CARMEL | CAPITAL PARTNERS

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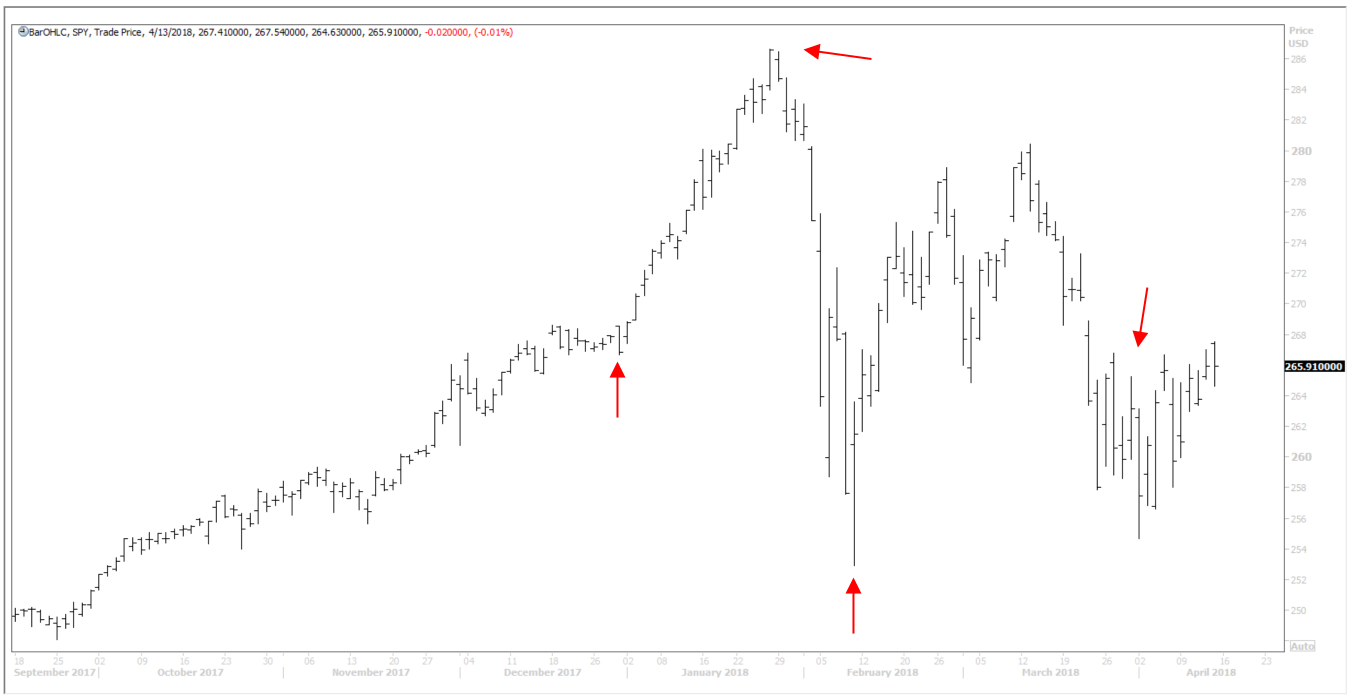
Q1 2018 Commentary

General Commentary

If you decided to sleep in really late after a New Year's Eve party, and woke on March 31st, upon first glance it would appear the U.S. equity market had a fairly quiet first quarter with a benign return of -1%. Clearly this was not the case.

The SP-500 started the year with a strong 7% rally, quickly plunged 12% from its high, and managed to finish the quarter at a slight loss.



Source: Reuter Eikon

This was a volatile start to the year and we expect a similar level of volatility in the coming quarters. As a reminder we do not equate volatility with risk. We believe risk should be defined as a permanent loss of capital, an outcome we work hard to avoid. We welcome volatility as an opportunity to add new positions to the portfolio, or in some cases add to existing positions. During Q1 we used the volatility to both add new positions and reduce exposure to existing positions. See commentary below in the Equity section of this letter.

Our past two quarterly letters contained a more cautious tone. In Q3 2017 we talked about our expectations for broad market equity returns over the next 7 years to be materially lower vs. the past 7 years. In Q4 2017 we further raised the caution flag due to reversing global stimulus by Federal Reserve banks.

The remainder of this General Commentary discusses the level of government debt and increasing short-term interest rates. While we are a firm that focuses on individual investments, and do not rely on macro-economic forecast for decision making, I did want to address the topic of government debt (and interest rates) because of its wide ranging impact on so many parts of the economy. Debt is the lubricant that keeps the U.S. economy moving and any rapid change or spasm in this market has the potential to create serious problems. We need to look no further then 2008/2009 to appreciate this point.

