CARMEL CAPITAL PARTNERS

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Q1 2019 Commentary

General Commentary

After a turbulent end to 2018 the US equity markets enjoy a strong start to 2019. A more friendly tone from the Federal Reserve in December was fully embraced by U.S. equity markets and pushed indexes higher as the quarter progressed. It's hard to believe that in early December the Fed bias was towards an interest rate increase, and now there are soft whispers about a possible rate cut. How quickly the winds of Fed policy shift direction, and yet another example why short-term forecasting of the economy or interest rates is futile.

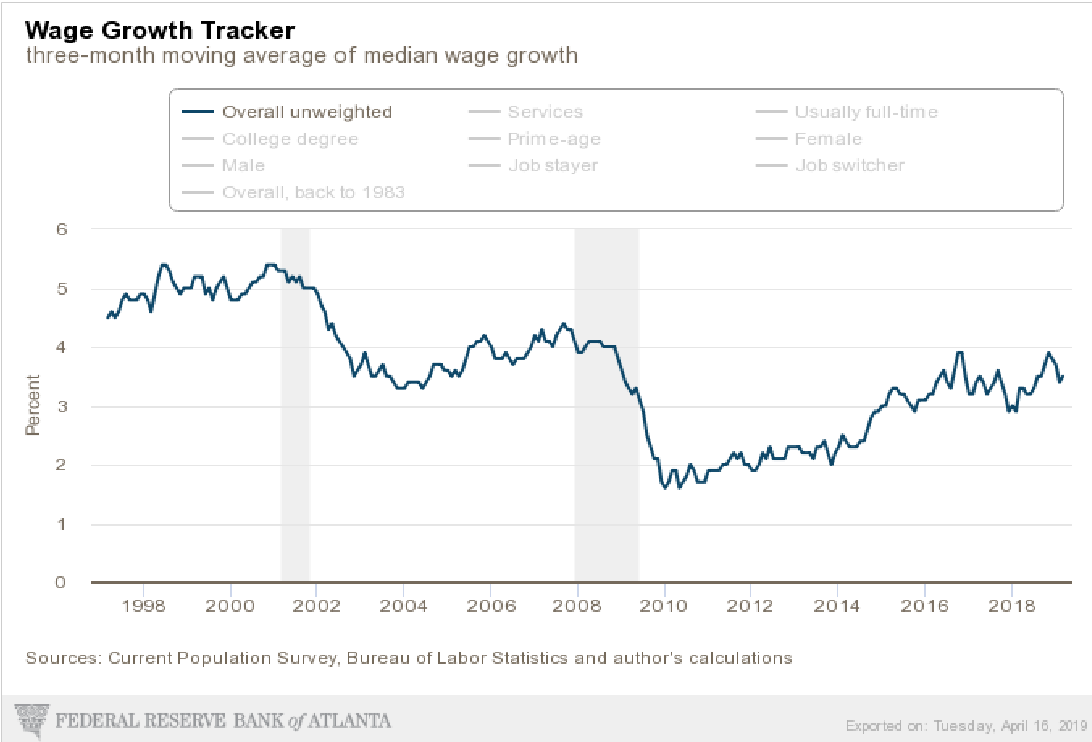
The equity and fixed income markets have now fully recovered from the December lows and our equity holdings have participated in the recovery. While we're always grateful to see appreciation in our equity holdings we remain cautious as the number of items on our worry list (as outlined in our Q4 letter) have not diminished. In fact, there is one new addition – wage inflation.

The bolded sentences are what's changed on our worry list since Q4:

1) Trade/tariff war – **still unresolved but apparently getting closer to a resolution.**
2) Quantitative tightening in US and Europe – **no longer a concern as the tone is now accommodative.**
3) Expanding government debt / expanding budget deficits – **increasing every second of every day with no end in sight.**
4) Weakening economic outlook in China and Europe – **getting worse and not better.**
5) U.S. wage pressure and its impact on U.S. corporate profits.

