June, 2021

Dear Partners,

Laughing Water Capital, LP ("LWC") returned approximately 9.5% in the second quarter of 2021 after all fees and expenses, versus 8.6% and 4.3% for the SP500TR and R2000TR respectively. Year to date, LWC has appreciated by approximately 37.8%, versus 16.8% and 17.3% for the SP500TR and R2000TR. Since inception, LWC has compounded at 31.9% per year, net of all fees and expenses. Individual results will vary, so please check your personal statements. As always, I remind you that our performance versus the indexes over shorter periods of time is largely irrelevant. Simply stated, we do not own the indexes, so there is no reason to believe that our results will align with the indexes. At times, we will outperform, and at times we will underperform, but at all times we will think and act independently, seeking to find good businesses, led by properly incentivized people, when they appear to be mispriced for reasons that we can understand. Behaving in this manner tilts the odds for long term success in our favor, although it can be uncomfortable in the short term. I believe that over longer periods of time we will continue to be rewarded.

Additionally, please note that this is the last letter that will be sent solely to LPs of Laughing Water Capital, LP as this fund is presently splitting into Laughing Water Capital, LP ("fund 1") and Laughing Water Capital II, LP ("fund 2"). As discussed previously, the formation of the second fund is a result of regulatory requirements, and the only substantial difference between the two funds is which exemption to the Investment Advisors Act of 1940 (3c1 or 3c7) the respective funds will operate under. While I cannot guarantee parity between the two funds due to potential differences in the timing of cash flows that are out of my control, I will be doing my best to have the two funds mirror each other. To the extent there are any differences in performance between the two funds, going forward I will be reporting the lower return in these letters. I suspect that any slight differences that may develop will even-out over time, and almost the entirety of my and my family's wealth will be split across both funds. Our interests are aligned.

Where Are We Now?

The debate surrounding a roaring '20's period vs. an inflationary period, the end of Covid vs. the delta strain, and (excessive?) government stimulus vs. asset bubbles continues to rage on, and is unlikely to end any time soon. Afterall, if these debates did end, how would the financial media generate their clicks, pageviews, and pay checks? With zero effort toward specificity, I can confidently opine that the financial media will have no problem generating the next fear (and click!) inducing headlines when the time comes. There are certainly things to worry about in the world and in the market today. That is because there are **always** things to worry about.

At the same time, in today's market I continue to feel as if there are an unusual amount of unusual opportunities. Every eyeball that is focused on the gyrations of crypto-coins, meme stonks, SPACs, and other seeming areas of excess is one less eyeball that is focused on the corners of the market where we make our money. Additionally, as discussed in our last letter under the heading of "Mice," there are a lot of companies that were forced to become better versions of their prior selves over the last year. Recognizing the opportunity that these companies now represent requires thoughtful, qualitative, forward looking analysis. This is a blind spot for the ~80% of market participants that rely on quantitative inputs that are dependent on now-irrelevant backward-looking data, or the forward projections of sell side analysts who largely ignore the ponds that we fish in.

The macro is perhaps a bit more difficult to decipher these days, but there is a ton of evidence to suggest that only broken clocks get macro right over an investing career. In contrast, at the moment I think at the micro level the opportunity to successfully iterate our process and invest in businesses where the odds of success are heavily skewed in our favor is rich. We own good companies, led by good people, trading at a low multiple of my estimate of their cash flow producing ability looking out a few years. Quite often, this future cash flow producing ability – and the market's ability to recognize this potential - is obscured by some sort of operational, optical, or structural problem that I believe will prove to be temporary.

Importantly, if the path from now to a few years from now involves a detour through an economic downturn and/or bear market, in many cases our businesses should be positioned to use this period of economic weakness to further increase their normalized per share earnings power a few years from now. To be clear – this says nothing about what will happen to the stock price of our companies when the market turns negative. Over shorter periods of time stock prices are victim to the seller with the weakest hand, and nothing is going to change that. My goal is to create a partnership with the strongest hand, and own businesses that can take advantage of difficult times. If I am able to continue to successfully iterate our process, the result of any downturn should be temporary pain rewarded by substantial long-term gain.

