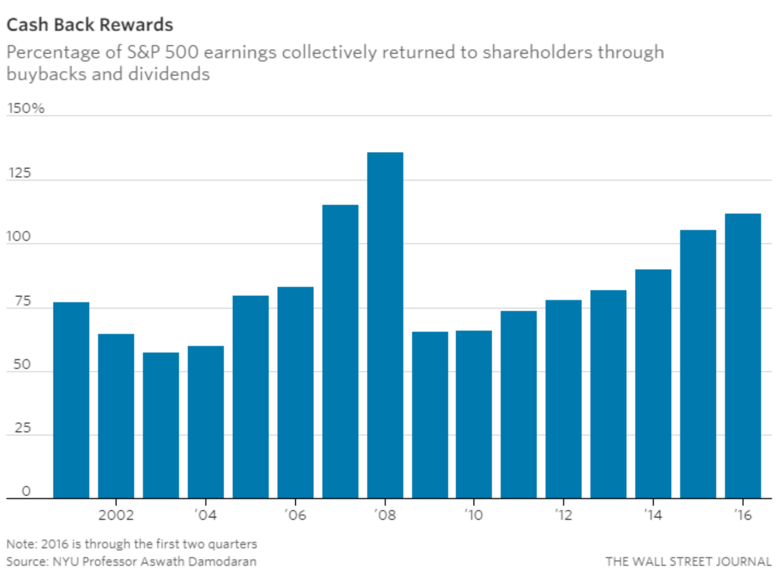
Long Lake Capital Management, LLC

74 E. Long Lake Rd. Suite #210
Bloomfield Hills, MI 48304
248.712-6160
www.longlakecapital.com

The third quarter shared many of the same concerns investors have faced for the entirety of 2016, as well as a few new ones: A potential European banking crisis; concerns the Federal Reserve is out of monetary tools; the Fed's perceived desire to hike rates; the ECB's possible tapering of QE; artificially low rates around the globe; aftereffects of Brexit; increased correlations amongst asset classes; and uncertainty over the U.S. Elections. That's a number of potentially major issues about which to fret. It has been our experience there is always a list of factors over which to worry, and while we remain mindful of these, we generally find it more productive to focus on company fundamentals.

One important fundamental item we have been keeping an eye on is the sustainability of cash returns to shareholders via buybacks and dividends. Recently, companies have been returning cash to shareholders in excess of earnings. Through the first two quarters of the year, S&P 500 companies returned 112% of their earnings through buybacks and dividends. This follows 2015, where cash returns to shareholders represented 106% of earnings.

The following chart offers some historical perspective for how this stacks up versus recent history. Through the financial crisis, cash returns to shareholders also comprised more than 100% of earnings - largely because earnings were depressed through that time period. However, over the past 15 years companies on average returned 82% of their earnings through buybacks and dividends.



The current state of affairs is a bit concerning - clearly companies cannot continue to indefinitely pay more out to shareholders than what they earn. Amounts returned to shareholders in excess of earnings have been funded primarily through either cash on the balance sheet or incremental borrowing. Given the current low interest rate environment, the borrowing option has been very popular.

Though the low rate environment allows companies to take on more debt while maintaining their ability to cover interest payments, without earnings growth there is a limit to the amount of debt companies can add. Without a further reduction in rates, or, more importantly, earnings growth, the amount of cash returned to shareholders will have to come down. The unfortunate news is we have gone five consecutive quarters with earnings declines, and estimates put Q3 earnings for the S&P 500 down 2.1% versus a year ago.

There is some evidence a slowdown in cash returns to investors has already begun. S&P 500 companies spent $127.5 billion repurchasing shares in the second quarter of 2016, a 21% decline from Q1 and a 3.1% decline from a 2Q15. Repurchases in 2Q16 were the least companies have spent on buybacks in two years. Furthermore, the number of S&P 500 companies participating in buybacks fell meaningfully in Q2, to 350 companies from 380 companies a year ago.

In recent years, share repurchases have been an important source of support for equity markets. According to Goldman Sachs, between 2012 and 2015, U.S. companies acquired $1.7 trillion of their own stock. If you exclude corporate buybacks, net U.S. equity flows would have been negative $1.1 trillion. If companies are forced to cut back on share repurchases, this would likely pressure markets.

We are not trying to paint an overly grim scenario, and to be certain it appears the general trajectory of earnings has improved - though for now that only means year-on-year declines are getting smaller. Given the modest expected decline in Q3 earnings of ~2%, this may actually signal an end to the earnings recession. Keep in mind analysts typically lower the earnings estimate bar throughout the quarter to the point where companies can heroically modestly "beat estimates" once results are actually announced.

