BLACK BEAR
VALUE PARTNERS

July 9, 2024

Black Bear Value Partners LP Q2 2024 Letter

"I love inside jokes. I hope to be part of one someday". – Michael Scott (The Office)

To My Partners and Friends:

- Black Bear Value Fund, LP (the "Fund") returned -6.7% in June and +2.1% YTD.
- The S&P 500 returned +3.6% in June and +15.3% YTD.
- The HFRI Index returned -0.3% in June and +4.3% YTD.
- We do not seek to mimic the returns of the S&P 500 and there will be variances in our performance.

Monthly Performance Net of Fees and Expenses

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year est.
2024	**Black Bear Value Fund**	2.0%	-0.8%	3.4%	3.4%	1.3%	-6.7%							**2.1%**
	HFRI Index - Value	-0.9%	2.6%	2.4%	-2.1%	2.7%	-0.3%							**4.3%**
	S&P 500	1.7%	5.3%	3.2%	-4.1%	5.0%	3.6%							**15.3%**

Summary Performance Net of Fees and Expenses

	June	QTD	YTD	3Y	5Y	Inception
Black Bear Value Fund	-6.7%	-2.4%	2.1%	12.4%	11.7%	9.8%
HFRI Index - Value	-0.3%	0.1%	4.3%	3.0%	8.8%	7.7%
S&P 500	3.6%	4.3%	15.3%	10.0%	15.0%	14.6%

Strategy Exposure @ 06/30/2024

	LONG	SHORT	NET
Equities	100.4%	-42.7%	57.7%
Preferred Equity	0.0%	0.0%	0.0%
Credit Related	0.0%	-27.8%	-27.8%
Total Investments	**100.4%**	**-70.5%**	**29.9%**
Cash	29.9%	0.0%	29.9%
T-Bills	22.9%	0.0%	22.9%
Total Cash/T-Bills	**52.8%**	**0.0%**	**52.8%**

Note: Includes delta-adjusted options position
Note: Cash balances include cash received from our short positions

Top 5 Gross Long Positions (Alphabetical)

Arch Resources	ARCH
Builders FirstSource	BLDR
LSB Industries	LXU
Paramount Resources	POU.TO
Warrior Met Coal	HCC

Note: As 6/30/2024

Gross Concentration Breakdown

	Long %
Top 5 positions	55%
Top 10 positions	91%

Note: As 6/30/2024

Note: Additional historical performance can be found on our tear-sheet.

Are the holders of the Magnificent 7 in on some inside joke? ☺ Michael Scott may be expressing what some in the active value community may be feeling of late. Note 60+% of the S&P 500 returns come from the Magnificent 7 with half coming from Nvidia. We do not own any of those companies and will likely lag if they continue going up in such a dramatic fashion. Several of these businesses seem expensive and rely on aggressive growth assumptions to justify the current pricing. To be fair, these companies have been strong performers, as businesses AND stocks, but the law of large numbers and capitalist competition can catch up.

The businesses we own are at extremely attractive prices with safe balance sheets and capable management. Small capitalization/cyclical names have gone down in price across the board as fears of a recession creep in. Our companies produce prodigious amounts of cash and are led by management teams who understand the power of buying back stock cheaply.

Exiting 2020, I felt our portfolio was in a very interesting position. We owned extremely cheap businesses with aggressive buybacks in place as well as very expensive shorts that had medium-term issues looming. Some combination of fear/prudence returned, and we were rewarded. This feels similar today though the eventual timing is impossible to predict. We have a long runway, patient investors and a high quality and safe portfolio. Time is our friend.

Brief portfolio discussion

We have a large exposure to energy names/royalty companies, natural resource companies, cyclicals (like BLDR or auto dealers) and industrials (like LXU). These names took a beating in June and were down 10+% each. At a high level, these companies have made massive changes to their balance sheets by either running with net cash or very small amounts of debt. The past concerns about long-term solvency are not present anymore. Most of the companies are operating in industries where there has been 8+ years of underinvestment. We have focused our names on the companies with the lowest-cost-to-deliver, healthy balance sheets and good management. They are largely companies trading at 10-25% unlevered free-cash-flow yields. In other words, if we owned all of these businesses privately, we would be delivered annual coupons of 10-25%, with no assumed benefit of growth, an outcome we'd all be pleased with.

Interest Rates and Credit Shorts

We continue to be short long-term interest rate/credit instruments. The current 10y rate has been hovering around 4.5% and credit spreads are at all-time tights. We are more focused on the Investment Grade (IG) and Emerging Market (EM) credit markets. Taking a step back if we were to presume

- 2-2.5% inflation is achieved then….
- Short-term interest rates would likely be in the ~2.5-3% range which would mean….
- A normal 10Y treasury would be in the 4-4.5% range, which is where we are NOW.

There is general confusion as to what kind of rate-setting power the Federal Reserve has. The Fed sets short-term interest rates (aka the Fed Funds rate). Absent market intervention, the market (i.e. supply & demand) will dictate what the longer-term interest rates will be. As you can see above, the current 10Y interest rate presumes success in getting inflation down to the low-mid 2's. <u>Interest rates would be higher if:</u>

- Inflation (real or forecasted) was persistently higher than 2-2.5%
- There was a need to fund increased fiscal spending/deficits – seems likely
- We needed to rollover existing low-rate debt – historical supply is coming
- A host of other variables that could go on ad infinitum

Additionally, many companies are entering a period with a need to refinance historically cheap debt. Spreads reflect close to ZERO concern about corporate balance sheets and the impact of lower margins and increased funding costs.

