July, 2016

Dear Partners,

Laughing Water Capital (LWC) returned approximately -1.0% net of all fees during the 2nd quarter of 2016. The SP500 and R2000 returned 2.5% and 3.8% over this period. Inception through quarter-end LWC returned 19.6% net, while the SP500 and R2000 returned 14.3% and 19.7% respectively. As always, I remind you that LWC makes no attempt to track the indices, and thus our performance will frequently diverge, sometimes to our benefit, and sometimes to our detriment. Our portfolio is concentrated, and thus volatile by design. As an illustration of this volatility, consider that in the final days of the quarter we lost 4%. We have since regained those losses and had considerable gains. It is likely we will give up some of these gains in the near term, and then regain them in the future as our investments meet our operational expectations. 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.

2nd Quarter Highlights

Although there was some slight tweaking around the edges, there is no notable portfolio activity to report for the quarter as we neither initiated a new investment nor exited an existing investment. Our basically flat performance hides the fact that some of the names that had incredible run ups last quarter gave back some gains, and some of the laggards caught up a bit. These short term fluctuations reflect the madness of crowds and are not really important. What matters is that operationally all of our companies continue to perform as expected. If this continues, the market will reward us eventually. Patience is essential.

For the most part the second quarter was dominated by talk of "Brexit," which now that it has come to pass serves as an excellent reminder of why it is best to avoid the noise generated by the market "experts" on TV and in the newspapers. After months worth of headlines, the Brexit "panic" lasted a touch more than 2 days. To be fair, there may be future implications, but when I considered our portfolio and our long time line in the face of Brexit I felt very comfortable ignoring the headlines. For the most part we own businesses that are enduring. For example, below I discuss our investments in Iteris (ITI) and Revlon (REV). I feel confident that regardless of whether the UK leaves the EU, municipalities will continue to upgrade their traffic systems, farmers will continue to want to maximize their harvest, and women will continue to wear makeup.

While longer term Brexit does not concern me, the event path was fascinating to watch. The day before the vote the market was up handily as early polling showed that a "Stay" vote would rule the day. The actual "Leave" vote brought 2 days of dramatic selling, and the recovery began shortly after.

This see-saw action illustrates what an enormous competitive advantage we have as a partnership due to our long term outlook. It is true that in the short term the multiples that the markets put on

businesses can contract, but we are able to look past multiples and focus on fundamental business performance. In fact, in many cases our companies will actually benefit from near term stock price declines and economic difficulties. Most importantly, as the last several hundred years of history have demonstrated, regardless of how bad the near term outlook is, in the intermediate and long term confidence will return.

Contrast our approach with short term oriented market participants (note: *not* investors) that are forced to make a decision on how to handle situations like Brexit. Each decision has a 50/50 chance of anticipating what the crowd will do, and when there are 3 decisions in a row as there were in the days surrounding the Brexit vote, the odds of successfully navigating the short term fluctuations are 12.5%. This should serve as a reminder that there are two ways to approach the market. You can guess which direction prices will go in next, or you can figure out what businesses and their securities are really worth. The former is gambling, and the latter is investing. I sleep well at night knowing that the partners at Laughing Water Capital are investors.

How Can We Compete?

As a small investor, the question I receive most often is "How do you expect to compete with large institutional investors that have billions of dollars, dozens of analysts, and near infinite access to industry experts and consultants?"

The answer is simple: I have absolutely no intention of competing with the large institutions.

As an investor, if you want differentiated results, you have to behave differently. As a small fund with a long term horizon, we are well positioned for success because we can invest in securities that are off the beaten path, which the large institutions with short term horizons simply must avoid.

According to the academics and the talking heads on CNBC, traveling off the beaten path is "risky" because in their world risk is defined as failing to match the DJIA or S&P 500. For our partnership, traveling off the beaten path represents opportunity. To us, fishing in the ponds that are passed over by others is just common sense as this sort of behavior provides the greatest chance for long term success, even if the near term is uncertain. The opportunity can perhaps most succinctly be encapsulated by the words of Warren Buffett who has commented, "it is a huge structural advantage not to have a lot of money."

The reasoning is simple. Consider a fund with $5 billion in assets under management. For this fund, a 2% position would be $100 million dollars. When one considers that owning more than 10% of a publicly traded company triggers onerous rules which limit one's ability to freely trade the security in question, this means that a $5 billion fund can only own companies with a market cap below $1 billion if they are willing to own a piece so small that it will have very little impact on the portfolio or if they are willing to be locked up. The former is unlikely because research time is a finite resource, and it is not worth dedicating time to a company if you can only own an insignificant amount. The latter is unlikely

because short term oriented investors may request their money back at any time, which is problematic if the fund is prohibited from easily liquidating a 10+% position.

