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

July 26th, 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: Cooper Companies (COO) and Yum China Holdings (YUMC). A brief summary of the letter is as follows:

- Broadly speaking, valuations appear reasonable and stocks are supported by solid earnings growth, the recently unveiled tax plan (and perhaps additional tax reform), historically low bond yields, and the possibility of a domestic infrastructure program.
- Economic data are strong. In contrast to prior years, when good data spooked the market due to Fed tightening fears, the market is reacting positively to good data.
- Trade "wars" and tariffs have kept a lid on the market, but…
- …the market appears more accepting of headline risk (trade, North Korea, healthcare prices etc.) as selloffs tend to recover fairly quickly.
- The Fed will likely raise rates at least two more times in 2018. Major questions remain about the impact of central banks beginning to tighten policy.
- Yield curve flattening may be concerning as it could signal weaker growth ahead.
- Hard Brexit? Soft Brexit? No Brexit?

<u>2Q 2018 Update</u>

In late January, the following quote from Ray Dalio, founder of Bridgewater Capital, the world's largest hedge fund, caught our attention:

> *"If you're holding cash, you're going to feel pretty stupid."*[1]

In early-June, billionaire investor Paul Tudor Jones had the following exchange with CNBC's Andrew Ross Sorkin:

> *"I think we'll see rates move significantly higher beginning sometime late third quarter, early fourth quarter," …"And I think the stock market also has the ability to go a lot higher at the end of the year. ... I can see things getting crazy particularly at year-end after the midterm elections ... to the upside."*[2]

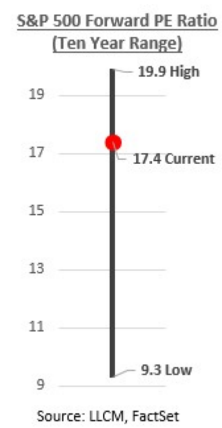
[1] https://www.cnbc.com/2018/01/23/ray-dalio-says-market-surge-may-be-ahead-if-youre-holding-cash-youre-going-to-feel-pretty-stupid.html
[2] https://www.cnbc.com/2018/06/12/tudor-jones-stock-market-higher.html

Also in early June, an exchange between JPMorgan's CEO, Jamie Dimon and Warren Buffett drew much attention from investors:

> *Dimon: "We're probably in the sixth inning…It's very possible you're going to see stronger growth in the U.S."*
>
> *Buffett: "Right now, there's no question: It's feeling strong. I mean, if we're in the sixth inning, we have our sluggers coming to bat right now."*
>
> *Dimon: The way I look at it, there's nothing that is a real pothole. If you look at how the table's set, consumers are in very good shape."* [3]

We tend to view broad sweeping market calls with a healthy degree of skepticism, but the data do not lie and the data continue to be strong. July's unemployment reading moved up from 3.8% to 4.0%, but as a result of roughly 600,000 people re-entering the workforce. Attempting to reenter the workforce is no small task and points to strength in the economy. June auto sales moved higher by 5.2% year-over-year. New home sales rose 14.1% year-over-year in June, with Realtor's largest complaint being lack of inventory. Consumer confidence sits near record highs. Wages are ticking modestly higher, interest rates are low, and consumers appear to be flush with cash.

Yet, despite all the seemingly bullish data, the S&P 500 was up roughly 1.5% through 2Q18 and would actually have been negative if not for the strong performance of a handful of mega cap tech stocks such as Netflix (+116% at end of 2Q), Microsoft (+27% at end of 2Q) and Amazon (+47% at end of 2Q). From a valuation perspective, the market is roughly in line with its five year average. So, why have stocks been fairly sluggish while the US economy is humming along? The answer is likely two fold.



First, most economic data are backwards looking while the stock market should reflect forward expectations of corporate growth. As such, it seems that investors may not believe the economy is in the sixth inning – perhaps the seventh or eighth – and possibly past its peak. Or, put another way, if the cycle has peaked, the expected return for stocks is likely not as strong as it was a year or two ago. As we mentioned in our 4Q17 letter, the primary bear case still seems to be: What if this is as good as it gets?

