CARMEL | CAPITAL PARTNERS

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Q1 2020 Commentary

General Commentary

The first quarter of 2020, and thus far for the month of April, will be remembered for many firsts. I do not want to use this letter to review the events that have been so widely reported. Instead, I would like to focus on the actions we have taken as it relates to our investment portfolios. Specifically, I will address what happened, what is happening now, and what we believe is ahead. I will reserve the Q2 2020 or Q3 2020 letter for a more detailed assessment of where we believe the investment landscape is heading.

Before doing so I believe it is helpful to frame what has occurred in the financial markets in terms of price changes, specifically the often-used benchmark indexes. As a refresher, the S&P 500 is an index of 500 mostly large companies, the Dow Jones 30 is also comprised of large companies but only contains 30 constituents, and the Russell 2000 is a broader measure of stocks that includes large, medium and small sized companies.

The first column in the below table shows index performance from January 1st, 2020 through the March 23rd lows. The second column shows where the indexes are today relative the start of the year.

	March 23rd Low	Year-to-Date thru April 30th
S&P 500	-31.83%	-9.42%
Dow 30	-35.90%	-14.32%
Russell 2000	-41.80%	-21.05%

In looking at the table one can observe that larger companies delivered better relative performance vs. medium and small companies, as evidenced by the poor performance of the Russell 2000 relative to the S&P 500.

Further, the COVID-19 shelter in place mandate is having a disproportionate impact on certain industries. For example, hotels, real estate, leisure, financials, energy, and industrials have all declined significantly more than the indexes. On the other side of the performance spectrum is any company benefiting from the quarantine - this includes grocery, online technology, cloud, and consumer staples. Lastly, because the S&P-500 is dominated by larger technology and consumer companies (such as Microsoft, Apple, Amazon, Facebook, and Google) this index has declined far less than the broader market.

I am highlighting the above because simply looking at the S&P 500 or the Dow 30 can lead one to believe that the COVID-19 impact on the "market" has been quite benign. The reality is most company's stock prices are still materially lower than the start of the year.

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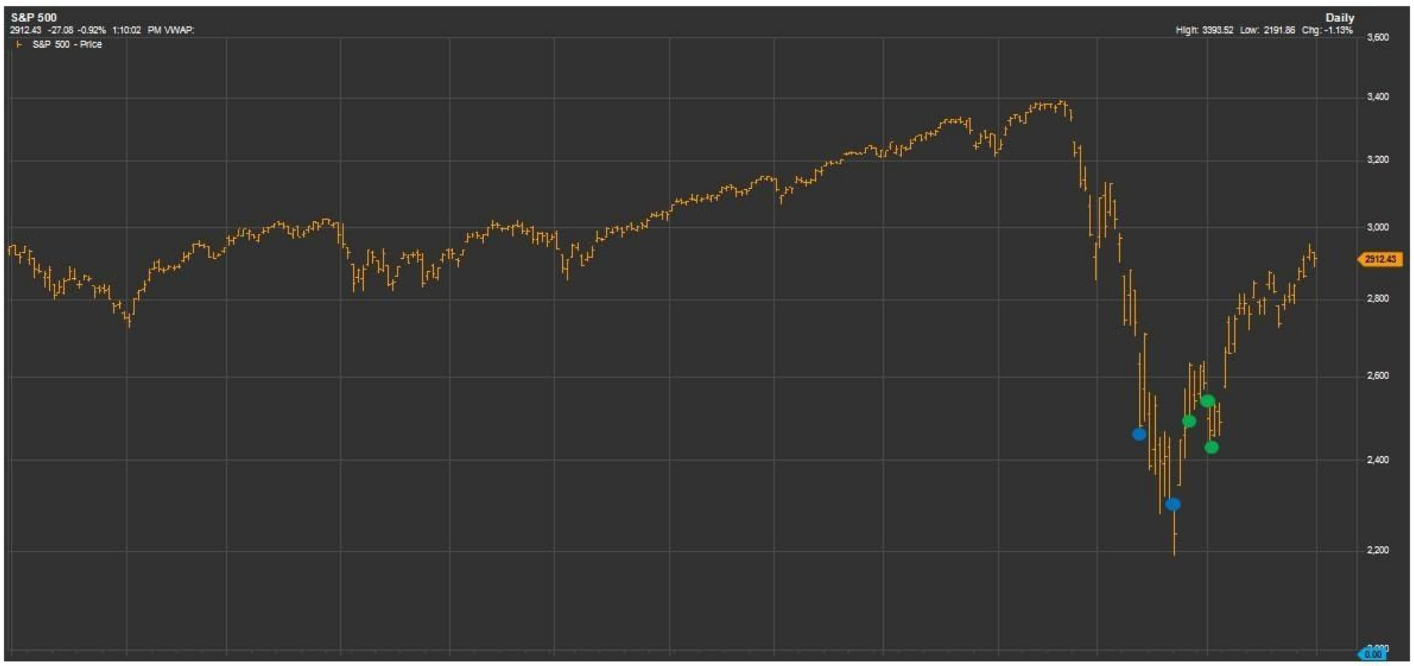
What Happened

