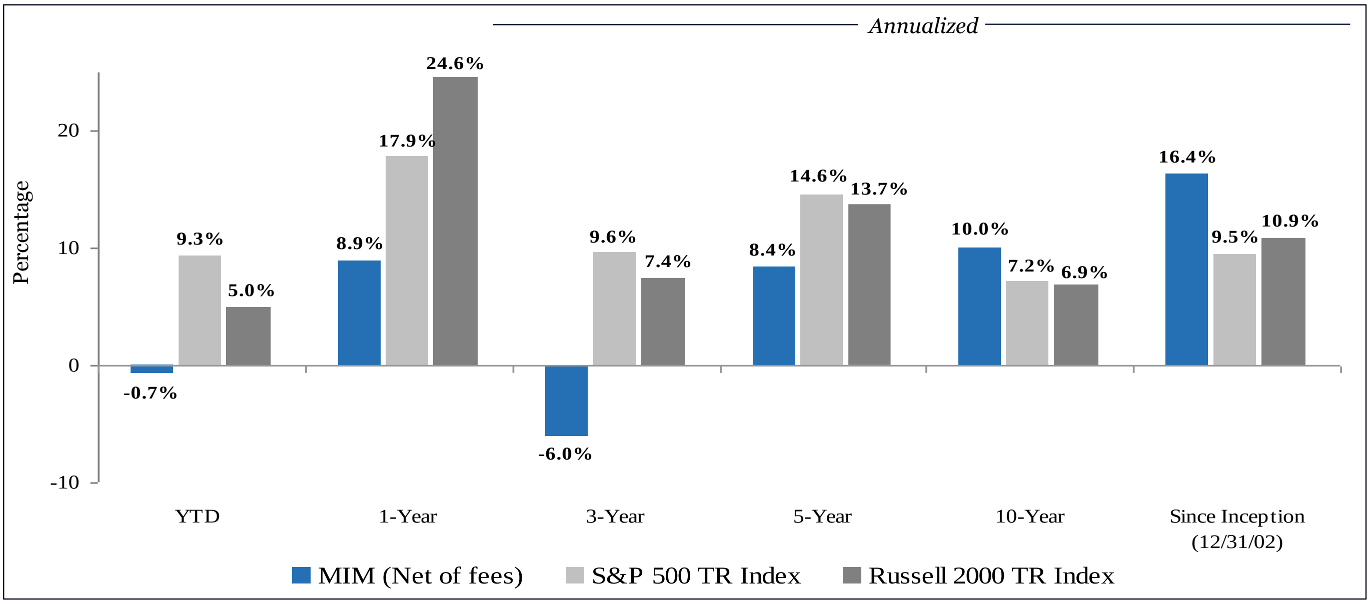
Chief Investment Officer Commentary – 8/2/17

Mittleman Investment Management, LLC's composite declined by 5.8% net of fees in the second quarter of 2017, versus gains of 3.1% 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 6/30/17 are presented below:



The top three contributors to our Q2 2017 performance were **KB Financial Group (KB)**: $43.97 to $50.49 (+17% with dividend), **Greatview Aseptic Packaging (468 HK)**: $0.50 to $0.62 (+24%), and **Rallye SA (RAL FP)**: $20.30 to $20.56 (+9% with dividend). KB had a greater effect on performance than the larger percentage gain from GaPack due to KB's larger position weighting in the portfolio.

The three most impactful detractors from our Q2 2017 performance were **Revlon Inc. (REV)**: $27.85 to $23.70 (-15%), **International Game Technology (IGT)**: $23.70 to $18.30 (-22% with dividend), and **AMC Entertainment Holdings (AMC)**: $31.45 to $22.75 (-27% with dividend). Larger portfolio weightings in Revlon and IGT made their losses more impactful than the larger percentage decline from AMC.

