To: Eagle Point Capital Clients
From: Matt Franz, President
Subject: 2018 H1 Update

“It's true, of course, that, in the long run, the scoreboard for investment decisions is market price. But prices will be determined by future earnings. In investing, just as in baseball, to put runs on the scoreboard one must watch the playing field, not the scoreboard."
— Warren Buffett, 1996 Letter To Berkshire Hathaway Shareholders

There’s good news and bad news to report from the last six months. The bad news is that the market price of our investments declined. The good news is that the intrinsic value of our investments appreciated.

Every business has both an intrinsic value and a market price. Intrinsic value is the business's true value to a long-term private owner. In theory, you could represent intrinsic value mathematically as the present value of all future cash flows. However, without a crystal ball, it is impossible to quantify intrinsic value precisely. In practice, intrinsic value is a range of estimates based on current earnings power and how that earnings power is likely to develop over time.

Market prices tend to be much more volatile than intrinsic values since the market is prone to overreacting to recent developments. Over long periods of time (say, five or more years), the volatility of market prices tends to net-out and track intrinsic value fairly well.

This has two important implications for how we operate. First, we focus on intrinsic value, not market price, since market price ultimately follows intrinsic value. Second, we use their relative volatility to our advantage by purchasing stocks when the business sells below the bottom boundary of our estimate of intrinsic value. We expect to produce satisfactory long-term returns by owning businesses with a growing intrinsic value purchased at a discount to that value.

In this letter, I aim to give you a brief update of our business's intrinsic value as of the end of June 2018. In each case, I present a metric which roughly estimates the business's change in intrinsic value.

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Bank of America

Date	Price	Earnings	Δ Price	Δ Earnings
2013-12	15.57	0.90		
2014-12	17.89	0.42	15%	-53%
2015-12	16.83	1.31	-6%	212%
2016-12	22.53	1.49	34%	14%
2017-12	29.90	1.56	33%	5%
TTM (June '18)	28.28	1.94	-5%	24%
5-year CAGR	13.8%	16.6%		
Incl. Dividends				

Bank of America continues to perform admirably. It continues to collect lots of low-cost deposits, growing them by 3% in each quarter this year. Low-cost deposits are the raw materials for banking. Bank of America's low-cost of funding is a critical component of its long-term competitive advantage and superior earning power. Earnings per share have continued to march higher this year, driven by continued cost reductions, loan growth, and higher interest rates. In 2017 Bank of America returned $17 billion to shareholders through dividends and share repurchases. This year it received regulatory approval to return $23 billion, a 53% increase. This is a significant sum as it represents approximately 10% of the entire market value of the bank.

Berkshire Hathaway

Date	Price	Book Value	Operating Earnings	Δ Price	Δ Book Value	Δ Operating Earnings
2013-12	118.56	89.98	6.14			
2014-12	150.15	97.46	6.71	27%	8%	9%
2015-12	132.04	103.67	7.04	-12%	6%	5%
2016-12	163.83	114.36	7.13	24%	10%	1%
2017-12	197.22	141.17	5.86	20%	23%	-18%
TTM (June '18)	187.83	145.12	9.76	-5%	3%	67%
CAGR	9.6%	10.0%	9.7%			

Berkshire Hathaway showed dramatically higher operating earnings as its insurance operations swung back to a net profit after last year’s hurricane losses. Berkshire’s stock price has historically been closely tied to its book value, reflecting the large amount of securities it owns. While Berkshire continues to own a lot of securities - over $174 billion of equities alone - it’s operating earnings are becoming an increasingly important part of the whole. As Berkshire has grown it has transitioned from primarily buying pieces of businesses (i.e. stocks) to buying entire businesses outright. When Berkshire does this it records the business purchased at cost and never re-values it higher, even if the business's earnings improve dramatically. The only place the performance of acquired businesses shows up in the income statement.

As a result Berkshire's stock should command an increasingly large premium over its book value as it continues to acquire new business and those businesses grow in value. In July Berkshire announced that they formally removed their self-imposed share repurchase ceiling of 1.2x book value. This opens the door to a more aggressive repurchase policy that could be a catalyst for driving intrinsic value higher.

Brighthouse Financial

Date	Price	Book Value
2017-12	57.67	121.19
2018-06	40.78	112.17
CAGR	-29.3%	-7.4%

Brighthouse Financial is a new holding. It is the former retail arm of MetLife which was spun out in 2017. The company provides variable annuities, life insurance, and other retirement-related products to US consumers. The stock closed out Q2 at 36% of book value which we feel is much too cheap. We believe the stock is cheap and temporarily mispriced for several reasons:

- Its quarterly results are volatile and difficult for analysts to predict because it is sensitive to changes in the stock and bond markets. Wall Street pays a premium for short-term predictability and punishes everything else.
- MetLife retained a 20% stake in Brighthouse after the spinoff which they recently swapped to repurchase its own debt. This produced an overhang of shares on the market which are now being absorbed.
- Brighthouse's management said it will not return capital to shareholders prior to 2020 in order to bolster its capital base and invest in cost-saving initiatives. This is a good long-term move at the expense of the short term, but few on Wall Street are willing to patiently wait it out when Brighthouse's competitors all pay dividends.

Despite lots of negative short-term sentiment, we believe the future looks much brighter. Management is guiding for an 8-9% ROE once the transition phase to a stand-alone company is complete in 2020. This implies earnings per share of about $8 and means the stock trades at just 5x future earnings. During their Q2 earnings release Brighthouse initiated a $200 million stock buy-back, which is well ahead of their prior capital return timeline. With the stock trading at a fraction of book value buybacks are very accretive to intrinsic value per share.

