To:	Clients of Eagle Point Capital
From:	Dan Shuart and Matt Franz, Principals
Subject:	Spring 2020 Portfolio Update
Date:	March 31, 2020

"There are decades where nothing happens, and then there are days when decades happen."

— Vladimir Lenin

March 2020 has been one for the history books. The economy ground to an abrupt halt. The stock market fell 34% from its February high. Congress authorized trillions of stimulus and central banks slashed rates to zero. For the first time in eleven years, we entered a bear market.

"It was the best of times, it was the worst of times."

— Charles Dickens, *A Tale of Two Cities*

These are trying times for people around the world. We have the deepest sympathy for anyone directly impacted by COVID-19 or its fallout. That said, the fear, panic, and uncertainty permeating markets makes this as ideal a time to operate as any we could imagine. We've said it before and we will say it again: volatility is our friend, not our foe.

Volatility makes investors fearful, and fearful investors think in days, not years. Wonderful businesses with tremendous long-term earnings power trade for a fraction of their price just weeks ago. Our businesses may face short-term headwinds, but they will survive. And when this too passes, they will thrive.

In this letter, as always, we aim to explain what you own and why you own it. We provide the details we'd want if our positions were reversed. The length of this letter may not show it, but we try to balance providing detail with brevity. Those interested in more detail should read our blog (eaglepointcap.com/blog). Subscribe to ensure you don't miss a post.

Our Advantage

Our long-term outlook and business-owner mindset give us a meaningful advantage over other investors. Our behavioral advantage is even more valuable during volatile times. And for that, we thank you.

Eagle Point Capital is a top-notch group of long-term investors. Everyone claims to be a long-term investor at the top of a bull market, but few walk the walk in a bear market. Your collective actions spoke volumes this month. We have had no unplanned outflows or discussions about moving to cash. Instead, we've seen meaningful inflows from new and existing investors alike.

This confirms what we already knew — this group "gets it". Stocks, like anything else, become more attractive when their price goes down, not up. Your patience allows us to take advantage of this.

Performance

Our investments have not been immune to falling market prices, but we are pleased with our portfolio's performance. We entered March with approximately 20% cash in most accounts. We have since deployed all of it and are now fully invested. We used our cash to buy a new business, American Express, and add to an existing business, Facebook.

Stocks continued to slide, so we began to "upgrade" our portfolio by selling stocks with relatively strong prices to buy stocks that fell further and possess greater long-term earnings power. We sold NortonLifeLock and Walgreens, and trimmed National Beverage. We bought new positions in AutoZone and NVR and added to existing investments in Berkshire Hathaway and Altria. Prices are up sharply since last week, but we are prepared to act if significant values reemerge.

We have never owned such a high quality, financially strong portfolio at such low prices. The future looks bright for our businesses and portfolios alike.

Your Q1 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.

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Fundamentals

"A majority of life's errors are caused by forgetting what one is really trying to do."
— Charlie Munger

Simple, clear, and actionable goals come in handy when the world devolves into chaos and panic. Our goal is to buy meaningful positions in good businesses for rational prices and hold them for long periods of time. This is no different than what many of the world's wealthiest individuals have always done.

We are long-term business owners first and foremost. We think and act like we own 100% of our businesses and have retained management to run them. Our portfolio is like a conglomerate with multiple decentralized operating divisions.

Look-Through Earnings

One way to value our "conglomerate" is to total each "division's" earnings and compare them to the sum of each division's market price. Below is our portfolio's look-through earnings and look-through price-to-earnings (PE) ratio.

Name	Price (3/31)	Adj. EPS	P/E, Excl. Non Operating Assets	% of Portfolio	Portfolio Weighted Price	Portfolio Weighted EPS
Altria	39	3.75	8.4	12	4.68	0.45
American Express	86	9.50	9.0	10	8.13	0.90
AutoZone	846	65.4	12.9	5	43.15	3.34
Bank of America	21	2.60	8.2	8	1.74	0.21
Berkshire Hathaway	183	8.00	5.4	12	22.12	0.97
Brighthouse Financial	24	9.50	2.5	4	0.99	0.39
Facebook	167	8.25	18.2	11	18.35	0.91
National Beverage	43	2.55	16.7	5	2.09	0.12
NVR	2,569	220	11.7	11	272.33	23.32
Schmitt Industries	2.75	0.00	NMF	10	0.27	0.00
Wells Fargo	29	5.20	5.5	7	1.98	0.36
Cash	1.00	0.00	NMF	6	0.06	0.00
Portfolio P/E	**12.1**	**Weighted**	**8.4**	**Total**	**375.8**	**31.0**
S&P 500 P/E	**19.5**	**Average PE**				
Discount To S&P 500	**38%**					

Our "conglomerate" is worth $376 per share and earns $31 per share. That's twelve times earnings, a 38% discount to the S&P 500's twenty times. Said differently, each $100 we have invested earns, in our estimate, approximately $8 while $100 invested in the S&P 500 earns $5. Net of non-operating assets**, such as marked-to-market securities and excess cash, our portfolio trades at 8.4x.

