July 2022

Dear Partners,

For Q2 2022 Class A interests in Laughing Water Capital returned approximately -19.4%, bringing our year to date returns to approximately -29.5%. The SP500 and R2000 returned -16.1% and -17.2% for the quarter, bringing year to date returns to -20.0% and -23.4% respectively. As always, please check your individual statements for the most accurate reading on returns, as returns will vary based on class, fund, and timing.

While our YTD *relative* performance might be "fine," we are an absolute return strategy, so it is also disappointing and frustrating. It is also not unexpected. As a reminder, as our portfolio manager I am not reinventing the wheel. I am simply putting my own spin on a strategy that has been well worn by most of history's greatest public equity investors. Examining the track records of these intellectual forefathers demonstrates that they were not immune from drawdowns, so there is little reason to expect that I would be immune from drawdowns.

If our past success had been built on buying high flying growth stocks that were perhaps interest rate plays in disguise, I would be worried.

If our past success had been built on buying cryptocurrencies of dubious utility, I would be scared.

If our past success had been built on meme stocks, I would be terrified.

Yet, I remain confident because our past success has been based almost entirely on common sense. I seek to buy good companies, led by good people, during times of temporary uncertainty due to some sort of optical, operational or structural problem that I believe can be fixed by our properly incentivized management partners given a reasonable period of time. If the analysis is sound, with time we should benefit from the dual forces of improving business fundamentals and improving sentiment, which should lead to acceptable investment returns. However, in the interim, we are consciously choosing to accept greater volatility in exchange for the potential to realize greater long-term returns. Embracing temporary uncertainty is what allows us to benefit from low purchase prices. However, during periods of macroeconomic uncertainty, the market tends to shun businesses dealing with idiosyncratic uncertainties in favor of businesses whose near term prospects seem more apparent.

In other words, we are deliberately pursuing lumpy outperformance, so while the journey at times can be disappointing or frustrating, we can't really complain about the lumps. True long-short funds and commodity focused funds that endured a decade of underperformance before presently outperforming deserve their moment in the sun. I remain confident that we will have plenty of sunny days in front of us, and for this reason almost the entirety of my and my family's wealth remains invested alongside your money. Our interests are aligned.

Where Are We Now?

In my opinion, at present Mr. Market's focus on inflation, interest rates, Ukraine, and assorted other boogeymen including the prospect of recession is presenting us with a lot of cheap stocks, and at the moment, the prospect for intermediate and long term forward returns for our portfolio are very good. At the same time, neither I nor anyone else can tell you what will happen in the near term, and it is entirely possible that stocks that I currently believe are very cheap can get considerably cheaper.

There is nothing unusual about this setup. The potential for attractive long-term returns and the potential for near-term declines are joined at the hip: you never really see one without the other. If the prospect of trouble or uncertainty does not hang heavy on the horizon, then stocks are typically not all that cheap to begin with.

Understanding this dynamic is easy.

Being comfortable with this dynamic is something else entirely, and in my view the ability to be comfortable being uncomfortable is a huge driver of investment results over time.

Evolution has ensured that this comfort is hard for most people to obtain. Afterall, to some extent we are all genetically hard-wired to place more emphasis on near term risks rather than intermediate and long-term opportunities. Those of our Cro-Magnon ancestors who ran for cover at the first sign of a lion at the waterhole were more likely to pass on their genes than those who stuck around to see if the lion was friendly. However, the investing world has far more nuance than lions at waterholes, and in my view those who are unable to navigate through what was a very useful evolutionary heuristic are likely to make the desire for "perfect" the enemy of the "good enough" when considering their investments. Afterall, when the answers to all of the world's current problems are more apparent, it is unlikely that discounts will abound.

To be clear, I have no idea what is going to happen next, and in my view anyone who claims that they do is a liar or a fool. However, I feel confident about what will happen *eventually*: good businesses led by good people will trade at a normalized multiple of their normalized earnings. In my view, the ability to ignore "next" and be indifferent in regard to the event path between "now" and "eventually" is the hallmark of a successful investor. At times like these, behavior is the greatest edge that an investor can have.

I believe our portfolio is filled with investments that fit well within this framework. In most cases, I believe that the idiosyncrasies of these investments are such that it is very likely that the market will come to appreciate their value within the next few years, regardless of what happens in the next few months or quarters with inflation, interest rates, possible recession, or the stock market. They can definitely go down in the near term, but I believe they are cheap enough to continue to own regardless of what happens in the near term.