Our portfolios entered 2020 with above average cash balances in our fixed income portfolios (20%) and average cash balances in our equity portfolio (10%). As the COVID-19 pandemic unfolded all financial assets declined in unison. Stocks, corporate bonds, and Real Estate Investment Trusts (REITS) all declined through the month of February and through March. As the Federal Reserve and the Treasury announced never before seen stimulus actions, the financial markets stabilized and eventually reached a low point on March 23rd.



New Position (s)

Added to Existing Position (s)

Since the March 23rd market lows, the equity markets and fixed income markets have recovered substantially. However, the recovery has been uneven across many sectors and industries. <u>During this time, we did what we have always done during these sharp and painful market declines – we deployed capital in two ways – we purchased new investments and added to existing investments.</u> The above chart shows the S&P 500 index with dots overlaid indicating the days where we were adding new positions as well as adding to existing positions. As the market recovered, we have slowed our buying activity. If the market begins to fall again, we expect to continue with the same strategy of adding new investments and adding to existing investments.

<u>**What's Happening Now**</u>

As I write this letter the financial markets are working through the daily news flow and desperately trying to determine when, if, and how the economy begins to open and commence its journey towards normalcy. Investors are attempting to identify those companies that will not make it to the other side, those companies that will emerge stronger, and those that will take substantially longer to recover.

The daily gyrations we observe indicate that the path higher will continue to be volatile. Consequentially, we fully expect there to be many false starts over the coming quarters. We are prepared for this outcome and will act as outlined above.

On a positive note, the numerous actions taken by the Federal Reserve and the Treasury are slowly starting to work their way through the economy and, as each day passes, assistance is arriving for those that need it.

<u>**What's Ahead**</u>

We have no special knowledge about where the equity markets will be one week, one month, or even one year from now. With the torrent of daily news, we have elected to keep it simple and focus on the three key elements we believe are necessary for a sustainable economic recovery to take place. Keep in mind I/we have no medical training and will never be confused for a professional epidemiologist. With that disclaimer out of the way, the three items we are focusing on are:

1) Anti-Viral Treatments
2) Testing
3) Vaccine

While there will be much news around unemployment, stimulus, new COVID cases, second wave, and the list goes on, we believe that certainty regarding the above three is what's required to place the economy firmly on a path to recovery. The most likely path forward for consumers and business will <u>**not**</u> be dictated by what the government decides can and should be open. Rather, we believe the journey towards recovery will be dictated by consumers and business <u>feeling safe or not safe.</u> Which side of this spectrum you lean will be determined by how close or how far you as an individual believe we are to achieving the above three items. We believe that consumer and business confidence will grow if there is clarity on treatment availability, the ability to test on a broad national scale (allowing for early warning and tracking), and lastly, long-term planning will begin once we have a vaccine that is widely available.

Our working assumption is that clarity on these three items will be available within the next 9 to 12 months and we are investing with this framework in mind.

Equity Update

As mentioned above there is a wide dispersion of individual stock performance across our equity portfolios.

As expected, our holdings in leisure, and hospitality were severely impacted by the travel halt. Included in this group are Extended Stay American (largest limited service extended stay hotel chain in the US) and Red Rock Resorts (largest locals casino operator in Las Vegas) and Disney (parks, hotels, and cruise).

Along with leisure our REIT holdings have also been negatively impacted, the largest being Seritage. The company is in the middle of a multi-year process to repurpose and re-rent many of the existing Sears retail locations. Seritage is redeveloping these sites into high end retail, mixed use office, and just recently announced it will be building 6,000 apartments across its portfolio. We continue to believe Seritage can create substantial shareholder value, but in interim investors are quick to sell anything retail real estate related. We expect Seritage to see little to no rent collected for the next 90 days but do believe they have the necessary resources to sustain themselves through the crisis.

We were very active during Q1 2020. We added 7 new equity investments and sold 5.

In an effort to provide a timely view of the portfolio performance, the following information is as of April 30, 2020. Our equity accounts on average declined -20.5% through April 30, 2020.

