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April 18th, 2018

Friends of Long Lake,

We would like to take this opportunity to offer our current thoughts on the market, and provide an overview of two new equity holdings: Time Warner (TWX) and United Continental (UAL). A brief summary of the letter is as follows:

- Broadly speaking, valuations have become less expensive and stocks are supported by solid earnings growth, the recently unveiled tax plan, historically low bond yields, and the possibility of a domestic infrastructure program.
- Following a year of unprecedented placidity, volatility has returned to the market as investors appear to have become less optimistic at the margin.
- Headlines are driving much of the volatility, but it remains to be seen which – if any – of these risks materialize. One could argue the market is resilient despite the apparent headwinds.
- The Fed will likely raise rates at least three times in 2018. Major questions remain about the impact of central banks beginning to tighten policy.

1Q 2018 Update

To date, the S&P 500 is down 0.12% has vacillated between 2,600 and 2,800 for the majority of the first quarter. However, despite the market being flat, it has not been a smooth ride as volatility picked up significantly. As of 4/18/2018, the S&P 500 had experienced a ±1% daily change 20 times. By comparison, at that point in 2017, which was a very placid year, it had occurred once (see Chart 1 in the Appendix). Intraday swings, often occurring in a matter of minutes, were particularly eyebrow raising, and as we communicated to clients in mid-February[1], likely a result of leverage embedded in ETFs combined with algorithmic trading. In short, 2018 has been two steps forward and two steps back, a fairly frustrating environment for asset managers and their clients.

The proximate causes for the increase in volatility are varied and changed almost as rapidly as your author was able to construct this letter. In roughly two months the market has reacted negatively to: rising bond yields, higher than expected inflation, continued investigations regarding Trump/Russia/Comey/Mueller, continue turnover in the White House (Gary Cohn out, Larry Kudlow in, etc.), bombing Syria, Stormy Daniels, concerns over mid-term elections, Tech stocks selling off following Facebook's data scandal, rising crude oil prices (highest in 3yrs), escalating trade war tensions with China, choppy

[1] Email: "Framing the Recent Market Decline" delivered 2/5/2018 and 2/9/2018

economic data, and – coming full circle – a flattening yield curve. Frankly, that is a significant amount of negative news flow for the market to digest and it is notable stocks have actually held up fairly well following a strong 2017.

Of the aforementioned headwinds, we remain most concerned about the possibility of higher bond yields combined with significant debt loads at the corporate and sovereign levels. Interestingly, corporations do not seem concerned about debt levels as the overwhelming majority of monies brought on to balance sheets through tax reform are going to be spent elsewhere.

Exhibit 5: How Are Companies Likely to Allocate Their Tax Savings, Average Responses by Sector

	Capital Spending	Balance-Sheet Repair	Share Buybacks & Dividends	M&A	Labor Compensation
Manufacturing	16.1%	5.6%	46.7%	22.8%	8.9%
Services	18.2%	9.9%	40.1%	15.4%	16.4%

Source: Morgan Stanley Research

The prospect of refinancing levered balance sheets at higher rates while experiencing a deceleration in economic activity (assuming the US economy is in the latter part of the cycle) is potentially daunting. As the saying goes, debt does not matter until it does.

On the positive side, corporate earnings are extremely strong. In fact, as a result of tax reform, 1Q18 saw one of the largest upward earnings revision in history with analysts expecting 17.3% year-over-year growth. While most investors would prefer earnings growth to come from increases sales or cost cutting measures, the benefit of lower taxes is certainly not a bad thing for stocks. As of 4-18-2018, 17% of the S&P 500 had reported 1Q18 results with 80% beating earnings estimates and 72% beating revenue estimates, both "beat rates" are above their respective five year averages.

