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April 7th, 2016

Friends of Long Lake Capital Management,

We would like to take this opportunity to provide a recap of 2016's first quarter and provide an update on some of our equity holdings. As always, please feel free to contact us should you have any questions.

1Q16 Recap

The first quarter of 2016 kicked off the year in a volatile manner. The S&P 500 index declined as much as 11% through the first six weeks of the year, subsequently rallying to finish the quarter up 0.8%. There are two items of note regarding this move. One, this was the largest intra-quarter reversal since 1933 during the Great Depression. Two, it is only the second time in history the market has closed positive for the quarter after falling over 10%.

The initial decline in the quarter was largely attributed to concerns surrounding China's deceleration, falling energy prices, and the Federal Reserve's interest rate policy following the first rate increase since June 2004.

The Fed's rate increase in December was initially met with a sense of relief the Fed had finally started to normalize rates. However, markets began to rethink their initial reaction and ultimately sold off on fears surrounding the path of future rate increases in combination with the uncertain macroeconomic backdrop. Despite the Fed standing pat on rates in January, markets were further spooked by the "dot plot" indicating Fed members expected there would be 100 bps worth of rate hikes in 2016 (four rate hikes of 0.25% each). This was more aggressive than many were anticipating and the market reacted by heading lower.

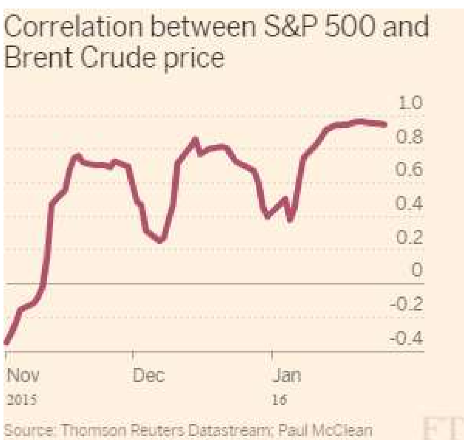
Why were the Fed's projections more aggressive than people were anticipating? For one, we are

S&P 500: Largest Intraquarter Drawdowns (1928 - 2016)

