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.

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**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.*

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**January 2018 Hedge Fund Performance Review | HFRI**

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Jan-2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>HFRI Event Driven</td>
<td>1.60%</td>
</tr>
<tr>
<td>HFRI Macro</td>
<td>3.70%</td>
</tr>
<tr>
<td>HFRI Relative Value</td>
<td>1.5%</td>
</tr>
<tr>
<td>HFRI Equity Hedge</td>
<td>3.0%</td>
</tr>
<tr>
<td>HFRI Fund Weighted Composite Index</td>
<td>2.80%</td>
</tr>
</tbody>
</table>

Source: HFRI

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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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**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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**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.

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**JevFFERIES 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?**
   - 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.**

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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**Jefferies Prime Services Monthly | February 2018**
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 after 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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**Jeffries 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. Celtrion(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 China saw its short interest increase more than 100% also.

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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**

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

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