FAIRHOLME CAPITAL MANAGEMENT, L.L.C.

Fairholme Capital Management Public Conference Call

Bruce Berkowitz

Moderator: Daniel Schmerin

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EDITED FOR CLARITY AND ACCURACY

Operator: Good morning. My name is Kristy and I will be your conference operator today. At this time, I would like to welcome everyone to the Fairholme Capital Management ("Fairholme" or the "Firm") June 2017 Public Conference Call.

Bruce Berkowitz, the Firm's Founder and Chief Investment Officer, will be answering questions submitted in advance by callers. Moderating the call today is Daniel Schmerin, Fairholme's Director of Investment Research. Also joining them on the call is David Thompson, Managing Partner at Cooper and Kirk and one of the lead attorneys representing Fairholme with respect to his clients' investments in Fannie Mae and Freddie Mac.

After the call, a transcript will be made available on www.fairholmefunds.com.

Daniel Schmerin: Good morning. I'm Daniel Schmerin, and I'd like to welcome shareholders of The Fairholme Fund, The Fairholme Focused Income Fund (the "Income Fund"), and The Fairholme Allocation Fund (the "Allocation Fund" and, collectively, the "Funds") and other listeners to our June 2017 conference call. A special thanks to all those who took the time to submit questions for our call today.

Without further ado, I'd like to introduce Bruce Berkowitz, our Founder and Chief Investment Officer and dive into our first set of questions.

Bruce Berkowitz: All right, thanks, Dan. Good morning to everyone. I want everyone to know that I recently appeared on Bloomberg Television and discussed a number of our key positions for over 40 minutes.[1] You can find a link to this interview in the "Press" section of www.FairholmeFunds.com to watch it yourself.

I want to also let everybody know that we are actually pre-recording this call one day early from Washington, D.C., because I will be attending some events tomorrow that happen to be taking place at exactly the time that we scheduled this call.

That being said, I look forward to answering as many shareholder questions as possible. Let's begin.

Daniel Schmerin: Great, I'd like to start by addressing some general questions that we received before tackling individual positions. What is management and employee ownership of the Fairholme Fund, and has there been any notable turnover among analysts and other important employees?

Bruce Berkowitz: Dan, Fairholme employees collectively own over 5% of the Fairholme Fund, 45.5% of the Allocation Fund, and about 8.5% of the Income Fund.[2]

Regarding the second question, no, we haven't had any recent turnover of analysts or key employees.

Daniel Schmerin: The vast majority of the Fairholme Fund is invested in roughly seven ideas. How can an investor feel comfortable that the current portfolio represents your very best ideas and is not merely the result of selling out of more liquid positions to meet redemptions?

Bruce Berkowitz: The Funds have had the same strategy since inception. We focus on best ideas and we're long-term value oriented. That has not changed, and

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[1] Bloomberg TV, "Why Bruce Berkowitz Still Likes Stocks Others Hate, June 19, 2017," https://www.bloomberg.com/news/videos/2017-06-19/why-bruce-berkowitz-still-likes-stocks-others-hate-video.
[2] Figures provided are as of June 26, 2017.

redemptions have not been an issue. We've had no issues selling large or less liquid positions – such as AIG and Chesapeake Energy – over time.

The Fairholme Fund has plenty of liquidity, with over 20% in cash and cash equivalents. This large cash allocation that we have, not just in the Fairholme Fund but in all the Funds, is prudent given what I believe is a limited opportunity set with lots of lofty valuations and an overall expensive market.

Our cash is invested in very short duration commercial paper, roughly about five days, and earning over 1.5%, which helps boost current income. And, look at our recent investments in high-yield credit. They've been quite successful. Chesapeake worked out well, Intelsat worked out well, and most recently, our Atwood Oceanics, Inc. ("Atwood") bonds worked out well as Ensco PLC announced that it's going to acquire Atwood.

Daniel Schmerin: Is your level of concentration more a reflection of the attractiveness of those holdings or of a relative lack of confidence in your next five best ideas?

Bruce Berkowitz: The current focus is based upon both factors. It is a reflection of the attractiveness of the holdings that we have and the relative lack of confidence in other ideas or lesser ideas. I like where the portfolio is.

Daniel Schmerin: Would investors be better served by spreading some of the issuer specific risks among the next few best ideas?

Bruce Berkowitz: Well, I've got to tell you: In hindsight, probably yes. Today, I don't think so. But the most important point I want to focus on today is the cash element, which is very large. Cash is quite valuable in tough times.

Daniel Schmerin: For new and existing clients, what would you say is your competitive edge?

Bruce Berkowitz: I think we've continually proven since day one of Fairholme that I'm willing to look wrong for years. But only as long as the facts tell us that we'll eventually be right. We have been able to avoid denial. We constantly question our ideas. We constantly try to kill them.

I don't think we have a history of being in denial, and the other major factor, of course, is that we eat our own cooking. My family is definitely the largest shareholder in each fund.

Daniel Schmerin: You say that you invest for the long term. How is that defined?

Bruce Berkowitz: I look at long term as decades. I look at long term investing the way that you would look at long term for a marriage. I think such long term investing creates the least amount of friction and the lowest possible taxes, and I think it's the best way to build upon the experience. You're getting huge economies of scale and the least amount of friction and cost. So my definition of "long term" is as long as possible.

Daniel Schmerin: Can you talk a bit about the Allocation Fund? Given underperformance in that smaller fund, what should current and potential new investors in the Allocation Fund know in order to maintain conviction?

Bruce Berkowitz: At Fairholme, we have the three Funds. They have differences. The Allocation Fund focuses on smaller quantity ideas and income. The Allocation Fund is beating its bond index, but we are badly trailing the equity index while holding nearly 30% cash.

Daniel Schmerin: Since 2011, you've been managing the Income Fund and the Allocation Fund in addition to the flagship Fairholme Fund. Do you feel that having to make allocation decisions between those funds impacts your focus or detracts from performance?

Bruce Berkowitz: No. We always study the entire capital structure of companies when we invest and sometimes we find variations on a similar theme. Sometimes when we study a company, the equity of the company may be most appropriate for the Fairholme Fund, while the debt may be appropriate for the Income Fund, and perhaps a combination of the debt and equity could be appropriate for the Allocation Fund.

