Applied Investment Management (AIM) Program

AIM Class of 2018 Equity Fund Reports
Fall 2017

Date: Friday, October 6th | ***Time:*** *2:30 – 3:30* p.m. | ***Location: Straz Hall, Room 106***

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These student presentations are an important element of the applied learning experience in the AIM program. The students conduct fundamental equity research and present their recommendations in written and oral format – with the goal of adding their stock to the AIM Equity Fund. Your comments and advice add considerably to their educational experience and is greatly appreciated. Each student will spend about 5-7 minutes presenting their formal recommendation, which is then followed by about 8-10 minutes of Q & A.

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Portola Pharmaceuticals, Inc. (PTLA)
October 6, 2017

Tim Donovan — Domestic Healthcare

Portola Pharmaceuticals, Inc. (PTLA) engages in the development and commercialization of unique therapeutics designed to treat thrombosis and other hematologic disorders. Its product portfolio includes Betrixaban, an FDA approved novel oral once-daily inhibitor of Factor Xa (fXa) designed to treat a form of thrombosis referred to as venous thromboembolism (VTE). PTLA's product pipeline includes Andexanet alfa, a clinical stage 4 drug designed to reverse the effects of fXa inhibitors, and Cerdulatinib, a clinical stage 2 oral kinase inhibitor that prevents spleen tyrosine kinase and janus kinases. The company derives 100% of its revenues within the U.S. It was founded on September 2, 2003 and is headquartered in South San Francisco, CA.

Price ($):	$ 54.17	Beta:	1.50	FY: Mar	2016A	2017E	2018E	2019E
Price Target ($):	$ 75.27	M-Term Rev. Gr Rate Est:	100.0%	Revenue (Mil)	35,504.00	44,380.00	272,937.00	545,874.00
52WK H-L ($):	15.68-67.10	M-Term EPS Gr Rate Est:	365.9%	% Growth	194.2%	25.0%	515.0%	100.0%
Market Cap (mil):	3,476	Debt/Equity (ntm):	98.90%	Oper Inc	-269594.84	-306864.90	-68455.85	182359.75
Insider Holdings	1.99%	Debt/Assets (ntm):	33.28%	% Growth	-18.67%	-13.82%	77.69%	366.39%
Avg. Daily Vol (mil):	1.0	WACC	11.73%	Op Margin	-759.34%	-691.45%	-25.08%	33.41%
Yield (%):	0.00%	ROA (%):	-	EPS	-4.75	-4.78	-1.07	2.84
ESG Rating	-	ROE (%):	-	P/E (FY)	-12.78x	-11.78x	-55.52x	21.91x
		ROIC (%):	-	EV/EBITDA	-12.89x	-11.79x	-55.59x	21.90x

Recommendation

Portola Pharmaceuticals strives to be a leader in the development and commercialization of novel drug treatments for deep vein thrombosis and venous thromboembolism. Deep vein thrombosis (DVT) is a disorder caused by overactive Factor Xa (fXa) enzymes which results in the coagulation of blood in deep veins most often in the legs. Portola's FDA approved product Betrixaban is a fXa inhibitor, preventing the clotting of blood in the veins. PTLA's orphan drug, Andexanta alfa, is in the final stages of FDA approval, and upon approval will be the first treatment designed to reverse fXa inhibitors. In 2015 80,000 patients were admitted to hospitals due to severe bleeding caused by fXa inhibitors. With no current reversal for fXa enzyme blockage, Andexanta alfa will control all the estimated $2.0 billion worldwide market upon FDA approval. By spending the next two years focusing on the development of a strong sales division and drug manufacturing process, management has outlined the commercialization plan for Betrixaban and ultimately Andexanta alfa to address the estimated $5-6 billion combined market. Beyond the market potential, Portola will have the opportunity to reduce the number of lives lost every year to DVT. Due to a significant potential for the commercialization of two novel DVT related drugs, it is recommended that Portola Pharmaceuticals, Inc be added to the AIM Small Cap portfolio at a target price of $74.77 representing a 38.39% upside. The company does not currently pay a dividend.

Investment Thesis

- **The unaddressed, addressable market.** In 2016, 22.5 million people in the G7 countries required VTE prophylaxis for acute medical illness. The current treatment, enoxaparin, is an injectable low molecular weight heparin has a duration of 6-11 days, while many patients experience asymptomatic VTE, stokes, or even death beyond the 2-week window. Betrixaban is the first treatment approved for over 14 days, and has a recommended once-daily dose for 35 days. The current market for enoxaparin is $2.9 billion, with $1.4 billion derived from acute medically ill patients. PTLA has estimated an addressable market for Betrixaban to be $3-$4 billion by 2020.