Second, there are a number of potentially concerning factors in the US, and abroad, that could slow or derail the otherwise fairly rosy economic environment. It is nearly impossible to look at a news source without seeing some sort of reference to trade wars and tariffs, particularly in regards to the world's second largest economy, China. Thus far, the impact of imposed tariffs has been mostly negligible, yet the prospect of further skirmishes in this regard have likely kept a lid on some of the stock market's potential gain. Over the long-term, a trade war does not appear to make much sense for either the US, or China, as both countries would likely see higher costs of consumption. However, it is definitely possible

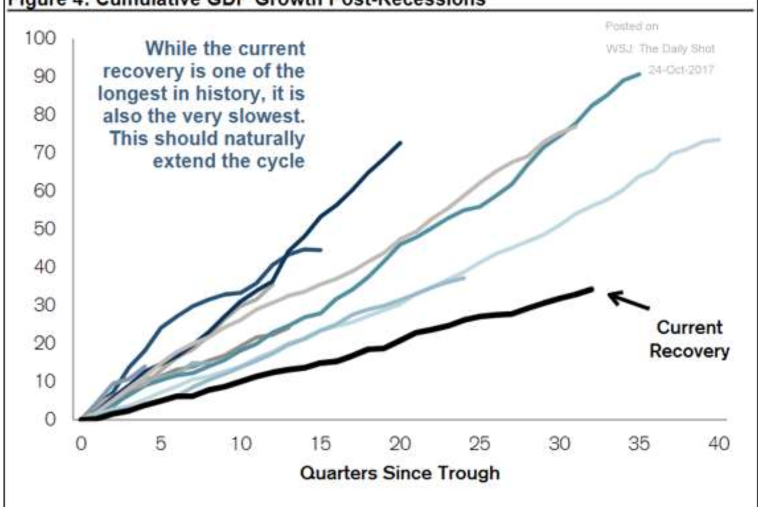
[3] https://www.cnbc.com/2018/06/07/buffett-says-economy-is-feeling-strong.html

there could be short-term pain as both countries posture and retaliate. It is our opinion that the US is primarily concerned with IP theft protection, appearing "tough" on China ahead of midterm elections, and checking the box next to Trump's campaign promise to reduce the trade deficit. If readers are interested in the potential impact of tariffs, Appendix **Figure 1** (China) and **Figure 2** (US) show the estimated impact by end market.

In addition, interest rates and the Brexit situation in Britain continue to be cause for concern. The Fed is likely to raise interest rates two more times in 2018 and will likely continue to further tighten (or "normalize", as the Fed calls it) into 2019. If the US economic cycle has peaked, raising rates in a decelerating economy could be challenging. Interestingly, this possibility is being somewhat reflected in the yield curve, as the spread between short-term and long-term rates has narrowed, an event known as "yield curve flattening". Declining long-term rates may signal lower growth expectations as investors appear willing to buy long-term bonds at rates that are marginally higher than shorter duration bonds. Finally, the Brexit situation in Britain has become increasingly cloudy, with many "hard"[4] Brexit politicos resigning and potentially paving the way for a "soft" Brexit, or perhaps, no Brexit at all. No Brexit would likely be received positively by the market, but the overall uncertainty surrounding the situation causes some volatility.

To counter the Bear argument, putting some context on the current economic expansion is an interesting exercise. Economic growth has been modest (1-3% yearly GDP growth), steady, and has lasted nearly a decade. With the arguable exception of automotive, the recovery has not been particularly cyclical. Additionally, much of this cycle's growth and optimism has been met with heavy skepticism, which tends to curb excess, and could prolong the cycle. Noted economist, and Director of the US National Economic Council, Larry Kudlow, recently referred to the current environment as a "growth recession"[5] and indicated that the US could be moving into a period of higher and more cyclical growth. We have used the following chart in prior letters, but feel it still remains germane:

Figure 4: Cumulative GDP Growth Post-Recessions



Note: 1949 to present; cumulative nominal GDP since trough indexed to 0
Source: National Bureau of Economic Research, Haver Analytics®, Credit Suisse

[4] Hard Brexit equates to severing all trade and immigration ties with the EU. Soft Brexit essentially means staying within existing confines of the UK's current trade agreement with the EU.
[5] Delivering Alpha Institutional Investor Symposium interview 7/18/2018.

