To:	Clients of Eagle Point Capital
From:	Matt Franz and Dan Shuart, Principals
Subject:	Spring 2021 Portfolio Update
Date:	April 1, 2021

As always, the goal of this letter is to explain what you own and why you own it. Our objective remains unchanged: to avoid the permanent loss of capital while maximizing the increase in the long-term, after-tax purchasing power of our funds. Put another way, we aim to build an indestructible long-term compounding machine.

Our method is to value the businesses behind stocks. We think and act like long-term business owners. Valuation is all about cash in and cash out. Warren Buffett has boiled the process down to three questions:

1. How much cash will you get?
2. When will you get it?
3. How sure are you of 1 & 2?

Most investors follow this process when buying private assets, like real estate. But many throw it out the window when buying public securities. Stocks are one of the few assets people get more excited to buy the higher prices go. Likewise, many panic and sell because prices fall.

We approach the stock market exactly like we'd approach buying a rental property.

First, we analyze the asset's competitive position. Is the property in a safe, up-and-coming neighborhood? Are the schools good? Are there lots of high-paying jobs nearby? Is supply constrained?

Next, we estimate the distributable cash the asset might produce. We focus on normalized rents and expenses over 5-10 years. Maintenance can be lumpy, making some years appear less profitable than others (like when a roof gets replaced). In the stock market, investors often value businesses as if these one-off expenses will reoccur in perpetuity. We look through these fluctuations to understand the asset's normalized earnings power and try to use mis-pricings to buy at bargain prices.

Next, we consider growth. We want to own assets likely to earn more in 5-10 years than they do today. A well-kept apartment in a desirable, supply-constrained neighborhood should be able to raise rents a few percent each year. We like that type of pricing power.

An asset's long-term return will approximate the sum of its earnings yield and growth rate. Earnings yield is the ratio of distributable earnings to price. It's the inverse of the price-to-earnings ratio. Lower prices make the same earnings more attractive, and vice versa. That's why investors should cheer lower prices.

Real estate investors can also make money flipping a property for a gain (or loss). This is akin to a stock's valuation rising or falling. We try to buy businesses at valuations more likely to go up than down, but predicting how valuations might change isn't really our game. We're most concerned about paying a low price to maximize our earnings yield. A higher valuation is the occasional cherry on top of an otherwise smart buy.

If price paid is the “cash in” part of investing, then dividends are the “cash out” component. Ultimately, rental properties and businesses are worth the present value of their future dividends.

It’s important to note the difference between dividends and earnings. Dividends are the fraction of earnings distributed to shareholders. Earnings that aren’t paid out are retained and reinvested. Companies retain earnings to try to increase their capacity to pay bigger dividends down the road. They can do this by reinvesting in their existing business, making an acquisition, paying down debt, or repurchasing shares.

Although retained earnings aren’t deposited directly into investor’s accounts like dividends, they’re just as valuable. How much cash a business retains and how well they reinvest it determine its growth rate. That’s why we focus on a business’s normalized earnings power and reinvestment opportunities, not merely their current dividends.

Cash in and cash out might sound simple, but it’s not always easy. Valuing even the simplest assets requires assumptions and judgments about the future which could prove false.

We confront this challenge in two ways. First, we aim to understand what we own. Knowledge and experience make estimating normalized earnings easier. We do our own research using primary sources, like S.E.C. filings.

We prefer to own simple, predictable, and profitable businesses because we understand them best. Buying a stock without understanding the underlying business is like buying real estate based on nothing but its price and address. That approach doesn’t make any sense to us.

Second, we maintain a margin of safety by using conservative assumptions and preferring low valuations. Pricing for perfection is a good way to go broke. **Rather than seeking brilliance, we focus on avoiding stupidity.**

Buying simple businesses with competitive advantages at undemanding valuations is the best strategy we’ve got. The hardest part is waiting for one of these “no-brainers” to come along. Fortunately, we don’t need many good investments to achieve good returns. One or two ideas a year is plenty.

