PRAETORIAN CAPITAL

Q3 2019 Investor Letter — October 22, 2019

TO THE INVESTORS OF PRAETORIAN CAPITAL FUND;

During the third quarter of 2019, the fund declined by 8.40% net of fees. Given our concentrated portfolio structure and focus on asymmetric opportunities, my expectation is that during most quarters, we will be up or down some negligible percentage—followed by quarters where one or more positions move dramatically and impact overall returns. During the third quarter, we experienced the former, as losses on a number of core positions offset gains in shipping names. Third quarter results were slightly augmented by realized gains in our short-term event-driven positions, offset by some losses on a number of shorts. Overall, the headline performance number was rather unremarkable—the third consecutive one.

Turning to the global macro backdrop, economic conditions have continued to decline no matter what metric you are looking at. (I tend to think trade statistics, transport statistics, and global PMIs are the most accurate and relevant). The global Central Banks have once again come to the rescue of equity markets with a fresh dose of QE and interest rate reductions. We've already seen that these can be quite stimulative the first time they are tried, but we're now on QE4 here in the States and I lost track of what number in other countries. We're effectively at permanent QE. It's no longer stimulative—if anything, it's likely making things worse. That doesn't mean that equity investors care—they're having a party currently. It will likely end in tears.

During the quarter, I felt that a US equity market sell-off was imminent and put out a reasonably-sized short position in various indexes in addition to a basket of large cap Ponzi Sector names (these are companies that are losing more money for each added dollar of revenue yet have no logical path to profits). Following the announcement of QE4, I chose to book the majority of these positions for about a 2% aggregate loss. I think these Ponzi Sector companies all go to zero, but I've been around long enough to know that you don't fight QE. If you are going to short (and I only do this quite rarely), you want to short at the top of the range and be disciplined about where you stop out if you are wrong. I did both. Keep in mind that I do not see these positions as hedges to our longs. Rather, I see these as discrete directional bets on expected outcomes. Therefore, when I booked the shorts, I felt no pressure to book an offsetting exposure on the long side. That said, I did take our long exposure down somewhat during the quarter and into early October.

On the long side, I continue to seek out opportunities to invest in asymmetric opportunities (more later); however, I have a very clear set of guidelines for investments, which is making it hard to find longs:

- ✓ I refuse to own anything closely tied to GDP growth or that will be hurt in the coming global depression
- ✓ I refuse to own anything with balance sheet risk and that cannot fund itself if the capital markets close for a year or three
- ✓ I refuse to own anything that cannot be purchased for a single digit multiple on next year's expected cash flow
- ✓ I want to own things that do better when the world is in crisis

Given my rather strict criteria for longs, it becomes harder and harder to own most things and our overall exposure is a good deal less than where I would target it to be. That said, the companies that we do own, like Scorpio Tankers or Altisource are potentially multi-baggers because of the above characteristics. With that in mind, lets look at our largest positions.

Position Review (top 5 positions at quarter end)

My expectation is that our largest positions will not change frequently from quarter to quarter. However, during the third quarter, there was higher than normal movement that I'd like to comment on.

To start with, we exited our currency positions for a small net loss (positive on CAD and negative on EUR). While I suspect that these both appreciate as the US Dollar depreciates, as I look at the overall environment, I wanted to reduce our risk exposure and it didn't seem to make sense to hold onto currencies at this time.

Likewise, in regards to position changes, I fully exited our position in Antero Resources (AR – USA). Simply put, I got it wrong. This position was our largest loss thus far during 2019. I believe in intellectual honesty in these letters and if I make an expensive mistake, it only makes sense to do a post-mortem.

Antero is a natural gas producer with substantial NGL production. Most importantly, it owns a 31% ownership stake in its midstream, Antero Midstream (AM – USA) along with an in-the-money hedge book that covers natural gas production until the end of 2020 and a good chunk of 2021 as well. My thesis was that no matter how bad natural gas prices got hit in the short term, Antero would be fully hedged; hence its competitors would suffer and reduce production first—leading to higher natural gas prices roughly when Antero's hedges rolled off. My mistake with Antero was to assume that public market investors would recognize this fact and not penalize Antero if gas prices declined. Instead, the market is mostly run by computers these days and Antero sold down with the other gas producers. Recent spikes in natural gas prices have given competitors the chance to increase their hedge books. This gives them more staying power and has somewhat negated Antero's edge. I think that when the natural gas sector finally recovers, Antero will be one of the leaders of this recovery, but it has become increasingly obvious that the only way for gas production to slow, is to have a wave of bankruptcies and mergers in the sector. This has yet to happen and the investment was wrong.

