CARMEL CAPITAL PARTNERS

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Q3 2017 Quarterly Letter

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The third quarter was quite active for us. We added two new equity positions, eliminated two existing positions, closed one real estate investment with another one scheduled to close in early November. We also added one new corporate fixed income position.

While our equity performance continues to lag the broader market, we are very pleased with both our strong corporate and municipal fixed income performance, and very pleased with our real estate performance thus far in 2017.

We are not a firm that compiles or relies on long-term macroeconomic or market forecasts. Each equity, fixed income, real estate and private equity investment is made one decision at a time. We evaluate each investment on its own merits and make sure we proceed with a margin of safety to account for the unexpected. However, there are occasions when we believe the investing landscape requires us to pause and pay more attention to what's happening outside our sandbox.

<u>In somewhat of an unorthodox fashion we'll start with the conclusion - we believe it's likely that broader stock market returns going forward will be materially lower over the next 7 years vs. the prior 7 years. Having said that, we also recognize markets can become even more overvalued, or possibly remain at these valuation levels for another one, three or five years.</u>

<u>We're not trying to communicate that a market decline is imminent, but we do believe that given the extreme valuation levels, future equity returns over the next seven years will likely be substantially lower than the past 7 years, and thus a shift in thinking is prudent.</u>

By many statistical measures today's equity market appears to be over-valued. Possible reasons are historically low interest rates, the tidal wave of passive investing that's come ashore over the past five years, or the U.S. markets being the best house in a bad neighborhood. Whatever the reasons for how we got here we believe the general markets (as defined by the S&P500) are overvalued. There is a school of thought that says abnormally low interest rates justify current market valuations, we're not so sure. If one shares this view then an investment in the broader equity market is an implicit "bet" on interest rates staying low or going down. Personally, given how polluted and manipulated (read central bank intervention) interest rates are today, we have no confidence in our ability to accurately forecast interest rates. The level of government intervention impacting interest rates has created a tremendous amount of uncertainty about what comes next. While it's quite possible interest rates could remain at current levels, or go lower, we are not investing with this framework in mind.

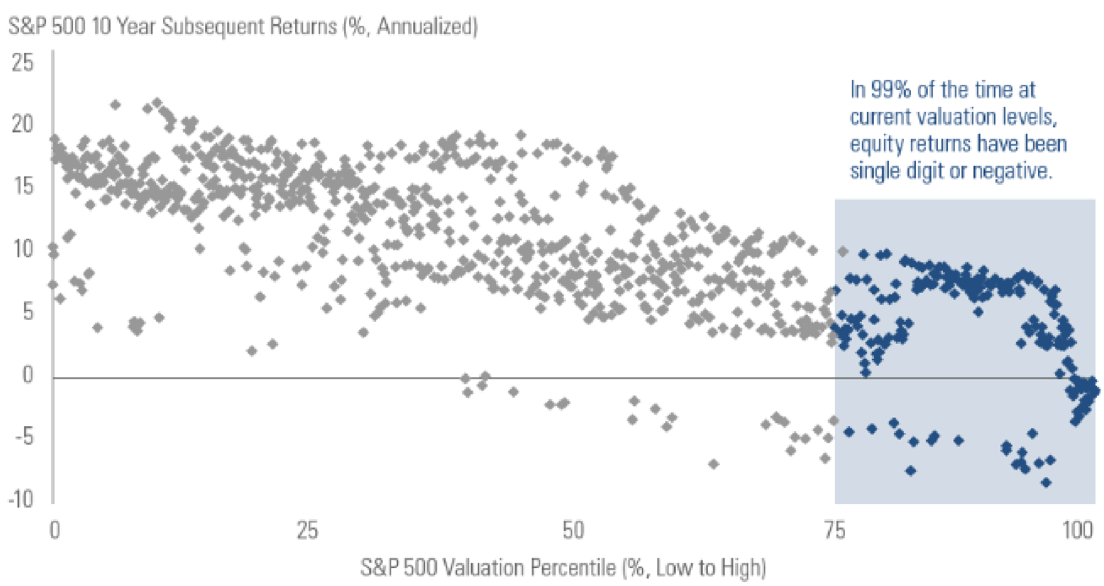
Our view regarding valuation is driven by one overriding belief – the entry multiple (the valuation that exists at time of purchase) is one of the largest determining factors of future returns. This means, the higher the multiple you pay the more growth, or even higher exit multiple is required to still earn an attractive return.

