

Year End 2019 Quarterly Commentary

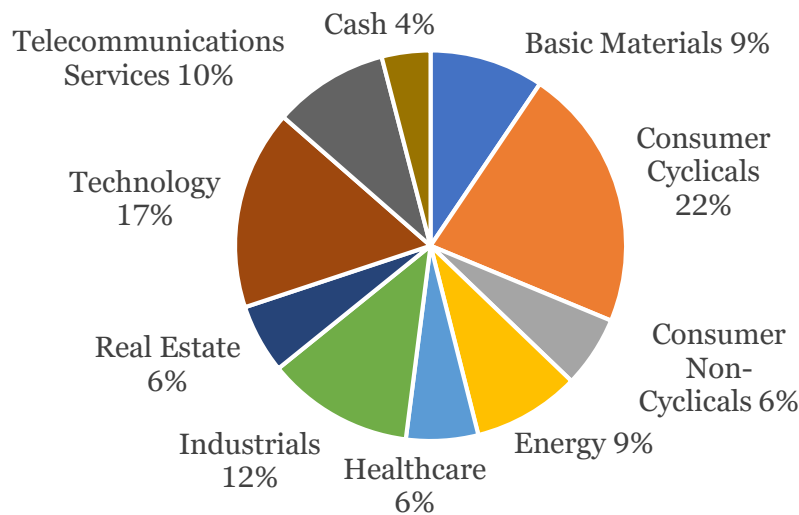
Portfolio Commentary

At year end, the Fund was 95.97% invested across 12 positions. For the partial year, since inception (*August 15, 2019*), the Fund's NAV increased by 14.56% net of all fees vs the S&P Midcap 400 up 9.11% and the S&P500 up 11.10%.

Top contributors to the Fund for the quarter were Box, Inc (BOX), Goodyear Tire, Inc (GT), and Brunswick, Inc (BC).

Top detractors from the Fund were First Solar, Inc (FSLR), Natus, Inc (NTUS), and new position Mohawk Industries, Inc (MHK).

Allocation by Sector



On a sector basis, our investments in the consumer cyclical, technology and industrials sectors were the top contributors to Fund performance, while our energy and healthcare investments were the top detractors.

During the quarter, the Fund exited Groupon, Inc (GRPN) and initiated a new position in Mohawk Industries and Broadmark Realty Capital, Inc (BRMK).

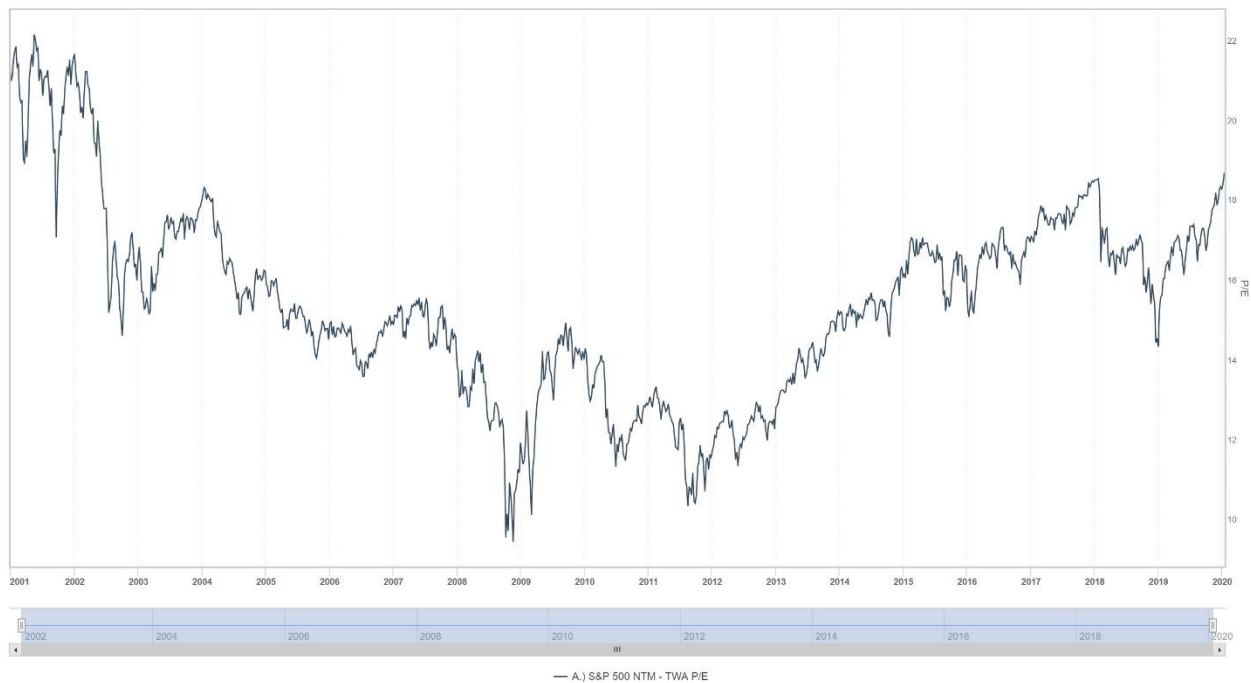
At 12 positions, the portfolio is relatively less concentrated than it has been. While the market as a whole is relatively expensive, it hides a growing dichotomy where high growth stocks are very expensive and slower growth stocks are very cheap. Disproportionately cheap.

