

Laughing Water Capital



Matthew Sweeney

Matt Sweeney is the founder and managing member of Laughing Water Capital, a concentrated, unlevered, long biased investment partnership focused primarily on small cap investments. The fund follows a fundamental, research driven process while taking a multi-year view on how the dual forces of increased earnings power and improving perception can fuel investment returns. Matt is a CFA Charterholder, former co-chair of the New York Society of Security Analysts Value Investing Committee, and graduated with a BA in History from The College of the Holy Cross. He began his career in an equity sales role at Cantor Fitzgerald, where he also led the Equity Syndicate Desk, and pioneered the firm's Equity Idea Generation efforts.

Editor's Note: This interview took place on April 21, 2023.

Graham & Doddsville (G&D):

Thanks, Matt, for speaking with the G&D team today. We're really excited to speak with you today. It'd be great if you could walk us through your background and go over how you first got interested in investing.

Matt Sweeney (MS):

I have what I think is a

very non-traditional background in the sense that I did not go to target schools, and I managed to make it through college without ever taking an accounting class or a finance class or a business class or anything like that. I was at a liberal arts school, where I was a history major, and it was a very research-intensive curriculum that had nothing to do with finance or even numbers in general. But through a twist of fate, I wound up in a middle office role at Cantor Fitzgerald a week after 9/11. I never expected to be in a finance role, but I wound up in one because there were 26 people from my hometown who were killed, including two of my friends from high school who both worked at Cantor Fitzgerald.

And I knew somebody else from my town who worked at Cantor Fitzgerald that survived. At the time, I was basically bartending and not really sure what I was going to do next because I was taking a gap year before planning on law school. This guy knew that I was in the wind sort of, and he knew that Cantor Fitzgerald needed help, so he tracked me down and said, "I know you're a smart guy, I know you're not really sure what you're doing next, why don't you come into Cantor? We really need the help." So, I went into Cantor Fitzgerald and started in a middle office role with literally no knowledge at all.

Within a couple of months, I was on the sales trading desk and covering institutional equity accounts. It was trial by fire. I mean, I didn't speak the language at all, so I was educating myself as quickly as I could, literally hearing a term or a phrase I didn't understand and Googling it or going to Investopedia.com and trying to figure out what it was so people didn't know I was basically in "fake it till you make it" mode.

In some ways, that non-traditional background has been an advantage for me because it leaves me with a very healthy level of self-doubt, bordering on imposter syndrome, and it makes it very easy for me to assume that I'm the dumbest person in the room which I think is very useful when you're dealing with the stock market. I don't know if you've heard the term, "The Great Humiliator," but that's what people have referred to the stock market as. When you are aware that you started in the wrong place and that you're not the smartest guy in the room, it's a good way to keep your defenses up and make it easier to set the bar for inclusion in the portfolio super high.

For me, an idea really has to boil down to two or three bullet points at most that explain how earnings power for a business is going to be changing for the better and how perception is going to change over the

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next few years. And I'm a big believer that as long as you don't overpay going in, if you can find a business that will have significantly higher earnings power in a few years and it's currently unloved, you have a very strong foundation from which to generate acceptable investment returns.

G&D:

Who were some of the investors or mentors that you looked up to during the early part of your career that you think really shaped your investment approach?

MS:

I think of myself as being both fortunate and unfortunate in that I never had a true mentor. The unfortunate part is obvious. If you have an opportunity to work closely with a master of the craft, I think you probably can't help but learn through osmosis. The reality though is that very few people are fortunate enough to find that perfect mentor. And despite my best efforts, I never did. Where I was fortunate though is that in my job as an equity sales trader in the early stages of my career, I had the opportunity to speak with more than a dozen portfolio managers on a regular basis. And each of these portfolio managers had their own style. Some of them were value oriented. And some of them were deep value, growth, special situations, etc.

I would do everything that I could to try and understand their processes and how they thought about their investments. And that included everything from trying to re-engineer their investments and then asking them if I was seeing it the same way they were, to developing my own ideas, and then pitching them, and asking them for brutal feedback. Over time, having access to these varying perspectives in an expectations free manner, in a way, made it easier for me to form my own style and solidify my own perspective, unique to my own skills and my own personality and abilities because there was no one person shaping my process. It truly is my process.

Beyond that, I spent a lot of time just reading, really anything and everything I could from the great investors that came before me from Ben Graham to more modern masters like Joel Greenblatt. Joel Greenblatt is the one that I identify with most closely probably.

G&D:

Could you talk about your time between Cantor Fitzgerald and when you went out to start Laughing Water Capital? What drove you to go out on your own and start the firm in 2016?

MS:

Somewhere along the line at Cantor Fitzgerald,

I just became really disillusioned. The job was very much a commission-generating role, and to generate commissions you're really trying to generate a lot of noise. And as a salesperson, I didn't even know the businesses that I was talking about. I was just creating noise. So, again, I started from zero, but as I began to educate myself, I realized how ridiculous it all was and started to take notice that the people who generated the most commissions and traded every day – a lot of these were the bigger mutual funds – were not really getting much return on that

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compared to just owning the S&P 500.

