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Oct. 29th, 2019

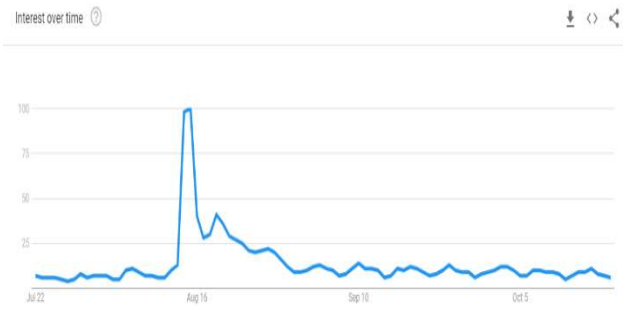
Friends of Long Lake,

We would like to take this opportunity to offer our current thoughts on the market, and provide a brief overview of two new equity holdings: Intellicheck Inc. (IDN) and Realogy Holdings (RLGY). A brief summary of the letter is as follows:

- US recession fears, coupled with deteriorating global economic data, have taken a back seat to…
- …trade, which continues to drive headlines. For the time being, the US and China appear to have declared a trade truce while laying the frame work for a multi-stage comprehensive deal.
- US employment and wage growth data continue to be very strong. It is difficult to envision a prolonged economic slowdown with a strong US consumer.
- Though still in flux, a "hard Brexit" scenario appears to be off the table. However, moving past this years-long period of uncertainty is arguably positive regardless of the final outcome.
- Investors are expecting the Fed to continue their accommodative rate cutting stance, with another 50bps of reductions forecast before year end.
- The Democratic primaries are beginning to show more liberal (Warren, Sanders) candidates taking ground from the presumed moderate front runner (Biden)…
- …consensus thought says Wall Street will not respond favorably to a President Warren or Sanders.
- For now, impeachment appears to be mostly background noise, but the prospect of a "smoking gun" that cannot be ignored always looms.
- Sentiment, as measured by equity outflows, is quite negative. This can ultimately be positive for stocks if sentiment reverses.

3Q19 Recap and Outlook

The third quarter of 2019 saw a number of interesting and intertwined developments on both the political and economic fronts, most of which caused investor uncertainty and led to a brief period in August where the market fell about 5% in five trading sessions as Wall Street digested the possibility of the US entering a recession. The adjacent chart, from Google Trends, shows results



for searches related to "recession" over the past 90 days. It appears Wall Street, and Main Street, were both sharing this concern.

Putting Main Street aside, why does Wall Street care so much about the US entering a recession? There are two main reasons. First, and most obviously, declining economic data are generally not good for stocks. Second, but perhaps more concerning to Wall Street, is that since the Civil War, only one president has won reelection if a recession occurred within the final two years of his term[1]. Wall Street can be fairly myopic, thus the market began reacting more strongly than usual to economic data points in the following way:

Bad Data → Recession → Loses Reelection = Meaningfully Reduce Stock Exposure

Mixed Data → Possible Recession → Possibly Loses Reelection = Reduce Stock Exposure

Good Data → No Recession → Reelected = Increase Stock Exposure

As a reminder, LLCM aims to remove itself from taking political sides, we are simply relaying what we believe the market wants/fears in regard to the 2020 election and how that could impact client portfolios. We have more on this topic later in the letter. Throughout the third quarter, on balance, US economic data were mostly mixed and global economic data were mostly bad. Here is some context:

- At +6.0%, 3Q19 Chinese GDP growth was the slowest in 30 years and at the lower bound of the government's stated 6%-6.5% growth target.
- Global manufacturing PMI data declined for the 15th straight month, then turned slightly positive in August and September. (see **Appendix Figure 1** chart)
- US CEO Confidence[2] fell to the lowest level since the great recession in 2009.
- US Consumer Confidence hit the highest level since the Tech Bubble of 1999 (note: interestingly, peaking Consumer Confidence often presages a recession).
- The US unemployment rate fell to 3.5%, the lowest level in 50 years.
- The EU's largest economy, Germany, saw its most recent new factory orders decline 5.6%, an acceleration from the prior month's -3.5% decline and worse than the -4.2% expectation.
- At 47.8%, the most recent US ISM Manufacturing report was the worst in a decade (note: a reading under 50% indicates contraction, above 50% indicates expansion)
- Though still expansionary, at 52.6%, the most recent US ISM Services report was the lowest in three years and a notable deceleration from August's 56.4%.
- At +4.4%, September's US retail sales declined 0.3% from August's 4.7%, the first deceleration in seven months.