After two years spent in the red, with a -0.81% slide in 2014 and a -21.96% tumble in 2015 for a cumulative loss of -22.6% over those two years combined, our composite enjoyed a +19.76% rebound in 2016 followed by a 5.39% gain in Q1 2017 for a cumulative gain of +26.2% over that year and a quarter time-frame, almost completely recouping what we had lost in the prior couple of years. But that healing process abruptly reversed in Q2 2017 as the share prices of our three largest positions, all U.S.-listed companies in unrelated businesses (cosmetics, lotteries/slot machines, and movie theaters), almost simultaneously, tanked. And while the prices of these stocks did drop sharply during the quarter, the actual intrinsic value of their underlying businesses almost certainly did not change that much, if at all, as we will attempt to explain in this letter.

And while we often invoke the "investing is two steps forward, followed by one step back" mantra, it is particularly frustrating to experience this step back while the market is racing upwards to new highs almost daily. In that way, this period is remarkably reminiscent of 1999 for me, when I owned (for clients who later became the foundation of Mittleman Brothers) hated value stocks like **Philip Morris (MO)** initially at about $40 as it went to $19, on its way to $65+ a few years later.

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 7.

Another core holding in 1999 that went the wrong way that year was **American Real Estate Partners (ACP)** which is now known as **Icahn Enterprises (IEP)**, Carl Icahn's investment vehicle. The stock dropped from $9.60 to $7.04 by year-end 1999, despite having a high-$20s NAV per share. We had been in the stock for three years already at that point, with roughly a $9.00 per share cost basis. The fact that we were down on that position after three years while a raging bull market was seemingly lifting everything else to the moon was immensely frustrating and embarrassing at the time. Yet, we sold that stock about seven years later in late 2006/early 2007 for about $54 per share on average and as high as $88 as the stock ran to $130 in 2007. The point of this walk down memory lane is to highlight how similar the dichotomy was in 1999 versus today, with the hot stocks like AOL, Cisco, and JDS Uniphase getting unimaginable valuations while those boring old free cash flow generators we owned back then were seen as cheap for good reason. Our portfolio underperformed in 1999, hopelessly out of sync with the popular stocks in the market indices, but made significant gains over the ensuing three year bear market that saw the S&P 500 drop nearly 40% and the NASDAQ Composite drop nearly 67%. So with valuations in the U.S. today at levels not seen since 1999 (although not as extreme as then), our current positioning amongst the unloved but discernibly cheap free cash flow generators that we own today should be a source of comfort rather than concern, despite the recently disappointing results. Some color on our three best and worst performers in Q2:

KB Financial Group (KB) owns the largest retail bank in South Korea, Kookmin Bank, and was first profiled in our Q3 2011 Investment Review as a new position initiated in September 2011 at average cost of $34.16. Encouraged by significant insider buying by the then-Chairman and CEO at about $45 per ADR, I argued for a $60 fair value based on a 10x P/E ratio on what we assumed would be $6.00 per ADR in net earnings for 2011 and 2012, and 1.25x book value multiple on net tangible book value of $48. And while earnings for 2011 came in at $5.82, KB produced unusually depressed earnings for the next five years: 2012: $3.96 per ADR , 2013: $2.97, 2014: $3.43, 2015: $3.87, and $4.80 in 2016. Needless to say, we were way off on the earnings progression. And we can't even blame it on currency because the South Korean Won actually strengthened slightly during the first three years of our ownership. Regardless, we felt the issues that plagued the business were either transitory or in the process of being fixed, and that this highly overcapitalized bank (11% CET1 in Q3 2011, 15% in Q2 2017) would eventually put that excess capital to good use by executing on their plan to expand in higher ROE businesses like asset management and insurance, evolving into a Citigroup-style financial supermarket. With earnings up dramatically year-to-date, they finally appear to be reaping the benefits of having done so.

