Jefferies Prime Services Monthly

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Year of the Earth Dog: Rewarding, but Demanding

…Not to be confused with Bob Weir's band RatDog.

With Chinese New Year on February 16th, we kicked off the year of the Earth Dog – which calls for a *good* year in most respects, but also a tiring one. Earth Dog years are expected to be rewarding, but require persistence and grit. For those of us who may not be crack Chinese astrologers, here are some of the things that are challenging and rewarding us early on:

1. **REWARDING: Performance seems to be back**. Hedge funds had a solid 2017 (+8.68% on average), a strong January (+2.8%), and anecdotal numbers put February performance flat to slightly up despite the challenging tape early on.
2. **DEMANDING: Reading the volatility tea leaves.** Self explanatory.
3. **REWARDING: The 'Age of Partnerships'** that has evolved between managers and allocators, as outlined in our recent *State of Our Union* white paper. Managers and allocators alike increasingly report unique, mutually beneficial ways to deepen relationships and build strong foundations meant to endure any future periods of acute stress and reward long term engagement.
4. **DEMANDING: Raising your fund's next incremental dollar**. Although net flows to hedge funds reversed in 2017 after 2016's net redemptions, the nearly $10 billion of net inflows to the industry remind us each dollar is hard earned. And in an era of continued consolidation across allocator portfolios – perhaps even harder to keep.
5. **REWARDING: Close to capping the decade after the 2008 crisis at all time industry asset highs, across the most diverse offerings to date.** The hedge fund industry has not just muddled through the 10 years since the global financial crisis, but it continues to thrive and innovate despite periods of considerable challenge.
6. **DEMANDING…**enduring what feels like 20 hours of Olympic curling throughout event coverage.

As we continue to march through February, many of the managers and allocators we're talking to share cautious optimism for the year ahead**. We spent much of January and February on the road in London, Geneva, Chicago, Miami, Boston and up and down the West Coast, and sentiment is resoundingly positive**. Maybe it's just a breather, maybe it portends a good year, maybe it's naiveté, but given it's the year of the Earth Dog, we'll stay focused on the rewarding – but be prepared for any challenges.

January 2018 Hedge Fund Performance Review I HFRI

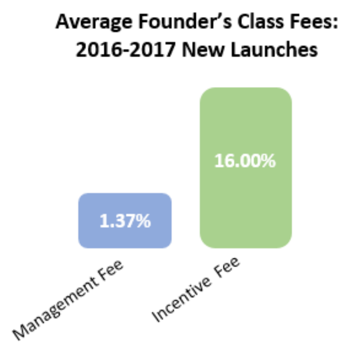
Strategy	Jan-2018
HFRI Event Driven	1.60%
HFRI Macro	3.70%
HFRI Relative Value	1.5%
HFRI Equity Hedge	3.0%
HFRI Fund Weighted Composite Index	**2.80%**

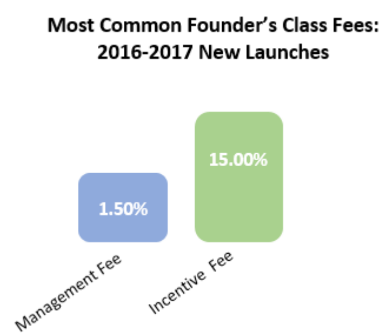
Source: HFRI

What's Your Founders' Capacity?