Most would attribute the weakening global and mixed US economic data to uncertainty regarding the US and China's trade dispute. There are no shortage of companies citing this dynamic in their earnings releases or during investor presentations, yet it is also possible

[1] https://www.washingtonpost.com/politics/2019/08/12/how-recession-could-doom-trumps-reelection/
[2] CEO Confidence Index is a monthly survey of US Chief Executive Officers across a wide range of companies

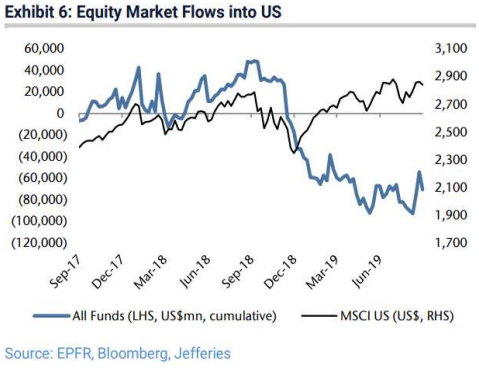
the current economic expansion – which is the longest in US history – is simply beginning to trend lower.

In regards to the Chinese trade dispute, while there has been no formal unveiling of a deal, the situation appears headed for a three phase solution. The first phase, basically calls for the Chinese to scale up their agricultural (mainly soybeans) purchases of US good to $40-$50B annually over the next two years. In exchange, the US vowed to leave the 25% tariff rate on $250B of Chinese goods unchanged instead of raising it to 30% on October 15th. Trump indicated there was no decision on a second round of 15% tariffs covering $160B of Chinese imports set to go into effect December 15th, but did say the Chinese had agreed to concessions regarding intellectual property protection and currency manipulation. The phase one deal is expected to be formalized November 16-17th during a global economic meeting in Chile.

Most would agree that phase one does little to resolve the dispute (5% and a hill of beans), but for now, that does not necessarily matter. What does matter is that the two largest economies in the world have seemingly reached an agreement to stop escalating the situation. If the trade dispute is the proximate cause of globally weak data, then providing clarity and an eventual resolution is likely to remove a significant overhang, which should ultimately be positive for equities as the various economies reaccelerate once confidence improves.

On the other hand, if the US expansionary cycle is coming to an end, the trade deal likely does not matter as much. However, we find it difficult to believe the US will fall into a recession given the incredibly strong labor market (3.5% unemployment rate coupled with 3.2% year-over-year wage growth) and the consumer's impact on US and global GDP growth. While there is certainly an "as good as it gets" argument to be made in regards to the labor market, most companies are reporting a shortage of qualified workers as a hindrance to hiring, or put another way, companies would like to hire more workers, but cannot. This dynamic does not seem like one in which the US economy is likely to fall off a cliff. However, that does not appear to be a consensus point of view. The following is from Jefferies' Investment Bank:

"To say that equities are unloved is an understatement. Global equity funds (US -$66B [in 3Q19]) extended their redemptions to a fourth straight quarter, the longest streak on record. Investor positioning is very bearish."[3]



Bearishly positioned investors tend to be bullish for the market if the reasons for bearishness (trade and recession) do not come to fruition as investors move cash off the sidelines to buy stocks.

Before wrapping up, we should touch on two more political topics: the prospect of impeaching Trump and what a non-Biden Democratic president would likely mean for the market.

[3] Jefferies email to clients "Global Asset Allocation: An October Chill" dated 10/7/2109

On impeachment, given the Democrats do not control the House and Senate it would be exceedingly difficult to actually remove Trump from office as the Republican controlled Senate requires a 2/3rds vote to do so. Presently, there does not appear to be enough support, nor enough indisputable evidence of wrong doing, to garner the necessary Senate vote. Obviously, that could change, but for now it seems unlikely. For those interested, **Appendix Figure 2** contains a flow chart[4] overview of the impeachment process.

