October, 2018

Dear Partners,

As you know, I prefer to write letters only twice per year in order to reduce the negative effects that come with discussing our portfolio too frequently. However, it is important that all partners understand what we own and why we own it, so that when difficult times inevitably come, we can focus on the quality of our businesses and our management partners rather than the noise that will surely dominate the headlines. We have 2 new large positions and 1 new midsize position in the portfolio, and as such, I felt an update was in order.

Laughing Water Capital (LWC) returned 1.9% in the 3rd quarter of 2018, while the S&P 500 and R2000 returned 7.7% and 3.6% respectively over this period. Through the end of September, LWC had returned 12.9% for the year, while the S&P 500 and R2000 returned 10.6% and 11.5% respectively. Please check your individual statements for your personal return. As a reminder, over shorter periods, the performance of the indexes is irrelevant to our partnership. We aim to achieve differentiated results, which means we must act differently. This is especially true at the moment, as our portfolio is increasingly invested in opportunities that are largely removed from the forces that will drive the U.S. stock market in the near term. Thus, it is not surprising that we trailed the S&P's move by a large margin in the 3rd quarter. Similarly, we must remain agnostic if we continue to trail the broader markets in the months and quarters to come. Over longer periods of time, our results will be tied to the performance of our businesses and our management partners. If they are able to execute as I expect, our patience will be rewarded. For this reason, almost the entirety of my and my family's wealth is invested in our strategy. Our interests are aligned.

Portfolio Comments

Broadly speaking, our portfolio is comprised of two major investment archetypes: compounders and special situations. In brief, compounders are businesses that can achieve supranormal returns on invested capital for long periods of time due to some combination of competitive advantages and/or extraordinarily talented management teams. Compounders typically justify a high multiple due to some combination of a predictable business, a longer runway to reinvest in the business at high rates of return, or the ability to return capital to shareholders. Identifying a compounder that is suitable for investment typically depends on identifying a great business and management team that are *even better* than the market realizes. As these are great businesses by definition, they will rarely appear cheap on any traditional metric outside of recessionary periods.

Special situations are investments where the business and management may be of lesser quality, but the opportunity exists less because of identifying a gap between the quality of the business and management vs. expectations, and more on identifying some failing in human nature or market structure that creates a mispricing. In the best cases, we will be able to find future compounders today, when they are available at special situation prices.

In the long term, I expect that our portfolio will increasingly tilt toward compounders. However, at the moment, our portfolio is tilting increasingly toward special situations. There is nothing wrong with this per se, but special situation investing will be less tax efficient, and has the unfortunate problem of requiring re-generation because unlike compounders, special situations are best sold when the temporary conditions that led to the mispricing have passed.

There are a number of reasons for the current tilt. First, in my view it is often more difficult to successfully identify compounders than special situations. Betting on a compounder can be thought of as betting that a company can defy the destructive forces of capitalism. Betting on a special situation can be thought of as betting that irrational behavior will eventually be replaced by rational behavior. I believe that betting on the return of rationality is simply a lower bar to step over.

To illustrate how difficult it is to successfully identify great businesses that are better than the market realizes, consider that in a recent interview, John Malone, Chairman of the Liberty Companies and easily one of the greatest investors of all time, told a story of how he advised Warren Buffett, literally the greatest investor of all time, to not invest in Microsoft, one of the greatest companies of all time led by one of the greatest entrepreneurs of all time, during its early days. If you are keeping score at home – that is one of the greatest, telling the greatest, NOT to invest in one of the greatest, led by one of the greatest. Buffett himself admits this was a colossal error of omission, and should be enough to cause any mortal to think twice before claiming they have found a business and management team so good that they are worth paying up for.

Second, special situations often resolve themselves over a defined – often short – period of time, independent of what the broader market does. To be clear, time is the friend of great businesses, which allows one to pay higher prices, but in today's environment where we are likely closer to the end of the economic cycle than the beginning (although it can certainly continue longer than anyone expects), I believe it makes sense to tilt the portfolio toward shorter duration opportunities that are likely to be somewhat removed from broader market action.

Third, investing in special situations ties well with the competitive advantages we have as a small firm. For example, while Buffett evolved to focus primarily on compounders, when he managed smaller amounts of capital, he largely focused on special situations. Simply stated, there is often less competition investing in small special situations than there is when investing in larger compounders.