In his younger days, Buffett took full advantage of his small size. When he first bought shares in struggling textile mill Berkshire Hathaway the market cap was less than $13 million (about $110 million in today's dollars). I see no reason why we would not seek to mimic this behavior, and as a result, many of the positions in our portfolio are simply not available to larger investors.

Comments on Selected Investments

As examples of investments that are simply not available to larger investors consider Iteris (ITI) and Revlon (REV), both discussed below.

Small Companies and Big Opportunities: Iteris (ITI)

At the time of our investment ITI had a market cap around $70 million, was trading around $2.19 per share, and based on GAAP financials was losing money. As we saw above, mathematically a $70 million company is out of reach for most institutional investors, and when you throw in the fact that at a glance the company is losing money, very few people take the time to do the work necessary to discover if there is more than meets the eye. For those like us who are willing to do the work, I believe the investment opportunity is substantial.

In brief, while the GAAP financials show Iteris is losing money, in my differentiated view ITI is an example of a "good co/ bad co" investment, an archetype which I briefly discussed in last quarter's letter. The company has 3 businesses, 2 of which are growing and generating cash while focusing on the Intelligent Transportation market, and 1 of which is more speculative, and currently losing money developing a Weather Analytics product for use in agriculture. The stock is cheap because the market is focused on the net loss from the combined businesses, while proper analysis requires dis-aggregating the business into its component parts. In my view, the transportation businesses alone are worth $4 per share, and this number is growing at a healthy clip. All that is needed for this value to be recognized is for management to shut down the agriculture business if it becomes clear that the business will not succeed. **This is just common sense**, and it does not require herculean efforts to drive revenue or cut costs. It is as simple as the stroke of a pen. Helping to ensure that the pen will be wielded if the agriculture business is a failure are the fact that the CEO owns 1.35 million options, and noted microcap activist investor Lloyd Miller owns 15.6% of the company. If these self motivated parties want to increase their wealth, all they have to do is prevent the agriculture business from sinking the whole ship if it becomes clear that it is not going to work.

However, there is a good chance the agriculture business will succeed, and I certainly hope it does. This business and industry are fast evolving and very competitive, and it is too early to know who the eventual winners will be, making the business difficult to value. What matters for us though is that at the price we paid for the combined company, we essentially got the agriculture business for less than

free based on the value of the transportation businesses. If the agriculture business succeeds, I can envision scenarios where our investment increases in value by more than 500%. I am certainly not counting on this happening – it is important to focus on the downside of any investment first – but I am happy to have this lotto ticket in our portfolio.

I recently gave a talk on Iteris at ValueX Vail, an investment conference that I attended in late June. The slide deck from my presentation is attached to this email, and will provide a more detailed analysis of our investment.

Liquidity and Time: Revlon (REV)

Revlon, the well known cosmetics company, is a $1.7 billion market cap company, but 78% of shares are owned by billionaire investor Ronald Perelman, meaning only about $350 million of the company is available to outside shareholders. While a levered capital structure also plays a role, Revlon's small public float and an illiquid stock lead it to trade at a ~50% discount to cosmetics peers on an EV/EBITDA basis. Simply stated, most investors just can't own Revlon.

It is no secret that the company is cheap; it has been for a long time. Perelman has owned Revlon for 30 years, and until recently the company was allowed to wallow. I believe a generation of investors have already discarded Revlon, assuming that the only way the valuation gap will close is via a sale to a strategic buyer. These investors fail to recognize that after 30 years of being under managed, it is now clear that Perelman is focused on increasing the share price, and both the stock and company are at an inflection point.

Perelman has hired an impressive new CEO, and the company has a new plan to engage with minority shareholders for the first time ever. Further, after the 2013 acquisition of the Colomer group the company aggressively increased their spending on advertising in an attempt to reinvigorate the brand. Pro forma for the pending acquisition of Elizabeth Arden (RDEN) the company will have doubled revenue over the last 4 years, and EBITDA should nearly double by 2019.

The question must thus be asked, **"if revenue has doubled and EBITDA is likely going to double, do we need the valuation gap to close for the investment to be successful?"** The answer should be a resounding **"NO."** Revlon is no longer a sleepy value company without a catalyst. It is a platform growth company trading at a very cheap price with a controlling shareholder that is focused on improving the company, and the stock price. When the broader investment community wakes up to what is happening at Revlon, I suspect that our investment will do very well.

