To: Clients of Eagle Point Capital
From: Matt Franz and Dan Shuart, Principals
Subject: Fall 2020 Portfolio Update
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In this update, as in previous, our objective is to explain what you own and why you own it. As long-term owners, we focus on the key factors that drive the businesses behind our stocks. This letter aims to delineate those so that you, too, can focus on fundamentals rather than price.

Stock prices, as you have undoubtedly noticed, are volatile. They are often more volatile than their underlying businesses. These mismatches provide us with opportunities to buy companies for less than their value to an informed private buyer. The gap between the price we pay and the value of the cash flows we receive provide two benefits:

1. A margin of safety against an uncertain future; and

2. The potential for the stock to outperform its underlying business.

To capitalize on a mismatch between price and value, we need to know what the business is worth. Investing awards no points for difficulty, which is why **we prefer to own simple, predictable, and profitable companies in "replication mode" that are not subject to rapid change. Our main advantage in this pursuit is thinking longer term than others are willing to.** Our attitude is that of a long-term private owner whose investments happen to have daily quotations.

Many of the world's most successful investors use this approach. Jeff Bezos, the founder of Amazon, is one of them. In a 2011 interview with *Wired*, he explained:

> *If everything you do needs to work on a three-year time horizon, then you're competing against a lot of people. But if you're willing to invest on a seven-year time horizon, you're now competing against a fraction of those people, because very few companies are willing to do that. Just by lengthening the time horizon, you can engage in endeavors that you could never otherwise pursue.*

We call this "time arbitrage" — buying on bad news when we're optimistic about the long-term. It's trading short-term pain for long-term gain. Pessimism creates low prices, and low prices offer the potential for outsized returns.

Time arbitrage works best on businesses levered to what won't change. Jeff Bezos explains:

I very frequently get the question: "What's going to change in the next 10 years?" That's a very interesting question.

I almost never get the question: "What's not going to change in the next 10 years?" And I submit to you that that second question is actually the more important of the two.

You can build a business strategy around the things that are stable in time. In our retail business, we know that customers want low prices, and I know that's going to be true 10 years from now. They want fast delivery; they want vast selection. It's impossible to imagine a future 10 years from now where a customer comes up and says, "Jeff I love Amazon, I just wish the prices were a little higher." Or, "I love Amazon, I just wish you'd deliver a little slower." Impossible.

So we know the energy we put into these things today will still be paying off dividends for our customers 10 years from now. When you have something that you know is true, even over the long term, you can afford to put a lot of energy into it.

Most businesses are subject to rapid technological change, fierce competition, or changing consumer preferences. By contrast, each of our businesses solves fundamental human needs or meets timeless desires. Further, our businesses are in replication mode. They have proven business models, good unit economics, and a "moat" to protect them from the competition. They merely need to continue doing more of what has already made them successful.

Though the world may appear different than six months ago, human nature has not changed in millennia. We humans still seek lower prices, faster service, higher social status, greater comfort, novel experiences, and deeper social interactions. Our businesses meet these desires.

Nevertheless, the pandemic has affected all of our businesses to varying degrees. While near-term results are likely to dip, our companies are positioned to emerge stronger. The pandemic has largely accelerated, rather than reversed, trends already in place. Some trends were nascent, and others, well established. Regardless, the strong are getting stronger while the weak are getting weaker. Our businesses are almost universally now in a stronger competitive position than they were six months ago.

The rest of this letter shares our thoughts on the pandemic's impact on each of our businesses, our assessment of their long-term earnings power, and the key factors driving their growth.

Keep in mind that a business's value is equal to the present value of the cash it generates over its life. Price-to-earnings ratios try to represent this duality. In the best of times, P/E ratios offer a ballpark estimate. During unusual times like the present, they are nonsensical. Trailing earnings simply do not reflect anything close to the normalized earnings of most businesses.

The only way to value a business today is to dig into its financials and estimate its earnings power from first principles. This is what we do. It requires significant discretion, and time may prove some of our assumptions faulty. We hope to be directionally right, if precisely wrong. We intend to buy with a wide enough margin of safety to absorb any errors.

Altria

Altria is the largest tobacco company in the U.S. It owns Marlboro and other Philip Morris trademarks in the U.S., 10% of A.B. InBev, 35% of Juul Labs, and 45% of Cronos. These investments give it broad exposure to leading alcohol, tobacco, e-vapor, and cannabis brands. We don't know precisely how e-vapor, cannabis, or heat-not-burn tobacco products will fare relative to traditional products, but sleep well knowing Altria has its bases covered.

Altria continues to trade well below the market's average valuation. However, this isn't out of the ordinary. The stock has spent a good deal of its history among the cheapest stocks in the market. Nevertheless, it was the best performing stock from 1963 through 2013, returning 20.23% annualized. That's over one million percent in total appreciation.

Altria typically pays out 80% of earnings as dividends. Today this produces an 8% dividend yield. So long as Altria continues to generate cash, shareholders will benefit, either through capital return or capital appreciation.

Altria's outstanding historical performance is the result of its strong competitive position. Michael Porter's "Five Forces" illustrates Altria's strength.

