OTSI KETA QUARTERLY

Thirty-Sixth Edition - April 2019

OTSI KETA CAPITAL

Q1 2019

Otsi Keta Quarterly is designed to share insight on both current performance and future potential.

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QUESTIONS...

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"It's about getting things down to one number. Using the stats the way we read them, we'll find value in players that no one else can see. People are overlooked for a variety of biased reasons and perceived flaws. Age, appearance, personality. Bill James and mathematics cut straight through that. Billy, of the 20,000 notable players for us to consider, I believe that there is a championship team of twenty-five people that we can afford, because everyone else in baseball undervalues them."

– Peter Brand, Moneyball (2011)

A METRIC MORE USEFUL THAN MOST

We are off to a solid start in 2019. On balance, the business environment and the economy indicate more resilience than many anticipated at the end of 2018. We expect the business climate to remain positive for the rest of the year. The businesses in our portfolio have demonstrated strong operating performance over the last 12 months—and will benefit from two to three percent GDP growth, low levels of unemployment, stable interest rates and low inflation.

The market value of our investment holdings rose 15.29% during the first quarter, resulting in a strong gain in value for our investors. We need and appreciate the market liquidity when we buy and sell securities, as well as calculate investor returns. However, most days of the year, stock market price gyrations are more of a distraction than arbiter of value. As we have espoused in the past, our investments aren't just pieces of paper, but represent the Fund's ownership interest in specific businesses.

Operating Results

When we talk about the operating performance of the businesses in the portfolio, we are aggregating our holdings and weighting each company's earnings contribution by their relative size within the portfolio. We believe the market prices of our holdings are well supported by their underlying economics.

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We look at the aggregated operating profit (earnings before interest and tax) of the companies in our portfolio against our invested capital as the most appropriate way to judge our holdings' operating performance in any single year. The portfolio's operating earnings in the last 12 months amounted to 15.11% of our cost basis. We value our holding at initial cost when comparing to operating earnings. We do this to avoid the problem of equity values rising during the year, causing operating performance to appear weak, as well as preventing a steep drop in equity values making a mediocre year look overly impressive.

Pre-tax Earnings Yield Using Initial Position Cost	
Fund's investments at beginning of period costs	$19.2 MM
OKFF prorate share of investments Operating Earnings - LTM (Last 12 months)	$2.9 MM
LTM Operating Earnings as a % of OKFF invested capital	15.11%

The accounting is not perfect due to transactions and reporting periods, but we believe the measurements are accurate enough…though not holy script. We are unconcerned that we don't physically receive our portion of operating earnings, with the exception of dividends and distributions. Over time, if management reinvests our portion effectively, the dollars we didn't receive can come back dressed up like fives and tens. While there are never any guarantees, we like to improve our odds over time by:

1. focusing on businesses we can understand with favorable prospects,
2. buying at attractive prices (businesses we can buy for less than our intrinsic value calculations),
3. investing in companies run by competent and trustworthy management, and
4. recognizing the importance of balance sheets that are appropriate for the industry and business environment.

Operating profit growth was strong last year, with our share of operating profits growing 42.1%. Our portfolio companies did a great job of increasing earnings. We think much of the improvement has not been fully priced by the market. We are not expecting as much operating growth over the next 12 months, but we do expect the current portfolio to produce more operating profit next year than this year. We will continue to make changes and add new positions when we see opportunities to enhance the portfolio's underlying economics.

Change in Fund's Pro Rata Share of Equity Holdings Operating Profit	
Operating Profit LTM	$2.90 MM
Operating Profit Prior 12 Months	$2.04 MM
Dollar Change in Operating Profit	$865.6K
Y/Y Growth in Operating Profit	42.1%

Sources of Earnings

The bulk of the operating profit growth came from our consumer cyclicals and industrial holdings. Transportation and energy holdings by and large underperformed our expectations. Both segments faced industry headwinds, but we expect them to be additive over the next 12 to 18 months. (See the chart on the following page.)

Prospects

We expect double-digit portfolio gains in 2019, driven by:

1. single-digit operating profit growth,
2. a good macro environment,
3. solid business execution from management teams,
4. continued share repurchases, and
5. one-to-two points of multiple expansion in our holdings.

In investing, we can't usually get things down to one number as Peter Brand said to the Oakland A's baseball general manager, Billy Beane, in *Moneyball*. If we tried to get to a single number, operating profit and its trend over time would be a good start. As the stock market moves up and down, people, appropriately, get spooked by the volatility. We keep our eye on our holdings' ability to generate and grow their operating profit. Risk comes from the underlying assets you hold over time—and, over time, business economics explain valuation. In the course of days, weeks and months, sentiment sets valuation, not fundamentals. Focusing on fundamentals keeps us from getting distracted.

Longtime readers will notice we seldom participate in certain industry categories, such as real estate, utilities and healthcare. We tend to avoid real estate and utilities due to their highly leveraged balance sheets. In healthcare, we avoid biotech, but are always looking for healthcare companies that don't depend entirely on government reimbursement.