At the end of this letter I have included a more detailed analysis of Revlon focusing on the changes that are taking place, the RDEN acquisition, the company's debt levels, and valuation. Please let me know if you have any questions.

Where Are We Now?

For the last several quarters investors have flocked to “safe” low beta stocks like consumer staples and utilities regardless of record high multiples, happily ignoring every investor's mantra of “buy low, sell high.” The "safe" stocks of today appear to be life boats on a choppy sea, but just like a lifeboat, the more people that climb aboard, the less safe they become. I am not in the business of identifying bubbles, but we have seen this pattern before in the tech bubble of the late 90’s and the “nifty fifty” of the 1970s. In both cases, boring, cheap stocks that were running at less than peak efficiency were widely ignored – or even punished – as investors moved as a pack into the flavor of the day. Eventually it became obvious that buying stocks simply because they were going up was a mistake and investors quickly sold the high-flyers and moved back to the cheap stocks. I believe it is only a matter of time until history repeats itself. This process may take years, but recently commentators have begun to point out that the oxymoronic strategy of "safety at any price" is ill advised.

As always, true safety comes from a low purchase price. Almost without exception, a low purchase price can only be found when buying companies that are dealing with some sort of problem, structural inefficiency, or market misperception. In the words of market observer Jim Grant, “You can have comfort, or you can have value. You cannot have both.” Our portfolio is mostly composed of companies like this, and over time we expect them to doubly benefit from moving past their problems and realizing higher multiples as investor angst recedes. The time is not yet here where our style has returned to favor, but the fact that commentators are starting to notice the life boat taking on water is a positive for us. When the pendulum swings it will happen slowly and then quickly. In the meantime our companies will continue to work through their problems.

However, for now fear still rules the day as evidenced by a recent Bank of America survey that revealed investor cash levels are at the highest level they have been at since 2001. I don’t have an opinion on the short term direction of the market, but I would note that bull markets typically end on greed, not fear. It is true that in the months and quarters to come interest rate policy will be uncertain, the economy may get worse, terrorists – both foreign and domestic – may temporarily interrupt our way of life, and the political scene may continue to devolve. However, similar waves of panic and fear are *always* on the horizon. They rarely materialize as expected, and their impact is quick to fade when they do materialize. History has shown that the best approach to facing down this ever-present fear is patiently owning pieces of businesses that will prosper regardless with a long term mentality. Will a change in Fed policy stop women from buying makeup? Will cities and towns cease to upgrade their traffic control systems based on who wins the Presidential election? I sleep well at night confident that in the long term, we will do just fine.

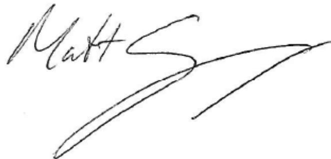
Administrative Notes

Going forward, I will be reducing the frequency of letter writing to a semi-annual format, although I may share commentary on investments or events in the interim. The reason for the switch is simple; I believe it is in the best interest of the partnership. History has shown that even the best performing funds out-perform the market only slightly more than 50% of the time on a quarterly basis. Additionally, studies

have demonstrated that investors feel the pain of loss more than twice as sharply as the joy of success. Further, there are multiple studies that demonstrate that investors as a whole woefully underperform the very funds they are invested in because they buy and sell at the wrong times, likely due to the aforementioned pain of loss. Considering these 3 factors, if we know a short term focus is not only irrelevant to long term results but is actually an impediment to long term results it is logical to limit the instances of short term reporting. However, if at any time you would like a personal update, please do not hesitate to call me. I will always be willing to discuss our portfolio should you desire.

I remain excited about the prospects of the investments we own. I can promise that the path will not be smooth, but I suspect our results will more than compensate us for the bumpy ride. If you have any questions, comments, or best of all, good investment ideas, please do not hesitate to contact me.