Top Five Disclosed Positions

Aimia Inc, (AIM.TO) – The thesis remains the same with Aimia. A properly incentivized and newly installed management team and board are working hard to realize value from the company's collection of investments, cash, and tax assets. At the top of the list is the company's near 50% ownership stake in PLM, which is Aeromexico's loyalty arm. Aeromexico remains in bankruptcy (although PLM does not), but with recent news from Delta and a group of Mexican shareholders indicating that they want to own Aeromexico equity, it is beginning to look as if owning the post-bankruptcy equity will be a competitive process. Further, a reading of the bankruptcy filings suggests that negotiations are taking place that would see Aeromexico purchase Aimia's stake in PLM.

What is less clear is if Aimia will receive cash or equity in Aeromexico. While I suspect most Aimia shareholders would prefer cash, depending on valuation equity in Aeromexico could be very attractive. I am bullish on Mexico in a post-Covid re-shoring of supply chains context, and Aeromexico's competitive position vs. other Mexican carriers should be much stronger as a result of Covid. I would also note that according to Goldman Sachs, as of June Mexican domestic air traffic was down only 13% vs 2019, while international air traffic was flat with 2019. Lastly, there appears to be some circularity, or perhaps a self-fulfilling prophecy at play here.

As a reminder, I first introduced Aimia to the partnership in our Q3'2018 letter. Shortly thereafter, in November of 2018, Air Canada announced a definitive agreement to purchase Aeroplan - Air Canada's loyalty arm – from Aimia. From then until the onset of Covid, Air Canada's stock rallied ~100%, while the JETS ETF, which includes a variety of airline related stocks, returned ~0%. I take this as a pretty clear indication that the market recognizes that an airline that owns its own loyalty program is much more valuable than an airline with a third-party loyalty program. This dynamic sets up some fascinating game theory for our investment in Aimia.

Aeromexico had previously agreed to pay Aimia the greater of $400M USD or 7.5x EBITDA (plus balance sheet adjustments) for its stake in PLM. I am sure that the new equity owners of Aeromexico would like to chisel this price as much as possible. However, if owning the loyalty arm outright can lead to a near instantaneous 100% return on their equity investment (depending of course on initial valuation) as was the case for Air Canada, then perhaps they will opt for a bird in hand. There seems to be some logic to paying a fair price for PLM in the near term rather than attempting to chisel while risking that PLM's performance could greatly accelerate in a world starved for travel.

Of particular note, long-term Aeromexico partner Delta (DAL), who saw their prior investment in Aeromexico evaporate, has re-entered the fray, and they now own $185M of Apollo's $1B DIP financing of Aeromexico. Delta is clearly familiar with the value of a loyalty program, having used their own loyalty program ("Skymiles") to secure $9B in financing less than a year ago. For Aimia, it appears that the company may be in a position to have its cake and eat it too. It is possible that they could perhaps agree to accept Aeromexico stock that does not fully incorporate the value of PLM, yet essentially receive stock that does incorporate the full value of PLM.

Only time will tell how this will play out, although I suspect we will have the beginnings of an answer by early September barring additional delays. Regardless of the timing, in my view over the last ~year the new management team at Aimia has proven their negotiating chops and that they are capable of extracting value from legacy assets in creative ways. I believe they are well positioned to do the same with PLM. This of course says nothing about Aimia's investment in former LWC holding Clear Media, which I suspect will be worth 2-3x what Aimia paid for its stake before long, nothing about Aimia's investment in Kognitiv, which to me looks like a prime target for an acquisition-hungry SPAC, nothing about Aimia's investment in AirAsia which will benefit from a return to travel across Asia, and nothing about Aimia's other odds, ends, tax assets, and cash.

Avid Bioservices, Inc (CDMO) – Long-term holding CDMO, our large molecule contract drug manufacturing business, is continuing with its expansion plans in a recession proof industry where supply struggles to keep up with demand. The biggest risk here continues to be an explosion of supply, but CDMO's long-term regulatory track record acts as a significant competitive advantage. Simply stated, upstarts can't fake a history of successful operations, and customers want to see a history of successful operations when choosing their manufacturing partner. The balance sheet has been strengthened, the backlog has nearly doubled YoY, and management has indicated they are considering additional opportunities within the core business, as well as in adjacent businesses which would broaden the range of services that Avid provides. In sum, everything is going as planned as management executes, and future opportunity remains abundant.