Further, analyst estimates are very optimistic on earnings growth in 2017, with projected growth of ~13.0%. If this comes to fruition, markets should do fine, though if estimate revisions stay true to form we expect this estimate to come down as the year goes on. Initial projections for earnings growth coming into 2016 were 7.4% versus full year estimates today for earnings to decline 0.2%. We don't need 13% earnings growth next year for the situation to improve but it will be worth monitoring the ability of companies to continue to return cash to shareholders.

Viacom – a case study

Viacom provides a good, if somewhat extreme example of what can happen when a company aggressively returning cash to shareholders runs out of capacity to maintain those returns.

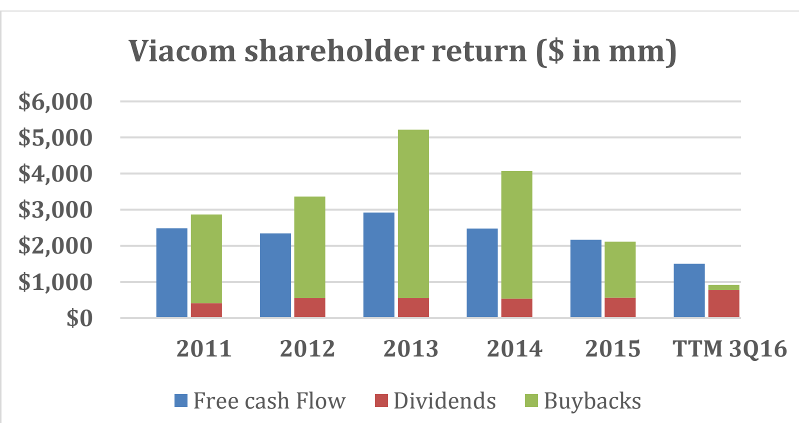
To provide some background, CBS and Viacom were split 11 years ago in what was an attempt to isolate Viacom's fast-growing, younger-focused cable networks like MTV, Nickelodeon, and Comedy Central, along with the Paramount Pictures film and television studio, from the less flashy broadcasting and radio businesses operated by CBS. Fast forward to today, and things have not exactly gone as planned. CBS shares have nearly tripled while Viacom's are below their spin-off price. Viacom has gone through a significant period of underperformance following poor operational results and terrible capital allocation.

Viacom operates out of two segments, Media Networks and Filmed Entertainment. Changing viewing habits and persistent ratings declines at Viacom's networks have weighed on the stock as results in the company's Media Networks segment have been uninspiring. Furthermore, results at Paramount Pictures have been poor and getting worse, with adjusted operating income in the Filmed Entertainment segment declining in a straight line from $325 million in 2012 to a loss of $186 million over the past year.

How did the company deal with challenged operational performance? Invest in the business? Mergers? No, they increased cash return to shareholders! Between 2012 and 2015, the company repurchased over $12.5 billion worth of stock at an average price of $70 per share. It is not a stretch to say these repurchases were done at elevated values. Today the stock trades in the neighborhood of $36 per share.

To put the magnitude of those share repurchases into perspective, the company today has a market cap of just over $14 billion. Total returns to shareholders over the 2012-2015 timeframe (dividends + buybacks) were $14.8 billion, outpacing total free cash flow generation of $9.9 billion (free cash flow is generally the cash earnings generated by the business). Viacom had a situation where it was paying more out to shareholders than the company was bringing in via free cash flow. The incremental money for dividends and repurchases came from $4.9 billion of new debt and a modest amount of cash already on the balance sheet.

The following chart illustrates annual free cash flow versus total shareholder returns.



This buyback bonanza boosted shares until mid-2014. However, operating results soured in 2014 largely due to the dreadful performance of the Filmed Entertainment segment. Viacom reduced the amount of cash they allocated to share buybacks by over half in 2015, and in fiscal 2016 (their fiscal year end is Sept 30th) the company repurchased only $100mm in stock, including no repurchases in the last two quarters. The company also recently announced they would be cutting their dividend in half. As a result of incremental debt and poor operational performance, Viacom exceeded their target leverage range (leverage is debt / EBITDA, or Earnings before Interest, Taxes, Depreciation and Amortization) of 2.75x - 3.0x, versus 3.6x today.

