



PERSHING SQUARE CAPITAL MANAGEMENT, L.P.

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October 2, 2013

Dear Pershing Square Investor:

The Pershing Square funds declined by more than 5% during the third quarter of 2013 generating flat performance net of all fees for the first nine months of the year. The funds' long-term track records and performance versus the market since inception are set forth below<sup>1</sup>:

	For the Quarter July 1 - September 30	Year to Date January 1 - September 30	Since Inception
<b><u>Pershing Square, L.P.</u></b>			<b><u>01/01/04 - 09/30/13</u></b>
Gross Return	-6.3%	1.8%	779.9%
Net of All Fees	-5.4%	0.5%	432.9%
<b><u>Pershing Square II, L.P.</u></b>			<b><u>01/01/05 - 09/30/13</u></b>
Gross Return	-6.2%	0.8%	505.3%
Net of All Fees	-5.4%	-0.3%	295.7%
<b><u>Pershing Square International, Ltd.</u></b>			<b><u>01/01/05 - 09/30/13</u></b>
Gross Return	-6.4%	1.4%	407.1%
Net of All Fees	-5.5%	0.2%	241.0%
<b><u>Pershing Square Holdings, Ltd.</u></b>			<b><u>12/31/12 - 09/30/13</u></b>
Gross Return	-6.3%	1.3%	1.3%
Net of All Fees	-5.7%	0.1%	0.1%
<b><u>Indexes (including dividend reinvestment)</u></b>			<b><u>01/01/04 - 09/30/13</u></b>
S&P 500 Index	5.2%	19.8%	84.8%
NASDAQ Composite Index	11.2%	26.1%	106.7%
Russell 1000 Index	6.0%	20.8%	92.3%
Dow Jones Industrial Average	2.1%	17.6%	85.8%

The third quarter's negative performance was driven by J.C. Penney and Herbalife. We discuss both of these investments in detail below along with an update on our recent investment in Air Products. We will review these investments and the balance of the portfolio on our upcoming quarterly call.

<sup>1</sup> Past performance is not necessarily indicative of future results. All investments involve risk including the loss of principal. Please see the additional disclaimers and notes to performance results at the end of this letter.

## **Portfolio Update**

### **J.C. Penney**

We chose to exit our entire stock and total return swap position in J.C. Penney at the end of August and incurred a loss of approximately 50% of our original investment. We did so because of a disagreement with the board about the timing and necessity for a CEO change at the Company, the valuation implied by the then stock price, and the risk of a successful turnaround.

Turnarounds are inherently risky and require a totally aligned board of directors, a CEO with substantial turnaround experience, and the support and confidence of all stakeholders. Without all of these ingredients, we are bearish on J.C. Penney's prospects.

I have said before that investing requires the confidence and conviction to believe that one is right even when the whole world, including other smart, high-profile investors, tells you that you are wrong. Buying 25% of General Growth for pennies per share during the financial crisis and shortly before its bankruptcy required detailed analysis, execution, and confidence. Staying short MBIA stock, when Warburg Pincus, with access to inside information, invested a billion dollars of capital into MBIA, and Marty Whitman, a famous distressed investor, invested hundreds of millions in capital, required a similar degree of analysis, confidence and conviction.

But confidence and conviction without humility can be dangerous in the investment business. When one shares an investment thesis publicly, it can be more difficult to change one's mind because the human mind has a tendency to ignore data that are inconsistent with a firmly held view, and particularly so, when that view is aired publicly. That is likely why Wall Street analysts continued to rate MBIA a buy until it nearly went bankrupt. And, I believe it is why analysts will likely keep their buy ratings until Herbalife is shut down by regulators or the company faces substantial distributor defections.

I have learned that the key to long-term success in investing is to balance confidence with the humility to recognize when the facts are no longer consistent with one's original investment thesis. It is critically important not to let psychological factors interfere with economic rationality in investment decision making.

We and the other members of the J.C. Penney board were extremely enthusiastic about the Company's prospects under Ron Johnson's leadership in light of his track record at Mervyn's, Target, and Apple, and his creativity and vision for the Company. However, when the results continued to underperform our expectations, we and the rest of the board elected to change course.