Houghton Mifflin (HMHC) – HMHC is the leading provider of instructional materials to students in grades K-12 in the U.S. At the end of this letter you will find a longer writeup, but in brief I believe the combination of a newly cleaned up balance sheet, slimmed down operating structure, a Covid induced acceleration of digital learning, and billions of dollars in federal stimulus set to flood the education world has put HMHC in position to gush cash over the next few years… but the market has failed to appreciate these changes. Given the pending onslaught of federal stimulus dollars I think it will be very difficult to lose money in this investment, and if the company reinvests this cash wisely and the market recognizes how this business has evolved, there is a path to multi-bagger returns looking out a few years.

PAR Technologies (PAR) – The story remains the same at long time holding PAR. The company has established itself as a leader in each of the major software process areas that allow quick serve restaurants to function, and is attempting to expand their footprint further. There is no guarantee that PAR will succeed on this front, but I like our odds. As a company outsider and an industry outsider this opinion may not carry much weight, but I think the fact that Ron Shaich of Panera Bread fame also likes our odds is a strong signal. Shaich is widely regarded as one of the best operators in the QSR world, and is particularly well regarded for his early adoption of technology. In April, Shaich was part of a group that invested ~$160M in PAR at as part of the acquisition of leading loyalty provider Punchh (not a typo), and one of his partners joined PAR's board. In this interview he shares his thoughts in a way that is more clear and informed than I can.

Transact Technologies (TACT) – Transact was introduced anonymously as "Company 1" in our Q1'2021 letter. As Mark Twain said, "history doesn't repeat itself, but it often rhymes" and in many ways Transact rhymes with our original investment in PAR. The company is transitioning away from a legacy hardware business and toward a food service/restaurant software business, yet the market has failed to notice what is going on beneath the surface. In this case, the legacy hardware business is specialized printers for niche applications, with the most notable being slot machine printers. Importantly, this business is actually much better than a casual observer would suspect.

As for the new software business, known as BOHA!, there are ~150,000 convenience stores in the United States, and virtually all of them are scrambling to improve their fresh food offerings in order to drive traffic and drive margin. Under FDA regulations, these "grab and go" offerings must be labeled with full nutritional information. Transact's SAAS offering allows convenience store chains to update fresh food labels in real time from a centralized location as menu items and prices change. I have no doubt that competition will be fierce in this space. However, as Transact has already entered into long term contracts with several of the largest C-store chains, including industry leading 7-Eleven with ~14,000 doors, Transact's competitive position should benefit from social proof.

BOHA! also recently began to sell software and labels into restaurant back of house to automate tasks such as food prep, time keeping, temperature monitoring and others. As restaurants struggle to keep up with rising wages and find workers, the trend toward automation of time-consuming, error prone tasks provides a favorable backdrop for continued adoption. While still small, through Q1 BOHA! revenue was growing 100%, and as the company recently started a partnership with Apple's (AAPL) restaurant enterprise sales force and began selling to small and medium businesses rather than just enterprise accounts, it seems likely that growth will continue. This is confirmed by the company's growing pipeline, which at present sits at $140M.

Ultimately, I think it is possible (likely?) that the company will sell the slot machine printer business and other small ancillary businesses in order to fully focus on the recurring revenue SAAS/labels business. The fact that they have already shut down multiple legacy businesses (that polluted the trailing financials) in order to focus on the future is by itself unusual behavior for a small company, where the incentives are more often toward empire building rather than value maximization. While the slot printer business sounds boring on the surface, digging deeper reveals a lot to like.

