CARMEL CAPITAL PARTNERS

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Q2 2017 Quarterly Letter

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During the first half of the year we generated modestly positive performance across each of our investment strategies. We will discuss results for each strategy in detail later in this letter, but we are generally satisfied with performance this year despite underperforming the S&P 500 return of 9.3%.

In an environment where asset valuations are abnormally high and interest rates are abnormally low we believe it's prudent to be disciplined and cautious. For example, this means refusing to participate in certain real estate transactions at ultra-low cap rates or avoiding many of the speculative investments fueling the stock market like the FANG stocks (incidentally, the four FANG stocks are responsible for roughly 1/3rd of the S&P 500 gains in 2017). It also means maintaining relatively short-duration fixed income portfolios without taking excessive credit risk.

The result is a portfolio of reasonably undervalued investments that will likely generate good, but not spectacular, returns. What we forego on the upside we recoup in the form of reduced risk and excess cash to take advantage of the next market dislocation. In the meantime, we continue to rely on inherent advantages of our structure and investment philosophy to find attractive investments in a difficult landscape.

Direct Investing

One of these advantages is our willingness and ability to invest directly in underlying investments rather than through a fund or some other intermediary. Whether it be publicly traded securities, fixed income investments, real estate properties, or private businesses, we are afforded major advantages by direct investing, some of which are listed below:

- **No Fund Life**: Most investment funds are structured with a pre-determined lifespan, typically lasting 10 years. At the end of this period all capital called from investors plus any gains must be returned. This creates a "use it or lose it" incentive for the manager to deploy as much capital as possible in order to start collecting fees, irrespective of the investment merits. We recognize this inherent conflict of interest and have purposefully avoided limited-life fund structures for private investments. Most importantly, we are comfortable holding investments if the fundamentals warrant, and any decision to sell is based on future expected returns and not some pre-selected time horizon stipulated by fund structure.
- **Cherry Pick Best Ideas**: Most investment funds are also dedicated to one particular asset class and occasionally to one specific sector (i.e. Private Equity Energy Fund). This type of structure often causes a manager to "pick the best apple from a bad bunch" when faced with no attractive alternatives. We are organized much differently with a wide-open mandate to evaluate potential investments. We can choose to ignore entire asset classes or sectors if investments do not meet our criteria. Our mandate

is simply to allocate capital where we see the best opportunities, and in this respect, we are completely aligned with your interests

- **Tax Efficiency**: One of the most significant – and least appreciated – advantages of direct investing is superior tax efficiency. A typical fund that pools investor capital will be forced to liquidate its holdings at the end of the fund's lifespan resulting in significant capital gains. Furthermore, a fund manager is unable to "look through" to the individual limited partners to understand their unique tax circumstances. By directly investing in individual investments we have a wide variety of options available to us to reduce taxes, including: 1031 exchanges on real estate, harvesting capital losses to offset gains, and, most importantly, eliminating the trigger of capital gains through long-term ownership rather than flipping investments to meet an artificial deadline.
- **Transparency:** Direct investing also provides an added level of transparency which is hard to replicate in a fund structure. You will know exactly what you own, your cost basis and any gain or loss for each individual investment. We believe this is helpful to understanding the underlying factors that contribute to the overall success of your portfolio.

Equity Update

Our equity portfolio returned 3.0% during the first half of the year. Excluding cash, the performance of the underlying investments increased 3.9%. We generated strong returns in most of our core long-term positions, although this was partially offset by weak results in our remaining energy investments. Keep in mind that these energy investments are relatively insignificant weightings so the overall impact to the portfolio was minimal. Below is a chart of the top five and bottom five performers through June 30th:

Top 5	
Name	**YTD Total Return**
Apollo Global Management	42.0%
Richemont	25.5%
Laboratory Corp	20.1%
Brookfield Asset Management	19.7%
Calpine	18.4%

Bottom 5	
Name	**YTD Total Return**
Denbury Resources	-58.4%
Transocean	-44.2%
Chesapeake Energy	-29.2%
Wesco Aircraft	-27.4%
SeaWorld Entertainment	-14.0%

We sold one position during the first half of the year, New Senior Investment Group (SNR), as the stock price approached our appraisal of fair value. As we mentioned in last quarter's letter, this investment produced a 33% return in a little over a year.

During the first half of the year we added two new positions to the portfolio: Seritage Growth Properties (SRG) and Extended Stay America (STAY). We discussed Seritage at length in last quarter's letter and we continue to be impressed with the company's ability to recapture and re-lease its valuable properties at much higher rates.

Our investment in STAY is a second turn at the wheel after successfully owning the stock prior to the financial crisis. The company, with 629 hotel properties, dominates the lower end segment of the lodging industry (average daily room rate of $66) with a 25% market share. STAY has a major advantage in its size and geographically diverse footprint. In addition, the company is embarking on a new initiative, dubbed "ESA 2.0", to become a more asset-light operator by selling 150 hotels to franchisees over the next five years (similar to what larger chains like Marriot have done very successfully). This should ultimately lead to higher returns and improving profitability for what is already a dominant franchise.

Fixed Income Update

Our taxable fixed income investments, which consists almost entirely of corporate bonds, returned 3.4% during the first half of the year. Interest rates were mostly unchanged since the start of the year, so the gains are attributed to a combination of current income as well as improvements in credit fundamentals. We added two new bond positions in Hertz and Windstream, both of which yield more than 7% and mature in less than five years. At quarter end the current portfolio of 17 positions has an average Yield-to-Maturity (YTM) of 5.1% with an average duration of 3.4 years.

The returns for our tax-free municipal bond investments also performed well during the quarter with a gain of 2.8%. The current portfolio has an average yield (YTM) of 4.4% with an average duration of approximately ten years.

Challenges continue to persist in the fixed income market with a lack of available inventory to purchase. With interests rate low and credit spreads narrow there is little in the way of true bargains to buy. However, if and when these do appear, we are advantaged over other market participants with our opportunistic investment philosophy and relatively small size.

Real Estate Update

We closed on two transactions during the first half of the year, as well as, another transaction subsequent to quarter end. While these three properties are distinct in nature, they do share some similarities: on each deal we partnered with an outside manager we trust and have fully vetted, these properties are uniquely situated to benefit from long-term fundamental trends, there is a value-add component to each project, and the properties are financed with a reasonable amount of debt. Depending on the property, we anticipate net returns to approximate 12-18% annually over the life of the investment.

If you are currently invested in one of these transactions you will find a more detailed description in the "Real Estate Update" letter included in this mailing.

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Private Equity Update

We are currently fund raising for a new private investment to acquire 65 Little Caesars restaurants. As part of this transaction, we are partnering with an existing franchisee to form a 50/50 joint venture to acquire and operate the restaurants. The total transaction value is approximately $39 million and we expect to finance it with $28 million in debt and $11 million in equity. Our goal over time is to improve store operations and grow the store base through additional acquisitions. We expect to close this transaction by the end of the third quarter. If you have not received information on this transaction and would like to participate please let us know.

It's important to remember that our direct investing structure we mentioned at the outset of this letter gives us an opportunity to review a large number of potential real estate and private equity deals. From this group, we can compare the risk and return profile of each investment against a wide range of other investments available to us, including publicly traded securities and fixed income investments. We will only allocate capital once we are comfortable that an investment meets are strict criteria *and* offers a better opportunity than all other investments available to us. It is undoubtedly a significant hurdle, but one that creates the best process to achieving superior returns with limited risk.

As always, we thank you for your continued support and trust and welcome any questions or comments.

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