BONHOEFFER CAPITAL MANAGEMENT

Dear Partner:

I hope you and your family had a nice holiday season and look forward to an eventful 2018. The Bonhoeffer Fund continues to invest funds and has now invested 90%+ of its capital. The Bonhoeffer Fund strategy will likely lead to low turnover; however, during the fourth quarter of 2017, we have monetized one portion of an investment—the Lotte Corp Preferred we received as a part of the Lotte Group restructuring (we held the Lotte Chilsung Preferred).

Two value-unlocking events: Lotte Chilsung Preferred and Asia Cement

In the fourth quarter of 2017, two firms in the Bonhoeffer Fund (Lotte Chilsung and Asia Cement) had a value-unlocking event. While in some cases these events occur over time, a one-time corporate action can unlock value for others.

Lotte Chilsung Preferred

In the case of Lotte Chilsung, we purchased the preferred shares of this cheap beverage company in part due to the large discount to the common shares. In addition to the beverage business, Lotte Chilsung also holds valuable real estate in Seoul near a subway extension and some investments in other firms. As a result of the holding company transaction Lotte Group has undertaken, the investments held by Lotte Chilsung were combined with the investments from the other publicly traded Lotte subsidiaries and spun off as a new company, Lotte Corp. Since Lotte Chilsung was the only subsidiary to have preferred stock, the Lotte Chilsung preferred shareholders received all of the Lotte Corp preferred. We analyzed this situation similarly to other compound mispricings by estimating look-through earnings and cash flows.

In these holding company transactions, there is typically a month's worth of time between approval and distribution of the new shares. In this case, we received new shares of Lotte Chilsung preferred (which holds the beverage operations and the real estate) and shares of Lotte Corp preferred (which holds the investment holdings of all the publicly traded Lotte subsidiaries). When the Lotte Corp preferred shares started to trade, they traded at a premium to the common shares. This is an uncommon situation as the preferred shares typically sell at a large discount to the common shares. We estimated the value at which the Lotte Corp preferred shares were trading on a look-through basis as being pretty close to the NAV of Lotte Corp, so we sold our Lotte Corp preferred shares as soon as we received them at around 92,000KRW. As of December

31, 2017, these shares were trading at 67,100KRW, which is about the same price as the common. What is interesting here is that the spin-off unlocked some of Lotte Chilsung's value; but the price of the new Lotte Chilsung shares trade at as much of a discount to intrinsic value as the price at which the shares traded initially. This is due to unlocking the value of the investments Lotte Chilsung held, which were discounted by the market when they were held by Lotte Chilsung. The spin-off also levered up Lotte Chilsung to industry-average leverage.

Asia Cement

The second value-unlocking event was the purchase by Asia Cement (Korea) of Halla Cement from Baring Private Equity Asia. Both firms produce and sell cement, aggregates, and related products. Asia Cement and Halla have complementary geographic regions where they produce and sell cement and related products—Asia Cement in the center of the country and Halla on the coasts. The purchase was financed by Asia Cement's excess cash and the assumption of debt and a small equity offering. Typically, cement firms use debt to finance plants and equipment, and this acquisition allowed Asia Cement to put excess cash to work in the purchase of a complementary asset. Even after the acquisition announcement and subsequent rise in price, Asia Cement still sells at a significant discount to both Korean and international competitors. Although there are no near-term prospects for reunification given the current situation in North Korea, when reunification does occur, Asia Cement's product will be in high demand. However, the current case for Asia Cement is not dependent upon this event; it is merely that Asia Cement's multiple increases to be in line with other domestic and international competitors. At December 31, 2017, Asia Cement was our largest holding

Bonhoeffer Fund Portfolio Brief Overview

The Bonhoeffer Fund's investments did not change much over the fourth quarter. The largest countries represented include: South Korea, South Africa, Hong Kong, Philippines, and Italy. The largest industries in which Bonhoeffer is invested include: consumer products, distribution, media, transaction processing, and cement. The fund has performed in line with the international benchmarks over the last quarter, but I can highlight that these 20 securities have a weighted average free cash flow yield of 18% and a weighted average EV/EBITDA of 3.5 (as of 12/31/2017).

