The Blue Chips Investor Letter
Winter 2018

Statement from the Chairman

Chairman, Investment Committee: Sid Jain

Successful value investing nowadays requires creativity. We have long passed the days where diligent investors could pore through Value Line and find quality companies trading at 2x earnings and below net current asset value. Any quant can run a quick screen and arbitrage the obvious deep-value bargains away. As a result, companies that look cheap on a strictly quantitative basis often deserve to be cheap. However, discretionary investors will always have an edge when analyzing a company's qualitative aspects, such as its untapped pricing power and reinvestment opportunity.

This past quarter, we found value in two industries most traditional investors would shy away from: Russian financials and enterprise SaaS. After revisiting the Financial Sector's previous pitch of Sberbank (OTC: SBRCY), we came to the conclusion that much of the macro risk had been eliminated (see page 23). From a bottom-up perspective, we view Sberbank as one of the highest quality banks in the world. It has monopolized the Russian financial system, generating a 30% return on equity in a normal environment. Furthermore, its management team led the company superbly through two financial crises without having to raise capital. Sberbank remains entirely deposit-funded and boasts one of the best efficiency ratios in the world. From a top-down perspective, Russia just emerged from a severe economic crisis and has begun new balance of payments and credit cycles. Russia now maintains one of the largest dollar reserves in the world, a current account surplus, minimal fiscal deficit, little debt, and low single digit inflation. As a result, rating agencies have continuously upgraded Russia and now deem it one notch away from investment-grade even with the prospect of increased sanctions. We also believe that recent government and company actions indicate significantly less corporate governance risk. We were able to enter our position at a mid-single digit multiple on trough earnings. Any sort of mean reversion with the multiple or earnings will result in a very successful investment.

Second, we invested in an early-stage enterprise SaaS company, Yext (NYSE: YEXT), that we believed had flown under the radar (see page 11). For a nominal fee, Yext allows customers to control business listing information across all platforms with the touch of a button. This industry represents a $10B opportunity with only 2% penetration. Furthermore, due to the existence of network effects, we believe the entire market will soon tip over to Yext, the dominant player with 10x more listings than the next biggest player. Despite its current unprofitability, Yext generates extremely attractive unit economics (3-6x LTV/CAC) and negative churn. It is highly scalable with minimal variable costs and has sufficient cash for at least the next three years (although we believe it will turn profitable well before then). Importantly, the company has poached several top Salesforce executives who have extensive experience scaling an enterprise SaaS business. In essence, we believe Yext has the potential to be a multi-bagger.

I would like to conclude by thanking everyone in the club for all their hard work. It has truly been an honor to lead Blue Chips over the past year and I look forward to seeing the club continue its upward trajectory in years to come. 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 previous Investor Letters. If you have any questions, feel free to contact me at sidvjain@gmail.com. With that, I hope everyone enjoys their spring break!

Winter Pitches

Barrett Business Services, Inc. (NASDAQ: BBSI)

Industrials Sector Leader: Liam Zhao

Company Overview

Barrett Business Services (BBSI) is a Professional Employment Organization (PEO) and staffing company that operates in the United States. BBSI consolidates human resources management, legal advice, payroll/staffing, and consulting services under one roof. BBSI's revenue comes primarily from its PEO service (81%) and staffing (19%). Geographically, BBSI mostly operates in California (77% of total revenue).

Investment Thesis

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

1. *Scalable business in an underserved industry*: BBSI operates a decentralized business model and relies mostly on human capital (capex is under 1% of revenue). Furthermore, BBSI takes a percentage of client's total payroll as compensation so its revenues grow with minimal expenses when its clients hire more employees or pay their existing employees more. Low industry penetration (6%) provides room to grow without having to steal clients from other competitors.

2. *Differentiated and unique business model*: BBSI's referrals generate over 90% of new business and are very effective (25% yield). The referral system has driven 24% annualized client growth over the past four years. Management has repeatedly noted the difficulties in building an effective referral system. Evidently, no other competitors have utilized a referral system and have all employed outside salespeople to identify and approach new clients, resulting in higher marketing costs. Moreover, BBSI has a 'sweet spot' client size of 20-500 employees, which effectively captures a large portion of the target market but also avoids direct competition as no other competitors currently focus on the same client size range. As a result, BBSI boasts of an above-average client retention rate of over 90% with little churn due to price competition. Because of its referral network, niche end market, and local moat in California, BBSI has strong competitive advantages against larger competitors, smaller local players and potential new entrants.

3. *Long runway with near-term expansion plan*: We believe BBSI will be able to maintain its historical 20% topline growth due to the largely unpenetrated market. BBSI's recent third-party agreement with Chubb ensures compliance with the PEO insurance law in all its untapped target markets. More importantly, BBSI has sufficient cash for expansion. BBSI's near-term growth comes from two parts: expansion within existing markets and expansion to the East Coast. In existing markets, increasingly complex regulation in HR and payroll will make BBSI's service more valuable. On the East Coast, BBSI has seven existing branches in six different states and plans to open 26 more in the next few years to penetrate adjacent markets.

Key Risks and Considerations

1. *Inadequate reserve*: BBSI's workers' compensation reserve might prove to be insufficient due to the complex regulatory environment and the difficulty in accurately estimating the exact number.

2. *Macroeconomic risk*: Payroll and employment are heavily affected by the general macroeconomic situation. As a result, BBSI took a significant revenue hit during the financial crisis.

3. *Reliance on California economy*: 78% of BBSI's FY16 revenue comes from California. Thus, if California has an economic crisis, BBSI will be heavily affected.

4. *Referral network*: Currently, BBSI relies on a robust referral network to source the majority of its new business. If this loses effectiveness one day, BBSI would have a tough time getting new customers.

Decision: NO PURCHASE

Chairman, Investment Committee: Sid Jain

The Industrials Sector pitched Barrett Business Services, Inc. (BBSI) on Wednesday, January 31, 2018 in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to purchase BBSI. Our reasons are as follows:

FIRSTLY: We have concerns over the strength of BBSI's insurance business. Insurance is a business where scale allows one to better measure and diversify risk — sub-scale players, such as BBSI, tend to struggle when competing against larger players. The company has already noted increased competitive pressures in this segment and recently even had to restate its reserves. While we view the hiring of a Chubb executive as a positive, it does not address BBSI's core issue. It sells itself as a niche consulting firm to SMEs, which conflicts with the importance of scale in insurance.

SECONDLY: BBSI's main competitive advantage does not appear to be particularly robust. The sector emphasized the company's referral system where customer recommendations and middlemen (insurance brokers, attorneys, etc.) drive most of its traffic. The referral system also allows for minimal advertising expenses. However, we do not believe these low customer acquisition costs are sustainable, especially outside the company's home state of California (78% of FY16 revenue). If the company continues to scale up and rivals take notice, there is nothing that necessarily prevents others from copying BBSI's model. BBSI also lacks brand recognition outside CA and so it may struggle to grow. Management has not provided profitability metrics for its non-CA locations, making it difficult to gauge the merit of its expansion plan.

THIRDLY: We do not find BBSI's valuation of 23x forward earnings to be very attractive. The stock is up over 200% since its trough at FY14 when the worker compensation change charge took place, which causes us to wonder what the market is missing now. Furthermore, BBSI has had extremely poor disclosure compared to peers. For example, we have no information on who their clients are, what industries they operate in, or even how prices compare to competitors. The lack of disclosure makes it difficult to gauge risk since customers could be operating anywhere from the E&P space to mom-and-pop restaurants. Credit risk is a legitimate issue since the average customer only has 30 employees.

