LONG LAKE CAPITAL MANAGEMENT, LLC

74 E. Long Lake Rd. Suite #210
Bloomfield Hills, MI 48304
248-712-6160
www.longlakecapital.com

May 2nd, 2019

Friends of Long Lake,

We would like to take this opportunity to offer our current thoughts on the market, and provide a brief overview of three new equity holdings: DaVita Inc. (DVA), Owens Corning (OC), and Service Corp. (SCI). A brief summary of the letter is as follows:

- The 2019 rally appears to have caught many by surprise. Pullbacks have been shallow with nothing over 3% to date.
- The Federal Reserve shifted its stance from stubbornly raising interest rates, regardless of economic conditions, to taking a "data dependent" approach. This has served as a tailwind to stocks.
- 1Q19 earnings have been better than feared, as many predicted an earnings recession, but one has not materialized.
- A $2T infrastructure program is on the table, though with a split Congress, it will be difficult to pass.
- A trade resolution with China appears imminent, which would likely end the current "tariff war" and should boost corporate earnings.
- Chinese economic data appear to have bottomed and government officials are considering taking further stimulative measures.
- Brexit has garnered many headlines, but has not yet had an impact on US equity markets.
- Should Trump fail to win reelection, the 2020 Democratic presidential candidates are likely to be considerably less business-friendly.
- The Healthcare sector has been under pressure due to rising concerns posed by "Medicare For All" and/or other public healthcare initiatives.

1Q19 Recap

Following one the worst quarterly selloffs in history during 4Q18, the S&P 500 posted a 13.1% gain in 1Q19. The primary drivers appear to have been a continuation of what began towards the end of 2018. From our 4Q18 letter:

> *"Overall, the potential negatives appear fairly well understood by investors at this point, and we have heard relatively few discuss ways the market could have a good 2019. To that end, it makes us wonder about the potential for upside: bond yields (as an alternative to owning stocks) are not particularly attractive; slowing European and Chinese growth towards the end of 2018 could make the end of 2019 easier from a comparable standpoint; although slowing, US corporate and*

economic data are not recessionary; the business environment in the US is still strong with record low unemployment numbers; the Federal Reserve is more accommodative on the margin; sentiment, as reflected by cash balances in money markets, is fairly negative (which can be a positive as cash reenters the market); and equity valuations seem reasonable. Taken as whole, these potential positives could make 2019 a better than expected year for equity investors.

Heading into the 1Q19 earnings season, investors were fearing an earnings recession[1]. There was a sharp decline, as aggregate S&P 500 earnings slowed from the +24.2% in 3Q18 to +12.6% in 4Q18 to +1.36% in 1Q19 to date[2]. 1.36% growth is not stellar, it is also not recessionary and is above expectations. This seems to have given investors confidence that fears of an economic slowdown in the first half of 2019 are not materializing, or are at least not being reflected in corporate America. As the old saying goes, earnings are the mother's milk of the market.

On the topic of earnings, coming to a trade resolution with China – assuming it removes currently imposed tariffs – should provide a tailwind for both economies and aid earnings growth as input costs are reduced. There has been a seemingly never-ending series of "we are close to a deal" statements from both parties, but recent commentary from President Trump and Treasury Secretary Steven Mnuchin seem to indicate a deal is likely within weeks. At this point, it is likely the market has priced in the positive impact from a trade deal, but as usual, the devil will be in the details.

