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BTN Thursday Thoughts

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The Third Wave of the Internet

Audio books and classes are great for flights, cardio exercise, or driving around. So, we have gone through several from http://www.thegreatcourses.com. Recently, they added one from Steve Case of AOL fame called *The Third Wave: The Future of Entrepreneurship in America.* Without trying to give them some free advertising, we'll just say it's about 80 minutes in length for $15.

The topic actually centers on the third wave for the Internet. Mr. Case tries to look at this like The Alvin Toffler book of the same name – *The Third Wave,* where Mr. Toffler used the past changes of the Agricultural Revolution and Industrial Revolution to forecast coming changes in the Information Revolution.

The first wave of the Internet was building the infrastructure over decades by the Department of Defense and then companies like Cisco, Hewlett Packard, and other hardware companies moving it to consumers with home computers. There were many chicken or egg battles fought as many pushed for Internet access for civilians and many pushed back asking, "Why would anyone want to?" Mr. Case noted that when they were working to create AOL, the first problem was it was illegal to go on the Internet. So, laws

had to be changed for the first wave to even begin. Another battle was pleading with PC makers to build computers with modems in them. Again, the question was "Why would anyone need one?"

The second wave of the Internet was building on top of the infrastructure. Companies like Google and Facebook developed along with e-commerce. Not to belittle accomplishments in this wave, but this has been an easier period. We say that because regulation and laws trailed the new development and many ideas were touted as an improvement rather than being fought by many asking, "why would anyone go online in the first place?" There were billions made very quickly by writing apps that became hugely popular very quickly. It was relatively cheap to start companies based on niche applications. Companies largely could focus heavily on the product rather than the end-market. They also could wait to monetize it until it reached millions of users.

Mr. Case sees the third wave has started and it will be characterized by the Internet no longer being owned by the Internet companies. It will become much more ingrained in all parts of life and will cover much more than checking emails in a restaurant. People will no longer think much about it and it will become like electricity in terms of it reaching into all aspects of life. He sees this being much tougher to succeed and perhaps taking longer because there will be more barriers to overcome. **Demonstrating the value-add and a plan to market new solutions will be necessary and even then, it may be tough to get approval for a new company to operate.** By our observations, Mr. Case is essentially saying there will be considerable money made, but there will be much fewer overnight billionaires who simply created an app to allow people to exchange cat photos. Here is what he envisions for the Third Wave:

1. **It will disrupt huge areas of heavily regulated industries such as transportation, education, energy, healthcare, and finance.** That means laws will need to change and the disruptions will impact more than entertainment options. Fail-safes will need to be built and many more scenarios will need to be imagined and accounted for. Who cares if the text with the cat photo has a delivery failure, but if the driverless car fails to stop at the red light, that would impact lives. Because it will impact areas larger in life by moving them to the Internet, the scope of the change will be much larger overall and move bigger markets. Think of the second wave allowing people to read magazines online. The Third Wave will be how people will change their energy usage automatically when they leave or return home. That's a much larger market.

2. **The entrepreneurs are more likely to be experienced in industry rather than tech people.** They will have a better understanding of the products and customers and can

identify problems, bottlenecks, and opportunities that a code writer would not. Mr. Case gave an example of a women who worked for a parts company and knew that many customers were getting the wrong part delivered. The customers didn't always know the name of the part or its catalog number. So, she talked to a tech friend and they created a new inventory recognition system that allowed customers to send in a picture of what they wanted. The system would identify the part and provide the name and number to fulfillment employees. This is an example of how people in the field can see problems long before people 1000 miles away can.

3. **Venture capital will move closer to the companies and industries where they are focusing.** Currently about 75% of all venture capital funding goes to California, New York, and Massachusetts. Internet entrepreneurs in the third wave are more likely to be found in Des Moines if they are working on agriculture or Tulsa if working on energy. This may also cut the cost of new companies with lower cost of living. It also means more industry experienced people will talk through problems they are trying to fix.

