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Friends of Long Lake,

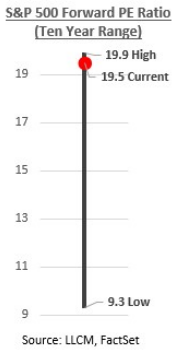
We would like to take this opportunity to offer our current thoughts on the market, and provide an overview of two new equity holdings: General Electric Co. (GE) and Sharps Compliance Corp (SMED). A brief summary of the letter is as follows:

- The market's valuation remains elevated, but stocks are likely being supported by solid earnings growth and the Trump agenda's eventual roll out.
- Economic data are choppy, but still mainly positive. Inflation may, finally, be creeping higher.
- The Fed will likely raise rates in December. 2018's rate path is unclear, as is who will be Fed Chair when Yellen's term expires.
- China continues to account for much of the world's GDP growth, a slowdown in China would negatively impact equity markets.

While gathering our thoughts on the market, it became increasing clear that the major drivers have not evolved much from 2Q17, which we stated as follows:

> "…it appears most investors are focused on ramifications from the eventual (if ever?) rollout of the Trump agenda, of which, the three major components – health care reform, tax reform, and infrastructure spending – are all expected to be positive for equities. While the market has been almost eerily calm, periods of volatility have occurred as various developments impact the agenda's timing…So far, the selloffs have been short-lived, as Trump could simply decide to address healthcare later, an event that would likely send stocks higher – no money manager wants miss the boat should that occur. The case can be made that the looming Trump agenda has set a floor in US equities."

On the valuation front, the S&P 500 trades at 19.5x 2017's earnings and 17.5x 2018's projected earnings, both multiples are near the top end of this historic ranges. As we begin 3Q17 earnings season, 75 companies in the S&P 500 have issued negative EPS guidance and 43 companies in the S&P 500 have issued positive EPS guidance. While the number of companies issuing negative EPS is slightly below the five-year average (79), the number of companies issuing positive EPS guidance is well above the five-year average (27). Looking ahead to 2018,

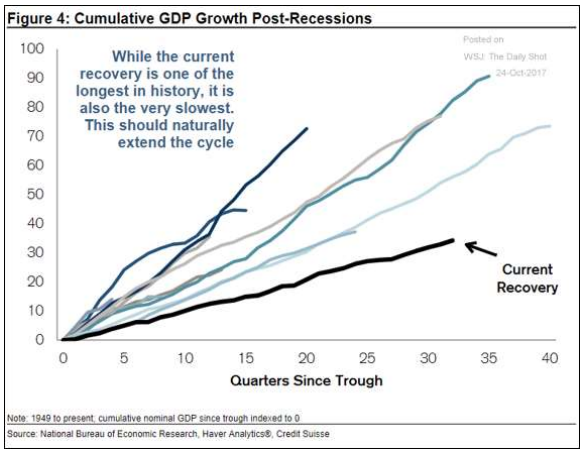


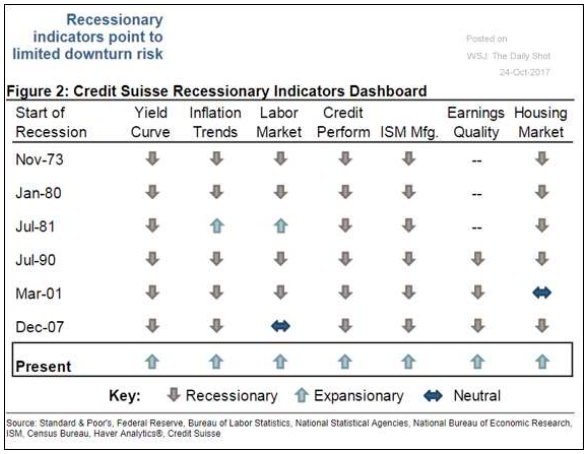
analysts forecast an 8.4% increase in the S&P 500, which would place the index at roughly 2,720.