1. **Bargaining Power of Customers** — Despite the known health risks, humans love tobacco. Consumption dates back over 5,000 years. For many, tobacco is an affordable luxury that offers a momentary escape. This, combined with nicotine's addictiveness, makes consumers insensitive to price increases. Altria typically raises prices a few percent twice per year. Pricing power is perhaps the most valuable business quality because it produces growth without any cost: an infinite return on investment. U.S. cigarette consumption has dropped 44% since 1981, but pricing power has allowed Altria's stock to rise 71,000% since then.

2. **Bargaining Power of Suppliers** — Tobacco leaf is the most expensive ingredient in a cigarette. Since many farmers produce suitable tobacco, Altria can shop for the lowest price. This gives Altria's suppliers little power over it.

3. **Threat of New Entrants** — The U.S. government banned T.V. and radio advertising in 1971 and all other forms in 1998. That entrenched the existing player's market share. New entrants no longer have the means to build a brand, which is a strong deterrent.

4. **Threat of Substitute Products** — New nicotine-delivery mechanisms have recently emerged and could threaten Altria's cigarette business. These include e-vapor products like Juul and heat-not-burn products like IQOS. Fortunately, Altria is hedged. It owns 35% of Juul and the U.S. rights to IQOS. No matter where consumer preferences drift, Altria will be there.

5. **Intensity of Competitive Rivalry** —Tobacco is now an oligopoly. The few remaining firms compete rationally and not on price. They tend to raise prices in tandem, which avoids price wars and protects margins.

Altria has performed well amidst the pandemic. Tobacco use soared as discretionary income and free time increased. Adjusted earnings per share rose 8.5% year over year.

Altria trades for around 9x 2020's expected earnings. This is a bargain considering our expectation of mid-to-high single-digit growth. If Altria's investments pan out and don't cannibalize its traditional business, growth could be even higher. Altria's 8% dividend looks secure and adds further to total return. A multiple re-rating towards Altria's historical median (16x) would be the cherry on top.

American Express

American Express operates a closed-loop payment network. They earn interest on loans, card fees, and a percentage of each transaction on their network (2.37% in 2018 and 2019). The company's customers are affluent and spend significantly more, on average, than Visa, MasterCard, and Discover's customers. This allows American Express to:

- charge merchants higher fees;
- offer cardholders attractive rewards; and
- maintain a high-quality credit portfolio.

These factors reinforce each other in a positive feedback loop to produce high returns on equity (ROE). Last year American Express earned 29% on equity. Its lowest ROE in a decade was 15% in 2009. Despite the headwinds, American Express remains profitable in 2020.

American Express's counter-cyclical balance sheet helps to make it resilient. During recessions, loans and receivables decline as consumers and businesses pare back spending. This causes their credit portfolio to shrink precisely as defaults jump.

This has two important implications:

1. Although net write-off rates may rise this fall, they will be on a smaller base. Existing reserves will cover a larger portion of loans than they appear to today.
2. Decreasing loan balances release capital and fortifies American Express's balance sheet.

Credit quality is remarkably good given the circumstances. August was the best month for consumer credit in a year and for small business credit in three years. This is a testament to the company's forbearance programs and government stimulus. However, we are not out of the woods yet. As stimulus and forbearance wind down, we expect charge-offs to rise.

American Express is prepared if that happens. They carry significant excess capital and credit loss reserves equal to 8.1% of total loans. For scale, loss provisions peaked at 7.8% in 2009. Q2 net write-offs were only 4%. If credit remains this strong, loan loss provisions will decelerate. However, what happens next quarter is of little consequence. What matters most is spending on Amex's network.

Spending bottomed in April down 40% and ended Q2 down 25%. Travel and entertainment (T&E) spending are down 75% while everything else is collectively up 5%. This implies that when T&E returns, total spending will reach new highs.

There are two reasons to be optimistic about T&E. First, spending is strong on co-brand cards with partners like Hilton and Delta. Consumers are using these cards for non-travel purchases to accrue points for future trips. Amex has also seen a substitution effect. Air travel spending has shifted to rental cars, and hotel spending has gone to Airbnb and VRBO. People still want to travel and are. When it is safe, old patterns will likely re-emerge.

We estimate the company's normalized earnings power at $6-7 billion. That's based on 2019's spending level and 3.0% through-cycle credit costs. The company is worth about $75 billion today, or 10-12x normalized earnings. This seems cheap. A decade from now, there will be more money spent than today, if for no other reason than inflation. And credit cards will likely garner a more significant percentage of total spending. Amex's spend-centric business model is well-positioned to benefit.

Over the long-run, we expect American Express to grow about 5% annually, which assumes a 40% incremental return on invested capital and a 13% reinvestment rate. Both are in-line with pre-pandemic results. Shares sport a 2% dividend yield, and buybacks could add another 6%. A multiple re-rating over five years (to 14x, its long-term median) would add another 2% to annual returns. Altogether, we think American Express stock can compound at double-digit rates over many years.

AutoZone

AutoZone is one of the largest auto parts retailers in the U.S. We purchased shares this spring at a decades-low valuation. They have since risen roughly 70%. We continue to see value in the business and stock.

We love AutoZone's incentive compensation structure. 90% of the CEO's pay and 78% of officers compensation is at risk. They only get paid if they perform. Performance is measured by operating income and return on invested capital (ROIC). You very often get what you incentivize, which is why AutoZone's ROIC hasn't dipped below 37% in a decade.

We also love management's "no-brainer" approach to capital allocation. All capital that can't be reinvested in the core business at 30%+ rates is returned via repurchases. Share count has declined more than 70% (8% annually) the past fifteen years. Despite this large payout, sales have grown 5% annually. AutoZone's business model is squarely in replication mode, so we expect this growth to persist.

