BONHOEFFER CAPITAL MANAGEMENT

May, 2024

Dear Partner,

Throughout the first part of 2024 and specifically within the first quarter, we continued replacing slower-growth firms with durable, faster-growing firms in temporarily depressed sectors and identified similar opportunities in new industries. These firms align with our longer-term growth themes of consolidation, transaction processing, affordable housing finance and housing construction We have identified and are analyzing opportunities in the following industries: specialized construction, natural resource royalties, distributors, logistics companies, housing, and specialty finance. New investments have a combined expected growth rate (RoE * (1-payout ratio)) plus dividends plus earnings yield of at least 30 to 40%.

As we continue to add faster-growing durable companies to the portfolio, I believe we have the highest-quality businesses in the fund's history, with a discount that continues to persist as the market fails to realize the improvement in our firms' positions. I believe high quality is reflected in free cash flow growth with highly recurring revenues (such as in subscription businesses), high free cash flow conversion, and returns on equity that are higher than less-risky alternatives, such as well-underwritten debt which currently has yields in the low-teens.

The Bonhoeffer Fund returned 5.9% net of fees in the first quarter of 2024. In the same time period, the MSCI World ex-US, a broad-based index, returned 5.7%, and the DFA International Small Cap Value Fund, our closest benchmark, returned 5.3%. As of March 31, 2024, our securities have a weighted average earnings/free cash flow yield of 12.3% and an average EV/EBITDA of 4.4.

The current Bonhoeffer portfolio has projected earnings/free cash flow growth of about 12.5%. The DFA International Small Cap Value Fund had an average earnings yield of 13.8% with 9% growth. Bonhoeffer Fund's and the indexes' multiples are slightly higher than the previous quarter, primarily due to share price increases.

Bonhoeffer Fund Portfolio Overview

Bonhoeffer's investment portfolio consists of value-oriented special situations, as well as growth-oriented firms that exhibit unique qualities when applying a value framework. We are particularly interested in companies in market niches that grow organically and/or through transition or consolidation. We also like to see active capital allocation through opportunistic buybacks, organic growth and synergistic acquisitions. Finally, we like to see durability, as measured by increasing recurring revenues and free high cash flow conversion in our portfolio companies. There were modest changes within the portfolio in the first quarter, which are in line with our low historical turnover rates. We sold some of our slower-growing investments and invested some of our cash into a distribution firm, Arrow Electronics, described in the case study below.

As of March 31, 2024, our largest country exposures included: United States, United Kingdom, South Korea, Canada, Latin America, and Philippines. The largest industry exposures included: distribution, telecom/media, real estate/infrastructure/finance, and consumer products.

Conclusion

As always, if you would like to discuss any of the investment frameworks or specific investments in deeper detail, then please do not hesitate to reach out. As we wrap up the second quarter, I wish you and your family a happy summer and want to thank you for your continued confidence in our work.

Warm Regards,

Keith D. Smith, CFA

INVESTMENT THEMES

Compound Mispricings (21.3% of Portfolio; Quarterly Performance 0.9%)

Our Korean preferred stocks and the nonvoting shares of Wilh. Wilhelmsen all feature characteristics of compound mispricings. The thesis for the closing of the voting, nonvoting, and holding company valuation gap includes evidence of better governance and liquidity. We are also looking for corporate actions such as spinoffs, sales, or holding company transactions and overall growth.

Our Lotte Chilsung preferreds is also a compound mispricing. The preferred shares trade at 45% discount to the company's common stock, which is also undervalued. Preferred shares are non-voting but have a higher dividend than the common shares. Since greater than 50% of the voting common shares are owned by the Shin family, the value of the voting shares versus the common shares should be nominal.

Lotte Chilsung, the largest beverage producer in South Korea, produces both non-alcoholic and alcoholic beverages. Overseas sales are expected to increase to 40% in 2024. This growth has become more important in recent years as South Korea is a mature beverage market. Over the past 5 years, Lotte Chilsung has grown EPS by 18% per year and is projected to increase EPS by 14% per year over the next two years. In addition, Lotte Chilsung owns a plot of land in downtown Soeul that has an estimated value larger than its current market capitalization. Due to the uncertainty of the timing of cash flows from this property's development, Bonhoeffer's valuation (see below) includes a 50% discount from the land's currently appraised value.

In 2017, the Lotte group performed a holding company transaction. The cross holdings were aggregated into a holding company. This simplified structure allowed the family to sell a portion of its stake in the holding company to pay estate taxes without losing control of the operating business. As a part of this transaction, the controlling family agreed to more disclosure and brought in outside management to manage some of the operating businesses. Since the holding company transaction in 2017, Lotte Chilsung has improved operations (a doubling of operating margins and tripling of net income), disclosures (quarterly disclosures in English), and communications of near-term and long-term plans. Free cash flow conversion is about 35%, interest coverage in 4x and Lotte Chilsung's bonds are rated AA. For Lotte Chilsung, the combined earning yield (25%) plus EPS growth (14%) is 39%.

Lotte Chilsung is a great business operationally and is in a good position to grow. The largest drawback at this point is management's reputation. Although disclosure and communications have improved, an employee was recently dismissed for bribing a government official and management compensation is high.