The drum beat of companies highlighting growing wage pressure grows louder as each month passes. The immense upward pressure on U.S. wages is a result of a tight labor market with the expected impacted being a negative effect on operating profits. Historically, the corrosive effective of wage pressure on corporate profits has been mitigated by improved productivity (technology improvements), increasing labor force (population growth or immigration), increased prices (inflation), moving jobs offshore (mostly already done), or a slowdown in economic growth (layoffs). Companies that can substitute technology for labor will successfully maintain profits, those that do not will suffer.

The below chart from the Federal Reserve in Atlanta shows the U.S. has now experienced two years of above 3% wage growth. We're mindful that a company's ability to address these pressures will not materialize overnight and thus will potentially impact the broader market over an extended period. There is a growing body of research indicating that U.S. corporate profit margins have peaked, if this is the case, wage inflation is surely to be one of the larger contributions to this problem.



From a portfolio perspective we were less active in Q1 2019. We sold one equity position and added three. We also completed two real estate investments, one self-storage and the other a multi-family investment.

In an environment where the equity markets keep forging ahead all the while dark clouds form on the horizon, its easy to lose discipline and deploy capital due to a fear of missing out. We emphasize, prioritize, and relentlessly focus on capital preservation and express this in our work each day through patience, discipline, conservatism, research rigor, and margin of safety.

Equity Update

For Q1 2019, excluding cash, the performance of the underlying equity investments on average increased 12.5%, and on average our equity accounts increased by 10.5%.

During the quarter we initiated positions in Nutanix (NTNX) and Cloudera (CLDR), and Owens Illinois (OI)

Nutanix (NTNX) / Market Cap: $7 billion

An accelerating trend in data storage has been the movement of information stored on local servers (in a company's office) to the cloud. The ability to accommodate, plan for, and hold increasing amounts of data in the cloud has driven the need for new technology to adapt to this rapidly changing environment. One company we believe is well positioned to benefit from this trend is Nutanix.

In 2009 the company pioneered a new approach for managing the compute and storage infrastructure at data centers that offer cloud services. This new approach is called hyper-converged infrastructure (HCI). The company's HCI solution is a software-based platform which displaces legacy data center hardware that consisted of separate "silos" for compute, storage and networking. The Nutanix advantage is that it can be deployed to manage any function on a general-use server from different vendors and across different operating environments and locations, including private data centers and the public cloud. Utilizing HDI allows customers to optimize hardware infrastructure, rapidly scale resources, and reduce both complexity and time spent managing infrastructure. In summary NTNX provides a solution anywhere and with any type of hardware.

Nutanix has grown quickly from inception 10 years ago, with more than 12,000 customers today. At last count NTNX's customers included 40 of the 50 largest global companies and more than a third world's largest 2,000 companies. The company's success is a result of its ability to remove customer pain points in managing and scaling computing needs, and to do so at a lower cost than legacy and competitor solutions. Its growth also reflects a successful "land and expand" strategy – start by winning a small portion of customer workloads, prove efficacy and cost savings, and then subsequently capture more workloads across the organization. Currently, the company is generating $1.2 billion in annual revenues in an HCI market estimated to grow to $10-12 billion within 5 years. While HCI is a large growth opportunity, the company is aggressively expanding its platform roadmap to the extent that management believes its addressable market could reach $75 billion in annual revenue.

Nutanix exhibits several attractive fundamental characteristics:

1) It's predominantly a recurring-revenue business with a subscription-only model that enjoys a 97% customer retention rate.
2) Management's ongoing compulsion to develop additional software solutions to remove other customer pain points, this not only expands its addressable market but further cements its overall relationship with the customer.
3) A culture that views customers as collaborators and partners, in contrast with others that adopt a "us vs. them" approach.

We purchased NTNX during Q1 after they reported Q4 2018 results that were below expectations. We believe the slow-down to be temporary and expect normal growth to resume as 2019 progresses.