Turning to the Fed, President Trump is nearing a decision on who will lead the Fed after Janet Yellen's current four-year term as chairwoman expires in February. Trump recently met with Stanford University economist John Taylor for an interview, which was also attended by Treasury Secretary Steven Mnuchin and Vice President Mike Pence. The other three candidates, according to sources quoted by the Wall Street Journal, are former Fed governor Kevin Warsh and current Fed governor Jerome Powell—who had meetings with Trump in September —and Ms. Yellen. The four candidates offer two contrasting views: Ms. Yellen and Mr. Powell have advocated easy-money policies and favored gradual interest-rate increases, while Mr. Taylor and Mr. Warsh have criticized the Fed's aggressive monetary easing and called for changes in how it sets policy. At present, it is not clear which way the president is leaning but he claims to be "very, very close" to deciding.

On the economic front, US data remains much as it has since the end of the Great Recession: choppy, but generally trending positive over longer durations. For instance, monthly housing starts have stayed above 1,000,000 annualized units dating back to early 2015, but have bounced between ~1,100,000 and ~1,300,000 during that timeframe. The most recent data came in at 1,127,000 in September. On the employment front, jobless claims for the week ending October 14th, 2017 came in at 222,000 the lowest level since March of 1973.

We found the following two charts from Credit Suisse to be quite interesting. The chart on the left displays cumulative GDP growth since the end of recessions. The current recovery has posted slow and steady cumulative GDP growth and indicates further expansion is possible. The chart on the right provides an overview of recessionary/expansionary indicators. Of the seven measured variables, all seven are pointing towards expansionary.



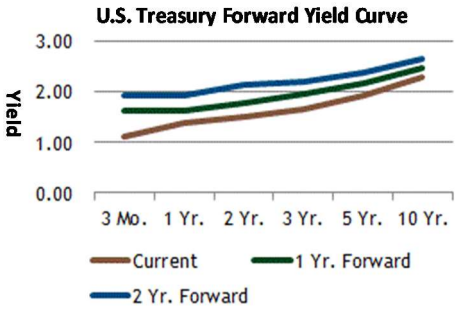


Current economic data are likely to be skewed by the recent hurricanes, floods, and forest fires, which could render them unreliable in the Fed's eyes and perhaps make it more difficult to justify a rate increase in December – although Fed funds futures imply an >80% chance of hike in December.

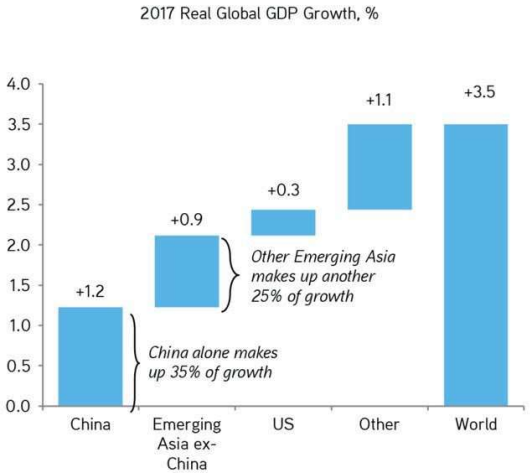
While on the topic of rate hikes, the prospect of inflation finally creeping into the US economy is gaining some traction. As summarized by Long Lake's Advisory Board member Robert Morgan at ProBank Austin:

> "The Producer Price index was up 0.4% for the month of September. This increase was driven by higher energy prices as ports were closed and refining was reduced due to the storms. However, the core rate, which excludes food and energy, was also up 0.4% and is up 2.2% on a year-over-year basis through September. This was viewed as some indication inflation is beginning to surface. The Consumer Price Index was up 0.5% for the month, but the core rate was only up 0.1%. The year-over-year increase for the core rate now stands at 1.7%, which is still below the Fed's target of 2%."[1]

As a reminder the Fed's dual mandate of 2% inflation and maximum employment are the primary drivers in their decision to raise or lower the Fed funds rate. As seen in the adjacent graphic, the market is forecasting modestly higher interest rates over the next one and two years. Our prior letters have mentioned concerns over rising rates coupled with a slowdown in economic activity. While the economy has remained strong, we remain wary of such a situation.



