

*This article by Matthew Sweeney is excerpted from a letter of [Laughing Water Capital](#).*

Early in this letter I reminded you that in the best cases, we will be buying shares from irrational sellers. Redknee Solutions entered our portfolio as a top 5 position, and is an excellent example of buying from irrational sellers.

We have often talked about finding value in the hidden corners of the market: microcap stocks, low priced stocks, stocks that don't screen well, stocks that trade in less efficient markets, stocks that have recently gone through some sort of drastic change. These are all good places to look for opportunity as they are often over looked by larger market participants, but they are fairly vanilla in the sense that there is not necessarily irrational action taking place.

The fundamental truth upon which all intelligent investing is based is that the present value of a business is equal to the discounted value of all future cash flows that the business can produce. Over longer periods of time, the market will always recognize this truth, however, over shorter periods of time, this logic can be suspended, which can lead to tremendous opportunity.

In the simplest form of a rights offering, existing shareholders are given the right - but not the obligation - to buy another share of stock in a company, so that the company can raise money, and existing owners can preserve their percentage of ownership. In layman's terms, what that means is that if you own stock in a company that is doing a rights offering, you will wake up one day to find a "right" in your portfolio. As the owner of this right, you have 3 choices; you can

- 1) scrounge up some extra cash and purchase more shares in the company
- 2) sell the right on the open market, and take the proceeds as "found money"
- 3) do nothing, in which case either the right will expire worthless, or your broker or the rights agent will sell the shares on the open market, with no regard for price.

This would all be rather mundane if not for the arbitrage that can be created between the common stock and the rights, which can create irrational selling.

By way of example, imagine you owned stock in a company that was trading at \$1.00, and this company declared a rights offering with an exercise price of \$0.50. Ignoring transaction fees and the changes to the capital structure that will accompany the rights offering, if the right has an exercise price of \$0.50, and the stock is trading at \$1.00, the right should have a market value of \$0.50. In other words, it would make sense that you could pay fifty cents for the right to buy a stock at fifty cents if the actual stock was trading at one dollar, because the two are equivalent.

Right Market Price	\$	0.50		
Right Exercise Price	\$	0.50		
<hr/> Effective Price	\$	1.00	=	Actual Stock Price \$1.00

However, in practice, it doesn't really work this way. For starters, if a company is doing a rights offering, it is likely because they need the cash for something: quite often to fix a problem. Shareholders are thus presented with the option of investing more money in a company that likely has a problem, or selling the right on the open market and pocketing the "found money."

If they sell the right on the open market, it will likely push the market price of the right down, which can set in motion a chain of non-economic selling as existing shareholders and/or arbitrageurs sell the stock in order to buy it back through the rights. In other words, if the actual stock is trading at \$1.00, but you can "create" a new share of stock at \$.90 by buying a right for \$0.40 and then exercising that Right at \$0.50, it makes sense to sell your stock at \$1.00.

Right Market Price	\$	0.40		
Right Exercise Price	\$	0.50		
<hr/> Effective Price	\$	.90	Vs.	Actual Price \$1.00

Of course, if people sell their stock in order to create a new share at a cheaper price, the price of the stock will likely go down... and if the price of the stock goes down, the price of the right will go down with it... and if the price of the right is going down, those people who have been looking at the right as found money may rush to sell it before it goes down more... and the cycle repeats itself as sellers race toward the bottom while focusing on the arbitrage opportunity, not the discounted value of all future cash flows that the company will produce.