And then there were others that were not great clients, but you could look at their holdings and it was maybe 10 or 15 stocks. And oftentimes, they were just super disciplined on price. They would wait months for a limit to come in sometimes, and then wait years to exit the

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position. In any case, I wound up at a dinner with some guys that worked at the Royce Funds, which is a small-cap value mutual fund. I basically said to one of the guys at Royce Funds how I was just having trouble finding my place in this world because, to me, making all this noise was a complete waste of time. But then there were funds like the Royce Funds where they had a much more disciplined approach and they were buying small cap off-the-beaten-track kind of things, and sometimes, it would take them weeks or months to build a position.

And I'll never forget what the guy at Royce Funds said. His exact words were, "Oh my God, I think you might have a brain in your head." I guess before that point, he wasn't convinced. But he said, listen, go read Ben Graham, read Warren Buffett, read Joel Greenblatt, read Ken Fisher, read Phil Fisher. Read, read, read, read. And I took his advice. I went home and I started reading and it was like my doors were blown off immediately. I always think of it as if I found something I had been looking for my whole life, but I didn't even know it existed.

That's where the seeds of Laughing Water Capital were planted. I probably spent 34 of those next 36 hours just reading and trying to figure things out and basically getting myself pointed in the right direction after a couple

of years of being pointed in the wrong direction. I of course also spent time learning accounting, and the other fundamental building blocks for successful investing, including becoming a CFA Charterholder. Laughing Water Capital is a long-biased investment partnership. I typically own 15 stocks with a focus on fundamental value that can be expressed in different ways. When I think of value, I tend to think of it as existing on a spectrum, from traditional Ben Graham-type value on one side to more underappreciated growth on the other end of the spectrum. I want to diversify across that spectrum. Most of my investments have lined up somewhere in the middle where it's a pretty good businesses that has some sort of quirky event or special situation or change. Something that makes me think that the stock market is missing something. And I'm biased towards small cap and domestic, although the strategy is unconstrained.

G&D:

Why did you call it Laughing Water Capital?

MS:

Laughing Water is a small community on the North Fork of Long Island where my family has a small place. And when I was a kid out there, it was more like just corn fields and potato fields. It's gotten

a little more built up these days, but it's still a great place to go and forget about the world and read a book and think. The joke in the hedge fund world is you name your fund after the street you grew up on. But I grew up on Homestead Avenue and there are already 12 different homestead funds, so I had to dig a little deeper and that's where I got to.

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G&D:

When you look back at 2016 when you started Laughing Water Capital, what did you get right? What did you get wrong?

MS:

I think one of the things I got right was that I spent several years picking the brains of these portfolio managers I had access to through my sales and trading roles, asking them, "What should I do? What mistakes did you make?" And that expressed itself in two major ways. One of them is just deciding what you want your

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strategy to be. It is a commitment to say, "I'm going to stay as a small fund, I'm going to invest primarily in small-cap stocks." Right now the average market cap in the fund is somewhere around \$1 Billion, but there are often stocks that are only a few hundred million in market cap. That strategy is not going to scale forever. Some people start up with a goal of getting to a billion in AUM. If I got to a billion, I'd have a problem because I don't think I could put a billion to work and maintain past outperformance. I'm very comfortable with probably, I don't know, call it \$300 million. But a lot of people, they'll tell you that's not even big enough to have a viable business model, which I of course disagree with.

I was very much aware that I was choosing a path that would lend itself towards performance but not scale. And then the other part of it, there was a very heavy emphasis on the quality of the investors you take on as your limited partners. And a lot of these conversations were happening right around 2008, 2009, and 2010, when a lot of people who thought they had great partners realized that they actually did not. During those times when the market is going down every day and fear and panic are peaking, a portfolio manager needs to be thinking very clearly, which is impossible if you have

partners that are panicking. So, I very heavily screen my limited partners and expect a multi-year commitment from everybody that comes in. And I don't think of that as a lockup being there to keep people in. I think of it as a commitment to a strategy that requires time to work, and to keeping the wrong people out. I do have some large family office

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partners, but the partnership base over indexes toward individuals, but they are very high-quality individuals. Think like individual investors who have been going to Omaha for the Berkshire meeting for 20 years. They're almost all fluent in investing. Like for example I've never had to explain to one of my LPs the definition of a special situation, or who Joel Greenblatt is.

G&D:

That's a good segue to get into talking about the concept of "edge". In your letters, you've articulated a few

different buckets where you think your firm has a competitive advantage. Could you share some thoughts on that with our readers?

MS:

There's some overlap in what we just talked about. I think having sticky capital is a huge competitive advantage, especially with my style where I don't really focus so much on what happens quarter to quarter. I'm more thinking big picture. How is the earnings power of this business going to change on a three to five -year timeline? And a lot of times, if you're looking for a change in three to five years, the first couple quarters of that can be really painful. It might involve increased investment that can depress margins. And then the sell side is disappointed by that quarter and it's painful. But given my capital base, I'm able to look at those opportunities. Of course, I wish I could bottom tick things. But I've never met a value investor who said they buy things and then they go up right away.

