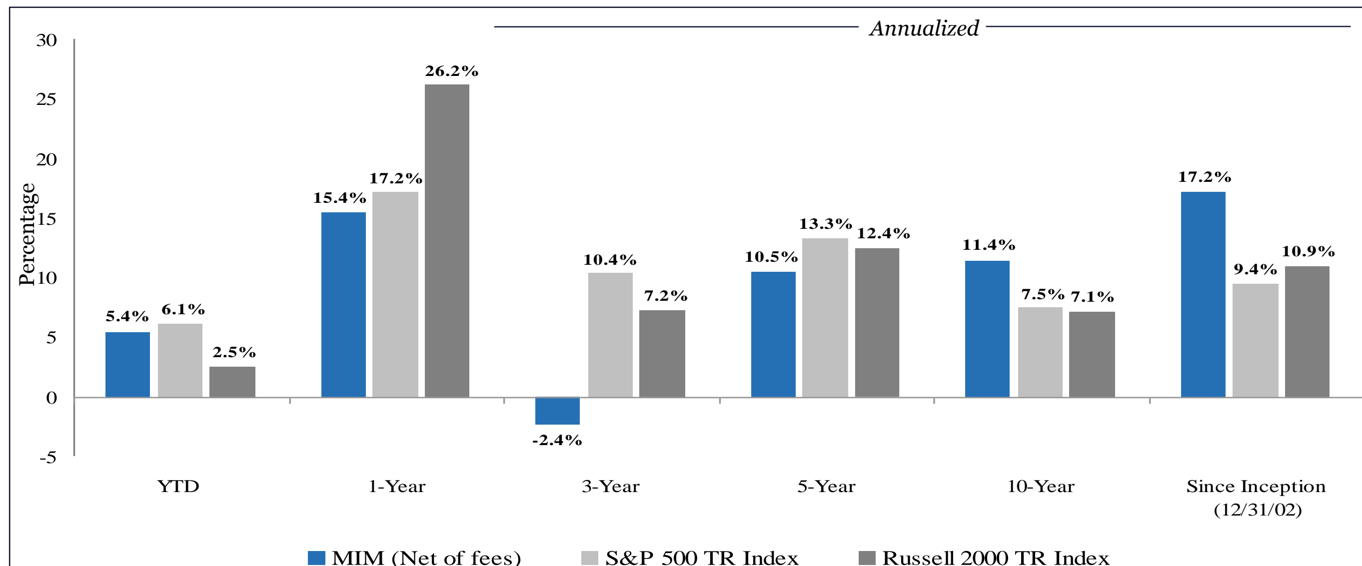
Chief Investment Officer Commentary – 5/1/17

Mittleman Investment Management, LLC's Composite gained 5.4% net of fees in the first quarter of 2017, versus advances of 6.1% in the S&P 500 Total Return Index and 2.5% in the Russell 2000 Total Return Index. Longer-term results for our Composite through 3/31/17 are presented below:



The top three contributors to our Q1 2017 performance were **Jardine Strategic Holdings (JS SP)**: $33.20 to $42.00 (+27%), **KB Financial Group (KB)**: $35.29 to $43.97 (+25%), and **Intralot S.A. (INLOT GA)**: $1.07 to $1.31 (+22%).

The three most impactful detractors from our Q1 2017 performance were **International Game Technology (IGT)**: $25.52 to $23.70 (-7%), **Revlon Inc. (REV)**: $29.15 to $27.85 (-5%), and **Gazprom PAO (OGZPY)**: $5.09 to $4.50 (-12%).

Q1 2017 started on a strong note as our foreign holdings began to react as if a potentially stronger U.S. economy might not be such a bad thing for the rest of the world after all, and thus we were up over 9% by early February. But as the Ides of March approached our two biggest holdings, Revlon and IGT, were pummeled after each reported weaker than expected results for Q4 2016. We believe those price declines were unwarranted over-reactions, as we explain below. Nonetheless, our end of Q1 2017 performance came in at a more subdued +5.4%, versus +6.1% for the S&P 500, and +2.5% for the Russell 2000. Two steps forward, one step back, but decent forward progress even so.

