October 2021

Longleaf Partners Small-Cap Fund Commentary

3Q21

Longleaf Partners Small-Cap Fund fell 4.20% in the third quarter, narrowly ahead of the Russell 2000 Index's 4.36% decline in the period. The Fund has delivered positive absolute returns year-to-date, adding 9.10%, but it trails the Index's 12.41% return for the year. In a volatile quarter for most global markets, the portfolio was fairly steady. Two companies declined double-digits - each for different reasons, which we discuss in more detail below. The majority of our investments reported flat to low-single digit + or - returns. Although our stocks' performance was disappointing in the period, most of the portfolio's companies grew their values. This compounding force should drive material future returns.

The bottom-up progress is far better than market sentiment would indicate, and our partners are acting on this disconnect. We have also acted on the disconnect in the US market, as declining interest rates, a cooling of COVID reopening excitement in the face of the delta variant and top-down China fear drove investors to flee into "safe haven"

Average Annual Total Returns for the Longleaf Partners Small-Cap Fund (9/30/21): Since Inception (2/21/89): 10.50%, Ten Year: 11.93%, Five Year: 7.55%, One Year: 28.26%. Average Annual Total Returns for the Russell 2000 (9/30/21): Since Inception (2/21/89): 10.00%, Ten Year: 14.63%, Five Year: 13.45%, One Year: 47.68%. Average Annual Total Returns for the Russell 2000 Value (9/30/21): Since Inception (2/21/89): 10.60%, Ten Year: 13.22%, Five Year: 11.03%, One Year: 63.92%.

Returns reflect reinvested capital gains and dividends but not the deduction of taxes an investor would pay on distributions or share redemptions. Performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by visiting southeasternasset.com. As reported in the May 1, 2021 prospectus, the total expense ratio for the Small-Cap Fund is 0.96%. Effective September 1, 2021, Southeastern has contractually committed to limit operating expenses (excluding interest, taxes, brokerage commissions and extraordinary expenses) to 0.95% of average net assets per year. This agreement is in effect through at least April 30, 2023 and may not be terminated before that date without Board approval.

stocks. This created compelling opportunities within our sweet spot of high – and improving, but not yet consensus recognized – quality businesses that have been generally overlooked this year. We have bought five new companies in the portfolio this year, two of which we initiated in the third quarter. This is the kind of pace that we expect over the long term and need to be fully invested. The new partial positions have taken our cash from 19% at the start of the quarter down to 15% at the time of writing this letter, and we expect to see the portfolio more fully invested as we uncover new opportunities in the current environment.

Some people might look at the Russell 2000's current next 12 months multiple of 15.5 and say that this doesn't look that expensive. If that really were the multiple for 100% of the Russell 2000 in normal, mid-cycle times, then we would probably agree. But the Russell 2000 multiple referenced above excludes 30-40% (depending on how you want to count it) of index companies that are currently unprofitable. This is significantly higher than even 10 years ago, when this was 20% (https://www.wsj.com/articles/small-cap-stocks-may-be-pricier-than-they-appear-11629640805). We continue to believe that our footnotes for certain "non-earning" companies are more conservative than the "adjustments" made for the index constituents. Our non-earners have either free cash flow power in a few years that gets us to much lower than market multiples (like Mattel, Hyatt, Graham Holdings and Idorsia) and/or are asset-rich companies with recent comparable transactions at higher multiples than our appraisals for inferior properties (like Madison Square Garden Sports and Liberty Braves, among others). Many of the market's non-earning favorites are at big multiples of all-time-high gross profit and therefore much larger and more uncertain multiples of free cash flow (FCF). We also carefully select companies with FCF per share that will continue to grow even as margins rebound and improve, when the stock market is often the other way around as after-tax margins are at peak levels.

