**October, 2017**

Dear partners,

While I had previously indicated that I would only be writing twice a year as I feel strongly that thinking in larger blocks of time will benefit our partnership, I also recognize that despite clever marketing campaigns, all investment strategies underperform at times, and how one behaves during the difficult times is a key determinant of long term investment success. As such, I want to make sure partners understand what we own and why we own it, so that someday in the (hopefully distant) future when the inevitable difficult times arrive, you will be well equipped to focus on the businesses we own, and not the prices that the market puts on them at any given moment. There has been an above average amount of activity in our portfolio in recent months, so I felt a quarterly update was in order.

Laughing Water Capital (LWC) returned 11.4% gross during the 3rd quarter of 2017. The SP500 and R2000 returned 4.5% and 3.5% respectively during this period. Year to date LWC has returned 23.5%, while the SP500 and R2000 have returned 14.2% and 10.9% respectively. As always, net returns are what matter to investors, so please check your individual statements. I remind you that partners that make longer term commitments to the fund are rewarded with significant fee breaks.

Additionally, I remind you that LWC makes no effort to track the indices. Rather, our strategy often involves buying businesses that are dealing with some sort of temporary optical, structural, or operational problem. In the best cases, we will be buying from un-economic, or irrational sellers. Simply stated, we don't want to buy from sellers who are completely measured in their decision to sell. We want to buy from people who are selling for irrational reasons. However, when you are buying from irrational sellers, it is impossible to know how long they will remain irrational, or if they will become even more irrational and drive prices down further. As such, it is entirely possible that we will give up some of our recent gains in the months and quarters to come before recapturing them as our management partners continue to work toward improving our companies. As always, patience is essential.

The price of long term out performance is a willingness to accept volatility in the short term. I am happy to pay this price, and for this reason, almost the entirety of my and my family’s assets are invested in our strategy. Our interests are aligned.

## New Positions

There are three positions worth talking about (some of which we started buying in the 2nd quarter), and a fourth which will remain undisclosed for the time being as we may seek to add to it in the near future.

**IES Holdings** (IESC) – IESC entered our portfolio as a smaller position. The company is a conglomerate with business in 4 verticals – Commercial & Industrial, Communications, Residential, and Infrastructure. While these businesses should benefit from both cyclical and secular tailwinds in the years to come and are thus interesting in their own right, what makes an investment in IESC more interesting is that it is almost 60% controlled by Jeffrey Gendell, an excellent capital allocator. Gendell is the founder of Tontine Capital, where he previously compounded capital at ~40% a year for a decade. Further, the company has approximately $400M in NOLs, meaning that Gendell will be able to allocate IESC's earnings under a tax shield, which should drive considerable shareholder value. Credit for this idea belongs to Chris Colvin of Breach Inlet Capital, who first brought it to our attention.

**Franklin Covey** (FC) - I have been following FC off and on since 2014 when I first met the management team, and it recently entered our portfolio as a smaller position. FC is in the business of performance improvement, with a strategy based on the ideas first laid out in the best-selling book, "The 7 Habits of Highly Effective People." Insiders own 33% of the company, and check Charlie Munger’s “cannibal” box, having repurchased almost 20% of outstanding shares since I first met with them. The crux of the thesis is based on stepping over what should be a very low hurdle: customers like getting more value for the same price.

In short, historically customers have been able to order FC's training materials a la carte, paying one price (~$200 per employee) for training materials on a specific topic. The materials are considered best in breed, and renewal rates are high. However, recently the company has shifted gears and began offering access to training materials across all topics for one price via their "All Access Pass." While this should represent incredible value to existing customers and has already opened doors to new customers, there are a few wrinkles that have impaired recent results and caused the stock to trade down. First, under the old model FC was selling to HR managers who could make purchase decisions out of their existing budget, leading to a short sales cycle. Under the All Access Pass, customers must sign a 1 year contract, which typically requires legal review, and thus a longer sales cycle. Second, under the new model, GAAP accounting requires that revenue be recognized ratably over the course of the contract, while expenses are recognized during the period that they are incurred. In other words, if FC sells a one year subscription, in the first quarter they must recognize all of the expenses associated with that subscription, but they can only recognize one quarter worth of revenue.

