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There is a growing debate (some might say consensus) in the financial markets today regarding the possibility of a broad-based bubble in technology stocks. The evidence is compelling: sky-high valuations for certain companies, permissive use of non-standard valuation metrics, record breaking number of IPOs, and the introduction of new phrases into our daily lexicon (our personal favorite is the “Phablet”). As disciplined value investors, these types of companies rarely cross our radar screen, let alone find a place in our portfolio; however, instructive lessons can be learned for intelligent investors by watching the madness of others.

Despite this latest bout of investor euphoria, it’s important to note that based on most metrics the market as a whole is not nearly as expensive as when the last tech bubble burst in 2000. The mania, and commensurate nose bleed valuations, remains confined to the technology sector and almost exclusively to companies associated with “the cloud”, mobile, or social networks (in fact, many large capitalization “old” technology companies trade at reasonable valuations). Yet, there are pockets of irrational speculation which leave run-of-the-mill value investors like us scratching our head.

Perhaps looking back 10 years from now the poster child for this excess will be Facebook’s recent purchase in February of WhatsApp for $19 billion. We don’t pretend to be experts of Facebook’s business model, and certainly not WhatsApp’s; however, it strikes us as highly unreasonable and speculative to pay $19 billion for a business that reportedly generates just $20 million in annual revenue. Very few companies in corporate America achieve a level of profitability which justifies a $19 billion valuation – a quick look at the list of the S&P 500 companies shows only 266 companies with a market value greater than $19 billion. Maybe WhatsApp will one day justify this valuation but the odds are undeniably stacked against it (about the only positive we see in this transaction is the fact that 80% of the purchase price was paid in Facebook stock, which one could argue is an overvalued currency to begin with).

In investing, like most things in life, you can't have your cake and eat it too. We are willing to forego the profits of a hyper growth company like Facebook or WhatsApp in order to avoid the permanent loss of a company like Pets.com. No one knows for certain whether or not, in this latest iteration of investor euphoria, the companies themselves will flourish or flounder, but the likelihood of investment success is severely diminished based on current valuations.

New Purchase: Blackhawk Network (HAWK)

At the beginning of April we added our first new position to the portfolio in more than six months with the purchase of Blackhawk Network. It's rare to find a truly high quality business franchise, and it's even rarer still to find one that's trading at a significant discount to intrinsic value – we think Blackhawk qualifies on both counts. We anticipate this position to be a core, long-term, investment so it's worth discussing in detail the attractiveness of the business and investment opportunity.

The company, founded in 2001 as a subsidiary of Safeway, started life with a simple mission: improve the convenience and breadth of the gift card market by creating a distribution network in third-party retail channels (like Safeway). Prior to the company's formation, the gift card market consisted of a purely direct relationship; for example, if you wanted to give a Best Buy gift card to a family member or friend then you needed to visit a local Best Buy store in order to purchase the card. This was terribly inconvenient for the consumer and, almost as important, limited the amount of gift cards a company like Best Buy could sell by relying exclusively on its own foot traffic. By the late 1990's the growth in the overall gift card market started to plateau.

At the time, there was no mechanism to enable the distribution of gift cards at third party retailers – it would require a middle-man to negotiate contracts, process payments, and facilitate physical distribution and merchandising. To solve this problem, Blackhawk built a proprietary electronic payment network and physical distribution platform to connect distribution partners (first Safeway and later on companies like Kroger and Home Depot) with content providers (think Best Buy, Macy's, AMC Theaters). In exchange for using its network, content providers are willing to pay Blackhawk a fee of approximately 3% and the distribution partner a fee of 6% (the remaining 91% is retained by the content provider).

The value proposition of Blackhawk's network to all constituents is quite compelling: consumers can purchase gift cards in a frequently visited location, distributors are able to increase their traffic and enhance their profitability without utilizing much square footage, and content providers have access to a much larger customer base.

More importantly, as Blackhawk grew its network of distributors and content providers over the past decade, a beautiful thing happened (at least economically speaking) – the company created the classic "network effect", whereby the more companies that use its platform the more valuable that platform becomes. Today, Blackhawk generates more than $1 billion in revenue ($10 billion in load value) and dominates the distribution of gift cards in the grocery and specialty retail channel with more than a 90% share (its only other legitimate competitor, privately held InComm, is primarily focused on the pharmacy and convenience store channel).

Over time, the company created an enormously valuable business franchise with characteristics any business owner would covet: a network that is difficult to replicate, with high-barriers-to-entry, almost always exclusive in nature, and incredibly sticky (in 2013 the company retained 100% of its top 50 customers). Moreover, thanks to the declining cost of technology over time, the network requires minimal incremental capital even as the number of transactions grow.

In addition to the high-quality nature of its business model, we believe the company has several avenues for outsized growth over the next five years. The largest and most immediate opportunity is the ability to enhance productivity at existing locations by implementing best practices and loyalty programs – this could add $2 billion, or 20%, in incremental load value. Additionally, load value will benefit from adding new content and services (like Google Play, iTunes, and Cardpool), expansion into adjacent channels (like the corporate incentive market), growth in new international markets, and continued expansion of domestic retail distribution. We believe total load value (a proxy for revenue) will grow in the low-double digits over the next several years.