Matt Sweeney, CFA



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Revlon – An Extended Look

Revlon is a company that is familiar to most people due to its well known cosmetics brands. Although competition is fierce, makeup is an excellent business due to its defensive nature. Take a moment and think about it; is there a situation you can imagine where women will materially stop buying makeup? Even during the "Great Recession" sales for Revlon only declined 5% between 2007 and 2009, but at the same time operating income rocketed 44% as the company was able to adjust its expense structure. The recession proof nature of the makeup business is highly valued by investors, and cosmetics companies regularly trade at P/Es north of 25x and EV/EBITDA multiples in the mid-teens, yet at the ~$32 per share price that Revlon presently trades at the market is assigning it a forward EV/EBITDA multiple of a paltry 8x the core Revlon business, giving no credit for the recently announced acquisition of Elizabeth Arden (RDEN - more on this below). If this deal were to fall through and shares were awarded a conservative 12x EV/EBITDA multiple on core Revlon – still cheap vs. comps that trade north of 15x – shares would trade hands at double the current price. If Revlon is able to successfully integrate Elizabeth Arden and only realize anticipated cost synergies with none of the likely revenue synergies and no operational improvement and trade at 12x shares would be worth $80, or 150% more than they trade at today.

This seemingly odd discrepancy can for the most part be simply explained by referencing our previous writings on the constraints faced by larger institutional investors. The discount is largely tied to the fact that billionaire investor Ron Perelman controls 78% of the company, and the company carries a fair amount of debt. These factors contribute to the mis-pricing of the security in three ways.

First, the company has a market cap of $1.6 billion, but only $350 million of that is available to outside shareholders due to Perelman's control investment. As described previously, most institutions simply can't invest in any meaningful way in a security whose float is this small.

Second, the limited float leads to limited trading volume (typically fewer than 50,000 shares trade hands a day), meaning that even for investors who are small enough to invest, a long term oriented shareholder base is a prerequisite because investors who are subject to imminent client redemption requests cannot own shares that trade in such limited quantity. If they needed to sell to return client money, they would not be able to sell at an acceptable price.

Third, Revlon's levered capital structure contributes to equity price volatility, which is akin to risk for investors who are judged on quarterly or monthly performance. This is especially true in a world where many investors have memories of the 2009 credit crisis burned in their brains. However, for patient investors debt should be viewed in relation to the quality of the company at hand, and as noted previously, this is a company with defensive revenues that was able to improve operating earnings and cash flow through the financial crisis, suggesting it is well suited for a levered capital structure (more on this below).

Fortunately for us LWC has been specifically structured to invest in situations that are unavailable to most of the investment community, which gives us a decided advantage in our pursuit of market beating returns.

OK, But if No One Can Buy It How Do We Make Money?!?

It is no secret that Revlon is very cheap, yet even many investors who share the same advantages we have decline to own shares. The common refrain is something along the lines of, “yes it is cheap, but full value will only be realized when the company is sold.” In fact, shares sold off 12% in the last quarter acting as a considerable drag on our performance as it became clear that the company’s previously announced strategic review would end in an acquisition, not a sale. This focus on a sale is an understandable knee-jerk reaction to a levered company that is cheap and has been cheap for a long time.

In fact, when I first began studying this company in 2013 I shared this view. I was initially turned off because investment success is predicated on viewing stocks as businesses, and no intelligent businessman buys a business with hopes of flipping it to the next person who is willing to pay more. However, as I will explain below, the story has changed materially and in my view investors who are solely focused on a sale event are missing the forest for the trees. I believe the stock will perform quite well in the years to come even without a sale.

Revlon is A Growth Company? Revlon is a Growth Company!

Ron Perelman has controlled Revlon for thirty years, and for almost all of that period the company and brands were under-managed and allowed to wilt, while the company completely ignored investors. Thirty years is a long time, and I believe it is likely that an entire generation of investors – if not 2 – have previously discarded Revlon due to a long run of uninspiring performance and opacity regarding Perelman’s intentions. However, in investing it does not pay to look in the rear view mirror, and it pays handsomely to be on the early side of realizing a dramatic shift in a company’s fortunes. It is clear that Revlon is at an inflection point and that Perelman is focused on growing the company and increasing the share price as he never has been before.

For starters, after a long history of churning through CEOs, Perelman has recently demonstrated that he is willing to pay up for quality management. New CEO Fabian Garcia (the 9th CEO that Perelman has employed at REV) was lured away from his position as COO at Colgate Palmolive (CL) with a $1.5 million base salary, a target bonus of 150%, and a $10 million stock grant. Compare this with former CEO Alan T. Ennis who in 2012 earned a base salary of $921,000 with a target bonus of 100%. Additionally, the company adjusted its by-laws to allow for a max annual bonus of $5 million versus a prior level of $3.5 million and adjusted its max “long term award” bonus from $3.5 million to $10 million. It seems very unlikely that Perelman would be willing to throw that kind of money at an executive unless the executive was expected to drive results going forward, rather than allow the company to stagnate as had been the case for much of the last 30 years. Further, Garcia earned almost $12 million over the last 3 years at Colgate. It is impossible to discount the value of the prestige that comes with being CEO of a company rather than COO, but it seems unlikely that Garcia would walk away from his Colgate job and the dozens of millions that came with it unless he was confident that he could have a real impact at Revlon.

