The Blue Chips Investor Letter
Fall 2017

Statement from the Chairman

Chairman, Investment Committee: Sid Jain

It has become the mantra of value investors everywhere to lament the dearth of investment opportunities and years of underperformance relative to growth strategies. One famous hedge fund manager even declared the death of value. We, however, disagree. Instead, we find solace in the fact that investment strategies move in cycles and are reminded of the infamous 1979 BusinessWeek cover story entitled "The Death of Equities" that was immediately followed by a twenty-year bull market. It has undoubtedly become more difficult to find value in these markets, but it is not impossible particularly now with the backdrop of global economic growth. For the first time in a decade, all 45 countries in the OECD are on track to grow this year, with 33 poised to accelerate. This synchronized growth will likely accelerate the mean reversion process for value stocks.

This past quarter, we made investments in three best-in-class businesses in distinct industries. First, after revisiting the Financial Sector's previous pitch of Air Lease, we came to the conclusion that the air leasing industry was a significantly better business than we had originally anticipated. We decided to purchase the largest public air lessor, AerCap (NYSE: AER), since its scale gave it a lower cost structure and the CEO's aggressive buybacks created a clear catalyst for value realization (see page 22). At the time of our purchase, AerCap traded at a discount to book value despite a mid-teens return on equity through a full cycle, a CEO highly skilled at allocating capital, and significant book value growth.

Second, we invested in a frac sand MLP, Hi-Crush LP (NYSE: HCLP), that had been punished due to overblown market concerns over incoming supply yet was now trading at a low single digit multiple (see page 7). Our contrarian view was that regulatory bottlenecks, stringent quality standards, and limited last mile transportation would make it difficult for announced supply to actually come online. Rig count and proppant intensity growth should result in continued tightness in the frac sand market. While we typically avoid making directional bets on commodity prices, Hi-Crush's attractive valuation, pristine balance sheet, and low-cost mines mitigate the downside with any rebound in oil prices representing pure optionality.

Third, we took another look at the Healthcare sector's previous pitch of Brookdale Senior Living (NYSE: BKD). After a nearly 40% selloff from the pitch, we were now able to enter at a price that offered significant upside for just the real estate even when assigning no value to the business' other cash-flow positive operations (see page 24). Senior living units benefit from a very sticky customer base, significant pricing power, and little customer credit risk. As the dominant player in the senior living industry, Brookdale owns a collection of highly attractive real estate assets. Three bidders have already been in talks to acquire the company and with the amount of dry powder in the financial markets, we believe it is highly likely Brookdale gets bought out. If the takeout cap rate is anywhere near precedent transactions, this could prove to be a very successful investment.

In this letter, you will find the sector leaders' summaries of their pitches this quarter and the Investment Committee's decisions on those pitches. For analysis on all our current portfolio holdings, please refer to our Spring 2017 Investor Letter. If you have any questions, please feel free to contact me at sidvjain@gmail.com. With that, I hope everyone enjoys the rest of winter break!

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Fall Pitches

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BioTelemetry (NASDAQ: BEAT)

Healthcare Sector Leader: William Xia

Company Overview

BioTelemetry (BEAT) focuses on the diagnosis and monitoring of cardiac arrhythmias primarily through its mobile cardiac telemetry (MCT) service. MCT devices are small wearable monitors that automatically send data to a 24-hour manned monitoring center when a cardiac anomaly is detected where it is then interpreted by certified cardiac monitoring specialists. The MCT and traditional monitoring services accounted for 79% of FY16 revenue. BEAT also provides core laboratory services for drug and medical device trials (16% of revenue) and manufacturing and engineering services for other medical device companies (5% of revenue).

Investment Thesis

The Healthcare Sector recommends a BUY in BEAT for the following reasons:

1. *Rapid industry growth*: The American Heart Association projects the number of people diagnosed with heart failure will rise 46% by 2030 despite already being the leading cause of death. This will result in greater demand for cardiac diagnosis and monitoring. However, more importantly, this growth in demand will be captured primarily by MCT services over traditional Holter and cardiac event monitors. Holter monitors have high non-diagnostic rates because symptoms may not reappear in the 24 to 48 hour Holter monitoring period. Cardiac event monitors, while worn for 30 days, require the patient to manually press a button to record cardiac data during symptoms and do not provide real-time monitoring and analysis. Non-connected devices must be returned for analysis, which the patient might not receive until 20 days after the wear period. MCT monitors are also smaller, sleeker, and easier to wear while its real-time analysis increases patient compliance.

2. *Sustained competitive advantages*: Recent acquisitions and patent protected product lines have best positioned BioTelemetry to capitalize on industry growth. The Telecare acquisition, a mobile blood-glucose monitoring system, expanded the addressable market due to the significant overlap between diabetes and heart disease patients. The LifeWatch acquisition should allow BioTelemetry's products to feed directly into electronic medical record (EMR) systems, significantly reducing doctor administrative costs. These acquisitions complete a complementary set of demand drivers: vertical integration driving referrals and cost savings for doctors. Lastly, BEAT is far ahead of competitors in contracting with insurance companies, having established contracts with half of Anthem's 14 subsidiaries. This high coverage during a time of market expansion will help establish BEAT as the industry standard, building greater brand familiarity among doctors and providing significant first-mover advantages.

3. *Suppressed share price from short seller report*: Off Wall Street published a sell rating on September 15th, causing shares to plunge nearly 20%. The report questioned BEAT's ability to continue growth, citing slowing revenue growth. However, the report did not consider a 1% reimbursement cut to MCT by CMS effective January 1st or an anticipated 2% reimbursement increase in 2018.

Key Risks and Considerations

1. *Increased competition*: Because MCT is a high growth industry, we expect entrants in the coming years ranging from early stage competitors like iRhythm Technologies (NASDAQ: IRTC) to well-capitalized medical device behemoths like Medtronic (NYSE: MDT). However, BEAT's advantages outlined above should mitigate some competitive pressure.

2. *Reimbursement and tax policy*: The potential introduction of a 2.3% medical excise tax would impair income. Additionally, approximately 33% of revenue is subject to reimbursement from CMS, making BEAT vulnerable to fluctuating rates. However, any policy change would affect the entire industry.

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Decision: NO PURCHASE

Healthcare Investment Committee Representative: Kassim Husain

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The Healthcare Sector pitched BioTelemetry, Inc. (BEAT) on Wednesday, October 18, 2017 in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to purchase BEAT. Our reasons are as follows:

FIRSTLY: BEAT's competitive advantages do not appear to be particularly robust. The sector emphasized patents, payer relationships, and data as the key competitive advantages. First, in terms of patents, competitors such as iRhythm (NASDAQ: IRTC), already have similar telemetry devices. Given the significant growth expected in this market, it does not seem reasonable to expect that a comparatively small company such as BEAT would be able to maintain its market share when large devices companies are already becoming interested in the market. Apple's entrance into the space via its Apple Watch proves this point. Second, in terms of payer relationships, BEAT has an advantage over smaller players but not against more dominant players such as Medtronic who have established long-term relationships with health care providers. Third, in terms of data, BEAT released its HCOT device only two years ago and so we do not believe it has collected enough data for it to be a competitive advantage, particularly given the low-priced alternatives in the marketplace.