Daniel Schmerin: Have you ever recognized an investment as a mistake and sold it to cut your losses? Are you open to the possibility that some of your current investments might be mistakes?

Bruce Berkowitz: Yes. I'm always open to that. I've never been 100% certain and I'm never seeking to be stubborn. There are many possible outcomes, and there's a large range of profitable outcomes. And yes, there were times I thought I've made mistakes and sold, but almost always they turned out not to be mistakes.

Daniel Schmerin: Our next set of questions pertains to Sears Holdings Corporation ("Sears"), Sears Canada, and Seritage Growth Properties ("Seritage"). Beginning with Sears, what is your current estimate of the intrinsic value of that stock and how has this figure changed in recent years. How do you arrive at your current estimate?

Bruce Berkowitz: Fairholme's latest internal figures have Sears at a net asset value (NAV) of over $90 per share. This figure has been dramatically reduced over time due to the retail cash burn. We come up with the $90+ per share based upon the remaining real estate of the company – including long-term leases, which we have significantly discounted to be conservative – and, of course, the other major asset values including the remaining brands and approximately $3 billion of paid-for inventory. So it's the owned real estate, leases, and the brands that account for the majority of our estimated NAV.

In terms of real estate, the company's been actively selling real estate over the years. Since 2012, the company sold more than 50 million square feet of owned real estate for more than $4 billion. That's about $80 per square foot. Data also includes property sold to Seritage for an average of $61 per square foot. And the Seritage joint venture sold for an average of $157 per square foot. Our analysis also includes Ala Moana, a ground lease which sold for $200 million, or $586 per square foot.[3]

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[3] Source: All data derived from Real Capital Analytics www.rcanalytics.com, and public filings.

So since 2016, Sears has sold 2.8 million square feet of owned real estate for slightly under $100 per square foot. It's very hard to come across an example where someone acquired real estate from Sears and did not succeed after redeveloping the location for higher and better use.

Most of the recent store closures are not the company's most valuable real estate. A majority of the malls in the country need to evolve with redevelopment. At present, Sears is typically the only anchor willing to sell back space at the best malls. And with Sears' goal of shrinking its footprint to a smaller box, there's more than enough opportunity for all sides to win.

Over the years we've found that you really need to conduct a property-by-property, submarket-specific analysis to truly understand the values, because the value goes way beyond the physical box containing a retail operation.

For instance, the Sears at South Coast Plaza in California and the two Kmarts in New York City have significant value. Even if you look at a location like the Clearview Mall in Louisiana, you'd be mistaken if you simply focused on the grade of the mall assigned by any type of national database. The Sears there is located at the best part of the mall. It has great visibility from the main streets. There's still strong demand to repurpose the big box, the detached auto center, and the parking area. So the true value of that real estate is considerably higher than what you might think by just looking at a database.

Daniel Schmerin: How have the company's operating results over the last few years impacted your investment thesis and perception of the company's intrinsic value? What amount of future operating losses, if any, from Sears' retail business does this estimate include?

Bruce Berkowitz: The last few years have diminished our estimate of intrinsic value by almost half due to the operating losses. The cash burn is real. And frankly the net asset value will continue to decline until the cash burn subsides. And more recently, we've haircut all the lease values by roughly 50% to reflect the continued cash burn. So, we put a major haircut on something that was already discounted at wholesale values. And the biggest risk to our thesis has been the company's desire and ability to effectively compete as a retailer. Effectuating that corporate transformation has been costly, and the results are not yet in.

Daniel Schmerin: What is the worst case scenario for Sears? Given the carnage in the retail industry and the ongoing cash burn at Sears, why do you keep investing in that company?

Bruce Berkowitz: Well, as for the worst case, I think that we're pretty much seeing it given that Sears equity is trading much closer to zero than it is to our $90 plus-per-share estimated net asset value. As for why we keep investing in the company, well, the price has declined much faster than net asset value.

A considerable margin of safety still remains and the operating losses can stop. And when losses do stop, I actually believe our net asset value estimates will increase.

Daniel Schmerin: In an earlier conference call, you mentioned your belief that the operating losses at Sears were largely voluntary. Can you expand upon what you meant by that statement? Do you still believe that is the case?

Bruce Berkowitz: The losses at Sears in recent years have primarily been due to the transformation of Sears the retailer into a profitable operation. If you stop the retail transformation, you stop a substantial amount of the losses.

Daniel Schmerin: You've also stated in the past that Sears was primarily a real estate investment. If this is true, why hasn't the company been focusing and investing in that asset rather than in the retail operation to maximize value for shareholders?

Bruce Berkowitz: Well Dan, I think we stated from day one that it's always been our belief that the real estate within Sears was the margin of safety in the investment. We were never certain on the retail; that's not our expertise and I think we've proven it's not our expertise. But the company is now moving faster and faster to right-size its operations.

In a best case scenario, Sears is able to successfully and effectively operate as a leaner retail operation focused on Shop Your Way members – that is, focused on best members, best products, best locations – and can do it in a way where cash flows are positive and the company is able to retain control and develop its valuable real estate.

In that case, the first $10 billion of profits will be tax free because of accumulated net operating losses. That's the upside scenario we are looking at.

Daniel Schmerin: How are our interests aligned with Sears CEO Eddie Lampert? Do his secured loans to Sears outweigh his equity interests? And should we, as shareholders, be concerned?

Bruce Berkowitz: We're quite aligned with the equity ownership and with the unsecured debt ownership. ESL Investments does own a significant amount of secured debt which would be paid first. But as the real estate is sold, you should see those secured debt amounts diminish.

Daniel Schmerin: With respect to Sears, what is the Fairholme Fund's average cost? In other words, from the current share price, how much higher will those shares have to climb for us to break even?

Bruce Berkowitz: Well, on a tax basis, our average cost is $61 per share. So there'll be no taxes on the Sears position until we get back to $61 per share. The book cost position is really a question of when shareholders decided to buy, when they decide to sell, and also it's a function of the Funds' decisions to buy, hold, or sell as the Funds' capital has been shrinking.

So a breakeven on Sears would be tough to compute for a shareholder and it really doesn't make a lot of sense. You should just look at the individual Funds' breakeven – in other words, where you bought it, where you are, and whether you're up or down.

Daniel Schmerin: Why do you favor Sears' equity over Sears' bonds?

