LAUGHING WATER CAPITAL

July, 2018

Dear Partners,

Laughing Water Capital (LWC) returned 2.9% net during the 2nd quarter, bringing net returns for the first half of 2018 to 10.8%. Of course, results will vary, so please view your individual statements. The SP500 and R2000 returned 3.4% and 7.8% respectively in the quarter, and 2.7% and 7.7% in the first half. As a reminder, LWC makes no attempt to track the indices, and thus our performance will frequently diverge, sometimes to our benefit, and sometimes to our detriment. Our portfolio is concentrated, and can thus move in unpredictable ways over short periods of time.

Under the heading of "interesting, but completely irrelevant," consider that for the 3rd year in a row our portfolio lagged the indexes in the 2nd quarter, and in the 10 quarters that we have been operating, we have lagged the indexes 4 times. It is my hope that pointing out this bit of trivia will serve as a reminder that our results will not come in a straight line. We own specific businesses, led by specific people, for specific reasons**.** Most importantly, many of our businesses are currently facing specific problems. This is precisely why we own them.

However, these problems may cause them to languish for long periods of time, and they are likely to fall behind when the indexes themselves appreciate rapidly, as was the case with the R2000 this quarter. This can be frustrating in the near term, but over time what matters is that if our analysis is correct, our businesses will eventually re-rate upwards, often quite rapidly. This pattern explains our significant total outperformance since inception, despite the fact that we frequently lagged the market over short periods of time.

It should also be noted that it is entirely reasonable to expect this pattern to continue across future quarters, and entirely possible that this pattern may eventually extend across years. If this does come to pass, we would be in good company as multiple studies have illustrated that over longer periods of time (think decades) the best investors often trail the market more than one third of the time. This is likely because buying truly cheap securities almost always requires disregarding the flavor of the day, and engaging with a business when it is facing some sort of optical, operational, or structural challenge. It would be unreasonable to expect a temporarily handicapped business to perform in a linear manner, and it would be foolish to think we will be able to buy at the lowest prices our businesses will see. Problems can always take longer than expected to fix. Challenges can always get worse before they are dealt with. Irrational sellers can always become more irrational. Patience is essential.

All that being said, I am firmly of the view that embracing short term lumpiness while focusing on long term success is the best path forward. For this reason, almost the entirety of my and my family's wealth is invested in our strategy. Our interests are aligned.

Rocket Scientists, Fishermen, and Investment Committees

"How could we have been so stupid?"

~Jeb Stuart Magruder, Deputy Director of Richard Nixon's re-election committee

Despite spending zero time on marketing, I have recently been receiving an increasing amount of requests for information about LWC from institutional capital allocators. One of the most frequent questions I receive is how can I be confident in my decision making as a committee of one? The implication of course is that a formalized investment committee comprised of several "experts" will lead to better outcomes. I disagree with this view. Like most of what we do, this is not an original viewpoint.

In the investing world there is no shortage of former rocket scientists, brain surgeons, chess masters, and PhDs. While these titles are undoubtedly useful for marketing purposes, to my knowledge there is no evidence to suggest that they lead to investment success. Conversely, my more humble beginnings are useless for marketing purposes, but they may be an advantage when it comes to generating returns over longer periods of time.

As I have mentioned in the past, much of my formative years were spent working in my Uncle's bar. This was not an environment that lent itself to learning about finance, but it was a useful perch from which to observe human nature. I vividly remember a group of regular customers that bonded over their mutual love of happy hour prices and complaining about their bosses. The group ranged from blue collar laborers to white collar middle managers, but they were united in that they all had a story that went something like this, "my boss doesn't get it. It would be so easy to improve the company if he just did X, Y, and maybe Z!" I have no doubt that the reality was sufficiently more complicated than the disgruntled employees were aware of, but for the other members of the group, the picture was always clear because understanding the problem at hand did not require expert industry knowledge. Rather, all that was necessary to clink a glass in silent agreement was an ability to focus on the few simple elements that could drive outcomes.

I didn't realize it at the time, but I was witnessing a very powerful mental model at work, and I have been relying on that model since I began my investing career. This view was crystalized more recently during conversations with one of our LPs, who together with his children have built dozens of businesses. Today they operate across North America and beyond, but one of their earliest ventures was commercial fishing off the coast of Long Island. Despite his subsequent success, when we were discussing Laughing Water Capital, this LP asked a series of probing questions while explaining, "I'm just a fisherman, so I need to ask these questions to make sure I understand."