Two key factors drive demand for auto parts: average vehicle age and miles driven. Average vehicle age was 11.8 years last year, the 8th consecutive year above 11. AutoZone benefits most when cars are at least seven years old because required maintenance increases and warranties expire. Recessions encourage owners to hold onto their cars longer and do more maintenance themselves. Both of these play to AutoZone's strengths and made AutoZone one of the best performing stocks on the New York Stock Exchange during the 2008 financial crisis.

Miles driven tends to rise steadily over time. Initially, lockdowns dramatically reduced miles driven as commuting stopped. More recently, a resurgence of road trips has partially mitigated the decline. We expect this to a blip in the long-term trend.

Last quarter same-store sales grew 22%, a record. Year-over-year same-store sales rose 7.4%, share count decreased 5.5%, earnings per share increased 13%, and return on invested capital hit 38%. By all accounts, AutoZone is firing on all cylinders. In response to growing demand, AutoZone plans to hire 20,000 "AutoZoners" this year.

AutoZone enjoys substantial competitive advantages (a "moat") that we expect will lead to years of continued growth. Customers go to AutoZone for quality parts and immediate availability, which requires a vast inventory of low-turning SKUs. Typically, this would hamper ROIC.
To overcome this, AutoZone uses its scale to bargain with suppliers for extra long payment terms. As a result, AutoZone typically sells its inventory before it's paid for it. This generates negative working capital and means AutoZone's suppliers finance its massive inventory for free. The company's mom-and-pop competitors cannot match this.

AutoZone's customers are not particularly price-sensitive, which allows for healthy gross margins and rational competition. Customers choose AutoZone for convenience and the free advice of each store's knowledgeable staff. The internet cannot easily replicate this. AutoZone's bulky and expensive-to-ship inventory strengthens its moat against online competition. Consumers who insist on shopping online can do so at AutoZone.com.

AutoZone earns solid (~30%) returns on reinvested capital and should grow 4-5% organically through new locations, expansion in Mexico, and a growing commercial presence. Its robust buyback program should further increase earnings per share. We expect low double-digit growth for many years.

The pandemic may present new opportunities to take share from weaker mom-and-pop competitors. The auto parts market is highly fragmented, so market share gains aren't zero sum between AutoZone and O'Reilly .Incremental sales tend to carry excellent margins as AutoZone leverages its fixed costs.

Berkshire Hathaway

Berkshire Hathaway is a large conglomerate assembled by Warren Buffett. It owns businesses ranging from GEICO and See's Candy to the BNSF railroad, gas pipelines, and several electric utilities.

Book value is one crude indicator of Berkshire's intrinsic value. For most of Berkshire's history, Buffett used change in book value as a proxy for growth in intrinsic value. Now that more of Berkshire's value resides in its wholly-owned subsidiaries, book value is less relevant. Nonetheless, it still has some utility in the back-of-the-envelope sense.

Until late 2018, Buffett said he'd repurchase Berkshire shares at or below 1.2x book value. He also said he'd only repurchase shares at a significant discount to intrinsic value. We think this implies 25% or more. That places intrinsic value around 1.6x book value or $284 per share. Late in 2018 Buffett removed the 1.2x repurchase limit, implying that Berkshire is a bargain even above that valuation.

A more comprehensive way to value Berkshire is the "five groves" method outlined in Berkshire's 2018 letter. This frames Berkshire as the sum of five groves of businesses:

1. **Non-insurance Wholly Owned:** Berkshire's non-insurance businesses include the BNSF railroad, Berkshire Hathaway Energy, and a collection of manufacturing, service, and retailing (MS&R) businesses. Comparable market valuations suggest this group is collectively worth $300 billion.

2. **Marketable Equities:** Berkshire's stock portfolio is worth $200 billion. Apple accounts for almost half of this. Berkshire's next largest positions are Bank of America, Coca-Cola, and American Express. The top four positions are collectively 73% of Berkshire's portfolio, which is remarkably concentrated. On a look-through basis, Berkshire's marketable equities earned $9.5 billion over the last 12 months and $10.3 billion in 2019. Capitalized at the market's median P/E of 22x, they're worth $210-220 billion, which isn't far from their market value.

3. **Equity Method:** Berkshire uses the equity method of accounting when it owns enough of a company to exert "considerable influence" but does not own the entire company. Equity method investments include 26.6% of Kraft Heinz, 50% of Berkadia, 38.6% of Pilot Flying J, and 50% of Electric Transmission Texas. Berkshire carries these at $17 billion, making them a relatively minor component of intrinsic value.

4. **Cash:** Berkshire's cash hoard makes its balance sheet a fortress. Berkshire's reinsurance units hold most of the cash in t-bills. Lower rates have reduced interest received by a few billion since last year. Buffett views t-bills as a free option on future, higher-return investment opportunities.

5. **Insurance:** Insurance is the engine that drives Berkshire. Insurance companies accept policy payments upfront, payout claims down the road, and invest the float in between. Berkshire has historically underwritten at a 2% margin, meaning it gets paid 2% to hold its $131 billion of float. Year to date, float increased $2 billion, and underwriting profits totaled $1.5 billion.