There are a couple of caveats worth mentioning:

1. The earnings figures for our investments are our estimates of their normalized earnings. These are non-GAAP figures. GAAP stands for "Generally Accepted Accounting Principles" and is the accounting convention used in S.E.C. filings. The S&P 500's figures *are* GAAP compliant. We adjust GAAP earnings for our businesses to account for their unique circumstances and capture their normalized earning power. Details about the adjustments follow in this letter.

2. These figures are backwards looking. The next year could be ugly and materially different in some cases. We focus on long-term earnings power, however, not next year's earnings per share. One lean year doesn't meaningfully reduce the present value of a growing business's future cash flows.

3. Our portfolio varies materially from the S&P 500. This isn't a perfect apples-to-apples comparison, but presented for context.

We look for value that jumps off the page and knocks us on our head. We are not interested in a 10-25% discount to intrinsic value. That's well within the error of estimates and vagaries of accounting. 50%+ discounts (100%+ upside) gets us excited. Today nearly every investment hits this mark. Our portfolio is cheap on an absolute and relative basis.

However, investing is not as simple as maximizing current look-through earnings. That would be a trivial mathematical exercise. We need to skate to where the puck is going, not where it is.

We want to own a portfolio that will deliver high look-through earnings a decade or so from now. Accordingly, most of our businesses have high return growth prospects and shareholder-friendly managers with excellent capital allocation skills. In other words, our portfolio is a collection of above-average businesses at below-average prices.

** *Adjustments for non-operating assets include: $140 for Berkshire Hathaway, $17 for Facebook, $7 for Altria, Schmitt Industries, and cash.*

The Anatomy of a Bear Market

"You make most of your money in a bear market. You just don't realize it at the time."
— Shelby Davis

To paraphrase Tolstoy, all bull markets are alike, but each bear market is unhappy in its own way. This bear market, in particular, has no obvious historical analogue. Though the precise cause of each bear market is unique, we can still make some general observations:

- 100% of past American bear markets have ended. American capitalism works. This isn't its first stress test.

- Stocks go down 30-50% every 5-10 years, on average. Bear markets aren't abnormal. If anything, the eleven-year bull market was.

- Bear markets always make sense in retrospect, but this is our hindsight bias. They are always uncertain, chaotic, and scary at the time. Malcolm Gladwell and Michael Lewis will probably write great books in a few years explaining how this whole mess could have been avoided. Remember that they will be writing after the dust has settled. Today, we are mired in the fog of war, but that doesn't mean we can't make intelligent purchases.

- The best time to buy is before there is a light at the end of the tunnel. You pay a high price for certainty on Wall Street. Baron Rothschild said it best: “buy when there’s blood in the streets.”

- People adapt and markets do too. People tend to extrapolate without considering the human response. David Tepper explains this with a story: “In 1898, the first international urban-planning conference convened in New York. It was abandoned after three days because none of the delegates could see any solution to the growing crisis caused by urban horses and their output. In the *Times of London*, one reporter estimated that in 50 years, every street in London would be buried under nine feet of manure.” Newspapers have always been full of gloomy headlines (and always will be), but society has continued to march forward.

- Lower prices increase future returns. Bear markets have been wonderful buying opportunities.

