CARMEL | CAPITAL PARTNERS

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Q4 2019 Commentary

General Commentary

Our investment results across all asset classes were strong in 2019 and as a firm we had a particularly active year:

Equities	Purchased 12 new equity positions and sold 11.
Fixed Income	8 bonds were sold due to early calls. One new bond position added.
Real Estate	Closed three new investments and exited one.
Private Equity	Completed one new investment – Fulcrum Building Group.

The 28.8% returns delivered by the SP-500 index last year were quite attractive by historical standards. One would have to go back to 2013, and then 1997 before that, to have enjoyed such strong returns. These high returns occurred despite weak U.S. manufacturing results, a weak European economy, a trade war with China, and a messy Latin America economic landscape. Offsetting all of these was (is) a VERY strong U.S. employment picture and a highly stimulative U.S. Federal Reserve Bank.

When discussing the equity markets, you often hear investors offer up statements such as "the stock market is high", or "the markets are overvalued", or the ever-popular question "what do you think about the market?". Interestingly, very similar questions and comments materialize when discussing real estate. We hear "valuations are stretched in the real estate" or "it's really tough to find good deals in the real estate market".

It's worth repeating again – Carmel Capital does not invest in "the market".

More importantly, our thinking is not oriented towards these "market" related statements or questions. Our sole focus, mental energy, and time is devoted to investing one stock, one bond, one property, and one company at a time, and always through the lens of high quality and margin of safety. Do advancing stock and real estate prices make this harder to achieve? Very much so. However, it does not mean we can't find opportunities to deploy capital in what we believe are attractive risk / reward investments. Having a long-term orientation makes our pursuit a little easier, especially in a world hyper focused on real time everything, a 60 second news cycle, and immediate availability of information. Our ability to think and act long-term often allows us to consider those opportunities that have been ignored or discarded because they do not meet the "here and now" mandate of today's world.

Investing is hard. It's easy to lose sight of this in a year where every investment class delivered outstanding results. The art and science of investing requires patience, a stable temperament, discipline, and a sizable amount of humility. As a firm we strive to always keep these attributes front and center.

Today, the heavy flow of global news continues to wash over financial markets, and much of it somewhere between concerning to outright negative. To navigate these waters, we continue to focus on what we believe will deliver attractive long-term returns – building a diversified and durable investment portfolio across multiple asset classes, all with an attention to quality and margin of safety.

Equity Update

Our equity returns for 2019 (excluding cash) on average increased +27.2%, and on average our equity accounts increased by +20.5%. Despite the market's appreciation during 2019, we managed to identify several new high-quality investments and believe our portfolio is well positioned for the future.

During the quarter we initiated new positions in Cleveland Cliffs (CLF), Occidental Petroleum (OXY), and Verizon (VZ).

Cleveland Cliffs (CLF) / Market Cap: $2.0 billion

Cleveland Cliffs is a U.S. based producer of iron ore, one of the primary feedstock inputs used to produce steel. Under a new management team that arrived in 2014, the company has experienced a material turnaround in its financial performance. The new CEO eliminated unprofitable divisions, streamlined the organization, and in a controversial move announced the commission of a new ore plant in Toledo, Ohio. Once completed, the new plant will place CLF's in an advantaged position to supply many of the steel makers in the mid-west with low cost ore. Today many of those same steel manufacturers purchase imported ore that not only costs more but is also of a lower quality.

We believe that once the new plant is complete (expected in Q1 2020), the company's capital expenditures will fall dramatically, and most of the excess cash flow will be returned to shareholders in the form of a regular dividend. Our analysis indicates the dividend could be as high as 10% - 15%. The company's CEO has stated on numerous occasions that returning excess cash flow to shareholders was a top priority.

While CLF's is considered a cyclical company, we believe its unique position in the market (both geographically and by the type of ore produced) make it better insulated from the typical profit swings experienced in the ore industry.