Bruce Berkowitz: I don't. Fairholme entities own 27% of Sears common stock and 30% of the outstanding warrants. We also own 58% of the Sears 8.000% bonds due in 2019 – the senior unsecured notes. We have a majority of that debt.

Daniel Schmerin: What is more important at this point in time, returning the company to profitability in order to alter market perception, or to show positive year-over-year sales trends to demonstrate that the company's footprint has been rightsized and give credibility to the company's e-commerce platform?

Bruce Berkowitz: There's no doubt, returning to profitability is the most important action because when you do that, time becomes the company's friend and the returns should increase. So time becomes very positive when you return to profitability. You're also going to get a better look at the assets of the company once the concerns about lack of profitability are extinguished. People will be able to focus on the assets of the company and understand what's truly there. And of course, I believe the value of assets that are transacted will improve.

But clearly, extinguishing the loss will put the company in a better negotiating position for its asset base. In fact, it'll put it in a better negotiating position with vendors and all others. So returning to profitability is key and the time is now.

Daniel Schmerin: Several shareholders asked for your thoughts on Shop Your Way. It has grown substantially and significant capital has been spent on that membership program. What does its future look like, and do you have a sense of its value today?

Bruce Berkowitz: Shop Your Way is the transformation vehicle. It's a social shopping destination with a rewards program, and there are tens of millions of members. The whole idea is you can shop anywhere and anyway that you want, and it's intended to deliver value and convenience to members every day. It also allows Sears to transition to an asset-light model and enables them to be more agile, more consumer centric.

When it comes to Shop Your Way, the best thing for shareholders to do is join the Shop Your Way program and try it out.[4] They should also try out the Sears MasterCard, which is really the Shop Your Way MasterCard, which has an industry-leading 5-3-2-1 rewards offer. So, test it out. Until I hear from people, I won't predict the end state of Shop Your Way. Send me your feedback. I'm a big user of Shop Your Way and I'd love to compare notes with our shareholders.[5]

Daniel Schmerin: Can you explain the value of the Sears reinsurance subsidiary based in Bermuda?

Bruce Berkowitz: Sears Re is the company's self-insurance vehicle. It allows the company to save costs by cutting out middlemen when paying claims on protection agreements and other types of insurance. It helps increase margins. The balance sheet of an insurance company is much different from the balance sheet of a retailer. The net asset value of insurers is basically the assets minus liabilities. In this case, the liabilities are reserves against expected insurance claim losses. In my opinion, the company is quite well reserved.

Daniel Schmerin: Can you explain why you are optimistic about the plans that Sears has announced over the course of 2017? What is the path to success for our investment?

Bruce Berkowitz: Sears has announced that expenses are going to be reduced by $1.25 billion. In addition, overall liabilities will be reduced by at least a billion dollars. This is a big change for one year. These actions will increase profitability and liquidity, but I know and I understand that most will not believe it until they see it.

Daniel Schmerin: Turning to Sears Canada, is it inaccurate to think of Sears Canada as a mini version of Sears? What makes you think that Sears will not follow the same path as Sears Canada?

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[4] https://www.shopyourway.com/getmore

[5] Fairholme shareholders are encouraged to send their comments regarding Shop Your Way to Bruce by emailing feedback@fairholme.net.

Bruce Berkowitz: Well, Sears in the U.S. has been less aggressive on physical space updates. And Sears in the U.S. has much more liquidity, it is much more liquid with many more assets, more levers at its disposal. I don't see any prospect of or need for a formal restructuring at Sears Holdings.

Daniel Schmerin: Sears owns 12% of Sears Canada. How will the company maximize the value of its stake in Canada given recent events?

Bruce Berkowitz: I'd hope the same way as Fairholme and other large shareholders.

Daniel Schmerin: What was motivating you to buy shares of Sears Canada during the last year? What was your estimate of the intrinsic value of Sears Canada before it filed for bankruptcy protection, and do you expect shares of the company to have value once it emerges from that process?

Bruce Berkowitz: Dan, I believe there is still ample asset value at Sears Canada as an ongoing entity. We estimated that the company had at least nine dollars per share of net asset value before restructuring charges. And if you adjust for the expected liabilities related to court proceedings, estimated NAV could be about seven dollars per share.

Right now, we are carefully examining the filings by Sears Canada and exploring all options. We want to make sure that the company is able to maximize the value of its assets for the benefit of all stakeholders, including us, the common shareholders. This process is expected to last for a few months. We'll know soon enough.

Daniel Schmerin: Do you envision that Seritage Growth Properties will seek to acquire some of those Sears Canada properties? Or more Sears and Kmart properties in the U.S.?

Bruce Berkowitz: I don't know, Dan. Seritage has many call options on Sears properties, and Sears has many put options on Sears properties. I don't know how it's going to exactly turn out.

Daniel Schmerin: To what extent does Seritage get dragged down by the challenges that Sears has faced in its retail operations? Can Seritage effectively absorb properties that Sears is turning over to them, while continuing the pace of redevelopment on its other projects?

Bruce Berkowitz: There's no doubt that Seritage has been tarnished by perceptions of Sears. But the company will be able to continue its pace of redevelopment, especially given the nature of the calls and the puts. Seritage will call a property when they have tenants lined up for that space with much higher rental rates. And if Sears puts part or all of a property to Seritage, then Seritage receives one year's worth of rent and operating expenses and most likely, they've already identified potential customers for the space. So, I don't envision any problems at the current pace or even at a somewhat accelerated pace.

Daniel Schmerin: What do you think the potential dividend per share of Seritage could be three years from now?

Bruce Berkowitz: I expect Seritage to eventually refinance what I call its IPO debt in a much more sensible fashion and a lower cost, which will allow faster expansion, more revenue, more operating income, and higher dividends.

I wouldn't be surprised if three years from now, it has roughly doubled its dividend to about two dollars per share while still continuing to grow over the next three year period. I would not be surprised over a roughly six to ten year period if Seritage doubled its dividend twice from a dollar to two dollars, and then from two to four dollars.

And there'll still be some growth after that, on an organic basis, without the need to acquire any other properties.

Daniel Schmerin: Right, just based on the properties that they have under their umbrella today.

Bruce Berkowitz: Yes.

Daniel Schmerin: Our next set of questions pertains to Fannie Mae and Freddie Mac. The first one up: What is the reason that you bought certain series of Fannie Mae and Freddie Mac preferred stock? Why not other series? And what about common stock?