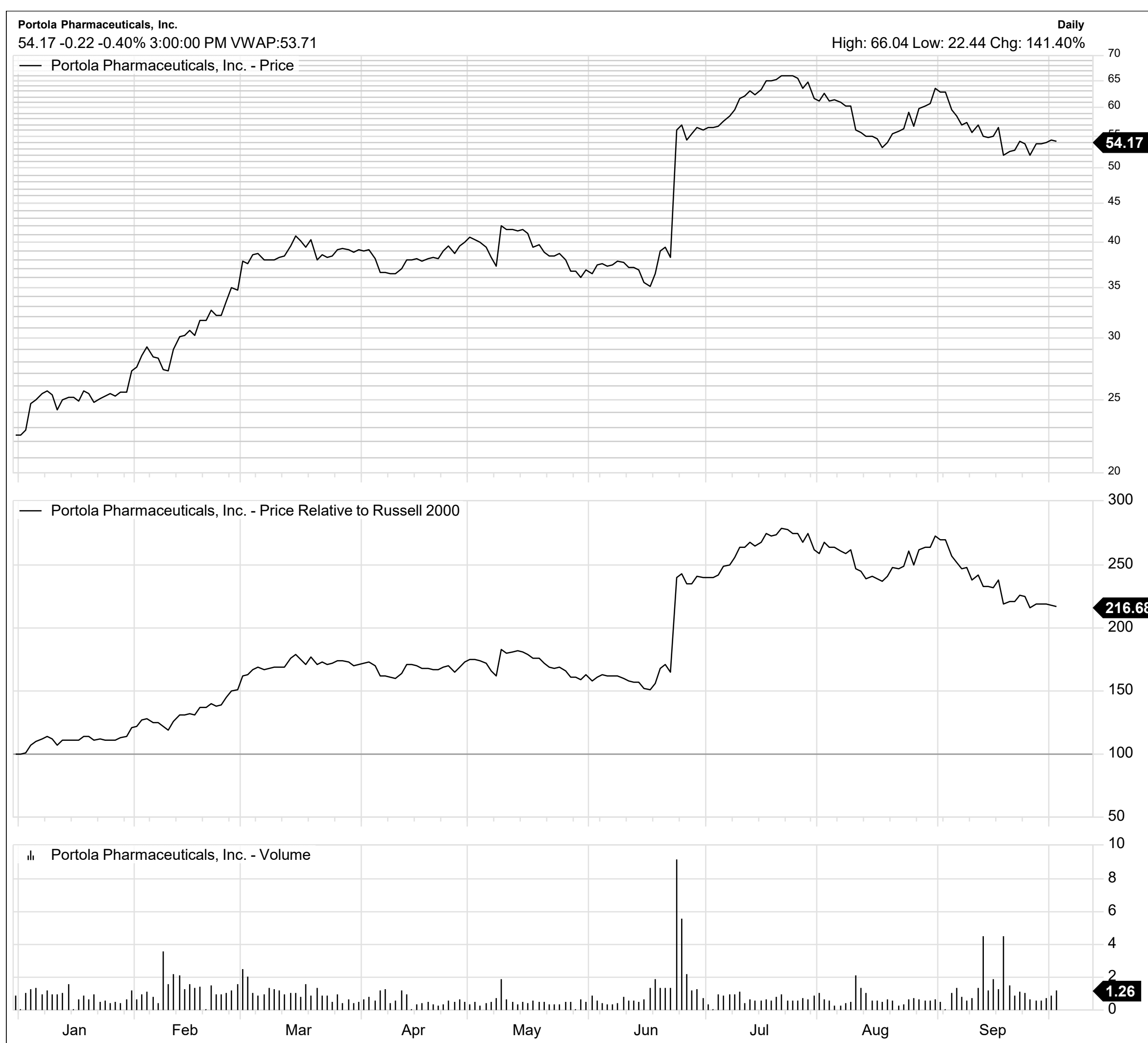
- **Full steam ahead.** Based on industry data, PTLA estimates between 23 million and 36 million patients will receive fXa treatment for VTE. Of these patients 1-4% will experience major bleeding along with an additional 1% in need of emergency surgery. Phase 4 candidate Andexanet alfa, which received orphan drug accreditation by the FDA, is designed to reverse the effects of fXa inhibitors. Having recently resubmitted its Biologics License Application (BLA), Andexanet alfa is in the final stages of approval, with drugs seeing an average approval rating of 85.3% from the BLA process according to the Biotechnology Innovation Organization (BIO) Clinical Development Success Rates report.
- **The aging of America.** Deep vein thrombosis is a disorder that effects an estimated 900,000 Americans each year with the majority of cases occurring in individuals above 40 years old. While the number of people entering this age bracket is increasing, the number of people leaving the group is declining. As life expectancy is stretched beyond what humanity has ever seen, the number of cases of DVT and VTE will become more of an issue. With a unique treatment to these disorders PTLA will have an opportunity to capture a significant share of a growing market.