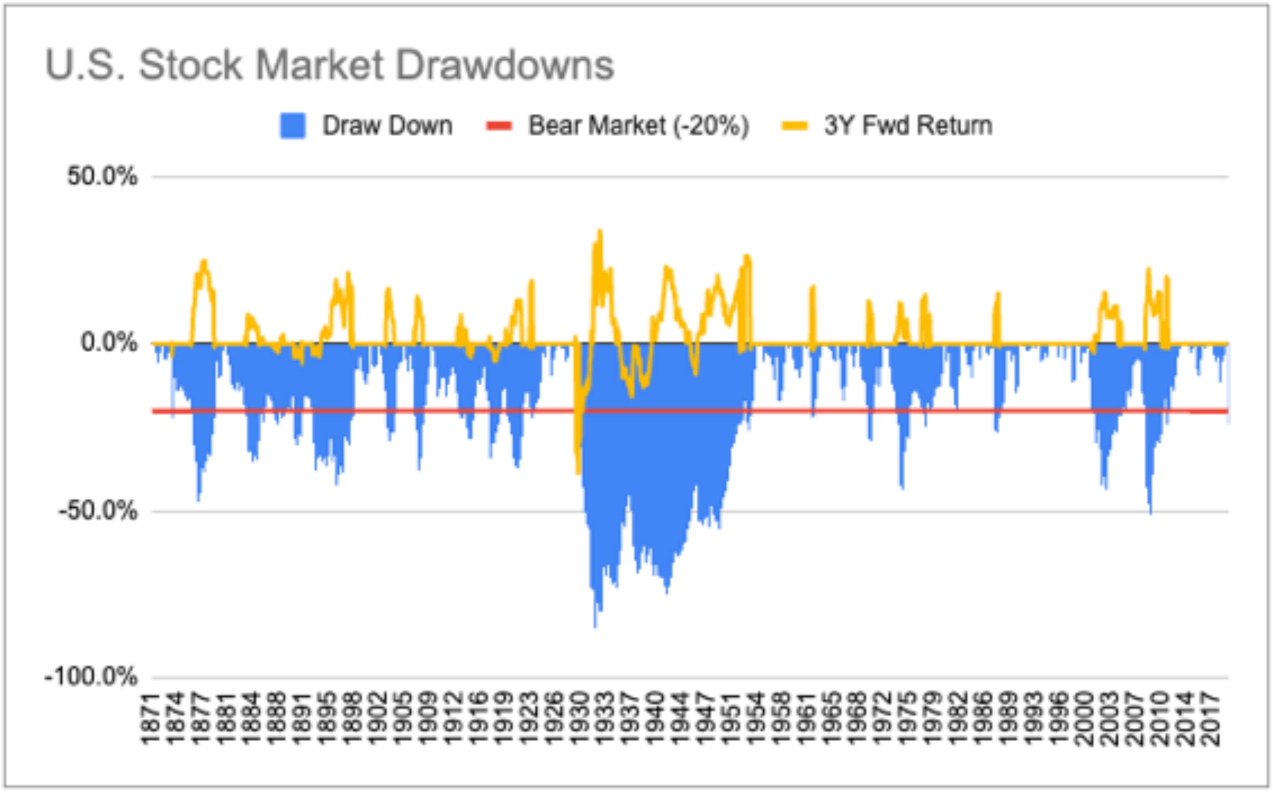
Base rates help us make decisions under uncertain conditions. A base rate is the probability that a desired outcome occurred in the past. For example, the base rate of a fair coin flip landing heads is 50% and the base rate of the U.S. stock market recovering from drawdowns is 100%.

Jason Zweig recently published some base rates on bear markets for the Wall Street Journal. He wrote:

> Since 1929, the S&P 500 has suffered 14 bear markets, defined by S&P Dow Jones Indices as losses of at least 20%. The shortest and shallowest was the 20% drop that lasted less than three months in late 1990. The deepest was the 86.2% collapse from September 1929 to June 1932; the longest, the 60% plunge from March 1937 to April 1942. On average, bear markets lasted 19 months and dealt a 39% loss.

The S&P 500 peaked on February 19th and entered a bear market on March 11th. So far the low has been a -34.1% drawdown on March 23rd.

Yale’s Robert Schiller has compiled monthly price data on the U.S. stock market back to 1871. We used his data to make the chart below. Bear markets (20%+ drawdowns) occurred when the blue line went below the red. The yellow line represents forward three-year returns from a bear market.



Since 1871 the market produced a 4.3% compound annual return before dividends. During bear markets, average annualized three-year forward returns increase over 50% to 6.9%.

Intuitively this makes sense: buying businesses for less ought to produce higher returns. Mathematically, it checks out too: a stock that is down 50% must double to get back to even. Buying in bear markets is a good idea.

Is The Market Efficient?

In each letter we include a table of the ten largest companies in the S&P 500 and their 52-week high and low. These are the most well-known, well-capitalized, and well-followed stocks in the world, yet their annual price range always astonishes us.

This edition did not disappoint. On average, the top ten moved 57%, high to low, for a collective market capitalization change over $3 trillion.

Name	Market Cap (B)	52-Week High	52-Week Low	High / Low	Change In MC (B)
Microsoft	1,200	190.70	118.10	61%	737
Apple	1,113	327.85	170.27	93%	1,030
Amazon	971	2,185.95	1,626.03	34%	334
Facebook	475	224.20	137.10	64%	302
Berkshire Hathaway	443	231.61	159.50	45%	200
Visa	346	214.17	133.93	60%	207
JPMorgan Chase	277	141.10	76.91	83%	231
Johnson & Johnson	346	154.50	109.16	42%	144
Walmart	322	128.08	96.79	32%	104
			Mean	57%	365
			Median	60%	231
			Total		3,289

A trillion is an incomprehensibly large number, so here is some context:

- Three trillion seconds is almost 95 thousand years.
- Three trillion dollar bills laid end-to-end would wrap around the equator 11,409 times.

Did the value of the 10 largest companies in America really change *that* much the last 52 weeks?

According to Ben Graham, “price fluctuations have only one significant meaning: an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal.” The more volatile markets become the more opportunities we have.

Surviving Without Predicting

“Mother nature gave us two kidneys when we only need about a portion of a single one. Why? Because of contingency. We do not need to predict specific adverse events to know that a buffer is a must.”

