SPITFIRE CAPITAL LLC

March 6, 2015

Risk is not the same as volatility; risk results from overpaying or overestimating a company's prospects. Prices fluctuate more than value; price volatility can drive opportunity. Sacrifice some upside as necessary to protect on the downside.

Seth Klarman, *What I've learned from Warren Buffett* (Financial Times, February 4, 2015)

Fourth Quarter 2014

	4Q 2014	2014	Since inception[1]
The Spitfire Fund L.P.[2]	**+6.5%**	**+6.9%**	**+147.6%**
Russell 2000	**+9.7%**	**+4.9%**	**+60.4%**
S&P 500	**+4.9%**	**+13.7%**	**+60.6%**

In the fourth quarter, The Spitfire Fund L.P. (the "Fund") was up +6.5% (net), compared to the Russell 2000 and S&P 500 which were up +9.7% and +4.9%, respectively. For the full year, the Fund was up +8.6% (gross) and +6.9% (net) compared to the Russell 2000 and S&P 500 which were up +4.9% and +13.7%, respectively. Since inception, the Fund has achieved a cumulative return of +147.6% (net) and has compounded capital at +12.9% (net) annually. Over the same period, the Russell 2000 and S&P 500 have achieved cumulative (compound annual) returns of +60.4% (+6.5%) and +60.6% (+6.5%), respectively.

Year	The Spitfire Fund LP (1)	Russell 2000 with dividends (2)	Relative Performance (1) - (2)
2014	6.9%	4.9%	2.0%
2013	28.9%	38.8%	-9.9%
2012	31.5%	16.4%	15.1%
2011	3.6%	-4.2%	7.8%
2010	36.6%	26.9%	9.7%
2009	75.6%	27.2%	48.4%
2008	-39.4%	-33.8%	-5.6%
2007 (partial year)	-9.3%	-7.5%	-1.8%
Total Return	147.6%	60.4%	87.2%
Annualized Return	12.9%	6.5%	6.4%

[1] The Spitfire Fund L.P. commenced operations on July 1, 2007. Performance data is through December 31, 2014.

[2] The Fund's returns are shown net of all fees and expenses. Index performance assumes reinvestment of dividends.

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Over the course of the year, smaller capitalization stocks dramatically underperformed their larger capitalization brethren. This divergence was reflected by the Russell 2000 which lagged the S&P 500 by 8.8 percentage points. Stripping out the pharmaceuticals and biotechnology sectors, in which we do not participate and which comprise about 8% of the index, the Russell 2000 returned only about +2%, before dividends. In light of our exposures, which included an average allocation to cash of 21%, our performance was creditable.

During the year, we added four and exited five positions, including our long-term holdings in AZZ, Inc. (NYSE: AZZ) and Powell Industries, Inc. (NASDAQ: POWL). While we have long admired AZZ's leading North American galvanizing franchise, a business which grows with GDP, enjoys mid-20s EBIT margins and generates significant free cash flow, we were less impressed by the previous management team's diversifying acquisitions in the nuclear products and services industries, and exited in the third quarter at a favorable valuation. In Powell's case, we became increasingly concerned with the potential for delays in large project awards in the petrochemical and oil & gas end markets and also exited our position in the third quarter.

The Fund's top performers for the year were GTT Communications, Inc. (NYSE: GTT); Libbey, Inc. (NYSE: LBY); US Physical Therapy, Inc. (NYSE: USPH); Whirlpool Corporation (NYSE: WHR) and Lear Corporation (NYSE: LEA)[3]. GTT, Libbey and US Physical Therapy have been core positions for the Fund for many years and date back to 2007, 2011 and 2007, respectively. We initiated our position in Whirlpool in the third quarter, ahead of the stock's 34% fourth quarter run.

The wooden spoon for the year goes to Hanger, Inc. (NYSE: HGR), the leading domestic provider of orthotic and prosthetic services. With the benefit of hindsight, the problems at the Company were obvious. First, the Company appointed a Chief Growth Officer, a worrying sign in a low-growth industry, and a leading indicator of a propensity to allocate capital outside the core business. Having completed a mediocre diversifying acquisition, the Chief Growth Officer was elevated to Chief Executive Officer. Problems soon appeared in the core, including a regulatory crackdown on reimbursement and two failed organic growth initiatives. The problems were compounded by accounting issues related to bad debt, inventory and leases, eventually leading to delayed SEC filings. While the cumulative impact of the accounting peccadilloes may not have been particularly significant, they provided the necessary few pennies of earnings per share to allow the Company to continually exceed the Wall Street consensus estimate, for which management was glad to take the credit[4]. We have learned our lesson and have committed to selling, quickly, when we read of "diversifying," or worse, of "transformative" acquisitions.