As a committee of one, it is easier to ask questions as if you are the dumbest person in the room, which is a good way to follow Buffett's advice to not be the patsy at the poker table. Similarly, with no experts to confirm our extensive research, we are forced to distill our theses down to something that could be easily explained to one of my former customers. This is a good way to make sure we are only trying to step over very low hurdles.

Conversely, a committee of experts can easily miss the forest for the trees as they focus on minutiae, are afraid to look foolish, are prone to group think, and are more prone to commitment bias. These trappings explain how group decision making has led to some of the most bone-headed decisions in history, such as Watergate. Thus, in my view in the investing world the idea that convincing a committee of experts will lead to better outcomes is backwards.

Lastly, focusing on theses that can fit on a napkin will help us follow Munger's advice to just not do anything stupid. In this sense, a thesis is like any machine; the more moving parts there are, the more things can break. Further, the fewer potential break points there are, the easier it will be to identify our mistakes and know when we are wrong.

Together, these simple ideas fit well with our process of seeking to identify good businesses, run by incentivized managers, that have defensive qualities, that are mis-priced for easily understandable reasons. Sticking to this simple process will keep us in our circle of competence, while insuring that on the whole we own better than average businesses, run by better than average people, at lower than average prices. This is the investing equivalent of deciding to not try to break into hotel rooms.

Portfolio Comments

At present, we have investments in 21 businesses. As a reminder, I think that over time ~15 businesses is probably the right number to hold, and I consider 10-20 to be the normal range. While 21 is clearly outside of the range and quite a bit away from what I think is the right number, please note that at present the smallest 5 positions combined are equal to less than 6% of the total portfolio. The proliferation of inconsequentially small positions is largely a function of rapid appreciation combined with new capital in the portfolio. Rapid appreciation has brought these positions to levels where I am comfortable holding them, but I don't feel compelled to buy more. New capital is of course equivalent to selling down these positions, even though I would be happy to hold them. Given their small size, these positions will likely be removed from the portfolio upon reaching long term holding status (or sooner if the thesis becomes impaired). That is of course unless we are fortunate enough to see a decline in their price in the near future, at which point they may be returned to meaningfully sized positions.

It should also be noted that the proliferation of positions is a function of unusual fruitfulness with new ideas. As a reminder, in 2016 we made one meaningful new investment all year. We have far exceeded that pace in recent months. I am not quite sure why this is, although I believe the most likely explanation is that it is simply random. Sometimes it seems like there is something interesting under a lot of rocks, and sometimes it seems like there is nothing interesting at all. From my perspective, what is important is that in no case have I felt like I was lowering our standards in order to "just do something" as new money has come into the partnership. I strongly believe that the key to our long term success will be to simply say no to almost everything, and I am comfortable holding cash if there nothing worth buying... but sometimes we will say yes more often than other times.

Comments on Selected Investments

EZ Corp (EZPW) – EZ Pawn should be familiar as we have owned it since inception, and it remains a top 5 position. I originally detailed the thesis in the Q1'16 letter, and I included a slide deck with an updated thesis with the Q2'17 letter. Since that update, much of what I had thought would happen has come to pass, and operationally, management has executed very well having almost doubled store count in Latin America and more than doubled EBITDA over the last year. However, this growth has been financed through the use of low coupon convertible debt, which introduces a number of new variables to the equation.

On the negative side of the ledger, convertible debt will result in dilution to our equity position, which necessitates a lowering of our long term price target. Additionally, I believe EZPW is a bit of an orphan at the moment in the sense that there is not a natural shareholder base. Vanilla institutions are turned off by the dual class equity structure, growth focused investors may be interested, but EZPW is not really sexy enough for them, and value investors are likely concerned by management's reliance on converts to finance the company, despite the (very) undemanding multiple.

On the positive side, using low coupon convertible debt has the effect of increasing near term cash flow, and it is highly likely that this cash will be used to continue to accretively grow the business. Unfortunately, this will likely lead to a Catch 22 in 2024 when the convertible debt begins to mature. By 2024, the company should be gushing cash, and this cash will likely be used to repurchase at least the face value of the convertible debt, minimizing dilution. However, if the company and stock perform as I expect, the convert will effectively have caused the company to issue stock at a low price and repurchase it at a high price, which is of course not very attractive.