The best news and the biggest market reaction surprise in the quarter was at our largest holding Lumen. After much engagement with Southeastern following our amended 13D filed last December, the company announced that it was selling two assets – the slowest growth part of its legacy copper landline business in certain states in the US and the Latin American (therefore highest discount rate / lowest multiple) part of its enterprise fiber business. At a time when the company was trading at 5.5x EBITDA (earnings before interest, taxes, depreciation, and amortization) for all of its assets, it sold the legacy landline assets (i.e., the lowest multiple part of its lowest multiple business) for that same 5.5x and the Latin American assets (i.e., the lowest multiple part of its higher multiple business) for 9x. The absolute amount of gross proceeds was almost equal to the company's market cap. We believe the remaining legacy assets are worth greater than 5.5x and the remaining fiber/enterprise assets are worth greater than 9x, especially because infrastructure funds have recently paid mid-teens multiples for similar fiber assets. Thus, we now have a higher quality, higher growth, lower leverage mix of assets at Lumen. But when this news was announced, Lumen's stock price initially went down, due to weak communications around future growth and capital allocation on the conference call. This communication failure can be fixed much more easily than a business failure, and we were encouraged that the company authorized a share repurchase to take advantage of the market's short-term misunderstanding. The stock price stabilized and increased as the quarter went on (although annoyingly-timed, negative sellside reports hit the stock on September 30), but there is still an enormous gap between price and our (growing) value.

Empire State Realty Trust (ESRT) and CNX Resources also detracted for various reasons in the quarter that are out of whack vs. their positive value development this year and likely future actions. ESRT's stock price traded down and back up in the quarter as the delta variant waxed and waned. We had neither banked on a speedy return to the office nor an immediate resumption of international tourists filling the Empire State Building Observatory, so our value was not impacted. We would point to how the company has a demonstrated history of repurchasing shares below net asset value. We recorded a new episode of the Price-to-Value Podcast with Small-Cap portfolio manager, CEO and Head of Research Ross Glotzbach interviewing ESRT CEO Tony Malkin in the quarter, and we would encourage you to listen to the episode here.

If you had told us two years ago that CNX would 1) accretively buy in its pipeline assets to be the low cost player in the basin; 2) further lock-in FCF with hedges; 3) buyback a material amount of company shares to grow FCF/share power above $2; 4) finally see more E&P industry consolidation, we would not have expected a sub-$12 stock price. But now that gas prices are up, hedges are viewed by the market as a negative, and sellsiders struggle for a short-term "catalyst". We expect CNX to create more catalysts and continue to take advantage of its dramatically undervalued stock price.

Contributors and Detractors

(Q3 Investment Return; Q3 Fund contribution)

MSG Sports (8%, 0.43%), the Knicks and Rangers holding company, was the top contributor in the quarter. The Knicks raised season ticket prices for the first time in seven years, and both teams maintained excellent 94% renewal rates. The National Hockey League's (NHL) new media rights deal should also more than double the Rangers' national broadcasting revenues. Recently transacted minority stakes in the Lakers and Warriors have attributed over $5bn enterprise values to both of those teams, while all of MSG Sports trades for $5.1bn. The stock attributes zero value to a controlling stake in the Knicks being worth materially more than those teams and/or for the Rangers against a widely accepted private-market value above our $1.5 billion appraisal. MSG management also confirmed in the quarter that MSG Sports will not be recombining with other MSG entities, further allaying fears on capital allocation.

Everest Re (4%, 0.20%), the insurance company, contributed. Underwriting results were excellent in a cyclically strong market with an 89% combined ratio for the quarter, 39% growth in net written reinsurance premiums, and a 26% increase in primary lines. The fund has successfully owned Everest Re shares on and off since 2004 and we have rarely witnessed better conditions in the reinsurance market. However we were disappointed again by Everest's capital allocation, particularly swapping a long-held conservative bond allocation into private equity at a moment of extremely risky high valuations. We sold the position for a solid gain after five quarters of ownership because Renaissance Re (Ren Re) presented a superior opportunity in the industry. Ren Re has a strong underwriting engine as well as a growing third-party capital segment with recurring fee-income worth a significantly higher multiple than the company's 11x price to earnings ratio (P/E) price at the time of our purchase.

Empire State Realty Trust (-16%, -1.01%), the iconic New York City commercial real estate and tourism company, was the top detractor, as discussed above. A retail tenant filing for bankruptcy hurt the stock, but we expect its Empire State Building office space to be quickly re-leased at a higher rent due to Manhattan's post-COVID reopening and rebounding office market. Observatory tickets are up to 30% of the 2019 level and should continue rebounding over the next year plus. We also believe the company remains on offense when it comes to capital allocation.

Lumen (-7%, -0.91%), the global fiber company, was also a top detractor, even as our value grew meaningfully in the period, as discussed in detail above.

