

We were fortuitous with the timing of our GME and WDC purchases. The two positions appreciated by about 30% and 20%. We decided to trim the GME position down to about 5%.

"*Sell in May and Go Away*" along with other world events such as Japan natural disasters, Greece issues (yet again) helped cause a correction of some sorts (about 7-8%) starting in May and into the middle of June. We made three other additions to the accounts towards the end of the quarter - **Big Lots (BIG), Bolt Technology (BOLT)** and **Vodafone (VOD).** We will discuss these in future letters.

Value investing comes in various flavors and different kinds of investments. During the quarter, we made 3 arbitrage investments.

Closed end fund tender offers: Two closed end funds from **Morgan Stanley - Asia Pacific Fund (APF) and Malaysia Fund (MAY)** had a tender offer to acquire 25% and 15% of the Funds' outstanding shares in exchange for cash at a price equal to 98.5 % of Fund's NAV. These two funds were trading at 94% and 91.5% of their NAV. The important thing about the tender offer was making sure the tender offers had the odd lot provision. The tender went smoothly and we received cash in our accounts a week after. On an absolute basis, we made roughly 5% and 7.5% on these transactions - not bad for a two week investment.

Merger arbitrage: **Shamir Technology (SHMR)** was selling 50% of its stake to French company Essilor (Market Cap 11 billion Euros) in an all cash transaction. When we bought SHMR shares in early June, they were trading at a discount of 5% from the purchase price. The transaction closed on July 1, 2011 and we are awaiting payment in lieu of our shares.

The response to our new firm has been incredible. We have received a lot of support and encouragement. We would like to thank each of you for placing your trust in us and would highly appreciate referrals. Thank you for your continued support and confidence.

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Portfolio Manager
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