International Game Technology (IGT), the #1 lottery and #2 slot machine business in the world, reported Q4 2016 results on March 9th that were slightly worse than expected, and also offered guidance for 2017 of adjusted EBITDA of $1.68B to $1.76B, versus consensus expectations of $1.78B to $1.82B, that is a 5% reduction at the midpoints. The main cause of the weakness was their social gaming division, which entices people to pay real money for virtual chips on various online casino games encountered on social media websites such as Facebook. This small subsidiary called DoubleDown Interactive, which at $62M in Q4 2016 revenues was less than 5% of total IGT sales of $1.32B for that quarter, was acquired by IGT in 2012 for $500M in cash. After losing market share to competitors like Scientific Games for the past couple of years, and punctuated by the very weak results in Q4 2016, IGT announced on April 17th that it is selling DoubleDown Interactive for $825M cash (10.5x EBITDA of $79M in 2016) which looks like a great exit value for such a poorly performing business.

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The buyer of IGT's DoubleDown Interactive unit, a publically traded South Korean company called DoubleUGames (192080 KS), will also pay royalties to IGT for any IGT casino games that DoubleUGames chooses to use on its social casino platforms. We think this is a very smart move by IGT, as they are selling their worst performing business for 10.5x EBITDA while IGT's stock is trading at only 7.5x EBITDA, and using that cash to de-lever the balance sheet; a highly accretive maneuver. Before the announcement of the DoubleDown unit sale, IGT's management estimated net debt of $7.7B at year-end 2017. We estimate after-tax proceeds of the $825M sale at $730M, reducing net debt to $6.97B, or 4.2x adjusted EBITDA of $1.65B for 2017. For comparison, IGT's smaller competitor Scientific Games (SGMS $23.65) carries net debt of $8.06B against consensus estimated EBITDA of $1.18B for 2017, for a 6.9x leverage ratio. Regardless, the lower 2017 EBITDA number expected for IGT reduces our estimate of fair value from $37 to $32. We arrive at $32 by applying the same EV/EBITDA multiple at which SGMS trades today, 8.5x, to our estimate of IGT's adjusted EBITDA for 2017 of $1.65B (post DoubleDown sale), which is an EV of $14.03B, minus net debt of $6.97B, minus minority interest of $580M, equals equity value of $6.48B, divided by 202.4M shares outstanding = $32.00 per share. That is a market value of 16x our reduced estimate of IGT's normalized free cash flow at $400M (down from $500M), still more than enough to cover IGT's $162M cash dividend ($0.80 per share annually) which gives the stock a 3.4% dividend yield on the quarter-end price of $23.70, plus 35% upside potential just to reach a parity valuation with SGMS on EV/EBITDA. Looking out to 2018 we'd expect to be targeting $35 for fair value by then as we expect EBITDA and FCF to rise slightly in 2018.

We continue to like IGT because of its global leadership in the lottery business (42% of sales, whereas SGMS gets only 27% of sales from lotteries). It's a global franchise with immense barriers to entry, a high EBITDA margin (34% in 2016), and very predictable cash flows. Their recently renewed concession to run Italy's Lotto lottery, their biggest single contract, will run for another 9 years, and their top 20 North American lottery contracts have an average remaining life of 8.5 years. In the U.S. alone $70B is spent annually on lottery tickets industry-wide. Lottery ticket sales drive about 25% of total sales for convenience stores like 7-11, not just from the roughly 5% cut the stores takes on each ticket sale, but from the other items the lottery ticket buyer picks up while he or she is there. So it seems strange that the market awards convenience store chains like Couche-Tard and Casey's General Stores with a 10x EBITDA multiple on their 7% EBITDA margin businesses, while IGT, the largest facilitator of a key product line for those chains, with a 34% EBITDA margin, wallows at 7.5x EBITDA.

Also, IGT's slot machine business, which was the weak spot in 2015, seems to have stabilized and may grow again. Gambling and lotteries are a source of incremental revenue for over-leveraged state governments; a sort of regressive tax to be sure, but a tax that the population seems to enjoy paying, and that can often promote tourism. That should lead to growing demand for IGT's products and services over time. Japan is legalizing casinos (targeting a 2022 opening) which should be a very large new market. We think legal sports betting is coming to the U.S. at some point, and buying lottery tickets from an iPhone or betting on a favorite sports team that way will eventually be pervasive and expand the market to the younger generation. We also have confidence that IGT's controlling shareholder, outstanding investor Marco Drago, age 70, of the De Agostini SpA private equity fund of Italy, with a 52% stake in IGT's shares, will continue to push the company toward maximizing shareholder value, as highlighted by this fairly miraculous sale of their troubled DoubleDown Interactive business.

