April 10, 2019

Longleaf Partners Small-Cap Fund Commentary

1Q19

Longleaf Partners Small-Cap Fund gained 10.50% in the first quarter, far outpacing our annual goal of inflation plus 10% but underperforming the Russell 2000 Index's 14.58% return. The market's rebound, following a double-digit fourth quarter decline in 2018, provided a tailwind. Most of the stocks in the portfolio made double-digit gains in the last three months.

Even as the issues of global economic slowdown, tariff and trade disruptions, and geopolitical unrest remained unresolved, the investor concern that dominated late 2018 appeared to dissipate. We have little insight into how macro questions about trade, U.S. and China economic growth, and inverted yield curves and trillions in negative yielding debt will be answered, but we are confident these uncertainties will continue to provide opportunities to disciplined, long-term business owners like ourselves.

When stocks become as deeply discounted as we saw in December, it is not uncommon to have a big turnaround. The Fund's largest contributors in the first quarter were among those stocks that hurt performance the most in the fourth quarter of 2018. These businesses, including fertilizer, toys, cement and luxury retail, have little in common, and their strong recent returns reflected positive progress specific to each company.

Information Technology (IT) stocks were the primary driver of the Index, as the sector gained over 20%. The Fund's smaller IT exposure (8.5% average weight versus 15.0% for the Index)

Average Annual Total Returns for the Longleaf Partners Small-Cap Fund (3/31/19): Since Inception (2/21/89): 10.66%, Ten Year: 16.55%, Five Year: 6.39%, One Year: 4.39%. Average Annual Total Returns for the Russell 2000 (3/31/19): Since Inception (2/21/89): 9.44%, Ten Year: 15.36%, Five Year: 7.05%, One Year: 2.05%.
Returns reflect reinvested capital gains and dividends but not the deduction of taxes an investor would pay on distributions or share redemptions. Performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by visiting longleafpartners.com. As reported in the Prospectus dated May 1, 2018, the total expense ratios for the Longleaf Partners Small-Cap Fund is 0.92%.

and mixed IT results (ViaSat up 31%, Kodak down 8%) accounted for 1.6% of the relative underperformance. CenturyLink, the Fund's single largest stock detractor, drove the Communications Services sector to account for 1.9% of underperformance.

We started the year actively assessing numerous new qualifiers, but the market's rally shortened our on-deck list quickly. Cash rose to 22%, as we sold Hopewell and trimmed four positions but did not buy any new investments during the quarter. Even with the large return, we believe substantial upside remains in the portfolio, with only one holding selling at over an 80% price to value (P/V).

Contributors/Detractors

(Q1 Investment return; Q1 Fund contribution)

OCI (35%, 1.73%), a leading producer of nitrogen fertilizers and methanol, was a strong contributor. OCI grew free cash flow (FCF) 210% year-over-year and earnings before interest, taxes, depreciation and amortization (EBITDA) over 100%. Strong cash generation should continue to help the company rapidly deleverage - net debt declined $327 million, and Net Debt/Operating Cash Flow fell from 7x to 4.4x over the last year. Volumes stepped up 16%, with U.S. assets increasing production up to 115% of nameplate, as OCI grew into its new capacities. Multiple strategic options are available to the company, which sells well below the replacement cost of its assets, and rumours of Saudi interest in the methanol plants helped the stock. CEO Nassef Sawiris is an owner operator who remains focused on value creation and recognition.

Mattel (30%, 1.47%), the toy and media company, was another large contributor. During the last quarter, Barbie and Hot Wheels grew nicely once again. Mattel's new media division demonstrated some of the possibilities for monetizing the company's brands, announcing Barbie and Hot Wheels movie joint ventures with Warner Brothers, an American Girl movie with MGM, and 22 television shows to distribute across multiple platforms. The company's earnings power should grow with a targeted 15% operating income margin over the next few years, following additional cost cuts, international inventory rationalization and longer-term investments during 2019. Management is focused on maximizing the value of the Barbie and Hot Wheels brands, while returning Fisher-Price, American Girl and Thomas to growth. Not only is the stock well below our current appraisal, but we expect that appraisal to grow rapidly over the next few years. CEO Ynon Kreiz personally bought $1 million of shares in the last few months.