— Nassim Taleb

We did not predict the current crisis, and we probably won’t predict the next one. Rather than devoting energy to prediction, we focus on maintaining a margin of safety. We are always prepared to weather a storm. That is the only way we know how to survive.

We haven’t lost a wink of sleep throughout this downturn because:

1. We do not use leverage, which means no one can force us to sell stocks at adverse prices. Our returns are not path dependent.

2. Our businesses use little to no debt and most hold substantial excess capital. Only Altria is meaningfully indebted, but their business is as durable and non-cyclical as they come. They also own liquid securities that can be converted to cash in a pinch.

Altria

Altria enjoys one of the widest moats in our portfolio. Regulators do not allow cigarette companies to advertise, which effectively prohibits new entrants from competing. Altria has exposure to other "sin" categories beyond cigarettes, such as alcohol (10% of AB InBev), vaping (35% of Juul), marijuana (45% of Cronos), and smokeless tobacco (100% of Copenhagen and Skoal, among others). Sin does well during good times and can do even better during difficult times. Altria's steady business makes market volatility more palatable.

We bought Altria in September as skepticism peaked over its investment in Juul and proposed merger with Philip Morris International. Altria has since taken a more hands-on approach at Juul and abandoned the merger with Philip Morris.

We paid about 9x earnings for Altria's core tobacco businesses, net of their investment in AB InBev. We paid nothing for Altria's stake in Juul, Cronos or their exclusive right to Philip Morris's iQOS heat-not burn product in the US. These are most likely worth billions of dollars.

Juul's regulatory issues are front-and-center today. Altria sent long-time lieutenant K.C. Crosthwaite to replace Juul's founder and CEO. Crosthwaite and his team know how to deal with Washington. If anyone can mend Juul's relationship with regulators, it is this team.

Altria currently trades at 8x earnings. It has only traded at this valuation twice. First, during the early 2000s, when litigation threatened to put big tobacco out of business. And second, during the depths of the financial crisis. We see no such crisis for Altria today. The company's earning power remains strong and the company's stakes in Juul, Cronos, and iQOS offer significant growth potential.

Altria's investments amount to $7 per share, using their most recent market prices and Q4 carrying values. Backing these out of Altria's $37 stock price gets us to $30 for Altria's core tobacco business. This business earned $3.75 per share in 2019 (net of non-cash charges) and will likely grow a few percent annually as Altria exercises its pricing power. Eventually the market should value this business closer to its 16x historical average multiple. Altria pays a well covered dividend that yields 10% and is also buying back stock. All together, Altria's stock could return over 20% for the next several years.

American Express

We've admired American Express for years but never saw a margin of safety in its price. That changed in March.

We bought American Express for $100 per share, which is 10x earnings — equal to its lowest average annual PE ratio in the last ten years. If we had to distill our approach to investing into a single sentence it might be: "Buy above average businesses at below average prices." American Express embodies this as well as anything we own.

American Express operates a closed-loop network. They extend credit and earn a percentage of each transaction. American Express'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.

This positive feedback loop produces high returns on equity. Last year American Express earned 29% on equity. Its lowest ROE in the last ten years was 15% in 2009. American Express's results will continue to benefit from strong tailwinds: increasing penetration of cashless payments and inflation.

American Express fell from a high of $138 in February to a low of $67 in March. Many of American Express's best customers are small businesses who are expected to bear the brunt of the COVID-19 shutdown.

Last year American Express's loss provision was 2.4% of loans and card member receivables. This is a little lower than their long-term average of 2.8%. If we normalize American Express's through-cycle earnings, we get $9.50 per share, which implies we paid 10.6x normalized earnings.

American Express's loss provision peaked at 7.8% in 2009. In that scenario American Express would earn $0.70 per share this year. It would take an unprecedented 8.2% provision to break even. One lean year has no effect on American Express's long-term earnings power and has little impact on the present value of its future cash flows.

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 recent results. It sports a 2% dividend yield and buybacks should add another 6%. A multiple re-rating over five years (to 14x, its long-term median) adds another 2% to annual returns. All in all, we expect American Express to return about 15% per year for several years.

AutoZone

We purchased AutoZone in March for $720 or 11.4x earnings. This equals its lowest average annual PE multiple over the last fifteen years.

AutoZone sells auto parts to amateurs (DIY) and professionals (DIFM) in the US, Mexico, and Brazil. Auto parts might not sound exciting, but AutoZone's model is unusually profitable.

AutoZone's value proposition is about speed. Customers want parts ASAP. Even 24 hours can be too long. Mechanics pass parts costs to customers, so they're less concerned with rock bottom prices than fast turnarounds. For customers, time in a garage is time they cannot drive to work or are paying for a rental. AutoZone operates a network of distribution centers, mega hubs, and hubs that allow most stores to receive deliveries at least once a day, and increasingly multiple times per day.