The other major depressant weighing on our Q1 2017 results was **Revlon (REV)**, which we discussed in our Year End 2016 Investment Review when it was our worst performer of Q4. Their Q4 2016 report released on March 3rd showed an accelerated rate of decline for Revlon's North American consumer sales, which account for 31% of total sales ($882M pro-forma 2016 sales out of $2,859M total). Despite the very weak result from that segment, growth in international sales and their professional segment led to a 2016 annual report of total pro-forma net sales of -0.6%, and +1.4% on a constant currency (XFX) basis.

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We believe that the recent sell-off in Revlon's share price is an overreaction to what should prove to be surmountable domestic headwinds, while ignoring impressive international sales growth, and that Revlon continues to trade at an unwarranted discount to its peers. It also remains an obvious takeover candidate that would likely yield a significant valuation premium in the event its controlling shareholder, Ron Perelman, elected to sell the company. We suspect that he may have tried to do just that when his holding company, MacAndrews & Forbes, announced it was exploring "strategic alternatives" for its 77% stake in Revlon in a press release on January 16, 2016. That he perhaps failed to find a buyer willing to pay his price at that time does not mean that he won't eventually be successful in that effort, so we speculate that after owning Revlon since 1985, Perelman, now 74, might be edging closer to selling.

Our current situation with Revlon seems somewhat analogous to a position we held in **Playtex Products Inc. (PYX)**, from 2001 until 2006. While at a prior firm, I, with clients who became the foundation of Mittleman Brothers LLC upon its founding in December 2005, had been buying Playtex at around $10 per share in 2001 and 2002 estimating it was worth $15. The largest shareholders, Haas Wheat & Partners (who bought 20M shares (32%) directly from the company in 1995 at $9 per share) and Blum Capital Partners (16% stake at $9.50), presumably caused the company to hire J.P. Morgan to explore "strategic alternatives" in late 2002, but no deal materialized. Then the business had a very bad year in 2003, with its tampon segment (35% of sales) under attack from an aggressively promoted new product launch by Tambrands (Tampax Pearl) owned by Procter & Gamble, and their Banana Boat sun tan lotion business (15% of sales) suffering from a severe bout of inclement weather across the country. Sales dropped 10.5% in 2003, EBITDA fell from $164M to $108M, and FCF from $61M to $29M and we were buying more shares as low as $5.60 while I wrote letters explaining to clients that all was not lost, as PYX's net debt to EBITDA ratio soared from 4.9x in 2002 to over 7.3x on the depressed EBITDA of 2003, requiring a debt covenant modification. EBITDA had only recovered to $133M by 2005, but we were still able to sell our shares around $14 to $15 in late 2005/early 2006, a solid gain on our lowered average cost of about $7.75 per share. A year and a half later in the Summer of 2007, the company was acquired by Energizer Holdings for $18.30 per share, a 13.7x EBITDA multiple. The lesson here being that just because a sale process doesn't produce the desired outcome on the first attempt, that doesn't mean it won't happen eventually (in this case five years later, but clearly worth the wait), especially if the business in question is a market leading brand of consumer product.

Back to Revlon; in acknowledgment of the continued weakness in their North American consumer sales during the past four quarters, we have lowered our estimate of adjusted EBITDA from $500M to $450M for 2017, and normalized FCF from $175M to $150M, so our minimum fair value estimate for 2017 drops from $76 per share to $65.

Our estimate of minimum fair value for Revlon of $65 is based on an EV/EBITDA multiple of 13.5x estimated 2017 adjusted EBITDA of $450M which is EV of $6.08B, minus $2.47B net debt, minus $184M pension deficit, equals $3.42B equity value, divided by 52.6M shares outstanding equals $65 per share, and a market cap/FCF multiple of 23x estimated $150M in normalized (ex-restructuring charges) free cash flow for 2017. 13.5x EBITDA is the multiple Coty (COTY $17.83) paid for its $12.5B purchase of Procter & Gamble's beauty brands (including Cover Girl) in October 2016, and Coty itself, at nearly a 52-week low now, is still trading at 13.3x EBITDA based on calendar 2017 consensus estimate of $1.42B, despite performing much more poorly than Revlon in their U.S. mass market business during 2016.