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[3] We discussed Libbey in our first quarter letter dated April 30, 2014 and Lear in our second quarter letter dated August 28, 2014.

[4] "In the world of business, bad news often surfaces serially: you see a cockroach in your kitchen; as the days go by, you meet his relatives." Warren Buffett, *Letters to Shareholders* (2014).

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As we approach the Fund's eighth anniversary, I thought it worthwhile to restate and summarize our investment approach, with particular emphasis on discussing those risks we are willing to take and those we are not.

1. We are willing to accept the risk that our results will not track those of any publicly-traded index. After all, it is only by holding a portfolio that materially differs from a benchmark that we can hope to beat it. We hold a concentrated portfolio of around 20 publicly-traded common stocks. Our portfolio does not resemble the Russell 2000 or any other index, thus guaranteeing that our performance will diverge, sometimes materially, from the index. Our hope is that superior stock selection will ensure that, over a longer time frame of three to five years, our performance will diverge in a substantially positive manner. Along the way, there will inevitably be periods when we underperform. As of December 31, 2014, the Fund did not hold any speculative biotechnology, pharmaceutical or social media stocks, increasing the possibility of underperforming the Russell 2000 if these sectors outperform.

2. "Time is the friend of the wonderful business, the enemy of the mediocre."[5] We are willing to take the time risk of owning the stock of a high quality company, even in the absence of a near-term "catalyst." Many market participants focus on whether or not a stock has a "catalyst" that will purportedly move the stock over the subsequent quarter. This "catalyst" might be an expected analyst upgrade, a consensus-beating earnings release, a product announcement, a management change, potential M&A activity or even just a meeting with sell-side analysts.

   Our companies often lack such a near term "catalyst." Instead, we focus on companies with sustainable competitive advantage (defined as a market leadership position in an industry with barriers to entry[6]) which are generating cash and compounding value over time. Growing intrinsic value should, over time, drive increases in the stock price, with a higher probability relative to the speculative, and generally irrelevant, "catalysts" listed above.

   Generally, we find that the market typically overvalues revenue and earnings growth and undervalues free cash flow generation, which can be used to pay down debt, buy back stock, pay dividends or fund acquisitions. One of the risks implicit in our strategy is that of growth-oriented management teams over allocating capital to their core businesses at ever diminishing returns or into diversifying acquisitions. Instead, we prefer management, as appropriate, to deploy excess cash towards reducing indebtedness, paying dividends or buying back stock.

3. We do not believe that volatility, a measure of the historical or prospective variation of a security price, is synonymous with risk, which we define as the possibility of incurring a

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[5] Warren Buffett, *Letters to Shareholders* (1989).
[6] Barriers to entry may include, inter alia, brands, customer relationships, invested capital, distribution, and scale.

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permanent loss of capital. Indeed, many of our smaller capitalization stocks have higher betas than the market and can fluctuate considerably, particularly in markets exhibiting risk on/risk off behavior. We do not enter into trades in order to mitigate volatility through shorting or derivatives because, over time, such behavior is expensive and eats into returns. Instead, we prefer to double down on our research and favorite positions in down markets when risk/reward can be most favorable. Holding a significant cash position is an asset during such periods.

4. We believe that gross exposure is a better indicator of risk than net exposure. After all, a speculator can lose money on both the long and short side of the balance sheet, and both gains and losses are magnified by the leverage implicit in running a high gross/low net balance sheet. A low net exposure is no guarantee of uncorrelated returns or of downside protection. As we learned in 2008, the world and the market are risky places, so risk/reward has to be compelling in order to deploy capital on either the long or short side. We will short opportunistically as we uncover compelling opportunities, but not simply as a means to reduce our net exposure or in the form of a pair trade. In the absence of compelling investment opportunities, and to be able to take advantage of such opportunities as they arise, we are comfortable holding cash, which was nearly 20% at calendar year end.