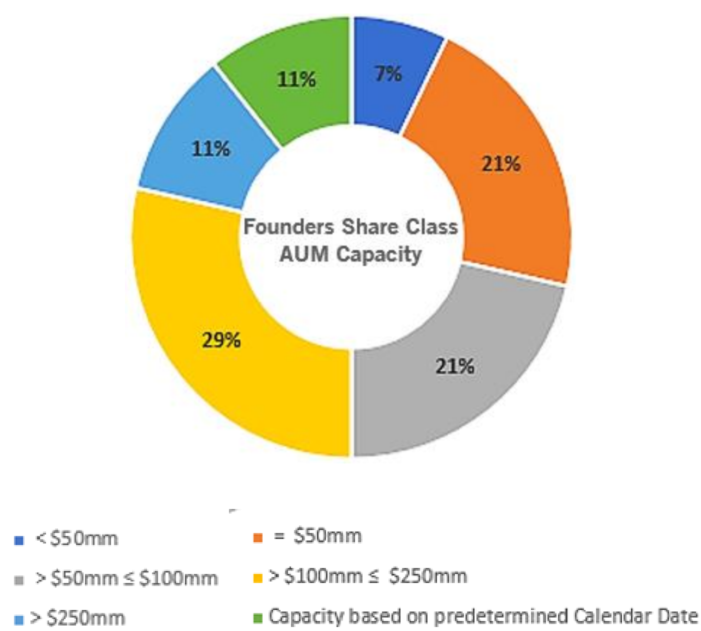
To kick off the year, Jefferies Prime Services reviewed 60 Equity Long/Short launches that came to market in 2016 and 2017 and conducted a **deep dive on their Founders' Class** terms, fees and capacity. Of note:

Discounts still primarily on the management fee side, with **average management fees of 1.37%**. The most common management fee was 1.50%, with ranges from 1 – 2%. Sector specialists continue to command slightly higher than average management fees – but a number of them instituted a "step down" for Founders, with management fees declining to between 0 – 1% after hitting an AuM threshold for incremental allocations.





Founders Share capacity varies widely, with more than 10% of those offering a Founders Share class limiting participation by calendar date rather than notional amount. The most common capacity is between $100 mm and $250 mm.



Founders Share classes remain an attractive way for early stage managers and allocators to partner. One allocator noted recently that they conducted an internal study on amount saved in fees by prioritizing Founders Share participation where appropriate, and determined the compounding effect was equivalent to somewhere between 30 and 50 bps of performance per year.

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Jefferies Capital Intelligence Corner

Q1 is always a busy time planning for the year ahead. Here are some of the top questions we've been getting from clients:

1. **What's happening on the regulatory front?**
   a. **GDPR** – it's time to be aware of this European regulation that goes live on May 25th. GDPR (the General Data Protection Regulation) is a far-reaching set of rules that, among other things, requires in scope managers to report cyber breaches that impact personal data within 72 hours to their regulator. It also calls on managers to ensure any vendors or third parties that handle personal data do so within the requirements of the new regulation. **U.S. managers are in scope for GDPR if they have a European investor or boots on the ground in the E.U.**
   b. **The SEC's 2018 Exam Priorities** were recently released. In focus topics include: "Matters of importance to retail investors," critical market infrastructure compliance and risks, examining FINRA and the MSRB, cybersecurity and anti-money laundering programs. Of particular focus for hedge fund managers is the continued focus on maintaining and enhancing robust cybersecurity programs, with updates as to any emerging best practices.
2. **Where are clients spending time on the outsourcing front?** This common question has a few added wrinkles for 2018, as managers review their operating expenses and work through optimization for the coming years. We increasingly hear managers of all sizes are revisiting recurring operating expenses to create more agility in their spending footprint. An area of increasing focus for potential outsourcing solutions is trading, which is balanced by a growing number of discretionary managers considering adding data or development expertise in house to address the growing availability and importance of data.
3. **What was sentiment like at some of the first industry conferences?** We traveled to Miami for BattleFin and Context Summits in early February, and while the two events attracted two very different audiences – overall sentiment was resoundingly (albeit *cautiously*) optimistic.

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Co-Investments

On the back of rising allocator interest in and manager willingness to consider offering them, we hosted a February breakfast to explore the topic of co-investments. We conducted a snap survey **of ~75 investors over year-end, in which co-investments were named a top 3 priority** by about one-third of respondents.