Revlon is a global (42% of sales from outside North America) purveyor of cosmetics to the mass market (Wal-Mart, drug stores like Rite Aid, Walgreens Boots, etc.) with significant market shares in key product categories of color cosmetics (#1 market share in lipstick, foundation, eye liner, and lip liner), nail polish, hair color, and beauty tools. The company entered the prestige market with its recent acquisition of Elizabeth Arden (RDEN), for which it paid about $900M upon closing on 9/8/16, funded entirely by debt. Due to Elizabeth Arden's subpar profitability, Revlon was able to acquire it at a bargain

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valuation of just under 1x sales (RDEN did $966M revenue in 2016), whereas most cosmetics firm takeovers happen at 2.5x sales. And some even get done at 3.2x sales, like Johnson & Johnson's (JNJ) buyout of Neutrogena (NGNA) in October of 1994 for $942M, which was a whopping 19x EBITDA of $50M, a 17% EBITDA margin on $295M in sales.

Revlon expects to achieve huge cost savings in the merger, and recently increased their initial target of $140M in annual cost synergies to $190M, to be realized in 3 to 4 years, at an incremental cost of $250M in cumulative restructuring costs, integration costs, and integration-related cap-ex, also spread out over 3 to 4 years. That would imply Revlon is paying only 4.9x EBITDA post synergies for RDEN ($900M initial cost, plus $250M in costs to achieve synergies = $1,150M total cost, / $235M in 2020 EBITDA ($45M in 2016 + $190M in annual synergies). For example, moving RDEN's outsourced manufacturing into Revlon's under-utilized (one million sq. ft.) factory in Oxford, North Carolina will account for a significant part of the cost savings.

Revlon's business is highly recession-resistant, with historically resilient EBITDA and FCF to support its highly leveraged balance sheet (net debt = 5.5x our $450M estimate for adj. EBITDA in 2017, and 6x 2016's pro-forma adjusted EBITDA of $409.4M), a leverage ratio we expect to drop as the company pays down debt from free cash flow.

Revlon, founded in 1932, is an iconic brand with decades of resonance across multiple generations of consumers. The addition of Elizabeth Arden, a 107-year old brand rebounding now (2016 RDEN pro-forma sales +0.4%, +1.8% XFX) after a fall from grace, opens up new channels for growth, particularly in Asian markets where RDEN is growing fast. The concept of merging mass market brands with prestige brands under one roof has been achieved successfully by Revlon's peers (L'Oreal bought Maybelline for 14.7x EBITDA in 1996; Coty also has both prestige and mass market brands) so Revlon is not pioneering an unproven strategy in that regard.

New Revlon CEO Fabian Garcia took the helm in April 2016 with extensive cosmetics experience at Procter & Gamble (Max Factor), Chanel, and more recently was COO and in charge of Global Innovation at Colgate-Palmolive. He appears to be the most qualified CEO to run Revlon in the past nearly 32 years since Perelman took control. Garcia recently stated a goal of $5B in sales in 5 years (from $2.86B pro-forma sales in 2016), implying a very ambitious 12% CAGR versus the 5% long-term industry average, a goal that we think will require further successful M&A activity in order to achieve. https://www.bloomberg.com/news/articles/2017-01-17/revlon-sees-long-term-growth-with-revitalized-brands-marketing.

That goal seems even more bold in light of the recent category headwinds afflicting large mass market cosmetic players in the U.S. such as Coty and Revlon, as well as the shrinking department store sales base weighing on a large chunk of Elizabeth Arden's prestige business. Those two components of weakness combined to cause 51% of Revlon's total sales in 2016 to decline (Revlon's N.A. consumer sales at 31% ($882M) pro-forma 2016 sales out of $2,859M, and Elizabeth Arden's N.A. sales at 20% ($573M) pro-forma 2016 sales out of $2,859M, while the other 49% of total sales (Revlon's international sales (consumer + professional) at $805M (28% of total sales), Elizabeth Arden's international sales at $393M (14%), and Revlon's North American professional / salon (hair care and nail polish) at $205M (7%), grew fast enough in 2016 to offset the declining segments (on an XFX basis). Even if these trends remain unchanged for some time, it appears that the company can still achieve some degree of organic growth, particularly if recently increased marketing spend and innovative new product launches underway prove effective. And with the USD finally weakening a bit in Q1 2017, the international business should get an added boost from that, so that more of their strong foreign sales growth benefits the company on an actual basis, not just when viewed XFX.