In our 2Q17 letter, we mentioned concerns about Chinese debt levels coupled with a state-run economy that has been reliant on government stimulus, rapid credit growth, and generally loose monetary conditions. In 3Q17, China posted GDP growth of 6.8% a slight deceleration from 2Q17's 6.9% number. Given the size of China's economy, GDP expansion nearing 7% is an impressive number. As seen in the chart to the right, China accounts for over one third of forecasted 2017 global GDP growth, making it one of the world's most important economies. A slowdown in China would have negative ramifications for equity markets.



Finally, readers of this letter may recall our consternation with some forms of algorithmic trading. On 10/12/2017 from 9:34AM to 9:36AM Dow Jones, a reputable and heavily relied upon news source, posted "in error" the following news release:

"DJ UPDATE: Google, Apple Join to Create Tech Giant"
"DJ Google to buy Apple for $9 billion"
"DJ Google Says Yay"
"DJ Google Says Steve Jobs Suggested this in His Will"

[1] The ProBank Austin Advisor newsletter delivered 10/16/2017

Apple currently maintains an enterprise value of ~$650B, and any human trader should immediately recognize the absurdity of such a release. However, the stocks of both companies actually reacted negatively to the "news". Why? Because headline-scanning algorithms are not able to discern real vs. "fake news". While this example is somewhat comical, it resulted in someone losing/gaining money and begs the question: What happens if an algorithm detects a more realistic headline published by hackers with the intent to manipulate a stock? Algorithmic trading certainly has a place in capital markets, but the case can be made that having a set of human eyes monitoring assets still has its benefits.

We hope you enjoyed the letter, and as always, please do not hesitate to contact us with any questions.

All the best,
Long Lake Capital Management, LLC

Select Equity Holdings Update

General Electric (GE: $21.45/sh, $202B market cap)
GE is a well-known industrial conglomerate with operations spanning the globe and an employee base of almost 300,000. The company operates in seven business units: Aviation $6.1B in 2016 operating income, Power & Water $5.0B, Healthcare $3.2B, Oil & Gas $1.4B, Transport $1.1B, Renewable Energy $0.6B, and Energy Connections & Lighting $0.3B. Interestingly, roughly 30% of the world's power is produced using GE products.

The company operated under the stewardship of Jeff Immelt for 16 years, a term that is almost unprecedented in modern corporate America. Immelt was dealt a fairly tough hand, taking the reins on Sept. 7th, 2001 just four days before the terrorist attack on 9/11. The stock traded at ~$28/share, adjusted for spinoffs. Immelt's tenure ended on Aug. 1st, 2017 with the stock at $25.50/share. The chart above highlights some of the notable events during Mr. Immelt's tenure at GE. To summarize, he spent a great deal of time selling and acquiring various assets, and often at the wrong time. For instance, the merger with Baker Hughes occurred with oil at ~$100/barrel vs. ~$45/barrel today. Exiting GE Capital began shortly after the financial crisis ended and well before banks began to recover. The NBC Universal sale would have commanded significantly higher prices in 2014, 2015, or 2016 when the market's mantra was "content is king". Exiting the appliance business began prior to the majority of the current resurgence in the US housing market.

Notable Events During Mr. Immelt's Tenure at GE	
Sept. 2001	Mr. Immelt begins tenure as GE's CEO
Oct. 2001	GE's attempt to acquire Honeywell for $40B is blocked by EU regulators
Oct. 2003	Acquires UK medical company Amersham for $10B
May 2004	Spins off Life and Mortgage Insurance co. Genworth Financial in a $3.5B IPO
Nov. 2005	Sells the majority of its remaining insurance business to Swiss Re for $6.8B
May 2007	Sells plastics business for $11.6B to Saudi Basic Industries Crop.
Oct. 2008	Accepts $3B from Warren Buffett's Berkshire Hathaway amid the financial crisis
Feb. 2009	GE shares hit a closing low of $6.66
Feb. 2013	Sells its 49% stake in NBC Universal to Comcast for $16.7B
Apr. 2014	Acquires Alstom's Power Grid business for $9.5B
Apr. 2015	Exits the majority of GE Capital via IPOs and sales
Jan. 2016	Sells the GE Appliance business to Chinese rival Haier Group
Oct. 2016	Executes a $35B merger of GE's Oil & Gas business with Baker Hughes
June 2017	Puts GE's century-old lighting business up for sale
Aug. 2017	Announces his intention to step down as CEO