The next series of charts will highlight the connection between elevated market multiples and future equity market returns.

Relationship Between Valuations and Future Returns

In the chart below, the x-axis shows the percentile valuation of the S&P 500, the further to the right on the axis you go, the higher the market valuation. The y-axis shows subsequent 10-year returns. Thus, if we start at the extreme left of the chart one can conclude that when the S&P 500 valuation is low, we can expect strong future returns. When we visit the far right of the chart, where valuations are higher, we can expect lower future returns.

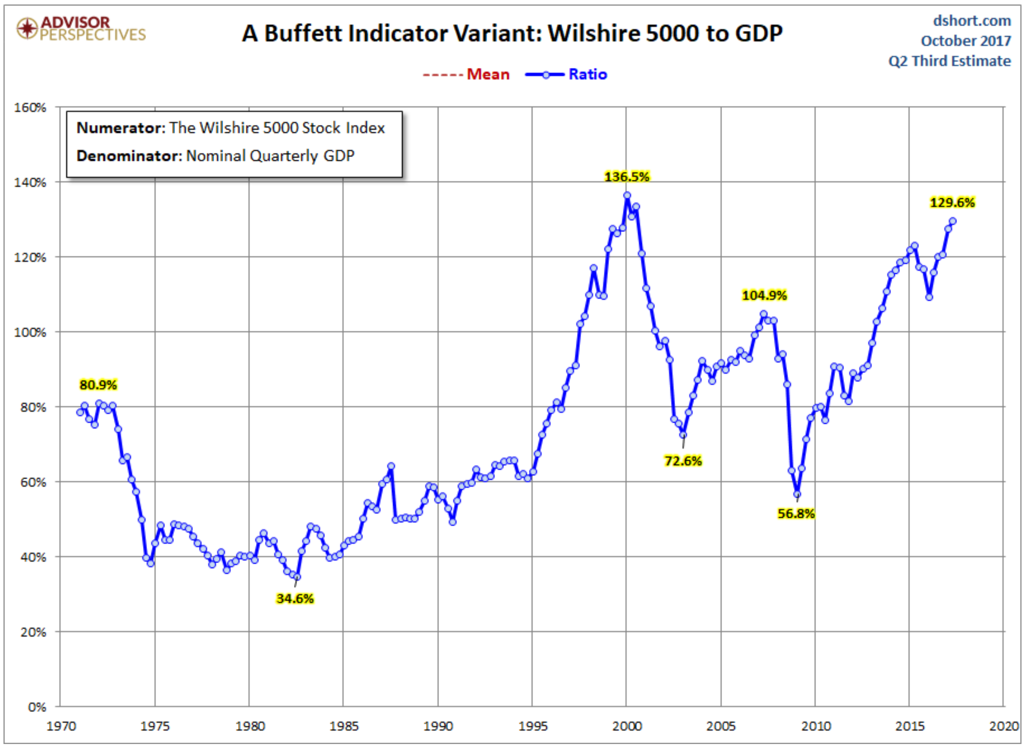
Today we are close to the 100th percentile for valuation, meaning relative to historical measures we are very overvalued, and so we can expect future returns to be poor.



Source: Bloomberg, Robert Shiller, and GSAM.

Market Valuations

This chart, also known as the Buffett Indicator (Warren Buffet mentioned his use of this ratio as a guide to market valuation) shows the Wilshire 500 Index relative to US GDP. The higher the ratio, the greater equity market values are in relationship to GDP. Assuming one believes a relationship exists between US GDP and equity markets, then this ratio indicates an extreme reading, exceeding that reached in 2008, and approaching a level reached in 2000.



We believe that in order for future broad market equity returns to match recent returns the following will have to occur:

1) Interest rates remain at or below current levels.
2) A material acceleration in corporate profits occurs.

We believe neither of these are highly likely to occur.

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What does this mean for us?