G&D:

You've mentioned that you have a willingness to say "no" to pretty much everything. Are there any situations that most value investors might say "yes" to where you would actually stay away?

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MS:

My job is to say no. Everybody that owns a stock owns it for a reason, presumably. There's some pitch that somebody else believes. Why is that not good enough for me? The answer is that I want to outperform. I have to be super selective. And it's not really a direct answer to your question but I guess it's the way I think of it. I'm always surprised by how many pitches, even on high-quality forums like Value Investors Club, boil down to "it's trading at 14 times earnings and it should trade at 18 times."

That does nothing for me. In my mind, the multiple expansion part always must be the cherry on top, because that is speculative. That is trying to predict the madness of the crowds, in a way. And you could, of course, look at comps and everything else and M&A transactions. But you just never know what multiple you're going to get. So, the analysis should really be on how the earnings power is going to change. And there are an awful lot of investment pitches out there that never even touch on that. That's fine. That's how most people operate. I just think if you're running a concentrated portfolio with, call it, 15 stocks, you can do better than relying on mean reversion. You can find much more interesting stories that are not about mean reversion. Instead, it's about some

sort of change that's taking place that will explain why earnings power will be meaningfully higher in a couple years.

G&D:

Matt, walk us through a typical day. How are you allocating your time? It would be interesting to hear if that allocation has changed or evolved since you started your fund.

MS:

My mornings typically start with my search process, which is very much keyword driven. I have a number of alerts set up to flag different sets of keywords that might appear in public filings or elsewhere. It's some combination of words that, over time, I've narrowed down to give me a reason to look at something. And it could be as simple as a tender offer, for example. If a company is making a tender offer, that suggests that they think their stock is undervalued. Now, that's a very simple example. A tender offer, by itself, is not super interesting. They happen a lot. But

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you can find ways to combine that data point with other things.

For example, one thing I always try to pay attention to is when management compensation changes off-cycle. Typically, management compensation is released in the proxy or maybe the 10-K and it typically happens at the same time every year. But if it happens in an 8-K in the middle of the year, for some unknown reason, and then they're doing a tender offer or making some other decision, it's a reason to say, "Wait a second, what's going on here?" A lot of times, that's five minutes because you look at it and don't understand it, or the incentives aren't aligned, or it's not a good business, or whatever it might be. But I always start my day by spending just an hour or so looking through what might be happening in the world to put things on my watch list.

From there, it's split between portfolio maintenance and working on new ideas. The best case is that I find a new idea I'm super excited about and drop everything. In other cases, it's sometimes just making some phone calls to people in the industry of a current holding such as former employees, competitors, and management teams. Other times, it's talking to other investors who maybe were involved with the name or are

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involved with a competitor or something. I'm just trying to understand what people are doing, how people are thinking, and how the landscape is evolving.

Lastly, there's always some time to just sit quietly and read something interesting. I think of it as part of my idea generation process. But it's very low hit rate and I think of it as what I call the "rabbit hole." You start reading one 10-K and maybe you see that they have a supplier that is really a key part of their business. Then you can read about that supplier and then maybe you notice that supplier has one large customer and maybe that supplier has a competitor, whatever it might be, and then you read about that one. It's a good way to just expand your universe and you never know what you're going to come up with. It helps round out the process.

G&D:

You've written about the way you spend your first hour on a new name is a lot different than most investors. Could you talk about that?

MS:

I start with a four-point process. It's understanding, one, is it a good business? And it's totally possible to make money buying a really bad business and hoping it gets a little bit less bad. There are people who have been very successful doing that. That's just not what I

want to do because I sleep better at night knowing I own better businesses. What is a good business? It's everything from the quantitative metrics, returns on capital, et cetera, but also more qualitative. Just close your eyes and imagine, is this business going to look reasonably the same in five or ten years? Is this business tied to some sort of disruptive success that I don't really know how to underwrite? That's probably not for me.

The next one is, who are the people that are running the business and who are we partnering with? That could be the management team, that could be the board, that could be an activist, but I basically want to understand that there's somebody there with skin in the game who's making sure that decisions are going to be made effectively. Especially with small caps, that's really important. There are just tons of small caps where the chart has been flat for 30 years. It often comes down to bad incentives, and I don't want to get involved with that. The next piece is understanding how it does through the cycle, or what happens when something goes wrong. You can quickly look at 10 or 15 years of history and see how the business performed historically through a recession.

Something that's more cyclical isn't an automatic no. But you want to understand what

you're doing and how it's going to function through the cycle. And it might be a cyclical

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business but if it could come out of a downturn stronger than the competition, that might be a good thing. All businesses run into speed bumps. What are they going to do at that moment? Do they have a history of intelligent capital allocation during difficult periods? Or do they have a history of panicking and doing something stupid? Do they have some sort of defensive revenues? Do they have a rock-solid balance sheet with a history of returning capital during downturns? Or M&A when competitors are struggling? Really anything to suggest that they can take advantage of a cyclical downturn in some way.

