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Seventh Inning Stretch

Rick Lane, CFA

While the challenging investment environment outlined in last quarter's review remains largely intact, recent economic data seem to be pointing to a mild economic acceleration. Recall that our prior outlook centered around the challenges of slow worldwide business activity combined with rich equity valuations and extremely low interest rates. Subsequently, Brexit happened. Interest rates around the world spiked downward, reflecting a general belief that this event might cause a recession in Europe. Surprisingly, after a short-lived decline, equity markets rallied as lower discount rates on risky assets overwhelmed further earnings worries!

So where does this leave us now? We liken it to coming out of the seventh inning stretch in baseball. But of course, that implies the possibility of only two-and-a-half more innings left in the game! As bottom-up investors, we will not dwell too much on this factor. We do observe that the current upward trend in the market is in its seventh year. This is quite long by historical standards. We will be increasingly vigilant from here on out with respect to the economic sensitivity of Broadview's investments.

We continue to believe many holdings in the portfolio offer solid outlooks and potential positive returns. In last quarter's review, we laid out the case for energy. We continue to look for further opportunities in this sector to supplement our "energy banks," including LegacyTexas Financial Group, Inc. (LTXB), Hilltop Holdings Inc. (HTH), IBERIABANK Corp. (IBKC), and Zions Bancorp(ZION), and our direct energy sector investments: Range Resources Corp. (RRC), Gulfport Energy Corp. (GPOR), Chicago Bridge & Iron Co. NV (CBI), U.S. Silica Holdings, Inc. (SLCA), Patterson-UTI Energy, Inc. (PTEN) and Superior Energy Services, Inc. (SPN). In addition, we are currently focused on industrial companies with meaningful exposure to the energy sector.

In our opinion, the housing upturn is alive and healthy. Broadview's portfolios have good exposure to housing through Masco Corp. (MAS), BMC Stock Holdings, Inc. (BMCH), HD Supply Holdings Inc. (HDS), MGIC Investment Corp. (MTG), and Mobile Mini, Inc. (MINI). Infrastructure (e.g. road building) still appears quite robust. Presidential candidates on both sides are talking about further spending initiatives next year. Vulcan Materials Co. (VMC), Astec Industries, Inc. (ASTE) and Summit Materials, Inc. (SUM) are current investments tied to anticipated infrastructure spending.

In the retail world, we continue to look for highly differentiated companies that can distinguish and delight customers and fend off the Amazon.com, Inc. (AMZN) juggernaut. For example, LuluLemon Athletica Inc. (LULU) has been a successful investment driven by unique products and loyal customers. We recently added positions in Nordstrom, Inc. (JWN) and Dick's Sporting Goods, Inc. (DKS). Dick's Sporting Goods stands to benefit from other sporting goods retailers, like Sports Authority, going out of business. Nordstrom's world class customer service and merchandising continue to differentiate its business, though admittedly competition continues to intensify. Chuy's, Holdings, Inc. (CHUY), which owns and operates distinct full-service TexMex restaurants, continues to execute well and we believe has significant growth potential.

It is apparent that the service sectors of the economy are doing well. The same cannot be said for industrial and manufacturing sectors. Fastenal Co. (FAST), W.W. Grainger, Inc. (GWW), and MSC Industrial Direct Co. (MSM) are three world class industrial distributors that we believe are accurate economic barometers. All three companies have reported weak sales in second quarter.

Finally, the current market environment is as challenging and perplexing as always. Unless you believe interest rates will stay close to zero forever, equity valuations appear quite stretched. We believe our five pillar bottom-up approach continues to yield solid opportunities.

Western Alliance Bancorporation (WAL)

Sam Koehler

Western Alliance Bancorporation is a financial sector holding that we have actively built this year. Western Alliance is comprised of regional bank divisions in Arizona, Nevada, and California as well as specialized national lending platforms. This is an organization and management team that we have followed and admired for some time before finally getting an ideal buying opportunity in the first half of the year.

All of the attractive qualities of the bank are tied back to an excellent management team. We believe CEO Robert Sarver and CFO Dale Gibbons are some of the most thoughtful and cavalier executives in the banking industry. Their management decisions have led Western Alliance to top tier growth and profitability.