How Cheap is Cheap Enough?

Consider the case of **Avid Bioservices (CDMO)**, a large molecule, small batch Contract Drug Manufacturing Organization that will be familiar to all but our newest partners, as we owned shares from 1H 2018 until

all but exiting our position in the low $30s in Q4 of 2021. Since that time, shares have declined precipitously as the company is both a "growth" stock and in the S&P Biotech ETF (XBI), which has declined ~36% YTD to quarter end. However, in my view Avid Bio is a baby with the bathwater, and we once again made Avid Bioservices a large position during the quarter.

First, unlike most "growth" stocks, Avid Bioservices is not a "disruptor." You don't have to make any blind assumptions about total addressable market (TAM), customer acquisition costs (CAC), or churn. There is very little risk of "garbage in, garbage out" when modeling Avid's future. Rather, Avid's assumed growth is tied to building additional manufacturing capacity. In my view, it is a much easier task to understand the dynamics of building an additional manufacturing facility than it is to understand the dynamics of alleged TAM, potential CAC, and unknown churn. Second, unlike most biotech stocks, Avid is a real business, not a binary bet on whether or not a drug will meet its hoped-for end state. Lastly, and most importantly, Avid Bio has one characteristic that staunchly separates it from other high flying growth stocks and biotech stocks that have been punished by the market: it is set to gush cash in the not-too-distant future.

The company is in the process of expanding its manufacturing footprint, having announced plans to have revenue generating capacity of $370M within the next ~12 months, vs. revenues of $119.6M in fiscal 2022 (YE April 30). This expansion is fully funded, and at that scale the company has guided to "low to mid 30%" EBITDA margins, which appears reasonable if not conservative based on commentary from competitors. From there, interest payments should be zero assuming outstanding convertible debt is equitized, and with nearly $700M of NOLs, it will be at least a few years before the company is paying meaningful taxes. Lastly, once the facilities are built out, they are relatively capital light, and maintenance cap-ex should be 3-3.5% of revenue. Thus, at the prices we were buying our shares, CDMO was perhaps 3 or 4 years away from trading at 7x-8x steady state free cash flow.

Future Revenue Capacity	$370,000	
EBITDA margin @ scale	33%	36%
EBITDA @ scale	$122,100	$133,200
- Interest	-	-
- Tax	-	-
- Maint. CapEx @ 3.25%	12,025	12,025
Free Cash Flow	$110,075	$121,175

To be clear, as always things can go wrong here. It is not impossible to believe that construction of the new facilities might run into speed bumps due to supply chain issues, or cost overruns. Further, there is no guarantee that the company will be able to fill this new capacity.

However, it is rare to see purely speculative capacity expansion in CDMO world, despite the fact that at present demand far outstrips supply, and I think the odds that Avid Bio has customers lined up for the lion's share of this new capacity are very good. Afterall, on their March earnings call the company noted that current 12 month backlog is larger than current capacity, and they have also noted that they have been asked to respond to Requests for Proposals (RFPs) from potential customers, even before their new facilities have been constructed.

In CDMO land, quite frequently when there is an increase in capacity, it is in response to existing customers and potential customers approaching an existing CDMO (such as Avid Bio), and *asking* them to build additional capacity in anticipation of their own future needs. This is because pharmaceutical

companies are reluctant to partner with de novo CDMOs that do not have long-established and reliable FDA regulatory track records.

In brief, when a pharmaceutical company partners with a CDMO, the CDMO becomes part of the FDA approval process for the drug. If the CDMO does not run smoothly, the drug will have trouble gaining FDA approval. For many small pharmaceutical companies, avoiding delay is of critical importance as they are often burning cash ahead of FDA approval. Further, the relationship between the customer and the CDMO does not weaken after FDA approval. If the pharmaceutical company wants to switch to a different manufacturing partner, the drug as manufactured at the new facility must go through FDA approval again; switching costs are high.

Thus, choosing the right CDMO partner is of critical importance. As a result, despite barriers to entry in this business being largely tied to capital and thus low, barriers to success are quite high. Quite simply, it takes ~30 years to establish a ~30 year track record of regulatory success similar to the one that Avid boasts, and without that long track record, the decision maker at a customer is taking an unnecessary risk. Just as decades ago "no one got fired for going with IBM," in CDMO land no one gets fired for going with a CDMO partner that has a well-established FDA track record… but they might if they go with an upstart. It bears mentioning that this is not just a theory. There is plenty of evidence that demonstrates that CDMO assets trade hands at many multiples of replacement cost, because capital alone cannot establish a successful CDMO – it takes time and a clean track record.