And then the last piece is understanding why something might be cheap. Why does this opportunity exist? I place a high emphasis on understanding why I

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might be so fortunate to find this mispriced security, which ties back to what I said earlier about assuming I am the dumbest person in the room. If I can identify some reason that the market might be making a mistake, then that goes a long way toward identifying a margin of safety. I typically think of it as identifying some kind of optical, operational, or structural problem either with the business, or market mechanisms that explain why I am able to look at the situation differently than whoever the seller might be.

Assuming I get through all of those, and most often I don't, then I can start to think about price and what something might actually be worth. And then it is about really digging into each one of those four points to understand what the opportunity might come down and what needs to happen for earnings power to move higher, and for sentiment to improve.

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G&D:

On the management

point, how are you assessing management teams and their capital allocation prowess? Do you typically engage with management? And, if so, to what extent?

MS:

Yes, it's hard. A quick shortcut is just looking at their ownership and looking at the decision-making they've done over the past however many years. I almost always talk to management teams, and at least introduce myself. Typically, I'll introduce myself in an email before I even speak to them. I'll tell them that I'm with Laughing Water Capital, and everything we do is a three to five-year-plus view. We are not interested in your quarterly earnings; we're interested in the big picture and how the business is going to change.

I think that kind of sets the tone. If you talk to any CEO, they will tell you how frustrating it is to deal with however many people that want to ask about what's going to happen next quarter. Or if they guided in a range, whether we are leaning towards the high end of the range or not. And it's a waste of the management team's time to do that sort of stuff, and frankly, it's a waste of my time too. But for the vast majority of people in the investing world, that's where they spend their time.

Even just trying to reach

out to management teams at a time where it's not the day after or the day of quarterly earnings, I think you get a whole different set of answers from them, and the conversation goes in a totally different way when you're the only one that they've talked to in two or three weeks.

G&D:

Could you go over how you think about answering the question, “why does this opportunity exist?” Why is that such an important concept to think about? In your letters, you've laid out a bunch of different situation-specific buckets that you like to fish in, so maybe you could talk about that as well.

MS:

With value investing, it all really comes back to a margin of safety. Historically, that was often quantitative. And I think in today's world, that just doesn't work the way it used to. If you look at everything from what Ben Graham was doing to Warren Buffett's early days to the Fama-French data, they all suggest that paying lower multiples works over time because, over longer periods of time, the market is a weighing machine, not a voting machine. But I think you have to be aware of the world we're in today where information is ubiquitous.

Back in Buffett's early

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days, you could look at something and say it's trading at one times earnings or two times

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earnings, and you could honestly say it's trading there because nobody knows this even exists. But in today's world, everybody with a laptop or a smartphone can instantly have a look at every stock that's trading at a low multiple. If it's trading at a low multiple, and everyone can see that it is trading at a low multiple, you have to ask, is it cheap for a reason? Has everybody with a simple screener already taken a look at it and passed? And if everyone has already passed, what does that say about the incremental buyer? Because while the market is definitely a weighing machine over reasonable periods of time, opportunity cost is real, and the data also show that over shorter periods of time, momentum trumps all. That is essentially value trap risk. Additionally, if you believe the research that J.P. Morgan has put out, they say that 80% of the world these days

are making their investment decisions based on some sort of quantitative input. And that 80% is looking at those cheap stocks and apparently passing, because if they weren't passing, they wouldn't still be cheap.

I think a more interesting way to come about it is to deliberately look at something that the quants will not find attractive, so something that is maybe optically expensive. It's very easy if you're a quant doing no actual fundamental research to look at this and say, oh, it's trading at 50 or 100 times earnings, we're going to pass on that because Fama-French says that's not going to work. That's fine and I have no doubt that the quants are way more sophisticated than I'll ever realize, but at a very high level, the quants are making their decisions based on two sets of inputs.

One is trailing financials and the other is forward estimates typically from the sell-side. So generally speaking, if you're only making decisions based on trailing financials and the trailing financials are not meaningful because there's been some change in the business, well, then the market is blind to that opportunity or 80% of the market is blind to that opportunity. If the other piece is forward estimates and it's a stock that's small-cap and has very little coverage, the market is also blind on that aspect. I don't want to compete with everybody else. I'd

rather be doing my own thing, and eliminating 80% of the market from the competitive pool is a great place to start. But then you also have to understand why it might be cheap and explain how those numbers are going to change over time, so that eventually, the incremental buyer that is not digging past the GAAP financials will have to take notice.

G&D:

In terms of what quant funds do and do not focus on based on their screens, would you lump in passive and index investing in that bucket? And then more broadly, do you think the rise of passive investing is a longer-term headwind or tailwind for active managers?