While earlier this year we believed that J.C. Penney could be turned around with adequate capital – we believed the \$2.25 billion Goldman financing would suffice – this was only the case if the capital were spent extremely judiciously and an experienced turnaround retail operating team was at the helm. When we became concerned about the board's and management's decision making, we voiced our concerns publicly in an open letter to the board and then exited in a block transaction as promptly as we could. While we were criticized in the press for airing our concerns, we did so because of our fiduciary duty to the Company's shareholders. Our candor

likely contributed to our ability to exit at a modest discount to the last trade, as investors were made aware of our concerns and could form their own assessment of our views when we sold.

Our willingness to change our mind and exit at a substantial loss on a high-profile investment should give you comfort that we will make rational investment decisions without regard to emotional, personal or other considerations. This approach will likely serve to mitigate losses in failed investments and is a critical component of our long-term approach.

### **Herbalife (HLF)**

During the quarter, Herbalife stock price rose from approximately \$45 to \$70 per share, and from approximately \$60 to \$70 per share during the month of September alone. The principal driver of the stock price appears to be the belief by bulls that government regulators will do nothing, and that the Company will continue to generate strong earnings and cash flows which will be returned to shareholders in the form of share repurchases, which could force shorts, including Pershing Square, to cover.

The stock price appreciation this past month appears to have been driven by commentary from Tim Ramey, a perennially bullish Herbalife analyst from D.A. Davison, who stated a few weeks ago that in September 2013 PriceWaterhouseCoopers (PwC) would complete its re-audit of the Company's last three years of financial statements, and Herbalife, shortly thereafter, would launch a \$2 billion investment grade bond issue at an interest rate of 4%, the proceeds to be used to fund a share repurchase at \$75 per share. According to Ramey, the buyback would serve to refute the bear case on Herbalife as shorts, including Pershing Square, are forced to cover.

The high degree of specificity of Ramey's bullish call has led investors to believe that he is speaking on behalf of the Company. While September has come and gone without PwC's completion of Herbalife's re-audited financials, bullish investors apparently continue to expect the re-audit to be completed shortly, and a large buyback to be forthcoming.

We are skeptical of Ramey's pronouncements for several reasons. While we do not know the timing of PwC's re-audit of Herbalife's financial statements, we have identified a substantial number of serious issues with Herbalife's accounting, disclosure, and tax policies that we have brought to the attention of PwC and the SEC in a series of three letters that we delivered to them in recent weeks, the first of which we shared with you earlier this month. At a minimum, we would not be surprised if the re-audited financials provide further disclosures about the Company which will raise additional questions about its business practices and its previously reported results.

With respect to the supposed \$2 billion investment grade bond issue at an interest rate of 4%, we believe it is extremely unlikely that Herbalife will be able to garner an investment grade rating and raise \$2 billion, let alone at an interest rate of 4%. As of March 2011, when Moody's withdrew its ratings on Herbalife, the Company was rated Ba1, a junk rating. When the ratings were withdrawn, Herbalife had only \$178 million of debt, approximately 0.5 times the then 12 month trailing operating profits, and there was little public scrutiny of the Company's business practices. If Herbalife were able to issue \$2 billion of additional debt today, the Company would

have \$3 billion of total debt, or 4.3 times 12-month trailing operating profits. With more than 16 times as much debt, substantially greater scrutiny of the Company's business practices, and a regulatory cloud over the Company, we believe that it would now garner a substantially lower junk rating than that of early 2011.

Furthermore, we question whether a bank would be willing to take on the potential underwriter liability associated with a debt issue for Herbalife. If the Company were later deemed to be a pyramid scheme, an underwriter could find itself liable for the face amount of the entire debt issue, as recoveries to creditors of a pyramid scheme are likely to be *de minimis*. To earn a 150 basis point fee and risk losing 70 times that amount in a lawsuit is a risk-reward proposition that we believe no financial institution would find attractive.

All of the above notwithstanding, if Herbalife could achieve a \$2 billion financing, we believe the interest rate would be much higher, and the buyback could only be completed at a price that would be minimally accretive to the Company, factoring in the after-tax cost of debt and the buyback price required to acquire nearly 30% of the outstanding float. When one considers the high degree of leverage that would result from the buyback, we would expect the Company's earnings multiple to compress accordingly. As a result, we believe that such a leveraged recapitalization would generate minimal, if any, shareholder value.

