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Q3 2014 Quarterly Letter

Anthony Josephson and Russell Silberstein 10/17/14

As recently as three months ago we wrote to you about the lack of investment opportunities due, in part, to the extremely low level of volatility. We went on to write that, "despite geopolitical turmoil and economic uncertainty, the stock market continues to exhibit a steady tranquility in mostly a positive direction. By almost any measure, the length and magnitude of this benign atmosphere is virtually unprecedented in recent history".

It's remarkable how quickly things can change.

The recent volatility, while unnerving in the short-term, should be viewed by patient long-term investors as a potential opportunity, rather than something to fear. Ignoring the hysteria of the masses is incredibly difficult, but our process of focusing on underlying business fundamentals to guide investment decisions will ultimately prove to be the best approach.

For the first time in 18 months we have started to see attractive investment opportunities and, consequently, put some of our large cash balances to work. If the market continues to remain volatile you should expect us to continue to invest additional capital. In the short-term, our performance might suffer (like this past quarter), but over the long-term we are confident our strategy will deliver superior returns. We are not in new territory as we have experienced periods of lagging performance in the past, such as in 2007. However, the five years following this previous period of poor relative returns produced some of our best outperformance compared to the S&P 500 (including 2008/2009).

Energy Exposure

The sub-par results during the quarter were mostly a result of our exposure to oil and gas investments. As of this writing, the price of oil is down approximately 25% from mid-year highs, and most energy related stock prices are in a free-fall. Looking at the table below you can see that the returns for our core energy holdings have detached from underlying commodity prices.

Symbol	Name	YTD Price Change (10/17/14)
CHK	Chesapeake Energy	-25.72%
DNR	Denbury Resources	-24.41%
RIG	Transocean Ltd.	-41.76%

Name	YTD Price Change (10/17/14)
WTI Crude Oil	-11.20%
U.S. Natural Gas	-11.29%
U.S. Dollar Index	5.84%

At mid-year oil traded up to $104, natural gas to $4.90, and the dollar index was down 2%. Since that time, the steep decline in oil has been the result not just of a slowdown in demand but also a much stronger U.S. Dollar. Keep in mind, oil is a global commodity priced in U.S. Dollars, and thus a stronger dollar will negatively impact the price of oil. The chart below highlights the impact of a rising dollar on oil prices (the white line is the U.S. Dollar Index and the orange line is crude oil.)

We are fortunate that no one has ever confused us for macro-economic or commodity forecasters – a skill that very few, if any, possess. Our rationale for owning the three investments listed above is not predicated on higher commodity prices. Instead, each company exhibits their own unique underlying reason for being in the portfolio, and in turn can deliver a successful outcome with commodity prices remaining where they are today.

In fact, over the years, we consistently assumed $85 oil and $4 gas as inputs in our financial models. Based on our analysis we believe that a good case can be made for a long-term floor of $85 oil and $4 natural gas. This is supported by the laws of supply and demand and in today's world the marginal cost of production is +-$85 for oil and $4 for gas. While in the short-term other factors can influence commodity prices, we think long-term prices will converge towards the marginal cost of production.

What follows is a brief summary of our three energy investments, the progress they've made year-to-date and why we expect them to recover from today's prices.

Chesapeake Energy (CHK)

CHK's CEO Doug Lawler continues to make tremendous progress fixing the sins of past management. Over the past 18 months, the company de-levered a risky and over-burdened balance sheet, shed non-core assets, and executed a companywide cost reduction program (both operating expense and capital spending). We expect more of the same to continue for the remainder of 2014 and into 2015. In addition, CHK continues to rebalance its portfolio and improve its mix of production to oil and away from gas. In our opinion, the company owns oil and gas properties (un-developed reserves) on its balance sheet that are not fully reflected in its share price. While questions remain about the actual value of these un-proven reserves we do believe they represent a significant asset. Our expectation is that the passage of time will allow CHK to continue its cost reduction program, advance its transition to a more balanced producer, and monetize its assets. Lastly, CHK has hedged 65% of its 2014 oil production at $94 and 69% of its gas production above $4. For 2015, CHK has hedged 35% of its gas production at $4.09 and 50% of its oil production at $92. All of these items will produce a material amount of value for shareholders going forward and can, in our opinion, be achieved with $85 oil and $4 gas.

No sooner had we written the above, than CHK announced a sizable asset sale on October 16th. The company sold less than 5% of its proved reserves for an amount equal to 33% of its market capitalization. We believe this transaction accomplishes two goals: (1) Highlights the value of CHK's unproven assets, and (2) finally removes any further concerns about the health of the company's balance sheet.