KB's book value was $48 per ADR when we started buying it nearly six years ago, now it's $67, a paltry 6% CAGR. But ROE looks closer to 10% prospectively in 2017 and 2018, with EPS running about $6.70 per ADR. So a $70 stock price (+39% upside) at a 10.5x P/E multiple shouldn't be too much to ask. Book value should be $74 by the end of 2018. Investing in South Korea entails special risks, with North Korea, run by a nutcase who executes his underlings with anti-aircraft guns for falling asleep during his speeches, seemingly the most urgent threat. But, given that China and the U.S. both have very significant interests in not seeing a war break out on the Korean peninsula, and China has immense leverage on North Korea, the nightmare scenario should likely be avoided. South Korea is in decent shape financially with low government debt to GDP of 36% (versus 75% for Germany, and 103% for the USA), a chronic current account surplus, and $371B in currency reserves. On the negative side, household sector debt is high in South Korea at 90% of GDP, vs. 79% for the U.S, and South Korea's biggest trading partner is China, a country with debt issues that may keep a lid on its growth rate for some time.

If no cataclysmic Korean war occurs, and despite its 43% YTD gain, KB Financial still seems just too cheap at a forward P/E of 7.5, and a price/book value of only 0.75x current book value. J.P. Morgan Chase (JPM $91.40) has a forward P/E of 12, and price/book value of 1.38x, despite a similar 10.5% ROE (KB about 10% ROE now), and a lower Tier 1 Common Equity ratio (12.6% CET1 vs. 14.8% for KB), so targeting $70 for KB (10.5x P/E, approx. parity with book value) is not a stretch.

Greatview Aseptic Packaging (468 HK), known as GAPACK for short, is the second largest provider of aseptic packaging in China, with a 15% market share (Tetra Pak is #1 with 65% share). Aseptic packaging (like juice boxes) allows juices and milk to be stored on shelves for up to six months with no refrigeration, and is especially important in countries like China and Vietnam where cold storage and cold transportation infrastructure are not yet fully developed. At year-end 2016 GAPACK was priced at $0.51 (our average cost is $0.50) and in our *What We Own and Why* ("WWOAW") publication for year-end 2016 I had estimated a $0.65 fair value based on 10x EBITDA and a market cap. to free cash flow multiple of 21x. In early June the stock spiked up to just above our estimate of fair value on news that **Jardine Strategic (JS SP)** had purchased a 22.15% stake in GAPACK for HKD 5.00 (USD 0.64), and subsequently bought more shares in the open market, raising their stake to 28.2% as of 6/19/17. An interesting coincidence given that Jardine Strategic is also a large holding for us, but we have no reason to believe that they know of our holding in GAPACK. We are very happy to have them on board, nonetheless.

GAPACK is a very small investment for Jardine Strategic, about $240M out of their $33B NAV, but transacted at HKD 5.00 (USD 0.64) which was a 25% premium to the HKD 4.00 price at which the stock was trading before it started running up in the days just before the announcement came out, and it just about matches the USD 0.65 fair value estimate I mentioned in the most recent WWOAW report, so we began selling it down a bit. But this could be a prelude to Jardine buying the whole thing, because if they increase their stake from 28.2% currently to 30% of the shares outstanding they would be required by Hong Kong listing rules to make a buy-out offer for all shares at a price no less than what was paid for the initial stake, and they usually strive for controlling stakes. And because Jardine Strategic has produced an outstanding track record investing in Asia for decades, compounding their NAV per share at over 21% since 12/31/99, the valuation at which they got involved here may indicate that our estimate of fair value is too low. We sold a small amount of shares on the news, and if we had sold it all there at $0.65, that would have been a 30% gain on our $0.50 average cost, plus an 11% dividend yield over our two years of holding (5.5% annual dividend yield x2 years), so just over a 40% total return in just over two years. Not amazing, but not bad. The Hang Seng index in Hong Kong where it trades was unchanged over that same roughly two-year period. I believe this highlights the deliberate conservatism in our fair value appraisals since Jardine is not paying a price that they deem to be full value, and they know the business prospects in China and Southeast Asia better than most, so their take on fair value is probably more instructive than mine. We are holding the shares for now, as the business grows while paying out most of its free cash flow as dividends (5% dividend yield), unless we come to need the cash for a superior investment opportunity.

