# SOUTHPAW CAPITAL

800 Bering Drive, Suite #401 | Houston, TX | 77057
281.770.0379 | southpaw-capital.com

April 12th, 2013

Dear Partners,

We ended Q1 2013 up 9.36% net of all fees and expenses. We finished with right at 60% net long exposure, below 35% beta-adjusted long exposure, and our correlation to the S&P 500 ($r^2$) for the quarter was 0.20, resulting in a Sharpe Ratio over 4. Monitoring our portfolio the last few weeks has been reminiscent of being stopped in your vehicle at an intersection when out of your peripheral vision you notice other cars moving--suddenly a quick modicum of panic washes over you as you are hit with the eerie feeling that you are rolling backwards and bound for imminent collision with the car behind you. In reality your right foot is planted firmly on the brake pedal and you are at a complete standstill--it's the relative forward movement of your surroundings giving you the unpleasant sensation. Lately we've had that same feeling of losing ground despite not actually doing so. The market has been bid up relentlessly while we've added to shorts and flat lined. Our shorts were a large performance drag, detracting several hundred basis points in Q1, as they've been caught in the inexorable updraft and seem to be rising even faster than the market. Weakness at the end of March may be partly explained by worsening market breadth along with the S&P 500 positively-diverging from the Russell 2000. Our shorts are biased towards Large Cap and our longs are almost entirely small and micro caps. Given this confluence of negative factors and increasingly defensive positioning we feel fortunate to have kept pace with the overall equity indices. It appears that some companies with poor near term prospects for profitability that tout open ended growth prospects are pricing in all of that growth as if it is a foregone conclusion with tiny likelihood of operational missteps or competitive threats along the way ("story stocks"). Indeed, if enough investors believe a price change is indicative of something positive and follow the trend then the trend takes on a life of its own…equilibrium be damned (a la Soros).

**Southpaw Value Fund, LP**

ESTIMATED NET MONTHLY PERFORMANCE | 2013

| PERIOD | SVF (Net) | SVF (Gross) | HFRX Index | S&P 500 TR |
|---|---|---|---|---|
| JANUARY | 7.22% | 9.10% | 1.96% | 5.18% |
| FEBRUARY | -0.18% | -0.15% | 0.43% | 1.36% |
| MARCH | 2.18% | 2.76% | 0.72% | 3.75% |
| 1st QUARTER | **9.36%** | **11.95%** | **3.13%** | **10.61%** |
| YEAR TO DATE | **9.36%** | **11.95%** | **3.13%** | **10.61%** |

All performance figures are unaudited, estimated, and may be subject to subsequent adjustment. A limited partner's actual returns may vary from published fund returns based on the timing of capital and fee arrangements. This statement represents information based on the policies of the fund's managers and general partner. Please contact Travis Cocke, Managing Partner of Southpaw Capital, LLC, with any inquiries.

At a recent presentation by a revered value fund manager, a young audience member asked something along the lines of "When do you stop reading others' work and putting weight on their opinions versus believing more in your own independent thoughts? Additionally, how do you filter out the junk from the good data?" Terrific question. Along with this particular investment manager, we believe all attempts at obtaining a sturdy foundation for a sound investment framework must begin with a judicious reading program and the aspiring guru must continue to hold this practice in the uppermost of their daily priorities. This investor, however, could not quite articulate a clear answer to the question, but answered simply "just read a lot" and proceeded to confessing to devouring 4-6 newspapers a day, cover-to-cover. Eventually a value investing framework is so deeply internalized that perhaps it is no longer consciously considered, but it is just lived. In the digital age, information is readily accessible and fact gathering is the easy part. Anyone can use Bloomberg and Google. Having judgment to connect the dots, put things into proper context and see around the corner (or the ability to process the abundance of data and filter it) is where the necessary investor skills lie. Given the substantive record of the above mentioned investor, it is my belief that this manager is quite adept at filtering the noise from the signal and has internalized such a filter. It has been honed to a sort of sophisticated unconscious pattern recognition akin to that of muscle memory and body control of a world-class athlete. One or two articles can set off a cascade of interconnected information and knowledge and an insight or actionable investment idea transpires at the juncture of intuition of financial theory/valuation, business economics and understanding of game theory and stakeholder incentives. Said judgment is only one of the necessary requirements of investor capacity and is but at most perhaps halfway to true investment nirvana. Temperament (the ideal emotional apparatus) and lack of institutional constraints (the ability to act on convictions in a timely manner) round out the ideal trinity.