We are keeping a watchful eye on these markets and ensuring all the investments we own are fundamentally sound and able to endure in the event future dislocations occur.

Onto the topic at hand - today the U.S. government debt stands at $22 trillion, with the U.S. Treasury estimating its borrowing needs at $955 billion in FY 2018 (vs $519 billion in 2017), followed by an additional $1.083 trillion in FY 2019, and a further $1.128 trillion in FY 2020.

We're also mindful that a 1% increase in interest rates requires $220 billion a year of additional interest expense. Current market forecast is for another 1.5% increase in short-term rates from this point forward.

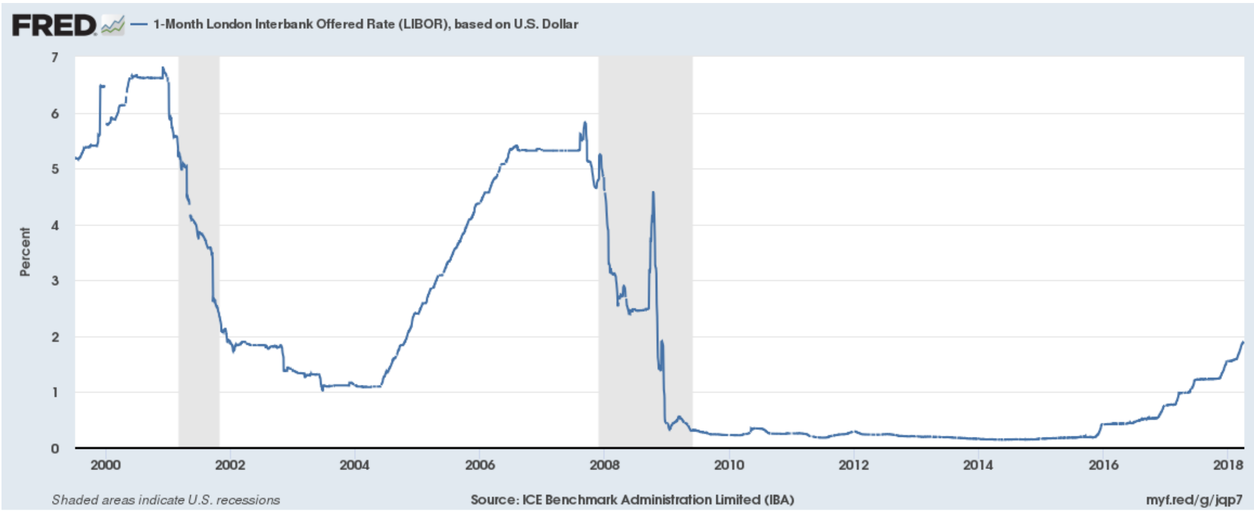
Do the math….it is not pretty. The U.S. is on an unsustainable path and could potentially be maxing out its credit card.

There are multiple points of view on this topic ranging from high alarm (head to the woods and hunker with guns and canned goods) all the way to outright dismissal (don't worry we'll grow our way out of this). Given the extreme level of debt and unchartered territory we're venturing into, one can understand why there is such a wide ranging debate.

The debt topic is relevant because one critical component of the government's financing needs is its reliance on the kindness of strangers. This means the US requires foreign investors to buy its debt. Lately, less buyers are lining up. Foreign holdings of U.S. federal debt are unchanged since 2013 at around $6 trillion. So who's been buying all the debt issued to finance our deficits, wait for it, yes you guessed, the U.S. Federal Reserve Bank. Unfortunately, as we've previously discussed the Fed is now unwinding its buying program and will no longer be supporting the Government's debt habit.

The one way you entice people to buy your debt is to increase the interest rate being offered. The government is not immune to this equation. Between the Fed's mandated increase in interest rates, and the Treasury's growing borrowing needs, we've already started to see early signs of increasing rates. Both short-term treasury rates and LIBOR (the rate most banks use for lending) have started to increase in recent quarters. We've also started to see similar increases with longer term interest rates.

One Month LIBOR



10 Year Treasury

It's possible the increase in short-term interest rates could have a material impact on the economy. Today over $100 trillion of financial instruments are tied to LIBOR. The result being that as LIBOR increases, so do interest payments. There are $3.2 trillion of residential mortgages / mortgage backed securities, +-$1.5 trillion of commercial mortgages, and $1.2 trillion of business loans, all tied to LIBOR. The same 1.5% increase in short-term rates that will result in higher interest expense for the government, would result in $120B of increased interest payments for business and consumers.