Rallye SA (RAL FP) made little progress in share price appreciation, but did provide a meaningful enough contribution to performance to qualify as our third best performer through its large cash dividend paid during Q2. The company's main asset, its 51.1% stake in Casino Guichard (CO FP), continues to see improvements in its major supermarket operations in Brazil (Grupo Pão de Açúcar (GPA)) and Colombia (Grupo Éxito), as well as in its core French chains such as Monoprix and Casino. Rallye is a hybrid supermarket operator and real estate developer, run by a French billionaire, Jean-Charles Naouri, who owns over 56% of Rallye's stock and has a long history of value creation. Casino Guichard is followed by supermarket/retail analysts who are generally dismissive of the company's real estate development activities, despite the significant and ongoing value those activities have clearly produced. A complex holding company structure obscures the true value of the entity from those relying on screens to find investment ideas, weighing on valuation. But when the accounting is confusing, we take comfort in the reality check of free cash flow and dividends, which Casino Guichard and Rallye have produced in generally increasing amounts for over twenty years now. At quarter-end price of $20.56, Rallye has a cash dividend yield of 7.8%, and 75% upside potential to our estimate of its sum of the parts NAV at $35 (EUR 30).

Revlon Inc. (REV), our largest position, was our worst performer in Q2. I went into the issues surrounding Revlon at length in last quarter's investment review letter, so I won't repeat all of that here. The primary source of weakness at Revlon over the past year has been coming from their North American consumer sales, which represent about 30% of total sales, and which dropped precipitously again in their Q1 report released in May, forcing another revision lower our my estimates for EBITDA, FCF, and fair value. And while international sales have been strong, and should benefit from the recent weakening of the U.S. Dollar, the mass market for cosmetics in the U.S. has been unusually weak over the past year and a half, as can also be seen in the results of Revlon's larger competitor, Coty (COTY $18.76). And yet despite Coty's operating performance being no better than Revlon's in that segment, Coty's stock closed Q2 at a valuation of 14.2x EV/EBITDA based on calendar 2018 consensus estimates. If Revlon were to trade at 13.5x EBITDA, based on our significantly reduced estimate of $375M in EBITDA for 2018, the stock would be $43, that's 81% above its quarter-end closing price of $23.70. $43 would also be 22x the $105M in FCF (excluding non-recurring charges and merger-related cap-ex) they should be able to produce in 2018, where Coty is trading at 22.5x FCF for 2018 already at current price. So, we continue to believe that Revlon's shares are immensely undervalued.

The adverse trends weighing on the U.S. mass market for cosmetics are primarily three: 1) premiumization, or trading up, with buyers increasingly interested in paying up for perceived prestige and/or natural ingredients, 2) fragmentation, with barriers to entry lower and a flood of new entrants in the market, and 3) channel shift, which is sales shifting to the specialty retailers like Sephora and Ulta from the drug store chains and other mass market venues like Target, as well as to online sales channels. Revlon is addressing the trade-up trend by adding higher priced, more feature-rich products like lipstick infused with natural oils. And Revlon's acquisition of Elizabeth Arden in 2016 puts them firmly in the prestige business with a brand that is doing very well in skin care in Asia. But the premiumization/trade-up trend is unlikely to be perpetual. The mass market, 70% of global sales in color cosmetics, exists for a reason: most people (the masses) don't want to pay $20 to $40 for lipstick like Urban Decay at Sephora when they can buy similarly effective products at Rite Aid or Walgreens for $5 to $10. That reality becomes most apparent during periods of economic stress, when luxury/prestige brands like Estee Lauder experience sales drops while mass market brands either see flat or growing sales in local currency terms. From the year 2000 to about 2012 there was a trend towards premiumization in the women's denim market, where new entrants like True Religion and Seven for all Mankind enticed women to abandon Levis and Wrangler at a $50 price point in favor of jeans priced at $200 to $400. And while Levi Strauss & Co. suffered a significant sales decline from 1999 to 2009, they resumed growing thereafter and over the past five years the premium denim craze has been completely undone, with True Religion in bankruptcy and many of the other premium brands much diminished in their profile. Likewise, the fragmentation in the cosmetics industry due to new entrants will likely be self-correcting when a shake-out eventually occurs. As we've said before, we think it's highly likely that the $300M in sales estimated for Kylie Jenner's cosmetics line will eventually revert back to more established players at some point in the not too distant future. As the CEO of L'Oreal, Jean-Paul Agnon, said at a recent industry conference, "novelty is nice, but loyalty is gold." Brands like Revlon, with decades of consumer resonance under their belt, endure because they adapt and innovate and because they've established a long standing trust with consumers.