For starters, the industry structure is essentially a regulated duopoly as there is only one major competitor, and slot machine printers and the slot machines they live in must be approved by the gaming authorities in whatever locale they operate in. This means that slot machine OEMs can't just switch printers without going back through the approval process. Additionally, the printer is a tiny fraction of the total cost of the finished product, yet is mission critical to the finished product; if the printer fails, the slot machine is just a giant paperweight. As such, slot machine OEMs care about quality much more than price. These attributes lead to high switching costs, pricing power, and ultimately high margins. To a strategic acquirer I believe this business could be worth a price that would be 50 - 75% of the current enterprise value. This would leave the SAAS/labels business trading at less than 2x recurring revenue, assuming they can fully penetrate previously announced customers, and giving no credit for whatever growth may come through the AAPL partnership and SMB effort. The APPL sales effort is essentially AAPL encouraging enterprise scale restaurants to use iPads while attaching BOHA!, and the new focus on SMBs is attractive because BOHA! can be self-installed, avoiding the delays that have plagued PAR's rollout (and in my view separating PAR's multiple from faster growing self-install peers).

There are more than a few moving parts here, and management needs to execute, but simply stated fast growing recurring revenue more often trades at a double digit multiple rather than a 2x multiple, and AAPL is determined to make inroads with the restaurant market, which bodes well for continued growth beyond previously announced customers. If things go as planned and the company is able to fully penetrate existing customers and benefit from their sales partnership with AAPL, I believe there is a path to multi-bagger returns looking out a few years. If things do not go as planned, the slot machine printer business should provide significant ballast, and in the near term the company should benefit from a significant cap-ex cycle in the slot machine world as casinos have yet to recover from Covid. It is also worth mentioning that there appear to be 3 activists circling the company at this point, and the company has recently strengthened its board, and taken steps to improve corporate governance.

Lastly, I would note that TACT stock is unusually illiquid for a stock that makes it to our top 5. As you know our partnership is designed to be able to mostly ignore liquidity constraints, and given sufficient liquidity in the rest of the portfolio and a severely skewed range of potential outcomes, I made TACT a large position. I suspect that the recent lack of liquidity is largely tied to owners knowing what they own, and potential buyers having not yet connected the dots. As the thesis plays out, liquidity is likely to improve substantially.

Comments on Select Investments

Thryv Holdings Inc (THRY) – Thryv was introduced anonymously as "Company 2" in our Q1 2021 letter. Historically, this company has been best known as the owner of the Yellow Pages phone books, which has been in and out of bankruptcy in the recent past. While phone books have clearly been in decline since the invention of the internet, this business continues to spit off substantial amounts of cash. Perhaps more importantly, the small businesses that pay to advertise in the Yellow Pages are a fertile hunting ground for the company's small business software product, which brings all aspects of daily workflow (estimates, invoices, billing, payments, scheduling etc.) into the cloud, replacing a system that is often a combination of post-it notes and an excel file. This SAAS offering has hit a few speedbumps over the last year or so as the company refined their go to market strategy, but growth is re-accelerating and there is a path to increasing customer count by 400-500% in the coming years. What is unusual about this business versus SAAS comps is that it is already profitable. The company has ample opportunity to re-deploy this cash in accretive ways, first through paying down debt, but also through buying up the few remaining phone book businesses globally. To be clear, these would be melting ice cube businesses, but Thryv has demonstrated in the past that they can convert ~10% of phone book customers into SAAS customers that would come with extremely high incremental margins, and these assets are generally available at very low prices. Overtime I expect that as the company grows and as the market gets comfortable with the relationship between cash flows from the declining phone book business, growing software business, and debt the stock will re-rate significantly higher.

Growth of our Partnership

Our partnership continues to grow, thus far entirely through word of mouth, as I have always felt my time is best spent on research rather than marketing. Notable new additions include a publicly traded company with an investment arm, a boutique RIA based in the Mid-West, and the family office of one of the most well-known and successful small cap investors of the last 50 years.

However, we remain comfortably below the level where the size of our asset base may preclude us from investing in the types of opportunities that have treated us so well over the last 5+ years. While I continue to believe that our small size is a tremendous advantage, I also believe that there are certain benefits that would come from being larger (but still small). If you are aware of like-minded individuals, family offices, and/or small institutions that you think would be a good fit, please encourage them to visit www.laughingwatercapital.com. Importantly, the goal is not simply to grow AUM. Rather, the goal is to find partners in the truest sense of the word.