Aspen Group, Inc. (NASDAQ: ASPU)

Consumer Sector Leader: Katherine Gerdes

Company Overview

Aspen Group is the holding company for Aspen University, a private, for-profit, nationally-accredited online university established in 1987. Aspen University offers undergraduate and graduate degrees in a variety of fields including education, computer science, technology, business, and criminal justice. It primarily focuses on nursing (74% of revenue).

Investment Thesis

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

1. *Disruptive business model*: Aspen offers a pay-as-you-go model that allows students to pay a monthly fee for their degree and is able to offer 70-80% lower tuition rates. Its affordability reduces student reliance on financial aid and loans. For example, only 20% of Aspen's students receive federal aid compared to 75% at other for-profit universities. This low reliance on Title IV funding reduces the regulatory burden on Aspen and decreases the risk of litigation since for-profit universities typically run into trouble due to their students' unmanageable debt burden.

2. *Unmatched marketing efficiency*: Aspen can offer such low tuition rates because of their incredibly low customer acquisition costs. All of Aspen's marketing is performed in-house using proprietary algorithms due to the CEO's background in internet marketing. This allows Aspen to save costs associated with third-party lead generation (which other for-profit universities rely on). Furthermore, Aspen has partnerships with over 90 hospitals that allow Aspen to recruit already employed nurses who are looking to earn a higher degree. These marketing tactics have allowed Aspen to maintain a CAC of $770, which is 80% lower than the $4k average CAC of competitors. Aspen achieves an average revenue per enrollment of $7k, yielding an 8.6x marketing efficiency ratio – twice that of the industry average of 4x.

3. *Favorable trends in the nursing industry*: Nursing is the largest segment of the healthcare workforce and nursing demand is expected to soon outpace supply. The driving forces behind this imminent nursing shortage are aging baby boomers, an increase in the number of retiring nurses (33% of US nurses will retire in the coming decade), and a bottleneck in the nursing education system (nursing schools are rejecting qualified applicants due to insufficient resources). Aspen's online-only model is easy to scale, and Aspen is virtually unlimited in the number of students they can add.

Key Risks and Considerations

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

1. *Untrustworthy management*: Aspen is currently being sued for allegedly falsifying financial statements and falsely listing a $4.7 million loan to the former CEO of Aspen as an asset on their balance sheet. In the lawsuit, there are quotes from the current CEO to the effect of "just sign this or we all go to jail" and "I just want to file an annual report the SEC won't raise an eyebrow at." These are incredibly concerning statements that lead us to believe that we cannot trust the information in the company's financial reports.

2. *Possibly replicable business model*: Aspen's main competitive advantage is the fact that they have the lowest CAC in the industry. This allows Aspen to offer such low tuition, have a disruptive pay-as-you-go model, and avoid the reliance on federal financial aid that many other for-profit online universities face. However, it is unclear how sustainable this competitive advantage is. It is feasible that a new entrant could build equally efficient algorithms and establish similar relationships with hospitals.

3. *Terrible reputation of for-profit universities*: For-profit online universities face a lot of regulation and scrutiny due to their terrible reputation. For-profit online universities are responsible for a disproportionate amount of student debt and defaults, and these universities have often acted in a predatory manner towards vulnerable members of society. One mitigating factor is that Aspen is trying to position itself as a white knight and distance itself from the poor reputation of for-profit universities by offering an affordable, debt-free education.

Decision: NO PURCHASE

Chairman, Investment Committee: Sid Jain

The Consumer Sector pitched Aspen Group, Inc. (ASPU) on Wednesday, January 31, 2018 in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to purchase ASPU. Our reasons are as follows:

FIRSTLY: We agree with the sector's assessment that the company's questionable management team made the stock un-investable. ASPU and several board members are currently being sued for issuing misleading financial statements, which makes it impossible for us to arrive at a fair value for the company. Furthermore, the company has changed its entire business several times. For example, as late as 2011, it used to sell escape ladders for homeowners before deciding to pivot to the online education business. The numerous name changes and shell companies combined with the lawsuit lead us to believe that there is a high probability of fraudulent activity.

SECONDLY: ASPU does not seem to have sustainable competitive advantages. The company cited its low customer acquisition cost and the lengthy accreditation process as differentiating factors. ASPU boasts of a cost per student of $770, far superior to peers' $4,000 due to its in-house marketing model. However, we find it hard to believe that competitors will not be able to replicate that model by utilizing Facebook's targeted advertising capability. Larger universities, such as Grand Canyon, could easily cut their costs significantly by simply going in-house and thus are likely to do so. ASPU also does not offer differentiated content as it buys content from third-party sources. As for accreditation, universities can go through the relevant process within just two years and few ever get their license revoked. If nursing is such an attractive end market, larger competitors will seek to capture it due to the lack of barriers to entry.

THIRDLY: We do not find the current valuation to be attractive. ASPU's 7x revenue multiple is far greater than peers and does not make sense due to the aforementioned issues. Even with the sector's aggressive assumptions (6x user growth and 34% EBITDA margins within five years), we arrive at only a 14% IRR. When investing in such an early stage company, we would require at least a 25% IRR.

Tegna, Inc. (NYSE: TGNA)

Special Situations Sector Leader: Rishi Krishnan

Company Overview

Tegna is a TV broadcasting and digital media company that owns and operates local TV stations across the US. These stations produce locally-targeted content and affiliate with TV networks (e.g. NBC, CBS) to fill the rest of their airtime with network-produced content. The company primarily generates revenue from two sources: (1) advertising spots on local and national content and (2) retransmission fees charged to cable, satellite, and other TV providers in exchange for access to Tegna's content in the providers' plans. Aside from the major news networks, Tegna is the largest owner of stations affiliated with the big four networks (NBC, CBS, ABC, and Fox) in the top 25 markets.

Investment Thesis

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

1. *Well-positioned TV stations and digital marketing platform*: With 46 stations in 38 distinct markets, Tegna boasts of a broad marketing platform that reaches approximately one-third of US households. The company manages a strong portfolio of affiliates and is the largest NBC, 2nd largest CBS, and 5th largest ABC affiliate group. Despite declines in national advertising, cyclically-adjusted local advertising spending has grown in recent years, reflecting the continued importance of local news to TV subscribers and the popularity of Tegna's content. Additionally, the company's digital offerings are the strongest in the industry and provide advertisers with a single platform that enables programmatic advertisement placement on content across a growing number of channels, including OTT (over-the-top) TV and social media. We believe that locally focused video content will continue to be important to consumers for the foreseeable future, and as such, Tegna will monetize its premium content across its profitable and expanding distribution platform.
2. *Rising retransmission fees and favorable regulatory shifts*: Since 2006, retransmission revenue has grown at a 42% CAGR, reflecting the growing negotiating power of broadcasting companies versus that of cable and satellite TV providers. Yet despite this growth, broadcast TV has persistently under-monetized its viewership, generating 30% of ratings but only 17% of retransmission fees. We predict continued 20-30% annual growth in this segment for the near future as broadcasters like Tegna continue to make up this gap, potentially expanding even further given the differentiated nature of local news. Furthermore, recent FCC changes look certain to spur industry consolidation and strengthen broadcasters' negotiating power with networks and cable providers within individual markets. With the least number of duopolies per market among the top broadcasters, Tegna looks uniquely well-positioned to benefit from these trends.
3. *Spinoffs allow for flexibility and acquisitions*: The 2017 spinoff and sale of Cars.com and CareerBuilder, respectively, will allow Tegna to focus exclusively on the broadcasting space and use the proceeds to retire debt, return shareholder value, and invest into growing its platform via acquisitions. Additionally, the lack of information about the newly independent company presents an obvious reason for the stock being undervalued.