Below is our current valuation of Lotte Chilsung, including a 20% holding company discount:

Lotte Chilsung (₩bn)								
	EBITDA	Multiple	Value	% of Value				
Beverage & Liquor Ops	₩433	8.7	₩3,773	79%				
Gangnum Real Estate			₩950	20%	50% of sale value		₩94,487	
Lotte Akhtar Beverage			₩48	1%	52% of Akhar Beverage (October 2018)			
Cash			₩260		3/2024 cash			
Debt			-₩1,497		3/2024 debt			
Valuation (₩bn)	NI (₩bn)		₩2,827	100%			Hold co Disc	20%
Shares (m)	₩166		10.054300					
Value Per Share	₩16,500	NI Mult	**₩281,213**	Discount				
Common Shares		7.8	₩128,400	-54.3%	119%	Tang BV	₩648	Ex Real Esate
Preferred Shares		4.1	₩67,500	-71.0%	245%	BV/Share	₩64,440	
						RoTE ex RE	25.6%	
EBITDA Multiple								
		Upside*				Tang BV		
7	**₩222,151**	196%				PP&E	₩2,594	
8	**₩256,604**	242%				NWC	-₩4	
9	**₩291,057**	288%				Debt	₩1,497	
10	**₩325,510**	334%				Tang BV	₩1,093	
						BV/Share	₩108,710	
						RoTE	15.2%	
* Preferred upside assuming preferred 90% of common stock								
EBITDA Multiples								
Korean Alcohol Comps	7.9	Hite Jinro & Muhak						
		7.9						
International Beverage Bottlers	9.5	Coca-Cola Cons, Coca-Cola Europacific, Coca-Cola FEMSA, Coca Cola Amatil, Arca Continental,						
		Icecek Cola-Cola, Coca-Cola HBC						
		13.4	11	8.3	12	7.1	6.6	8

Public Leverage Buyouts (LBOs) (44.6% of Portfolio; Quarterly Performance 0.2%)

Our broadcast TV franchises, leasing, building products distributors and dealerships, plastic packaging, and roll-on roll-off ("RORO") shipping fall into this category. One trend we find particularly compelling in these firms is growth creation through acquisitions, which provides synergies and operational leverage associated with vertical and horizontal consolidation. The increased cash flow from acquisitions and subsequent synergies are used to repay the debt and repurchase stock, and the process is repeated. This strategy's effectiveness is dependent upon a spread between borrowing interest rates and the cash returns from the core business and acquisitions. Over the past 12 months, interest rates have been increasing, which has reduced the economics of this strategy, but a large spread still exists if assets can be purchased at the right price. Increasing interest rates has affected the returns on public LBO firms. Some firms have been reducing debt to reduce the impact of higher rates on earnings.

Many of our holdings used the acquisition/buyback model described above. Some of these firms have also used modest leverage to magnify the returns of equity to 20% and above, over the past five to ten years from the acquisition/buyback model. These firms include: Terravest, Asbury Automobile, Ashtead, Autohellas, Builder's First Source and Millicom. In addition, many of these firms are buying back stock and the modest current valuations make these buybacks accretive.

Distribution (55.9% of Portfolio; Quarterly Performance 6.8%)

Our holdings in car dealerships and branded capital equipment dealerships, building product distributors, automobile transportation logistics, and capital equipment leasing firms all fall into the distribution theme. One of the main key performance indicators for dealerships is velocity, or inventory turns. We own some of the highest-velocity dealerships in markets around the world. Over the past two years, there have been challenges in some markets hit by COVID, like South Africa and Latin America, but we are seeing recovery now that vaccines have been approved and distributed.

One of our holdings in the distribution theme is Asbury Automotive, an automobile dealer. In one model of stock market returns, three factors drive returns: 1) net income growth (which can be decomposed to sales growth, margins and leverage), 2) changes in shares outstanding (which include share issuances and share repurchases) and 3) changes in PE. The first two factors are to some extent in the control of management and thus merit the most attention from analysts. The table below illustrates auto dealership trends since the year 2005 for net income growth, changes in shares outstanding, and earnings per share (EPS) growth, change in the price to earnings (PE) multiple, and change in RoIC.

		Annual Performance 2005-2023					
		Net Income Growth	Change in Shares	EPS Growth	Change in PE	Stock Price Return	Change in RoIC
Car Dealers							
AutoNation		4.1%	-9.5%	15.0%	-4.8%	11.0%	5.0%
Asbury		13.6%	-2.5%	16.4%	-4.3%	15.0%	3.0%
Group 1		14.2%	-3.1%	17.8%	-4.8%	14.0%	4.0%
Lithia		17.6%	1.3%	16.1%	-3.4%	15.0%	1.0%
Penske		12.9%	-1.8%	15.0%	-2.4%	15.0%	0.0%
Car Parts Distribution							
Autozone		7.9%	-7.6%	16.8%	1.6%	20.0%	5.0%

The starting PEs of the dealership group was in the mid-teens (similar to Autozone) but the ending PEs are in the mid to high single digits. Autozone ended the period with a PE of 20. Each firm had EPS growth in the mid to upper teens. Even after factoring in a pattern of declining PE multiples, stock price returns for the car dealer group ranged from 11% to 15%. Just about every firm also had an increase in RoIC (the firm's quality was increasing over time). However, for the automobile dealer group the multiples compressed, implying quality degradation. If we look at car parts distribution, another part of the automotive value chain that has similar historical EPS growth, the multiple for its largest firm, Autozone, has expanded to 20x from the mid-teens in 2005. This resulted in a 20% total return for Autozone vs. low to mid teen growth for the auto dealers.

What is interesting about the car dealer group of firms is that the EPS growth has been reasonably close despite how different the firm's operating models were. AutoNation, with few acquisitions and a lot of repurchases, had net income growth close to total auto US dealer sales growth of 3% compared to Lithia which was very acquisitive and issued more shares than it repurchased. As can be seen by stock price returns, the market discounted AutoNation's approach of fewer acquisitions and more buybacks versus the more common acquisition and buyback approach.

Given the current modest valuation (implying no to 1% annual growth rate), a question going forward is: can these results continue as in the past? This growth has been driven by three factors: sales growth, modest margin expansion (primarily through M&A) and accretive share buybacks. Given that publicly traded automobile dealers firms represent less than 10% of all US vehicles sold, there is a large Tangible Addressable Market (TAM) for continued consolidation into the future. Also, given the modest current valuations, buybacks are very accretive at current prices. If consolidation and buybacks continue, which I think they will, there is no reason not to expect higher than EPS growth in stock prices in the future as multiples rise combined with the tailwinds of consolidation.