It became clear that Garcia intended to focus on the stock price during his first conference call with investors back in May when he was asked whether he planned to engage with shareholders: something that to my knowledge has never happened before at Revlon. To paraphrase Garcia's response, he indicated that things were about to change, and that he would engage with shareholders because he wants to be sure that the company is appropriately valued. To date, Revlon has never to my knowledge presented at an investor conference and has no sell-side equity research coverage, but when that changes in the not too distant future, investors will begin take notice. As evidence that these changes are on the way, note that shortly after the 2nd quarter ended, Revlon issued a press release announcing the hiring of an executive away from Estee Lauder to lead Revlon's Global Corporate Communications as a direct report to Garcia. Again, it is hard to imagine that this hiring would happen unless Garcia and Perelman were determined to raise the company's profile with investors and improve the share price.

In addition to spending money on quality executives, since the 2013 acquisition of Colomer Group, the company has aggressively stepped up its advertising by adding $100M to the annual budget as they seek to rejuvenate the Revlon brand. This was long overdue, and has led to a growing market share on the back of mid single digit organic growth rates, which are for the most part masked at present due to currency fluctuations, but which will shine through eventually.

Lastly, while investors continue to shun the stock based on the belief that a sale is necessary for full value to be realized, they fail to notice that pro forma for the pending acquisition of Elizabeth Arden (RDEN) sales will have doubled between 2013 and 2016 (19% CAGR). Further, I estimate that the combined entity will generate more than $700 million in adjusted EBITDA in 2019 inclusive of synergies and expected performance improvement at RDEN: a potential doubling since FY15. While it still seems likely that the *eventual* outcome will be a sale, it is a mistake to not acknowledge that the business has been performing very well in recent years, and it is clear that Perelman is giving the company the tools it needs to continue this trend.

The question must now be asked**, "if revenue can grow at a 19% CAGR and adjusted EBITDA can double in the next 3 to 4 years, do we even need multiple expansion to see acceptable investment results?"** The answer should be a resounding **"NO,"** and I expect the stock to perform well in the intermediate term as the investing community realizes that the days of Revlon being an under-managed "value" company lacking a near term catalyst are behind us, and today Revlon is actually a growth company with a controlling shareholder that is determined to raise the share price trading at an incredible discount.

So What is a Growth Company Worth?

While defensive consumer staple businesses such as cosmetics companies nearly always trade at high multiples, in recent years the market has been infatuated with "platform" companies that have been growing quickly through debt fueled acquisitions whereby acquisitions are purchased, stripped of their duplicative costs, and added to the platform providing a broader product offering. In a low growth world investors have proven they are willing to pay up for these companies, and they are richly valued.

Ticker	Business	4 Yr Rev. CAGR	EV/EBITDA	Recession Proof
MIDD	Restaurant Supply	76%	17.5x	No
FLT	Payment Programs	140%	18.0x	No
ZAYO	Connectivity / Cloud	258%	14.7x	No
CMPR	Print / Customization	46%	15.5x	No
TDG	Aircraft parts	59%	16.6x	No
Average		116%	16.6x	No
REV[1]	Cosmetics	100%	7.3x	YES

I confess to not understanding what the market sees in these companies, as in my view for the most part they are overvalued, but my conservative, skeptical, value based approach to investing has been decidedly out of favor in recent years while growth and momentum stories are all the rage. I can think of no reason that Revlon should not be on the radar of the investors that are buying these platform companies other than the fact that they have not yet realized that Revlon is no longer the sleepy under-managed company it was for most of the last 30 years. With its 100% 4 year revenue growth, potential to double adjusted EBITDA in the next 3 to 4 years (pro forma for the RDEN transaction), and a business that is recession proof, in theory Revlon deserves a spot on the above list. The stock would trade hands at ~$130 per share representing 300% upside at the average multiple on pro forma 2016 adjusted EBITDA guidance inclusive of synergies provided in Revlon's most recent investor presentation. If we are to give credit for the internal performance improvement plan that RDEN developed prior to the transaction, the stock would trade at ~$180 per share on 2019 numbers at the average "platform" multiple representing more than 460% upside.