Right Market Price	\$	0.35		
Right Exercise Price	\$	0.50		
<hr/> Effective Price	\$	.85	Vs.	Actual Price \$.90

Eventually, the market will once again focus on the value of the future cash flows, and the stock price will rebound to levels supported by the fundamentals of the business, rather than hovering at the bottoms created by arbitrage players. To be clear, rights offerings are

not a magical way for investors to easily profit. As always, it is essential to have faith in the business and the management team; focusing only on a rights offering while ignoring the company and the management team conducting it is a recipe for disaster. However, rights offerings are a fertile hunting ground for outsized opportunities. All of the above is predicated on the idea that “sometimes people just sell rights,” which can drive the price down. This by itself can be interesting, but in my view, it becomes considerably more interesting when people are basically forced to sell the rights. It becomes extremely interesting when a knowledgeable party creates a negative atmosphere around the stock, forces people to sell the rights, and then offers to backstop any shortfall of the rights offering by investing more of its own money. This basic setup is what prompted our investment in Redknee Solutions, which was brought to our attention by Scott Miller of Greenhaven Road Capital.

### **Redknee Solutions (RKN.TO)**

On the surface, Redknee is a money losing Canadian microcap with declining revenue and a history of operational and balance sheet problems due to recent acquisitions. If that isn't enough to turn your stomach, consider that shares trade hands for less than \$1 a share, making it off limits for many funds, and even some brokers. In other words, just about every quality that the market hates can be seen here with a cursory glance or quant stock screen, putting Redknee well off the beaten path.

Despite the perceived negatives, the company is in the business of providing mission critical billing and customer management software to telecom companies, which has high switching costs, and thus represents a rather sticky revenue base. For patient, long term focused investors, a sticky revenue base can often outweigh a great many negatives, and thus despite its many problems, Redknee was able to attract multiple suitors after announcing that it was exploring strategic options in August of 2016.

First, Constellation Software, a publicly traded conglomerate that has been described as the “Berkshire Hathaway of software” offered to invest \$80M in the company through preferred shares with a warrant kicker. However, ESW Capital, a private software investment group, matched the \$80M offer while imposing less onerous warrant terms. It should also be noted that ESW had previously invested ~\$20M CAD in shares of Redknee's common stock at prices in the CAD \$1.50 to \$1.70 range, bringing their total investment to ~\$100M.

By way of a recap, the important takeaways at this point are that on the surface, everything about Redknee is something that the stock market hates. It is a money losing small company, with a sub \$1 per share price, trading in Canada with balance sheet problems. Despite this backdrop, 2 of the world's most accomplished software conglomerates fought over the opportunity to invest in this company, and the winning party invested approximately \$100M at prices significantly higher than where shares trade today. Clearly either the short term focused manic market is wrong, or 2 of the world's most accomplished software investors are wrong.

Upon investing this \$100M, ESW took control of the board of directors, installed a seasoned ESW executive as CEO, and began setting the stage to institute ESW's best practices at

Redknee. ESW is not well known to the investing world, but they are very well known in the software world as they have completed dozens of successful investments in the space. In short, they succeed by bringing the advantages of scale to under-scaled businesses, allowing them to greatly widen margins, and enhance profitability. They are able to do this by relying on their competitively advantaged platform that allows them to 1) increase productivity through their internally controlled Crossover talent outsourcing platform, 2) reduce costs through their DevFactory software development platform, and 3) share administrative expenses across their many owned and operated businesses. While I am generally wary of turnaround stories, I gain comfort from a story that revolves around a management group that made an initial investment of ~\$100M in the belief that they can successfully run the same process that they have successfully run dozens of times before.

### **“Do As I Do, Not As I Say”**

However, before beginning the turnaround, ESW began painting a negative picture of Redknee’s situation, including talking down revenue expectations and customer satisfaction scores, and basically saying that the situation at Redknee was worse than expected. Further, ESW announced that Redknee would be conducting a rights offering in order to raise ~\$60M to fund the company’s turnaround.

As you would expect, with the management team painting a negative picture of the situation at the company, shares traded down significantly. It is important to understand however, that prior to the rights offering, ESW had every incentive to WANT a lower share price, as the lower the share price, the more of the pro forma company ESW would own. Additionally, ESW offered to backstop the rights offering, meaning that they would purchase any shares that were unwanted by other rights holders, again giving them every incentive to paint a negative picture of the company, so that other market participants would not exercise their rights.