Telecom/Transaction Processing (17.6% of Portfolio; Quarterly Performance -10.7%)

The increasing use of transaction processing in the markets of our respective firms, as well as the rollout of fiberoptic and 5G networks is providing growth opportunities within this theme. Given that most of these firms are holding companies and have multiple components of value (including real estate), the timeline for realization may be longer than for more mono-industry-focused firms.

Millicom (TIGO) is one the remaining telecom firms in the portfolio as the company retains favorable market conditions including operating in many two player markets or in markets where the number of participants is getting smaller. With fewer players, telco firms can recover pricing power to offset the increasing cost of network construction and operations. In one of its key markets, Columbia, a large player has entered bankruptcy which will reduce the number of market players. Lati, Millicom's tower spin-off, is progressing with investor interest from US tower firms such as SBA Communications. In addition, Millicom continues to implement cost cuts identified by the new CEO and team that was put in place by the new large shareholder, Xavier Niel.

Consumer Product (11.1% of Portfolio; Quarterly Performance 2.5%)

Our consumer product retailing, tire, and beverage firms comprise this category. The defensive nature of these firms can lead to better-than-average performance. One theme we have been examining is the development of category-killer retail franchises. These firms have developed local franchises which have higher inventory turns, margins, and sales per square foot than competitors. These factors resulted in great unit economics and high returns on incremental invested capital. They also have some unique characteristics, including specialty niches (such as tire stores or athletic shoes) or offering something the competitors will not do (such as selling hunting supplies).

Real Estate/Construction/Finance (42.6% of Portfolio; Quarterly Performance 9.5%)

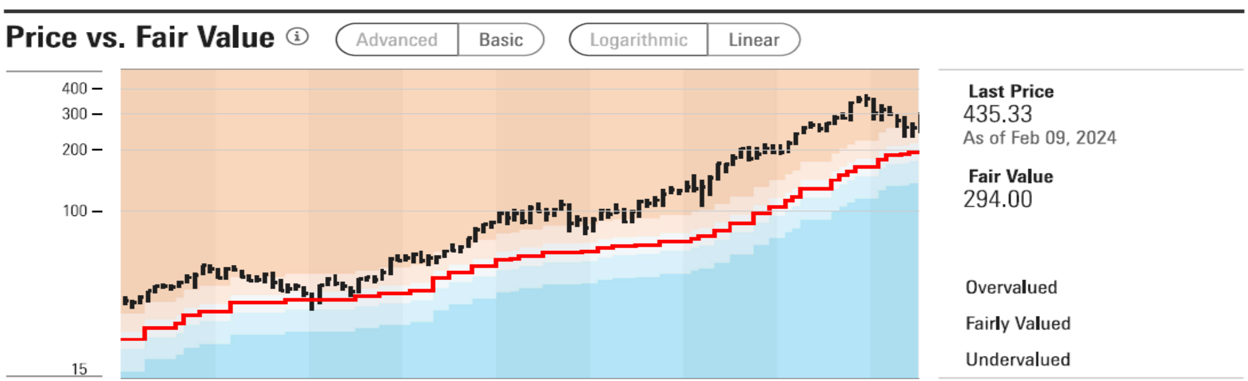
The current construction holdings (in US/Europe via Builders FirstSource and Vistry) should do well as the world recovers from COVID shutdowns, governments worldwide incentivize infrastructure programs and new construction continues to replenish the housing deficit in the US and the UK. Financing of low-income real estate development as well as growth in small business lending (via small business administration ("SBA")) and the purchasing of forced sale loans from mergers and acquisition as well as the FDIC are themes driving growth in our bank holdings, FFB Bancorp ("FFB"), United Bancorp of Alabama ("UBAB") and Northeast Bank ("NB").

NEW PORTFOLIO IDEAS

Examining the Bonhoeffer Portfolio in Light of Charlie Munger Speeches

In remembrance of Charlie Munger, I listened to and read his investment speeches in Poor Charlie's Almanac. His speech to the University of Southern California business school specifically dealt with the application of worldly wisdom to investment management and business. There were five ideas presented by Munger in that speech which are particularly relevant in the Bonhoeffer portfolio. First, over the long term, it's hard for a stock to earn more than the underlying business earns. As an illustration of this principle, we examined two firms, Old Dominion Freight Line (ODFL) and Warner Brothers/Discovery (WBD).

ODFL is an example of a growth stock whose value has been driven by increases in intrinsic value over time. From a commodity trucking business, ODFL has developed a franchise over time through consolidation. Using a DCF model with analyst estimated inputs, Morningstar estimated ODFL's intrinsic fair values, which appeared overvalued, but stock price grew by 28% per year in-line with intrinsic value which grew by 28%/year which outperformed the index average of 12.7%/year. ODFL's average RoE was 24.5% and increased thorough the period and ended in the 30%s. The chart below shows both the stock and an estimate of its intrinsic value over time. [1]



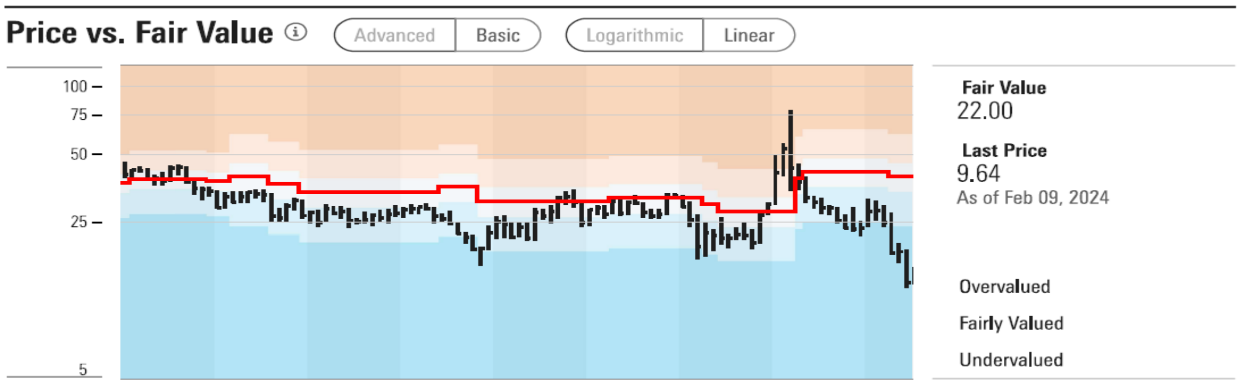
2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	YTD	
1.62	1.07	1.45	1.64	1.30	1.79	1.86	2.19	1.41	1.44	1.48	Price/Fair Value
46.44	-23.92	45.23	53.81	-5.73	54.23	54.74	84.03	-20.48	43.40	7.40	Total Return %
12.85	0.69	12.44	21.47	-5.05	31.22	20.90	25.78	-19.43	26.44	5.14	Index Total Return %