Key Risks and Considerations

1. *Decline of TV advertisement*: Although local broadcasting advertisement has continued to grow slightly, it is uncertain how long this trend will continue for with the rising prominence of low-cost, highly targeted digital advertisement on Facebook and Google. Some of TV advertisement's largest spenders, such as major CPG companies, are facing a tough outlook with the growth of Amazon, which could potentially decrease their ability to compete for pricey airtime.
2. *Reverse compensation growth*: Reverse compensation, or compensation that networks demand from affiliates, has exploded over the past few years, up to an estimated 47% payout ratio. For now, rapid growth in total retransmission revenue has meant that net retransmission revenue, or the spread between retransmission revenue and reverse compensation, has continued to increase significantly. However, if networks are very successful in negotiations, it may be possible that the payout ratio eventually rises so high that broadcasters experience declines in net retransmission revenue.

Decision: NO PURCHASE

Chairman, Investment Committee: Sid Jain

The Special Situations sector pitched Tegna, Inc. (TGNA) on Wednesday, February 7, 2018 in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to purchase TGNA. Our reasons are as follows:

FIRSTLY: We remain skeptical of the long-term sustainability of TGNA's advertising business (60% of FY16 revenue). While TGNA's focus on local markets positions it better than other media players, we still believe it will struggle to compete against the Facebook/Google duopoly. Targeted digital advertising removes much of the need for niche local ads and its usage will only increase — under 8% of businesses that maintain pages on Facebook actually use the platform to advertise. Even demand for multi-platform advertising will likely not be enough to counter the increasing supply and effectiveness of digital advertisements. Furthermore, many of the TV industry's largest advertisers (such as auto and CPG) will continue to struggle due to both cyclical (peak auto) and secular (e-commerce) concerns. We are already seeing many big Olympics advertisers, such as GM, P&G, and AT&T, cut TV spending for the 2018 games. Finally, given peers' difficulty in creating an online presence, we find it hard to believe that TGNA's foray into digital advertising and content production will be a profitable endeavor.

SECONDLY: TGNA's position as a middleman between networks and MVPDs seems increasingly precarious in a digital world. TGNA has historically been able to earn upwards of 40% operating margins because it controlled a bottleneck in distribution. The sector cited the FCC's 39% household cap and weak O&O economics to explain why networks continue to rely on affiliates such as TGNA. However, the bottleneck no longer exists in the current world where networks can reach consumers directly over the Internet. As an example, NBC decided to stream the 2018 Winter Olympics online for the first time ever. At the very least, networks can use this as leverage when negotiating reverse compensation. Finally, it is unclear if M&A will give TGNA sufficient leverage to fight back given that the company already reaches 32% of households (versus a 39% cap). A lax-FCC could actually further weaken the thesis since the cap is the main source of TGNA's moat.

THIRDLY: We do not believe TGNA's current 11x EBITDA multiple provides us with an attractive enough entry point. The sector assumed a constant multiple, subscriber base, and advertising revenue as well as $5 per subscriber per month retransmission revenue. Even with these aggressive assumptions, we barely arrive at a 12% IRR over the next three years. We expect multiple contraction as the company's outlook will likely be less attractive down the road. Google and Facebook will pose even graver threats to TGNA's advertising revenue and there is a limit to how much retransmission revenue can grow. In terms of subscribers, local broadcast ratings have been declining as a result of increasing competition from cable networks and online platforms that have increasingly fragmented viewing habits across multiple platforms. Traditional video subscribers have declined every year since 2013, with this decline accelerating significantly in 2017. The sector's $5 per subscriber projection seems high since Fox News earns under $1.50 per subscriber despite an extremely loyal subscriber base. If we assume the terminal multiple contracts to a more reasonable 8x EBITDA, TGNA would have to grow per subscriber retransmission revenue to $7.50 for us to earn a reasonable rate of return on our investment. In other words, TGNA would somehow have to charge ESPN-level rates, which seems unlikely.

Yext, Inc. (NYSE: YEXT)

TMT Sector Leader: Nick Nigro

Company Overview

Yext is a SaaS business that went public in March 2017. The company is currently growing revenue at nearly 40% annually but has never recorded an operating profit. Yext's core business is to facilitate the exchange of information (store hours, dates of sales, restaurant menus, etc.) between businesses and listings sites (Google, Facebook, Yelp, Yahoo, etc.). Its Listings product provides businesses a single portal where they can ensure that information is accurate across a network of over 150 listings services.

Investment Thesis

The Technology, Media & Telecommunications sector recommends a BUY in YEXT for the following reasons:

1. *Dominant competitor in a large addressable market*: The digital knowledge management industry is currently highly fragmented, with Yext as the only major player. Competitors generally offer inferior products but try to compete with Yext on price. Moreover, competition is primarily focused in the SMB segment of the market, while Yext has increasingly focused on selling to the more profitable enterprise and mid-sized segments. The company provides $10B as a very rough estimate of the size of the addressable market, while total penetration (by all competitors) is currently in the low single digits.

2. *Continuation of rapid growth*: We believe that two industry trends will make non-consumption an increasingly uncompetitive option, leading to continued top-line growth for Yext as market penetration rises. First, the means through which people find information is changing, from users being given a list of links to websites to being given a collection of information believed to be relevant (as in the Google sidebar today) or a direct answer to a question by a service like Siri or Alexa (in the future). Second, the complexity of digital knowledge and the frequency with which it changes is increasing, making manual management of this knowledge increasingly difficult. Expansion into new product categories (e.g. Yext for Events), new geographic locations (Europe, Japan, China, etc.), and new industry verticals (e.g. Yext for Food) will further contribute to growth.

3. *Attractive cost structure*: Although Yext is a pre-profit business, it has already proven its ability to realize attractive unit economics. Based on 20% gross customer churn, we estimate Yext's LTV/CAC ratio for enterprise and mid-sized businesses to be 5.78, significantly above the 3.0 target generally sought in SaaS businesses. As revenue grows, Yext will additionally benefit from significant operating leverage. We estimate that only 17% of Yext's TTM expenses were truly marginal costs.

4. *Long-term competitive advantages*: Yext benefits from a two-sided network effect. As the amount of data in Yext's network increases, listings sites—who want to use this data to provide their customers better listings—become more willing to spend time and money to efficiently integrate Yext's network with their own. This improves the quality of Yext's services, making it easier for Yext to attract further customers. Yext also benefits from economies of scale—which will make it increasingly difficult for competitors to compete on price—and on moderate, but growing, switching costs.

Key Risks and Considerations

1. *New entrants*: Given the winner take-all nature of the industry, the biggest risk is that a capable competitor enters before Yext is able to achieve sufficient scale. However, we believe that a major SaaS company (e.g. Salesforce) would be more likely to acquire Yext than to enter the market directly. We also believe that a major listings service (e.g. Google) would be unlikely to enter due to differences in the two business models and the niche size of the industry.