So what's the risk? There seem to be two. One is that the company has under-reserved for its liabilities and dramatic write-offs of book value are ahead. We see no evidence of this. The second is a major decline in stock and bond prices. A market crash is impossible to predict and would negatively affect all stocks, not just Brighthouse. Brighthouse has reserves and hedges in place to ensure a crash does not put its balance sheet in jeopardy. At 36% of book value, we feel that the stock has a substantial margin of safety against these risks.

Exor

Date	Price (USD)	NAV (USD)	Δ Price	Δ NAV
2013-12	39.87	51.26		
2014-12	41.40	51.67	4%	1%
2015-12	46.02	56.01	11%	8%
2016-12	50.03	61.39	9%	10%
2017-12	61.53	96.32	23%	57%
CAGR	11.5%	17.1%		

Exor is an Italian holding company listed in Milan. As is the custom for European businesses, it reports only twice annually and as of writing, it has not reported H1 results. 2017 was one of the best years in the company's history as NAV grew by 57%. This was primarily due to the near doubling of Fiat-Chrysler's market value. As you may recall, we owned Fiat for a number of years believing it to be undervalued. Towards the end of 2017 we sold our stock and rolled the proceeds into Exor, which was trading at a 30% discount to its NAV. Today this undervaluation persists, but we are being "paid to wait" because NAV itself continues to compound higher. 2017's performance is unlikely to be repeated anytime soon, but we do expect NAV to continue marching higher.

We were saddened to learn that Sergio Marchionne, a senior leader at Exor and its publicly traded subsidiaries, passed away in July. Mr. Marchionne was a bold, value-focused leader that turned Fiat-Chrysler around and is responsible for much of the value creation at Exor over the last several years. There is no denying that Exor and its subsidiaries are worse off without him. John Elkan remains Exor's CEO and Chairman and is himself a capable capital allocator. We feel the company continues to be in good hands and will monitor the transition to new management at the subsidiary levels.

Markel

Date	Price	Book Value	Δ Price	Δ Book Value
2013-12	580.35	477.03		
2014-12	682.84	544.04	18%	14%
2015-12	883.35	561.19	29%	3%
2016-12	912.67	606.52	3%	8%
2017-12	1,116.31	683.75	22%	13%
2018-06	1,083.61	682.76	-3%	0%
CAGR	13.3%	7.4%		

Markel is a specialty insurance company with a small but growing operations arm that operates similarly to how Berkshire Hathaway did decades ago. Insurance operations continue to perform well, with the company posting a consolidated combined ratio in Q2 of 92%. The combined ratio is a measure of profitability for insurance underwriting - anything below 100% implies profitability. Insurance companies can make money in two ways: profitable underwriting and profitable investing. When a company collects premiums for a profit and can invest those premiums at high rates, the intrinsic value of the businesses becomes a compounding machine. This is what Berkshire and Markel have done. Exor purchased a large insurance company, PartnerRe, in 2015, to get in on the action. It is a powerful business model and one we like a lot.

So far in 2018 book value growth at Markel has been anemic. This is largely due to temporarily adverse movements in Markel's security's portfolio. When interest rates rise bond prices fall. This has produced marked-to-market losses in Markel's portfolio and offset gains in book value. Over the long run higher interest rates are good for Markel. If held to maturity, Markel's bonds will be redeemed at par (above their current mark-to-market price), reversing the losses. Furthermore, Markel will be able to reinvest the proceeds of those bonds into higher yielding bonds.

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Transactions

We purchased one stock in the first half of 2018, Brighthouse Financial (discussed above), and made three sales: Seritage Growth Properties, Wells Fargo, and Consol Energy.

Seritage Growth Properties is a REIT which was spun out of Sears and subsequently leased back much of its portfolio to Sears at below-market rates. Sears has continued to struggle and its operations have deteriorated faster than we expected. Seritage has been diversifying away from Sears as fast as possible and re-leasing at significantly higher rates. However, it appeared to us that this was not progressing fast enough and that Seritage's future could be put in jeopardy if Sears filed for bankruptcy. We were unwilling to accept the risk of ruin in this case and decided to sell. It's conceivable that we would re-enter Seritage in the future once it has diversified sufficiently away from Sears, if the price is attractive.

We owned Wells Fargo though TARP warrants which were expiring in October 2018. In my last memo, I wrote that we would likely sell Wells Fargo next, pending finding a new business to re-deploy the funds into, because of the upcoming expiration. We chose to do this when we discovered Brighthouse Financial. It was unfortunate to have to sell Wells Fargo in the midst of its current scandals. Despite these, the bank continues to be extraordinarily profitable and will continue to be. Although the scandals are a short-term negative, they are likely to result in a strong culture of compliance going forward. We will continue to watch Wells Fargo and look for opportunities to own it at a bargain price.

Consol Energy was a spinoff we invested in during 2017. The thesis was a simple sum-of-the-parts scenario: we felt it would be worth more separate than together. This thesis played out as the combined market value rose after the spinoff. Ultimately the two businesses are very dependent on oil, gas, and coal prices. It is unsettling to own a business that is so sensitive to variables that are totally outside of management's control. We like to invest in businesses who control their own destiny more firmly. We decided to exit the positions to lock in our gains and free up capital for businesses we feel are higher quality.

Since the end of Q2 we have begun accumulating shares of a new stock which was a recent spinoff. We are still buying our desired position, so I will hold off discussing it until my next letter.

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That about wraps up the first half of 2018. I'd like to thank you for your continued support and patience. A manager can only be as patient as his clients. Patience and a willingness to look past short-term volatility is absolutely critical for generating long-term market-beating returns. You can expect to hear from me again in the spring of 2019 once all of our businesses have reported year-end numbers for 2018. In the interim, if you have any questions or concerns feel free to contact to me.