Of course, in the near term one can certainly argue that P/E or P/FCF is the more relevant metric as EBITDA of a levered company is most relevant to a strategic buyer. I also concede that with much of Revlon's current cash flow going to debt holders the near term equity valuation argument loses some luster. However, in my view a leverage/debt pay down cycle is an attractive use of capital in this recession proof sector, and as debt is paid down earnings and cash flow for equity holders will quickly grow. This growth should serve to reinforce the notion that Revlon is a "growth stock" deserving of a high multiple. With a new approach to investor communications and clear signals from Perelman that he wants to focus on share price, I think it is just a matter of time before the growth/momentum crowd wakes up to the Revlon story.

When considering the above analysis critics will be quick to opine that it is flawed because surely Revlon deserves a discount to other platform companies due to its elevated debt levels and the presence of a controlling shareholder. I would agree, but note that when the upside based on comps is more than 400%, the discount applied can be massive and the investment can still be a tremendous success. The point is not to focus on the upside number in an absolute sense. The point is to illustrate that the valuation gap is enormous. We can be wrong about a lot of things and we will likely do just fine. That

[1] Pro forma for RDEN transaction: anticipated close by year end 2016

being said, the market has been frustratingly crazy about growth stories for some time and there is no reason that Revlon could not be painted with the same brush.

Elizabeth Arden Acquisition

Of course, securing a spot in the growth / momentum investor's hearts requires successfully completing the RDEN acquisition. Given that Revlon has recently demonstrated their ability to integrate a sizeable acquisition through the 2013 Colomer purchase and given that Garcia has substantial acquisition integration experience from his time at Colgate, I do not anticipate much trouble.

It is worth mentioning that there are some questions surrounding this deal, most notably that the resulting company will be heavily levered and skepticism regarding the quality of RDEN's business as it is broadly viewed as a celebrity fragrance company. This view is somewhat understandable as the company spent the last several years moving aggressively into this space as they chased the trend. Unfortunately for RDEN, the celebrity fragrance trend has crashed and burned, which resulted in the company generating negative earnings in recent years, which led to the sale.

Fortunately for REV investors, there is more to RDEN than celebrity fragrances. For starters, Revlon should be able to generate $250 million in sales from RDEN's cosmetics and skin care lines. These businesses should be able to easily match Revlon's system wide 20% adjusted EBITDA margins on the Revlon platform. This may in fact be conservative as incremental margins tied to increased volume on Revlon's platform are likely higher than base margins, and RDEN management has been neglecting these businesses in recent years. At a reasonable 13x multiple this piece of the acquisition justifies 75% of the entire deal price, meaning that Revlon is paying around $220 million for more than $700 million in fragrance sales, or .3x sales. When one considers that Inter Parfums (IPAR), an asset light fragrance pure play trades at 1.8x sales, it seems as if Revlon is stealing the RDEN fragrance business, not buying it.

Another way of looking at the transaction is to focus on the 100+ year old core Elizabeth Arden brand which encompasses much of the cosmetics and skin care business as well as Elizabeth Arden fragrances. This business generated $377 million in revenue last year, and has been growing low to mid single digits in recent quarters. I expect this growth will accelerate in the quarters to come as we have empirical evidence that Revlon can re-invigorate a flagging brand through effective advertising. With the economies of scale that the core Elizabeth Arden brand will realize on the Revlon platform this business should be able to reach high-teens adjusted EBITDA margins, in which case a 13x multiple would mean the core Elizabeth Arden brand alone almost justifies the purchase price of the whole company.

In that sense, I am not really concerned about the cyclical and uncertain celebrity fragrance business which has already been reduced to a small fraction of RDEN's business. If Revlon can make it work, it is gravy. If they can't, they didn't really pay for it anyway. That being said, they should be able to make it work on some level due to their greater scale and through increased discipline on which celebrities they partner with (Real Housewives need not apply in my view) and what the economics of the partnership look like. In the past, RDEN compromised on this front because they felt celebrity fragrances were their

best way forward. They were wrong. REV will be able to remain disciplined because celebrity fragrances are just one small piece of a much bigger and more important pie.