SECONDLY: We believe expectations for BEAT's ability to improve margins are overstated. While the move from traditional Holter monitors toward MCOT would improve margins, the company's continued reliance on Holter monitors as a short-term revenue base suggest that such margin improvement cannot be so ambitious. When margins have historically been negative or in the low single-digits, we felt that it was difficult to place significant confidence in the company soon improving to a 20%+ EBIT margin scenario as suggested by the base case. Consensus estimates have operating margins increasing from 12% to 28%, which causes us to believe the margin expansion opportunity is largely priced in. When considering additional uncertainty present in the industry relating to issues including Medicare reimbursements and the medical device excise tax, our confidence was further diminished.

THIRDLY: We do not find the current valuation particularly attractive. A 4x revenue multiple for what is essentially a one-product company growing just 10% annually and highly dependent on a very fickle customer (Medicare) does not make a lot of sense. Companies with more substantive moats and higher potential growth rates are trading at similar multiples. As a result, we do not believe the market has mispriced the stock. After BEAT's stock tripled in the last 18 months, there are no sell ratings on the Street and the average price target is 50% higher than the current stock price. When adjusting the annual growth projected in the pitch to reflect the 10% target set by management, we found that any discount had eroded. Even in the situation where we project the company meets management's ambitious mid-20s EBITDA margin targets by 2018, the current price did not appear to provide us with a sufficient margin of safety. Ultimately, while the company does currently hold a unique position in what we expect to be a growing market, we felt that the company was fairly valued and did not move forward with initiating a position.

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Hi-Crush Partners (NYSE: HCLP)

Natural Resources Sector Leader: Roland Huang

Company Overview

Hi-Crush Partners (HCLP) is a vertically integrated frac sand producer and logistics solutions provider. The company operates four facilities in Wisconsin producing Northern White sand and one facility in the Permian producing Regional Brown sand, with a total capacity of 13.4M TPY. In the logistics segment, HCLP owns 12 rail terminals and its own last-mile logistics solution, PropStream. Frac sand is a critical input for the hydraulic fracturing process (fracking) that allows for the recovery of oil and gas from impermeable rock formations.

Investment Thesis

The Natural Resources Sector recommends a BUY in HCLP for the following reasons:

1. *Industry rebound from growing demand:* We believe that the frac sand industry is climbing out of a cyclical low due to both fundamental and technological factors. On the fundamental side, we see steadily improving oil prices and a corresponding increase in rig count from 557 to 909 during the past year, equating to more demand for frac sand. More importantly, advancements in fracking technology have increased proppant intensity requirements and the length of horizontal wells, amongst other factors. The fundamental and technological drivers are expected to generate 70M TPY of frac sand demand by 2018. As an established frac sand player with an integrated logistics network, HCLP will benefit from industry growth. Furthermore, HCLP's Kermit facility will be the only operational regional brown sand facility in the highly attractive Permian basis until mid-2018, giving the company a significant first mover advantage.
2. *Industry leader in logistics:* Frac sand is a commoditized business, so the value-add lies almost entirely in the logistics solutions. HCLP has one of the most vertically integrated logistics networks of all the frac sand producers, which we believe to be a reliable source of competitive advantage and cost efficiency. HCLP owns 12 rail terminals across the U.S. and has class-1 railroad access directly from its facilities to centers of demand. The company's last-mile logistics solution, PropStream, offers more efficient storage and sand delivery as compared to traditional pneumatic delivery.
3. *Management to return unit-holder value:* We believe that HCLP is the best positioned to generate unit-holder value via distributions and unit-buybacks in this current cyclical upswing. HCLP has very manageable leverage and healthy financials compared to its peers. Furthermore, management invested heavily in the down cycle so we expect minimal capex going forward, resulting in more distributable cash flows to unit-holders. With management recently being the first frac sand producer to reinstate dividends, we have further confidence in this thesis.

Key Risks and Considerations

1. *Oversupply:* Improving industry conditions have led many frac sand producers to expand their capacity, especially in facilities that produce regional brown sand in the Permian. The total potential capacity addition from all currently planned projects is close to 67M TPY, though only 32M TPY of capacity is expected to be realized by the end of 2018. A supply glut would hurt frac sand prices and consequently, distributable cash flows.
2. *Decrease in oil price:* HCLP's stock price is highly correlated with oil prices. A fall in the price of crude oil will reduce incentives to drill for oil, ultimately leading to a reduction in frac sand demand due to lowered rig count.
3. *Freight costs:* Freight cost is by far the largest component of cost for frac sand producers. An increase in freight cost will have a large effect on contribution margins from the sand sold.
4. *Environmental policy:* Stricter environmental regulation surrounding fracking and frac sand mines, including concerns about the endangered Dunes Sagebrush Lizard, could raise the compliance cost of HCLP and its customers.

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Decision: BUY

Chairman, Investment Committee: Sid Jain &
Natural Resources Investment Committee Representative: Henry Luo

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The Natural Resources Sector pitched Hi-Crush Partners LP (NYSE: HCLP) on October 25, 2017 in General Meeting as a Buy. The Investment Committee (ICOMM) decided to follow the recommendation and purchase HCLP. After further analysis, we agreed with the sector's thesis that Hi-Crush Partners is a cost-advantaged leader poised to surge as demand eclipses supply, an eventuality that the market has failed to appreciate. We believe HCLP is attractive for the following reasons:

1. *Bottlenecks limit supply expansion*: Frac sand companies have been punished in 2017 due to market fears over incoming frac sand capacity. However, upon further analysis, we arrived at the conclusion that regulatory bottlenecks, stringent quality standards, and limited last mile transportation will make it difficult for new entrants to significantly increase supply. Furthermore, two of the big four public proppant suppliers are highly levered and so financial constraints should be a barrier to entry. These bottlenecks have inhibited HCLP's competitors, who currently operate at close to full capacity, from increasing nameplate capacity. For example, US Silica (the largest frac sand producer) recently even remarked that little optionality existed for capacity expansion. As a result, we expect the current tightness in the frac sand market to continue for at least the next two years.
2. *Long runway for increased proppant intensity*: We believe the industry is still in the early innings of increased proppant intensity (or proppants used per well). Proppants constitute a small percentage of fracker's cost (~15%) but are mission critical. While the average well uses around 7,000 tons of frac sand, many new wells are now using 2-3x as much, highlighting how much demand could shoot up. Furthermore, when oil prices are low, frackers tend to use more proppants to maximize the NPV from existing wells rather than opening new wells, mitigating the impact of fewer rigs. It is also important to note that while we believe the range of oil prices over the next five years is skewed to the upside, we are not counting on higher oil prices — instead, we view it as pure optionality. Given that HCLP's mines are still only operating at 75% capacity, any new volume will have high incremental margins as a result of operating leverage.
3. *Best positioned player trading at a reasonable valuation*: With a pristine balance sheet and no major debt maturities for the next 5 years, HCLP should be able to weather a prolonged frac sand downturn if we are wrong in our supply/demand forecasts. As a first mover in the low-cost Permian basin, the company was able to lock up favorable access to Class 1 railroads and is one of only two vertically integrated proppant and logistics providers. HCLP does not have the lowest production costs but once logistics costs (2/3 of total proppant costs) are taken into account, it operates on the low end of the industry's cost curve. In terms of valuation, the company trades at just over 4x forward EBITDA. Specifically, HCLP has two key assets which we believe constitute the majority of its current value: its PropX logistics system and the Kermit mine. Management expects PropX to easily generate upwards of $120M in EBITDA. If supply comes on line, this unit would benefit as many smaller new entrants will likely outsource logistics to HCLP. The Kermit mine is currently the only mine located directly within the Permian basin and has the lowest costs in the region. Given that it was acquired for roughly $300M before it was fully contracted out, we believe that it should be worth at least $500M (or 5x EBITDA). If we assume a conservative 5x multiple for PropX as well, we get the other four mines for free. Finally, we believe a clear catalyst is in place. HCLP recently became the first frac sand company to reinstate its dividend in two years. As distributions increase, a likely scenario given HCLP's IDRs, yield-seeking MLP investors who fled following the distribution's suspension should return to the company. Management has also been buying back shares and insiders own 13% of the LP and 39% of the GP.