These two items combined have been a drag on recent results, but over time they should lead to higher revenues and lower expenses: a potent combination. In the near term, as the launch of All Access Pass is lapped, deferred revenue will be recognized, which should catalyze shares by mid 2018. Longer term, the company's addressable market is enormous, the combination of secular growth and a management team with a proven affinity for rewarding shareholders through repurchasing shares is attractive, and there is potential to separate the company's education business from its corporate business, which the market would likely reward.

**Redknee Solutions** (RKN.TO) - Redknee is a vertical market software company focused on selling billing software to telecom companies, that entered our portfolio as a top 5 position. In short, a year or so ago the company ran into problems with its balance sheet after being overly focused on growth, and making poor acquisitions. The company announced they were reviewing strategic alternatives, which led to a controlling investment from software turnaround specialist ESW Capital. I am generally wary of turnaround stories, but upon learning more about ESW, I think the odds are tilted very heavily in favor of success.

ESW has traditionally operated in the private markets, and has previously maximized profitability at ~40 small software companies by bringing the benefits of scale to these small software companies. This has been accomplished by partnering the target companies with ESW's competitively advantaged platform, which includes internally controlled outsourcing capabilities, software development capabilities, and shared infrastructure.

Our investment is rooted in the fact that in August, the company raised capital through a rights offering, which led to un-economic selling, and thus a very attractive purchase price for our shares. In sum, Redknee is an excellent opportunity to partner with a best in class management team that has invested well over $100M in the company in the belief that they can simply do what they have done dozens of times before: maximize revenue at a small software company with sticky revenue. A more thorough description of the mechanics of the rights offering and the business can be found at the end of this letter.

## Comments on Selected Investments

**EZCorp** (EZPW) - EZCorp has moved past the stock price weakness caused by the convertible bond offering which I detailed in our 1H'17 letter. More importantly, the company recently announced a major acquisition in the form of 112 Latin American stores. While operationally this appears to be a good use of cash, there are larger implications which I believe will play out in the months and years to come as the market digests the news. First, for the last few years the narrative surrounding EZPW has been somewhere between "it is a disaster" and "they have a lot of changes to make." As the company enters the final year of their 3 year plan with a cleaned up balance sheet and incredible operational improvements, the narrative should shift to, "they are back on a growth track," which should lead to increased interest from the investment community. Secondly, for the last few years while EZPW struggled, their largest competitor, FirstCash (FCFS) has been hoovering up large pawn operations throughout the western hemisphere without any competition. Now that EZPW has signaled they are back in the game, I believe it is likely that FCFS will realize that their best move would be to buy EZPW, even if it required a large premium. First, FCFS would be able to realize massive synergies by eliminating virtually all of EZPW's infrastructure. Second, if they do not buy EZPW, FCFS will be living in a world where all of their substantial growth ambitions will lead them to competitive bidding processes, driving up prices. Simply stated, paying up for EZPW means they will be able to pay down for every other pawn group. EZPW remains a top 5 position.

**Iteris** (ITI) - In our last letter, I noted that curiously management created a new, separate legal entity to house the agriculture/weather business, which suggests that an eventual sale of this business may be somewhere on their radar. Adding to the intrigue, Iteris recently hired Jim Chambers to run the agriculture/weather business. A review of Mr. Chambers' CV reveals that of the previous companies where he was employed, four (4!) of them were acquired. It seems clear that management has positioned the agriculture business for eventual sale, and hired an executive that knows a thing or two about selling businesses. However, the company has also registered a shelf which would allow them to raise capital in a secondary offering. If the agriculture business was sold in the near term it would be unlikely that the company would need to raise additional cash, so the tea leaves are muddled. This is just fine because the company continues to execute at a very high level, and the traffic management business remains an undiscovered gem at the forefront of the future of intelligent transportation and autonomous vehicles. ITI remains a top 5 position.

**Now inc** (DNOW) - I have sold our shares in DNOW. The original thesis was that an investment in DNOW was an investment in the beaten-up oil space that would benefit independent of oil prices as management used their massively over-capitalized balance sheet and long track record of successful M&A to gain market share by buying struggling Mom and Pop players in the oil field distribution business. Shares rallied quite a bit from our purchase price as the price of oil recovered, but quickly gave back the gains. The price of oil was never germane to our thesis so we should have exited on this brief move, but we did not. Management has since signaled that the rally in oil prices has made M&A increasingly unlikely because bid-ask spreads between buyers and sellers are too wide. Absent the opportunity to take market share through M&A, in my view DNOW is a bet on oil prices, and I have no reason to think I am any good at predicting oil prices so we exited the position.