Based on an analysis of comparable situations with our prime brokers, we believe that such a buyback would not require us to cover our position. Furthermore, if a large amount of debt were issued, an Herbalife CDS market would likely develop, presenting us with an even more attractive method to bet against the then highly leveraged Company. We could then choose to add to or replace all or a portion of our existing short position with an even larger notional short position in the debt through the purchase of CDS. We would welcome such an opportunity, although for the reasons described above, we do not believe that the Company will be able to borrow funds to complete such a transaction.

Since our presentation on Herbalife at the end of last year, we have not learned any facts that are inconsistent with our belief that the Company is a pyramid scheme that engages in unlawful and deceptive marketing practices. In fact, there have been a number of materially positive developments that increase the likelihood of regulatory intervention and the Company's closure.

Numerous state, federal, and international regulators have launched investigations or inquiries into the Company's business practices and products that we believe are ongoing. Many federal, state and local elected officials, consumer protection and community organizations and other advocates have publicly called for the FTC and state regulators to investigate the Company. A number of whistleblowers have contacted us, several in the last few weeks alone, and provided us with information that is confirmatory of our thesis that Herbalife is a pyramid scheme while raising additional concerns that we had not previously identified. Bottom line, we continue to have enormous conviction in our investment thesis.

While we have endured mark-to-market losses on this investment as Herbalife bulls have promoted the stock and downplayed the probability of government intervention, we believe it is only a matter of time before the Company is shut down and prosecuted by regulators.

In order to mitigate the risk of further mark-to-market losses on Herbalife, in recent weeks we have restructured the position by reducing our short equity position by more than 40% and replacing it with long-term derivatives, principally over-the-counter put options. The restructuring of the position preserves our opportunity for profit – if the Company fails within a reasonable time frame we will make a similar amount of profit as if we had maintained the entire initial short position – while mitigating the risk of further substantial mark-to-market losses – because our exposure on the put options is limited to the total premium paid. In restructuring the position, we have also reduced the amount of capital consumed by the investment from 16% to 12% of our funds.

We were able to restructure the position cost effectively due to several factors. Over the last 60 or so days, the cost to borrow Herbalife shares has declined substantially while the stock price has risen. Shortly after we filed a formal complaint with the SEC regarding what we believe to be unlawfully manipulative conduct by other market participants, the cost to borrow Herbalife shares dropped substantially to the lowest rate since prior to our presentation last December. In an unrelated recent enforcement action, the SEC confirmed that attempting to engineer a short squeeze by removing stock from the available lending base is a form of market manipulation.

Because of the rise of the stock price, the low cost of borrow, and the fact that we are betting on the failure of the Company, we have been able to purchase long-dated, privately negotiated out-of-the-money put options on terms that offer us an attractive opportunity for profit versus their cost. Furthermore, by substantially reducing the size of our short position as a percentage of the share float, we minimize the risk of so-called short squeezes or other technical attempts by market manipulators to force us to cover our position. In that a substantial component of the bull case on Herbalife is predicated on forcing us to cover, we think the restructuring of our investment negates this important pillar of the bull case.

The biggest risk of the restructured position is that time begins to be a factor with respect to a portion of our investment. We believe, however, that the long-term nature of the options we own will provide sufficient time for us to be rewarded on this portion of our position. In that the options are privately negotiated, over-the-counter contracts, we have the ability to extend their terms, if we deem it prudent and attractive to do so in the future.

At yesterday's closing price of \$72.84, we believe the potential reward from being short Herbalife is extremely attractive relative to the risk of loss. Using the average analysts' price target of \$77 per share – which assumes that the Company is operating entirely legally – investors have less than 6% upside compared with 100% downside if the Company is determined to be a pyramid scheme by regulators.

In my career, I have not seen a less attractive risk-reward ratio than a long investment in Herbalife common stock at current levels.

### **Air Products and Chemicals, Inc. (APD)**

We began a productive, private dialogue with Air Products and its Board shortly after our July 31, 2013 Schedule 13D filing and reached an agreement with the Company on September 24th.