Of note:

- Interest in Co-invests has ticked up considerably as allocators seek diversified ways to bring down fee averages while offering differentiated products to *their* end investors. **A robust co-investment portfolio can help to define an allocator's differentiated value proposition to their clients**.
- We keep coming back to this theme: **Partnership**. Co-investments are seen as an additional dimension to add depth and breadth to the allocator/manager partnership.
- Co-investments add to the **diversity of ideas** managers are able to pitch to allocators, while providing a window on their full research, idea and due diligence process. Allocators get a front row seat on granular ideas, whether thematic and top down, or single stock/bottoms up investments.
- Allocators who are active in co-investments are more willing to invest with managers both on and not-yet-on their platforms. Co-investments may offer a venue for test-driving a smaller allocation with an emerging manager as allocators continue to build a relationship and get to know them.
- Co-invests provide a solid **opportunity for smaller funds** to engage with larger allocators who may not be able to allocate to a master/feeder vehicle until it hits a certain AuM threshold.
- Fees remain fairly range bound, with 0/10 the most common structure for co-investments.

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"We need to become a focused medicines company that's **powered by data science** and digital technologies."

- **Vasant Narasimhan, CEO of Novartis**

"BlackRock has long sought to be on the cutting edge of technology in the investment world and **the setting up of the AI lab, and an internal "Data Science Core" unit**… is part of the company's "Tech 2020" plan."

BlackRock Bulks Up Research Into Artificial Intelligence.
The Financial Times. 2.19.20

Jefferies Serves as Lead Co-Sponsor for Battlefin Miami Discovery Day

The Jefferies Data Science Working Group traveled to BattleFin Discovery Day Miami recently to meet with nearly 100 alternative data providers and investment firms focused on the space. Of note:

- **Getting a better handle *on one's own data*** is just as important to many investment firms as sourcing alternative data. Organizations are increasingly focused on how to build their own "data lakes" that merge multiple systems across CRMs, trade/order data or research information.
- **Internet of Things (IoT) data will generate massive new information to digest.** From logistics and shipping firms to retail or energy companies, many are leveraging sensors to generate real time data. Many expect this output to become a new "must have" for investment research as it becomes available, and some firms are working to build infrastructure that can ingest and leverage it.
- **We remain in the early days of next generation data going mainstream**, but things are changing fast. There is an enormous amount of data being generated and explored by industry companies who may use it differently than financial services firms. Data providers are focused on tailoring their products to fit the needs of different industries who may leverage them.

Top Jefferies Research Reads in recent weeks

Leaders of the Pack:

- Active v. Passive Debate 2.0 – the Kettle is Moving from Simmer to Boil
- Two Weeks in Two Minutes: Late cycle, Small Caps and Shale
- Reading the Yee Leaves: Bull-Bear on Big-Caps and Catalyst Calendar for Top Events
- Notable Takeaways from FB's 10K
- NKTR: Report of NKTR Exploring Strategic Options a Logical Development

Other Notable Reads

- A Trip Around the Block: Online Real Estate Deep Dive
- Finding Fresh Arms in the Bottom of the 12th: Stocks That Can Still Work

Jefferies Equity Strategy: US – Follow the Ten-Year Treasury, Follow the FCF Yield

- The US 2-year note yield continues to push higher (2.2%) raising the probability of 4 rate hikes this year – same as Jefferies. Last week we reviewed the best and worst sectors as the 10-year yield rose from its record July 2016 lows – high FCF and dividend yield, respectively. This week we further examine how stocks out- and underperform through the rate cycle and the potential 'pinch point' when they finally succumb to tighter monetary conditions.
- Once again the US experienced net selling with US$5.7bn withdrawn from US funds despite net inflows of US$5.6bn into global equities last week. The rotation in the fixed income markets reveals a better picture of investor sentiment with ongoing outflows out of US high yield and investment grade credit while government bonds across the duration spectrum saw inflows. The 'rotation' away from credit into government bonds is entirely intuitive given the higher yields on offer from treasuries.
- However, the distortions within global fixed income markets have still some way to unravel. For instance, Italian 10-year government bond yields are less than US 2-year note yields while UK 10-year Gilt yields are over 100bp less than 10-year US treasury yields!