If this rings hollow to you, I assure you that if simply attracting capital was the goal, our partnership would already be much larger. In fact, through the life of LWC I have rejected more capital than I have accepted. The reason for this is simple: my family and I are the largest partners in LWC, and I don't want to risk taking capital from LPs that could be detrimental to our success due to a less than full understanding of what LWC is trying to do, why we do it the way we do it, and how a strong LP base is a considerable competitive advantage in the investing world. In sum, while I am hopeful that we will continue to add additional LPs to our partnership, I remain committed to closing the doors of LWC at a small size to maintain all of the competitive advantages we now enjoy, and I will continue to fiercely defend the quality of our LP base. Our interests are aligned.

Looking Forward

As always, I am mostly agnostic on the near-term direction of the stock market. What seems clear is that there is a lot of pent-up consumer demand, and some portion of the global population believes that Covid is over. What also seems clear is that supply chains are struggling to keep up with demand which contributes to inflation, and some portion of the global population believes that Covid is not over, and is instead destined to come back in different forms.

What is less clear – and the only thing that matters - is what is priced into the market at the moment. This is a hard question.

From my perspective, determining what is priced into individual securities where the key variables that will drive outcomes can be more easily identified is considerably easier. As such, I continue to spend nearly all of my time seeking out situations where the odds for success seem to be heavily skewed in our favor, and I remain excited about the multi-year prospects of the businesses we own. Arriving at this multi-year future will undoubtedly involve some unexpected detours and market turbulence, but our management partners are well positioned – and well incentivized – to navigate through any troubled waters. The key is to stay focused on the intermediate and long term, while mostly ignoring the near term.

Please let me know if you have any questions,

Matt S

MSweeney@LaughingWaterCapital.com
917-306-0461

New Positions

Houghton Mifflin (HMHC)

Houghton Mifflin is the largest provider of K-12 educational curriculum in the United States, with ~30% market share in Core, and ~10% market share in Extensions (think supplemental programs, intervention programs, and professional training). Following the recent sale of their publishing division – which has not shown up in quarterly financials yet - the company will soon be net-debt free. While looking backwards shows a limited ability to generate free cash flow, the future looks much brighter. A new management team joined in 2016/2017 and set the company on a course toward a digital first approach to curriculum, which has many benefits, including a fixed cost base that is now ~30% lower than it was in 2016. As a result, management has indicated that going forward they expect that annual billings above ~$850M will convert to FCF at ~65% margin.

The business is cyclically tied to state curriculum adoption calendars with states typically upgrading their curriculum every 5-7 years. However, if one attempts to smooth the cyclicality by looking at the 2016-2020 period as being "normal," and applies the current cost structure to historical billings, then in a normal year the company should be able to generate ~$190M in FCF. This is assuming that the company does not refinance ~$300M in 9% debt that is callable in February, 2022, and which could presumably be refinanced at annual interest savings of ~$10M or more. To be clear, this is an average number, and in reality the business will remain lumpy, but at present the stock is trading at approximately 6.5x my estimate of normal FCF, which appears very cheap.

Last 5 Years - Actual Ed. Billings, Pro Forma Cost Structure, Implied FCF

(000)	2016	2017	2018	2019	2020	Average	Cumulative
Education Billings: Actual*	$ 1,163,540	$ 1,133,823	$ 1,114,709	$ 1,412,267	$ 897,834	$ 1,144,435	
- Breakeven Billings: Pro Forma	850,000	850,000	850,000	850,000	850,000	850,000	
Profitable Billings	$ 313,540	$ 283,823	$ 264,709	$ 562,267	$ 47,834	$ 294,435	
FCF flow through: Pro Forma	65%	65%	65%	65%	65%	65%	
Implied FCF	$ 203,801	$ 184,485	$ 172,061	$ 365,474	$ 31,092	$ 191,382	$ 1,148,295

*adj. for 2018 sale of Riverside

Further, in 2016-2018 management had indicated that they viewed those years as trough years due to lack of major adoptions by "the big three" of CA, FL and TX. 2019 was clearly a peak year, and 2020 was a Covid disaster year, so using this period as the reference period appears conservative.