Key Risks and Considerations

1. *Incoming supply*: A key part of our thesis is that we believe it will be more difficult for new supply to come on line than the market expects. This belief is challenged by the preponderance of low-cost frac sand players funded by private equity, which some may argue resembles the fracking boom that ultimately led to uncontrolled supply growth and

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deteriorating oil prices. Though private equity firms may similarly hope to strike it big in frac sand, we believe their efforts will be challenged by the aforementioned bottlenecks, which make it difficult for players whose sole advantages are their well-lined pockets to succeed, a notable distinction from the fracking industry.

2. *Shift to brown sand*: A shift away from white sand towards lower-quality, cheaper brown sand could be deleterious as HCLP was not profitable during the prior downturn. However, HCLP's clean balance sheet and fiscally responsible management team provide us with an assurance that the company is among the best-positioned players in the frac sand industry to survive transient downturns. Furthermore, HCLP's low cost in-basin mines mitigate the impact of demand shifting towards brown sand.

We will continue to monitor industry dynamics closely, focusing on new entrants, new capacity, and diminishing demand from HCLP's customers. Since it takes 6-12 months for supply to come online, we will quickly know if our thesis is correct and if the announced supply will actually be able to come into fruition.

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Signature Bank New York (NASDAQ: SBNY)

Financials Sector Leader: Abhimanyu Sharma

Company Overview

Signature Bank New York (SBNY) is a commercial bank headquartered in the New York area. SBNY operates 30 private client offices and offers a variety of business and personal banking services. A typical private client banking team focuses on privately owned businesses with revenues less than $200M. SBNY also offers a variety of financing and leasing products. After being founded in 2001, SBNY has grown its asset base to upwards of $40B and about $33B in loans.

Investment Thesis

The Financial Sector recommends a BUY in SBNY for the following reasons:

1. *SBNY's PCB model leads to industry-leading fundamentals*: Since 2008, SBNY's premier client banking teams have been able to acquire and keep business owners and high-net-worth individuals as clients. The efficient PCB model ensures pristine fundamentals: low costs of funds (0.45% vs. peer's 0.6%), impressive efficiency ratios (38%), and high revenue per employee ($160k). Going forward, SBNY is looking to acquire PCB teams from larger banks that are laying off teams. SBNY has also increased its focus on growing its commercial banking and specialty finance segments.
2. *Limited and advantageous exposure to NYC's real estate*: Despite the recent slowdown, we are likely in the middle of the housing cycle. Specifically, post-election uncertainty and a sudden rise in 10-year yields contributed to a 43% decline in residential permits issued. Since then, political uncertainty has been comparatively reduced and 10-year treasury yields have decreased. However, SBNY's focus on low-to-middle income segments ensures stable cash flows and support for underlying loans. Given the population density of NYC, multifamily living continues to be a necessity for the region.
3. *Short-term factors weighing on stock performance*: The recent decline in the taxi industry has forced SBNY to write-off a significant portion of its taxi medallion loans book (reduced exposure from 3% of loan portfolio to 1%). In addition, higher levels of CRE concentration have required SBNY to increase spending on compliance and regulatory costs. These factors have caused the stock to decline by nearly 20%. However, we believe that 1) reducing the taxi medallion risk to 1% of portfolio significantly mitigates the exposure to an industry in secular decline, 2) SBNY crossed the 300% CRE-to-Total Risk Based Capital threshold in 2010, and 3) SBNY has since overhauled its risk management system and sustained pristine credit quality.

Key Risks and Considerations

1. *Loss of PCB teams*: Due to the company's business model, there exists an inherent risk of PCB teams and, subsequently, clients leaving the firm. As a result of SBNY's client-centric operating strategy, however, it has only lost 15 teams in more than 15 years and retained the team's clients in every single one of these instances.
2. *SIFI threshold*: SBNY intends to cross the $50B in assets threshold by early 2019, which could result in additional compliance costs due to regulatory expenses from becoming a SIFI. Although it remains likely that the government will increase the SIFI threshold, SBNY has invested in risk management systems to compensate for its growing asset base.

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Decision: NO PURCHASE

Financials Investment Committee Representative: Vaibhav Verma

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The Financials Sector pitched Signature Bank (SBNY) on Wednesday, November 1, 2017 in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to purchase SBNY. Our reasons are as follows:

FIRSTLY: While we believe SBNY is a high-quality bank, we do not find the current valuation particularly attractive. 2x book and 20x earnings for a financial institution, albeit a well-run one, does not provide us with a sufficient margin of safety. SBNY used to warrant this multiple due to its incredible 30% annual loan growth following the financial crisis, however we do not believe that is sustainable going forward given increased competition, declining NYC transaction volumes, and less incremental impact from each new team hired. As a result, we believe the stock may face multiple contraction as the market readjusts its growth expectations.

SECONDLY: We do not feel comfortable with SBNY's significant exposure to NYC real estate. Cap rates in NYC are in the sub-5% range, implying that we have arguably reached a peak, which is worrisome given that NYC real estate constitutes over 80% of loan collateral. A marginal decrease in real estate values would put the company in a difficult position. Refinancing opportunities typically come from increases in asset values or decreases in interest rates, neither of which are imminent. Thus, it is unlikely that SBNY will be able to maintain double-digit loan growth. In fact, NYC multi-family volumes are already down 55% year-over-year.

THIRDLY: We believe SBNY's net interest margins may come under pressure because it has mostly long-term fixed rate loans and floating rate deposits in the face of a rising interest rate environment. Unlike most banks, SBNY lacks a sticky deposit base as business deposits tend to quickly negotiate for higher interest rates (versus retail deposits). This problem is exacerbated by the fact that deposit competition in NYC has intensified. Competitors have been hiking deposit rates while cutting loan interest rates to gain market share and improve their loan-deposit ratio (96% on average). The company has also regularly issued equity over the past few years, possibly indicating that it is struggling to adequately grow its deposit base.