USD | As of Feb 09, 2024 | Index: Morningstar US Market TR USD

WBD is an example of a value stock whose value has been impaired by a declining intrinsic value over time. Historically, WBD has been consolidating media content and distribution firms. However, the media content and distribution industry has been fragmenting over the past 20 years, with many new competitors and lower barriers to entry. Based upon Morningstar's estimates, WBD is almost always undervalued, but stock price declined by 13.4% per year less than intrinsic value which declined by 5% per year, which is still a disaster compared to the index which increased by 12.7% per year. The average

[1] Chart from Morningstar Investor

RoE was 7.2% and was declining through the period and ended negative. The chart below shows both the stock and Morningstar's estimate of its intrinsic value over time. [2]



	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	YTD	
	0.91	0.78	0.81	0.72	0.80	1.02	1.07	0.56	0.32	0.46	0.44	Price/Fair Value
	-15.40	-22.55	2.74	-18.35	10.55	32.34	-8.09	-21.77	-59.73	20.04	-15.29	Total Return %
	12.85	0.69	12.44	21.47	-5.05	31.22	20.90	25.78	-19.43	26.44	5.14	Index Total Return %

These trends of growth and their effects on returns are reflected in the new investments we have invested in and those firms we have sold recently. We have sold most of our telecom and media firms (which have had flat to declining intrinsic values over time). These firms have been replaced by consolidating capital light distribution firms and specialized financial services firms (which have had increased intrinsic value over time) one of which is described below.

The second takeaway is that specialization and focusing on niches is where favorable economics can be found. Munger relays that markets are like ecosystems, where specialization can lead to the thriving or the extinction of a species. An example can be found in banking. Banking has large economies of scale and the large "too big to fail" (TBTF) banks take advantage of these benefits. However, regulation constrains the TBTF in what they can invest in as they hold depositors' cash. As a result, smaller banks can specialize in areas TBTF cannot or will not enter due to either size or regulatory constraints. The banks Bonhoeffer invests in specialize in these areas including UBAB who specializes in low-income/affordable housing financing and FFBB who specializes in SBA and apartment loans and card processing. Both of these banks have generated more than 20% returns on equity with large runways for growth.

The third idea is that advantages of scale are ungodly important. Munger mentions scale advantages resulting from experience, volume, operational leverage, search costs, social proof and network affects. The advantages of scale are typically offset by bureaucracy required to coordinate the activity that is subject to scale. Scale advantages can be seen in consolidation where synergies occur at both the local and national levels. These scale advantages are evidenced in our portfolio by Arrow Electronics, Builder's First Source, Asbury and Ashtead.

[2] Chart from Morningstar Investor

The fourth idea is to examine who gets the economic benefits of technology. In a commodity business, the customer gets the benefit, whereas in a franchise, the firm and the customer share the benefits. Munger gave the example of textiles where Berkshire had to pass on the benefits of technology to its customers to stay competitive with competitors who implemented the same technology. In electronics distribution and equipment rental, technology benefits are shared as the largest players provide timely availability due to scale, which the customer is willing to pay a premium for.

The fifth idea is surfing trends where a powerful idea or theme can last over many decades. Munger describes the development and propagation of the cash register as an example. The founder of National Car Register was a merchant who recognized the utility of the cash register early on and left retailing and entered the cash register business. The cash register reduced pilferage of revenues as it provided a tie between products sold and cash received. The cash register has remained to this day a key element of retailing. Henry Singelton's focus on the firms that benefitted from the usage of semiconductors is another example of a surfable trend. Some of the longer-term surfing trends associated with Bonhoeffer holdings include: automation of banking functions (including transaction processing) and the consolidation of distributors and equipment lessors in growing demand segments of the market like housing and transportation.

Compounder Financial Services Firms

The financial services industry is an out-of-favor industry whose participants engage in multiple businesses. Background information on financial services firms was presented in the previous letter. I include a brief overview below.

Most banks have both a lending franchise and a deposit franchise. The lending franchise generates value by originating creditworthy loans at interest rates that more than compensate for loan losses, impairment, and the cost of funds. Banks can have niches (such as SBA loans and mortgages) in which parts of the loans or the whole loans are sold to third parties, and the originator retains the servicing, making the operations capital light. Some banks specialize in the purchasing of third-party-originated loans from the FDIC (in the case of failed banks) or as a result of a regulatory stipulation in a bank merger. The key KPI in the lending franchise is the total asset return or yield (equal to yield plus fees plus principal, less any losses). Losses can be estimated based upon the historical write-offs and losses incurred. Banks reserve for expected loan losses through loan loss reserves. Recent financial reporting changes have introduced the metric of criticized loans (non-performing loans plus loans that are paying but have a significant chance of becoming non-performing) to get an idea of which loans are having problems before becoming nonperforming and actual losses. Since banks are levered firms, small amounts of losses can result in large declines in equity.