The first multi-page newspaper (four pages long, but they only filled three in the first and only edition) in America, Publick Occurences Both Forreign and Domestich, appeared in Boston in 1690[1]. The editor promised to furnish the news once a month and maybe slightly more often if a "glut of occurrences happen."[1] With the hyper-connected 24/7 information cycle, it is increasingly necessary that the news seem to change, so news gathering morphs into news creating. For most aspiring investors simply reading multiple periodicals is not a recipe for stock market genius, but would in fact be quite toxic to returns.

> "Better to know a few things which are good and necessary than many things which are useless and mediocre. The difference between real material poison and intellectual poison is that material poison is disgusting to the taste, but intellectual poison, which takes the form of cheap newspapers or bad books, can unfortunately sometimes be attractive." –Leo Tolstoy

These mediocrities are as ubiquitous as they are utterly useless. Popular media outlets often inculcate a careless and deplorable logic which can be hard to unlearn, therefore most popular media interpretations of events as it pertains to capital markets pricing must be ignored as they impede an investor's journey to a purer style and focus on what is required to make money on a consistent basis. Popular media should be referenced sporadically in order to gauge the sentiment of the overall investment community, but otherwise it should be avoided so as to prevent getting buried in an avalanche of sensational, unscientific data. Being a small firm and having limited resources (namely man hours devoted to research), we must try to narrow down the security universe and our daily reading regimen in a highly methodical manner by focusing on source documents of securities with value altering corporate actions taking place. We aim to focus on those securities which are pre-selected to be most likely to systematically outperform (or underperform for shorts) due to various technical supply/demand factors and certain corporate actions. Reading the rest of the high frequency news is, generally speaking, not relevant to managing our portfolio, nor worth re-hashing in these limited pages.