The US's strong economy is supportive for some to show strong, profitable, growth, and outperform given their meager prices. As the Fund has entered new positions, the portfolio has become more concentrated in these so-called value stocks, and I expect it to continue to more heavily weigh value stocks for the foreseeable future.

Market Commentary

During 2019, the S&P500 established new highs on a near daily basis and the overall market valuation trended towards the high end of its historical range.

S&P 500 Next Twelve Months Price/Earnings



That valuation is driven by:

- 1) The largest tech companies, Amazon, Google, Microsoft, Facebook and Apple. Together, they make up ~18% of the S&P500 market weighted index (up from ~10% in 2017) and have performed well as investors continue to believe they will continue to be dominant in the future. Additionally, the rise of passive investing via S&P500 ETFs provide a liquid, easy way to invest in all of them. With increasing allocations to index based ETFs, large cap stocks have performed well.

- 2) Negative interest rates in Europe and low rates in the United States have changed bank behavior. Central banks across the globe have engaged in buying risky assets – including large cap US equities. For example, the Swiss Bank has invested ~\$100bn in US equities, the Norwegian Central bank reportedly owns \$245bn in US stocks, and it's believed the Japanese and Israeli central banks also own billions in large capitalization US stocks.

US commercial banks are similarly compromised with low US rates distorting incentives. The disfunction of the repo market is a good example of low rates changing participant behavior and breaking markets. With rates low, large US commercial banks have shifted their excess reserves from absolute safety – where it can supply the repo market – to riskier, but more profitable use. As a result, the Fed has had to use emergency measures to step in and allow banks to access capital for any overnight needs.

Neither of these dynamics should continue indefinitely, but there's also no identifiable catalyst that would point to their unwind besides for generally higher interest rates, globally.

In this environment that has strongly favored large cap stocks, (the S&P Midcap 400 underperformed the S&P 500, by 529 bps or 5.3% in 2019) White Brook Capital Partners performance has been solid since launch - outperforming our midcap index significantly. Should the tailwinds that have supported large cap performance begin to unwind, we should be well positioned.

Historically, midcaps have outperformed in bull markets by a wide margin and underperformed in bear markets by a small margin resulting in very significant outperformance over time. Over the past several years, historical correlations haven't held up, however, and instead we fall back to the one golden rule. Price matters. Given the reasonableness of midcapitalization prices and stretched large cap valuations, the likelihood of continued midcap underperformance continues, in my view, to be low. Things can get crazy and stay crazy in any market for a while, but at one point a stretched rubber band snaps. White Brook has performed well despite being on the wrong side of the rubber band stretching, and I believe we'll benefit when it snaps back as well.

