PRAETORIAN CAPITAL

Q4 2019 Investor Letter February 3, 2020

TO THE INVESTORS OF PRAETORIAN CAPITAL FUND;

During the fourth quarter of 2019, the fund appreciated by 12.42% net of fees. Given our concentrated portfolio structure and focus on asymmetric opportunities, my expectation is that during most months, we will be up or down roughly 10%—followed by months where one or more positions move dramatically and impact overall returns. During the fourth quarter, we experienced the latter during December, as prior declines in a number of core positions reversed themselves while our sizable position in shipping greatly augmented performance. Finally, an investment in Stage Stores (SSI – USA) further amplified returns as it nearly tripled. (As I'm writing this to you at the end of January, it's worth foreshadowing that SSI proceeded to miss their guidance in early January and revert to the starting price of the investment—though we did manage to sell roughly a fifth of the position near the highs, and closed out the balance of the position for a small gain). Finally, our event-driven book produced a loss of a bit less than 1% to round out the puts and takes on the portfolio for the quarter.

While we ended the year up approximately 15% net, I remain disappointed with overall performance. Every year will have its winners and losers, but it is highly outside of my expectations that three of our top five positions will not work out (Antero Resources, Sandridge and Tesla puts) while we only have one true winner in Scorpio. Furthermore, I would expect that event-driven opportunities will produce a reasonably positive result throughout the year—unfortunately, during 2019 this was not the case as overall results were only a few hundred basis points positive. For whatever reasons, there simply were fewer attractive opportunities during 2019 and the ones that did show up tended to be on the long side, which I underweighted or didn't participate in as I remain bearish. While I cannot promise that we'll always be profitable in event-driven strategies, I feel relatively confident that their number will increase in future years as these things tend to go in cycles.

Turning to the global macro backdrop, economic conditions have continued to decline, although Q4's decline is masked somewhat by easy comps when compared to Q4 2018. In fact, it's likely that we are already in a recession here in the USA with many other countries experiencing similar difficulties. If you have any doubt on the state of economic affairs, just look at the prices for many critical commodities like oil, copper, zinc, lead, nickel, and coking coal, which cannot get out of their own way. These are the building blocks of an industrial economy. Even more surprising is that, despite Middle East turmoil and OPEC reducing production, oil prices have tumbled. Commodity supply doesn't grow rapidly, but demand can taper off in a hurry—this is what is happening as the global economy stalls.

As expected, the global Central Banks have once again come to the rescue of equity markets with a fresh dose of QE and interest rate reductions. That's great for large cap liquid securities, particularly if they are cross-owned by multiple equity ETFs, but what about the broader economy? Beyond a certain point, does monetary stimulus even help anyone outside of the financial sector? Globally, we've effectively reached "permanent QE." Next comes fiscal stimulus as politicians convince themselves that deficits no longer matter. The only current roadblock to fiscal stimulus is a fight over which politician gets to take credit for the spending and which groups benefit from this largess. Any way you slice it, this will all be highly inflationary.

Here in the US, the government has convinced us that inflation is abnormally low and contained. Yes, if you use hedonically-adjusted data, you may come to a similar conclusion. Unfortunately for most

consumers, they do not judge their iPhone on the cost per mega-pixel or relative computing power. Overall purchase price is the only variable that matters in their ability to afford something. If you turn to an alternative gauge of inflation like the Chapwood Index (https://chapwoodindex.com/) which surveys the cost of 500 consumer items in the 50 largest cities in America, you end up with the 5-year average rate of inflation at somewhere between 6.6% (Mesa, Arizona) and 13.1% (Oakland, California). No sampling model will be perfect and the Chapwood Index has its limitations, but I'd also argue that it has more bearing on the change in the cost of goods than US Government data.

Think back in economic history. Can you name me a country that collapsed from too low inflation? I can name you plenty that have collapsed from too much inflation. With governments around the world convinced that they want to create inflation, I suspect that they'll succeed beyond their wildest dreams—particularly as the Chapwood Index says that consumer inflation is already here. Why does all of this matter to us as investors in this fund?

As long as you have a flexible mindset and a sense of history, high or low inflation shouldn't matter to you as an investor. It's somewhat akin to the weather. If it's cold, you wear a jacket; if it's warm, you wear shorts. The only concern should be if your closet doesn't give you the right wardrobe to adequately cope. Fortunately for us, I've spent most of my life studying inflation and its effects on financial systems. Meanwhile, most of my fellow investors have focused their attention on investing in a disinflationary environment—likely leading to an unusually diverse set of mispriced opportunities for us over the next few years.

