BONHOEFFER
CAPITAL MANAGEMENT

Dear Partner,

Welcome to the Bonhoeffer Fund, LP. As the fund manager, I want to humbly thank you for entrusting me with the responsibility of investing and growing your hard-earned money. The Bonhoeffer Fund, LP, is a private hedge fund for accredited investors that utilizes value-oriented investment principles. The objective of our boutique fund is to grow capital at a higher rate than equity index funds—after accounting for management fees—and to provide minimal exposure to permanent loss.

The fund combines an investment strategy inspired by Benjamin Graham and Warren Buffett with the lessons I have learned, honed, and executed over fifteen years of working across international markets. I have invested successfully in unconventional locations and industries where the popular market perception does not match the reality of the specific investable opportunity. Doing so requires filtering information through an unique lens, but the subsequent investment opportunities are significant.

The fund's namesake, Dietrich Bonhoeffer, was a public figure whose commitment to his faith and life philosophy served as a strong and public resistance to the Nazi regime in World-War-II Germany. He ultimately paid with his life. Dietrich Bonhoeffer demonstrated the valor needed to be an independent thinker and inspired others to have the courage of their own convictions. Mr. Bonhoeffer serves as an inspiration for the foundation of independent thinking at the Bonhoeffer Fund.

As part of my commitment to the Bonhoeffer Fund, I have invested the majority of my investable net worth in the fund or in securities that follow a similar strategy to ensure that our interests as partners are aligned. This letter provides more details about the fund, my investment philosophy/strategy, investment process, portfolio management, how we're balancing risk and return, and how this fund might fit into your broader portfolio. As always, please do not hesitate to contact me.

Investment Strategy

My expertise is to find and invest in attractive securities at reasonable prices both domestically and internationally. I scour the market to find the "50 ¢ dollar" opportunity; where, under normal market conditions, a security is either undiscovered or misunderstood and, therefore, trades at approximately half of its intrinsic value. The difference between the current stock price and the underlying value (intrinsic value) of the business is defined as the "margin of safety". Utilizing the margin of safety investment principle gives our fund a cushion in a market downturn and allows us to capture upside appreciation. To the impatient investor, this approach may appear to underperform in comparison to high-risk and/or short-term strategies. However, in the long run, this approach reliably yields higher net appreciation over full-market-cycles. The Bonhoeffer Fund's specialty is to find these "off the beaten path," discounted securities in unassuming places.

While I expect my circle of competence will grow as opportunities present themselves, I plan to seek opportunities with many of the aforementioned characteristics that also may possess the added benefits of compound mispricings, miscategorized firms, and corporate actions. My established knowledge base from both my work as an appraiser and from my personal investing experience includes groups of recurring-revenue businesses such as: telecom and media services, logistics services (including auto and heavy equipment distributors and service providers), asset managers, food and beverage services, information processing, real estate services, cement and aggregates, and recreation services.

<u>Compound Mispricings</u>
Compound mispricings occur when both a firm and its underlying securities are mispriced. This strategic opportunity can be found in holding companies, non-voting equity securities, and derivative securities, such as long-term options. In evaluating these opportunities, "look through" analysis and market data from around the world are used to analyze securities within multiple layers of a corporate structure. I have included a case study in this letter as an example.

<u>Miscategorized Firms</u>
Another approach is to analyze firms that the market has miscategorized, possibly, because the firm is transitioning from one business model to another. Examples include, a shipping company moving to logistics, a telecom company transitioning to triple-play services, and a construction company pivoting to real estate and project development. In each of these circumstances, the market values the business as it was, not as it will be. This discrepancy presents us with a distinct value opportunity.

<u>Corporate Actions</u>
Corporate actions also provide value-enhancing opportunities because prospective securities can be found in out-of-favor industries and firms engaged in corporate actions such as share buy-backs, spin-offs, rights offerings, and bankruptcies.

<u>Our Investable World</u>
The geographic scope of the fund is in any geographic region that has adequate disclosure, a history of free enterprise, and economic freedom where we can capture investable opportunities. This is important, as when we locate an opportunity, we want to have a reasonable chance of realizing the upside for our shareholders.

