

T2 Partners LLC

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January 31, 2012

Dear Partner,

Our fund rose 13.5% in January vs. 4.5% for the S&P 500, 3.6% for the Dow and 8.1% for the Nasdaq.

On the long side, we had many big winners including Netflix (73.5%), Pep Boys (36.4%, which received a buyout offer yesterday), Goldman Sachs (23.3%), Iridium warrants (22.8%), Resource America (19.7%), J.C. Penney (18.2%), Dell (17.8%), Howard Hughes (17.3%), Citigroup (16.8%), and Microsoft (13.8%). We had no losers of note on the long side other than SanDisk, which declined 6.8% after it gave weak guidance when it reported earnings last week (we took advantage and bought more).

Our short book offset some of our gains thanks to Lululemon (35.3%), InterOil (31.2%), ReachLocal (27.5%), First Solar (25.2%), Green Mountain Coffee Roasters (18.9%), ITT Educational Services (15.8%), and Salesforce.com (15.1%).

Some might say that we have a hot hand so far this year, but this would be incorrect. Our hands have been largely idle, as our portfolio today is nearly identical to the one that did so poorly last year. As we noted in our annual letter, time will tell whether we were wrong or just early on many of our favorite stocks – but the past month has provided some evidence for the latter.

Netflix

After Netflix reported earnings last week and the stock jumped, we sent you an email (attached in Appendix A) with our thoughts.

J.C. Penney

The new CEO of J.C. Penney, Ron Johnson, and his #2, Michael Francis, hosted a two-day launch event for analysts and investors in New York City last week, during which they outlined their plans to transform the company and make it “America’s Favorite Store.” We were extremely impressed and after meeting and hearing from Johnson, we are even more convinced that he is the best retail CEO in the world, bar none. Attached in Appendix B is a summary of the two [press releases](#) from the launch event.

St. Joe

We have long been bearish on St. Joe, but as the stock declined last year to under \$13 in November – it ended the year at \$14.66 – we covered most of our position such that it was well under 1% going into this year. Like many beaten-down stocks, however, it jumped in the first weeks of 2012, to over \$17, so we took our short position to nearly 2%.

On Friday, St. Joe [announced](#) that it “intends to significantly reduce planned future capital expenditures for infrastructure, amenities and master planned community development” and will “record an aggregate non-cash charge for impairment associated with these projects that may range from \$325 million to \$375 million in the fourth quarter...,” an amount equal to about half of the total real-estate assets on the company's balance sheet.

We feel a measure of satisfaction, as St. Joe is finally admitting what we have long maintained: that many of its assets will likely never be developed and thus need to be written down. We shared our analysis in our May 2011 [letter](#) (along with many photos and videos from a recent trip to see some of the properties):

In the early years of the housing bubble, St. Joe built a small number of developments such as WaterColor and part of WaterSound on the ocean in popular areas. Because of their attractive location (and, of course, the housing bubble), St. Joe sold most of the lots in these developments at good prices. But then St. Joe went crazy, spending well over \$1 billion during the bubble years on developments that aren't on the ocean (WaterSound Origins, RiverCamps, RiverTown) or are far away from the airport and well-trafficked areas (WindMark, SummerCamp). The combination of the unattractive locations and the bursting of the housing bubble has resulted in these developments being ghost towns today. In our opinion, they are likely to always remain so (though they would be perfect for the government to hide people in the witness protection program).

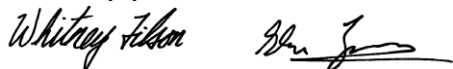
These developments clearly aren't worth even a fraction of what St. Joe spent to build them, yet the company hasn't marked them down to any meaningful degree, apparently due to the use – and, in our opinion, abuse – of the “recoverability test”...

The stock has declined moderately since this announcement – and we believe it has further to fall.

Conclusion

Thank you for your continued confidence in us and the fund. As always, we welcome your comments or questions, so please don't hesitate to call us at (212) 386-7160.