Bruce Berkowitz: The preferred stock is a contract with stated values, terms, and conditions. And the preferred stock is senior to the common stock, common equity. In terms of different prefs, each pref has a different price based on different dividend rates and other terms and conditions. So there are trade-offs between price and stated terms and conditions. And we wanted a spectrum of the different prefs.

Daniel Schmerin: The upside potential for our Fannie Mae and Freddie Mac investments have been widely discussed. From the perspective of a preferred stock investor, what is the worst case scenario that you can envision?

Bruce Berkowitz: The worst case is the companies remain nationalized by the last administration and we're unable to prevail before any of the courts, including the Supreme Court. But I really don't consider that to be a probable scenario.

Daniel Schmerin: Why do you believe that our stake in Fannie Mae and Freddie Mac is more of an investment than mere speculation?

Bruce Berkowitz: Well, we have two companies that earn over $15 billion a year after taxes. We have taxpayers that own 80% of the companies, a stake that I personally believe is worth over $100 billion. Taxpayers have the option to buy 80% of each company for a penny and end up with a $100 billion profit. In order for taxpayers to receive the profit, which they should receive, our preferreds must be worth par. So for these warrants to have value, our preferreds must have value.

And frankly, when you go through all the processes and all the possibilities, restoring "safety and soundness" to the companies remains the best solution by far.[6]

Daniel Schmerin: What would need to happen for you to change your view and sell the position in Fannie Mae and Freddie Mac?

Bruce Berkowitz: Let me back up a little bit. Again, the reason why I purchased Fannie Mae and Freddie Mac preferred stock is that we have a contract in our hands. It's an economic bundle of rights that includes a stated liquidation preference and a preference on dividends. And the companies are enormously profitable. In fact the United States Treasury has been paid back every penny it invested plus $83 billion in profit. We expect, at least, to get the return of our investment let alone a return on our investment.

And as to what would need to happen for me to change my view, to sell the position? New facts would have to come out about the companies, or markets, or funds, or the economy. As the facts change and the environment changes, we will change. If at some point in the future, neither the administrative nor legal path to success are viable, that would change my view. But honestly, I can't see this administration putting a $5 trillion liability on the federal balance sheet. I also can't see the administration giving away $100 billion dollars in taxpayer profits. It just doesn't make sense. I think we're all aligned on this.

Daniel Schmerin: Why do Fannie Mae and Freddie Mac securities trade on the pink sheets? And why aren't their securities listed on the New York Stock Exchange anymore?

Bruce Berkowitz: The companies were directed by the FHFA, their regulator and conservator, and by Treasury, also a major investor, for whatever reason to de-list their securities in 2010. It makes no sense to me. We've written to the companies, we've asked for the companies to relist their securities on the New York Stock

[6] Per the FHFA website, "Conservatorship is intended to stabilize troubled institutions with the objective of maintaining normal business operations and restoring financial safety and soundness." https://www.fhfa.gov/Conservatorship

Exchange. Fannie Mae and Freddie Mac are certainly the largest companies we've ever seen to trade on the OTC market. So it makes no sense to us.

Daniel Schmerin: The opponents of Fannie Mae and Freddie Mac pushed hard to eliminate the companies a few years ago. Today, their tune appears to have changed. What do the opponents of the GSEs now seek to achieve?

Bruce Berkowitz: I have asked the same question but there is no answer that makes any sense, or any answer of substance. They appear to have come to a common sense conclusion, that Fannie Mae and Freddie Mac can't be eliminated without causing significant damage to the housing market or hurting the middle class. But some of the biggest banks are still looking for handouts, they're looking for some way to boost their bottom line and reduce liabilities.

I know that the opponents of Fannie Mae and Freddie Mac talk about the need to foster more competition or to split the GSEs into many little companies or separate their single-family and multifamily businesses. But there's no math that makes sense. There is no financial analysis whatsoever to support these wishes. So it's hard to really figure out why certain people are recommending certain actions.

Daniel Schmerin: What is the most likely path to success for this investment? Is it through legislative action or administrative action? And what is a reasonable timeline?

Bruce Berkowitz: With regard to administrative action, FHFA Director Mel Watt was pretty direct at his May 2017 Congressional hearing. He will not permit the company to operate with zero capital. It's unsafe, it's unsound. I think there is good reason to expect that Director Watt will act on his words and take corrective steps this year. We should go through a process now that's no different from the process that Treasury undertook for AIG.

I just don't see any evidence of any consensus in Congress on future legislative action. Congress passed the comprehensive law in 2008, the Housing and Economic Recovery Act ("HERA"). And it's not clear that this Congress is going to be a beta tester on unsubstantiated alternatives, especially when you take into account that our housing finance market is a $10 trillion system. There are real consequences to getting it wrong. It just makes no sense when the existing system can work quite well.

Daniel Schmerin: Has the Trump administration indicated a position with respect to Fannie Mae and Freddie Mac?

Bruce Berkowitz: From what I've read, the Trump administration has made clear that they're bringing a practical business approach to Washington, and that capital market participants are not the enemy. You should have a say if you are an owner. I've heard the same things from this administration as everyone else has. Treasury Secretary Mnuchin indicated that for very long periods of time Fannie Mae and Freddie Mac had been well run without creating risk to the government. He believes they are very important entities to provide the necessary liquidity for housing finance. He also said we shouldn't just leave Fannie Mae and Freddie Mac as is for another four or eight years under government control without a fix. The status quo is not acceptable.

He also discussed how he's concerned about low- and moderate-income families who need mortgage loans having access to capital. What I read and what I think is pretty consistent is that the Treasury Secretary wants to make these companies absolutely safe and get them out of government control. I think he's been pretty straightforward about it and he's indicated that they're going to work on this issue, but first they need to tackle healthcare, the debt ceiling and tax reform.

Earlier this month, Ben Carson, the Secretary of Housing and Urban Development ("HUD"), told CNBC that he is not opposed to shareholders getting their money back, and I think he said that would be the eventual goal – for shareholders to get a return of their investment.[7]

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[7] NBC.com, *Secretary of Housing Carson: Familiar with Blackstone and its Leadership* (June 1, 2017), http://video.cnbc.com/gallery/?video=3000623709&play=1

Again, it's refreshing. It's a 180 degree change from the last administration. And finally, one thing is absolutely clear: it makes no sense whatsoever for a Republican Congress to tie the hands of a Republican administration.