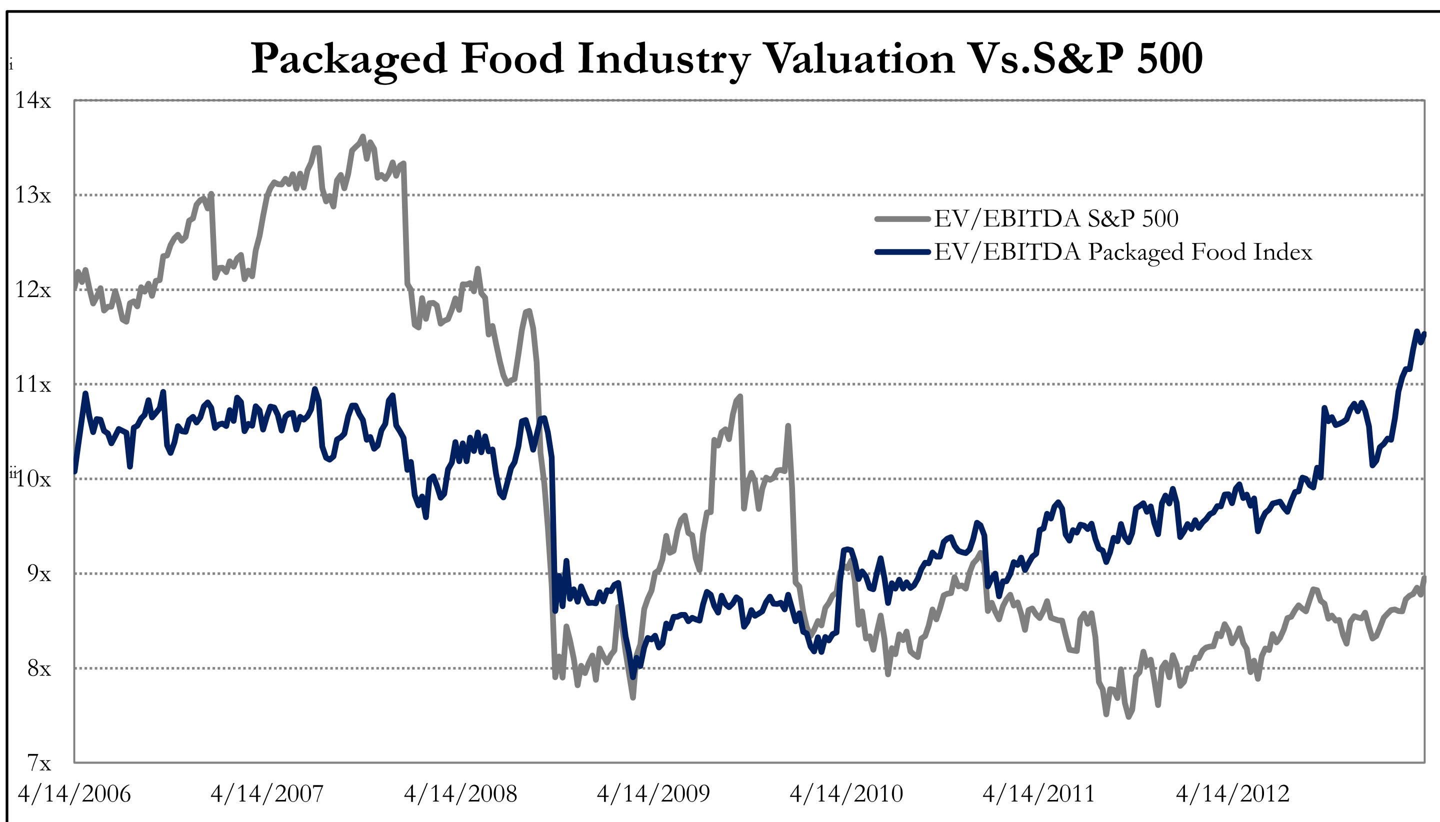
As pointed out above, it seems like story stocks are thriving in this market environment, as the future business dynamics are unknown, but many have charismatic management teams and nice narratives of unlimited growth prospects (for example, biotech, which is the best performing industry YTD). We are as anecdotally inclined as anyone and this has indeed been the root cause of some mistakes on our part. One such mistake/disappointment has been Overhill Farms (OFI). OFI is a value-added manufacturer of frozen food products. We bought shares at a 7.7x EV/trailing EBITDA multiple. We bought on the premise that there was massive operating leverage inherent in the business model and that gross margins could slowly revert back Q2 2011 levels, where revenue was much lower. If gross margins got back to the 13% level, we thought we were buying shares under 5x our forward EPS estimates. Additionally, at the time of investment we thought that:

- Food inflation had likely peaked
- OFI's rapid deleveraging over the last few quarters had both meaningfully lowered interest expense as well as allows future free cash flow to benefit equity valuations
- It was in a somewhat "defensive" industry and this relative stability could command higher multiples
- Low asset utilization meant that incremental margins would be much higher
- A new Boston Market contract caused a messy quarter as investment and inventory were raised yet the full revenue effects were not felt
- The new Boston Market and Target accounts could boost revenues by 30% over the next year and with the operating leverage it should cause EPS to at least double
- Largest shareholder had been a net seller, given anemic volume, this caused a substantial overhang and the share price had literally been going down 2-3% every single day for a while
- A new food safety certification increased the company's ability to win new business going forward
- Heinz had a lot of excess inventory sitting on retailer shelves, therefore the full brunt of the new Boston Market sales on a normalized basis would not likely be seen for a while

What actually has happened? Well, when looking back at our financial projects, we nailed the revenue numbers within 1% of the actual results. Everything else was way off and the profitability never materialized for a multitude of reasons. Our main initial concerns were customer concentration and a management team that continuously over promised and under delivered and they have certainly not broken precedent. Eventually the company had announced they were hiring Piper Jaffray to explore strategic alternatives and the stock got a nice boost. We still held on believing there was still more premium to come if a strategic or financial buyer (who could substantially improve profitability) made a bid, based on the >60% discount to peers on an EV/Sales basis. Nine months have now gone by with no resolution to the strategic review/shopping process, despite continued promises that an announcement is always just around the corner and the shares have drifted lower. We still hold the shares in hope of some positive strategic development, but as our Fund assets have grown we made the active decision to not add to the position, so its portfolio position weighting has come down dramatically to only around 2%. In hindsight, OFI is in a very competitive/commoditized industry and it is not earning a return on its invested capital that exceeds its cost of capital. A sudden negative shift in gears is usually indicative of a situation that will not turn around as quickly as management would have shareholders believe.