Sincerely yours,



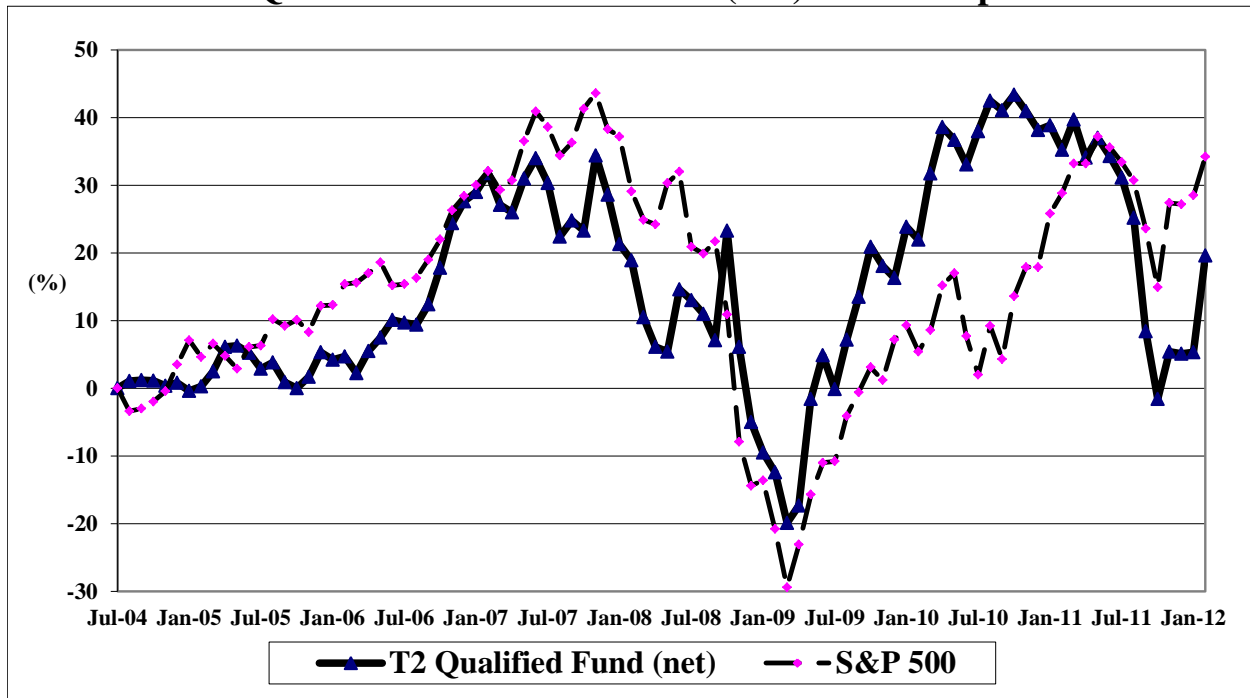
Whitney Tilson and Glenn Tongue

The unaudited return for the T2 Qualified Fund versus major benchmarks (including reinvested dividends) is:

	<u>January</u>	<u>Since Inception</u>
T2 Qualified Fund – net	13.5%	19.6%
S&P 500	4.5%	34.2%
Dow	3.6%	47.1%
NASDAQ	8.1%	43.0%

Past performance is not indicative of future results. Please refer to the disclosure section at the end of this letter. The T2 Qualified Fund was launched on 7/1/04.