What could move the economy into a higher growth phase? Another tax bill could be in the works. While there are few details available, it would perhaps make permanent the individual tax cuts recently passed, modify the short/long term capital gains rates, and possibly further lower individual rates while also widening the tax base.[6] Additionally, lower corporate tax rates, combined with repatriated funds, could help spur greater corporate spending. Ditto lower personal tax rates and consumption. Finally, around the mid-term elections in November, rhetoric surrounding a large-scale infrastructure program is likely to increase.

Overall, we believe the backdrop for equities appears relatively attractive and note that rising bearish sentiment can lead to a stronger market if the bear case does not play out. It is also worth noting that we feel many of our holdings can produce returns in a choppy or declining market. For this reason, we tend to rely more on individual stock analysis than overall market calls, but appreciate that a declining market will almost certainly take down many stocks.

We hope our readers have enjoyed the market outlook portion of the letter. The following section contains an overview of two new equity holdings.

All the best,
Long Lake Capital Management, LLC

[6] Delivering Alpha Institutional Investor Symposium interview 7/18/2018

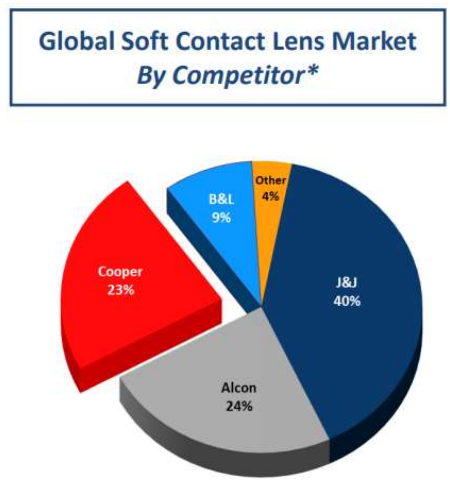
Select Equity Holdings Update

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.

Cooper Companies (COO, ~$255/share, $12.3B market cap)

We added COO to client portfolios at ~$227/share in early June. Cooper Companies, headquartered in Pleasanton, CA, operates in two business segments: CooperVision ("CVI", ~78% of revenue and 88% of operating income), which primarily consists of contact lenses and CooperSurgical ("CSI", ~22% of revenue and 12% of operating income), which focuses on women's health, fertility, and diagnostics.

CVI is the company's crown jewel, producing attractive operating margins (~25%) and consistent growth. The contact lens market is attractive, and is primarily controlled by four major players. Industry leader, Johnson & Johnson Vision Care, maintains a broad ocular operation with contact lenses (ACUVUE), LASIK, and consumer contact lens care products. However, ocular accounts for less than 10% of total J&J revenue. Alcon is owned by Novartis, which is in the process of spinning it off into a standalone publicly traded company by mid-2019. Bausch & Lomb "B&L" is a subsidiary of the much maligned pharmaceutical company, Valeant, and is possibly going to be sold or spun off to help strengthen Valeant's highly levered balance sheet. Overall, it is a consolidated industry with two of the main competitors experiencing possible distractions as they separate from their parent companies. It is worth pointing out, that as a result of the consolidated nature of the market, it possesses high barriers to entry as production requires advanced technological precision and large scale production is necessary for profitability.