Of course, this sort of backward looking analysis is precisely the trap that many value investors have fallen into over the last decade, as they failed to recognize that the future could be markedly different than the past. Looking forward, there is reason to believe that the future is bright, but there is of course reason for doubt as well. As a starting point, let's assume that the business gets considerably worse over the next three to four years.

Traditionally, education budgets are ~90% dependent on state and local tax receipts. Now consider that as a result of the educational hole caused by Covid, the federal government has already committed to spending hundreds of billions of dollars supplementing school budgets over the next three years. While I have no doubt that much of this money will be used to bolster administrative bureaucracy and prop up teacher's unions, I don't think it is aggressive to assume some small portion of it will be spent on curriculum. As such, even if we assume that HMHC's competitive position worsens going forward, the company should still be able to generate most of its market cap in cash over the next few years. In other words, even if HMHC is in fact set to lose market share, in the near term the pie is likely to get much bigger due to stimulus dollars, so HMHC should be just fine.

I believe this sort of "heads we win, tails we don't lose" dynamic places the odds of a successful outcome to this investment heavily in our favor. Now consider that HMHC's competitive position and business quality seem to actually be improving.

Covid greatly accelerated the shift toward digital education. Prior to Covid, U.S. classrooms had 1 device (iPad, laptop etc.) for every 2 students. Without a 1:1 ratio, the education world has been stuck in analog. However, as a result of Covid, nearly every student in the U.S. now has access to a device, which allows for massive leaps forward in the penetration of digital education. This is noteworthy not only because the transition to digital should widen margins and increase returns on capital, but perhaps more importantly because HMHC is the only player with a digital platform that can link Core curriculum with Extensions curriculum, so that teachers, tutors, and parents can best track student progress. There is a saying in the education world, "you are not selling product, you are selling outcomes," and a connected solution should go a long way toward delivering the best outcomes.

This should enhance HMHC's ability to cross-sell their Extensions business from their leading Core position. As mentioned above, HMHC has ~30% share in Core, and ~10% share in Extensions, with some portion of the 20% delta representing fertile opportunity. At this point evidence of success here is anecdotal, but the 2020 Texas English Language Arts adoption had a 90% attachment rate to HMHC's Extension program, which is encouraging to say the least. Importantly, the Extensions business is much more of a high margin "Ed-tech" business, with a more attractive margin structure, and represents an opportunity to accelerate the company's billing mix toward digital. While disclosure is limited, common sense and interviews with industry insiders suggest that gross margins on HMHC's Digital Sales are dramatically higher than those for print. Intuitively this makes sense; digital product does not require expensive print runs, shipping heavy product, or warehousing costs, and incremental margins are extremely high. Further, in a digital world content travels better as it can be easily tweaked to meet the needs of other states without requiring a complete re-work.

Illustrative Gross Margin Potential

	% of Billings (TTM actual)	Gross Margin (LWC estimate)
Digital	42%	65.0%
Print	58%	20.0%
Blended		38.9%
	Future State?	
Digital	75%	65.0%
Print	25%	20.0%
Blended		53.8%

It seems unlikely that industry sales will ever go 100% digital as there will always be some benefit to printed materials, but as the mix shifts, it seems as if HMHC has room for considerable margin improvement. It is worth stressing that the example presented here is illustrative; it would be unwise to assume that the company can pick up 1,500 bps of gross margin in the near term. However, it is undeniable that the shift to digital is underway, and I would expect incremental gross margin improvement going forward. For reference, assuming a normal year, given the company's more than $1B in tax assets, a 1% increase in gross margin should translate into an additional ~$11M in FCF. Notably, a growing portion of digital billings will come in the form of Software as a Service (SAAS). The company recently soft-guided to $116M in annual recurring revenue (ARR) from their subscription businesses for 2021, and as of Q1, recurring revenue grew 80% YoY with 142% dollar retention.

Despite these signs of improvement, if we simply assume that "normal" billings remain the same as the last five years, and that massive Federal stimulus will lead to an uptick from "normal" over the next 3 years, then with reasonable assumptions HMHC's FCF yield approaches 25%.