Again, by way of recap, we now have a company that the market hates, with a very experienced and successful group in control after fighting to invest in the company. After winning control, it appears that this group began to intentionally drive the stock price down, while simultaneously offering to invest an additional ~\$50-70M in the company. From my perspective, this was an instance of actions speaking louder than words, and I chose to focus on ESW’s willingness to write a big check, rather than their negative comments.

If talking down the company’s prospects was not enough, when the rights offering was formally announced, the details revealed that if one were to exercise their rights, the shares that they would own would not be registered in the U.S., meaning that 1) any non-accredited U.S. based investor could not exercise their rights, and 2) any accredited investor had to jump through paper-work hoops to prove their accredited status, and after they proved their accredited status, they would own shares that they could not trade on any exchange. Unsurprisingly, many investors simply cannot own shares that they cannot trade, meaning that they were forced to sell their rights.

As I attempted to demonstrate above, the structure of a rights offering can lead to irrational selling on its own accord. When the rights offering is structured so that some market

participants are forced to sell their rights, a mis-pricing of the underlying security is highly likely. Further, I am aware of at least 1 U.S. based brokerage (Schwab) that would not allow investors to sell their rights of their own free will. Rather, this brokerage elected to forcefully sell all of the rights in its client's accounts in one fell swoop regardless of price: clearly that is not an economic sell decision, which means potential opportunity for investors that are focused on the long-term prospects of the business such as us.

### **Downside First**

To reiterate, rights offerings are not a magic pill for successful investments. In fact, quite often companies that are pursuing rights offerings are doing so because they are in real trouble. As always, it is essential to understand the quality of the business, the quality and incentives of the management team, and what will likely happen to the business during difficult times. Redknee gets an excellent score on management due to their long track record of success in situations that parallel the Redknee situation, and the fact that on a fully diluted pro forma basis they own approximately 40% of the equity. Further, the company gets a good score on the quality of the business and what will happen during difficult times due to their sticky revenues, and the defensive nature of their customer's revenues. Where Redknee really shines however is valuation. To be clear, the company must meet considerable challenges in the quarters and years to come, but we established our position at close to 1x EV/Sales, while many comparable companies trade at 3x EV/Sales. Further, if ESW is able to execute the playbook they have executed many times before, Redknee should be capable of generating above peer group margins, justifying a higher EV/Sales multiple than peers. Most important, even if the company stumbles as they streamline operations, sellers are likely to be more rational than the uneconomic sellers we purchased from, likely putting a floor under shares. Thus, an investment in Redknee is essentially a very cheap bet that an extremely talented management team with a long track record of success and well over \$100M invested can simply do what they have done dozens of times before.

### **Potential Upside**

Marking a downside valuation in terms of a sales multiple pushes us to the fringe of our valuation framework; after all - cash flow is what it matters - not sales. However, given ESW's aforementioned internally controlled platforms that should allow Redknee to operate at high margins, we gained comfort. If they are successful, looking forward a year or three Redknee will likely be able to generate EBITDA margins somewhere between 25% to 45%. Further, while the company has guided to \$120M in sales, that may prove conservative as 1) they have had no incentive to say anything positive (yet), and 2) focusing on improving customer satisfaction and updating their offering could clearly drive sales. It is impossible at this point to know what the company will look like in a few years, and what it will be worth. However, it is not hard to imagine scenarios where a few years from now the company generates \$130M in revenue, 40% EBITDA margins, and trades at 10x EV/EBITDA. In this scenario, shares would trade hands at ~\$2.00 CAD, or almost 200% higher than where we last bought shares.

More interesting - and even harder to predict - it is possible that ESW uses Redknee as the

foundation for future public equity transactions. To date ESW has operated almost exclusively in the private markets, but as an acquirer of small software companies, public equity to use as currency should be attractive. In this case, which is impossible to handicap, our investment in Redknee could turn out be worth many multiples of its current price. From our perspective, what is important is that this is a free option that could be very valuable. We are happy to partner with an excellent management team, and excited to see how they create value at Redknee in the years to come.