In regards to a non-Biden Democratic president, consider the following from the Wall Street Journal:

> *The 2020 election is still more than a year out, but one sector is already feeling the electoral heat: health-care stocks.*
>
> *The group has been among the worst performing sectors in the S&P 500 this year, rising just 3.9%, compared with an 18% gain for the S&P 500. Only the energy segment has fared worse, up less than 1% in 2019.*
>
> *Although health-care stocks are often considered defensive investments that tend to hold up during economic turmoil, they also can be vulnerable to any perceived changes in government policy. Some of investors' recent squeamishness coincides with a climb in the polls by progressive candidates Elizabeth Warren and Bernie Sanders ahead of the Democratic primary.*
>
> *Mr. Sanders has proposed a "Medicare for All" plan that would move every American on to a government-run health insurance plan regardless of whether they have insurance through their employer. The plan, which Ms. Warren has endorsed, could effectively eliminate health insurers' business.*
>
> *Mr. Biden, who is considered a moderate Democrat, has supported building on the Affordable Care Act with a public health-insurance option, like Medicare, that would compete with private insurers.*[5]

In 2018, the US spent over $3.5T on healthcare, or 17.9% of GDP[6]. The sector is the largest employer of workers in the US[7]. To say the healthcare sector is critical would be an understatement. Yet, two of the Democratic frontrunners support plans that would fundamentally alter, if not destroy, the sector. It is because of proposals like this that Wall Street generally fears a non-Trump or non-moderate Democrat president. To be fair, what politicians say, and what they do, are often very different, yet as we know all to well, Wall Street dislikes uncertainty and a dramatic change in the political landscape would certainly raise a great deal of it.

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[4] https://www.nytimes.com/2019/09/24/us/politics/impeachment-trump-explained.html
[5] https://www.wsj.com/articles/elizabeth-warrens-rise-is-battering-health-care-stocks-11571140800
[6] https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/NationalHealthAccountsHistorical.html
[7] https://www.theatlantic.com/business/archive/2018/01/health-care-america-jobs/550079/

LLCM Business Update
Two small items of note occurred this quarter that are worth discussing.

First, very little on Wall Street comes for free, but in this case, LLCM's custodian, Charles Schwab, appears to have given clients a gift in the form of commission free trading. Says Bernie Clark, head of Schwab's Advisor Services:

> *"I'm pleased to announce that we rolled out $0 commission pricing for all online equity trades today—great news for investors and advisors. This move is part of our ongoing commitment to minimizing the cost of investing and helping you and your clients achieve better outcomes. Our new pricing is broadly applicable to all clients and account types that currently pay a per-trade transaction fee for online stock, ETF, and option trades placed on a US or Canadian exchange."*

Trading commissions have been on the decline for years, and Schwab's were already an industry low $4.95 prior to the cut, but money is money and we'll take it.

Second, for the past five years, LLCM has called 74 E. Long Lake Rd. in Bloomfield Hills our home. That will change on November 1st, as we are moving to a new office in downtown Birmingham at 401 S. Old Woodward, Suite 333. The space is similar to our current location, but has a dedicated reception area with a receptionist, a conference room, and a handful of other amenities that are generally an upgrade over our current space.

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

Intellicheck Inc. (IDN, $5.09/sh, $80M market cap)

Intellicheck performs real-time identification authentication and validation, primarily in the retail sector, via its core product ID Check, which is a robust software-as-a-service package installed on a retail scanner.

When we first began looking at Intellicheck, it was shocking to discover how easy it is to obtain a fake license or to purchase a stolen identity online. For instance, the average cost of a stolen social security number is $1.00. Driver's license information is usually about $20.00. Credit card numbers can be obtained for as little as $5.00. As seen in the following table, these are truly staggering figures.

According to our conversation with IDN's CEO, Bryan Lewis, the fraudulent purchase process typically works in the following way. First, the criminal will obtain the necessary personal information via the dark web. Second, they will order or create a fake driver's license that uses their photo with someone else's information. Third, they will open a new credit card account at the retailer's store using the fake/stolen identity (retailers generally encourage customers to open credit cards in the store in exchange for a discount on the initial purchase). Fourth, the thief will then make purchases with the new account and walk out of the store with thousands in merchandise that will never be paid for.