Daniel Schmerin: I agree. What is your view of the recently published Moelis blueprint to restore the safety and soundness at the GSEs?[8] Does it make sense?

Bruce Berkowitz: It's definitely the most pragmatic, feasible, viable path to achieve what the administration has articulated as its objective. It's the only proposal I've seen that has numeracy. It focuses on Fannie Mae and Freddie Mac as insurers – they're not banks. They come up with a way that taxpayers earn at least another hundred billion dollars by monetizing the government warrants. Think about it: a hundred billion bucks! That's real money, even in Washington, D.C. Their plan is a big win for the administration. It can be achieved through executive action and allows the president to demonstrate his ongoing commitment to draining the swamp by upholding the rule of law and by enforcing HERA.

Keeping Fannie Mae and Freddie Mac captive in a perpetual conservatorship hamstrings their ability to help communities gain access to homeownership. Fannie Mae and Freddie Mac's current state of limbo is just fostering continued market uncertainty and exacerbating our nation's housing problems. It doesn't have to remain this way. I think Ken Moelis' team has done a superb job.

GSE's mission returns to the basics of ensuring wholesale financing through affordable mortgage guarantees. The noninsurance assets of the GSEs are liquidated. The blueprint implements a capital restoration plan to promote safety and soundness. Capital is rebuilt with retained earnings and the liquidation of their legacy portfolios. The plan calls to raise additional private capital to absorb risk and enable Treasury to dramatically reduce its outstanding commitment to each company.

As I mentioned, the owned portfolio runs off. That will generate a significant amount of profits and the plan calls for no distributions until the companies are

[8] Moelis Blueprint, http://gsesafetyandsoundness.com/.

fully capitalized. Again, no legislation is required and there is no cost to the federal government. The bottom line is that the Moelis blueprint is strongly supported by many of the President's allies and it definitely will help minimize taxpayer risk.

It will definitely strengthen what people call cyclical resilience and it will promote safety and soundness in the housing finance markets. The government would receive $100 billion above and beyond the $83 billion in profit the Treasury has already made on its investments in Fannie Mae and Freddie Mac, and this $100 billion would go a long way to help increase employment, GDP growth, housing formation, mortgage affordability, and tax revenue.

I truly haven't heard one person, not a single one, offer a compelling argument for why Ken Moelis is off base. In fact, alternative proposals present serious transition risk and are really fraught with unintended consequences for America's $10 trillion housing finance system. We can't afford to get this wrong as a nation. I believe the administration implicitly understands this.

Daniel Schmerin: A Bloomberg news article recently argued that agency debt investors might be skittish about the Moelis blueprint because it doesn't include an unlimited government guarantee on mortgage-backed securities. So shareholders ask, "Is this just more fake news?" What is your view?

Bruce Berkowitz: I don't know what you want to call it other than inaccurate. There are asset-backed, corporate and municipal debt securities that trade at or near U.S. government rates. It's all about underlying collateral, insurance, risk weightings, tax rates. Reinsurance markets, rather than taxpayers, can create the necessary construct for Fannie and Freddie. These markets already exist. Catastrophic markets already exist for hurricane insurance and earthquake insurance.

It just seems crazy that the article suggests that adding $5 trillion of debt to the federal budget will somehow reduce taxpayer risk. An unlimited government guarantee of all mortgage-backed securities makes no sense. It just creates unlimited liabilities. It's very much – I've heard this term once – a type of Obamacare for mortgages.

It doesn't get taxpayers off the hook. Instead it puts taxpayers squarely on the hook. Rumors about mortgage-backed security investors getting jittery, that there's not an unlimited government guarantee, it sort of reminds me of fears over Y2K, which ended up being complete nonsense. Bottom line is that Fannie Mae and Freddie Mac can build substantial private capital, then use the reinsurance markets to reduce risk, and maintain a limited explicit line of credit from Treasury that they pay for.

Taxpayers will be absolutely safe and the markets will function as normal, homeowners will have reliable access to mortgage credit, and the economy will be able to prosper. The math is easy.

Establishing an unlimited government guarantee for all mortgage-backed securities hands the big banks a major win because it would substantially reduce capital requirements. I can understand why they would want it.

Regulators currently require banks to hold capital against mortgage loans and mortgage-backed securities that those banks keep on their books. If you're a large financial institution like Wells Fargo, an unlimited government guarantee requires zero capital. It's a free lunch. I think it's a terrible outcome for taxpayers and will likely prove highly destabilizing to the $10 trillion housing finance system.

I can understand why the Mortgage Bankers Association is lobbying so hard for it. But again, they have to show us the math for doing this. Advocates for unlimited government guarantees should explain what fees will be levied for the guarantee and how those fees will be passed along to consumers. I'll give you a hint: if the analysis is honest and you follow the cash, mortgage interest rates will dramatically rise with an unlimited government guarantee that properly compensates taxpayers for the risks borne.

So there are a number of major hurdles when you start talking about unlimited government guarantees. It will likely raise mortgage rates for the most vulnerable homeowners, it will expand the government footprint, it will expose taxpayers to covering losses. It's clearly a pro-cyclical and systemically riskier form of mortgage finance and it will likely lead to unequal and unfair distribution of lender access to the secondary mortgage market.

These are just a few concerns. There are many other concerns, but these are just some of the points which I'm sure the Bloomberg article pointed out.

Daniel Schmerin: Not exactly. At the end of 2017, both Fannie Mae and Freddie Mac are set to have zero capital as a result of the unlawful Net Worth Sweep. Will the conservator put our housing finance system in jeopardy and allow this to happen?

Bruce Berkowitz: We all know it would make zero sense to do that. We all know that it goes against everything we know to be true in business prudence. It flies in the face of all post-crisis financial regulatory reform. You simply can't operate systemically important insurers without capital. The equivalent would be a Berkshire Hathaway or an AIG in business without any equity whatsoever. It would be financial suicide.

Daniel Schmerin: What is your view on the appropriate amount of capital that Fannie Mae and Freddie Mac should be required to hold to mitigate taxpayer risk?

