CARMEL CAPITAL PARTNERS

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Q4 2018 Commentary

General Commentary

By any measures Q4 2018 was the most turbulent, volatile and financially challenging period since 2011. From its peak in early October, to the lows in late December, the SP-500 Index declined a little over 20%. The damage was far more extensive for small/mid cap stocks, with declines approaching 30%. Further, the bond market was not immune with many corporate bonds experiencing 10% price declines.

What caused such a quick and sharp move to the downside? It was the items highlighted in our Q3 2018 letter - increasing interest rates, unwinding of quantitative easing, and trade tensions. The impact these three variables will have on corporate earnings created a climate of intense concern. Adding fuel to the fire was the overly large presence of Index/ETF trading. In recent years passive investing (ETF and index funds) have attracted a substantial amount of investor capital. During several trading days in December these funds represented an estimated 80% of daily trading volume with trades being indiscriminately executed by computer driven algorithms and strategies.

Financial markets were primarily concerned that the Federal Reserve Bank was out of sync with the U.S. and Global economies. Specifically, investors were concerned the Fed was going to raise interest rates and unwind its Balance Sheet irrespective of the economic climate. It all started with the October 3rd comments by the Fed Chairman Jerome Powell when he stated “we’re a long way from neutral” – loosely translated, the Fed has a lot more work to do in terms of raising interest rates. It was the Fed’s effort to communicate that the friendly and accommodative policy required to rehabilitate the economy after 2008/2009 recession was over. The global markets did not like these comments as they were perceived to be out of touch with the building global economic headwinds.

As the December Federal Reserve meeting approached where the Fed would communicate its next interest rate move, the media narrative blossomed into a “will they, wont they” as it related to increasing rates. As we now know the Fed decided to raise rates in December, and further communicated a desire to continue unwinding the its balance sheet. For those limited few who might be WWF wrestling fans – it was a haymaker from the top rope.

The cumulation of higher U.S. rates, negative trade/tariff effects, unwinding of both the US and European Central Bank balance sheets, and the weakening economic landscape in China and Europe, resulted in investors believing the headwinds against corporate profit growth were simply too strong. As the saying goes “if you can’t stand the heat, get out of the kitchen”, and flee the kitchen they did. Equity and fixed income prices plunged in the last week of December, reaching a low the day after Christmas.

It was indeed a perfect storm.

That takes us to January 7th when Chairman Powell, during a public interview, chose to communicate a different path ahead for the Fed. His very deliberate and scripted comments were designed to communicate a specific message - the Fed is aware of the economic landscape today, will adopt a more flexible stance on interest rates, and will be less rigid in shrinking its balance sheet. Since this speech the stock and bond markets have appreciated in a material way, and while the future remains uncertain investors have exhaled knowing the Fed is open to a more flexible mandate.

A reasonable question to ask is - what were we doing at Carmel Capital while the above was going on? I will point to the concluding paragraph of our Q3 2018 letter:

> *"Our cash levels continue to be above historical levels as we continue to be patient and wait for opportunities that meet our criteria – quality franchises with a margin of safety. Market timing and economic forecasting are not part of our day to day decision making. We make decisions one investment at a time and patiently wait for attractive opportunities to come our way. "*

Well come our way they did. We were extremely active during the quarter and took advantage of the market decline to invest a portion of our cash balances. Specific investments will be addressed below in the Equity Update.

Using Q4's volatility and turbulence as a backdrop I would like to revisit our 2015 decision to enhance investment portfolios with the addition of real estate and private equity. Fundamental to our decision was a belief that augmenting our equity and fixed income investing with these two asset classes would deliver a more durable and diversified portfolio, while at the same time offering more attractive returns.

