KASE CAPITAL

Whitney R. Tilson
Managing Partner

phone: 212 277 5606
WTilson@KaseCapital.com

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Dear Partner,

Our fund declined 3.8% in September vs. -2.5% for the S&P 500. Year to date, our fund is down 10.7% vs. -5.3% for the S&P 500. [Update: after the first eight trading days of October, our fund is down 2.2% year to date vs. -0.5% for the S&P 500.]

On the long side, nearly half of our fund's losses during September were due to Platform Specialty Products (discussed below), which declined 33.9%. Other losers included Pershing Square Holdings (-16.3%), Spark Networks (-10.3%; discussed below), SodaStream (-9.7%), Micron Technology (-8.8%; discussed below) and Howard Hughes (-8.7%). The only winner of consequence was JetBlue, which rose 15.5%.

It was a fabulous month on the short side mostly thanks to a biotech ETF I shorted in mid-August (-33.7%), World Acceptance (-28.6%), Exact Sciences (-18.6%) and Lumber Liquidators (-13.2%). With our short book much smaller (19%) than our long book (94%), however, it wasn't enough to offset the losses on the long side.

Historical Perspective and Current Portfolio Overview

Our fund has declined each of the past five months, totaling 13.3%. While it is never fun to experience a drop like this, I am not overly concerned about it, in part because I've gone through this before – much worse, in fact – and things have always turned out well in the end. Specifically, in our fund's nearly 17-year history, this is only the third time it's had a five-month losing streak: it declined 32.8% from October 2008 through February 2009 and 28.7% from May through September 2011. Each of these drops ended after five months and was followed over the subsequent seven months by a sharp rebound: 52.6% and 33.6%, respectively.

I think there's a good chance that history will repeat itself because I'm more bullish on our portfolio than I've been in years. The stocks we own on the long side, which I liked at the beginning of the year, have fallen by an average of nearly 20% this year yet, as a group, I don't think their intrinsic value has declined at all. Consequently, I believe our long book has gone from moderately undervalued to downright cheap. We now own numerous stocks that I think are a good bet to rise 50-100% over the next year, as I discuss below.

Largest Two Short Positions

I feel similarly about our short book, even though it's already been an epic year, led by Lumber Liquidators collapsing 80.2% (see pp. 7-8 for an update on this position). In addition, Unilife has plunged 70.7%, World Acceptance is down 66.2%, and Exact Sciences has fallen 34.4%.

We remain short all of these stocks because I anticipate further declines, but the main reason I think our short book will outperform going forward is that our two largest short positions are

likely to collapse in the near future. The first is a company that, I've discovered, is poisoning its customers with formaldehyde-drenched laminate flooring, just as Lumber Liquidators was. The story parallels the Lumber Liquidators one in other ways as well: an industry insider gave me a tip, I hired a lab to test the products, which confirmed my source's information, and now I'm working on bringing this story to light. Stay tuned.

Our second largest short position is Herbalife, the only short that's hurt us this year, rising 44.5%. I remain confident that this will work out well, however, for two main reasons: a) The business is in decline in pretty much every market except China; and b) I think one or more U.S. regulators are (finally!) about to drop the hammer on the company, as evidenced by the following:

- In Q1, HLF spent $2.9 million on "Expenses incurred responding to attacks on the company's business model" and $2.1 million "Expenses related to the FTC inquiry."
- In Q2, these amounts soared to $4.8 million and $3.7 million, respectively, a combined increase of 70%.
- Also in Q2 the company changed the language from "Expenses related to the FTC inquiry" to "Expenses related to Regulatory inquiries," implying that the company is incurring meaningful costs not only responding to inquiries from the FTC, but also from other regulators as well.

At today's price, I view Herbalife as an absolute gift and if it weren't already a substantial short position, I'd be adding to it.

Portfolio Construction

On the long side, I seek to construct a portfolio that is both highly concentrated, yet also diverse in terms of industries, types of value, catalysts, and risk. I break it down into the following categories:

- Blue-chip companies whose stocks are the foundation of the portfolio like Berkshire Hathaway, Air Products, Canadian Pacific, GE, Goldman Sachs, Mondelez and Union Pacific. These stocks are moderately undervalued, not crazy cheap, but the businesses are of exceptional quality so there's less risk;
- "Platform" companies: Howard Hughes and Platform Specialty Products;
- Companies in consolidating industries (discussed in my Q2 letter; user name: tilson; password: funds): semiconductors (Micron), airlines (Delta and JetBlue) and auto rentals (Avis);
- A long-term bet on Korea and, in particular, Korean preferred stocks (Samsung Electronics and Hyundai Motor); and finally
- A handful of special situations, turnarounds or small-cap companies such as Reading International, Tetragon Financial Group, magicJack, Pershing Sq. Holdings, SodaStream, Spark Networks, Fannie Mae and Grupo Prisa.

Allow me to discuss four of these stocks, all of which I've been adding to over the past month.

Berkshire Hathaway
I've written many times about Berkshire in the past, so I will only provide an update here (for background, see my slide presentation).

Using the valuation methodology I've used for two decades (see pages 13-18 of my presentation), which has proven to be quite accurate, I estimated at the beginning of this year that Berkshire's intrinsic value was $254,593. With the year now ¾ over, I estimate that this has risen by ~6% to ~$270,000, based on the company's 2.4% increase in book value and 14% increase in operating income of the non-insurance businesses in the first half of the year. Thus, with the stock closing September at $195,260, it's trading at nearly a 30% discount to intrinsic value.

I think that's compelling for an extraordinary company that is growing at a decent clip, whose stock offers the wonderful combination of substantial upside and limited downside. But it's even more compelling than it appears because Berkshire has made a nearly $14 billion profit, equal to $8,428/share, on its investments in Heinz and Kraft, which is not yet reflected in the company's financial statements. To my knowledge, this extra value hasn't been noticed by any analysts, media or investors.

Here's the story: on June 7, 2013, Berkshire invested $8 billion in preferred stock and $4.25 billion in equity in the 3G-led buyout of Heinz. This $12.25 billion investment is carried on Berkshire's balance sheet in the line item "Investments in The Kraft Heinz Company" and is accounted for using equity accounting. Reflecting some amortization, it is carried on Berkshire's balance sheet at $11.45 billion in its latest reported financials (Q2, ending June 30th).