IDN's research estimates the average department store credit card fraud is roughly $2,100 per transaction. The average hardware store, furniture store, and jewelry store credit card fraud is $2,500, $2,900, and $3,500 per transaction, respectively. The brunt of the expense

associated with these fraudulent transactions is the responsibility of the credit card issuers, which ultimately book the amounts as charge-offs.

By detecting the fake ID nearly 100% of the time, IDN can eliminate these costs. The company's database of license information was obtained through long standing partnerships with the American Association of Motor Vehicle Administrators, the American National Standards Institute, and the International Standards Organization. Per IDN, their database is the largest and most accurate of any in the industry. In fact, in a recent test of 1,000 fake IDs, IDN's technology detected all 1,000. The company's closest competitor detected about 700. Part of IDN's technological advantage comes from focusing on the barcode to detect fakes. Unlike the information contained on the front of a license, it is significantly more difficult to create a functional fake barcode. The following photo from evolvedids.com, shows just how advanced, and inexpensive fake IDs have become.

For $95 one can obtain a fake license that passes most fraud detection tests. Underage college kids everywhere, rejoice!

The aforementioned CEO, Bryan Lewis, is relatively new to IDN, but in his 19 month tenue, the company has undergone a significant strategy overhaul. Most importantly, Lewis realized that prior management was selling to the wrong target audience, as IDN was targeting the retailers themselves as opposed to the card issuing banks that actually take the financial hit from fraud. IDN has made significant inroads with the banking channel, securing contracts with five major banks, including four of the ten largest issuers of store-branded credit cards.

Current Financial Services Customers

	Bank Type	Contract Status	Description
Bank 1	Card Issuer	Under Contract	Smallest Client Good reference client
Bank 2	Card Issuer	Renewed Contract	Oldest Banking Client Recent brought 11 new retailers to on-board Issues private label cards for ~55 retailers
Bank 3	Card Issuer	New Contract	Deploying with four largest retailers Development work underway for bank branch rollout
Bank 4	Card Issuer	New Contract	60-day pilot converted in 30 days Integration with bank branches underway Two largest retailers, one in pilot other in development
Bank 5	Online Bank	New Contract	Using ID Check for Mobile enrollment Joint Sale with Facial Recognition partner

Source: Company reports

Another significant change made by Lewis was the switch from a flat fee to a per-swipe model. Under prior management, IDN would charge a flat monthly fee based on the number of retailers. Now, IDN takes a small fee (generally $0.40 to $1.00) per ID scan. Effectively, card issuers are paying a nominal fraud insurance fee to potentially save thousands in theft cost. Obviously not every swipe results in fraud detection, but the economics are so attractive for the card issuers that Lewis indicated raising the per-swipe fee by multiples of what it is today would still allow the software to more than pay for itself. For IDN, their software-as-a-service "SaaS" model generates gross margins approaching 90%. From an economics standpoint, the service genuinely appears to be a win, win for IDN and their customers. Interestingly, according to Lewis, this has not gone unnoticed by the card issuer industry, as he indicated the banks are now approaching IDN for demos as opposed to IDN pushing to solicit business.

Outside of retail fraud prevention, IDN has opportunities in age-based ID verification. Presently, most states have relatively lax requirements as whomever is checking the ID is generally only required to manually inspect it. Furthermore, most mom-and-pop shops are not looking to turn away business. However, given the preponderance of vaping and legalized marijuana – two categories that have appeal to underage consumers – there is chatter about requiring ID scans at the point of sale. That would like be a meaningful revenue driver for IDN, as government mandates are tough to ignore.

Finally, although not a large area of focus for IDN, the company's products are currently in use by a variety of government organizations (FBI, Department of Homeland Security, Border Patrol, and local law enforcement agencies), airports, seaports, and other businesses that require a high-level of access security such as oil refineries.

In 2018, IDN did $4.4M in revenue, that number is trending higher in 2019, as the company expects to generate over $6M sales. Given that third party research estimates the fraud detection/prevention market is somewhere in the ballpark of $200M annually, there appears to be a significant long-term growth opportunity.

Overall, we like IDN's competitive position, ability to mitigate a challenging problem for retailers, Lewis' shift in corporate strategy, long-term growth opportunity, and margin profile. Given these factors, we can foresee the company potentially being worth multiples of today's current price. It could also be an easy tuck-in acquisition for a larger security firm or, given the margin profile, an attractive target for a private equity firm.