Date	PX_LOW	PX_LAST	Quarterly Low	Low to Close	Quarter Return (Price)
12/31/1929	17.66	21.45	-41.45%	21.46%	-28.88%
6/30/1932	4.40	4.43	-39.81%	0.68%	-39.40%
12/31/2008	741.02	903.25	-36.47%	21.89%	-22.56%
9/30/1931	9.71	9.71	-34.52%	0.00%	-34.52%
12/31/1987	216.46	247.08	-32.74%	14.15%	-23.23%
6/30/1931	12.20	14.83	-26.90%	21.56%	-11.14%
6/28/1940	8.99	9.98	-26.19%	11.01%	-18.06%
3/31/2009	666.79	797.87	-26.18%	19.66%	-11.67%
9/30/1974	63.54	63.54	-26.12%	0.00%	-26.12%
12/31/1937	10.17	10.55	-26.09%	3.74%	-23.33%
6/29/1962	52.32	54.75	-24.77%	4.64%	-21.28%
6/30/1930	19.39	20.46	-22.87%	5.52%	-18.62%
9/28/2001	944.75	1040.94	-22.84%	10.18%	-14.99%
6/30/1970	69.29	72.72	-22.69%	4.95%	-18.87%
12/31/1930	14.44	15.34	-22.32%	6.23%	-17.48%
9/30/1946	14.33	14.96	-22.25%	4.40%	-18.83%
9/30/2002	775.68	815.28	-21.63%	5.11%	-17.63%
12/30/1932	6.42	6.92	-20.54%	7.79%	-14.36%
12/31/1931	7.72	8.12	-20.49%	5.18%	-16.37%
3/31/1933	5.53	5.85	-20.09%	5.79%	-15.46%
3/31/1938	8.50	8.50	-19.43%	0.00%	-19.43%
3/30/2001	1081.19	1160.33	-18.11%	7.32%	-12.11%
12/31/1941	8.37	8.69	-17.94%	3.82%	-14.80%
9/28/1990	295.98	306.05	-17.33%	3.40%	-14.52%
9/30/1998	939.98	1017.01	-17.10%	8.19%	-10.30%
6/28/2002	952.92	989.81	-16.95%	3.87%	-13.73%
9/30/2011	1101.54	1131.42	-16.59%	2.71%	-14.33%
3/31/1939	10.98	10.98	-16.44%	0.00%	-16.44%
6/30/1937	15.12	15.40	-15.63%	1.85%	-14.06%
3/29/1935	8.06	8.45	-15.16%	4.84%	-11.05%
12/31/1973	92.16	97.55	-15.01%	5.85%	-10.03%
9/28/1934	8.36	9.08	-14.78%	8.61%	-7.44%
3/31/2008	1256.98	1322.70	-14.40%	5.23%	-9.92%
9/30/1937	13.20	13.76	-14.29%	4.24%	-10.65%
9/30/1981	112.77	116.18	-14.05%	3.02%	-11.45%
9/30/1975	82.09	83.87	-13.76%	2.17%	-11.89%
9/30/2008	1106.39	1166.36	-13.56%	5.42%	-8.88%
12/29/2000	1254.07	1320.28	-12.70%	5.28%	-8.09%
3/31/1982	107.34	111.96	-12.41%	4.30%	-8.64%
6/30/2010	1028.33	1030.71	-12.07%	0.23%	-11.86%
9/30/1966	74.53	76.56	-12.05%	2.72%	-9.65%
6/29/1934	9.38	9.81	-11.68%	4.58%	-7.63%
9/29/1933	9.65	9.72	-11.55%	0.73%	-10.91%
3/31/2016	1810.10	2059.74	-11.44%	13.79%	0.77%
12/29/1933	8.61	9.97	-11.42%	15.80%	2.57%
3/31/1960	53.47	55.34	-10.72%	3.50%	-7.60%
6/30/2000	1339.40	1454.60	-10.62%	8.60%	-2.93%
9/30/1957	42.42	42.42	-10.45%	0.00%	-10.45%
3/31/2003	788.90	848.18	-10.33%	7.51%	-3.60%
6/29/2012	1266.74	1362.16	-10.06%	7.53%	-3.29%
6/30/1949	13.55	14.16	-10.03%	4.50%	-5.98%

currently in the midst of a profits recession, meaning a bias towards a more accommodative stance by the Fed would be appropriate. According to FactSet estimates, profits for 1Q16 are expected to decline by 8.5% versus a year ago. If this comes to fruition, it would make four consecutive quarters of earnings declines, the longest streak since the four quarters beginning in the fall of 2008. This is hardly an ideal backdrop for raising rates. Furthermore, GDP growth has struggled to sustain positive traction, with real GDP growth hovering just north of 2% and trending lower. Finally, inflation measures have generally been disappointing, running below the Fed's stated target of 2%. Increasing rates would serve as a further headwind for inflation.

Why does the market want inflation? Much of the answer has do with the energy space. Given the large amount of debt outstanding, there are concerns that without higher levels of inflation we could experience a wave of bankruptcies for energy and materials companies, which in turn could have a negative impact on the banks. In fact, several banks, including Bank of America, JPMorgan Chase, Citigroup, and Wells Fargo have cautioned about write-downs and provisions on their energy company loans. Bank stocks performed terribly out of the gate this year and only really found footing once Jamie Dimon made a meaningful purchase of JPMorgan shares and oil prices started to rise.



Furthermore, U.S. energy companies account for ~20% of the high-yield bond market. The risk premium in the equity market typically tracks high yield spreads, and when high yield spreads widen as a result of concerns regarding energy-related names, stocks also typically come under pressure. So far this year, what has been good for the energy market has also generally been good for stocks. The correlation between the S&P 500 and oil in the first quarter was around 0.9, running higher than usual due to factors outlined above. During the market decline in January, oil prices fell on the back of concerns over slowing global demand, focused in large part on slower growth in China, as well as worries that the lifting of sanctions against Iran would add to a supply glut.