Valuation
In order to reach an intrinsic value for PTLA a 5-year DCF model and a relative valuation model were constructed. Using a WACC of 11.73% and a terminal growth rate of 2.50% a value of $74.10 was reached. A relative valuation model was constructed using a comparable FY2 EV/Sales multiple of 18.39x and a FY2 Price/Sales multiple of 18.67x. These two valuations resulted in intrinsic values of $78.57 and $77.37 respectively. Weighting the DCF 75% and the two relative valuations 25% combined an intrinsic value of $75.27 was reached, representing a 38.94% upside.

Risks

- **Making it is one thing, selling it is another.** Having spent the last decade in the development stage of the pharmaceuticals business, PTLA is now experiencing its first run with an approved product. With the goal of a 100-150 employee sales force, PTLA is forced to dedicate time and energy towards developing a strong sales force in order to introduce their product to the market. Without successfully launching a full-scale sales force PTLA will be unable to satisfy the needs of their addressable market.
- **Phase 4 is no guarantee.** A sizable portion of projected revenues rely on the FDA approval of Andexanet alfa. If the prospective drug is denied approval, or requires a longer approval process, the revenue loss and costs associated with further testing will greatly hinder PTLA's ability to generate sustainable top line growth going forward.
- **A whole new world.** Historically PTLA is a company focused on research and development of novel pharmaceuticals. Contingent on the approval of Andexantet alfa PTLA will have two FDA approved products and must make the transition from a development company to a manufacturing and sales company. If PTLA is unable to make this transition the revenues from their new products will be adversely affected.

Management
William Lis has served as the Chief Executive Officer and Director of Portola Pharmaceuticals since 2008, and currently sits on the Board of Directors of the Biotechnology Innovation Organization. He was previously employed as VP-Business development of Scios, Inc, as well as Marketing Director of Millennium Pharmaceuticals, Inc. Mr. Lis is accompanied by Mardi Dier, the Chief Financial Officer, as well as John Curnutte, MD, PhD as the Executive Vice President of Research and Development.



Peer Fundamentals

Name	Ticker	Revenue	R&D Expense	EBITDA	Debt/Equity	NOI
Portola Pharmaceuticals, Inc.	PTLA	31.9	223.20	-251.00	98.90%	-258.1
Sarepta Therapeutics	SRPT	56.8	192.00	-232.40	0.0%	-124.2
Ligand Pharmaceuticals	LGND	117.1	25.80	59.90	6.3%	9.1
Nektar Therapeutics	NKTR	133.1	223.50	-154.10	10256.6%	-209.2
Amicus Therapeutics	FOLD	16.3	119.40	-180.40	59.6%	-208.4
Peer Averages		**80.8**	**140.18**	**-126.75**	**41.2%**	**-81.08**

Peer Valuation

Name	Ticker	Market Cap (mil)	Price/Sales FY2	Sales/Share FY2	EV/Sales FY2	EPS (NTM)
Portola Pharmaceuticals, Inc.	PTLA	3,467.2	12.70x	4.25x	12.20x	-2.4%
Sarepta Therapeutics	SRPT	3,163.9	11.39x	4.32x	10.27x	-1.6%
Ligand Pharmaceuticals	LGND	2,869.6	16.34x	8.39x	15.80x	3.6%
Nektar Therapeutics	NKTR	3,830.0	19.20x	1.28x	20.05x	-1.0%
Amicus Therapeutics	FOLD	2,447.1	27.75x	0.54x	27.43x	-1.1%
Peer Averages		**3,077.7**	**18.67x**	**3.63x**	**18.39x**	**-1.510%**

Natural Gas Services Group Inc. (NGS)
October 6, 2017

William Reckamp Domestic Energy

Natural Gas Services Group (NYSE: NGS) is a primary midstream rental provider of small to medium horsepower natural gas compressors. The company rents, manufactures, and provides maintenance work for these compressors. The company operates in three segments: Gas Compressor Rental (71% of 2017 Q2 revenue), Engineered Equipment Sales (27%), and Service and Maintenance (2%). Their machinery is largely used to enhance wellhead production in non-traditional natural gas and oil regions in the United States. In addition, the equipment sales segment fabricates various other energy machinery products such as flare stacks and control devices for onshore natural gas drilling. NGS was founded on December 17, 1998 and is headquarters in Midland, TX.

Price ($): 10/02/2017	$28.95	Beta:	1.69	FY: Dec	2015	2016	2017E	2018E
Limit Buy Order	$26.00	WACC	13.99%	Revenue (Thou.)	95,919	71,654	72,573	84,834
Price Target ($):	$31.03	M-Term Rev. Gr Rate Est:	9.95%	% Growth	-1.1%	-25.3%	1.3%	16.9%
52WK H-L ($):	$34.50-$20.65	M-Term EBIT Gr Rate Est:	29.12%	Profit per Compressor (mil)	6.56	6.30	5.82	6.51
Market Cap (mil):	364	Debt/Assets (ttm)	0.00	# of Compressors Rented	1,818	1,440	1,262	1,612
Short Interest (%):	1.2%	Yield (%):	0.00	% Growth	-17%	-21%	-12%	14%
Avg. Daily Vol (Thou)	32.10	ROA (%):	1.13%	Henry Hub Spot Price (mil BTU)	2.28	3.00	3.32*	3.51*
ESG Rating	BBB	ROE (%):	1.42%	EPS (GAAP)	$0.79	$0.50	$0.48	$0.62
		ROIC (%):	1.38%	Pretax Margin	15.9%	11.8%	5.3%	11.2%

