

Second Quarter 2017 Commentary

Housekeeping

The new client portal is now fully set up. Clients can use the portal, accessible on whitebrookcapital.com, to access all documents from White Brook Capital. The portal should bring enhanced transparency to the investment portfolio on a near real time basis. Please reach out if you have any questions.

White Brook is excited to have begun incubating a new portfolio called the Concentrated Opportunities Portfolio (“Concentrated Opportunities”). In conversations with clients, consistent feedback received was a desire for an investment option that is more concentrated and holds fewer positions. Concentrated Opportunities is that strategy.

The Concentrated Opportunities Portfolio will be significantly more concentrated than the White Brook Capital Model Portfolio (“Model Portfolio”), with no constraint on position size or cash concentration, and will invest in equities of any market capitalization in any concentration in any sector. This means that Concentrated Opportunities can be invested in a single stock or hold 100% cash, although my expectation is that it will usually be well invested and contain a maximum of 12 positions. Traditional literature would dictate that the portfolio will embed increased risks due to the increased concentration of investment and all the other risks detailed in White Book’s ADV, which also apply to this portfolio.

Like the Model Portfolio, Concentrated Opportunities is intended to outperform the S&P500 over a market cycle. It can be expected to primarily invest in the same opportunities as the Model Portfolio although in fewer, and at a higher concentration. While all stocks are in part dependent on the performance of the overall market and sector, Concentrated Opportunities seeks to invest in those stocks whose fortunes are least dependent on a macroeconomic view, but not in so called “special situations” that have a binary outcome. While it is not the right portfolio for every client for clients that can stomach volatility it may advantageous.

It is also important to note that during the two and a half months of incubation, there have been times where the Model Portfolio has outperformed the Concentrated Opportunities strategy. White Brook is attracted to certain types of ideas, and generally those ideas are suitable for both portfolios. However, due to the more limited number of stocks in Concentrated Opportunities, sometimes stocks included in the Model Portfolio won’t be in the Concentrated Opportunities strategy. For instance, through the third week in July, Liberty Global (LILAK), Microsoft (MSFT), and Google (GOOGL), are up 20%, 7%, and 7% respectively vs. the S&P 500 up 1.9%. On the other hand, Box a 5.5% holding in the Model Portfolio but over 10% in Concentrated Opportunities is currently up almost 8% so far in July. Since inception, Concentrated Opportunities is 4.7% vs the S&P up 3.5%. The track record is short however, and therefore not very significant.

As I approached the end of White Brook Capital’s first year, I reflected on exactly what I want White Brook to be moving forward. White Brook continues to be an equity-first manager and, with the launch of the Concentrated Opportunities strategy, is doubling down on that sentiment. While White Brook is happy to be a client’s primary investment advisor and advise in crafting fixed income portfolios, it is also delighted to be a complementary advisor - investing only an individual’s equities, and will work hand in hand with another advisor to do so for clients. Most wealth managers are paid equally regardless of asset class. From a wealth manager’s perspective, the least amount of work with the highest return is building a fixed income and ETF portfolio. White Brook is building its reputation, however, on long term



investing performance. It's the most amount of work with the lowest return per gray hair for a wealth manager, but it's what I love doing and I believe I have a differentiated skill set that will be apparent over time. White Brook Capital is aimed squarely at those who want to invest in stocks or hedge funds, but aren't thrilled at the thought of paying a 2% management fee and 15-20% of profits for performance that is consistently less than 50% of the return of the S&P500 in good markets and worse in bad markets.

Finally, in appreciation for joining White Brook Capital during its first year of operation, White Brook Capital will not be charging clients a management fee for the second quarter of calendar year 2017. Thank you for your confidence and support. I will continue to strive to earn your trust.

Market Discussion

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 depreciated during the quarter, as expected, and now are a better investment for new capital today than they were a quarter ago. I continue to believe bond prices will continue to depreciate as the 10-year treasury yield increases from ~2.4% to closer to 3%. When markets are free, large changes in value tend to occur quickly. It is my expectation the long term fixed income market becomes more free as the Federal Reserve further restrains its Quantitative Easing program. I continue to believe that vehicles that may trade the underlying securities are unattractive, while buying bonds to hold to maturity is a more appropriate way to earn yield for the long-term investor.

Cash can always be expected to depreciate on a real basis at the rate of inflation less money market yields – currently just north of around 1% a year for most clients. As mentioned, I believe the risks to inflation to be to the downside. Cash represents an option to invest later and, with potential changes in fixed income is a more attractive option than it has been.

Cash-like securities are less attractive than they were a quarter ago. The Model Portfolio exited its modest investment in gold during the second quarter. With short and long term interest rates likely to rise and the economy growing, albeit slowly, assets that store value, but do not yield, are likely to act more like cash (less the money market interest that cash yields). The Trump administration's retreat from a global leadership role does increase geopolitical instability, which may manifest itself in a crisis where cash-like securities would do well. At this time White Brook's preference is for cash rather than cash-like securities.