Even if the current trends towards premiumization and fragmentation don't abate anytime soon, Revlon can still adapt and be successful through innovation and marketing, as they've done in the past. Revlon rocketed to the #1 market share position in color cosmetics from 1990 to 1996 due to a ramped up advertising campaign and the release of their innovative ColorStay longer-lasting lipstick and makeup. Revlon's CND division introduced Shellac nail polish in 2010 and it dramatically expanded the entire category. Revlon's new CEO, Fabian Garcia, was most recently COO at Colgate Palmolive overseeing "Global Innovation and Growth" and seems to know how to "do" innovation. The company has already shifted much of its $500M+ annual advertising budget away from print and TV to embrace social media more fully, and they just moved their creative advertising account to Grey Advertising (WPP Group), so maybe a refreshed marketing campaign will be productive.

The biggest risk we face with Revlon I believe is not if the business will resume a growth trajectory, it's whether or not Revlon's largest shareholder, Ron Perelman, will attempt to buy out the remaining shares at an unfairly low price. Beginning on May 8th, three days after Revlon's surprisingly weak Q1 report came out and the stock plummeted, Perelman began aggressively buying more shares, at prices ranging from $18.20 to $23.25, and through June 20th he had acquired roughly 2.44M additional shares, raising his stake from 77.5% to 81.9%. Normally insider buying like that would be simply encouraging; a show of confidence by a well-informed insider with an excellent track record in timing such investments. But given Ron Perelman's well-known proclivity for trying to take advantage of minority shareholders when a stock he controls is down, his buying is at least as disconcerting as it is encouraging, given what it likely portends.

To paraphrase Max von Sydow's character, the assassin, Joubert, in advising Robert Redford's character not to go back to New York City at the end of the 1975 movie classic *Three Days of the Condor*, "It will happen this way…" Revlon reports Q2 results on August 4th, and the numbers are weak again. The stock drops to $15. Shortly thereafter, Perelman announces an all cash takeover offer at $25, a magnanimous 67% premium to $15. An investment bank is paid $5M to say it's fair, and they will come up with various contortions of data to say it's fair. The sycophantic board of directors approves in order to stay on the guest list for Perelman's annual New Year's Eve/Birthday bash on St. Barts and other important parties he hosts during the year. Arbs buy stock at $24.80. Rational shareholders loudly object to $25 and appear to have enough votes to block. Perelman raises offer to $27 and arbs rejoice and vote yes, pushing the balance to the necessary 50.1% of the minority held shares, and Perelman laughs heartily all the way to the bank when he sells Revlon two years later to Unilever or Shiseido for the equivalent of $75 per share.

That is the sad way the movie would normally end, except that in order to win the majority of the minority-held shares in a tender offer, Perelman would need just over 9.035% of shares outstanding of the 18.07% held by minority investors to vote in favor of any bid, and since Mittleman Brothers LLC controls nearly 5%, and we know of some other value-oriented investors who we think own around 3.5% and would likely not be fooled into selling out cheaply, it wouldn't take much more than another 1% of shares outstanding voting no to block any such potential low-ball deal. Hopefully we won't have to test that theory, but a simple google search for "Ron Perelman and minority shareholders" shows that the threat is real.

International Game Technology (IGT), our second worst performer in Q2, reported a slighter weaker-than-expected Q1 result on May 25th which saw the stock drop from $21 to $18.25 that day, a 13% decline that we thought was a vast overreaction. Yesterday the stock rose 13% from $19.04 to $21.46 on a slightly better than expected Q2 result. IGT was also discussed at length in our last Investment Review letter for Q1, and not much has changed since then. We estimate IGT is worth roughly $35 per share. That's an 8.5x EV/EBITDA multiple on 2018 consensus estimate of $1.7B EBITDA (Scientific Games (SGMS $38.20) already trades at 8.9x EBITDA today, despite SGMS's much higher balance sheet debt and more volatile business mix). $35 for IGT would also be roughly 16x the $450M in annual normalized free cash flow we expect. Those are below market target multiples for a business with much higher margins and much less vulnerability to general economic cycles than the average company in the S&P 500, so IGT attaining those multiples should not be a stretch.

