OTSI KETA QUARTERLY

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OTSI KETA CAPITAL

Q2 2013

Otsi Keta Quarterly is designed to share insight on both current performance and future potential.

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QUESTIONS...

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MID-YEAR REVIEW

As we move through another interesting year, we think it is important to reflect back on the markets, our holdings, our learnings and our accomplishments since the beginning of the year. This assessment at the Fund allows us to review both good and bad for continued improvement going forward.

The Markets

Coming into this year, we were optimistic about the equity market. This optimism did not directly correlate with the macro stories, but it reflected our view that the 30-year bull run in the fixed income market had a high probability of starting to curtail. This left us with the belief that a slower-than-normal recovery, with lower-than-average interest rates, was going to leave income investors with a need to offset their bond portfolios with a growth component. From time to time, we talk about this barbell approach to compensate for smaller income streams. The small-cap market provides an interesting vehicle for this approach.

The other macro component that has been hanging over the head of the market for the last couple of years is a sentiment that securities should not go any higher due to current valuations. These statements were easier to diffuse at the Fund, as we spend our days reviewing companies in the Midwest. We saw many attractive options at the beginning of the year with inexpensive valuations and continue to find these opportunities at mid-year as well.

Our Holdings

We have rotated some holdings in our portfolio since the beginning of the year as they reached fair value. Some of the holdings were positions we have had for multiple years, and others were holdings that quickly exceeded our expectations. Either way, we were happy to make those sales and look for opportunities elsewhere.

The advantage that is born from exiting a holding is the amount of working knowledge that has been invested in the company. That knowledge is not discarded, but filed away with the belief that the marketplace will yield an opportunity in the future to reinvest in that same company.

Not everything in the portfolio is always rosy, and this year has been no exception to that rule. We take investments that have not met our expectations as learning experiences to be used in the future. We always try to minimize our risk in learning these lessons.

Our Learnings

Our learnings lie in the duration of our holdings. Sometimes you can hold on to a company that exceeds its growth in the marketplace. Guilty as charged. The fundamentals, officers of the company and our evaluation do not always give us the red flag to exit a holding before the market puts a new price on the stock. Not unlike everyone else, it is a topic of conversation regularly (What if we would have…). Rest assured, these lessons have not hampered our returns.

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PUTTING CAPITAL TO WORK PRODUCTIVELY

"You can observe a lot by just watching." – Yogi Berra

Great management teams do two things well: Set strategy and allocate capital productively. When management gets the strategy wrong, it hurts; when management gets the capital allocation wrong, it leaves a scar. Human nature causes capital investments to be sticky. Management teams dread admitting defeat and always fear giving up too soon on ideas and projects. Announcing a new strategy is easy, but redeploying the capital—not so much. Our job at the Fund is to compound our partners' capital, a goal made easier if the firms we are investing in are actively compounding their own capital. Too often management becomes complacent in low-return capital projects; poorly invested capital has a tendency to stay poorly invested.

We spend significant energy evaluating capital allocation and returns on capital for the Fund. A firm's return on capital can often tell us more about intrinsic value than its strategic plans. We always listen to what management is telling us, but focus on following the cash.

Big firms need big projects to move the needle. and big projects too often come with pedestrian expectations for return on capital. The $5.3 billion Keystone XL pipeline, in the news due to years of regulatory delays, would be an example familiar to most of our readers. The pipeline is brilliant strategically—fundamentally changing where and how TransCanada competes in the marketplace. Unfortunately for investors, the completed project is only expected to generate a mid-single-digit ROIC. We don't have a problem with big capital projects, but we do have a problem with big projects that don't generate double-digit returns on capital.

We think small companies have structural advantages in putting capital to work efficiently. For the smaller companies' OKFF targets, the number of projects that can meaningfully impact the business is greater, and we believe less risky. At Otsi Keta, we have our own corollary to the well-known law of large numbers.