*U.S. Energy Information Administration Short-Term Outlook, September 2017

Recommendation

Since the drop in WTI oil prices, which went from $107 in 2014 to $26 per barrel in February of 2016, there has been a shift to a more stable environment with oil prices ranging from $42-$53 during the past 18 months. Henry Hub natural gas prices have seen a range of $1.92-$3.59 per million British Thermal Units (btu) during this period. Management and the U.S. Energy Information Administration (EIA) expect the Henry Hub natural gas price to increase substantially in the next 2-4 years. They see an increase in demand from the cost savings of natural gas versus oil - and its environmentally appealing features. The EIA believes production bottomed out in January 2017 and will increase 12% by the end of 2018. Overall the Henry Hub spot price is projected to increase nearly 20% on increased demand by the beginning of 2019. NGS's revenue base is heavily influenced by E&P company spending which is a function of commodity prices. During 2016, E&P budgets decreased 40%; however, there is now an anticipated increase of 32% over the next year according to Barclays. Many competitors felt the pressure from the price fall in 2016, while NGS was able to generate $28 million in free cash. This resiliency toward E&P spending cuts was caused due to a 55% gross margin which funneled down to a 11.8% pretax margin (with the competitors' average being negative). These positive margins will help create further FCF and protect NGS during any future downturns. In addition to producing small and medium horsepower compressors, NGS is planning on entering into the large horsepower market. Management is hoping that already existing clients will be the main customers for the new product launch. With NGS's high margins, favorable commodity and E&P spending outlook, and product expansion, it is recommended that Natural Gas Services Group be added to the AIM Equity Fund with a price target of $31.03 representing a 19.33% upside. The firm does not pay a dividend.

Investment Thesis

- **Cash Stockpile.** NGS's rental model and above competitor average profit margins has allowed for $73 million of cash to accumulate on its balance sheet. Even during the double-digit declines of upstream capital expenditures in the past two years, NGS's 55% gross margins and virtually no debt, placed them well above the competitors' cash average of $15.25 million. This positions NGS to further strengthen its rental fleet as needed.

- **Boost in Backlog.** In 2015 and 2016, NGS had an order backlog of approximately $6 million and $4.1 million respectively. During the second quarter earnings call, analysts and shareholders were told that two large orders have pushed the backlog up to $25 million. These orders have caused the backlog to reach its highest point in over a decade. Management stated that these should be filled by the end of 2018, thus providing profitable visibility for the next 15 months – which should help protect against unforeseen commodity price declines.
- **Expanding Product Line Footprint.** NGS has planned to further diversify its product base by directing its capital expenditures toward both larger and smaller horsepower compression units. The emergence of pad drilling (the practice of drilling multiple wells into a single surface location) requires the use of larger compression units. Management hopes to step into this larger horsepower space to capitalize on the newer pad drilling technique. Additionally, spending is also being directed toward smaller units to take advantage of the regulatory environment. Increased regulatory pressure has been placed on E&P companies to reduce wellhead vapor emissions. NGS' management has decided to further increase the small horsepower fleet to support customers with this rising regulatory issue.

Valuation

To reach an intrinsic value for NGS, a five year DCF model and comparable multiple approach models were employed. Using a terminal growth rate of 2.0% and a WACC of 13.99%, a DCF intrinsic value of $27.44 was reached. A sensitivity analysis of the WACC (12.22-14.22%) and perpetutity rate (1.5-2.5%) produced a range of $27.28-28.76. An EV/EBITDA and P/FCF multiple valuation was used with the following 2016 peer averages, 16.31x and 12.55x respectively. In order to calculate the EV/EBITDA intrinsic value, NGS's 2017 E EBITDA of $25.9 million was muliplied by the peer average (16.31x) to arrive at an intrinsic value of $38.64. The P/FCF value was calculated by multiplying the 2017 E free cash flow per share of $2.28 by the 12.55x peer average to reach a $28.57 valuation. Weighting the DCF, EV/EBITDA, and P/FCF 50/30/20% respectively, a final value of $31.03 was reached. Recently the stock has climbed 11% due to improving oil demand and expectations that producers will extend output cuts. It appears this will have a short term effect on the price and therefore a $26 limit buy order should be placed. The upside from the $26 limit buy order and price target of $31.03 is 19.33%.