Our patience paid off last spring when investors panicked and prices crashed. We acquired pieces of businesses we like, admire, and understand at prices we felt more than compensated for the pandemic's uncertainty.

Since then, panic has given way to greed. The market averages are near all-time highs, and enthusiasm for stocks has soared. **We remain optimistic but paranoid.** If last spring was a time

to be aggressive, this spring is a time to be conservative. We will move forward, but with caution. Though we can't predict what will come next, we can prepare by ensuring our investments maintain a margin of safety.

We believe our portfolio remains conservatively valued relative to its long-term earnings power. We own a collection of simple, predictable, and profitable businesses run by skilled capital allocators whose incentives are aligned with our own. Many carry net cash on their balance sheets and several are non-cyclical.

We expect our portfolio's *earnings* to hold up better than the broad market's in a protracted recession. In a continued bull market, we'd expect our portfolio's *earnings* to continue to grind along and produce satisfactory returns.

Attached to this letter, we've written more about each of our businesses to explain why we own them, how they've performed, and our expectations for them. We also explain each of the recent changes to our portfolio.

But first, we'd be remiss if we did not **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.

We are grateful to you for supporting EPC's long-term approach to investing. Our clients have proven themselves as exceptional and stoic investors, which provides us all with a significant competitive advantage. We are honored that you entrust us with your capital, and we are proud to be your investment partners.

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 October 1, 2021, with another portfolio update. In the meantime, you can read our previous letters and blog at www.eaglepointcap.com. We encourage new readers to join our mailing list to receive future updates.

Best,

Matt and Dan

Altria

Altria is the largest tobacco company in the U.S. It owns brands like Marlboro, Black & Mild, Copenhagen, and Skoal and has an exclusive license to IQOS in the U.S. Altria also owns non-tobacco businesses: 100% of Ste. Michelle Wine, 10% of Anheuser-Busch InBev, 35% of JUUL Labs, 43% of Cronos, and 80% of Helix.

2020 showcased the resilience and stability of Altria's business. Free cash flow from operations increased 12% to $8 billion. Over the last five years, Altria has produced $34 billion of cumulative core free cash flow and grown at a 23% CAGR.

Altria's Smokable and Oral Tobacco segments drove 2020's performance. Consumers had more time and money on their hands and increased their consumption. Smokeable volume declined 0.4%, while Oral increased 1.2%. Altria also raised prices three times last year. Pricing power is Altria's most potent value creation tool.

Despite its pricing power, Altria continues to trade at a modest valuation. The stock trades for eleven times operating free cash flow. The company returns 80% of its earnings to shareholders via dividends and yields 7%. Buybacks could add another 1% of yield.

We expect higher prices to more than offset lower volumes. Volumes will likely decline at a low-single-digit rate while prices increase about twice as fast. On balance, revenue should grow at a mid-single-digit rate and ahead of G.D.P. and inflation. Between growth, dividends, and buybacks, we expect Altria to produce double-digit total returns.

Altria also owns equity investments in Anheuser-Busch InBev, Cronos, and JUUL. These are currently worth $20 billion. Anheuser-Busch is the most valuable, accounting for 85% of the portfolio and 14% of Altria’s market capitalization. These investments give Altria broad exposure to leading cannabis, alcohol, tobacco, and e-vapor brands. We don't know how e-vapor, cannabis, or heat-not-burn tobacco products will fare, but sleep well knowing Altria has its bases covered.

Altria trades at a discount to the sum of its parts. Subtracting $20 billion of investments from Altria’s $85 billion market capitalization yields $65 billion for the core tobacco business. That’s a 12.5% free cash flow yield. Including its investments, which don’t produce free cash flow, Altria trades at a 9% free cash flow yield.

Long term, we expect Altria to replace its combustible products with reduced-risk products. The F.D.A. spent two years reviewing IQOS and has approved it for sale and marketing as a

reduced-risk product. Since Altria's core business more than justifies the entire company's valuation, we view Altria's investments as free options.

American Express

American Express operates a closed-loop payment network. They earn a percentage of transactions on their network (2.28% in 2020 and 2.37% in 2019), card fees, and interest income.