A few days after the end of the quarter, on July 6, 2015, Heinz (a private company) merged with Kraft (a public company). In connection with this transaction, Berkshire invested an additional $5.26 billion in the new company. As a result, Berkshire now owns $8 billion of preferred stock and 325 million shares of the new, merged Kraft Heinz Company (whose stock is currently at $71.41), worth a total of $31.2 billion. Berkshire's cost, however, was only $17.5 billion ($8 billion of preferred stock plus two equity investments of $4.25 billion and $5.26 billion), resulting in a profit of $13.7 billion, or $8,438/A share.

None of this enormous gain is reflected in Berkshire's Q2 financial statements, so it should be added to the estimate of intrinsic value ($270,000 + $8,438 = $278,438), meaning Berkshire's stock today is even more compelling than it appears. In addition, there's a near-term catalyst, as the profit Berkshire has made via its Heinz and Kraft investments will become apparent when it releases its Q3 earnings next month.

Platform Specialty Products
After being our biggest winner last year, Platform has been our biggest loser this year. As background, this is what I wrote about Platform in my 2014 annual letter:

> PAH is a platform of "asset-light, high-touch" specialty chemicals businesses with a superb operating CEO, Dan Leever, and a proven deal-doing chairman, Martin Franklin, of Jarden (JAH) fame.

The company came into being in late 2013 when a SPAC headed by Franklin paid $1.8 billion to acquire MacDermid, a high-quality specialty chemicals business helmed by Leever. Since then, PAH has spent $5 billion acquiring three additional businesses, Chemtura AgroSciences, Agriphar, and Arysta, and is now positioned as a leading global crop solutions business that offers a full product portfolio and diversity across crop varieties and geographies.

The objective is to repeat what Franklin did with Jarden (resulting in investors making more than 30x their money) by being smart and strategic in acquiring and integrating other companies in the specialty chemicals industry. I believe that PAH has the opportunity to invest large amounts of capital at a high rate of return over the next decade by acquiring additional businesses that can operate more efficiently as part of a larger industry platform.

I can't think of better people to execute on this opportunity than Franklin, a proven deal maestro, and Leever, who grew up in the industry (his father started working at MacDermid in 1938, became Chairman in 1959 and spent 60 years at the company; Dan joined the company in 1982 and was made CEO in 1990). I remember well the dinner I was invited to in December 2013, shortly after the MacDermid deal closed and PAH started trading. At the time, the stock, at $14, appeared quite expensive by traditional valuation metrics, but after meeting Franklin and Leever, hearing their plans and looking at their track records, I decided I had to own the stock – a position I've added to a number of times since then on pull-backs – which has worked out beautifully, as it currently sits at $24.39.

In a remarkably short period of time (just over a year), PAH has become a large company (sales and EBITDA this year should exceed $3 billion and $750 million, respectively), yet it's very difficult to analyze because of the large recent acquisitions and lack of analyst coverage. This weighs on the stock for now, but over the next year I expect PAH to become a more "normal" company and the valuation to reflect this.

If you'd like to read more about PAH, I've posted a few good write-ups on it here.

The stock peaked above $28 in June, but since then it's been more than cut in half because the company got caught in the crosshairs of the weakest sectors of the market last quarter, namely:

- Companies with exposure to emerging markets (especially China and Brazil), commodities, and/or the agricultural sector;
- Companies with a lot of debt;
- Serial acquirers that rely on their own high stock price and/or cheap debt to make acquisitions; and
- Stocks widely owned by hedge funds.

In light of this, it's not surprising that Platform's stock has performed so poorly.

Note, however, that I said the *stock* has performed poorly, not the company. Dan Leever and Martin Franklin are still running it, and doing a superb job. They acquired high-margin, low cap ex, high-free-cash-flow businesses and are cutting costs and improving operations. For sure the company is being affected by weakness in some of its markets and there will be no more acquisitions for a while, but that's okay, as there's plenty to digest.

Martin Franklin made investors in Jarden more than 30x their money by not only being a savvy acquirer, but also a great operating manager (and hiring many more). Platform is now entering this latter phase and I'm confident that the results will be outstanding. If I'm right, then the stock, which trades today at 8-10x estimated normalized free cash flow, will likely be at least a double from today's depressed levels.

Micron Technology

I wrote about why I liked Micron in last quarter's letter, but I was too early, as the stock has fallen another 20%. I don't think it's too early anymore and I recently added to our position.

The company reported dismal earnings on Thursday and gave weak guidance for next quarter, yet the stock *rose* 7.7% on Friday because expectations – and the stock price – were so low. This is the kind of stock I like to own: one that is almost impervious to bad news, but will soar on any hint of good news.

The stock is stupidly cheap at ~4x the company's potential earnings power in a good environment (which I estimate at $4/share), a 40% discount to the replacement value of its manufacturing facilities, and 24% below a lowball $21 bid by a Chinese state-owned chip design company, Tsinghua Unigroup Ltd.

While short-term demand for DRAM chips is weak and Micron's costs are elevated due to the need to upgrade its manufacturing plants, the two key pillars of my investment thesis remain intact: 1) continued strong (20%+) underlying growth in long-term demand; and 2) rational industry behavior (i.e., restrained capacity growth), the combination of which should lead to solid pricing and healthy profits over time. Those last two words – "over time" – are important, however, because while the economic characteristics of the industry have improved markedly, it remains cyclical (as we're seeing now).

Spark Networks

I hesitate to write about this position, in part because it's small (3.1%), but mainly because it's been such an embarrassing mistake. While it was initially a big winner – we bought it in 2010 at prices as low as $3.16 and it subsequently soared to nearly $9 in mid-2013 – it's been a terrible value trap ever since and now sits near a four-year low at $3.09. But I'm going to stick my neck out here because, based on subscriber data the company just released as well as my conversations with the CEO and a friend who's on the board, I think a major turnaround under new management is underway, which isn't in any way reflected in the stock price, so I've been adding to this position.

Spark operates two main dating web sites, JDate (for Jewish singles), a cash cow, and ChristianMingle, which was supposed to be the growth vehicle. The previous management team took the profits from JDate (and then some) and invested heavily in ChristianMingle, which led to strong subscriber and revenue growth for a while, but customer acquisition costs were very high, losses mounted and, by the end of 2013, despite continued heavy marketing spending, the number of ChristianMingle subscribers began to decline. As the company cut marketing spending, subscriber losses accelerated, declining by 36% in the past year and a half.

Making matters worse, the previously stable JDate franchise began to weaken such that it's now lost about a quarter of its subscribers and contribution profit in the past two years.

To some extent, Spark Networks' woes are due to the rise of Tinder and other free dating apps and websites. But I think a major factor was the utter incompetence of the management team – a problem that has now been fixed thanks to a successful proxy battle a year ago, which I supported.