FOURTHLY: The company's standout 33% efficiency ratio will likely increase, as SBNY becomes a systematically important financial institution (SIFI) over the next few years. Management expects to cross the $50 billion threshold in late 2018/early 2019 and has already increased investment in compliance system and non-interest expense guidance by 10-15%. SBNY has also surpassed the allowed CRE concentration limit, which could result in additional regulatory expenses.

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Nexeo Solutions (NASDAQ: NXEO)

Industrials Sector Leader: Liam Zhao

Company Overview

Nexeo Solutions is the largest distributor of plastics and the third largest distributor of chemicals in North America. It operates in North America (82% of total revenue), Asia (6%) and EMEA (12%). Nexeo's segments include chemicals (47%), plastics (50%) and environmental services (3%). Nexeo completed its IPO in June 2016 through the Wilbur Ross Holding Corporation, a Special Purpose Acquisition Vehicle (SPAC).

Investment Thesis

The Industrials Sector recommends a BUY in NXEO for the following reasons:

1. *Undervalued opportunity with potential for future margin enhancement*: We believe that the market is undervaluing the company as a result of it being a SPAC. This pessimism was exacerbated by changes in accounting practices, overly ambitious management guidance leading to earnings misses, and the departure of Wilbur Ross as the company's chairman. Nevertheless, we are optimistic about this opportunity because of the financial and technical expertise that Wilbur Ross' team brought in and well-aligned incentives such as management buy-ins. More importantly, Nexeo had been starved of investment under Ashland, before TPG's takeover in 2011. Since then, Nexeo's operating margins have increased from 0.7% in 2012 to 2.5% in 3Q17. We believe there is room for future margin enhancement through cost-savings, increased efficiency, and shift to specialty chemicals as Nexeo's margins are still far below the industry 6% operating margins.

2. *Competitive advantages in a fragmented market*: The chemical distribution industry is highly fragmented as the top three global players (Brenntag, Univar, and Nexeo) only constitute 12% of the market. The industry does not compete purely on price; rather, it prioritizes value-add services and delivery timeliness, thus creating high barriers to entry due to the significant upfront investment required. As a result of its extensive distribution network, best on-time delivery rate, and superior value-add services (supply chain logistics, IT, etc.), Nexeo has created a sticky customer and supplier base with an average relationship of over 20 years.

3. *Favorable long-term industry trends*: The chemical distribution subsector is projected to grow at a 6% CAGR through 2020, which is twice the chemical industry growth. Moreover, chemical distribution demand is growing as customer consolidation continues; when chemical companies grow in size, they are more likely to turn to distributors to tailor to smaller customers' individualized demands, giving Nexeo an opportunity to further roll-up the fragmented distribution industry.

Key Risks and Considerations

1. *Leverage*: Nexeo has a high debt/equity ratio of 120% and a leverage ratio of nearly 5x as of 3Q17. However, we believe this risk is mitigated by the ABL Revolver and Term Loan's flexible credit terms. In addition, the industry's average leverage is 5.8x due to the steady cash flows. Nexeo has also shown consistent efforts in reducing its leverage (7.0x in 2014) and based on our projections, Nexeo should be able to reduce its leverage to a more manageable 2.4x in 2022.

2. *Commodity*: Nexeo's product pricings are affected by commodity prices as the products it distributes are oil derivatives: a decrease in crude oil prices will result in lower chemical product prices and hence lower sales. Nevertheless, Nexeo has maintained stable margins due to its short-term contract structure and ability to pass on costs to its customers. In addition, we remain optimistic on oil prices and end market demand over the next five years.

3. *TPG sell-off*: TPG currently owns 35% of the company and its sale could depress the stock price. However, this risk is mitigated as TPG chose to maintain a 35% stake of Nexeo when selling the company to Wilbur Ross, thereby demonstrating its long-term interest in the company.

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Decision: NO PURCHASE

Industrials Investment Committee Representative: Stephanie Liu

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The Industrials Sector pitched Nexeo Solutions (NXEO) on Wednesday, November 8, 2017, in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to purchase NXEO. Our reasons are as follows:

FIRSTLY: We are skeptical of NXEO's competitive advantages. The sector proposed that NXEO's competitive advantages lay in its national distribution network and its value-added services. Although NXEO has an expansive distribution network in the U.S., it can not be considered a competitive advantage because moats for this industry depend on local monopolies rather than national ones. Therefore, NXEO's national distribution network would still need to compete in every single location and thus face smaller competitors. In regards to its value-added services, we do not see these services as a sustainable competitive advantage as we believe the critical variable over the long-run will be price. At the moment, NXEO is outcompeting its peers because of its services, but NXEO's larger competitors, Brenntag and Univar, can easily replicate this and capture NXEO's market share. It is unclear how much suppliers are willing to pay for these value-added services, particularly since NXEO's suppliers are consolidating and will likely cause NXEO to face intensified pricing pressure.

SECONDLY: NXEO's high leverage makes it difficult for the company to carry out its margin expansion plans. Due to the higher margins in specialty chemicals distribution, management intends to increase specialty chemicals mix through acquisitions. However, NXEO is highly leveraged with a debt/equity ratio of 120%, an interest coverage ratio of 0.52, and a leverage ratio of 4.9x, driven mostly by the $58 million Ultra Chem acquisition. As NXEO continues to pursue margin expansion through acquisitions of smaller players, NXEO will have to take on significant debt and utilize its $505 million ABL facility, of which $199 million is outstanding. With these future prospects in mind, we are not confident that NXEO can reach its margin expansion targets or rollup strategy with a level of debt we are comfortable with.

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Conduent (NYSE: CNDT)

Special Situations Sector Leader: Rishi Krishnan

Company Overview

Conduent is a business process outsourcing (BPO) provider that specializes in transaction-intensive processing, analytics, and automation. The company was spunoff from Xerox at the end of 2016. It reports earnings in three segments: commercial industries (60% of revenue), public sector (35%), and other (5%).

Investment Thesis

The Special Situations Sector recommends a BUY in CNDT for the following reasons:

1. *Attractive and overlooked recurring revenue contracts*: Approximately 80% of Conduent's revenue is tied to recurring services contracts that boasts of a 98% renewal rate. The often mission-critical nature of the company's services creates switching costs and the large suite of offerings provides cross-selling opportunities. Conduent's customers include 76 of the Fortune 100, all top 20 managed US healthcare plans, and 27 countries. The company's tolling solutions and health savings account (HSA) business segments are worth noting. Its patent-protected tolling solutions business operates in a duopoly market with Roper and has strong 20-30% EBITDA margins. A back-of-the-envelope EBITDA multiple of 17x (a 25% haircut to Roper's multiple) yields an EV of $2.7bn, or 54% of Conduent's current EV. The HSA segment (BenefitWallet) is one of the top 5 health savings providers, operates in an industry growing upwards of 20% annually, and will benefit from regulatory approval to collect float on its accounts. Applying a sales multiple of 14x, based on that of HealthEquity (a pure HSA competitor), to BenefitWallet's estimated revenue yields an EV of $1.4bn, or 28% of Conduent's EV. Given that these two segments only account for 15% of the company's revenue, we find strong evidence that Conduent is compellingly undervalued.