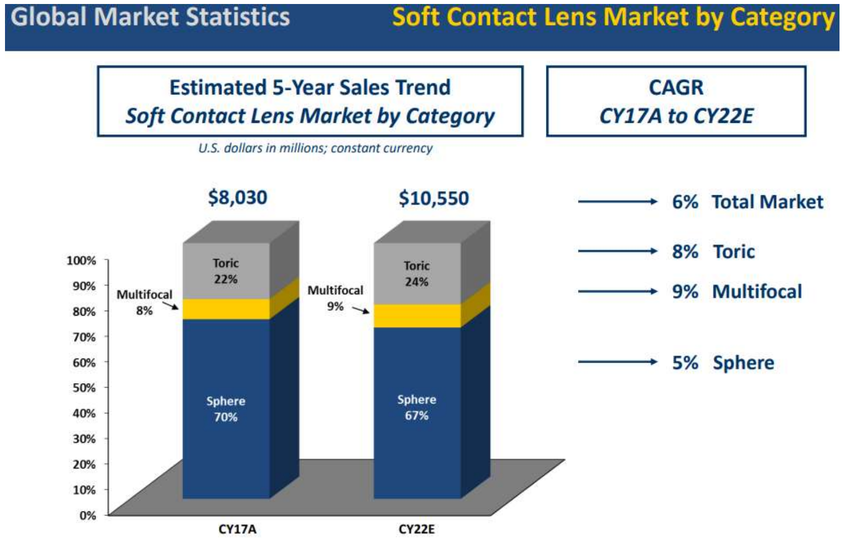


Globally, contact lenses are experiencing consistent growth driven by four primary drivers: better technology (silicone hydrogel lenses, toric lenses, and multifocal lenses), increased eye strain from digital device usage, the trade up to daily disposable lenses "dailies", and emerging market growth in countries such as China and India.

Cooper is a leader in advanced contact lens technology. Management describes the contact lens market as a bell shaped curve, with Cooper spending greater resources on targeting the tails on the bell with specialized toric lenses, multifocal lenses, and other innovations. Toric lenses correct for astigmatisms[7] and open the contact lens market to more consumers. Multifocal lenses contain two or more lens powers and allow wearers to see objects at all distances after the eye has lost its ability to change focus. Recently, CVI released Biofinity

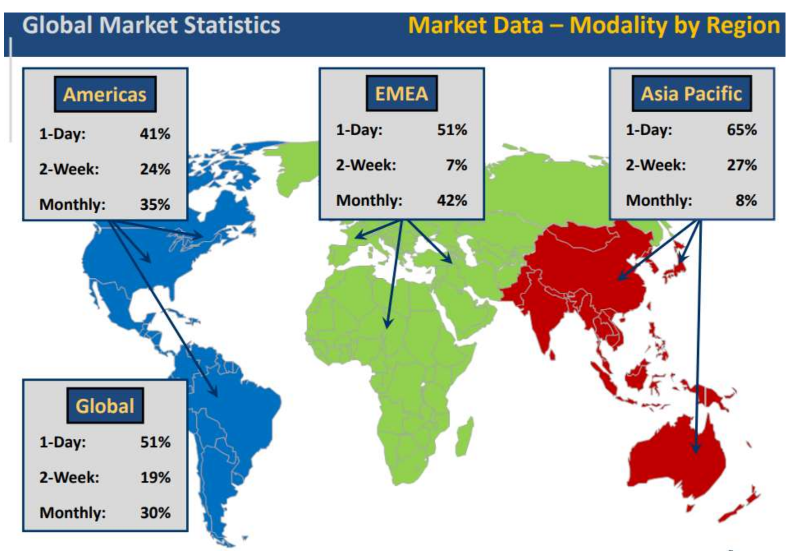
[7] A defect caused by deviations in the spherical curvature of the eye that prevent it from properly focusing light rays thus resulting in distorted or blurred vision. In contrast to traditional lenses, toric lenses have a hole located in the lens and looks like a donut.

Energys contacts, which are designed to reduce eye strain incurred from viewing digital devices (computer screens, iPhones, iPads etc.), and are the only such product on the market. Again, this technology broadens the potential consumer base.