MS:

I do think about the ETF-ization of the world, if you will, and I think there are some very obvious problems with it. The first being that the S&P 500 index is market cap-weighted and float-adjusted, which essentially means that all else equal, the index will want to own more of a stock that's more expensive and the index will want to own less of a stock that has high insider ownership. That is nonsensical. You want to own more of something that's cheap and you want to own more of something where the management team owns a lot of stock. ETF-ization is another

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one of those things in today's world where again, you have something that's expensive and the market just keeps buying more of it without anyone doing any work. It's just flows. It explains how things can get out of whack. I don't know how to think about whether that is a headwind or a tailwind. There's an argument that over the last 10 or 15 or 20 years, it has been a headwind as the money has flowed out of active and into passive. And we're at the point now where I don't want to say it's saturated, but I think it's more than half the market as ETFs at this point. So, you have to argue that it's not going to be as bad going forward as it was in the past, just by definition.

G&D:

Can you give an example of an investment that is optically expensive to quants and other screeners, but that you think is actually cheap?

MS:

Sure. Avid Bioservices (CDMO) is a great example. If you were to look at Avid right now, it looks like it's trading at 100 times EBITDA or something like that. Nobody would call that cheap. But it's not a typical disruptive growth story that's trading at 100 times EBITDA. That's not what it is at all. At its core, it's a manufacturing business. CDMO is a contract drug manufacturing

organization and they're tied to markets with little or no cyclicalty.

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And if you're paying 100 times EBITDA for a growth company that's trying to change the world, you have to underwrite it in a different way. There are a lot of very difficult intangibles you have to value and questions you have to answer. What's the product? Who's the customer? What is the adoption curve going to look like? What is the competition doing? Those things are hard. And a lot of times, you need winner take all economics to make it work. But then you look at Avid Bioservices, and all they're doing is expanding their manufacturing footprint. So, for fiscal '23 (April 30th year end), they are guiding to \$150 million in revenue. Within two to three years, they could have \$400 million in revenue because they're expanding their footprint and will have \$400 million in revenue capacity available by this summer. And at that point, the analysis comes down to a supply-demand conversation,

which is a lot easier to investigate rather than adoption curves for some sort of new and untested technology.

You can look at the way the world is shifting towards biologic drugs or large molecule drugs, and there's just a severe lack of capacity. These guys are adding capacity. They're not the only ones adding capacity, but they have a real competitive advantage because they have a 20-plus-year track record with no regulatory problems with the FDA. And if you're a biotech and you're working on a new drug, you have a budget, and you have a burn rate, and you have a drop-dead date where you're just out of money. You cannot take a chance with an unproven manufacturer that either has no FDA track record or some blemishes on their existing track record. If you run into a problem with your manufacturer, you're going to run out of money and you're going to be bankrupt. So, CDMO has a huge competitive advantage in winning new business.

There are maybe three or four sell-side analysts that are covering CDMO. The trailing numbers are meaningless. And even the ones that do cover it, they straight line their growth assumptions where management has said, look at our track record, in the past, when we added capacity, we've filled it almost immediately. So, the sell side is thinking that it's

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going to take them five or six years to fill this capacity. The delta is 250 million in additional capacity. And then you look at the bigger players like Catalent or Lonza or some of these other big biologic CDMOs, and they add 500 million of capacity in a single year. Why can't CDMO do 250 million in two or three years? I can't think of a reason. But if they're successful, it's going to look like it's trading at 10 times free cash flow in two or three years. That is a really low multiple for a business that is arguably recession-proof, and certainly recession resistant, and benefitting from massive secular tailwinds that are fueling growth.

So, the current headline valuation looks like a venture story, except they're just building a factory. They're not trying to change the world. They're not trying to push some unproven technology, they're just adding another building, bricks, and mortar. Can things go wrong with the construction process? Of course. But they have a bulletproof balance sheet, a regulatory track record that you can't fake, and it has taken 25 years to develop that regulatory track record. It's a huge competitive advantage. And as CDMO shifts from something that people look at and immediately dismiss because at 100x EBITDA it's so expensive to "it's only 10 times free cash flow for a business that is super high quality." I think we're going to get really

well rewarded.

G&D:

How did CDMO first come across your desk?

MS:

I've owned Avid now for, I don't know, six or seven years probably. And it started as this contract drug manufacturing organization that also had a pharmaceutical development arm and a management team that basically tripled the share count over a number of years in pursuit of some novel drug that they never really figured out. And at some point, an activist came along and told them that they were lighting an enormous amount of money on fire in pursuit of a drug that doesn't seem to work. At the same time, you have this business in the manufacturing arm that is a cash cow, and the trend is really going towards biologics and outsourcing. So, if you look before the Great Financial Crisis, most pharmaceutical companies did their manufacturing in-house and then they realized, we're tying up a lot of capital in this. And if you're in-house and you already have your inventory on-hand, then those assets are idle. But if you're a third party and you have one customer that doesn't need more inventory, then you bring your next customer on so you could run your assets all the time and get much higher utilization rates

and much higher returns on capital. So, there's just been a huge trend towards outsourcing from the pharmaceutical companies. But this old management team was quite content to pay themselves a lot of money and just triple the share count. So, the activists wound up throwing them out, and then it became a pure play CDMO. They had some balance sheet problems in the early days, but they did a couple capital raises to repair the balance sheet and then they started investing in the future and it's been off and running since then.