No sooner had we purchased our position CLF's announced it would acquire AK Steel (AKS), a company engaged in the manufacture of flat-rolled steel, stainless steel, and electrical steel products. AKS primarily serves the automotive and infrastructure markets. The acquisition now makes CLF's a vertically integrated steel manufacturer.

While we acknowledge this is a change in our thesis, we believe there are many positives imbedded in the AK Steel acquisition. The company has laid out a compelling case for the acquisition and we're inclined to see how the acquisition progresses before determining if we continue to hold the investment.

In the interim we will earn a 3.2% dividend yield with the opportunity of material price appreciation if the AKS acquisition realizes its full potential.

Verizon (VZ) / Market Cap: $250 billion

Verizon is one of the two dominant providers of consumer wireless services (60% of revenues) in the US with an approximate 30% market share and 94 million consumer subscribers. It also provides wireline fiber services to consumers and businesses in the Northeastern U.S. pursuant to its history as one of the original Baby Bell companies created from the 1980's breakup of AT&T. Other businesses include global communications services for large multinational enterprises and consumer online media content and services, which include Yahoo, AOL and HuffPost, among others.

Verizon's consumer wireless business is mature with minimal/flattish subscriber growth expected for smartphone devices, while generating healthy cash flow margins. The industry has consolidated down to a handful of competitors. The cost and expertise required to build out and maintain infrastructure, and the scale of existing providers, eliminates the likelihood of meaningful competitive threats. Meanwhile, phone subsidies have mostly disappeared in the past 2-3 years, leading to a stable competitive and margin outlook for the industry. Internally, the company in early 2019 initiated a planned three-year $10 billion cost reduction program, further supporting the positive margin outlook. We expect modest revenue growth even with a flat smartphone subscriber count mostly driven by conversions to higher-priced unlimited data plans and growth in non-smartphone devices. Verizon's stock price looks reasonably attractive based on this utility-like profile, selling at 12x earnings with a 4% dividend yield.

Making it a more compelling investment is the potential for its next-generation network buildout (5G) to enable incremental revenue sources. This should lead to a higher ROI on network capital spending, and a gradual multi-year acceleration in revenue growth. New revenue sources will include connected infrastructure, surveillance, manufacturing automation, virtual and augmented reality, edge computing services, autonomous driving, and fixed wireless which will compete with traditional wireline cable in dense population centers. As these new services come into focus and top-line growth improves, we believe the narrative can change from "utility-like" to "enabler of high-growth technology services", and the stock is likely to be re-valued upward by investors.

Occidental Petroleum (OXY) / Market Cap: $37 billion

OXY acquired Anadarko in mid-2019, a deal universally ridiculed by investors and analysts as an over-pay following a public bidding war with Chevron. From the time of its final increased bid in April up to the date of our purchase in mid-December, the share price declined nearly 45%, wiping out $27 billion in market value. Chevron's share price, the losing bidder, was nearly unchanged over this same period.

OXY paid $57 billion to acquire Anadarko, funded primarily with $40 billion in newly issued or assumed debt, plus a $10B preferred stock deal with Warren Buffet's Berkshire Hathaway. The stock was punished for some combination of overpaying in the first place and taking on excessive leverage in the second place, even though its weighted cost of debt funding was a very reasonable 4.6%. Subsequent to closing in August, OXY planned various divestures among the acquired assets, which management expected to reach $15 billion. All the asset sale proceeds are earmarked for debt reduction. To date, OXY has announced nearly $10B in asset sales, the bulk of which have closed with corresponding debt reduction. Assuming the company reaches its $15B asset disposition target, and adding to this the $27 billion market decline, we, as new shareholders are effectively paying just $15 billion for the remaining Anadarko assets, a huge discount to the $57 billion initial deal price thrust upon former shareholders. Likewise, the remaining assets are highly cash accretive, putting OXY on a path to sharply reduce its leverage to a comfortable level, mitigating the excess-leverage risk currently in the shares.