Comments on Selected Investments

Rimini Street, Inc (RMNI/RMNIW)

Rimini was introduced in our H1'18 letter. In short, the company provides 3rd party maintenance for enterprise software. Their basic sales pitch to customers is, "we will save you 50% on your maintenance costs, while providing better service," which is clearly attractive. Most often, they are undercutting Oracle, and not surprisingly, Oracle is attempting to litigate the company to death. It has been a wild few months for RMNI, with shares having rallied ~50% from our purchase price, only to decline to below our purchase price on news in mid-August that a Nevada court granted a permanent injunction against Rimini for infringing on Oracle's copyrights. This "permanent" injunction lasted about a month, at which point it was stayed until the 9th Circuit Court of Appeals can hear Rimini's appeal, and shares once again rallied significantly.

From our perspective, while all of this legal wrangling is likely an impediment to near term growth, it is mostly just noise. First, the court has already ruled that 3rd party maintenance providers have the right to exist: only the manner in which they conduct their business is at issue. Second, the 9th Circuit previously vacated an injunction against Rimini, with Judge Michelle Friedland commenting, "I don't really understand why there also needs to be an injunction" in light of "a whole lawsuit [Rimini II] to try to figure out if they're complying with the liability determinations." This is reading tea leaves, but Judge Friedland was previously a partner at the law firm of Munger, Tolles & Olson. That is Munger as in Charlie Munger, Warren Buffett's partner who is famed for his no nonsense approach to life and reason, which suggests perhaps Judge Friedland shares this sentiment, and recognizes that Oracle is simply attempting to keep RMNI tied up in court so they can not undercut Oracle on price. As such, it seems likely that this injunction will be vacated.

Importantly however, regardless if the injunction is vacated or not, I believe Rimini will be just fine. The company has already commented that if they were forced to comply with any injunction, it would impact gross margin by between 1-4% of sales. In other words, in order to keep gross margin flat, Rimini would have to change their sales pitch to, "we will save you between 46-49% on your maintenance costs, while providing better service." In my view, this is still a very compelling pitch, and is reflective of Rimini's untapped pricing power at this stage in the game. It is important to recognize how much Rimini's customers dislike Oracle. By some estimates, Oracle has subpoenaed ~1,200 of Rimini's ~1,500 customers, and yet revenue retention remains over 90%. It seems unlikely that these customers would balk at a 1-4% price increase.

That being said, in my view raising prices now would be the wrong strategy for Rimini. Eventually, the legal situation will be resolved, and it is fair to expect a flood of new competition at that time. However, there will also be an explosion in the number of potential customers as those who previously had not been willing to contend with litigation threats from Oracle look to 3rd party maintenance providers. Rimini is best served for the long term by developing as many relationships as they can now, so that switching costs will act in their favor when new competition does arrive. Additionally, given their scale, Rimini will be in a position to shift their business model toward a "shared economies of scale" model, where Rimini's large size relative to nascent competition will allow Rimini to fend off competitors by embracing lower pricing, and sharing the benefits of their size with their customers. It may seem odd to suggest that Rimini's best path forward may be to purposefully lower their prices in the face of new competition, but in businesses with large total addressable markets, this model is very powerful, as demonstrated by Amazon, CostCo and others. It is too early to spend a lot of time thinking about these potential developments as legal concerns will rule the day in the near term, but zooming out and focusing on the big picture reveals that while we bought Rimini as a special situation, it has the potential to become a business that can compound wealth for decades. We added to our RMNI position on the recent weakness.

I would also like to point out that Rimini – specifically the warrants (RMNIW) – are a good example of why I always stress that short term performance is irrelevant. On one day in early September, 200 warrants traded at $1.00 per share, up from the closing price of $.62 per share. If we were to take the market at its face, this would mean that an investor with $200 created about $5.6M of stock market value. Even the alchemists of old would blush at this feat.

EZCorp, Inc. (EZPW)

EZCorp, which should be familiar by now, continues to frustrate following the May 2018 issuance of convertible debt, which is potentially dilutive. To be clear there are other things not to like here, but as far as the sell off following the convert, I think the market is being overly shortsighted. The perception is that the convert is dilutive to equity, and given the weak corporate governance, the conclusion is that the company does not care about per share value. Yet, if one takes the time to review company history over the last ~30 years and adjusts for splits and equity financed acquisitions, one can see that shares outstanding have grown by about 2% per year over this period, which is entirely reasonable relative to the amount of shares that most companies issue. Speaking of equity financed acquisitions, if back in May rather than completing a $15.90 convertible bond offering EZPW had announced that they were paying for an acquisition with stock at $15.90 per share (~9x consensus EBITDA, acquisitions typically 4-5X EBITDA), the market would likely be crowing about how accretive the transaction was.

One could argue that issuing a convert with a $15.90 conversion price is essentially issuing low coupon debt with an option to issue equity at $15.90, and if a large acquisition had been announced subsequent to the convert offering, I suspect shares would be trading higher than the pre-convert price, rather than ~30% lower. Yet, a large acquisition has not been announced, so shares have wallowed.