   It's impossible to delineate where Berkshire's insurance operations end and the rest begins because float finances many of Berkshire's assets. To be conservative and avoid double-counting, we don't add any value for Berkshire's insurance operations since it funds the assets we've already valued.

Summing the five groves suggests Berkshire is worth about $700 billion or $293 per share. The book value method suggests shares are worth about $284, which is remarkably similar. In 2019 we valued Berkshire between $276 and $298 using similar methods, suggesting little change to intrinsic value despite the upheaval in 2020. This steadiness speaks to Berkshire's resilience.

If Berkshire compounds at 7% for the next five years, intrinsic value will exceed $400 in 2025. This is about double the current stock price and doesn't seem too far fetched as Berkshire currently earns a little over 8% on its equity.

Berkshire doesn't have the best growth prospects in the market, but we think it is one of the safest equities around. In the spirit of looking down before we look up, we continue to like Berkshire's potential return profile today.

Facebook

Facebook is the world's largest social network. Over 3.1 billion people use one of Facebook's properties monthly. These include Facebook, Instagram, Messenger, WhatsApp, and Oculus. Network effects make Facebook's user base difficult to replicate. The network also produces a trove of unique data that generate unusually high returns for advertisers. Advertisers can target users based on age, gender, location, interests, and behaviors.

Facebook's network remains healthy. Measurements of network size increased 12-15% year-over-year in Q2. Engagement remains strong at 66%, up modestly year-over-year, as usage benefited from stay-at-home orders. As lockdowns end, network growth may slow. Nevertheless, Facebook should continue to acquire new users for the foreseeable future.

Facebook generated $75 billion of revenue over the last twelve months. Catch-up investments in security and privacy have temporarily elevated expenses. Operating margins peaked at 50% in 2017, fell to 34% in 2019, and are 37% today.

Facebook's business model has a tremendous capacity for operating leverage. Eventually, we expect Facebook's margins to normalize above 50%. Cost controls and network growth will drive margin expansion. The network will eventually grow into its current spending and leverage the infrastructure Facebook is building today.

We estimate earnings power at $32 billion based on $75 billion of revenue, a 50% operating margin, and a 16% tax rate. Facebook could earn this today if it stopped investing in growth. We think investments in growth, privacy, and security are smart and will widen the company's competitive advantage.

As an above-average business, Facebook should command at least an average price. At the market's median P/E of 22x, Facebook's normalized earnings are worth $700 billion. Adding the company's $58 billion of cash suggests intrinsic value is $760 billion or $265 per share. This is a lower bound, rather than an upper bound, and in-line with the current stock price.

Facebook benefits from tailwinds of increasing digital advertising, growing e-commerce, and greater internet penetration in emerging markets. Its growth prospects fall into three categories:

1. Multi-tenanting —Facebook can replicate the external networks its members belong to in-house. For example, Instagram Stories is a clone of Snapchat, Reels is a clone of

TikTok, Facebook Dating is a clone of Tinder, and Messenger Rooms is similar to Zoom. Facebook's scale makes these low risk and high-return opportunities. Not all will work out, but the ones that do can create tremendous value.

2. Increased Monetization— Facebook doesn't monetize WhatsApp or Messenger at all despite billions of users. Someday Facebook may monetize them indirectly through mobile payments. Stories and Reels are under-monetizatized and far from maturity.

3. Shopping — Small and medium-sized businesses already rely on Facebook's pages to host content, Messenger to interact with customers, and advertising to reach customers. Shopping aims to bring the entire e-commerce transaction under Facebook's umbrella.

While most of Facebook's businesses are thriving, one is under threat. Audience Network tracks users across the internet and serves ads beyond Facebook's properties. Every iPhone has a unique device code known as an IDFA which Facebook uses to track users. Apple has decided to ban third parties from collecting IDFAs unless users explicitly opt-in. Trials suggest fewer than 50% will opt-in. Facebook doesn't disclose how big a business this is, but we don't think it is huge.

In the short term, this will be a modest headwind to earnings. In the long-term, it may provide a tailwind. Increasing privacy protections make it difficult for everyone, not just Facebook, to track users across sites. But no one can prevent Facebook from tracking users across its properties. Thus, regulations make large properties like Facebook and Google more valuable. We expect regulation will entrench and protect Facebook much like tobacco regulations entrench and protect Altria.

While Facebook shares aren't nearly as cheap as at the end of Q1, we believe they continue to offer compelling forward returns at a reasonable valuation. We sleep well knowing Facebook has a fortress balance sheet and that Mark Zuckerberg has plenty of skin in the game and thinks in decades, not years.

Hilton

Hilton is one of the world's largest hotel and hospitality companies. They own the Waldorf Astoria, Hilton, DoubleTree, Embassy Suites, and Hampton Inn brands, among others.

Hotels require lots of capital to build and maintain. That's why Hilton owns virtually none of its properties (65 out of 6,000+). Instead, it operates as a franchise and management company. Hotel owners pay Hilton a percentage of gross revenue (or occasionally operating profit) and contribute to Hilton's advertising fund. In return, they gain access to 100 million Hilton Honors

members, an online reservation system, and benefit from Hilton's supply-chain purchasing power and brand awareness. This creates a win-win relationship between owner and franchisor.

Hilton Honors members generate significant repeat business. Membership grew 20% last year and has grown 16% annually since 2012. As membership grows, so does Hilton's value proposition to hotel owners. This incentivizes developers to build more hotels using Hilton's brands. This increases Hilton's value proposition to consumers, driving a positive feedback loop.

