OTSI KETA QUARTERLY

OTSI KETA CAPITAL

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Q2 2019

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

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QUESTIONS...

Contact us at:

312.473.3982

F. William Schwarz, III
bill@otsiketacapital.com

Frederick P. Rollins, Jr.
fred@otsiketacapital.com

INTERESTING TIMES

The general market has moved up in the first half of the year. We have moved up as well, but less so. As the general markets move higher, concern and worry among investors naturally grows. We appease our anxiety by focusing on the underlying businesses that compose the portfolio. These companies are well-run, currently undervalued and have attractive long-term economics. However, we also recognize that our holdings must contend with the macro environment in which they operate. None of our companies is immune from political and economic malpractice or calamity. While we find ourselves in interesting times, we believe the economic conditions are favorable for equity investing.

Below we have included a passage from Warren Buffet's annual letter to shareholders circa the early 1980s. In it, he describes the economic conditions, namely inflation, that were reducing the attractiveness of equity investing. Indeed, he describes a time when most corporate investment resulted in the destruction of real returns to shareholders. To state the obvious, we are not in the conditions he describes and not being there doesn't guarantee a rising market. However, after reading the short passage, we hope you recognize that, here, is a pretty good place.

> *High rates of inflation create a tax on capital that makes much corporate investment unwise—at least if measured by the criterion of a positive real investment return to owners. This "hurdle rate," the return on equity that must be achieved by a corporation in order to produce any real return for its individual owners—has increased dramatically in recent years. The average tax-paying investor is now running up a down escalator whose pace has accelerated to the point where his upward progress is nil.*
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> *For example, in a world of 12% inflation, a business earning 20% on equity (which very few manage consistently to do) and distributing it all to individuals in the 50% bracket is chewing up their real capital, not enhancing it. (Half of the 20% will go for income tax; the remaining 10% leaves the owners of the business with only 98% of the purchasing power they possessed at the start of the year—even though they have not spent a penny of their "earnings.") The investor in this bracket would actually be better off with a combination of stable prices and corporate earnings on equity capital of only a few percent.*
>
> Excerpt from Warren Buffet's Letter to Shareholders 1980

As of quarter end, the portfolio's average ROE was 37.45%, inflation is currently about 2% and the top tax bracket is 37%. There are no guarantees in investing, but the macro environment is better than average.

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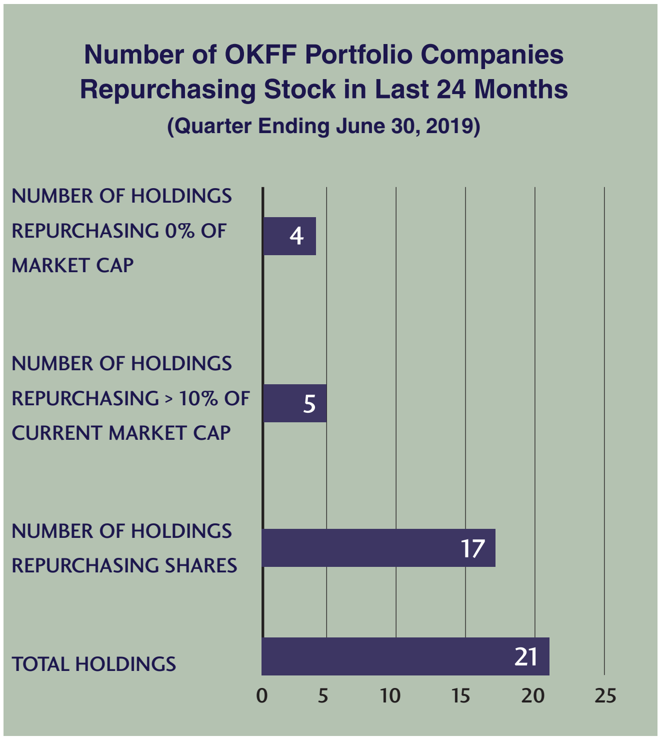
Buybacks

