CARMEL | CAPITAL PARTNERS

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Q2 2020 Commentary

General Commentary

Since our last update we have seen the intensity of the initial COVID panic fade and an unfortunate new normal set in. We are witnessing a few industries stabilize but we have also seen large swatches of the economy continue to suffer. The numerous government stimulus plans have provided some stabilizing force; however, we are far from back to normal.

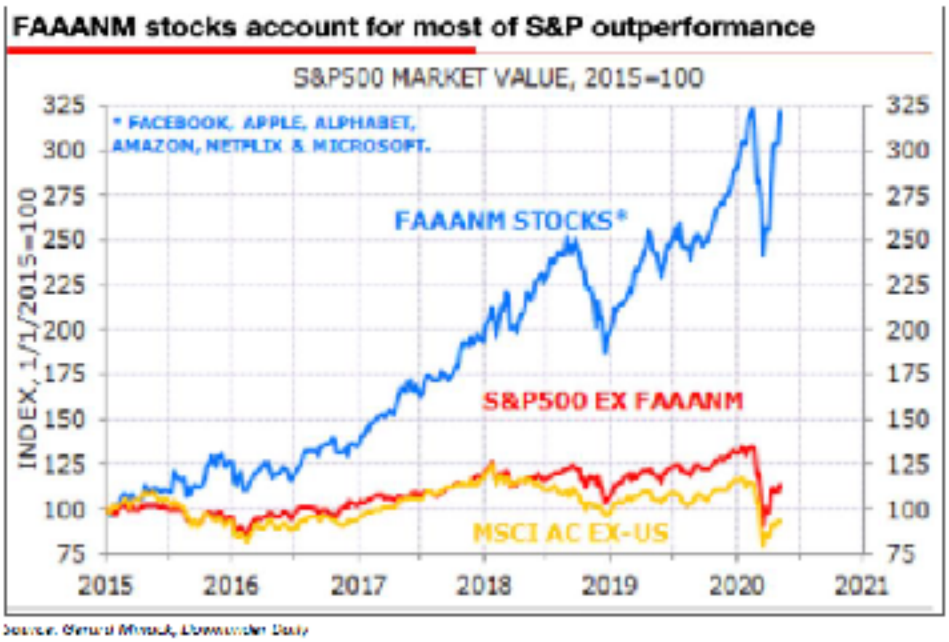
We continue to believe that anti-viral(s), testing, and vaccines are still the three items to focus on when it comes to driving a sustainable economic recovery. We have better visibility on the vaccine roadmap but still a healthy amount of uncertainty around timing, and until news footage of a factory churning out millions of doses a month, business owners and CEO will remain guarded and in a defensive posture. To add to the challenges, financial results and economic statistics reported each month have been unreliable due to many outside influences – the biggest one being the various financial stimulus plans offered by the government.

There are two primary stimulus plans that phased out at end of July, first, Paycheck Protection Plan (PPP) initially distributed on April 1st and two, enhanced unemployment benefits of $600 / week. As this letter is being written it appears likely the government will reload on the unemployment benefits (however at a lower rate) and possibly a new version of the PPP. It will be sometime before we see the true strength of the economy, and how it is functioning without economic training wheels. We too remain guarded until we can get a better understanding of the investment landscape. However, the lack of clarity has not prevented us from continuing to invest capital. We added 5 new public equity investments in the quarter, and in early July closed our first real estate investment since November 2019. We also continue to work on several new private investment opportunities.

The return dispersion identified in the Q1 2020 letter has continued as evidenced by table below. The tech heavy SP-500 continues to deliver returns at a higher rate versus the broader market.

	March 23rd Low	Year-to-Date July 30th
S&P 500	-31.83%	-0.13%
S&P 500 Equal Weighted	-37.71%	-8.59%
Dow 30	-35.90%	-6.06%
Russell 2000	-41.80%	-11.84%

Looking back further in time this phenomenon has been at work since 2015. One can quickly conclude that if you did not own Facebook, Apple, Google, Amazon, Netflix and Microsoft, and have then occupy 15% to 25% of your portfolio, you generated significantly lower returns relative to the "market." The below chart shows just how wide this performance gap has been, effectively showing that the SP-500 excluding the top 5 has generate a 12% return over the past 5 ½ year – that's total return and not an annual return.



Our equity portfolio returns have been much improved since the market bottomed in March 2020 when we used the market decline to add high quality companies at very attractive valuations. If the equity market continues to gyrate, or experiences another sizable decline, you should expect us to continue forward with the same strategy of add to our equities.