The core local banking markets are attractively positioned in growing economies in the southwest. To supplement growth, Western Alliance also has specialized lending platforms in fast growing industries including restaurant franchises, life sciences, renewable energy, homeownership associations, and technology. The specialized lending niches have less competition and more customer demand which also drive higher loan yields. The combination of high yields and low expenses has led to a Return on Tangible Common Equity ("ROTCE") in the high-teen percentages which is remarkable for a regional bank.

The management team has executed several acquisitions of traditional banks and specialty platforms to further increase the growth trajectory. The March 29, 2016 acquisition announcement of GE Capital's U.S. hotel franchise finance loan portfolio is an illustrative example of Western Alliance's specialty platform acquisitions. We believe this high-yielding loan portfolio was acquired at a reasonable price and will generate significant earnings growth over the next several years. Additionally, the Western Alliance management team has a deep history in commercial hotel lending and the newly acquired lending team is already located in Scottsdale, Arizona. The Bridge Capital Holdings merger in 2015 was a whole bank acquisition but with a similar niche-focus in technology lending. We believe that its strong capital base and history of solid acquisition execution allows for more deals to be announced in the future.

Unlike many regional banks, growth for Western Alliance will not hinge solely on Federal Reserve interest rate hike decisions. Even without increased rates, the bank has demonstrated high profitability, impressive growth, defendable market niches, and a top-quality management team. The recent market correction allowed a buying opportunity of a highly profitable bank at a discount.

LDR Spine Holdings (LDRH) & K2M Group Holdings (KTWO)

Aaron Garcia, CFA

Late last year, we made an investment in a small but well positioned spine implant company, LDR Spine Holdings ("LDR"). The company had a fast growing niche suite of products. Its most market-disruptive product was an artificial cervical disc that was the only approved product with superiority for two level discectomy over fusion, the traditional standard of care. The product portfolio at LDR was growing faster than the overall spine industry and taking market share from larger players. However, in late 2015, the company's stock had been pressured due to growing pains. Specifically, the company's initiative to build out the salesforce contributed to volatility in the quarterly results. Also, given the smaller size of the company's revenue, new product launches proved difficult for management to forecast with accuracy. We believed the products at LDR were unique, and the weakness in the stock presented a compelling opportunity. Unfortunately, another larger player in the spine industry had the same view.

In the second quarter, LDR agreed to be acquired by Zimmer Biomet Holdings, Inc. (ZBH) in the second quarter. While we are happy with the acquisition premium of approximately 40%, we felt that LDR was well positioned for 2-3 years of outsized revenue growth and an even greater recovery in the stock price. We feel that management was perhaps frustrated with the quarterly reporting process of a public company and chose the quicker path to value realization. Nevertheless, we are still very bullish on the spine implant segment of the medical device industry.

The larger players continue to cede share with less differentiated products; and smaller unique spine companies are benefiting. We reallocated some of the position in LDR to another company in the sector, K2M Group Holdings ("K2M"). K2M has a leading position in complex spine and deformity, and has differentiated itself in the treatment of scoliosis in children and adolescents. Medtronic and Johnson & Johnson are the leaders in complex spine with 35% market share apiece, while K2M has a growing 15% market share. In our opinion, the company is growing revenue nicely and has a reasonable enterprise-value-to-sales multiple of 2.7x despite a strong recovery in the stock price year-to-date. Additionally, we feel the company's stock trades at a similar discount to its private market value as LDR. We believe the industry will continue to consolidate.

Pandora Media, Inc. (P)

Faraz Farzam, CFA

We have been accumulating shares of Pandora over the course of the last year which has been rather tumultuous for the popular streaming music app. We believe it is one of the most strategic internet assets trading now at rock-bottom prices. According to comScore, Pandora boasts nearly 90 million

active users representing five billion listener hours. This level of usage, 22 hours per user per month, rivals both Facebook and YouTube. This compares to Spotify at 100 million (of which only 30 million are paying subscribers) and 15 million for Apple Music. It is important to note that Pandora's core service is free; supported by advertising revenue. Spotify and Apple Music require a monthly subscription for an on-demand service. Furthermore, the active user metrics for Pandora's competition are global while Pandora's is almost exclusively domestic.

