HUFFMAN PRAIRIE
HOLDINGS

Huffman Prairie Fund I, L.P.

Partnership Letter – 1Q2020

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PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

Partnership Update:

If you are an accredited investor, please contact us for performance information.

The index returns above can be useful for context around market performance. However, we should note that **the Fund does not own a single stock in the S&P 500**, which encompasses the 500 largest public companies traded in the United States. Many of the companies we do own fall within the Russell 2000, which consists of 2,000 of the smallest companies as measured by equity value or capitalization (i.e., small-cap) traded in the United States. The Fund's small-cap tilt is a reflection of the strategy and process outlined in detail in past letters. In short, **the Fund's qualitative, hands-on research process is geared to find small companies with unrecognized potential for long-term value creation**.

Small-cap stocks declined dramatically during the first quarter as the global pandemic crisis unfolded resulting in an unprecedented economic slowdown. As fear set in, sellers overwhelmed buyers and stock prices tumbled. From its peak on January 17th to its trough during the quarter on March 18th, the Russell 2000 fell -43.5%. Amidst the fastest selloff in history, our companies were not spared, and the Fund's short-term quarterly performance reflects that. Also, as a reminder, the Fund does not have any short positions or hedges and seeks to stay fully invested (i.e., not hold material cash balances).

The Fund did experience a relatively smaller loss than the Russell 2000. This achievement does not make stomaching a loss any easier, but it does further our conviction that the research and risk management (see discussion below) processes are working.

[1] Net returns for the "Long-Term Interest" class corresponds to the fee structure associated with Series A interests in the Fund and reflect the deduction of: (i) an annual asset management fee of 0.75%, charged quarterly; (ii) a performance allocation equal to 10% of the ratable share of the Fund's profits for each year that such profits exceed a 6% hurdle, subject to the "high water mark;" and (iii) transaction costs actually incurred.

Quick Read:

- To supplement our comprehensive mid-year and year-end letters, **we will provide quarterly updates going forward**. Details on individual holdings will come in the mid-year and year-end letters. We will **remain in close communication with partners in the Fund and are always available to discuss positioning and current research activity**.
- Staying true to "The Process" discussed in past letters, **research activity continued apace during the quarter as cross-country travel and research road trips gave way to Zoom meetings and conference calls**. Highlights include:
    - Joining a composite materials trade association and attending their annual members' meeting; a management and manufacturing onsite with an industrial company in New Hampshire; company visits in Boston; a two-day automation conference in Anaheim; a company visit in Santa Ana; two days of company visits in NYC; calls with several software and hardware technology resellers; calls and real-time updates with commercial real estate industry executives.
- The **five largest positions in the Fund at 1Q20** quarter-end were: Iteris, Inc. (NASDAQ: ITI), MAXIMUS, Inc. (NYSE: MMS), Clean Harbors, Inc. (NYSE: CLH), ePlus Inc. (NASDAQ: PLUS), and Morningstar, Inc. (NASDAQ: MORN).
- Fear and uncertainty regarding COVID-19 created a flight to liquidity and safety with no regard to value. We **remain steadfast in our belief that fear fades and owning valuable businesses over the long-term will prove rewarding**.
- As a part of our risk management discipline, we will not invest in companies that combine considerable operational and financial risk. This helps us protect capital, look past near-term economic uncertainty, and stay on our front foot looking for opportunities.
- **Uncertainty creates opportunity and this quarter was one of those rare moments**. Several high-quality companies were added to the Fund at attractive discounts.

The Market:

Partnership Letters are a cornerstone of what we do. Sharing the details of our strategy, process, and holdings with our partners is the right thing to do. **Readers may notice we do not spend much time detailing the latest macroeconomic commotion or quarterly market gyrations**. This is purposeful as those topics detract from the discussion of the real drivers of long-term performance – our process and the companies. These are what we know best and are most qualified to speak on. **However, the events of last quarter warrant some discussion**.

What began as a regional outbreak in China, **the respiratory illness called COVID-19 rapidly spread across the globe during the quarter**. The entire world came face to face with a threat to our health and well-being especially for those on the frontlines battling for the sick. Initial travel restrictions gave way to shelter-in-place orders aimed to slow the spread. **Widespread actions appear to be working but fears of the economic fallout ended the longest bull market for stocks in history**.