Bruce Berkowitz: This is an area that people need to think more about. Let me dig into it, because you have to understand all the mortgage finance risks and how they're all covered. There are various forms of insurance. First you have to understand when a homeowner takes on a mortgage, that homeowner's income and the deposit that the homeowner puts down are a form of insurance, especially given the fact that the mortgage is cross-collateralized with all the homeowner's wealth and income. We're seeing deposits of 10% to 20%. And then when you look at the originators who are creating the mortgages and holding the paper after it's packaged by Fannie Mae and Freddie Mac, they have to retain 3% of the mortgage as equity capital on hand. And then you have to consider the third-party insurance market. There are private insurers that insure, if needed, a part or all of the mortgage.

I've talked a little bit about a catastrophic reinsurance market that can clearly mitigate any catastrophic government risk. There are also other types of insurance such as quota share, which – if needed – could further reduce more traditional risks. Then you have to think about the insurance based upon how conventional mortgages are sold.

And by that I mean that they're only offering a certain type of conforming mortgage, there's a limited amount that you can borrow for the mortgage, there's a specific amortization schedule. There are significant qualifications needed in order to get a mortgage and mortgages are geographically diverse. So put all those insurances together and then you would look at what Fannie Mae and Freddie Mac would need.

First, Fannie Mae and Freddie Mac have a significant amount of reserves, and I wonder whether they would need more than 3% of their mortgages as a reserve. Then you'd have to take into account the equity that they would need – people are saying between 3% and 5%. When you add up all of these forms of insurance, you'll understand that there is no risk to taxpayers, only profits.

If Fannie Mae and Freddie Mac continue to stick to their knitting and focus on their original mandate, there's very little risk. Any remaining risk can always be controlled by different layers of insurance, just the way it's controlled in all other industries.

Daniel Schmerin: Do you think that the Trump administration will be steamrolled by the proverbial swamp on housing finance reform? In other words, do you believe that the big bank lobbyists and other special interest groups and highly conflicted Washington insiders, all of whom seek to put their own personal interests ahead of any pragmatic solution that would accelerate economic growth and help America's middle class – do you think those special interests will ultimately prevail?

Bruce Berkowitz: I don't think they're going to prevail if we are truly the United States. They may prevail if we are a banana republic. Yes, if we're Venezuela, we are going to have issues. But at that point the issues we'd have would go far beyond just Fannie Mae and Freddie Mac.

Daniel Schmerin: Along the same lines, another shareholder asked why the Trump administration would pay any attention to big Democrat bundlers and operatives including Dave Stevens at the Mortgage Bankers Association, Mark Zandi at Moody's and Jim Parrott at Bank of America and the Urban Institute. Why would they pay attention to any of those individuals on this issue?

Bruce Berkowitz: In all honesty, I don't know why they would pay attention. These are the same actors who brought us the last financial crisis. I understand that opponents of GSEs are making a lot of noise on behalf of their clients, because these people are paid to do just that. The real problem is that their recommendations about moving forward lack substance.

Their proposals are clearly self-serving, and I cannot see how they are in the best interest of the country. Their proposals are certainly not in the best interest of America's middle class. We shouldn't be taking advice from people who have failed miserably with past advice. I mean, why should anyone listen? You'd be better off doing absolutely nothing on any one of their ideas, which in my opinion would lead to the next financial crisis, brought to you by the same people as the last financial crisis.

Daniel Schmerin: The remaining Fannie Mae and Freddie Mac questions pertain to the ongoing litigation so I'd like us to turn to David Thompson from Cooper & Kirk, whose team has been representing the Fairholme Fund on behalf of all our shareholders. David, I get to speak to you every day but our shareholders do not, so given the large number of questions that we've received on this topic I wonder if you could begin by providing some historical context.

How do these cases compare to Glendale Savings or the Winstar litigations? And have you ever seen such blatant overreach by the administrative state before?

David Thompson: Dan, I think there are a lot of parallels to the Winstar situation. Back in the late 1980s, the government upended settled expectations of investors in financial institutions and specifically the S&L industry. And we brought suit challenging that governmental action. Very few people thought we would succeed and indeed, when we went to the Court of Appeals for the first time, we lost two to one, just as we have in the *Perry Capital* case.

We ultimately prevailed seven to two before the Supreme Court in that case, and I think the lesson we learned is that the path to victory isn't without some bumps along the road. I think this path to victory will be more expeditious because the issues are not as factually complicated and we're proceeding in multiple forums, but I do think that's a powerful historical analogy.

Daniel Schmerin: Can you discuss the current state of play in the Court of Federal Claims? Where do we stand on discovery? How do you feel about the results to date, and what are the anticipated next steps?

David Thompson: Just to refresh recollections, when we had our last call together, at that point we had been very upset that the government had given us a privilege log with over 12,000 items. It was really the mother of all privilege logs. So we selected 56 documents for the court to look at to see if the government had been turning square corners.

The court agreed with us that the government had improperly withheld all 56 of those documents. The government appealed since our last call to the Federal Circuit and prevailed on four presidential privilege documents, but on 48 of the 52 deliberative process documents, the government lost. So it was remanded back and we went to the court and said, Your Honor, if they're wrong on 48 of the 52 documents that we've randomly selected, they should have to go back and reassess all the others.

And they were ordered to do so through the full privilege log and we've now received over 3,500 additional documents. We're continuing to skirmish a little bit in the weeks ahead, but discovery should end shortly. We're very gratified that we have insisted on our rights and on receiving documents that should not be improperly withheld, and we'll be amending our complaint in the coming months, and then our case will move forward to adjudication on the merits.

Daniel Schmerin: The cases brought around the country under the Administrative Procedure Act have had only limited success to date. Can you discuss the D.C. Circuit's recent opinion in our case and next steps for us and other similarly situated plaintiffs?

David Thompson: Sure. So the D.C. Circuit ruled at the end of February of this year and we were gratified that Judge Janice Rogers Brown saw the case exactly the way we see the case. I'd like to just read to you a few of the quotes from her excellent dissent. Thanks to our Court of Claims discovery, she said that "information recently obtained in this litigation creates, to put it mildly, a dispute of fact regarding the motivations behind FHFA and Treasury's decision to execute the Third Amendment."

She continued, FHFA "pole vaulted over" the boundaries of its statutory authority when it agreed to the Net Worth Sweep, "disregarding the plain text of its authorizing statute and engaging in *ultra vires* conduct."