Source: LLCM, WSJ

Since Mr. Immelt's departure was announced, various stories have emerged regarding the excesses of GE under his tenure, as well as Mr. Immelt's personal extravagances. Perhaps the most notable of the stories involves the use of private jet travel. In corporate America, travel via private jet is not abnormal and arguably justified given an executive's time value. However, Mr. Immelt took this one step further and commissioned an empty jet to trail his jet. This way, should his jet face mechanical issues, Mr. Immelt would not be inconvenienced. As they say, it's good to be king.

Taking the helm from Mr. Immelt is John Flannery, who previously served as the company's CFO and views GE with a seemingly no-nonsense eye on margins and growth. In just three months, Mr. Flannery has cut over $2B in operating expenses and believes there is room for at least $1B more to be removed in the next year. Notably, Mr. Flannery has reduced the size of GE's private jet fleet and mandated their use to only necessary travel.

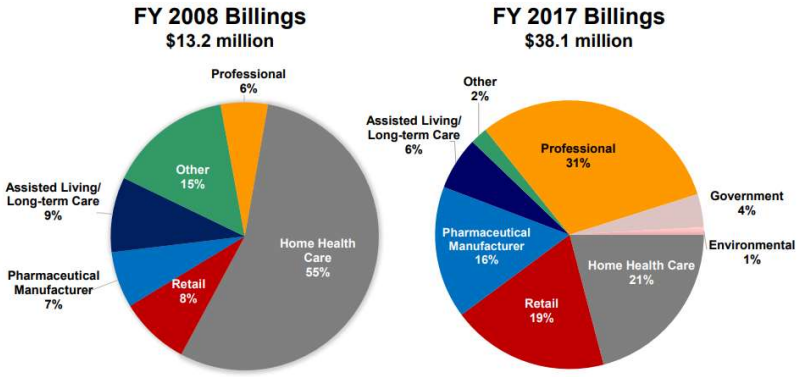
Mr. Flannery faces a significant task in turning around GE. The company's stock has fallen over 25% year-to-date, erasing nearly $80B in market value, while raising concerns over whether or not the dividend (yielding 4%) will remain intact. It is our opinion that Wall Street is forecasting a sizable dividend cut, perhaps in the 50% range, which would bring the yield to 2% placing it in line with the S&P 500's. GE's core cash flow from industrial operations has not been large enough to fund the $8B/year dividend payment for the past two years, and as a result, the only way to maintain the dividend is to take on additional debt, divest assets, or rapidly improve cash flow from industrial operations.

During GE's 3Q17 earnings call on 10/20/2017, Mr. Flannery pledged to divest $20B worth of assets over the next one to two years and said GE "has a number of other businesses which drain investment and management resources without the prospects for a substantial reward". Doing so should improve the company's margin profile and cash flow position. In 2017, GE should produce $7B in cash flow from operating activities. Following the release of its quarterly results, GE traded lower by over 10% in the premarket before rallying to close positive on the day. The turnaround coincided with the company's conference call and Mr. Flannery's subsequent appearance on CNBC, which seemed to suggest that the company's financial performance had troughed and would likely improve from that point. In particular, Mr. Flannery stated that 2017's $7B in cash flow from operations was "not the new normal". Consensus estimates forecast over $12B in 2018, and over $14B in 2019, operating cash flow.

It is also worth noting that the Trian Fund, which is managed by Nelson Peltz, a well-regarded activist investor, took a stake in GE in 2015. Contrary to most of his activist campaigns, Mr. Peltz has worked behind the scenes and has expressed confidence in Mr. Flannery. Trian's investment thesis predicts ~$2/share in normalized EPS for GE coupled with a market multiple of ~19.5x, which implies a stock price approaching $40. If Mr. Flannery can successfully streamline GE, it should reward shareholders. The next catalyst for GE is their Investor Update Day held on November 13th in New York City, where Mr. Flannery is expected to lay out long-term corporate and financial goals.