G&D:

Another company that you own, Thryv (THRY), is a really interesting example of your "GoodCo, BadCo" framework. Can you give our readers an overview of Thryv, your investment thesis, and this framework?

MS:

I'll start with an overview of GoodCo, BadCo. We covered quants and how market participants that are relying on mechanical screens might look at something. If you're just looking at the headline, consolidated GAAP numbers and there's a business that has two different business lines and one of them earns a dollar a share and one of them loses 50 cents a share, on a net basis, you're making 50 cents

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a share. And then the market puts some multiple on those 50 cents. There are always some people that are smarter, and they'll do a sum of the parts, and I'm sure there are quants that are sophisticated enough to look past the headline numbers. But broadly speaking, the market will put a multiple on the consolidated earnings. And then the analysis at that point comes down to, well, what happens if they shut down that segment or business that loses 50 cents? And essentially, what happens is that if you shut down that money-losing business, overnight your earnings power doubles. Instead of looking like you're making 50 cents, now you're making a dollar. And that analysis comes down to human behavior and incentives and figuring out if the management team wants to pull the right levers to double earnings power overnight. I think it's often easier to underwrite how a management team will behave and whether or not they will pull those levers rather than to try and figure out future growth, for example. If the good business is reasonably stable, the analysis is almost entirely about how the management team will behave.

Thryv is an example of a GoodCo, BadCo, though it's a little bit different than the scenario I just described, and this is an example that is on the growthier side of the value spectrum for us. It

has a very, very high, what I call, "ick" factor where people would look at this and wonder how I could ever own it. The legacy business is essentially the Yellow Pages, and here we are in 2023 and everybody knows the Yellow Pages is going the way of the dodo. And I don't disagree with that sentiment. Neither does management. Management is very aware that it is a business in decline, but it's also a business that kicks off a lot of cash flow. Perhaps more importantly, it gives them a huge competitive advantage with their other business line. And the other business is essentially a software product designed to help all elements of a small and medium business run its operations. Think of your local plumber. The old system was your local plumber maybe had a pile of sticky notes or post-it notes and an Excel spreadsheet and tried to keep his business together.

With Thryv, you can do everything from email marketing, to scheduling different teams to go to different locations, to texting the customer, to telling them when you're going to be there, to reminding them about service, to sending them their bill via text message. Everything is integrated through software. And what's interesting about this is that combining it with the Yellow Pages business is a huge competitive advantage for two main reasons.

First, Yellow Pages, or what they call marketing services, is kicking off a lot of cash flow. There

“If you are a small pre-profit software company, as most of the competitors are, you have a problem in the current funding environment.”

are other software competitors out there, and over the last several years capital was free as everybody had access to that capital. But now, all of a sudden, the world has changed. And Thryv is able to internally finance themselves through the Yellow Pages business, which is a big advantage to not having to worry about capital markets. If you are a small pre-profit software company, as most of the competitors are, you have a problem in the current funding environment.

Second, all of the businesses that are still using the Yellow Pages are potential customers for Thryv's software. There are still a lot of customers out there that use the Yellow Pages because it's actually the highest return on marketing spend you can get. It does not cost a lot of money to put an ad in the Yellow Pages, but you have people that find you. What Thryv is doing, essentially, is taking businesses that advertise in the Yellow Pages and calling them to pitch them on this software product. This is

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the natural customer base. Management calls it "hunting in the zoo."

You are essentially subsidizing your software sales force with a distribution advantage. 400,000 businesses are still using the Yellow Pages. So, you have access to these 400,000 businesses, all of whom are great potential customers for the software offering. And since you're calling them anyway to renew Yellow Page advertising, you're not even really paying your sales force anything extra. Now, at some point, those economies are going to degrade somewhat, but for right now, it's a big competitive advantage to have a direct line to your potential customers in place and have a sales force that is already calling on them, especially in end markets that are so

"I've actually talked to people who are software specialists about this name, and they've never heard of it because it doesn't show up on their screens. But this year, when they finally cross over, all of a sudden, it'll show up on software screens."

diverse. With SMBs its not like one customer can make your whole year. It's a numbers game.

The next piece is that Thryv has the best software product at the lowest price point. There are other competitors, like HubSpot, who are bigger and say that they focus on small and medium businesses. But Thryv starts at five employees and HubSpot defines small businesses as around 50 employees. HubSpot has a freemium offering, which is tough to compete with, but it is very limited in scope compared to Thryv's offering which is about half the price of HubSpot's introductory paid offering. Thryv's software business is currently profitable in the U.S. The international side is a slight drag on profitability. For the first time this year, the SaaS revenue is actually going to cross over. It'll be a greater piece of the pie than the print revenue.

I think that's important because this business is still relatively unknown. One part is because of the "ick" factor. People hear Yellow Pages, and they don't even look at it. They don't take the time to investigate the SaaS opportunity. The next piece is that they came public through a direct listing. So, there was no roadshow educating people about it. And then the last piece is that it still screens as a marketing business because, historically, the Yellow Pages business has accounted for most of the company's total revenue. And the GICS system that categorizes businesses by industry and sector is based on

revenue. I've actually talked to people who are software specialists about this name, and they've never heard of it because it doesn't show up on their screens. But this year, when they finally cross over, all of a sudden, it'll show up on software screens. At the very least, that will raise awareness.

