

2019 First Quarter Commentary

Portfolio Review

During the first quarter, White Brook was up 8.66% vs the S&P 500 up 13.65%. Overall, first quarter earnings were disappointing for White Brook. In January, the portfolio snapped back, with performance exceeding the market's by a considerable amount. However, as companies reported earnings, they generally came in below expectations. While that was true for many companies, others were able to shrug off expectations misses, companies we are invested in did not. My belief is that expectations are now reset such that for the marginal trader, expectations have been lowered, and outperformance is more likely.

White Brook didn't trade during the quarter - except for investing new investor capital. The lack of trading confirmations was not a bug, it was a feature. White Brook has a multi-year investment horizon and targets high after-tax returns which means trading occurs when there are large opportunities or risk management needs, not because of boredom. I continue to be happy with the composition of the portfolio.

Of the new stocks in the portfolio as of 4Q18, during the first quarter, one, First Solar, Inc (FSLR), was a significant outperformer, while the other, Itron, Inc (ITRI), was an underperformer. Both continue to be well positioned.

The largest outperformers during the quarter were Covanta Holdings Corporation (CVA), First Solar, and Keysight Technologies, Inc (KEYS).

Covanta's outperformance so far this year is a regression towards normalcy. As a reminder, Covanta is an energy from waste company that competes with and complements landfill companies like Waste Management and Republic Services. It is particularly well positioned to compete when municipalities pick up their residents' garbage rather than outsource the function to others. The waste environment is strong in the US as you'd expect during an economic expansion. For the past couple years, in many ways Covanta couldn't win despite that. It generates renewable energy and for years has alternatively been valued at the lower of an energy and a waste company. Until recently the price of the stock reflected worries about its ability to sustain its dividend. Worries persist, but the marginal investor this quarter seems to be beginning to appreciate the Company's growing and steady free cash flow generation and recognizing that its dividend is sustainable. As its high return on capital growth efforts come online starting later this year and continue for the next several, those worries should meaningfully decline and the company should continue to re-rate higher.

Keysight has been a solid performer since we entered the stock and is now up ~70% since we entered in June of 2017. The company is executing in line with our thesis, and the market is beginning to notice its exposure to the development of 5G and has increased its value due to its strategic value and the expectation of earnings from that segment.

First Solar is a provider of solar modules to the industrial and commercial segment. In short, they offer industry leading power/cost solar panels, have a fortress-like balance sheet that ensures their ability to honor contracts years into the future, and have sold out of capacity for the next several years. Future growth relies on the ability to convert older factories from older technology – something they have done a couple times already – to their newer technology, making cost effective execution likely. Stay tuned for more expansive thoughts on White Brook’s approach to the solar space via White Brook Capital’s Insights. I continue to like the stock despite its stellar year thus far.

The largest drivers of underperformance were Itron, Mosaic, Inc (MOS), and Natus Medical, Inc (BABY).

Itron was a new addition to the portfolio in the fourth quarter of 2018 although it may be familiar to long-time investors with White Brook. Itron bought Silver Spring Networks, a White Brook portfolio company, in 2017. At the time of the purchase I recognized and conveyed to investors that the management team was high quality and relayed our belief that the price they were offering for Silver Spring was too low. That has proven true as synergies have come in above expectations.

The quarter reported during the first quarter was underwhelming, primarily due to the continued shortage of MEMS chips that is delaying and increasing their cost to provide older model, replacement, smart meters to their utility customers. In my view, this is a temporary issue.

More significant to the stock price, but not the underlying company, the largest shareholder, Scopia Capital, announced that they intended to reduce its stake from ~13.5% to ~11% by selling in the open market. Normally about 20% of the volume traded (they are required to report each day’s trading volume), their reduction has created constant selling pressure and the stock has underperformed since. As of April 10th, they are approximately half way through the apportioned shares. If they continue at the same pace, and it proves to be the end of their reduction, they should be done by May and I would expect the stock to be stronger during the second half of the quarter and year.

Mosaic reported exceptional numbers and was up 5% intraday until revealing during the conference call that 2 of the 32 dams bought in conjunction with the purchase of Vale Fertilizantes in Brazil last year would need remediation. The stock traded off after the announcement, selling which has continued as the Midwest of the United States flooded, delaying plantings, and caused Mosaic to adjust their guidance for the 1st quarter. The dams have been determined to not be an imminent threat and a full accounting of the expense to remediate those dams should be available by the time they report in May. The floods in the Midwest should push fertilizer orders that would have occurred in the first quarter to the second and likely means that volumes will be a bit lighter for the year. I view the dam problem as a problem, but one with a relatively limited impact, and the floods to be endemic to the business and a non-issue over the medium term.

Natus Medical, a relatively new position, was a victim of a short piece during the quarter that contended that Natus’ new CEO was engaged in financial manipulation and fraudulent behavior. The irony of the piece was that the exact fact pattern that they laid out was evidence of a bullish thesis as well as a bearish

thesis. This dynamic isn't unusual. The bull thesis is that the company under previous management had over acquired and poorly integrated while underinvesting in bringing new innovations to market. By suspending the acquisition spree, integrating, selling off underperforming businesses, and introducing new innovations, the company could significantly improve its organic growth, its margins, and its returns on the capital employed. Part and parcel of that plan is that short-term inventories increase as the company builds new products, at the same time as long-lived inventories increase, before working down over the next 12-18 months.