With a current stock price of ~$4.00 compared to our original cost basis of $3.61, it has still been a profitable investment, but a relative laggard in the bull market and considered a costly mistake of opportunity cost nonetheless. OFI still currently trades below Processed Food comparable peers on an enterprise multiple basis at 8.1x EV/trailing EBITDA versus 12.4x for peers. Packaged Food as a whole is an industry we follow closely. Interestingly, the industry's historically large multiple discount (spread between gray line and blue line from 2006-

2009) has flipped into its largest ever multiple premium, but we have unfortunately not benefitted from this rally that happened right under our noses. On the flip side, we are now finding selective shorting ideas within the food space. The entire industry as a whole is at just 12.0% EBITDA margins versus the S&P 500 at over 18%. The average dividend payout ratio for the Packaged Food industry is at 46.5% and yet it yields only 2.05%, right in line with the market. The average P/E, however, is at 24.7x trailing and 26.4x Price/Free Cash Flow (median 21x). The chart below shows forward EBITDA estimates. Trailing EV/EBITDA is at 12.4x and sell-side consensus calls for 12.0% EBITDA growth this year[2]. The market is clearly paying up for perceived earnings stability and M&A in the sector is on fire (Buffett's HNZ deal news was announced in February). In our opinion, almost every Packaged Food company we look at seems to have gotten ahead of itself and is quite stretched from a valuation standpoint and will need to consolidate for a while as it grows into such a premium valuation. Also interesting to note, the chart below makes the overall market appear not that expensive, although this shows only a limited history.