All of this might sound interesting, but what about a recession?!?

CDMOs are largely recession proof businesses. Patients still need their drugs regardless of what is happening in the real economy. This of course says nothing about what multiple the market might put on Avid Bioservices 3-4 years from now, and it is conceivable or perhaps even likely that in a recessionary environment Avid Bio would be awarded a multiple below what it would deserve in more normal times. However, if the company ~triples revenue and sees free cash flow go from a negative number reflective of current investment to something well north of $100M over the next 3-4 years, I feel confident that fundamental business improvement will far outweigh the impact of any market-wide multiple contraction.

If the world is "normal" in 3 or 4 years, I think it is reasonable to say that recession proof free cash flow deserves a 20-25x multiple, which implies a stock price of somewhere in the $31-$43 range, or a CAGR of 27%-53% over that 3 or 4 year period assuming all else equal. Of course, I would not be surprised to see a higher multiple for Avid Bio given the tremendous strategic flexibility the company will maintain at that time. For example, with no debt and recession proof revenues and cash flow, the company could comfortably lever the balance sheet by 3x, which would allow them to repurchase almost half of the equity if the stock does not move considerably higher between now and then. They could also continue to grow organically, or become a buyer of smaller orphaned CDMO assets, or they would be an attractive target for a bigger CDMO player.

If the world is still panicked by inflation and recession 3-4 years from now, and market multiples have contracted severely, I think we would still be pleased with the result of this investment. At a multiple of 15x my estimate of FCF, which seems punitive for fast growing, recession proof free cash flow with strategic flexibility, shares would trade hands at $25, or a 20%-28% CAGR from our purchase price, assuming all else equal.

But what about inflation?!?

CDMOs are well positioned to pass on inflationary cost pressures to their customers. The actual manufacturing of a drug represents a small portion of the total cost of drug development, switching costs are very high, maintenance capex needs are low, materials costs are contractually passed on to customers, and at present manufacturing capacity in the industry is tight.

I want to stress again that things can go wrong with our investment in Avid Bioservices; there is no such thing as a perfect investment. In particular, the obvious risk here is that industry capacity expansion becomes less rational than it has been historically. To be clear other industry participants are also adding capacity, although much of this expansion has been international, and focused on larger scale (20,000+ liter) capacity drug substance, while Avid plays in the smaller scale (2,000 liter and smaller) arena, and I believe domestic capacity is highly valued due to supply chain concerns. Avid also has a concentrated customer base, although capacity expansion should dilute this potential problem, and their largest customer Halozyme Therapeutics (HALO) is guiding to more than double revenues over the next few years, which is likely a big reason that Avid Bio is expanding. Still, I think the odds for success here are very favorable, and as I see it, the potential problems with this investment have little to do with inflation, interest rates, or the economy, as long as one can remain focused on the *business*. In fact, there is an argument that higher inflation and interest rates and a weaker economy could actually *strengthen* Avid Bioservices' competitive position. After all, if the big risk here is that the industry abandons its historic discipline and binges on speculative capacity expansion which could weigh on margins, it seems that reduced access to capital for development stage pharmaceutical companies would reduce the demand for speculative capacity expansion. Additionally, appetite for deploying speculative risk capital into building de novo facilities should decline during periods of tighter money supply and higher cost to build new capacity.

Further, while I feel confident that the pieces are in place for this *business* to be in a much better place in 3-4 years than it is today, I have no idea what will happen to the *stock* in the near term. If the broad markets continue to decline, there is no reason that Avid Bio's stock cannot decline as well. Of particular note, while Avid estimates that only ~5% of their backlog is tied to Covid treatments, the industry may get spooked as Covid treatment related demand rolls off. Further, as new capacity comes online, capacity utilization – and thus margins - will quite naturally dip as it will take time to fill this capacity. But with the future, normalized, success of this business being tied mostly to their ability to successfully kit out a new building and customers continuing to choose CDMO partners with outstanding regulatory track records rather than unknown upstarts, I think the odds for success here are very favorable.