Their 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 higher rewards; and
- maintain a high-quality loan portfolio.

These factors reinforce each other in a positive feedback loop that produces high returns on equity (R.O.E.). Last year American Express earned 14% on equity, its lowest in a decade. We love investing in businesses like American Express, whose "bad" years put most companies' good years to shame.

Although American Express remained profitable in 2020, profits declined. Billed business declined 19%, driven by a 1% decrease in non-T&E spending (travel and entertainment) and a 61% decrease in T&E spending. Although American Express is often associated with travel, non-T&E spending makes up two-thirds of billed business.

T&E spending carries a higher discount rate than non-T&E spending, so last year's mix shift towards non-T&E pushed the average discount rate lower. We expect mix, average discount rate, and billed business to revert towards their mean in 2021 and 2022.

Card fees were a bright spot, growing 15% year over year. We think this bodes well for a rebound in billed business. Consumers don't pay $550 per year for an Amex Platinum if they don't intend to use it. That American Express could grow card fees during a pandemic speaks to the company's strong brand and loyal customers.

Credit quality remains good given the circumstances. Write-offs were 2.4% of loans and 2.0% of receivables. These are well below the peak write-offs Amex saw last recession (9.8%). The performance is a testament to the company's conservative underwriting, forbearance programs, and government stimulus. If credit continues to hold up, reserve releases could provide a tailwind to earnings in the coming years.

American Express trades for approximately 17x our estimate of normalized earnings. This is a reasonable valuation given that American Express benefits from a strong tailwind of increased spending and a shift from cash to credit. We are confident Americans will spend more on their credit cards in the years and decades to come. For every dollar spent on their network, American Express earns about 2.3% as revenue. This is like owning a toll booth on American spending which is virtually certain to grow over time.

Autozone

AutoZone is one of the largest auto parts retailers in the U.S. They sell parts to D.I.Y. consumers and commercial customers.

When someone's car breaks, time is everything. AutoZone's state-of-the-art distribution system can get the right part to the right place fast. If a store doesn't have a part, most can get it within 24 hours.

Although AutoZone carries a lot of inventory, it still manages to produce excellent returns on its capital. That's because AutoZone's vendors finance its inventory for free. AutoZone uses its scale to extract long payment terms. The company has usually sold its inventory before it pays for it. Last year, return on invested capital averaged 40%.

Internet distributors pose little threat to AutoZone. Car parts are bulky and hard to ship. E-commerce works best for small, high-volume products. Further, AutoZone's staff offer expert advice and free tool rentals. Customers come to AutoZone as much for these as the parts themselves.

The last thirty years have shown that AutoZone is recession-proof. We now know that it is also pandemic-proof. During tough times, customers work on their cars themselves to save money. AutoZone's strongest growth has always followed recessions. More importantly, AutoZone doesn't usually see sales decline when the economy improves. Once customers start coming, they keep coming back.

Government stimulus and favorable recession dynamics produced a record year for AutoZone. Same-store sales rose 7.4%, net income grew 7.2%, and earnings per share grew 13.4%.

AutoZone is growing at three times the industry's pace by taking market share. Last year's gain came at the expense of independent operators who did not have the resources to stay open. Share gains were strongest on the commercial side, which is also AutoZone's largest growth opportunity.

Earnings per share grew faster than net income because of AutoZone's "no-brainer" capital allocation. They reinvest in the business as much as possible and use the leftover cash to

repurchase shares. Between 2004 and 2020, they reduced shares outstanding by 71%, a 7.4% annual rate. This provided a tailwind to earnings per share, which grew 10x, or 16.1% per year.

Miles driven and average vehicle age drive demand for AutoZone's parts. As miles driven and vehicle age increase, so do the cost and frequency of repairs.

Stay-at-home orders caused miles driven to decline last year. Over the last fifty years, miles driven have increased 2.5% per year. We expect the trend higher will continue when the pandemic ends.

The average vehicle age was 11.9 years in 2020. That marked the ninth consecutive year that the average exceeded eleven years. We expect that the average vehicle age will continue to increase as new cars become more costly.