T2 Qualified Fund Performance (Net) Since Inception



T2 Qualified Fund Monthly Performance (Net) Since Inception

	2004		2005		2006		2007		2008		2009		2010		2011		2012	
	T2	S&P	T2	S&P	T2	S&P	T2	S&P	T2	S&P	T2	S&P	T2	S&P	T2	S&P	T2	S&P
	QF	500	QF	500	QF	500	QF	500	QF	500	QF	500	QF	500	QF	500	QF	500
January			0.7	-2.4	0.5	2.7	2.2	1.7	-2.0	-5.9	-3.2	-8.4	-1.5	-3.6	-2.6	2.4	13.5	4.5
February			2.2	2.0	-2.4	0.2	-3.6	-2.1	-7.1	-3.3	-8.6	-10.8	8.0	3.1	3.3	3.4		
March			3.5	-1.7	3.2	1.3	-0.9	1.1	-4.0	-0.5	3.2	9.0	5.2	6.0	-3.9	0.0		
April			0.2	-1.9	1.9	1.4	4.0	4.6	-0.7	4.9	19.0	9.6	-1.4	1.6	2.1	3.0		
May			-1.0	3.2	2.4	-2.9	2.3	3.3	8.7	1.2	6.6	5.5	-2.6	-8.0	-2.0	-1.1		
June			-2.2	0.1	-0.4	0.2	-2.8	-1.5	-1.4	-8.4	-4.8	0.2	3.7	-5.2	-2.4	-1.7		
July	1.1	-3.4	0.9	3.7	-0.3	0.7	-6.1	-3.0	-1.8	-0.9	7.3	7.6	3.3	7.0	-4.5	-2.0		
August	0.1	0.4	-2.8	-1.0	2.7	2.3	2.0	1.5	-3.5	1.3	5.9	3.6	-1.0	-4.5	-13.4	-5.4		
September	-0.1	1.1	-0.9	0.8	4.8	2.6	-1.2	3.6	15.1	-9.1	6.5	3.7	1.6	8.9	-9.2	-7.0		
October	-0.7	1.5	1.7	-1.6	5.6	3.5	9.0	1.7	-13.9	-16.8	-2.3	-1.8	-1.7	3.8	7.2	10.9		
November	0.4	4.0	3.5	3.7	2.6	1.7	-4.3	-4.2	-10.5	-7.1	-1.5	6.0	-2.0	0.0	-0.3	-0.2		
December	-1.2	3.4	-1.0	0.0	1.1	1.4	-5.7	-0.7	-4.7	1.1	6.5	1.9	0.5	6.7	0.2	1.0		
YTD TOTAL	-0.4	7.1	4.6	4.9	23.7	15.8	-5.9	5.5	-25.4	-37.0	37.0	26.5	12.1	15.1	-24.1	2.1	13.5	4.5

Note: Returns in 2009 and 2012 reflect the benefit of the high-water mark, assuming an investor at inception.

Appendix A: Email to Partners, January 26, 2012

Dear Partner,

Netflix reported Q4 earnings after the close yesterday and the stock is up more than 20% today to \$115 (we purchased it late last year at \$76), which is contributing to a good start the year for our fund. We wrote up our take on the company's earnings and wanted to share it with you before circulating it more broadly.

As we disclosed and discussed in our annual letter, it was our 10th largest – about a 5% – position entering the year. As we discuss below, we still like the stock, but have been trimming it for position sizing and risk management purposes as it has risen.

Please let us know if you have any questions.

Sincerely yours,

Whitney and Glenn

Netflix's quarter was very strong across the board and blew away analysts' estimates, and guidance was strong as well. Here are the highlights:

- Most importantly, net domestic streaming subscribers increased by 220,000, with particular acceleration in the last month of the quarter (Dec.), where Netflix “not only returned to strongly positive net streaming additions (aided by strong seasonal gross adds) but exceeded our forecast. In particular, we saw fewer streaming cancellations, as well as lower migration to DVD-only plans, resulting in the outperformance for streaming members.”
- Contribution margin in this segment was 10.9%, far above the company's and analysts' estimates of 8%, and guidance is to maintain 11% in Q1 12 and then increase by a full percentage point per quarter the rest of the year.
- International streaming subs grew by 380,000, so total streaming subs grew by over 600,000. This is still far below the peak net additions of 3.3 million in Q1 11, but it's a complete turnaround from the loss of 810,000 the previous quarter, so there's a very favorable trend – and guidance for Q1 12 is for 1.7 million net additions.
- EPS of 73c was far above consensus estimates of 55c.
- Revenue of \$876M was well above estimates of \$855M.
- Free cash flow was \$34 million, up from \$14 million the previous quarter.
- There are a lot of competitors out there, which Netflix discusses extensively on pages 3-4, but they don't seem to be getting much traction or impacting Netflix to a material degree: “Both Amazon and Hulu Plus's content is a fraction of our content, and we believe their respective total viewing hours are each less than 10% of ours.”
- The DVD-by-mail business, Netflix's cash cow, lost 2.76 million (19.8%) of its customers in Q4, but that's not surprising given the huge price increase from \$2 to \$8 per month (it used to be \$9.99/mo. for both streaming and DVD-by-mail, and it's now

\$7.99/mo. each). Netflix guided to 1.5 million cancellations in Q1 12 (13.4%), “with the sequential decline moderating in future quarters.” The business remains highly profitable (a 52.4% contribution margin in Q4, leading to \$194M in contribution profit), and Netflix expects that it will remain so: “The DVD business model is predominantly variable cost based. So, as the size of the market opportunity continues to decline, we expect healthy contribution profit margins to be maintained.”