With this gusher of cash set to arrive, perhaps the biggest risk is that management and the board fail to allocate it effectively. However, I believe there are multiple ways to win. The obvious option may be to simply repurchase shares, and in fact, the company previously had a $1B repurchase authorization in place. However, as we saw with our ownership experience of Rosetta Stone (RST, acquired in October, 2020), M&A in the education space has historically been extremely accretive, and with an unlevered balance sheet and cash accumulating at a rapid rate, HMHC will be well positioned as a buyer.

With ~10% market share in the highly fragmented Extensions market, HMHC has the largest market share in an arena where competitors are often under-sized, and walking on a tightrope over high fixed costs and the challenges of a difficult sales cycle. In education the selling season has a cliff; if you are unable to complete a sale by August or September, you have to wait a year – and carry those fixed costs – until you get another bite at the apple next school year. As such, a large part of the cost structure for smaller players is the SG&A line. However, for an acquirer such as HMHC – who already has the largest sales force in the industry – almost all operating costs at a target company can be synergized away. An acquisition would be almost entirely about the IP, which would become just another offering in HMHC's sales force's bag.

I believe that there are a number of smaller companies that could be snatched up by HMHC in a very accretive fashion, and CFO Joseph Abbot has previously noted that "opportunities abound for consolidation in our sector, particularly in the extensions category."[1] Much of the extensions market is more of a SAAS based model, and it would not be unusual for an ed-tech company to have ~80% gross margins. Given the ability of an acquirer like HMHC to wipe out almost the entire cost structure, it is possible that HMHC could generate mid 70% FCF margins on this incremental revenue, if acquired. Precedent transactions have occurred at 3-5x billings, implying that M&A could result in high-teens to mid-twenties percent unlevered cash returns, before considering growth. However, taking good IP out of the hands of an upstart sales force and placing it in the hands of the industry's most penetrated sales force is almost guaranteed to result in significant growth, meaning that the actual opportunity to deploy cash in acquisitions would come with extremely high cash on cash

<u>**Illustrative M&A Example**</u>		
Target Co. Bookings	$ 10,000	
multiple	3.0x	5.0x
Cost to Acquirer (EV)	$ 30,000	$ 50,000
Acquirer's ULFCF Margin	75%	75%
No Growth FCF	$ 7,500	$ 7,500
Bookings Growth	50%	100%
Growth FCF	$ 11,250	$ 15,000
EV / No Growth ULFCF	4.0x	6.7x
No Growth ULFCF Yield	25%	15%
EV / Growth Implied ULFCF	2.7x	3.3x
Growth ULFCF Yield	38%	30%

[1] HMHC at the Citi Global Technology Conference, September 8, 2020

returns. While disclosure is limited, as evidence consider that in 2019 HMHC bought *Waggle*, an AI based reading and math Extensions solution for grades K-8 for $5.4M. CEO Jack Lynch recently likened the experience to a "rowboat harpooning a whale" as now that this very small early stage company is in the hands of the industry's largest sales force, it is growing revenue at a triple digit pace.

If that is not enough, the Extensions market is not tied to state adoption cycles, which means it is not as cyclical as the Core business. Given that following the sale of the Books & Media business the company is essentially net debt free, and the company's ability to generate cash through a cycle has been vastly improved, re-levering the balance sheet to some extent in pursuit of M&A that would shift the revenue mix in a less cyclical direction seems very attractive. For context, while not a perfect comp, McGraw Hill is currently levered more than 4x. As M&A allows Extensions to become a larger portion of total revenue, the FCF variability of the consolidated entity should decline, which in turn should generate a higher multiple from the market.

Lastly, if HMHC begins to generate cash as I believe is likely, it is unlikely that the private equity world and other strategic education players will fail to notice the cash flow and unlevered balance sheet. There is an undeniable trend toward consolidation in the space, and most of the big education companies – including HMHC – have previously been owned by private equity.