The general takeaway right now is while the economy continues to plod along, conditions remain somewhat fragile. True to what we have said we will typically do in the past, we were buyers into the sharp decline in January, and have eased off the buy button as the market rallied. Though we feel the market as a whole is reasonably valued, we do remain cautious on a near-term basis given the factors we have highlighted could cause an abrupt shift in market sentiment. If the Fed maintains a stance that is biased towards multiple rate hikes, the market is not likely to take that in stride and we would obviously prefer to add exposure at lower prices. Fed Chair Yellen has taken a more cautious view of late based on her comments, and this has been supportive to markets. Inflation and oil prices will also continue to be something to keep a close eye on going forward.

<u>Earnings and Market Valuation</u>

As mentioned, Wall Street analysts expect first-quarter earnings to decline 8.5%, down from an anticipated 0.8% increase at the start of the year. If projections hold, it would mark the fourth straight quarter of earnings contraction, and the largest year-over-year decline since the third quarter of 2009, when earnings dropped 16%. To date, 94 companies in the S&P 500 have issued EPS guidance for Q1 below analyst estimates, representing the second highest level going back a decade. By comparison, only 27 companies in the S&P 500 have issued positive EPS guidance. The expected struggles in the quarter are a continuation of the same themes: a stronger U.S. dollar, slower global growth, and lower oil prices.

We are believers in earnings driving stock market returns. At the end of 1Q15, the S&P 500 closed at 2,068 with a 1-year forward earnings forecast of $124. At the time we are writing this letter, the S&P 500 is at 2,072 with projected forward earnings of $124. A forward P/E ratio of ~16.5x continues to look reasonable to us, particularly given the low rate environment. Many continue to point out current P/E multiples are elevated versus historical levels but to us this is a false comparison. In investing, comparisons need to be made on a relative basis. A P/E multiple of 16.5x with today's yield on the 10-year Treasury at ~1.7% is in our opinion more justified than if the yield on the 10-year Treasury was meaningfully higher. U.S. Treasury bonds are generally accepted as the measure of expected return on a risk-free asset. If those returns are declining, it should follow that expected returns on other assets would also decline (i.e., higher P/E multiples, or from a different perspective, a lower earnings yield, or E/P).

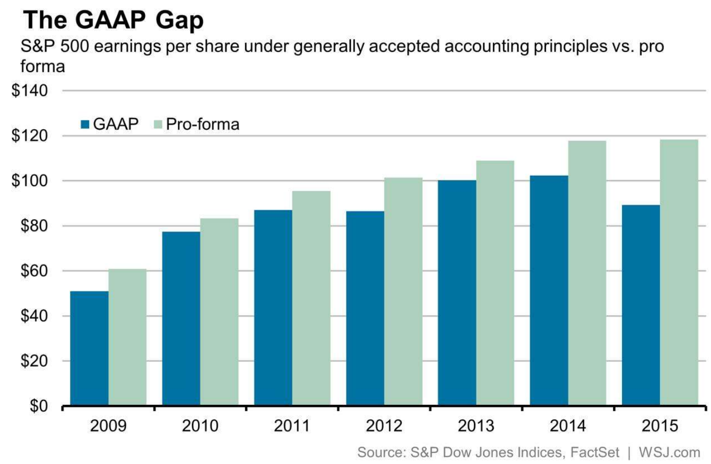
When articles indicate current multiples are "elevated" versus historical averages, keep in mind over the past 10 years 10-year treasury yields have averaged ~3.0%, and over the past 20 years have averaged ~4.0%. Thank you to all the journalists/analysts pointing out the "elevated" multiples versus historical levels, but based on the decline in rates, P/E multiples in our opinion should be higher than they have been in the past!