Looking back to 2014, Viacom found itself in an unenviable position. Operating results were getting worse at the same time they had borrowed a substantial amount of money to fuel share repurchases. The company essentially ran out of money to buy back stock and support shares. The following chart shows what happened to the share price. Viacom stock is down more than 50% over the past two years. Even the potential sale of a minority stake in Paramount would not have solved the company's issues. At the high end of speculated valuations, the use of sale proceeds (the company ultimately chose not to pursue a sale) to pay down debt would only have brought leverage to just under 3.0x and not provided room for incremental buybacks.

Viacom 5 year chart

Though Viacom is a somewhat unique situation, it does offer a couple of potential lessons of which to be mindful. Unsurprisingly, it is of critical importance for operational results to remain strong if a company is going to load on debt with the intent of using the incremental liquidity to repurchase shares. Those share repurchases boost the earnings per share of the company, but also represent funds not being invested to help grow earnings down the road.

Secondly, many people try to paint buybacks with a broad brush as either "good" or "bad." In our opinion, whether buybacks are good or bad is highly dependent upon the circumstances surrounding the company. There are companies, like Viacom, who had no business repurchasing shares when the stock was trading in the $70s. Those funds would have been better spent elsewhere - either internal investment or M&A. This highlights the importance of capital allocation and the ability to correctly decide if a dollar of free cash flow should be used for investment, M&A, repurchases, or dividends. A track record of strong capital allocation is an important characteristic we look for from management teams when making investment decisions.

Crimson Wine Group (CWGL)

While most investments we make are based in large part on our analysis of a company's ability to generate attractive amounts of free cash flow, not all names we own fit neatly within that category. One such name is Crimson Wine Group, a small winemaker with properties focused on the west coast. We believe Crimson should be able to generate acceptable returns from its wine operations in the future; however, a large part of the investment thesis is the underlying value of Crimson's assets, which includes property in places like Napa Valley.

Crimson (market cap of ~$210 million) is in the business of making and selling wines, typically sold at prices between $15-$250 per bottle. Last year, the company shipped approximately 350,000 total cases (a standard case includes twelve 750ml bottles), with total bottled cases in 2015 of 425,000. Cased wine in any given year is generally expected to be sold over the next 12 to 36 months.

An overview of the company's key properties is included in the following table:

Property	Location	Acres Owned	Owned since	Other information
Pine Ridge Vineyards	Napa, CA	158	1991	Owns acreage in 5 Napa Valley appellations and has been in business since 1978. Originally acquired from the FDIC.
Archery Summit	Dayton, OR	101	1993	Started by Leucadia in 1993.
Chamisal Vineyards	San Luis Obispo, CA	99	2008	Acquired for $19.2 million. Has been in business since 1973.
Seghesio Family Vineyards	Healdsburg, CA	318	2011	Acquired for $86 million. The acquisition increased Crimson's annual production by ~70%. Seghesio has been in business since 1895.
Double Canyon Vineyards	Horse Heaven Hills, WA	184	2005	Sold 307 acres in May 2014 for $4.2 million. The initial investment was $5.9 million for 611 acres of land.
Seven Hills Winery	Walla Walla, WA	N/A	2016	Bought by Crimson for $7.9 million. No vineyards were involved in the sale.

Crimson was originally part of Leucadia National Corporation, the conglomerate co-founded and run by Ian Cumming and Joseph Steinberg. Between 1979 and 2012, Leucadia shares compounded at a stellar 19% annual rate under the stewardship of Cumming and Steinberg, as the duo developed a reputation for focusing on long-term value creation as opposed to short-term earnings.

In February 2013, Crimson became a standalone, publicly traded company after it was spun out from Leucadia. The spinoff was done prior to Leucadia's combination with investment bank Jefferies Group LLC. Jefferies' management viewed Crimson as less strategically relevant than Leucadia's other subsidiaries and according to filings, assigned a value to Crimson "no greater than approximately book value." Cumming and Steinberg balked at this valuation and decided instead to spin-off

Crimson. Though there is a possibility Crimson is simply a vanity project, we believe it is more likely this was a valuation-based decision, as book value did not adequately approximate the true value of the business.

The underlying economics of the business today are underwhelming, though the trajectory is positive. Trailing twelve month pretax earnings for the company were ~$5 million; however, on a normalized basis are closer to $8-$10 million, growing modestly. For a company with a market capitalization of ~$210 million (the company does have cash net of debt of $18.5 million), it would be difficult to justify ownership of the stock on operating results alone. The wine business requires scale, which Crimson has been working to achieve, most recently via its acquisition of Seghesio Family Vineyards. That acquisition boosted annual production by 70%. Cumming and Steinberg have consistently emphasized keeping short-term expectations in check as progress in the wine business takes time. True to form, they remain focused on long-term value creation and we are comfortable with this approach.