AutoZone maintains a large, slow turning inventory to ensure rapid delivery. To finance inventory, AutoZone leverages its scale to extract long payment terms from its suppliers. Payables are 130% of inventory, which means suppliers are financing all of AutoZone's inventory and then some. This allows AutoZone to earn high returns on capital. Its lowest return on invested capital in the last ten years was 32% in 2009. Last year it was 49%.

AutoZone's logistics network, bulky, slow-turning inventory, and extensive store footprint protect its moat. We don't think anyone, Amazon included, is likely to re-create what AutoZone and O'Reilly (a similar business) have already built. AutoZone's knowledgeable in-store staff give it a further leg up over internet retailers.

AutoZone's management are exemplary capital allocators. Their policy is simple: prioritize reinvestment in the business and spend whatever is left over on share buybacks while always maintaining an investment grade rating. Shares outstanding are down 75% over the last 15 years.

AutoZone reinvested 16% of its cash flow at a 29% incremental return over the last ten years, If the future looks like the past (it probably does), it will grow about 4% per year. They used the remaining 84% for buybacks. This works out to a 9.6% yield at our cost. Combined, the business should return about 14%.

We bought AutoZone at a 24% discount to its median PE (15x). This provides a margin of safety plus the potential for our stock to outperform the business. If the multiple re-rates over five years, it will add 5.6% to our annual returns, bringing our total to 20% per year.

We were able to buy AutoZone at a historically low multiple over concern about store closures. So far, AutoZone's stores remain open with shorter hours. AutoZone has enough liquidity to last through months of closures. Results may dip in 2020, but AutoZone's long-term earnings power remains unimpaired.

Bank of America

Bank of America reported a terrific 2019 with higher earnings, more deposits, and a generous buyback. The only disappointment is that Bank of America appears to have exhausted its ability to further cut costs and generate operating leverage. Their efficiency ratio is 60% which is still wonderful and a massive improvement over the 89% they posted in 2014.

Last year Bank of America provisioned 0.37% of loans and leases for losses. This is likely to mark a cyclical high in credit quality. We expect provisions to jump in 2020. Over the last twenty years' provisions for credit losses averaged 0.8% of loans.

Last year Bank of America earned $2.98 per share. Normalizing provisions to 0.8% bring EPS to $2.60. At $22 per share, the stock trades for 7.4x trailing earnings and 8.5x normalized earnings. We think it is worth at least 10x pre-tax (12-13x after tax). This is based on zero growth and a 10% discount rate. This should prove conservative. This values shares at $34, about 50% higher.

We expect Bank of America will grow at a GDP-like rate while returning 90% of net income to shareholders through dividends and buybacks. That suggests its normalized yield is currently 10.6%.

Bank of America's earnings may dip in the short term as provisions rise and lower rates take their toll. Long-term, Bank of America's earnings power has little to do with the absolute value of interest rates. Banks are spread businesses. They care more about the relationship between short-term and long-term rates than their absolute value.

This month investors who remember 2008 sold bank first and asked questions later. In 2008 banks were part of the problem. This time they will be part of the solution. Bank of America is overcapitalized to the tune of $32.4 billion. This is a wonderful buffer that didn't exist in 2008.

Berkshire Hathaway

Buffett caught flack the past few years for amassing a $125 billion cash hoard at Berkshire. Now he's having the last laugh.

We think about Berkshire as the sum of two parts: insurance, which includes Berkshire's excess cash and equity investments, and its non-insurance wholly-owned operations, like BNSF and Precision Castparts.

Berkshire's insurance operations are worth at least book value. Book value is a proxy for liquidation value and is conservative because it does not ascribe any value to Berkshire's consistently profitable underwriting franchise. Most insurers lose money on underwriting. Berkshire has averaged a 2% positive underwriting margin and made money in the last 16 of 17 years.

Year-end book value was $162 per class B share, up from $126 in 2018. As of March 26th, Berkshire's stock portfolio is worth about $58 billion less. This puts current book value around $140 per share.

Berkshire's non-insurance operations earned $8 per share in 2019. If we subtract the book value of Berkshire's insurance companies ($140) from its stock price ($180) we get $40. The market is valuing non-insurance earnings at just 5x.

This is an extraordinarily low price for a wonderful collection of businesses and we do not expect this valuation to last long. 15x is a more appropriate long-term valuation. For example, Union Pacific, a close competitor to BNSF, currently trades at 16x.

Historically Buffet said he'd buy back Berkshire stock below 1.2x book value. Currently Berkshire trades at 1.03x. In fact, Berkshire traded below its 2009 low price-to-book multiple of 0.97x on March 20th. We expect Berkshire has been buying back stock at these levels. With any luck, Buffett will also find a large acquisition that will increase Berkshire's earnings power.

We think Berkshire is worth about $260 today and that it can compound at 7%. In this case it would be worth $365 per share in five years, double the current quotation, a 15% rate of return.

Brighthouse Financial

Brighthouse continues to execute its strategy and the stock rose appreciably in 2019 and early 2020. However, Brighthouse is sensitive to both stock and bond prices, and shares have been exceptionally volatile this month.