Interestingly, 2 weeks after the convert priced, the company's plane was involved in a crash in Honduras. Photos of the crash site reveal the plane's tail number, and with that information, one can go back and track where the plane had been to previously. From this information, we know that EZPW's executives had visited Colombia in the weeks before the convert, and EZPW currently does not have any operations in Colombia. It thus seems likely that a deal in Colombia was close, but ultimately failed to close. However, considering the mismatch between what the company's excess liquidity is earning and what their cost of carry is, it seems likely that an acquisition is in the works. I suspect that shares will appreciate quickly if this is indeed the case, but for now the market does not seem interested in EZPW.

In addition to a likely acquisition in the near future, the company will be releasing a new 3 year plan in the coming weeks, and following significant shareholder agitation by us and other, much larger holders, it seems likely that the new plan will include an improvement in corporate governance – specifically tying executive compensation to per share metrics, rather than just company-wide metrics. Combined with a likely pending acquisition, a lapping of last year's hurricane season, impressive operating metrics, cyclical weakness tied to record low unemployment, and a very attractive relative and absolute valuation, the bar for success for EZPW stock is very very low from where we are today.

New Investments

Aimia, Inc (AIM.TO): A Low Ball Bid, Cash and NOLs, and Capable Capital Allocators

Aimia is technically not a new holding as we first purchased shares some time ago, but it has not been previously introduced due to its formerly small size, and the thought that I might seek to purchase more shares. As it is now a mid-sized position, it merits discussion. Aimia is a collection of assets in the loyalty space, which I became familiar with last year when researching Points.com (PCOM), which was introduced in our H1'17 investor letter.

Aimia's main asset is essentially Air Canada's frequent flyer program, known as Aeroplan. However, in May of 2017, Air Canada announced that they would be terminating their agreement with Aeroplan in 2020, in order to build their own in-house loyalty program, and shares of Aimia cratered on the news. Aimia's management team made a number of moves to shore up their balance sheet and prepare for a future without Air Canada as Aeroplan's anchor partner, but execution was poor to say the least. Management's shortcomings led to the arrival of Mittleman Brothers, a NY based money manager, as an activist with an ~18% ownership stake, and an agenda to change management, and fully realize the value of Aimia's assorted assets.

In late July of 2018, a consortium consisting of Air Canada, TD Bank, CIBC, and Visa bid C$250M for Aeroplan (equal to about $1.60 per share) and made reference to ~$2 in additional value per share tied to Aimia's other assets, which drove the share price to the ~$3.50 level. I believed that this bid dramatically undervalued Aeroplan, and increased our position accordingly. Management shared this view, and promptly rejected the bid.

To understand why I felt the bid was far too low, a brief description of the loyalty ecosystem will be helpful. When a consumer uses a credit card attached to an airline, a portion of the spend (~2%) is diverted to the issuing bank in the form of interchange fees. These interchange fees have high incremental margins to the bank, which means the bank wants to encourage people to use the card as often as possible. In order to incentivize people to use the card, the bank takes a portion of the interchange fees and purchases –typically from an airline - points or miles, and gives the miles to the consumer.

Most airlines own their own loyalty program, and in fact, Air Canada owned Aeroplan until it was spun off in 2005 following their 2003 bankruptcy. Owning their own loyalty program is important to airlines, because loyalty is a much better business than the business of actually flying planes. Consider this; the essence of loyalty is that someone pays you now for something they won't need until later (if ever), and delivering the product (the redeemed flight) costs you nothing, because you are already flying the plane. For this reason, some Wall Street analysts have theorized that in many cases, the captive loyalty programs themselves are worth more than the entire airline.

In the case of Air Canada, there were multiple reasons to believe that their initial $250M bid was drastically low. First, $250M dramatically undervalued Aeroplan vs. its own history and loyalty peers. However, peers and historical multiples were not a reliable indicator of the company's value, as Air Canada itself is a key part of the equation. Second, Air Canada itself had claimed that the present value of the loyalty program they planned to develop internally was $2B+, and as with any proposed project, there would be substantial execution risk as well. It thus seemed hard to believe that they would not be willing to pay more than $250M for something whose equivalent they believed was worth $2B, while they could simultaneously avoid execution risk.