4. **Partnerships will become a bigger phenomenon**. The partnerships can combine large companies and small ones. It may include large companies that are in danger of being disrupted by new technology and want to stay in front of that trend. **It adds more credibility** when instead of saying, "Seth Smith has a new business that will change how doctors diagnose cancer" the story becomes "Humana and Met Life have joined Seth Smith in rolling out a new cancer diagnosis program." **The Partners can also bring more expertise** in understanding the market as well as simply running a business and providing back office support. Mr. Case does not think there will be as many 2-3 man-shops creating an app in the third wave because the scope will be too large and too many barriers to market will exist. He cited Apple rolling out the iTunes store as an example. Apple disrupted how music was sold, but it created partnerships with participants in the music industry first like Warner Brothers to gain scale and product. Even the tech may be outsourced to a large degree as the ideas around the product and getting market acceptance will be more important than the actual coding.

5. **Policy will become a bigger issue. Government and industry will need to be on board early on.** This will likely also gain help from partnerships as larger companies may have experienced people and legal teams to navigate this area. Some of the disruption will impact areas government operates too – think of Uber being denied the ability to operate in Austin, TX because the cab companies pay the city for operating licenses and Uber did not. Industry experience will play a role here too as people with a history

of the issues will know what failed and what has worked in the past and understand the current parameters government has in place.

6. **Perseverance will be needed. There will be fewer overnight successes and it may require pushing a team of several dozen people forward in many directions** to handle concerns from suppliers, government, customers, and partners. The second wave meant creating software to sell movie tickets online. The third wave will mean using the Internet to allow one trained nurse to oversee thirty inexperienced people handling more routine issues such as drawing blood or changing dressings on wounds. This is also where the expertise in industry, credible partners, deeper pockets, and knowledge of the laws will also come into play.

7. **Gate Keepers will need to be overcome such as government rules and administrative people** who won't know how to classify employees at a joint venture. Wall Street will also have to be overcome. Projects that take years to develop and implement do not fit into analysts' models and they don't fit into executive pay formulas. School districts make decisions on what goes into a classroom, not an individual teacher or principal.

8. **Obstacles will be bigger than computer hardware and software in the second wave.** Logistics will need to be worked out, entrenched players will resist, laws may need to be rewritten, new training will be required, how to classify outsourced employees, barriers to market will exist such as how to deal with taxi-cab licenses vs. Uber. Think about replacing the current school system, federal money allocation, and tenure. There will be much more to overcome than "how do we get the local newspaper online?"

9. **More reinvention within companies will need to continually happen. Disruption will come quicker to companies and hit many more that were thought immune to technology changes**. Jobs will be lost, but many new ones will be created, and the world has gone through this many times. ATMs at banks eliminated many bank teller jobs. However, new ones emerged, and banks now employ more people than before with more skills. Mr. Case thinks we will see more companies develop internal groups to look for new start-ups to partner with and always be looking at creative destruction within the firm. More long-term thinking will be necessary in his view. For example, Apple introduced the iPad and that cut into MacBook sales. The iPhone wiped out the iPod. New markets may be bigger and with longer lives than what they are replacing.

10. **The product won't be an app. There will be much more team work from people with very different skill-sets**. The product will be fixing greater issues and moving full systems to the Internet. The time to market and the payback ROI will likely be much longer but may be greater overall than the 2nd wave apps.

We believe Mr. Case is painting a picture that the Third Wave will be much more like the first wave and will likely require heavy infrastructure investment. That means more fiber to carry more data at higher speeds. It may mean more electronics in roads and bridges. It could mean more satellites and greater demands on security. With his view of things taking longer to come to market, he's also painting a picture more of a pipeline operating model – spend years building a new system and paying for it all that time without generating a dime until it finally turns on and capital spending goes to basically zero. That could create some bigger changes in cash flow at many companies if that level of investment is chased.