Investment Process

After identifying a promising opportunity, Bonhoeffer Capital Management has a rigorous investment process, where we perform the necessary due diligence and legwork to ensure the success of the venture. A critical factor in evaluating a firm's competitive advantage is to determine whether their edge is sustainable. This edge, sometimes called "moat", indicates their ability to maintain an advantage over competitors. The moat protects long-term profits and maintains and/or grows the firm's market share. Bonhoeffer Capital Management then evaluates the firm's management to ensure that they are actively growing the value per share of the business, and to ensure that management's incentives are aligned with shareholders.

Finally, the individual securities of the target firm are examined to determine where the best risk-adjusted returns are located. For a real-world preview of how this process takes place, please see the case study at the conclusion of this letter regarding compound mispricings in a Korean conglomerate.

Portfolio Management

Portfolio construction through efficient diversification is critical with regard to limiting your losses and maximizing your gains. The Bonhoeffer Fund portfolio comprises 10 to 20 securities in multiple business sets, both across industries and companies. The portfolio is conviction-weighted and constrained via the Kelly criterion method, which is a tested mathematical evaluation that helps determine the long-term growth probability of capital. By weighting our securities based on the relative valuation discounts adjusted for country risk, and including securities with multiple levels of discounts in a state of distress or transition, we effectively diversify our portfolio to prevent against permanent capital loss and position ourselves to capture our desired gains.

Risk Management

While we know there are some interesting, undervalued stocks available out there, what is Bonhoeffer's strategy for risk management? Broadly, we have five risk mitigation filters:

- All positions are purchased at an estimated discount to intrinsic value of 50%.
- Positions are in diverse sectors and regions of the world that have different economic drivers.
- Most positions have compound mispricings caused by a diverse set of factors.
- For allocation weightings all positions are subject to the Kelly Criterion method. Stocks that have 100% potential upside will have a maximum weight of 10%, and stocks with 200% potential upside will have a maximum weight of 15%. Most often, weights are less than these maximums.
- For leveraged firms, a credit analysis will be performed to ensure that the debt is serviceable. We also take into account what the debt market is signaling about the firm's valuation.

The Bonhoeffer Fund and Your Portfolio

The Bonhoeffer Fund is a concentrated value-oriented hedge fund and we frequently invest in smaller firms from around the world. As a result, the fund will expose your portfolio to different risks and more volatility compared to traditional funds.

The Bonhoeffer Fund provides you with the unique opportunity to invest in multiple types of security mispricings in overlooked and/or misunderstood investment environments. In light of this, we ask you, as a partner, to be patient with the principle of value investing. We must exhibit patience and trust in the process. My respect for these values also led me to the fund's namesake, Dietrich Bonhoeffer.

Dietrich Bonhoeffer believed that the measure of a person was evaluated not by their net worth, social standing, or political acumen, but on the individual's discipline and how they endured suffering. I draw inspiration and determination from both Mr. Bonhoeffer and the movements he influenced: Civil Rights, Anti-Communist, and Anti-Apartheid. I apply this level of careful fortitude to my work at Bonhoeffer Capital Management.

I am honored by the trust you placed in me and in my investment approach. I look forward to many good years of partnership going forward. Please feel free to contact me if you have any questions.

Sincerely,

Keith D. Smith, CFA
Portfolio Manager
Bonhoeffer Capital Management

September 1, 2017

Case Study: Compound Mispricings in a Korean Conglomerate

Nexen Corporation is a Korean holding company with a large stake in Nexen Tire, one of Korea's largest tire companies. Nexen Corporation serves as a good example of several special-situation investments rolled into one, which leads to compound mispricings. Compounded discounts are multiplicative, not additive, which can lead to complex situations to assess. One of the key evaluative tools is discounted benchmarks pulled from market data or the economics of the situation, such as capitalized overhead expense for holding companies. Other appraisal tools include a "look through" of earnings or cash flow using normal holding and voting discounts.

There are also qualitative factors which can reduce these discounts, such as, better corporate governance, firm growth, increasing liquidity in shares, value enhancing events, and new management.

