Longleaf Partners Funds

*Advised by Southeastern Asset Management, Inc.®*

*For Professional Investors Only*

# Third Quarter 2014 Commentary

*Longleaf Partners Global UCITS Fund declined 6.9% in the third quarter, underperforming the MSCI World Index's 2.2% decline. Year-to-date (YTD), the Fund declined almost 1.0%, below the Index's 3.9% return. This short-term decline negatively impacted the Fund's returns since inception. The recent price declines did not reflect changes to our investment cases, and we believe the portfolio is well positioned for strong future performance.*

## *Cumulative Returns at 30 September 2014*

| *Global Fund* | Since Inception | Three Year | One Year | YTD | 3Q |
|---|---|---|---|---|---|
| **Class I - USD (Inception 04/01/10)** | **42.40%** | **57.52%** | **8.45%** | **-0.97%** | **-6.93%** |
| MSCI World USD | 58.09 | 64.00 | 12.20 | 3.89 | -2.16 |
| **Class I - EURO (Inception 20/05/10)** | **50.47** | **67.01** | **16.24** | **7.87** | **0.90** |
| MSCI World Euro | 70.99 | 74.18 | 20.23 | 13.32 | 6.05 |
| **Class I - GBP (Inception 13/11/13)** | **2.82** | **na** | **na** | **1.04** | **-1.79** |
| MSCI World GBP | 6.46 | na | na | 6.14 | 3.20 |



*Average annual total returns for the Longleaf Partners Global UCITS Fund and its respective benchmark for the one and since inception periods ended 30 September 2014 are as follows: Longleaf Partners Global UCITS (Class I USD) 8.45%, 7.75%; MSCI World Index (USD) 12.20%, 10.15%; Longleaf Partners Global UCITS (Class I EUR) 16.24%, 9.81%; MSCI World Index (EUR) 20.23%, 13.08%. Each index is unmanaged and the returns include the reinvestment of all dividends, but do not reflect the payment of transaction costs, fees or expenses that are associated with an investment in a fund. An index's performance is not illustrative of a fund's performance. You cannot invest in the index.*



Fiber and networking company Level 3 Communications' 7% gain in the quarter took YTD return to 38%, making the company the largest contributor for both periods. Level 3 had a strong quarter with EBITDA (earnings before interest, taxes, depreciation, and amortization) up over 20%, organic revenues up 7%, and positive free cash flow. The company's purchase of tw telecom, announced in the second quarter, remains on track to close around year-end. Even after its gain, the stock sells for a deep discount to our appraisal and is an overweight position.

FedEx, rose 7% in the quarter and 13% YTD. The company reported strong operating results led by the Ground segment, where revenue grew 8% year-over-year and operating margins expanded toward 20%. Express had healthy U.S. volumes, and Freight saw both volume and revenue increases. While Ground remains the majority of our appraisal, Freight's results were notable with 70% operating income growth and double-digit margins. Sustained operating performance in this division would drive future value growth. During the quarter the company continued to demonstrate its pricing power. The company repurchased 5.3 million shares, an annualized rate of 7%, and authorized an additional 15 million shares.

Vopak, the global leader in independent oil and chemical tank storage, added 10% in the period. This Netherlands-based company rebounded after reporting results in line with expectations and providing higher EBITDA guidance. One reason we were able to buy Vopak at a discount last year was that crude oil had been in an unusual period of backwardation, meaning the front end of the futures price curve was higher than the back end. In this environment, traders exit the market, and oil storage declines. In August, the oil futures' price curve returned to an upward slope or "contango," meaning the longer dated price is again higher than the front end price. Vopak benefitted from an uptick in traders storing oil for future profit.

Bank of New York Mellon (BK) gained 2% in the quarter and 11% YTD. Expense controls helped results, although low market volatility and low interest rates this year have hampered revenue growth in asset services. The asset management business grew steadily along with the markets. The company emphasized the substantial earnings power that modest interest rate increases will create as money market fee waivers will end and net interest margins will expand. During the quarter BK repurchased almost 1% of outstanding shares, approximately one-third of the total buyback approved by the Federal Reserve.

The majority of holdings declined in the quarter, as prices decoupled sharply from long-term business values amid global macro fears, including lower energy prices, a weak European economy, slower growth in China, and heightened geopolitical turmoil in Russia, Ukraine, the Middle East, and very recently, Hong Kong. While we have limited direct exposure to companies based in emerging markets, top line exposure to developing regions impacted a number of our names. Our companies with exposure to China demand, whether directly as with Macau gaming or indirectly as with natural resources, came under more pressure with the government crackdown on corruption, civil unrest in Hong Kong, and more pervasive concerns about slowing economic growth. General instability in the Middle East and slower Latin American growth also negatively impacted the segments of some of our holdings. Another factor that negatively impacted short-term performance was the U.S. Dollar (USD) strengthening. Most currencies moved meaningfully lower against the USD causing the translation of the stock returns of our non-U.S. names from local currencies into USD to weigh on many of our holdings and accounting for approximately 40% of the Fund's decline. These short-term movements did not reflect the underlying operating performance of our businesses and did not impact our long-term appraisals. *(The stock return figures cited in this report are shown in USD; local returns were higher.)*