With the S&P500 up 8.24% through the end of the 2nd quarter and trading at ~17.1x 2018's estimated earnings and structural reforms to the economy on hold, further gains for the overall market this year are likely driven by positive estimate revisions in S&P500 member earnings, an increase in GDP growth, or an increase in oil prices that drives inflation expectations economy-wide.

Model Portfolio Discussion

White Brook Capital's Model Portfolio continues to be focused on companies that create value and are improperly valued, rather than those that have only enjoyed past success. The second quarter was marked by significant volatility with most of the stocks in the Model Portfolio up or down over 15% peak to trough during the quarter, even if they ended the quarter little changed. On multiple days during the quarter companies that are infrequently volatile and have significant liquidity traded in greater than a 3% range. This is unusual.

As always, the Model Portfolio's concentration in a limited number of positions may result in it not tracking with the S&P500 over the short term. The Portfolio underperformed during the second quarter. I feel passionately about the discrepancy between the valuation and the prospects of the stocks in the Model Portfolio. In White Brook's view, the proverbial spring is loaded with positive performance in the second quarter offset by stocks that experienced one-time items whose transience will become obvious in the short term. I look to some of those detractors from performance during the first half to become sources of outperformance in the quarters ahead.

- Covanta (CVA) operates incinerator facilities in the US and internationally. Energy from waste incinerators, like the ones that Covanta operates, have several advantages over landfills. They have a relatively small footprint, emit less smell, and substitute more environmentally harmful methane gas for carbon dioxide. As a source of comparison, the overall emissions of an energy from waste incinerator are cleaner than coal, but worse than a natural gas plant.

The presence of natural gas in a geography is a key consideration in the viability of an energy from waste facility. In the US, where delivered natural gas is cheap and a large part of the electrical grid, the competitiveness of energy from waste facilities depends on a municipality's tolerance to landfill locally and the cost to transport to a landfill. If either is prohibitive, Covanta's higher cost (to build) facilities become competitive. When built, Covanta earns several revenue streams from the waste it consumes. It charges "tipping fees" for the waste similar to landfills; it generates energy from the waste which it sells to the local electric utility; and it sells metals reclaimed from the waste ash that it generates.

Internationally, the Company has recently had more success, particularly in Western Europe, where it is in the middle of starting up a facility in Dublin, Ireland that should generate significant EBITDA and cash flow growth. Compared to the US, European cities are more densely populated, have a higher cost of energy for transport, and do not have large stores of natural gas. These factors make them great markets for energy from waste facilities and I expect Covanta to continue to grow in the region.

Covanta's poor performance during the second quarter was due to news revealed on the 1st quarter earnings call that Covanta suffered a fire at its Fairfax, Virginia facility at the end of the first quarter. With recovery from the fire suspending plant activities, the company also accelerated its planned maintenance from the second half of the year to the 2nd quarter resulting in increased guided costs and lower guided revenue for the 2nd quarter. While the lost earnings will be fully paid by an insurance policy and the maintenance expense would have been incurred anyway, bearish investors believe the operational hiccup increases the likelihood of a dividend cut. The Company was insured and will receive a cash payment in lieu of lost earnings, making the probability of a dividend cut low per White Brook's model. Additionally, the Company's new Dublin, Ireland incinerator facility is in its testing phase and is on schedule to open during the 3rd quarter, ramping through the end of the year and into next year. If it can begin full operations within a couple quarters of its schedule, the significant EBITDA and cash flow growth will secure the dividend and fund further growth for the Company.

White Brook believes the Company's efforts to generate additional cash flow streams by disposing hazardous waste and improving the recovery of metal in its ash waste will also result in continued growth, regardless of whether it establishes another incinerator after the Dublin facility.

As the Fairfax facility incident is put in the rearview mirror and Dublin comes online, White Brook expects Covanta's stock to significantly appreciate supported by the very high dividend yield. The stock is owned by both the Model Portfolio and Concentrated Opportunities.

- Mosaic (MOS) is a potash and potassium miner that also encountered difficulties during the 2nd quarter. Already dealing with a consensus view that supply would exceed demand for potash over the medium term, during the first quarter call, the company revealed that an elevator used to bring product to surface level broke down at its largest production facility. Fixing it would also impact second quarter production levels.

Additionally, the Company has significant operations in Brazil. While the company's operations haven't been affected by the political tumult, the Brazilian Real has weakened against the US Dollar, resulting in a negative translation effect. White Brook believes that there are signs that the potash market is more in supply demand balance than consensus currently believes and that the elevator problem will prove to be a one-time event. White Brook has no view on Brazil, but doesn't believe the economy will further descend to the recent depths of recession. In White Brook's view the stock price encapsulates bad news and even worse sentiment while there are multiple potential positive catalysts. The stock is trading at a deep value and is owned by both the Model and Concentrated Opportunities portfolios.

- Finally, Lance-Snyder (LNCE), was another underperformer during the first quarter. I've written about Lance-Snyder before, and the Model Portfolio is still up on the position despite the drawdown during the quarter.

