May 3, 2017

"If you take care of the small things,
the big things take care of themselves.
You can gain more control over your life by
paying closer attention to the little things."

- Emily Dickinson

Dear Client,

During the first four months of 2017, we were relatively active on the buying and selling front. With a reasonable amount of information to report on individual positions, we will dispense with any broad economic and asset class commentary and dig right into each of the transactions that occurred between January and April. We will start with a brief update on Express Scripts. While we did not affect any transactions in Express during the beginning of 2017, it is one of our biggest positions, and the company did report a significant development related to its largest client, Anthem.

Large Position Update

Express Scripts (ESRX). While we made no buys or sells in ESRX during the first four months of 2017, there was an important development at the company. On April 24, 2017, Express reported strong earnings. EBITDA for the quarter was $1,496.2mm, up 3% compared to the year earlier. Adjusted earnings per diluted share were $1.33, up 9% compared to the year earlier. In addition, the company raised 2017 earnings guidance to a range between $6.90 and $7.04 per diluted share. Yet, the company also announced that they were now assuming the Anthem contract would not renew after the current term expires at the end of 2019. Today, Anthem provides 18% of Express Scripts revenue and thus the stock immediately lost 10% of value. (We would argue that the market sold both the rumor and the news in this case, but that sometimes happens.)

We wrote about the ESRX/Anthem ongoing negotiation in our third quarter 2016 letter. As we wrote there, we recognized the risk that Anthem would not renew, yet at the time ESRX was trading around $70/share and we believed then (and still believe now) that even without

Anthem, ESRX is worth in the mid-$80s. Importantly, while the announcement hurt ESRX's price in the short-term, it may have been a terrific negotiating tactic on the part of Express' management. Recall from our previous writing, Anthem has very few PBM choices: other than Express, CVS is the most viable option. The only other PBM that has the scale to service Anthem is UnitedHealth, but they are a direct competitor on the health insurance side so that seems unlikely. A final option would be to re-internalize the PBM function (Anthem previously sold their PBM to Express.) Any of the options other than Express will have significant switching costs. Perhaps that explains why when Anthem reported quarterly earnings just two days later, the CEO stated on their investor call that they had made no decision on its pharmacy benefit management (PBM) contract and Express was still a viable option. It seems that today the risk of losing Anthem should be fully priced into ESRX, but there remains a call option on the possibility that Anthem remains after all.

Buys – January through April 2017

LiLAC Group (LILA). On April 6, 2017, we purchased a "starter" position in LILA at $22.87/share. Liberty Global (LBTYA) issued LiLAC as a tracking stock in July 2015 to represent the Latin American and Caribbean telecommunication and cable assets of Liberty Global. On July 2, 2015, the first day of trading post distribution, LILA closed at $49.61/share. Then in 2016, Liberty Global acquired Cable & Wireless (CWC) and subsequently issued another distribution from Liberty Global to LiLAC for the Cable & Wireless business. Since the initial distribution, LILA has traded lower and lower. The 52-week low is $19.10/share.

While overdone from a long-term perspective, we think the sell-off is understandable. To begin with, investors who were happy to have a large-capitalization, European telecommunications firm, received shares in the small-capitalization developing market telecommunications firm and many likely sold. Then, the follow-on transaction to acquire Cable & Wireless was very complex, likely alienating an additional group of shareholders. Finally, the LiLAC / CWC integration hit some bumps. For us, all of this has created an opportunity.

We are excited to "partner" with John Malone, the controlling shareholder (again… he is also the controlling shareholder of TRIP through Liberty TripAdvisor Holdings, LTRPA). We believe LiLAC's assets are technologically superior to the majority of their competitors (i.e. greater bandwidth). With CWC, LiLAC acquired Columbus International, a sub-sea backhaul network that provides LiLAC cost advantages and contributes its own revenue stream. LiLAC's geographies are certainly development-stage economies, but bandwidth usage is growing quickly. Penetration rates and average revenue per user are low, leaving ample space for LiLAC to grow.

*TripAdvisor Inc. (TRIP)***.** We described our TRIP thesis in last quarter's letter. After our initial purchase on January 6, 2017 at $49.54/share and near its 52-week low at the time, the stock proceeded to continue its decline. It hovered at a low near $42/share for all of March and most of April. This was despite reporting solid traction in Instant Booking signaled by flat branded-click and transaction revenue. In just the prior quarter, branded-click and transaction revenue was down 10%. (Recall from our thesis, TRIP is currently in the midst of a migration from click-based advertising revenue to the new Instant Book platform.) Marketing costs were up and that is what investors seemed to focus on. More recently, TRIP announced on April 27, 2017 that InterContinental Hotels Group (IHG) joined Instant Book – further validation of the platform. We took the lower stock price amidst increasing signs of Instant Booking progress as an opportunity to add to the position and purchased additional shares on April 28, 2017 at $44.75/share.