Over the first few letters, I have been describing some key frameworks we utilize for security selection including compound mispricings, miscategorized firms, and capital structure analysis. In this letter, I will describe miscategorized firms.

Miscategorized Firms

I will walk you through how the Bonhoeffer Fund identifies and assesses miscategorized firms. The ability to implement this technique will enhance any investor's tool kit; and much of the Bonhoeffer Fund's holdings represent opportunities where a miscategorization is present.

A "miscategorized firm" is a situation where a firm is categorized as one type of firm (in a given industry, for example) but is actually in another industry or transitioning to another industry. Historically, I had seen this happen, but I had not seen the term formally defined until I read page 90 of John Neff's book John Neff on Investing, where he provides an example of a miscategorized firm—Bayer AG—that had about 50% of its earnings coming from non-cyclical chemicals while 50% were from more cyclical chemicals. The firm, however, was priced as though it was a cyclical chemical company. The result was that the firm was repriced and John Neff's fund (Windsor) reaped the rewards. Miscategorization can also occur between countries, where firms in a given country sell at a larger-than-warranted discount to similar firms in a different country.

We often find miscategorized firms when looking at firms in cyclical industries where a segment of the industry is less cyclical than the larger industry. One way to identify these firms is to examine the value chain of cyclical industries and determine less cyclical, distribution or recurring revenue segments in the value chain. Examples of this are in the tire and automotive service segments of the auto industry. Both segments are consumer facing and generate recurring revenue. They also make a large majority of their profits from after-market sales and services. The profitability and return on capital of these businesses are also closer to consumer product and service businesses than automobile businesses. These firms are more akin to consumer product and service companies than the capital-intensive auto business. Thus, their multiples should reflect the more consumer product and service orientation of their sales. However, there are times when the multiples of these firms trade in line with cyclical auto firms versus less cyclical consumer product and service firms. Another example is cable-like telecommunication firms (whose cash flows are rising) trading like legacy telecommunications firms (whose cash flows are declining).

To determine if each of these opportunities provides an opening to generate profit, the multiple of the subject firm can be compared to the multiples of the firms that are closest to the target firm. In some cases, like the tire firms mentioned above, the appropriate multiple is a consumer product versus auto parts. An example of this is Nexen Corp preferred, a tire holding company preferred security. Nexen Tire generates more than 90% of its profits from aftermarket sales of tires; thus, it is more of a consumer product company selling replacement parts that will not be replaced as automobiles go electric. Growing consumer product firms typically sell for at least 9-10x EBITDA versus auto parts companies that sell for 3-5x EBITDA. This pricing difference is due to the differences between the cyclical and non-cyclical firms and the amount of recurring revenues. The Nexen Corp preferred sells for a look-through value of 3.5x EBITDA, clearly being priced as an auto parts supplier. Even if a conservative multiple of 8x is applied to Nexen Corp's EBITDA, then it implies an upside of 197% for the Nexen Corp preferred.

An important aspect of investing in miscategorized firms is growing value. If you are investing in growing firms, then the securities will have a tailwind. If you are investing in declining-value firms, then it is difficult to determine what the real discount is because part of the discount is due to the expected decline in the firm's value in the future.

Some of the key catalysts to unlocking the miscategorization discount include: increasing revenue from the recurring portion of the business; growth (which reduces firm value discount) and corporate events such as spin-offs or new management; and management, who can engineer and communicate changes and transitions in firms. Some of the key value traps associated with miscategorized firms include declining firm value and declining relative profits from the recurring portion of the business.

Mischaracterized companies are often found in non-cyclical segments of cyclical businesses which makes them challenging to analyze but all the more rewarding to leverage in our investment strategy. It is my hope that this letter provides a small vignette of what we do at the Bonhoeffer Fund and highlights the amount of thought and due diligence we are putting into investing your money.