- Customers love the streaming service, as evidenced by the fact that “Members enjoyed over 2 billion hours of Netflix streaming video in Q4, which is approximately 30 hours per member per month on average.” Netflix is a tremendous value, offering a wide range of entertainment for only *27 cents per hour* (\$7.99/mo. divided by 30 hours/mo. of average viewing).

We know the bear thesis well – we wrote about it extensively a little over a year ago (<http://valueinvestingletter.com/why-were-short-netflix.html>) – and it just doesn’t hold much water anymore. The key pillars of the current bear thesis are that Netflix permanently damaged its brand last year with the price increase and Qwikster debacle, so subscribers would continue to flee, thereby reducing cash flow at a time when the cost of content commitments (which are fixed) are skyrocketing, triggering a cash crisis and a collapse of the stock. We couldn’t rule out this scenario, which is why we sized this position in the 5-6% range, but the odds of it just dropped a lot in light of yesterday’s earnings report. It shows convincingly that the furor over last year’s missteps is fading, subscribers are once again flocking to – and heavily using – the streaming service, the international opportunity is robust (who knew that Netflix is available in 47 countries?), and that the company is in good shape financially to weather this year’s small expected losses.

All of this didn’t change the mind of one analyst, Michael Pachter of Wedbush Securities, who appeared on CNBC’s Fast Money just after me and said, “The company was more out of touch than I thought they were before. They’re making light of their diminishing content quality.” We think he’s the one out of touch, as Netflix is hugely focused on streaming content quality and this topic is discussed at length on pages 2, 3, 7 and 8 in the attached earnings release. In addition, Netflix’s streaming content is *increasing* in quality, even with the loss of the Starz titles. In fact, Starz is the big loser here: they turned down what was surely a very generous offer and instead tried to extort Netflix, so Netflix walked – and then went around Starz and got back many (most?) of the lost titles by negotiating directly with the content owners.

This is a very important development that undermines of the key pillars of the bear thesis – namely, that Netflix’s streaming business will never be very profitable because content providers hold all of the cards. This would be true if Netflix had to offer all movies and TV shows, but it doesn’t. One of the key insights from our survey a year ago of 500+ Netflix customers is that they don’t expect a huge selection of the latest, most popular movies and TV shows for a mere \$7.99/month. They only need to find something enjoyable to watch for one hour a day on average. This gives Netflix the power to play content providers off against one another. If Starz tries to extort Netflix, Netflix can walk and buy other equally good content from someone else. Netflix is providing a huge, brand new revenue stream to all sorts of content providers, which gives it a lot of negotiating power. And here’s the key: nobody else has even a tiny fraction of the number of subscribers that Netflix has (Hulu has a bit over 1 million, less than 5% of

Netflix), so nobody else can bid anything close to what Netflix can. How much is Starz is going to get for its content that Netflix walked away from? Likely only a tiny fraction of what Netflix was offering. (It remains to be seen whether Apple, Amazon, HBO, Verizon, and the cable providers, who obviously do have tens of millions of subscribers, can become effective competitors – this is a risk we’re monitoring closely. But these are all much bigger companies, with 10x-100x Netflix’s market cap, so if they wanted to make a serious push in this area, it would be logical for one of them to buy Netflix, rather than spend billions trying to dislodge it.)