Clorox (CLX) Review

Clorox (CLX) topped EPS estimates in the 3/18 quarter, posting $1.37 versus the Zack's consensus of $1.30. However, we note several items of concern with the quarter:

- CLX is trying to push through price increases to counter rising costs. While the company may have more pricing power than some of the other consumer packaged goods companies, we are concerned it may have difficulty getting higher prices pushed through. Higher promotional spending (increased couponing and point of sale promotions) more than offset the benefit of raising prices in the 3/18 quarter.

- The timing of advertising spending added about $0.09 to the quarter. CLX is planning not only to raise prices, but also introduce more higher margin, value-added products. This should result in pressure to spend more on advertising in upcoming quarters. Easy comparisons on advertising spending end after the 6/18 quarter.

- Lower research and development expense added about $0.02. Like advertising, this expense will likely be increasing above recent trends. Comparisons will be difficult starting in the next quarter.

- Gross margin is eroding as higher raw materials and transportation costs are outrunning the ability to cut other costs and raise prices.

- We do note that CLX does not report the massive, ongoing charges that many of its consumer products peers do.

CLX Seems Confident It Can Push Through Pricing- Maybe Too Confident

As we have seen in our recent reviews of PG, KMB and CL, consumer packaged goods companies are having a very difficult time pushing through price increases in the current retail environment. Meanwhile, they are all besieged by rising raw materials costs and skyrocketing transportation costs resulting from increased trucking rates. CLX is facing a similar cost situation but has begun to raise prices in certain areas including wipes and cat litter. It is also seeking to grow in higher-margin product areas. In addition, management points out that it faces private label competition in only 3 of its 9 product categories. Despite

this, the price increases are not showing up as improvement to results. The following table shows a breakdown of recent growth rates by segment:

	03/31/2018	12/31/2017	9/30/2017	6/30/2017
Cleaning (34% of sales)				
Volume Growth	4%	2%	5%	4%
Pricing/Mix/Promotion	-1%	-1%	0%	-2%
Total	3%	1%	5%	2%
Household (32% of sales)				
Volume Growth	3%	0%	7%	5%
Pricing/Mix/Promotion	-2%	-3%	-2%	-1%
Total	1%	-3%	5%	4%
Lifestyle (17% of sales)				
Volume Growth	0%	3%	2%	-1%
Pricing/Mix/Promotion	2%	0%	2%	3%
Total	2%	3%	4%	2%
International (17% of sales)				
Volume Growth	3%	0%	-2%	1%
Pricing/Mix/Promotion	1%	4%	3%	4%
Total	4%	4%	1%	5%
Total				
Volume Growth	3%	1%	4%	3%
Pricing/Mix/Promotion	0%	0%	0%	0%
Total	3%	1%	4%	3%

We can see that the company has managed to sustain a positive volume growth over the last several quarters without slashing prices- something the personal care companies have been unable to do. However, recent price increases on many products have been overshadowed by increased promotional spending. (Note that promotional spending such as coupons are recorded as a reduction of revenue rather than advertising expense.)

In the commentary on overall results for the quarter, management stated that a 1% increase in pricing was offset by negative mix. However, in individual segment commentaries on the cleaning and household segments which together account for over 60% of sales, increased

promotional spending was cited as an offset to price increases. Consider the following excerpts from the 10-Q:

Cleaning segment:

"'Volume outpaced net sales primarily due to unfavorable mix and higher trade promotion spending, partially offset by the benefit of price increases."

Household segment:

"Volume outpaced net sales primarily due to a price decrease on a portion of the Glad trash portfolio, unfavorable mix and higher trade promotion spending."

