Spitfire Capital LLC - Spitfire Fund LP

Julian Allen - Founder

At a Glance:

Spitfire Fund LP

Fund Assets	$21.2 million
Firm Assets:	$35 million
No. of Employees:	3

Account Information

Minimum Investment:	$250,000
Management Fee:	1.5%
Incentive Fee:	20%

Performance Analysis

Start Date:	January 2009
Total Return:	212%
Compound Annual Return:	35.46%
Worst Drawdown:	17.02%
Sharpe Ratio:	2.14
% of Winning Months:	75.56%
Average gain:	4.68%
% of Losing Months:	24.44%
Average loss:	-3.52%

Correlations

Barclay Equity L/S Index	+0.84
S&P 500:	+0.72
U.S. T-Bonds:	-0.69
World Bonds:	-0.61
EAFE:	+0.72

Annual Returns Past 4 Years

2009	75.64%
2010	36.69%
2011	3.61%
2012 (thru 9/12)	25.45%

Past results are not necessarily indicative of future performance.

Before starting Spitfire, Julian Allen spent three years with Cannell Capital, a San Francisco-based long short fund specialized in neglected small cap equities. Working for Cannell was an opportunity to learn about public market investing. Says Julian, “While there are similarities between public and private investing in terms of business and cash flow analysis, it is important to understand the expectations of future performance embedded in any stock price. Private equity investors also enjoy control over the board of directors and management. As a public market investor, your governance protections are much weaker. Unfortunately, you can’t just fire an underperforming CEO or self-serving board.” Julian was previously Managing Director of J.H. Whitney & Co., a private equity investor with over $5 billion under management. He also served as a Principal of Capital Z Partners, a private equity and alternative asset manager, and he started investing at Patricof & Co. Ventures, Inc. Julian holds an MBA from the Harvard Business School, where he graduated as a George F. Baker Scholar, and is a graduate of Cambridge University, England.

Research Analyst Kevin Leary joined Spitfire from Grant Thornton, LLP, where he led the San Francisco office’s private equity portfolio valuation practice. Kevin is a graduate of Santa Clara University.

Investment Philosophy

Spitfire’s investment philosophy is based on the belief that while markets are generally efficient, longer term investors who are willing to source their own ideas and do their own research can identify mispriced securities. Of the nearly 6,000 public companies, fewer than 1,000 have greater than $2 billion in market value. These companies receive the majority of institutional interest, leaving the majority relatively underfollowed. Small caps are also heavily impacted by portfolio flows and quantitative investors. During risk on/risk off markets, portfolio flows impact good companies as well as bad, providing opportunities to buy good businesses at attractive prices. Investors typically also focus on revenue growth rather than margin expansion, free cash generation, and debt pay down as drivers of equity value accretion.

Spitfire focuses on identifying companies with defensible market positions and wants to invest in the market share leader. These companies have the established brands and dominate their categories. Small cap companies can appear statistically cheap, but this can reflect poor positioning and competition from larger companies with scale, distribution, and other advantages. Targets typically achieve high returns on invested capital and generate free cash flow, after financing working capital and capital expenditures. Free cash flow provides a margin of safety, as these companies are not dependent on the capital markets for funding. Free cash flow also allows management to pursue value enhancing initiatives including debt reduction, dividends or stock repurchases. Prospects must also demonstrate increasing equity value over time. A market leading business which generates excess cash and whose value is increasing will attract new investors. If the stock price does not move, the company will be an attractive takeover candidate. Spitfire seeks to buy these companies at a discount to their private market value. Since inception, thirteen, or about a quarter of Spitfire's investments, have been acquired by strategic or financial acquirers.

Trading Edge

Spitfire's trading edge derives from its focus on neglected smaller cap equities, its research-intensive process, its concentrated portfolio, and its longer term orientation. Spitfire identifies investments offering asymmetric risk reward propositions benefiting from a margin of safety. By concentrating on fewer investments, Spitfire dedicates more resources to researching each company. "We try to understand the constellation of competitors, customers, and suppliers around each of our companies. There is a lot of publicly available research if you are willing to grind through the data. We can afford to do it as we might add only three or four investments a year. We are not trading the quarter or near term catalyst; rather, we are looking to compound value over time," Julian explains.

> ***"We try to understand the constellation of competitors, customers, and suppliers around each of our companies. There is a lot of publicly available research if you are willing to grind through the data."***
>
> **— Julian Allen**

Risk Management

Spitfire manages risk by maintaining low gross exposure, by focusing on high quality businesses, and by hedging. Spitfire operates with lower gross and higher net exposure than the typical fund. Since inception, gross exposure has averaged less than 100%. Net exposure has averaged 80%. "Over the last five years, correlation has been high, a result of risk on/risk off trading patterns. We believe that gross exposure has been a better risk indicator. After all, you can lose money on both sides of your book," says Julian. The Fund has maintained a net cash position to be able to add to positions during periods of market stress. Spitfire believes that the research process mitigates risk. By focusing on quality businesses, with leading market positions, high returns on capital, strong balance sheets, and free cash flow, Spitfire minimizes the potential for loss. It also partially hedges the portfolio using single name shorts, index shorts, and options. Single name shorts are intended to add alpha and are not typically paired against long positions. The fund has also maintained short positions in the Russell 2000 and Russell MicroCap indices. While fully hedging the portfolio with put options is prohibitively expensive, there have been periods when complacency is high which has allowed Spitfire to partially protect the portfolio from adverse moves.