From our Q3 2016 letter:

> *"Our decision to move down this path is driven by several factors:*
>
> - *First, we would like to expand the investable universe to deploy your capital beyond traditional stocks and bonds. As a firm we have a long history of opportunistic investing and applying this to private equity and real estate is a natural evolution.*
> - *Second, the ability to invest across a broader set of asset classes will produce a more diversified and durable portfolio over the long-term. While we will surrender liquidity with these two investment options, we will gain exposure to attractive areas that might not necessarily be available in the public markets.*
> - *Third, we believe our private equity investments will offer an opportunity for increased returns over time and we're comfortable sacrificing medium-term liquidity (3 – 5 years) in order to achieve better returns.*
> - *Finally, our goal with real estate is to consider capital preservation first, income second, and capital appreciation third. We will view all our real estate opportunities through this filter. Doing so allows us to again surrender liquidity in favor of incrementally better returns compared to publicly traded fixed income. "*

Since writing the above we have completed seven real estate investments, and one private equity investment. In addition, we currently have two real estate investments, and one new additional private equity investment in the pipeline. Thus far we are extremely pleased with the results and continue to believe our current path is the correct one for our firm, and for you our client.

The volatile environment experienced in Q4 2018 further validates the benefit of having a more diversified and durable portfolio. The ability of your overall investment portfolio to endure a challenging environment for stocks and bonds is very important for long-term capital appreciation. We continue to uncover attractive opportunities in both real estate and private equity.

The equity and fixed income markets have partially recovered since the December lows, and we have more than participated in the upside move. While we're pleased to see the appreciation in our portfolios, we still see several clouds on the horizon, and are keeping the worry dial set to medium. From where we sit today, we still these concerns as front and center:

1) Trade/tariff war.
2) Quantitative tightening in US and Europe.
3) Expanding government debt / expanding budget deficits.
4) Weakening economic outlook in China and Europe.

We continue to push ahead evaluating investment opportunities utilizing the same tools as always - patience, discipline, conservatism, research rigor, and margin of safety.

Equity Update

After a strong start to the year and strong performance through Q3, we were unfortunately unable to escape the market turbulence in Q4. For 2018, excluding cash, the performance of the underlying equity investments on average declined -9.4%. For the full year 2018 on average our equity accounts performance was -7.2%.

As mentioned earlier, we took advantage of the market decline in December to deploy capital. We purchased six new investments and in one case we re-purchased a company we had previously sold, Mohawk (MHK). We also eliminated four holdings, all sold in October and November prior to December's steep decline.

You might have noticed that 2018 was an above average year of activity. Our patient and disciplined approach to deploying capital may result in long periods inactivity, followed by brief periods of action, with the call to action driven by market volatility or declines. For the full year we have added 15 new investments to the portfolio and sold 9. The volatility early in 2018 and in Q4 provided us with an opportunity to add high quality franchises at attractive valuations. Today, we have a robust on-deck list and continue to evaluate the most prudent path ahead to deploy capital.

In summary, during Q4 we added six new equity holdings and eliminated four.

We sold FIS (on January 1st to push gains into 2019) as our original thesis largely played out. We originally purchased FIS after concluding it was a high-quality company with highly predictable cash flow that was being temporarily penalized (inappropriately in our opinion) for an acquisition it made. After our purchase the company successfully integrated the acquisition and realized the expected benefits. The company reached fair value and we sold. Over our holding period we earned a 75.7% (21.8% annualized) return over 2.8 years.

After holding Johnson Controls (JCI) for a little over 2 years we sold the investment in late November. Our original thesis included JCI's participation in two attractive industries – energy efficient buildings, and power solutions for automobiles (battery technology). During our holding period the company experienced uneven results across all business segments with the management team never being able to get the company firing on all cylinders. Recently the Board decided to sell its battery business to Brookfield Asset Management, thus removing a core part of our thesis. Given JCI's un-even performance, coupled with the market decline, we felt there were more attractive avenues to invest this capital. Over our holding period our return was -10.8% (-5.0% annualized) over 2.23 years.

We sold our investment in Hanes Brands (HBI) in early November. At the time of purchase, we believed Hanes to be a high-quality business but one not being given credit for future margin expansion resulting from a string of recent acquisitions. Over time the company experienced un-even results and struggled to integrate its numerous acquisitions, all the while forging ahead with new acquisitions while still not digesting previous ones. Management continued to promise a hiatus on acquisitions but could never seem to stick to its word. As a result, we lost faith in their ability to execute. Over our holding the return was -29.3% (-15.6% annualized) over 2.04 years.