Third, Aeroplan has ~5,000,000 members. We have all seen credit card offers that come with 40,000 or 50,000 miles as sign up bonuses. If Air Canada were to try to build their own loyalty program from scratch, they would have had to issue all of those miles to attract new members. It is difficult to know exactly how the economics of such an endeavor would work between Air Canada and their bank partners since Air Canada actually flies planes, and because surely not all 5,000,000 Aeroplan members would be worth pursuing. However, for back of the envelope math I assumed that the Air Canada group would want 2,000,000 members, that these members would want 15,000 signup miles, and that the miles would cost $.01 each. These numbers represent dramatic haircuts vs. the going rates. For example, Canadian upstart airline WestJet has been attempting to take share from Air Canada, and had been offering credit cards in conjunction with RBC with a $250 signup bonus. Additionally, while airlines no longer disclose their cost per mile, in 2015 American Airlines disclosed that the going rate was $.0123 per mile, and it is widely known that rates have been going up since that time. Based on the extremely conservative estimates used in my calculations, the total cost to acquire a mere 40% of Aeroplan's customers would have been $300M. Note that this would only be the cost of getting a credit card in the hands of these customers. As the banks surely know, getting customers to put this card front of wallet would be an additional challenge, as it is very difficult to get anyone who has their existing credit card linked to automatically pay their bills to move a new card to the front of their wallet. I thus reasoned that the Air Canada coalition would surely pay at least $300M – and likely much higher - for 100% of Aeroplan's customers in a transaction.

Fourth, Air Canada has historically traded at a discount to airline peers, with most industry observers citing the lack of a controlled loyalty program as the reason, and management acknowledging that their margin gap vs. peers is largely tied to their lack of a captive loyalty program. By simply assuming that Air Canada would enjoy some multiple expansion if they owned their own loyalty program, one could see that acquiring Aeroplan would create billions of dollars of value. Presumably Air Canada would be willing to pay more than $250M to create billions.

On the downside, the biggest risk in my view was that Mittleman Brothers, who had publicly stated that they believed the value of Aeroplan was $1B, and other shareholders would demand a price so much higher than Air Canada's $250M bid that Air Canada would simply walk away. If that had happened, the stock would have surely declined in the near term, but Aeroplan had been making progress on recruiting new airline partners to their network, and the value of Aimia ex Aeroplan would still have been very real, meaning that we likely would have been fine with time. However, I believed that the two sides would find a middle ground. My years spent following Mittleman Brothers' investor letters left me with no doubt about their conviction in their valuation of Aeroplan, but there was also the risk of a shrinking ice cube problem as uncertainty regarding Aeroplan's future could have led to consumers attempting to redeem their points *en masse*, which would have the effect of draining Aimia's cash reserves, and potentially causing the equivalent of a run on the bank. As such, I suspected that when push came to shove, Mittleman and other large equity holders would accept a bid that was acceptable to both sides, even if it was well below the stated value of $1B.

Ultimately, Air Canada wound up raising their bid by 80% to $450M dollars, providing a quick return for us. The deal has not yet closed, and there is some uncertainty regarding what Aimia's path will be after selling their largest asset, however in my view the long-term outcome is likely to be positive. Following the close of the transaction, Aimia will be a pile of cash, a large NOL, and assorted loyalty assets. It is impossible to pinpoint NAV as the assets are largely privately held, we don't have full visibility into recent cash flows or the company's plans for their preferred shares, and the present value of the NOL is indeterminate, but this is a case where I am happy to be approximately right rather than exactly wrong. I think a range of somewhere between $6 and $10 per share is a reasonable guess, suggesting that if following the sale of Aeroplan the remain-co was simply shut down and sold for scrap, we would earn an acceptable return. This is always a good place to start, but assuming that Mittleman Brothers remains in the driver's seat, it is likely that NAV per share will grow over time, and that the gap between market prices and NAV will shrink, which provides the potential for considerable future appreciation.

One near term path forward would be to simply pay off the company's debt, restore dividends to the company's preferred shares, and then began buying back common shares in order to shrink the gap to NAV. If repurchasing shares is indeed the plan going forward, we are in the fortunate position that if shares move lower in the near-term post deal close, in the long term we will realize more value. However, repurchasing shares would not effectively deploy the company's NOL, so it is also seems likely that the company will become an acquiror. In that case, we can take comfort in the fact that Mittleman Brothers have an enviable long-term track record of identifying businesses with very stable current cash flows when they are trading at low prices. While this style of investing is currently out of favor in public markets, when attached to a large NOL and potentially executed in private markets, the rewards will likely be substantial with time.