One of the keys to investing is to be the first to recognize when a thesis is not playing out correctly and exit before others realize this. Even then, the cheap valuation should reduce your downside risk. I failed to recognize this in time and the cheap valuation wasn't cheap enough. After many years of large gains from buying sector bottoms, I tried to project a bottom, rather than wait for the obvious signs. I simply got this one wrong.

Scorpio Tankers (STNG – USA)

During the third quarter, Scorpio's share price was largely unchanged. Everything about the IMO 2020 thesis seems to be tracking along just fine—if anything it is doing better than expected. This is a result of over two dozen LR vessels transitioning from the product tanker market to the crude tanker market seeking out better rates—these vessels are unlikely to return back to the product tanker market. This has substantially tightened product tanker rates and led those rates to overshoot dramatically. Recently, I have seen reports of LR2s fixed at over $100,000 while MRs are at approximately $40,000 a day. If these rates were to hold for twelve months, Scorpio would have cash flow in excess of $50 per share—compared to a share price today of $35.

Are these rates sustainable? It is hard to say. However, I suspect that demand for clean tankers will increase dramatically over the next few weeks as demand for low sulfur fuel ramps during the fourth quarter. It doesn't hurt that President Trump continues to create geopolitical volatility, which always tends to increase charter rates. For that matter, shipping is by far our largest sector weighting and our other holdings are exposed to similar trends—though they also have exposure to unrefined oil, LPG and dry bulk.

After being ignored for years, shipping has suddenly emerged in the financial news. My experience is that once it's on the radar, a revaluation process often happens over the next few quarters. Fortunately, we have been positioned here almost since the fund's inception and our cost basis is quite low.

Altisource Portfolio Solutions (ASPS—USA) continues to sell non-core assets, pay down debt and repurchase shares. I don't know what an asset-light service provider ought to be worth, but three times pro-forma adjusted cash flow seems wrong—especially if demand for its default mortgage servicing recovers from decade-lows. Remember, when the economy rolls over, people lose their jobs, people default on mortgages and ASPS makes money from that. We are already seeing residential price declines in almost every major metropolitan market. While these declines are mostly centered in the high-end luxury market, I see no reason why they won't continue to filter down to middle class housing as well.

Housing is a funny thing; when prices aren't going up, they tend to go down as much of the market is dominated by speculators lately. These people cannot hold onto a property that is depreciating due to carrying costs. As whole neighborhoods and buildings are priced based on the last trade, a few transactions suddenly mark down everyone's books and change banks' ability to underwrite new loans at prior valuations. This process is happening already, even though the US economy is still growing. In the coming recession, I suspect that this process accelerates.

As the number of moving pieces at ASPS declines and there are fewer one-time expenses, I suspect that investors see the rather obvious value here—especially if the business starts to comp positive. Early in October, the company announced that they will close down their money-losing Owners.com business ($16.2 million annualized loss) and ring fence their other money-losing VC business, Pointillist. Combined, I suspect that in excess of $20 million in cash flow is revealed. At a 15 multiple, which seems appropriate for an asset-light service provider, these two moves should unlock an entire doubling of the market cap. Following these moves, we added to our position in Altisource and it is now our second largest position.

(Put Spread Position) Tesla (TSLA – USA) was a sizable detractor to our performance during the quarter. This is a result of the share price rising modestly and our puts decaying. Nothing changes my mind that the company is a blatant stock-promotion fraud with no pathway to profitability. As new competition emerges, Tesla should go to zero. Additionally, despite a record number of vehicle deliveries during the third quarter, I suspect that revenue will comp negative and losses will accelerate when the results are released this week. This should open some eyes as Tesla will no longer be showing annual revenue growth. In addition, core markets like America are now showing annual vehicle volume declines as well. As the company runs out of backlog in 3rd tier foreign markets, I suspect that vehicle volumes will decline precipitously and by the fourth quarter of 2019, they may begin to show annual vehicle delivery volume declines in addition to revenue and gross margin declines. Then again, Tesla has shown an increasing proclivity to focus investor attention on the delivery number at the cost of Average Selling Price, margins, and any hope of profitability. If you discount a consumer product deeply enough, you will always sell more of them. That's why the focus needs to be on the other metrics.

Tesla is the largest Ponzi Sector company of them all. No matter how much they sell, they lose money. A global economic crisis will only make this all worse. I don't know when Tesla fails, I just know that it will and since most of our puts are June 2021, we have plenty of time to see this play out.