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The explanation for the adverse trend in Revlon's North American consumer mass market business is primarily that for the past few years, there has been a shift in sales in the U.S. cosmetics industry away from the mass market channels (drug stores, Wal-Mart, Target, etc.) to specialty stores (Ulta and Sephora) and with that shift, a trend towards premiumization, meaning consumers are paying up for prestige products such as Urban Decay (owned by L'Oreal), MAC (owned by Estee Lauder), and Benefit Cosmetics (owned by LVMH), while leaving behind cheaper mass market brands like Revlon, Coty (Rimmel and Cover Girl), and Maybelline. So instead of paying $5 for Revlon lipstick (where Revlon maintains a #1 market share), many defecting customers are paying $20 for Urban Decay lipstick and comparable prestige brands at Sephora and Ulta. We think Revlon's answer to this challenge, at least in part, is to bring more feature rich product line extensions (lipstick infused with natural oils, etc.) into those growing channels such as Ulta at higher price points, which Revlon appears to be doing, in a sense meeting the customer half way with a $10 lipstick in Ulta competing against $20 lipsticks, but $10 is significantly more than their base $5 lipsticks sold in the drugstore chains. The answer also lies in further innovation (like the company did with Shellac nail polish, a category killer when it came out in 2010), as well as more recent innovations in product features and form factors, albeit less impactful so far. However, they need to accelerate their time to market for new launches, and the new CEO, Fabian Garcia, has a good track record with innovation as his previous job was COO: Global Innovation & Growth, at Colgate-Palmolive, a position to which he ascended after running their Asia business since 2003, and Latin America since 2007. He also ran Chanel's Asia Pacific business from 1996 to 2001. So, we think they'll do better at innovation starting now.

In addition, the online sales channel is taking share away from the traditional mass market outlets and Revlon has yet to perfect their online strategy, although the newly acquired Elizabeth Arden has done much better in online penetration and Revlon hopes to adopt some of their best practices in that critical area.

The shift away from the mass market channel accelerated throughout 2016, with Revlon's North American consumer sales -0.5% in Q1 2016, -1.3% in Q2 2016, -5.3% in Q3 2016, and -9.0% in Q4 2016 (again, not only a Revlon issue, as Coty did much worse in the N.A. mass market channel last year) and seems to be continuing in Q1 2017, albeit at a moderating rate which looks like -6% in Q1 2017 judging from the Nielsen's trailing 12 week data as of 3/25/17.

Some of the sales decline in Revlon's N.A. consumer segment is also due to competition within the mass market channel, such as the recently IPO'd e.l.f. Beauty (ELF $27.44), which has been taking share in the mass channel by accepting a lower gross margin using manufacturing outsourced to China and undercutting on price, and using a highly effective internet / social media advertising strategy to gain awareness and shelf space.

And yet according to IRI, Revlon still occupies the top spots in foundation, lipstick, lip liner and eyeliner. And although barriers to entry have fallen and a proliferation of new niche competitors has eaten away at the bigger players in the mass channel (Maybelline, Revlon, Cover Girl primarily), it remains to be seen which of these new brands will have staying power. For example, The Body Shop was once the hot up-and-comer from 1990 to 2001, before stagnating in the early 2000s, and now L'Oreal is trying to sell it after buying it in 2006 at 12x EBITDA. Or Richard Branson's Virgin Cosmetics line, which only lasted from 1997 to 2009. How long until reality TV star Kylie Jenner's $300M in cosmetics sales in 2016 revert back to established players? It should also be noted that the prestige brands don't do so well during recessions, while the mass market brands usually show impressive resilience. So while Estee Lauder (EL) saw a 7.3% decline in sales in 2009 during the Great Recession, Revlon saw a 3.8% decline (all due to currency), with EBITDA and FCF actually increasing in that year. Thus the trend toward premiumization as traditional mass market buyers shift their spending upmarket might reverse if we ever encounter another recession, as the value proposition of the traditional mass market brands might see renewed appeal amidst a likely shakeout amongst the recent flood of new entrants as most of these smaller brands face their first test of staying power.