Macau gaming company Melco International fell alongside all Macau gaming stocks and was the largest detractor for the quarter and YTD, declining 22% and 36% respectively. A meaningful drop in VIP visitors led to lower revenues. The causes include China's crackdown on corruption causing wealthier people to keep a lower profile away from Macau, slower Chinese economic growth hurting property sales that boosted gambler credit, and liquidity challenges faced by junket operators who organize VIP visits and extend credit to them. Other pressures impacting the stocks are difficult to quantify such as tighter transit visa requirements, wage inflation and labor unrest, UnionPay credit card restrictions, and a smoking ban starting in October. We met with all of Macau's casino operators in September. Our confidence in Macau's long-term attractiveness, and particularly Melco, remains high in spite of the negative news flow. Our appraisal already incorporated lower growth in both VIP and mass revenues than most sell-side analysts had previously assumed for the year. Over 80% of Melco's EBITDA comes from the non-VIP segment that is still growing gross gaming revenue at 15%. This important mass market has margins several times higher than the margins on VIPs whose revenues are split with junket operators. 100% hotel occupancy also has limited growth this year, but new hotel inventory, projected to increase over 50% in the next three years, should expand visitation as should the new Hong Kong–Macau bridge that will allow passengers at the Hong Kong airport to arrive in Macau in half an hour. Melco has a near-term supply advantage with its Studio City casino and hotel opening in 3Q 2015. Despite analyst downgrades on Macau gaming stocks, Melco is estimated to have high EBITDA growth in 2015 and 2016. The company began repurchasing shares in Melco Crown in September, and our partner, CEO Lawrence Ho, bought more stock personally in the last two quarters.

The energy sector fell 9.5% in the MSCI World Index, as oil declined 13%, and U.S. natural gas dropped 7%. Our appraisals of our energy-related holdings did not fall in spite of large stock declines, because our models already incorporated lower commodity prices based on the futures curve pricing and the marginal cost of production in our various plays. Chesapeake fell 21% in the quarter. Well costs declined, capex remained on plan, and the company moved production estimates up slightly. During the two year tenure of the new board, balance sheet leverage has been reduced by $6 billion, primarily from noncore asset sales. CEO Doug Lawler is driving value recognition in ways he can control and is building additional upside with the $2-3 billion of annual discretionary capital spending that management projects should deliver strong returns on capital, even without higher commodity prices. The company's 4.8 million net developed acres and 7.5 million undeveloped acres of oil and gas fields cannot be replicated.

Global fertilizer and chemical producer OCI declined 21% in the third quarter and 32% for the year. Natural gas is the primary component in nitrogen fertilizer production, and during the quarter, gas supply interruptions impacted OCI's two Egyptian plants, weighing on stock price in the short term. Management anticipates that plant utilization will improve over the next year with several factors increasing gas supply: Egypt has begun to import liquid natural gas for the power sector, the cement industry is switching from natural gas to petroleum coke, and the major producers have begun to return to Egypt to ramp up exploration in the wake of a more stabilized government. We assume a continued low utilization rate of 50% in our appraisal, but even at this rate, the plants are cash flow positive. OCI's other plants around the world are operating at or near full capacity and benefitting from low cost gas and higher prices for Ammonia and Urea, two primary outputs. CEO Nassef Sawiris announced that in early 2015, OCI will separate its fertilizer and legacy construction businesses to remove the conglomerate discount in the stock price.

The Hong Kong property company K. Wah International declined 18% in the quarter and 13% YTD. The Macau gaming concerns that affected Melco also negatively impacted K. Wah because of its 3.9% stake in Galaxy Entertainment, one of the six operators licensed in Macau. Slower sales of K. Wah's luxury China properties driven by the government-imposed slowdown were somewhat offset by mass market property sales in Hong Kong. Management opportunistically bought attractively priced land in urban Hong Kong at a discount to subsequent land auctions in the same area.

For the YTD period Loews was among the Fund's primary performance detractors, down 12% after a 5% decline in the quarter. The stock fell because of pressure on its energy-related investments in Diamond Offshore, the drilling company, and to a lesser degree Boardwalk Pipeline. Loews recently announced the sale of Highmount Exploration and Production in line with our anticipated price. Through the last reported period in July, the company aggressively repurchased shares.

In the quarter we bought several new positions including adidas and Vivendi, taking the total number of new positions for the year to seven. German-based adidas is among the top global sportswear and sports equipment brands. Short-term currency moves, concerns over its business in Russia, and management's postponing 2015 margin targets gave us the opportunity to buy this world class brand at a discount. Management recently announced plans to repurchase up to €1.5 billion - over 10% of shares - and to return capital via a dividend. French company Vivendi consists of two key businesses - Universal Music Group, the world's biggest record label, and Canal+ Group, France's biggest pay-TV operator. The recent auction of Vivendi's Brazilian broadband business, GVT (Global Village Telecom), highlights Chairman and 5% owner Vincent Bolloré's focus on creating value for shareholders. Southeastern has invested in Vivendi successfully twice before, and the company's focus, asset quality, and management team have grown even stronger.

To fund our purchases, we trimmed several appreciated stocks and sold Bank of New York Mellon, Fairfax Financial, Sino Land, and Guinness Peat Group in the quarter. These exits highlight our long-held investment discipline of selling more fully valued and/or lesser quality names to position the portfolio in businesses with a larger margin of safety and higher expected value growth. Additionally, we sold cement producer Texas Industries early in the quarter when Martin Marietta's all-stock acquisition of the company closed.

The Fund ended the quarter with a price-to-value ratio (P/V) in the low-70s% and cash below 3%. Overall, prices remain more compelling outside of the U.S., due to more disruptions and broader uncertainty. This geographic discrepancy is evident in our on-deck list, our new purchases, and our lower-than-normal U.S. weight in the portfolio. We will continue to opportunistically take advantage of short-term market volatility around the world. Our competitively positioned businesses, strong balance sheets, and capable management partners give us confidence in the longer-term prospects for the portfolio.