We expect AutoZone to increase its store count by a few percent each year. Same-store sales growth should add a few more points of growth. Stock buybacks and operating leverage will add further to returns. Overall, we expect double-digit total returns for the stock. At 16x earnings and a 6% earnings yield, the stock remains attractive.

Diamond Hill

Diamond Hill is a boutique investment advisor. They offer mutual funds, separate accounts, and limited partnerships. At year-end, they managed $26.4 billion across eight equity and five fixed income strategies.

Diamond Hill's investment philosophy is like our own. They do bottoms-up research to identify discrepancies between price and value. Their goal is to buy good businesses for less than they're worth. This provides a margin of safety against unpredictable events and misjudgments.

Diamond Hill makes money from management fees. These accrue as a percentage of assets under management (AUM). Earnings increase when AUM increases, which happens when clients invest more or investments appreciate.

Last year AUM increased by $3 billion. Half of that was inflows, and half was appreciation. Inflows and appreciation can be volatile, so 5-year trends are more telling. Over the last five years, AUM has grown $9.6 billion, a 9.4% compound rate. 96% was appreciation, and 4% was inflows.

The last five years have been incredibly difficult for active managers as investors have shifted funds from active to passive strategies. That Diamond Hill received net inflows at all is impressive and speaks to the strength of their brand.

Ultimately, capital follows performance. The better Diamond Hill performs, the more AUM will grow. Eleven of Diamond Hill's thirteen strategies have outperformed their benchmarks since inception.

Diamond Hill is an attractive business because it benefits from a rising stock market. Markets tend to rise over time, which provides a tailwind to earnings. But, Diamond Hill faces a headwind in pricing. A shift in mix, from equity to fixed income strategies, has reduced Diamond Hill's average fee rate.

Over time we expect good performance to drive net inflows and market appreciation to compensate for pricing headwinds. On balance, we think Diamond Hill is likely to continue growing.

Diamond Hill is also an attractive business because it earns high returns on incremental capital. Diamond Hill is launching funds in the areas where they can add the most value. This year they will launch two funds. One will be a concentrated (i.e. less diversified) version of their already-successful large-cap mutual fund. The other will be a Micro-Cap hedge fund. Micro-caps are hard to index, which makes them an easy place for Diamond Hill to add value. This is the same reason Diamond Hill has pushed into fixed income strategies in recent years.

To get these funds going, Diamond Hill will seed them with some of its own capital. If all goes according to plan, this capital will appreciate, create a track record of success, and attract outside capital. Then, Diamond Hill can withdraw its seed capital and distribute it to shareholders. This is a high return on investment proposition.

In 2020 the company earned $38 million for an earnings yield of 7.7%. But that's not the whole story. Diamond Hill is also overcapitalized. They own $180 million of cash and securities and carry no debt. Subtracting Diamond Hill's excess capital from its market value reveals a 13% earnings yield.

We expect management to return the majority of its current earnings as well as excess capital over the coming years. Historically Diamond Hill has returned capital via an annual special dividend in December and opportunistic repurchases. They've instituted a regular quarterly dividend this year.

Diamond Hill was one of the few companies that increased repurchases as prices fell last spring. This signals that management thinks and acts like long-term owners. Every employee owns

stock, and employees collectively own 17% of the company. Skin in the game is an important incentive.

Diamond Hill should earn even more in 2021. The crash last March depressed average AUM and earnings, well below year-end's levels. We estimate that Diamond Hill's operations trade for 6-7x 2021 earnings, exceptionally cheap for a growing business with solid fundamentals.

Facebook

Facebook is the world's largest social network. Over 3.3 billion people use one of the company'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 generates 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 11-15% year-over-year. Engagement remains steady and strong. Facebook should continue to acquire new users for the foreseeable future.

Facebook generated $86 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 38% today.

Facebook has a tremendous capacity for operating leverage. Eventually, we expect Facebook's operating margin 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.

Last year Facebook earned $10 per share and currently trades for 28x that. That's a reasonable premium to the market's median valuation (22x) for such a fast-growing, high-return business.