People are worried about earnings quality

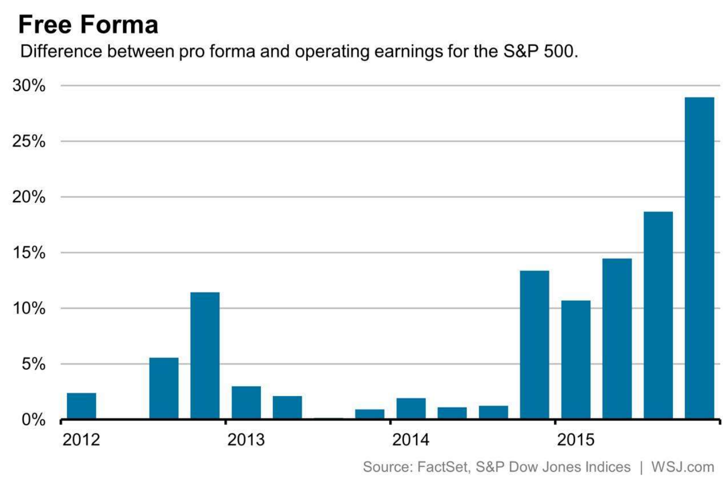
We have borrowed this header from Matt Levine at Bloomberg, a former Goldman banker who also worked as an M&A attorney at Wachtell, Lipton, Rosen & Katz. Levine writes "Money Stuff," a daily newsletter addressing topics of interest in the financial news while weaving in a healthy dose of humor (primarily by simply highlighting the absurd). We highly recommend his work.

In the Money Stuff newsletter, Levine has subjects he regularly revisits, such as "People are worried about bond market liquidity" and "People are worried about unicorns" (with "unicorns" referring to privately held, start-up companies valued at over $1 billion). Given the number of articles we have read recently about earnings quality, we felt it appropriate to borrow the title of this section from Mr. Levine.

There has been increased focus on the difference between companies' reported "pro forma" performance and their performance under generally accepted accounting principles (GAAP). The pro forma earnings numbers companies report typically boost reported results by excluding items such as "one-time" restructuring charges or non-cash costs such as stock-based compensation. Companies ostensibly report pro forma numbers because they believe these numbers better reflect the underlying trends in their operations. As justified as this is in certain cases, some management teams take things too far and expand adjustments to include questionable items. The widening gap between pro forma and GAAP earnings is highlighted in the following chart.



Outside of 2008, the only other times the difference between GAAP and pro forma earnings was as wide as last year was in the 2001-2002 timeframe, when companies took large write-offs associated with dot-com investments. Furthermore, in 2015 we saw the difference between GAAP and pro forma earnings increase by quarter. These charts highlight why the topic has been attracting more attention of late.



The difference between GAAP and pro forma earnings has even attracted the attention of the Securities and Exchange Commission, with SEC Chairman Mary Jo White recently indicating they are looking at taking a look at corrective measures, including regulation.

In our analysis of companies, much of what we focus on is making the appropriate adjustments to results in order to reflect "true" earnings. We never rely entirely on either GAAP (which has flaws of its own) or pro forma earnings. As far as the appropriateness of companies excluding items such as stock-based compensation from earnings figures, we will let Warren Buffett have the final word. The following comes from this year's Chairman's letter for Berkshire Hathaway:

> *"…it has become common for managers to tell their owners to ignore certain expense items that are all too real. 'Stock-based compensation' is the most egregious example. The very name says it all: 'compensation.' If compensation isn't an expense, what is it? And, if real and recurring expenses don't belong in the calculation of earnings, where in the world do they belong?"*

Select Equity Holdings Update

As usual in our letter, we intend to communicate with investors regarding a few of our equity positions. This quarter's update covers ViaSat, Inc. and Shutterfly, Inc.

ViaSat, Inc. (VSAT) $72.90

ViaSat was a strong performer, up over 20% in Q1. VSAT is a technology company, providing satellite-based broadband services, wireless networking applications, and networking systems, products, and services. The company sells to end markets including the government, individual consumers, and airlines for in-flight internet connectivity.

In the mid-1980s ViaSat started out as solely a technology provider, primarily to the satellite industry. One of the things management learned through the years as a technology provider was people were consistently interested in getting additional bandwidth, and the bottleneck in providing bandwidth to customers was in the satellites themselves. In an attempt to address this in the mid-2000s, ViaSat went to their satellite customers to see if they would be interested in constructing satellites with significantly more bandwidth at costs comparable to what they were already spending. The company found their satellite partners didn't think it was in their best interests to pursue such a solution, as meaningfully better satellites would more quickly obsolete the investment they had already put into space.