In addition to a free look at the celebrity fragrance business, RDEN has a suite of more dependable "designer" and "heritage" fragrances under names like John Varvatos and Juicy Couture. These brands should fit nicely with Revlon's existing fragrance business which was largely acquired through the April 2015 purchase of CBB Beauty. Given that the core Elizabeth Arden brands arguably justify the entire purchase price these fragrance brands can also be viewed as essentially free. Yet given some time and hard work they may prove to be quite valuable. Fragrance is expected to be the fastest growing segment of the global beauty market in the years to come. Revisiting fragrance pure play Inter Parfums (IPAR), we have evidence that mid teens EBITDA margins are not out of the question and that a 10x EV/EBITDA multiple is appropriate for the fragrance business. There is likely quite a bit of work to be done before reaching this point, but if Revlon can make it work, this too would come close to justifying the entire purchase price of the company, making the core Elizabeth Arden brands free. To be clear, there will be some challenges, but free options are my favorite options.

Leverage

Turning to debt levels, according to management the combined company will be levered 4.2x inclusive of the $140 million in cost synergies that are expected to be realized. Disregarding these synergies the leverage level is closer to 5.7x, which is indeed a number that demands caution even for a recession proof business like cosmetics. Further giving investors pause is the fact that at the time of the deal announcement Revlon management predicted that it would take 3-5 years for the synergies to be realized. However a thoughtful review of the situation illustrates that the leverage is easily manageable and will be quickly reduced.

For starters, in my view Revlon management is being extremely conservative both in terms of the actual dollar amount of cost synergies and the timeline. Let's not forget, the company has zero incentive to be anything but conservative. If they were to talk about higher synergy potential, calls for a higher deal price would soon follow and employee defection would increase. Additionally, Revlon CEO Garcia's $10 million stock grant is effective based on the stock price on March 28, 2017: one year from his hire date. Garcia is incentivized to keep the share price low until this date. Further, the $140 million that is being called for is less than one third of RDEN's trailing SG&A cost. When you consider that 40% of the savings are expected to come on the gross margin line through scale benefits with vendors, manufacturing partners and procurement partners, as well as warehouse consolidation and distribution efficiencies, expected SG&A savings dwindle to less than 20%. It is impossible to know how much greater the cost savings may be, but management has indicated they are "very comfortable" with the $140 million estimate, suggesting they see this number as a low ball target. Further, there is empirical evidence to suggest that the synergy number is likely low: realized synergies from the 2013 Colomer acquisition are 40% higher than initially estimated. In terms of timing, while management's initial comments pointed to

a 3-5 year timeline for synergy realization, they have since indicated they expect $100 million of the $140 million in savings in year 1.

It should also be noted that the $140 million number is all on the expense side, with no mention of possible revenue synergies. At present the 2 companies have overlap on 36% of their customer base, meaning there is a 64% opportunity to cross sell into new customers. Revlon has historically focused on the “mass” channel and entered the “salon” channel following the 2013 Colomer acquisition. RDEN largely focuses on the “prestige” channel (department stores etc.) and there is no reason why at least some company SKUs should not be able to migrate across channels, driving revenue. Further, RDEN’s distribution network throughout Asia is more developed than REV’s, and REV’s digital presence is more developed than RDEN’s. Each business will benefit from leveraging the other’s capabilities as they are integrated.

Lastly, to date there has been no commentary from Revlon management on the possibility of performance improvement in the RDEN businesses. However, according to the merger agreement, RDEN management had previously developed plans that would see their business grow to more than $1.1B in sales by 2019 while generating $132 million in adjusted EBITDA as a standalone company. Investors are wise to be skeptical of this number as turn-around stories are difficult to complete, but if this comes to pass, in 2019 Revlon will likely be capable of generating more than $700 million in adjusted EBITDA when one considers the core Revlon business, RDEN’s standalone targets, and the synergies. At this level of EBITDA the company would be levered less than 3.4x assuming no previous debt pay down or cash accumulation, which is unlikely. **Perhaps more importantly to investors, even assuming no improvement to the capital structure between now and 2019 and a ridiculously low 8x multiple on adjusted EBITDA this would result in a doubling of the stock price in about 3.5 years, or a CAGR north of 20%.** At a more appropriate but still conservative 12x multiple, shares would trade hands at $115, representing a CAGR of more than 40%.

When considering the debt level, it is also worth considering Perelman. According to Forbes, he is the 78th richest person in the world, with over $12 billion to his name. He amassed his fortune through dozens of leveraged buyouts, and has likely forgotten more about debt markets than most investors will ever know. It is likely that over the last 50 years Perelman and his companies have paid Wall Street banks hundreds of millions for their assistance with this debt financing, making him one of the most valuable clients in the world. While this does not fit neatly into the spreadsheets of the credit rating agencies, after spending most of my career at an investment bank I feel comfortable saying that better customers get better treatment, and in the event of a credit crisis where debt market activity was curtailed it is likely that Perelman and his needs would be among the first to be addressed.