We're unsure where this all leads but do believe it's an area of the markets to pay attention to. We can address these risks by staying diversified through our various asset classes (equity, fixed income, real estate, private equity), maintaining a rigorous research process, and prudently allocating capital with a high margin of safety.

Equity Update

Our equities on average returned -1.8% during the quarter, versus a -1% return for the broader market. We had a busy quarter in that we added seven new investments, sold three, and reduced our exposure to four. A busy quarter for us by any measure.

As outlined in the Q4 2017 letter "*The proceeds from the sales will be redeployed into new investments we have on deck. Our expectation is we'll add two to three new investments in Q1. When the dust settles we expect the dollar amount allocated to equities will not change materially, however, there will be a handful of new investments in the portfolio.*"

The market volatility in Q1 allowed us to add new investments to the portfolio beyond what we anticipated. As a firm we have always embraced volatility and used it to our advantage, hence the large number of new holdings in the portfolio.

What follows is a brief description of the new additions to the portfolio.

Axalta / Market Cap: $8.0 billion.

Axalta delivers a wide range of coating solutions to the auto/truck/bus markets, as well solutions in the general industrial and electrical market. In 2012 the Carlyle Group (a private equity firm) acquired the Performance Coatings business of DuPont Chemicals and renamed it Axalta. Soon thereafter in 2014 the company went public.

With its new-found independence from DuPont the management team focused on cost cutting, growth and capital allocation. Axalta is poised to grow.

The company's crown jewel is it Refinish segment that provides paint to hundreds of thousands of auto repair body shops globally. This a stable and predictable business that delivers consistent cash flows in just about all economic environments. Repair shop business is almost exclusively driven by collision repair with many repair jobs paid for by auto insurance companies. Axalta has a long runway of growth ahead - opportunities include further penetration into the global repair shop business and acquiring other coating providers in adjacent industries.

In addition, AXTA provides coatings to new vehicle manufactures like Ford, GM, BMW, etc. Here the company has the opportunity to grow by expanding its products into the truck, bus, and commercial vehicle segment.

We're attracted to the stable recurring nature of the AXTA's business and its ability to invest its prolific cash back into the grow opportunities discussed above.

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Cable One (CABO) / Market Cap: $4.0 billion

CABO provides video, voice, and data services to both residential, Small Medium Size Business (SMB) and large enterprise customers in mostly rural areas of the U.S.

The company was originally a subsidiary of the Washington Post and was spun out as a separate public company in 2015.

We consider the management team and the Board to be extremely high quality. All members have demonstrated a strong track record of growing shareholder value by prudently allocating shareholder capital and growing shareholder value.

In 2011 CABO became disenchanted with the long-term prospects for the traditional voice/video/data residential cable business. As a result the company decided to redirect its capital and focus on residential high speed data (HSD) and Business Services. The profit margins available in these business lines are 4 times that of traditional cable video.

We believe CABO can grow its cash flows in two main areas, (1) acquiring additional rural cable systems and shifting their focus more towards HSD, (2) further penetrate SMB and Enterprise customers in its existing footprint.

We expect to see CABO use its large amount of annual cash flow to grow shareholder value through the growth opportunities outlined above.

Colony NorthStar (CLNS)

CLNS was formed in January 2017 through a tri-merger of three entities: Colony Capital, NorthStar Asset Management (NSAM), and NorthStar Realty Finance (NRF), with Colony Capital's management taking over reins at the new entity. Prior to the merger CLNS had a complex entity structure, and the merger was going to further add to this problem. However, our initial thesis was driven by management's plan to simplify its capital structure (post-merger) by shedding 'non-core' assets and greatly simplifying the business. This is a similar plan successfully executed by another one of our holdings, Brookfield Asset Management.

Simplifying the business model would allow investors to see the true underlying strength of CLNS's assets and thus reward the company with a higher valuation.

Unfortunately, we woke on March 1st to the surprise news that CLNS had reduced its dividend by 60%, from $1.08 to $0.44. In our subsequent calls with management three points became clear, one of the entities CLNS acquired had overstated its ability to raise new capital, a portion of the assets acquired had been incorrectly valued at the time of the merger, and management had simply bitten of far more than they could chew. The result being, in the near-term, two thirds of the business will not produce the cash flows previously expected, and thus the dividend reset was necessary.