The deposit franchise will have value when a bank can generate below-market-rate deposits from a sticky customer base whose reason for choosing the bank is not deposit yield. These can be value enhancing when combined with a great lending franchise. Examples of valuable deposit franchises include prepaid gift and debit card float, transaction processing float, providing value-add service for demand deposit accounts, and catering to a specific demographic group (minority or low-income folks). The key KPI for a deposit franchise is cost of funds. Combining asset yield and cost of funds results in an important KPI: net interest margins.

Banks can focus on other lines of business such as trust services, transaction processing services, multi-family GSE origination, and import/export financing. Some of the larger banks also provide asset management and custody services, investment banking, and advisory services. Occasionally, these services are the primary services provided by banks. In most cases, lending and deposit services act as an introduction to these other services.

All banks incur costs associated with the services they provide. One way to measure the efficiency of a bank's operations is through the efficiency ratio—another key KPI—which is equal to the non-interest expense/(net interest income plus non-interest income). The average efficiency ratio for banks is currently 56%. Many times, efficiency is culturally based. A consistently low efficiency ratio is not common and can signal exceptional management stewardship of the bank's assets—primarily personnel and money. Banking is a business of controlling surpluses versus generating scarce profits as found in most other industries. Therefore, stewardship of surpluses is an important bank management metric. This metric is reflected in KPIs such as top five executive compensation/net income.

Specific niches within the banking industry have allowed for compounder-type returns over time despite the relatively mature, slow growing, stable and fragmented market. Sticking with those niches and not diluting them over time with lower return opportunities is a key skill in finding a financial services compounder.

Today, there are some financial services firms competing in niches that generate roughly 20% long-term returns on equity, can reinvest most of their earnings and are selling for attractive valuations (less 8.0x times earnings) which make for a good investment. In addition, at such share prices, share buy-backs very accretive.

Bonhoeffer holds FFB Bancorp (FFB), a California community bank that provides transaction processing services nationwide. FFB provides its services out of one branch in Fresno to the central valley of California as well as Southern and Northern California. Management has aspirations to grow its assets by 6x in the three regions it operates (Central Valley, Northern and Southern California) over the next 10 to 20 years. FFB has grown EPS by 35% per year over the past five years. For many banks, fast growth is sign of lax underwriting of loans. That is not the case for FFB Bancorp, whose criticized plus watch list loans is equal to 1.6% of loans and NPA's of 0.5%. Net interest margins (NIMs) are at 5.2% with a low cost of funds of 1.1% primarily from transaction processing float and non-interest bearing deposits from loan customers. The average loan yield is 6.7% and the incremental yield is estimated to be about 8%. So, in FFB, we have a fast-growing bank (one of only four companies to have EPS growth of greater than 20% in each of the past 5 years) with a long runway for growth at 6 times its current size selling for only 8x TTM earnings. FFB has the capability to grow EPS at least in the mid-20% for the next 5-10 years. If FFB can grow the bank by 6x over the next 7.5 years (27% annual growth) and have the multiple double to the mid-teens, FFB will be a 12 bagger, implying a 39% annual return over 7.5 years.

CASE STUDY: ARROW ELECTRONICS (ARW)

Arrow Electronics ("ARW") is the world's largest authorized electronics components distributor (15% market share including larger shares in key markets) serving both electronics OEM customers and component suppliers. Most large component manufacturers buy directly from component suppliers. ARW has over 220,000 customers with a 90% customer retention rate and over 3,700 suppliers. ARW also distributes IT products such as servers, software, storage and computer security products. ARW has over 22,000 employees at over 219 sites located in 85 countries, including 39 distribution centers and 180 offices. Over 67% of its revenue is associated with products that include value-added services such as component design services and supply chain management services. The large portion of components associated with value-added services allows ARW to generate industry leading operating margins of 5.3%.

Arrow Radio, the predecessor to ARW, was founded in 1935 on Radio Row in New York City. In 1946, ARW was incorporated. In 1961, ARW had $4 million in sales and went public via an IPO. In 1968, Mr. Glen, Green and Wadell bought a controlling interest in ARW and executed a leveraged roll-up strategy. By 1970, ARW was generating $9 million in sales and was the 12th ranked electronics distributor. At that time, Avnet was the largest. By 1979, ARW had $177 million in sales and was the second largest distributor listed on the NYSE. In 1980, Mr. Green and Glen were killed in a fire and Mr. Wadell stepped in as CEO until 1982 when Mr. Kaufmann became CEO. In the 1980's and 1990's, under Kaufman's leadership, ARW participated in more than 50 mergers and acquisitions transactions, expanded its range of products distributed and spread geographically around the world. In 1988, Arrow joint ventured (JVed) with Maruban to distribute components in Japan. In 1994, ARW entered the IT products distribution market with the purchase of Gates/FA. In the 2000s, under the leadership of Mr. Duval and Mitchell, ARW continued to purchase 17 distribution firms worldwide. In the 2010s, under the leadership of Mr. Long, ARW purchased an additional 40 distribution firms. In 2022, Mr. Keirnes became CEO, and is currently serving this role. ARW has been recognized over the past 11 years as one of Fortune's "Most Admired Companies".

ARW has repurchased about 50% of its shares over the past 10 years most of that in the past 5 years as the pace of consolidation has slowed down. These repurchases have been accretive as ARW has sold between 5 and 10 times earnings over the past 10 years despite revenue and profit growth in-line with overall semiconductor sales growth. This has resulted in mid-teens EPS growth rates which I believe will continue if not accelerate as component demand increases through the end of the decade. Historically, ARW's revenue has grown with the growth in worldwide component sales.

A distribution productivity measure is return on working capital, pre-tax profit/working capital. One of the best distributors in Europe, Bergman & Beving, has a goal of 45% pre-tax return on working capital. ARW's competitors have returns on working capital of 14% for Avnet and 24% for Manica. ARW's pre-tax return on working capital ranged from 20% to 30% over the past few years. This far exceeds its competitors and compares well even with the best among distributors.