Thankfully we do not invest in the S&P500 index or any other broad market index. As we have always done we strive to own a select portfolio of 20 – 25 stocks which we believe to be high quality, undervalued, purchased with a margin of safety, and run by rational, capable and trust worthy people. We continue to believe our existing equity portfolio is well positioned to deliver attractive future returns.

Further, our ability to invest beyond public equities in real estate and private equity provides us with an expanded universe of opportunities where we can uncover attractive opportunities at more reasonable valuations.

Equity Update

Our equity portfolios on average returned 1.7% during the quarter. Excluding cash, the performance of the underlying investments increased on average 3.3% for 2017.

During the quarter we sold Wesco and Denbury Resources. Both performed far below our expectations.

We initially purchased Wesco (a distributor of aerospace parts) in 2014 after it closed a sizable acquisition. The inability to digest and integrate the acquisition, elevated management turnover, and shifting industry dynamics all created a perfect storm. We sold the investment believing our capital could better be deployed elsewhere.

Denbury was purchased in 2010. The company has a differentiated process for recovering oil from partially depleted wells. The decline in energy prices and it's uncertain future, coupled with management missteps resulted in sub-par operating results. Similar to Wesco, we believe our capital can be better deployed elsewhere.

Despite elevated market valuations we did manage to add two new equity positions.

Under Armor (UA)

In order to buy high-quality businesses at reasonable prices it usually requires allocating capital at the exact point in time when pessimism is at its peak. A great company does not trade at a bargain price unless there is an elevated perception of uncertainty. Only in retrospect does it become apparent that this thinking is misguided and the price rises as a result. We believe this to be the case with our new investment in Under Armour (UA).

We have followed UA for many years and admired the company's ability to create a dominant global athletic brand in less than 20 years. Unfortunately, the stock consistently traded at valuation multiples which reflected its hyper growth and left no margin of safety for value investors like ourselves. However, this changed over the past two years as the share price declined from a high of $54 to $17 following a plethora of concerns: slowing growth in performance apparel popularity, exposure to a challenging US retail environment, disruption caused by ecommerce growth, and several self-inflicted stumbles.

Despite these challenges, the company retains a core competitive advantage with a distinct brand that still resonates strongly with young consumers. Moreover, two large revenue growth opportunities exist in its footwear line and international expansion. The company is run by founder Kevin Plank (16% shareholder) with an owner-oriented mentality that focuses on building long-term shareholder value. If the company can double revenue over the next 5-7 years ($5bn to $10bn) and achieve a 13% operating margin, this will translate into $2/share of sustainable earnings power and a valuation in the $40+ range.

Essilor (ESLOY)

In the absence of extreme pessimism, another alternative for finding attractive businesses that are undervalued occurs in the midst of transformative acquisitions. This is especially true if the businesses are large and complex and the disclosures are somewhat limited. In our opinion, this dynamic is at play with our most recent purchase of Essilor (ESLOY) and its pending merger with Luxottica (LUX).

The combination of these two businesses will create the only dominant, vertically integrated, player in the growing global eyecare industry. Both of these companies, on a standalone basis, already possess enviable qualities: exposure to a structurally growing end market, leading market shares, large barriers-to-entry, scale and distribution advantages, irreplaceable brand equity, and long-term owner-oriented management teams.

Once combined, we believe the new company will gain an insurmountable advantage through the production of both optical lenses and frames. Not only will this create large cost synergies, but it will also fuel revenue growth by taking advantage of shared distribution and deep relationships with eye care professionals. The new EssiLux will be the only company on the planet with this capability.