During the 2nd quarter, the Company negatively preannounced and announced that the former CEO of Diamond Foods Bob Driscoll would be interim (and now permanent) CEO. While the previous management team was instrumental in putting together a great collection of assets that are positioned squarely at the future of healthy snacking, there were significant changes, particularly in the cost structure, that the previous team dragged its feet in obtaining. My confidence in Lance at the time of the initial investment was informed by Mr. Driscoll's presence on the board and the operational talent that was part of Diamond Foods. Driscoll's ascension to CEO of Lance-Snyder is a value creating event, that as shareholders, we are lucky to have had occur.

White Brook's expectation moving forward is that the Company will follow the blueprint Mr. Driscoll established at Hostess Brands and Diamond Foods. The following quarters should exhibit slow revenue growth but with significant margin improvement, followed by a resumption of revenue growth that further enhances profit growth and dramatic stock price appreciation.

The stock is owned by both the Model and Concentrated Opportunities portfolios, and I expect the process initiated by Mr. Driscoll to provide substantial returns in the medium term with the potential for the process to be shortened by a sale to a larger company in need of its "better for you", non-Amazon/Whole Foods exposed assets.

- Box Inc (BOX), the largest gainer in the quarter, reliably traded down when what White Brook believes is good news was announced. Box is the largest position in either portfolio and is likely to become even bigger in the Concentrated Opportunities strategy. The central misconception is

that Box's basic file share and sync can and will be replicated by every major storage provider. That is true. Google, Microsoft, Amazon, Dropbox, and Documentum amongst others can all provide outsourced enterprise level basic file share and sync services. Box has innovated on that platform, however, increasingly modularizing each aspect of the service and adding features that have made it a holistic content management system making files easy to access, use, analyze, and secure. It's a valuable product for any business that has valuable data.

During the quarter, the Company reliably traded down whenever good news was announced (earnings report above expectations, new product launch with Google, new standalone product launch, and an incredibly significant new partnership with Microsoft) and then up in the weeks that followed. White Brook believes despite the significant stock price increase during the quarter, the Company continues to build value at rates in excess of that improvement. The most recent partnership with Microsoft dramatically expands the geographies where Box is offered (it will be sold by Microsoft salespeople) while also demoting the offering of one of its most viable competitors. Microsoft knows how to develop productivity software, yet they partnered with Box in a way that promotes a competitive offering above their own to strengthen their Cloud offering. That Microsoft was a closer competitor than the others, makes White Brook believe Box's lead in content management is sustainable. Box is owned by both the Model Portfolio and the Concentrated Opportunities portfolio, where it is currently the largest holding.

During the quarter, Box Inc (BOX), Inc, Alphabet Inc (GOOGL), and Integrated Device Technology, Inc. (IDTI) were the biggest contributors to the Portfolio's performance, while Mosaic Inc (MOS), Covanta (CVA), and Synchrony Financial (SYF) were the biggest detractors to performance.

Synchrony Financial and the position in the Gold ETF (GLD) were exited during the quarter. Synchrony's exposure to slowing physical retail, loss of exclusive relationship with Amazon, and need to more aggressively provision for losses for a second time in a year caused White Brook to lose confidence in its ability to compound returns at a healthy rate over time. Gold (GLD) performed well during the first half. Both its exit as well as SYF funded the addition of Keysight Technologies (KEYS) to the portfolio.

New Position: Keysight Technologies (KEYS)

Keysight Technologies is a leading provider of test and measurement equipment to manufacturers of wireless and electronic equipment. The Company was spun out of Agilent Technologies in 2014 and has slowly been rebuilt over the past three years, with management investing heavily in R&D and acquiring key technologies to build itself into a preeminent standalone business.

Today, the Company is a market leader and market share gainer in network and signal analyzers, signal sources, and simulation software. The acquisition of Ixia, which closed in April, added leadership in network test, visibility, and security and a recurring software business to the Company's revenue stream.

Moving forward White Brook sees several compelling tailwinds.

1. Increasing utilization of a wide variety of wireless spectrum to run multiple technology standards, including greater use of spectrum "white spaces", are more likely to increase the need for test and measurement equipment. Millimeter wave technology and machine to machine communications further complicate the electronics development environment, leading to a likely increase of its services.



2. Adoption of electronic and network enabled devices, particularly in the automotive and energy markets where Keysight is a strong player, are starting to move up the S curve with many manufacturers adopting more sophisticated technology.
3. The increased adoption of 5G, which heretofore has only partially offset the decline in services for 4G, should begin to exceed the decline in the coming quarters. That revenue stream is growing close to 100% and is likely to grow at very fast rates for the foreseeable future, while 4G has likely already bottomed.
4. The merger with Ixia has provided expense synergy opportunity. The Company is ahead of schedule in obtaining these synergies.

Over the next few years, White Brook expects to see greater than 40% upside, not including the outperformance already enjoyed since entering the position. It's unusual for a stock so critical to the future to be so underfollowed and I look forward to our benefitting as other investors find this gem hiding in plain sight.

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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