Equity Update

Our equity portfolios delivered strong returns since the market bottom on March 23rd and on average have appreciated +48.6%. Year-to-date returns through July 30th on average for equity portfolios is -8.1% as we still work to make up for lost ground heading into COVID. The equity markets have continued to offer us opportunities to invest in high quality companies at attractive valuations and thus we continue to allocate capital where appropriate. In Q2 2020 we added three new investments and sold four. Of the 35 stocks we hold 16 have been added year-to-date in 2020 as we have used the COVID sell off to add high quality durable companies to our portfolio. In some cases, the companies we sold were still viable and attractive investments, but we made the decision to replace them where we believed the risk vs. return was more favorable and there was less cyclical economic exposure.

During the quarter we initiated new positions in Elan Co Animal Health (ELAN) Google (GOOG), Otis (OTIS), Grocery Outlet (GO) and LKQ Corporation (LKQ)

During Q2 2020 we sold Discovery Holdings (DISCK), Seritage (SRG), Brookfield Properties (BPY), Cleveland Cliffs (CLF)

Otis Elevator (OTIS) / Market Cap $25.1 Billion

Otis is the world's largest elevator company, selling new elevators and providing multiyear follow on service and repair. For many years Otis was division of United Technologies until it was spun out as a separate company April 3rd, 2020.

Otis operates the classic "razor blade / razor" business where it sells and installs an elevator in a building and then signs a multi-year service and repair agreement. Otis's service business is recession resistant because local building codes and regulations require mandatory ongoing maintenance and service for installed elevators.

While the new installation business is slow growing it is the service busines that represents opportunity. There are 16 million elevators in the global installed base. OTIS currently services 2 million, another3 million are serviced by OTIS's main competitors, and the remaining 9 million are serviced by independent service providers. It is the 9 million that OTIS has its eye on. As elevators become more digitized it will become increasingly tough for independent service providers to service these advanced elevators. In addition, OTIS has invested a sizable amount of capital in arming its technicians with the necessary tools to service each elevator unit more efficiently. When a technician arrives to service the elevator, they already know what has failed and needs servicing (due to advanced sensors) and have already ordered the necessary parts. Previously a service call that would have required multiple trips now can be done in one. OTIS plans to grow its service busines both organically and by acquiring independent service provides.

While we expect a near-term slow-down in new construction due to COVID we do not expect a slow-down in the service business. We expect OTIS to continue to driving revenue grow as it executes its service initiative over the next 3 – 5 years.

Elanco Animal Health (ELAN) / Market Cap $9.4 Billion

Elanco is 4th largest animal health company in the world. It was previously part of Eli Lilly Pharmaceuticals until September 2018, when it was spun out as a separate company. ELAN develops, manufactures, and markets health products for both companion animals and food animals.

Since spinning out as a separate company the CEO has executed a multiyear plan to significantly boost profit margins, expand distribution channels, and accelerate new product introduction.

On August 20, 2019 Elanco announced its intent to acquire Bayer's animal health business. Completing this acquisition will allow ELAN to further expand its profit margins beyond its original target, increase its exposure to the companion market, and expand its geographic footprint. By increasing its exposure to the companion animal market ELAN will better capitalize on the trend of increasing pet ownership, extended life span of family pets, and the increasing amount of pet medications purchased outside the veterinary clinic.

Lastly, we expect the Bayer acquisition to deliver increased benefits from costs saves and better leverage of R&D budgets. The combined company will have a robust new product pipeline that will drive sales and profits for several years.

Alphabet (GOOG) / Market Cap: $1.0 trillion)

Alphabet is one of the world's leading technology services companies, operating diverse businesses under brands which include Google, YouTube, Pixel, Nest, and Waymo. GOOG derives more than 80% of its revenues ($135B last year) from online advertising. Google Search is its largest ad business with additional sources including YouTube, Gmail, Maps, Google Play and partner websites. With 40% of overall advertising spending still occurring offline, online advertising has not yet matured. GOOG's ad revenues increased 15% last year and 10% in a difficult Q1 environment. Google Cloud, one of the 3 major public cloud providers (along with Amazon and Microsoft) provide outsourced computing infrastructure and software. Google Cloud accounts for 7% of revenues and is growing at a 50% annual rate. GOOG also invests in a portfolio of early-stage companies (its Other Bets segment) which generate minimal revenues presently but could develop into large businesses over time. Waymo (autonomous driving) is the highest profile business in this segment.

GOOG has $115B in cash on its balance sheet and is well prepared to continue investing in its Other Bets as well as its core businesses. We purchased GOOG at an attractive valuation given its attractive growth profile and the potential upside of its Other Bets.

The primary risk for shareholders relates to regulatory reforms and threats of anti-competitive lawsuits and fines. However, it is unclear how such threats could meaningfully impair the value and growth of GOOG's businesses. Experience has shown that regulators generally have limited success corralling market dominance in rapidly changing and complex businesses.