Top 5 Businesses We Own

ARCH Resources (ARCH) / Warrior Met Coal (HCC)

ARCH and Warrior are 2 of the leading U.S. producers of high-quality metallurgical coal ("met coal"). This is the kind of coal used for steelmaking. ARCH also has a small thermal coal business that contributes ~20% of their earnings. Each company is independently a top 5 position meaning met coal is a meaningful percentage of our assets.

Both companies are largely export driven producers. For example, Warrior exports 97% of their production. Both have a large cost advantage as they can ship to Europe and South America in ~2 weeks versus Australian competition of ~5 weeks.

Met coal demand is projected to climb for the next 25 years, driven by the economic development and urbanization in India and the rest of Southeast Asia. ~60% of the world's population lives in Asia, where met coal demand is centered and where local sources are limited. Over the coming years demand will likely outstrip supply, leading to higher prices. There has been a severe lack of investment in met coal due to ESG concerns with investment peaking in 2014.

Rough math on ARCH (quarter-end price of $152 and market cap of ~$2.8BB and $0 net debt)

- Various liabilities of -$6.50 per share
- Over next 2 years the business should generate ~$35-$50 per share in cash.
- The existing business should generate ~$20-$30 in FCF per share. Some see a runway to them generating $30-$40 in annual FCF per share.
    - Let's presume non-heroic FCF yield of 15% on $20-$30 = $133-$200 per share
- Operating business $130-$200 + $35-$50 of cash generated per share - $7 per share for liabilities = **$158-$243 per share vs. current price of $152.**

Warrior has a similar profile though they have the added value of a growth project that will come online in 2 years add significant value.

The above is a very rough calculation and shows the wide margin of safety baked in the price. I believe the operating business should command a better valuation implied by a 15% FCF yield…. but for now, we do not have to make any big leaps with respect to valuation. I wouldn't be surprised to see these businesses surprise to the upside given the worldwide looming high grade met coal shortage and cost-advantaged production/shipping.

<u>Builders FirstSource (BLDR)</u>

BLDR is a manufacturer and supplier of building materials with a focus on residential construction. Historically this business was cyclical with minimal pricing power as the primary products sold were lumber and other non-value-add housing materials. Since the GFC, BLDR has focused on growing their value-add business that is now 50%+ of the topline. The company has modest leverage and has **<u>been using their abundant free-cash-flow to buy in over 41% of the stock in the last ~3 years.</u>**

While mortgage rates are higher, they are not unusual versus history. The low rates of the last 5-10 years are the outlier. We have a structural shortage of housing in the USA. With existing homeowners locked into low-rate mortgages, the aspiring homeowner may increasingly need to find a home from a homebuilder.

Normalized free-cash-flow per share looks to be in the range of $13-$16 per year. Margins are structurally higher given their increased shift into value-add products. At quarter end pricing of ~$138 that implies a free-cash-flow yield of 9-12%. which does not reflect the long-term housing needs or their pricing power.

<u>LSB Industries (LXU)</u>

LSB Industries manufactures and sells nitrogen-based products for the agricultural, industrial and mining markets. They are the 5th largest producer of ammonia and the leading merchant marketer of nitric acid in the U.S. The Company has gone through a remarkable turnaround (both operationally and financially) as it was chronically undermanaged by the previous ownership/management team. Looking forward, they are beneficiaries of the low-carbon movement as they are co-developing low-carbon ammonia projects as well as growing their existing capacity. LSB (and other domestic producers) use natural gas as their main raw material. This is a competitive advantage given the low cost of natural gas in the US versus foreign competition.

Management has a very good grasp of quality capital allocation. The Company is currently levered 2.5x but has been buying back their debt at a discount. While the stock is cheap (and they are buying back stock) having a safer balance sheet is a priority and free cash flow has been allocated between stock buybacks and debt paydown/buybacks.

As capacity expansion comes online the company should be able to generate $75-$110MM per year in free cash flow. That equates to a 13-19% levered free cash flow and 9-13% on the enterprise value. In addition, LSB has a blue ammonia development (utilizes carbon capture/storage) and a longer-term low-carbon ammonia export project. These 2 projects will generate 50-100MM in additional cash flow over the coming 2-4 years, effectively doubling the earnings power of the business. At today's price that translates to a 20-40% annual FCF yield. We stand to make the most if the price remains low and management can buy in shares cheaply.

Paramount Resources (POU.TO)

Paramount is an ENP (exploration and production) in the energy space. It has minimal debt ($70MM) and ~$570MM in securities (13% of the mkt cap). Management is fully aligned with us as they own 46% of the Company. 2024 FCF will likely be ~5-6% yield which at it's face doesn't scream cheap. Management is reinvesting in near-term attractive growth opportunities. Absent this reinvestment Paramount would generate a 12-14% unlevered free cash flow yield. This is a business that should benefit if there is overall weakness in the energy sector as they have an abundance of cash/securities on hand and cash-generating assets.

New Hire

Welcome to our summer intern Holden Leder. Holden is a rising Freshman at Wharton. I met him at the Grant's Interest Rate Observer Conference in New York this past year (a unique place for a high school senior to be hanging out). We are doing some joint learning together and reviewing the Buffett Partnership letters as well as doing a deeper dive into the met and thermal coal industries. Welcome aboard Holden!

General Thoughts

It is impossible to predict the timing and/or cadence of events. Very little prudence is priced into the indices or credit spreads. Our investments have extreme bearishness priced in while our shorts see sunny skies forever. If the prices of our portfolio companies continue to decline with no change in fundamental value, you should expect even further concentration. We have excellent managers at the helm of well-financed companies with growth opportunities and very cheap stocks. This is a good long-term recipe for both capital preservation and eventual appreciation. The key is for us to remain patient when others seem to have discarded their better judgement.

Thank you for your trust and support.

Adam

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