From a portfolio management standpoint, we were net buyers during Q1, adding positions in Time Warner (TWX) and United Continental Airlines (UAL). More information on those two holdings can be found in the Select Equity Holdings Update section. Despite the market's volatility, we reduced our trading frequency as the market lacked a trend direction and became overly susceptible to headline risk. From our standpoint, it is odd to see something like a medical stock fall rapidly with the broader market based on a headline, such as bombing Syria, that has almost zero impact on the company's business prospects. This often signals mindless selling, and can be an opportunity, but with the market moving hundreds of points on a Tweet, we concluded the risk/reward was not favorable to trading. Warren Buffett has a great analogy about the day-to-day ticks of the stock market being similar to a moody neighbor yelling out the price at which he would purchase your house every morning[2]. Buffett's point being that short-term volatility is mostly noise and that long-term prices are dictated by the underlying business' profitability. As such, we elected to ride out the volatility maintain our current holdings.

On a personal note, the Mortenson family welcomed Henry Alan (his paternal and maternal grandfather's respective middle names) on 3-23-18. We have notified Michigan's head basketball coach, John Beilein, and are looking forward to receiving a scholarship for the freshman class of 2036…

[2] http://fortune.com/2014/02/24/buffetts-annual-letter-what-you-can-learn-from-my-real-estate-investments/

We hope our readers have enjoyed the market outlook portion of the letter. The following sections contains an in-depth look at the new equity holdings.

All the best,
Long Lake Capital Management, LLC

Select Equity Holdings Update

For first time readers of this letter, we aim to make the equity update easily understandable for clients that may not have a background in finance. For each long-term investment idea, Long Lake constructs an in-depth report, which we do not distribute due to compliance reasons.

Time Warner (TWX, $96.43/share, $76B market cap)

TWX, owner of Warner Brothers, HBO, CNN, TNT, and TBS among others, is currently in the process of being acquired by AT&T (T, $214B market cap), a deal that has been opposed by the US Government. The deal's terms are $53.75 in cash plus $53.75 in T stock or 1.437 in T stock if T is below $37.41/share (currently ~$35), which means TWX shareholders would receive ~$104/share, around an 8% premium.

During the presidential campaign, Trump said the transaction would be rejected by his Administration as it concentrated too much media power in one entity. Trump also said he would seek to break up Comcast-NBC Universal. Despite campaign rhetoric, we believe the proposed transaction will ultimately be approved (and doubt the DOJ will file a lawsuit to break up Comcast-NBC Universal) as the DOJ's case does not appear to be particularly strong. An article[3] from Forbes assesses the situation well:

> *Antitrust scholars, media industry experts and economists across the political spectrum have been scratching their collective heads since November, when the Department of Justice filed suit to block AT&T's planned $85 billion merger with Time Warner.*
>
> *As the case now heads for an early trial in March, that confusion has only grown.*
>
> *The government's untested new theory is that the merged entity will have both the incentive and the ability to withhold or overcharge for Time-Warner content if the deal goes through.*
>
> *But that view stands in stark contrast to what is happening across the media landscape. Incumbents, including AT&T, have continued to lose ground to new entrants and new forms of content, pushing traditional producers and distributors into more deal-making.*

[3] https://www.forbes.com/sites/larrydownes/2018/02/01/the-governments-unraveling-antitrust-case-against-att-time-warner/#5936dd631268

Even since the government filed sued to block the AT&T-Time Warner deal, for example, Disney proposed a $52 billion takeover of much of Fox's content business. And just last week, Reuters reported that CBS and Viacom had begun talks about recombining the two companies.

With little to no legal or economic basis to support the government's complaint, the possibility of potentially unlawful White House interference in the Justice Department's review has grown from wild speculation to something more plausible.

The trial began March 19th, 2018 and the government wrapped up its case nearly a month later. TWX and T executives will now present their side of the case and we can expect a ruling sometime in the following weeks.

We have no real interest in owning either the combined entity or TWX as a standalone company. Thus, when the ruling is announced, or potential prior to, we will most likely exit the position. From our standpoint, allocating a portion of client capital towards an investment with less market risk (as TWX shares are supported by the price T is paying) and some modest near-term upside made sense given the volatile backdrop in the broader market.

