July, 2019

Dear Partners,

Laughing Water Capital ("LWC") returned 10.3% in the 2nd Quarter after all fees and expenses, versus 4.3% and 2.1% for the SP500 and R2000 respectively. Year to date, LWC has returned 15.3% vs 18.5% and 17.0% for the SP500 and R2000 respectively. Of course, individual results may vary, so please reference your personal statement. Additionally, please remember that as always, the indexes are provided only for long term comparisons as the most easily accessible investment alternatives. Our portfolio has very little overlap with the indexes, and thus we should not be surprised if our performance varies widely over shorter periods of time, sometimes to our benefit, and sometimes to our detriment. Despite this short-term volatility, over longer periods of time the performance of the individual businesses that we own will drive the performance of their stock prices, which will drive the performance of our portfolio.

Short term relative underperformance is of course frustrating; it is human nature to want to keep up with the Joneses at all times. However, there is an enormous amount of evidence which demonstrates that over longer periods of time, the investors with the best results often trail the indexes over shorter periods of time. This is because if you want differentiated results, you have to behave differently than the masses.

Our portfolio remains very different than the market. On average, I continue to believe that our companies have better business models, more properly incentivized management teams, and greater future earnings potential than the average index company.

Additionally, the near-term prospects of our companies are considerably *less* predictable than most companies in the indexes.

This is entirely by design, and this uncertainty leads to low prices which we take advantage of. We are not reinventing the wheel; there is an enormous amount of evidence to suggest that patiently buying good businesses, led by incentivized people, during times of temporary uncertainty, at very low prices is a recipe for long term success. However, at the moment the market is rewarding near term predictability above all else, meaning that our investments are swimming against the current. Despite this, I remain confident in our future, and as our management partners navigate through their temporary problems, I expect that we will ultimately be rewarded by improving earnings power and expanding multiples as the market recognizes the intrinsic value which I see. For this reason, almost the entirety of my and my family's assets are invested in our strategy. Our interests are aligned.

Sources of Underperformance

While no strategy works all the time and we should thus not be surprised to have periods of relative underperformance, it is nevertheless important to examine the sources of our underperformance in order to ensure proper adherence to our process. As a reminder, we cannot control outcomes – only process. Reviewing our portfolio reveals that year to date, two investment archetypes, discussed below, have been largely responsible for our relative underperformance. In both instances I remain confident that our process is being appropriately applied, and that with patience our investments will be rewarded.

Free Options and Expensive Defense

"But everyone else was doing it!" ~ Child

"If your friends jumped off a cliff, would you do it too?!" ~ Every Parent Ever

As of the last week of June, on a trailing 12 month basis the best performing sectors in the SP500 were Utilities (XLU) and Consumer Staples (XLP). These sectors are traditionally associated with safety during periods of market uncertainty, reflecting wide spread caution amongst investors.

However, in the case of XLU and XLP, I believe investors are mistaking predictability with safety. For example, the XLU has Nexterra Energy (NEE) as its largest holding with a ~12% allocation. Nexterra has been bid up to 25x forward GAAP earnings, which likely significantly overstate economic earnings as capex far outpaces historical depreciation. Switching to XLP, the top ~40% of this sector ETF is invested in aging brands whose value is almost undoubtedly eroding as social media has made brand building for upstarts easier than ever, and consumer tastes have shifted toward more boutique products. Despite clear signs of secular decline, these stocks trade at more than 25x earnings and are unlikely to grow much faster than inflation.

To be clear, utilities and staples are predictable, but as Buffett has cautioned, you pay a high price for certainty, and uncertainty is the friend of long term values. These sectors, which are perceived as "safe" trade at very full multiples with growth prospects likely constrained by the rate of inflation, suggesting that any upside potential from here is limited, while simultaneously calling into question what sort of downside protection may be offered in the event of a broad market selloff. In terms of potential distribution of returns, it thus appears that upside is limited, while downside is unknown.

In my view, this is a recipe for mediocrity at best, but this is what the market is currently embracing. From my perspective, just as no parent wants their child to blindly follow the actions of their foolish friends, it would be a mistake to blindly follow the market on this path to illusory safety. <u>This illustrates how important it is to our long term success that we are not beholden to the indexes over shorter periods of time</u>.