Following early tremors in January, **the market (as measured by the S&P 500) set one last all-time high on February 19th and then in a 23-day stretch cratered -35.3%** – the fastest drop of this magnitude in history. The second, third, and fourth fastest pullbacks all occurred during the Great Depression. Small caps fared even worse plunging -43.5% peak to trough.

I can attest we were not a part of the panic selling. The **selling stampede of leveraged funds, short-term traders, and computer algorithms left a cloud of dust** though, and battered some of our companies. Selling pressure routinely pushed down share prices by 10%, 20%, and even 30% on no company-specific news. Prices decoupled from the value of these businesses. **Irrational sellers sold based on liquidity with little care for the value of the businesses they were selling**. Small caps in general and several companies in the Fund – many of which are illiquid due to high insider ownership – felt the brunt of this flight to liquidity at any price. On March 20th, the Goldman Sachs Low Liquidity basket of U.S. stocks was down -43% for the year underperforming the High Liquidity basket by 19 percentage points or 1,900 basis points.

Amidst the extreme uncertainty, fear and anxiety naturally set in. An enormous range of outcomes from over-night experts flooded social media. Near-term predictions ranged from "no worse than the flu" to "a complete failure of the U.S. healthcare system." Predictions of economic outcomes were equally as wide and remain so today. While **we doubt anyone will accurately predict the coming months and quarters ahead**, we know for certain it will not be us. We are not economists nor epidemiologists and perhaps our acknowledgement of such is to our benefit.

> *"It ain't what you don't know that gets you into trouble. It's what you know for certain that just ain't true."*
> *Mark Twain*

We are investors and remain steadfast in our belief that fear fades and owning valuable businesses over the long-term will prove rewarding. The value of a business is set by expected cash flows over many years, not the coming quarters. Of course, the **key assumption in all of this is that a business can ride out economic highs and lows and reap the rewards of compounding value over the long term**. Our risk management discipline helps to ensure this longevity.

Past partnership letters cover the Huffman Prairie strategy and research process at length. This quarter provides a timely opportunity to discuss the unheralded aspects of our risk management discipline.

Risk Management – That Didn't Age Well:

Volatility is a key measure of risk in modern finance theory. If the price of a company's stock varies widely especially relative to the broader market, conventional finance deems it risky. Short-term investors may agree. Their time horizon does not afford them the ability to ride out volatile peaks and valleys in the business and the economy. An average return earned in a smooth fashion may be a very acceptable result.

Those with a longer horizon can have a radically different definition. **We measure risk based on the probability of a permanent capital loss or impairment**. We are **fine with the ups and downs as**

long as the return on the other side is attractive. In fact, the ups and downs offer opportunities to buy from those unable to look past near-term volatility to long-term performance.

Avoiding a permanent loss requires that BOTH us and the businesses we invest in make it to the other side. If the company goes bust or does not make it through intact, our strong stomachs will not matter. Our hours and hours of analysis to find and understand a great company with great opportunities will be for naught. We will be left with a loss.

Over the long term, companies encounter recessions, industry downturns, strategic mistakes, and financial mishaps. This is the nature of business. **Prudent management teams that think like long-term owners manage their businesses accordingly and stand prepared**. If not, they may not make it to the other side without substantial, permanent damage.

On occasion, social media serves up particularly apt descriptions of everyday situations. One such saying "that didn't age well" describes a tweet, post, or comment that after the fact proved ill-timed, off-base, or untrue. Investing is ripe territory for things "that didn't age well." We only need to look back to our last partnership letter to find one such potential example.

We **purchased shares in Park Aerospace Corp. (NYSE:PKE) in the second half of 2019**. PKE is a **growing aerospace business that manufactures advanced composite materials** used in jet engines, commercial aircraft, military aircraft, business jets, space vehicles, and other specialized aerospace applications. **PKE is a high-quality company run by a talented and well-aligned management team**. Customers sign long-term, sole-source contracts with PKE to buy its proprietary composite materials. There was a clear line of sight to healthy growth in the business as contracted customers ramped production.