I'm very impressed with the new CEO, Michael Egan, who spent the past dozen years as a senior executive at Internet Brands and Yahoo. Soon after he started in January, Egan brought in a new management team and quickly returned the company to profitability by drastically reducing marketing expenses and abandoning the failed pie-in-the-sky growth strategy. The focus now is on overhauling the JDate and ChristianMingle apps and websites (which were pathetic), developing a range of free, "freemium" and paid products to better compete in the rapidly changing marketplace, and return the company to growth while also increasing EBITDA margins to the 25-30% range.

This all sounds great, but is there really room in the new online dating world for Spark, or is it a dinosaur, destined to spiral downward into oblivion? It's too early to know for sure, but the many conversations I've had with the CEO and a friend who's on the board have given me reason for optimism. Because the company was so poorly run under prior management, there's low-hanging fruit everywhere to cut costs, improve the products and attract more subscribers.

The latter is most important in the long run. The new management team was able to quickly return the company to profitability by cutting costs, but there are only so many costs that can be cut – and, meanwhile, over the past year the subscriber base has continued to decline.

Thus, I was heartened to see the end-of-quarter subscriber numbers that the company released on Thursday, which showed growth in both JDate and ChristianMingle for the first time in two years:

> We've made significant strides across both brands and our Q3 ending subscriber numbers reflect this. The growth in ending subscribers in our Jewish Networks relative to Q2 represents the first quarter of sequential growth in two years and was led by the strongest growth in our key U.S. market in over five years. Likewise, we were able to grow our ChristianMingle subscriber numbers for the first time since early 2013 and did so with our most efficient marketing spend in years.

While it's possible that Spark increased subscribers by ramping up its marketing spend and/or slashing prices (we won't know for sure until the company releases its full earnings report next month), I think that's highly unlikely in light of what they've said and done in recent quarters. In addition, this line – "our most efficient marketing spend in years" – further reinforces my belief that the company is beginning to achieve profitable growth.

I think this information is the best evidence to date that a turnaround is underway. The sequential declines in subscribers have been large and consistent for two past two years, so even one quarter of growth is a huge achievement, especially since it happened one quarter earlier than expected

and was likely accompanied by low spending, which would of course translate into meaningful profits.

In short, Thursday's news shifted the risk/reward probabilities meaningfully to the upside, so I'm adding to our position.

Lumber Liquidators

With the stock around $13, one might ask: "Why don't you just cover your position, lock in your big gains, and declare victory?" I did, in fact, cover about 20% of our position in August at $12.90, but no more because I still think it's a good short – though certainly not as good as it was at double today's levels just a few months ago, when I was aggressively adding to the position.

I think there's a decent (maybe 35%) chance that the stock is a zero and there are numerous other scenarios in which the stock tumbles into the single digits. Not one of the half dozen regulators investigating the company has taken any action, there are numerous lawsuits that will likely be an overhang on the stock for years and, most importantly, I'm hearing that the company is in major turmoil.

One piece of evidence is an email I received last week from a current store manager, who, in response to my question whether he thinks company founder Tom Sullivan, who's stepped back into the CEO role, can stabilize the situation and turn things around, wrote:

> After some time with new leadership, I would have to say no. It is a train wreck waiting to happen. The politics within the company have taken precedence over actually running the company. It was described to me as a bunch of 5-year-olds in charge. Those of us that are still left are just riding it out till it goes under, really just to watch.
>
> The issues are everywhere: no stock, everything is back ordered for months, the new stock program for stores is not working, the merchandising team is a complete joke. How Marco [Pescara, the new Chief Merchandising and Marketing Officer] has his job is really beyond any of us. They have no real direction ; every week it's something new that contradicts the previous week. They'd rather fire those that question poor decisions than listen to positive suggestions from the stores.
>
> The installer program is a complete mess. It's just a money grab and they don't even have a basic understanding of local and state laws. My store is the only one in the company at this time able to install in [my state]. I have repeatedly told them how they are not following the state law with licensing and payment requirement and they act as if I'm the problem when customers ask me why they don't seem to follow it. I have voiced this as far up as my arm's reach, which is well above the regional level, and it falls on deaf ears.
>
> I haven't been able to come to work and just run my store and help my customers in months. They have us doing so much other stuff that the customer is a distant 3rd or 4th on my daily list.
>
> The numbers for this quarter are going to show how bad it really is. This was the worst month I've ever had at my store and they made the plans pretty high. We all feel it was to steal more money from all of us. The word is we got rid of Rob [Lynch, the former CEO] and replaced him with a scumbag [Tom Sullivan] who is ill-prepared to run a company of this size.

> The company is so far down right now from last year, it's going to be ugly when they report this quarter to the shareholders.

These are, of course, just the opinions of one person, but they certainly ring true to me. If he's even close to being right, then this stock has plenty more downside.

Lastly, I heard from a few former installers, two of whom contracted exclusively for Lumber Liquidators for four years. They told me that the company has major quality problems across many of its product lines, especially bamboo flooring, and that the company is aware of this, yet rather than improving quality, it instead has set up a rigged inspection system that results in the company rarely standing behind its highly publicized warranty. See Appendix A for an article that I plan to publish tomorrow about this.

(For further information about Lumber Liquidators, click here to see three public presentations I made about it in November 2013, October 2014 and May 2015, and click here to read the articles I've published on it since the 60 Minutes story aired.)

As always, thank you for your support and please let me know if you have any questions.