- Full note: US: Follow the Ten Year Treasury, Follow the FCF Yield

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Software: Analyzing the Impact of Tax Reform on Software Companies

John discusses provisions in the new tax law that impact the Software sector and quantify company-specific effects. ALRM, PAYC, and CA stand out as major CF beneficiaries. We explore potential demand effects and estimate global software growth could increase to at least 13% from the 8% currently expected.

M&A deal volume/sizes should rebound due to deemed repatriation as interest rates remain low and lower tax rates increase the value of recurring revenue. Major beneficiaries. When considering the aggregate impact of the various tax provisions on 2018/F2019 FCF, major beneficiaries include ALRM (potential 18% benefit), PAYC (17%), and CA (11%), while MSFT could see a modest 2% negative impact to FCF (due to potential incremental foreign tax liabilities).

Federal corporate tax rate from 35% to 21%. Major CF beneficiaries, measured in terms of tax savings as a % of consensus 2018/F2019 FCF estimates include: ALRM (16%), PAYC (14%), CA (11%), RHT (5%), ORCL (4%), SSNC (4%), VMW (3%), and CTXS (2%). We don't expect CA to realize this tax benefit until about 5 yrs from now due to significantly higher cash taxes related to upfront recognition of term licenses under ASC 606. Major non-GAAP EPS beneficiaries include ALRM (30%), PAYC (20%), CVLT (16%), and CA (14%).

Demand effect—potential 5% boost to worldwide Software spending. We estimate that US Software spending could increase materially, given increased net corporate profit in the US due to the lower tax rate and assuming the percentage of this profit on Software spending remains constant. Our estimate isolates only the benefit of the lower cash tax rate—which we assume decreases from an avg. 29% to 21%. We estimate that even if both US GDP and aggregate corporate pretax profits don't grow from 2017 levels, there could be at least a $19B benefit to US Software spending due to the lower US corporate tax rate, which could materially increase US Software spending growth to 13.2% from 8.3%

Deemed repatriation may benefit all for the next few years as more cash in large tech companies' coffers will likely drive M&A and capital returns (and executive pay). We estimate that our covered companies with the most foreign-held funds available for use in the US after paying repatriation fees are: MSFT ($118B), ORCL ($49B), and VMW ($7B), followed by CTXS ($2B), CA ($2B), RHT ($1B), and SYMC ($1B).

Tax reform should boost M&A. Aggregate value of large deals declined to $19B in 2017 from a record $93B in 2016, as valuations expanded. We expect Software M&A deal volume and sizes to rebound over the next few years, as repatriation increases available funds, and interest rates remain historically low. A lower cash tax rate also increases the value of recurring revenue, boosting the "base value" of a license/maintenance company to 6.2x EV/Recurring Rev from 5.1x, and to 5.4x from 4.5x for a SaaS company.

Full note available here.

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Jefferies Stock Loan Corner

In the US, Short interest vs Float has remained relatively flat over the past month at 3.8% after reaching 4.1% mid 2017, which was its high over the past year. Not much has changed at a very high level. Over the past month we have seen a pickup in activity and rotations since volatility returned to the market in early February. Sectors where we are beginning to see an increase in short exposure include Energy, Utilities and Real Estate. Sectors where we see less interest and light reductions in short exposure include Basic Material and Industrials. The desk is involved with AMGN, a dutch tender expiring March 5th, and NSM's acquisition by WMIH for cash and stock (with election and proration optionality that should be completed in 2018). Please call the desk for latest color on flow and availability on both.