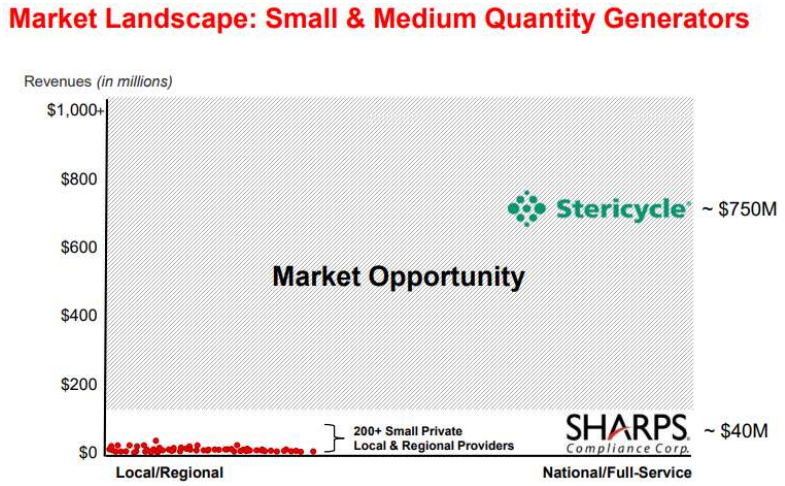
Sharps Compliance Corp. (SMED, $4.30/share, $65M market cap)

Sharps Compliance Corp. is a Houston, Texas based medical waste management company serving small to medium sized waste generators (i.e. pharmacies, physician practices, surgery centers, dentists, long-term care facilities, and veterinarians). SMED offers route-based (16.6% of 2017 revenue) or mail-based (83.4%) pickup and disposal options, has grown steadily over the past decade, and has diversified into new end markets. Of note, management owns 17.7% of SMED's stock.



There are a number of secular trends that should benefit SMED over time. An increasing amount of services (i.e. flu shots) are shifting toward in-pharmacy minute clinics and standalone Urgent Care facilities, both of which align with SMED's focus on small to midsize waste generators. Currently, ten states have passed anti-stick laws making it illegal to discard used sharps (i.e. needles, lancets and other objects used to pierce the skin) into household trash. A number of cities have passed similar ordinances as well. This trend should benefit SMED's mail-based business as customers simply place used sharps in a puncture proof bag that is picked up by the USPS and processed by SMED.

Currently, SMED's operating income is negative with losses of $1.1M in fiscal 2017. However, SMED operates a primarily fixed-cost, scalable business model, with high reoccurring revenues and low customer turnover. For instance, SMED's current gross margin is ~31% whereas gross margins on incremental revenues are in the 45%-50% range. If the company reaches sufficient revenue generation, the results should flow through to the bottom line. According to management, SMED aims to grow through increased penetration of their existing markets/customers, as well as through acquisition. The following chart displays SMED's acquisitions opportunity, which are numerous:



Stericycle is the "800lb gorilla" in the medical waste disposal space and could, potentially, be interested in acquiring SMED as it would likely recognize similar incremental scale benefits.

Recently, a number of headwinds have impacted SMED's results. First, SMED has considerable operations in the Houston area, including one of only ten fully licensed medical waste incinerators in the country. The impact of Hurricane Harvey has not yet been quantified, but it is expected to be significant. Second, industry pricing has been under pressure. However, industry leader Stericycle indicated on their most recent conference call that pricing pressure had started to abate. Finally, SMED is somewhat reliant on flu shots to drive volume at minute clinics. The 2016-2017 flu season was underwhelming, but the CDC is forecasting a significantly worse 2017-2018 season.

Reversal of current headwinds, continued expansion of the core businesses, leveraging scale to obtain profitability, continued M&A optionality – both as a buyer and perhaps as seller – should provide upside for shareholders.