

First Quarter 2017 Commentary

Housekeeping

Concurrent with this commentary, White Brook Capital (“White Brook”) released another memo entitled *Ad-Hoc Memo: White Brook Asset Quotient* that describes a key part of the White Brook Capital investment process. It may be useful to read that memo to better understand White Brook’s investment process.

March Quarter 2017 Commentary

White Brook Capital’s Model Portfolio (“Portfolio”, “Model Portfolio”) continues to be more conservatively positioned in its view, focused on companies that create value at an enhanced rate that White Brook believes is underappreciated by the market. As always, the portfolio’s concentration in a limited number of positions may result in the Model Portfolio not tracking with the S&P500 over the short term.

In the first quarter, five stocks in the Portfolio outperformed the S&P 500 by over 10%: Box Inc (BOX), Chipotle Mexican Grill (CMG), Dolby Laboratories (DLB), Liberty Global PLC (LBTYK), and Realogy Holdings (RLGY). Three stocks underperformed by over 10%: Baker Hughes Corporation (BHI), BBT Corporation (BBT), and Silver Spring Networks (SSNI). A number of stocks unmeaningfully underperformed and that outweighed the strength of the big moves, however, resulting in the Portfolio performing slightly weaker than the benchmark in the quarter.

During the quarter, Chipotle Mexican Grill (CMG), Inc, Liberty Global (LBTYK), and Box Inc (BOX) were the biggest contributors to the Portfolio’s performance, while Silver Springs Networks (SSNI), Baker Hughes Inc (BHI), and Synchrony Financial (SYF) were the biggest detractors to performance.

Silver Spring Networks (SSNI) was the only new position entered during the quarter. White Brook continues to build the position and is very bullish on the long-term opportunity.

No positions were exited during the quarter and no investment theses changed materially during the quarter.

Following up on the previously mentioned stocks:

- Chipotle (CMG) rallied strongly during the quarter, as it engaged in a series of actions almost directly out of the playbook prescribed in the Ad-Hoc Memo published in September. White Brook has not sold the position in the Model Portfolio and believes the upside continues to be considerable.
- Envision Healthcare (EVHC) is also playing out as outlined during the 3Q letter with its ambulance services asset (AMR) now formally evaluated for sale. Unfortunately, the stock has been weighed on by health care reform concerns and the stock has not yet positively responded. White Brook believes the stock is very cheap and has added to the position.
- Baker Hughes (BHI) traded down with the price of oil during the quarter. White Brook believes the correlation and the corresponding downtrend will end, and the stock should become uncorrelated to oil prices in the medium term. White Brook has not added to or sold the position in the Model Portfolio and believes the upside from here to continue to be considerable.
- Brexit, the first macroeconomic event visited in White Brook’s second investment letter, was finally triggered at the end of the quarter. White Brook has become more bearish on the

likelihood that the UK remains in the EU. Its eventual outcome has a limited impact on the portfolio. The Portfolio does have exposure to Brexit via the investment in Liberty Global (LBTYK), a European cable conglomerate that owns Virgin Media, the largest UK cable company, and on a more limited basis through investments in multinational companies. Liberty Global has smartly matched its expense and revenue currency exposure such that its pound exposure is limited to the translation effects of reporting in US dollars. The exposure is a drag on the stock price, but one that is outweighed by the strength of the franchise.

Market Outlook

As always, there are broadly five investment alternatives one can hold at any time: cash, cash-like alternatives, debt, equity, and real estate, all of which you can or will soon be able to invest in through your investment account at White Brook Capital.

Fixed income securities overall have appreciated and are a slightly worse investment today than they were when discussed in the letter last quarter. It continues to be an appropriate time to begin to engage in conversations about how best to enact a fixed income strategy, even while it is not yet time to dedicate additional capital to one. It now appears that the White House and Democrats want to raise the debt ceiling with little fanfare, while the motivations of House Republicans continue to be a wildcard. White Brook continues to believe it prudent to wait until US government spending bills are passed, as a change to US tax and spending policies may have an outsized impact on low yielding bonds.

Cash can always be expected to depreciate at the rate of inflation – currently around 2% a year. However, cash does represent an option to invest later and, with potential changes in fixed income and equity markets, is a more attractive option than it has been.

Cash-like securities continue to be attractive. The Model Portfolio's modest investment in gold performed well in the first quarter and due to that price appreciation is a less attractive investment today. Macroeconomic risks, continue to make it a good hedge and the Model Portfolio continues to hold the asset. Please reach out if you would like additional exposure.

White Brook continues to feel passionately about the discrepancy between the valuation and the prospects of the stocks in the Model Portfolio. The Portfolio slightly underperformed during the first quarter, significantly outperforming in January and much of February, before underperforming in the last week of February and the first three weeks of March. In White Brook's view, the proverbial spring is loaded. The companies in the Model Portfolio continue to build value and that value is not being accounted for appropriately in their stock prices.