Management, of course, thought they were making a good deal even at $57 billion (now $42 billion net of divestitures), based upon the expected future cash flows of assets acquired and strategic synergies with the pre-existing OXY assets. Since 2013, OXY has been divesting and focusing on a narrower set of oil & gas assets and regions where they believe the production profile is both highly sustainable and offers a superior return on investment opportunity. Internationally, OXY operates in three middle eastern markets (Oman, Abu Dhabi and Qatar) and in Columbia, South America. In the US, they are predominantly focused on the Permian Basin across West Texas and New Mexico. Following the acquisition, their production profile will be close to 80% domestic.

Forecasts indicate that shale production in the US is rapidly approaching a peak with many operators struggling to achieve targeted returns as a result of rapid depletion rates. OXY has nonetheless achieved high returns on capital due to a combination of scale advantages and proprietary technology, both of which were key factors when contemplating the Anadarko acquisition. The proximity and scale of Anadarko's Permian assets were an ideal fit per management's viewpoint. OXY's subsurface modeling technology for shale properties has led to meaningfully better drilling efficiency, while their leadership in CO_2-enhanced oil recovery allows them to more completely extract hydrocarbons and extend the production life of shale wells. Management estimates more than $3 million per well drilled in cost savings in the Permian under OXY's ownership, with a total of $600 million in drilling cost savings by 2021 for Anadarko assets and more than $2 billion in total cost synergies.

Often, discounted share prices involve buying into either poor execution or deteriorating industry fundamentals. Neither was the case here as OXY has been executing at a high level and the outlook for oil producers looks attractive in the near-term. We believe we have acquired a high-functioning operator with high quality assets at a deeply discounted price. As negative sentiment dissipates, we expect OXY's share price to recover.

During Q4 we sold our position in PINC as the long-term nature of their contracts were called into question. While we still look favorably on the company and its fundamentals, the risk side of the equation shifted a little too far for our comfort and we elected to sell.

Fixed Income Update

During Q4 2019 our bond portfolios experienced an above average number of calls (companies redeeming their bonds prior to maturity), and the call activity continued into January. In total 5 bonds were called during Q4, and another 2 bonds were called during the first two weeks of January. This level of call activity might not sound material, but when viewed against a total bond portfolio of 28 holdings, it's a lot. We added one new bond to our portfolio in Q4.

The interest rate environment today makes it challenging to replace these called bonds. The bonds we lost were on average yielding 5.7%, and the yield on the bonds available to replace them is 3.5% - 4.00%. We do not believe reinvesting at the current yields is prudent. Rather, we prefer to be patient and wait for more attractive opportunities to materialize.

Our taxable fixed income portfolios on average produced a +12.3% return in 2019. These returns are substantially above what we would typically expect. We do not expect these types of returns to repeat in the coming year. In general, the corporate bond market is stable but with limited opportunity to safely deploy capital at yields much above 4%.

Today, our corporate bond portfolio has a yield to maturity of 4.30% with an average maturity of 4.2 years. We added one new corporate bond to the portfolio in Q4 2019.

Our municipal bond portfolios on average delivered a +5.7% return for 2019. Similar to our corporate bonds, these returns are quite strong, and we do not expect similar returns to be available in the coming year. Today we're able to purchase municipal bonds with maturity of 10 – 12 years at yields of 2.0% - 2.25%.

Real Estate

We completed one new real estate investment in Q4 2019. Overall our real estate portfolio continues to perform well and is expected to deliver attractive returns in 2020. A more detailed description and update can be found in the "Real Estate Update" included with this letter. Please note – the format for this report has changed.

Private Equity

We did not make any new private equity investment in Q4 2019. We currently have two new investment opportunities in our pipeline and will update you on our progress later in Q1 2020.

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

Concluding Remarks

Returns across all our four investment classes were strong in 2019. Despite material appreciation in all asset classes we are still uncovering attractive investment opportunities that meet our criteria of quality and margin of safety.

Sincerely,

Russell Silberstein