In Europe, increased volatility has led to a significant activity driven by strong moves in both long and short side positioning. There continues to be a strong pipeline in the event driven space, names of interest:
BOK/TSCO – scheme doc has been published. Due to the structure of the deal, a high prorate is expected on Max Cash, somewhere in the region of 95-98% which makes the trade somewhat unexciting for the moment. 26th Feb remains a key date with the vote to approve the deal falling at that time.
GVC/LCL – scheme doc expected around 28th Feb (Mix & Match).
MRO/GKN – Melrose have launched a hostile bid for GKN.
SKY/FOX - completion seems to be edging closer with the companies looking to remedy the CMA findings. Sky is now trading through the terms.

In Asia we have witnessed active short side activities across the region creating better opportunities for fundamental plays. In Japan, weakened JPY allowed investors to take profit on down side of exporters, especially auto makers. In Korea, short interest on bio-similar sector has gone up significantly. Celltrion(068270 KS) recorded historic high daily short sell turnover of $300mn on 8th February. Kakao(035720 KS) GDR issuance had been completed in early February, mostly converted back to the ordinary shares. In Hong Kong / China, China Evergrande Group(3333 HK) saw its short interest increase more than 100% MoM on a negative research report published by activist funds. Amidst worse-than-expected iPhone X shipment news hitting the tape, Apple(AAPL US) suppliers in Taiwan have been the main target of TMT focused smart money to short. CB plays on Nanya Tech(2408 TT)/Neo Solar Power(3576 TT) remain active.

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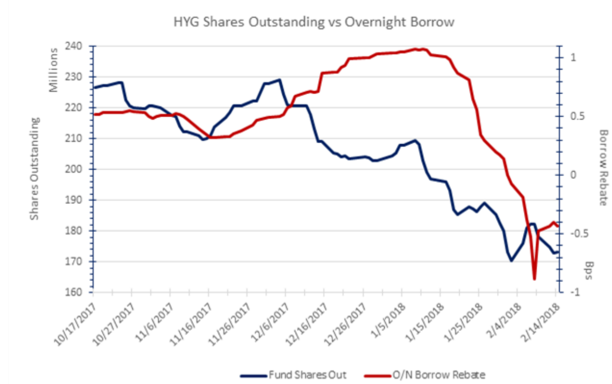
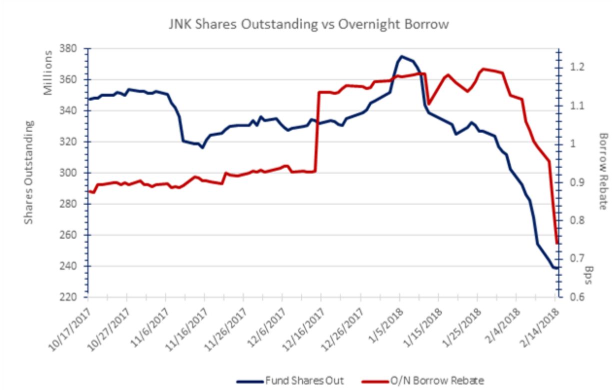
Observations on the High Yield ETF market.
HYG and **JNK** saw almost $6 billion in combined outflows over the last 30 days (largely due to the considerable selloff in credit/HY during the beginning of February 's volatility). Even before the considerable outflows seen in February, HYG saw redemptions heading into yearend (likely balance sheet driven), yet borrow levels remain elevated as funding desks were concerned about keeping supply lent. The outflows seen earlier this month quickly moved HYG borrow to levels as bad as -10%, with buyins impacting a number of desks. As borrow reached stressed levels and the higher fee level supported, a number of more sophisticated credit desks quickly stepped in and created shares to lend (or synthetically lend through swap or options) which has stabilized HYG borrow albeit maybe temporarily. This dynamic has not yet occurred in JNK (a name that rarely moves off GC/warm levels), indicating that availability is still under pressure and as a result, shorts may be exposed. Without inflows into both of these funds borrow will likely remain expensive as supply remains tight. Below is a chart showing the effect of redemptions on the borrow fee over the time period discussed.