So why do we continue to own the stock? At the current price of $6 the stock price is trading below our worst-case net-asset-value of $7. The dividend reset to $0.44/share is a conservative baseline that we believe offers an attractive runway to grow in the high single digits over the medium-term. We believe that management's recent blunders should not overshadow what is otherwise a solid long-term track record - deployed $11bn of capital at a weighted average IRR of 19% since 2009. Thus, if management can properly execute on its original plan of simplifying the business model, successfully raise external capital, we expect the market to reward the company a higher stock price.

<u>Discovery Holdings (DISCK) / Market Cap: $15.5B</u>

Discovery Holdings is global cable TV content provider that sells programing to cable companies through channels such as The Discovery Channel, TLC, Animal Planet, and OWN.

In July of 2017 the company announced it would acquire Scripps Networks, also a provider of cable programing. Scripps channels include HGTV, DIY Network, The Food Network, and the Travel Channel. The acquisition is expected to deliver $350MM of cost saving opportunities and provide Discovery with a much larger content platform to deliver globally.

Since the acquisition was announced Discovery's stock price has declined due to two concerns:

1) Concerns about "cord cutting", a term used to describe cable subscribers who cancel service and only utilize services like Netflix, Hulu, Amazon, or ITunes. Because Discovery gets paid on a per subscriber basis investors are concerned that a reduction in cable customers will lead to lower revenues for DISCK.
2) The Scripps acquisition is an effective "doubling down" into an eroding market.

We disagree with the markets conclusion for the following reasons:

1) Discovery has an outstanding management team and Board that has shown skill and creativity in navigating the rapidly changing media landscape. The company's leadership has continued to deliver relevant and interesting content that viewers are attracted to.
2) DISCK provides content across the globe and while cord cutting is a very real phenomenon in the U.S. it's far less of an issue outside the U.S. The primary reason is the relative cost of cable in the US relative to alternative entertainment options. The average video portion of one's cable bill is $110/month vs. Netflix / Hulu at $9.99 per month. Outside the U.S. monthly cable bills are significantly less and thus customers find less reason to substitute. In fact, in many countries customers end up utilizing both cable and Netflix.
3) Scripps has expanded in a material way outside of the U.S. As a consolidated entity, DISCK plans to take Scripps content and offer it to many countries outside the U.S.

4) Discovery has an average of 10 channels in each country it offers service and offers programming in over 50 languages. This diversity and adaptability makes DISCK programming unique and highly sought after in many local markets around the world.

Post-acquisition DISCK will have debt above historical levels. Management has indicated it will use all excess cash flow to reduce leverage to more conservative levels, at which point it will begin returning capital to shareholders.

We're attracted to DISCK's stable and predictable cash flow, and the company's opportunity to grow its cash flow outside the U.S.

<u>Liberty Latin America (LILAK) / Market Cap: $3.2B</u>

LILAK provides voice, video, telephone and wireless phone service to residential and business customers in Latin America. Today the company serve customers in markets like Puerto Rico, Chile, Jamaica, Panama and the Bahamas.

The company was initially incubated and then spun out of Liberty Global, one of Europe's largest cable/voice/data providers. Liberty Global was systematically built (through acquisition and organic growth) over a fifteen-year period by John Malone, Balan Nair, and Mike Fries. Today Liberty Global generates $15 billion in revenue, operates in 12 European countries, and passes 45 million homes.

I can't overstate enough the high-quality nature of LILAK's management team and Board. Senior leadership has an outstanding track record of creating shareholder growth. All the above named individuals sit on LILAK's Board with Balan Nair functioning as CEO of Liberty Latin America.

We expect Liberty Latin America to continue acquiring cable/telephone/data operators in Latin America. Most recently (in February 2018) the company announced the acquisition of the leading cable operator in Costa Rica. While acquisitions represent a large part of the growth plan for LILAK we also expect the company to add organic subscribers by offering superior internet speed/service, broader programing content, and top-quality technology. LILAK's relationship with Liberty Global is extremely beneficial as it allows the companies to share technology – a key differentiator when providing voice/video/wireless service.

<u>Spirit Airlines / Market Cap: $2.47B</u>

SAVE is an ultra-low-cost carrier (ULCC) serving 225 North and South American markets with a fleet of 112 aircraft. A unique and differentiated low cost structure (think Costco) allows SAVE to be the lowest-cost producer in a commoditized market. Legacy (United, Delta, American) and low-cost competitors (Southwest, JetBlue) are unable to achieve similar economics without sacrificing market share. The post-consolidation landscape of the airline industry makes it impossible for a new entrant to implement the ULCC model. Despite more than doubling capacity over the last 5 years, SAVE only has 5% market share in the US, providing ample room for future growth.