Sincerely yours,

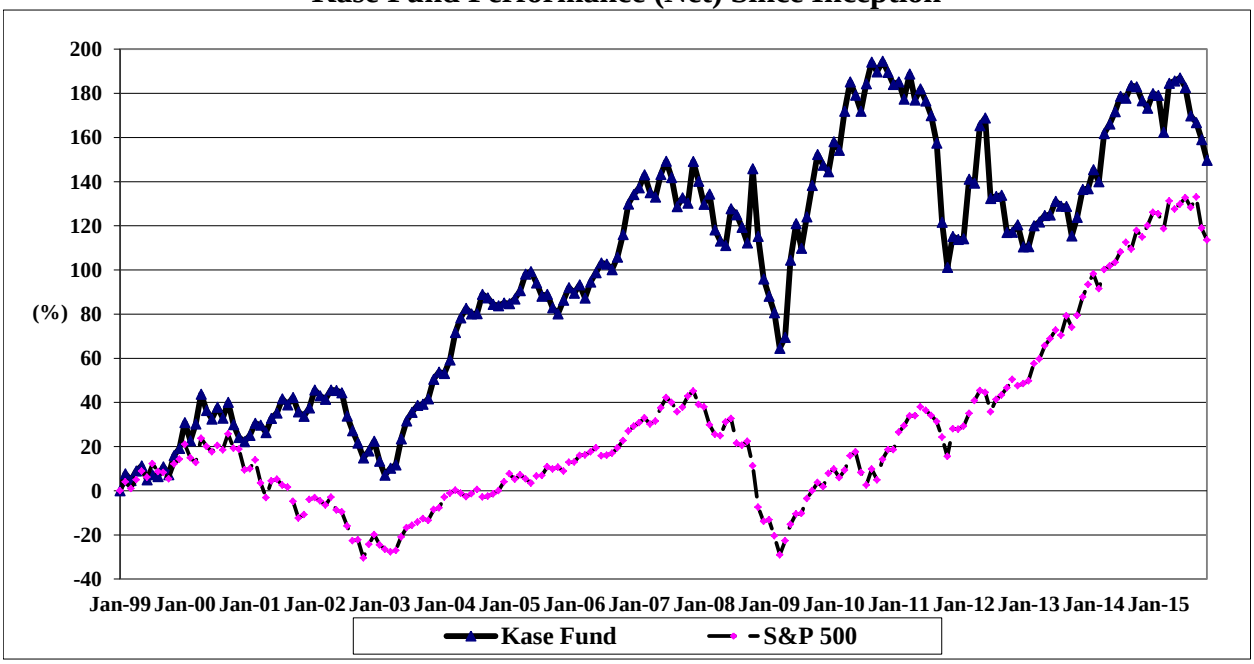
Whitney Tilson

The unaudited return for the Kase Fund versus the S&P 500 (including reinvested dividends) is:

	September	Q3	YTD	Since Inception
Kase Fund – net	-3.8%	-7.7%	-10.7%	149.2%
S&P 500	-2.5%	-6.4%	-5.3%	113.6%

Past performance is not indicative of future results. Please refer to the disclosure section at the end of this letter. The Kase Fund was launched on 1/1/99.

Kase Fund Performance (Net) Since Inception



Past performance is not indicative of future results.

Kase Fund Monthly Performance (Net) Since Inception

	1999		2000		2001		2002		2003		2004		2005		2006		2007		2008		2009		2010		2011		2012		2013		2014		2015	
	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500	Kase Fund	S&P 500
January	7.8	4.1	-6.3	-5.0	4.4	3.6	-1.8	-1.5	-5.5	-2.6	4.7	1.8	1.1	-2.4	1.9	2.7	2.4	1.7	1.9	-5.9	-3.6	-8.4	-1.6	-3.6	-2.8	2.4	12.6	4.5	4.5	5.2	-2.2	-3.5	-6.0	-3.0
February	-2.9	-3.1	6.2	-1.9	-0.6	-9.2	-1.1	-2.0	2.9	-1.6	7.0	1.5	2.1	2.0	-3.1	0.2	-3.3	-2.1	-6.9	-3.3	-8.9	-10.8	7.3	3.1	4.1	3.4	-0.8	4.3	0.8	1.4	9.1	4.6	8.6	5.7
March	4.1	4.0	10.3	9.8	-2.6	-6.4	3.0	3.7	1.4	0.9	3.9	-1.5	3.9	-1.7	3.9	1.3	-0.8	1.1	-2.3	-0.5	2.9	9.0	4.6	6.0	-4.1	0.0	10.9	3.3	1.3	3.8	1.7	0.8	0.5	-1.6
April	2.1	3.7	-5.1	-3.0	5.1	7.8	-0.2	-6.0	10.5	8.2	2.4	-1.5	0.6	-1.9	2.2	1.4	4.4	4.6	-0.9	4.9	20.1	9.6	-2.1	1.6	1.9	3.0	1.3	-0.6	0.1	1.9	2.1	0.7	0.5	1.0
May	-5.7	-2.5	-2.8	-2.0	1.8	0.6	0.0	-0.8	6.6	5.3	-1.4	1.4	-2.6	3.2	1.8	-2.9	2.5	3.3	7.9	1.2	8.1	5.5	-2.6	-8.0	-1.9	-1.1	-13.6	-6.0	2.8	2.3	2.6	2.3	-1.9	1.3
June	2.2	5.8	4.1	2.4	4.6	-2.4	-7.3	-7.1	2.9	1.3	0.1	1.9	-3.1	0.1	-0.2	0.2	-3.0	-1.5	-1.2	-8.4	-5.0	0.2	4.5	-5.2	-2.4	-1.7	0.5	4.1	-1.0	-1.3	-0.3	2.1	-4.5	-1.9
July	-0.7	-3.2	-3.6	-1.6	-1.1	-1.0	-5.0	-7.9	2.3	1.7	4.6	-3.4	0.5	3.7	-0.9	0.7	-5.4	-3.0	-2.5	-0.9	6.8	7.6	3.5	7.0	-4.6	-2.0	0.2	1.4	-0.1	5.1	2.0	-1.4	-1.1	2.1
August	4.1	-0.4	5.4	6.1	2.5	-6.3	-4.3	0.5	0.4	1.9	-0.9	0.4	-3.2	-1.0	2.9	2.3	1.7	1.5	-3.3	1.3	6.3	3.6	-1.5	-4.5	-13.9	-5.4	-7.2	2.3	-5.8	-2.9	-0.2	4.0	-2.9	-6.0
September	-3.3	-2.7	-7.2	-5.3	-6.1	-8.1	-5.4	-10.9	1.7	-1.0	-1.6	1.1	-1.5	0.8	5.0	2.6	-1.1	3.6	15.9	-9.1	5.9	3.7	1.7	8.9	-9.3	-7.0	0.0	2.6	3.9	3.1	-1.7	-1.4	-3.8	-2.5
October	8.1	6.4	-4.5	-0.3	-0.8	1.9	2.8	8.8	6.2	5.6	-0.4	1.5	3.5	-1.6	6.3	3.5	8.2	1.7	-12.5	-16.8	-1.9	-1.8	-1.7	3.8	7.0	10.9	1.6	-1.9	5.6	4.6	-1.4	2.5		
November	2.8	2.0	-1.5	-7.9	2.3	7.6	4.1	5.8	2.2	0.8	0.8	4.0	3.1	3.7	1.9	1.7	-3.6	-4.2	-8.9	-7.1	-1.2	6.0	-1.9	0.0	-0.6	-0.2	-4.5	0.6	0.2	3.0	2.6	2.7		
December	9.8	5.9	2.3	0.5	6.5	0.9	-7.4	-5.8	-0.4	5.3	-0.2	3.4	-1.3	0.0	1.4	1.4	-4.3	-0.7	-4.0	1.1	5.5	1.9	0.5	6.7	0.1	1.0	0.1	0.9	3.6	2.5	-0.4	0.3		
YTD TOTAL	31.0	21.0	-4.5	-9.1	16.5	-11.9	-22.2	-22.1	35.1	28.6	20.6	10.9	2.6	4.9	25.2	15.8	-3.2	5.5	-18.1	-37.0	37.1	26.5	10.5	15.1	-24.9	2.1	-1.7	16.0	16.6	32.4	13.7	13.7	-10.7	-5.3

Past performance is not indicative of future results.