She added, "Having been appointed as conservator for the companies, FHFA was obligated to behave in a manner consistent with the conservator role as it is defined in HERA or risk intervention by courts."

She went on to say that by imposing the Net Worth Sweep, Treasury received a contractual right from FHFA "to loot the companies to the guaranteed exclusion of all other investors," and "FHFA's decision to strip these cash reserves from Fannie Mae and Freddie Mac, consistently divesting the companies of their near entire net worth, is plainly antithetical to a conservator's charge to 'preserve and conserve' the companies' assets.

She added, "The capital depletion accomplished in the Third Amendment, regardless of motive, is patently incompatible with any definition of the conservator role … rendering Fannie Mae and Freddie Mac mere pass-through entities for huge amounts of money destined for Treasury does exactly that which FHFA has deemed impermissible."

She went on to say, "The practical effect of the Court's ruling is pernicious. By holding, contrary to the Act's text, FHFA need not declare itself as either a conservator or receiver and then act in a manner consistent with the well-defined powers associated with its chosen role, the Court has disrupted settled expectations about financial markets in a manner likely to negatively affect the nation's overall financial health."

She concluded, "What might serve in a banana republic will not do in a constitutional one."

It is a powerful opinion, yet unfortunately, it was a dissent. There were two judges on the panel who disagreed. Now, one might say how could you look at the Net Worth Sweep and conclude that it is consistent with the statute's language that FHFA is supposed to preserve and conserve assets and operate institutions in a sound and solvent manner?

I would submit that it is impossible to square that language with the Net Worth Sweep. And the majority essentially conceded as much, because the maneuver the majority employed was to say that those are mere suggestions, that they're not binding on the FHFA, and so FHFA wasn't required to operate the companies in a sound and solvent manner. And the problem with that argument and holding is that for years in official filings and sworn written statements, the FHFA has consistently acknowledged that those are statutory mandates.

In sworn testimony to Congress just last month, Mel Watt said, "FHFA's statutory mandate obligates it to conserve and preserve the assets of the enterprises while they are in conservatorship." So we feel very confident that the line of analysis adopted by the *Perry Capital* majority – and that was really the linchpin of the decision – is not going to withstand judicial scrutiny.

It’s likely that you’ll see a cert petition filed in the coming months in *Perry Capital* and if the Supreme Court takes that case, we’ll get a decision about a year from now.

In addition, Cooper & Kirk has now been retained in four cases that we had been closely following but we are now counsel of record for those cases in the Fifth, Sixth, Seventh, and Eighth Circuits. The Sixth Circuit oral argument will be on July 27, and I think it is reasonable to expect that we might well get a decision by the end of the year out of the Sixth Circuit. There is a lot going on around the country.

Daniel Schmerin: Good. Are there any other legal avenues that plaintiffs are exploring?

David Thompson: Yes, there are. Just in the last couple of weeks, there are two very interesting new suits that have been launched in Michigan and Minnesota, and we’re following them closely because they are premised on the idea that even if the government is absolutely right about the factual background of the Net Worth Sweep and the reasons why they did it – and discovery has shown they’re not – but even if they were right, these suits say the Net Worth Sweep must be invalidated on the basis of three separate theories.

The first is the separation of powers theory. Namely, that the FHFA is unconstitutionally structured. It is an agency that we are told is immune from judicial oversight. It is immune from congressional oversight because it doesn’t rely on Congress for appropriations. It’s immune from presidential oversight because the president can only remove the director for cause. And it has a single director, not a multimember panel which is more frequent among independent agencies.

To my knowledge, there is only one other prominent agency that is so constituted and it’s the CFPB. And both are obviously of recent vintage, and the CFPB was recently ruled unconstitutional on exactly this theory by a majority of the D.C. Circuit.

The second theory is the Appointments Clause, which requires principal officers to be nominated by the president and confirmed by the Senate. In this instance, Ed DeMarco, when he was the acting director of FHFA and signed the Net Worth Sweep, had been acting for three years and these lawsuits maintain that it's inconsistent with the Appointments Clause to put someone in as a principal officer in an acting capacity for three years. That would just be way too easy an end run around the Appointments Clause.

The final theory is nondelegation, which is a constitutional doctrine that says that agencies need to have an intelligible principle that binds their conduct. Well, of course, the *Perry Capital* majority said that the intelligible principle of preserving and conserving assets and operating the institutions in a sound and solvent manner was not binding at all. And so these new lawsuits are saying that if that's correct, then we have a nondelegation problem because there is no intelligible principle binding the FHFA because it can do whatever it wants. So those are two suits to be watching. The first theory is present in the Fifth Circuit appeal that we'll be handling in a case called *Collins*, but all very important litigation that is proceeding.

Daniel Schmerin: Another shareholder focused on the violations by big banks of federal securities laws and common law in the sale of residential private-label mortgage-backed securities to Fannie Mae and Freddie Mac, and he asked why plaintiffs have not brought direct or derivative suits against those big banks for the harm they caused to the GSEs?

David Thompson: The short answer is that the companies themselves have brought that litigation and have garnered settlements well in excess of $20 billion. So it wouldn't make sense to try to bring a derivative case when the companies have already directly vindicated their rights. That is pretty much water under the bridge at this point.

Daniel Schmerin: What is your assessment of the timeline for this multifaceted legal fight, and what events should we mark down on our calendars as we look ahead to the remainder of 2017?

David Thompson: As I noted, on July 27 the Sixth Circuit will be having oral arguments in a case that is very similar to *Perry Capital* and we expect that an opinion may be rendered before the end of the year. So that'll be a very important moment. Certainly if the cert petition for *Perry Capital* is filed as we expect later this year, it will be important to see whether the Supreme Court grants cert and that should probably happen toward the end of the calendar year.

We'll be amending our complaint in the Court of Federal Claims and bringing together the fruits of all of the documents that we found that are helpful, including from those 3,500 additional documents that we recently received. I think six to 12 months from now, we're going to know a lot more than we do right now. So there are number of important events over the next year.

Daniel Schmerin: If you have to summarize the most important points for someone who is new to the situation, what would you say to them?

David Thompson: I would say we are in multiple forums and there are multiple theories that are moving forward. If a plaintiff wins in just one of these places, the Net Worth Sweep will be enjoined on a nationwide basis. As in Winstar, the path to victory may not be without setbacks along the way, but we remain very confident that the federal judiciary will not uphold the Net Worth Sweep.