2. *Execution risk*: Effective management is important for any rapidly growing tech company. Yext recently hired James Steele to act as President and Chief Revenue Officer. Steele was Head of Sales at Salesforce, where he helped scale the business from $25 million in revenue to over $5 billion. The company has also hired a large number of Salesforce alumni. Given Yext's attractive unit economics and the competitive dynamics of the industry, we believe management's decision to invest heavily in expanding Yext's enterprise sales force is the right one.

Decision: BUY

Chairman, Investment Committee: Sid Jain

The Technology, Media & Telecommunications Sector pitched Yext, Inc. (NYSE: YEXT) on February 14, 2018 in General Meeting as a Buy. The Investment Committee (ICOMM) decided to follow the recommendation and purchase YEXT. We believe Yext is attractive for the following reasons:

1. *Dominant player in a large, winner-take-all industry*: With a $10B TAM and only 2% penetration, the business listing management industry represents a massive greenfield opportunity with no established competitors other than Yext. Secular trends such as the disaggregation of data sources (60% of listings are incorrect), and the augmented presence of artificial intelligence will increase the attractiveness of Yext's services. We also believe the entire market will likely tip over to Yext as a result of the company's two-sided network effect. Businesses want to partner with Yext because it has the most listing provider partnerships, and listing providers want to partner with Yext to improve the relevance of as many listings as possible. As Yext continues to gain more data and improve the quality of its services, it will become extremely difficult for new entrants to steal market share—Yext already has 10x more locations under management than its second largest competitor. Furthermore, enterprise customers are notoriously risk-averse and will default to the company with the strongest brand. Yext recently launched an API to allow enterprises to integrate Yext's services with their internal systems, which will increase switching costs even more. On the other side of the network, Yext already has partnerships with most major listing providers (Tencent, Google, Facebook, Apple, etc.). It can take up to two years to work with a listing provider to develop the right APIs, connect the databases, and make everything seamless—the first mover advantage matters. As data becomes increasingly complex, getting everything to sync in real-time will become extremely difficult for new players.
2. *Attractive unit economics*: Since Yext is currently not profitable, we must understand its unit economics to gain confidence in the business model and potential long-run profitability. We estimate that the company currently maintains anywhere from a 3-6x LTV/CAC ratio (with uncertainty due to limited cohort information). We believe this ratio will grow over time as the company transitions from high-churn SMBs to stickier enterprise customers. Given our confidence in the unit economics, we believe the company's current strategy to hire new sales reps and accelerate growth makes sense. Yext also benefits from tremendous operating leverage due to mostly fixed costs (70% gross margins). Furthermore, high-margin up-selling should improve profitability. Yext's average revenue per listing is only about $130 and given the high customer ROI (Marriott earned a 40x ROI from Yext's services), we believe the company has untapped pricing power. When people access intelligence services, they are doing so with a clear intent to do a transaction, which allows businesses to clearly measure their ROI and pay Yext accordingly. Recent results confirm this view; Yext is the rare company that boasts of negative churn (120% retention rate). As a result, we believe Yext will be able to follow the margin trajectory of its more established peers, and eventually hit 25% EBITDA margins. In terms of valuation, Yext trades at just over 4.4x forward revenue versus peers at 6-9x multiples. We find this to be a reasonable entry point given the attractiveness of Yext's business model and industry dynamics.
3. *Skilled management team*: We believe the management team is uniquely qualified to take Yext to the next level. The CEO has already led several startups to profitable exits. Yext has also poached Salesforce's former head of global sales, CFO, chief marketing officer, and more. Most of these executives led Salesforce as it transitioned to targeting enterprise customers and an initial public offering. In short, Yext's management knows how to scale an enterprise SaaS company. Insiders are also invested in the company, owning 20% of shares outstanding.

Key Risks and Considerations

1. *Disintermediation*: Further consolidation of data towards Google, Facebook, etc. would increase the risk of disintermediation. If a major listing provider were to yank its data off Yext's platform, it would be a devastating blow for the company. However, there are a few reasons why we view disintermediation as an unlikely event. Firstly, listing providers benefit tremendously from the improved data quality after partnering with Yext. Yahoo even agreed to be exclusive with Yext, essentially outsourcing data management entirely. As Yext scales up, it will benefit from increasingly favorable terms with listing providers; for example, Google does not charge Yext at all. It would not make

sense for Google to directly profit off of its connection with Yext when that connection makes its core service more valuable. Since Yext targets a very small market for Google, it would make more sense to simply buy out Yext than go through the hassle of recreating Yext's platform. Secondly, no one listing provider would ever be able to replicate Yext's services. For example, Google would never be able to get access to Facebook's data; only a neutral third-party such as Yext could consolidate data from all listing providers. Proof of Yext's growing clout with listing providers is evident with the move to a "Yext on Top" approach. With this move, if Yext verifies certain data, listing providers will prioritize it over other sources.

2. *Continued unprofitability*: Yext currently does not generate a profit which could force it to tap into the capital markets. However, the company has well over $100M in cash and no debt on its balance sheet. At its current $20M annual cash burn rate, Yext does not need capital immediately; it will likely be cash flow breakeven within three years. Furthermore, the main cost (sales and marketing) is discretionary and can be cut back if necessary. As long as the unit economics remain attractive, we are not concerned by the losses. In particular, we will monitor customer acquisition costs since it is where most startups get in trouble. Yext could have already won the low-hanging customers and so winning over new enterprise customers could prove to be difficult and expensive.

3. *Retail exposure*: Yext's large retail exposure (analysts estimate 1/3 of revenue) raises concerns since increased e-commerce penetration could limit the company's growth potential. While the large retail exposure is not ideal, we believe current retail customers are unlikely to stop using Yext. In today's world, retailers struggle to attract foot traffic, which makes Yext's services even more valuable. For just $100, retailers can ensure that key information such as store hours and location are correct across all platforms; Yext just needs to prove it can bring in a few additional customers for it to make sense for retailers to continue contracting its services. Additionally, Yext has been diversifying into more attractive sectors, such as healthcare and finance.

Voya Financial, Inc. (NYSE: VOYA)

Financials Sector Leader: Abhimanyu Sharma

Company Overview

Formed in 2013 and spun off from ING USA after the 2008 crisis, Voya Financial is primarily a retirement company focused on a holistic approach to retirement. As of 2016, Voya serves 13 million customers across the country. The main lines of business in which Voya operates are Retirement (49% of total EBIT), Investment Management (27%), Employee Benefits (14%), and Individual Life Insurance (10%). Overall, Voya's management has focused on streamlining the business and shifting its focus away from its capital-intensive insurance business to its capital-light retirement and investment management businesses. VOYA currently trades at 0.6x P/B.

Investment Thesis

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

1. *Industry strength and continued tailwinds*: A rise of employee-sponsored retirement plans and a decline in pensions mark a shift from institutions to individuals in retirement products. Mass-market, a historically underserved group, serves as a strong source of growth in retirement products today. Total life insurance coverage was up to $20 trillion, and the gross amount of insurance bought continues to increase.
2. *Capital-light and fundamental business model*: Voya is one of the largest retirement service providers and is well-positioned to take advantage of industry tailwinds through its highly synergistic business model. The increase in fee-based sources of earnings (as opposed to spread-based) marks a shift towards a more reliable and stable source of cash. In 2013, VOYA revamped its management team; its senior management averages 25 years of experience in the retirement industry. Since taking charge, management has increased company's ROCs to 10.3%.
3. *CBVA divestiture and capital redeployment*: From 2000 to 2005, ING's former U.S. business underwrote risky annuities in a highly competitive environment. In 2009, the variable annuities division was discontinued completely and separated from the core business in a closed-block variable annuities division (CBVA). As of December 2017, VOYA agreed to sell the CBVA, which will have two major effects on Voya. First, the divestment unlocks additional capital for shareholders. Second, by divesting a volatile segment, Voya can focus on its core, less capital-intensive business. Voya also has a history of returning cash to shareholders, recently approving a $500M in share buybacks.