As part of the agreement, John McGlade, Chairman and CEO, announced his plan to retire by June 30, 2014, and the Company committed to launch a CEO search promptly. Three new directors – Pershing Square Advisory Board member Matt Paull (former CFO of McDonald's), Seifi Ghasemi (Chairman and CEO of Rockwood Holdings and a former industrial gas executive at British Oxygen Corporation), and Edward Monser (President and Chief Operating Officer of Emerson Electric) will join the board replacing three retiring directors. Matt Paull and Seifi Ghasemi will serve on the search committee along with four existing Air Products directors.

We have high expectations for the future of Air Products and are delighted that we could come to an agreement with the Company promptly in light of John McGlade's and the board's collaborative approach.

### **Organizational Update**

In September, Steve Milankov joined our legal team as Senior Counsel. Prior to joining Pershing Square, he served as Director, Equity and Derivatives in the legal department at Société Générale, which he joined in 2007. Steve also held similar positions at BNP Paribas and The Bank of New York. Steve began his legal career as a Derivatives/ Structured Finance attorney at Clifford Chance. A native of Canada, Steve received Law (with distinction) and MBA degrees from McGill University and a Bachelor of Commerce (*magna cum laude*) from the University of Toronto.

### **Save the Dates**

Please mark your calendar for the following events:

**Third Quarter Conference Call, 11AM EDT, Thursday, October 17, 2013.** A replay of the call will be available at investor request until 12AM EDT, Sunday, October 20, 2013.

**2013 Annual Investor Dinner.** Please note that we have changed the date of our 2013 Annual Investor Dinner. The new date is **Thursday, February 13, 2014.**

Please feel free to contact the Investor Relations team or me if you have questions about any of the above.

Sincerely,

A handwritten signature in black ink, appearing to read 'William A. Ackman', with a long horizontal flourish extending to the right.

William A. Ackman

**Additional Disclaimers and Notes to Performance Results on p. 1**

The performance results shown on the first page of this letter are presented on a gross and net-of-fees basis. Gross and net performance includes the reinvestment of all dividends, interest, and capital gains, and reflect the deduction of, among other things, brokerage commissions and administrative expenses. Net performance reflects the deduction of management fees and accrued performance fee/allocation, if any. Performance fee for Pershing Square Holdings, Ltd. is 16%; performance fee/allocation for each of Pershing Square, L.P., Pershing Square II, L.P. and Pershing Square International, Ltd. is 20%. All performance provided herein assumes an investor has been in each of the funds since its respective inception date and participated in any “new issues”. Depending on the timing of a specific investment and participation in “new issues”, net performance for an individual investor may vary from the net performance stated herein. Performance data for 2013 is estimated and unaudited.

The inception date for Pershing Square, L.P. is January 1, 2004. The inception date for Pershing Square II, L.P. and Pershing Square International, Ltd. is January 1, 2005. The inception date for Pershing Square Holdings, Ltd. is December 31, 2012. The performance data presented on the first page of this letter for the market indices under “since inception” is calculated from January 1, 2004. The market indices shown on the first page of this letter have been selected for purposes of comparing the performance of an investment in the Pershing Square funds with certain well-known, broad-based equity benchmarks. The statistical data regarding the indices has been obtained from Bloomberg and the returns are calculated assuming all dividends are reinvested. The indices are not subject to any of the fees or expenses to which the funds are subject. The funds are not restricted to investing in those securities which comprise any of these indices, their performance may or may not correlate to any of these indices and it should not be considered a proxy for any of these indices.

**General Disclaimers and Notes**

Past performance is not necessarily indicative of future results. All investments involve risk including the loss of principal. This letter is confidential and may not be distributed without the express written consent of Pershing Square Capital Management, L.P. and does not constitute a recommendation, an offer to sell or a solicitation of an offer to purchase any security or investment product. Any such offer or solicitation may only be made by means of delivery of an approved confidential private offering memorandum.

Any returns provided herein based on the change in a company’s share price is provided for illustrative purposes only and is not an indication of future returns of the Pershing Square funds.

This letter contains information and analyses relating to some of the Pershing Square funds’ positions during the period reflected on the first page. Pershing Square may currently or in the future buy, sell, cover or otherwise change the form of its investment in the companies discussed in this letter for any reason. Pershing Square hereby disclaims any duty to provide any updates or changes to the information contained here including, without limitation, the manner or type of any Pershing Square investment.