Should we not have bought shares at ~$12 that I think have a fairly clear path to ~$40 because they might go to $10, or $9 or $8 first? If they did go to $8, all else equal the potential 3 year CAGR as I see it would be ~75%: clearly that would be ridiculously attractive. But should we pass on the potential for a ~50% 3 year CAGR – also ridiculously attractive - that I think has a good chance of happening because we *might* be able to get a 75% CAGR?

The point is that I think it would be a mistake to let the desire for a perfect investment opportunity become the enemy of a very good investment opportunity. It would also be a mistake to fret about inflation, and interest rates, and near-term stock market volatility, rather than to simply believe that if a business can notably improve its earnings power over the next few years, as long we don't overpay going in, we will be

well rewarded despite some market swings in the interim. There is an enormous amount of evidence to suggest that we are more likely to generate acceptable investment returns over longer periods of time if we simply ride those swings, rather than fool ourselves into believing that we will be able to perfectly time our exits and re-entries in order to avoid the swings.

Avid Bioservices is just one example of the type of business - and the type of investment - that we own. Each of our businesses and investments is different, but each of them is similar in that they all have a unique path in front of them that should allow them to thrive in the intermediate term, and generate acceptable investment returns over that period, regardless of what happens in the near term. Not all of them will work as envisioned. The only certainty is that I am wrong about something somewhere. But despite some inevitable mistakes on my end, and despite near term price action that may be uncomfortable, I think we will be rewarded with time. As always, patience is the key.

Top 5 Disclosed Investments

Below you will find brief updates on several of our largest investments.

Aimia Inc. (AIM.TO) – Long term holding Aimia should shortly receive about C$6.00 per share in after tax cash proceeds from the sale of PLM (Aeromexico's loyalty program), which will bring cash and liquid investments on the balance sheet to somewhere around C$575M. The current market cap is approximately C$400M. There is no debt, but there is ~$236M of perpetual preferred stock. Without going into detail, I think Aimia's other assets far outweigh the preferred stock (which I would also argue should not be debited at face value since it is perpetual, trades at a severe discount to face, and a recent discounted tender offer was well oversubscribed). Aimia is a holding company and thus will likely always trade at some discount to NAV, but what discount to cash do you need to feel comfortable here? Does it only make sense to buy ~$575M in cash for $300M rather than $400M? Keep in mind that while the dollar value of this cash has remained constant in recent months, the purchasing power of this cash has theoretically gone UP by the inverse of the market's decline. If the economy slows, and the market continues to decline, the purchasing power of this cash will go up further still.

To be clear, Aimia likely does not have exciting upside potential like most of our other investments, but it's soon to be cash heavy balance sheet ~~does~~ should act as useful ballast to our portfolio. Perhaps the market will not take notice until the cash actually hits the balance sheet, which won't happen in a quarterly filing until Q3. This is likely a good thing as management has indicated they will be repurchasing ~$75M of stock in the near term. As the company deploys the rest of its capital into cash generating businesses in the near and intermediate term, I expect that intrinsic value will grow substantially. At the same time, if the market continues to decline, I would expect that Aimia will outperform, and perhaps become a source of funds as other opportunities become relatively more attractive.

Avid Bioservices (CDMO) – discussed above

Cannabis Basket – Our cannabis stocks have continued to perform terribly, and the day that cannabis is legalized at the federal level continues to get closer. I continue to believe that in the near term these stocks trade on flows, and with at least 3 cannabis focused funds and 2 cannabis focused news letters having shut their doors recently, the flows have clearly been negative. I believe this will reverse aggressively when cannabis inevitably enjoys federal legalization, which will lead to not only improvements to our business's cost structures, but also a flood of capital entering the space. This will allow us to benefit from a macro trend that is completely divorced from the real economy. Further, if cannabis rhymes with alcohol, then the industry itself should be recession resilient.

The businesses we own are largely geographically diversified in limited license states, have strong balance sheets, good operators, and unique opportunities in front of them that should allow them to grow revenue 30-50% in the near term. Further, they trade around mid-single digit multiples of EBITDA. Critics will rightly point out that it is impossible to know what normalized margins will look like in this sector as it continues to mature, but given growth opportunities, scale opportunities, and very undemanding current multiples, I believe we are being more than compensated for that risk. It is also unknowable what multiple these businesses will ultimately command. At the low end, perhaps they deserve a low to mid-teens multiple similar to large beer businesses that grow mid-single digits per year. Or perhaps they deserve a low 20s multiple similar to liquor businesses due to their local monopoly characteristics in limited license states. But should we not own these businesses at 5-8x rapidly growing EBITDA because they could go to 3-4x EBITDA before ultimately going to 10-20x EBITDA? From my perspective, the intermediate and longer-term upside seems large enough to justify ignoring the short-term swings.

