CARMEL CAPITAL PARTNERS

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Q2 2018 Commentary

General Commentary

After a turbulent first quarter the equity markets resumed their orderly weekly increases. Despite the growing threat of a large-scale trade war and increasing geopolitical uncertainty, the US equity markets continue to progress as if all is alright in the world. The large-scale tax reform that occurred in 2017 has now found its way into the economy and is providing a shot in the arm to many US corporations. We're finally able to see the bottom line benefits, and in some cases, it's having a material impact on earnings. Equity markets will feast on these benefits for the balance of the year, however, once exhausted we're unsure what fuels the market higher.

Our last three quarterly letters have struck a more somber tone and thus there is no need to repeat our views again. We continue to invest with a cautious stance but are able to find opportunities to deploy capital into equity, fixed income and real estate.

Equity Update

Our equity portfolios on average returned 7.3% during the quarter. For Q2 2018, excluding cash, the performance of the underlying equity investments increased on average 11.1%.

With reduced equity market volatility in Q2 we found less opportunities to add new positions. Our pipeline of on deck investments remains full and if volatility returns, or we experience a material decline in the markets, we expect to deploy capital into our on-deck opportunities.

We added one new positions during Q2.

Autonation (AN) / Market Cap: 4.31B

AN is the largest owner of franchised car dealerships in the US with 253 stores in major metropolitan markets. The company also operates 76 collision repair centers. We previously owned AN from September of 2002 through February 2011 during which time enjoyed a 2.5X return on our capital.

In early 2018 concerns over the credit cycle, trade wars, and threat of autonomous vehicles caused a sell-off in AN's stock. We believe present earnings are understated as the company is embarking on a multi-year $500m initiative to build-out its standalone used vehicle franchise, expand its parts offerings, and grow its collision repair footprint. These investments are having a temporary impact on AN's income statement and are leading to a short-term impact on earnings and cash flow. As long-term investors, we are attracted to the risk/reward profile of the initiative.

Over time we expect these initiatives to result in increased earnings and cash flow. Further, we believe as AN increase its mix of more "annuity" like revenue (maintenance, repair, and parts) we'll see multiple expansion along with increased earnings. Both used vehicle and parts are higher margin, higher return, and less sensitive to cyclicality. Collision repair is a $38bn industry where single shops make up 67% of the marketplace. Going forward, we expect auto insurers' favoritism towards multi-shop operators like AN to drive consolidation in the industry.

There is much debate about where we are in the auto cycle, but we are comforted by AN's capable management team that has a history of prudent capital allocation and ability to generate cash in down cycles - AN produced ~$300m of free cash flow in 2009.

Fixed Income Update

Our taxable fixed income portfolios on average delivered 1.8% returns in Q2 2018. Interest rates (as measure by the 10 Year Treasury) were unchanged for the quarter, which means our returns were mostly driven by a combination of current income and improvement in credit fundamentals. However, short-term interest rates continue to increase and moved higher by 30bps in Q2. The increase in short-term rates should be a concern for equity investors, fixed income investors, and real estate investors. We are hyper aware of this trend and continue to include higher short-term rates in our analysis of existing and future investments.

We added one new bond positions during Q2. Covanta Holdings, the bonds will deliver a 6.099% yield to maturity through 2024.

Today, our corporate bond portfolio has a current yield of 6.32% with an average maturity of 5.5 years. Our municipal bond portfolios on average delivered 3.1% returns in Q2 2018. Call activity continued to slow and today we're able to purchase municipal bonds with maturity of 10 – 12 years at yields of 3.3% - 3.5%.

Real Estate

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

Private Equity

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

Concluding Remarks

Our cash levels remain above historical levels as we continue to be patient and wait for the right opportunities that meet our criteria – quality franchises with a margin of safety.

Wishing you all a great summer.

Sincerely,

Russell Silberstein