5. We are willing to accept some liquidity risk in order to invest in smaller capitalization companies offering superior risk/reward characteristics. A number of our highest returning investments including GTT Communications, Inc. (NYSE: GTT) and Rural/Metro Corp. were made in companies with less than $100 million in market value at the time of our initial investment. GTT today has a market value of nearly $500 million, and Rural/Metro was acquired by private equity firm Warburg Pincus in 2011 for $443 million. We generally limit less liquid situations to less than 10% of our portfolio. As sell-side firms reduce the number of stocks under active coverage and as buy-side funds grow ever larger, we believe that we will continue to uncover smaller capitalization stocks that are underfollowed by the institutional community and that offer compelling investment opportunities.

As of December 31, 2014, the weighted average market capitalization of the Fund's positions was $2.4 billion, up from $1.4 billion at December 31, 2013. In part, the increase is due to the continued growth in market value of the Fund's long standing positions. Over the years, we have also been open to investing in larger market capitalization situations. Our first such "larger" capitalization investment was in Jarden Corporation (NYSE: JAH), a diversified branded consumer products manufacturer, in January 2012. At the time, Jarden had a market value of about $2.9 billion and was trading at an undemanding multiple of less than 7x the consensus EBITDA estimate for 2012 and at less than 10x after-tax earnings. Despite its larger size, the Company demonstrated the same drivers of equity value that we seek in smaller companies: it was growing organically and inorganically, it was increasing margins and it was generating substantial free cash flow. Today, the Company has a market value of approximately $10 billion and remains in the portfolio, having generated a very satisfactory return for the Fund.

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At the time, I had to wonder why the market was offering us an opportunity with the same, if not better, asymmetric risk reward proposition as the smaller companies we traditionally invested in. With smaller companies, I could at least argue that they were off the radar screen, received little or no sell-side coverage and were misunderstood, perhaps because of perceived high leverage or some other flaw. In Jarden's case, we were gaining the benefit of category leading consumer brands such as *Coleman*, *Mr. Coffee*, *Marmot* and *Volkl*, among others. In addition, the stock enjoyed substantial trading liquidity. Given its market value and tier one analyst coverage, Jarden was clearly not far off the beaten track.

We concluded that that the market was undervaluing the Company's free cash flow generating potential and its ability to compound equity value through revenue growth, margin expansion and free cash flow applied to debt pay down, dividends and stock buybacks. It is the combination of these value drivers, working together, that make a compelling investment opportunity. Revenue and EPS growth alone, in a relatively mundane industry, cannot compete with the higher growth rates available in racier industries such as 3D printing or biotechnology. While revenue growth is an important driver of value, it is the easiest attribute to screen for and thus prone to overvaluation. Instead, we try to identify other drivers of equity value and of long term compounding, primarily free cash flow and the change in the balance sheet over time, that are perhaps harder to see at first glance and therefore underappreciated by the market.

Since our experience with Jarden, we have successfully invested in other larger (by our standards) capitalization stocks. Two of our top five 2014 contributors were in such larger capitalization companies, including our first quarter 2014 investment in Lear Corporation (NYSE: LEA), which we discussed in our Q2 letter[7], and our third quarter investment in Whirlpool (NYSE: WHR).

Over the years, we have studied a number of world class businesses and did not invest only because of their larger market values. In this list, I would include Anheuser-Busch Inbev SA/NV (NYSE: BUD), which we have followed as an industry bell weather and customer of bottle manufacturer Owens-Illinois, Inc. (NYSE: OI); The Home Depot (NYSE: HD), which we study in the context of our work on the consumer discretionary, home remodeling and home building industries; and The Sherwin-Williams Company (NYSE: SHW), which we analyzed in the context of our work on portfolio company BWAY Corporation, a paint can manufacturer acquired by Madison Dearborn Partners in March, 2010. These companies enjoy superior, market-leading positions, world class scale, strong management and industry-leading returns on capital employed. While we will continue to invest in smaller capitalization companies, and will limit our size to retain this flexibility, we will be open to investing in larger capitalization companies if we feel that they offer similar, or better, risk reward.

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[7] Please see the Fund's Q2 letter dated August, 28, 2014.

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We have completed the 2014 Fund audit and have emailed electronic copies of the audit and Form 1065 Schedule K-1 to Partners. We have also sent hard copies of the K-1s. Please contact Patrick Ryan (patrick@spitfirecap.com) if you did not receive your copy or if you would like to receive a copy of the Fund's audited financial statements.

I will be traveling to Omaha on Friday, May 1; Boston on Wednesday, May 27 and New York in mid-July. Please let me know if you have time to meet. As ever, we are grateful for your interest and support.

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