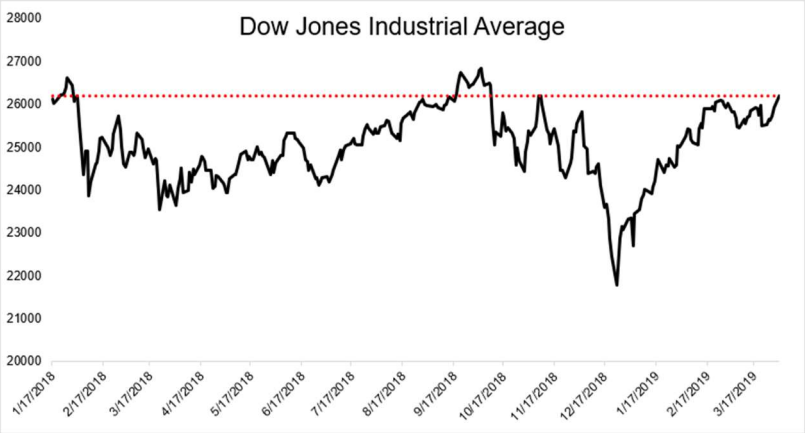
Staying in the political realm, on April 30th, Democratic congressional leaders Chuck Schumer and Nancy Pelosi, along with President Trump, announced they are targeting a $2T infrastructure program. With a split Congress, passing an infrastructure program will be difficult as both sides will haggle over funding and projects. However, members on both sides of the aisle agree there is a need for greater infrastructure spending. Trump, Schumer, and Pelosi are scheduled to meet again towards the end of May. We would categorize the Street's expectations of success as relatively low, so if a deal were to materialize, it would likely be positive for the broader market.

In our 4Q18 letter, we noted that part of the market selloff was likely due to investor's belief the Fed was going to continue raising interest rates despite decelerating economic data. The Fed quickly shifted its tone to one of data dependency and flexibility, which calmed investor's fears. Now, sentiment has, perhaps, shifted too far the other way, as the odds of a rate hike in 2019 are lower than the odds of a rate cut. Given mostly decent economic and inflation data, cutting rates seems unlikely to us. Of note, on 5/1/2019, the Fed announced it was keeping rates unchanged at 2.25%-2.5% and Fed Chairman Powell stated "we don't see a strong case for moving [interest rates] in either direction.[3]" That statement caused a nearly 300-point intraday swing in the Dow and a 120+ point drop the next day. We find it difficult to change our market outlook based on investor's future expectations of a quarter percent difference in interest rates, but acknowledge there could be some market angst as the Street adjusts to the Fed's outlook.

---

[1] A decline in year-over-year earnings growth
[2] 5/1/2019
[3] https://www.barrons.com/articles/dow-fell-163-points-fed-wont-take-it-easy-51556744888?mod=djem_b_Weekly%20barrons_daily_newsletter

We continue to monitor the situation around the 2020 presidential campaign and feel it bears mentioning the current impact on the healthcare sector. Many of the Democratic candidates believe in Medicare For All "M4A" or some version of public healthcare. We will spare readers the details of M4A, but it is basically a single-payer healthcare system that would likely have significantly lower payouts than the current private pay system. This would, obviously, pressure most companies that are part of the healthcare system. Bernie Sanders is the main proponent of M4A, and Joe Biden recently announced his desire to see a public healthcare option. Sanders and Biden are the two Democratic front runners, so the healthcare sector has started to price in a greater-than-zero-percent chance of modifications to the industry. We feel overhauling the healthcare system, particularly to a single payer system, is a massive undertaking and would require the Democrats to sweep the Presidency, House, and Senate and is thus unlikely. However, given our exposure to healthcare stocks, it is an outcome we cannot ignore.



A final thought to our readers: Even though 2019 is off to a strong start, the market going back to the beginning of 2018, has not done much more than move laterally. Since that time, the Dow's absolute daily changes add up to over 58,000 points. Yet, over that time, the index has gained less than 100 points. We would characterize the current outlook for stocks as fairly balanced. Valuations are not unreasonable, nor are they cheap. The economic backdrop is stable, but not particularly expansionary. The Fed is not a major headwind, but is also not as accommodative. Earnings are still growing, but at a slower rate than quarter's past and 2Q19 and 3Q19 face tougher year-over-year comps. It has been our experience when the market outlook appears balanced, new data points tend to see larger reactions. Thus, we would not be surprised to feel some bumps in the road ahead.

We hope our readers have enjoyed this portion of the letter. The following section contains an overview of three 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 readily 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.