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But rather than waiting for a recession, Revlon should find that their plan to increase brand support and innovation will have significant positive effects on sales. In 2014, Revlon increased brand support by 10.8% (+$38.1M) versus 2013, from 18.5% of sales in 2013 to 20.01% of sales in 2014, and that appears to have boosted N.A. consumer sales significantly in both 2014 and 2015, before the 2016 decline began. We guesstimate (the company wouldn't provide a specific number here when asked) that marketing spend will increase from about 20% of sales in 2016 to 22% in 2017, an increase of $57M (the large legacy players in cosmetics generally spend 20% to 30% on advertising and promotion) consuming much of the cost savings we expect Revlon to realize in 2017 from the Elizabeth Arden acquisition. But if history is any guide, that should give sales a noticeable boost of some multiple of the incremental dollar amount spent.

More on the Elizabeth Arden acquisition: While two segments of Elizabeth Arden's (RDEN) business have been in sharp decline, the rest has been growing fast enough to offset that decline. RDEN's 2016 pro-forma adjusted sales were up 1.8% XFX to $966M, with growth in skin care and color cosmetics offsetting a decline in celebrity fragrances, and international sales growth (+6.6% XFX) on 41% of RDEN's total sales offsetting North American weakness (-1.4% XFX) on 59% of RDEN's total sales. So, RDEN, misperceived by some as a dying dinosaur, as a whole it clearly does not appear to be dying.

The part of Arden's business that may actually be dying is the "young celebrities" fragrance business (Justin Bieber, Taylor Swift, and others whose fragrances exhibited fleeting popularity), which imploded over the past few years, dragging RDEN's overall sales down 28% over the past 3 years from $1.34B in FY 06/30/2013 (adj. EBITDA $162M) to $967M in FY 06/30/2016 (adj. EBITDA $24M). That aspect of RDEN had always been a significant risk, and was a major reason why we chose to avoid investing in RDEN, as it just seemed obvious that the celebrity fragrance lines were problems waiting to happen. But Revlon swooped in after that portion of the business had already been reduced to rubble, and it now represents only 5% of RDEN's total sales. RDEN has other celebrity fragrances beyond the "young" ones that had been the main problem, but those are with older celebrities like Elizabeth Taylor, Christina Aguilera and Britney Spears which seem to have a more stable sales profile due to the iconic status of the celebrity. RDEN also has a substantial designer fragrance business, which has been growing nicely with names like John Varvatos and Juicy Couture, doing particularly well in Asia. It's also important to note that RDEN was not alone in terms of suffering in the fragrance business during that time frame. For example, New York, NY-based Inter Parfums Inc. (IPAR) saw its sales drop from $654M in 2012 to $469M in 2015 (a 28% drop, same as RDEN's), before rebounding 11% in 2016. And IPAR at $35.45 today trades at an enterprise value of 2x sales and 12x EBITDA with a 15% EBITDA margin.

As discussed above, Revlon paid less than 1x sales for RDEN. Of course, not all sales are created equal. RDEN was terribly managed prior to the acquisition with a bloated cost structure, and barely profitable, with adjusted EBITDA of only $24M in RDEN's FY ended 6/30/16, a paltry 2.5% EBITDA margin in an industry that typically does not achieve less than a 15% EBITDA margin. That metric implies that Revlon paid an obscene 38x EBITDA if one uses that trailing 12 month measure. But for calendar year-end 2016, RDEN's EBITDA was $45M, so now the EV/EBITDA multiple appears to be closer to 20x, before synergies: still too high. But as previously mentioned, if they achieve targeted cost savings and adding one-time costs to achieve them into the purchase price, Revlon will have paid only 4.9x EBITDA post synergies for RDEN ($1,150M total cost / $235M in 2020 EBITDA ($45M in 2016 EBITDA + $190M in annual synergies)).

Looking beyond the trailing twelve months, or the immediately prospective twelve months, rather than overpaying, Revlon appears to be getting RDEN at a very low valuation that should be hugely accretive to Revlon's intrinsic value per share. Even if we only look at 2017, if we add Revlon's low-end expectation for the portion of the total $190M in annual cost savings on RDEN to be realized in 2017, that is $45M, plus RDEN's $45M in EBITDA for 2016 presumed flat in 2017, totaling $90M in EBITDA for RDEN in 2017, then Revlon will have paid just over 10x. As a reference point, Inter Parfums

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is trading at 12x EBITDA today, and Coty at 13.3x calendar 2017 EBITDA est., and Coty is currently performing more poorly than any of these businesses. So again, rather than overpaying as a cursory look might lead one to believe, Revlon's opportunistic buy-out of RDEN looks like an unusually accretive deal. And Revlon was uniquely positioned to do that deal given it's huge manufacturing facility in North Carolina has the excess capacity to bring much of RDEN's outsourced manufacturing back to the U.S., saving a lot of EBITDA margin in the process.

