RAGING CAPITAL
MANAGEMENT

August 7, 2013

July Performance Commentary

The Raging Capital Master Fund gained 22.0% net of all fees and expenses in July, its best monthly performance ever. We normally only comment on quarterly performance, but this month calls for an exception to that.

While the portfolio's long positions had a strong showing across the board, the stand-out gainer was Facebook, Inc. (NASDAQ: FB), which accounted for over 80% of our returns for the month. Excluding Facebook, the balance of the portfolio gained approximately 500 basis points on a gross basis, comparable to the S&P 500's 4.95% return.

As we outlined in our Q2 letter in mid-July (see full write-up below), we had a bullish and differentiated view on FB. Our conviction strengthened throughout June and July, as it became clear to us from numerous conversations with advertisers, agencies, and industry participants that the company had reached an inflection point in its advertising model. Specifically, advertisers were seeing fantastic improvements in the returns from their FB advertising, as a result of the broader roll out of the company's "News Feed" ad format. In turn, advertisers began shifting a growing share of their budgets to FB. Our conclusion was that FB could materially exceed Wall Street's estimates.

On July 24th, FB reported revenues of $1.8 billion, a figure exceeding the high-end of Wall Street's estimates by roughly $200 million. This represented growth of more than 24% sequentially and 50% from a year ago. Advertising revenues alone increased 61% from the same quarter last year. Average price per advertising impression and average revenue per user each increased roughly 25% sequentially. Mobile revenues accounted for 41% of total revenues in the quarter, up 76% sequentially. User engagement statistics also remained robust.

Anatomy of the Facebook Trade

We decided to swing hard at the FB pitch for a number of reasons: 1) our timely research edge that significantly deviated from consensus, 2) Wall Street's overwhelming bearishness on FB, and 3) because of our medium- to longer-term bullish outlook on FB's equity. That proved to be a wise decision; the stock closed up 30% at over $34 per share the day after the earnings release. It now trades above $38, roughly 50% higher than our cost basis.

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Facebook Position Allocation:

	% of Portfolio	% FB Position	% FB Profits	Commentary
Common equity & deep-in-the-money, long-dated calls	12.4%	83%	44%	Volatility risk in-line w/equity price, but minimal risk of near-term impairment
Long-dated, out-of-the-money calls	1.7%	11%	29%	Greater volatility risk, but only moderate risk of near-term impairment
Short-dated calls	0.8%	6%	26%	At-risk of immediate and total impairment

Altogether, we allocated nearly 15% of our portfolio to a combination of FB equity and options. Approximately 83% of this exposure was either common equity or long-dated, deep-in-the-money call options, thus minimizing the risk of permanent impairment of our capital in the event that we were wrong. Approximately 44% of our gains came from this "core position."

We complemented this core position with another 11% of our position exposure in long-dated, out-of-the-money call options, which limited our risk of near-term capital impairment. This allocation translated into substantial notional exposure as FB crossed $29 and $30 per share, and thus generated an outsized 29% of our total gains.

Importantly, only 6% of our position exposure, or approximately 80 basis points of capital, was "risked" in call options expiring in July or August 2013. This tail portion of the trade produced 26% of our total gains, including returns of more than 3,000% for some of the options. However, if we were wrong, these options would have likely expired worthless.

In sum, for a trade that generated more than 2200 bps of gross upside returns, we estimate that only 80 basis points of capital was at risk of near-term impairment. Further, in the event FB shares traded -7.5% to -12.5% lower after earnings, we estimate that our position would have only experienced additional *mark-to-market* losses of approximately 150-250 basis points. Again, given our medium-term bullish view on FB, we were comfortable with this type of short-term negative volatility outcome and felt that the ultimate risk of material impairment was reasonable and limited.

Current Positioning

On the day after earnings, we reduced our notional exposure by roughly 70% as we locked in significant gains. Today, we continue to maintain FB as our largest position in the Fund. We believe the company is now just "jogging" when it comes to monetization; in a few more quarters, it will be "running." We believe the company's advertising momentum is enormous. As a result, Wall Street estimates are too low across the board for the foreseeable future. Further, the stock remains under-owned and undervalued by the market versus similar growth peers.

Conclusion

We recognize that this may on the surface seem like a complicated trade, but in reality it was a pretty simple thesis. In many ways, it was the Peter Lynch style of investing at its finest: buy what you know. Anyone who uses FB, of which there are about 1.1 billion users, could have detected that News Feed advertising was becoming visually more prominent and engaging and that both ad loads and the volume of unique advertisers were rapidly increasing in the second quarter. All we did was match this observation against proprietary survey work, dozens of due diligence calls, and meetings with industry participants.

In the history of Raging Capital, this is only the third time that we "position-maxed" an idea. Hopefully, our "anatomy" of this trade highlights our balanced focus on both maximizing returns as well as carefully protecting capital. We are not afraid of volatility, and will swing hard when the right pitches come along. However, maintaining prudent risk management and always living to play another day are immutable rules of the game.