CLX disclosed details about its gross margin progression showing that a 50 bps improvement from price increases was more than offset by 60 bps in pressure from an increase in promotional spending. In other words, the average list price of its portfolio increased, but that was more than given away in the form of higher coupons and trade promotions. The next couple of quarters will be a key indicator of whether CLX will be able to raise net prices (after promotional impact) and have those increase stick. It is very important that they do take hold given the rapidly rising costs which have been crushing gross margin:

	03/31/2018	12/31/2017	9/30/2017	6/30/2017
Gross Margin	42.8%	43.0%	44.9%	45.7%

	3/31/2017	12/31/2016	9/30/2016	6/30/2016
Gross Margin	44.0%	44.7%	44.4%	45.4%

CLX's gross margin declined significantly in the quarter as 140 basis points in cost savings was no match for the 160 basis point increase in commodity costs and 130 basis points of higher logistics costs. Other consumer companies have cited shipping cost increases in the 20% range and we see little to cause that to let up in the next couple of quarters.

Timing Advertising Spending Adds 9 cps to Earnings

Advertising expense fell by 100 basis points in the quarter, as seen in the following table:

	03/31/2018	12/31/2017	9/30/2017	6/30/2017
Sales	$1,517	$1,416	$1,500	$1,647
Advertising Expense	$150	$140	$134	$182
% of sales	9.9%	9.9%	8.9%	11.1%

	3/31/2017	12/31/2016	9/30/2016	6/30/2016
Sales	$1,477	$1,406	$1,443	$1,600
Advertising Expense	$161	$128	$128	$192
% of sales	10.9%	9.1%	8.9%	12.0%

We estimate that this added about 9 cents to earnings in the period. Management indicated that this was a timing issue and not a change in advertising strategy and its long-term target of advertising expense of 10% of sales remains in place. While the 6/17 quarter saw an 11% spend rate, after that the easier comparisons end. In addition, the company's products are presumably less susceptible to substitutions due to the value they add above competitors' products. Trying to lead the market with price increase as well as its plans of introducing more valued-added, higher-margin products will require strong advertising spending to remind consumers of those advantages. Therefore, we would expect the company to have to raise its advertising above recent trend.

Lower R&D Added Another 2 cps

Research and development cost as a percentage of sales fell by 30 basis points during the quarter:

	03/31/2018	12/31/2017	9/30/2017	6/30/2017
Sales	$1,517	$1,416	$1,500	$1,647
R&D Expense	$32	$31	$32	$37
% of sales	2.1%	2.2%	2.1%	2.2%

	3/31/2017	12/31/2016	9/30/2016	6/30/2016
Sales	$1,477	$1,406	$1,443	$1,600
R&D Expense	$35	$32	$31	$42
% of sales	2.4%	2.3%	2.1%	2.6%

We estimate that this added another 2 cents per share to EPS in the quarter. Over the last five fiscal years, R&D expense as a percentage of sales has been in the 2.3%-2.4% range.

Similar to advertising expense, R&D spending is important to the company's plan of releasing higher margin products. If anything, we would expect to see R&D spending rise above the trend of the last five years. The next three quarters will face difficult comparisons at the R&D level as spending was lower during the year-ago periods.

Ocean Yield (OCY NO, OYIEF) 1Q Review

The Ocean Yield (OCY NO, OYIEF) story is still playing out as expected. Dividend growth is still happening but at a slower rate. It grew 3.0% y/y in 1Q. We expect dividend growth to be in the 2%-5% range based on growth in the fleet. The payout ratio was 87% of earnings in the 1Q18. Remember, depreciation is penalizing EPS by a considerable amount. Adding back that non-cash expense, the payout ratio on the dividend was 49% in 1Q. There were some transitional issues in the quarter such as some new ships were delivered in 1Q, they essentially came in the final couple of days, thus second quarter will see full periods of accretive results from some of the new ships that were on order in 4Q and early 1Q. Second, the *Lewek Connector* was in dry dock and then moving to its new job in 1Q, so it had minimal impact on 1Q results. In 2Q and 3Q, we would expect the dividend payout ratio of earnings and earnings + depreciation to both decline.