Grocery Outlet (GO) / Market Cap: $3.9 billion)

GO operates an asset-light grocery store business model that sells a combination of deeply discounted close-out inventory supplemented with discounted staple items through 355 stores located primarily on the West Coast. A typical Grocery Outlet shopper will spend 40% less than at a conventional grocer and 20% less than at discount grocer for comparable items. GO acquires its close-out merchandise at a substantial discount that arises from cancellations, manufacturer overruns, packaging changes and approaching "sell-by" dates.

The treasure hunt retail model is a well-known concept that was developed nationally by Ross Stores (ROST) for close-out apparel and household goods, and on the West Coast and in Pennsylvania (via acquisition) by Grocery Outlet. Unlike ROST, GO uses a franchise-like model in that it selects and trains entrepreneurs to start independent businesses to operate GO stores, with GO procuring inventory and real estate and providing support systems. GO has a market potential for 1900 stores and at its current 10% growth pace in store expansion it could expand for nearly 18 years just in current and contiguous markets.

Both near-term and long-term fundamentals look attractive. Historically, its stores have performed well throughout economic cycles. GO is not a franchisor, but it is similar in its ability to offer entrepreneurs a proven platform, product inventory and support services, providing them an opportunity to build and manage their own business. As an investor, GO provides a portfolio of sustainable stores with consistent returns and a clear path to a much larger store footprint.

LKQ, Inc (LKQ) / Market Cap: $8.4 billion)

LKQ is the largest distributor of alternative (non-OEM) replacement parts in the US, Canada, and Europe. The company sells salvaged, refurbished, remanufactured and new aftermarket parts to collision and mechanical repair shops. It also sells specialty (upgrade/custom) aftermarket parts and accessories for trucks, vans, SUVs, muscle cars and RVs. It was formed in 1998 through an initial roll-up of several recycled parts businesses and has since completed 280 acquisitions. Management estimates that it is 20 times larger than its next competitor, however the market still is fragmented providing substantial growth potential from its current market share of 6%-7%.

LKQ has multiple size advantages, including technology integrations, high-fill rates (availability) for parts, fast delivery with in-house fleets, giving it preferred supplier status with its customers and insurance payors. The inability of smaller competitors to implement technology cost-effectively or to be a broad-based solution to larger partners should continue to result in share gains for LKQ. As the first mover, and to date only mover of size to consolidate the industry, the company has established a strong and sustainable market position with a long runway for growth. Greater density in North America will lead to margin expansion, while in Europe margins will benefit from an ongoing restructuring program including the rollout of a common technology platform.

LKQ's share price has stagnated in recent years because of operational issues in Europe, specifically a large acquisition in Germany. Management has indicated that it has Europe on the right path and expects operating profits to increase substantially over the next several years. The issues in Europe and the negative impact on the stock price, provided us with an attractive entry point.

Fixed Income Update

During Q2 2020 our corporate fixed income portfolios continue to recover lost ground. The historic low level of interest rates, and the first-time purchase of corporate bonds by the Federal Reserve has help drive bond prices higher. As prices have moved higher the landscape for fixed income investors has become challenging. With elevated prices where they are today, and the associated ultra-low yields, we do not expect to make any additional bond purchases going forward. In the current environment we believe that on an after inflation and after fee basis owning fixed income is a poor use of capital. We will maintain our existing bond portfolio until our positions are either called away or mature. When, or if, the environment changes to where we believe a reasonable return is available, we will once again purchase fixed income.

Through July 30, 2020 our taxable fixed income portfolios on average have produced a -7.5% return. Similar to our equity portfolios we have seen our bonds stage a strong come back from the March lows. Our exposure to a handful of cyclical bonds has impacted year-to-date performance, but we expect our existing holdings to continue to recover as the economy recovers. Today, our corporate bond portfolio has a yield to maturity of 4.59% with an average maturity of 3.61 years.

The returns available in the municipal market are even less attractive with bonds trading at 1.5% - 2.5% yield to maturity. Like corporate bonds we do not expect to add new municipal bonds to our portfolios.

Real Estate

We did not make any new real estate investment in Q2 2020 but did close one new investment in Atlanta just after quarter end.

Our real estate portfolio thus far in 2020 has shown to be quite resilient. However, we are still cautious as we wait to see how tenants perform in the absence of government stimulus that supported the economy since COVID began. Based on the performance of our properties year-to-date 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 Q2 2020

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

Concluding Remarks

In today’s world there is plenty to be cautious and concerned about. A quick scan of the headlines will cause even those with the strongest constitution to swallow hard – COVID, high un-employment, social unrest, and election year politicking. However, the U.S. has been challenged many times in its 244 years. Our fighting spirit, desire to persevere, and our appetite to fight for a better tomorrow ultimately pushes us forward to a brighter future. No doubt we’re in some rough waters but we continue to believe in the long-term viability of our form of government and the resiliency of our economy – we believe we’re going to make it, and we continue to invest as such.

Sincerely,

Russell Silberstein