While some point to the dot.com bust as a time when prices got out of hand, then got very out of hand, before snapping back, I think the Nifty Fifty is a superior analog to today. As a reminder, the “Nifty Fifty”, was a term coined by a couple of different investment firms to a combined set of 70+ stocks during the boom market of the 60s and early 70s. While the lists were somewhat different, they identified blue chip, growth stocks that it was argued could be bought regardless of price because they dominated markets that benefitted from strong secular growth trends. Unlike the dot.com bust, their theses, like today, were reasonable. The companies they identified for the most part continue to be around in some shape today. Investors who recognized the virtue of the Nifty Fifty before it was coined, did ok, experiencing gains of hundreds of percent before those gains were ultimately cut by ~70%. But those that bought towards the end, and held, would have only regained their initial investment a decade later.

The argument advisors told their clients through the run up was strong – they were the largest companies, they were growing, the secular growth trends were strong, and the companies would be dominant. They erred in not thinking about price, arguing that price doesn’t matter if truly long term. The crash of 1973 and 1974 destroyed many investors who sold after at a fraction of their entry or who held and underperformed for the decades following.

The folly of the Nifty Fifty wasn’t that people lost money or that markets are fickle. They did and all markets (public and private) are. Nor were their theses wrong. Only a handful went bankrupt in the almost half century since. Instead, two things worked against them.

- 1) Price always matters
- 2) Hordes destroy value.

The Nifty Fifty was formalized consensus thought, promoted by advisors with no real understanding of valuation, but that were able to tell a good story and allocate client capital to with little risk of getting fired. Clients that went along with them were poorly but not maliciously served.

Even fundamental investors today, both public and private, are subject to horde thinking if not horde investing. They’re overweighing similar questions and ending up with similar theses. If a business’ potential success was historically determined by whether the business was offering an excellent good or service at a reasonable price, with a large market opportunity, led

by capable people, and was priced cheaply, today that analysis has almost entirely morphed to – can the company raise prices and is its cash flow contractually recurring?

That is bad.

Analysis that is dominated by shorthand fails. And in my experience, those are the two questions investors ask before their eyes glaze over and they view the rest as noise.

Over the past year, I've sensed the way the horde was moving and the investment portfolio has begun to evolve away from explicitly recurring cash flow machines to those that implicitly recur due to superior service/product or distribution, are or will be generating significant cash flow, and are trading at a favorable price.

Major Developments in Selected Investments

Goodyear Tire (GT) [Previously “Undisclosed Investment G”] – During the third quarter White Brook entered Goodyear Tire, a position that we previously mentioned during the third quarter as “Undisclosed Investment G” but it reached the desired allocation during the fourth quarter. (I previously mentioned Goodyear in one of my *Insights* posts – if you didn't receive and believe you should have, make sure you add whitebrook@substack.com to your contacts or search your “updates” or “promotions” folder, it's also still available at whitebrook.substack.com).

Goodyear is one of the 3 largest tire companies in the world and operates a distributed manufacturing capability globally. 50% of their revenue comes from the America's region, with the US and Brazil as the notable markets within that group, EMEA is 30% of the business and the rest is Asia Pacific which contains the notable markets of China and India. About 80% of their revenue are replacement tires with the balance sold to new car manufacturers (OEM).

Within the OEM market, there's a distinct sales cycle, where tire manufacturers pitch and are awarded business for specific models from the OEMs. It can sometimes require custom tires to be launched to support the model. While less profitable, OEM business is important as it's guaranteed revenue and because consumers “know” the product when it comes time to replace. Goodyear uses a size nomenclature to denote premium and non-premium tires, where less than 17 inches, is a commodity tire and above, is premium. Most of their business is non-premium, commodity tires, where they earn on average \$9 per tire in the replacement market, and \$7 at the OEM. However, a rapidly increasing percentage of tires are now above 17 inches

due in large part to the popularity of SUV and light truck sales and now make up almost 50% of the replacement market. Goodyear earns \$19 on average in the OEM channel and \$28 when replacing a 17-inch tire. In 2019, Goodyear took some short-term pain, dropping some low profitability 16-inch OEM business, in order to be able to guarantee production for more profitable 17-inch business that will come online in 2020 and 2021 and buttress revenue growth.