Silicone hydrogel lenses are a softer, more oxygen permeable lens, which allows greater levels of oxygen to reach the eye than traditional lenses. As result, they are more comfortable for the wearer, reduce eyestrain, reduce the need for lubricating drops, and generally promote better eye health. Of note, Cooper is the global leader in silicone hydrogel lenses (accounted for 65% of CVI's total revenue in 2017) and appears well positioned to capture growth from this trend.

The trade up to dailies is the largest shift in the US contact lens industry. In the US, roughly 41% of contact lens wearers use dailies vs. 51% in Europe and 65% in Asia-Pacific. Management believes the US will trend toward 65% over time, and perhaps exceed that mark.



The benefits of dailies are two fold to the consumer. First, there is no nighttime maintenance/cleaning routine, the lens is simply discarded, which is convenient and saves the cost of contact solution. Second, they reduce eye related health problems as a new, sterile lens is used every day. From Cooper's standpoint, the trade up to dailies is very favorable as dailies are 2-3x more expensive than weekly or monthly products. Additionally, dailies are higher volume (24 lenses per year for monthly wearers vs. 730 lenses per year for daily disposable wearers), which helps with production capacity utilization.

In Asian countries, particularly India and China, ocular care is becoming more accessible as their healthcare systems modernize. For instance, Cooper had minimal exposure to Asia-Pacific five years ago, but now derives almost a quarter of its revenue from the region albeit primarily from Japan. However, Cooper management has publicly stated the intent to build out their sales and marketing operations in China, which should make the country a material contributor to revenue over the coming years.

The CSI segment is primarily focused on women's health, reproduction and fertility. Cooper produces a variety of medical tools and instruments used in the birthing process, during female-oriented surgical operations, and during examinations conducted by an OB/GYN. The products range in complexity from disposable clamps and rings to advanced wireless EndoSee hysteroscopy[8] systems to Paragard, the world's only non-hormonal IUD[9].

Cooper grows the CIS segment organically and via acquisition. A typical acquisition is in the $65M range, with $1B+ deals occurring roughly every three years. Most recently, in September of 2017, Cooper acquired Paragard from Teva Pharmaceuticals (TEVA, $24B market cap) for $1.1B.

Unlike the vision segment, many products in this space are more niche focused and do not enjoy the same benefits of scale production that CVI enjoys. As a result, the segment typically produces operating margins in the low to mid-teens, whereas CVI trends into the mid-20s.

Management is frequently asked to explain the synergies between CVI and CSI (Read: Why not spin off CSI?) and responds that the growth outlooks are both strong, each segment is self-funding via generated free cash, and the back offices share various overlaps that reduce costs. Frankly, this is not a particularly strong answer and it is possible a motivated activist could agitate to split up the company. A free standing CVI should

8 Hysteroscopy is used to diagnose or treat problems of the uterus. A hysteroscope is a thin, lighted telescope-like device used to transmit video and still images used for diagnostics and treatment.
9 Intrauterine Device – a multi-year form of birth control that is inserted into the uterus.

command a higher trading multiple than the combined entity and would likely be a shareholder friendly event. The pending Alcon, and possible B&L, spinoffs should give investors a better ideas to what multiple pure-play ocular franchises will command.

Overall, we feel there is a lot to like about Cooper: high barriers to entry and limited competition due to the oligopolistic nature of the contact lens market, trade up opportunities within the existing contact lens user base, and secular as well as geographic drivers within eye care. Relative to CVI, we are less excited about the CSI segment, but the potential optionality behind a spin-off is intriguing and do not view the segment as a subpar operation.