Daniel Schmerin: Thank you, David.

David Thompson: My pleasure.

Bruce Berkowitz: David, on behalf of all our shareholders, thanks to you and all of your team members for their hard work. We are looking forward to a positive outcome in one of the venues.

David Thompson: Thank you.

Daniel Schmerin: Bruce, I'd like to return to The St. Joe Company ("St. Joe") and wrap up. You recently said that if you could only invest in one of our positions, St. Joe would be it. A shareholder asks a slightly different question: If you had no investment positions at all, what is the first investment you would put money into today? Would it still be St. Joe?

Bruce Berkowitz: Yes, it would.

Daniel Schmerin: So what is happening at St. Joe these days that gives you cause for optimism and what is the timeline for meaningful profitability?

Bruce Berkowitz: I should give everyone a taste of the new activities starting at St. Joe in Northwest Florida. St. Joe is increasing jobs in the area by helping to create global high-tech manufacturing facilities. St. Joe signed its first global high-tech company, GKN plc ("GKN"), an automotive and aerospace components company. Hopefully they will open up before the end of this year. St. Joe is increasing primary home choices for the first time, building apartments to rent as well as townhomes and condominiums to increase density. Of course, there is also the further expansion of retail and village spaces that go along with more jobs and more homes.

St. Joe is trying to increase the quality of education, looking to build new schools and very much focused on the "STEM" areas: sciences, technology, engineering, and mathematics. They are in talks to expand the healthcare system in the area. They're working hard on a very large biomedical engineering project. Of course, they're also looking to continue to increase tourism. I believe that Northwest Florida Beaches International Airport has crossed a million legs. I know airlines are exploring additional routes. For the first time they're starting the process of looking to build new hotels and a new convention center. They're also finalizing plans for a very large national sports facility.

I'm sure people haven't heard of Triumph Gulf Coast. Triumph Gulf Coast is a nonprofit corporation that was created by the Florida legislature to distribute about a billion and a half dollars of funds for economic damages in the State of Florida that resulted from the 2010 Deepwater Horizon oil spill.

Florida's Governor Rick Scott executed the Triumph legislation earlier this month, and it is now in effect. Triumph Gulf Coast attempts to establish, hold, invest, and administer this trust of a billion and a half dollars for the economic recovery, diversification, and enhancement of eight Northwest Florida counties that were disproportionately affected by the spill.

St. Joe owns property in five of the eight counties, with significant ownership in three of the counties – Bay, Gulf, and Walton counties.

I mentioned GKN. We're constructing a 137,000 square foot building at Venture Crossings, which is proceeding well and should be completed later this year. St. Joe is constructing the building and leasing it to GKN. GKN has started the hiring process, and we expect them to create 170 aerospace manufacturing jobs with a median annual salary of about $65,000. We also expect another 400 to 500 jobs to be created from the knock-on, secondary effects associated with this new facility.

I mentioned apartments. St. Joe is constructing 240 units in a joint venture with HomeCorp near Pier Park. It is expected to commence in the third or fourth quarter of this year. St. Joe will be the majority owner of the JV and owns most of the land surrounding this project.

We expect many more starts to come, so I tell everyone to stay tuned.

Daniel Schmerin: Here's an interesting one we received. Given that the Intergovernmental Panel on Climate Change expects that the oceans will rise between 11 and 38 inches by 2100, can you please discuss how much, if any, of St. Joe's highly desirable real estate properties would be at risk?

Bruce Berkowitz: The coastline in Northwest Florida typically has higher elevations than other parts of Florida. For example, the gulf front at our Watercolor Inn has an elevation of 13 feet. Pier Park North commercial center has an elevation of 30 feet. Watersound Origin, one of our growing communities, has an average elevation of 35 feet. And our high-tech manufacturing area at Venture Crossings is adjacent to the airport with elevations ranging between 50 and 60 feet above sea level.

St. Joe is going to be A-OK, at least for the next few hundred years. I think those of us living in Miami have a lot more to worry about.

Daniel Schmerin: For the last several years, shares of St. Joe have underperformed the market and its peer groups. What action do you anticipate the company will take to highlight the value for investors of its cash and property, and when? And what actions will the company take to potentially increase capital allocation for shareholders, whether in the form of dividends or accelerated buybacks, especially given the strength of St. Joe's balance sheet?

Bruce Berkowitz: I'm happy to report the company is executing on its plans. It's focused on recurring revenues, executing joint ventures to maintain low fixed cost structures, working hard to diversify the regional economy. We've been very lucky and fortunate to have great support from the state and local officials, be it from Governor Rick Scott, Commissioner Adam Putnam, and many others who believe there's a bright future for Northwest Florida. I'm quite excited.

And in terms of capital allocation, more capital will be directed toward new programs and projects. But St. Joe will still have significant excess liquidity, and shareholders could see substantial amounts of capital used to continue repurchasing shares if the price is right.

Daniel Schmerin: Another shareholder asked, "Are there accommodations for us small fry investors to go down to St. Joe and get a tour of the facilities and the region itself?" How would you recommend people go down and tour this area? And is Joe doing enough to promote itself?

Bruce Berkowitz: All of our shareholders are welcome at St. Joe. Feel free to call St. Joe and arrange a visit. Tell them I encouraged the visit. Shareholders who visit will be pleasantly surprised and it's going to get easier and easier to get to the area, because every year, we expect more direct flights into Northwest Florida Beaches International Airport. And we're hoping to see flights from the New York area in the not-too-distant future.

St. Joe is moving faster and faster on all fronts. However, they are still exercising prudence. Every project must be profitable from day one. Every project must add value to all other current or future projects. St. Joe has at least 30 years of organic growth ahead. People at St. Joe want to make sure that they achieve this tremendous growth with minimum risk to the company and communities. It's my belief that the company is now ready for whatever may come.

Daniel Schmerin: I think we'll leave it there. We've covered a lot of material today. Thank you all for taking the time to join us. If you have further comments on what you've heard, please send us a note.

Bruce Berkowitz: To all our shareholders, I continue to thank you for your trust and for your confidence, and we look forward to the next conference call.

Operator: Thank you for participating. This concludes the Fairholme Public Conference Call.

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