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ARW has generated 20% to 30% free cash flow returns on tangible equity over the past 10 years. The ability to generate these returns is the result of high customer retention rates (higher than 90%) and high free cash flow conversion ((CFO less cap-ex/CFO) - 90%). These are characteristics of a business with a durable moat. During the 2010s and into the 2020s, ARWs return on equity increased as the acquisitions and divestitures generated high incremental returns on capital (see analysis below).

ARW has five levers for cash flow growth: 1) electronic component market growth; 2) expanding the distribution franchise to new suppliers; 3) operational improvements; 4) paying down debt; and 5) distributing excess cash by buying back shares. The firm generates cash flows in excess of what is needed to modestly grow the firm, which is used to purchase firms in its target or adjacent markets. If no firms can be found that meet management's operational and valuation criteria, then management will buy back shares as the shares have typically traded at modest valuations reflecting modest organic growth. ARW currently spends about 10% of operational cash flow on capital expenditures leaving 90% for buy-backs and mergers and acquisitions.

The business sector in which ARW competes is subject to economies of scale from distributing and value-added services and have route density characteristics with respect to the distribution of components. Evidence of the increasing scale is ARW'shigh margins compared to its authorized distributor competitors.

Authorized Component and IT Products Distribution Services

ARW competes in the authorized components distribution and IT product distribution markets worldwide. ARW is the largest worldwide authorized component distribution company with a 15% market share (more than 30% in key markets) in a market with an estimated size of $195 billion in 2022. This market grew by 2.6% last year. Over the past 5 years the market grew by 4%/year and 5%/year over the past 10 years. The market is expected to grow in the mid to high single digits per year through 2030 driven by AI and the "internet of things". The top four firms in the distribution market have a 40% market share worldwide. Two Asian firms dominate the Chinese and Taiwanese markets (combined 35% market share), one firm dominates the Japanese market (23% market share) and two US firms have 30%+ market share in the rest of the world.

Authorized electronic component distributors can be thought of receiving a royalty on a capital-intensive semiconductor industry. Value-added services (such as design services and outsourced supply chain management (SCM) services) will enhance returns on capital and add stickiness to customer relationships. The relevant market share is a country/regional market share versus an international market share. ARW is a competitor in all markets, many of which ARW is the leading firm.

ARW also competes in the IT Products distribution market. The competitors in this market provide OEM products to value added resellers and systems integrators and smaller customers. This market has historically grown at GDP levels of 2% to 3% per year.

Another aspect of electronic component and IT product distributors versus other firms in the electronic component value chain is the capital light nature of these firms. Most semiconductor and IT product manufacturers are more capital intensive and have lower free cash flow conversion. The capital light nature of the business leads to higher returns on capital. These factors, as well as consolidation have generated above average returns on capital for the large, more scaled firms in the components distribution industry.

Component and IT distribution is a slow-moving business with many firms in this business being over 70 years old. This allows consolidation to occur, with disruption being less of a threat than in telecom, media or computer hardware industries.

As described above, organic growth in these segments is expected to be 5% annual growth rate[3] with any other growth coming from identified growth projects, acquisitions or share repurchases. In this case, buybacks add about 9-10% growth on a per share basis.

ARW operations have become better over time as acquisitions accelerated ARW's scale quicker than competitors. The return on equity have increased from 6% in 2012 to 2014, to 28% in 2022 and is expected to normalize in the high 10%s. Free cash flow conversion also increased from 84% in 2014 to about 93% in 2023. The return on equity drivers included increases in net income margins from 2.2% in 2014, to 2.7% in 2023, and decrease in inventory turnover from 8.8x in 2014, to 5.5x in 2023. Leverage also increased slightly from 1.6x to 2.1x EBITDA.

ARW's 5-yr average RoICs have also increased from 10% from 2014-18 to 13.5% from 2019-23. ARW's two closest competitors, Avnet and TD Synnex, had lower 5-year average RoICs in 2023 (8.4% for Avnet and 10% for TD Synnex) and declines in RoICs from 2014-18 to 2019-23.

The incremental return on invested capital over the past five years is close to 100%, which has increased ARW's RoE over the past five years. See the calculations below.

Arrow													
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022		102.6%
Capital Invested	393.9	484.1	285.4	666	228.8	183.2	449.4	163.9	124.3	60.9	78.8		877.3
2-yr sum			769.5	951.4	894.8	412	632.6	613.3	288.2	185.2	139.7		
4-yr sum					1664.3	1363.4	1527.4	1025.3	920.8	798.5	427.9		
CFO	663	622.8	718.6	711.2	748.7	750.9	986.4	722	848	1358.6	1651.2		900.3
2yr change			55.6	88.4	30.1	39.7	237.7	-28.9	-138.4	636.6	803.2		
4yr change					85.7	128.1	267.8	10.8	99.3	607.7	664.8		
												5-yr avg	
2-yr ROIIC			7.2%	9.3%	3.4%	9.6%	37.6%	-4.7%	-48.0%	343.7%	574.9%	180.7%	
4-yr ROIIC					5.1%	9.4%	17.5%	1.1%	10.8%	76.1%	155.4%	52.2%	
Equity	3987	4185	4159	4195	4466	4998	5376	4866	5149	5341	5611		
RoE	6.7%	1.4%	10.4%	0.2%	13.8%	11.7%	9.1%	12.2%	14.1%	24.3%	28.0%	17.5%	

[3] Based upon management's estimates of 3-5% market growth rate plus market share gains. The total 5-year projected annual revenue growth is 5% (14% on a per share basis) with the historical revenue annual growth rate of 3% (12% on a per share basis).

Downside Protection

ARW's risks include both operational and financial leverage. Operational leverage is based upon the fixed vs. variable costs of the operations. There are economies of scale in terms of purchasing and local logistics operations.

Financial leverage can be measured by the debt/EBITDA ratio. ARW has a lower net debt/EBITDA of 2.1 versus other electrical components and IT product distributors (like Avnet, CEC Port, Macnica, ScanSource, Supreme Electronics, TD Synnex, WPG and WT Microelectronics). The history and projected financial performance for ARW is illustrated below.