Fast forward a few months, this thesis clearly didn't age well. The problem being that about 55% of PKE's revenue comes from customers building new commercial airplanes. Suffice it to say that airlines will not be purchasing many new planes anytime soon. While PKE's primary program – the Airbus A320 – may be somewhat insulated, PKE will undoubtedly experience substantial revenue declines in this line of business.

I have had the great fortune to work for some of the smartest small-cap investors operating today. Learning from them helped shape Huffman Prairie and in particular one key aspect of our risk management discipline. **We will not invest in companies that combine considerable operational and financial risk**. It is typically **the ones that combine excessive amounts of both that cannot make it to the other side unscathed**.

The **aerospace and airline industries are prone to cycles** of low (i.e., after 9/11) and high (i.e., the 2010s) demand. As a manufacturer, PKE invests ahead of demand and carries fixed capacity regardless of demand. If demand falls, PKE is left paying for underutilized facilities, machinery, and tooling. The performance and cash flows from operations will suffer and perhaps turn sharply negative.

We were well aware of the operational risk factors above late last year. **PKE was deemed to have operational risk but that did not make it unsuitable for investment. PKE counterbalanced its operational risk by carrying almost zero financial risk**. At year-end 2019, PKE had no debt and $144 million of cash on its balance sheet – an extraordinary position for a company worth $334 million as a whole at the time. **With a Fort Knox balance sheet, PKE mitigates the risk of permanent capital loss and ensures that it will make it to the other side**. Instead of facing an existential risk similar to many of its peers, shareholders in PKE can instead look through the near-term haze and value expected cash flows in the years ahead.

Shares of PKE were down -17.5% in 1Q20[2]. Reporting such performance is typically not the fodder of investor letters but is noteworthy in this case compared to an average loss of -58.6% for other small cap aerospace OEM suppliers[3]. Risk management is an often-overlooked component of running a concentrated fund. We would much rather talk about the companies with 50% or 100% upside! But **we remain mindful that the substantial losers matter too and are what often derails the powerful math of compounded returns**.

[2] Adjusted for a $1.00/share special dividend paid during the quarter.
[3] Spirit AeroSystems Holdings, Inc. Class A (SPR), Hexcel Corporation (HXL), Astronics Corporation (ATRO), Ducommun Incorporated (DCO)

The Other Side:

The **processes and disciplines like the one outlined above give us confidence in our ability to ride through this period and future volatility on the strength of our companies**. None are holding their breath hoping for government money or dependent on tapping capital markets to fund their unprofitable business models. Prudently managed, strong companies survive and thrive in difficult times as debt-fueled and unsustainable competitors struggle. Actions of the federal government and Federal Reserve may help the latter but in many cases the damage has already been done.

On March 3rd, the Federal Reserve announced a -50 basis point (-0.5%) interest rate cut as markets started to tremble. As the economy showed further signs of faltering and financial markets began to unravel, the **Federal Reserve fired bullet after bullet and did not back off until markets stabilized**. All told, in a matter of weeks the Federal Reserve bought almost $2 trillion in financial assets and Congress followed up with another $2 trillion of economic stimulus through the CARES Act.

With trillions backstopping markets and the economy, worries about not making it to the other side quickly shifted to what the other side might look like. Recession shapes such as V, U, and L became top of mind. Similar to predictions around COVID-19, predictions around short-term economic activity are equally as tough.

We avoid investing in situations where outcomes depend on short-term economic conditions. However, the shape of the recovery and state of the economy on the other side will impact cash flows in the years to come. There will be companies that march on regardless (stable) and others that benefit sooner (short cycle) and later (long cycle) as the economy recovers and gets back to work. We own businesses in each category and, as such, are **well balanced and positioned to perform notwithstanding the shape the economy takes**.

In Closing:

A quick check of my cell phone after stepping off the plane in Boston in early March revealed that markets were poised to crash that morning. That day, we drove through rural New Hampshire, visited a manufacturing facility, and met with management teams. We were not staring at red stock quotes on our screens or putting out fires in the portfolio. **Instead, we were on our front foot out in the field doing research and finding opportunity**.

Along with several other new investments, one of those companies we visited that day is among the several high-quality companies added to the Fund during the selloff. Many are businesses already on our Select List and others we have wanted to own for years at the right price. **Uncertainty creates opportunity and this quarter was one of those rare moments**.