Risks

- **Skilled Technician Retention.** NGS's business model is heavily supported by their technician personal and their ability to actively manage their products. They are specially trained to service both the gas compressors and the customized energy products. Furthermore, growth is dictated by the number of technicians available to monitor this equipment. A shortage of technicians will result in fewer rental contracts and will decrease NGS's operation growth.
- **Undiversified Customer Base.** Approximately 40% of NGS's revenue and 30% of their accounts receivable are derived from two exploration and production companies. No other customer accounts for more than 10% of their revenue. A failure to retain a contract or loss of one of these customers will have a detrimental effect on the company's financial condition.
- **Non-renewed Contracts.** Initial rental contracts range from 6-24 months. After expiration of the contracts customers typically rent on a month-by-month basis. Currently, 78% of NGS's contracts are on this monthly basis. Oil and natural gas prices are very volatile resulting from changes in OPEC decisions, economic and currency conditions etc. If any of these conditions affect E&P capital expenditures negatively there may be a significant decrease in monthly leases.

Management

Stephen C. Taylor has been Chairman, President & Chief Executive Officer of Natural Gas Service Group for 12 years. He received his undergraduate degree from Texas Tech and his MBA from the University of Texas. Taylor previously worked as Chief Operating Officer at Enventure Global Technology LLC. Before this, he was the Vice President-Operations at Halliburton Resource Management.

Source: FactSet

Peer Fundamentals

Name	Ticker	Revenue (mil)	ROA (%)	ROIC (%)	Debt/Assets (%)	5 yr Average Pretax Margin (%)
Natural Gas Services Group, Inc.	NGS	367	2	1	0	19
Flotek Industries, Inc.	FTK	267	0	-2	11	11
Matrix Service Company	MTRX	406	0	0	8	2
USA Compression Partners LP	USAC	1,030	1	2	49	-6
CSI Compressco LP	CCLP	185	-15	-1	65	-8
Archrock Inc.	AROC	891	-2	0	60	-5
Peer Averages		556	-3	0	39	2

Source: FactSet

Peer Valuation

Name	Ticker	Market Cap (mil)	EV/EBITDA	P/FCF	P/E
Natural Gas Services Group, Inc.	NGS	364	12	17	105
Flotek Industries, Inc.*	FTK	266	193	-	-
Matrix Service Company	MTRX	406	7	-	1,456
USA Compression Partners LP	USAC	1,030	49	25	123
CSI Compressco LP	CCLP	185	9	29	-
Archrock Inc.	AROC	891	9	9	41
Peer Weighted Averages		556	16	18.7	349

*Removed from valuation

Source: FactSet

Glaukos Corp (GKOS)
October 6, 2017

Jacob Schwister Domestic Healthcare

Glaukos Corp (NYSE:GKOS) is an ophthalmic medical technology company focused on the treatment of glaucoma, one of the leading causes of blindness. In 2012, GKOS commercialized iStent, the first Micro-Invasive Glaucoma Surgery (MIGS), which is safer and more effective than traditional incisional glaucoma surgery. GKOS has relied solely on the revenue growth of iStent, but currently they have five promising pipeline MIGS products in development that they hope to commercialize in the coming years. GKOS sells iStent through a direct sales model to end users consisting of hospitals and surgical centers. The company derives a majority of revenue from the United States (91.8%), with additional revenue from Germany (4.6%), Canada (2.0%), and Australia (1.6%). The company was founded in 1998, has 264 employees and is headquartered in San Clemente, CA.

Price ($): (10/3/2017)	33.48
Price Target ($):	39.21
52WK H-L ($):	52 - 28
Market Cap (mil):	1,119
Insider Holdings	10.9%
Shares Out (mil)	34.40
Avg. Daily Vol (mil):	0.703
Div Yield (%)	N/A
ESG	BBB

Beta:	1.00
WACC	9.5%
M-Term Rev. Gr Rate Est:	23.0%
M-Term EPS Gr Rate Est:	150.9%
Debt/Equity:	N/A
Debt/EBITDA (ttm):	N/A
ROA:	3.60%
ROE:	4.26%
ROIC:	4.24%

FY: Dec	2015	2016	2017E	2018E
Revenue (Mil)	71.70	114.40	158.11	186.57
% Growth	57.28%	59.55%	38.21%	18.00%
Operating Income	-10.01	4.85	-1.06	13.06
% Growth	N/A	N/A	N/A	N/A
Operating Margin	-0.14	0.04	-0.01	0.07
EPS *Adj.	($1.05)	$0.12	*$0.16	$0.24
P/S	6.02	10.93	7.31	6.20
EV/Sales	9.94	9.34	7.19	6.30