AMC Entertainment Holdings (AMC), even though it was the worst percentage loser in Q2 (total return -27%) of our major holdings, it was only the third most impactful detractor from our overall performance due to its smaller portfolio weighting. AMC first entered our portfolio in late December 2016 as part of the compensation we received (with the rest being cash) in AMC's take-over of Carmike Cinemas, the 4th largest theater chain in the U.S. at the time, and where we had been major shareholders for nearly 10 years. AMC initially attempted to buy Carmike for $30 per share in cash. We pushed back and got a modest improvement in the deal price to $33.06 per share, and roughly a third of the value in AMC stock. We had pushed for more of the deal to be in AMC's stock because it was $33.45 then and I thought it was worth $45, but no further improvements in the deal structure were to be granted, a classic "blessing in disguise" scenario, as least in the short-term.

We believe AMC's stock price declined in Q2 because of fears that one of their largest shareholders, UK-based private equity firm Terra Firma, would be forced to sell or distribute the 4.54M shares (8.2% of total outstanding) that Terra Firma's private equity fund received (along with cash) in exchange for selling Odeon-UCI, the largest theater chain in the UK and Europe, to AMC. The lock-up on those shares expired on May 30, 2017. Regardless of the ultimate disposition of those shares, whether or not Terra Firma continues to hold the shares or they are held by others, it would have no effect on the fair value of the shares, no matter how impactful to the share price in the short-term from any supply/demand imbalance that might develop as a result. Short interest in AMC increased dramatically in advance of the lock-up expiration.

Other factors weighing on AMC's share price in Q2 were concerns about the potential for PVOD (Premium Video On Demand), whereby studios would stream movies directly to the home on the same day the movie is released in theaters. This would violate the traditional window of exclusivity that the theaters enjoy and require in order to fill their seats during the first few weeks when a movie is most productive for the theaters. Theater operators are talking to the studios about how PVOD might work to serve both of their interests, if the theaters would be compensated for acquiescing and how. But it seems like the two sides are far apart on this issue, so we don't think PVOD is happening in 2017 and probably not in 2018 either.

Another concern that pressured AMC's stock price later in Q2 was the news that AMC's controlling shareholder, Dalian Wanda Group, was being restricted by the Chinese government from any further offshore ventures and might in fact have to sell some. Again, like with Terra Firma, someone selling their shares doesn't change the intrinsic value of the shares, even if it's the largest shareholder doing the selling. But some investors confused the issue, imagining that AMC itself was somehow financed by Wanda which is simply not true, it's a U.S. company based in Kansas City, Kansas, with its own balance sheet and no Chinese banks among its creditors. So that story was not a legitimate cause for concern.

Lastly, the U.S. box office receipts were down 4.4% in Q2, and here concerns about the effect on AMC proved legitimate as AMC last night (August 1st) provided reduced guidance for Q2 and FY 2017 that saw the stock drop 25% after hours. At the low end of AMC's revised guidance range for 2017, sales would be $5.1B (-3.8% vs. consensus at $5.3B), and EBITDA would be $860M (-8.6% vs. consensus at $941M). I am lowering our estimate of fair value from $40 to $33, which assumes a 9.5x EV/EBITDA multiple on our lowered estimate of $900M in EBITDA for 2018 (down from $1B), and a market cap to free cash flow multiple of 13x my lowered estimate of $340M in FCF for 2018 (down from $400M).