For the past three decades, we have mostly experienced a period where inflation has subsided while borrowing costs have declined in a surprisingly linear manner. This shouldn't be surprising, as low interest rates are themselves dis-inflationary since they lower the financing cost of equipment for producing most goods—leading to excess supply and lower costs. That said, these trends can easily reverse as the cost of a final good is only decided by basic supply and demand equation. Why has the price of oil declined for five years? Oil guys will drill shale wells like madmen and produce a product at a loss if financiers will let them have the capital to try—low interest rates incentivize a search for yield in risky places. Why has the cost of residential housing in most large cities gone parabolic? Because there's highly restrictive zoning and an elongated permitting process. Although both the oil and residential housing industries have excess liquidity and historically low cost of capital, housing has supply restrictions and oil doesn't, hence the reason that housing prices are up and oil is down. Of course, if demand for oil had expanded at a more rapid rate than supply, oil prices would have increased. Instead global GDP growth has been weak for an extended period of time and oil demand has not kept up with supply.

What will fiscal stimulus do to change this? Remember, in a supply and demand equation, the price of a good is based on the marginal demand. If the government is going to print money and consume stuff, it will force demand up for that good. Additionally, it will also force interest rates up as the government's demand for credit also increases (this is already happening in the repo market). This will end the greatest bond bull market of all time and create a healthy dose of inflation along the way. These things then feed upon themselves as higher interest rates lead to less supply, which increases inflation and leads to higher interest rates. Let me give you an example—will shale guys keep drilling if their borrowing costs go up? Probably. Will anyone lend to them if they can get an acceptable yield lending to the US government at the new higher rate? Probably not. Now you have supply destruction at a time that demand is increasing. This is all inflationary. Remember, this is all coming at a time when consumer inflation is already high. Is there any wonder that populist candidates in both parties are gaining increased market share amongst voters? Most consumers are getting squeezed—they have a

sense of who's doing the squeezing but don't know how to solve the problem. Therefore, they're directing their attention to various solutions—none of which is likely to help and most are likely to create added inflation making things worse. If you could inflate your way out of problems, Venezuela and Zimbabwe would be financial powerhouses instead of basket cases.

Enough with the economic theory, let's accept that inflation is coming. Returning to our portfolio and how this all will impact us, I want to own companies that do well when inflation is increasing and consumers are getting squeezed—not because I take pleasure in others' pain, but because I recognize that it is happening and my job is to profit from it.

The most obvious question is why we don't own the most widely-touted hedge against inflation--gold miners? What if I told you they don't really hedge inflation? Over time, gold mining is a giant earth-moving operation that uses a lot of steel, diesel, and manpower. In an inflationary environment, these inputs often increase at a roughly similar rate to the price of gold. There's the reason that the All-In Sustaining Cost (AISC) to produce an ounce of gold amongst the largest miners has increased from roughly $300 to $1,300 in the past 20 years. Along the way, you take on a host of geological, operational, geopolitical and capital allocation risk. The price of gold has increased 5-fold over my investing career and most large gold miners haven't appreciated at all—inflation isn't helping them. What about gold itself? I suspect that it appreciates at some number roughly in-line with the increase in inflation. Despite a lot of charts showing the price of gold tracking the Fed's balance sheet, I think the more important metric is how it tracks AISC. In the end, gold is a commodity that should be valued at the cost to produce it along with a very small return on capital to producers so that they can continue to invest in their business. I feel confident that gold will continue to appreciate, but barring a complete hyper-inflationary scenario, it will likely appreciate at a rate of return that is below my expectations for this fund. Instead, we want to own companies that leverage inflation in superior ways.

Let's talk about tankers as we have our largest exposure there. A tanker is a piece of capital equipment that depreciates to scrap value. In an inflationary environment, the cost for a new vessel increases as does the ultimate scrap value over a period of time. More importantly, as interest rates increase, the necessary charter rate to incentivize new vessel construction also increases. Let's do a bit of algebra here. Say you are going to order a VLCC that costs you approximately $100 million to purchase today with a BWTS and scrubber. Bankers will lend you 70% of the purchase price at 4%, but you need $30 million of equity. Finally, assume that the tanker depreciates for 20 years to an ultimate scrap value of $20 million. This works out to depreciation of $4 million a year. If your operating costs, including periodic dry-dock are $20,000 a day and you want to earn a 10% return on your capital, what charter rate do you need?