Two factors drive earnings: new unit growth (NUG) and revenue per available room (RevPAR). New unit growth consists of new construction and existing hotels that convert to a Hilton brand. Pricing and occupancy drive revenue per available room.

We like Hilton's capital-light business model and long-term growth prospects. Hilton's asset-light model doesn't require retained earnings to grow. This results in ample free cash flow for buybacks. Between 2017 and 2020 share count decreased 16%.

In a normalized environment (i.e., post-COVID, we expect Hilton's market-leading pipeline of new hotel developments to drive high single-digit earnings growth. While some projects may no longer pan out, most will proceed. Hotels are long-lived assets, and owners think in decades, not years. During recessions, conversions of existing hotels to a Hilton brand increase as Hilton's loyal customer base becomes even more valuable.

Hilton is the prototypical time-arbitrage investment. Travel restrictions crushed current earnings, which allowed us to buy shares for 15x normalized earnings, a considerable discount from its 25x historical average. While we have no idea what earnings will look like this year or next, that is of no particular concern. Hilton has several years of liquidity in a zero-revenue situation which gives it time to wait for a recovery. If travel recovers to 2019 levels within five years, we think our purchase price will look like a steal.

The Spanish Flu of 1918 was more lethal than COVID-19 but by 1920 there was little evidence of a lasting cultural shift. The roaring twenties became famous for their parties and social gatherings. In the spirit of investing in what doesn't change, we think the desire to experience new cities, meet business partners face-to-face, and see loved ones who live far away will not diminish. We see increased travel as a long-term trend dating back hundreds of years. When this crisis is over, Hilton will be ready.

NVR

NVR is one of the largest homebuilders in the United States. They build single-family detached homes in fourteen states concentrated around the Baltimore-Washington D.C. metro area. NVR's business model is subtly different than most homebuilders and results in profoundly higher returns.

First, NVR generally doesn't develop land. Instead, they acquire finished lots via options from local developers. These cost up to 10% of the lot's price. Options allow NVR to walk away, losing only the premium paid, if the homebuilding cycle turns and the lots are no longer economically viable to build on. This minimizes capital employed. It also means NVR can't earn profits by speculating on land which concentrates management's focus on homebuilding efficiency. Management says, "We like to think of ourselves as the In-N-Out Burger of Homebuilders."

Second, NVR obtains and maintains a leading market position everywhere they operate. This produces economies of scale and generates bargaining power over suppliers.

Third, NVR primarily builds homes on a pre-sold basis. This reduces the chance NVR is left holding inventory when the cycle turns.

Finally, NVR operates an in-house mortgage banking and title insurance operation. 90% of the homes NVR builds use these services, which add capital-light fee income to each sale. NVR sells all of the loans they originate on the secondary market to minimize credit risk.

These factors allow NVR to earn best-in-class returns on its capital (30%+). A high ROIC allows NVR to grow while returning a substantial portion of its profits to shareholders. Over the past fifteen years, shares outstanding have halved while sales have nearly doubled.

Why don't all homebuilders operate like this? Incentives. Most builders pay bonuses based on revenue or earnings growth. Managers know the easiest way to do this is to use debt to buy lots of land. When this works, revenue explodes. When it doesn't, shareholders, not managers, pay the price. Often that price is bankruptcy.

NVR ties executive compensation to return on equity and return on capital. By charging management for the capital they use, managers become thoughtful and discerning stewards of your money. It also helps that executives and directors have plenty of skin in the game. They collectively own 9% of the company which is worth about $1.3 billion.

The pandemic has jump-started the housing market. July's existing-home sales were the strongest since 2006. A confluence of factors is behind the boom: all-time low mortgage rates, a marginal buyer who is location-agnostic, increasing importance of the home, and the relative safety of outdoor construction. It's unclear if this is a short-term boom or secular bull market. Either way, NVR is well-positioned with little debt and plenty of liquidity. In May, NVR issued $900 million of 10-year senior unsecured notes at 2.67%. This is an attractive rate and is likely to be invested at high incremental rates of return.

NVR settled 8,526 units in the first half of 2020, which is down 7% year over year due to the pandemic's interruptions. New orders increased 5% year over year. Gross margins declined from 18.7% to 18.0% due to an impairment charge taken against a land option.

Returns on capital and equity are robust. Annualized return on equity through the first half was 26%. This is an excellent absolute return and compares favorably with NVR's ten-year average of 20%. However, it is well below last year's 42% due to one-off disruptions.

NVR's stock has performed well since we bought it in March. The stock returned to its historical valuation around 18-20x earnings. Nevertheless, we continue to believe the company can produce satisfactory forward returns. We expect through-cycle settled units to grow at a 6% rate. NVR will need to retain 15% of earnings to fund this growth and will likely spend the remainder on share repurchases. Done at an 18-20x multiple, this would produce a 4-5% yield. All together, per-share returns could grow at a low double-digit pace. Our assumptions could prove conservative if NVR can continue to expand margins and improve returns on equity.

Schmitt Industries

Schmitt Industries is a small ($19 million) conglomerate that owns:

- Xact, a remote tank-monitoring business,
- Acuity, a precision-measurement business,
- Real estate in Portland, OR with a recent leased for 10-year triple-net to an investment-grade multi-national,
- Ample Hills, a Brooklyn-based iced cream company, and
- Over $10 million of cash.