The Nexen Corporation holds stakes in several businesses including Nexen Tire, Nexen Corp operations (tire tubes and golf balls), KNN (a TV and radio broadcaster), Nexen Technology (auto wire harnesses), real estate and other investments in several publicly traded securities. This structure is typical for holding companies in Korea.

Nexen Corporation has preferred shares. Generally, preferred shares in Korea are non-voting common shares. To make up for the absence of voting rights, the shares typically have a higher dividend than the common stock. Additionally, in Korea many firms are family controlled, thus minority shareholders are marginalized. Hence, voting rights have little value for minority shareholders. These preferred shares have an interesting history because they, on average, trade at a 20% discount to the common shares pre-1998 crisis and have been sold at a larger discount (up to 70%) ever since. In the US, Canada, and the UK, similar securities (non-voting common stock) trade at discounts of 5% to 10%. The primary difference in the past and present-day Korea is in corporate governance because better corporate governance leads to a decrease in the discount.

For the Nexen Corporation, in particular, the Net Asset Value (NAV) of the firm is dominated by Nexen Tire (more than 85% of NAV) and it's economics is the key. Presently, the tire business is a good business because tire companies have generated returns on invested capital in excess of 2.5% per year over their cost of capital for the past 10 years. A majority of the profits are made in the aftermarket (with characteristics of a consumer good); and tires are resistant to obsolescence from major changes on the horizon for automobiles—electrification. In fact, electrification will increase tire demand for each mile driven.

Over the past five years Nexen has achieved above average sales growth versus competitors and has grown book-value and dividends at 17% per year. This growth was driven by above-competitor cash flow margins and product-line expansions to higher-priced segments. In 2013, before many competitors, Nexen Corporation reorganized as a holding company and simplified its corporate structure. As a result, the controlling family held a 50.5% stake in the holding company.

To illustrate the power of compound mispricings, one only has to observe “look through” EBITDA and earnings multiples of Nexen Corp and Nexen Tire. As of August 2017, Nexen Tire, commons trade for 8.5x P/E and 5.9x EV/EBITDA, this appears undervalued when compared to other tire manufacturers and even more undervalued when compared to consumer product companies. The compound mispricings is even better, when we look at the Nexen Tire preferred, which sells at a 52% discount to the common share. The “look through” multiples assumes a 10% non-voting discount that results in a 4.5x P/E and 4.1x EV/EBITDA.

When looking at Nexen Corp, we must consider an additional holding company discount for the “look through” analysis. One way to look at these expenses is to capitalize holding company expenses. In this case, if we capitalized Nexen Corp’s G&A expenses at 10%, we imply a discount to NAV of 3.4%. If we conservatively use a 20% holding company discount (to account for other factors contributing to the discount), the “look through” P/E for Nexen Corp is 5.3x and the EV/EBITDA is 5.3x, cheaper than Nexen Tire. And here too it’s even better because Nexen Corp has a preferred which trades at a 52% discount to the common. The “look through” multiples assuming a 10% non-voting discount are 3.9x P/E and 3.2x EV/EBITDA. In my view, the best place to hold shares in Nexen is at the holding company, not only because it is the most undervalued place but also because the controlling family holds its shares at this level.

What this case demonstrates is that an undervalued firm is growing, has discounted securities in its capital structure, and management holding large stakes in the same or similar securities. We’ll keep watching as this situation unfolds. Some Korean firms also have many of the catalysts mentioned above, which can lead to the discount narrowing, including growing asset values, better corporate governance, and corporate restructuring. This is just one example of why Korea is currently a treasure trove for special-situation investors.

This letter does not contain all the information that is material to a prospective investor in the Bonhoeffer Fund, L.P. (the "Fund").

Not an Offer – *The information set forth in this letter is being made available to generally describe the philosophies of the Fund. The letter does not constitute an offer, solicitation or recommendation to sell or an offer to buy any securities, investment products or investment advisory services. Such an offer may only be made to accredited investors by means of delivery of a confidential private placement memorandum, or other similar materials that contain a description of material terms relating to such investment. The information published and the opinions expressed herein are provided for informational purposes only.*

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