Hill International (HILI / HIL): Activist Investors, Forced Selling, and Low Hanging Fruit

> *The time other investors spend delving into the last unanswered detail may cost them the chance to buy in at prices so low that they offer a margin of safety despite the incomplete information.*
>
> ~ *Seth Klarman*

Hill International is a global provider of asset light construction management and consulting services, with 47% of 2017 revenue from the U.S., 35% from the Middle East, and the balance from EMEA, LatAm, APAC, and Africa. Unlike a general contractor that has to bear the cost of overruns, HILI generally operates on a cost+ basis, providing information and advice in order to avoid problems before they blossom. With an activist campaign to remove the founding family from the C-suite already complete, a division sold to shore up the balance sheet and simplify the business, a cost cutting plan underway, and rampant M&A in the space at premium prices, there are a lot of moving pieces that could explain HILI's mispricing. However, the most notable piece is that HILI – formerly HIL – was delisted from the NY Stock Exchange in August, which caused shares to tumble ~30% over night.

The delisting is a result of the fact that a year ago HILI announced that they would have to restate 3 years of SEC financial statements due to problems with how they accounted for foreign currency translation adjustments. A year later, they were still not current on their financial statements, so they were out of compliance with NYSE listing requirements. Removal from the NYSE and relegation to the pink sheets does not fundamentally alter HILI as a business, but it does impact certain investors' ability to hold the stock. Specifically, it is likely that assorted index related and quantitative based investors were forced to sell HILI stock upon the delisting for no reason other than the decision rules that govern their investments prohibit owning pink sheet stocks. Importantly for us, as of October 12th the company is current on their financials, relisting on the NYSE is expected on October 18th, and the company will host their first investor call in over a year on October 18th. The relisting, investor call, and first current financials in over a year should be a very bright light shining on the opportunity at HILI.

To be clear – when we began buying our position we were operating with incomplete information. Management had indicated that they were dealing with some revenue weakness in 2018, and it was impossible to know exactly what was happening with the financial restatements, meaning it was possible that there was more than one cockroach in the kitchen. However, the fact that they had already successfully restated their 2014, 2015, and 2016 filings without uncovering any additional major negatives suggested that we were on fairly stable ground. I took further comfort from the fact that activist investor Ancora Advisors, who has been involved for ~2 years, purchased additional shares subsequent to the delisting, and has nominated a candidate to the board of directors. Additionally, my conversations with experienced consolidators in the space confirmed the quality of the U.S. assets, although they are less familiar with the international businesses. Lastly, as always, we took comfort in the low purchase price vs. normal earnings power at which we acquired our shares.

Importantly, in addition to the non-economic selling tied to the delisting, there is reason to believe that at the moment HILI is significantly underearning vs. its true potential. First, as mentioned previously, HILI's revenue is tilted toward the Middle East. This business has slowed considerably over the last few years as lower oil prices have led to decreased capital spending in the region. With oil prices recently on the rise, revenue in the Middle East should rebound, with *Building Design + Construction* estimating 6.4% annual regional growth through 2022. Second, HILI's founding family had a history of taking advantage of their position, including using the company to pay for assorted country club memberships, private vehicles, and other perks. An analysis of peer companies suggests that there is quite a bit of low hanging fruit that could be removed in order to improve margins now that the founding family has been removed. In fact, new management has announced they are targeting 10% to 12% EBITDA margins, and is in the midst of completing a profit improvement plan that has targeted ~$40M in annual savings, which is significant vs. the company's slight EBIT loss in 2017, and ~$260M enterprise value at the time of our purchase. Third, the company's internal struggles over the last ~2 years have certainly distracted management, and possibly deterred customers, so a return to a stable C-suite is likely to lead to an improvement in revenue. All of these factors are simply to suggest that at present, HILI's earnings power appears to be substantially below normal.

In terms of what HILI is worth, it should be noted that comp transactions have taken place at ~1x EV/Sales and ~10.5x EV/EBITDA . Ordinarily, betting on a sale when considering valuation is bad practice, but in the case of HILI, the owners of almost 50% of the outstanding shares have publicly called for a sale, so an eventual sale seems inevitable. At the prices we were buying our shares, a 1x multiple on FY17 U.S. sales alone would almost justify the entire enterprise value, suggesting that we were able to buy all of the company's international operations for nearly free. Some of these international assets are under-scaled and a drag on profitability, suggesting that simply shutting them down would create value. However, a sale is more likely than a shuttering, and a 1x multiple on total FY18 guided sales suggests a price per share of ~$6.00, which provides a substantial margin of safety vs. where we bought shares.