Countryside Partnerships (CSP.LN) – Countryside, our UK based homebuilder, is in the midst of exiting its asset intensive operations in order to focus on its asset light operations. The original thesis as introduced in our YE'21 letter was predicated on a belief that asset light home building is simply a better business than asset intensive homebuilding. Secondary to this thesis was a belief that near term downside to Countryside's stock would fuel intermediate and long-term upside as the company had committed to using the cash obtained from the runoff of its asset intensive operations to repurchase shares of the remaining company. Through most of May the thesis was largely intact, with recent results having been more disappointing than expected, but the company taking advantage of this weakness by buying back more stock than expected.

However, in late May Inclusive Capital, a large shareholder and well-known activist, publicly announced that they had submitted a bid to take the company private. Subsequently, the company announced that they would be suspending the buyback and running a formal sale process, but not for several months.

It seems clear that Inclusive Capital's bid was opportunistic, as the company is presently dealing with near term problems (that are worse than I anticipated), that have been weighing on shares. In brief, I believe many of these problems can be tied to an interim CEO and a board that was under attack by activists (that we supported) trying to grow at any cost in order to stave off the activists. Essentially, in this business the CEO's job should be primarily about capital allocation. If there are two projects available, and one offers the potential for a 40%+ ROCE (in line with Countryside's Partnership's business history) and the other offers the potential for a 15% ROCE, capital should be steered toward the higher ROCE opportunity. However, if the interim CEO and/or board believe that growth regardless of ROCE is the solution to their

immediate term problems with activists, they may be tempted to pursue low return projects just for the sake of growth.

I believe some version of this problem, combined with poor corporate communication during a transition period, led to the market excessively punishing shares of Countryside. At the same time, the company's decision to announce a sale process – but not for several months – seems designed to allow these low ROCE projects to roll off, so that the normalized earnings power of the business can be more accurately captured by the financial statements prior to a sale process.

A sale process has a few consequences of note. First, as mentioned above the company has stopped buying back shares, so the second leg of my initial thesis is clearly broken: lower prices in the near term will no longer lead to higher prices in the long term. Second, the company has been conducting a CEO search, and has been reluctant to lay out a clear vision for the future prior to filling the CEO spot. It is hard to imagine that a high-quality CEO will sign on to lead a company that may be for sale in a few months, so it seems likely that corporate communication will continue to disappoint.

Lastly, if the company will soon be for sale, the valuation lens should shift to view the company as a potential acquiror would. I believe there are several strategic buyers that could realize somewhere between $60-$80M GBP in synergies by eliminating corporate level and regional level administrative costs. If one were to adjust the company's current enterprise value by the assumed cash value of the remaining runoff of the company's legacy asset intensive division, and then note that U.S. asset light homebuilder NVR Inc. has often traded at 10-14x EBIT, then the value of the potential cost savings alone far exceeds Countryside's adjusted enterprise value. In other words, at current prices, a strategic acquirer could theoretically get the actual business for less than free.

I do believe that if Countryside were to remain public as a pure play asset light homebuilder hell bent on returning capital to shareholders a la NVR, eventually the market would figure out that perhaps NVR's multiple is relevant to Countryside. However, in the immediate term I admit that this is clearly an optimistic view, as Countryside has not yet proven to the market that it deserves a similar multiple to NVR. Regardless, even applying Countryside's historic multiple as a mixed asset light / asset heavy business to the potential savings a strategic acquirer could realize suggests that a sale of the business could result in ~100% upside from recent prices. While this might sound exciting vs. the uncertainty of broader markets, a 100% return from current prices would be a disappointment versus my initial expectations that Countryside would be a business that we could own and compound for years to come. But at this point, how cheap is cheap enough? Should we not own shares at a price that suggests that a buyer could buy the actual business for free by just capitalizing the potential savings at a reasonable historic multiple? Must we wait until a buyer could buy the business for significantly less than free?