The *Lewek Connector* is now getting higher rates than in 2017 on a contract that runs until late August with a 72-day extension option. Ocean Yield is seeing stronger demand for the vessel for future work as well. It is currently working to lay cable for an offshore wind project. As a construction support vessel, the connector should benefit from renewed offshore drilling as well. Diamond Offshore noted it sees more prominent signs of recovery for moored rigs and pricing on contracts there is rising. It still believes deep-water drill ships have problems, but the utilization rates and pricing should be close to the bottom at this point. It still sees too much supply of rigs in the floating market – but demand is turning up. Higher demand in any of these areas should help boost business opportunities for the *Connector* to lay cable and support lines. The 2Q18 will see higher revenue and EBITDA from the *Connector* and some of the new tankers and dry bulk ships entering the fleet.

The FPSO – *Dhirubhai-1* continues to operate on its contract that expires in September. Ocean Yield is giving a low probability to the 130-day extension option being picked up by Reliance. The reasons are two-fold – if they keep production going at the current field, they will want to do it for more than 130 days, so they would rather have a longer charter at a lower rate. The field does have a longer life than through September. Also, the new field being opened in the area by Reliance and BP will use an FPSO and *Dhirubhai-1* meets the

feasibility tests already done. That gives the vessel two chances at a new charter with the current clients or having them buy the vessel for $255 million. On the conference call Ocean Yield CEO Lars Solbakken noted:

> *"We expect [Reliance to] continue the operation on the MA field (where the FPSO is working now). We are bound by confidentiality clauses in the agreement in order to that it's very limited [on what] we can comment on our dialog with Reliance. I still think there are reasons to be positive with respect to continued production, but we don't expect any news flow before/after the summer."*
>
> *"With respect to the MJ field (new project) there has been different request for interest from Reliance. First before Christmas, there was a request for an episode with long-term charter. Then there was a request for basically conversion of the vessel with sale to Reliance. We are all on the same spec as a conversation of Dhirubhai. We don't expect any news flow there before more into Q4. We don't exactly know when they will make the final investment decision but more towards the end of the year. So, we expect more news on the extension [of the current field] before MJ [the new field.]"*

Clearly, they are talking with Reliance and a new charter on the current field or a purchase of the vessel to operate the new field seems to be where this is heading. It also appears likely that this ship will have lower EBITDA after September 2018 through a reduced charter fee or having it purchased and needing to redeploy the cash into new vessels.

We were hoping to hear a more finalized plan on the FPSO in this quarter rather than in 3Q. The basic issue is Ocean Yield generates about $90 million per quarter in EBITDA, which is growing with the Connector working and the 12 new ships coming online over the next year. The cash needs are $18 million for interest expense and $30 million in dividends paid along with scheduled debt maturities. Doing some rough math – the EBITDA should be moving closer to $100 million and interest expense closer to about $22 million.

On the negative side, the FPSO is just under $30 million of the EBITDA, which is a material amount of total cash flow. Ocean Yield has been aggressively paying down the debt on the FPSO so the net cash from that vessel has been much less than $30 million in many periods:

	2016	2017
Total EBITDA	$291.30	$340.70
FPSO EBITDA	$114.50	$115.90
FPSO Interest	$4.90	$1.90
FPSO other Fin Exp	$2.40	$2.20
FPSO debt payment	$67.60	$79.90
Net Cash from FPSO	$39.60	$31.90

So, for the last two years, the FPSO was generating about $8-$10 million per quarter in cash flow. Right now it only has $20 million in debt so interest expense is essentially gone and the debt payment will only be $20 million in 2018 versus about $75 million in the last two years. So, Ocean Yield will essentially collect about $83 million and let's say pay out $22 million through September. That means the FPSO will produce about $50 million in cash for the first 9 months of the year vs. $30-$40 million for each of the last two years. Therefore, there will be more cash build this year than in prior years. It also means that as long as Ocean Yield can charter the vessel for $8.5 million per quarter vs. the current $28.5 million per quarter, the net cash flow production will be the same as what they were getting before. If they charter it for a rate above $8.5 million, net cash flow should increase on the FPSO. If the vessel is sold for $255 million, Ocean Yield can use that to buy more ships and generate cash flow. In the meantime, the cash cushion could sustain the $10 million per quarter the FPSO was producing for a long time to protect the dividend.