What attracted us most is Schmitt's management. CEO Michael Zapata, a former Navy SEAL commander, turned value-investor, bought a large stake in the company through his hedge fund. Subsequently, he took over day-to-day management. He follows an "Outsider" approach focused on opportunistic value creation.

We expected Zapata to buy back shares and sell assets. Instead, Zapata seized an opportunity to buy Ample Hills out of bankruptcy in March. Ample Hills is an ice cream company in Brooklyn with a cult-like following. Oprah Winfrey and Bob Iger (Chairman of Walt Disney) are among its biggest fans - not something most businesses with $10M in revenue can claim.

Before the pandemic, all of Ample Hills stores enjoyed positive operating margins. It declared bankruptcy after prior management decided to build an ice cream factory in Red Hook, Brooklyn. It's difficult to imagine a more expensive place to build a factory. The builders delivered the factory several years late and millions of dollars over budget. Adding insult to injury, the factory then ran at a fraction of capacity, producing dis-economies of scale.

Ample Hills was auctioned out of bankruptcy in mid-March when New York was in the throes of its crisis. The usual crowd must have missed the memo because Schmitt submitted the only bid and won by default. Weeks later, jealous would-be bidders filed lawsuits to block the sale arguing that they missed the auction's announcement. The courts threw the suit out. Zapata was on top of his game, played by the rules, and won fair and square.

The price paid looks like a bargain: $1 million in cash plus another $1 million in assumed leases. Ample Hills has over $10 million of revenue and an ample (pun intended) growth runway. Today its stores in New York and New Jersey are open, along with a new store in Long Beach, CA.

Aside from Ample Hills, the rest of the business remained steady throughout the pandemic with no COVID-related layoffs. Management kept a lid on operating expenses and only burned ~$200k of cash for fiscal 2019 despite substantial disruptions this spring. Schmitt has committed to energizing a sleepy salesforce in the measurement business, which should bear fruit in the coming year.

Zapata's philosophy of "buy on assets, sell on earnings" aligns with our value-centric approach. Schmitt's current price only reflects its hard assets' value despite the possibility of meaningful future earnings power. We think that this creates a favorable risk/reward proposition.

Wells Fargo

Wells Fargo is one of the country's largest banks. Tangible book value, a crude indicator of intrinsic value, has decreased 5% year to date. The stock has been much more volatile and is down 50% year to date.

The stimulus has so far kept the full effects of the pandemic off Wells' balance sheet. This accounts for some of the disparity between the stock price and book value. Now that stimulus measures are winding down, credit costs could jump. Net charge-offs were 0.46% (annualized) in Q2, up from 0.28% in Q1. This is still well below our 0.75% estimate of through-cycle credit costs. This downturn is more extreme than average, so credit costs could be even greater.

Fortunately, Wells is overcapitalized by about $24 billion (2.55% of loans). This is after adding $18.5 billion of loan loss provisions this year. These provisions and other write-downs pushed net income to a loss of $1.7 billion year to date. Allowance for loan losses now stands at 2.0%. We expect more provisions in the coming quarters, albeit at a slower pace. It remains to be seen if government stimulus nipped credit problems in the bud or merely kicked the can down the road.

It's crucial to value cyclical companies like Wells on a normalized, through-cycle basis rather than on a single year's earnings. Last year Wells over-earned and this year it will under-earn. We estimate through-cycle earnings power around $20 billion. This assumes rates near zero, net interest margin around 2.25%, an efficiency ratio of 56 (down from 68), through-cycle credit costs of 0.75%, and a 18.5% tax rate. The key assumptions here are the 56 efficiency ratio and 0.75% though-cycle cost of credit.

Wells used to be one of the most efficient banks in the country. That is no longer the case. Expenses have gotten out of control on the heels of the company's scandal. CEO Charlie Scharff thinks there's $10 billion of costs to cut, which we modeled. This would bring Wells' efficiency ratio in-line with peers Bank of America and J.P. Morgan and back to its historical range. However, this won't happen overnight.

Our estimate of credit costs is based on data back to the recession in 1990, which hit California real estate, and by extension Wells Fargo, particularly hard. Unemployment figures suggest that this downturn is more severe than the 2008 financial crisis's depths. Therefore, our 0.75% credit cost assumption may be optimistic. If full-cycle costs double to 1.50%, normalized earnings will drop 25% to $14.5 billion.

At a $100 billion valuation, Wells is cheap by almost any metric. It trades for 5x our normalized earnings estimate and 6x earnings if loss rates are twice as bad. This is less than half of Wells' long-run average P/E ratio. It trades for 0.7x tangible book value, while peers are well above 1.0x and 0.07x deposits, half of its peers.

There are many reasons to dislike Wells Fargo, which is why it trades at a low valuation. The Fed's asset cap has certainly hampered their ability to navigate the pandemic and support their clients. Growth restrictions forced them to send profitable business to competitors and, in doing so, likely damaged some relationships. CEO Charlie Scharff's top priority is to get the asset cap lifted, but it's unclear when that may come.

We think Wells is virtually sure to return to growth someday. Its current valuation implies otherwise, which makes that future growth cheap. Historically Wells has been one of the most conservative lenders and we've seen no indication that its underwriting standards slipped. Their sticky deposit base isn’t going anywhere, which gives us confidence its earnings power will reemerge.