However, that's not the whole story. Facebook has $25 per share of cash, marketable securities, and equity investments that don't contribute to its earnings. Further, Facebook intentionally runs WhatsApp at a loss, reducing earnings. Capitalizing earnings would therefore ascribe a negative value to WhatsApp.

There's no way to pinpoint WhatsApp's current value, but we're confident that it is worth more than zero. It’s probably worth much more. Facebook bought WhatsApp in 2014 for $22 billion or $55 per user. Since then, monthly active users have grown from 400 million to 2 billion, a 31% compound growth rate. Continuing to value WhatsApp today at $55 per user suggests it could be

worth $110 billion or $40 per share. Though $110 billion might be high, we think WhatsApp is worth significantly more than Facebook paid for it in 2014.

Facebook may face a headwind this year. Apple plans to update iOS 14 to prevent user data from traveling between apps and websites. Apps and websites may still collect first-party user data but can't send or receive it from third parties. This may reduce Facebook's absolute value proposition to advertisers but will likely increase its relative value proposition.

Since user data can no longer travel between websites, websites with the most first-party data will have an advantage over smaller websites. Facebook, Google, and Amazon have the most first-party data by a long shot. No one else is even close.

Accordingly, Facebook will try to move more online interactions inside its apps. They partnered with Shopify to help businesses build e-commerce shops inside their Facebook pages. If activity and commerce move from third-party web pages onto Facebook, Facebook will benefit from the added data and engagement. Business owners will likewise benefit from Facebook's data regarding the effectiveness of their ads.

Overall, Apple's privacy changes will likely produce a short-term headwind. Over time, that headwind may become a tailwind.

McKesson

McKesson is the country's largest pharmaceutical wholesaler. They buy branded and generic drugs from manufacturers and deliver them to pharmacies. The industry is an oligopoly in the U.S. McKesson, AmerisourceBergen, and Cardinal Health together move over 90% of drugs.

Pharmaceutical wholesalers are middlemen who sit between large and fragmented markets. On one side, there are 1,300 manufacturers, like Pfizer, Eli Lilly, and Teva. On the other are 180,000+ dispensation points, like Walgreens, CVS, Walmart, and hospitals.

McKesson earns a fee for service on branded drugs in return for handling the manufacturer’s inventory, compliance, and credit risk. This frees manufacturers like Pfizer and Johnson & Johnson to worry about formulating new pharmaceuticals.

McKesson earns higher margins but lower revenues from generic drugs. Generics are branded drugs that have lost their patent protection. Instead of a fee for service, McKesson buys generic drugs, marks them up, and sells them to pharmacies.

McKesson aggregates tens of thousands of pharmacies' purchasing power to negotiate rock bottom prices. Individual pharmacies would never be able to get the wholesale deals McKesson strikes with generic manufacturers. McKesson modestly marks up generics and passes the bulk of the savings on to the pharmacies.

McKesson's competitive advantage is its efficiency. It earns net margins of just 1%, which provides a barrier to entry. Despite anemic margins, McKesson's scale and efficiency allow it to earn 50%+ on its equity. Mind-numbing drug distribution regulations further widen McKesson's moat.

We think of McKesson as a toll bridge that connects manufacturers with pharmacies. Every time a drug crosses its bridge, McKesson earns a small toll. The more drugs that cross the bridge, the more McKesson earns. We're confident that Americans will consume more pharmaceuticals in five or ten years than they do today. The population will increase, and age, pills per capita will increase, and prices will rise. This will provide McKesson a tailwind.

McKesson currently trades for 10x earnings, below its long-term median of 14x. Uncertainty about drug pricing and negative headlines over the company's opioid settlements are to blame. Over time, we expect strong earnings to speak for themselves.

Last year McKesson repurchased 10% of its outstanding shares. This is precisely what managers should do when business is strong and valuations are low. Going forward, we expect repurchases and dividends to average 5-6%. McKesson will likely make small bolt-on acquisitions, and earnings should grow mid to high single digits. Together, we expect double-digit total returns for the business. If shares re-rate back towards their historical valuation, the stock could outperform the business.