In terms of valuation, I would note that looking backward at a decade where the company failed to generate FCF through a cycle improperly punishes the company for an inefficient capital structure and operating structure that have both since been remedied. However, the Covid disaster year of 2020 proves that HMHC is now a company with cyclical exposure that can still generate cash at the bottom of the cycle, and suggests that the company will gush cash at the top of the cycle. Companies such as auto suppliers including BWA and TEN have similar cash generating characteristics through a cycle, and have often traded at ~15x a multi-year average of FCF. If HMHC's billings over the next few years look reasonably similar to levels reached over the last few years and the company were to trade at 12.5x normal FCF, the stock would trade at $20, assuming no cash accumulation, no margin benefit from a continued shift to digital, no supra-normal years due to federal stimulus, no reduction in share count, and no accretive M&A. If one believes that some combination of these factors will manifest over the next few years, and that a company whose revenue is increasingly tied to subscriptions deserves a higher multiple than auto suppliers, then a stock price in the high $30s or low $40s becomes possible looking out a few years.

Another way to think about it is to consider the value of the Extensions business – which is more of an Ed-tech business – as a standalone entity. As noted previously, Ed-tech businesses have traded hands at 3-5x billings in recent years. Conservatively taking the low end of this multiple and applying it to HMHC's Extensions business implies that the Extensions business alone would be worth ~$12 per share, suggesting that the rest of the business is available for less than free.

A third way to think about valuation is to consider that just last month McGraw Hill was sold at 10x EBITDA after plate cap-ex.[2] McGraw Hill is not a perfect comp, but applying this multiple to HMHC suggests a price of ~$15 would be appropriate today assuming some value for the more than $1B in tax assets that HMHC has. I would note however that the seller of McGraw Hill was a private equity fund apparently nearing the end of its life cycle suggesting perhaps they did not hold out for the best multiple, and unlike McGraw Hill

[2] Plate cap-ex is an industry term that in today's world refers to on-going content development costs. The term is derived from the historical practice of setting typeset on a plate before printing.

which is saddled by cash-consuming debt, HMHC's newly cleaned up balance sheet and cost structure will allow for a valuation based on actual cash flow. While valuation is never a precision exercise and in theory the market's omniscience should be agnostic when it comes to cap structure, in the real world it is not difficult to theorize that a company positioned to generate actual cash in public markets could be valued more favorably than a company whose debt consumes its cash in private markets.

To be clear, everything above is predicated on zooming out and viewing billings and FCF on a normalized basis, essentially ignoring the fact that in the real world the business is lumpy and cash will not magically appear in a straight line. I believe that this is the correct way for an intelligent business person to value the business, and our partnership has been specifically designed to allow us to behave in this way.

However, this approach is demonstrably wrong in the near term, as we already know from company guidance that 2021 will not be a "normal" year, although management has also hinted that guidance will be boosted in the near term. Further, the vast majority of the stock market does not behave as an intelligent business person would, and I have no doubt that short-sighted traders and sell side analysts will focus on every wrinkle in the adoption calendar rather than the normalized potential of the business, which could result in mark to market losses in our position in the near term. Other risks include a trend amongst some educators toward shifting their attention to open-source curriculum rather than purchasing curriculum from established providers such as HMHC. I do however think that this risk is mitigated by a "you never get fired for going with IBM" mentality among administrators. Lastly, there is pricing power risk, as ultimately it is tax dollars that drive billings, and it is not hard to imagine that at some point municipalities push back against a business that is printing cash at the expense of constituents. I believe that this risk is mitigated by the tendency of bureaucracies to spend every nickel they can get their hands on for fear of having their budget shrink, and the fact that few parents would want to short-change their child's education. It is also worth noting that plenty of businesses make their profit on the back of tax dollars, and ultimately the ~$10B that is spent on curriculum in the U.S. every year represents only a drop in the bucket of the ~$740B that is spent on the totality of K-12 education each year. Lastly, while I believe there is sufficient evidence to support the hypothesis that HMHC is now a much better business than it has been historically, it will take time for the market to appreciate this evolution and stop anchoring to historic multiples, which were reflective of an inferior ability to generate cash. As always, patience is the key.

I first looked at HMHC a year or two ago when I was researching our former position in Rosetta Stone (RST), and Chris Colvin of Breach Inlet Capital deserves a tip of the hat for encouraging me to revisit it earlier this year.

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