As always, we focus on the fundamentals, not the stock price. Annuity sales increased 23% in 2019 and statutory adjusted earnings totaled $1.9B, 15% higher than 2018.

Brighthouse's GAAP financials are confusing because of its extensive stock and bond hedges. GAAP accounting requires Brighthouse to mark its hedges to market. But, the rules don't allow Brighthouse to change the value of the corresponding liabilities. This creates a mismatch and distorts the GAAP figures. Fortunately, regulators understand this and require life insurers to prepare statutory financials to help them asses their strength. Statutory financials provide a clearer picture for investors too.

Brighthouse, at $25, trades at just 2x statutory earnings. This is absurdly low for a well-capitalized company. The market is clearly worried that Brighthouse won't be profitable with the present market prices. However, the present situation is still within management's Q1 sensitivity analysis. That analysis suggests Brighthouse will still be able to return $1.5 billion (over 50% of its market cap) to shareholders over the next four years.

The company repurchased $440M of its shares in 2019 and announced a new $500M repurchase authorization in 2020. For context, the market cap at the end of the year was $4.4B and is currently $2.8B. The current authorization would allow Brighthouse to buy back 20% of shares. Insiders are putting their money where their mouths are, too: they bought over a $1 million of stock in the open market in March.

We expect Brighthouse to earn a normalized 7% ROE, which suggests the stock is worth $60-70 per share, more than triple its current quotation. This would put it at just 60-70% of book value and produce annual returns in excess of 20%.

Facebook

If we were given a $100B budget and directed to create a network of nearly 3 billion people worldwide, we would fail miserably. That's to say, we don't think Facebook's network is easily replicable. Facebook's dominance and user base create a virtuous cycle of profitable growth, which continued in 2019.

Facebook's share price rose 56% in 2019. We estimate its intrinsic value grew 20%. In March Facebook shares fell back to their January 2019 levels, putting them back into bargain territory. We added to our Facebook position at 18x (ex-cash) normalized earnings, a which we consider fair for a capital-light business with a long growth runway. There are few businesses we'd consider paying this much for.

Key operating metrics across the board gained traction. Monthly Active Users grew to 2.5 billion in the fourth quarter, up 8% since last year. User monetization rose even faster, up 16% worldwide. Expenses are temporarily elevated due to heavy reinvestment in privacy and R&D, but earnings per share still advanced 7.5% in 2019.

Looking out at the next decade, and using conservative assumptions for user penetration and monetization rates by geography, we think that the business can compound intrinsic value per share at a high-teens rate. We expect to see operating leverage and see additional upside if Facebook chooses to monetize free properties like WhatsApp.

The pandemic should have no discernible impact on Facebook's long-term earnings power. Monetization may slip in the near term, but will probably bounce back quickly. Total Facebook traffic rose 70% month over month worldwide and group video calling rose 1,000%. Facebook doesn't monetize video calls, so there won't be a direct effect on earnings, but it can't hurt. It's possible that this crisis will shift user behavior towards more engagement with Facebook.

National Beverage

National Beverage put in a solid 2019. There were two important events outside the company which will help drive long-term results.

First, the lawsuit claiming LaCroix contained artificial ingredients was withdrawn due to lack of evidence. This was a baseless claim that resulted in lots of bad PR. Fortunately, it is now behind us.

Second, Coke shut down its Dasani sparkling water brand. LaCroix and Pepsi's Bubbly now sit atop the market in the #1 and #2 positions. We're optimistic this means Pepsi will compete more rationally than they did last summer and the price wars will end. Though there are still lots of competing brands, including new ones from Coke, the market is showing signs of stabilization and consolidation.

National Beverage's sales returned to growth in the fourth quarter notching 1% ahead of the prior year. New La Croix flavors have been well received and pantries are likely being stocked for lockdown as we speak. Earnings per share rose 7% on better sales, gross margins, and operating leverage.

National Beverage's underlying fundamentals remain attractive. The business continues to earn exceptional returns on invested capital (31% in 2019), maintain a pristine balance sheet (zero debt), and sits atop a growing end market. Even if National Beverage were to cede some market share to Pepsi and Coke, the overall sparkling water market ought to grow enough to offset the loss.

National Beverage's stock has held up relatively well in the March selloff. Given this, we trimmed our position to fund the purchase of other stocks. We think National Beverage can grow intrinsic value at a low-teens clip. A modest valuation re-rating brings our expected return into the mid-teens range.

NVR

We bought shares of NVR in March for around $2,300. Normally we wouldn't touch a homebuilder with a 10-foot pole, but NVR is far from ordinary.

Most publicly-traded homebuilders are closet land speculators. Often the profits from flipping the land dwarf the profits from building the home on it. Land speculation requires lots of capital (i.e. debt) and ties capital up for years. This produces low returns on capital, high leverage, and cyclicality.