**Revlon** (REV) - Revlon's wild ride continues, with shares having traded hands below $16 in mid September and above $27 in late September. Business value just doesn't change that quickly absent catastrophic events, but as a stock Revlon is its own animal as controlling shareholder Ron Perelman and the largest independent shareholder, Mittleman Brothers, do battle through SEC filings that seek to influence the supposedly fiduciary minded board of directors. Notably, Mittleman asked for Perelman to agree to not squeeze out minority shareholders for a period of five years. Perelman agreed to not exceed 90% ownership for a (woefully short) one year period. From our perspective, it is of course frustrating that shares have traded down from ~$35 earlier this year, but they remain drastically under-valued if you are a long term, patient shareholder. Lower prices make Revlon an attractive candidate for tax loss selling, but Perelman's 1 year standstill agreement had the curious side effect of emboldening short sellers (who are likely hedging debt investments) who no longer have any reason to fear a buyout deal at a premium. As a result, we are presently earning a ~15%+ yield lending our shares to those who are concerned with short term volatility while patiently waiting for long term value to develop. Getting paid 15%+ to wait for something that I believe may ultimately be worth multiples of its present price helps sooth the pain of our mark to market losses incurred this year.

## Portfolio Review

"All man's miseries stem from his inability to sit in a room alone and do nothing." [sic]

*~Blaise Pascal, c/o Mohnish Pabrai*

The above quote has been popularized in investing circles by super-investor Mohnish Pabrai. It is especially relevant to our portfolio at the moment due to the previously referenced increased level of activity. Our strategy is largely based on buying good businesses during moments of weakness, and giving our skilled management partners the time they need to work through their problems. Focusing on price is extremely important during the buy process, but once we have purchased shares, the stock price can do whatever it wants to do in the near term as irrational sellers weigh on shares. Our ultimate success will be based on our ability to weather the short term volatile stock action, and patiently wait for the true economics of our businesses to shine. Patience is key to the strategy: frequently trading in and out of businesses will not help our long-term results.

While our "busy" quarter would represent a slow hour on most hedge fund trading desks, relative to 2016 when we made one meaningful investment all year, the 3rd quarter was a flurry of activity. This activity level meant that entirely too much time was spent staring at screens thinking about price, and not enough time was spent simply thinking about our businesses, their management teams, their problems, and their opportunities. In order to help tip the scales of my focus away from short term market action, and back toward the fundamentals of our investments, I spent a week in September "off the grid" on a backcountry archery elk hunt.

From my perspective, spending a week in the middle of no-where is perhaps the best way to conduct a portfolio review. With no access to the internet or cell phones, and no possibility of getting distracted by new ideas, one is forced to focus entirely on the present opportunity set.

Additionally, there are a lot of parallels that can be drawn between hunting in the backcountry and concentrated value investing.

For starters, it is not for everyone; in fact, it is basically anti-social. There is a certain confused/skeptical look that most people give when they learn that our strategy is based on the belief that one person with limited resources willing to dig through the hidden corners of the investment universe searching for anomalies has massive advantages over Wall Street and its infinite resources. This look is basically the same look I get when I explain to people who are panicked by the idea of a dead cell phone battery that my idea of a "mental-reset" is not a trip to some exotic beach location. Rather, I much prefer spending a week by myself sleeping in a tent in bear country while hiking through the mountains 10,000 feet above sea level, hours from the nearest paved road and wi-fi signal.

Second, well known hunting personality and author Steve Rinella often comments that successful backcountry hunting is dependent on, "being comfortable with being uncomfortable." This quote bears a striking resemblance to two of my favorite investing quotes. The first, "you can have comfort, or you can have value. You cannot have both,"[1] and the second, "the capacity to suffer is essential for successful investing."[2] The point is the same whether you're talking about hunting or investing; if you want to seek out the best opportunities, it is not going to be easy.

Third, whether you are talking about backcountry hunting or investing, the proper approach is to spend 99% of your time planning, preparing, and waiting, and 1% of your time taking decisive action.