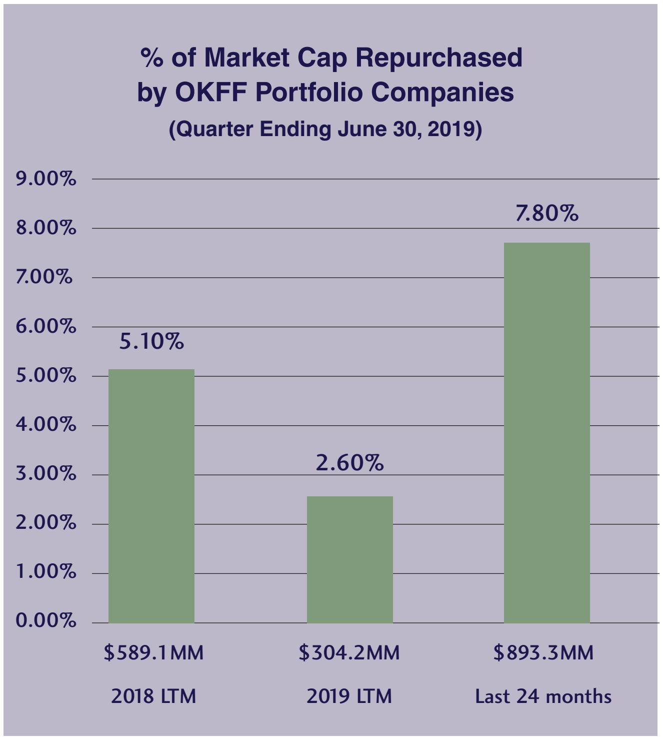
A number of politicians and media folks don't like the idea of companies buying their own stock back. Opponents of buybacks often equate share repurchases to buying your own Christmas presents; you can do it but it makes you Grinch at best, and out of ideas at worst. There are some members in Congress, and even a few presidential candidates, who are floating the idea of ending or restricting the practice. We are optimistic their initiative will die a quick death.

We take special delight when the companies we own repurchase their own shares. As value investors, with a longer-term orientation, the idea of a company using its retained earnings to purchase its own stock seems a perfect use of capital. As a fund, we aim to buy pieces of companies below their intrinsic value and are glad to have the companies we invest in do the same. When companies reduce their shares outstanding, our percentage ownership of the business increases without us having to invest additional capital.

Of all the acquisition activity a management team can engage in, buying stock below intrinsic value often generates the best long-term returns. Too often, management teams look to buy companies outside their competency and often have to pay a significant premium for the pleasure of doing so. The auction nature of the public markets typically generate buyout premiums of 30% to 35%. We have had a couple handfuls of buyouts in the last eight years, and our models say the acquirer is paying typically a little better than intrinsic value. We fear management teams in pursuit of acquisitions get swept up in the potential hunt and forget the true cost of the bullets. In contrast, managements buying their own shares back in our portfolio appear to be buying their shares in at a 20% to 30% discount to our intrinsic value calculation.

We have a number of portfolio companies that have been actively buying back their shares over the last 24 months. We don't specifically look for companies with buybacks on, but when we find attractive investments, buybacks are often found when we open the glove box. We prefer companies invest in attractive growth opportunities first, but we think ending the practice of buying back undervalued shares should be a management, decision not something the government eliminated from the menu.





The Window Indicator

Believed to be the first ship built since 1983, a ship for the U.S. Great Lakes service is now in the works and expected to be completed by mid-2022.

According to a news release from the Ohio-based Interlake Steamship Company, the company has partnered with Wisconsin-based Fincantieri Bay Shipbuilding to build this new River-Class, self-unloading bulk carrier.

The vessel will be built in Sturgeon Bay and is expected to measure 639 feet in length. It will transport raw materials to support manufacturing throughout the Great Lakes region and is expected to be equipped with "advanced vessel and unloading systems automation." This endeavor also "represents hundreds of good-paying jobs for U.S. Merchant Mariners and Wisconsin shipyard workers," the release added.

"When we approached such a historic project—building our company's first ship since 1981—we knew it was critical to choose the right partners. Fincantieri Bay Shipbuilding is the shipyard that has the experience and skill to execute on our long-term vision," Interlake President, Mark Barker, said.

"We've had a long and positive relationship of partnering with Fincantieri Bay Shipbuilding as we have modernized and reinvested heavily in our fleet. They have skillfully handled four repowers and five exhaust gas scrubber installations, as well as regular maintenance and regulatory dry-dockings on our vessels." Barker also added that the ship is being built after Interlake listened to and addressed logistical needs brought up by their customers.