$30 million equity @ 10% ROE = $3 million of income

Divide $3 million by 365 days = $8,219 a day in required net margin

Costs are $2.8 million interest ($70m @4%) + $4 million depreciation + $7.3 million of operating expense (365 X $20,000) = $14.1 million cost or $38,630 a day

You need charter rates at $46,849 ($8,219 + $38,630) to earn your 10% return on equity

Now let's assume some new inflationary math is tossed into the mix and vessel costs and interest rates have increased. Your vessel now costs $120 million because steel costs have gone up due to inflation and borrowing costs are now 7%. Additionally, in a higher interest rate environment, 10% no longer

looks like an attractive rate of return for all the risks of shipping. You now want a 15% return on your capital. Finally, your $30 million in equity only gets you 83% of a vessel. Let's say you're a wealthy shipping magnate willing to put up the full $36 million you now need. Here's the new math:

$36 million equity @ 15% ROE = $5.4 million of income

Divide $5.4 million by 365 days = $14,795 a day in margin

Costs are $5.9 million interest ($84m @7%) + $5 million depreciation + $7.3 million of operating expense (365 X $20,000) = $18.2 million cost or $49,863 a day

You now need charter rates at $64,658 ($14,795 + $49,863) to earn your 15% return on equity or a 38% increase in rates.

I realize that there's some bad math here as there's $6 million more of capital at risk and in an inflationary environment, operating expenses likely increase along with scrap values. In any case, the key point is that charter rates need to increase dramatically before anyone starts building new vessels—which serves to constrict supply and allow rates to increase. Remember, humans like to anchor expectations. While shipping magnates tend to be gamblers, it's hard to get bankers to commit to lending on a $120 million vessel when it was $100 million a few years ago (a VLCC was only $85 million back in 2018). This means that supply will likely lag demand increases and lead to an elongated cycle. Meanwhile, as an existing vessel owner, you've locked in your vessel purchase price and interest rates at pre-inflationary levels. That increase in charter rates of $17,809 is all profit to you, or an added $6.5 million a year.

Needless to say, you make a fortune as inflation picks up and constricts new supply—leading to much higher rates. Even better, your leverage ratio looks lower and banks want to lend you money to buy more vessels and grow.

Why doesn't similar math work, for instance, on an office tower? Isn't it also a piece of capital equipment? Well, yes but it's currently being priced at a low single digit yield. Over time, higher interest rates will step-up everyone else's cost of capital and needed ROA to add supply, but that takes time. Meanwhile, in a higher interest rate environment, your cap rate expands and the asset value collapses, even before taking into account an increase in vacancy due to the economic distress caused by inflation. In periods of inflation, property does poorly, while shipping does well. They are two assets that are leased and look similar at first, but operate very differently in practice due to relative starting points. Additionally, we purchased our shipping companies at huge discounts to NAV (40-75% of NAV), while NAV is also rapidly appreciating due to vessel values increasing and retained earnings. Meanwhile, if an office building goes from a 4-cap to a 6-cap, it has lost half of its value—before any other impacts from vacancy. Cycle investing works, but it's critical to know where you are in the cycle.

In our portfolio of eight core positions at year end (seven currently) all but two positions should have positive leverage to inflation and neither of those two outliers are particularly large.

With this dissertation on inflation out of the way, let's move onto what we currently own.

Position Review (top 5 positions at quarter end)

Tanker Basket (DHT – USA, EURN – USA, STNG – USA, TNK – USA)

Going forward, rather than comment on individual tanker companies, I will focus on the sector as a whole, as we recently diversified the position into four core names. Tankers stocks rallied strongly all quarter and ended the year at their highs. This is a result of charter rates hitting multi-year and, in some cases, decade highs. Our tankers were able to earn extra-ordinary rates starting in October 2019, with elevated rates continuing at least until early March when a lot of recent bookings run out. While rates have fallen off over the first few weeks of January, they remain dramatically above 2019 rates—likely leading to a full year of excess profits. Based on my models, our tanker holdings trade for somewhere between one and three times 2020 cash flow. More importantly, with monthly earnings running at mid-single digit percentages of total market cap, they're rapidly de-leveraging.

I have been baffled at why tanker stocks have not performed better during 2019 and the repeated refrain is that the rates are unsustainable. The prevailing view is that rates will decline, but I don't see how this is possible as the fleet continues to age, demand continues to grow, and the forward order book is at the lowest level it has been at in years. Even if you order a tanker today, it will be almost two years until it is delivered. During this two-year window, the tanker companies that we own can easily earn many times their current market caps if rates increase from here. I don't know when people will realize that current rates are not only sustainable but likely to increase, but it will happen eventually. In the interim, with debt rapidly being paid down, the next step is capital returns to shareholders in the form of dividends and buybacks that hopefully should re-rate the valuations of these companies.