The other declining segment of RDEN's business is their North American department store sales (due to store closures by Macy's and the like), which is the bulk of their North American sales (vs. their online sales which are growing in N.A. and spa and specialty store sales (Ulta, Sephora) also doing better), and N.A. sales are the bulk (59%) of RDEN's total sales. But if RDEN's international sales (41% of total sales) keeps growing at 6.6% as in 2016, and N.A. sales keep shrinking at 1.4% as in 2016, that's still 1.8% annual growth rate overall, improving each year as international sales would overtake N.A. sales in 5 years if such annual rates persist. Obviously either trend could get worse or better, but that's the risk we take, and at a valuation of 9x normalized FCF for Revlon right now, and less than 9x EBITDA, it remains a very good risk / reward ratio.

In addition, Coty has performed much worse in each of the last two quarters than Revlon. Revlon's Q4 2016 had sales -4.5% (-2.7% XFX), but much better than Coty (COTY) which reported a few weeks prior at -7% (-4% XFX) in the same period. And looking at just their consumer (mass market) business, although they don't break out N.A., overall (globally) Coty was down -11% XFX, versus -3.3% XFX for Revlon's global consumer segment in Q4 2016. And yet Coty at $18.13 on 3/31/2017 is trading at 13.3x EBITDA for CY 2017 and 20x FCF, multiples that if applied to Revlon today would put the stock at $57 to $63, more than double the March 31st price of $27.85.

We started buying Revlon at $10 in December 2010. The stock was $27.85 on 3/31/2017, down from an interim peak of $41.67 in April 2015. Revlon's stock is highly volatile, and had just moved up from approximately $27 to $37 before this recent weakness. The small float allows short term swings in sentiment to weigh more heavily on the share price than it would for a more liquid stock.

In terms of sales, EBITDA, and FCF trends, sales in 2010: $1,321M. EBITDA in 2010: $257M. Free cash flow: $82M. Sales in 2016: $2,859M (pro forma). EBITDA in 2016: $409M (pro forma, adjusted). Free cash flow: $140M (excluding $80M non-recurring expenses related to acquisition of Elizabeth Arden and associated restructuring).

That is a total of 6 years (24 quarters) that have been reported during the course of our ownership, and sales have been down in 8 of the 24 quarters, so 35% of the time Revlon showed a decline in quarterly sales, and 65% of the time they showed increasing sales on quarterly basis.

And while almost all of Revlon's net growth has been through acquisitions, the two major acquisitions (Colomer Group in 2013, Elizabeth Arden in 2016) have been done at very attractive multiples (sub 9x EBITDA) and highly accretive to intrinsic value per share in our estimation, both funded entirely with debt. There should be opportunities for further such accretive deals in the coming years as a shakeout of some magnitude is likely the reaction to this recent surge in new brands over the past few years.

Even if sales for the overall company remain relatively flat in 2017, EBITDA and FCF should grow significantly as cost savings from the Elizabeth Arden merger are only partially consumed by increased marketing spending. And the international growth story is really overlooked here, as the opportunities for Revlon to further penetrate in Asia and Latin America in particular are significant and near term. And while Elizabeth Arden may be considered "your grandmother's cosmetics company" by many in the U.S., in Asia the brand is considered much differently, and a re-launch of the brand here is coming.

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Revlon had been woefully late to embrace the social media influencers and e-commerce in general, but they've taken steps recently to address that, using Instagram and YouTube influencers much more noticeably:
http://www.elle.com/beauty/makeup-skin-care/news/a42803/revlon-taps-beauty-influencers/

It's encouraging to note that Revlon was once before late to embrace a major media shift but then caught up. In the early 1950s, Revlon's founder, Charles Revson, didn't want to use the new medium of TV for his ads (he prefered print) because TV at the time was in black and white and he wanted to sell with color, and back then you had to sponsor an entire show, and if you picked a dud, the effort was wasted. But then Revlon lost their #1 market share position in lipstick to an upstart called Hazel Bishop which grabbed 25% market share from 1950 to 1953 by sponsoring "This is Your Life" a very popular TV show at the time. Revlon ultimately got into the TV game by sponsoring "The 64,000 Question" which became a huge hit and brought Revlon's market share back up beyond its prior high, and while Revlon is still (more than 60 years later) #1 in lipstick and other lines, Hazel Bishop is a distant memory... The story is here: http://www.cosmeticsandskin.com/cdc/question.php

Now obviously Revlon got very lucky back then, but the point is, the first mover advantage in embracing new media doesn't always mean the first movers get the last laugh. We think Revlon has gotten the message and is in the process of adapting.

