

Exploring each of those categorizations further:

Asset quality: White Brook believes that asset quality is the most important factor in determining the long-term value of a company. There are times when a Company is significantly undervalued - even when it's not meaningfully building value - because of a temporary stock dislocation which less meaningfully impacts the underlying business than reflected by the stock price movement. Those types of inefficiencies are more strongly felt in the market in recent years but are too sparse to build a somewhat diversified portfolio with attractive after tax properties.

In White Brook's view, valuing asset quality must be at least somewhat synonymous with discovering asset value. While stock prices usually reflect value from growing assets before or while they are being built by a company, sometimes there is an "asset quality inefficiency" where the stock price indicates that the market doesn't adequately value a company's assets. White Brook spends most of its time looking for these inefficiencies through a detailed analysis of a company and its industry, carefully sizing the risks and opportunities of the company's base business and new ventures. Organizational changes, industry shifts, changes in the characteristic of revenue and cost generation, and latent monetization opportunities, for example, can all lead to a company whose asset quality is inappropriately valued.

The difficulty in finding these companies and owning them over the long term is that it takes time and money to develop new or change existing businesses. Traditional asset quality ratios like return on equity, return on invested capital, and cash return on invested capital are based on historic data and do not reflect the company's current or future reality. At the same time, the additional spending on a new initiative increases the risk of further deterioration to the company's run rate financial metrics. This makes it hard for analysts who rely on data to develop a credible investment thesis. Ironically, the more compelling the opportunity and therefore the necessity of the investment, the worse its metrics will be, and the more pronounced the apparent risks. It's only when the new asset quality is unveiled that the company gets credit, and the stock appreciates – and that can be a slow or step function process. Either way, over the medium and long term, if properly applied, it should result in above market appreciation as the market reassigns the multiple it places on the earnings of the business and revises the forecast of the company's earnings.

One recent example of this inefficiency is the large capitalization stock Microsoft. Large capitalization stocks are frequently thought of as being efficiently priced because hundreds if not thousands of analysts are constantly reviewing the projections for large companies. Yet in the case of Microsoft, since the CEO change, the stock value has doubled. Satya Nadella, Microsoft's CEO, led an accelerated change of the organization from one that was PC dependent to one that was productivity dependent. The PC was and continues to be the most productive device in the workforce's disposal, but by growing the Office division and emphasizing a multi-platform approach, the company pivoted. Apple and Google business product market share gains were reversed by Office becoming an affordable software as a service product whose robustness could not be matched by upstarts. On the back of this, the Company accelerated its cloud services growth, differentiating from the market leader, Amazon, by offering higher service reliability and the ability to integrate with on premise offerings that established enterprises had already invested in. Creating a SAAS revenue stream and using its incumbency as an advantage were latent assets previous to Nadella's leadership. On the back of those expansions, Windows and Microsoft's Surface line-up have once again become "cool", particularly amongst Millennials - a position Microsoft has never enjoyed. The foundational assets of much of the gains were built years ago under Steve Ballmer's leadership, yet it took a CEO change and a pivot to emphasize what was already one of the

company's largest businesses to focus investors on Microsoft's potential. The company has carried through with a culture change and forward thinking that has coincided with a change within Silicon Valley to focus on productivity rather than the Social Networking emphasis of the early 2010s. Microsoft, once an afterthought, is becoming "loved" by developers and businesses alike, and the resiliency of their income stream, once thought to be in irrevocable decline, is growing. With the continuing realization of these asset quality improvements, Microsoft's stock value has appreciated accordingly.

Invested capital: The WBAQ is significantly driven by balance sheet optimization, with a focus on value creation trends and future potential. The firm's "firepower" compares the current amount of debt to the amount of debt the company should have given its cash flow characteristics. Growth in EBITDA as well as FCF generation increases that value, while an increase in the cost of that debt for any reason has a depressing effect.

There are potential lollapalooza effects driven by improvements in asset quality. A company that would be considered highly levered at 2.0x EBITDA when its revenue stream is transactional or discretionary is appropriately levered at 3.0-4.0x if its revenue is contractual or its business is a utility for another company. Therefore, evaluating the appropriate capital structure of the business requires a full evaluation of the company's assets as well.

The WBAQ focuses on the potential leverage of the firm that optimizes the capital structure and preserves flexibility, rather than the current amount of debt. The belief is that an under-levered balance sheet represents a latent ability to buy earnings whether it's another company or its own. Therefore, the ability to shrink equity or the potential to buy earnings is a significant contributor to WBAQ.

Messaging/Management: Assessment of management is a component in the assessment of a company's asset quality, but is done as a wholly contained module rather than combined with a wider asset quality assessment. It is one of the most difficult assessments and one that I believe the market mishandles frequently. In White Brook's experience, investors consider management teams to be high quality when the company has already made investors a lot of money, rather than based on evaluation of strategy, expertise, and fit. At the same time, White Brook believes that investors who often speak to management outsource their thinking and put their own judgement in hibernation.

Instead, White Brook examines management on two bases:

1. What is management's skillset? Does it coincide with what the Company needs?
2. How does management communicate with investors?

We believe these two questions lead to prescriptive judgements about the likely evolution of a company and can result in identifying great companies before they're widely regarded as such.

To answer the first question, we go back to understanding the business and industry and then the structure of the company. If it's a multidivisional firm, who is the divisional head, what is the required skillset and responsibility, and do these match? Is the sales process aided by the CEO? Does the current CEO have the appropriate qualities? Is the Board of Directors an oversight organization or does it determine strategy, with the CEO left to execute? Is the job of the CEO to communicate with Wall Street? How well does the CEO explain the company's strategy or their vision of how the industry will evolve?

CEOs can be multiplicative to the business, or they can be additive as well as the reverse.



Revenue: Most investors focus on revenue and cost trends. White Brook's belief is that for a company building a new asset, financial revenue and cost trends are less impactful than when the business is at other points in its life cycle. This is not to say that the overall level of earnings isn't important. It is important. It helps define the stocks valuation and a lower bound. However, White Brook doesn't believe that correctly forecasting those trends as the asset begins to earn helps define the opportunity. The firm instead focuses on the strategic value of the new asset and its overall potential as outlined earlier.

Costs: While White Brook will forgive cost overruns for a new business, White Brook scrutinizes the costs and margin expansion opportunity of the remaining business. Companies are typically able to achieve improving margin profile by either raising prices of their goods or services or by selling more items with a fixed cost dominant structure. White Brook seeks companies that can improve costs outside of those two avenues or that have costs that are more variable than fixed, such that the company enjoys exponential free cash flow growth when revenue grows.

My hope is you've found this exploration into one of White Brook's tools valuable. As always, feel free to reach out if you have any questions.

Sincerely

A handwritten signature in black ink that reads "Basil F. Alsikafi".

Basil F. Alsikafi
Portfolio Manager
White Brook Capital

All investments involve risk, including loss of principal. This document provides information not intended to meet objectives or suitability requirements of any specific individual. This information is provided for educational or discussion purposes only and should not be considered investment advice or a solicitation to buy or sell securities. The information contained herein has been drawn from sources which we believe to be reliable; however, its accuracy or completeness is not guaranteed. This report is not to be construed as an offer, solicitation or recommendation to buy or sell any of the securities herein named. We may or may not continue to hold any of the securities mentioned. White Brook Capital LLC and/or their respective officers, directors, partners or employees may from time to time acquire, hold or sell securities named in this report. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable, or that the investment decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.