"Good investing is about putting together good risk reward situations, not rate of return situations. But people get confused sometimes because they have a calculator. They're looking at rate of return rather than 'what can I lose vs. what can I make?' Value investing is about minimizing the downside by definition."

~Joel Greenblatt

True safety comes from anomalous investment opportunities where the distribution of potential returns is limited downside, and unknown – but potentially substantial – upside. Year to date, on average upwards of 25% of our portfolio has been invested in stocks that are essentially cash or near cash shells on a look through basis. In addition to their liquid balance sheet strength, these stocks also represent ownership stakes in businesses which could prove to be quite valuable, representing free optionality. Importantly, these stocks are controlled by – or are about to be controlled by – properly incentivized capital allocators who will steward the cash, and ensure that value will not be unnecessarily destroyed. Day to day and week to week these stocks are unlikely to do much either positive or negative, and year to date they have been a significant drag on our performance vs. the indexes. However, at some point in the not too distant future I expect specific events to take place which will illustrate the value within, causing the stocks to leap higher.

In my view, any parent should be proud to own stocks such as these. Like a child who misses out on the fun of doing something bad, we have recently missed out on the best performing sectors. At the same time, we are also theoretically largely avoiding the downside risks that may come with macro developments, just as the child avoids the risks that come with misbehaving.

Importantly, we are maintaining the opportunity for significant uncorrelated upside, even if the timing is uncertain. However, while over an investing lifetime owning uncorrelated free upside is a winning strategy, when the market has the best opening 6 months in 20 years, we should not be surprised that this portion of the portfolio has lagged behind.

To be clear, there is a mountain of evidence to suggest that trying to time the market around macro and political moves is a losing strategy. Yet, at a time when trade wars, a fractured political system, and an aging bull market are among the scary headlines that are driving the market, owning near cash shells allows a portion of our portfolio to be mostly insulated from any negative market moves tied to the macro economy, while at the same time giving us a free option on significant upside potential. These investments are thus less about timing the market, and more about appreciating anomalous opportunities. While the future of these investments is far less clear than that of the utilities and staples, if there is no real downside and our management teams are properly incentivized, with time there should be only one way to go… and it is not off a cliff.

Bubble Hockey & Hidden Value

On an absolute and relative basis, Bluelinx Holdings (BXC) and Hill International (HIL) have been our biggest losing stocks year to date. These are different businesses, but they fit a common theme. If your first thought is that they have more cyclical elements than the businesses we typically focus on, you would be correct. However, this cyclicality does not explain their recent underperformance. In fact, in both cases peer groups have performed very well year to date, while these stocks have traded down significantly.

Perhaps the most tired cliché in investing is to follow Wayne Gretzky's advice and "skate to where the puck is going to be." However, in my view in light of JP Morgan's claim that 80% of stock market trading is now controlled by index funds, and quants, this quote has new meaning.

In his day, Gretzky roamed ~15,000 square feet of ice, free to take advantage of every inch. In contrast, 80% of the stock market is now playing bubble hockey, with their movements tied to codified decision rules that are akin to hockey stick holding action figures whose movements are restricted by the metal rods that define their range of motion. The bubble hockey players can only "skate" to predetermined locations, just as the quants will buy stocks based on predetermined decision rules applied to well defined inputs.

BXC and HIL are similar in that in both cases, historical financial data is completely irrelevant; the databases show either N/A or obscenely high numbers for any relevant measure of value. For example, according to Thomson Reuters, at year end HIL was trading at an EV/EBIT of 190x, and BXC was at 225x. This is because both businesses have undergone substantial changes in the recent past, which negatively impact trailing margins, and hides their true go-forward earnings power.

While quantitative strategies are no doubt infinitely more sophisticated than I realize, they ultimately all must rely on filtering available inputs through some measure of value (inclusive of growth), quality, and momentum. In the case of HIL and BXC, the historic inputs surely relegate their value, quality, and momentum rankings to the lowest decile, if not percentile, of available equities.