During the quarter we initiated new positions in Agilent Technologies (A), API Group (APG), Cintas (CTAS), Crown Holdings (CCK), Formula 1 Group (FWONK), Spotify (SPOT), and Zillow (Z)

During Q1 2020 we sold AutoNation, Mohawk, Fiat Chrysler, Abiomed, and Axalta.

Agilent Technologies (A) / Market Cap $23.5 Billion

Agilent is a leading laboratory equipment and analytical measurements company that sells instruments, consumables, and services that assist life sciences, food, manufacturing, and chemicals companies in measuring and analyzing biological and physical properties of products manufactured. The business model is the quintessential “razor blade/ razor” model where Agilent sells lab equipment and then provides consumables and services for many years post sale.

The company operates in a consolidated industry (top 5 companies account for 75% of the market) where it is the number one player with a 20% market share. Agilent has a conservative balance sheet and is well positioned to drive improved profit margins as they accelerate the sale of higher margin service contracts and consumables.

In a world where life sciences (biotechnology and large pharmaceutical) has a vital role to play in improving and extending the lives of an aging population, we believe Agilent has a significant role to play.

The recent market downturn allowed us to add a high-quality company to our portfolio at a discounted valuation.

API Group (JJAQF) / Market Cap $1.2 Billion

API Group provides essential services and solutions that assist buildings and infrastructure assets with safety and security needs. The company is a leader in offering life safety, fire protection, and sprinkler installation and services.

API's customers are required by law to test and maintain their systems on a regular basis and thus API has an attractive recurring revenue model.

The current management team has a well-developed plan to build shareholder value through both organic growth and acquisitions. The company operates in a fragmented industry and has a documented track record of using acquisitions to create shareholder value.

Cintas (CTAS) / Market Cap $19.4 Billion

Cintas operates weekly delivery routes that provide uniform and other textile rental/laundry services along with safety and cleaning supplies replenishment to more than one million businesses in the US. More than 95% of its revenue are covered by long-term service contracts, although volumes can be variable based primarily on customer/employee headcounts.

This is a high-service business that relies on scale and route density built around large distribution/laundry facilities with one-to-one direct relationships between customers and route drivers. Highly focused on employee professionalism and customer satisfaction, the business has seen minimal account loss even during recessionary periods, all the while growing consistently over business cycles through expansion of service routes, account penetration, new product lines and acquisitions. Although CTAS is the largest operator in its industry, it continues to have a pipeline of acquisition opportunities, organic route growth, and the ability to leverage existing routes to sell more product and services with high contribution margins.

We view CTAS as a very high-quality business that generates high margins and is highly diversified by customer and industry. In addition, we very much like that management has run the business to benefit long-term shareholders with consistent top-line growth, margin expansion, dividends and share repurchases.

We added CTAS to portfolios after a price decline of nearly 50% from recent highs on the heels of the economic shutdown.

Crown Holdings (CCK) / Market Cap $8.2 Billion

Crown is one of three major manufacturers which produce 60% of aluminum cans globally, most of which are for food and beverage packaging. Aluminum is more desirable than other packaging alternatives from an environmental standpoint since it is 100% recyclable. Aluminum has been gaining share with craft beer producers because of its superior shelf-life, freshness, and increasingly premium perception, especially with newer form factors, such as slim cans. And in the US, aluminum cans are emerging as an ESG-friendly alternative for premium bottled water.

Crown operates a highly sustainable free cash-flow business serving mostly non-cyclical end markets in food and beverage, and to a lesser extent household products.

We added CCK to portfolios after the stock price experienced a more than 30% decline. While certain parts of its business will see reduced demand in this economic environment, food and beverage demand is strong and overall, the company is seeing minimal demand disruption relative to most businesses.

Formula 1 (FWONK) / $16.3 Billion

Formula 1 owns and operates the Formula One World Championships, a nine-month long motor racing competition that takes place in 21 countries across Europe, Middle East, and North and South America. The company earns revenue and profits through a combination of TV and online viewing, race day income, and advertising. Formula 1 racing has consistently been in the top 5 most watched sporting events globally for many decades. With drivers originating from many countries around the globe the sport's international appeal has expanded in recent decades. The company enjoys a mostly fixed revenue stream with annual guaranteed increases.

Formula 1 is a one of a kind unique franchise with many years of growth ahead, mostly driven by the addition of new races to the annual competition, increased online viewing, and expanded advertising revenues.

The stock price declined materially in response to the COVID-19 crisis and we took the opportunity to add a one of a kind high quality franchise to the portfolio.