The primary reason for owning the stock today is the underlying asset value. Crimson trades at 1.0x book value, which we believe is a conservative estimate of actual value given most of the estates were acquired many years ago. In support of this belief, Crimson has had two moderately sized sales of non-strategic land since the start of 2013. Each sale was done at ~1.8x book value. Though it may be a stretch to apply the 1.8x book value as implied by these sales to the entire company, it does offer some indication there is a margin of safety built into today's price.

Further evidence of substantial land value comes from Leucadia's prior attempt to sell two estates. In 2000, Pine Ridge and Archery Summit were put on the market. At that time Leucadia indicated they anticipated a sale to be in the $150 million range. Investment to that point in the two vineyards was $52 million. In their annual letter to Leucadia's shareholders, Cumming and Steinberg indicated offers for the two estates were inadequate but "considerably in excess of its investment."

More recently, Joseph Steinberg indicated at the company's investor meeting in 2014 it is his belief the private market value of the wine estates is well above book value. Cumming and Steinberg have put their money where their mouths are and are currently the company's two largest shareholders. Each owns a ~10% stake and have both been adding to their positions over the past year.

Given the favorable locations of the company's estates, our expectation is they will continue to gain in value. Our view of the business is the rise in estate values over time should be viewed in conjunction with the profits from the wine business itself. Furthermore, the estates should provide a reasonable inflation hedge in the event we start to see an uptick in inflation in the coming quarters/years.

We believe this opportunity exists for a couple of reasons. First, with a market capitalization of just over $200 million, Crimson is far too small for most investors to consider. Second, even though the stock looks attractive on a total asset value basis, there is the question of when the gap between intrinsic and market value closes. A sale of the company would clearly serve as a catalyst, but there is nothing to indicate a sale is on the horizon and that the underlying value of the wine estates will be realized.

For investors focused on the short-term performance derby, Crimson is not a particularly attractive investment. The day-to-day price moves are typically modest, and to an investor worried about short-term performance, an investment in Crimson looks like "dead money." However, we believe we will ultimately be rewarded. As Joseph Steinberg communicated to Crimson shareholders at the investor meeting, "we will get rich together slowly." Given the price action in the stock, this statement has become a running joke in the offices of Long Lake Capital; however, we believe Crimson represents a unique, valuable asset and there will be a payoff down the road.

Liberty Ventures (LVNTA)

We cringed at the recent cover story in Barron's, which looked like this…

The gentleman pictured is Dr. John Malone, architect of the various Liberty entities. Receiving such prominent placement in Barron's is viewed by some as akin to the Sports Illustrated "cover jinx." The good news is Dr. Malone has a background in engineering and is viewed as an exceedingly logical person, whom we doubt believes in such things.

The article offered a reasonable overview of the Liberty names (13 in total including spinoffs!), and it is worth a read if you are interested in learning more about the Liberty family.

All of this is a long lead-in to let you know the Liberty Empire is scheduled to be adding another name in Q4. Liberty Ventures (technically Liberty Interactive) is expected to spinoff its 15.8% stake in Expedia Inc. (this stake represents a 52.4% voting interest in Expedia due to the ownership of "supervoting" shares), creating Liberty Expedia Holdings, Inc (ticker: LEXEA). Liberty Ventures shareholders will receive 0.4 shares of LEXEA for each share they own of Liberty Ventures.

The primary reason for the spinoff is to facilitate a potential combination of Liberty Expedia with Expedia Inc. Malone and Liberty Ventures CEO Greg Maffei have indicated they believe a combination with Expedia down the road makes sense and the spinoff is a step closer to making that happen.

The new entity, Liberty Expedia, is reasonably simple to understand. LEXEA will hold the stake in Expedia, plus Liberty's subsidiary, Bodybuilding.com. The new entity will also have $350 million in margin debt backed by the Expedia shares. The inclusion of Bodybuilding.com may look a bit odd, but there are two important reasons it is part of the newly spun entity. First, as a wholly-owned operating company it allows for a tax-free spinoff. This could not be accomplished by simply spinning out the Expedia stake. Second, Bodybuilding.com also provides operating cash for the new entity. Though Expedia does pay a modest dividend (0.9% dividend yield), the new standalone company will have a need for cash to conduct operations and Bodybuilding.com helps with that need.