With an irrelevant past, the only option available to quants is to look to the future. However, neither of these businesses have a sell side consensus estimate for future revenue, EBITDA, earnings, or cash flow. Thus, as far as the quants know, there is no future for these businesses. They are thus essentially at best invisible to the computerized investing models which dominate the markets. At worst, as is likely the case with BXC, they may appear to be candidates for a short sale.

However, as the quarters roll by, in both cases the trailing numbers are primed to drastically improve. Importantly, this potential improvement is not tied to Herculean assumptions. If these businesses simply tick along, the removal of the one-time items that have polluted their trailing financials will be addition by subtraction. At that time, these stocks will be like pucks moving to the predetermined spots that the bubble hockey playing quants will appreciate. For example, in a few quarters, assuming no change to the stock price, it is likely that HIL will screen as trading at ~5x EBIT rather than 190x, and that BXC will screen as trading at ~4x EBIT rather than 225x. These are drastic discounts to peers, and the quants are all but guaranteed to notice. This notion is strengthened by the fact that both companies are presently working to establish sell side research coverage and proactively marketing to investors. These efforts are likely to generate inputs which can describe the future for the quants, and potentially help swing momentum in a favorable direction. Improved trailing financials, consensus forward estimates, and improving momentum would be a hat trick leading to substantial appreciation.

Top Five Positions

Aimia, Inc. (AIM.TO) – Aimia was introduced in our Q3'18 letter, and discussed again in our Q1'19 letter. The business is essentially a cash shell with a money losing Loyalty business attached, as well as some other investments that are quite valuable. Together, and depending on how the cash is eventually deployed, net asset value is likely somewhere in the $6-$9 range. The problem however is that at the moment the company is controlled by an improperly incentivized board of directors with a poor track record of value creation.

Fortunately, that seems primed to change in the coming months as a group of aggrieved shareholders has called for a special meeting, and the company's largest shareholder, Mittleman Brothers, has indicated they are likely to propose a new slate of directors. As of now a go forward plan has not been produced, but absent a now expired standstill agreement that previously restricted Mittleman Brothers, the existing board would have already been voted out. I have received unsolicited communications from other shareholders who fear that Mittleman Brothers intends to turn Aimia into a vehicle from which to purchase shares in public companies that Mittleman Brothers have a pre-existing interest in. I think this view is grossly misplaced, and fails to contemplate the implications of Aimia qualifying as a Passive Foreign Investment Company, which would lead to adverse tax consequences and administrative nightmares for Mittleman and other U.S. based investors.

Rather, I think Mittleman Brothers are likely to assemble an independent team of highly skilled capital allocators with diverse industry experience in order to buy controlling stakes in operating businesses. Being familiar with their past work and investment philosophy, I am certain that Mittleman Brothers recognizes the importance of proper alignment between investors and management, and I am hopeful that new directors will be required to purchase meaningful amounts of stock, in contrast to the existing board who collectively own ~0% of the company.

While Mittleman's long term investment track record is excellent, in recent years they have struggled. Examining past investor letters and interviews makes it clear that they place a very heavy emphasis on the stability of current cash flows in their investment decision making, and stable current cash flows have been largely discarded by the market in recent years in favor of growth at any cost. While this focus on stable cash flows has been a liability in the public markets, in a holding company structure where cash flow can be effectively redeployed, I think this skill set would be ideally suited. Consider that according to a 2016 interview with MOI Global Chris Mittleman indicated that during the financial crisis, almost two thirds of the businesses that Mittleman Brothers owned did not see any decline in their free cash flow or EBITDA despite the fact that S&P earnings dropped by 40%.

It is of course true that holding companies often trade at a discount to their NAV, but at present the discount here is excessively large, and in my view, for a holding company that is managed by properly incentivized capital allocators focused on recession proof cash flows, any discount to NAV is an opportunity to drive long term per share value through repurchasing shares.

In any case, at present the company is aggressively repurchasing shares, which in conjunction with the asset value – much of which is cash – suggests that there is no downside here. At the same time, if Mittleman Brothers or other aggrieved shareholders are able to produce some truly impressive directors as they have suggested, the stock should trade up significantly in the near future as it becomes clear the company is entering a new chapter.