Ocean Yield committed to its dividend in the press release, in the presentation, and in the conference call:

Lars Solbakken on 1Q18 call:

> *"We also intend to continue to pay attractive and stable dividends going forward. I think it's important for us to have stability in the dividend payments even if there should be some fluctuations in earnings. We will have strong focus and stability of dividends."*

From the 1Q18 Press Release on Outlook:

> *"The Company has continued to expand and diversify its fleet of vessels on long-term charter in order to further increase the Company's earnings and dividend capacity."*

From the 1Q18 Presentation Deck:

OUTLOOK

- **Ambition to continue to expand the portfolio of vessels**
  - Market conditions for new transactions viewed as positive
  - Substantial investment capacity following recent equity issue
  - Access to competitive funding from banks
- **Intends to continue policy of paying attractive quarterly dividends**
- **Key focus**
  - Continued fleet growth
  - Secure a positive outcome for Dhirubhai-1

Further supporting the dividend at this point is the cash and liquidity at Ocean Yield. We noted that it appears to be generating more free cash from the FPSO in 2018 of at least $10 million after paying off the last $20 million in debt. Cash flow for the year should be a minimum of $350 million (assuming a worst case zero for the FPSO for 4Q.)

There is $124 million in cash already on hand plus $49 million in investment cash currently in some bonds listed for sale, and $45 million in liquidity on its credit line. Altogether, that is $219 million in liquidity for Ocean Yield. Add that to the $350 million in cash flow and there is $569 million in cash available.

The company will need to pay $18 million more on the new ships over the next 12 months. The interest expense should be about $75 million. The debt due in 2018 is $109 million, which includes the $20 million on the FPSO. Of the $109 million, $18 million was already paid in 1Q18. The dividend is essentially $125 million also (assuming some modest growth). So that is about $309 million in cash commitments against $350 million in EBITDA and $569 of cash flow and liquidity. As of March 31,2018, the amount of debt due in one year is now $206.5 million (including the $20 million on the FPSO), which indicates to us that that 1Q19 has some scheduled maturities of over $100 million.

It appears to us that getting the FPSO resolved takes care of all the issues – either they have a future cash flow stream or they receive a sizeable amount of new cash. Even if the FPSO is generating no revenues/cash flow in 4Q18 as we assumed in these numbers, they

can certainly handle the 1Q19 debt payments and can be looking to remarket the FPSO at a lower charter rate if the options with Reliance do not come to fruition.

Macquarie Infrastructure (MIC) 3/18 Quarter Review

Macquarie Infrastructure reported its 3/18 quarter last week. We note the following highlights:

- Proportionally combined EBITDA was roughly flat with last year. Management maintained its outlook for 2018 EBITDA to be roughly in-line with last year as growth at Atlantic Aviation, Contracted Power and likely MIC Hawaii will offset declines at IMTT from lost contracted capacity.

- Management offered more color and clarification on the lost contracts at IMTT. About 17 million barrels (40% of total capacity) of IMTT's capacity was in heavy and residual oils. The lost contracts amounted to about 3.5 million barrels in 2018. The company is now in the process of repurposing 3 million barrels of capacity to other uses at a cost of $35 million. The remainder of the $225 million in spending referenced in the fourth quarter conference call is actually related to investments in infrastructure and the expansion and repositioning at its current facilities to focus on more profitable and higher growth areas.

- Management will be cutting back on growth capital deployment to $300 million in 2018 from its previous guidance of $350 million. While somewhat disappointing, we view this as management wishing to focus time and resources on the repositioning at IMTT.