Denbury Resources (DNR)

Over the past three years DNR has made steady progress in disposing of acquired assets considered non-core to it operations. These assets were the result of a series of acquisitions in recent years with the goal of increasing the company's EOR acreage (Enhanced Oil Recovery is a technique whereby CO2 gas is pumped into old wells to stimulate additional oil production). In an effort to acquire valuable EOR assets, DNR was forced to acquire a larger portfolio of assets which included reserves not eligible for EOR – truly a case of having to "take the good with the bad". The constant noise from asset dispositions, plus several operating missteps, coupled with the accounting nuances of when DNR is allowed to recognize developed EOR assets, resulted in DNR's stock declining 25% since our purchase four years ago.

There's patient and then there is **patient**.

Along the way senior management recognized DNR's inherent value and prudently repurchased stock during this time. In addition, over the past three years, the company expended a large amount of capital that is only now running at full capacity. DNR currently pays a $0.25 dividend that will increase to $0.50 - $0.60 next year (management is using $85 oil in its planning assumption for the 2015 dividend). Lastly, for the remaining portion of 2014 DNR hedged 75% of its oil production at $92.52, and for 2015 hedged 75% of its production at $81. We expect a prodigious amount of free cash flow to materialize in the coming years. As with CHK, our investment success is not dependent on higher oil prices.

Transocean (RIG)

The offshore drilling industry is currently experiencing the negative implications from a classic case of supply and demand. Over the past three years the trifecta of elevated oil prices, increased demand for deepwater drilling, and cheap capital enticed rig owners to bring to market a historic amount of new rigs. Inevitably, this new supply overwhelmed demand and weakened pricing (we shared our views on RIG in depth at our investor meeting this past Spring). There is little doubt that recent weakness in RIG's stock price is due to fears that the company may cut its dividend payment (currently at 10%). While this is a possibility, we think it is unlikely given the profitability of the company and the different sources of capital at its disposal.

More importantly, the long-term outlook for RIG remains robust. Based on a declining industry order book for new rigs and steady long-term demand for deepwater drilling we believe that the current “supply glut” will eventually work its way through the industry in 2014 and 2015. In the meantime, RIG can rely on its $30 billion backlog of long-term contracts plus an ongoing cost-cutting initiative in order to maintain its profitability.

New Position - Wesco Aircraft (WAIR)

During the quarter we initiated a new position in WAIR. The work started on WAIR during the summer of 2013, at which point we concluded the company cleared many of our qualitative hurdles; however, we deemed the valuation too expensive and decided to pass. More recently, investor concerns regarding the short-term build rate at Boeing and Airbus weakened WAIR’s stock price which allowed us to initiate a position.

WAIR is the largest distributor of Class C aircraft parts (fasteners) in the aerospace industry, and with its recent Haas acquisition is now a dominant player in the distribution of chemicals, paints and solvents used in the aerospace industry.

The company was originally founded in the 1950s by the Snyder family and through strong organic growth and strategic acquisitions today distributes 525,000 SKUs to 1,200 different customers. WAIR’s customers are a collection of blue chip manufacturers in the commercial and defense aerospace industry including Boeing, Airbus, Gulfstream, and Lockheed Martin. WAIR operates a classic distributor model utilizing scale (through better buying power), and superior parts availability through the use of an excellent IT platform, to benefit customers in the form of lower pricing. Size, reliability and availability are the key elements that WAIR relies on to build long-term profits and shareholder value.

WAIR’s secret sauce is its IT platform. Built over many years, the platform is a mix of off-the-shelf software plus proprietary enhancements that provides a full look up and down the supply chain. This level of transparency results in superior business intelligence and allows WAIR to earn extremely strong operating margins for a distributor – over 20%.

In 2012 WAIR entered the aerospace MRO segment (**M**aintenance, **R**epair, **O**perations), providing parts directly to airlines for use in the maintenance and repair of airplanes. Management believes it can use existing infrastructure and supply chain knowledge to gain traction in the MRO space. We expect WAIR’s MRO revenues to make a material contribution to the topline over the next 3 – 5 years.

More recently, WAIR acquired Haas and gained entry to the Chemical Supply Chain Management segment of the aerospace industry. Haas offers a strong value proposition by lowering scrap rates for its customers and assisting with the large and complex amount of State and local laws governing procurement and disposal of chemicals. Haas's platform allows its customers to reduce scrap rates from an industry standard 15% all the way down to 1% - 2%, a material cost savings to customers.

We view WAIR as an excellent franchise, run by a highly capable management team with an outstanding menu of growth vehicles. We look forward to seeing the Snyder family's strong legacy maintained.

Carmel Capital Additions

We are pleased to announce that James Eberlein has joined the firm as an Analyst. James originally hails from Boston but more recently relocated from Chicago – where he completed his undergraduate degree in Economics at Northwestern University. James initially joined Carmel Capital as a summer intern where he impressed us with his analytical and research skills; so much so that we asked him to be a permanent part of the team. We are eager to see him contribute in the years ahead.

Anthony Josephson
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