We would be happy to speak further if you have any questions or thoughts.

Thank you for your continued confidence.

Sincerely,

William C. Martin
Chairman & Chief Investment Officer
Raging Capital Management, LLC

Raging Capital - Q2 Letter: FB Commentary (Published on July 17, 2013):

First, as we briefly noted in our first-quarter letter, we have re-established a material position in Facebook, Inc. (NASDAQ: FB). Most of you will recall that we accumulated a large position in FB when it was private, and sold it for a substantial gain in February 2012 at $34 per share prior to the IPO. In our Q1 letter last year, we cited a substantial slowdown in revenue growth and noted that we did not feel comfortable "rolling the dice" by holding it through the IPO. That sale proved prescient.

Fast forward to today and FB continues to suffer from the investor hangover in part caused by their disappointing IPO. Despite its immense success, FB has become the company that everyone loves to hate. Still fixated on the failed IPO, investors worry about user engagement, advertising effectiveness, and quality of management. Even the media has turned skeptical of Mark Zuckerberg & Co.

We are bullish on FB and it is our view that Wall Street's estimates for revenues and earnings are too conservative. Specifically, in contrast to Wall Street's bearish views, we believe the following:

- **User Engagement is Not Waning:**

  As Mark Zuckerberg noted on the last earnings call, it has become "urban legend" that usage by the "under-25" crowd is waning. In particular, the popularity of new apps like Vine and Snapchat has contributed to investor concerns. We recognize the emergence of a new mobile medium, and fully expect that a diverse range of apps will indeed gain consumer mindshare, but our central view – as has been the case since we first bought the stock in 2010 – is that FB is an operating system for personal communications, and thus is very persistent and sticky with enormous network effects. Just ask my mother-in-law who has 1,759 friends on FB. She never fails to "Like" one of my pictures of her grandchildren within 10 minutes. Is she really ever going to leave FB?

  Facts back up our view that there is no engagement problem, even with the "cool" crowd: In our proprietary survey of approximately one hundred 15-18 year-olds, 96% of respondents said they use FB daily and 58% use it more than five times per day. If those users were allowed to use <u>only one</u> social app/platform, 62% said they would choose FB and 11% would choose Instagram (owned by FB).

  FB's own internal engagement statistics also demonstrate that, while the proliferation of mobile has led to the rise of new apps, it has also made it easier for users to engage with FB:

  Daily Active Users as a % of Monthly Active Users

March 2009	March 2010	March 2011	March 2012	March 2013
47%	54%	55%	58%	60%

- **Facebook Advertising is Effective:**

  Rewind to the beginning of 2012 and, yes, FB had a big problem: Its bet on HTML5 had put the company temporarily behind in mobile apps, and the mobile apps it did have lacked any advertising altogether. Its desktop advertising model primarily consisted of selling static ads the size of postage stamps. Not surprisingly, the performance of some of the original advertisements was very poor, leading some marketers to conclude that FB was an ineffective medium despite its sheer volume of consumer mindshare (20%+ of all time spent on the Internet and Mobile). Many on Wall Street still believe that this is the case.

  We believe the most powerful story at FB today is the aggressive roll-out of new, powerful, and quite innovative advertising tools over the past year. From Custom Audiences to Partners Categories to Mobile App Install Ads to Facebook Ad Exchange, FB has revolutionized its offerings. Our research indicates that with the new capabilities FB has been able to improve the performance of some its "postage stamp" advertisements by 3-10x alone in recent quarters. More impressively, the roll-out of advertising into the News Feed (first on mobile last year, and more recently on the desktop) has led to average increases in engagement and clicks from 25x to 200x prior levels. Those are exponential improvements. Further, the News Feed advertisements are visually beautiful and becoming more and more contextually and locally relevant. Anecdotally, some of the News Feed advertisements I have recently seen are among the *best* advertisements I have ever seen online.

  Progressive marketers understand these changes and are increasing their budgets accordingly, and the rest of the marketing industry is going to follow. Meanwhile, Wall Street consensus expects another slowdown in advertising revenue growth at FB. In contrast, we believe that the company is only in the top of the third inning in terms of monetizing its massive advertising inventory. Average revenue per user, average CPM, and overall inventory utilization – whether on the desktop or mobile – are all poised to ramp meaningfully, thus driving greater-than-expected revenue growth.

Again, Wall Street is focused on the noise around FB and ignoring the core, fundamental improvements that are taking place. They also give the company little to no credit for the medium-term monetization opportunity at Instagram, video advertising (FB is effectively offering the marketing equivalent of the Super Bowl each and every day of the year), the opportunity to launch a broader Facebook Ad Network, the potential for Graph Search (albeit early days, but clearly an impressive and visually beautiful product), or the option value associated with FB's massive network effects.