Cloudera (CLDR) / Market Cap: $2 billion

Like Nutanix, Cloudera will also benefit from the prolific growth in enterprise cloud storage. Cloudera is an enterprise-focused software company, but it serves end markets relating to machine learning, real-time analytics and artificial intelligence (AI). These end customers accumulate massive amounts of "big data" and use these data sets to drive better corporate decision making.

Most "big data" is managed using a software platform called Hadoop. This platform allows for distributed processing across thousands of computers simultaneously. Cloudera's chief software architect co-founded this open source platform in the mid-2000's, and subsequently helped develop the Cloudera platform to simplify and integrate software tools from other vendors that work in conjunction with Hadoop. CLDR's platform is a software subscription service used for managing real-time data analytics, machine-learning and artificial intelligence for enterprise-scale customers.

Although the company has grown steadily, the stock has under-performed since its IPO two years ago with a current share price of $11 versus its initial price of $15. As its enterprise customers undergo a digital transformation across most of their business processes, they are generating massive amounts of data but are still trying to understand how to use it to reduce costs, drive revenue and otherwise improve operations. This is where CLDR comes in as it will assist its customers with making sense of all the data that's collected. We believe 2019 is likely to be an inflection point for machine learning and data analytics and a precursor to more advanced AI systems. Likewise, faster data communications from next generation 5G cellular service being rolling out this year, will drive more use cases. We expect incremental growth for CLDR as companies undergo this learning curve, with modest near-term growth eventually becoming a larger-scale acceleration.

Owens Illinois (OI) / Market Cap: $2.8B

OI is a dominant player in the global glass container industry. Today the company operates in U.S., Europe, Latin America and Asia. Owens Illinois produces glass containers for alcoholic beverages, including beer, flavored malt beverages, spirits and wine. The Company also produces glass packaging for a variety of food items, soft drinks, teas, juices and pharmaceuticals.

In recent years there has been renewed interest in glass containers as food/beverage companies utilized glass to "premiumrize" their products. Essentially utilizing glass packaging to sell a product at a higher price point. The best example of this has been the beer industry where premium and craft beers are sold in bottles vs. aluminum cans for lower priced beer. This can also be seen in the food industry where higher end jams/spreads are sold in glass vs. plastic. In addition, the growing trend in sustainable packaging (environmentally friendly with no plastic) has also pushed companies towards glass.

The glass container industry has consolidated in recent years with the remaining players demonstrating more pricing discipline. Adding to this has been OI's proactive strategy of engaging customers with strategic long-term partnerships vs. traditional transactional contracts. These new agreements allow the company to enjoy better manufacturing scale and better cost control.

In recent years OI has spent heavily on a new glass manufacturing technology (MAGMA) that when deployed in 24 – 36 months will materially improve the company's cost structure and profitability. We believe this technology will transform OI and not only allow it to improve its cost structure but also win new business.

Today many investors still see OI as a beer only company and do not appreciate the company's shift towards food and wellness. As a result, OI trades at a very attractive 7X cash flow valuation. Acknowledging the undervalued nature of its share OI is aggressively repurchasing its shares.

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Fixed Income Update

Our taxable fixed income portfolios on average produced a +5.5% return for Q1 2019. The strong returns we experienced in January continued throughout Q1 2019. Mirroring the equity markets, the strong fixed income returns were driven by the expectation of lower interest rates. In general, the corporate bond market is stable but with limited opportunity to safely deploy capital at yields much above 5%.

Today, our corporate bond portfolio has a current yield of 5.18% with an average maturity of 5.4 years.

Our municipal bond portfolios on average delivered +1.8% returns in Q1 2019. Today we're able to purchase municipal bonds with maturity of 10 – 12 years at yields of 3.0% - 3.5%.

Real Estate

We completed two real estate investments during Q1 2019 – one self-storage and one multi-family. Overall our real estate portfolio continues to deliver attractive returns with 2019 off to a strong start. 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

While our overall tone remains cautious, we continue to find opportunities to deploy capital in all four asset classes and are doing so with a healthy margin of safety and a commitment towards capital preservation.

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 2018.

Sincerely,

Russell Silberstein