GCI Liberty (35%, 1.46%), the cable holding company, contributed despite a tough quarter for GCI, its namesake Alaskan subsidiary. The bad news included an earthquake, a government funding cut and difficulties rolling out a new billing system. Meanwhile, Charter Communications, which constitutes two-thirds of GCI Liberty's net asset value, reported strong FCF and gains in residential and small-business subscribers. Charter CEO Tom Rutledge is completing the complex integration of the 2015 acquisitions of Time Warner Cable and Bright House, plus a costly network-wide improvement to 1 gigabit service, which should allow the consolidated Charter to grow its cash flows significantly for years to come. Despite the appreciation of GCI Liberty stock, it still trades at a double-digit percentage discount to the sum of its parts. The company repurchased GCI shares at a good pace, and Chairman Greg Maffei has additional strategic options to realize the growing value.

Summit Materials (28%, 1.44%), the aggregates and cement company, meaningfully contributed. For the quarter, Summit's aggregates pricing increased 8%, while cement pricing gained $10 per ton. This year's FCF should be used to deleverage the balance sheet. While Summit has some sensitivity to unpredictable weather and cost inflation, its cyclical risk is moderate with the company's lack of exposure to high-rise and office tower construction. As the U.S. cement and aggregates industry consolidates, CEO Tom Hill will have numerous strategic options to close the stock's price-to-value gap. Hill bought additional shares in the quarter, increasing his ownership by 5%.

Neiman Marcus (31%, 1.16%), the luxury retailer, helped performance as the bonds that we own rallied in March when the company announced a restructuring agreement with a majority of creditors to extend its debt maturities past 2023. The extension allows additional time for Neiman's turnaround, which has yielded six straight quarters of positive comparable sales. As part of the agreement, bond holders, including the Fund, will receive a preferred equity position in Mytheresa, Neiman's high-growth e-commerce subsidiary.

ViaSat (31%, 1.09%), the consumer and military satellite communications company, contributed after reporting strong growth in revenues and cash flow. We believe ViaSat's government segment is on track to grow at a mid-teens or better pace this year once again. Residential broadband average revenue per user (ARPU) increased. Inflight took additional market share with 260 net global installations in the quarter, as its superior aircraft internet service continued to beat competitors. The third satellite in the ViaSat-3 constellation was announced, which sets the company up to have a best-in-class, worldwide satellite broadband offering for airlines and governments in the years to come.

CenturyLink (-19%, -1.45%), the fiber and telecom company, was the primary detractor to first quarter returns after a dividend cut. We were disappointed by that decision and filed a 13-D to enable us to become more active in the investment through seeking to improve the board, encouraging opportunistic asset sales and exploring creating tracking stocks for the company's two segments. Private-market transactions of assets comparable to some of CenturyLink's (CTL) fiber assets have been over 15X EBITDA, far above CTL's depressed 5X EBITDA stock price. In addition to monetizing some of this fiber, separating the enterprise and consumer segments into distinct tracking stocks could help highlight the values and different opportunity sets for both. We believe that adding board members with experience in fiber and financial transactions can bring additional capital allocation discipline to drive value recognition. We maintain our support for Jeff Storey and his team operationally even while disagreeing about some capital allocation items. Storey bought $1 million in shares personally in the quarter, and CFO Neel Dev, as well as multiple directors, also increased their ownership of the stock.

Portfolio Activity

Our on-deck list of prospective investments shrank as the market rose. We added to a couple of positions and trimmed four holdings. We sold Hopewell Holdings, the Hong Kong-listed property company that was one of the Fund's largest contributors in 2018. In December, the founder, Gordon Wu, offered HK$38.8 per share to buy out other shareholders and privatize the company. We sold after shareholders approved the deal in March. Over the Fund's five-year holding period, the stock gained over 100%.