Key Risks and Considerations

1. *Warrants to ING*: ING fully divested its US-based businesses between 2013 and 2015, and shares of Voya were sold to the public as well as repurchased from ING by Voya. As part of a final share buyback, Voya granted ING 26M warrants expiring in 2023 at an exercise price of $48.75. So far, no warrants have been executed. However, the higher the stock price, the greater the effect of dilution. A large percentage of stock could be issued to a single holder (ING), leading to rapidly changed shareholder-dynamics.
2. *Cyclical insurance business*: While VOYA has agreed on terms to divest its costly CBVA division, its insurance business is still cyclical, and its cost ratios have risen above expectation (but still below peers). However, VOYA has placed its insurance business under strategic review as of 1Q18.

Overall, VOYA has shifted away from a capital-intensive business model to a more capital-light and streamlined business while primarily focusing on its retirement business. In the future, we see VOYA focusing primarily on non-cyclical fees from AUA and AUMs.

Decision: NO PURCHASE

Chairman, Investment Committee: Sid Jain

The Financials Sector pitched Voya Financial (VOYA) on Wednesday, February 21, 2018 in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to purchase VOYA. Our reasons are as follows:

FIRSTLY: We lack confidence in Voya's management team. They have had a history of aggressive underwriting in their individual life insurance and retirement businesses, which makes us nervous this late in an economic cycle. For example, Voya recently incurred a sizable charge as part of its annual actuarial review for the third straight year. The company has also consistently touted its adjusted ROE numbers which ignore many supposedly one-off expenses, such as those linked to the aforementioned aggressive underwriting. Furthermore, as the entire management team joined after 2008, we do not know how they will perform in the next bear market. Since most financial companies are essentially a black box to outside investors, we do not feel comfortable investing in one where we do not fully believe in management's quality.

SECONDLY: We question Voya's competitive positioning. In a commoditized industry such as insurance, you must have a low cost of production to generate sustainable returns. However, Voya neither has the scale to underwrite efficiently nor a unique distribution model to ensure it can always underprice competitors. The sector mentioned the company's strength in retirement services and the value proposition of offering a one-stop shop to customers, but there are several larger peers that also offer the same services. Management has repeatedly discussed intensifying competition in its key segments driven by secular changes such as the unbundling of services, growth of passive investments, etc. If we look at Voya's unadjusted financials, we find that the company has consistently underperformed peers both on a margin and ROE basis. As a result, we believe the multiple gap relative to peers is warranted. Voya deserves its 0.6x P/B ratio given its negative to mid-single digit ROE over the past few years and questionable underwriting standards.

Eagle Pharmaceuticals, Inc. (NASDAQ: EGRX)

Healthcare Sector Leader: William Xia

Company Overview

Eagle Pharmaceuticals is a manufacturer and distributor of generic drugs patented exclusively through the 505(b)(2) approval pathway. Eagle went public in 2014. The majority of expected cash flows are generated from Eagle's Bendeka patent, which is licensed to and distributed by Teva Pharmaceuticals.

Investment Thesis

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

1. *Stable cash flow base from Bendeka*: Royalty and product revenue from existing and approved drugs provide a stable valuation floor, making EGRX a low-risk investment. The majority of this value is derived from a ten-year Bendeka licensing deal with Teva Pharmaceuticals under a 25% royalty fee structure. As the best first line treatment for chronic lymphocytic leukemia (CHL) and non-Hodgkin's lymphoma (NHL) with limited therapeutic substitutes, Bendeka competes well against other CHL and NHL treatments. As the only patent-protected easy to use, reject-to-inject formulation, Bendeka should compete well against upcoming generic competition. Therefore, we expect Bendeka to maintain significant market share, generating ~$130M in annual royalties for the remainder of the deal. The remaining cash flows are received from Ryanodex, Argatroban, and the tentatively approved Pemfexy.

2. *Effective 505(b)(2) business model*: Although the 505(b)(2) pathway is not a unique process to receive regulatory exclusivity, Eagle is the only known major player to focus on this pathway. The general benefit to the 505(b)(2) pathway is an R&D-light method to achieve drug exclusivity. New Molecular Entity commercialization is highly time consuming, expensive, and risky while generics offer no exclusivity. By patenting improvements on already approved drugs, Eagle can gain drug exclusivity without heavy R&D expenditure, generating strong returns on past R&D. Typically upon pending regulatory approval, Eagle enters litigation with the original drug producer. As in the case of Bendeka, Eagle will outsource the patented drug in return for royalty payments, which minimizes SG&A costs and reaps the benefit of a larger company's distribution network.

3. *Significant pipeline potential*: R&D is expected to be allocated primarily in three areas: 1) Ryanodex indication expansion to exertional heatstroke, 2) approval for Fulvestrant, 3) joint-R&D deal with AMRI pharmaceuticals. While there are limited details on the third area, the first two would provide Eagle with exclusive access to a $400M market and an expected 25% market share in the $500M market respectively. The current implied equity value assumes up to $44M in annual R&D expenditure is allocated to the existing pipeline without any value generation. Such a scenario is extremely unlikely and would leave the company with limited implied downside.

Key Risks and Considerations

1. *Stability of Bendeka cash flows*: The current value of EGRX rests significantly upon the realization of Bendeka royalty payments from Teva. If improved therapeutic substitutes are commercialized within the license timeline, EGRX will lose the cash flows required for R&D to extend its current pipeline. Additionally, Teva has a $32.5B debt burden, which may result in it selling its oncology division and leaving the Bendeka deal uncertain.

2. *Failure with pipeline progression*: Associated R&D and SG&A are projected with a "matching principle" that links costs to specific drug development. If EGRX fails to find success among any of the three avenues listed above, it is likely that the share price will decline. However, our model suggests that even in this extreme case, we would not lose much money.

Decision: NO PURCHASE

Chairman, Investment Committee: Sid Jain

The Healthcare Sector pitched Eagle Pharmaceuticals Inc. (EGRX) on Wednesday, February 28, 2018 in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to purchase EGRX. Our reasons are as follows:

FIRSTLY: We have concerns regarding the company's chief executive officer. At his previous firm (Par Pharmaceuticals), Scott Tarriff faced a securities class action accusing him of misleading investors on accounting practices and overstating revenue. The board then asked him to resign, after which he founded Eagle Pharmaceuticals. Furthermore, accountants recently found a material weakness over Eagle's income tax provision. These recurring issues cause us to lose trust in the company's management team.

SECONDLY: We disagreed with the sector over the value of Eagle's primary drug, Bendeka. The sector assumed a 97% market share for Bendeka over the next ten years and only used an 8% discount rate. We found the first assumption to be aggressive since anyone could steal market share (not just another small molecule) once exclusivity ended. We also believed a higher discount rate was warranted given Teva's high leverage. Teva has considered selling off its oncology division to alleviate its debt burden, which would put the Bendeka royalty deal at risk. Once we adjusted the sector's assumptions for the locked-in Bendeka revenue, we found that the current valuation implied significant pipeline value.