Revlon closed Q1 2017 at $27.85, representing an equity market cap. of $1.46B against $140M in TTM FCF. A 10x FCF multiple in an industry that's 20x to 25x. And $27.85 is an EV of $4.1B, that's 10x TTM EBITDA in an industry that's 13x to 15x. There is no sell-side research coverage of Revlon's stock (although their debt is followed by a few firms), so we believe that is part of the reason for the valuation disconnect. Another reason is that billionaire Ron Perelman owns 77.4% of the stock and has controlled Revlon since 1985. Perelman, now 74 years old, has a history of achieving premium valuations when selling major holdings. Unfortunately, he also has a history of abusive behavior towards minority shareholders, the fear of which likely keeps some potential investors away from the stock. We are less concerned about that risk in this situation simply because Perelman already attempted to effectively force out Revlon's minority shareholders at around $5 per share after the stock had crashed to $2.30 in early 2009 during the Great Recession, only to be substantially thwarted by a shareholder's lawsuit in the Delaware Court of Chancery which forced the offer to be made voluntary rather than mandatory. Still, many suckers accepted Mr. Potter's low ball offer for their shares during that time of panic. Any similar attempt at a low ball take-out of minority shareholders would be even less likely to succeed now since Mittleman Brothers controls 4.5% of the shares outstanding and we see other value-oriented investors in the shares that we think would prevent the majority of the minority shareholders (50.1% of 22.6% = 11.3%) required to vote in favor from approving any obviously poor deal. Mere parity with Coty's current 52-week low valuation would be $57 to $63 for Revlon shares, more than double the current price.

Legacy mass market cosmetics brands will need to fight back against the dual threats of premiumization and fragmentation, with better innovation, faster new product launches, and better marketing. So while barriers to entry have dropped, the test of time remains. Revlon was founded in 1932 and has endured despite many new entrants coming and going since then. I think the current management team has what it takes to meet the challenges.

Revlon was #1 in lipstick in 1957, 60 years ago, and it remains #1 in lipstick today, as well as other key product lines, despite intense competition from much larger and smaller entities for decades now. It is the definition of a durable franchise, and its global potential for growth remains very attractive.

In summary, we see the recent stock price drop as a severe over-reaction to the recent slide in Revlon's N.A. consumer business, while ignoring the offsetting strength in their international sales, and the scarcity value of the last remaining major U.S player in cosmetics with global scope that has yet to be acquired by a giant. The stock is fairly illiquid and prone to outsized volatility of this sort. We think we'll see double and eventually triple the current price within a reasonable investment timeframe, with or without a takeover.

NOTE: Past performance is no guarantee of future results. Performance results presented are preliminary, net of fees and include the reinvestment of all income. Individual account returns may vary from those presented due to differences in the timing of contributions and withdrawals, and account start dates. Refer to the important disclosures on page 9.

Lastly on Revlon, perhaps some good news from their biggest competitor, L'Oréal, when their Chairman and CEO Jean-Paul Agnon spoke on their April 18th conference call he said that despite the mass market being "very unexpectedly soft" in the first six to eight weeks of Q1 2017, "the latest information we have is pretty positive" and that the mass market has been accelerating in the U.S. in April, allowing it to come back to its normal rate of growth.

I apologize for making this letter more than twice as long as the usual four pages within which I normally try to constrain my verbosity, and for breaking our traditional format and making this entire letter just about our two biggest losers of the quarter, but since Revlon and IGT are also our two biggest positions, I felt that the extra level of detail is warranted at this time.

We initiated a new position during the quarter, an Australian company, but because we are still looking to accumulate more shares, I would rather hold off on discussing it in this semi-public format until our next quarterly review.

Overall, the upside potential in the equities we own remains immense, with valuations that, on average, are at gaping disparities with the very expensive broad market indices. If anyone has any questions about Revlon, IGT, or any of the other 17 holdings that are not Revlon or IGT, please do not hesitate to contact us.

Sincerely,

Christopher P. Mittleman
Chief Investment Officer - Managing Partner

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