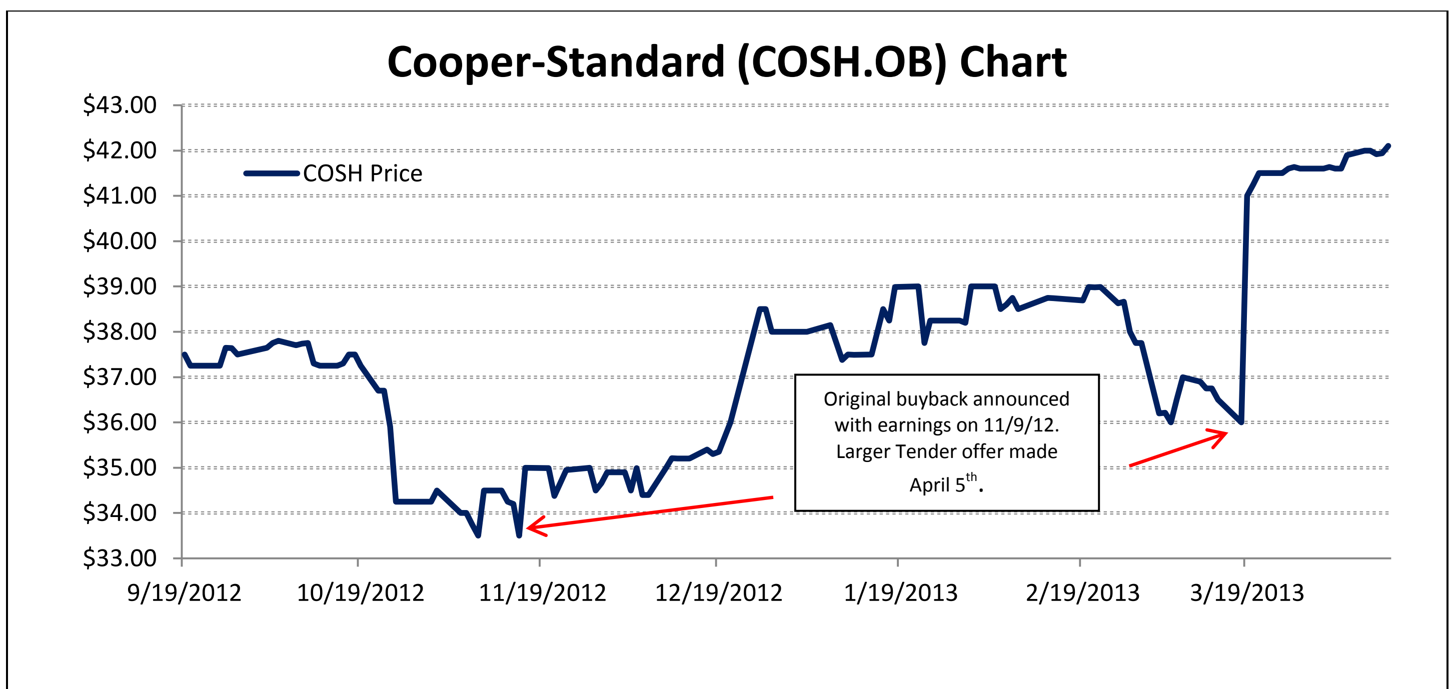



We generally do not like talking about ideas because people have a tendency to like investments based on a fancy narrative so many of our ideas won't sound compelling when condensed to divulge to outsiders. A recent investment, Cooper Standard (COSH.ob), possessed no real narrative embedded within our thesis. It is admittedly boring, obscure and illiquid. Our decision at the time of purchase can be succinctly summarized by the following points:

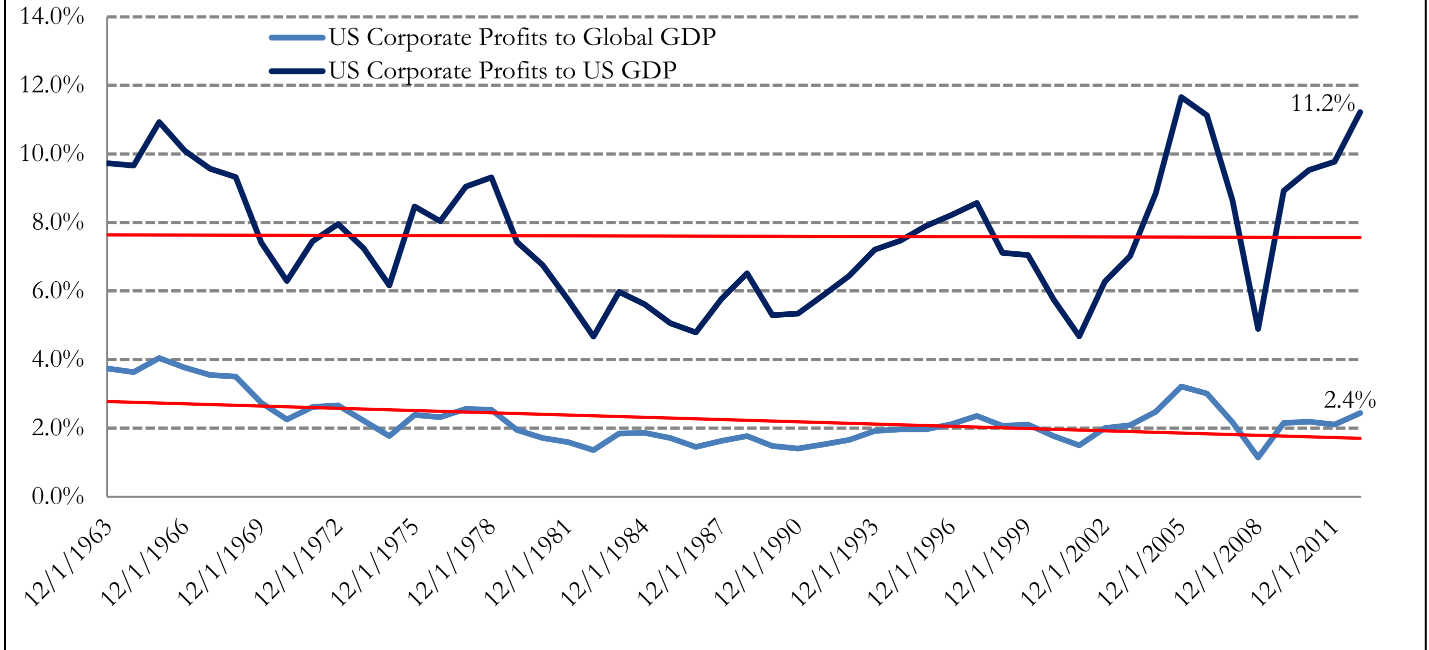
- Leading global supplier for the auto industry of:
  - Sealing, rubber/weather strip assemblies
  - Fluid systems: pumps, hoses, connectors, and valves to control fluid delivery
  - Anti-vibration systems: engine mounts, dampers, other related products to reduce vibration and improve vehicle ride handling
- Recently emerged from bankruptcy (orphaned stock); no sell-side coverage