Sandridge Energy (SD—USA) has also detracted from performance in the third quarter. The only thing more contrarian than buying the WeWork IPO is owning small-cap E&Ps, which is ironic as many of them are unusually cheap based on historic metrics or aggregate valuations. I have used past letters to highlight the value at Sandridge. I don't have a strong opinion on the price of oil as there are many factors that determine the price of this global commodity. Rather, at current energy prices, Sandridge is amazingly cheap and at higher oil prices it is even cheaper. While oil prices could decline in an economic crisis, given the nature of short-cycle shale oil, such a decline would be short-lived. I believe that we are near the lower bound of equilibrium prices today with oil in the low $50s—any lower and shale completely cuts off and even in an economic crisis, demand doesn't cut off as rapidly.

I have clearly been early on Sandridge, but I don't believe I am wrong in terms of the valuation.

Short Index Basket was our final large exposure at quarter end. All through the summer, I felt there was the chance for a dramatic market collapse. I still think there is the chance for a dramatic market collapse. That said, I respect money printing and have covered this position for a small loss.

I don't intend to be short often in this fund and when I do short, it will either be through put options or broad-based baskets of equities and indices with tight stops. I'm well aware of how shorts can get away to the upside.

On Asymmetry

In this quarter's letter, I wanted to give some thoughts on the most important factor to successful investing—asymmetry. If you are reading this letter, you likely read many other quarterly fund letters. I remain stunned at how often someone gives a multi-page thesis for why a stock trading at $10 should really be worth $12 or even $13 in a best-case scenario. To me, this seems like the height of folly. Sure, if you can repeatedly buy 80-cent dollars and recycle your capital frequently, you may put together some good returns for your investors. However, this assumes that you will make no mistakes along the way. In fact, I'd argue that most of an investor's expected return in the above scenario is simply taking advantage of market volatility—not analytical ability. Meanwhile, in the above scenario, losses are unpredictable and potentially extreme—while winners will become fairly valued and sold at a pre-determined price that isn't too far from the entry price. This almost ensures a sub-par overall return profile, even if there are only a few large losses.

Let's face it, the stock market is the aggregate opinion of a collection of the smartest people on this ball of dirt. There aren't many mis-pricings. I enter every investment with the view that I can get it wrong and if I see an opportunity, it is probably because I do not yet possess some critical piece of information. With that in mind, my primary edge is ensuring that my winners more than make up for my losers. While many people point to their batting ratio, I'd rather point to the fact that my winners often go up a few hundred percent and the losers in aggregate shouldn't hurt too badly.

During the Q1 letter, I set some expectations for this fund. What I may have neglected to mention is that I also expect that the vast majority of our positions will effectively offset each other (some up and some down) and in aggregate go nowhere during our time of ownership. That is the basic nature of markets and investments. Over time, the thesis will either play out or not play out and we can adjust our positions accordingly with a lot of small gains and losses that roughly offset each other. Since I'm underwriting these positions at substantial discounts to various metrics (replacement cost, book value, multiples on look-forward cash flow, etc.), even when the thesis doesn't play out, the losses should be minimal. Meanwhile, since I'm often looking for inflections in businesses, sectors, or countries, when the inflection has legs, the upside is often a few hundred percent because the pendulum swing from despised to market darling can be quite phenomenal. Over time, I have found that the most frustrating part of this strategy isn't the losses (there aren't usually many large ones), it is the time spent waiting and the theses that don't quite pan out, where capital gets tied up for a negligible return.

This year has been something of an outlier to my expectations as we have had two positions that dramatically overshot my expectations of total potential losses (Antero and Sandridge). I am usually quite good at using market sentiment and chart patterns to determine when to enter a position. Clearly, I got this wrong at both.

You may wonder why I bring this all up in my discussion of asymmetry. However, I think it proves that what I'm doing is working. Why? Think of it this way, two of our five largest investments have not worked this year, with large losses on each of them (Antero and Sandridge), a third (Tesla put spreads) have been burning theta for months and finally, we have a slight loss on Altisource. Despite a pretty upsetting outcome from the core of the portfolio, the fund is still up on the year due to gains in

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shipping. In a year where core positions haven't done well, where event-driven strategies have produced only negligible returns and almost none of our other positions have worked in our favor, one position has more than made up for all of this. That is the power of asymmetry. In years where multiple positions work for us, we should be up a lot more. People like to think of the upside that asymmetry brings, but I always think of the downside first. Having a single winner cover for everything else is how you protect your downside as well.

This is the whole point of asymmetry. You want to be long enough positions so that no one position hurts too bad, but not so many that your winners cannot impact the bottom line. In my experience six to twelve non-correlated positions should be sufficient to accomplish this—as long as you can underwrite that they can each double or better within the next year.

I have continued to use this approach because it works. It works less when you have reduced exposures like we do now, but over time I expect it to continue working. Though our fund is only up slightly this year, I naturally expect that asymmetry will produce upside in due course.

Sincerely,

Harris Kupperman

Chief Investment Officer