A Sale: Unnecessary but Inevitable

While I believe that in the intermediate term our investment will perform nicely without multiple expansion and perhaps extremely well as the wider investor community wakes up to what is going on at

Revlon, longer term I continue to believe that a sale is practically inevitable. Given our comfort with unusually long term investments, an examination of what a sale might look like is warranted.

First consider that Perelman is 73 years old, has no apparent heirs in the business, and he has signed "The Giving Pledge," a campaign started by Bill and Melinda Gates and Warren Buffett to encourage the world's wealthiest people to donate their estates to charity upon their death. An eventual sale is not guaranteed, but it seems extremely likely... eventually. In order to be conservative, I think it is reasonable to assume that a sale will happen in 12 years, when Perelman reaches the age of 85.

Next consider that this is an excellent business unlikely to decline, and likely to grow by *at least* inflation annually, with a 1-2% kicker likely as emerging markets consumers continue to increase per capita spend on beauty products in the years to come. Actual revenue will bounce around due to currency fluctuations, but over a 12 year time line I am comfortable ignoring currency as over longer time periods currency fluctuations tend to normalize. Given this dynamic, assuming a 4% revenue growth rate is very conservative and should serve as a downside case. As demonstrated previously growth is likely to be substantially higher as Revlon continues to lever its platform and increase spending on advertising, and I think a base case of 10% is appropriate with an upside case of 15% not completely unimaginable.

Now consider that over the last several years adjusted EBITDA margins have ranged from 18-21%. In the interest of conservatism we will assume that at the time of a sale in 12 years the company will be generating bottom of the range EBITDA margins of 18%. Now consider leverage, which has ranged around 4x EBITDA recently, but could easily be paid down to the 2x range by the time of a buyout. In the interest of conservatism, we will assume that the business is still levered 4x at the time of a sale, which of course reduces the value to equity holders as bond holders must be paid as well. Finally, consider a sale multiple of 12-14x and choose the low end of 12x. The outcomes of the 3 different growth scenarios and the above assumptions are presented below:

	Downside	Base	Upside
Years Until Sale	12	12	12
Revenue CAGR	4%	10%	15%
Exit EBITDA Margin	18%	18%	18%
Exit Net Debt/EBITDA	4x	4x	4x
Exit Multiple	12x	12x	12x
Exit Price	$132	$258	$440
CAGR	12.5%	19.0%	24.4%
% Upside	313%	706%	1,275%

The low end of 12.5% may not sound super exciting, but when one considers that many market "experts" are calling for 5-6% returns over the next decade, 12.5% should be considered very attractive. Over 12 years $1 million at 5.5% annually turns into $1.9 million while $1 million at 12.5% turns into $4.1 million.

Now consider that a sale could happen earlier – say in 7 years – and that margins could easily be closer to the top end of the range as the company is prepped for sale, the capital structure should be much

more attractive after a few years of debt pay down, and the exit multiple could be closer to the top of the range. In this case potential returns are astounding.

	Downside	Base	Upside
Years Until Sale	7	7	7
Revenue CAGR	4%	10%	15%
Exit EBITDA Margin	20%	20%	20%
Exit Net Debt/EBITDA	2x	2x	2x
Exit Multiple	14x	14x	14x
Exit Price	$180	$267	$364
CAGR	28.0%	35.4%	41.6%
% Upside	463%	734%	1,036%

When looking at these scenarios, the point is not to begin counting chickens, but rather to think that a lot of eggs could break, and we would still do well. The margin of safety is huge for those patient enough to just wait.

In sum, while I have very little faith in my ability to predict the future via excel spread sheets, I have a lot of faith in **common sense** and man's tendency to want to maximize his own wealth. In the short term Revlon will remain volatile due to its high debt load and the uncertainty surrounding the RDEN acquisition, but in the intermediate and long term **Revlon is a case where if Ron Perelman simply takes the common sense steps necessary to allow his business to realize its full valuation potential we as investors alongside him will likely do very very well.** I am quite confident that Perelman is fully aware that the true value of this business is dramatically higher than the value that the stock market puts on it, and recently he has demonstrated that he is focused on educating the market. Longer term, if he were to sell, he would pocket a fortune. Investing is a game of probabilities, and given the scenario as described in the preceding pages, it seems as if the odds for a very good investment outcome are clearly stacked in our favor if we can remain patient.

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