- Large relative discount to comparable peer group[3]:
    - Peer Average EV/Forward EBITDA (estimates) = 5.3x, COSH 3.5x
    - Peer Median EV/Forward EBITDA = 4.8x
    - Average Peer EBITDA Margins of 8.8%, COSH = 10.7%
- Compared to the same peer group, COSH has an above average ROA, superior revenue growth profile, higher gross margins, and higher operating margins
- Large EBITDA/Market Cap Ratio; expansion in the Enterprise Multiple has an outsized effect on equity
- Equity had 40% upside to a 4.5x multiple, 53% upside to the median multiple of 4.8x, and 75% upside to the average multiple of 5.3x
    - All of the above assumes zero EBITDA growth
- Despite leverage, no debt maturities until 2018
- North American centric; >52% of sales in North America
- New CEO as of mid-October 2012; several cost saving and strategic initiatives underway
- On 11/19/12 COSH had announced a $25 million buyback, with a recent average of $20k/day volume, the buyback was very meaningful and likely provides support for the stock
- COSH had not rallied along with the market and Peer group (no index or ETF membership, money is slow to flow into it, so its relative discount was growing)

The only possible reason we could come up with for such a large discount is liquidity (and thus Private Equity ownership overhang), which could change eventually with a re-listing on an exchange.




Given our still small asset base, we took advantage of this situation. We remain constructive on the auto sales cycle and the reason this investment was attractive to us is we felt it offered an asymmetric bet skewed to the upside. It would have been hard to lose money and shares could eventually be re-rated higher with a more in-line multiple. Given the share buyback in place was so large, not just relative to the float, but relative to the average trading volume, it helped to put a floor on the stock. After a few weeks of holding, the company announced a $200 million tender offer for 21% of the company at a price of up to $43 per share which we stand to benefit from.




A common chart or point investors are making lately is that US Corporate profits are at a peak relative to US GDP. One mistake investors commonly make is to fail to think globally. If one applies corporate profits (of which both domestic and international are reported) to global GDP, then the profits look normal and are actually trending lower. US GDP only counts activity that goes on inside the US borders (as opposed to GNP). Given over one half of S&P 500 constituents' revenue comes from outside the US (versus a smaller percentage 3, 5, 10 years ago), an increasing ratio of US profits to US GDP doesn't seem reason for alarm to us.

## History of S&P 500 Margins

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | Current |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| EBITDA Margin | | | 15.4 | 15.9 | 17.8 | 19.1 | 19.5 | 21.2 | 21.1 | 21.6 | 20.0 | 20.5 | 20.2 | 20.2 | 21.3 | 23.2 | 23.1 | 18.5 | 19.3 | 19.4 | 19.0 | 18.7 | 18.8 |
| Operating Margin | | | | | | | | 18.3 | 19.0 | 18.7 | 16.7 | 18.2 | 19.1 | 20.0 | 20.0 | 20.2 | 19.2 | 18.2 | 17.6 | 19.5 | 20.2 | 20.0 | 19.9 |
| Profit Margin | 7.0 | 6.0 | 6.3 | 8.3 | 9.6 | 10.6 | 10.8 | 13.5 | 12.6 | 11.7 | 8.8 | 10.4 | 12.1 | 12.9 | 13.7 | 14.6 | 12.9 | 10.6 | 11.5 | 13.3 | 13.7 | 13.4 | 13.3 |

| S&P 500 from 1991 - Current | Gross Margin | EBITDA Margin | Operating Margin | Profit Margin |
|---|---|---|---|---|
| **Current** | 45.2% | 18.8% | 19.9% | 13.3% |
| **Average** | 45.9% | 19.7% | 19.1% | 11.2% |
| **Median** | 45.3% | 19.5% | 19.1% | 11.7% |
| **Minimum** | 44.2% | 15.4% | 16.7% | 6.0% |
| **Maximum** | 48.0% | 23.2% | 20.2% | 14.6% |

Source: Bloomberg LP

As shown in the chart and table above, current profit margins for S&P 500 companies as a whole are also not overly stretched to the upside at present, although they're certainly in the upper percentiles, historically speaking. It helps to have a broader historical context of margins but we do not make investments or allocate our time based on broad data sets like this. Everything needs to be distilled down to industry and individual company level for better understanding of margins trends. There are lots of idiosyncratic situations where massive restructuring has systematically improved margins and situations where entire industries are facing margin pressure headwinds.