Realogy Corp (RLGY, $8.45/sh, $$977M market cap)
Realogy is the nation's largest real estate brokerage, operating under Century 21, Coldwell Banker, ERA, Sotheby's International, Corcoran and a number of others. Traditionally, real estate agents are independent employees and use Realogy's marketing, back office staff, title support and office space in exchange for a portion of the agent's sales commission.

A number of factors have combined to make Realogy a poor performer over the past few years. First, the traditional brokerage model has been under pressure, as startups like Redfin, Zillow, Trulia and others aim to disrupt the industry by offering agents a larger portion of the commission pie, using more advanced digital marketing tools to make listing a home easier for a seller, and, in the case of Zillow Offers, using a pricing algorithm to purchase a seller's home in a handful of markets across the US (adjacent chart). Additionally, Realogy derives roughly 25% of revenue from California, and home values in California have been on the decline, which therefore reduces the commission value per home sale.

Realogy is going on the offensive as it adapts to the shifting real estate landscape. Recently, the company announced a partnership with Amazon called TurnKey, in which prospective buyers indicate their interest at www.amazon.com/turnkey and are then matched with a Realogy agent in their area. If the buyer purchases a home, they receive between $1,000 and $5,000 worth of smart home products (see **Appendix Figure 3** for an overview). The partnership was initially viewed as Amazon trying to enter the home buying space, but we think there could be more to the story as the amount of consumer data (financial profile, credit score, number of dependents etc.) that is revealed during the home buying/financing process is extremely valuable to a company like Amazon. While it is early innings, the initial returns on TurnKey have exceeded management's expectations and have produced home sale values that are exceeding the company's average. In addition to TurnKey, Realogy has improved its online marketing through partnership with Facebook and others that aid at discovering prospective home buyers/sellers, and basically generate more leads for Realogy's agents.

Although outside of the company's control, home values and transaction volumes, in California may have reached an inflection point, as September data saw prices rise 4.7% (largest gain in 12 months) and volumes increase 5.8%. This has certainly helped the stock, and given the favorable interest rate environment, we hope it continues.

We feel that if the housing environment stays stable, Realogy should find a way to navigate the industry's shifting landscape. The company has a sizeable debt load ($3.5B relative to a ~$1B market cap), 4.2% dividend yield, and generates roughly $250M/year in free cash flow (much of which goes to pay down debt). Given the cyclical nature of the housing market coupled with a company undergoing a turnaround, with a highly levered balance sheet, we do not presently view Realogy as a core long-term holding.