Importantly, a sale in the near term is not necessary for success. As mentioned previously, the company has been dealing with a number of short term problems, and upon moving past these problems, it is possible that they become a buyer rather than a seller. NV5 Global (NVEE), a peer company that has been rapidly growing through acquisitions, has traded at more than 20x EBITDA and 2.7x sales. While not a base case, if HILI seeks to become an acquiror and is able to execute successfully, shares could be worth a price in the-high teens a few years from now. In my view, the best plan going forward may be to raise capital through selling the international assets piecemeal to buyers who have more regional density, and then focus on growing in the United States. According to *Engineering New Record*, HILI is in the top 10 in terms of revenue in the U.S., and by some estimates, there are almost 150,000 domestic engineering firms, providing a lot of potential acquisitions that could leverage HILI's existing scale, which would drive revenue and margins in the years to come. The unique dynamic tied to the exchange delisting and imminent relisting was something that I felt should be taken advantage of, and thus HILI joined our portfolio as a large position.

Radisson Hospitality AB (CPH: RADH): **American Football, Swedish Laws, and Chinese Tourists**

> *"My largest positions are not the ones I think I'm going to make the most money from. My largest positions are the ones I don't think I'm going to lose money in."*
>
> ~ Joel Greenblatt

In American football, if the defense goes offside and the ball is snapped, the offense gets a "free play." In other words, if the outcome of the play is positive, the offense receives the benefit, but if the outcome of the play is negative, rather than suffering the consequences of the negative play, the offense is rewarded with a five yard gain, and an additional play. This creates extraordinary skew, in which the offense is incentivized to attempt a play that would normally be high-risk / high-reward, because the high-risk element has been removed from the equation.

I was first introduced to Radisson Hospitality, formerly known as Rezidor, by Brad Hathaway of Farview Capital several month ago. In brief, the company is a Swedish-listed hotel group with more than 80,000 rooms across Europe, the Middle East and North Africa, which makes it the 15th largest hotel group in the world, and the 5th largest in Europe. Of note, the company is undergoing a turnaround led by a new CEO with an impressive record of successful hotel turnarounds. If he is able to replicate his past success, a case can be made that Radisson Hospitality AB will be worth multiples of its current value looking out a few years. While the uncertainty attached to the turnaround plan has surely weighed on shares, there is additional reason to believe they have been trading cheap for non-fundamental reasons. Namely, ~70% of the business is owned by HNA Group, a Chinese conglomerate that has ran into trouble with its debt obligations after levering up to finance an aggressive acquisition spree over the last few years. I believe that HNA's distress has been acting as an overhang where potential buyers were unwilling to invest due to the fear that HNA group would be a forced seller in the near future. As a reminder, while the price of an asset may go down because someone may be forced to sell it, the value of the asset remains unaffected, and buying from distressed sellers can create excellent opportunities.

Despite identifying a security that appeared cheap for reasons which were easily understood, I initially passed on the opportunity. Broadly speaking, the hotel business is unattractive due to its cyclical nature, and turn around stories don't always turn. As the stock has rallied ~50% since that time, it may be tempting to label this as a mistake of omission, but that would be incorrect, as the company did not score well on our "what happens when something goes wrong?" criteria, and over longer periods of time, remaining true to our process will be far more important than any individual investment opportunity.

However, in the months since first passing on Radisson, quite a bit has changed. In early August, Jin Jiang, a second Chinese conglomerate that is 75% owned by the Chinese government, agreed to buy the 70% of Radisson Hospitality AB that is owned by HNA for SEK $35 per share, as part of a bigger deal to acquire U.S. based Radisson Hotel Group for a reported USD $2 billion. The deal is expected to close by year end. For shares of Radisson Hospitality AB this should have the intermediate term benefit of removing the overhang caused by HNA's distressed position, but a wrinkle in Swedish takeover law makes the opportunity significantly more interesting.

In Sweden, when a buyer purchases more than 30% of a business, they are legally obligated to bid for all remaining shares within 4 weeks of the initial transaction closing, at a price that is not less than the price of the initial transaction. If they are able to buy 90% of outstanding shares, they can then force the remaining shareholders to accept their bid. Given this pending obligated bid, shares of RADH purchased after the announcement of Jin Jiang's bid for HNA's stake essentially come with a free put option at SEK $35 attached to them, meaning that the downside appears to be extremely limited in the near term.

To be fair, this investment is not entirely risk free. First, it is possible that Jin Jiang walks away from the deal, at which point shares would conceivably retreat to their pre-announcement price of SEK ~$29, or lower. However, I view this as extremely unlikely. Jin Jiang is effectively controlled by the Chinese government, and thus it seems likely that the Chinese government had a hand in orchestrating the transaction between Jin Jiang and HNA. Thus, the actions of Jin Jiang can be taken as representative of the Chinese government.