From there, you can look at how their earnings power is going to improve. This is a growth story. They look at it and say that they can increase their customer count from around 60,000 today to 150,000 in 2027, while also growing ARPU by adding additional modules. At that point, they'll be doing \$200 million in EBITDA. And if you look at what SMB software comps trade at, that suggests that the THRY stock could be up about 5x. We, of course, have to be suspicious of that, but we are not paying much for the potential today, and there is a massive secular tailwind in that SMBs have not yet embraced software the way that larger businesses have. And this is not winner take all SAAS. They are targeting less than 2% market share of SMBs, which does not strike me as super ambitious. But again, they have these competitive advantages that will help them get there.

And as soon as some people in the local business community start adopting this product, almost

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everybody has to. I think the adoption curve is going to get very steep at some point. Let's say there's three plumbers in a town and one of them can update you on their timing by text message, and send you your invoice by text message and make everything super simple. And the other plumbers, you can't even get in touch with them because they lost the sticky note that had your piece of business on it, and you're sitting around all day waiting for them to arrive. As soon as one person adopts this type of software, then everybody has to go in that direction or they're just going to lose all their business. And we can see already that this business grows by word of mouth because 30% of new customers are coming by referral these days.

I think the growth story is going to work, but if it doesn't, the other piece is that the Yellow Pages business produces a ton of cash flow. And right now, you have a fair amount of leverage on the business that was tied to the historic Yellow Pages business. But they expect to be paying it down really quickly. They're starting the year right now with \$470 million in debt and expect to pay down \$100 million this year. The de-leveraging story, by itself, is very good for the equity.

So, we have a couple years until we know for sure whether or not the growth story is going to work. But even before

that point, just cleaning up the balance sheet should help improve the stock. There are obviously things that could go wrong, but there's some very easy-to-track metrics that could tell us if they're on track in terms of this transition from the legacy business to the future business.

G&D:

Tell us about Hilton Grand Vacations (HGV). What is your investment thesis?

MS:

HGV is basically a case where I think the market views it as a cyclical business with some ESG concerns. And I think that view is mostly misplaced. In actuality, it's much less cyclical than you'd expect. HGV is a cash flow machine on top of that. If you think of Hilton, you think of hotels. But that's not what this is. It's basically property management. And then, of course, there's a sales angle to it as well. But for the core business, 50% of revenue is recurring and another 20% is highly predictable because they have 25 years of cohort data showing how people upgrade their spending over time. And then 30% of revenue is tied to new sales. But that actually has a huge variable cost to it because the big part of the sales COGS is sales commissions.

People tend to be surprised that historically HGV has not been that cyclical. They

grew through every recession prior to the financial crisis, and revenue was down only 3% during the financial crisis. And part of that is because it's not a true hotel where you're tied to business travel in a lot of ways. It's all leisure travel. It's stickier than business travel during downturns.

The other thing that's interesting on the culture side is that they do things a lot differently than the competitors. They use a fair amount of asset-light development. Rather than keeping all their buildings on balance sheet, they'll have an outside developer build a building and then they'll sell through the inventory. And that's interesting because it's a lower margin model, but it's also a much higher return on capital. I think that prioritizing ROIC over margin is the right way to think about it.

“It's much less cyclical than you'd expect. HGV is a cash flow machine on top of that.”

Despite that being a better model, I don't think the competition can switch at this point because they're public companies. If they switch, then they have to explain how they are going to sacrifice margins and earnings. That is just very difficult to do in public markets. Stocks like Marriott Vacations would be

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punished if they did that. So, I think Hilton has an advantage in that they have the flexibility to do asset-light development.

The other piece is that they focus on new owner growth whereas most of the competitors spend most of their time upselling the existing owners. It's a lot easier to upsell an existing owner than it is to win a new customer. And that's important because, during a downturn, HGV can actually lean more heavily on existing customers, whereas competitors are already leaning on existing customers. That allows HGV to do better in a difficult period. And a big part of the reason they're able to do that is because they're tied into the Hilton loyalty network which is 140 million members strong.

It is a huge advantage in this business to have access to a brand and a loyalty network. And I'll explain more about that in a minute.

You're just paying a low price today, roughly nine times normalized cash earnings. But more important than that, there's a clear path to see how earnings are going to improve over time. I mentioned it previously, but HGV has 25 years of cohort data showing how customers spend more as they age. So, just the new owners that they've added over the last couple of years, 25 years of data say that those people alone are going to drive earnings power higher. So, you have a low starting

multiple with built-in growth.