NortonLifeLock

Norton LifeLock is a global leader in consumer cybersecurity. We previously owned Norton from late 2019 to early 2020 and repurchased an interest in late 2020.

Norton is nearing the end of its corporate makeover. In 2019 the company sold its struggling enterprise business to focus on its superior consumer segment. Today Norton is a pure-play consumer cybersecurity company with branded products that allow consumers to protect their devices, online privacy, identity, and home networks.

Cybersecurity is an attractive business because it produces recurring revenue, has low incremental costs, and isn't too economically sensitive. Norton produces strong free cash flow, 50% operating margins, and 25% returns on capital. As more and more of life moves online, cybersecurity will become more critical. Norton will benefit from this tailwind.

Until recently, the business's true economics were obscured by the "stranded costs" left behind from the Enterprise business. Positions, facilities, and contracts associated with the Enterprise business were wound down and sold throughout 2020. Now that the work is complete, Norton's true earnings power should shine through.

We already see green shoots of progress. Norton has grown revenues mid to high single digits in each of the last five quarters. Management is focused on acquiring new users and increasing average revenue per user (ARPU) by tweaking price, mix, and cross-selling. Last, management will focus on reducing churn. Overall, we expect Norton to attract more subscribers at higher prices and keep them longer. If Norton succeeds, earnings should grow faster than revenues due to operating leverage.

Last year Norton used some of the cash produced by its corporate transformation to repurchase 8% of its shares. We expect them to continue repurchasing shares, albeit at a more sustainable pace, and continue paying a quarterly dividend.

Norton will spend the rest of its capital on organic and inorganic growth. Last year Norton acquired Avira, a “freemium” pioneer in cybersecurity with a strong presence across Europe. Avira brings 1.5M paid users and 30M active users into Norton’s ecosystem.

Today Norton trades for 14x earnings, or a 7% earnings yield. We expect the company to return most profits to shareholders while growing at a high single-digit rate. Combined, these should produce a satisfactory total return. If the stock's valuation multiple expands to trade in-line with other software as a subscription (SaaS) businesses, the stock could outperform the business.

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 operates a little differently than most home builders. Usually, builders buy raw land, develop it, build a house, and then sell it. This is capital intensive and often requires taking on lots of debt. Buying cyclical, non-cash-producing assets using leverage is a recipe for disaster and explains the sector's poor historical returns.

Instead of developing land itself, NVR acquires finished lots via options from local developers. They only start building after they've pre-sold the house. Management runs the company like a manufacturing outfit. They're disciplined about cost and leverage local economies of scale to drive efficiency. As a result, NVR's returns on capital are 2-3x higher than competitors.

NVR's board of directors incentivizes management to produce high returns on capital above all else. These incentives, combined with management's nearly 10% ownership stake in the company, align incentives with minority shareholders.

Last year NVR's revenue increased 2%, net income 3%, and earnings per share 4%. This was a good result considering the backdrop. More importantly, new orders increased by 28%, and the average price increased 3%. NVR's backlog grew 43% in dollar terms. This should drive record results in the coming years.

We think the wind will remain at NVR's back. The number of 30- to 39-year-olds in America is about to reach its highest point in history. These are prime home-buying years. Despite the recent surge in demand, the country remains critically underbuilt since 2008.

While demand is increasing, supply remains scarce. People are living in their homes longer than ever. 25% of homeowners have been in their house longer than 20 years, up from 9% 15 years ago.

Rising demand and tight supply should drive new construction and higher prices for several years. We think NVR can grow revenue at a high single-digit rate, though we expect the results to come in lumps.

Today NVR trades for 17x earnings and a 6% earnings yield. We expect management to return the majority of profits to shareholders via buybacks. High single-digit growth on top should drive double-digit total returns.

Though homebuilding is cyclical and downturns are inevitable, NVR's strong balance sheet and capital-light operations will help it weather the storms and emerge stronger than its competitors.