As always, if you would like to discuss any of this in deeper detail, then please do not hesitate to reach out. In future letters, I will similarly dig into capital structure analysis to give you a feel for the Bonhoeffer Fund investment strategy. Until then, thank you again for your time and confidence in our work. Have a wonderful new year, and we will be in touch later in 2018.

Warm Regards,
Keith D. Smith, CFA

February 26, 2018

BCM CASE STUDY

Miscategorized Firm Case Study: Wilh. Wilhelmsen Holding ASA (OSE:WWIB)

As discussed earlier, a miscategorized firm is a situation where a firm is categorized as a one type of firm (in a given industry, for example) but is actually in another industry or transitioning to another industry. This situation is not common but advantageous for the investor because understanding business classifications and their industry analogs are important aspects of firm valuation.

In this case study, I will focus on an industry miscategorization in a company called Wilh. Wilhelmsen Holding ASA (OSE:WWIB), an auto and heavy equipment logistics company with assets around the world and 75,000 annual port calls.

Wilh. Wilhelmsen Holding ASA holds three types of assets: 1) a maritime services business (including seafarer staffing, logistics, and ship management) that amounts to 42% of the company's NAV; 2) a portion of the world's largest roll-on/roll-off (RORO) shipping business via Wallenius Wilhelmsen Logistics that amounts to 37% of NAV; and 3) investments in other logistics businesses (such as Hyundai Glovis, Qube, and NorSea) that amount to 21% of NAV.

Wilh. Wilhelmsen Holding ASA has excellent management which has generated returns on equity from 14% to 23% per year since 2000 in contrast to most every other shipper which has generated negative returns in capital over the same time period. This is a result of Wilh. Wilhelmsen Holding ASA providing logistics services (with specialized shipping being a portion) versus the commodity shipping provided by most shippers. The specialized RORO shipping is very customized and manpower intensive versus more commoditized shipping services like container or bulk shipping. This fact, along with Wallenius Wilhelmsen Logistics being the largest RORO shipper, provides a moat for Wilh. Wilhelmsen seen in logistics firms, not shipping firms.

Wilh. Wilhelmsen Holding ASA has the typical corporate structure of Scandinavian shipping firms, where family-controlled holding companies hold the underlying ships and various services firms. This structure can marginalize the minority shareholders. This can also lead to large holding-company discounts (as is the case for Wilh. Wilhelmsen) that can decline as management demonstrates good corporate governance. However, in this case, the excellent management and low management expense ratio should result in a lower holding company discount. One aspect of management I respect is that the CEO is paid less than some managers who work for him. In addition, his family owns about 50% of Wilh. Wilhelmsen Holding ASA's common stock. In management's communications to shareholders, management is frank in its disclosures and has live annual meeting webcasts with shareholders.

Given the excellent return on equity over the past ten years, Wilh. Wilhelmsen Holding ASA has achieved above-average book value growth with a book value and dividend growth rate of 9% per year. This growth was driven by earnings from logistics services and specialized RORO shipping services.

To illustrate the power of mischaracterized firms in this situation, observe the "look through" EBITDA, cash flow, and NAV multiples of Wilh. Wilhelmsen Holding ASA. As of December 2017, Wilh. Wilhelmsen Holding common stock trades for 4.2x EV/EBITDA, 8.7x P/Cash Flow, and 0.51x EV/NAV; this is undervalued when compared to other logistics firms' companies that typically sell at least at EV/EBITDA multiples of 10x.

When evaluating Wilh. Wilhelmsen Holding ASA, we must consider an additional holding company discount for the "look through" analysis. One way to consider these expenses is to capitalize holding company expenses. In this case, if we capitalized Wilh. Wilhelmsen's general and administrative expenses at 10%, then we imply a discount to NAV of 2.0%. We conservatively use a 10% holding company discount (to account for other factors contributing to the discount) in our calculations of NAV above.

BCM Case Study Conclusion

Considering these parameters, in my view, Wilh. Wilhelmsen Holding ASA is a cheap and growing compounder with excellent management and great capital allocation skills. Wilh. Wilhelmsen Holding ASA has a well-deserved reputation as the Berkshire Hathaway of shipping.