THIRDLY: After speaking with a post-doctoral researcher and a medical doctor, we came to the conclusion that Eagle's technologies were not widely applicable, thus limiting the company's potential runway. Since we disagreed with the value of the core Bendeka drug, we would have to be very confident in the company's pipeline to warrant an investment. Our primary research led us to believe that the pipeline may not be that valuable. Furthermore, there is nothing proprietary about Eagle's use of the 505(b)(2) pathway and the low R&D requirements make it very easy for a new entrant to steal market share.

Warrior Met Coal, Inc. (NYSE: HCC)

Natural Resources Sector Leader: Henry Luo

Company Overview

Warrior Met Coal (HCC) is a pure-play metallurgical ("met") coal producer with its industry leading assets, Mines No. 4 and 7, based in Alabama. Originating from the Chapter 11 bankruptcy of Walter Energy, HCC was formed by its predecessor's first-lien creditors (e.g. Apollo, GSO, KKR, and Franklin Mutual) in order to recover the aforementioned mines through a 363 Asset Sale restructuring.

Investment Thesis

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

1. *Differentiated met coal sold at a premium to domestic peers*: We view Warrior Met Coal as the best-positioned domestic coal producer due to its differentiated met coal. HCC's product is unique in its low-vol formulation of hard coking coal, which makes it well-suited for use as an input in steel production. As a result, HCC enjoys a sizable price premium compared to domestic producers with ASPs trading below the Australian benchmark by 2-3% at most.
2. *Variabilized cost structure limits downside risk*: Further bolstering our view of HCC as best-positioned is its variabilized cost structure designed to limit any downside from the almost inevitable supply-driven price fluctuations in the coal industry. HCC has renegotiated various elements of its cost structure, many of which are unique and cannot be replicated by other producers. For example, HCC can choose between CSX's rail system or its wholly-owned barge load-out facility capable of transporting 15% of its product, which provides it with some leverage when negotiating rail rates. Moreover, at just 300 miles from the nearest port, HCC is advantaged compared to other domestic producers located 400 miles away. Labor costs are subject to a new Collective Bargaining Agreement. Though it expires in 2021, we expect it to be renegotiated on similarly favorable terms as HCC represents an important source of jobs in the community. Moreover, salaried employees represent only 29% of the company's total employees.
3. *Favorable industry dynamics*: As the lowest cost producers, Australia and China have historically disrupted prices through growth in coal output but our outlook towards their impact on the industry is favorable. According to HCC's management, Australia's cost of production has risen by 15% from 2009 – 2017 due to slowing capital expenditures. We have witnessed a significant decline in capital spending by BHP, Anglo American, and Rio Tinto over the past three years. The key driver for demand is steel producers' use of either Basic Oxygen Furnaces (BOFs) or Electric Arc Furnaces (EAFs), the latter using scrap steel instead of met coal. However, since the beginning of the decade, BOF production has been stable in all regions except the US. We expect it to continue to be integral, especially for specialized, higher-quality steel that necessitates the use of higher quality coal.
4. *Experienced management returning FCF to shareholders*: Walter Scheller is a capable CEO whose tenure at Walter Energy included managing Mines No. 4 and No. 7 and forestalling bankruptcy through various cost-cutting initiatives. During his time at HCC, he has prioritized reinvestment in its assets to restore its nameplate capacity and the return of cash to shareholders via a quarterly dividend as well as special dividends. The company's willingness to fund special dividends is significant for not only providing the company significant flexibility during a downturn that a quarterly dividend does not but also providing us with the promise of cash returns on a potential investment.

In sum, HCC's ability to weather any coal pricing environment is rooted in its industry-leading assets, which include not only its mines but also $2B of NOLs. Coupled with abundant opportunities for us to recoup returns on investment through special dividends alone, the company presents us with an attractive, low-risk investment opportunity.

Key Risks and Considerations

1. *Supply risk by international producers*: Future Australian supply growth is limited with few new announced projects capable of significantly disrupting market dynamics.

2. *Transition away from met coal in steel production*: China's use of EAFs instead of BOFs could seriously dampen demand for met coal but we view such a transition as not economical for China due to the steep costs associated with steel scrap, electricity, and required capex as well as its relatively low scrap generation.
3. *Creditors' sale of stakes*: Creditors currently control a majority of shares outstanding and the duration of their ownership is uncertain, potentially resulting in an overhang upon the sale of their shares. We view this risk as immaterial because (i) the entrance of value-oriented shareholders indicates institutional interest in the company with funds likely to open or add to existing positions upon any overhang so long as company fundamentals remain intact and (ii) the major creditors continue to remain highly involved as members of the boards of directors.
4. *Use of leverage to finance dividends*: Management's willingness to fund special dividends through debt appears questionable given leverage's role in Walter Energy's and many others' bankruptcies. Nevertheless, this risk is mitigated by management's use of the debt to return cash to shareholders not finance value-destructive acquisitions and HCC's lower level of leverage and labor-related liabilities compared to peers. We do not expect this trend to continue given the additional FCF that will be freed for dividends following the current capex requirements. However, if it does and the company continues to lever up beyond peers' levels, this would be a major red flag.
5. *Divestment by major institutional investors*: Thus far, divestment has primarily occurred at the cost of thermal coal producers without any significant movement against met coal producers though this could change depending on how the climate change campaign evolves.

Decision: MONITOR

Natural Resources Investment Committee Representative: Henry Luo

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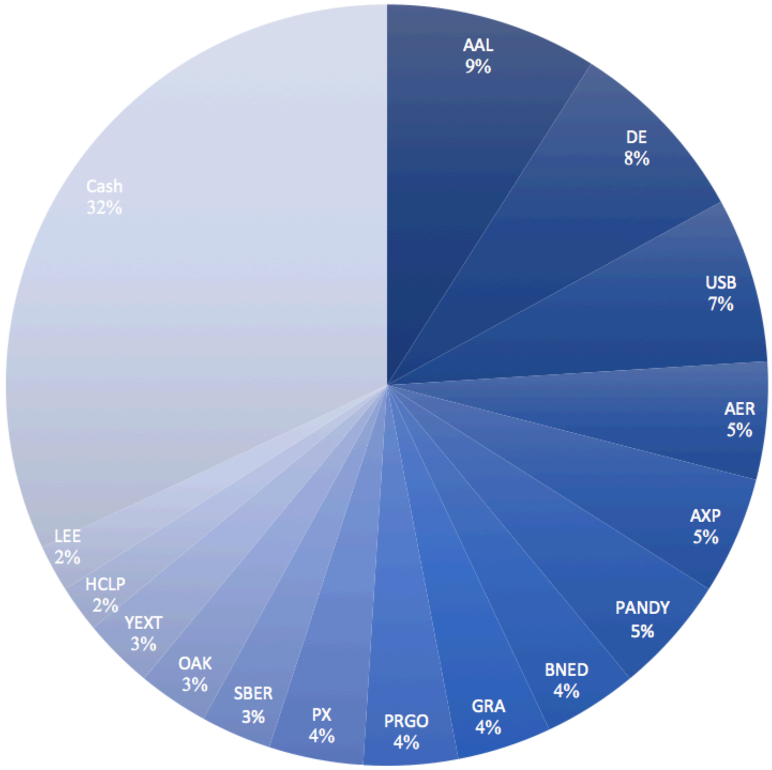
The Natural Resources Sector pitched Warrior Met Coal (HCC) on March 7, 2018 in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to follow the sector's recommendation but will continue to monitor the stock for additional clarity into the met coal industry's supply/demand dynamics.