Recommendation

The Glaucoma treatment market is estimated to grow from $2.4B in 2013 to $3B by 2023. Glaucoma is one of the leading causes of blindness affecting 3M+ people in the US. For cases that reach the severity of surgery, GKOS is the go-to provider of leading edge technology. Their flagship product, iStent, is a micro-bypass stent measuring 1mm long and .33mm wide, which is the world's smallest medical implant. This implant was the first Micro-Invasive Glaucoma Surgery (MIGS) product designed to reduce intraocular pressures. Since 2012, GKOS has built a solid foundation in the market, and they are developing products to continue controlling the space. iStent is known in the market as the safest, most effective, and most durable treatment of surgical glaucoma. Building off of past success, iStent and iStent Inject (awaiting approval in 2H 2018) will provide significant revenue growth opportunities in the future. Both of these products have a safety and efficacy profile superior to CyPass, a competing MIGS product. In 2020 the company is hoping to pass iStent Supra/SA and iStent Infinite, with a combined TAM near 6M eyes. On September 15, 2017, GKOS released the highly awaited iDose Phase II clinical trial data. Both investors and the company were very pleased with the trial data (iDose is a hybrid MIGS product that is injected into the eye and delivers a continuous flow of medicine). iDose is designed to replace daily prescription eye drops treating mild glaucoma. It is noted that 10-25% of patients do not fill their second prescription of eye drops and around 50% of patients stop taking eye drops past the one-year mark. GKOS believes the iDose has the right setup to capture prescription eye drop users, which totals around 6M eyes. Although 2017 revenue guidance decreased due to short-term headwinds, development of the product pipeline is crucial to strong growth and the premium valuation. The headwinds could affect the stock price in the coming months, but across the board, the long-term play is favorable. Despite these concerns, GKOS' pipeline has the potential to drive both top and bottom-line growth well into the future. Their long-term profitability outlook is promising due to an increase of the TAM, proprietary technology, and experience in the market. For these reasons, it is recommended that Glaukos Corp be added to the AIM Equity Fund with a price target of $39.21, which represents a 17.13% upside.

Investment Thesis

- **Near-Term Pipeline Growth Prospects.** Since a successful launch of iStent in 2012, the first commercially available MIGS treatment, Glaukos has been strategically researching and developing five new products in its pipeline. The iStent Inject, which is expected to launch into the market in the 2H of 2018, has superior safety and a much easier delivery system compared to the competition. Inject is expected to accelerate revenue growth near the end of 2018. The company also recently announced Infinite, the newest product in the pipeline that will target the more severe glaucoma cases that iStent does not cover. It is estimated that about 425k glaucoma patients are categorized in the severe stage. Also, the company is developing iStent Supra and iStent SA, which also have competitive advantages and an addressable market near 1M patients.
- **Long-Term Focused.** With the recent developments in their pipeline, GKOS is shifting from strictly a MIGS device company to including the pharmaceutical aspect. iDose, a device that is injected into the eye, provides continuous delivery of medicine for extended periods of time. Although this product is not planned to be commercialized until 2022-2023, it will provide GKOS with a potential long-term driver later on. This will open up a plethora of new opportunities and treatable patients in the market.
- **Total Addressable Market Growth.** Glaucoma is one of the leading causes of blindness worldwide. In the United States, it is estimated that 1% of the population is living with primary open angle glaucoma (POAG). With the advancing pipeline, GKOS has a favorable chance of providing treatments to a majority of this market. The aging population 65 and older in the US and worldwide will provide long-term opportunities for GKOS to grow their product base and revenues. Those over the age of 65 are more prone to glaucoma; therefore, the demand for treatment should increase.

Valuation

To reach an intrinsic value for GKOS, a five-year DCF and EV/Sales multiple analysis was conducted. Using a terminal growth rate of 3.0%, a WACC of 9.5%, an intrinsic value of $37.93 was reached. A sensitivity analysis on the terminal growth rate and WACC ranged from $33.04 - $44.61. Additionally. An EV/Sales multiple was conducted using a peer average of 7.85x, which resulted in a valuation of $40.07. By weighing the two valuations 40/60, a price target of $39.21 was reached, resulting in a 17.13% upside.

Risks

- **Growing Competition.** Although GKOS has a strong position in the MIGS field, competition has started entering the market. One company in particular, Ivantis, has devleoped a product similar to the iStent. This product is in Phase IV clincal trials. GKOS has a broad range of patents that they strongly believe will protect their devices from an Ivantis launch. Also, Alcon's CyPass is slowly creeping into the market. These risks decreased managements' revenue guidance in the short-term and this could continue depending on how forceful the competitors enter the market.
- **Clinical and Regulatory Approval of Pipeline Products.** Any failure or delay in FDA product approval during clinical stages could have a significant effect on forward revenues and earnings. If a product does not pass FDA approval, the company could endure significant research and development expenses in order to resolve the issue.
- **Reimbursement.** The company recently ran into reimbursement troubles with insurance companies. These issues arose due to the increase in iStent prices. If these issues continue into the future, they could impact the top-line growth of GKOS.

Management

Glaukos Corp was founded in 1998 by Olav Bergheim, Richard Hill, and Mory Gharib. Thomas W. Burns is the CEO and President, and he has been with the company since 2001. Joseph Gilliam serves as the CFO & Senior VP of Corporate Development, and he began in 2017 and is one of the newest members of the management team.