Fourth, in both hunting and investing, it pays to be very selective. If you take your shots at middling opportunities, you will never have the opportunity for tremendous success.

Lastly, and perhaps most importantly, in order to be successful in either hunting or investing, you have to enjoy the process, not just focus on the endgame. Just like most hunts end without a shot, almost all research ends without a buy decision. The only way to eventually succeed is to continue to iterate the process.

## The Importance of Process

"Gamblers bet on possibilities. Pros bet on probabilities"

*~Bob Dancer, Professional Gambler*

Our investment process entails identifying companies that pass a four-part framework before we ever consider the fifth piece, which is price. The four questions I seek to answer are:

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[1] Jim Grant
[2] Tom Russo

1) Is it a good business? (what will it look like in 5-10 years)

2) Who are we partnering with? (is management capable and properly incentivized)

3) Why does the opportunity exist? (are sellers irrational or shortsighted)

4) What happens when something goes wrong? (because it will eventually)

Each of these questions is deliberately open-ended, and meant to encourage careful analysis and deep thought, not quick answers. When followed properly, this process should lead us to better than average companies, with better than average management teams, that we buy at better than average prices, that will do better than average when the economy hits a rough patch. While nothing is guaranteed, <u>if we can simply stick to this process, the result should be a portfolio that has a high probability of performing better than the averages (ie the SP500 or R2000) over time</u>.

However, while it sounds simple, when spending a week off the grid I had little else to do other than run our businesses through this framework, and I came to realize that one of them fell short.

**Points International** (PCOM) - In the 1H '17 letter PCOM was introduced as a mid-sized addition to our portfolio. This was a mistake, and we sold our shares well below my multi-year price target. Thankfully, the combination of a large margin of safety from our initial purchase price, our short holding period, and an aggressive move in the stock led to us realizing an IRR of almost 90%. This is not cause for celebration. Rather, this should be viewed as a pyrrhic victory, and not only because it comes with painful short-term capital gains.

In the case of PCOM, I came to realize that our investment was based on a short-sighted answer to question 1 (putting too much weight on the possibility that the company would be sold), and an insufficient answer to question 2 (management does not own much stock, and after repeated questions on this topic, the CFO and President both responded by buying a measly 1,000 shares). Our portfolio is concentrated; we only need a few good ideas a year to perform well. There is no reason to own stock in a business that fails to impress at 2 points during our process.

Analytical mistakes are a simple fact of life in the investment business. Even the world's very best investors have batting averages in the mid .600s, and we are guaranteed to have investments that simply don’t work out the way we thought they would (such as DNOW). However, PCOM was less an analytical mistake, and more a mistake in process. Mistakes in process are much more worrisome and much less forgivable than analytical mistakes because over an investment lifetime, a repeatable process well-followed is much more important than any individual investment. Thus, our successful outcome in PCOM should be viewed no more favorably than a drunken bachelorette who screams "Black Jack!!!" upon being dealt a 3 after hitting on 18. Winning one gamble doesn't make you successful. Diligently following the process in order to put the probability of success on our side is our only chance for long term success.

## Growing Our Partnership

Our assets remain well below the level where our size will prevent us from accessing the best opportunities. In the past, I have indicated that I believe the best candidates to join us are people who have experience owning or operating businesses, as they innately understand that in the real world, when a business faces short term difficulties, the long-term value of that business does not necessarily change all the much. The same cannot be said of the stock market, where short term difficulties can often lead to large declines in price, and thus large opportunities for patient investors such as ourselves.

I would like to add sportsmen to the list of candidates to join our partnership, for the reasons described previously. Thus, I would ask that if you know of people with experience operating businesses, or of people that have the ability to "be comfortable being uncomfortable," please invite them to join our mailing list at www.laughingwatercapital.com.

## Looking Forward

The indexes' continued march upwards with almost no volatility is certainly unusual, and it definitely will not last forever. However, at the same time, it would be a mistake to listen to the charlatans calling for a near term crash, who will only one day be right for the same reason as a broken clock. These critics often base their negativity on the length of the current rally, while simultaneously criticizing the shallowness of the economic recovery. From my perspective, it is not clear that one should matter more than the other, and the shallow economic recovery has seemingly prevented any sense of euphoria that typically precedes a fall.