Note: Returns in 2001, 2003, 2009, 2013 and 2014 reflect the benefit of the high-water mark, assuming an investor at inception.

Appendix A

More Evidence That Lumber Liquidators Is Rotten To The Core

Whitney Tilson

Oct. 5, 2015 2:50 AM ET

Disclosure: The author is short LL. **(More...)**

http://seekingalpha.com/article/3549946-more-evidence-that-lumber-liquidators-is-rotten-to-the-core

Summary

- Two former installers for Lumber Liquidators told me that the company has major quality problems across many of its product lines, especially bamboo flooring.
- They said that the company is aware of this, yet rather than improving quality, it instead has set up a rigged inspection system that results in the company rarely standing behind its highly publicized warranty.
- I added to my short position at numerous points on the way down and, though I've taken a bit of profits around today's prices, LL remains a substantial short position in the funds I manage.

Soon after the 60 Minutes story on Lumber Liquidators first aired on March 1st, I heard from numerous people in the industry, including a number of the company's current and former employees and contractors. Without exception, told me that Lumber Liquidators (NYSE:LL) is a notorious bad actor: that it cuts corners at every opportunity, sells very low-quality products, treats customers, installers and employees badly, and, worst of all, is not serious about compliance.

Since then, I (and customers, the media and regulators) have been primarily focused on the most important and damning charge: that Lumber Liquidators sold its American customers hundreds of millions of square feet of laminate flooring sourced in China that contained high levels of formaldehyde, a dangerous chemical and known carcinogen - and that senior executives knew (or should have known) this.

I don't have any new information on this topic - we're all waiting for the Consumer Product Safety Commission and other regulators to complete their investigations and take action - so in this article I'd like to share what I heard from two former installers for Lumber Liquidators, who told me that:

- The company has major quality problems across many of its product lines, especially bamboo flooring, which is consistent with the widespread quality and customer service problems highlighted on many review websites - see here, here, here, here and here;
- The company is aware of this, yet rather than improving quality (which would raise costs and lower profits), it instead has set up a rigged inspection system that results in the company rarely standing behind its highly publicized warranty.

I was reminded of these issues when I read this recent article about a Canadian customer who bought Lumber Liquidators' bamboo flooring that, soon after it was installed, was gapping, squeaking and buckling - yet a year later, the company still hasn't fixed the problem.

This family's tale of woe is very common among Lumber Liquidators' customers based on everything I've heard and read, including what these two installers told me.

Installer #1

The first story I heard was from someone (let's call him Jim) who's been in the flooring installation business for decades and for four years from 2011-2014 installed thousands of floors exclusively for Lumber Liquidators. While installing laminate flooring was the largest part of his business (he guessed 40%), bamboo was a close second, in the 30-40% range.

Jim told me that Lumber Liquidators' flooring had quality problems across the entire product line, which had been the case since the company was founded:

> Lumber Liquidators is a pretty miserable company. Tom Sullivan founded it in the early 1990s by buying for ten cents on the dollar excess flooring that had often been sitting in warehouses for years and then reselling this junk for 20 cents. But that wasn't a scalable or sustainable business model, so that's when he started buying in China. But they're still applying the same principles.
>
> Lumber Liquidators' products have huge warranty issues. The company had a production problem [when sales were booming in 2012 and 2013]: they couldn't find enough cheapo product to sell, so they pushed their manufacturers to put out quantities of product that led to big quality problems.

[All of the quotes in this article are from my notes, not a recording, so I verified them with the two sources.]

Jim explained that it had to do with the moisture content of the flooring:

> It's really important that the moisture content of the flooring is in the 6-9% range because if it's higher, then the flooring will dry out and buckle and gap when the humidity in the home declines, as it typically does in the winter.

> Thus, the manufacturer is supposed to season the product for months: take the rough cut, then put in a big room or an oven to decrease the moisture content down to 6%, then put it through the finishing process.
>
> But Lumber Liquidators pushed its manufacturers so hard that all of the company's products were coming in wet: 20-28% moisture content. Thus, it contracts *after* it's installed, causing it to look terrible.
>
> Lumber Liquidators tries to deal with this problem by telling their customers to leave the flooring in their homes for a week before installing it, but this isn't enough time. In a week, the moisture content only declines by 4-8%.

Jim said this is a particularly acute problem for bamboo flooring, especially when they switched to a water-based resin from a formaldehyde-based one:

> The process of making bamboo flooring involves injecting resin into it to strengthen it. For years, the resin had formaldehyde, which produced a good product, but suddenly in early 2014 I started getting huge numbers of warranty calls from customers in whose homes I'd installed Lumber Liquidators' bamboo flooring - it was insane.
>
> I complained to a Senior VP at the company, and he was completely honest with me: he explained that they knew they had a formaldehyde problem with the bamboo line, so around the end of 2013, they told their manufacturers to switch to a water-based resin. But this resin is inferior, so the bamboo flooring was contracting and separating - just look online and you'll find huge numbers of complaints about this problem.

If true, this is a stunning revelation: that Lumber Liquidators' senior management was aware of a formaldehyde problem years ago and were so concerned that they instructed their suppliers to switch resins, even knowing that the new product was of terrible quality and would fail at high rates. In light of this (again, if true), it's equally stunning that they didn't deal with the formaldehyde problem in their laminate product lines.

[I cannot verify that Lumber Liquidators' bamboo flooring had high levels of formaldehyde prior to 2014 because neither I nor the lab I hired was able to find any old product to test. But even if we had, I suspect that we wouldn't have found high levels of formaldehyde today due to off-gassing (though it still might have been highly toxic at the time it was installed). As for the company's current bamboo flooring, I've had numerous samples tested, none of which had any meaningful levels of formaldehyde. Thus, Lumber Liquidators' customers who have bought this product likely only have to worry about lousy quality, not being poisoned.]