2. *Post-spinoff restructuring is a temporary burden*: Conduent's earnings have been depressed by a series of one-time spin-off related restructuring costs. In 2016, the company incurred almost $1B in goodwill impairment, with additional restructuring and separation costs. Under Xerox's management, Conduent was further burdened by low-profit contracts and a bloated cost structure. As a result, the company's gross margin and operating margin are 15% and -1% respectively, versus competitor averages of 47% and 17%. Subsequently, it has significant room to increase profitability, a fact made clear by margin improvement over the past year. The 'other' segment, long a profitability drag, has increased its margin through a series of divestitures from -25.8% in 3Q16 to 1.3% in 3Q17. The company has divested $60mm in revenue in 3Q17 alone and is on track to cut $700mm in additional costs by the end of 2018.

3. *Industry M&A and activist presence*: The BPO market has continued to experience strong M&A activity, with private equity buyers like KKR and Blackstone as well as strategic buyers like Accenture and Cognizant making large acquisitions in the past few years. Conduent's significant portion of fixed costs (about 20%) and multi-industry offerings make it an attractive target. Activist investor Carl Icahn, who owns 10% of the company, successfully pushed the company to waive temporary anti-takeover measures after the spinoff, an obvious signal he is pushing for a sale in the near future. Icahn's presence will help the firm attract buyers and, given the multiple expansion associated with a sale, provide an immediate catalyst for shareholders.

Key Risks and Considerations

1. *High leverage*: Conduent has $2B in debt that was created as part of the spinoff from Xerox. While interest coverage remains fairly strong, net leverage, at 2.9x adjusted EBITDA, is not trivial. The company's debt has a net leverage covenant of 4.25x (with a step down to 3.25x at the end of 2018) leaving it with some risk if EBITDA declines significantly. Thus, it is unlikely Conduent can raise any more debt, making it reliant on operating cash flow for capex.

2. *Possible commodification of BPO*: Although 40% of revenue loss is strategic, the remainder of revenue declines across all segments could be attributable to the commodification of the BPO industry, a possibility supported by reported pricing declines in some offerings. Direct competitors and the BPO industry at large have seen sales increases over the past few years. As a result, it is unclear if Conduent's flagging revenue is because of unprofitable contracts as management claims or broader pressure on the company's service offerings.

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Decision: NO PURCHASE

Special Situations Investment Committee Representative: Sid Jain

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The Special Situations Sector pitched Conduent (CNDT) on Wednesday, November 8, 2017, in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to purchase CNDT. Our reasons are as follows:

FIRSTLY: We are skeptical that CNDT's low margins are simply a function of Xerox mismanagement rather than a deteriorating business. In contrast to growing peers, CNDT has faced consistent pricing pressure, volume declines, and massive billion dollar impairments, which seem to indicate a commoditized business. As a result, we believe that closing the margin gap with competitors could prove to be more difficult than people expect.

SECONDLY: We do not believe that the current price is attractive even under a SOTP valuation. The tolling business is highly attractive (patent-protected duopoly) but does not warrant a 17x EBITDA multiple. Roper also operates in this space but trades at a higher multiple due to its brilliant acquisition strategy and focus on asset-light businesses, which CNDT does not offer. We do not feel comfortable valuing the early stage HSA segment at $1.4B (or 14x revenue). Once we assigned more conservative multiples to these two segments, we found that the rest of the business was trading at an implied multiple that did not provide us with a sufficient margin of safety. Since we do not have a strong understanding of CNDT's competitive positioning outside of its tolling and HSA segments, we are not comfortable assigning a high multiple to those businesses.

THIRDLY: CNDT'S leverage situation causes us to hesitate. While the business has mostly stable recurring revenue, strict covenants will make it difficult to reinvest significant amounts back into the business or distribute cash to shareholders. The company's revolver and term loan covenants have a max leverage ratio of 4.25x in 2017 and 3.25x in 2018. While the company has recently brought down leverage below 3x, it could be in trouble if its business continues to deteriorate. Furthermore, we also believe that CNDT's high leverage will decrease its attractiveness as an M&A target.

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InterDigital, Inc. (NASDAQ: IDCC)

TMT Sector Leader: Nick Nigro

Company Overview

InterDigital is a wireless research company that was founded in 1972 and went public in 1981. The company develops and patents technologies used in a variety of wireless communications standards (WiFi, 3G, 4G, etc.). It then licenses these technologies to device makers who incorporate these standards in their products. Many of InterDigital's patents are valuable Standard-Essential Patents (SEPs), which anyone wishing to comply with a certain technical standard must license.

Investment Thesis

The TMT recommends a BUY in IDCC for the following reasons:

1. *Stable base of licensing profits:* Because of how valuable SEPs are, courts require that SEP holders license their patents on Fair, Reasonable, and Non-Discriminatory (FRAND) terms, which regularly forces SEP holders—like InterDigital—into litigation to debate what is reasonable to charge as a royalty. InterDigital has recently established patent licensing agreements with several major licensees—the three largest of which are Apple, Samsung, and Huawei—which expire (with options for renewal) between 2021 and 2023. We see litigation for InterDigital as a form of customer acquisition; now that these customers have been 'acquired' through litigation, InterDigital will benefit from an extremely stable base of 100% gross margin licensing revenues through at least the early 2020s. Furthermore, the vast majority of InterDigital's patent-licensing revenues come in the form of fixed fees, which are paid regardless of the number of devices sold or the economic environment.

2. *Well-positioned for transition to 5G:* The next major wireless standard will be 5G, which is currently in development and is expected to be finalized in the early 2020s. InterDigital has consistently made high numbers of contributions to the industry working groups—3GPP's RAN1 and RAN2 groups—associated with the development of 5G technologies, suggesting that InterDigital is likely to possess important patents for the 5G standard. Moreover, because 5G is an entirely new standard and not just an improvement on the existing 4G standard, phones implementing 5G technologies will also need to separately incorporate 2G, 3G, and 4G technologies. As such, even after 5G is released, phone manufacturers will need to continue to license InterDigital's older SEPs. Both these factors make us confident that InterDigital's patent portfolio will remain valuable throughout the transition to 5G.

3. *Upside from Internet of Things (IoT):* The number of internet-connected devices is expected to grow from 13.4 billion in 2015 to 38.5 billion in 2020, driven primarily by an expansion in the Internet of Things. Although InterDigital has lagged behind other larger companies in the number of IoT-related patents it files, it has consistently maintained a portfolio of extremely high-quality IoT patents. As patent-licensing agreements, either explicitly or implicitly, entitle the patent holder to some royalty for each patent-incorporating product sold, InterDigital is poised to benefit significantly from this massive expansion in the number of devices sold.

Key Risks and Considerations

1. *Uncertainty in 5G standards:* The 5G standard has not yet been finalized and, as a result, there is no way to know for sure which patents will be included. The uncertainty regarding the 5G standard is impossible to fully quantify; however, we believe the risks associated with 5G are asymmetric to the upside. There is a simple reason for this: the uncertainty surrounding the 5G standard can either benefit or harm InterDigital—depending on whether InterDigital's portfolio of 5G patents is stronger or weaker than expected—while the expansion of wireless devices under 5G is guaranteed to benefit InterDigital, regardless of the relative strength of the company's 5G portfolio.