Wyndham Hotels

Wyndham Hotels is the world's largest hotel franchisor. It has 9,300 hotels with 831k rooms across 90 countries. Like Hilton, Wyndham franchises and manages hotels rather than own them.

Like Hilton, Wyndham also operates an extensive rewards program with 81 million members. This drives a positive feedback loop for hotel owners and customers. Buffett described the best business as "a royalty on the growth of others, requiring little capital itself." Wyndham fits this mold almost perfectly.

Economy and midscale hotels dominate Wyndham's portfolio. Most properties are drive-to leisure destinations rather than fly-to business. Accordingly, Wyndham has fared slightly better than Hilton and ought to recover faster. In the meantime, Wyndham has 36 months of liquidity under draconian occupancy scenarios, virtually ensuring it will be around to see the recovery. Occupancy and RevPAR have already improved substantially since early summer.

New unit growth and RevPAR drive Wyndham's results. While new construction is a more significant factor for Hilton, conversions are more meaningful to Wyndham. Conversions usually spike during recessions as Wyndham's loyal customer base becomes ever more attractive. This allowed Wyndham to grow rooms throughout the financial crisis.

When travel returns to 2019 levels, Wyndham should grow at a 5%+ clip. A healthy buyback yield and a modest dividend should drive per share results into the double-digits.

Management's exemplary cost-cutting efforts during the first weeks of the crisis attracted us to Wyndham. Management quickly cut $100 million of cost from the business and expects the savings to be permanent. We don't think the market appreciates that through-cycle margins will likely exceed last cycle's.

While Wyndham's normalized growth is lower than Hilton's, its valuation more than compensates. We purchased our interest for around 10x earnings against a fair value of about 20x. Though shares have risen modestly since our purchase, we continue to see value.

Trades

We've continued to upgrade our portfolio’s quality since March. We added to our interests in AutoZone and purchased new interests in Hilton and Wyndham. To facilitate this we sold our stake in National Beverage, Brighthouse Financial, and Bank of America. Below is a brief explanation of each trade. Please note that the figures exclude fees, commissions, and taxes. These differ by account, as did each account's exposure to these investments.

We sold National Beverage after eight months of ownership. We earned 0.1% on our investment compared to a 21% decline in the S&P 500 over the same period. While we continue to like the business, we took advantage of its relative strength to buy more of AutoZone at a decades-low valuation.

We sold Brighthouse Financial after nearly two years of ownership to buy Hilton. We sold at $30 per share, well off its March low of $12. **Brighthouse Financial is our first significant loss of capital, but (spoiler alert) it won't be our last.** We lost 31% compared to an 11% rise in the S&P 500. We bought the stock at what we judged was a statistically cheap valuation. But cheap stocks can become cheaper.

Persistently low interest rates, confusion over the company's hedge accounting, and a preference for buybacks over dividends drove the stock's multiple lower even as book value per share rose. Time will tell if our thesis was correct, as we still think the business is undervalued. Nevertheless, we prefer to own Hilton. Though Hilton trades at a higher valuation, it is a higher-quality business and trades at a similar discount to intrinsic value as Brighthouse.

In June, we sold Bank of America as shares rallied 45% off its March lows and approached our estimate of fair value. While fundamentally strong, Bank of America's intrinsic value was modestly impaired by the interest rate environment and increased likelihood of credit losses. We used the proceeds to purchase Wyndham and replenish our modest cash balance. Bank of America was a long-term holding for us, pre-dating the founding of Eagle Point Capital.

Today we are nearly fully invested: most accounts hold about 7% cash. Our cash balance rises and falls based on the opportunities we see, not a macro forecast. We don't think we can make macro calls or time the market. Occasionally, we think we can purchase interests in simple, predictable, and profitable businesses at reasonable prices. We expect these investments to outperform cash over 5+ year stretches, which is why we generally prefer to be fully invested. We will sell businesses under three circumstances:

1. When we realize that we made a mistake;

2. When we no longer expect the business’s 5+ year return to outperform cash; or

3. When we find a more attractive investment.

Housekeeping

Your Q3 Interactive Brokers statements will soon arrive in the mail. The statement will include your quarterly performance and holdings. You can access more detailed account information on the Interactive Brokers website. Please contact us with any questions.

As a reminder, we manage all accounts *pari passu*. However, new accounts will only purchase existing positions if the current price, relative to value, makes sense. Eventually, all accounts will

"sync up," but this could take a while. Until then, please be aware that you may not hold all of the investments discussed in this letter.

Fractional Shares

We enrolled in the IB Lite program this summer. The program offers two advantages:

1. It does not charge commissions or inactivity fees; and
2. It allows us to transact in fractions of a share.

The only downside is a 1% lower yield on excess cash balances. Since we generally hold little cash, we expect this arrangement to produce net savings. Fractional shares carry all of the economic and voting rights of regular shares.

New Fee Structure

We recently introduced a new fee structure inspired by the Buffett Partnership. It is a "0/6/25" structure, which means there is no management fee but a 25% incentive fee on annual profits greater than 6%.

Regulations only allow us to offer this fee structure to Qualified Investors. Any client who meets the regulator's definition of a Qualified Investor may elect it. If you have questions about the fee structure or your eligibility, please contact us.

Rule of Three

Every few years people forget that every few years stock prices crash. As the quoted value of our business interests have soared the last six months, we think this is an apt time to remember that stocks do not always go straight up.