NVR learned this the hard way when they went bust in the early '90s. They opted for a unique capital-light model when they reorganized. Rather than speculate on land, NVR sticks to their core business of building homes. Instead of buying raw land in advance, NVR acquires options to buy finished plots. They only begin building once they've sold the house. This keeps inventory low, removes speculative building, and means customers finance working capital.

Since NVR doesn't make money developing land, they're forced to run a lean homebuilding operation. They only operate in markets where they're the top player to leverage economies of scale. They operate more like an assembly line than a traditional builder. Management once said, "We like to think of ourselves as the In-N-Out Burger of Homebuilders".

NVR also originates mortgages and provide title services for their customers. NVR doesn't take credit risk. They sell the mortgages and earn an origination fee providing a capital-light income stream.

NVR earns high returns on capital (30%+) with almost no debt. NVR has compounded earnings per share 9% annually since 2004, a feat few companies can claim. During the 2008 housing bust NVR's free cash flow was negative for just one quarter. Since 2010 the business has compounded earnings per share at 25% annually while actually taking capital *out* of the business.

Accordingly, NVR trades at a premium valuation to competitors. Its median PE (18x) is nearly double peers. This valuation prohibited us from buying in the past. That changed in March when we were able to buy NVR for less than 10x earnings.

NVR's business model is squarely in "replication mode". They are simply applying their proven model to an expanding footprint. We expect NVR will continue to grow for years. Organic growth combined with a reversion towards an 18x valuation should allow shares to compound at high-teens to low-twenties rate for several years.

Schmitt Industries

Schmitt Industries is a micro-cap based in Portland, Oregon. Mike Zapata, former Navy Seal and founder of value investment firm Sententia Capital Management, took control of the company in late 2018 and is orchestrating a turnaround. Zapata sold Schmitt's largest business line (SBS) in late 2019, leaving it with two operating businesses, real estate, and cash.

We spoke with Zapata before investing and felt he would be a good steward of our capital. Zapata has a number of options to create value:

- Execute on Schmitt's share repurchase authorization (20% of market cap);
- Grow the existing businesses organically with moderate internal investment;
- Monetize Schmitt's rental real estate; and/or
- Sell Schmitt's operating businesses outright.

We think management will monetize Schmitt's assets over the next 1-2 years. In the meantime, Schmitt's cash burn should be modest. It wouldn't surprise us if Schmitt appears to be dead money until it announces a monetization event.

Schmitt currently trades for less than the price of its *net cash*, and a 40% discount to its hard assets (cash plus real estate). Adding in the value of Schmitt's operating businesses to a private buyer puts our expected return over 100%, which could mean 20%+ annual returns.

Schmitt's rock solid balance sheet and bargain valuation protects the downside. It's a classic "heads I win; tails I don't lose much" situation.

Wells Fargo

Wells Fargo had a tough 2019, which didn't surprise anyone. They continue to grapple with the fallout from their fake accounts scandal but made substantial progress towards a turnaround in 2019.

Charles Scharf took over as CEO in October. He previously ran Bank of New York Mellon and Visa and spent 25 years working alongside Jamie Dimon. An outsider is the right choice to lead Wells forward, clean house, and rebuild trust with consumers and regulators. Scharf bought $5 million of Wells stock on March 13th at $28.69 which suggests he sees as much value as we do.

In February Wells settled with the Justice Department and SEC for $3 billion. This is slightly more than 10% of our estimate of normalized (though-cycle) pre-tax earnings.

Wells still faces two more regulatory hurdles: A Department of Labor investigation and the Fed's asset cap. Wells' asked the Fed to lift the asset in mid-March so that they can make additional loans to small businesses in need. The Fed has not publicly responded yet.

At $30 per share Wells' stock trades for 6.1x trailing earnings. Wells' is under-earning because of elevated legal costs and over-earning because of cyclically low credit costs. Normalizing Wells' efficiency ratio to 60%, in-line with peers Bank of America (60%) and J.P. Morgan (57%), and provision for credit losses to 0.75% (its 20-year average) brings earnings per share to $5.20.

At $30 per share Wells trades at just 5.8x. We think it is worth about 10x pre-tax (12-13x after-tax) which would be $68 per share — double its present quotation. If we also discount Wells' earnings to account for lower rates, normalized earnings per share drop to $4.65, putting it at a 6.5x PE - still a bargain in this scenario.

Our fair-value multiple is based on zero growth and a 10% discount rate. This should prove conservative. Eventually, the Fed will lift its asset cap and Wells will return to GDP-like growth. Long-term, we think Wells will retain about 10% of its net income and return the rest to shareholders. Currently Wells' pays a 7% dividend. Buybacks could add another 8-9% on top.

Wells has about $28 billion of excess capital on its balance sheet. Today this is an important buffer against an uncertain world. For context, Wells' provision for credit losses peaked at 2.77% in 2009. The same provision today would cost $26.7 billion — less than Wells' excess capital and just one year's normalized pre-tax earnings.

