PRAETORIAN
CAPITAL

Q2 2019 Investor Letter July 22, 2019

TO THE INVESTORS OF PRAETORIAN CAPITAL FUND;

During the second quarter of 2019, the fund appreciated 6.44% net of fees. While the overall performance was positive, no single position stood out dramatically. 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 appreciate dramatically and push overall returns higher. During the second quarter, we experienced the former. These returns were further augmented by realized gains in our short-term event-driven positions.

Taking a step back and looking at a big-picture view of the world, we're in the 10th year of an economic expansion. Such duration is unprecedented in economic history. The Federal Reserve seems focused on prolonging this expansion. Offsetting this, all manner of data points from rail data to trucking data to bad debt data to new housing starts to automobile sales seem to imply that economic conditions are rapidly deteriorating. Will it lead to a full-blown recession? Or just a short-term thing? Who knows? It is completely binary. Either we have economic cycles—in which case the market likely drops dramatically, or we are forever in an over-stimulated Narnia and the economy floats higher on repeated injections of stimulus. Given the binary nature of things and the risk to getting it wrong, I cannot think of a harder time to invest.

As a history major, I am reminded of other times that a country over-stimulated. Look at the chart below of the Venezuela Stock Market Index for a recent example of what happens when rates stay too low for too long:

I'm also reminded of 1929 and 2008 when an overvalued stock market met with a garden variety recession. Given the dramatic leverage in the system at the time, small changes in interest coverage ratios led to very dramatic changes in equity values where many companies did not make it to the other side. It is quite binary—which makes it so tough.

How do you navigate this environment? I want to have excess liquidity in order to be flexible and I want to own "long-shorts"—these are businesses that should do well in an economic crisis. These are businesses that do well when credit gets cut off to competitors who are in a worse financial position. We own quite a few of these in energy, shipping and default mortgage servicing sectors. If they stimulate and the market goes higher, these should still out-perform. If they don't force the market higher, these should also out-perform. Let's look at a few of these.

Position Review (top 5 positions at quarter end)

Our largest position at quarter end is our combined long position in the Euro and Canadian Dollar. I don't try to over-think currencies. Over the years, I have made a lot of money on currencies by eating, drinking, and traveling in various countries to get a feel for if it is "cheap" or "expensive" to be there. Over time, currencies tend to move in sine-waves where "cheap" places become "expensive" and "expensive" places become "cheap." This is due to global capital flows. I have felt that Europe and Canada were cheap for quite some time. During the second quarter, the charts gave us a set-up where we could risk a rather small amount to potentially capture this currency appreciation. There are many investors who play currencies with huge quantities of leverage—I am not one of those investors. I like to take a very-low torque approach to currencies, and our total exposure is roughly equivalent to our equity capital—a rather low-risk position compared to other global-macro funds—with firm stops in place as well. That said, I expect that over the next few years, the US Dollar will depreciate and other currencies will appreciate. I base this mostly on the fact that I feel like a king overseas with my US Dollars and the charts say that a reversal of this trend is underway.

I am reminded that when bullish news does not lead to an asset appreciating, bad news likely makes it go the other way. Over the past 3 years, the US Dollar has had every advantage possible, including; higher GDP growth, higher interest rate differentials, tax changes allowing overseas capital repatriation, overseas flight capital, international inflows into our equity markets and VC sector, etc. Despite all of this, the US Dollar has effectively made a giant head and shoulders pattern (see next page). While I don't like to fixate on charts much, I have found that they can give you good clues to entry points or obvious levels where you'd want to reduce your risk if you are wrong. In the case of the Canadian Dollar and Euro, the charts gave us both of these. We're effectively risking 2% to see what happens at a time when they're both quite undervalued and the macro says that we are at an inflection point.

It's worth noting that I do not intend for currencies to become a dramatic percentage of our overall performance over time. Rather, as the owner of equities, you need to denominate your account in some currency and it might as well be in an undervalued one so that you can pick up some accretion over time. Unless there are material changes to this currency position, I don't intend to update it each quarter and don't consider it to be one of our top 5 positions—despite the size. Rather, it's the currency that we choose to hold our equities in. (On a side note, this position is partly reflected through futures due to advantaged tax treatment and reduced interest rate leakage when compared with the spreads that our broker charges us).

Scorpio Tankers (STNG – USA) substantially beat Q1 earnings expectations and has been the primary prop to our performance in the second quarter. Since then, Q2 charter rates have softened and I anticipate that they'll miss Q2 expectations. I reduced our position by roughly half on account of this along with the roughly 50% gains in the share price since we acquired this position. If the shares decline, we'll add back what was sold; if not, we own a pretty meaty position as is. This is a play on IMO 2020, which states that starting January 1, 2020, all vessels will need to burn low-sulfur fuel. As a result, the demand for product tankers should increase dramatically, at a time when there is minimal new supply. I suspect that there will be real fireworks during the implementation period that starts to heat up in a few months. Even if there isn't, we came into this position at a bit over half of Net Asset Value. It was effectively a free shot on goal. So far, we've had very healthy returns on this position. If rates don't pick up dramatically in Q4, we'll exit. If we see strength, I intend to ride this for as long as possible. I have been in the markets for two decades now, and I can assure you that there is no bull market quite like a shipping bull market. A good strong shipping market will make Bitcoin seem tame by comparison.