DaVita Inc. (DVA, $51/sh, $8.5B market cap)

DaVita, along with Germany's Fresenius Medical Care AG (FMS, $24.3B market cap), are the two largest players in the dialysis market for patients suffering chronic kidney failure, often as a result of diabetes. Each firm controls roughly 40% of the market, with the balance comprised of regional players. DVA also maintains a non-core division called DaVita Medical Group "DMG", which operates nearly 300 clinics and half a dozen outpatient surgical centers in six states – Florida, California, Colorado, Washington, Nevada and New Mexico.

DMG has been a thorn in DVA's side for many years. The business has struggled to gain traction as financial results and margins have been inconsistent, resulting in the segment often operating at a loss. To us, it has seemed like a mismanaged business and outside the scope of DVA's core dialysis operations. To that end, on December 6th, 2017, DVA announced it was selling DMG to UnitedHealth (UNH – the nation's largest insurer – $218B market cap) for $4.9B. DVA's stock rose ~14% on the news to $69/share. Just over a year later, on December 17, 2018, the purchase price was reduced to $4.3B "as a result of underlying business performance" and the process of obtaining FTC approval. The transaction was expected to close by the first quarter of 2019[4]. DVA intends to use the proceeds for stock repurchases and to repay debt. Currently, the company's leverage ratio (net debt divided by EBITDA) stands just above 5x. Management has indicated their preferred ratio is 3-3.5x. To achieve this, assuming roughly $2.0B in 2020 EBITDA, the company would need to pay down about $2.7B of their $9.9B debt load. This would leave roughly $1.6B of the $4.3B DMG proceeds remaining, which equates to just under 20% of DVA's $8.8B market cap.

Post-DMG's divestiture, the remaining portion of DVA's business will focus on providing dialysis services for chronic kidney disease "CKD" and end-stage renal disease "ESRD". Though the business model is fairly simple, the dialysis industry is complex with many puts and takes. On the plus side, the duopolistic structure of the industry limits competition and non-scale regional players periodically become M&A targets. Overall, demand for dialysis is fairly stable due to consistent growth in CKD, though the ESRD population has been on a slow decline for the past 20 years. On the negative side, DVA has struggled to grow revenue and profitability in recent years due to issues at DMG and reimbursement rate pressure.

On the revenue side, DVA services commercial (i.e. private healthcare plans) and government paid patients. Commercial payers make up ~10% of the patient mix[5], but nearly 100% of profitability. While that mix seems onerous at first glance, this dynamic

[4] The recent government shutdown had a material impact the timeline to close.

[5] This is partially due to a patient's immediate Medicare eligibility, regardless of age, for government assistance if they develop kidney disease.

has been present throughout the firm's existence and does not appear to exhibit any signs of erosion.

Commercial payment rate changes are expected to be between -1.0% headwind and +0.5% tailwind in 2019[6]. On the government side, there is perhaps more reason for optimism, as payments will increase 1.2% in 2019. Additionally, Medicare Advantage pays, on average, 10% higher reimbursements rates. Another area of potentially positive revenue gain could come from the extension of Medicare as a Secondary Payer "MSP" by another three – more profitable – months to 33 months. Currently, commercial health plans are only required to cover the first 30 month coordinated period, which begins on the date that patient is entitled to Medicare coverage.[7] With slim profitability on the government pay side of DVA's business, any gains in government pay should be welcomed news to investors. Finally, DVA is exploring ways to capture a greater portion of a patient's total healthcare expenditures. The thought being that if a patient is receiving dialysis, which can take hours to administer, DVA could also deliver additional treatments during that time. In the industry, this is known as capitated care, in which a healthcare provider receives $X per patient, regardless of whether or not the patient uses $X worth of treatment.