Trading Specifics

Investing ideas are identified from a variety of sources including quantitative screens, publicly reported holdings data and extensive reading. Spitfire uses screens to identify businesses with attractive economic characteristics and also applies its screens against out of favor segments, such as companies trading below their IPO price and analyzes 13Fs to determine what certain funds are buying or selling. Says Julian, "We run a manager's top ten positions through our screens. We read a lot of public filings, transcripts, proxies, and earnings releases, for the company and its peers and will typically conduct calls with management, key customers, suppliers and competitors. Our goal is to understand the buying process. What product attributes do customers value? How does the company score against those metrics? Does it enjoy a sustainable source of competitive advantage?" Spitfire will also develop a financial model to understand the drivers of free cash flow, including profitability, working capital, capital expenditures as well as pension contributions, and cash restructuring payments. Julian adds, "We want to know how much cash is left for owners. We then want to know how management intends to spend it. We will assess the company's proxy statements to understand governance and how management is paid. We want to know what behaviors are rewarded by the incentive plans. Is it revenue growth? Acquisitions? Profitability? Working capital efficiency? Return on capital? We also look at the team's track record in terms of capital allocation. What is the company's acquisition history or success with stock buybacks? While we listen to what management says, we are more interested in what they have done. Once Spitfire decides to proceed, the Fund will initiate a relatively small position. We want to see how our thesis plays out and how management executes before committing significant capital. Once we have established a core position, there is no set time frame for exit. We constantly reevaluate each position and can remain invested for years provided risk reward remains favorable."

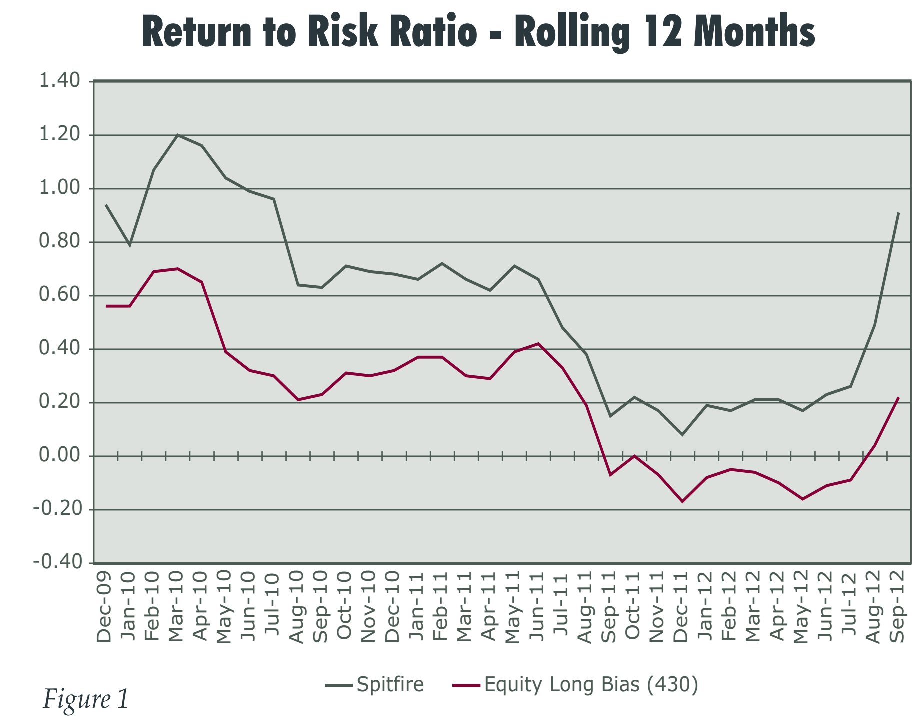

Figure 1

Peer Group Comparison

In order to evaluate whether the effect of combining Spitfire's trading approach with its risk management protocols can demonstrate any observable edge over its peers, we've compared the risk adjusted performance of Spitfire Fund L.P. with a universe of 480 equity long-bias hedge funds for the period from January 2009 through September 2012. Figure 1 compares the rolling 12-month risk adjusted returns for Spitfire with the average values for its relevant subgroup. Risk adjusted returns are calculated by dividing the 12-month rolling average of the monthly returns by the 12-month rolling average of the standard deviation. As we can see, in all of the 12-month periods since its inception in January 2009, Spitfire has been able to consistently deliver risk-adjusted returns that are greater, oftentimes by significant margins, than the averages generated by its peer group.

Future Plans

Spitfire's priority is to maintain its track record of outperformance against the public markets and hedge fund benchmarks while growing assets. Its goal is to attract investors who want strong absolute returns and who measure performance over a multi-year period. Fortunately, Spitfire has benefited from interest in smaller managers and in niche strategies. As the Fund grows, it intends to add investment analysts to allow for more in depth research and to cover a larger group of companies. Says Julian, "Our goal is to continue compounding capital at attractive rates while maintaining robust risk controls." ◊