At this point you should be asking yourself the following question: why would a high-quality business with seemingly ample growth opportunities trade at a discount to intrinsic value? The answer is partially a result of unique market dynamics and partially due to the short-term nature of most market participants.

After 12 years buried inside a much larger organization, Safeway IPO'd approximately 20% of Blackhawk outstanding stock on April 18, 2013 (the remaining 80% of stock was spun-off to existing Safeway shareholders last week). Often times, when a parent company sells or spins-off a subsidiary, it creates an opportunity for mispricing because the smaller company is not widely followed or well understood. In addition, the likelihood of forced selling increases as shareholders of the parent company are unwilling, or unable, to maintain ownership of the subsidiary. Spin-offs are fertile ground for value hunters.

In the case of Blackhawk, after the company IPO'd at $23 per share with a public float of less than $200 million, we quickly recognized the attractiveness of the business model. After further due diligence and discussions with the management team we believe the company will more than double free cash flow over the next five years – yielding a fair value of $43 per share.

There are two main reasons we believe the company is trading at a price significantly lower than its true intrinsic value. First, the current stock price reflects management's stated long-term goal of stable profit margins. However, based on a detailed analysis of the company's expenses, we believe the business operates with a relatively fixed-cost structure and that, as a newly public company, management is being overly conservative. Second, there is a concern that the company's valuable network will ultimately be disintermediated through digital

payment technologies and online gifting. We have studied this threat extensively and believe that any impact will be felt years, if not decades, from now; and, Blackhawk stands as good a chance as anyone to be a major player in this space. While our eyes are open to this threat, the technology is still nascent, current digital platforms are too numerous, and the physical gift card market is still a very convenient platform.

As we finish our discussion on Blackhawk, it should be noted that this situation reminds us of an investment we made in Mastercard in 2008 with many similarities: a captive subsidiary for many years prior to its IPO in 2006 (Mastercard was previously owned by a consortium of banks), a high-quality business model based on a valuable payment network, investor concern that digital payment technology would eviscerate this network, and a conservative management team guiding for long-term stable margins. Fast forward to 2013, and Mastercard expanded EBITDA margins from 23% to 57%, grown EBITDA over 6x, and experienced an 18x return on its stock price since its IPO. While we are quick to note that no two investments are identical, we do believe that the future for Blackhawk is bright.

Sales: Sprint (S) and Crosstex Energy (XTXI)

During the quarter we exited two long-term core holdings in Sprint and Crosstex. Both of these positions were sold after the stock price reached our estimate of fair value. In the case of Sprint, our involvement with the company dates back to our original purchase in the first quarter of 2011 at $4.95 per share. At the time, the company was emerging from its disastrous purchase of Nextel and embarking on a “network vision” strategy to simplify its network, enhance data speeds and voice quality, and, most importantly, reduce operating and capital costs.

Our timing couldn’t have been worse: over the next six months the stock declined to a low of $2.25 on widespread fears of increased competition, ballooning subsidy costs, no iPhone offering, and increased capital spending to shut down the Nextel network. With a levered balanced sheet some commentators even speculated an impending bankruptcy filing was possible. After reassessing our original thesis we came to the conclusion that the company had enough liquidity to ride out the storm, and, over the long-term, could still capitalize on its “network vision” plan to improve margins and profitability. We doubled-down on our position during the first quarter of 2012 at $2.25 per share – which lowered our total average cost basis to $3.60.

In 2013 the company completed a majority sale to Softbank and we sold our position this past January at an average price of $9.20 per share. Over the course of the three-year investment we earned a total return of 155% and an IRR of 37%.

The sale of Crosstex during the first quarter ended an investment that pre-dates the financial crisis and, over the long-term, generated unsatisfactory returns. The company, founded in 2000, owns one of the largest natural gas pipeline and gathering system focused primarily on resources in Texas and Louisiana. We originally purchased the stock in 2007, at an initial price of $30, based on the premise that the company had excellent exposure to fast-growing resource plays with little commodity exposure – both assumptions ultimately proved faulty.

During the height of the financial crisis it became apparent that the company relied on the processing of natural gas liquids (NGLs) for a significant amount of its gross margin. When NGL commodity prices (which are difficult to hedge) collapsed in early 2009, the company's EBITDA shrank by 75%, putting enormous stress on the company's over-leveraged balance sheet. This forced the company to eliminate its dividend and issue a highly dilutive convertible debt offering which resulted in a 30% increase in the share count. Compounding the decline in NGL prices was a simultaneous slowdown in natural gas production due to lower natural gas prices. The stock declined below $1 per share by March of 2009.

Subsequent to the debt offering we visited with the company in Texas where management outlined a plan to sell assets, reduce its exposure to NGL processing, and eventually reinstate the dividend. We maintained our position in the stock and, over the next four years, the company executed its turnaround plan diligently. This culminated in a merger announcement with Devon Midstream this past November and a simultaneous increase in Crosstex's stock price. We sold the position in January at $36 per share and managed to collect a total of $3.50 in dividends during our holding period. This "round-trip" ultimately resulted in a less than glamorous total return of 32% over a seven-year period. And while the "cash" profit was negligible, the investment did yield an enormous intangible "lesson learned" profit.

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