With the Trump administration starting to mimic some of the attitudes of a reasonable administration, White Brook is more comfortable with the market multiple than it was a quarter ago. Unfilled positions in the administration raise the prospect that citizens will suffer in unpredictable ways while Attorney General Sessions continues to outrage reasonable people with a far-right wing social agenda. I believe there is an increased likelihood of Democrats taking a majority in the House of Representatives in 2018, and that that specter will freeze major conservative legislation that requires moderate congressional support late into 2017 and early 2018.

On economic policies, increased influence by moderate elements in the administration is likely to be beneficial and lead to a continuation of more of Obama's economic policies than initially assumed. White Brook believes keeping the country's economic animal spirits at bay will result in slower but steadier growth and economic order that is supportive for investment. In White Brook's view, minimal tax or

health care reform is a good thing for markets over the medium and long term, even while it might disappoint actors with short term incentive structures. Instead, White Brook favors little tax reform and targeted change to health care that fixes specific market failures until the balance of power is less partisan and compromise can result in better larger reform or no reform at all.

At an earnings multiple of ~17.5x, the market as a whole is fully valued given the current projected growth prospects. In White Brook's view the bias of growth prospects is likely upwards, but it's prudent to assume an unchanged earnings multiple - resulting in market appreciation of approximately the consensus earnings per share annual growth rate for the S&P 500, 7%, for 2017.

Some investors are more bearish. They see a consumer that cannot get much stronger given already very high confidence, low unemployment, and a consumer savings rate within the range of normalcy. They see consumer credit delinquencies starting to tick up, along with non-performing car loans, and corporate gross margins at a historically elevated level even while corporate balance sheets are more levered than they have been. White Brook notes the same fact pattern and believes it's prudent to be cautious, but is reminded of the history of the market, which habitually climbs the so called "Wall of Worry."



It will at one point be the top, but White Brook tempers its near-term concerns with a focus on the fundamentals of the fixed income markets.

Fixed income markets are said to be a pricing mechanism for risk. The so called "risk-free rate" is set by the US treasury because of the de minimis risk that the United States Treasury defaults on its debt. With the bond guaranteed to be paid, the only variable is time. Every subsequent security therefore can be ultimately compared to a security backed by a US backed note, and the individual risks represented by a given security can be distilled. While short term notes are largely determined by the Fed through the Fed Funds rate, in the absence of quantitative easing, the Fed has less influence on notes the further into the future they mature due to the massive size of those markets. In that way, the market directly prices *time* and in so doing adds a recursive element where the attractiveness of other investments impacts the price of time. Simply, US Government securities are not only an anchor but also reflect other activities in the fixed income market.

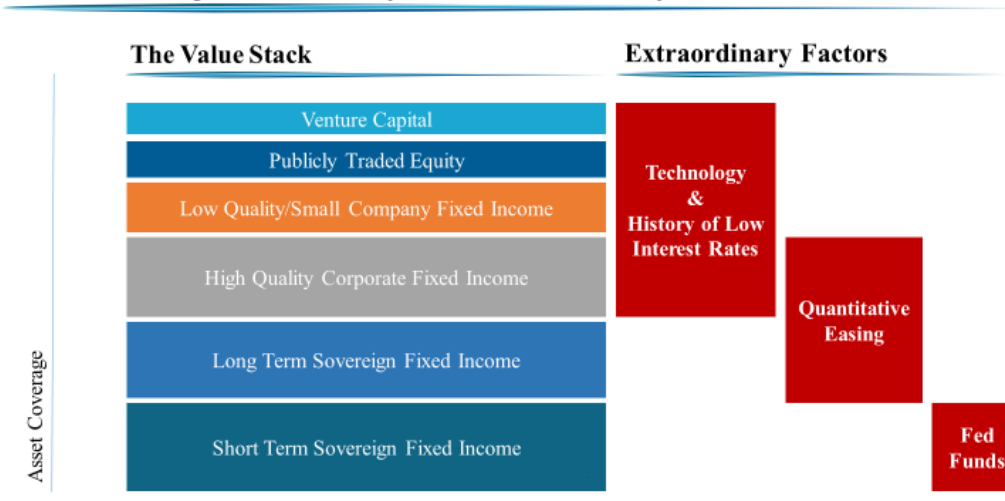
That said structures of markets can change. Practitioners often comment that equity markets have changed since the 1980s and 1990s as the internet made the flow of information fast and ubiquitous. Over the past decade, extremely low interest rates and the inexorable march of technological

sophistication have similarly changed fixed income markets. On the financial front, since the financial crises, high quality companies like Microsoft have issued medium term debt with interest lower than 1%, and very long term (40 year) bonds with coupons lower than 5%. At the same time the catastrophe bond market has multiplied in size, democratizing the reinsurance market and lowering the fundamental price of risk for insurance companies. To emphasize, companies that absorb undiversifiable risk are able to fund their operations more cheaply. These developments are substantial. Large, high quality corporate credits compressing the spread to the treasury and undiversifiable risks becoming more cheaply mitigated fundamentally change the price of risk.