United Continental (UAL, $69.65, $19.8B market cap)
UAL, along with Delta (DAL, $38.6B market cap), Southwest (LUV, $31.8B market cap), and American (AAL, $22.1B market cap) is one of four legacy domestic carriers. The company is headquartered in Chicago, IL and operates a fleet of nearly 750 aircraft around the globe.

Historically, the aviation industry has been a poor steward of investor capital, as a large number of carriers frequently fought for market share via price wars that often resulted in carriers filing bankruptcy. Warren Buffett famously said "if a farsighted capitalist had been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville [Wright] down."

Today, the industry has consolidated to four major carriers and handful of regional (i.e. Jet Blue or Alaska Air) and value carriers (i.e. Spirit Airlines or Allegiant Air). Participants are seemingly behaving rationally as each major carrier has a significant presence at a number of hubs and does not aggressively seek to interfere with another carrier's hub.

UAL Hub Geography

AAL Hub Geography

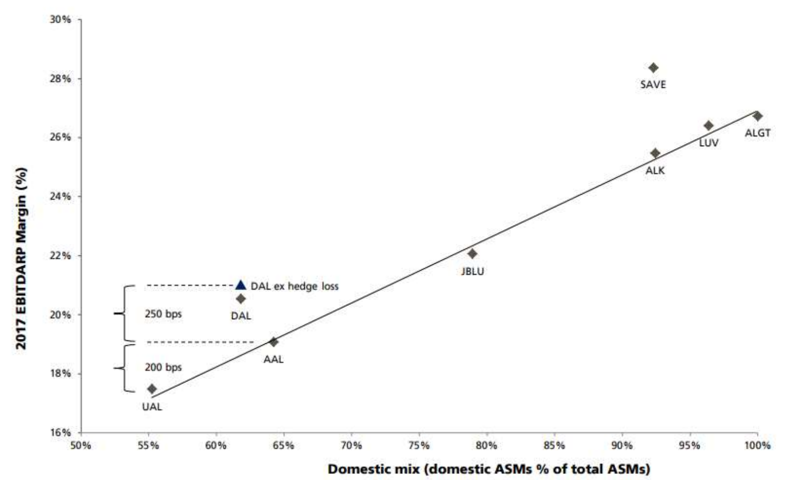
DAL Hub Geography

Additionally, industry capacity has moved almost in lockstep with passenger traffic, generally growing low-to-mid-single digits per year. Mostly gone are the days of flights with empty rows, and it is increasingly rare to find a flight with more than a handful of empty seats. Industry pricing has also been primarily positive, as the carriers seem to have figured out driving each other into bankruptcy with price wars is not a viable long-term strategy.

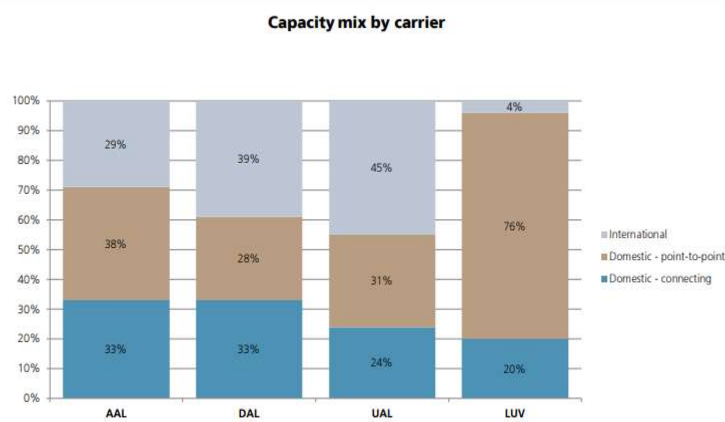
Interestingly, after our purchase, CNBC interviewed Warren Buffett about a variety of topics, but one question centered on Berkshire's investment[4] in the aviation industry and whether or not Berkshire would consider owning an airline in its entirety. Buffett said he would not rule it out, and given Berkshire's ownership of Burlington Northern Railroad, it is not unfathomable to envision furthering Berkshire's position in transportation. Traditionally, Berkshire has chosen companies with great management teams, industry leading margins, or a significant durable moat. If continuing along this route, LUV would be the most likely target. However, Berkshire has partnered with firms, such as 3G capital, that are adept at cost cutting and turning around underperforming assets. If that path was chosen in the aviation industry, UAL would be a likely target.