Avid Bioservices (CDMO) – Avid was first introduced to the partnership in the 1H'18 letter as a small position, and then appreciated into a mid-sized position. The company is a Contract Drug Manufacturing Organization focused on biologics. In early May the company's CEO resigned unexpectedly, causing shares to fall more than 20%.

Drilling down past the GAAP numbers reveals that CDMO is essentially a "good co/bad co" situation where the results of a second facility that was built on spec has been a major drag on consolidated results. By way of illustration, looking back at FY16 results and isolating the performance of their first facility reveals that this business formerly ran at ~50% gross margins. However, over the last few quarters as the company has been building out their second facility, consolidated gross margins went negative, and the company had been burning cash.

Following the sell off, shares traded hands at a level where I believed we were paying a fair price for the first facility, and getting the second facility for free. Importantly, management had indicated increasing sales momentum with existing customers as well as new customers, and a board member was perfectly suited to step in as interim CEO. I thus added to our position substantially on the weakness.

Fourth quarter earnings (fiscal year end 4/30) showed CDMO gross margins returning to 20% and positive cash flow as occupancy has risen to a level where operating leverage on the gross margin line has kicked in. This led to the company issuing positive forward guidance, and shares rerated significantly. This is a recession proof business that importantly lies outside the crosshairs of politicians who are eager to attack health care companies and drug companies more specifically. The actual manufacturing cost of pharmaceuticals is a very small piece of the total cost of a drug and regulatory compliance is of vital importance, so even if drug prices come under pressure, the manufacturers are unlikely to be asked to carry any freight. While there are sure to be bumps in the road going forward as customer volume requirements ebb and flow, demand for small batch biologic manufacturing is strong and growing, and it appears as if CDMO has successfully navigated the buildout of their second facility, meaning that this investment is now “good co/good co.”

From this time forward operating leverage should be significant as new sales are realized. Importantly, the company has levers to pull with their capital structure that can increase per share value, and the runway for future growth remains long as CDMO has the potential to once again double existing capacity in the coming years. Notably, this future capacity is likely to ultimately be brought online in conjunction with customer financing, which will be much less painful than the recent speculative capacity expansion. It should be noted that this sort of arrangement is typical for the industry, which is important in context of the risk of industry supply outstripping demand. Quite simply, at the moment demand is exceeding existing supply, and absent speculative building the worst-case scenario should be equilibrium.

Any sort of long-range projections are guaranteed to be wrong and should not be taken too seriously, but it is not unreasonable to think that within 4-5 years CDMO could be well on their way to tripling existing revenue guidance. This would be near the end of their existing growth runway and would thus unlikely deserve a multiple inline with recent industry transactions, but even absent additional growth, recession proof recurring revenue and its associated cash flows deserve high multiples, meaning that in my view CDMO still has multi-bagger potential in the years to come.

Flotek (FTK) – Flotek was introduced last quarter as an undisclosed position. At the time of our purchase, the company was trading below our estimate of net current asset value (current assets minus all liabilities) with two thirds of its market cap in cash or near cash, which essentially means we bought the balance sheet, and got the business for free. This anomaly came about due to the recent sale of one of the company’s two segments for an amount that was greater than the enterprise value of the entire company at the time of the sale.

If you believe in efficient markets, please take a moment to re-read the previous sentence. To recap, this company owned *two* businesses, and was able to sell *one* of them to a knowledgeable buyer at a price that was ~150% greater than the price that the stock market put on *both* businesses. Clearly Mr. Market was asleep at the wheel, and while nothing is ever guaranteed, this is a good reminder that digging through the forgotten corners of the markets can lead to fantastic opportunities for the patient.