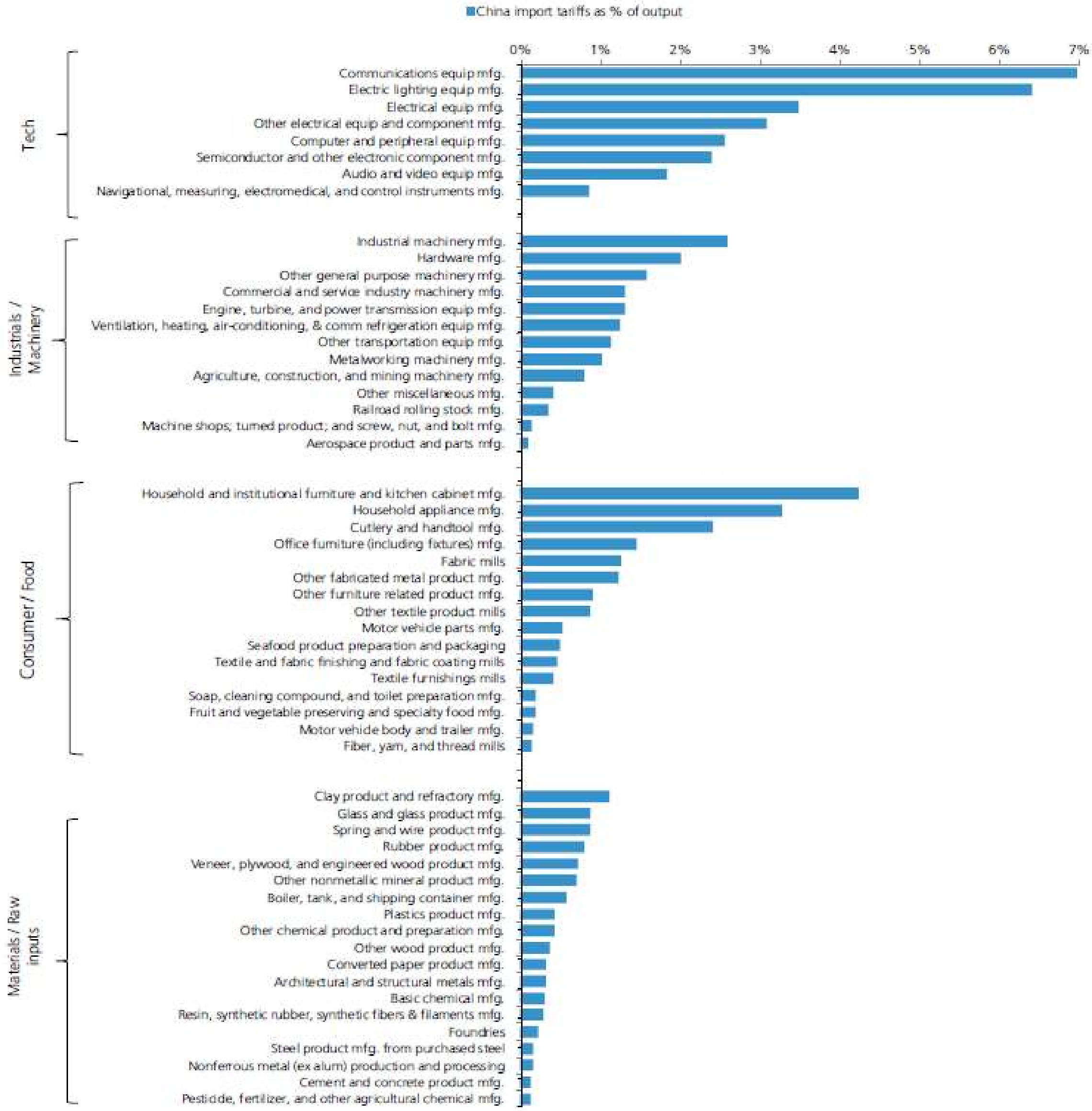
Yum China Holdings (YUMC, ~$37/share, $12.5B market cap)
On July 24th, we took a trading position (hence the shorter overview) in YUMC at ~$33/share ahead of their quarterly report on August 1st. YUMC comprises the Chinese operations of Yum Brands, which is includes KFC, Pizza Hut and Taco Bell.

The stock had recently hit a 52 week low on pessimism regarding the Pizza Hut and KFC operations and a downgrade to sell from Bank of America. The issues appeared well understood by the Street, and we thought sentiment had become too negative.