Borrow Names with Largest Rising Interest since Mid-January

Security	Utilization	Indicative Rate	Avg 30D Volume	Quantity on Loan	Borrow Delta since 1/15/2018
AMC	96.52%	-6.12	2,083,242.38	264,679,008	63,449,696
VXX	88.30%	-1.25	60,401,740.00	22,954,060	13,455,711
SIRI	94.14%	-4.50	24,583,572.00	402,693,792	10,176,448
GNK	56.49%	-7	104,449.77	49,283,400	7,528,680
SPWR	95.98%	-43.87	3,403,784.75	27,447,928	6,524,216
STON	70.85%	-6.50	250,694.47	22,622,000	6,168,000
OPK	65.24%	-0.25	4,955,375.00	62,592,524	6,064,212
RES	81.75%	-6.75	2,644,823.75	29,233,370	5,185,510
DDD	82.99%	-30.25	2,787,243.75	36,368,944	4,803,432
MUX	76.49%	-1.00	3,539,506.75	52,902,212	3,880,312

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JEFFERIES UPCOMING EVENTS

Spotlight on Israel, Jefferies Tech Trek Conference and the Israeli Hedge Fund Association Conference

Jefferies, in partnership with Leader Capital Markets, will be sponsoring its fourth annual Israel Tech Trek Conference from June 3 – 6 in Tel Aviv, convening local and global investors, featuring senior executives from publicly traded issuers and private firms paving the way in disruptive technologies.

Israel is increasingly in view as investors become more familiar with emerging Israeli companies and the fertile landscape of start up and growing firms. Somewhere between 50 and 100 local firms are acquired annually by the likes of Google, Facebook or Amazon – firms like Waze (the map app), which was acquired by Google in 2015 for more than $1 billion. In fact, per *The Economist*, Israel is now one of the most likely places to start a tech firm – with an estimated 375 start ups per million inhabitants, versus 190 in the U.S.[1] Public company c-suite management will be presenting and hosting 1x1 meetings on June 5th, and some of Israel's best private companies will be featured on June 6th. More than 25 global investors attended last year, with the majority returning, and a high number of new investors already registered.

Tech Trek will be followed on June 7th by the Israeli Hedge Fund Association Conference, co-hosted by Jefferies. Israel plays host to nearly 100 hedge funds, overseeing ~$4 billion – with assets doubling since 2011. Jefferies continues to deepen its focus and footprint on the country, partnering with clients and growing capabilities across multiple products and business lines.

1: https://www.economist.com/blogs/graphicdetail/2014/01/internet-startups

Upcoming Conferences & Events		
February 21-22	DALLAS	Jefferies 2018 Cybersecurity Summit & NSS Labs Visit
March 6	NEW YORK	Jefferies Payments & IT Services Investor Relations Summit
March 7	ZURICH	Learn 2Quant Zurich
March 8	FRANKFURT	Learn 2Quant Frankfurt
March 14	LONDON	Jefferies 2018 Paper & Packaging Summit
March 15	NEW YORK	Jefferies brands Still Matter Conference Series
April 3	NEW YORK	Jefferies Healthcare REIT Summit
April 9-10	LAS VEGAS	Jefferies 3rd Annual Broadcast Roundtable at the NAB Show
May 9-10	BEVERLY HILLS	Jefferies 2018 Global Technology Conference
June 3-6	ISRAEL	Jefferies Israel Tech Trek
June 7	ISRAEL	Israeli Hedge Fund Association Conference
June 5-8	NEW YORK	Jefferies 2018 Global Healthcare Conference
June 12	TORONTO	Learn 2Quant Toronto
June 14	BOSTON	Learn 2Quant Boston
June 19-20	NANTUCKET	Jefferies 2018 Global Consumer Conference