I would be remiss if I didn't point out that in early January, I sold our call options on Scorpio along with roughly a quarter of our share position and used the proceeds to buy shares of DHT, Euronav and Teekay Tankers. At the prices that we reduced our position in Scorpio, it had appreciated almost 125% in the year since we purchased our shares. Reducing this position isn't in any way a criticism of Scorpio, which has been a great performer for us—rather it's a recognition that Scorpio has dramatically outperformed many tanker peers and it made sense to diversify our tanker basket as many of the others are now dramatically cheaper on multiple metrics.

Stage Stores (SSI -USA)

We purchased shares of Stage Stores in late November on news that their plan of converting from a dying department store chain into an off-price retailer was gaining traction. In addition, management guided to pretty dramatic growth in Q4 same store sales and EBITDA on top of rather impressive Q3 results. In early January, Stage missed management guidance by a mile. When I met the CEO at ICR in January, just after they released results, he couldn't explain why they missed and was highly evasive as to how the conversion process was going. I subsequently liquidated the position at a slightly higher price than where we originally purchased the position. Fortunately, we sold approximately a fifth of our position in the mid $8's which was roughly two and a half times what we had paid for the shares a few weeks earlier. Clearly, I was a bit too optimistic or I would have sold a larger percentage of the position after such a rapid advance in the share price. Then

again, how often does a company dramatically raise guidance after an incredible quarter and then miss their own guidance just one month later?

The important fact is that despite getting the thesis wrong, we made roughly 30% on the investment—largely as a result of selling part of the position near peak pricing. Everything I do in this fund is founded on the principle of asymmetry—which means risking very little to make a lot. Even when wrong, I would expect us to mostly get our money back. Stage Stores was priced for death when we purchased it. When the thesis didn't pan out, it went back to where it started and we got our initial capital back plus some—asymmetry in action.

Altisource Portfolio Solutions (ASPS—USA)

Following our sales of Scorpio to diversify and Stage stores, Altisource is our largest single equity position. As there has been no news since Q3 earnings, I have little to report here. However, given my discussion on inflation above, I'd be remiss if I didn't point out that as consumers get squeezed by inflation, they tend to fall behind on their mortgage payments—which would dramatically benefit Altisource.

Sandridge Energy (SD—USA)

I have clearly been early on Sandridge, but I don't believe I am wrong in terms of the initial valuation that I underwrote the investment at. That said, the company has continued to make capital allocation mistakes—which is odd as Icahn doesn't often make mistakes. I suspect that there will be some sort of corporate action here as Icahn recently removed the under-performing CEO. Then again, weak energy prices aren't exactly helping Sandridge. Fortunately, there is almost no debt and adequate cash flow, even at today's energy prices, making Sandridge quite undervalued. We may have to wait and I'll admit that there may not be the same sort of upside that I originally underwrote when I made the investment, but I suspect that at today's prices, Sandridge remains highly mispriced.

Uranium Participation Corp (U – Canada)

Uranium is a globally traded commodity that trades for roughly half the marginal cost to produce it. Over the past few years, a number of uranium mines have been shuttered due to low prices, and today there is an annual deficit of around 30 million pounds against roughly 200 million pounds of annual demand. There are above-ground stocks, but they are depleting and US utility inventories are now approaching historic lows. Additionally, we will see less byproduct uranium as SWU pricing has increased, leading to a decrease in underfeeding, which will put further strain on the annual uranium deficit. I don't know when the price of uranium increases to the price of production, but I know it eventually will. Furthermore, I suspect that it will likely overshoot on the way up. Remember, a nuclear power plant is a very expensive paperweight without uranium—likely leading to panic buying as the price increases due to the supply deficit. Unlike owning a uranium miner, Uranium Participation Corp owns physical uranium and has a carrying cost of 80 basis points a year—giving us a very long-dated call option on what happens to the price of uranium. Returning to my AISC example in gold above, I assume that the uranium price will also track AISC over time and if I had to choose to own uranium or gold, I'd much rather own the one that is trading at half of AISC.

In summary, 2019 was a year where the fund under-performed my expectations. There are a variety of reasons for this but most were self-inflicted. Investors like to say they "stepped on a landmine" when describing a bad investment. For whatever reason, during 2019 I spent a good part of the year dancing in a minefield. Despite this, we ended the year with a positive performance result due to asymmetry from our tankers and a few smaller positions that have escaped mention.

I feel strongly that we are well positioned for whatever may come in 2020 and I want to thank you for your confidence in me during this fund's first year of operation. Being chosen to deploy your capital is a great honor and responsibility—neither of which I take lightly.

Sincerely,

Harris Kupperman

Chief Investment Officer

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