- The company is still considering the sale of part or all of its BEC energy complex to shore up its balance sheet and fund growth internally.

- Atlantic Aviation posted stronger than anticipated results despite one of its major airports undergoing construction. Contracted Power also benefitted from colder weather and better conditions for wind and solar. BEC II remains on track to begin producing EBITDA in 2018.

- MIC Hawaii underperformed due to higher costs and disappointing growth at its contracting business. Nevertheless, the HPUC rate case offers a good chance for a boost to results.

- In addition to shareholder lawsuits, the company faces a proxy fight led by Moab Capital to replace the board in the upcoming annual meeting.

- While management seemed to indicate the dividend of $1.00 per quarter will hold for 2018, we believe cash flow and likely the dividend will resume growth in the 2019-2020 time frame as capacity at IMTT is brought back on line under higher value, higher growth contracts.

IMTT Results

IMTT's EBITDA was down 6% compared to last year due to the previously disclosed loss of heavy oil contracts at its Louisiana facilities coupled with higher repair and maintenance expense. EBITDA for 2018 is forecast to be down about 11% from last year. This is expected to essentially be offset by increases at Atlantic Aviation, Contracted Power and MIC Hawaii.

Management added more color to the lost contracts. It disclosed the following breakdown of IMTT capacity by product:

	mm barrels
Chemicals	7.7
Vegetable and Tropical Oils	2.5
Gasoline	4.7
Distillates	10.5
Heavy and Residual Oil	17.3
Crude	0.8

Heavy and residual oil totals 39% of total capacity. The bulk of this resides in its Lower Mississippi locations with its Bayonne, New Jersey facility housing mostly gasoline and distillates. Management explained that during the fourth quarter it was notified that 1.6 million barrels of heavy oil capacity leased by traders was not being renewed. It explained that also during the quarter, it had conversations with other customers leading it to believe that 1 million of those barrels would be re-contracted which did happen in January. The resulting 600k barrel net loss was not considered material at the time of the third quarter conference call. However, in December, the company was notified that another 1.8 million

barrels was not being renewed for 2018 and 1.6 million was not being renewed after December 2018. This unexpected loss in capacity is what led to the decision to cut the dividend and the eventual stock price decline.

The company also offered the following explanation for the departure of these customers:

> *"It is accurate that the majority of the counterparties who did not renew their contracts were mainly commodity traders, not system players. Commodity traders exited the market as a consequence of a backwardation in heavy and residual oils. We believe heavy and residual oils are in backwardation in part as a result of the uncertainty surrounding the implementation of new regulations related to low sulfur fuel oil in 2020."*

The company had earlier stated that it would spend $75 million a year over three years to "repurpose and reposition" assets at IMTT. However, it clarified on the first quarter call that not all of this was related to the lost capacity. Rather, it is only repurposing 3 million barrels of heavy oil capacity at a cost of $35 million with $15 million of that to be spent in 2018. Note that it has already contracted 500k barrels of the 1.3 million barrels in capacity it is currently repurposing. The remainder of the $225 million will be spent building infrastructure such as truck, marine, pipeline and rail capacity. In addition, it will reposition its existing facilities to expand and diversify its product storage capabilities to higher growth areas such as chemicals, vegetable and tropical oils. These products produce higher revenue per barrel and are less exposed to commodity traders not, to mention having a better growth outlook.

While capacity utilization is expected to fall to the mid-80% range in 2018, MIC should gradually re-contract the capacity and put it back on line over the next two years with the hopes of being back in the low 90% range around 2020. While the contract losses were admittedly an unexpected setback, MIC should emerge over the next two years in a better position to grow.

On a side note, IMTT sold its OMI spill response business in April. This division has been very volatile in the past and its removal should help make results more predictable going forward.