But where it really got interesting for me is that they recently acquired a non-branded competitor, Diamond Resorts. Having a brand in this business is a huge advantage. The simplest way for me to illustrate that is, in this business, when you have unused inventory, you basically make it available to the general public. And if you're unbranded, what that means is spending a fortune on Google search or the OTAs. Diamond was running their rental business at a loss. If you're Hilton and you have unused inventory, you just make it available to the millions of people on the Hilton Honors network. It costs you almost nothing to do that. And they have a relationship with Hilton Hotels that sees Hilton Hotels get a cut. But basically, they're able to run that business at a 35% margin.

You can just take Diamond's historic rental revenue and put HGV's rental margin on it and underwrite revenue synergies of about \$100M in EBITDA from this transaction. But the management team has never spoken about those revenue synergies. They talked about the cost synergies, but they've never talked about the revenue synergies. And if you look at the go-forward estimates that they put out in the merger proxy, you could say that they're not baking in any of these revenue synergies. If you look at

the very limited analyst universe that covers it, they're basically straight lining their estimates right along with the merger proxy. But in reality, there should be a huge uplift from combining the Hilton brand with the non-branded properties. And it's not just on the rental business. There is also a huge advantage in customer acquisition costs when you have a brand. A huge portion of HGV's customer acquisition is from people who are already booked into a Hilton Hotel room and then call the Hilton hotline to ask a question about their room. And then the operator can ask if they would like to learn about the timeshare options. So they have an inbound funnel, versus competitors that are out there with kiosks in the mall or something.

I think all the things that have worked for the HGV business, historically, are going to also work on the Diamond properties. It's just a matter of time. They have to rebrand and update things and integrate the computer system. So, it's probably a two to three-year process. But ultimately, I think it's a business you can look at and say on a normalized basis it generates a ton of cash, trades at a low multiple, and there's strong reason to believe it's going to become a share cannibal. The ESG and cyclical concerns keep the multiple low. The management team is

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aware of the true economics of the business, and they take advantage of that low multiple by buying back stock. Over time, you probably should see multiple expansion as people come to realize, wait a second, the float is shrinking by 3% to 6% every year as cash flow and earnings power is also growing. Those businesses don't stay at single-digit multiples forever.

G&D:

One thing that always comes to mind when we're looking at cyclical stocks is trying to understand what it's going to take for the market to respect them. What do you think is going to drive that change in the sentiment?

“If you have good ideas, you're going to be fine. So, work on your ideas and then share them with people because if you have a good idea, there's automatically a target audience of people to speak with.”

MS:

A couple things. First, this business hasn't been public that long. So, if you want to see how this business actually did through the financial crisis, it's work. You have to go look at Hilton

Hotels which was private at the time, but you can track down some of their stuff through their bonds that were outstanding to get to what actually happened at Hilton Grand Vacations. I think once this goes through a normal recession in public markets, people will see how it can actually perform during a difficult period. And you can look at the experience with COVID and that was very much not a normal recession because people literally couldn't travel. But in a garden-variety recession, I think people say, wait a second, this is nowhere near as cyclical as I thought it was.

Or the market will just look at it and say, this business, maybe it has some cyclical elements but it's chugging along and they're returning capital, they're shrinking the float. And there's plenty of examples of businesses like that, that people thought were cyclical in the beginning and then realized over time, they weren't as cyclical. The example that comes to mind is when Eddie Lampert got involved with AutoZone. People thought, oh, it's auto parts. Auto parts are cyclical. Well, turns out they're not when there's a big DIY market for auto parts. During a recession, people do more DIY work, and the business did fine. Every year, they grew earnings a little and they used a little more leverage to buy back stock. And over time, the multiple goes from 10x to 20x because people wake up

and realize that this is working.

G&D:

Great. Moving on to closing questions. Do you have any advice for undergrad or MBA students who want to get into this industry?

MS:

The thing I would say first is that ideas are the currency of the investing world. And I'm a prime example. I didn't have the advantages that come from the right pedigree. I'm entirely self-taught. And if you have good ideas, you're going to be fine. So, work on your ideas and then share them with people because if you have a good idea, there's automatically a target audience of people to speak with. Anyone that shows up on the 13F list should want to talk to you, and you never know where that conversation can lead. One of the things that always baffles me is that I get a fair number of emails from people trying to break into the industry, specifically in undergrad, but grad school as well, where they say, hey my name is so-and-so. And they include their resume, and they say that they would love to talk. I always respond. But your resume tells me who you are. I don't care who you are. I care how you think. Send me something that shows me how you think, which means an investment

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idea, and then we should talk. And most of them, I never hear from again. But those that I do hear from, there's a couple examples of younger analysts that I still have ongoing relationships with.

G&D:

Last question, what do you like to do for fun outside of investing?

MS:

I have three little kids now so I try to spend as much time with them as I can, but historically, a lot of my hobbies were very good for investing. So, it's basically just activities you can do where you can let your mind wander. So, going for a hike, going fishing, skiing. These are all things where you have to be comfortable inside your own head and let your thoughts wander. I think that there's a lot of value that comes from that. You never know where it's going to take you. Maybe at some point later, you connect some dots that you came up with while you were hiking or fishing or whatever it might be. I'm just a big fan, in general, of those kinds of activities.

G&D:

Great. Matt, thanks for joining us today.