DVA faces a potential profitability headwind in the form of a union labor dispute. In California, the Service Employees International Union "SEIU" is lobbying for minimum staff levels and higher hourly wages. This has been an ongoing, and costly, challenge for DVA as the company spent millions in lobbying efforts last year and will spend another $30M this year. California's new Governor, Gavin Newsome, is pro-union and actually returned campaign contributions from dialysis companies. If the SEIU is successful, DVA believes it would hit EBITDA by ~$200-$220M, or roughly 10%. Given Newsome's election in 2018, the SEIU's very vocal stance on the matter, and DVA's decline from $79 to $50 post-election, the risk is likely somewhat reflected in the stock's price.

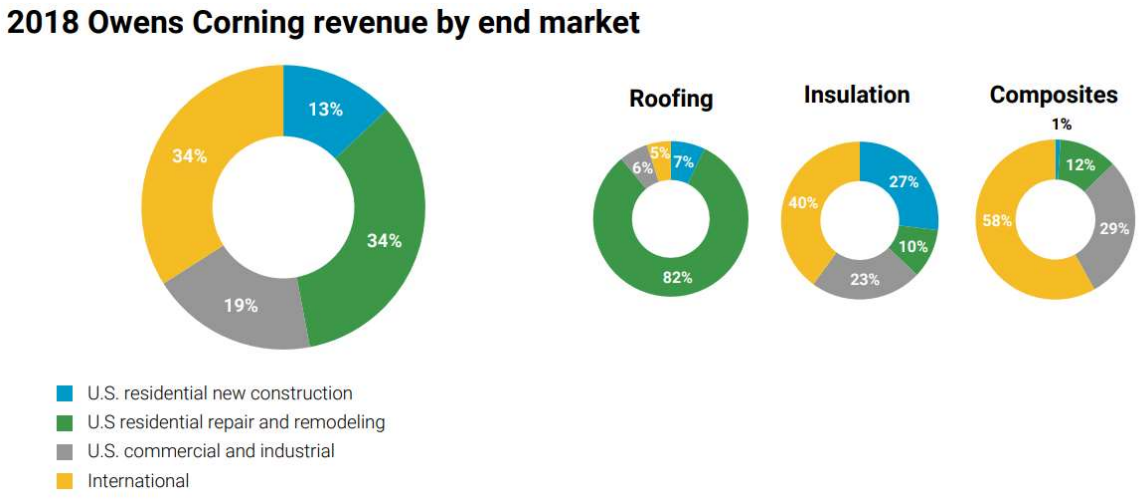
Finally, at ~23%, Warren Buffett's Berkshire Hathaway is the company's largest shareholder and Ted Weschler, one of two heirs apparent to Buffett personally owns a 1.3% position in the firm. Berkshire Hathaway's cash position stands in excess of $110B and Buffett has lamented not being able to deploy the funds for M&A. This is not a core part of our investment thesis, but worth noting nonetheless. At 12.5x 2019's earnings and 10.6x 2020's earnings, DVA trades at a significant PE discount to its long-term low 20s average and could be viewed as a bargain.

Overall, despite a complex pricing environment, DVA appears to have a strong long-term position in the dialysis and diabetes care market. Closing the DMG transaction should result in lower leverage and a sizeable share repurchase program (with the stock down 30% from its 52 week high) that should benefit investors.

Owens Corning (OC, $51/sh, $5.5B market cap)
OC operates in three segments: Roofing (asphalt singles), Insulation (mainly Pink Panther fiberglass), and Composites (fiberglass and other substrates). Segment sales vary by a few percentage points each year, but on balance, each segment usually accounts for about 1/3rd

[6] Pricing dynamics fluctuate by payer and vary by year.
[7] Basically, patients stay on commercial pay for 30 months then the government begins paying. MSP policy changes would extend that to 33 months.