Management at ViaSat felt this created an opportunity. At that time, the company had built up a pile of cash, allowing them to make the strategic decision to move to a vertically integrated model by also becoming a services provider. The company appears to have benefited from this strategic move as they have moved to the forefront of satellite broadband connectivity.

Today, ViaSat owns two satellites, ViaSat-1 and the older WildBlue-1 satellite. The ViaSat-1 satellite was put into service in 2012, and at that time it was the highest capacity satellite in the world. With the ViaSat-1 satellite essentially at capacity, the company has plans to launch the ViaSat-2 satellite in Q1 2017, which will have more than twice the capacity of ViaSat-1 and seven times the coverage area. Further on the horizon, the company also has announced plans for ViaSat-3. ViaSat-3 will be three separate satellites, each covering 1/3 of the globe, with the first satellite expected to be in service in 2019. Each ViaSat-3 satellite is expected to have a terabit of capacity, more than the combined capacity of all satellites in space today. Projected returns on invested capital for the company are attractive and we believe the earnings power of the company will grow significantly in coming years.

One of the reasons ViaSat's stock has performed well so far this year is the traction the company has achieved in its in-flight Wi-Fi business. As the pioneer in the space, Gogo has been the incumbent inflight Wi-Fi provider on many airlines, but it would be charitable to label Gogo's service even "subpar." Streaming videos via Gogo's air-to-ground (ATG) service is nearly an impossibility due to a lack of capacity – some of us have learned this the hard way, traveling across the country with a toddler. In response to its capacity issues, Gogo has cleverly decided to resolve the issue by simply charging users more, so fewer passengers use it. The cost for in-flight Wi-Fi for a cross-country flight can be nearly $40.

Along comes ViaSat as a provider to JetBlue and Virgin America, offering a vastly superior experience at a much cheaper cost for both passengers and airlines. JetBlue and Virgin offer free basic Wi-Fi and free streaming of Amazon Prime (JetBlue) and Netflix (Virgin America), while premium Wi-Fi is also available for a reasonable charge. ViaSat's service is vastly superior to alternatives offered by Gogo and airlines (and their passengers) are taking notice.

In February, American Airlines looking to switch Wi-Fi providers, cited a clause in their contract with Gogo allowing them to end their agreement if a competing Wi-Fi provider offers a deal Gogo cannot match. American indicated ViaSat made such an offer. American dropped its legal action after Gogo said it would submit a competing proposal to ViaSat's, but even Gogo's next-generation, satellite-based technology (2Ku) is inferior to what ViaSat offers via their superior Ka-band technology and insufficient to meet passenger's needs. Though this situation has not yet been resolved, it is indicative of a shift in the landscape of in-flight Wi-Fi. Even if American retains Gogo, it will only be the case because Gogo has to enter into an agreement that is uneconomic.

The American-Gogo dispute was the first shot across the bow of the industry. Passengers expect to be connected all the time and the fastest, most cost-efficient alternative for airlines is ViaSat. On the most recent earnings call, ViaSat's management was extremely confident they would capture new airlines in the near term as well as capture more of existing customers' fleet. It is worth noting ViaSat has a portion of United's fleet today from a legacy deal with Continental.

