

Message

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**Sent:** 6/12/2015 3:15:28 PM  
**To:** J. Kyle Bass [k@haymancapital.com]  
**CC:** Andy Jent [aj@haymancapital.com]; Henry Becker [HB@haymancapital.com]  
**Subject:** RCAP Up on Citi Note  
**Attachments:** image001.png; image002.png; image003.png; image004.png; image005.png; image006.png; image007.jpg

Not a lot of analysts cover RCAP but Citi does and their analyst is one of its biggest cheerleaders; the one thing that he mentions that will concretely give the stock support is if the company can get a waiver or amendment on its leverage covenant, which they are apparently in the process of working on. I've spoken with this analyst several times; he definitely drank the cool-aid. Even if RCAP gets a waiver or extension, it will not change the ultimate outcome for the business and it's downward trajectory, especially when news breaks of UDF

Can The Stock Pull Out Of Its Gravitational Descent? Favorable Q&A With CEO And CFO

RCS Capital Corporation (RCAP)

12 June 2015

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This company belongs to Focus List  
Buy/High Risk

Price (11 Jun 15)

US\$6.94

Target price

US\$18.00

Expected share price return

159.4%

Expected dividend yield

0.0%

Expected total return

159.4%

Market Cap

US\$536M

\* Favorable Q&A With Management

Given the further decline in the shares, we ran through a series of topics with the CEO + CFO. Our discussion covered: 1) debt dynamics; 2) EBITDA disclosure; 3) wholesale economics; 4) recent regulatory filings (and implications); and, 5) an update on the DoL proposal. While clearly the decline in the shares has us second guessing ourselves, we believe the recent trading reflects adverse technicals owing to the decline in the shares themselves (against thin float); the absence of action by management since 1Q results; and, developments elsewhere, notably at Neutral-rated LPLA, but not due to adverse fundamental changes. Our conversation was constructive but...

\* ...2Q Will Be Make Or Break On Management Credibility

As the firm will need to deliver on: 1) Retail B/D adjusted EBITDA targets; 2) wholesale profitability; and, 3) restructuring of debt covenants, the latter likely to stem the negative feedback loop on the shares, we believe. However, given management's inability to deliver on financials recently, 2Q is now "make or break" time around credibility. No question, the shares screen cheaply, and we now think rate leverage alone (see also 5/11, No Debt (or Equity) Call Likely; Still See A "Double"

Potential<<https://www.citivelocity.com/rendition/eppublic/documentService/ZmlsZV9uYW1lPVhaUjcucGRm?parentDocData=cGFyZW50X2RvY19pZD01ODI5NzImY2hhbm51bd1EQ00mc3ViLWNoYW5uZWw9RW1haWwmcGxhdGZvc090DE>>) is worth more than where the shares are trading, enhancing the break-up value of the firm, in our view. Yet, if the EBITDA targets prove illusory, the shares are likely to remain under duress.

\* What Did We Learn From Our Q&A Session?

1) Management is working closely with the bankers to obtain a consent agreement to lift the somewhat onerous debt to adjusted TTM EBITDA required multiple, and we expect a resolution ahead of 2Q earnings; 2) management continues to rationalize the Wholesale business, suggesting further improvement into 2Q and 2H15 around EBITDA; and, 3) recent share authorization and shelf registration are strictly procedural. Management has no plans to issue equity, particularly at these levels, and we do not see equity recapitalization as necessary, particularly should RCAP successfully negotiate higher covenants. DoL risks seem both largely discounted and manageable.

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Investment Summary

Figure 1. RCAP's Debt Has Recovered And Is Trading Close To Par...