The key point of differentiation between Pandora and other services is that, not only is it a free advertising supported service akin to terrestrial radio, it serves as a unique discovery engine for new music for its listeners. The company has developed algorithms that use intrinsic qualities of music to initially create stations that then adapt playlists in real-time based on the individual feedback of each listener. Its streaming service is available through various distribution channels and it has developed applications for smart phones, tablets, smart televisions, gaming consoles, and home streaming devices. Furthermore, Pandora is currently integrated into the automotive infotainment systems of 190 car models. Management expects this integration to be expanded to 50% of all cars sold in the U.S. in 2016.

Utilizing an advertising based model, Pandora aims to capture a share of the massive $23 billion digital advertising market and the $17 billion radio advertising market. We believe Pandora will eventually close the gap between its leading share of US radio listening hours (estimated at 10%) and its advertising share, estimated at approximately 4%. This implies that, if pricing is held constant, the company has the opportunity to double its revenue as it closes that gap. However, the company also has an opportunity on the pricing front. Today their ad rates are far lower that the rates charged by terrestrial radio, even though Pandora has been steadily raising rates. Over the course of the last 3 years, Pandora has expended considerable effort building out a sizable sales force, nearly 160 strong "feet-on-the-street" in 39 markets, to attack the local radio advertising market. This is an asset that neither Spotify nor Apple possess.

In our opinion, neither Apple Inc. (AAPL) nor Spotify are truly direct competitors. This is a point of confusion amongst investors that caused a lot of volatility in the stock over the course of the last year. As we mentioned earlier, Pandora's service is free to listeners who are willing to listen to a few ads per hour. However, Spotify and Apple Music offer a paid service that amounts to $120 per year. This requires the building of playlists and is often referred to in industry parlance as a "lean in" model vs Pandora's "lean back" model. A few months ago, Apple quietly shuttered its iRadio business, the service that directly competes with Pandora, to focus on Apple Music, the Spotify-like service. Although Spotify offers a radio service, in our opinion, it lacks a meaningful recommendation engine. Spotify also does not possess the local sales force required to compete for local ad dollars.

2014 was a watershed year for Pandora. The company hit $1 billion in revenue and generated nearly $60 million in earnings before interest, taxes and amortization ("EBITDA"), a measure of cash flow. By the fourth quarter, it hit a run-rate EBITDA of $175 million, demonstrating the economic power of the business model. 2014 was also the peak year for the stock price, topping $40 per share. However, over the course of the following year and a half, the stock came under considerable pressure for several reasons.

First, investors began to "climb a wall of worry." The Copyright Royalty Board ("CRB"), a three judge panel that sets royalty rates for the industry, began deliberations on what rates Pandora and other providers would have to pay artists and record labels over the next five years. Investors feared a dramatic increase in rates that would permanently impair the economic model. The royalty rates were eventually set and, although modestly higher, they were nowhere near the dramatic increase bearish investors predicted.

Second, the company acquired Ticketfly, an online music venue ticketing app similar to Ticketmaster. Pandora aims to marry the vast storehouse of information on its users, their likes, their stations, and music preferences with performing artists' touring schedules. In the age of digital music, 80% of an artist's income is generated through touring. According to Pandora, 50% of tickets go unsold prior to the event. Pandora sits in the unique position to help artists connect with their fans, providing a unique service that no one else can deliver.

Third, Pandora acquired the technology assets of Rdio, Inc. out of bankruptcy to deliver a Spotify-like on-demand platform in 2017. According to Pandora, the company will break even on the acquisition if they convert a mere 2% of their already vast user base to a paid on-demand service. Although bear investors point to a company that struggles to make money, we believe that the core ad-supported radio business is generating EBITDA. In our opinion, this is currently masked by the investments in the two new platforms.

Pandora's goals are ambitious. They aim to be the dominant music platform for consumers; spanning radio, on demand, and concerts ticketing. We believe that, if Pandora can achieve these goals, the value of the company will be dramatically higher than today's price. However, should they fail, the core radio asset with its 90 million user base and 160 strong domestic sales force will surely be a sought after asset for other internet platforms such as Spotify or Facebook.