China is keenly interested in asserting itself on the world stage, and proving that they are a reliable investment partner. Publicly failing to follow through on a financial obligation would cause the Chinese government to lose face, and weaken their status as global investment players. It is also true that at times in the past the Chinese government has taken broad steps to curtail debt fueled offshore investment as a means to restrict capital flight and combat the weakening of the RMB. However, given the current U.S./China trade spat, the Chinese government is likely comfortable with the prospect of a weakening RMB, which will aid exports, and thus it seems unlikely that the Chinese government would move to restrict Jin Jiang's ability to complete the purchase of Radisson AB.

Second, Jin Jiang is only obligated to bid SEK $35 per share, and we bought our shares at a ~2% premium to this price. It is entirely possible that Jin Jiang simply may not want to pay up for additional shares, in which case they will bid SEK $35, which will put us in a position where I will have to choose if we should accept the ~2% loss of capital, or hold on to our shares in hopes that the in-progress turnaround effort succeeds. Given that there are early signs of progress, and that if the turnaround is successful I believe a few years from now shares could be worth ~200+% more than they are today, that would not be a terrible outcome.

However, I think it is very likely that Jin Jiang will bid higher than SEK $35, and possibly significantly higher. For starters, as stated previously, if the turnaround is successful, a few years from now shares could be worth 200+% more than they are today. Jin Jiang surely did extensive diligence before agreeing to buy 70% of the business, and thus seemingly would believe that the turnaround will be successful. As such, agreeing to buy more today in anticipation of a successful turnaround would be akin to buying dollar bills for pennies on the dollar.

Second, only 2 years ago HNA was in the same position that Jin Jiang is now in, and they bid SEK ~$35 for remaining shares. Radisson AB's board recommended that shareholders reject this bid as they considered it too low. At the time, this bid was ~7.2x EBITDA. In the 2 years since, EBITDA has improved by approximately 20%, so that a 7.2x EBITDA bid today would come in somewhere between SEK $41-45, depending on adjustments.

However, we already know that the board considers 7.2x to be too low, and it is unlikely that Jin Jiang will be able to take Radisson private without an endorsement from the board. As such, it seems possible that Jin Jiang will bid at least a modest premium to HNA's failed 7.2x bid. If Jin Jiang were to bid 8x EBITDA, that would equate to a share price in the range of SEK $46-51, or a return north of 30% for us. While this would be an acceptable outcome, it should be noted that 8X EBITDA appears conservative based on peer valuations, and Jin Jiang's own transaction history. 8x would be a ~20-40% discount to European hotel peers, and Jin Jiang paid ~12.5x EBITDA for French hotel group Groupe du Louvre in 2015. While no two hotel groups are perfect comps due to differences in market segmentation and business models, and I do not consider this a base case, at 12.5x Radisson AB would trade for SEK ~$72-80 per share. Importantly, at 12.5x for the remaining shares, the blended multiple for Jin Jiang would be only ~8x, still a very low price vs. comps and past transactions, making a 100% return on our capital within the realm of possibility, even if it is a low probability. However, it should be noted that this outcome is unlikely without a protracted back and forth, where minority investors collectively hold out for a higher price.

For Jin Jiang, bidding at the top end of the conservative range of SEK $51 would require an incremental outlay of USD ~$90M USD, which is only 4.5% of the larger USD $2B Radisson Hotel Group deal, ~4% of the liquid assets on Jin Jiang's balance sheet, and an incremental ~0.1x turns of leverage if they were to rely on debt financing. I view this as a small ante for Jin Jiang, China and Asia's largest hotel owner, who has more than 100M members in their loyalty club, and is playing a high stakes game.

According to a study completed by Chinese travel company Ctrip and the Chinese Tourism Academy, China has the highest number of outbound tourists in the world, yet only 10% of Chinese people have a passport, and fewer than 10% travel internationally. Jin Jiang recognizes that hotels are a business where scale matters, and they are building a hotel empire in an attempt to get in front of a pie that will be enormous as the Chinese middle class continues to develop. Importantly, they are doing this at the direction of the Chinese government, as evidenced by the fact that in March of 2018 the Chinese National Tourism Administration and the Chinese Ministry of Culture were merged into a single entity known as the Ministry of Culture and Tourism. The official announcement of this move proclaimed that the goal was, "enhancing the country's soft power and cultural influence." In other words, the Chinese government views encouraging foreign travel among Chinese nationals as a tool in their quest to improve China's standing on the world stage.

Additionally, Jin Jiang has surely learned lessons from their past attempts – and failures – to grow, and thus it seems likely that they would want to take advantage of opportunities when they can. For example, in 2016 Jin Jiang informed the board of asset-light French company Accor Hotels that they intended to increase their ownership from 15% to 29%. However, Accor's board and management maneuvered to block Jin Jiang's attempts. Thus, it seems likely that Jin Jiang would prefer to make a respectable bid for remaining shares of Radisson Hospitality AB rather than remaining in a position where minority shareholders can be a nuisance to their ambitions.