[<https://www.citivelocity.com/rendition/eppublic/akpublic/documents/output/582972/images/image109.png?ts=20150519171137>]

Source: Company Reports, Bloomberg, Citi Research

Like an aging satellite that is slowly deteriorating from its orbit, RCAP's stock can't seem to catch a bid, even as the debt is trading close to par (Figure 1) and rate sensitive names are outperforming (Figure 2). The question is whether RCAP can escape the negative gravitational pull where a number of technical issues are weighing on the equity. Yet, the further descent in the shares prompted us to work through a series of topics with management in a Q&A session on 6/11 that are key investor issues of late. Our conversation covered the following topics: 1) debt restructuring dynamics; 2) adjusted EBITDA (used in the debt covenant calculation) disclosure; 3) Wholesale Banking economics; 4) recent regulatory filings; and, 5) a DoL update. Despite the decline in the shares, we did come away from the call constructive, with one particularly large caveat: management credibility is on the line and 2Q earnings/call will be "make or break", in our view.

Figure 2. ...While RCAP's Equity Has Lagged, Even As Rate Names Outperform

[<https://www.citivelocity.com/rendition/eppublic/akpublic/documents/output/582972/images/image110.png?ts=20150519171137>]

Source: Factset, Citi Research

No question, the shares screen cheaply to us, and we believe rates leverage alone is now worth more than the rest of the entity. Further financial and/or execution disappointment could set the stage for a restive shareholder to step in and break up the company (see also 5/11, No Debt (or Equity) Call Likely; Still See A "Double")

Potential<<https://www.citivelocity.com/rendition/eppublic/documentService/ZmlsZV9uYW1lPVhaUjcucGRm?parentDocData=cGFyZW50X2RvY19pZD01ODI5NzImY2hhbm51bd1EQ00mc3ViLWNoYW5uZWw9RW1haWwmcGxhdGZvc090DE>>). Still, if management is successful in renegotiating the debt covenants, we do think a major (real and perceived) set of issues will lift from the shares, which could result in a sizeable snapback rally. Once again we are fielding calls from Bearish investors arguing the equity is worthless.

What did we learn from the call? First, we expect management to announce it has obtained consent agreements to amend the debt covenants, likely to run through 2016, which should then give management time to refinance the debt. Second, we expect RCAP will begin to provide adjusted EBITDA disclosure

in/around debt covenants in concert with 2Q earnings. Third, even as wholesale volumes have picked up from 4Q14 levels, we understand there are more expenses coming out, on top of those announced in concert with 1Q earnings. Fourth, and perhaps most critically, management has no plans to issue equity, with recent regulatory filings procedural in nature. Fifth, like the building consensus, management believes the current DoL proposal faces rising headwinds but even should the current proposal pass in current form the economic impact is manageable, particularly should the debt covenants get renegotiated.

#### Favorable Rap Session

Taking time out from celebrating my 20th wedding anniversary (my wife has the patience of a saint), we grilled management on a number of key topics. Below is the Q+A:

#### Topic - Debt Restructuring

Q: Are you negotiating with the bankers to restructure the debt covenants, and when can investors expect some resolution?

A: Two part answer. First, management is working with the bankers, and while not specific, they did note making very good process. Second, management is hopeful to resolve the discussions over the next few weeks, announcing perhaps before quarter end and/or in concert with 2Q earnings.

Q: What form will the restructuring be?

A: Two part answer. First, RCAP expects they will get a consent agreement that will increase the debt to TTM adjusted EBITDA required ratio. The consent will run through 2016. Second, management intends to refinance the debt ahead of 12/31/16.

Q: How much might the consent approval cost and what might be the negotiated new debt/TTM adjusted EBITDA levels?

A: Management did not provide specifics but we generally believe there will be two costs - one of which is one time in nature; the other reflects a higher cost of debt. We believe the one-time cost might be about 50 bps, or ~\$3.5M (50 bps x \$703M in debt). We think such one-time item may be added back to adjusted EBITDA though we expect some clarification. In turn, we believe RCAP will be required to pay a higher coupon, with the step up ranging from 50 bps to 100 bps (Figure 3). If our math is right, such a give up will cost about \$4.1M annually.

#### Figure 3. We Estimate Coupons Could Rise 50-100 Bps Under Renegotiated Covenants

[<https://www.citivelocity.com/rendition/eppublic/akpublic/documents/output/582972/images/image111.png?ts=20150519171137>]

Source: Citi Research

In turn, we believe such costs will boost the debt to trailing TTM EBITDA covenant required ratio by 0.75x to 1.0x through YE16. In Figures 4-6, we work through the new dynamics versus the existing dynamics, and note nominal EPS hit but sharply higher strategic flexibility.