Peer Valuation

Name	Ticker	Market Cap (mil)	P/S	P/E	EV/Sales (NTM)	P/B
Glaukos Corp	GKOS-US	1,137	8.10	--	6.24	9.03
Align Technology	ALGN-US	14,671	12.06	62.68	8.80	13.60
Inongen	INGN-US	1,987	9.44	75.50	6.59	9.56
Insulet	PODD-US	3,231	7.87	--	6.93	49.91
Nevro	NVRO-US	2,618	9.39	--	6.55	10.86
ABIOMED	ABMD-US	7,160	15.59	95.49	10.40	12.62
	Peer Averages	5,933	10.87	77.89	7.85	19.31

Source: Factset

Peer Fundamentals

Name	Ticker	Revenues (ttm) (mil)	ROE	ROA	Debt/Equity	Est 5-yr NI Growth
Glaukos Corp	GKOS-US	140	-1.0	-0.8	0.0	--
Align Technology	ALGN-US	1,239	23.9	17.0	0.0	166.4
Inongen	INGN-US	222	12.9	10.6	0.0	--
Insulet	PODD-US	410	-64.9	-8.3	526.6	47.4
Nevro	NVRO-US	228	-16.4	-9.6	58.8	--
ABIOMED	ABMD-US	475	16.2	14.2	2.8	731.7
	Peer Averages	515	-5.7	4.8	117.6	315.2

Source: Factset

City Office REIT, Inc. (CIO)
October 6, 2017

Mitchell Beine International Financial Services

City Office REIT (NYSE: CIO) is a real estate investment trust formed with the intent to acquire, own, and operate office properties primarily within the southern and western regions of the United States. The company's target investments are high-quality office properties in mid-sized metropolitan areas with strong economic fundamentals. CIO operates in one industry segment through commercial real estate and 100% of the company's revenues come from the properties located within the United States. CIO has 18 employees and was founded in 2013 with its headquarters located in Vancouver, Canada.

Price ($): (10/3/17)	13.77
Price Target ($):	16.77
52Wk H-L ($):	11.43 - 13.83
Market Cap (mil)	416.1
Short Interest (%):	1.32
Avg. Daily Vol:	121,388
Dividend ($):	0.94
Yield (%)	6.8
ESG Rating	N/A

Beta:	0.73
WACC	5.35%
M-Term FFO Gr Rate Est:	22.34%
M-Term FFO/Sh Gr Rate Est	-3.30%
Debt/Equity	1.46
ROA:	-0.15%
ROE:	-0.53%
FFO/Total Debt	8.22%
ROIC	-0.17%

FY: Dec	12/31/2015	12/31/2016	12/31/2017	12/31/2018
Revenues (thousands)	55,401	72,760	89,015	108,900
% Growth	32.18%	31.33%	21.70%	25.40%
FFO (thousands)	15,905	18,525	20,218	26,938
% Growth	76.00%	16.47%	9.14%	33.23%
FFO/Share	$1.27	$0.76	$0.66	$0.70
% Growth	72.6%	-40.2%	-12.9%	6.3%
P/FFO	9.6	17.3	12.3	14.1
EPS	-0.11	-0.21	-0.27	-0.33

Source: Factset

Recommendation

Despite its headquarters in Canada, City Office REIT derives all its revenues from the U.S. The firm has grown from 14 properties (3.3 million square feet) to 19, which includes 36 buildings and covers 4.4 million square feet. Their properties span across six different states: Arizona, Colorado, Florida, Idaho, Oregon, and Texas. CIO focuses on assets valued at $25-100 million with targeted cap rates, which are assets that the large-scale REITs often pass over. This gives CIO a competitive advantage in this area as there is generally less competition for assets in these secondary-markets. City Office REIT is presently under contract to close a large portfolio in San Diego. Once this is completed, the company will have over $1 billion in real estate assets. By continually adding to their commercial real estate portfolio, City Office REIT offers consistent growth in some of the most rapidly growing areas of the country. Population growth in the secondary markets that CIO is targeting is one of the main drivers behind the recommendation of this stock. The company also compares favorably to its competitors in both dividend yield and valuation (P/FFO ratio). City Office REIT's combination of high quality assets and tenants, prime opportunity for growth, and favorable valuation - compared to its peers - make it an appealing stock. As a result, it is recommended that CIO be added to the AIM International Fund with a target price of $16.77 representing 21.8% upside. The REIT pays an attractive dividend that yields 6.80%.