As always, I have no idea what the near-term future will bring. What I do know is that our strategy has been time tested by history's best investors. We own a collection of good businesses that are led by very capable and incentivized managers who should be able to steer their businesses through the problems they are currently facing. Further, while the "market" may not scream cheap, of late I have been finding an unusual amount of attractive investment opportunities off the beaten path. Regardless of what the market does, if we can continue to invest with a patient eye toward the future rather than a fearful eye toward the latest negative headlines, human nature will ensure that opportunities will always exist, and our portfolio will provide satisfactory returns despite the inevitable rough patches.

Matt Sweeney, CFA

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# Rights Offerings & Redknee Solutions

Early in this letter I reminded you that in the best cases, we will be buying shares from irrational sellers. Redknee Solutions entered our portfolio as a top 5 position, and is an excellent example of buying from irrational sellers.

We have often talked about finding value in the hidden corners of the market: microcap stocks, low priced stocks, stocks that don't screen well, stocks that trade in less efficient markets, stocks that have recently gone through some sort of drastic change. These are all good places to look for opportunity as they are often over looked by larger market participants, but they are fairly vanilla in the sense that there is not necessarily irrational action taking place.

The fundamental truth upon which all intelligent investing is based is that the present value of a business is equal to the discounted value of all future cash flows that the business can produce. Over longer periods of time, the market will always recognize this truth, however, over shorter periods of time, this logic can be suspended, which can lead to tremendous opportunity.

In the simplest form of a rights offering, existing shareholders are given the right - but not the obligation - to buy another share of stock in a company, so that the company can raise money, and existing owners can preserve their percentage of ownership. In layman's terms, what that means is that if you own stock in a company that is doing a rights offering, you will wake up one day to find a "right" in your portfolio. As the owner of this right, you have 3 choices; you can

1) scrounge up some extra cash and purchase more shares in the company
2) sell the right on the open market, and take the proceeds as "found money"
3) do nothing, in which case either the right will expire worthless, or your broker or the rights agent will sell the shares on the open market, with no regard for price.

This would all be rather mundane if not for the arbitrage that can be created between the common stock and the rights, which can create irrational selling.

By way of example, imagine you owned stock in a company that was trading at $1.00, and this company declared a rights offering with an exercise price of $0.50. Ignoring transaction fees and the changes to the capital structure that will accompany the rights offering, if the right has an exercise price of $0.50, and the stock is trading at $1.00, the right should have a market value of $0.50. In other words, it would make sense that you could pay fifty cents for the right to buy a stock at fifty cents if the actual stock was trading at one dollar, because the two are equivalent.

| | | | | | |
|---|---|---|---|---|---|
| Right Market Price | $ | 0.50 | | | |
| Right Exercise Price | $ | 0.50 | | | |
| Effective Price | $ | 1.00 | = | Actual Stock Price | $1.00 |

However, in practice, it doesn't really work this way. For starters, if a company is doing a rights offering, it is likely because they need the cash for something: quite often to fix a problem. Shareholders are thus presented with the option of investing more money in a company that likely has a problem, or selling the right on the open market and pocketing the "found money."

If they sell the right on the open market, it will likely push the market price of the right down, which can set in motion a chain of non-economic selling as existing shareholders and/or arbitrageurs sell the stock in order to buy it back through the rights. In other words, if the actual stock is trading at $1.00, but you can "create" a new share of stock at $.90 by buying a right for $0.40 and then exercising that Right at $0.50, it makes sense to sell your stock at $1.00.

| | | | | | |
|---|---|---|---|---|---|
| Right Market Price | $ | 0.40 | | | |
| Right Exercise Price | $ | 0.50 | | | |
| Effective Price | $ | .90 | Vs. | Actual Price | $1.00 |

Of course, if people sell their stock in order to create a new share at a cheaper price, the price of the stock will likely go down… and if the price of the stock goes down, the price of the right will go down with it… and if the price of the right is going down, those people who have been looking at the right as found money may rush to sell it before it goes down more… and the cycle repeats itself as sellers race toward the bottom <u>while focusing on the arbitrage opportunity, not the discounted value of all future cash flows that the company will produce</u>.

| | | | | | |
|---|---|---|---|---|---|
| Right Market Price | $ | 0.35 | | | |
| Right Exercise Price | $ | 0.50 | | | |
| Effective Price | $ | .85 | Vs. | Actual Price | $.90 |

Eventually, the market will once again focus on the value of the future cash flows, and the stock price will rebound to levels supported by the fundamentals of the business, rather than hovering at the bottoms created by arbitrage players. To be clear, rights offerings are not a magical way for investors to easily profit. As always, it is essential to have faith in the business and the management team; focusing only on a rights offering while ignoring the company and the management team conducting it is a recipe for disaster.