Lastly, we sold Under Armor (UA) in late October. At the time of purchase, we believed UA to be a high-quality brand that was experiencing some temporary headwinds in its business. The company had experienced some execution issues in rolling out its footwear line and was also suffering from limited exposure to the growing athleisure segment. We believed that capitalizing on its international growth opportunities and correcting the footwear missteps would eventually lead to better results. UA's international business proved to be a growth engine, however, a high number of Senior Executive departures and uneven domestic results led us to conclude UA should be moved to the "too difficult pile". We elected to sell. Over our holding period we earned a 19.7% (+15.7% annualized) return over 1.22 years.

During the quarter we initiated positions in Abiomed (ABMD), Alliance Data Systems (ADS), Fiat Chrysler (FCAU), Mohawk (MHK), Micron Technologies (MU), and Premier Inc (PINC).

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Fiat Chrysler (FCAU) / Market Cap: $24.7B

Fiat Chrysler produces cars and trucks for sale globally. Under the direction of its largest shareholder (the Elkann family) the company has transformed itself into a lean and profitable company. FCAU owns the iconic Jeep brand that has experienced a global resurgence in both popularity and operating profit. In addition, FCAU owns Dodge, Chrysler, Ram, Alpha Romeo, and Maserati. In recent years the company has shed unprofitable lines and focused on return on capital, vs. the historic model of only focusing on market share. For example, today in the U.S the Chrysler sells only domestically manufactured passenger car, the Chrysler 300.

To further increase operating profits the company has identified multiple avenues to reduce its cost structure, both through manufacturing efficiencies and purchasing efficiencies. In aggregate these savings will amount to $10B between 2018 – 2022. The reduction in cost structure will not only boost FCAU's profits in the current environment, but also significantly lower its breakeven point when the industry eventually softens.

We believe the Elkann family has a very specific plan to unlock shareholder value. Early signs of the plan can be seen with the company's recent announcement to sell its parts subsidiary (Magenti Marelli) to CK Holdings for €6.2B. The company will use the proceeds to fund a one-time €2B ($1.33 /share) divided to shareholders and will retain the remaining capital on its balance sheet. In addition, the company will begin paying a regular annual dividend of €0.70 /share, delivering a 4.75% yield. Other shareholder friendly actions could include FCAU either IPO'ing, spinning off, or outright selling one or two of its brands. Fiat, Maserati and Alpha Romeo could be candidates for sale to one FCAU's European competitors.

Lastly, we see large upside in the company's autonomous driving investments. To date the company has partnered with Google's Waymo self-driving subsidiary and with BMW to commercialize and deploy self-driving technology.

As 2019 progresses we expect additional shareholder friendly announcements from the Elkann family.

Alliance Data Systems (ADS) / Market Cap: $9.1B

ADS provides data-driven marketing and loyalty solutions to large, consumer-based businesses. The company operates three different segments:

1. Card Services provides private label and co-branded credit cards to 160+ subscale retailers.
2. Epsilon, the largest marketing services firm specializing in end-to-end loyalty solutions.
3. LoyaltyOne which includes AIR MILES, the largest loyalty program in Canada, and BrandLoyalty which designs and implements tailor-made loyalty programs for grocers.

We initiated a position based on an attractive valuation (12x earnings and 11% free cash yield), the high-quality nature of the business, shareholder-friendly management team, and the secular migration away from traditional mass marketing mediums towards direct, data-centric personalized forms of marketing.

In Q3, management announced its intention to sell the Epsilon business. We conservatively estimate the asset to be worth $4bn, or 37% of ADS's current enterprise value. Following the sale, we believe management will deploy the proceeds in value accretive ways through a combination of balance sheet deleveraging and share repurchases.

In mid-December, an industry-wide rise in delinquency rates and slowdown in receivables growth caused ADS to be sold-off along with other credit card companies. While there may be elements of cyclicality, we believe the ongoing importance of customer loyalty programs, new verticals in e-commerce, autos, and hospitality, as well as the shift towards a cashless society will enable ADS to sustain a high-teens, low-20s earnings growth rate over the long-term.