Of the major domestic carriers, UAL trails the peer group in terms of margins and profitability, which is primarily the result of having less exposure to more profitable domestic routes and greater exposure to less profitable international routes. This dynamic is something management aims to remedy and, we feel, has provided an opportunity for investors.

UAL's margins are low, partially because of low domestic mix



UAL's domestic connecting mix is particularly low



In mid-February, UAL's stock declined from \$78 to \$66 after management indicated they intended to raise capacity 4%-6%, which is above that of the aviation market's 3%-4%. Recall, the industry has historically been reckless with capacity and pricing decisions and, on the surface, this decision seemed like a reversion to the "bad old days". However, following the announcement, UAL management spent a significant amount of time clarifying the strategy at various conferences and investor events and we believe the capacity additions are meant to improve UAL's capacity mix domestically and are not meant to disrupt the industry's currently favorable structure. To fully understand what UAL is

[4] Berkshire owns sizable positions in all four legacy carriers, and may be their way of getting an internal look at which company would make the most sense to acquire

attempting, management wants investors to compare UAL's "natural market share" to its peer group. Natural share is essentially the share of domestic revenue a carrier *should* have based on the number of hubs the carrier operates. Admittedly, this is not an exact science, but the following table illuminates how far behind the peer group UAL is:

Figure 5: All one-stop connecting passengers

Passengers (in m)	AAL	DAL	UAL	Total	Natural share
AAL	16.8	11.9	5.9	**34.6**	**35%**
DAL	7.8	14.5	6.1	**28.4**	**29%**
UAL	12.7	11.8	10.9	**35.3**	**36%**
Total	**37.2**	**38.2**	**22.9**	**98.3**	**100%**
Actual share	**38%**	**39%**	**23%**	**100%**	
Incremental Passengers	**(2.6)**	**(9.8)**	**12.4**	**-**	

Source: DoT Domestic O&D Survey and UBS estimates

The assumptions behind the math[5] are certainly up for debate, but the main takeaway is that UAL operates a similar number of hubs as AAL and DAL, yet flies significantly fewer passengers, and therefore captures less than its "natural share" of the available market. Management believes fliers are choosing other carriers due to UAL's lack of capacity in certain connecting markets. This point is one that was not well understood during the initial capacity announcement. UAL does not aim to add more capacity in Detroit (DAL hub) or Miami (AAL hub), but it does seek to add capacity from Houston (UAL hub) to, say, Albany, NY (no one's hub). UAL is not attacking the major hubs of other carriers, but it is seeking to give current UAL passengers greater access to their final destinations. As shown in the prior graphs, UAL's profitability could be improved by increasing the number of domestic flights. Interestingly, flights from hub cities to non-hub cities are some of the most profitable in the domestic industry. Your author is always surprised that the cost of a flight to Birmingham, AL from Detroit is typically hundreds of dollars more than a flight from Detroit to Los Angeles.

