

# The Spitfire Fund L.P.

A private equity approach to investing in neglected public equities

Darden Value Investing Conference

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SPITFIRE CAPITAL LLC

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# Agenda

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- Introduction
- Investment thesis
- Market opportunity
- Case study
- Biographies

# Introduction

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- An investment fund focused on neglected small capitalization equities
- Target US companies with less than \$500 million in market value
- Concentrated style with fewer than 20 positions
- Spin out from Cannell Capital, a San Francisco-based hedge fund with long term track record and historical focus on neglected small capitalization equities
- Launched July 1, 2007

# Investment thesis

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“...we had learned from Ben Graham that the key to investing was the purchase of shares in good businesses when market prices were at a large discount from underlying business values.”

Warren Buffett, 1985 Annual Letter

- Achieve superior absolute and relative returns by focusing on neglected small capitalization equities;
- Identify companies with improving operations, strong balance sheets and positive free cash flow trading at low absolute valuations (our margin of safety);
- Apply a “whole company” approach to valuation and due diligence;
- Purchase minority positions at discount to intrinsic value;
- Limit the universe to smaller capitalization companies with market values generally below \$500 million; and
- Manage risk and maximize returns with a concentrated portfolio of fewer than 20 intensely researched positions.

# What is neglect?

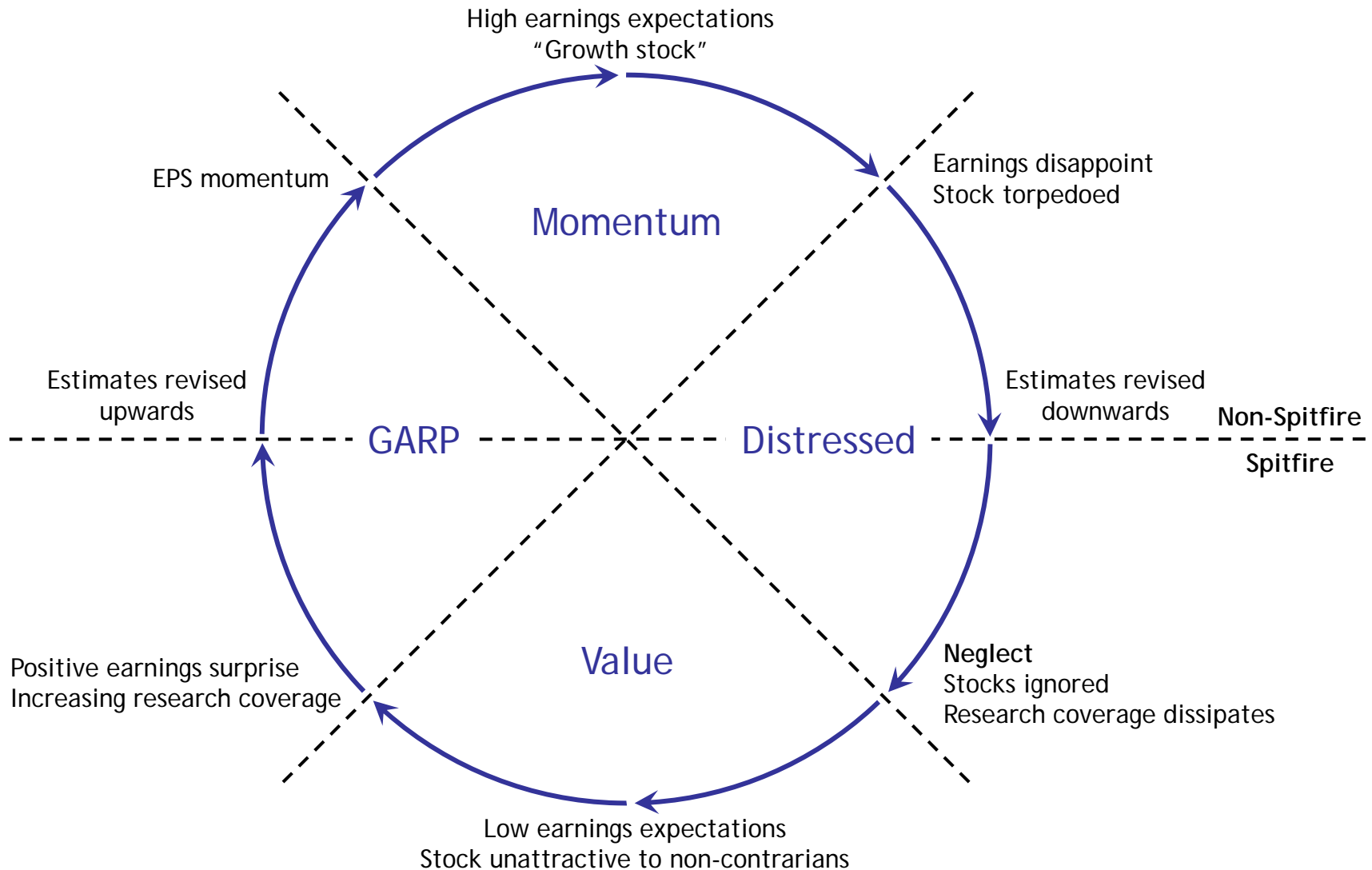
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“I shall not today attempt further to define the kinds of material to be embraced...but I know it when I see it.”