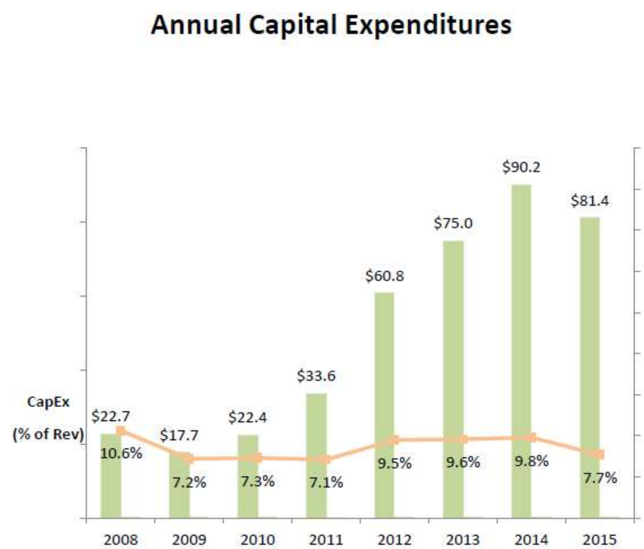
The in-flight Wi-Fi angle is only part of the ViaSat story but it has been the primary mover of the stock so far this year. Below is a comparison of Gogo (-41%) and ViaSat's (+20%) year-to-date performance.

In a world where bandwidth is becoming increasingly valuable, we like how ViaSat is positioned. Furthermore, the company has characteristics we find attractive, including strong returns on invested capital, a high percentage of insider ownership and the continued presence of the founders of the company, including Mark Dankberg as CEO.

Shutterfly, Inc. (SFLY) $45.83
Shutterfly is a consumer facing company engaged, primarily, in the printing business. The company produces traditional photos, greeting cards, household goods, calendars, and a variety of other items amenable to displaying an image. Shutterfly is the largest player in the industry at over 6x the size of their closest competitor. The company has a healthy mobile presence via its app, offers unlimited photo storage, and is making a nascent push into the enterprise side of printing (~10% of revenue, growing nearly 100% year-over-year).

In June of 2015, the company found itself engaged in a lengthy proxy fight with long term shareholders Marathon Partners. In short, Marathon argued management compensation was excessive, profitability was impaired due to excessive spending and lax cost controls, and that management had stonewalled potential acquirers (at prices rumored to be north of $65/share). The proxy contest called for the ouster of CEO, Jeffery Housenbold, and the appointment of three Marathon Partners representatives to the board.

Initially, it seemed Marathon scored a partial victory, successfully gaining two board seats but failing to oust Housenbold. However, on December 1st, 2015, Housenbold announced his intention to step down from the company effective February 19th, 2016. Shortly thereafter, on February 23rd, Shutterfly filed a Form-8K indicating it had been approached by private equity firm Thomas H. Lee about a potential sale of the company. Shutterfly has also recently amended certain executive compensation agreements to include change of control provisions that would provide additional incentives to management in the event the company is sold.



Source: Long Lake Capital and Shutterfly Filings

Certainly, much has changed in the past ten months and there seems to be significant activity beneath the surface. However, if an acquisition is not on the near-term horizon, Shutterfly has the potential to increase profitability through reductions in capital expenditures and a more reasonable executive compensation package. It's worth nothing that Housenbold's total pay package during his tenure at Shutterfly equated to over 10% of the company's current $1.6B equity market capitalization – with roughly $100M coming from dilutive equity compensation! Of note, Shutterfly's stock declined 9% over the past five years while the NASDAQ increased 75%. We would be challenged to find a more egregious example of excessive management compensation. In regards to capital expenditures, Shutterfly guided 2016's level to be in the 7.1-7.8% of revenue range, a ratio that is more in line with its historical average. We feel this level is likely to decline going forward following significant infrastructure and technology spending in 2014 and 2015.

Overall, it appears Shutterfly offers multiple ways to win: potential M&A, increased profitability on a stand-alone basis, and stronger management that is better aligned with shareholders.

Play ball!

With opening day in baseball upon us, we'd like to point out many of you are starting the 2016 season as owners of the Atlanta Braves via your stake in Liberty Media. The bookmakers in Las Vegas have given the Braves 140/1 odds of winning the World Series but at Long Lake Capital we remain optimistic. Even if the season is a disappointment, the team moves to a new stadium in 2017, and according to ESPN, the Braves have the top-rated farm system in baseball. The future looks bright. Go Braves!

We hope your 2016 is off to a great start and thank you once again for your trust in Long Lake Capital. If you have any questions or concerns, please do not hesitate to contact us.

Bryan & James