Mattel (-8%, -0.51%), the global toy and intellectual property franchisor, detracted despite strong quarterly performance that increased our appraisal of the value by 5%. Sales grew 40% above weak 2020 comps, with particularly encouraging results in American Girl, the doll brand that had been struggling for years before CEO Ynon Kreiz initiated a successful turnaround. Despite some cost inflation, the consolidated gross margin increased nearly 4%. We think Mattel will earn $1.50/share next year and the multiple remains too low despite two years of price appreciation. The company has recently announced 13 feature films, 18 TV shows, and 24 other projects in development. The intellectual property (IP) efforts create substantial earnings power but haven't contributed much yet. These are some of the best non-earning assets in our portfolio and we expect many of them to be realized within the next few years.

Portfolio Activity

We added two new holdings in the quarter. We made a swap in the insurance world – buying a position in RenaissanceRe (RenRe) and selling our position in Everest Re at a 30% gain. We believe this was an upgrade on Business, People and Price. We prefer how RenRe has built a growing fee business that will continue to improve return on equity (ROE) and reduce volatility going forward. We also prefer RenRe management's capital allocation, which is much more focused on discounted buybacks at the moment. All this is for a better price-to-value than Everest Re, which has been a solid performer since we purchased it for a second time in 2020. We believe the next several years will be bright for RenRe, even if fears about near-term losses due to floods and hurricane moved the stock this quarter. We also initiated a position in a company that is a unique mix of steady consumer brand and strong real estate network. We have followed the business for a long time (some of that time as a competitor to one of our successful holdings). We are still building out the position and look forward to sharing more details on the company next quarter. While we moved our new holdings off the on-deck list in the quarter, we found more replacements for overall on-deck growth. Current highlights include names in distribution, media (both traditional and digital), durable goods and real estate.

Outlook

The Small Cap Fund in aggregate is more attractive than it was last quarter and also more attractive than it has been post-"Pfizer day" almost 11 months ago. The price to value (P/V) is in the low-60s%, and as mentioned above it is rare to have a portfolio that on average is close to 10x FCF when the index is closer to 20x+ on a comparable basis. While we remain focused on the bottom-up fundamental values of our individual portfolio holdings, the team has spent a lot of time this year analyzing the much-debated topic of inflation and interest rates, and we will include a more detailed review in our year-end letter.

We are beginning our search for our next North American junior analyst, as Luke Willert has been making strong progress behind the scenes and will be moving up to analyst status next year. We always value input from our shareholders and client partners, who are one of the most important groups within our extensive global network, and we welcome references for this position. We have already gotten some strong applicants and look forward to adding to our talented team.

See following page for important disclosures.

RISKS

The Longleaf Small-Cap Fund is subject to stock market risk, meaning stocks in the Fund may fluctuate in response to developments at individual companies or due to general market and economic conditions. Also, because the Fund generally invests in 15 to 25 companies, share value could fluctuate more than if a greater number of securities were held. Smaller company stocks may be more volatile with less financial resources than those of larger companies.

The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3,000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index. The Russell 2000 Value index is drawn from the constituents of the Russell 2000 based on book-to-price (B/P) ratio. An index cannot be invested in directly.

EBITDA is a company's earnings before interest, taxes, depreciation and amortization.

Free Cash Flow (FCF) is a measure of a company's ability to generate the cash flow necessary to maintain operations. Generally, it is calculated as operating cash flow minus capital expenditures.

Price / Earnings (P/E) is the ratio of a company's share price compared to its earnings per share.

Return on equity (ROE) is a measure of profitability that calculates how many dollars of profit a company generates with each dollar of shareholders' equity.

P/V ("price to value") is a calculation that compares the prices of the stocks in a portfolio to Southeastern's appraisal of their intrinsic values. The ratio represents a single data point about a Fund and should not be construed as something more. P/V does not guarantee future results, and we caution investors not to give this calculation undue weight.

A 13D filing is generally required for any beneficial owner of more than 5% of any class of registered equity securities, and who are not able to claim an exemption for more limited filings due to an intent to change or influence control of the issuer.

As of September 30, 2021, the top ten holdings for the Longleaf Partners Small-Cap Fund: Lumen, 12.7%; Realogy, 7.5%; Mattel, 6.2%; Madison Square Garden Sports, 5.6%; Empire State Realty 5.5%; CNX Resources, 5.5%; Liberty Braves Group, 5.0%; Gruma, 5.0%; Graham Holdings, 4.9%; and Lazard, 4.8%. Fund holdings are subject to change and holding *discussions are not recommendations to buy or sell any security. Current and future holdings are subject to risk.*

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