However, on July 26th, a report surface in “The Information”, a small digital/tech focused subscription-based media outlet founded by a former WSJ employee, that YUMC was in talks to be acquired by Hillhouse Capital, a $20B investment management company that primarily invests in publicly traded stocks. We sold YUMC at $37.30 on July 26th for two reasons: One, the deal would be very large relative to Hillhouse’s size, and is outside of Hillhouse’s normal investment type. Two, “The Information” is not known for breaking M&A news, which raised some possible credibility issues. Overall, we thought it was better to sell the rumor and move on.

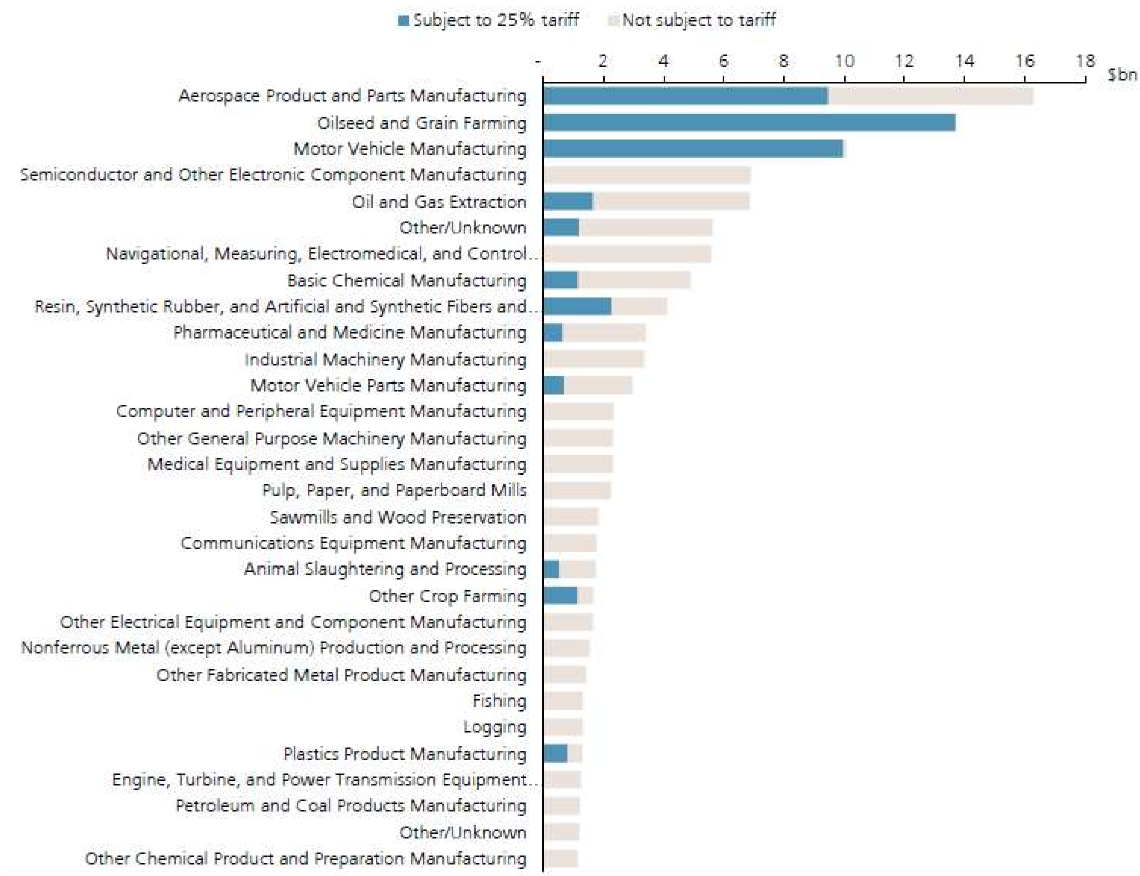
Appendix

Figure 1: Impact of implemented and proposed tariffs on China imports into the US (as % of industry output)



Source: BEA, US Census Bureau, UBS Evidence Lab

Figure 2: US exports to China: value subject to tariffs and not subject to tariffs



Source: BEA, US Census Bureau, UBS Evidence Lab