In this same fact pattern, the short seller saw evidence of fraud, believing the inventory build to be part of booking revenues it didn't earn and hiding inventories on the balance sheet. Where we saw a CEO, that as CFO had been sent to and executed on integrating the most troubled acquisitions, they saw evidence of fraud committed as a CFO and that as a CEO he was attempting to hide. Mal intent is tough to disprove over the short term, and its absence is revealed over the fullness of time. In the case of Natus, the stock reacted immediately to the potential for fraud. If I am right, and the CEO isn't engaged in criminal-like behavior, the stock, which was already steeply undervalued before the report, is even more so now.

Groupon, Inc

Earlier this quarter White Brook published research on Groupon, Inc. The presentation can be found under "Investment Theses" on White Brook Capital's website. Groupon is a deep value investment, that while meaningful, is not a top 3 investment in terms of current allocation. I expect to realize the fullness of value over an extended period.

In 2011 Groupon was an innovative company that married the internet with group purchasing. It was a time-tested source of successful innovation: use a new distribution platform to introduce a new audience to an existing source of value creation. For merchants focused on maximizing their gross profit dollars and customers reeling from the Great Recession and growing more comfortable with online purchasing, it was a great match. Its service drove large volumes to its merchant clients and its sales force used that volume to establish trusted advisor relationships.

Since, the stock has fallen by over 75% as its client growth has turned to decline, and its volumes have stagnated.

Core to Groupon's meteoric rise was the product it sells – access to deals. While a good or service typically has incremental costs associated with generating that good or service, Groupon only sells access. The manufacturer or service provider is responsible for the cost to manufacture and fulfill. Margins are high and Groupon was well compensated for finding an audience. The key for Groupon was cost efficiently generating that audience. By being first and by being good at what they did, they built a business.

As the saying goes, "your margin, is my opportunity," and Groupon's success attracted copycats. The technology necessary to generate and redeem vouchers is relatively simple, needing few partners, and only the ability to generate an audience for a deal and a merchant to offer that deal. While that audience

may be smaller and less suitable for long term success with one provider than another, for a particular small merchant, it's difficult to know that ahead of time and which provider is most appropriate. Adding to difficulties, the voucher redemption process was emasculating in the best circumstances. The economy, throughout the sector's life has also been in expansion, a headwind for a somewhat difficult to use deal product as their somewhat affluent audience experienced growing salaries and opportunity dampening the willingness to spend time searching for deals. As these dynamics played out over years, the most serious challenger to the throne in the heyday, Living Social, backed by Amazon and once valued at \$4.5 bn, was purchased by Groupon in 2016 for an immaterial amount.

There are very few potential competitors to Groupon today with the breadth that they have, with most potential providers helplessly conflicted. Credit card companies, payment processors, and banks are paid on a percentage of transaction value. Their incentive is for consumers to spend as much money as possible with their card, not to drive volumes to a particular merchant. Best case, they encourage spending that otherwise wouldn't occur – a more difficult proposition than directing spending to a particular merchant, as Groupon does. New financial technology players generally fall into the same bucket. Instead, over the past decade, companies like Facebook and Yelp have gotten stronger. While offering a different proposition, they vie for mindshare within the SMB customer base and also promise to drive volumes. Groupon's sales force's trusted relationship is less special than it was, while the need to define the IRR of the deals is greater. They can compete on that basis, but they have to continually prove their proposition.

For Groupon to be successful, it needs to be easy to use and relevant. While their competitors have atrophied, they have invested in solving the easy to use piece, having developed card-linked offers some years ago – if only deploying it now. Everyday relevance across a wide populace is a far bigger issue. As alluded to earlier, the continuing macroeconomic strength dampens organic mindshare gains, both for merchants and for consumers. Additionally, the site and the app haven't evolved as the way we use our devices have. Groupon, probably wisely, realizes that people are unlikely to download two of their apps, but both the site and the app don't encourage deep, every-day, use. Its marketplace of deals is thin and poorly arranged – designed to give the illusion of depth rather than feature specials, make search easy, and be a resource for consumers. It needs to be.

Groupon balance sheet has a significant amount of cash, and the deals they do sell continue to generate a lot of cash flow. Groupon is wisely reinvesting some of that cash flow back into the business, but even despite that, at these levels, the company generates in excess of 10% of its market capitalization in cash flow and trades at less than 5x EBITDA. That makes sense only for a business in terminal decline. I don't believe that should be true, and if that trend can be nudged up to low growth, very healthy returns are likely.

Housekeeping



1. We've added Interactive Brokers as a second custodian. For clients who don't get much value out of Schwab's retail network and additional services, I think they'll get a lot of value using Interactive Brokers as their custodian.
2. White Brook Capital Partners, a commingled fund, continues to get closer to launch. If you think you might be interested in investing in White Brook Capital Partners, please reach out.

As always, feel free to reach out to discuss this or any of your investments at White Brook Capital. I thank you for your support and will strive to continue to earn your trust.

Sincerely,

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

Basil F. Alsikafi
Portfolio Manager
White Brook Capital, LLC

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