	12/31/13 A	12/31/14 A	12/31/15 A	12/31/16 A	12/31/17 A	12/31/18 A	12/31/19 A	12/31/20 A	12/31/21 A	12/31/22 A	12/31/23 A	12/31/24 E	12/31/25 E	12/31/26 E	12/31/27 E	12/31/28 E	5-yr growth	5-yr forward growth
Revenue	21,353.90	22,768.67	23,282.02	23,825.26	26,812.51	29,676.77	28,916.85	28,673.36	34,477.02	37,124.42	33,107.12	31,500.00	33,000.00	35,000.00	37,000.00	38,850.00	2.21%	3.25%
% Change YoY	*4.60%*	*6.60%*	*2.30%*	*2.30%*	*12.50%*	*10.70%*	*-2.60%*	*-0.80%*	*20.20%*	*7.70%*	*-10.80%*	*-10.80%*	*5.70%*	*7.30%*	*5.71%*	*5.00%*		
EBITDA	954.06	1,036.15	1,049.00	1,091.34	1,194.34	1,397.86	1,204.19	1,087.56	1,767.34	2,269.62	1,736.20	1,307.46	1,502.46	1,567.04				
% Change YoY	*7.50%*	*8.60%*	*1.20%*	*4.00%*	*9.40%*	*17.00%*	*-13.90%*	*-9.70%*	*62.50%*	*28.40%*	*-23.50%*	*-24.70%*	*14.90%*	*4.30%*				
% EBITDA Margins	*4.50%*	*4.60%*	*4.50%*	*4.60%*	*4.50%*	*4.70%*	*4.20%*	*3.80%*	*5.10%*	*6.10%*	*5.20%*	*4.40%*	*4.80%*	*4.70%*				
Net Income Normalized	519.03	592.98	592.27	609.76	678.98	781	636.5	609.68	1,137.36	1,465.16	976.6	620.00	780.00	891.00	1015.00	1130.00	4.57%	2.96%
% Change YoY	*6.30%*	*14.20%*	*-0.10%*	*3.00%*	*11.40%*	*15.00%*	*-18.50%*	*-4.20%*	*86.60%*	*28.80%*	*-33.30%*	*-35.90%*	*28.80%*	*2.40%*	*13.92%*	*11.33%*		
% Net Income Margins	*2.40%*	*2.60%*	*2.50%*	*2.60%*	*2.50%*	*2.60%*	*2.20%*	*2.10%*	*3.30%*	*3.90%*	*2.90%*	*2.10%*	*2.60%*	*2.50%*	*2.74%*	*2.91%*		
EPS Normalized	5.01	5.93	6.19	6.63	7.56	8.83	7.55	7.75	15.5	22.38	17.12	11.79	15.93	19.66	27.72	33.91	14.16%	14.65%
% Change YoY	*13.90%*	*18.40%*	*4.40%*	*7.10%*	*14.00%*	*16.80%*	*-14.50%*	*2.60%*	*100.00%*	*44.40%*	*-23.50%*	*-31.10%*	*35.10%*	*23.40%*	*40.99%*	*22.34%*		
WA Number of Shares	103.60	100.00	95.68	91.97	89.81	88.45	84.30	78.67	73.38	65.47	57.04	48.59	44.22	40.24	36.62	33.32	-8.40%	-10.19%
% Change YoY		*-3.48%*	*-4.32%*	*-3.88%*	*-2.35%*	*-1.52%*	*-4.69%*	*-6.69%*	*-6.72%*	*-10.78%*	*-12.87%*	*-14.81%*	*-9.00%*	*-9.00%*	*-9.00%*	*-9.00%*		
BV/Share	41.83	43.32	45.56	49.64	56.47	62.51	59.69	68	77.61	93.61	107.89	116.5	119.6	144	166	185.7	11.53%	11.47%
Return on Equity	*11.98%*	*13.69%*	*13.59%*	*13.36%*	*13.39%*	*14.13%*	*12.65%*	*11.40%*	*19.97%*	*23.91%*	*15.87%*	*10.12%*	*13.32%*	*13.65%*	*16.70%*	*18.26%*		

Management and Incentives

ARW's management team has developed an M&A engine and an operationally efficient firm in the electronic component distribution and value-add building products. They perform M&A when targets are available at the right price and can expand their product or geographic scope partially financed by debt, pay down debt, and return capital via buybacks when there are not opportunities to invest organically or via M&A.

The base compensation for the management team (top five officers) ranges from $11.6 million per year for the chairman of the board to $2.9 million per year for the Senior Vice President and Chief Information Officer. Over the past year, the top 5 management folks total compensation was about $35 million per year, about 2.5% of net income per year. The CEO currently hold 128,107 shares and options (worth $15.6 million), which is more than 11 times his 2022 salary and bonuses. The CEO's compensation is structured to include a $1.1 million base pay and up to a $10.5 million performance bonus. Short-term management incentive pay is based upon meeting stretch EPS target and strategic goals and is paid in cash. Long-term management incentive paid in RSUs that include a 50% time based and 50% performance-based vesting schedule. The performance-based vesting is based upon relative EPS growth to a peer group and the difference between the return on invested capital and the firm's weighted average cost of capital goal. In addition, performance-based vesting is based upon meeting a net income threshold.

Board members have a significant investment in ARW. The board and management owns 630,128 shares, about 0.6% of shares outstanding ($77 million). Option grants, provided to management and employees, were equal to 0.8% per year of the shares outstanding over the past three years. The CEO is required to hold 5x his salary in common stock, and other C-level management are required to hold 3x their salaries.