Frontdoor (FTDR) / Market Cap: $2.23B

FTDR was spun-off from ServiceMaster, a company we own, on October 1st at $45/share. Shortly after reporting poor Q3 results due to increasing cost pressures and a slowdown in housing starts the stock was cut in half to $23/share. At this price point FTDR represented a highly attractive investment with an asymmetric risk/reward profile. We added to our position in December.

FTDR's core business is American Home Shield (AHS), the largest provider of home service warranties in the US fulfilling 4MM service requests for its 2MM customers. AHS is a high-quality subscription-based business with recurring revenues, minimal capital requirements, durable scale advantages and healthy growth prospects. We value the AHS business alone at $35/share, 50% higher the current share prices.

We think the company has a long-term opportunity to penetrate the broader $400bn US home services market via an On-Demand offering (think Uber for home services). We believe FTDR's technology-focused management team led by former Lyft COO Rex Tibbens can successfully carve a position in On-Demand by leveraging AHS's existing competitive advantages. More importantly, platform businesses do not require significant upfront fixed or working capital to build-up or scale. Thus, FTDR is capable of financing On-Demand entirely with cash flow and does not risk its balance sheet in the event On-Demand is a blunder.

Mohawk Industries (MHK) / Market Cap: $9.4B

MHK is a global manufacturer and distributor of residential and commercial flooring with considerable scale advantages in procurement and distribution. The company is well managed by an owner-operator and competes in a structurally attractive industry with one other competitor of comparable size.

An opportunity arose to purchase shares after a deceleration in housing starts and concerns over input cost inflation caused the stock to plummet 60% from its 2018 highs. In the past, MHK has successfully implemented price increases to regain margin in the face of rising costs, but with a time lag. Thus, while we expect some cost headwinds to pressure margins in the short-term, we believe the impact will be transitory as industry-wide price increases and capacity reductions will allow MHK to raise prices and absorb cost inflation by 2020. Further, a portion of MHK's sales are in repair and restoration which is not tied to interest rates and real estate cycles.

At 10x forward earnings, MHK trades at an attractive valuation considering the quality of the company and opportunity to continue growing through bolts-on acquisitions.

Abiomed (ABMD) / Market Cap: $14 billion

Abiomed designs and sells heart-related medical devices. The company's Impella product line consists of small mechanical pumps inserted into the heart via a catheter to "unload" the heart muscle for short periods of time. They're used to stabilize heart attack patients and allow heart failure patients to undergo surgical procedures which otherwise may be too risky.

The first Impella device received US approval in 2008. Since then Impella products have since been used in the treatment of more than 70,000 US patients. A database of hundreds of peer-reviewed studies has shown the use of Impella leads to higher patient survival rates, improved subsequent quality of life and lower re-admission and treatment costs.

Market penetration for Impella remains low at less than 10% of the potential 230,000 annual patients in the US, and at even lower usage rates outside the US. The primary alternative for circulatory support in heart attack patients is the intra-aortic balloon pump, first approved by the FDA in 1976. Studies have demonstrated Impella's superiority, and no new competing products are on the horizon, leaving ABMD with a clear path to continued growth as more physicians are trained to use the Impella system.

ABMD realizes very attractive returns with gross margins above 80%, operating margins approaching 30%, and the prospect of continued operating margin expansion for the foreseeable future. Nearly all revenue comes from one-time use products and services, ensuring a steady stream of revenue from new procedures. The company reinvests more than 10% of revenue into R&D and has the potential to more than double its addressable market in the next few years with approvals for several additional patient indications.

While the stock sells at a relatively high multiple of current earnings, we believe the multiple is sustainable for at least several years given the visibility of ongoing 25-30% annual sales growth and margin expansion in a still vastly under-penetrated market.

Micron (MU) / Market Cap: $37 billion

Micron is a global manufacturer of memory chips which are used to store digital data in computers, servers, wireless phones and other electronic devices and equipment. It produces both DRAM, functional memory for computer operating systems, and NAND/Flash for persistent storage in products such as USB drives, smartphones, and camera data storage. It also produces solid state drives (SSD) for PCs, servers and other electronic equipment.