Landec Corporation (LNDC) - LNDC is new to the portfolio, and is an example of an investment archetype that should be familiar: good co. / bad co. A year or so ago, the company owned several businesses, including a packaged salad business, a processed avocado business (shelf stable guacamole), a salad oil business, a breathable produce packaging business and… a high quality injectables focused CDMO known as Lifecore Biomedical. With a 2 year old son and a 1 year old daughter, Sesame Street is presently the sound track of my life, and "one of these things is not like the others."

With help from activist investor and friend of LWC Legion Partners, LNDC has realized that pairing commodity based packaged food businesses with a high quality CDMO makes zero sense, and LNDC has been selling off the food businesses in order to become a pure play CDMO. We bought our shares around $10, and I estimate that Lifecore Biomedical is worth somewhere between $14 and $25 a share today, and that value will grow substantially in the years to come. At this point, the bulk of the remaining food business is the avocado business, which was purchased 4 years ago for $80M. It is not impossible to believe that the value of this business has declined, but if the CDMO is worth somewhere between $14 and $25 per share, this implies that the market thinks the avocado business is worth somewhere between negative $120 million and negative $440 million. I think this is overly pessimistic.

Notably, the company has been clear that they intend to use the proceeds from the sale of the avocado business to pay down and refinance debt, which is catnip for investment bankers. Those same investment banks have already had their CDMO focused research analysts out to meet with management of Landec, but management has indicated that so far commentary has been, "we will have to wait until the avocado business is gone before launching coverage." But when Landec becomes a pure play CDMO – probably within the next few months – I suspect that awareness will raise quickly, and the stock will re-rate substantially higher. Also contributing to this potential re-rating is the fact that at present LNDC is categorized under "packaged food and meats" by the Global Industry Classification Standards (GICS), that powers equity screening tools that are relied upon by the estimated 80% of market participants that make their investment decisions based solely on quantitative inputs. In other words, at present health care focused investors – and investors that may want to hide in healthcare during uncertain economic times - may not even know that Landec – or more appropriately Lifecore Biomedical - exists.

In addition to these non-economic factors, Lifecore is primed to benefit from fundamental improvement. Historically Lifecore was milked for cash to help support the food businesses. However, more recently Lifecore has made substantial investments to expand capacity in fill/finish of injectable-grade pharmaceutical products, and is on pace to more than double capacity by 2025 in order to meet expected demand from the existing pipeline.

Again, how cheap is cheap enough? Is an implied value for the avocado business of negative $120M to negative $440M not enough? Should we wait until the implied value is negative $500M? why not negative $700M? At some point you just have to say that this does not make any sense, hold your nose, and accept that the market can do whatever it wants in the near term. However, over reasonable periods of time the market will find some level of rationality. Neither I nor anyone else can tell you with any certainty what will happen next with inflation or interest rates, but at the risk of being flippant, I feel pretty confident that at some point within the next few years the market will realize that a high quality CDMO with competitive attributes similar to Avid Bioservices is more attractive than commodity packaged salads and pre-made guacamole.

Comments on Additional Investments

Thryv, Inc. (THRY) – Thryv is our small business software company that is milking the cash flows from the legacy yellow pages business. Shares have sold off perhaps because all things SAAS have been punished, and perhaps because this business has exposure to small and medium businesses, which will presumably

be challenged in a recessionary environment. At the same time, I do not think the trend of small businesses moving to the cloud is at risk, and Thryv's product replaces labor by automating many tasks, and thus likely actually saves its customer's money which may accelerate adoption in a recessionary environment. Most importantly however, Thryv's software business is fully scaled, and was previously cash flowing before management elected to increase growth spending. In a more challenged economic environment, management could simply flip the switch back to focus on cash flow. The team here is excellent, having navigated through many challenging economic cycles over the last 30 years, they have a lot of skin in the game, and they understand that at the end of the day cash flow is king. Earlier this year they laid out a plan to ~5x the business over the next 5 years, and then 4x the business in the 5 years after that. These are clearly ambitious plans, but given the undemanding valuation, they could fall well short and we would still be rewarded. It is worth noting that they did not suggest that this growth would come in a straight line, and I would be shocked if they did not plan for many speedbumps along the way.

