September 1, 2010

Cannell Capital August 2010

With remorse, and without delay, I am writing to deliver our Funds' lackluster results for August 2010.[1]

Fund	Long Equity	Short Equity	Net Equity	Fixed Income	August 2010 Performance	YTD Performance
Tonga Partners, LP	101%	(44%)	57%	10%	(10.5%)	(6.7%)
Tristan Partners, LP	112%	(11%)	101%	-	(6.6%)	3.7%
Nashuk Partners, LP	78%	(17%)	61%	7%	(2.9%)	6.7%
Russell 2000 Index	-	-	-	-	(7.4%)	(3.0%)

Source: Bloomberg LP and Cannell Capital LLC

What is peculiar, and noteworthy, is the fact that during a month where the Russell 2000 Index declined (7.4%)[2], one would have thought that the lower net equity exposure of Tonga would have rendered better results than those of long-biased Tristan and Nashuk. Such was not the case. The Tonga short book delivered breakeven performance results.

August – typically the summer doldrums – turned out to be action-packed for Hewlett-Packard Company (HPQ). The Company settled a corruption claim with the U.S. government, parted ways with its CEO, announced three acquisitions and launched a $10 billion share repurchase program. We did not anticipate being negatively impacted by one of these events.

During the month, HPQ, then Dell Inc. (DELL), then HPQ again made successive bids for 3Par, Inc. (PAR), a Fremont, California niche storage provider – a usually mundane but evidently "hot" industry right now. The current bids value the Company's equity at around $2 billion compared with the $194 million of revenue recorded for its fiscal year ended March 2010. Regretfully, when the bidding began, Tonga was short PAR and realized losses.

PAR went public in November 2007. It has never been profitable on an annual basis nor is it expected to be this fiscal year. It is, however, likely to have GAAP earnings of $0.06 per share in fiscal 2012, which values PAR at 500 times these distant earnings estimates. (To our knowledge, PAR has no claim to large gold reserves or a solution to world hunger.)

A rational, patient and seasoned long/short investor with experience in technology investing would likely judge that this acquisition by the people at 3000 Hanover Street, Palo Alto displays lack of prudence (but is consistent with other HPQ acquisitions like Compaq, Palm, et alia).

In a similar vein, and also during August, Intel Corporation (INTC) proposed to acquire McAfee, Inc. (MFE) at a price that represented a 52% premium to its previous closing price. The MFE

[1] Unaudited, estimated gross performance.
[2] With dividends reinvested in the Index.

valuation of 3.5x forward sales and 10.0x EV/EBITDA was in line with valuations of smaller, faster-growing peers – effectively putting a floor on valuation and raising the level of takeover speculation. Indeed, ArcSight Inc. (ARST), another Tonga short position, rallied over 40% on speculation that it was up for sale.

But the foregone is academic. I care less about being "right" than about making money for you (and me). Any asset is worth what a buyer is willing and capable of paying. There have been numerous acquisitions like (but maybe not as ludicrous as) PAR which have occurred in the last month.

Target	Acquirer	Total Value ($M)	EV/TTM Sales	EV/TTM EBITDA	TTM PE
McAfee	Intel	6,593.7	3.7	15.8	29.1
3PAR	Hewlett-Packard	1,893.7	9.8	308.8	NMF
Cogent	3M	662.4	8.0	29.7	44.3
Datacash Group	Mastercard	510.5	9.0	39.1	63.3
Unica	IBM	425.9	4.3	45.8	149.9
Diamond Mgmt	Pricewaterhouse	291.0	1.6	16.2	32.8
ICx Technologies	FLIR Systems	228.4	1.6	153.2	NMF

Source: Bloomberg LP

Sadly, these transactions produced a ripple effect across other technological shorts that we had tracked and deployed based on deteriorating fundamentals such as compressing gross profit margins, balance sheet stress or de-accelerating revenues and earnings growth. Specifically, the other positions that hurt us in this regard were Compellent Technologies, Inc. (CML), CommVault Systems, Inc. (CVLT) and SourceFire (FIRE).

Tonga's short equity exposure of (44%) was intended to provide at least proportionate Russell 2000 Index inverse returns, or about 3.8%. The PAR acquisition, rumored ARST acquisition and related positions negatively impacted the short book performance by about 2.5%. The remaining drag is attributed to sector exposure. Technology, the best performing industry group in the Russell 2000, was our largest sector short while our short exposure to consumer discretionary, the worst performing group, was *de minimus*.

All in all, August was a terrible month in a poor summer that saw the Tonga strategies YTD gross performance drop from 17.9% as of April 30 to an estimated (6.7%) as of August 31. We cannot change the past but we *can* try to affect the future, and so we reflect and ponder our next steps:

(i) On a relative basis, we are doing well (Nashuk and Tristan) to fair (Tonga).
(ii) We now believe cash or purchase of certain high yielding "money good" credits are substitutes for shorts during short-selling slumps (currently, our fixed income exposure is 10%).
(iii) We focus on Main Street, not Wall Street. We have built a good book of what we believe are inexpensive, "value" companies, most of which have a definable event or events which will lead to their becoming significantly less cheap.

Below are examples of absolute and relative cheapness in "growing" companies.

Company	% of Long Book	Dividend Yield %	EV/TTM Sales	EV/TTM Cash Flow	EV/ Equity
"A"	4.1	NA	0.1	5.1	1.0
"B"	2.9	7.6	0.7	3.9	1.5
"C"	2.6	6.9	0.2	6.6	1.6

Source: Yahoo Finance

Let's consider the words of value investor Seth Klarman:

> The overwhelming majority of people are comfortable with consensus, but successful investors tend to have a contrarian bent. Successful investors like stocks better when they're going down. When you go to a department store or a supermarket, you like to buy merchandise on sale, but it doesn't work that way in the stock market. In the stock market, people panic when stocks are going down, so they like them less when they should like them more. When prices go down, you shouldn't panic, but it's hard to control your emotions when you're overextended, when you see your net worth drop in half and you worry that you won't have enough money to pay for your kids' college.

People are afraid. Companies are starting to deploy cash balances through acquisitions; investors less so. In July, *CFO Magazine* reported that nonfinancial firms in the S&P 500 reported year-end 2009 cash levels at 13% of sales, the highest level in more than ten years. Our update of this analysis suggested these balances have increased to 14% of sales as of the most recent filings. Apple Inc. (AAPL), Google Inc. (GOOG), Microsoft Corporation (MSFT), Oracle Corporation (ORCL), Exxon Mobil Corporation (XOM), Johnson & Johnson (JNJ) and Merck & Co., Inc. (MRK) reported a combined $152 billion of cash and short-term investments in their most recent filings.

At the end of the day, it is not my place or practice to whine or rant about August 2010. It is my job to point out that this cash will be deployed somewhere and sometime. The alternatives – near zero return for "riskless" sovereign bonds – is not attractive, and certainly not compared with the shares of the companies that we know better than anybody. After all, as most of you know, we are the only ones who follow them!

Money is made in the dark, not in the light of day. Rejoice in the gloom and fear and consider adding to your investment.

Carlo Carl C

J. Carlo Cannell