However, rights offerings are a fertile hunting ground for outsized opportunities. All of the above is predicated on the idea that "sometimes people just sell rights," which can drive the price down. This by itself can be interesting, but in my view, it becomes considerably more interesting when people are basically <u>forced</u> to sell the rights. It becomes extremely interesting when a knowledgeable party creates a negative atmosphere around the stock, forces people to sell the rights, and then offers to backstop any shortfall of the rights offering by investing more of its own money. This basic setup is what prompted our investment in Redknee Solutions, which was brought to our attention by Scott Miller of Greenhaven Road Capital.

**Redknee Solutions** (RKN.TO) On the surface, Redknee is a money losing Canadian microcap with declining revenue and a history of operational and balance sheet problems due to recent acquisitions. If that isn't enough to turn your stomach, consider that shares trade hands for less than $1 a share, making it off limits for many funds, and even some brokers. In other words, just about every quality that the market hates can be seen here with a cursory glance or quant stock screen, putting Redknee well off the beaten path.

Despite the perceived negatives, the company is in the business of providing mission critical billing and customer management software to telecom companies, which has high switching costs, and thus represents a rather sticky revenue base. For patient, long term focused investors, a sticky revenue base can often outweigh a great many negatives, and thus despite its many problems, Redknee was able to attract multiple suitors after announcing that it was exploring strategic options in August of 2016.

First, Constellation Software, a publicly traded conglomerate that has been described as the "Berkshire Hathaway of software" offered to invest $80M in the company through preferred shares with a warrant kicker. However, ESW Capital, a private software investment group, matched the $80M offer while imposing less onerous warrant terms. It should also be noted that ESW had previously invested ~$20M CAD in shares of Redknee's common stock at prices in the CAD $1.50 to $1.70 range, bringing their total investment to ~$100M.

By way of a recap, the important takeaways at this point are that on the surface, everything about Redknee is something that the stock market hates. It is a money losing small company, with a sub $1 per share price, trading in Canada with balance sheet problems. Despite this backdrop, 2 of the world's most accomplished software conglomerates fought over the opportunity to invest in this company, and the winning party invested approximately $100M at prices significantly higher than where shares trade today. Clearly either the short term focused manic market is wrong, or 2 of the world's most accomplished software investors are wrong.

Upon investing this $100M, ESW took control of the board of directors, installed a seasoned ESW executive as CEO, and began setting the stage to institute ESW's best practices at Redknee. ESW is not well known to the investing world, but they are very well known in the software world as they have completed dozens of successful investments in the space. In short, they succeed by bringing the advantages of scale to under-scaled businesses, allowing them to greatly widen margins, and enhance profitability. They are able to do this by relying on their competitively advantaged platform that allows them to 1) increase productivity through their internally controlled Crossover talent outsourcing platform, 2) reduce costs through their DevFactory software development platform, and 3) share administrative expenses across their many owned and operated businesses. While I am generally wary of turnaround stories, I gain comfort from a story that revolves around a management group that made an initial investment of ~$100M in the belief that they can successfully run the same process that they have successfully run dozens of times before.

**"Do As I Do, Not As I Say"**

However, before beginning the turnaround, ESW began painting a negative picture of Redknee's situation, including talking down revenue expectations and customer satisfaction scores, and basically saying that the situation at Redknee was worse than expected. Further, ESW announced that Redknee would be conducting a rights offering in order to raise ~$60M to fund the company's turnaround.

As you would expect, with the management team painting a negative picture of the situation at the company, shares traded down significantly. It is important to understand however, that prior to the rights offering, ESW had every incentive to WANT a lower share price, as the lower the share price, the more of the pro forma company ESW would own. Additionally, ESW offered to backstop the rights offering, meaning that they would purchase any shares that were unwanted by other rights holders, again giving them every incentive to paint a negative picture of the company, so that other market participants would not exercise their rights.