Whole Earth Brands (FREE) – Whole Earth, our alternative sweeteners business, currently trades around 6-7x my estimate of normalized FCF, versus packaged food peers at more than 20x. To be fair, the company has somewhat painted themselves into a corner as they have been pitching themselves as an M&A growth story, but after ~doubling revenue over the last 2 years, at present the balance sheet is full, and they do not have the equity cost of capital needed to continue to pursue M&A with equity. Thus, the revenue growth story is on hold (although their category should grow faster than other packaged foods), which combined with some inflationary pressures has led to shares being punished. From my perspective, a stalled growth story is not great, but it is better than a continued growth story that is based on value destroying dilutive equity transactions: management deserves some credit for being disciplined. Further, debt paydown is a totally reasonable strategy to build equity value. The company is presently rebuilding the balance sheet, which at some point will likely be fire power for future M&A.

Putting the balance sheet aside, perhaps the most notable recent development is Martin Franklin bought ~14% of the equity during the quarter. No one is infallible, but at the very least it is curious to note that the last time Martin Franklin and FREE's Chairman Irwin Simon worked together it was at Jarden Corporation, where Franklin compounded capital at 30% a year for 15 years before selling the business. Again, there is no guarantee here that history will rhyme, but a low starting valuation is a prerequisite for that sort of compounding, so we are starting from a good place. How cheap does a stock have to be to partner with people that have an incredible history of buying and building businesses? Should we wait for 4x or 5x normalized FCF? Or should we plow ahead at 6-7x and just acknowledge that the road forward will have plenty of speed bumps?

Transact Technologies (TACT) – Transact, our slot machine printer business that is also developing back of house restaurant and convenience store software, has fallen victim to supply chain issues that have slowed its growth. Quite simply, they have been unable to meet customer demand. This is of course frustrating, and it does come with balance sheet implications, but it is not as if this unmet demand is missed opportunity. Rather, it is delayed opportunity because competitors have not been able to meet demand either. In fact, this delayed opportunity is likely to come with pricing power. My research suggests that on the slot machine printer side – a duopoly market – TACT's main competitor has been

telling customers that it could be 12-18 months before they have product. TACT expects product much sooner, and appears to be in position to decide if they should build relationships with new customers by being accommodative on price, or if they should be a bit more greedy with the expectation that this business may be one time in nature. Regardless, with time the supply chain issues will resolve themselves, and TACT will continue its march forward. It bears mentioning that the decline in TACT's stock has shrunk the market cap to a level that we normally would not bother with, and it is possible that selling pressure is tied to the small size. At the same time, at present TACT is trading at 3-4x my estimate of the normalized EBITDA of the slot machine business, which you may remember operates in a unique niche with regulatory protection and only one real competitor. This gives no value to the restaurant/C-store business, and in my view selling here for structural reasons would make little sense.

Partner Meeting

As I have tried to stress through this letter, I am a firm believer that during market conditions like today, an investor's best defense is behavior. I believe that our partnership is well positioned to behave well due to both structural decisions and the high-quality nature of our LP base. I also believe that the best way to enhance one's ability to remain rational and focus on future potential rather than near term problems is to know what you own. As such, I am planning to host a virtual meeting for LPs at some point in the not-too-distant future. Please stay tuned for further details.

Looking Forward

I typically end these letters by reminding you that neither I nor anyone else knows what will happen to the economy or the market in the near term. This is as true now as it ever is. In my view, in times of great uncertainty, the most important determinant of investment success is behavior. Our strategy is based on a firm belief that over reasonable periods of time, businesses trade at normalized multiples of their normalized earnings power. I believe our portfolio is filled with businesses whose normalized earnings power will be substantially higher three to five years from now then it is today. In almost all cases, these businesses operate in niches that are largely insulated from the real economy, or are set to benefit from a larger trend that will ultimately dwarf short term economic swings. The key to our success will not be how these businesses perform from quarter to quarter. Rather the key to our success will be our ability to ignore the noise in the short term, and remain true to the belief that in the intermediate and long term per share earnings power will determine our success.

Thus, I continue to believe that the best path forward is to do what we always do: stick to our process. If we can find good businesses, run by good people, at cheap prices tied to some sort of temporary problem or under-appreciated transition, then over time I believe we will continue to be rewarded. It is entirely possible that our investments will move lower – perhaps due to macro concerns, or perhaps due to individual problems – in the near term. In fact, to truly maximize our long-term returns, there is an argument that I should rotate the portfolio into more economically sensitive investments that have the potential for more downside in the near term, but more upside in the intermediate and long term. Regardless, I believe our process will work all the time over longer periods of time, which is more attractive

than attempting to time the stock market, or attempting to flit from one style to another in hopes of being one step ahead of whatever will work best in the near term.