Spotify (SPOT) / Market Cap $25.4 Billion

Spotify is the world's most popular audio streaming subscription service with a total of 271 million monthly active listeners and 124 million paid Premium subscribers.

SPOT's revenue is generated from monthly subscription fees it charges to premium subscribers (commercial free) and earns advertising revenue from commercials played for regular subscribers.

The company has established a sizable lead in the music streaming industry. More recently, SPOT has expanded its efforts in the Podcasting arena by purchasing its own original content.

We believe SPOT can continue growing its global subscriber base while at the same time rapidly growing the advertising revenue associated with its Podcasting segment. In the future, we expect SPOT to find new avenues to monetize its growing subscriber base and attractive proprietary podcast content.

Zillow (Z) / Market Cap $7.5 Billion

Zillow is the leading online provider of consumer information for the residential real estate market in the US. The company's high level of consumer engagement has enabled it to establish a dominant market position for advertising and lead generation among real estate agents, mortgage brokers, developers, and property managers. In addition to zillow.com, its online properties include Trulia, realestate.com, hotpads, StreetEasy, Naked Apartments and Out East.

The company's "Zestimate", a proprietary data-driven property value estimate, is checked by 90% of sellers prior to listing their home. After incorporating computer vision and Artificial Intelligence into its algorithms, Zillow can consider curb appeal and interior aesthetics. As a result, Zestimates have achieved accuracy within 2% of actual selling price for 50% of property sales. To further leverage its market position and analytics, the company began directly buying and selling properties two years ago, and subsequently acquired a mortgage brokerage.

Zillow's traditional business of advertising and lead generation results in high margins and free cash flow. However, the long-term upside to the business is management's "Zillow 2.0" strategy. This is a transformation of the business model from solely advertising and lead-generation to one that leverages its market knowledge to capture transactional revenue in the form of direct buying and selling of properties, direct financing, and eventually other ancillary services such as title insurance. Zillow is positioned to see market trends in advance thus allowing it to purchase homes in markets where demand is strong, and it can gain a pricing advantage. Zillow will then re-market inventory on their own platform with a one-stop shopping solution offering transaction, direct mortgage lending, title insurance and other buyer services. As this business scales, they will see cost savings and operational efficiencies which will be difficult for others to duplicate. Zillow's traditional advertising and lead generation business has an addressable market of around $20 billion; adding mortgage origination and direct buying/selling expands its market to an estimated $1 trillion.

We purchased Zillow in early February and then added to the position in mid-March as the market declined.

Fixed Income Update

We entered Q1 2020 under invested in fixed income due to the high call activity that occurred in the second half of 2019. While bonds are typically expected to be safe investments, they were not spared during the recent financial market decline. Thankfully, as of late April, many of our bond holdings have recovered.

In response to the COVID crisis, the Federal Reserve Bank drastically cut interest rates to the point where the 10-Year U.S. Treasury now yields 0.60%. Yes – that is correct, less than 1%. While these actions are expected to be simulative to the economy, it is possibly laying the foundation for a very challenging future for bond investors. Today our corporate bond portfolio has a yield of 4.52% with many of our high-quality bonds trading at a yield to maturity of 3%.

Through April 30, 2020 our taxable fixed income portfolios on average have produced a -12.8% return. We unfortunately had two holdings in the energy sector that have experienced a meaningful price declines, both these holdings impacted returns in Q1 2020. The balance of our holdings has delivered returns as expected.

Today, our corporate bond portfolio has a yield to maturity of 4.52% with an average maturity of 3.96 years.

The returns available in the municipal market are even less attractive with bonds trading at 2% - 2.5% yield to maturity.

Our municipal bond portfolios on average has delivered a -2.1% return through April 30,2020. We are not purchasing new municipal bonds for portfolios as we have growing concerns about the financial pressure that is building in many cities and counties around the country.

Real Estate

We did not make any new real estate investment in Q1 2020.

During Q1 2020 and thus far in April our real estate portfolio has performed well, and we are pleased with the resiliency of the assets we own. We believe the enhanced unemployment benefits and Paycheck Protection Funds will assist tenants and provide them with the financial resources to remain current on rents while they wait for the economy to reopen. We are monitoring our properties very closely and are in direct contact with property managers on a weekly basis. As of today, we do not expect to see any permanent impairment to any of our real estate holdings.

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

Private Equity

We did not make any new private equity investment in Q1 2020.

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

Concluding Remarks

We are prepared for additional volatility and fully expect the path ahead to be uncertain. However, we will continue forward and keep our core investment philosophy front and center – quality, margin of safety, and long-term horizon.

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 2019.