Exits

We exited several investments over the last six months. Below is a brief rundown. Please not that the figures exclude fees, commissions, and taxes. Those differ by account, as did each accounts exposure to investment.

Kontoor Brands

We bought Kontoor Brands in August 2019 and sold in December 2019. We outlined our thesis in our Fall 2019 Letter. We realized a 44.1% gain from August to December compared to a 13.1% rise in the S&P 500 during the same period. We sold Kontoor Brands after the stock rapidly rose to our assessment of intrinsic value.

NortonLifeLock

We bought NortonLifeLock in November 2019 and sold it in late February and early March 2020. We published our thesis on our blog on November 17, 2019. We sold Norton as the market began to falter in order to reinvest our capital into Berkshire Hathaway and Altria at attractive prices. We earned a 26% return compared to a 3% loss for the S&P 500 over that same period.

Odd Lots

We participated in a number of odd-lot special situations over the past six months. These arise when companies offer to buy or exchange shares from investors that own 99 shares or fewer.

We participated in two exchange offers, buying Danaher and receiving Envista, and buying McKesson and receiving Change Healthcare. We also participated in XBiotech's modified Dutch auction and Parker Drilling's going-dark transaction.

Collectively these trades lost roughly 1% for larger accounts and slightly more for smaller accounts. Since we can only buy at most 99 shares, these positions made up a small percentage of larger accounts and larger percentage of smaller accounts.

We think these types of trades have positive expected value and will produce profits over time. They're an attractive use of excess cash. This year we owned two (McKesson-Change Healthcare and Parker Drilling) during the market's severe March sell-off which drove the overall result of this group slightly negative. We took losses on both of those, but made money on the rest.

Southern Bancshares

We bought Southern in May 2019 and sold it in December 2019. We realized a 4% gain compared with a 17% gain for the S&P 500 over that same period. We sold Southern to raise cash for future investments with more promising long-term earnings power. Southern was illiquid and we feared that precisely when we would want to sell Southern to “upgrade” our portfolio, we would not be able to. Our capital from Southern helped to finance our purchases of American Express and Facebook in early March.

Walgreens Boots Alliance

We bought Walgreens in August 2019 and sold it in March 2020. We outlined our thesis in our Fall 2019 Letter. We sold in March to buy NVR. Walgreens shares held up relatively well compared to the S&P 500 and NVR in March’s strong sell-off. NVR was more attractively valued given its superior long-term earnings potential. We realized a 4% loss compared to a 12% loss for the S&P 500 over the same period.

In Closing

We would like to 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.

Please contact us with any questions about your account or your investments:

- dan@eaglepointcap.com
- matt@eaglepointcap.com

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 next fall for another portfolio update. In the meantime you can read our old letters and blog at eaglepointcap.com. We encourage new readers to subscribe to future updates.

On the following page you will find 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.

Disclosure

This letter has been distributed for informational purposes only. Neither the information nor any opinion expressed constitutes a recommendation to buy or sell the securities mentioned, or to invest in any investment product or strategy related to such securities.

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Eagle Point Capital LLC

FUNDAMENTALS

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 an antifragile capital structure.
  (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.

- We think independently and do our own research. We don’t rely on the opinions of analysts or journalists, both of which may have different motivations than ours. We rely primarily on S.E.C. filings for information. This can be a significant competitive advantage: in 2013 G.E. found its annual report had been downloaded fewer than 800 times. Although the S.E.C. goes to great pains to create a level playing field most investors don’t take advantage of it. You can lead a man to the library but you can’t make him read.

- We do not diversify excessively. Good investments are hard to come by and we would rather put our capital into our best ideas than spread among many mediocre ones.

- We act like business owners. As owners, we focus on the fundamentals of the business and do not obsess over fluctuations in price quotations. 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. We cannot control where the market prices our investments, but we can control whether our investments have a stable and increasing intrinsic value. So long as this is the case we are happy to hold them, regardless of market volatility.

- The best way to measure our success is to compare Eagle Point's return, after fees, to the S&P 500's total return (including the reinvestment of dividends) over a five-year period. Measurement over a shorter timeframe would 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*. A two percent annual fee on assets under management is charged to all accounts. Fees are calculated daily and deducted quarterly in arrears.

- Clients will receive a letter every six months detailing what they own and why they own it. We will be candid in our reporting to you, emphasizing the pluses and minuses important in appraising business value. Our guideline is to tell you the business facts that we would want to know if our positions were reversed. We owe you no less.

- Eagle Point is not in the business of predicting the general stock market or business fluctuations. If you think we can do this or you think it is essential to an investment program you should not be a client of Eagle Point.

- We cannot guarantee results to clients. What I 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
    - My immediate family and I have virtually our entire net worth outside of real estate invested alongside Eagle Point clients. We eat our own cooking.

Many of you already familiar with Eagle Point may feel, like Paul Hornung, that this material is unduly repetitive. However, I 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.