Jim told a damning story of how Lumber Liquidators handled customer complaints when its products failed:

> When Lumber Liquidators' flooring fails, they send in an inspector using a nationwide company called Inspect Solutions. This person is just a hired gun. The inspector can say the product failed for three reasons: a product-related reason (which is Lumber Liquidators' problem), an installation issue (the installer's problem), or a site problem (too much or not enough moisture in

> the air, etc., which the inspector will say is the homeowner's fault). Guess what they determine? The inspector nearly always blames either the homeowners or installers. It's a joke.
>
> They *know* they're sending product into customers' homes that's not been manufactured right. Then in the winter, when it gets dry, the flooring gaps. Then the inspector comes in with a moisture meter, says it's too dry in the home, and blames the homeowner and refuses to fix the problem.
>
> Or else they blame me, even though I always take all of the precautions and necessary steps. I'm a third-generation floor installer. I put down 6,000-8,000 floors prior to installing for Lumber Liquidators and didn't have a single warranty claim. But in four years with Lumber Liquidators, I had warranty claims on 8-10% of my installations. It got to the point I couldn't make any money.

Jim concluded:

> I quit because of ethical issues - I couldn't keep installing such a poor quality product.
>
> Lumber Liquidators is a terrible, greedy company. Everything they do operationally relates to their bottom line: the way they source product, treat installers and treat customers. It's a dirty, rotten company. I hate the company and what they stand for. They're taking advantage of everybody.

Installer/Inspector #2

The second person I spoke with (let's call him Steve) was an installer for Lumber Liquidators (also for four years) and then became an inspector. He told a similar story:

> Only 1% of the oak floors I install fail, whereas 20% of the bamboo floors do. Most bamboo on the market is a low-end product - but Lumber Liquidators' is the worst.
>
> The moisture level in the bamboo flooring has to be in the 6-12% range before it can be installed, but it typically takes two months for it to reach this level and neither homeowners nor installers are willing to wait this long. If you told customers how long they should wait, they'd never buy it so Lumber Liquidators' salespeople don't say anything. And then once it's installed, the company doesn't want to deal with it.
>
> I use a moisture meter, but it's only good for the specific product it's calibrated to, so I called all of the meter manufacturers and asked if their meter was calibrated for Lumber Liquidators' strand bamboo. They all said no, that it's impossible to accurately measure it [the moisture content in Lumber Liquidators' bamboo flooring].
>
> Nobody would say it, but it's because Lumber Liquidators doesn't control the sourcing of the bamboo stalks - they get bamboo from three different plants, which is all mixed into one batch. Each supplier has its own construction process, with different levels of formaldehyde (a lot of the issues with moisture in bamboo flooring is related to the resin used). To cut costs, the suppliers use cheap resin with lots of formaldehyde.

> There is no meter that can read the moisture - and Lumber Liquidators *knows* this. I've talked to their head of tech services.
>
> As a result, I stopped installing all bamboo flooring in the southeast - the hot, humid climate is bad for it. I also told customers to return the bamboo flooring they'd bought - that was the end of Lumber Liquidators sending me any business…

Steve's comments about the inspection process also echoed Jim's:

> Overall, Lumber Liquidators' products are crap, but when customers complain the company hires the worst inspectors who blame the customer or the installer - never the company. The inspectors, many of whom are low quality and unscrupulous, side with whoever pays them.
>
> In one inspection I did, I determined that the problem was defective flooring, but when I submitted my report to The Home Service Store, Lumber Liquidators' installation "partner", they told me to amend it and blame the customer. When I said no, they backed down - but have never hired me again (and instead blamed the installer and made him eat the cost of fixing it).

Steve mostly blames Lumber Liquidators, but also its customers:

> The American consumer is so dumb. People buy in droves from Lumber Liquidators because it's so cheap. Their wood products are as inexpensive as carpet. Lumber Liquidators' salespeople convince them it's high quality, but it's not. You don't buy ground chuck and expect a fillet dinner.

Conclusion

Normally after a stock declines more than 80% from the price at which I first shorted it, I declare victory, cover the position, and move on. But in the case of Lumber Liquidators, I haven't: I added to my short position at numerous points on the way down and, though I've taken a bit of profits around today's prices, it remains a substantial short position in the funds I manage.

The primary reason for this is that I don't think this is a case of a good company encountering temporary, isolated and fixable problems. Rather, everything I've heard, read and observed leads me to believe that Lumber Liquidators is rotten to the core. Tom Sullivan says, "Our goal is to sell a good product at a good price." While the company's prices are indeed low, all of the research I've done leads me to believe that this is more than offset by product quality that ranges from mediocre to outright defective (not to mention, in the past, illegally sourced or poisonous!). Worse yet, if the flooring fails, Lumber Liquidators is unlikely to stand behind it.

This business model isn't sustainable in my opinion - and bringing back its architect, Tom Sullivan, only makes things worse.

The T2 Accredited Fund, LP (dba the Kase Fund) (the "Fund") commenced operations on January 1, 1999. The Fund's investment objective is to achieve long-term after-tax capital appreciation commensurate with moderate risk, primarily by investing with a long-term perspective in a concentrated portfolio of U.S. stocks. In carrying out the Partnership's investment objective, the Investment Manager, T2 Partners Management, LP (dba Kase Capital Management), seeks to buy stocks at a steep discount to intrinsic value such that there is low risk of capital loss and significant upside potential. The primary focus of the Investment Manager is on the long-term fortunes of the companies in the Partnership's portfolio or which are otherwise followed by the Investment Manager, relative to the prices of their stocks.

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The fee schedule for the Investment Manager includes a 1.5% annual management fee and a 20% incentive fee allocation. For periods prior to June 1, 2004 and after July 1, 2012, the Investment Manager's fee schedule included a 1% annual management fee and a 20% incentive fee allocation. In practice, the incentive fee is "earned" on an annual, not monthly, basis or upon a withdrawal from the Fund. Because some investors may have different fee arrangements and depending on the timing of a specific investment, net performance for an individual investor may vary from the net performance as stated herein.

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October 31, 2015

Dear Partner,

Our fund rose 8.2% in October vs. 8.4% for the S&P 500. Year to date, our fund is down 3.4% vs. +2.7% for the S&P 500.

It was a big up month for the market and our fund almost kept pace amidst a very tough month for many hedge funds.

Entering the fourth quarter down more than 10%, I'd pretty much given up hope at ending the year in the black, but the odds have improved significantly after October's strong performance.

On the long side, there were numerous double-digit gainers including Grupo Prisa (66.7%), Samsung common and preferreds (21.0% and 30.3%, respectively), magicJack (29.2%), Reading International (22.3%), Spark Networks (17.4), GE (14.7%), Avis (14.3%), Delta Airlines (13.3%), Micron (10.8%) and Mondelez (10.4%). The only loser of note was Platform Specialty Products, which fell 17.4% (discussed below and in last month's Q3 letter).