Appendix

Figure 1

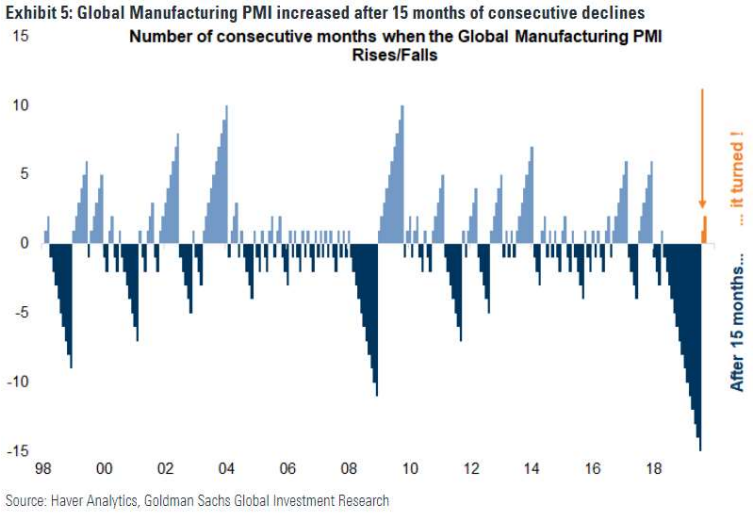

Figure 2

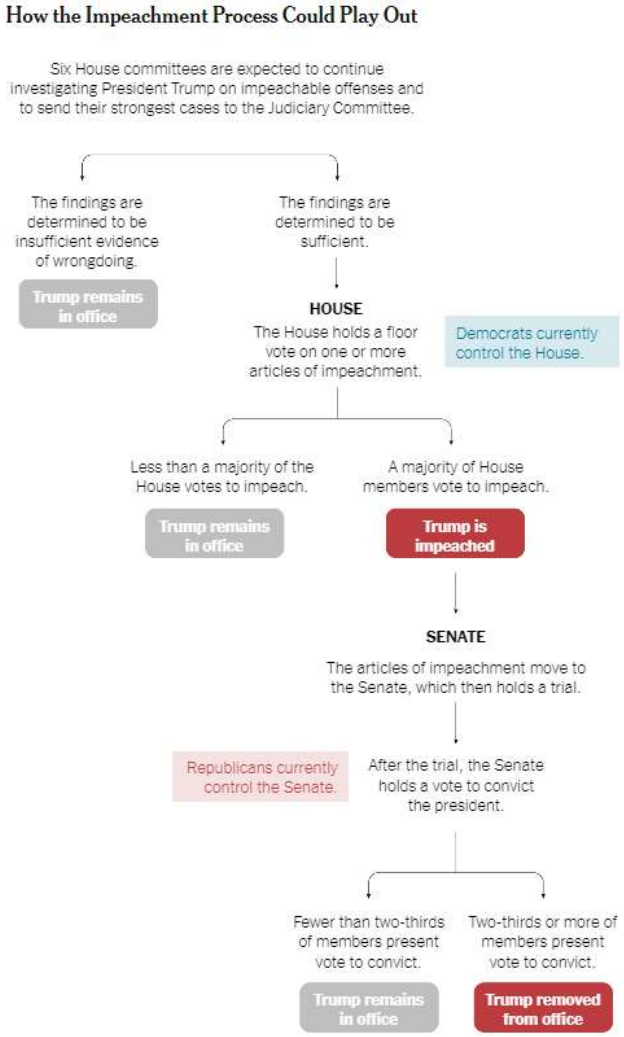

Figure 3

YOUR HOME PURCHASE PRICE	YOUR HOME PURCHASE PRICE	YOUR HOME PURCHASE PRICE
$150K - $399K	**$400K - $699K**	**$700K +**
Package Value **$1,000**	Package Value **$2,500**	Package Value **$5,000**
Amazon Home Services Over $450 of credit toward your choice of services, including unpacking, cleaning, handyman services, carpet cleaning, furniture assembly, and more.	**Amazon Home Services** Over $1,000 of credit toward your choice of services, including unpacking, cleaning, handyman services, carpet cleaning, furniture assembly, and more.	**Amazon Home Services** Over $1,500 of credit toward your choice of services, including unpacking, cleaning, handyman services, carpet cleaning, furniture assembly, and more.
Amazon Smart Home Products • 1 Echo Dot • 1 Echo Show 5 • 1 Ring Doorbell II All products installed and set up in your home by Amazon or Amazon-vetted professionals.	**Amazon Smart Home Products** • 2 Echo Smart Speakers • 2 Echo Show 5s • 1 Ring Doorbell II • 1 Sonos Beam • 1 eero WiFi All products installed and set up in your home by Amazon or Amazon-vetted professionals.	**Amazon Smart Home Products** • 4 Echo Smart Speakers • 4 Echo Show 5s • 1 Ring Doorbell II • 1 Schlage Connect Smart Deadbolt • 2 Fire TV Cubes • 2 Sonos Beams • 12 Kasa Lightbulbs • 1 eero WiFi • 1 Smart Things Hub All products installed and set up in your home by Amazon or Amazon-vetted professionals.
Amazon Move Amazon Move helps customers who are moving by providing convenient access to products, services, and Amazon programs that make relocating easier. Amazon Move customer receive a coupon good for 10% off on up to $200 of eligible products shipped and sold by Amazon. Restrictions apply. See full terms and conditions here.	**Amazon Move** Amazon Move helps customers who are moving by providing convenient access to products, services, and Amazon programs that make relocating easier. Amazon Move customer receive a coupon good for 10% off on up to $200 of eligible products shipped and sold by Amazon. Restrictions apply. See full terms and conditions here.	**Amazon Move** Amazon Move helps customers who are moving by providing convenient access to products, services, and Amazon programs that make relocating easier. Amazon Move customer receive a coupon good for 10% off on up to $200 of eligible products shipped and sold by Amazon. Restrictions apply. See full terms and conditions here.