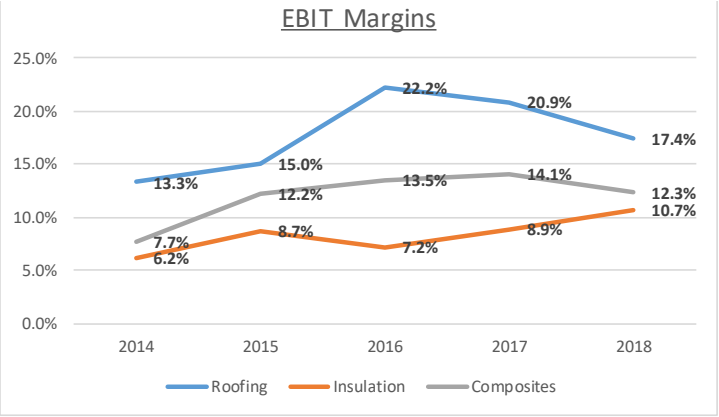
of total company revenue. OC's end markets are mainly tied to residential housing with the balance comprised of commercial exposure primarily in composites and insulation.



For OC to produce positive returns for shareholders, we feel two main things need to happen. First, housing trends needs to improve. Second, segment margins need to stabilize and, ideally, improve.

On the housing front, new building permits and housing starts data have begun to show signs of stabilization in their monthly data. Historically low interest rates, strong consumer balance sheets, high levels of employment, and a relative lack of inventory (particularly at entry level prices) appear supportive of housing trends. Overall, we feel the housing demand picture could end up being fairly strong in 2019.

In regards to margins, the situation is presently less favorable. Despite their roughly equivalent contributions to sales, OC's three segments have more variance in profitability.



Source: LLCM, Company Filings

As evident in the preceding chart the Roofing and Composites segments have seen notable margin pressure driven by rising input costs[8] and weakening demand trends across certain housing-related end markets. Stabilizing, and ideally, reversing these trends is a primary

[8] Asphalt, which is derived from crude oil, is a significant cost component of shingles.

area of focus for management and could be accomplished through better capacity utilization (i.e. cutting capacity) coupled with an increase in demand and better cost management. On April 24th, during OC's first quarter earning's call, management indicated optimism regarding the outlook for both demand and margins in the back half of 2019. Should that dynamic materialize, we believe OC shareholders will be rewarded.

Service Corp (SCI, $41/sh, $7.5B market cap)
SCI is the largest funeral service provider and cemetery operator in North America with 1,195 stand-alone funeral home locations (along with ancillary businesses, like floral arraignments, burial vaults etc.), 195 stand-alone cemeteries, and 286 funeral home-cemetery combinations. SCI operates in 44 states, eight Canadian provinces and Puerto Rico. At year-end 2018, there were roughly 22,000 funeral homes and 5,000[9] large cemeteries in North America, which implies SCI's unit market share is roughly 6% and 9%, respectively. On a revenue market share basis, SCI is closer to 16% of industry total due to a focus on higher end properties.

The funeral services portion of SCI's business usually draws the most criticism from skeptics as the segment has seen a trade down from more expensive traditional burial services to less costly cremation. In 2018, the average cost of traditional burial was $7,360 while cremation can cost $1,000[10] or less. While the cost of burial vs. cremation is a factor, in certain areas the cost of acquiring a burial plot is also prohibitive:

> *"If the ever-soaring price of condos in New York City has your head spinning, wait until you shop for a cemetery plot. Prices for the last piece of real estate that any New Yorker will ever own — a cemetery plot or an aboveground crypt — have also climbed significantly over the years. Basic cemetery plots across the five boroughs now generally cost $4,500 to $19,000, not including hefty fees for foundations, interments and maintenance. The best deals can be found on Staten Island, where a grave site can be had for less than $3,000, but an increasingly rare final resting place in Manhattan can go for $1 million."*[11]

We believe the headwinds facing traditional burial are well understood by investors as they are frequently discussed by management and have persisted for years. Additionally, SCI owns the nation's largest cremation service, Neptune Society. However, there is growing concern over a perceived lack of transparency in regards to atneed[12] services.