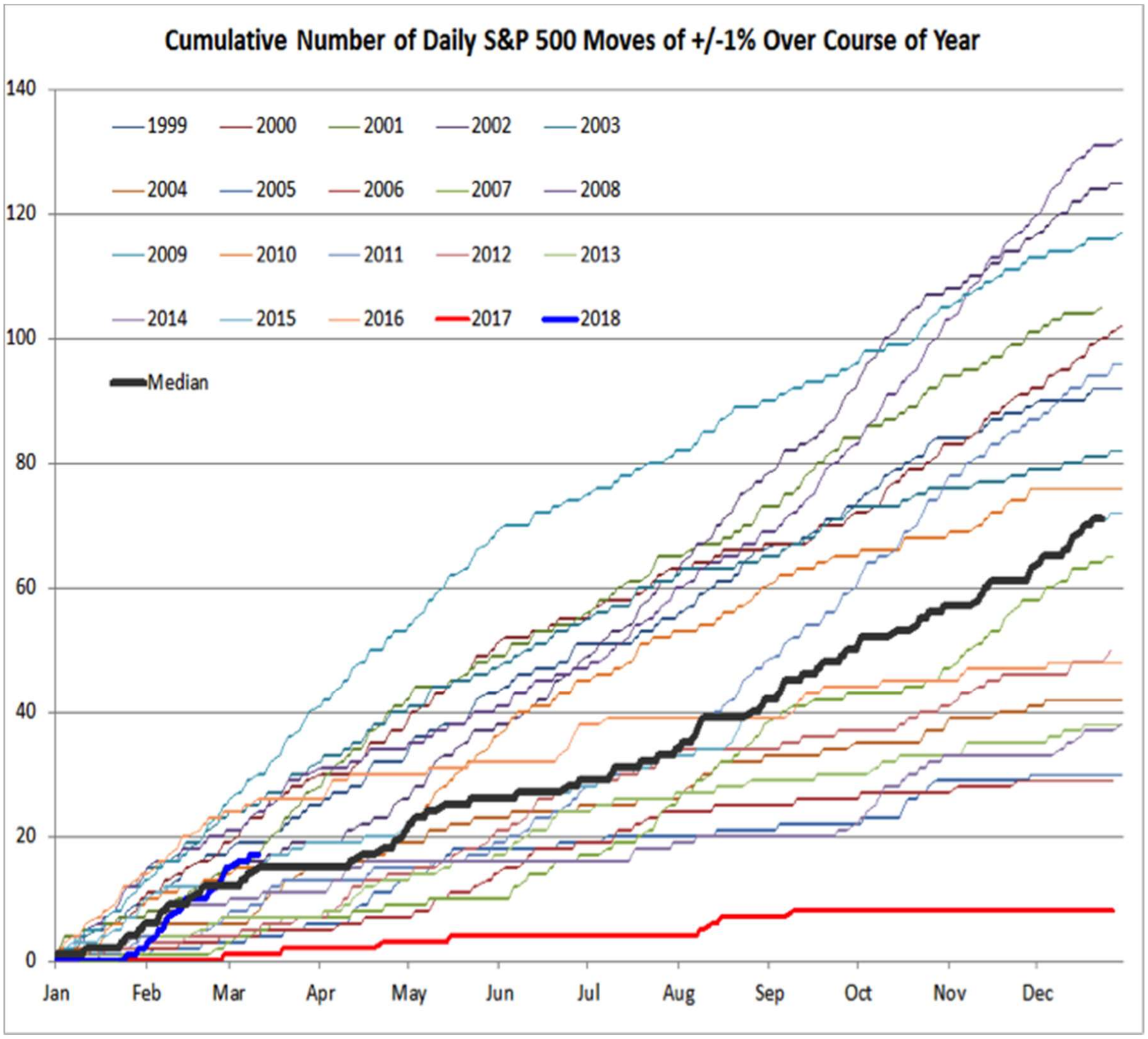
UAL released its 1Q18 earnings on 4-16-2018 and guided to EPS of $7.00-$8.50 (implying the stock trades at 10x earning at the low end of the range) in 2018 and believes it can achieve EPS of $11.00-$13.00 by 2020 (6.3x earnings at the low end), which would equate to 25% compounded annual earnings growth. The company also trimmed its capacity addition forecast by 0.5% at the top of the range, which investors seemed to receive favorably. In December of 2017, the company authorized a new $3.0B share repurchase program, which is in addition to the $3B remaining on the company's prior share repurchase program. If completed at today's share price, the $6.0B in repurchase capacity equates to just over 30% of the company's outstanding equity.

Overall, UAL seems like a cheap stock with company specific earnings drivers and a shareholder-friendly management team. The industry has improved so much from its auspicious past that it attracted billions of dollars from an investor who once believed the industry would have been better off never existing. We suspect the smooth flying will continue to be mostly devoid of turbulence.

[5] Should a reader wish to see the math and assumptions, we are happy to provide it.

Appendix

Chart 1



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