Investment Thesis

- **Position in Secondary Markets.** City Office REIT's smaller size provides it with a unique opportunity – it can target markets of lesser size, protecting it from falling prey to larger institutional investors. These secondary markets, scattered throughout the western and southern United States, are also rapidly growing in population. Projected growth from 2017 to 2022 in each of CIO's cities ranges from 5.5% to 8.3%, while the national average is under 4.0%. Not surprisingly, projected job growth is above the national average as well in each of these cities. By focusing on markets that are growing rapidly with strong economic fundamentals and demographics, CIO is positioned to capture enhanced credit quality and further rent growth.
- **Poised to Continue Growth.** While this REIT is relatively small, it has a management team that will allow it to continue to grow quickly. The company held just 14 properties when it IPO'd in 2014, but has added five more properties in just a few years with a sixth on the way. CIO is under contract to close on a San Diego property for $174.5 million before year end. Management has expressed a desire to tap into the California market, and this 10-building property in America's largest state is a great signal for future growth. CIO has increased its Funds From

Operations (FFO) at a 45% CAGR and revenue at a 39% CAGR over the past 7 years. This REIT has shown no signs of slowing down and further growth will continue to grow the company's FFO as well as its already-large dividend.

- **Favorable Valuation Relative to Peers.** Given CIO's rapid growth, it would be expected that it would trade at a higher multiple. While the stock has traded up recently, there is still significant untapped value to be obtained. CIO pays a dividend much larger than its peers, and its P/FFO ratio is also below that of its competitors. The firm has managed to grow rapidly while at the same time maintaining exceptional credit quality in its tenants - to go along with continuously high occupancy rates. Approximately 54% of CIO's base rental revenue is derived from tenants that are government agencies, investment grade companies, or their subsidiaries. The company also enjoys a healthy in-place occupancy rate of 90.1% paired with a stable, long-term tenancy profile with a 5.3 year weighted average remaining lease term.

Valuation

To find CIO's intrinsic value, a five-year discounted dividend model and P/FFO relative valuation were used. Using a terminal growth rate of 2.25% and a WACC of 5.35%, the DDM produced a value of $16.47 yielding a 19.60% upside. A sensitivity analysis of the WACC and terminal growth rate produced a price range of $11.93 to $21.14. To compare CIO to its peers, a P/FFO valuation model was created. Using a peer average P/FFO ratio of 16.29x and an estimated 2017 FFO/share of $1.12, a value of $17.07 was obtained. This produces an upside of 24.0%. Weighing the DDM and relative multiple valuations 50%/50%, an intrinsic value of $16.77 was found, yielding a 21.79% upside – in addition to the strong dividend.

Risks

- **U.S. Economy Slows Down.** Due to CIO having all its revenues and properties located in the United States, an economic slowdown or recession would have a significant impact on the company's performance. The REIT has 100% exposure to the U.S., and a stagnating economy would likely increase the number of tenants that fail to pay their dues to CIO. A declining market for real estate would similarly have a negative impact on CIO's ability to sell their properties to harvest gains or generate additional cashflow.
- **Management Unpredictability and Equity Offerings.** Although CIO management has not done anything out of the ordinary thus far, there is still the chance of the company going a direction that may take shareholders by surprise. The company has only been publicly traded for about 3 years. Management has also shown a willingness to issue additional shares of stock, whether common or preferred. While this is a negative for current shareholders, CIO has shown that it can use the proceeds from these offerings to generate additional FFO in the future through real estate purchases.
- **Interest Rate Risk.** One risk that all real estate investment trusts face is the threat of rising interest rates. Because REITs derive much of their value from dividends, rising rates suppress the value of these future cash flows. A surge in interest rates would negatively impact the value of City Office REIT which pays a high dividend. However, if the overall economy continues to expand, the demand for commercial real estate and the resulting growth in rents could support CIO even through volatile periods of rising interest rates.

Management

James Farrar serves as Chief Executive Officer and Director at City Office REIT. He has over 20 years of experience in the private equity, real estate, and corporate finance industry. Since 2011 he has been involved in over $1.7 billion of real estate acquisitions across the United States. Mr. Farrar joined the company in 2009 as a Managing Director. President & COO Greg Tylee and CFO & Secretary/Treasurer Anthony Maretic both have over 20 years of experience in various REIT and real estate roles.

Ownership

% of Shares Held by All Insider and Owners	7.65%
% of Shares Held by Institutional & Mutual Fund Owners	65.06%

Top 5 Shareholders

Holder	Shares	% Out
Wealhouse Capital LP	2,300,000	7.60
Adrsley Advisory Partners	1,480,000	4.89
BlackRock Fund Advisors	1,322,000	4.37
Nuveen Asset Management LLC	1,300,000	4.30
The Vanguard Group, Inc.	1,094,000	3.61

Source: Factset

Peer Analysis

Name	Ticker	Market Cap (mil)	FFO (mil)	Div. Yld. %	P/FFO	D/E
City Office REIT	CIO	416.6	41.8	6.80	14.20	1.46
Corporate Office Properties	OFC	3,289.0	198.4	3.40	15.50	1.27
One Liberty Properties	OLP	455.5	34.9	6.61	12.60	1.39
PS Business Parks	PSB	3,700.0	179.9	2.50	22.50	0.14
BlueRock Residential Growth REIT	BRG	267.1	16.9	10.50	15.40	1.56
Peer Averages		1,927.9	107.5	5.8	16.5	1.1

Source: FactSet