Sells – January through April 2017

Independence Realty Trust (IRT). On February 7, 2017, we sold our entire position in IRT at $9.10/share. We had purchased IRT in October 2016 at $9.01/share and earned four monthly dividends during our holding period. Prior to our purchase, the stock sold down from its all-time high in anticipation of a large secondary stock offering. The company used the stock offering to internalize the management company, pay down debt, and repurchase shares owned by a third-party, publicly-traded firm. Prior to the deal, the company communicated their intention to make post-deal capital allocations that would lead to full dividend coverage in early 2017. Shortly after the deal was completed, management communicated a change in capital allocation plans that would leave the dividend uncovered through the end of 2017. This change of plans combined with a decrease in monthly apartment rents through much of the country (and especially in a few key IRT geographies) caused us to sell that stock at a modest gain.

Colony Northstar Inc. (CLNS). On February 8, 2017, we sold our entire position in CLNS at $14.57/share. We originally purchased CLNS (as NSAM) on September 8, 2016 at a CLNS-adjusted price of $12.90. We earned one regular and one special dividend during our holding period. The NSAM purchase was in anticipation of the three-part merger of NSAM, NRF, and CLNY into what became CLNS. Prior to the merger, NRF traded at a significant discount to private market net asset value. However, NRF was obligated to pay NSAM a fixed base management fee. For this reason, they were practically precluded from selling assets and buying back stock (a process typically used to remedy such a discount). The merger eliminated the problem. We believed NSAM traded at the largest discount to our expectation for the pro-forma merged company. The valuation gap closed quickly after the merger's completion and we were able to sell the new CLNS in February 2017. Our overall return was just under 23%.

Hanesbrands (HBI). We first purchased HBI on August 16, 2016 at $27.24. The stock had made a high of almost $35/share toward the end of June and into early July 2015. Since mid-2015, retail equities in general, and apparel manufacturing in particular, suffered as businesses reported poor sales ascribed to various and changing issues such as bad weather, uneven execution shifting to e-commerce, poor product innovation, and an overall sluggish consumer. As we discussed in our fourth quarter 2016 letter, we believed that HBI could navigate these issues given their #1 or #2 brand positions and the essential nature of the core innerwear business. Following the election of Donald Trump as US president, share prices for almost all manufactures with significant offshore capability sold at lower prices. We took that as an opportunity to add to our position at $21.51 in January 2017.

Unfortunately, fourth quarter results lent significant credence to the bear arguments. Growth in ecommerce could not offset traffic losses at brick-and-mortar retailers. Innerwear was down 8% overall. Operating cash flow was far below managements' previous guidance and thus there was less deleveraging than expected. Our original thesis might still prove correct – this could well be a cyclical slowdown in innerwear and HBI may eventually navigate the transition to ecommerce. However, after two quarters of missed guidance, only modest de-leveraging progress, and the ongoing risk of punitive tariffs from a protectionist administration, we decided to move on. When the stock rebounded a few dollars from its post-earnings lows, we took the opportunity to sell our entire position on February 23, 2017 at $21.24/share. Including several dividends, we existed at a loss of just under 13% over a holding period of approximately five months.

Annaly Capital Management (NLY). At its heart, NLY is a simple business. It is essentially a bank. The company borrows money short-term and buys (mostly) Federal Agency-backed mortgage bonds, earning a spread. When we purchased the bulk of this position in September 2015, the stock traded at less than 85% of book value with a double-digit dividend yield. The assets of NLY and similar businesses are liquid, publicly traded securities. One could buy the whole company and realize book value in a relatively straightforward way. The stocks were out of favor given the absolute low level of interest rates and everyone's belief that rates would rise. We felt the risk of rising rates (while very real) was more than factored into the discount to book value. When the stock price reached 98% of book value in March of 2017, we sold. Including dividends, our total return was close to 44% over a holding period of approximately 18 months. NLY is a name we have owned on and off for many years. We would look to re-buy at either a meaningful discount to book value or a scenario where rates are higher than today and the environment was developing in such a way that rates were likely to go lower from there.

Elekta (EKTAB-SE; EKTAF). We purchased EKTAF in August of 2015 at a converted rate of $7.26/share. Elekta is a Swedish-based and Stockholm-traded manufacturer of radiotherapy machines, software, and services for cancer treatment. When we initiated the position, Elekta

and US-based Varian had formed an industry duopoly. Given radiotherapy's efficacy, we believed there was a significant growth opportunity outside the US where penetration rates are lower. EKTAF had sold off due to poor operational execution – a delayed product and poor working capital management. Neither were structural problems with the business and we felt the new CEO was capable of fixing the issues. Through the first quarter of 2017, Elekta improved sales, gross margin, and cash conversion. The stock reached our target price and we decided to book our gain at $10.32/share. Total gain, including dividends, over the approximately twenty one month holding period was 44%.

Conclusion

Big picture items like economics, asset class valuations, and investor sentiment really do matter. However, sometimes (most times), it is the little things that are in our control that ultimately make the difference. Every quarter is busy, but often times that busyness never manifests beyond quiet research, analysis, and reflection. The past four months involved a number of transactions and the rationale behind each should provide investors with greater insight into the Grey Owl Capital Management investment process and philosophy. We are excited about our new TRIP and LILA positions. In addition, we are optimistic that as ESRX continues to show the strength of its core business, investors will award it a multiple that reflects that strength. We believe all three ideas are secular growth stories with robust futures.

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

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Sincerely,

Grey Owl Capital Management

Grey Owl Capital Management, LLC

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