Goodyear's sizable replacement business partially insulates the Company from the impact of new car sales. Recessions, however, still impact the business as tire replacement is a function of consumer confidence and miles travelled. In the US both are and have been strong, but that hasn't been true in the Chinese or Indian markets or much of EMEA through much of 2018 and 2019. Despite that, Goodyear has been able to grow their replacement business in Asia, while EMEA is subject to a more wholesale restructuring process. With the amelioration of some of the US-China trade hostilities, I expect a more supportive non-US global economic environment to benefit the company either directly via economic improvement and/or via a less punitive foreign exchange environment – a headwind through 2018 and 2019.

In 2017, Goodyear traded for \$35 a share vs less than \$15 today. In between there was a raw materials pricing shock that particularly impacted the economics of 16-inch and below tires as manufacturers absorbed price increases rather than cede market share. While 17-inch and above tires from China were subject to anti-dumping tariffs in 2017, similar measures were determined appropriate in April of last year. Since, the major tire companies have been able to put in price increases in various lines and at least Goodyear has announced another increase effective in 2020 even as commodity pressures appear to be ending. Raw materials should be a significant tailwind to gross profit growth in 2020.

At 4.6x 2020 EBITDA, and a mid double digit 2021 FCF yield, I believe Goodyear is very inexpensive. They've made necessary short-term sacrifices to ensure the long term which they should begin to benefit from in 2020. Their business is macroeconomically resilient, and with a \$150mm+ EBITDA tailwind (12%+) based on the cessation of the raw material headwind alone, I am confident in their ability to generate substantial cash flow over the medium term. I believe owning the stock at these prices represents a great investment opportunity.

Box, Inc (BOX) – Box outperformed during the quarter. The Company reported a solid quarter with very strong performance in deals above \$100,000 while maintaining momentum in

deals above \$1,000,000. The Company also showed strong operating leverage with margins up over 500bps y/y. The stock had turned into a show me story, the last quarter was the first in regaining credibility in the market. If they can execute effectively for another couple quarters, I believe the stock will prove to be extremely undervalued.

Groupon (GPRN) – Mea Culpa. While other stocks in the portfolio underperformed the S&P500 during the year, Groupon was a mistake. At the end of the year we took the tax loss and sold our last shares of Groupon. Underlying the Groupon investment was a belief that either I or another investor would have the ability to influence how Groupon approached the market. In 2019 I put together a presentation of the opportunity available. I know that the presentation made it to Groupon headquarters and I understand that it came up in company meetings with other investors. They don't appear to be adopting any of the more substantive recommendations, however.

The key message of the presentation was that it was imperative to grow users and gross profit per user on a similar or growing operating expense base by investing in the business and building on their differentiated capability while filling white space left by others. They've decided instead, to change their focus from gross profit growth on a declining sales and marketing base to gross profit per user growth and now to transactions per user growth. They're getting further away from focusing on generating increasing cash flow, while at the same time cutting their most valuable asset, all while paying themselves exorbitantly. Awful.

My mistake was hoping that I or someone else could influence strategy or shame the board into action. After White Brook exited, MIG Capital announced their activist intent while also asking for a board seat. Combined with PAR Capital, I hope for all involved, that this is enough activist pressure to dislodge management, remake the board, and change the trajectory of the business.

Mistakes happen, but it's important to learn. My estimation of investor activism has changed after this investment. I thought that the Groupon board could be shamed into doing the right thing. But it's possible to not feel shame, and in that case a CEO can get a board to continue doing nothing. In the future, we'll be backing management teams who may or may not present well but have the right strategy and know how to run their business. Good assets & good managers – I'll leave the activism and early turnaround work to someone else.



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I also learned about how I want to evaluate management teams going forward. Throughout my career, I've been disappointed with how the Street evaluates company management. For most investors, management teams are good if they've made investors money and bad if they've lost money. Calls with management are often focused on pulling out "color" or checking a financial model. To my mind, they've provided negative value to the investment process and at best served to check a box. I think, however, I've found a different and insightful approach that will be valuable to both investors in White Brook Capital Partners, the management teams that I converse with, and differentiated from our peers.

I continue to be constructive as it pertains to midcap value stocks especially relative to large cap stocks and on an absolute basis for the medium to long term investment horizon.

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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