Law of Large Numbers

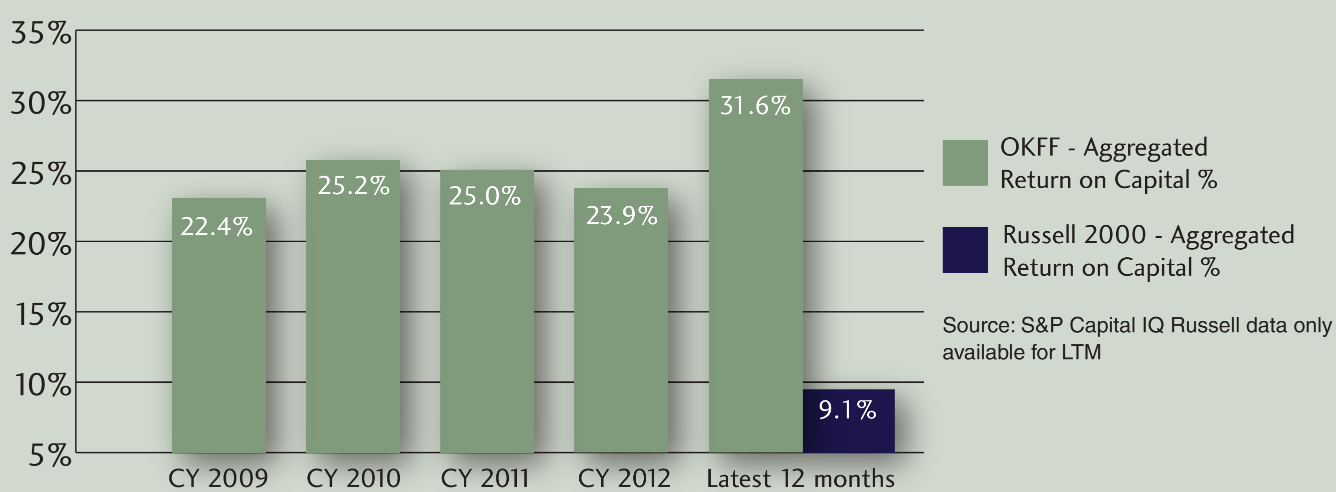
The law of large numbers (LLN) is a theorem that describes the result of performing the same experiment a large number of times. According to the law, the average of the results obtained from a large number of trials should be close to the expected value and will tend to become closer as more trials are performed.

The Otsi Keta Corollary

The bigger any single capital project is relative to the size of the firm's existing capital base, the more likely the project's return will "stink." Stink being a technical term for below average and often less than zero.

As many of you know, we are not fans of bet-the-ranch investing. We like companies that are investing in close-in projects and who have a lot of potential projects to choose from. Below is a review of our current portfolio's aggregated return on capital based on our holdings at the end of Q2 2013.

OKFF Portfolio Companies Return on Capital



Source: S&P Capital IQ Russell data only available for LTM

The Window Indicator

The shipping season is underway for 2013. Though the fleet has not changed in appearance since last fall, there have been some interesting changes to note.

Ships in Service

As of June 14, there are still quite a few vessels laid up in port from last shipping season. Eighteen Canadian-flagged boats are idle—with one boat going to the scrap yard, while the United States has four that have not been put into service yet. Typically by June, barring any individual mechanical or structural issues, the fleet is fully in service.

Cargo

The St. Lawrence Seaway reported that year-to-date total cargo shipments for the period, March 22 to May 31, were down by 8.1 million metric tons, or 12 percent. The burden on these figures points to the shipment of coal and iron ore.

The decrease in coal and iron ore does not come as a big surprise to us. The coal decrease speaks to the shift from coal-fired power plants to natural gas, with the province of Ontario, which borders the Midwest, going coal-free by the end of 2013. It will be the first coal-free jurisdiction in North America with potentially more to follow. This province had 25 percent of its electricity produced from coal just a decade ago.

The iron ore industry started showing glimpses of a slow down in late 2012 with the idling of crushing lines at the Northshore Mining Company facility in Silver Bay, Minnesota. Their only client, Cliffs Natural Resources, is a major player in the steel trade in North America. Northshore has always been closely monitored by Otsi Keta Capital LLC, and was featured at the 2012 Annual Meeting.

The shipment of grains and liquid bulk products (chemicals and petroleum products) has seen large increases from last season. The blossoming grain and liquid bulk product business can be explained by the world needing to eat as it continues to expand, and production costs (cheap natural gas) have allowed the liquid bulk product business to stay very cost efficient. We have a watchful eye via the portfolio on both of these sectors for investment opportunities.