On the technological front, new methods of determining credit worthiness have increased the feasibility of peer-to-peer and asset based lending to small and very small businesses. Investing in real estate, often considered an asset with many fixed income characteristics, is also being democratized by technology focused real estate ventures that syndicate the loans and equity directly to accredited investors, rather than relying on Private Equity or other institutional investors. With more potential investors, capital is more cheaply accessed, enhancing the returns to the equity holders.

One of the ways to think about investing in equity is to think of it as investing in the most junior bond available with no guaranteed asset coverage or dividend payment.

White Brook Capital: An Economy's Asset Class Hierarchy



The value stack of a country can be thought of as:

1. Sovereign debt, which is the most secure asset;
2. High quality corporate debt, which is also very secure but less so than sovereign debt;
3. Low quality corporate debt, which promises a dividend but may or may not be covered by assets;
4. Publicly traded equity, which may or may not promise a dividend and may or may not be covered by assets; and
5. Finally entrepreneur equity or venture capital, which has no dividend or assets.

The idea of fixed income pricing is to say that a tick up in the price of risk at the short term sovereign level should have a follow-on impact on everything that is built on it. However, if the structure of the

market changes and the pricing mechanism itself changes, then that transmission may occur differently than historically has been true.

White Brook has expected the Fed's support of the economy to begin to wane and is certain that government securities' interest rates will rise in time. I suspect, however, that the impact of that increase in rates will be less than is commonly assumed based on historical precedent, as the recognition and impact of new financial instruments and technology is underappreciated. I further suspect that the most junior elements of the value stack will have a steady state valuation that is higher than has historically been true. While overall market valuation therefore is full, White Brook doesn't expect a wholesale long term devaluation of the market and therefore believes that earnings growth will continue to slowly propel the market to the upside.

In Focus: Silver Spring Networks (SSNI)

White Brook entered Silver Spring Networks (SSNI, "Silver Spring" or "The Company") slightly too early and took an early loss in its position this quarter. White Brook has been adding to its initial position in the Model Portfolio, however, and believes the potential returns to be more than what it conservatively models.

To White Brook, Silver Spring is a perfect tweener. It splits the investment community, as energy analysts do not quite understand the smart/telecom aspects of the business while technology analysts don't quite understand the municipal/utility aspect of the business. At the same time, while the Company is well led, it is poorly messaged. White Brook believes if the Company can fix their messaging and continue to execute, in time, it will prove to be a tremendous investment opportunity at these levels.

Silver Spring Networks was founded in July 2002, signed its first customer in 2007, and went public in March 2013. The Company's legacy business is as a provider of technology that enables power utilities to automate the reading of a building's energy meter. While there are differences between smart meters, the business has become commoditized. The Company, however, has widened its solutions and built on their two-way communication technology to: help electric utilities manage their load and respond to demand fluctuation, help water utilities manage their meters, and help municipalities light their streets. Of these solutions, the first two are basically commoditized industries, while the third is less competitive and Silver Spring's position is enviable.

White Brook's excitement is based on the Company's smart streetlighting products. A leader in the industry, the Company enables intelligence in 30% of intelligent streetlighting with a recent win – share of over 50%. In conjunction with providing communication capability to street lighting, Silver Spring includes a second radio that creates a mesh wireless network that the Company manages, to provide a layer of communication across "smart devices". The network benefits from classic network effects with each system growing in importance and capability as more devices are connected. The devices extend the network, and the abilities of the devices grow as they work in conjunction with adjacent systems.

The latest version of the network provides throughput of up to 2.4 MB/sec to each device, is redundant by nature of its mesh networking, and is power sipping, secure, and can connect devices within 50 miles. It operates on an open standard that is extensible, backward compatible, and easy to develop for. It is most appropriate for devices that are either stationary or that move and then stop. The Company earns between \$2-\$3 for each connected endpoint and a \$100 fee for the communications chipset used to connect to the network.