Team Update

We welcomed Taieun Moon as a junior analyst in our Singapore office in the quarter. Taieun interned for Southeastern last summer and joins us full time following his graduation from The University of Hong Kong. We also concluded our search for a junior analyst in London. Alicia Cardale will join Southeastern in May. She has interned at several investment firms and most recently worked at a U.K. real estate company. Alicia has a Master's degree in Real Estate from the University of Reading. We look forward to the broad depth that Taieun and Alicia will add to our research team.

In March, we shut down the concentrated Europe Fund ("SCV"). Although SCV had a strong performance record over its four years, in the last fifteen months the Fund's cash balance grew to more than three-quarters of net asset value. Over the same period, the International Fund's cash declined from 22% to less than 3%, as we were finding opportunities, including several European qualifiers. SCV's idea generation was no longer benefitting Southeastern's broader client base, and our investment partners could own the most compelling European engagement opportunities via the more flexible and less costly International and Global Funds. Consequently, we returned the capital to our partners, much of which was internal to Southeastern and will be re-deployed into the Longleaf Funds. Because Scott Cobb was solely focused on managing SCV, he will depart from Southeastern upon its closing. We thank Scott for his years of service to Southeastern and our clients.

Outlook

The Fund began the year at a rare discount, with the P/V below 60%. The subsequent rally is not surprising from such depressed prices. More encouraging is that rebounds from 50s% P/Vs historically continued over several years. With the portfolio trading at a mid-60s% P/V today, we believe there is substantial upside opportunity. We will deploy the cash as qualifiers emerge that are selling at substantial discounts. Beyond the P/V math, we are seeing value growth at our companies, which should drive further opportunity. Additionally, our partners are taking proactive steps to drive value recognition at many of our holdings. We believe their actions can drive much stronger long-term results than we expect from the fully valued Index.

See following page for important disclosures.

Before investing in any Longleaf Partners Fund, you should carefully consider the Fund's investment objectives, risks, charges, and expenses. For a current Prospectus and Summary Prospectus, which contain this and other important information, visit longleafpartners.com. Please read the Prospectus and Summary Prospectus carefully before investing.

RISKS

The Longleaf Small-Cap Fund is subject to stock market risk, meaning stocks in the Fund may fluctuate in response to developments at individual companies or due to general market and economic conditions. Also, because the Fund generally invests in 15 to 25 companies, share value could fluctuate more than if a greater number of securities were held. Smaller company stocks may be more volatile with less financial resources than those of larger companies.

The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3,000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index. An index cannot be invested in directly.

P/V ("price to value") is a calculation that compares the prices of the stocks in a portfolio to Southeastern's appraisal of their intrinsic values. The ratio represents a single data point about a Fund and should not be construed as something more. P/V does not guarantee future results, and we caution investors not to give this calculation undue weight.

Free Cash Flow (FCF) is a measure of a company's ability to generate the cash flow necessary to maintain operations. Generally, it is calculated as operating cash flow minus capital expenditures.

Leverage refers to the use of debt. De-leverage refers to a decrease in debt.

Aggregates are materials such as sand or gravel that are ingredients in concrete.

A 13D filing is generally required for any beneficial owner of more than 5% of any class of registered equity securities, and who are not able to claim an exemption for more limited filings due to an intent to change or influence control of the issuer.

As of March 31, 2019, the top ten holdings for the Longleaf Partners Small-Cap Fund: Graham Holdings, 6.7%; CenturyLink, 6.2%; Summit, 5.9%; Mattel, 5.7%; GCI Liberty, 5.3%; Liberty Media, 5.1%; OCI, 5.1%; PotlatchDeltic, 5.1%; Park Hotels, 4.8%; Lazard, 4.6%. Fund holdings are subject to change and holding discussions are not recommendations to buy or sell any security. Current and future holdings are subject to risk.

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