2. *Legal treatment of FRAND royalties:* The question of how much SEP holders should be paid for licensing their patents—"What constitutes a FRAND royalty?"—is a hotly-debated legal topic. If the legal treatment of FRAND royalties were to change, InterDigital's licensing revenues could be affected—either positively or negatively. We have no view on future legal developments in this field. However, we believe that Broadcom's recent offer to buyout Qualcomm and Qualcomm's subsequent decision to decline the offer demonstrate insiders' faith in InterDigital's underlying business model.

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Decision: MONITOR

TMT Investment Committee Representative: Michael Presutti

The Technology, Media & Telecommunications Sector pitched InterDigital, Inc. (IDCC) on Wednesday, November 15, 2017 in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to purchase but to continue to monitor IDCC. Our reasons are as follows:

FIRSTLY: We would like to preface the discussion of our decision not to purchase IDCC with a brief discussion of our perspective on IDCC's business model and future prospects. What appealed to us most about IDCC were its highly predictable licensing revenues from previously settled patent litigations, coupled with asymmetric upside from additional settlements, the transition to 5G, and the growing ubiquity of IoT. The valuation is highly resistant to operational assumptions, considering near-term operations have little effect on near-term revenues. We believe IDCC owns an industry-leading patent portfolio for 5G technologies, and that furthermore, most investors, i.e. short term investors, fail to account for the potential upside from this portfolio within the next five to ten years.

SECONDLY: Although we admire the IDCC business model, we believe IDCC is currently too expensive for purchase. IDCC traded around 8x earnings in 2016 because of the effects of one-time revenue. However, we project IDCC to trade around 20x earnings in 2017, and expect the earnings multiple to increase thereafter. The valuation yields an implied price of $58.21, assuming the current tax structure, or $64.49, assuming the proposed tax structure currently in Congress passes, and decreasing corporate tax rates to 21%. Goldman Sachs assigned a 65% likelihood for the tax bill to pass in October, and if we assume investors incorporate similar probabilities into their valuations, we arrive at a weighted implied price of $62.29. Considering the current price of $74.95, we believe IDCC is too expensive for purchase without any substantial near-term catalysts. Additionally, we believe the market has already priced in a portion of the longer-term upside. Though we intend to continue to monitor IDCC, we should note IDCC's near-term projected revenues, most of which are recurring revenues, are likely too stable to surprise investors, and, consequently, significantly impact IDCC's market value in the near-term. As such, we do not consider a sufficient discount to the current IDCC market value intrinsically likely. However, were the sector, or even the market, to tumble, and IDCC's market value alongside them, we would feel more comfortable entering a position, again considering IDCC's revenues are highly predictable in the near-term.

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Liberty Tripadvisor (NASDAQ: LTRPA)

Interim Consumer Sector Leader: Bruce Li

Company Overview

Liberty TripAdvisor Holdings is a holding company that owns approximately 18.2M shares of TripAdvisor's (NASDAQ: TRIP) common stock and 12.8M shares of TRIP Class B common stock. This constitutes 13.8% of TRIP's outstanding common stock shares and 100% of its outstanding Class B common stock shares. TRIP is a travel site that aggregates travelers' reviews and price-compares vacation destinations, accommodations, transportation, attractions, and restaurants.

Investment Thesis

The Consumer Sector recommends a HOLD in LTRPA for the following reasons:

1. *Special situation with little coverage*: LTRIP trades at nearly a 50% discount to the value of its TRIP holdings and we believe that its spinoff from Liberty Interactive in 2014 coupled with its small size are causing the market to misprice LTRIP. For example, in earnings calls, analysts have been asking about Liberty's other holdings.
2. *Turnaround situation with TRIP allows for future value*: Although nearly half of all travelers are influenced by TripAdvisor's recommendations, the company has struggled to monetize those eyeballs. As a result, TRIP has pivoted from its advertising model to instant booking where consumers purchase directly through TRIP's website as opposed to being redirected to another website. This business model is projected to be more profitable in the long run, but has depressed margins due to increased SG&A costs. Post-transition, we expect TRIP's 10% profit margins to increase to competitors' 15% to 35% level.
3. *Online travel market expected to grow rapidly*: The online travel market is expected to reach $1.1T by 2022, growing at an 11% CAGR, primarily driven by the 22 to 31-year-old demographic. Most of this growth will be in emerging markets, as consumers with increased discretionary income increasingly spend on leisure. TRIP's online review system has built a high degree of trust from consumers, especially in the aforementioned 22 to 31-year-old group. This group is technologically savvy and more willing to trust online reviews than their older counterparts. As time goes on, we expect the market to shift in TRIP's favor as more tech-friendly consumers trust and use its platform.

Key Risks and Considerations

We found two crucial risks to the investment that influences our HOLD recommendation.

1. *Debt repayment severely erodes margin of safety*: LTRIP took on $400M of debt in the form of a margin loan, backed by its TRIP shares, during the 2014 spinoff. The cash was distributed to the former parent, Liberty Interactive, to repurchase Liberty shares. In 2016, LTRIP entered into a Variable Postpaid Forward (VPF) deal that repaid $259M of its margin loan and PIK interest commitments. In exchange, LTRIP must repay its VPF obligations in TRIP shares in 2020, based off a predetermined price per share conversion range. From our calculations and the current stock price of TRIP, we find that repayment of this VPF reduces our margin of safety from 49% to approximately 16%, even before repayment of the remaining margin loan balance (approximately $200mm). While VPF is structured such that LTRIP pays fewer TRIP shares if TRIP's price per share increases, we are concerned with TRIP's ability to appreciate significantly within the investment horizon.
2. *Difficult business model transition*: TRIP operates as the smallest player in the online travel business, behind Priceline (NASDAQ: PCLN) and Expedia (NASDAQ: EXPE). Furthermore, TRIP has exhibited low growth when compared with its competitors, compounded by the fact that TRIP depends on PCLN and EXPE for 46% of its consolidated revenue. This revenue percentage has not changed for the most recent three years, which leads to our concern that TRIP is struggling to convert its viewers into booking customers and that PCLN and EXPE are squeezing out TRIP in the bookings market. We are also nervous of Google as a review aggregator and Airbnb as an accommodation aggregator.

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Decision: NO PURCHASE

Consumer Investment Committee Representative: Thomas Dunn

The Consumers Sector pitched Liberty TripAdvisor Holdings (LTRPA) on Wednesday, November 29, 2017 in General Meeting as a Hold. The Investment Committee (ICOMM) decided not to purchase LTRPA. Our reasons are as follows:

FIRSTLY: We are skeptical of TRIP's ability to monetize its large base of reviews. Until 2014, TRIP generated revenue by directing customers who looked at its high quality reviews to partner sites such as Expedia and Priceline where they could complete their booking. If customers booked reservations at hotels they had found on TRIP, then the partner site would pay TRIP a percentage of the booking as a finder's fee. In 2014, TRIP decided to add an instant booking feature on its site to increase its revenue and compete more directly with Expedia and Priceline. However, they have seen little success due to network effects benefiting established players. As a result, in early 2017, TRIP announced that it would no longer focus on instant booking, and it remains unclear what its business model is going forward. While TRIP continues to be the best travel review site, it has become clear that monetizing that asset is challenging. We believe it will be even more challenging to monetize mobile as many other tech companies have realized.