For an analogy of how important it is that Netflix doesn’t have to provide all content, consider Costco and Wal-Mart. How does Costco buy at lower prices than Wal-Mart (and pass greater savings along to its customers), despite being a fraction of the size? Costco and Wal-Mart stores are roughly the same size, yet Costco only carries approximately 5,000 SKUs, whereas Wal-Mart carries 100,000+. Take light bulbs, for example. I’m making this up, but let’s say that the average Wal-Mart carries Sylvania, Phillips and GE bulbs, 40, 60 and 100 watt, in packages of 4, 8 and 12. That’s 27 SKUs (3 x 3 x 3). Let’s say that Costco, on the other hand, sells a 12-pack of 60- and 100-watt bulbs made by one company – that’s 2 SKUs. So when the buyers for Costco and Wal-Mart go to the three manufacturers to negotiate the best price, the Costco buyer says, “We only want two SKUs and we’ll give you more volume in those SKUs than anyone else – and we’re only going to carry one of you, so whoever has the lowest price gets 100% of our business.” The Wal-Mart buyer can’t say that – all three know they’re going to share Wal-Mart’s business, plus each manufacturer has to incur the added cost of supplying nine SKUs – so guess who gets the lower price? Netflix has similar advantages of being able to play suppliers off against each other to get a good price.

Regarding position sizing, Whitney disclosed on CNBC last night (see article and video at: www.cnbc.com/id/46138387) that we trimmed our Netflix position going into the earnings report, yet said we’re as bullish as ever and think the stock is a good bet to double this year. The explanation for this apparent inconsistency is that we have to carefully manage Netflix’s position size for risk management purposes because of the wide range of potential outcomes, including some severe downside scenarios. When we purchased the stock last year, we decided that we were comfortable with a 5-6% position, which is where it was entering this year. As the stock quickly ran up 40% prior to the earnings report, it became larger than a 7% position at the same time that the margin of safety had shrunk (our estimate of intrinsic value didn’t go up 40%), so logic dictated trimming a bit, which we did (back to the 5-6% range). Our selling didn’t reflect any change in our bullishness on the company – rather just the sharp rise in the stock price with little change in the underlying fundamentals.

So with today’s run-up, will we be trimming it back to the 5-6% range? No. We’re now comfortable with a somewhat larger position because we have a lot of new information that changes the odds of the various possible outcomes: for the reasons discussed above, the likelihood of a severe downside scenario has declined significantly, while the upside scenarios are both more likely and more robust. In terms of safety, this is no Berkshire Hathaway to be sure, but it’s much safer today than it was yesterday.

Appendix B: Highlights of J.C. Penney Launch Event, January 25-26, 2012

Here's a summary of the two [press releases](#) from the launch event (you can watch the entire webcast [here](#)):

Beginning February 1, we will have Fair and Square Pricing, making every day a great day to shop. We will create tremendous excitement through monthly promotions that are in sync with the rhythm of our customers' lives. And we will transform each and every jcpenny store over the next four years with a month-by-month, shop-by-shop roll-out of exciting new merchandise initiatives," Mr. Johnson said.

Fair and Square Pricing and Monthly Promotions in Sync with Customers' Lives:

During the presentation, Mr. Johnson and Mr. Francis introduced a new pricing strategy called Fair and Square, which includes three types of prices. Everyday, regular prices, which are always great; Month-Long Values, even better prices on the things you need now; and Best Prices, jcpenny's lowest prices, which always happen on the 1st and 3rd Fridays of every month as jcpenny makes room for exciting new merchandise.

These prices will be coupled with a new promotional cadence that is in sync with customers' lives. Rather than inundating the customer with a relentless series of sales, coupons, rebates and retail gimmicks, jcpenny will host 12 promotional events each year, on a monthly calendar. Each month will include even better values on the things customers are looking to buy during the month and a host of exciting products and services that are unique to the month.

Commenting on the new monthly calendar, Mr. Johnson said, "We want customers to shop on their terms, not ours. By setting our store monthly and maintaining our best prices for an entire month, we feel confident that customers will love shopping when it is convenient for them, rather than when it is expedient for us."

Re-inventing the In-Store Experience around New and Transformed Brands:

At the event, Mr. Johnson and Mr. Francis also outlined plans to entirely re-invent the jcpenny store experience, to include *Main Street* -- the entire store merchandised in a series of 80 to 100 brand shops, rather than the confusing and seemingly endless racks common in department stores today. It will also feature *Town Square* -- an exciting new place that replaces the traditional retail center core of a department store with a series of services, which customers will enjoy before they buy, while they shop and afterwards. And, throughout, the new jcpenny store experience will merge the physical and digital worlds, assuring the physical retail stores' vital role as the centerpiece of retailing's future.