Supreme Court Justice Potter Stewart, 1964

- Neglect occurs when a majority of investors and analysts lose interest in trading or owning a stock as a result of:
  - Earnings disappointment(s);
  - Missed product cycle;
  - Failure to consolidate acquisitions;
  - Poorly marketed IPO (“IPO face plant”) or spin off; or
  - Financial distress, restructuring and Chapter 11; or
  - Macro, market or technical fears.

# Part of the life cycle of every stock

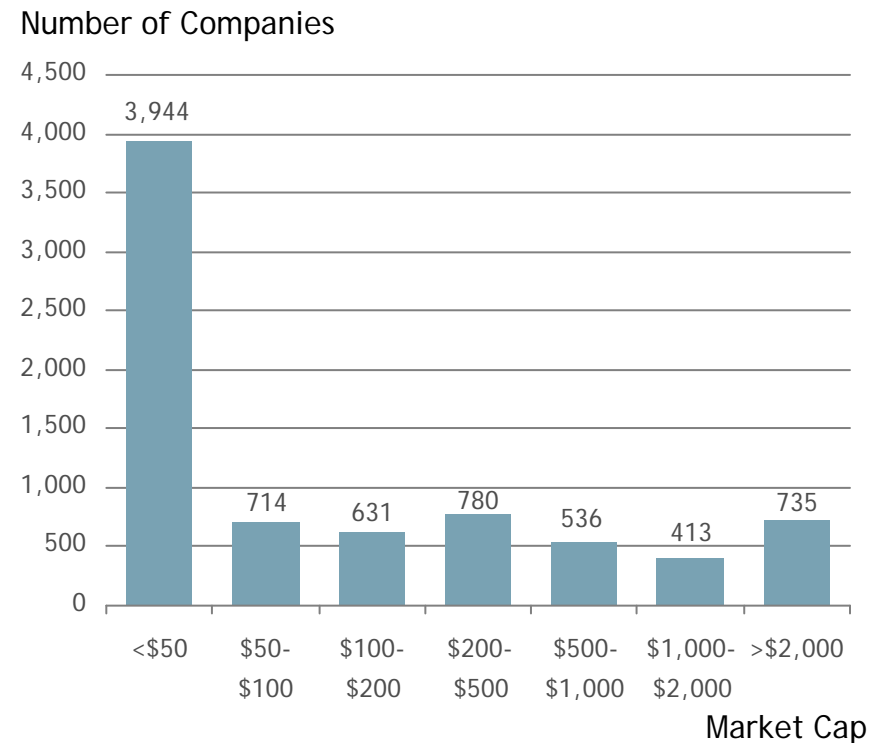


Source: Adapted from Merrill Lynch Quantitative Primer, June 2005.

# Large target market

“Fish where the fish are ...”

- 6,069 or 78% of all public companies have less than \$500 million in market value
- 2,125 or 27% are in the \$50-\$500 million “sweet spot”
- Only 735 or 9% have more than \$2 billion in market value



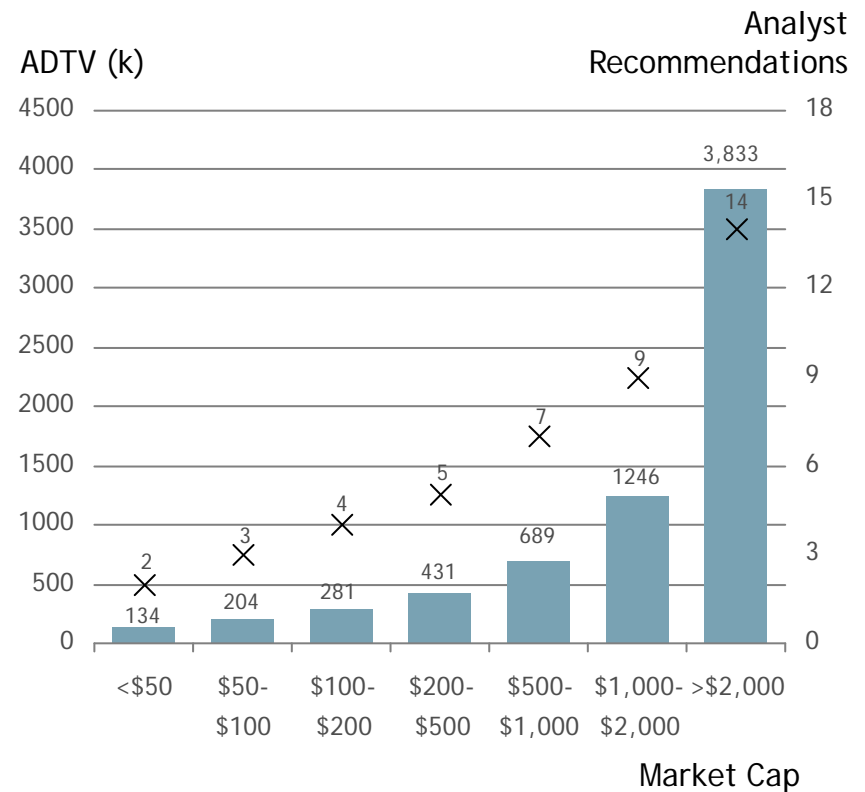
Source: Factset Research Systems, Inc.; n = 7,753

# But few analysts

“ ... but the fishermen are not.”