SECONDLY: TRIP faces a difficult path navigating a market with two large, successful competitors, and the threat of new entrants is high. Expedia and Priceline dominate the American and European online travel agent (OTA) markets due to a strong network effect. These two players also constitute nearly 50% of TRIP's revenue which causes us to believe TRIP may face pricing pressure. This problem is magnified by the threat of disruptive competitors in the OTA market. Google appears to be moving toward aggregating hotel prices and reviews directly. As Google has a massive network of users who generate high-quality reviews similar to TRIP's, this technological powerhouse poses a huge threat since booking on Google would essentially remove a step for customers. It is unclear TRIP can address this fundamental threat to its business model. Competitors like Airbnb, who are disrupting the hotel industry as a whole, also pose a threat.

THIRDLY: LTRPA initially appeared attractive as it is trading at a discount to the value of its TRIP shares, but upon further review this discount is justified and does not represent a margin of safety. First, we believe TRIP itself is expensive at 14x forward EBITDA (for what is arguably a melting ice cube). Second, when Liberty Interactive spun off its TRIP ownership stake into Liberty TripAdvisor Holdings in 2014, the SpinCo paid a large cash dividend to the Parent financed by a loan placed on LTRPA's books. This loan will be repaid in TRIP shares, and the number of shares LTRPA will be forced to divest will be determined by the price of TRIP. As TRIP's share price has dropped, LTRPA's expected future ownership stake in TRIP has decreased. This, along with overhead costs and uncertainty about LTRPA's future plans, has caused the widening margin between LTRPA's price and the market value of its TRIP holdings. In our opinion, the market is fairly valuing LTRPA based on TRIP's share price and LTRPA's outstanding debt.

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Portfolio Weightings

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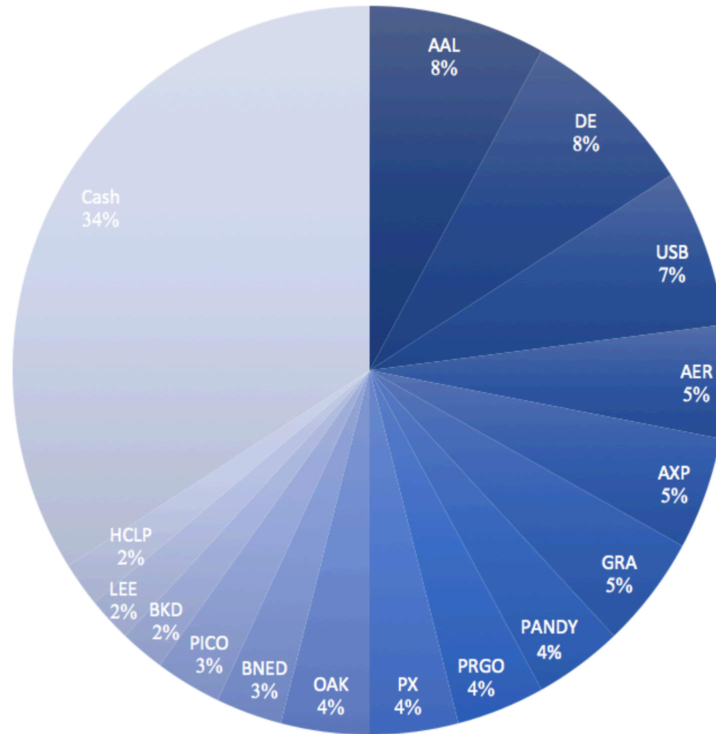

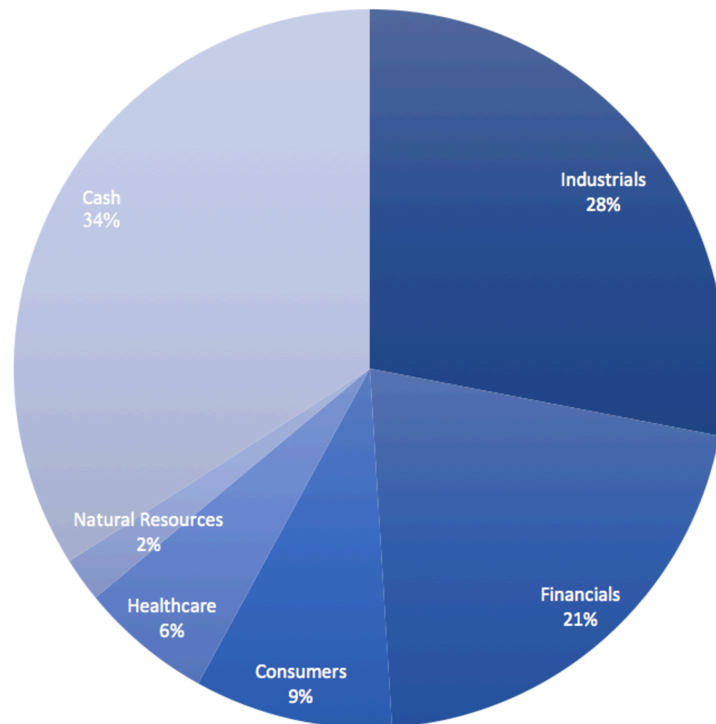

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Other Investments

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AerCap Holdings (NYSE: AER)

Chairman, Investment Committee: Sid Jain

Investment Thesis

After revisiting the Financial Sector's pitch of Air Lease (NYSE: AL), the Investment Committee (ICOMM) decided to purchase its larger competitor, AerCap (NYSE: AER). We believe AER is attractive for the following reasons:

1. *Scale in highly attractive business*: The air leasing business entails of borrowing money to acquire aircraft from OEMs and then leasing it to airlines. Airlines benefit from a smaller balance sheet and the lessor's stronger credit rating and negotiating clout. It is a growing industry — today, 42% of the world's commercial jets are leased (50% expected in 2020) from zero in the 1960s. These triple-net leases typically last for over a decade and provide a source of predictable revenue (93% of revenue through 2019 is already contracted) with mid-teens ROEs throughout the cycle. After the lease ends, the planes tend to hold their value extremely well since the Boeing/Airbus duopoly does not allow for a supply glut to form. If a customer cannot pay, the airline is quickly repossessed and re-leased in the fairly liquid secondary market. Finally, consolidation has resulted in two large players (AER and GECAS) controlling 40% of the air leasing industry. As the largest independent air lessor in the world (and one of Airbus/Boeing's largest customers), AER's scale enables cheap financing, bargaining power with OEMs, and favorable lease rates with customers.

2. *Skilled management team*: CEO Aengus Kelly's capital allocation prowess warrants a premium multiple. Unlike several of its peers, AerCap did not have to take large asset value impairments during and after the crisis. When AER was trading below book value in 2011 and 2012, he bought back nearly 25% of the company. When AIG was forced to sell off its air leasing business (ILFC) in 2013, AER scooped it up for less than half its adjusted book value. Even though ILFC was four times the size of AER at the time, this transaction was immediately accretive and hit Kelly's profitability and leverage targets ahead of time. Over the past two years, with the stock again trading below book value, AER has already bought back 25% of the company with plans to keep buying back shares until the stock trades at fair value. With nearly $10B of liquidity, the company has enough firepower to continue with the share buybacks, which mitigates the risk of a value trap. It's also important to note that Kelly has most of his net worth in AER stock.