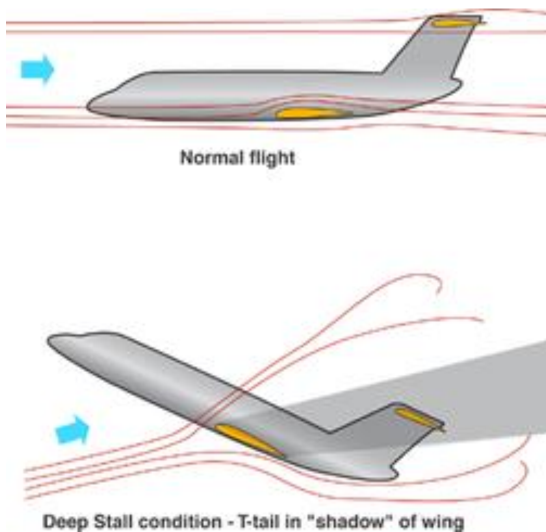
On June 1st, 2009, Air France Flight #447 going from Rio de Janeiro to Paris disappeared over the mid-Atlantic. As AF447 passed into clouds associated with a large system of thunderstorms known as the inter-tropical convergence near the equator, its speed sensors became iced over and the plane's autopilot then disengaged.

> "In the ensuing confusion, the pilots lost control of the airplane because they reacted incorrectly to the loss of instrumentation and then seemed unable to comprehend the nature of the problems they had caused. Neither weather nor malfunction doomed AF447, nor a complex chain of error, but a simple and persistent

mistake on the part of one of the pilots." – *What Really Happened Aboard Air France 447* by Jeff Wise, Popular Mechanics magazine, December 6th, 2011

The crew had not studied the storm patterns and neglected to request a route circumnavigating the most intense area. Unusually high temperatures prevented them from climbing to their desired altitude. The Captain had left the cockpit for a nap and never again took the controls. The co-pilots then banked slightly to the left to avoid the worst of the storms. One of them without the other having known it, puts the plane into a climb, despite the two having just discussed not being able to do so safely due to the unusually high external temperatures.

When the Airbus computer lost airspeed data, it disconnected autopilot and switched from normal law mode to "alternate law", a flying regime with far fewer restrictions on what a pilot can do. In alternate law a plane can stall. The junior co-pilot kept the side stick pulled all the way back, putting the plane in a steep climb at a rate of 7,000 feet per minute. A stall warning then chimed and alerted the cockpit. This is a synthesized human voice that repeatedly calls out "Stall!" followed by a loud and intentionally annoying sound called a "cricket."




A stall is from flying too slowly, causing the wings to become ineffective at generating lift and thus can lead a plane to "plunge precipitously." One of the co-pilots was unaware that the other had been pulling back on the controls, doing the exact opposite of what he should have done. This is because the side sticks are "asynchronous" – that is they move independently of each other. "All pilots are trained to push the controls forward when they're at risk of a stall, so that the plane will dive and gain speed."[4] As one article on the incident pointed out, "Intense psychological stress tends to shut down the part of the brain responsible for innovative, creative thought."[4] The junior co-pilot does the exact opposite of what he should, so although the Airbus' nose was pitched upwards, the aircraft was actually declining at nearly a 40 degree angle. The cricket and stall warning went off 75 times and within minutes everyone aboard was dead. This event is a human tragedy beyond words and picking stocks is obviously not a matter of life or death, but there are still portfolio management lessons to be gleaned.