Fincantieri Bay Shipbuilding's Vice President and General Manager, Todd Thayse, said that they are excited to construct the upcoming, historic, large-scale bulk carrier.

A rendering of a planned U.S.-flagged Great Lakes bulk carrier to be built by Fincantieri Bay Shipbuilding in Sturgeon Bay, Wisconsin, in partnership with the Interlake Steamship Company. It is expected to be completed by mid-2022. (Photo: Interlake Steamship Company)

"We are very proud of our long-term relationship with Interlake, and we appreciate their continued confidence in our shipyard and in our shipbuilding team," he said. "This new project and our past work are indicative of the quality and attention to detail that our customers have come to expect from Fincantieri Bay Shipbuilding. It brings steady employment to the hundreds of women and men we employ from across the region, and the economic benefit to our suppliers and others is widespread."

The ship is scheduled to be completed by 2022 and will be built by Fincantieri Bay Shipbuilding's nearly 700 skilled trade workers, a release said.

In other news around the Great Lakes, the U.S. flagged lakers are undergoing more than $70 million in maintenance and modernization in regional shipyards. The work ranges from engine maintenance to technology upgrades for the fleet. Most, if not all, of this work will be accomplished during the winter months when shipping comes to a standstill with the idling of the locks in the St. Lawrence Seaway and Sault Ste. Marie. Fortunately for the Great Lakes fleet, corrosion is not a contributing factor to the maintenance schedule.

There are four major shipyards on the Great Lakes. They are located in Sturgeon Bay and Superior, Wisconsin; Erie, Pennsylvania; and Toledo, Ohio. During the winter months employment can exceed 1,000.

Happy anniversary is in order for the Poe Lock in Sault Ste. Marie. Fifty years of servicing the Great Lakes fleet is celebrated this season with an eye on improvements to the complex in the near future (see previous issues). According to a recent United States Army Corp of Engineers economic vitality study, the Poe Lock hands 89% of the tonnage that passed through the Soo Locks and on average has 60 million tons of cargo (mostly taconite) that passes through it annually. This year could see those numbers improve due to the high water.

Speaking of high water, did you know that the Great Lakes are setting new records this year for water levels? While this will impact areas around the region for tourism, it is allowing the Great Lakes fleet the opportunity to set new hauling records. We think we can open the window right now and hear the river rising! If recent studies and news are to be believed, the lakes have crested for the season. We do not have a direct line to Mother Nature, so stay tuned to the Window Indicator in Q3.

OUR PERFORMANCE

For the second quarter ended June 30, 2019, the Otsi Keta Focus Fund was down 5.30% versus the Russell 2000 Value Index up 0.83%. Since inception, the Fund has returned 130.85%. 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
Otsi Keta Focus Fund Limited Partnership*	**(5.30)%**	**32.12%**
Russell 2000 Index (^RUT)	1.74%	31.32%
Russell 2000 Value (^RUJ)	0.83%	17.37%

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%.

Fund Activity

We introduced this piece approximately a year ago to share more about the activity in the Fund. For this quarter:

Additions

Methode Electronics, Turtle Beach and Heidrick & Struggles were added to current positions during the quarter. Methode is an Illinois-based industrial that showed a better quarter than we anticipated along with promising future projections. Turtle Beach continues to be an interesting play in the gaming space. And, yes, we talk to our children about this holding. Heidrick & Struggles should benefit from the current hiring environment/carousel. We continue to like this company, too.

Reductions

We eliminated our holding in InTest Corporation. What started out as a promising investment in the testing instrument space turned into an example of why we are very careful around companies that live at the low end of our market capitalization parameters. We initiated a small position in this company about a year ago, and their forecasts didn't materialize in the subsequent quarters. Our volume discipline allowed us to exit without much damage.

We continue to monitor the portfolio and are very excited about the future with our current holdings. We think that the second half of 2019 will be interesting in a positive way.

F. William Schwarz, III
Partner
direct: 810.247.3133
bill@otsiketacapital.com

Otsi Keta Capital, LLC
110 South Third Street
Suite 206
Saint Clair, MI 48079

312.473.3982

Frederick P. Rollins, Jr.
Partner
direct: 810.357.8566
fred@otsiketacapital.com

OTSI KETA CAPITAL