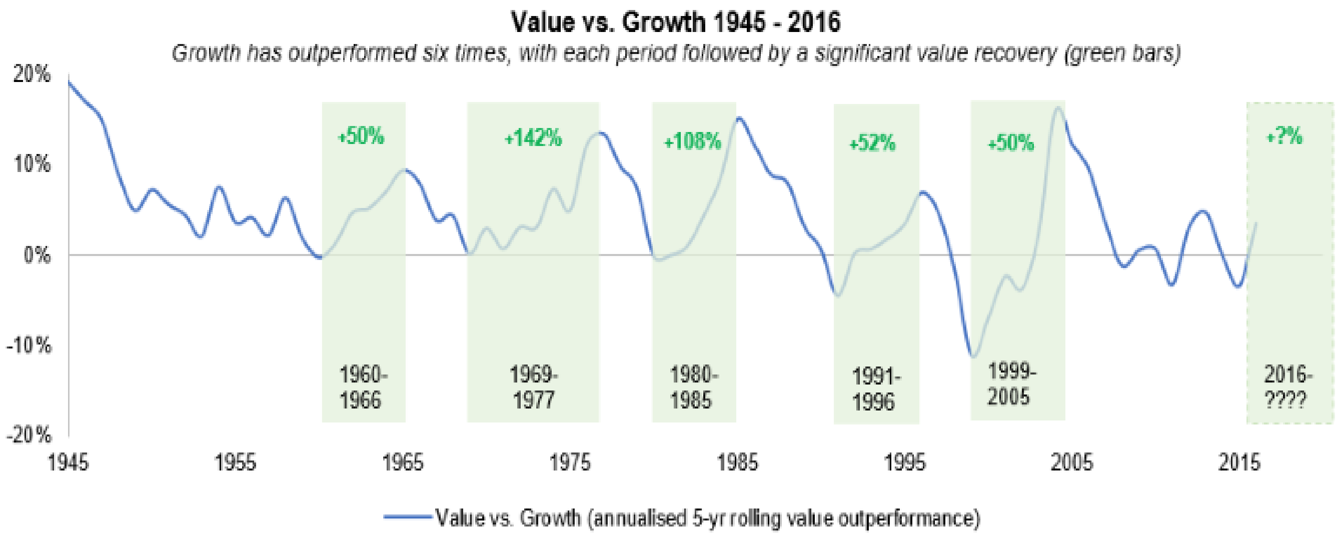
AMC's revised guidance expects North American box office receipts industry-wide to end 2017 at $11.2B, down 1.5% from 2016 (which was an all-time record). If Q3 and/or Q4 produce more encouraging results, obviously the operating leverage in this highly fixed cost business works both ways. We view this negative volatility in operating results as within the normal range. During our nearly 10 years with Carmike Cinemas' stock we endured many such quarterly setbacks along a long term path of outstanding returns. So don't be depressed by the hysterical talk that this is the beginning of the end of the theater business as Netflix takes over. AMC is the best in class operator, worldwide, and the innovator that everyone else is following. Even if the box office was flat for the next five years, AMC should still see EBITDA and free cash flow growth as they continue reaping very high ROIs for renovating theaters with reserved recliner seating, and they are not even half way done there.

So while this letter was supposed to be a review of Q2, I felt that given the recent bad news on AMC, and the good news from IGT just prior, we would expand the scope a bit to at least touch on those important news items from the current quarter.

Largely for idiosyncratic reasons that defy a neat overarching generalization, our three biggest holdings, investments in some of the most predictable and "safe" businesses that we know (cosmetics, lotteries, and movie theaters), somehow conspired to crush our Q2 and YTD results. Maybe bad luck really does come in threes. If so, then hopefully our other 17 positions are safe for now.

We have added a couple of new positions during the course of this year, one in Australia and one in Canada, but I will continue holding off on discussing those until we have our targeted full weighting established. A new university endowment client account was funded on August 1st and getting that substantial amount invested is easier if I'm not out there highlighting the upside in our newest holdings as they are small caps and thus have more limited liquidity.

The chart below comes from Professor Kenneth R. French's data library at the Tuck School of Business at Dartmouth, and shows that value investing in general underperformed from 2005 to 2015 (although we outperformed in that period) with the implication being that usually the value style enjoys a substantial rebound after such periods. Hopefully he's right, as it would be nice to have a tailwind for a change.



Sincerely,

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