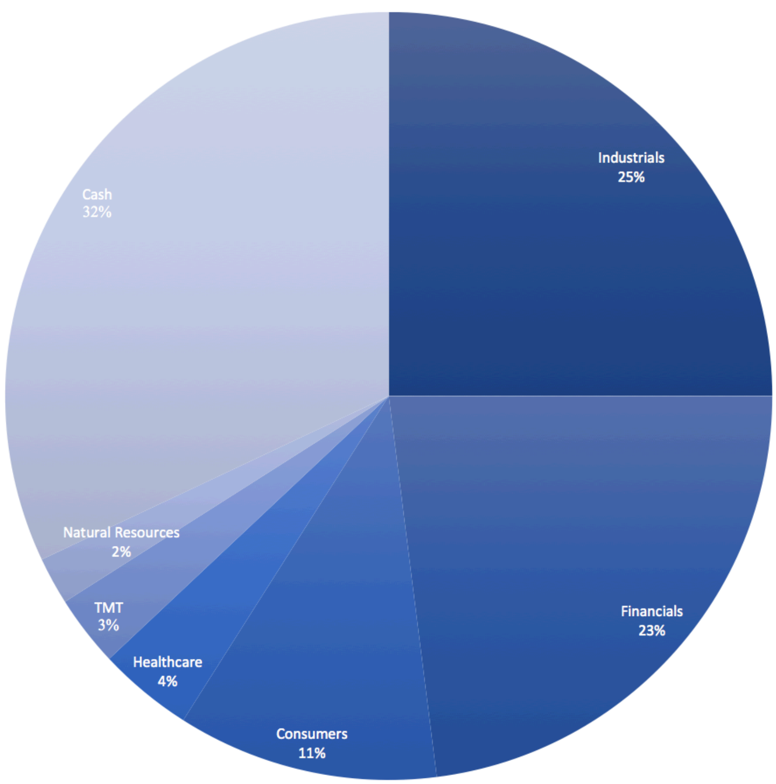
FIRSTLY: We agree with the sector's assessment of HCC as a best-in-class met coal producer. Our shared view stems from the company's sustainable margin advantage driven by significant financial and operational improvements post-bankruptcy as well as its strong FCF generation aided by minimal cash tax payments (2% cash tax rate due to extensive NOLs) and low CapEx requirements. As a result, we agree that HCC is well-positioned to succeed within a wide range of met coal prices, including current long-term forecasts of $120 - $130/mt. We expect the company to be capable of either generating significant FCF to be returned to shareholders through special dividends when prices are higher or surviving and sustaining its core mining assets when prices are lower. In particular, the special dividend of $600M in 2017 and our current expectations of a special dividend of up to $350M this year protect our downside.

SECONDLY: We find HCC's current valuation to be attractive. With a current 25% FCF yield, the company is exceedingly cheap. Moreover, due to the unique nature of HCC's formation through a 363 Asset Sale, we have a unique perspective into other investors' valuation of the company's assets. The first-lien creditors' bid for Walter Energy's Mines No. 1 and No. 4 totaled $1.37B compared to a current enterprise value of $1.99B. Though there will always be a degree of uncertainty about the creditors' valuation of the mines given the nuances of the restructuring process and the auction, we believe that the winning bid may not have fully accounted for the true value of the assets. For example, sell-side analysts have valued the Blue Creek Energy mine as high as $100M based on precedent transactions for Appalachian assets. Additionally, the auction took place at the trough of met coal prices and the first-lien creditors' ability to submit a credit bid as its stalking horse offer are factors that may have deterred higher bids from emerging. Finally, this valuation may not include other advantages of the assets, namely the creditors' refusal to assume legacy labor liabilities or the potential to also transfer ownership of Walter Energy's NOLs to HCC, which should further bolster HCC's valuation. A more nuanced assessment of the assets may indicate additional downside protection for us as equity investors.

THIRDLY: However, our favorable view of the company is tempered by continued uncertainty surrounding the future of the met coal industry and its potential ramifications for HCC. Though we believe that premium met coal is a mission-critical input for blast oxygen furnace production, we question how sustainable this source of demand is and whether we could be underestimating the rapidity with which steel producers transition to electric arc furnaces, a process spurred by improving scrap steel availability, carbon regulations, and a concerted effort by China to shut down inefficient blast furnaces. Moreover, despite all of HCC's advantages, it is still at the whim of Australian producers, who are the lowest cost producers. HCC's advantageous cost structure may allow it to survive but sustained lows in met coal prices driven by Australian or Chinese production would limit the company's potential for positive FCF generation. For us to rationalize an investment in HCC, we must gain further confidence in the future of met coal as an input in steel production and rational production by the lowest cost players.

Portfolio Weightings


AAL
9%
DE
8%
USB
7%
AER
5%
AXP
5%
PANDY
5%
BNED
4%
GRA
4%
PRGO
4%
PX
4%
SBER
3%
OAK
3%
YEXT
3%
HCLP
2%
LEE
2%
Cash
32%


Industrials
25%
Financials
23%
Consumers
11%
Healthcare
4%
TMT
3%
Natural Resources
2%
Cash
32%

Other Investments

Sberbank Rossii PAO (OTC: SBRCY)

Chairman, Investment Committee: Sid Jain

Investment Thesis

After revisiting the Financial Sector's pitch of Sberbank (MCX: SBER), the Investment Committee (ICOMM) decided to purchase it. We believe SBER is attractive for the following reasons:

1. *Dominant banking franchise*: There is no comparable financial institution in the developed world that rivals SBER's dominance in Russia. Not only does it control 50% of retail deposits and mortgages (equivalent to the top-five US lenders combined) but it generated over 100% of the entire Russian banking system's profits in FY15. In a country that has experienced numerous bank runs, citizens flock to the one bank that has survived everything. This flight to quality has increased SBER's market share over time, allowing it to pay less for deposits (150bps less than peers) and charge more for loans. The government has played an active role in this consolidation. In a drive to clean up the banking sector, it has already revoked hundreds of licenses, resulting in the number of active banks dropping from by nearly half. Consequently, SBER typically enjoys 6% NIMs and the highest return on equity amongst all global banks (30% in a normal environment).

2. *Conservative management*: CEO Herman Gref (former Russian Trade Minister) has been at the helm since 2007 and superbly led the company through two financial meltdowns. Unlike global peers, SBER remained profitable every quarter in both crises without having to rely on costly capital raises. In fact, the company even returned money back to the Treasury and Bank of Russia in FY15. NPLs peaked at just 5% and SBER has always over-provisioned (1.2x coverage in FY15). In terms of liquidity, Gref has reduced the bank's reliance on wholesale funding to 2% of total liabilities and maintains a conservative tangible equity/assets ratio of 11% (vs. 8.4% for US banks). Finally, SBER is one of the most efficiently run banks in the world with a 40% cost-to-income ratio (vs. 58% for JP Morgan). It has been an early implementer of technology and plans on continuing to cut expensive physical locations and headcount.

3. *Under-levered economy*: In contrast to essentially every major economy in the world, Russia has relatively little leverage as a result of an under-penetrated banking system. For example, Russia's mortgage debt-to-GDP stands at just 5% vs. 20% for other emerging market economies and 50% for the US. As Russia reaches peer levels, we believe SBER will be the main beneficiary. SBER already has a 270bps buffer over Basel CET1 capital ratios and a 90% loan-to-deposit ratio which should enable it to grow its loan base significantly. Furthermore, with a rebounding Russian economy, the average income is now sufficient to service a mortgage with 57% of the population comfortably above the required income levels (in comparison to less than 15% eight years ago).