Atlantic Aviation

Atlantic performed above expectations as same-location gross profit rose by over 5%. General aviation activity in the US rose by 2.2%, but airports where Atlantic operates only rose by 0.7% due to runway construction and temporary flight restrictions at one of its key locations, Santa Monica Municipal Airport. This was offset by higher hangar rentals, deicing activity, ancillary services and an increase in fuel gross margin.

Contracted Power

Contracted Power also posted better than expected results with revenues and EBITDA up 25-26%. The outperformance was driven by the colder weather as well as strong results in renewables also driven by beneficial wind and weather conditions.

Construction at BEC II was completed in February, generators have been test-fired, and integration into the grid currently in progress. As noted above, all or part of the BEC complex is being considered for sale to shore up the company's balance sheet. Regardless, the project looks to be on schedule to begin generating EBITDA this year which will help offset the decline from lost capacity at IMTT.

MIC Hawaii

MIC Hawaii was an area of underperformance due to disappointing results at its design-build contractor, lower margins at its non-utility business and higher transmission and distribution costs. However, the rate case with the Hawaii Public Utility Commission is still expected to be decided by the middle of 2018. A positive result could add an additional $15 million a year in annual revenues, most of which should fall to the bottom line.

Moab Petitioning for a Change to the Board

Whenever a company experiences a sudden, significant decline in its stock price, lawyers and activist shareholders can be expected to arrive on the scene shortly. MIC's case has been no exception. Moab Partners owned about 1% of MIC's outstanding shares prior to the decline. It has issued a public letter calling for MIC shareholders to vote out the current board at the May 16th annual meeting and engage it to create a new board with interests

more closely aligned with shareholders. Its complaints mostly center around whether management knew about and should have disclosed the lost contracts at the November 2 conference call or the November 28th investor dinner. It also criticizes the manager's compensation policy as not being in line with the interest of shareholders. Finally, it makes known its belief that the company should spin off its Atlantic Aviation business to shareholders. We have the following quick observations on these matters.:

It is very difficult to know who knew what when given the available information. Moab utilized company disclosures of average and ending capacity utilization rates during the quarter to "prove" that the capacity was empty prior to the conference call. However, the company contends that while 1.6 million barrels of contracted capacity was not renewed during the quarter, it was confident that 1 million of that was likely to be re-contracted and in fact was in January. The net 600,000 barrel loss was about 1.3% of capacity and the decision not to announce that as a subsequent event to the third quarter does not seem unreasonable, although we are sure the lawyers will go over all of this very carefully during all the shareholders lawsuits.

The simple fact that the manager compensation agreement is calculated off company market cap and it therefore would have hurt the fourth quarter base management fee for the stock price to have fallen before the end of the year seems circumstantial to us. We have noted before that the company is far away from being able to collect its performance incentive fee given the decline in the stock price during all of 2017. This was not a case of the company being able to collect an extra $150 million from qualifying for the incentive fee if the stock price remained above $60 for another couple of months. Instead, the manager might have arguably benefitted in the fourth quarter by closer to $5 million by the stock price declining after the quarter's end. We would also note that Moab misspoke when it said the management fee base included over $3 billion in debt rather than the corporate debt level of just $542 million.

It is also worth noting that MIC's manager, Macquarie Infrastructure Management, has a huge position in the company and has chosen to take its management fee in stock. It also regularly buys additional shares and continued to do so both in February prior to announcing the lost contracts and in April after the stock price decline.

The proxy voting firm Glass Lewis has reportedly recommended investors vote for the current MIC board to remain in place at the May 16th annual meeting. However, its peer, ISS, has recommended a vote against the current board in a report that takes the same position as Moab (and according the MIC management, makes some of the same mistakes.) Were it not for this, we would consider the whole issue just noise. Given Macquarie

Infrastructure Management's and specifically MIC management's track record of producing strong, growing and diversified cash flows for investors over time as well as the growth outlook for the company post 2019-2020, we are hopeful that the current structure will be left in place.

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