3. *Reasonable valuation*: Despite the solid business and management team, AER trades at just 8x forward earnings versus its historical 10-11x multiple. No financial institution with <1% net charge offs and profitability throughout the recession, 10% NIMs, and 15% adjusted ROE (AER does not pay cash taxes) over the past decade should trade at under book value, yet AER does. In the past, air lessors have traded all the way up to 2x book value. However, this is not just a mean reversion story as book value continues to compound at double digits. Furthermore, book value understates the company's true assets. If we adjust the aircraft values to current market value, we find that the stock trades at just over 0.8x book. This assigns negative value to the AER platform. As management continues to sell planes at 1.2x book and buy back stock at 0.9x book, we expect to see significant multiple expansion. Precedent transactions and comps all point to a higher multiple.

Key Risks and Considerations

1. *Potential for aircraft oversupply*: The market has been extremely concerned with the supply of aircraft that will be hitting the market over the next few years, which would place downward pressure on aircraft residual values. Furthermore, low oil prices have decreased demand for fuel-efficient aircraft. However, there are two mitigating factors. First, the OEM duopoly has historically been very adept at matching supply and demand growth and will likely continue acting rationally to maintain aircraft values and not flood the market with new aircraft. As a result, aircraft deliveries are expected to remain around 8% of the current fleet, close to historical levels. Boeing's recent cuts for the 777 indicate discipline in production rates. Second, high oil prices are not the only driver of aircraft demand. A replacement wave is approaching as 30% of the global fleet will be 25 years old by 2024. With RPKs continuing to grow at mid-single digits and load factors above 80%, airline operators will eventually need to expand their fleet. Boeing forecasts that China alone will need nearly 7,000 new aircraft over the next two decades to meet passenger demand.

2. *New Chinese entrants*: Strong returns tend to attract competitors — the air leasing industry is no different. However, the fear of new Chinese entrants driving down returns has been overblown. First, there is enough demand to meet the incoming supply of air lessors. Every 1% market share gain for lessors could add 200+ aircraft worth $8-$10B to lessor

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books in aggregate. Second, capital is not the only competitive advantage in this industry. In opaque markets (such as air leasing), if you have more data than anybody else and you can use that data, you have a moat. Two decades ago, many Japanese trading houses had aircraft leasing businesses but few survived as they underestimated the importance of having proprietary data on supply/demand and long-term customer relationships. Third, these new players are simply replacing the role export development agencies and the Ex-Im bank used to play in providing subsidizing financing to airlines.

3. *Leverage in a cyclical industry*: Operating with 3x debt/equity in the airline industry could be seen as a recipe for disaster. However, the air leasing industry has proven to be stable through a full cycle since airline operators turn to leasing in a downturn rather than owning aircraft outright. Even in the recession, fleet utilization never dipped below 97% and publicly traded lessors generated over 20% pre-tax margins. Furthermore, after a recent Moody's upgrade, the mostly fixed-rate, long-term debt has been deemed investment-grade by all three major credit agencies. This makes AER the first independent lessor to ever receive the distinction. The bonds are trading at 100c on the dollar and we believe the equity market will follow the credit market and re-rate the company upwards. Even in a liquidity crunch, AER could allow its mostly unsecured lenders to collateralize up in exchange for later maturities. Finally, since most of the debt is fixed rate but contracts have interest rate escalators, an interest rate hike should actually improve margins.

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Brookdale Senior Living (NYSE: BKD)

Chairman, Investment Committee: Sid Jain &
TMT Investment Committee Representative: Michael Presutti

Investment Thesis

After revisiting the Healthcare Sector's pitch of Brookdale Senior Living (NYSE: BKD), the Investment Committee (ICOMM) decided to purchase it. We believe BKD is attractive for the following reasons:

1. *Dominant player in attractive business:* Senior living has historically been a top-performing real estate class due to a very sticky customer base (elderly residents typically do not leave) and significant pricing power (BKD raises rents annually including in recessions). Customer credit risk is also not a major concern since residents are usually well-off and pay with family savings rather than relying on Medicare. Specifically, BKD is the largest player in a highly-fragmented industry with over twice as many units as the number two player, and its economies of scale give it the industry's lowest cost structure.

2. *Potential acquisition target:* We believe there is a high likelihood of BKD being bought out within the next 12-18 months by either a financial or a strategic player. Blackstone, Ventas, and a Chinese real estate firm have all been in talks that fell through due to financing troubles or difficulties circumventing a "change in control" lease provision. As for the latter, BKD recently announced that it has removed this provision from its HCP leases, and we are optimistic that it will continue to do so in the upcoming wave of lease renewals. Even when assuming an extremely conservative 8% cap rate (characteristic of Class B properties), we arrive at a healthy 25-50% upside for our real estate valuation. Recent transactions in the space have occurred all the way up to a 5% cap rate. The Chinese firm was even willing to pay a 7% cap rate for BKD. Furthermore, this assigns no value to the management part of the business. BKD could potentially spin off its real estate and start offering management services like Marriott, which is currently valued at over 20x earnings. Given the hundreds of billions of dollars in dry powder in the private equity industry, we believe BKD represents a highly attractive acquisition target. The significant activist involvement and the multiple board members with real estate experience further bolster this thesis.

Finally, we recommend selling the stock within 12-18 months if the company is not bought out by then or if its bond prices start to deteriorate.

Key Risks and Considerations

1. *Supply glut:* Due to the attractive economics of the senior living business, the industry has struggled recently with new supply coming online, causing BKD's occupancy to decline to 85%. However, demand is expected to accelerate over the next few years as baby boomers approach their mid-70s, which is the average age of admission into senior housing facilities. In particular, BKD estimates its target demographic living within 20 miles of its communities will grow more than 30% over the next five years. Furthermore, anecdotal data by management indicates that construction starts have slowed down significantly as a result of financing drying up and higher construction costs. Regardless, we do not intend to speculate on the operational prospects of BKD, but rather to evaluate its buyout prospects. Even a buyout at a significant discount to historical industry premia would unlock BKD's value.

2. *Leverage:* BKD operates with significant operating and financial leverage. The senior living industry's cost structure is dominated by fixed rather than variable costs. As a result, if occupancy continues to decline into the 75-80% range, BKD will likely not be cash flow positive. However, movement from the current 85% occupancy to below 80% would not only take years to occur but would also be highly unlikely, as none of BKD's competitors have the scale necessary to squeeze its operations so much. In terms of financial leverage, BKD has over $3.5B (~5x EBITDA) in debt and $1.2B maturing in 2018. This debt consists of mostly non-recourse mortgages collateralized by the facilities and should be easily refinanced. We feel comfortable with the nearly 2x interest coverage given the stable cash flows and potential for asset sales to raise further cash. Credit markets are also not concerned with BKD bonds trading at par.

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