Schmitt Industries

Schmitt Industries is a small ($23 million) conglomerate that owns:

- Ample Hills, a Brooklyn-based ice cream company;
- Xact, a remote tank-monitoring business, and Acuity, a precision-measurement business, collectively the “measurement” segment;
- Real estate in Portland, OR with a recent 10-year triple-net lease to an investment-grade multi-national; and
- Around $7 million of cash.

We initially purchased our position in Schmitt because of the combination of high-quality management and a low price relative to its hard assets.

Former Navy Seal turned activist value-investor Mike Zapata has run the company since 2018. Since becoming C.E.O. Zapata has:

- Sold the SMS business line for $10M to a Japanese conglomerate;
- Developed plans to double the existing measurement segment;
- Upgraded the management team; and
- Bought Ample Hills out of bankruptcy for $1.6 million.

We think Zapata has done a great job the last two years and think he's only getting started.

Sales at Schmitt's measurement business were down roughly 8% in 2020. This was primarily due to interruptions from the pandemic and a pivot towards more profitable recurring revenue streams. Schmitt has been investing in the segment's sales infrastructure and aims to double revenue over the next five years.

Ample Hills enjoys a cult-like following and counts Oprah Winfrey and Bob Iger among its loyal fans. Founded in Brooklyn in 2011, Ample Hills has grown steadily. All of its stores are profitable on a stand-alone basis. However, the founders doomed the business when they built an ice cream factory in Red Hook. The factory came in behind schedule and over budget. Utilization was so low that it created dis-economies of scale. They declared bankruptcy in March 2020 on the same day New York City instituted a lockdown.

Ample Hills may have been able to restructure if not for the pandemic. While most buyers were distracted by the lockdown and abrupt transition to working from home, C.E.O. Mike Zapata was on top of his game. Schmitt submitted the only qualified bid for Ample Hills and won by default. Schmitt paid $1 million-plus $600,000 to cure certain leaseholders. Zapata took control of the business in June and spent the rest of 2020 stabilizing it.

Today Ample Hills has ten locations, a factory, an e-commerce business, and a wholesale business. All together, we expect it to produce about $10 million of sales. While the stores are profitable, the factory isn't. Zapata plans to soak up excess capacity by offering co-packing. There's also plenty of low-hanging fruit to reduce corporate overhead.

Chuck Green, the former V.P. of Sales at Ben & Jerry's, now serves as the company's C.O.O. Green helped negotiate Ben & Jerry's sale to Unilever in 2000 and knows how to grow a niche ice cream brand profitably. We think Green is an excellent hire.

We expect Ample Hills to begin turning a profit soon and enjoy high incremental return growth as they expand.

In addition to its operating businesses, Schmitt owns excess real estate and has $7 million of cash. In December, Schmitt listed its excess real estate for sale for $5.5 million.

Today Schmitt is worth $23 million. Backing out $5.5 million for the real estate and $7 million for the cash leaves $10.5 million for Ample Hills and the measurement businesses.

$10.5 million is only 1x Ample Hill's sales. Venture capitalists previously valued Ample Hills at $40-45 million. If Ample Hills garnered even half that valuation (~2x sales), Schmitt's stock price would be materially higher.

If management hits its targets, Xact and Acuity will be earning $2 million in five years, producing a 20% earnings yield from that segment alone.

We expect Schmitt to continue using its excess capital to grow its existing businesses and possibly purchase new ones. Zapata's strategy is to "buy on assets and sell on earnings." This produces a margin of safety. Buying undermanaged businesses with solid brands at bargain prices is a strategy we like.

Wells Fargo

Wells Fargo is one of the country's largest banks. 2020 was an unusual year at the company. Nevertheless, Wells Fargo still produced a $3.3 billion profit. Though that's 90% lower than last year's earnings, we consider any profit in this environment a win.

Earnings fell for two main reasons. First, interest rates declined. The yield on interest-earning assets decreased from 3.80% to 2.72%. Wells is "asset sensitive" because its assets reprice faster than its liabilities. This hurts earnings when rates fall but benefits earnings when rates rise. Wells estimates that a 1-point increase in rates would increase net interest income by 17%. We have no idea where interest rates will go in the short term but think they're more likely to rise than fall over time.