As the Internet economy came to life in the late 1990's demand for data storage experienced tremendous growth. However, intense competition to supply the industry led to generally poor economic returns for memory chip suppliers for more than a decade thereafter. In the past 5 years the industry has consolidated down to six competitors which supply more than 90% of global DRAM, and three supplying 95% of global NAND. With a smaller number of manufacturers and increasingly high barriers to produce more advanced chips, capacity growth has been rational and economic returns have become attractive.

Nonetheless, memory chips from any given supplier still can be substituted for another (for the most part) which results in product pricing and earnings volatility as new capacity comes on-line in bursts. Several industry price cycles can be contained within a single broader economic cycle. This in combination with the industry's "irrational" history can result in memory chip companies becoming excessively inexpensive as concerns of a cycle downturn appear – which happened this quarter, in our view.

We purchased Micron at 3 times trailing earnings. We expect lower earnings in the first half of calendar 2019 as the industry digests inventory and new capacity comes on line. We then expect stabilization in the back half of 2019 with the view that earnings, within a few years, should exceed 2018's peak. Growth in storage capacity bits is still a high-growth market, with sustainable forward-looking growth estimated at 20% for DRAM and 40% for NAND. The ongoing digitization of consumer services and business/industrial processes have been major growth drivers of storage capacity. Rapid growth will continue as even more data-intensive technologies such as 5G communications, IOT sensors and artificial intelligence achieve widespread adoption.

Premier Inc (PINC) / Market Cap: $5 billion

PINC is the largest group purchasing organization (GPO) in the US for healthcare providers. It provides its members access to scale efficiencies for supplies, pharmacy purchasing, and other cost-saving services such as data analytics and best practices advisory. Members include hospital groups representing over 4,000 US hospitals and 150,000 other providers such as doctor's offices and clinics.

Premier has a unique corporate structure in which 40% of its common stock is publicly-traded and 60% is owned by its healthcare members/customers, who also receive volume-based incentive rebates. More than $60 billion in healthcare purchases flow through PINC annually with the company realizing revenue of 1%-3% of gross product sales.

Revenues are highly predictable as they are tied to growth in overall healthcare spending and a very stable customer base. The tenure of its average member is 19 years with annual retention in the 97-98% range.

Trends toward value-based reimbursement, whether by government or private-payor, strengthens the case for cost-effective delivery of service as it rewards those who manage total patient treatment costs rather than piecemeal reimbursement based on services provided. The company's Performance Services division, which provides data analytics and best-practices consulting, should benefit from this directly over time with higher member usage rates.

We purchased PINC at 15x earnings and are attracted to its unique business model and stable earnings stream. The company has an unlevered balance sheet and generates significant free cash flow.

AutoNation - Update

AN is one of the country's largest retailer of new and used automobiles. AN's share price declined in the quarter as a result of disappointing earnings, the decision to cease expansion of AutoNation USA (its standalone used concept), a broad selloff in automotive retail stocks over trade-war concerns, and fears that we've reached peak auto sales in the US.

The most disappointing news in the quarter was AN decision to halt expansion of AutoNation USA in 2019. At this point, it is unclear whether the decision is temporary or permanent. Management suggested the motive is based on the decision to deploy more capital into Parts & Service where it witnessed stronger than expected demand over the past few quarters. At face value, this is a reasonable explanation as Parts & Services (1) requires less upfront capital to generate high incremental returns and (2) is less susceptible to the effects of cyclicality relative to AutoNation USA.

If the economy weakens, we expect earnings to be relatively stable going in to 2019 and 2020. Economic weakness and/or auto tariffs would adversely impact New Vehicle volumes and sales of Finance and Insurance products. However, as auto retail is a variable cost business, volume declines have a negligible impact on margins. Headwinds in new auto sales will be offset by growth in higher margin non-cyclical Parts & Services and lower SG&A levels as the company begins pulling back investment spend. At a 6.7x earnings multiple we believe we have a comfortable margin of safety.