By winning streetlight contracts, Silver Spring creates a better propagated network than competitors with an incumbent presence in energy or water meters. This technological capability, depending on how it is defined, is shared with a handful of other companies of which three, like Silver Spring, do not provide major infrastructure. In the utility and municipal space, where entities need to prove to rate and tax payers that they're getting the best deal, municipalities may seek to avoid locking in to one provider of streetlight infrastructure for fear that they may overpay on big-ticket items like the water meter or streetlight. Instead, being agnostic to the infrastructure provider can be an advantage in subsequent negotiations. Of the agnostic network providers, Silver Spring is the largest, with a backlog equating to over \$1.1 billion. When that backlog turns into cashflow, under conservative assumptions, it represents over 80% of its market capitalization.

White Brook believes the management team is both good and appropriate. While "the largest Internet of Things Company You've Never Heard of" is their chosen message, White Brook believes that it is terrible branding. In White Brook's conversations with experts, no two experts give the same definition of what the "internet of things" ("IOT") encapsulates, and investors don't either. That said, Mike Bell, the CEO, has previous experience that suggests he is the type of leader that is well positioned to lead Silver Spring Networks. He is an engineering visionary that a company with a great technological core that needs to be developed will benefit by having. White Brook believes, however, that his go to market capabilities are limited.

To Mr. Bell's credit, he hired Aysel Ildeniz as COO. A veteran of Intel, Ms. Ildeniz built and managed in-country marketing teams. While her last stop was in the ill-fated New Devices Group, White Brook contributes that failure to a slow developing technology without a purpose rather than to an inability to execute. Ms. Ildeniz's hire suggests a change in go to market strategy from a US centric model to building out longer term in-region sales teams that are also available for support. While this model will result in higher fixed costs, it's the right model for the Silver Spring business and Ms. Ildeniz is well suited to carry it out successfully.

Conservatively, White Brook sees over 60% upside over the investment horizon based on the following:

1. **The international opportunity is just getting started and the US IOT business is nascent:** Both opportunities are in the very early innings with total addressable markets that add multiples to Silver Spring's total addressable market. While it will take time to educate and execute on those sales, the company has 6 years' worth of backlog, and it can continue to grow sales high single digits while adding to the backlog.

Additionally, the deal sizes from both segments are likely to be smaller than the more consolidated US energy utility market and will help stabilize Silver Spring's growth, which has suffered from limited but repeated contract slippage by different customers. Smaller contracts will even out quarters and fill in Silver Spring's installation capacity when a large customer delays, resulting in smoother revenue growth and fewer earnings surprises.

2. **Silver Spring can use its cash balance to build a traditional SAAS business:** While Silver Spring's services should be ratably recognized, some of the Company's municipal and utility customers prefer for their expenditures to be capital expenditures where they can show an IRR rather than a continuous operating expense. Silver Spring accommodates their customers, making their revenue look lumpier than it is. As corporate customers address their connectivity needs, the services will be booked as the more valuable recurring revenue stream that it is.



Additionally, Silver Spring has a significant cash balance that it can use to help corporate customers finance the rollout of the technology. While the Company will use its cash balance, it will be able to outcompete its smaller competitors while building a formidable recurring revenue stream.

3. **Silver Spring can fix its messaging:** The Company's sell-side analyst base does it no favors, with a healthy supply of "new energy" analysts focused on solar companies and a few networking infrastructure analysts – neither of which reflect accurate comparables to either side of its business.

Consider that the Company sells a \$100 communications solution for a product that costs between \$200-\$5,000 and has another company's label on the box along with managing a network for \$2-3 an endpoint. In many ways, Silver Spring Networks is a semiconductor company, whose customers are the energy, water, and streetlight manufacturers that install it, and the municipalities and utilities that buy the capability rather than a consumer goods, computing, or communications company. The difference in end markets creates a different growth profile, lowers reinvestment costs, and lowers gross profit margins, but results in much higher barriers to entry and similar operating margins when compared to most semiconductor companies. Management should position the Company in line with that reality. As the Company's technology expands to non-municipal customers the more highly valued SAAS component will result in a much higher valuation for the combined company.

Ultimately Silver Spring is a company with a tremendous strategically valuable asset base and good management team, currently depressing earnings by investing in its sales and go to market capability. As the Company has success in the marketplace, White Brook expects the stock price to reflect the sizable backlog and for the stock to appreciate considerably. White Brook believes that its forecasts are conservative, and looks forward to the company executing over the next couple quarters and creating sizeable value over the next several years.

Housekeeping cont'd

This letter was delayed so that current clients would concurrently receive an invitation to White Brook Capital's new investor portal. You will receive an email from White Brook in the next several days inviting you to complete the login process. Its release also accounts for the slightly different format of this quarter's commentary. Please be on the lookout for that invitation and reach out if you have any questions or comments.

As always, I appreciate your time, investment, and interest. If you have any questions or concerns or just want to chat, please do not hesitate to reach out.

Sincerely

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

Basil F. Alsikafi
Portfolio Manager
White Brook Capital

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