We did not buy our shares until after the announcement of the sale when shares had already moved higher, but this position was still sized large from the outset, as I expected the stock to trade up substantially more as quants digested updated financials which revealed the pro forma balance sheet for the first time. This prediction came to pass and shares traded up by ~25% before retreating into the end of the quarter leaving us with a slight gain. In my view FTK is properly viewed as near cash with a free option on a business that while tied to frac drilling has characteristics that make it better than the industry as a whole. Importantly, there is an incentivized capital allocator at the helm, ensuring that this cash is not squandered, and this individual has recently personally purchased additional shares. My original assumption was that a large portion of the cash would be returned to shareholders following Q1 earnings, but that did not happen as the board had not finished a strategic review. There is reason to believe that cash will be returned in conjunction with Q2 earnings, and if it is, I will re-underwrite at that time.

Hill International (HIL) – HIL, discussed above, is our asset light construction business which I first introduced in the Q3’18 letter. The worst hand in poker is the second-best hand at the table because the player gets sucked in by seemingly favorable odds. The investing equivalent to the second-best hand may be shares that appear cheap due to forced selling tied to an exchange de-listing right before a series of events that cause more forced selling, and this series of events describes our experience to date with HIL.

However, despite share price weakness, fundamentals have begun to improve and insiders have ravenously been purchasing shares. Thus, I have doubled down and increased our position. I recently pitched HIL at the Value X Vail conference, and you fill find the presentation attached to this email.

Iteris (ITI) – Iteris, our traffic management business, has been a strong performer year to date as it is clear the company has moved past the temporary headwinds it faced last year, including the fact that the estate of the previously largest shareholder has fully exited its position. However, more important than any stock price movements is the beginning of a new chapter for the company. In June Iteris made a bolt-on acquisition in the traffic space, which will allow the company to cross sell its software into new geographies. Pro forma for the acquisition, shares presently trade at a mid teens multiple of my estimate of the free cash flow that the traffic business generates, which is cheap on an absolute basis, while the company remains extremely cheap vs. its strategic value, as demonstrated by recent transactions. I believe there is a long runway for continued success here, and the fact that CEO Joe Bergera is a veteran of Roper Technology (ROP) suggests that the future could be very bright.

Roper went public in 1992, and since that time the stock has compounded at over 20% a year by executing a strategy that is tied to outstanding capital allocation and disciplined M&A in niche verticals. I believe that Iteris is an excellent platform from which to run the Roper playbook, and I believe Bergera and CFO Andy Schmidt are well suited to quarterback as they pursue additional bolt on M&A.

On the negative side, it is not clear to me that the board of directors outside Bergera has a sophisticated understanding of how per share value creation works. At this time, it is abundantly clear that the traffic business is a gem, but the market has difficulty fully valuing it because consolidated GAAP financials are polluted by a money losing Agriculture business. As a long term focused partnership we have the luxury of generally not caring about stock prices day to day, but if the board begins to use equity as currency, then valuation becomes all important because long term per share value will be directly tied to today's dilution.

I am absolutely positive that on a probability weighted basis Traffic is a much better business than Ag, and 99.9% certain that Traffic is a much better business on an absolute basis. It is thus disappointing that we sold 18% of Traffic and 18% of Ag rather than just selling 100% of Ag. In my view by continuing to fund the Ag business the board is behaving like an over indulgent parent that raids their child's college fund to pay for acting lessons. There is a chance that the child might be the next Tom Cruise just as the venture stage Ag business might be very valuable to the right buyer at some point. However, to date it is increasingly clear that following some early success the Ag business and its mounting losses is more like an understudy in a high school production. At a time when there is massive strategic interest in Traffic and competitors are aggressively funding R&D, we risk losing our ticket to college by chasing a dream. Any good parent should encourage and support varied interests, but there comes a time when you have to face reality and focus. Over the past year I have had multiple conversations with management and board members trying to illustrate the above and more properly align incentives with long term per share value creation. Simultaneously, I have told potential activists that their time would be better spent elsewhere. I am now less certain, although I remain hopeful that the board will institute policies that align long term incentive comp with measures such as total shareholder return and some measure of capital efficiency of their own volition.

To be clear, I think this transaction makes sense, and increases per share value, but on a long time line, simply increasing per share value is less attractive than increasing per share value in the most efficient way. Given the size of the capital raise, the pro forma cash balance, and the fact that the company should be imminently cash flow positive I think the risk of additional dilution is minimal, and there are likely to be additional acquisitions in the not too distant future. Combined with organic growth, these acquisitions should lead to high teens revenue growth, and significant operating leverage, which when combined with long term contracts and a cheap valuation indicate a continued bright future for Iteris.

