Blue Tower Asset Management, LLC
311 RANCH ROAD 620 SOUTH
SUITE 111
AUSTIN, TX 78734

July 22nd, 2018

The Global Value strategy composite returned -0.92% gross (-1.22% net) for Q2. Significant losses in our Japanese and European equities were partially offset by a gain in our holding in Enova International. These losses were a combination of decreases in share prices as well as the strengthening of the dollar against the Japanese Yen, Euro, and Russian Ruble.

In this letter, we will provide updates on our views of Sberbank and the pending acquisitions of Express Scripts and Aetna.

Sberbank

We initially covered Sberbank in our 2014 letter to investors.

Four years later, we are still bullish on the stock of the company. The recent decline this quarter is due to three factors; fears over possible future sanctions/general dread about Russian investments, a decline in the value of the ruble which affects the value of Russian financial stocks (ruble fell by about 9% against the dollar in the 2nd quarter of this year), and the impact of non-performing loans from the sanctions imposed on April 6. Much of the sanctions focused on Oleg Deripaska, the president of the Rusal Corporation which was the second largest aluminum producer in the world. Sberbank's loans with sanctioned entities amounts to about 2.5% of Sberbank's financial assets. The majority of these loans are fully collateralized with assets that should retain their value so Sberbank does not appear to be in any significant financial risk from these current sanctions.

The danger is the possibility of future sanctions targeting Sberbank. Currently, there are no indications from the Trump administration that this will happen. Around 90% of the float of Sberbank (45% of its total shares) is owned by American and British investors, so hurting the share price would hurt Americans more than Russians. Some republican congressmen have submitted bills (HR 5428) that would have severe sanctions that essentially cut Russia off from the US financial system, but I believe that those bills are not going to get much traction. If a bill like HR 5428 were to pass, it would cause a permanent impairment of our Sberbank investment.

It is difficult to predict what will happen with the EU sanctions which are currently the most significant for Sberbank's business. The new prime minister of Italy, Giuseppe Conte, has expressed the desire to withdraw sanctions and have rapprochement with Russia. If the sanctions would be dropped, it would increase Sberbank's access to capital and potentially

expand their net interest margins. It goes without saying that a dropping of sanctions on Russia or Sberbank specifically could act as a catalyst to increase the share price.

In May, it was announced that Emirates NBD, Dubai's biggest lender, would buy Denizbank, Sberbank's Turkish branch, for 14.6 billion Turkish lira ($3.2 billion). This purchase price is 1.17 times the book value of the company when the negotiations were begun in October. We see this purchase price as disappointing as some early rumors in the media suggested the deal would be done at over $5 billion, and Sberbank paid 6.9 billion lira ($3.5 billion at the time) to purchase the bank in 2012. The 2012 acquisition was part of an early strategy for Sberbank to purchase foreign banks in Europe and the Middle East and gain a significant international footprint. However, recent political tensions and the international sanctions against Russia placed their international plans in jeopardy. These sanctions have limited Sberbank's ability to access international debt markets. Since then, Sberbank has made a decision to reorient themselves towards domestic opportunities. Divesting makes sense with Denizbank as the return on equity and income-to-cost ratio are both far more attractive for Sberbank domestically than what it was achieving in Denizbank.

As we mentioned in previous letters, the value of the Russian Ruble is closely tied to the price of crude oil. An increase in the price of oil may cause a rise in the Ruble and make Russian financial assets held by Sberbank more valuable.

Despite the decline of the past quarter, Sberbank stock is still far above the average share-weighted price paid by early investors in the global value strategy. Sberbank is a solid and growing bank and one of the best run in Europe. They have a significant technology advantage over their domestic competition and a very high return on equity at 24%. They recently boosted their dividend to 36% of earnings and they are hoping to increase their dividend to 50% of projected earnings by 2020. Without the "Russia discount", it is unlikely we would ever be able to find a stock of this quality trading at this bargain valuation.

Selected Financial Figures for Sberbank of Russia

Price to Tangible Book	ROE	Tangible Equity-to-Assets	Net Interest Margin	Trailing P/E	Trailing Dividend Yield
1.26	24.2%	10.8%	5.6%	5.57	5.85%

As of July 20th, 2018

Express Scripts and Aetna

Our holdings in Express Scripts, a pharmacy benefit manager, and Aetna, a health insurance company, are both in the progress of being acquired (by Cigna and CVS respectively). For both of these companies, we now believe the merger highly likely to be approved. The market apparently disagrees with this view as the targets are trading significantly below their acquisition prices. ESRX shares are being purchased for $48.75 cash and 0.2434 shares of

Cigna. Aetna shares are being purchased for $145.00 cash and 0.8378 shares of CVS. As of the end of trading on July 20th, this means that ESRX trades at 84.2% and AET trades at 93.8% of their proposed acquisition prices.

The approval by the Department of Justice for the merger between AT&T and Time Warner can be interpreted as a signal that the Trump Administration is going to take a permissive attitude towards vertical mergers within industries. A vertical merger is when the target and acquirer do not directly compete within their industry but instead operate at separate stages of the supply chain for a specific finished product or service.

Vertical mergers still have hurdles to approval which can be seen in the guidelines for vertical merger approval published by the Department of Justice[1]. However, these hurdles are generally easier to pass than for horizontal mergers. As can be seen in the DoJ guidance, their regulatory review focuses on horizontal effects from a vertical merger and how the merger could affect the potential future competition within the market. The health insurance marketplace today is highly concentrated which has led to regulators blocking several attempted horizontal mergers in recent years. This includes the Anthem-Cigna and Aetna-Humana mergers which were begun in 2015 and eventually abandoned after facing regulator pushback.

For the Aetna acquisition, shareholders of both the acquirer and target have already approved the transaction, and the transaction is currently being reviewed by the Department of Justice and the state departments of insurance. CVS has stated that they expect all of the reviews to be completed by the end of the year.

We expect both acquisitions to be approved, but if they are blocked we are likely to maintain both stocks within our portfolio. For both ESRX and AET, we owned them in the portfolio before the acquisition and consider them to still be trading at an attractive long-term valuation. Additionally, for Express Scripts, if regulators block the acquisition, the agreement obligates Cigna to make a $2.1 billion payment to Express Scripts (equal to approximately $3.73 per share).

Sincerely,

Andrew Oskoui, CFA
Portfolio Manager

[1] https://www.justice.gov/atr/non-horizontal-merger-guidelines