It was a mixed bag on the short side. One of our largest positions, Exact Sciences, blew up (finally!) and crashed 53.7% (see Appendix A for the article I published about it on October 7th). Nearly exactly offsetting this was World Acceptance, which had what I believe is a dead-cat bounce and rose 42.1% (it's still been a huge winner this year), and our largest short position, which I plan to disclose in November.

Platform Specialty Products

I added to our position recently ~$10 when the news of CEO Dan Leever's departure tanked the stock. I liked Leever, but this investment, for me, is a bet on Martin Franklin. I suspect that Franklin realizes that, both financially and reputationally, his butt is on the line here and he's now engaged in a big way to fix this situation -- and, as part of this, pushed Leever out.

The stock has been more than cut in half in the past few months because the company is in the crosshairs of the weakest sectors of the market, namely:

- Companies with exposure to emerging markets (especially China and Brazil), commodities, and/or the agricultural sector;
- Companies with a lot of debt;
- Serial acquirers that rely on their own high stock price and/or cheap debt to make acquisitions; and
- Stocks widely owned by hedge funds.

In light of this, it's not surprising that Platform's stock has performed so poorly.

Note, however, that I said the stock has performed poorly, not the company. Yes, the company has taken down guidance, but Platform owns high-margin, low cap ex, high-free-cash-flow businesses, and I have no doubt that Franklin and his team are rapidly cutting costs and improving operations. For sure the

company is being affected by weakness in some of its markets and there will be no more acquisitions for a while, but that's okay, as there's plenty to digest.

Importantly, I don't think the company will issue any debt or equity, either of which would have to be done on very poor terms in this environment and thus would likely hit the stock. Rather, I think it will be able to get by with its bank line (though debt levels will be uncomfortably high until the company can use its substantial free cash flow to pay it down; hence the recent Moody's downgrade). Once the market realizes that Platform isn't going to do a distressed financing, I think the stock will start to recover.

Franklin made investors in Jarden more than 30x their money by not only being a savvy acquirer, but also a great operating manager (and hiring many more). Platform is now entering this latter phase and I think it's a good bet that the results over the next 2-3 years will be strong (I make no prediction about the next 2-3 months).

If I'm right, then I think the stock is a 3-4 bagger from today's depressed levels by ~2018.

As always, thank you for your support and please let me know if you have any questions.

Sincerely yours,

Whitney

PS -- I'm running my first marathon tomorrow morning here in NYC to raise money for one of my favorite charities, the Robin Hood Foundation (I've raised more than $50,000 so far). If you're interested in tracking my progress and/or seeing my finishing time, you can download the NYC Marathon app and entering my bib number: 19999. Wish me luck!

Appendix A

Why Exact Sciences Is A Great Short At $10

Whitney Tilson

Oct. 7, 2015 9:46 AM ET
Disclosure: I am/we are short EXAS. **(More...)**

http://seekingalpha.com/article/3555646-why-exact-sciences-is-a-great-short-at-10

Summary

- The U.S. Preventative Services Task Force's Colorectal Cancer Screening Draft Recommendation issued yesterday is devastating for Exact Sciences' only product, Cologuard.
- I think this is the beginning of the end for the company.
- My price target for the stock a year from now is $3, so I shorted more yesterday.

The shares of one of my largest short positions (~3%), Exact Sciences, crashed by more than 46% yesterday to close at $9.98 after the U.S. Preventative Services Task Force's Colorectal Cancer Screening Draft Recommendation listed Exact's sole product, Cologuard, a poop-in-a-bucket screening test, as an "Alternative Test" rather than a recommended one, and said numerous damning things such as:

- The USPSTF found no studies that assessed the impact of screening with FIT-DNA [Cologuard] on cancer incidence, morbidity, quality of life, or mortality.
- Evidence on the optimal screening interval, if any, is lacking.
- A theoretical concern about FIT-DNA is whether its use might lead to more frequent and invasive followup testing in persons who are not at increased risk of colorectal cancer because of patient or clinician concerns about abnormal DNA results.
- There are no data that evaluate how to implement FIT-DNA into a longitudinal colorectal cancer screening program.
- …empiric evidence is lacking on appropriate followup of abnormal results, making it difficult to accurately bound the potential net benefit of this screening test.

I haven't written about Exact Sciences prior to now because it isn't a fraud/scam or doing nefarious things like so many of the stocks I've written about on Seeking Alpha (see Chris DeMuth's summary of my calls on WRLD, LRN, LL, IOC, DDD and UNIS). Exact has a real product that addresses a very serious problem, the low screening rate for colorectal cancer, the second-leading U.S. cancer killer.

Nevertheless, I felt (and still feel) that it's a great short because the test has significant drawbacks that will severely limit its adoption and, in light of this, the valuation is absurd.

While I've never published an article about it before now, I did pitch this stock as my favorite short at the Robin Hood Investors Conference a year ago when it was at $24.22 (click here to see my slide presentation). In light of the 59% drop in the stock since then, it might appear to have been an easy short, but it was anything but. I first shorted it at $14.22 in April 2014 and watched it soar over the subsequent 15 months to a peak in late June of $32.85. This was extremely painful, but I was confident in my analysis and didn't cover a single share - in fact, I added to the position on a number of occasions, most recently just a couple of weeks ago at $19.57 - so it's nice to see my analysis (and stubbornness) pay off.

Why I Shorted More

Now I have a high-class problem: what to do when an investment works? While it can be dangerous adding to a short position that's already fallen a lot, it can also be highly profitable if the stock continues to plunge, as my experience with Lumber Liquidators demonstrates.