To drive home the above points I find myself tempted to trot out one of the many quotes from legendary investors that relate to focusing on the long term, ignoring volatility, and remembering that stocks are businesses, not pieces of paper that go up and down. I am also tempted to point out the huge drawdowns that the most successful stocks of the last several decades have seen during their climb toward incredible returns. Instead, I am going to list some of the things that I am thinking about these days. To be clear, neither I nor anyone else can assign any predictive value to these items. They are just for pondering.

- There are signs inflation is moderating:
    - Wage growth is decelerating
    - Agricultural commodities have rolled over aggressively
    - Fertilizer prices peaked in late March
    - Housing inventories saw the largest jump in active listings in June since 2017
    - Shipping rates from China to the U.S. have fallen by ~40%
    - Domestic trucking demand has moderated significantly
    - Average U.S. gasoline prices just had their largest monthly drop since March, 2020
    - Large retailers have warned they will be discounting to clear excess inventory
    - Chip manufacturers have warned their customers have excess inventory

- Scant evidence the consumer is slowing down
    - BofA credit card data shows spending up 11% in June YoY
    - Untapped home equity is double the 2006 peak
    - Job market is still very tight
    - Travel data still very strong

- Sentiment is very negative, which historically has been good for forward returns
    - The percent of stocks that are trading below cash and short-term investments is at the highest level in 30 years
    - Gallup's economic confidence index is at the lowest level since February, 2009
    - AAII investor Sentiment is at levels not seen since the late '80s / early '90s
    - BofA bull/bear indicator has been at 0.0 (extreme bear)
    - Morgan Stanley reported US hedge fund exposure in the 2nd percentile since 2010
    - As of June, 85% of Americans said they believed the economy was getting worse
    - IPO proceeds are down 90% year over year
    - Merger arb spreads are at levels not seen since the depths of Covid
    - Google searches for "recession" are at all-time highs
    - US small cap forward P/E ratios are at levels last seen at the covid low, and during the financial crisis
    - The Equal Weighted SP500 P/E ratio is at similar levels as seen during the financial crisis
    - Economically sensitive stocks like MU cut revenue guidance by 30%, and the stock traded UP in the following days.
    - The dollar value of the recent drawdown is equal to ~60% of US GDP. This is the largest drawdown in 40 years

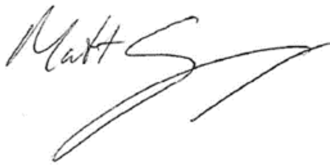
- According to BofA, 80% of fund managers expect stagflation

As I am sure you noticed, the above list slants positive. I am certain we could all find an inverse list somewhere that would highlight the many negatives in the world with a minimum of effort. Particularly worrisome is the idea that the strong USD will crush non-U.S. earnings for U.S. based large caps, and the view that the supply of oil and other hard commodities will be challenged for some time due to a combination of long lead times and a divisive political environment. But that is the point… the negative news is everywhere, and you have to dig to find any sort of positives. Perhaps this is why at present the SP small cap 600 trades at the largest discount to the SP500 since the late '90s tech bubble.

Of course, in macro world pervasive negativity can be reflexive, meaning that the expectation of a negative environment may lead to the conditions that bring forth a negative environment. However, historically, forward returns from periods of extreme negativity have been attractive. Further, history has shown that the market will turn higher long before any data says it should. Thus, at this point in my view the risk of missing the market's turn toward a bright future is at least equal to the risk of further decline. I am not alone in this view. Through May, insider buy activity was at the highest level since the depths of the pandemic. More specific to our portfolio, on a whole we own businesses that should perform better than the average business through a down turn, and we own them at much cheaper prices (based on normalized earnings) than the average business.

This does not mean that I am calling a bottom or anything like that. The only thing that is absolutely certain is that the market can do whatever it wants in the near term. But what I can tell you with a high degree of certainty is that regardless of what happens in the interim, if we can own businesses today whose earnings power per share will be substantially higher looking out a few years, we will be rewarded for our patience as long as we don't over pay. In this regard I believe we are unusually well positioned for intermediate and long-term success, and I am excited for the future, despite the fact that the journey will not be smooth.

Please let me know if you have any questions,



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"we're not putting that capacity in because we don't expect to utilize it, maybe not always on the first day that it opens as we probably almost did [with our last facility] but, certainly, in the not-too-distant future."

~Nicholas Green, CEO, Avid Bioservices March 2022 earnings call

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