Comments on Select Other Investments

EZ Corp (EZPW) – EZPW, our pawn business, has fallen out of the top five as our more defensive investments were sized up. This is a recession proof business operating in the depths of its cycle with interesting growth prospects that is trading at a very low cash flow valuation, below break up value, and at an absurdly low relative value. Corporate governance remains less than ideal, but the company has taken steps in the right direction by revamping their board of directors, and linking management pay with per share metrics. Further, the company recently began work on a new digital initiative which is likely to drive traffic, and attract a new class of investors who are focused on fin-tech. EZPW remains a mid-sized position in our portfolio.

Fiat (FCAU) – Similar to EZPW, FCAU has fallen out of the top five as more capital was put into our more defensive investments. Despite cyclical exposure, Fiat's brands Jeep and RAM leave the company ideally positioned to face any secular industry challenges, and management has multiple levers to pull to drive value in the years to come. Near the top of the list is a merger with another auto OEM. During the quarter it seemed as if a pairing with Renault was in the cards, but that deal has been called off for the time being. FCAU remains a mid-sized position in our portfolio.

New Positions

There were two small additions to the portfolio this quarter. In both cases, insider ownership is high, management speaks about capital allocation with remarkable clarity, the addressable markets are large, future growth is very likely, and we were able to purchase shares at low prices due to non-economic selling tied to events that will prove to be transitory. In both cases I may buy more shares in the not too distant future, so for now it is in our best interest if we do not discuss them further.

Short Positions

On the short side we recently profitably closed a capital structure hedge vs. one of our longs, we continue to hold a small position in a high yield credit ETF, and we are short one company that is best thought of as a case of mistaken identity. Our short book is small and likely to remain so as in my view the return on brain damage of aggressively shorting is not worth it in context of simply finding securities whose downside is well protected by an attractive entry price.

Partners' Meeting

We will be having a partners' meeting on September 25 in New York City in the offices of the CFA Society of New York. If you would like to attend, please RSVP to msweeney@laughingwatercapital.com and I will forward additional details. Seating is limited, but potential additions to our partnership are welcome as well.

In Closing

As always, I have no idea what the stock market will do in the near term, and in my opinion anyone who tells you that they do is a liar or a fool. What is clear however is that of late we have been swimming upstream. Over time our fund performance will be directly tied to the performance of the businesses we own, but over shorter periods of time the gyrations of the market will help or hinder us at different times. Fundamental to our strategy is the belief that owning relatively obscure businesses at low prices is a recipe for success. This is not rocket science, and thus we are most likely to find these opportunities where most participants cannot go: small and microcap stocks.

While the SP500 recently reached new highs, the Russell Micro Cap Index (IWC) remains ~17% below its highs from last year, and was up only 8% in the first half of the year. As a result, the ratio of microcaps to large caps is at an all time low. Also of note, a recent piece from Goldman Sachs noted that year to date through May popularity was a better predictor of performance than valuation, with the most owned names beating the market by 600 bps over that period. Jeffries recently further noted that the highest P/E small and midcap names beat the lowest P/E names by the most since 1999.

If you received a marketing pitch from an investment manager that said, “our strategy is to buy what everyone else owns, and then buy more when it gets more expensive,” you would probably laugh. However, the fact is that that strategy has been effective lately. Yet, the idea that the most popular names at the highest prices can continue to outperform forever fails the common sense test. At some point the pendulum will swing, and the headwinds we have been facing will become tailwinds. Even with recent headwinds and our defensive positioning our stock picking has allowed us to perform well, and with a tailwind I would not expect a deceleration. For this reason, my family and I intend to increase our investment in the partnership in the near future. It is unlikely that we will pick a bottom. However, looking out a few years, I am confident that we will be happy with this decision.

Please let me know if you have any questions,

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“We generally do not spend a lot of time guessing about when the next recession will be – we manage our business knowing that there will be cycles.”

~Jamie Dimon, 2018 Letter to JPM Shareholders