Again, by way of recap, we now have a company that the market hates, with a very experienced and successful group in control after fighting to invest in the company. After winning control, it appears that this group began to intentionally drive the stock price down, while simultaneously offering to invest an additional ~$50-70M in the company. From my perspective, this was an instance of actions speaking louder than words, and I chose to focus on ESW's willingness to write a big check, rather than their negative comments.

If talking down the company's prospects was not enough, when the rights offering was formally announced, the details revealed that if one were to exercise their rights, the shares that they would own would not be registered in the U.S., meaning that 1) any non-accredited U.S. based investor could not exercise their rights, and 2) any accredited investor had to jump through paper-work hoops to prove their accredited status, and after they proved their accredited status, they would own shares that they could not trade on any exchange. Unsurprisingly, many investors simply cannot own shares that they cannot trade, meaning that they were forced to sell their rights.

As I attempted to demonstrate above, the structure of a rights offering can lead to irrational selling on its own accord. When the rights offering is structured so that some market participants are forced to sell their rights, a mis-pricing of the underlying security is highly likely. Further, I am aware of at least 1 U.S. based brokerage (Schwab) that would not allow investors to sell their rights of their own free will. Rather, this brokerage elected to forcefully sell all of the rights in its client's accounts in one fell swoop regardless of price: clearly that is not an economic sell decision, which means potential opportunity for investors that are focused on the long-term prospects of the business such as us.

## Downside First

To reiterate, rights offerings are not a magic pill for successful investments. In fact, quite often companies that are pursuing rights offerings are doing so because they are in real trouble. As always, it is essential to understand the quality of the business, the quality and incentives of the management team, and what will likely happen to the business during difficult times. Redknee gets an excellent score on management due to their long track record of success in situations that parallel the Redknee situation, and the fact that on a fully diluted pro forma basis they own approximately 40% of the equity. Further, the company gets a good score on the quality of the business and what will happen during difficult times due to their sticky revenues, and the defensive nature of their customer's revenues. Where Redknee really shines however is valuation. To be clear, the company must meet considerable challenges in the quarters and years to come, but we established our position at close to 1x EV/Sales[3], while many comparable companies trade at 3x EV/Sales. Further, if ESW is able to execute the playbook they have executed many times before, Redknee should be capable of generating above peer group margins, justifying a higher EV/Sales multiple than peers. Most important, even if the company stumbles as they streamline operations, sellers are likely to be more rational than the uneconomic sellers we purchased from, likely putting a floor under shares. Thus, an investment in Redknee is essentially a very cheap bet that an extremely talented management team with a long track record of success and well over $100M invested can simply do what they have done dozens of times before.

## Potential Upside

Marking a downside valuation in terms of a sales multiple pushes us to the fringe of our valuation framework; after all - cash flow is what it matters – not sales. However, given ESW's aforementioned internally controlled platforms that should allow Redknee to operate at high margins, we gained comfort. If they are successful, looking forward a year or three Redknee will likely be able to generate EBITDA margins somewhere between 25% to 45%. Further, while the company has guided to $120M in sales, that may prove conservative as 1) they have had no incentive to say anything positive (yet), and 2) focusing on improving customer satisfaction and updating their offering could clearly drive sales. It is impossible at this point to know what the company will look like in a few years, and what it will be worth. However, it is not hard to imagine scenarios where a few years from now the company generates $130M in revenue, 40% EBITDA margins, and trades at 10x EV/EBITDA. In this scenario, shares would trade hands at ~$2.00 CAD, or almost 200% higher than where we last bought shares.

[3] Management guidance of $120M in revenue, without penalizing the EV for future restructuring costs

More interesting - and even harder to predict – it is possible that ESW uses Redknee as the foundation for future public equity transactions. To date ESW has operated almost exclusively in the private markets, but as an acquirer of small software companies, public equity to use as currency should be attractive. In this case, which is impossible to handicap, our investment in Redknee could turn out be worth many multiples of its current price. From our perspective, what is important is that this is a free option that could be very valuable. We are happy to be partnered with an excellent management team, and excited to see how they create value at Redknee in the years to come.

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