Following the separation of Liberty Expedia Holdings, Liberty Ventures will consist of positions in Charter, Liberty Broadband (which holds Charter shares), FTD Companies (FTD), LendingTree (TREE), Interval Leisure Group (IILG), Time Inc (TIME), and Time Warner Inc (TWX). Ventures also owns stakes in certain private companies as well as some tax-advantaged exchangeable debt. Ventures is a relatively complicated entity, but the primary driver of the stock post-spinoff will be the performance of Charter Communications. In conjunction with the spin, Liberty Expedia will also be distributing $300 million in loan proceeds to Liberty Ventures, which will then be used to repurchase Liberty Ventures' stock.

The primary point of this is to let you know the spin is expected to occur in Q4, most likely in early November. Once the spin occurs, you will see shares of LEXEA in your account and a corresponding decline in the value of Liberty Ventures stock you own.

Keryx Biopharmaceuticals (KERX)

In early August we established a position in Keryx Biopharmaceuticals, further adding to the position in some accounts in September. KERX's only product is Auryxia, a drug currently approved to balance phosphorous levels in patients with diabetes. Sales are growing ~50% year-over-year, off a small base, as KERX makes in-roads with physicians that study the kidneys, and their various diseases, (formally referred to as nephrologists) to build product awareness.

On July 29th, Norwich Pharma Services, the company which manufactures Auryxia for KERX, announced that it had run into problems converting the active compound (ferric citrate) into pill form at a consistent potency. At the time, KERX management indicated it will take a while to diagnose the production problem and they did not expect a solution until Q4 of this year. True to their word, roughly a month later, management announced the problem had been isolated and reiterated production would commence in Q4. Also of note, KERX is in the process of securing a second manufacturer for Auryxia called Patheon. The FDA is expected to rule on this request on November 13th, 2016. Management does not expect the delays at Norwich to impact the FDA's decision or timeline, though it is a possibility.

One of the major concerns with the production hiccup is, that since Auryxia is KERX's only product, the company's revenue effectively becomes $0 until manufacturing restarts. However, KERX has $156M in cash, is burning through $15M per quarter, and has $126M in debt. Additionally, the Street worried the company's sales force would experience meaningful turnover given they have no product to sell at the moment. To prevent attrition, management changed the sales force's incentives to reward conducting educational meetings/seminars with nephrologists that are able to prescribe Auryxia. To date, only two salespeople – of sixty – have left the firm.

Despite the seemingly transient nature of the production issue, Wall Street had little patience, and sent KERX shares down ~36% on July 29th and ~43% over five days. We have followed KERX for quite some time as two of our favorite value investors, Seth Klarman of Baupost Capital, and David Abrams of Abrams Capital, own ~25% and 6%, respectively, of the company and have been in the name for years (Baupost's average cost is $14.50, Abrams' is around $5.00). We decided the sell-off was an overreaction and used it as an opportunity to establish a position.

As previously mentioned, Auryxia is currently approved for treating phosphorous levels in patients with chronic kidney disease. However, the more meaningful driver for Auryxia is likely to be a secondary indication that combats iron deficiency, or anemia, in diabetes patients with chronic kidney disease. Anemia is a larger problem than phosphorous level management and more difficult to effectively treat. The current treatment options include expensive, time consuming, but effective, infusions at dialysis centers or less effective and not well tolerated pills. Auryxia, which is taken in pill form, appears to be very well tolerated (no material safety issues) and effective. Additionally, in many instances, nephrologists would likely prescribe Auryxia to treat both anemia and balance phosphorous levels, thus eliminating the need to receive two separate treatments. This would, in turn, lower the overall cost of care for many patients with chronic kidney disease. In short, it appears to be a superior treatment option and would likely become the standard of care.

The FDA still needs to approve Auryxia for anemia treatment, but the data seem compelling and KERX will submit a request for approval in early 4Q16. A ruling from the FDA is expected sometime within 6-10 months of filing. As with any drug application, there is always a chance the FDA will deny the request.

Valuing KERX is a tricky task given the variability and timing of outcomes. The Street tends to value biopharmaceutical companies based on revenue multiples and yearly projected drug sales. Taking into account the current selling price of Auryxia for phosphate management (~$4.21/pill times eight pills per day) along, the total addressable patient population for phosphate management and anemia (~1 million in the US alone), and making some conservative assumptions on market share, it is not difficult to produce revenues approaching $500M to $1B per year (for comparison's sake, the Street estimates ~$921M per year). Biotech equity multiples generally range from 5x-10x annual revenues, so that would imply $2.5B on the low end vs. ~$580M today. Additionally, a larger drug company, with a sizable salesforce and scale distribution, could be interested in acquiring the company. From our perspective, the risk/reward seemed favorable.

If you have any questions, comments or concerns, please do not hesitate to contact us.

Regards,
Bryan & James