4. *Low multiple on trough earnings*: SBER trades at just 1x book value and 7x forward earnings despite earning upwards of a 20% return on equity. Not only is this a massive discount to any developed market bank but also to other emerging market banks; the MSCI EM Financials Index trades at 1.3x book and 10x earnings with only a 12% return on equity. Importantly, SBER's numbers are based off depressed earnings as it is emerging from the longest recession in the country's recent history due to sanctions and low oil prices. The argument that Russia will always be cheap also does not hold; in a normal environment, SBER has traded at over 2x book and between 10-20x earnings. The normalized multiple could actually even expand given the company's diversification into other areas. For example, it is now the dominant player in digital banking, life insurance, and asset management as well as a variety of tech industries, all of which are higher multiple businesses. In addition to multiple expansion, we also expect earnings growth as Russia finally leaves the recession. Inflation has stabilized to 3%, allowing the central bank to cut rates to revitalize consumption and loan demand. The country's real GDP grew at over 2% and is expected to significantly outpace global economic growth. It has also already been over three years since the recession began so the NPLs on loans written at $100 oil have likely peaked. Credit markets agree as the rating agencies upgrades and the sharp drop in Russian spreads indicate a de-risking of the Russia story.

Key Risks and Considerations

While we are confident in the company's quality, our thesis could be broken by a variety of macro issues.

1. *Increased sanctions*: Further economic sanctions would put a damper on Russia's economic recovery. However, there are

a few mitigating factors. First, severe sanctions are unlikely due to Europe's dependence on Russia's natural gas, which constitutes 40% of Europe's energy supply. Second, even if the US passes harsh sanctions, Russia will be able to survive since the US is not a top five trading partner. Russia also has a high 25% savings rate which means it is not very dependent on foreign investment. One particular sanction that people are worried about is the country being banned from the SWIFT payment transfer system. However, passing this ban requires European support and Russian officials have already made it clear they would consider it the equivalent of beginning another Cold War. As such, the logic of mutually assured destruction would likely deter Europe from ever supporting US actions against Russia. Third, the majority of sovereign debt is ruble-denominated and domestically held and thus can be easily refinanced or inflated away without US consent. Since short-term external debt is just 4% of GDP, Russia will not have a liquidity issue. Fourth, SBER is a domestic bank with no operations in the US.

2. *Political risk*: The Russian government's majority stake (50.1%) in SBER could raise concerns of nationalization and politically motivated lending. However, Putin likely only resorted to nationalization early in his career to establish his image as a strongman; his recent actions seem to indicate a change in mind. For example, the government has been selling off its stake in major companies, including SBER and VTB Bank. In contrast, the US essentially nationalized Fannie Mae and Freddie Mac in the financial crisis. The country is also just one notch away from being deemed investment grade by all three ratings agencies, which increases the cost of nationalization. The second concern has also been proven false with the establishment of an independent central bank in 2015. Putin ignored public pleas from several of his wealthy friends (such as the Rosneft CEO) to allow their companies to receive cheap financing from the central bank. He also allowed the central bank governor to let the ruble float and hike interest rates, both of which were politically unpopular moves. Putin backtracking and potentially hurting Russia's economic growth seems unlikely given that 2018 is a presidential election year.

3. *Corporate governance*: Historically, many emerging market countries have had poor corporate governance records; Russia is no exception. However, the country has gone through a lot of change recently. For example, the Moscow Exchange incorporated the majority of the Corporate Governance Code's rules into its listing requirements. The World Bank now ranks Russia 35th in the world in terms of ease of doing business, higher than many developed countries. SBER, in particular, has taken moves in the right direction. It has increased the number of independent directors from one to six and its disclosure is comparable to most western financial institutions. The Russian government is clearly aware that the treatment of minority shareholders in SBER (one of the largest public companies) will have a meaningful impact on the country's reputation as an investable country for foreign capital.

4. *Ruble devaluation*: Currency meltdowns (Asian Financial Crisis, Mexican Tequila Crisis, etc.) have typically resulted from a combination of the following: low foreign exchange reserves, chronic current account and fiscal deficits, significant debt, and high inflation. None of these red flags exist with Russia. Even at the current oil price, Russia has $400B in dollar reserves (23% of GDP), a current account surplus (3% of GDP), minimal fiscal deficit (2% of GDP), little debt (17% of GDP), and low single digit inflation. Decreasing interest rates also indicate the central bank's belief in a stable ruble and consequently, the beginning of a new balance of payments cycle. On a company level, both sides of SBER's balance sheet have a similar percentage of dollar-denominated items, mitigating the impact of ruble fluctuations.

5. *Low oil prices*: Historically, the Russian economy has been highly correlated to oil prices. However, it has quietly been diversifying its economy. For example, natural resource rents as a percent of GDP has dropped from 50% at the turn of the century to under 20% as other sectors, such as retail, telecom, and entertainment, have become increasingly important. Furthermore, only 8% of SBER's loans are to oil and gas companies and 64% of its corporate loans are to large businesses (which are likely to be able to weather a prolonged low oil price environment). At SBER's current valuation, we do not need oil prices to increase for this to be a successful investment. Regardless, we believe that oil prices will likely head higher due to accelerating global economic growth and diminished investment in production.

To summarize, we believe SBER is a quality business in an economy emerging from a severe recession. From a portfolio construction perspective, the stock offers attractive uncorrelated returns and the primary "Russia" risk can be diversified away in a US equity portfolio. That being said, we will monitor the Russian macro environment for any deterioration.

Exited Positions

Sold Brookdale Senior Living (NYSE: BKD) for $7.38
Bought at $9.50 (-22% loss)

We sold BKD after the company turned down numerous buyout offers and instead decided to embark on a turnaround. At the time of our purchase, we had concerns over BKD's underlying business but were attracted to its real estate which we felt was easily worth upwards of $15/share — as such, our thesis was predicated on a buyout. However, the Board ended up only receiving a $9/share offer. We believe that potential buyers are attempting to use BKD's deteriorating fundamentals and significant debt load to essentially force the company into accepting an unattractive offer. A few buyers were interested in paying a higher price but all the deals fell through for a variety of reasons, including a failure to achieve the necessary consents from lessors. The CEO and several board members chose to step down after the end of the strategic review and have been replaced by people pushing for a turnaround rather than an outright sale. We believe our thesis has been broken and are not particularly interested in the turnaround story. We would have maintained our position for the significant real estate value if not for the leverage and deteriorating underlying business.

Sold PICO Holdings (NASDAQ: PICO) for $16.05 (includes $5 special dividend)
Bought at $12.51 (28% return)

We sold PICO after our thesis played out the way we expected. The CEO as well as the majority of the executive board had been replaced and the new management team quickly started selling the company's assets. Importantly, the company sold off its UCP real estate subsidiary for cash and distributed the entire amount in a special dividend to shareholders. At the current valuation, we do not believe there is a lot of upside in maintaining our investment. An important lesson in asset plays (such as PICO or Brookdale) is the importance of management compensation structure. Brookdale's management team was not being compensated for selling off its real estate. In contrast, with PICO, its management team's bonus depended on selling assets above the purchase price.