#### Figure 4. Adjusting Debt Covenants Would Add More Flexibility...

[<https://www.citivelocity.com/rendition/eppublic/akpublic/documents/output/582972/images/image112.png?ts=20150519171137>]

Source: Company Reports, Citi Research

#### Figure 5. ...While Alleviating Covenant Risk...

[<https://www.citivelocity.com/rendition/eppublic/akpublic/documents/output/582972/images/image113.png?ts=20150519171137>]

Source: Company Reports, Citi Research

#### Figure 6. ...With Minimal EPS Impact, We Believe

[https://www.citivelocity.com/rendition/eppublic/akpublic/documents/output/582972/images/image114.png?ts=20150519171137]

Source: Company Reports, Citi Research

Topic - Adjusted EBITDA Disclosure

Q: Can investors expect greater disclosure on how to calculate adjusted EIBTDA used in the debt covenant calculation, and when?

A: Yes and "hopefully" in concert with 2Q results.

Topic - Wholesale Distribution Economics

Q: Will you take out more costs from the Wholesale business beyond the \$12M annualized announced in concert with 1Q results?

A: Yes. Management will continue to right-size the business, and investors should expect further reduction in costs into 2Q15 and 2H15, even should volumes further rebuild.

Q: So, should investors expect further improvement Q/Q in Wholesale EBITDA?

A: Yes.

Topic - Recent Regulatory Filings

Background: RCAP has recently filed to triple its share authorization (to 300M) while filed a shelf registration, including \$250M in debt.

Q: Is management planning on issuing equity?

A: No.

Q: Does management understand that issuing equity at these levels would be a very Bearish signal?

A: Yes.

Q: Is management looking to do a deal or execute on existing game plan?

A: Focus is on driving results. No current plans for a deal (again appreciative that stock is down sharply).

Q: Why the authorization boost anyway?

A: Just procedural given the rise in the share count due to acquisitions and prior preferred offering impact.

Q: Why the shelf now, and why \$250M in debt - is this a placeholder?

A: Given the drop in the stock, management need to refile with the SEC to reset a shelf registration. This is procedural in nature. There is no plan to raise equity. The \$250M in debt is merely a placeholder, and investors should not read into this that a debt raise is likely.

As a side note, we believe the shelf registration gives RCAP flexibility in terms of strategic alternatives - the filing expedites a potentially necessary process should it be required if a solution presents itself.

Topic - Updated DoL Fiduciary Reform Thoughts

Q: Latest thoughts on DoL proposal?

A: Per the CEO, his personal view is that the proposal faces increasing difficulty in gaining consensus, and will either be delayed and/or watered down versus the current form.

Q: What is the current impact to the business should the current form ultimately get enacted?

A: No change in guidance. Or, 2-3% EBITDA hit to Retail broker dealer, while 37% of Equity origination are into qualified accounts. Note, the 2-3% EBITDA drag is gross of any moves to migrate accounts into non-qualified mandates and/or cost adjustments.

Other Notables:

1. Stepped up volatility is good for liquid alternatives, boding well for Hateras.
2. No change to rate leverage, and management is encouraged by the recent back up in LT interest rates. As RCAP is significantly levered to the short-end of the curve, our math points to \$0.55 NPV earnings impact (53% earnings accretion) from 100 Bps higher rates;

What Is Dragging The Shares Lower?

We think a few issues have hurt the shares:

1. The drop in the stock is feeding on itself, as the market cap shrinks, Bullish investors are capitulating while Bearish investors are emboldened;
2. News flow from management around debt restructuring is taking longer than most anticipated while the procedural regulatory filings have raised dilution worries;
3. LPLA has made some news that is perceived as favorable unwinding the RCAP/LPLA pair trade.

In our view, covenant resetting could be major catalyst, reversing the sharp pullback of late.

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