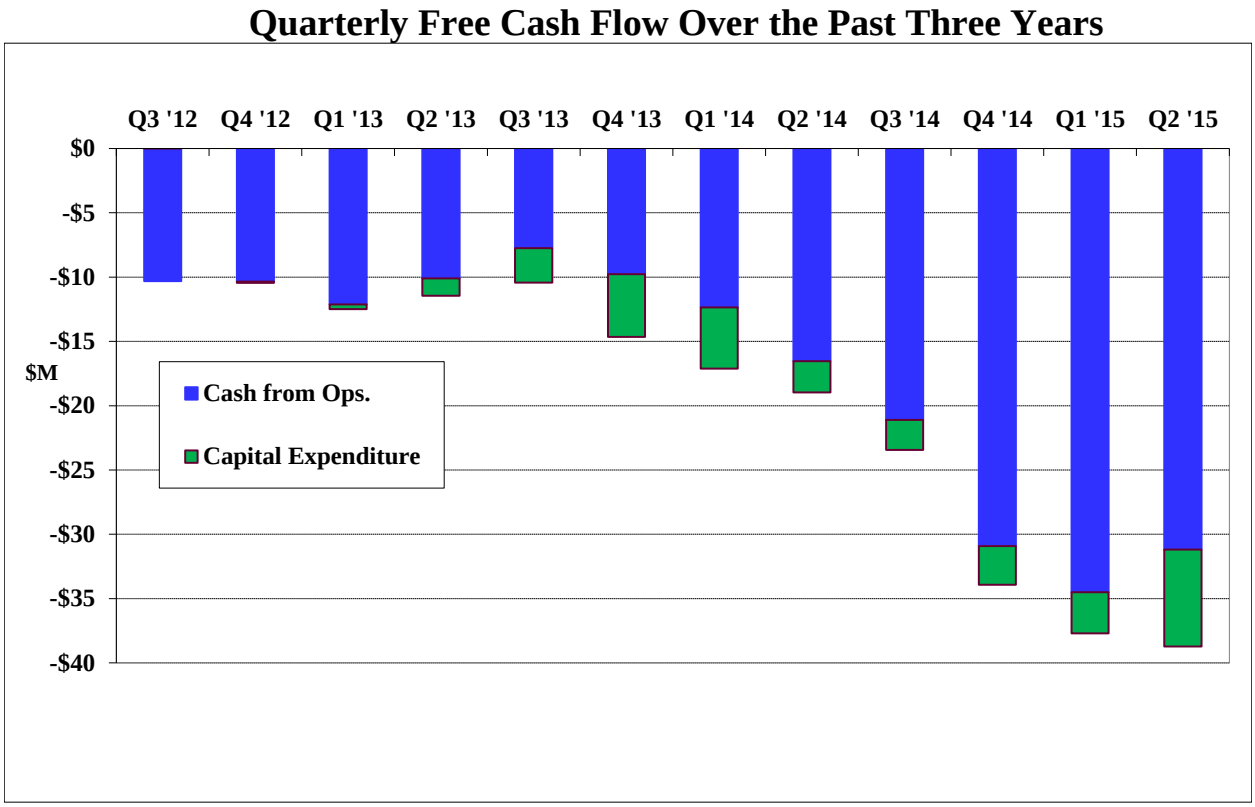
The only rational way to think about this is to pretend like I never had a position and was looking at this stock for the first time today. In the case of Exact Sciences, I fail to see how a "single product" diagnostic company, whose test just got body slammed by a highly influential group, could be worth anything close to its current market cap of nearly $1 billion.

I expect that the USPSTF report, which could hardly have been more damning, will cause what little demand there is for the test to plunge (what physician is going to prescribe an "Alternative Test" when far cheaper, established "Recommended Screening Tests" are available?) and many good salespeople to flee (one friend, who knows many Exact salespeople, tells me that the sales force is in a state of chaos, hardly surprising since most of their options are now underwater). As a result, I think the company is likely to miss analysts' revenue estimates by a country mile. Specifically, Cannacord and Wedbush, in their latest reports, predict 2016 revenues of $112 million and $113 million, respectively, which I think is laughable.

In Q2, Exact's revenues were $8.1 million, which analysts expect rose to $12.6 million in the just-ended Q3. I have no view on whether Exact will meet this number when it reports earnings at the end of this month, but I have a strong opinion that the company has almost no chance of meeting analysts' consensus going forward revenue estimates of $18.2 million in Q4 and $139.8 million next year. In fact, I think Q3 may well prove to be the peak and that the company's revenues will be well less than half what analysts are currently forecasting.

Enormous Cash Burn

If I'm right about a massive revenue miss, this, by itself, will crush the stock - but in addition, I think it will be difficult for Exact to reduce the enormous cost structure it's built up in anticipation of Cologuard's launch. As this chart shows, the company has been burning an average of $37 million over each of the last three quarters:



Note: Free cash flow is defined as cash from operations minus capital expenditure.
Source: S&P Capital IQ

Assuming Exact burned a similar amount in Q3, then it has roughly $350 million in net cash remaining (nearly $4/share, thanks to a very well-timed secondary offering in July at $25.50), which gives the company some breathing room. But investors who think this cash provides much downside protection for the stock are mistaken, in my opinion, because it will be needed to cover the company's large ongoing losses and thus will never be returned to investors.

Further adding to Exact's potential problems are two agreements with the state of Wisconsin and the city of Madison. Earlier this year, the company struck a deal with the Wisconsin Economic Development Corporation in which Exact will receive $9 million in tax credits, but only "by investing $26,264,000 in capital expenditures in Wisconsin and creating 758 new full-time positions - with an average wage of $24.47 per hour - in the state by December 31, 2020." Additionally, Exact is on the verge of signing an agreement with the city of Madison whereby the company would receive a $12 million grant to build its new headquarters in a downtown development. In exchange, however, Mayor Paul Soglin notes that "Exact Sciences will provide financial guarantees to bring at least 400 jobs to the headquarters facility and repay the city if those jobs are not created or if the jobs are relocated from the facility in the future." These agreements will make it very expensive for Exact to downsize, should that be necessary.

Thank You, Analysts

As Exact reports the dismal sales and enormous losses I expect over the next year and the stock continues to collapse, I think analysts will eventually throw in the towel, just as they did with Lumber

Liquidators. For now, though, they're in denial: of the three reports I read Monday, by the analysts at Jefferies, Canaccord and Wedbush, not one downgraded the stock and they generally said positive things such as:

- We'd be buyers below our price target of $18;
- Initial reaction appears overdone… we continue to view Cologuard as a potentially game-changing test; and
- We expect volatility, but reiterate our BUY rating.

Tuesday morning, the Canaccord analysts issued a new report in which they took down their numbers, but reiterated their BUY recommendation and wrote: "With EXAS' stock down ~45% following the news, but with EXAS owning a great test across a large sales force with strong commercialization intact, and Medicare unaffected (~60% of payors), we think the risk/reward is to the upside today."

I am grateful to these analysts for propping up the stock enough for me to add to my short position above $11 Tuesday. (Hat tip to the two analysts who've consistently been spot-on: Dr. Cathy Reese at Empire Asset Management and Bryan Brokmeier at Maxim Group.)

My Price Target is $3

I think Exact's stock will trade down over the next year to a slight premium to cash (which I estimate will be about $2.35/share a year from now), which would put the stock around $3, a very nice return on my short from current levels.