Second, Wells reserved $14 billion of current earnings for future loan losses. Those losses have yet to emerge. Actual losses increased to 0.35% from 0.29% last year. This is an excellent showing by any standard, let alone in a pandemic.

The divergence between expected and actual losses caused Wells' loan loss reserve to double to 2.22% of loans. This strikes us as conservative. If actual losses remain modest, Wells could release loan loss reserves. This would boost earnings short-term.

Despite significant loss reserves, Wells remains overcapitalized by $31 billion. That's 19% of the company's market value. Normally, Wells would return excess capital to shareholders via

dividends and repurchases. However, the Federal Reserve has temporarily restricted these for all large banks. As a result, Wells cut its quarterly dividend from $0.51 to $0.10 per share. These restrictions are temporary measures and will likely end soon.

Deposits were a bright spot in 2020. Non-interest-bearing deposits increased 18% to $471 billion. They now account for 27% of all liabilities, up from 23% in 2019. Low-interest rates mask the value of low-cost deposits, but they will help drive net interest income higher if rates normalize. Total loans to deposits stand at 65%, well below historical levels. If loan demand picks up, Wells will have the capacity to lend.

Wells has several paths to higher earnings. First, higher interest rates could increase earnings dramatically. This is outside of Wells' control. Second, Wells could reduce expenses and bring its efficiency in-line with peers. Expenses decreased last year, and management expects even more improvement this year. Achieving parity with Bank of America and J.P. Morgan will require a multi-year effort. Third, the Fed could remove the asset cap, which would allow Wells to grow its balance sheet. And fourth, loan demand could pick up.

If any of these come to fruition, Wells will see dramatically higher earnings in the years ahead. Between 2016 and 2019, Wells Fargo's net income averaged $21.5 billion. We see no reason it can't earn as much or more in a few years. That would mean Wells trades for 7.5x normalized earnings today.

Trades

Over the last six months, we sold our interest in Hilton, Wyndham, and Berkshire Hathaway. We purchased interests in McKesson and Diamond Hill. Below is a brief explanation of each transaction.

NOTE: The returns presented are from EPC's Model Portfolio. They include reinvested dividends and are net of a 2% management fee. They exclude other fees, commissions, and taxes, as these differ by account, as did each account's exposure to these investments. Individual returns may vary.

We sold our interests in Hilton and Wyndham in early 2021. Last spring we thought they looked like bargains relative to their post-pandemic earnings power. We reasoned that so long as travel reverted to 2019 levels within five years, we'd profit. In reality, Hilton and Wyndham's stock prices reverted to their pre-pandemic highs much faster than their underlying businesses. Given their full prices, we opted to sell our interests and reinvest the proceeds into businesses with more attractive risk-reward ratios.

On an annualized basis, our Hilton investment returned 73% versus 48% for the S&P 500 while Wyndham returned 60% versus 42% for the S&P 500.

We bought Berkshire Hathaway at Eagle Point's inception in July 2017 and sold it in January 2021. We added and subtracted from our investment several times over our more than three-year holding period. We earned an 6.4% money-weighted compound annual return on our investment which trailed the S&P 500's 14.3% return.

Although we like and admire Berkshire, the company has become a victim of its own success. It has amassed more capital than it will be able to deploy at attractive rates of return. C.E.O. Warren Buffett has "more cash than ideas."

Since Berkshire does not pay a dividend, its long-term returns will approximate its return on equity plus any valuation re-rating it may or may not realize. Today, that's about 10%, a decent but not terrific figure. We expect that we can earn higher returns elsewhere.

Rule of Three

Francois Rochon of Giverny Capital is one of the investors we most admire. He coined the Rule of Three, which we've decided to clone and adopt as our own. It is a rule of thumb based on empirical stock market data that 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.

Every few years, people forget that stock prices crash every few years. This is good news since crashes produce bargains, and bargain purchases tend to produce higher returns. When we think and act like long-term business owners, volatility becomes our friend and not our foe.

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.

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.