They also gave a sneak peek into the exciting new brands that will be featured in jcpenny's brand shops. They include Martha Stewart® and l'amour nanette lepore™, which were

shown at the event today, among many others. jcpenny also announced plans to transform its customers' favorite existing brands, including, IZOD®, Liz Claiborne® and The Original Arizona Jean Company®, which were also featured at today's event, and a number of others. jcpenny expects to feature 30 new and transformed brands by fall 2012.

On the second day, COO Mike Kramer gave financial guidance:

"The blueprint Ron and Michael outlined yesterday dramatically simplifies our operations and significantly improves the Company's ability to flow margins through to the bottom line. As we transform the business model, our teams are committed to improving sales productivity in our stores, generating 40 percent or better gross margins, while lowering expenses to industry-leading levels. Taken together, this creates a formula for long term, sustainable profit growth," Mr. Kramer said.

Commitment to Reduce Expenses Begins February 1:

The Company announced it is targeting \$900 million in expense cuts to be completed over the first two years of its transformation, ultimately lowering jcpenny's expenses below 30 percent of sales in just two years. Kramer stated he expects to achieve an expense run rate of 27 percent by the end of the transformation in 2015. The savings will come primarily from stores, advertising and the operations in the Company's home office.

Transformation of jcpenny's Store Fleet with Cash from Operations; \$800M to be spent in 2012:

During his presentation, Mr. Kramer revealed plans to fund the transformation of jcpenny's stores through cash from operations, beginning with \$800 million in capital expenditures in fiscal year 2012. The majority of this capital will be spent enhancing jcpenny's store experience and installing the company's new in-store shops. Beginning in August 2012, jcpenny will begin a month-by-month, shop-by-shop strategy to update its stores with new and exciting merchandise and in-store presentations. Two to three shops will be installed each and every month, over the four-year transformational period. Kramer reiterated the expectation that jcpenny's transformation would be complete by the end of 2015.

Commenting on the Company's plans to self-fund its transformation, Mr. Johnson noted, "We are fundamentally re-imagining every aspect of our business and we fully expect the bold and strategic changes we are making to our operations will result in improved profitability. This should enable us to fund the transformation of jcpenny's store experience, while at the same time returning value to shareholders with steady earnings growth."

T2 Qualified Fund, LP (the “Fund”) commenced operations on July 1, 2004. The Fund’s investment objective is to achieve long-term after-tax capital appreciation commensurate with moderate risk, primarily by investing with a long-term perspective in a concentrated portfolio of U.S. stocks. In carrying out the Partnership’s investment objective, the Investment Manager, T2 Partners Management, LLC, seeks to buy stocks at a steep discount to intrinsic value such that there is low risk of capital loss and significant upside potential. The primary focus of the Investment Manager is on the long-term fortunes of the companies in the Partnership’s portfolio or which are otherwise followed by the Investment Manager, relative to the prices of their stocks.

There is no assurance that any securities discussed herein will remain in Fund’s portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed may not represent the Fund’s entire portfolio and in the aggregate may represent only a small percentage of an account’s portfolio holdings. It should not be assumed that any of the securities transactions, holdings or sectors discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein. All recommendations within the preceding 12 months or applicable period are available upon request.

Performance results shown are for the T2 Qualified Fund, LP and are presented gross and net of incentive fees. Gross returns reflect the deduction of management fees, brokerage commissions, administrative expenses, and other operating expenses of the Fund. Gross returns will be reduced by accrued performance allocation or incentive fees, if any. Gross and net performance includes the reinvestment of all dividends, interest, and capital gains. Performance for the most recent month is an estimate.

The fee schedule for the Investment Manager includes a 1.5% annual management fee and a 20% incentive fee allocation. Because some investors may have different fee arrangements and depending on the timing of a specific investment, net performance for an individual investor may vary from the net performance as stated herein.

The return of the S&P 500 and other indices are included in the presentation. The volatility of these indices may be materially different from the volatility in the Fund. In addition, the Fund’s holdings differ significantly from the securities that comprise the indices. The indices have not been selected to represent appropriate benchmarks to compare an investor’s performance, but rather are disclosed to allow for comparison of the investor’s performance to that of certain well-known and widely recognized indices. You cannot invest directly in these indices.

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