Antero Resources (AR—USA) has been the primary detractor to our performance since the start of the year. The shares now trade for less than the value of their equity stake in Antero Midstream (AM—USA), meaning that you get the whole upstream business for free. While this upstream comes with some debt, it also comes with an attractive hedge book that is deeply in the money. My view on natural gas can be summed up as: eventually, credit will get cut off from unprofitable shale oil and dry gas players, and natural gas supply growth will slow or even contract on account of the rapid decline curves that exist in shale wells. This will all come at a time when US natural gas demand is rapidly expanding while a number of sizable LNG projects begin to export gas. This would seem to imply that while 2019 may not be the best year for gas prices, prices will recover—possibly quite dramatically as this thesis plays out. For AR, the worse it gets, the better it gets. This is because they are fully hedged for 2019 and almost fully hedged for 2020. Therefore, they can simply ignore what happens to gas prices and ride the recovery wave when gas prices recover.

In the past, the stock market would look at these facts, realize that AR was one of the few likely survivors and give it a premium valuation—looking through the chasm where it was hedged and into the blue sky beyond. Unfortunately, this has not played out as I had expected—particularly as a large PE fund has been a forced seller of a substantial position in the shares at a time when buyers are scarce due to fears of low gas prices—which as noted above, will bankrupt the competition and not impact AR. I would be remiss to gloss over weak current NGL pricing which has indeed impacted AR earnings and may impact future earnings as well. My view is that this is transitory, but I don't have complete confidence in this fact. Rather, I believe that NGL pricing will be much like natural gas pricing where demand is rapidly expanding and if no one is making money at current pricing, the competition goes bust first. Meanwhile, while NGL pricing is important to AR, recent weak pricing isn't enough to change the thesis—even if it persists indefinitely. At some point, investors will recognize that a handful of gas companies are going to be the winners of the coming wave of bankruptcies and these winners will diverge from the pack and sport premium valuations. Unfortunately, there is no way to know when this is—I just know that AR is unusually cheap and we've come into the upstream assets for less than free.

Sandridge Energy (SD—USA) has also detracted from performance in the second quarter. Sandridge is a producer of natural gas and oil that trades at less than 2 times enterprise value to EBITDA, despite currently-depressed commodity prices. Additionally, the company has minimal debt while the corporate headquarters is likely worth approximately half of the current enterprise value. Stripping out the corporate HQ, the shares trade for about 1 times enterprise value to EBITDA. These metrics make it one of the cheapest energy companies in my universe.

The company is using its cash flow to drill holes in Colorado at an oil asset that has repeatedly exceeded expectations. While I am not a fan of drilling holes when a stock is this cheap (they should be buying back shares), Carl Icahn is the largest shareholder and he controls the board. Icahn is one of the smartest financial operators over the past century and I feel confident that he will find a way to extract the obvious value here by proving up the Colorado asset and then selling off the pieces. Oil prices have increased since we acquired the position, hence the value of the assets have also increased—which should aid Icahn in his sale efforts. Despite this, the shares have continued to decline with the rest of the energy sector.

(Put Spread Position) Tesla (TSLA – USA) was a sizable addition to our performance during the quarter. We previously had January 2020, 200/100 put spreads. As the 100 strike puts decayed, I realized those short puts for sizable percentage gains. Then, when it became obvious that Q2/2019 deliveries would beat expectations, I chose to book the 200 puts before the delivery number was reported. While the stock had rallied nearly 20% from the lows, we still realized sizable gains on the position. More importantly, we avoided an additional 15% (and counting) rally in the shares. I have slowly been re-building our Tesla put position using June 2021 200 puts offset by January 2021 75 puts. Given the duration on these options, I believe we will almost certainly capture the ultimate implosion of this Ponzi-scheme. In an ideal world, the 75 puts would expire worthless and we will still have the opportunity to capture the full decline to zero with our 200-strike puts. More likely, Tesla implodes long before January 2021 and we make $125 on this position that cost us roughly $45 to put on.

I will admit to being somewhat infatuated with Tesla. You effectively have an automobile OEM, which is an amazingly awful business, that has no chance of hitting scale, increasingly facing technological obsolescence, with far too much debt, with a liar sitting on top of it. Add the fact that there are dozens of competing models all coming to market in the next few years and it should be obvious that Tesla is

the Blackberry of automobiles—popular when there were no other smartphones but easily beaten when better managed competition appeared. The only difference is that Research in Motion (owner of the Blackberry franchise) made a fortune when they had the dominant position in the sector. Due to stunning levels of incompetence, Tesla has never earned a sustainable profit and that is despite rather blatant accounting fraud that takes horrid numbers and makes them look more palatable to those who believe that there will one day be an inflection in the business. I have been early in my calls for Tesla's demise, but I am certain that the business will fail in a cataclysm of regulatory and legal chaos. It is only a question of when. Until then, we will continue to own long-dated put spreads and occasional trade around them depending on Musk's propensity to fake numbers and achieve artificial self-created milestones.

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. 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. Additionally, any recovery will have even further torque as the company continues to repurchase a few percent of the shares outstanding each quarter. During the second quarter, the Russell 2000 was an unusually large seller of ASPS shares due to its annual re-weighting of positions. Unfortunately, this happened on the last day of the quarter. As you can see in the chart below, once this forced selling finished, the shares rapidly recovered. Unfortunately, this hurt our fund's performance by a few percent during Q2.

Returning to the fund itself, at quarter end, we had 8 core positions (excluding currency exposures) and a few other smaller ones that were of minimal significance. We remain under-invested compared to my expectations. On one hand, this gives us increased flexibility should something interesting happen. On the other hand, unless something interesting happens in the market, we will be under-exposed to the market. Given our focus on long-term out-performance, I am fine with this situation. My experience is that most of the time, there is little to do and there are only a few good opportunities a year to make a smart decision. Every few years, you have a window where you can make multiple smart decisions. Those periods are the ones that determine overall performance, not the periods where you wait around with too much capital looking for a home.

Sincerely,

Harris Kupperman

Chief Investment Officer

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