Francois Rochon of Giverny Capital is one of the investors we admire most. He coined the Rule of Three, which we've decided to adopt as our own. It is a rule of thumb rooted in history which will help level-set expectations.

1. One out of every three years, the stock market will decline by 10% or more.

2. One out of every three stocks we buy will not perform as expected.

3. One out of three years, we will underperform the index.

While we don't think our performance over the last six months will repeat anytime soon, we do believe that our portfolio has bright prospects and should produce satisfactory returns over the coming 5+ years.

Thank You

Thank you for your continued support and trust. Investment managers can only afford to be as patient as their clients allow. Your patience and trust contribute as much to our success as anything we do at Eagle Point Capital.

Our clients have proven exceptional and stoic investors, which provides us with a significant competitive advantage. We've had no unplanned outflows despite the market volatility, and have seen significant inflows from new and existing accounts. Your choice to take the long view allows us to take advantage of "time arbitrage," and we are exceedingly thankful for that.

Please contact us (**matt@eaglepointcap.com** or **dan@eaglepointcap.com**) with any questions about your account or your investments.

If you know any like-minded investors who would enjoy this letter, please forward this to them or put them in contact with us.

You can expect to hear from us again on or around April 1, 2021, with another portfolio update. In the meantime, you can read our previous letters and blog at www.eaglepointcap.com.

Fundamentals
Attached is a copy of a short memo on our fundamentals. It explains our goals and methods. Investing is simple but not easy, and success is made or lost on the application of fundamentals.

Eagle Point Capital LLC — Fundamentals
June 25, 2020

Once, after winning two consecutive national championships, the Green Bay Packers lost a game due to sloppy play. Coach Lombardi called a meeting the very next day. When all the players were assembled, Lombardi held a football high up in the air and declared, “Gentlemen, this is a football!” From the back of the room, running back Paul Hornung shouted back, “Coach, can you slow down?”

In investing, as in football, success is made or lost on the application of the fundamentals.
This document sets forth the fundamental operating principles of Eagle Point Capital. Through the up and down markets ahead, we will always return to the principles below to inform our attitudes and actions.

- Our objective is to avoid the permanent loss of capital while maximizing the increase in long-term, after-tax purchasing power of our funds. Put another way, we aim to build an indestructible long-term compounding machine.

- To achieve this objective we seek to make concentrated investments in businesses that:
    1. We understand.
    2. Have a demonstrated and enduring competitive advantage.
    3. Have a resilient balance sheet.
    4. Have honest and able management who run the company for the benefit of shareholders.
    5. Can be purchased for a reasonable price that affords a margin of safety.

- In other words, we aim to purchase, at a rational price, interests in easily-understandable businesses whose earnings are virtually certain to be materially higher five, ten, and twenty years from now. We prefer cockroach-like businesses — very hardy and almost impossible to kill.

- We think independently and do our own research. We don’t rely on the opinions of analysts or journalists, both of whom may have different motivations than ours. We rely primarily on S.E.C. filings for information.

- We do not diversify excessively. Good investments are hard to come by and we would rather concentrate our capital into our best ideas than spread among many mediocre ones. We typically own six to ten businesses and put 10% of our capital, at our cost, into each.

- We think and act like business owners. As owners, we focus on the fundamentals of the business and do not obsess over price fluctuations. When possible, we use periods of unjustified pessimism to purchase high quality companies at attractive prices. Likewise, we prefer to use

periods of unjustified optimism to sell companies for more than we feel they are reasonably worth. The market is our servant and not our master.

- The best way to measure our success is to compare Eagle Point Capital's return, after fees, to the S&P 500's total return (including the reinvestment of dividends) over five-year periods. Measurement over a shorter timeframe may reflect luck more than skill. The S&P 500 is our benchmark because it is widely followed, offers the potential for large, low-cost investments, and, we expect, will produce satisfactory long-term returns. Over time, we expect good relative returns to the S&P 500 to become excellent absolute returns.

- All accounts are managed *pari passu*. Clients may elect one of two fee structures:
    1. A two percent annual fee on assets under management charged quarterly in arrears.
    2. 25% share of profits in excess of a 6% hurdle rate, subject to a high water mark, charged annually in arrears. This option carries no management fee.

- Clients will receive a letter twice a year detailing what they own and why they own it. Our reports will be candid, emphasizing the positive and negative factors important to appraising intrinsic business value. Our guideline is to tell you the business facts we would want to know if our positions were reversed. We owe you no less.

- Eagle Point Capital is not in the business of predicting the general stock market or business fluctuations. If you think we can do this or that it is essential to an investment program you would be best suited looking elsewhere.

- We cannot guarantee results to clients. What we can and do promise is that:
    - Our investments will be chosen on the basis of value, not popularity;
    - We will attempt to bring risk of permanent capital loss (not short term quotational loss) to an absolute minimum by obtaining a wide margin of safety in each investment; and
    - We have virtually our entire net worth invested alongside Eagle Point Capital's clients. We eat our own cooking.

Many of you who are already familiar with Eagle Point Capital may feel, like Paul Hornung, that this material is unduly repetitive. However, we would rather have many bored clients than a single client with any basic misconceptions. As Charlie Munger says "A majority of life's errors are caused by forgetting what one is really trying to do." A firm grasp of our fundamental operating principles will help us stay the course in the future.