Percentage of Investment by Industry

	OKFF Holdings	Russell 2000	Delta
Cyclical (%)	**50.16**	**42.60**	**7.56**
Basic Material	2.07	5.12	(3.05)
Consumer Cyclical	38.33	12.78	25.55
Financial Services	9.76	15.98	(6.22)
Real Estate	--	8.72	(8.72)
Sensitive (%)	**43.59**	**35.50**	**8.09**
Communication Services	--	1.33	(1.33)
Energy	3.29	3.06	.23
Industrials	19.71	13.85	5.86
Technology	20.59	17.26	3.33
Defensive (%)	**6.26**	**21.90**	**(15.64)**
Consumer Defensive	6.26	3.53	2.73
Healthcare	--	14.61	(14.61)
Utilities	--	3.76	(3.76)
Not Classified	--	--	--

What Is Going on in the Midwest?

- The locks in Sault Ste Marie, Michigan, opened in late March, indicating the start of the Great Lakes shipping season.
- Minnesota and other Midwest manufacturers enjoyed solid sales and production in March, according to a report issued by Creighton University. Creighton's nine-state Mid-America Business Conditions Index rose to 58.2 in March from 57.9 in February amid increases in new orders and production. This signaled the best business condition in the region since August 2018.
- Spring flooding in the Midwest has put a damper on near-term growth in the region. Excessive rains could put off the typical start to the summer farming season.
- The Midwest continues to be an interesting geography for potential tech companies. With the region hosting many large universities (think Big Ten and Big 12), there is a natural driver to bring successful entrepreneurs in from the coasts to take advantage of affordable, hardworking employees.

We continue to see the benefits of investing in the Midwestern United States. Companies continue to pop up on our investing radar to explore for the Fund. Value remains a focus as the region continues to thrive under this positive economic cycle.

OUR PERFORMANCE

For the first quarter ended March 31, 2019, the Otsi Keta Focus Fund was up 15.29% versus the Russell 2000 Value Index up 11.32%. Since inception, the Fund has returned 143.77%. All Otsi Keta Focus Fund numbers mentioned are net of all fees and expenses. Please see the table below to review the performance of Otsi Keta Focus Fund Limited Partnership versus competitive indexes.

Fund Name	ROR 1st Quarter 2019	5-year total return	ROR From Inception (May 7, 2010)
Otsi Keta Focus Fund Limited Partnership*	**15.29%**	**38.00%**	**143.77%**
Russell 2000 Index (^RUT)	14.18%	31.26%	129.05%
Russell 2000 Value (^RUJ)	11.32%	18.56%	88.94%

Sources: Otsi Keta Capital and Russell Investment
*Note: All OKFF performance data is shown net of all fees and expenses and is based on an investment with the maximum charge of 1.5%/10%.

Our Changes

Normally, under Our Performance, you would see some bullet points on activity in the Fund. We originally introduced this piece approximately a year ago to continue to open the curtain around this activity. In this edition, we would like to speak to the activity a little further.

Initiations

Normally, this area is reserved for one or two names during the quarter. In fact, some quarters show this area to be inactive. The end of 2018/beginning of 2019 proved to have its own unique attributes. Hence, this section was more robust than normal.

Wabash National was an old friend and former holding that decided to migrate back down into our undervalued crosshairs. We have consistently followed this company since its exit, and we were excited to welcome it back into the Fund. Mastercraft Boat Holdings and Greenbrier fell into that category of competitors to previous holdings that we looked at with excitement, but their competition at the time were more attractive “values” for the portfolio (think Malibu Boats and American Rail). We, nonetheless, continued to follow these businesses as the work put into our analysis doesn’t need to end when a competitor is chosen over a like business. The beginning of the year continued to bear new fruit, and we acted accordingly.

We initiated four other small holdings that look to be larger holdings down the road. These were very interesting companies that not only diversified our businesses within the Fund, but came to us with very attractive fundamentals. Remember, if we are actively accumulating when we come to press, we will withhold the names of the companies. More on these in future letters.

Additions

Hurco Companies continues to be an Indiana standout and favorite of the Fund. Petmed Express has a unique business model and stalwart management team. Winmark Corporation is the oldest holding of the Fund, and a diverse, well-run business with a dynamite owner.

Reductions

As featured in the fourth quarter Spotlight, we exited the acquired Electro Scientific Industries in the first quarter. Goodbye old friend! Sleep Number Corp had exceeded our fair value and was subsequently exited. This has been a cycling name over our tenure and wouldn’t surprise us if it gave us a third bite of the apple. Time will tell. F T S International and Sanderson Farms became casualties of recent conference calls.

To answer the question rolling around in your head, “yes” we had dry powder when the market became irrational at the end of 2018. Opportunities don’t arise like they recently did every quarter or even year, but you should have an expectation that we will keep a level head and act in the Fund’s best interest when presented. We remind or educate prospective partners at all of our meetings the importance of the managing partners being substantial investors, too. We answered the bell!

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