The Federal Trade Commission has long required prices of goods and services, such as caskets, or embalming fluid, to be itemized and divulged to the customer. Yet, the so called "Funeral Rule" does not explicitly state how the information is delivered. In most cases, it is presented by the funeral director on a sheet of paper and negotiating prices is virtually unheard of. In the era of increasing digital transparency and price shopping, it is possible the FTC will mandate that prices be posted online to allow for comparison shopping. The

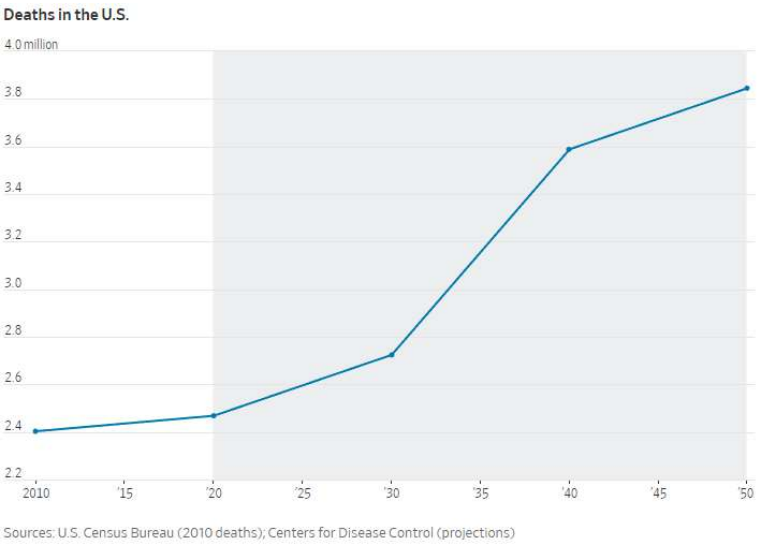
---

[9] SCI estimates another 5,000 very small cemeteries across North America.
[10] Given a traditional funeral usually includes a viewing, wake, service and food, its not apples-to-apples to simply compare the cost of cremation to a traditional funeral. But, it is cheaper to avoid the cost of a casket, embalming, styling etc.
[11] https://www.nytimes.com/2019/03/15/realestate/real-estate-for-the-afterlife.html
[12] As opposed to "preneed" services, which are purchased before death, "atneed" services are purchased at the time of death with little or no preplanning.

Funeral Rule has been in effect since 1984, was amended once in 1994, reviewed again in 1999 and 2008, each time with no changes enacted. SCI already posts starting price points in some of its markets (certain states, like California, mandate it) and is quick to point out that, as with most purchases, price is rarely the sole determining factor. Management has not publicly stated how they believe the FTC will rule, but does note that the total number of complaints received by the FTC grew from 2.8M to 2.9M in 2018 while the number of funeral specific complaints declined from ~1,300 to under 1,000 – perhaps the FTC has bigger fish to fry?

On the preneed side of the business, SCI generated $1.8B in 2018 sales and has an $11.1B backlog ($8.2B funeral, $2.19B cemetery). SCI receives money from customers at the time of sale yet does not incur the expense of delivery until the time of death. As a result, SCI can invest the funds (often in stocks and bonds) until they are needed.

In 2018, the North American death care industry generated ~$20B in revenue and performed over 3 million funeral services. However, as the Baby Boomer generation continues to age, the number of deaths per year is forecast to increase substantially as seen in the adjacent chart (note: US only, excludes Canada). Arguably, despite the headwinds posed by cremation, the sheer number of new customers entering the system should be enough to produce a favorable long-term dynamic.



Overall, SCI appears well positioned to capture long-term demographic trends, has a dominant market position, enjoys scale benefits, and trades at a reasonable 12.5x earnings and 9.3x EBITDA (both of which are below the long term averages). Additionally, the company has reduced the number of shares outstanding from 302M in 2003 to 180M in 2018, pays a decent dividend (1.7%), and believes it can continue to grow earnings in the 8-12% range over the long-term. As Benjamin Franklin said: "In this world nothing can be said to be certain, except death and taxes".