Jeffrey Timmons, HBS 1995

- 30% of companies in the \$50-500 million sweet spot have no analyst coverage
- Analyst attention is correlated with trading volume
- Few analysts and few institutional investors contribute to neglect
- Identify attractive investment opportunities using proprietary screens



# A challenging market for investors

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**“At other times he [Mr. Market] is depressed and can see nothing but trouble ahead for both the business and the world...he will name a very low price, since he is terrified you will unload your interest on him.”**

Warren Buffett, 1987 Annual Letter

- Most markets (domestic & international equities, commodities and fixed income) down over 30% - nowhere to hide
- Significant uncertainty regarding economy, stock and credit markets
- Asset prices declining in a deleveraging market
- Buy and hold investors enduring significant losses
- Valuations hammered by:
  - Credit fears;
  - Recessionary fears;
  - Investor deleveraging; and
  - Company specific performance.

# Opportunities for long term investors

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**“I know that this liquidity environment cannot go on forever. And I know that the longer it lasts, the worse it will be when it ends. And of course when it ends the buying opportunity will be a once in a lifetime chance.”**

William E. Conway, Carlyle Group  
January 31, 2007

- Many companies trading at discount to fair value based on current operating performance - future performance a zero cost option
- Don't take credit risk (near term maturities, dependence on asset sales for deleveraging);
- Focus on companies with improving operations (accelerating rates of revenue growth; and expanding gross and operating margins);
- High returns on invested capital; and
- Owner oriented management teams applying free cash flow to debt repayment and/or stock repurchases;
- Trading at low absolute valuations.
- Long term investment horizon with committed capital - able to take the time risk of owning a stock

**“In the short run the market is a voting machine but in the long run it is a weighing machine.”**

Ben Graham

## Business description

Alloy provides teen-oriented media and marketing services through its Promotion, Media and Placement segments. The Media segment includes Channel One, the in-school television network, the teen.com interactive advertising network, and Alloy Entertainment, creator of *Gossip Girl* and *Sisterhood of the Traveling Pants*.

## Financial summary

	<u>2007</u>	<u>2008E</u>	<u>2009E</u>
Revenue	\$199MM	\$225MM	\$240MM
Growth	+1.5%	+13%	+7%
Adj EBITDA	\$10MM	\$20MM	\$25MM
Margin	5.2%	8.9%	10.4%
EPS	\$0.08		
Net cash	\$16MM	\$23MM	\$35MM
FCF	\$(9)MM	\$7MM	\$10MM

## Valuation metrics

	<u>Nov '08</u>	<u>Target</u>
Price	\$4.77	\$13
Market value	\$68MM	\$185MM
Net cash	<u>20</u>	<u>35</u>
Enterprise value	\$48MM	\$150MM
EV/Revenue	0.2x	0.7x
EV/EBITDA	2.4x	6.0x

## Investment thesis

With a market value of \$70 million, Alloy is a buy because of its:

- Growing profitability (EBITDA will double '08 vs. '07) and free cash flow;
- Hidden value of Channel One, acquired in 2007 for ~\$11MM or about 1x Channel One's near term EBITDA contribution, which could drive ~\$140MM of shareholder value @ 7x \$20MM EBITDA;
- Core focus on teen demographic and demonstrated ability to develop teen oriented content and aggregate and monetize teen audiences;
- Net cash position and positive free cash flow;
- Cheap valuation of less than 2.5x EBITDA;
- Over 2x return potential;
- Margin of safety with debt free balance sheet, positive free cash flow, improving profitability and low valuation.



# The Spitfire team

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## **Julian A.L. Allen (39), Managing Member**

- Over 10 years professional hedge fund and private equity investing experience, including two years with Cannell Capital LLC
- Eight years private equity experience with J.H. Whitney & Co. (General Partner), Capital Z Partners (Principal) and Apax Partners (Associate)
- Harvard Business School, MBA with High Distinction & George F. Baker Scholar, Cambridge University, BA

## **Carlo Cannell (44), Advisory Board**

- Over 17 years of investment management experience
- Founder of Cannell Capital, LLC
- Princeton University '85

## **Richard Van Doren (32), Advisory Board**

- Over eight years of accounting, operations and compliance experience
- Chief Financial Officer of Cannell Capital, LLC since 2004
- University of San Francisco '99; candidate for Masters in Tax, Golden Gate University

# Contact details

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