In summary, given that Jin Jiang is legally bound to bid at least SEK $35 for our shares (~2% downside) and it is not at all difficult to imagine situations where we can make 20-45% with an outside chance of 100% all within a few months, in my view our investment in Radisson Hospitality AB is the investing equivalent of a "free play." To further illustrate how skewed the odds are, consider that if there was an 80% chance that Jin Jiang would bid SEK $35 and a 20% chance they would bid SEK $51, assuming a time frame of 4 months, the IRR to the probability weighted price would still be more than 24%. In my view, relying on that sort of false precision is generally bad practice, but I think the odds that Jin Jiang only bids SEK $35 are significantly lower than 80%, which builds in a large margin of safety. As such, just as the quarterback is incentivized to throw for the end zone when the defense goes offsides, we are incentivized to think big in Radisson Hospitality AB, and I have added it to our portfolio as a large position. If we wind up with an incomplete pass, that is fine. We will live to fight another day.

A Brief Word on Taxes

If our investments in Hill International and Radisson AB develop as envisioned, it is possible – and perhaps even likely - that we will generate short term capital gains. Personally, as a taxable investor in our partnership, the idea of paying taxes at the higher, regular income rate rather than the reduced, long term capital gains rate pains me. However, it would be foolish to ignore the opportunity for very high rates of return, over short, relatively well defined time periods, with little risk of losing money because of the tax consequences. These investments were largely funded by cash on hand that has laid dormant for most of this year, and even after accounting for taxes, if these investments work out as envisioned, the results will be significantly better than the return earned on our cash.

Growth of our Partnership & Soft Close to New Investors

Our fund continues to attract an extraordinarily high-quality investor base. Importantly, each of these investors sought out and bought into LWC independently, rather than having had LWC sold to them through fund marketing. Building a partnership in this manner has the major benefits of 1) taking almost zero time away from my investing pursuits 2) keeping expenses low, which justifies lower AUM, which will lead to higher returns, and 3) ensuring that our LPs understand our strategy, and are fully aligned with our patient approach, which will be tremendously valuable when difficult times inevitably appear on the horizon.

Largely as a result of our no-marketing approach to marketing and refusal to take capital from potential partners that are not properly aligned with our interests, fund AUM remains well below our potential size. However, with the exception of existing partners and potential partners that I am presently engaged with, the fund is now temporarily closed absent a notable pullback. This may seem somewhat ridiculous, especially as I am personally paying an outsized percentage of our operating costs in order to protect the returns of limited partners that have chosen to join me in these early days. However, as with most things in life, a look toward incentives can explain this behavior. Simply stated, almost the entirety of my and my family's wealth is invested in LWC, I like what we own, and at the moment a fairly large proportion of our investments are short duration and expected to come to conclusion within a few months. I thus see no reason to dilute the returns of existing partners – and my personal returns - through taking new capital at this time. The fund will reopen to new investors in the not too distant future – most likely Q1'19 - so for prospective investors, please feel free to join our waiting list by visiting www.laughingwatercapital.com or emailing info@laughingwatercapital.com.

Looking Forward

As always, I have no idea what the market will do in the coming weeks or months. With headlines surrounding trade wars, rising interest rates, and midterm elections in the U.S., there is no shortage of unsettling factors that can keep investors up at night. It is certainly possible that one of these factors will develop into the straw that breaks the market's back. However, history suggests that the time for real fear is when there is no detectable trace of fear. With so many talking heads trumpeting the approaching danger, it is not clear that now is the time to head for cover, and history has proven time and time again that attempting to time the market is not a winning strategy.

As such, on the long side I believe the best course of action is to do what we always do: focus on finding investment opportunities that put the odds heavily in our favor by focusing on better than average businesses, with better than average management teams, when they are available at prices that just don't make sense vs. the businesses' normalized potential. As always, there should be no expectation that our returns will come in a straight line, but we should take comfort from Buffett's observation that, "the market will determine when we will be right, but our analysis will determine if we will be right." On the short side, I believe there are some very skewed opportunities to insure our portfolio against a recession, and I have been spending more time in this area recently. To be clear – I do not think a recession is imminent, and it may be years before one develops – but flood insurance is best purchased before the rain clouds are on the horizon. I would further note that my wife and I recently personally increased our investment in LWC. As is always the case, it is unlikely that we picked the bottom. However, looking out 3-5+ years from now, I expect that we will be happy with our returns.

Please let me know if you have any questions,

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