EssilorLuxottica - Update

On October 1st Essilor, the world's largest manufacturer of lenses, merged with Luxottica, the world's largest manufacturer of frames. While we expected the merger to ultimately be approved, we were disappointed by the length of the process.

EssilorLuxottica has impenetrable scale advantages spanning the entire value-chain in a globally underpenetrated and structurally growing market. Management was opaque regarding the merger's economic benefits during and after the approval process. Subsequently, the merger's merits remain grossly underappreciated by investors.

The combination of near identical supply-chains, Luxottica's brand equity and Essilor's deep relationship with eyecare professionals will enable EssilorLuxottica to realize both cost and revenue synergies well in excess of management's guided €400-600m range. To add perspective, the midpoint of the range equates to a mere 3% of the combined company's revenues.

We are attracted to EssilorLuxottica's integrated business model and believe that in a soft economic climate cash flows will to hold up well due to its global footprint and the nondiscretionary nature of prescription eyewear.

Seritage Growth Properties - Update

SRG's largest tenant, Sears Roebuck (accounts for ~70% of current rental income), declared Chapter 11 bankruptcy in the quarter. In response to this news (despite being known) SRG's share price has been weak over concerns of its ability to continue development activity and cover other cash needs in the event Sears terminates its lease. However, its $800mm in borrowing capacity from Berkshire Hathaway provides enough liquidity to sustain itself while Sears navigates bankruptcy. Over the next 24-months, properties coming online from the development pipeline will produce $155m in annualized rental income, 1.7x the income potentially lost from Sears.

SRG's Master Lease with Sears stipulates that SRG is permitted to recapture and redevelop 50% of space occupied by Sears. As non-Sears tenants pay a rental rate 4x higher than Sears on a per sq. ft. basis, the bankruptcy presents a long-term opportunity to recapture and redevelop 100% of space previously occupied by Sears at significantly higher rents.

Despite its recent weakness we believe SRG has attractive returns ahead.

Fixed Income Update

Our taxable fixed income portfolios on average produced a -1.25% return for 2018. Up until November our corporate bonds were on track to deliver mid-single digit returns, however, as the market turbulence of December gained steam, we experienced a large down draft in our corporate bond prices. Contributing to the December price decline was general market anxiety about the Fed's path on interest rates and concerns about global economic growth. Further exacerbating these declines was consistent and indiscriminate selling from index/ETF holders into an already illiquid market. Like equities, it was a perfect storm. Thankfully we've seen some return to normalcy in early January with many of our bonds recovering in price.

Today, our corporate bond portfolio has a current yield of 6.35% with an average maturity of 5.7 years.

Our municipal bond portfolios on average delivered +9.25% return in 2018. These are unusually strong returns for municipal bonds and we don't expect future results to be as strong. Today we're able to purchase municipal bonds with maturity of 10 – 12 years at yields of 3.3% - 3.5%.

Real Estate

We did not add any new real estate investments in Q4 2018. Our real estate portfolio performed well in Q4 and 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.

We have a new investment opportunity currently in the pipeline and expect to have more information available later in Q1.

Concluding Remarks

Despite our active Q4 we continue to have above average cash holdings. We are expecting additional volatility in 2019 and will continue to look for opportunities to deploy capital where we see attractive returns with a margin of safety. Declines in the equity markets are an ongoing and regular part of investing, and while unpleasant to experience they should be viewed through an opportunistic lens. We are long-term investors looking to deploy patient and long-term capital - with this mind set we see volatility as opportunity.

A final word on our quarterly letter. The goal of each letter is to provide a summary of investment activity in the quarter, how we see the investment landscape, the investment opportunity set today, and some thoughts on the road ahead. Historically our goal was to distribute the quarterly letter around the 15th of the month following quarter end. With real estate and private equity becoming a growing portion of our assets, the time required to compile all the information for the letter has increased. Thus, going forward we expect to distribute our letter the last week of the month following quarter end.

Wishing you a healthy and prosperous 2019.

Sincerely,

Russell Silberstein