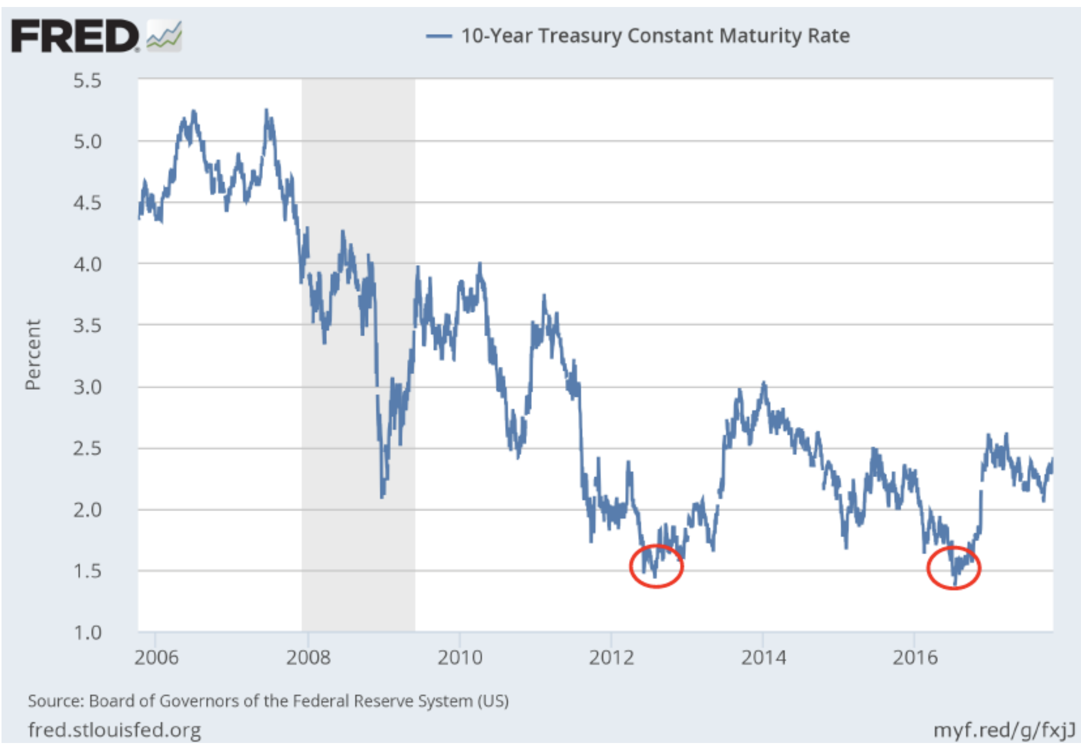
Because of its size and dominant position, the company has purposefully downplayed the merger benefits in order to appease regulators. Moreover, the company has only provided very limited disclosures to investors pending the close of the deal. As a result, we believe most investors are not accurately pricing in the potential run-rate profitability of the new company over the next few years. This situation is creating a rare opportunity to own a very high-quality business at a discounted price.

Fixed Income Update

Our taxable fixed income investments, which consists almost entirely of corporate bonds, on average returned 0.8% during the quarter, and 5.5% for 2017. Interest rates are essentially unchanged since the start of the year, thus gains so far have been mostly driven by combination of current income and improvements in credit fundamentals. We added one new bond position, Rite Aid which was purchased with a yield-to-maturity of 7.5%. At quarter end the current portfolio of 18 positions has an average Yield-to-Maturity (YTM) of 6.6% with an average duration of 5.5 years.

The returns for our tax-free municipal bond investments have performed well thus far in 2017 returning on average 4.5%, and also performed well during the quarter with a gain of 1.7%. The current portfolio has an average yield (YTM) of 5.0% with an average duration of approximately ten years.

The 10-year US Treasury reached low points in August of 2012 and July 2016 and have struggled to move beyond 3% since then. Persistently low interest rates have created a difficult environment for fixed income investors, despite this we have continued to uncover attractive corporate and municipal fixed income investments.



Real Estate

The three investments we've closed thus far in 2017 continue to perform as expected and are delivering strong results. We continue to expect returns from these investments to be in the range of 12% - 18%.

We have one additional real estate investment scheduled to close in early November.

A more detailed description can be found in the "Real Estate Update" letter included in this mailing.

Private Equity

The Little Caesars investment discussed in the Q2 letter is scheduled to close in early November. We continue to be very enthusiastic about this opportunity and look forward to closing the transaction and executing our multi-year business plan.

We are actively engaged with additional franchisees to make further acquisitions and are encouraged by our growing pipeline of additional stores to add to our existing base.

With broader market valuations at multi-decade highs, and interest rates at multi-decade lows we continue to tread carefully through the investment landscape. We remain prudent and disciplined, always with our primary mandate in mind – capital preservation first.

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

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