Water Levels

Due to recent dry summers and mild winters, levels in the Great Lakes are at historical lows. The conditions are most extreme in the northern lakes, especially Michigan and Huron, but the fresh water flows toward the Atlantic Ocean, and precious little of it has been reaching Lake Erie, according to the *Milwaukee Journal Sentinel*. With a strain on Lake Erie, major ports like Cleveland, which see both inbound and outbound traffic, have seen a reduction on a variety of hauled tonnage. Boats that typically draft to 29 feet while loaded are seeing their draft limited to 25 feet. This translates to a 20-plus percent decrease in capacity. This type of strain on the shippers could cause a rethinking of water transportation. We will keep you apprised as the season rolls on.

Did you know?

Lake Carriers' Association represents 17 American companies that operate 57 U.S.-flag vessels on the Great Lakes that carry raw materials for the nation's economy: iron ore, flux stone, aggregate, cement, coal, salt, sand and grain. Collectively they can haul more than 115 million tons of cargo per year. These vessels generate more than 103,000 jobs. – Lake Carriers' Association

OKFF Portfolio Aggregation

	(~ OKFF FUND)	(Russell 2000 Index)
Equity Valuation		
Market cap ($mm)	1269.2	1752427.1
P/E	15.2x	82.4x
Price/BV	2.6x	2.2x
P/Tang BV	3.0x	3.8x
Margins		
Gross Margin %	34.2%	28.4%
EBITDA Margin %†	14.3%	11.0%
Earnings from Cont. Ops. Margin %	5.0%	1.6%
Net Income Margin %	5.0%	1.6%
Leverage		
Total Debt/EBITDA†	1.2x	3.6x
Total Debt/Equity	89.1%	112.2%
Total Debt/Capital	47.1%	52.9%
Enterprise Valuation		
TEV ($mm)†	13530.9	1999361.1
TEV/Total Revenut (LTM)†	0.8x	1.3x
TEV/EBITDA (LTM)†	6.2x	12.1x
TEV/EBIT (LTM)†	7.4x	20.8x
Profitability		
Return on Assets %	16.1%	2.3%
Return on Equity %	25.1%	3.1%
Coverage		
Current Ratio	2.0x	1.5x
EBITDA/Interest Exp.†	10.0x	4.6x
(EBITDA-CAPEX)/Interest Expense	10.0x	2.4x

Watch List financials are updated nightly. Only public companies are included in financials.
†Banks are not included in Watch List financial calculation.

OUR PERFORMANCE

Ffor the second quarter ended June 30, 2013, the Otsi Keta Focus Fund was up 2.74%. Year to date the Fund is up 10.11%. Since inception, the Fund has returned 38.81%. All of the Otsi Keta Focus Fund numbers mentioned are net of all fees and expenses. Please see the table below to review the performance of Otsi Keta Focus Fund Limited Partnership.

2013 has continued to be interesting. There have been many factors at work, both domestically and globally, that have influenced the market so far. It continues to prove that you cannot judge the race by who is leading on the first or second lap. We still believe 2013 will end up being a good year for equities, and the Fund will perform very well.

Fund Name	Morningstar Rating	ROR 2nd Quarter 2013	ROR YTD June 30, 2013	ROR From Inception (May 7, 2010)
Otsi Keta Focus Fund Limited Partnership*	**N/A**	**2.74%**	**10.11%**	**38.81%**
Royce Special Equity (RYSEX)	4 star	3.44%	12.40%	46.70%
iShares Russell Microcap Index (IWC)	N/A	5.23%	18.21%	46.94%
Russell 2000 Index	N/A	2.73%	15.09%	45.39%
Russell 2000 Value	N/A	1.93%	13.27%	35.13%

Source: Morningstar, Otsi Keta Capital, Russell Investment (Russell Value data dollar weighted)
*Note: All OKFF performance data is shown net of all fees and expenses.

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Our Accomplishments

Three accomplishments stood out to us as we celebrated our three-year anniversary on May 7. The first was reflected in our last investor's letter and our Annual Review to our partners. We have doubled our assets under management every year since our inception. We continue to strive for this goal as we move forward, and we are pleased that it keeps getting more difficult. The second accomplishment was attaining a +38% return for our partners who have hung in with us since the doors opened. We had a target of 40%, so we give ourselves a B+ on the scorecard.

The third accomplishment that continues to be met, are the partners that we have the pleasure to work with. We could not have accumulated a better group, and we are using this benchmark as a guideline for adding partners in the future. Thank you.

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