Getting increasingly cautious and building short positions too early has hurt and cost us a lot in terms of performance the last few weeks, but our prudence should eventually provide thrust. It is important not to get caught up in the mistake of focusing on relative returns in a raging bull market, yet care only about positive absolute returns in a bear market. Despite being seemingly at stall speed the last few weeks and wanting to pull back to keep the 'angle of attack' steep, we can't risk losing altitude as the market ascends into thinner air. We're currently experiencing CAVU, ceiling and visibility unlimited, which makes for ideal flying and investing conditions. That said, now is not the time to kick back on cruise control, but rather do some neck rolls, brew some strong coffee, "check our six," and practice hand-flying under various scenarios at cruise altitudes. Every now and then it's okay to dive or take a shallower angle to regain speed. As we all know, should the market disengage from autopilot, a positive feedback loop can quickly flip into a negative one. We must stay fully engaged, constantly going through iterative cross-checks of the portfolio holdings and do our best critical thinking now while skies are calm so that we may be better prepared for the inevitable turbulence to come.

Best Regards,

Southpaw Capital, LLC

## Disclosures and Notices

The information contained herein reflects the opinions and projections of Southpaw Capital, LLC ("Southpaw") as of the date of publication, which are subject to change without notice at any time subsequent to the date of issue. Southpaw does not represent that any opinion or projection will be realized. All information provided is for informational purposes only and should not be deemed as investment advice or a recommendation to purchase or sell any specific security. While the information presented herein is believed to be reliable, no representation or warranty is made concerning the accuracy of any data presented. This communication is confidential and may not be reproduced or distributed without prior written permission from Southpaw. This confidential report is only intended for the recipient and may not be redistributed without the prior written consent of Southpaw Capital, LLC. This report is provided for informational purposes only and does not constitute an offer or a solicitation to buy, hold, or sell an interest in any Southpaw Value Funds or any other security. An investment in any Southpaw Value Fund is speculative and involves substantial risks. Additional information regarding the Southpaw Value Funds listed herein, including fees, expenses and risks of investment, is contained in the offering memorandum and related documents, and should be carefully reviewed. An offer or solicitation of an investment in any Southpaw Value Funds will only be made pursuant to an offering memorandum. There can be no guarantee that any Southpaw Value Fund will achieve its investment objectives.

**Past performance does not guarantee future results.** There is a possibility for loss as well as the potential for profit when investing in the funds described herein. Performance of the Southpaw Value Fund is presented on both a net and gross basis. Performance information labeled (Net) is net of all fees and expenses and includes the reinvestment of dividends and other income. Performance information labeled as (Gross) does not reflect the deduction of fees. Gross numbers include the reinvestment of dividends and other income. Portfolio characteristics and other information are provided as of the dates set forth herein. Current or future characteristics and other information may vary significantly from those provided herein and the firm undertakes no obligation to notify the recipient of any such variances. Indexes are unmanaged and have no fees or expenses. An investment cannot be made directly in an index. The funds consist of securities which vary significantly from those in the benchmark indexes listed above and performance calculation methods may not be entirely comparable. Accordingly, comparing results shown to those of such indexes may be of limited use. The S&P 500 Index™ is an unmanaged index and a market-capitalization-weighted index of 500 stocks designed to be a broad measure of United States stock market. The HFRX Global Hedge Fund Index is designed to be representative of the overall composition of the hedge fund universe.

THIS SHALL NOT CONSTITUTE AND OFFER TO SELL OR THE SOLICITATION OF AN OFFER TO BUY ANY INTEREST IN ANY FUND MANAGED BY SOUTHPAW. SUCH AN OFFER TO SELL OR SOLICITATION OF AN OFFER TO BUY INTEREST MAY ONLY BE MADE PURSUANT TO DEFINITIVE SUBSCRIPTION DOCUMENTS BETWEEN A FUND AND AN INVESTOR.

---

[1] http://www.historybuff.com/library/reffirstten.html

[2] Packaged Food Industry Comp List and Statistics Source: TSN, MDLZ, HRL, SFD, CAG, GIS, K, CPB, HSY, HNZ, MKC, SJM, SAFM, FLO, MFI; Data source: Bloomberg LP

[3] COSH trading comp group includes (identified by Ticker): VC, TEN, TRW, LEA, DAN, GT, FDML, BWA, AXL. Data source: Bloomberg LP

[4] http://www.popularmechanics.com/technology/aviation/crashes/what-really-happened-aboard-air-france-447-6611877