In recent quarters SAVE's financial performance has been impacted by an ongoing pricing war with American and United. Both these legacy airliners are losing money on seats dedicated to competing against SAVE and we believe minimal exposure (ULCC competition extends to 5% of United's revenues) and low fuel prices have enabled them to discount with minimal repercussions. However, as SAVE and fellow ULCC Frontier (~3% market share) increase their capacities by 2x and 3x, respectively, over the medium-term, sustaining a full-blown pricing war becomes increasingly more painful for American and United.

We expect SAVE's thoughtful and disciplined approach to market share growth to prevail over time. We own SAVE at a price below the replacement value of the company's aircraft and thus have confidence in our margin of safety with this investment.

<u>Positions Sold / Positions Reduced</u>

During the quarter we sold SeaWorld Entertainment, Calpine and Blackhawk Networks.

Our SeaWorld investment was extremely disappointing, and we sold the investment with a 12% loss. During our holding period the company turned over leadership twice and could not articulate or execute on a consistent strategy. In addition, the level of competition (both from Disney and Universal) increased materially in recent years.

Our investment in Calpine produced a total return of 10.5%, however this was over a 7 ½ year holding period. We always considered the leadership to be high quality, unfortunately when you're in a business that sinks, or swims based on government regulation it can sometimes be a roll of the dice, no matter how good management is. The original thesis that attracted us to the stock played out far slower than we anticipated, ultimately the decision to hold or sell was taken out of our hands. Calpine was acquired by a private equity firm.

We enjoyed excellent returns from our Blackhawk investment with a 16.97% annual return over an almost four year holding period. During our holding period the management team executed well and delivered strong results. Like Calpine our decision to hold or sell was taken out of our hands, Blackhawk was acquired by a private equity firm

During the quarter we reduced our investment in Apollo Global Management, Brookfield Asset Management, American Express, and LabCorp of America. All four of these companies have delivered strong results in recent quarters and their stock price performance reflected this. Our capital preservation and diversification mandate dictated that we reduce our exposure to these companies and redeploy the capital to other opportunities.

Fixed Income Update

In Q1 2018 our taxable fixed income investments delivered a -0.8% return vs. a -1.5% return for the Barclays Aggregate Bond Index.

Interest rates (as measure by the 10 Year Treasury) increased from 2.4% to 2.7% during Q1. As relevant, short-term interest rates increased from 1.3% to 1.6%. Both increases are fairly material given the short-period of time.

We continue to be measured and prudent in adding new corporate bond positions. If interest rates continue to increase, and volatility continues, you should expect us to be more active in adding corporate bonds.

Today, our corporate bond portfolio has a current yield of 5.4% with an average maturity of 4.6 years.

We added two new positions during the quarter. Penske Auto Group, the bonds have a 5.15% yield to maturity in 2024. We also added Sonic Automotive Group, the bonds have a 5.21% yield to maturity in 2023.

Our municipal bond portfolios delivered average returns of +3.1% in Q1 2018. Call activity has slowed. Today we are able to buy municipal bonds with a maturity of 10 – 12 years at yields of 3.3% - 3.5%.

Real Estate Update

We completed one real estate investment in Q1. This was a value add multi-family investment located in San Diego.

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

Private Equity Update

A detailed update can be found in the "Private Equity Update" included with this letter.

Concluding Remarks

The investment landscape has clearly shifted thus far in 2018. The combination of technology stocks coming under fire, a possible trade war with China, a volatile political climate in Washington, and the building geopolitical stresses, it appears the tranquil daily increases we experienced in 2017 are gone.

This climate demands increased vigilance and a focus on quality and durability. We remain diversified in our holdings and are prepared to act if, and when, future opportunities present themselves.

As a firm we are required to provide certain disclosure information to each of our clients on an annual basis. Pursuant to meeting our disclosure requirements, the purpose of this communication is to notify you of any material changes to our Form ADV Part 2A Disclosure Brochure ("Disclosure Brochure") since the last annual update of that Disclosure Brochure and to notify you that a complete copy of our Disclosure Brochure is available upon request. If you would like a current copy of the Disclosure Brochure, you may contact us at info@carmelcap.com, or at telephone number 858-457-7544 ext. 210. Please note that you may obtain information about our firm and our individual investment adviser representatives at the Investment Adviser Public Disclosure (IAPD) website address (http://www.adviserinfo.sec.gov/). The Disclosure Brochure provides information about our firm, including a description of our programs, fees, conflicts of interests, and other business activities. We last provided you with a copy of our Disclosure Brochure January 2017.

Sincerely,

Russell Silberstein