Valuation

Arrow Electronics							
				Senstitivity Table			
						Price	**Upside**
Current Adjusted Earnings *	$17.12						
7-year Expected EPS Growth Rate	15%				0.1%	$126.68	-0.6%
Historical EPS Growth Rate	14%				5.0%	$267.99	110.3%
Current AAA Bond Rate	5.2%			**Growth Rate**	7.5%	$340.42	167.1%
Implied Graham Mutiplier **	32.58				10.0%	$412.86	224.0%
Implied Value	$557.72				12.5%	$485.29	280.8%
Current Price	$127.44				15.0%	$557.72	337.6%
* Normalized earnings (2023 norm revenues * norm margin/shares outstanding)							
* (2*Growth Rate + 8.5)							

The key to the valuation of ARW is the expected growth rate. The current valuation implies an earnings/FCF increase of 0.1% in perpetuity using the Graham formula (EPS multiple = (8.5 + 2g)). The historical 5-year earnings per share growth has been 14% per year including acquisitions and the current return on equity of 17%. To estimate ARW's growth rates, I started with estimates of future growth in the electronic components and IT products markets and market share growth was used to estimate an organic revenue growth rate of 6% for ARW. Factoring in operational leverage and planned buy-backs, the estimated EPS growth rate is 15%. Historically, ARW's EPS growth rate was 14% per year driven by fourteen smaller and one larger acquisition over five years. Using a 15% expected growth rate, the resulting current multiple is 33x of earnings, while ARW trades at an earnings multiple of about 7x. If we use a 5% growth rate, which implies a 4% earnings decline with a 9% buyback per year, the implied multiple is 15x. If we apply 15x earnings to ARW's current 2023 earnings of $17.12, then I arrive at a value of $256 per share, which is a reasonable short-term target. If we use a 15% seven-year growth rate, then we arrive at a value of $558 per share. This results in a five-year IRR of 23%.

Growth Framework

Arrow													
				EPS Growth	17.9%								
	2021	2022	2023	2024	2025	2026	2027	2028	2029	$ 127.44	3.76	5-yr fwd PE		7% growth PE
										19.4%	9.43	Earnings/FCF Yield		22.5
Revs	$34,477	$37,124	$33,107	$29,700	$31,500	$33,000	$35,000	$37,000	$38,850					
		8%	-11%	-10%	6%	5%	7%	7%	5%		6% organic growth			
											2% Operation Lev			
NI	$1,137	$1,465	$977	$620	$780	$891	$1,015	$1,130	$1,187		9% Repurchase		Future SP	$762.98
	3.3%	3.9%	3.0%	2.1%	2.5%	2.7%	2.9%	3.1%	3.1%		17% Total EPS growth		IRR	43%
EPS	$16.70	$24.70	$13.52	$12.76	$17.64	$22.14	$27.72	$33.91	$39.13					
		48%	-45%	-6%	38%	26%	25%	22%	15%	History	EPS GR Rate			
Buyback										5	19%			
9% /year	68.1	59.3	53.4	48.6	44.2	40.2	36.6	33.3	30.3	10	14%			

Another way to look at growth and the valuation of companies is to estimate the EPS five years into the future and see how much of today's price incorporates this growth. I am also assuming 70% of net income will be used for buybacks, consistent with historical buyback levels. Using the same revenue described above results in a 2028 EPS of $33.91, or 3.8x the current price. Assuming a steady-state average growth rate from 2027 on of 7%, then this results in a fair value Graham multiple of 22.5x or $762 per share, higher than the five-year-forward valuation above of $558 per share.

Comparables and Benchmarking

Below are the building product distribution firms located in the United States. Most of ARW's competitors are private firms. Comparatively, ARW's debt is on the low end of the range, its inventory turns and margins are better and it has higher return on tangible equity (RoTE). The low debt allows ARW to return much of its generated cash flow to investors via share buy-backs. ARW also has the one of the highest RoTEs with multiples lower than firms that have similar RoTE (WY Microelectronics).

	Price	Book Value	Tang Book Value	2024 Earnings	Inv Turns	EBITA Margin	RoE	RoTE	P/E	P/BV	Net Debt/ EBITDA	EBITDA Int Coverage
Component Distribution												
Arrow Electronics	**127.44**	**107.89**	**67.42**	**11.85**	**5.51**	**4.9%**	**11.0%**	**17.6%**	**10.8**	**1.18**	**2.19**	**5.44**
Avnet	48.53	51.94	43.41	5.75	4.10	4.3%	11.1%	13.2%	8.4	0.93	2.89	4.05
WPG	91.7	48.63	45.36	3.28	6.01	1.5%	6.7%	7.2%	28.0	1.89	9.38	1.77
WT Microelectronics	140.51	78.56	74.8	10.14	6.19	1.4%	12.9%	13.6%	13.9	1.79	1.09	3.75
Macnica	6993	3815	3700	693	4.49	6.4%	18.2%	18.7%	10.1	1.83	N/A	N/A
CECport	18.07	4.86	4.82	0.36	4.18	2.0%	7.4%	7.5%	50.2	3.72	13.50	4.90
Supreme Electronics	178.2	Neg		27.62	N/A	3.0%	N/A		6.5	N/A	0.99	4.90
IT Distribution												
TD Synnex	116.31	93.3	34.7	12.04	6.78	2.8%	12.9%	34.7%	9.7	1.25	1.75	7.41
ScanSource	41.59	37.91	27.83	3.4	4.74	3.6%	9.0%	12.2%	12.2	1.10	3.14	7.15

Risks

The primary risks are:

- slower-than-expected market growth (currently projected to be 5% growth rate) due to slower than expected AI and/or internet of things roll-outs;
- lower-than-expected free cash flow conversion; and
- a lack of new investment opportunities (mergers and acquisitions) coupled with higher stock prices making buybacks less accretive.

Potential Upside/Catalyst

The primary catalysts are:

- faster-than-expected market growth due to quicker roll out of artificial intelligence and internet of things roll-outs; and
- higher than expected free cash flow conversion.

Timeline/Investment Horizon

The short-term target is $256 per share, which is almost 50% above today's stock price. If the continued component growth due to AI and internet of things thesis plays out over the next five years (with a resulting 15% earnings per year growth rate), then a value of $600 (midpoint of the two methods described above) could be realized. This is a 39% IRR over the next five years.

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