For now however, these are high class problems that do not deserve much attention, because the near term setup is very attractive. Convertible bond offerings are typically purchased by arbitrageurs who sell short common stock against the bond. This is of course non-economic selling, which is taking place not because of any decline in the company's prospects, but rather due to the arbitrage opportunity. At the same time, the company has been vocal that they intend to use the proceeds of the convertible bond offering to make acquisitions, and in fact, the company has recently announced a number of small acquisitions. I believe more acquisitions are likely in the near future. Importantly, these acquisitions come with operating leverage, and management has proven they are capable of driving margins in Latin America. Buying stock from non-economic sellers while the company is making accretive acquisitions is generally good practice, and I think we are well positioned for strong performance from EZPW in the not too distant future.

Fiat Chrysler (FCAU) – Similar to EZPW, we have owned FCAU since inception, and it remains a top 5 position. Management has been executing at a very high level, and recently released a 5 year plan that should continue to drive intrinsic value for years to come. Perhaps most notably, the company plans to launch a financial arm in the U.S. that I believe could be worth ~40% of current enterprise value and ~60% of current adjusted enterprise value within a few years. However, at the moment the market is more focused on the possibility of tariffs, and there seems to be some disappointment that management was not more aggressive with their 5 year plan.

There isn't much to be said about tariffs except that ultimately, I think these concerns will just be noise. In terms of the 5 year plan, I much prefer management teams that under promise and over deliver, and Fiat has a track record of doing exactly that. What is more important in my view is that successfully completing the 5 year plan is not necessary for investment success; the stock is very cheap today, and there are identifiable events on the horizon that will illustrate this value. First, the company has announced they will be spinning off their parts division into a stand-alone company. Second, if the company hits their year end guidance, which is all but guaranteed at this point, the balance sheet will be in a net cash position. Adjusting the enterprise value for these two factors reveals that core FCAU is trading close to 1.6x EBIT.

Bears will of course note that this is a cyclical stock, and 1.6x EBIT may not appear cheap if the economy goes off a cliff. There is some validity to this view, but in my view current valuation is fully pricing in a recession in the near term that might not develop for years. Further, from a high level, I believe that bears are still applying historical multiple ranges to the auto makers, despite the fact that following the structural and operating changes that were made in the wake of the great recession these are much better businesses that will be much more resilient during downturns than they had been historically.

In any case, FCAU is not a stock that we will hold forever, but with a cleaned up balance sheet and very low valuation set to be revealed to the masses (and the mechanical screeners that dominate markets) in the near future, I think we will be well rewarded for ignoring the potential cyclicality in the near and intermediate term. Longer term, progress on the 5 year plan will have to be monitored for signs of success or difficulty, but if their previous 5 year plan is any indication, the next 5 year plan includes a large margin of safety, and should be attainable.

New Investments

There are 3 notable additions to our portfolio. Interestingly, each of them played a starring role at the Value X Vail conference, which I attended in late June.

Avid Bioservices (CDMO) – CDMO entered our portfolio as a small position, but has graduated to a mid-sized position due to its ~50% return. In my view shares remain materially undervalued vs. their potential looking out a few years. The crux of the investment is "good co / bad co," whereby the cash flow profile of one business (drug development) had been obscuring the quality of the other business (contract manufacturing). Often in good co / bad co setups the damage from the bad co is limited to the reported financials of the combined company, but in the case of CDMO, I believe that the existence of the drug development company extended beyond the financials and negatively impacted the ability of the contract manufacturing business to generate revenue. We purchased shares shortly after the bad co was sold off.

The remaining contract manufacturing business is involved with the production of biologic drugs, which are extraordinarily complex (example: a molecule of Aspirin has 21 atoms, while a biologic drug may have 25,000 atoms). This complexity combines with regulatory oversight to create a business with high barriers to entry and high switching costs; it would be costly and time consuming for any customer of the contract manufacturing business to move to another manufacturer. Historically, given that CDMO was also working on developing their own drugs, any potential customer was thus wary that if CDMO were successful in developing a new drug, they may need to reclaim their manufacturing capacity for their own use.

An appropriate analogy might be buying a house. Imagine you spent several months searching for a new home that you intend to spend a lot of money on, and then live in for the next 20 years. You are down to the final two choices, both of which meet all your needs, but one of which comes with an eminent domain clause whereby you can be kicked out of the house with little or no compensation at any time. Which house would you choose?

Now that the development business is out of the picture, this eminent domain overhang has been removed, and it should be much easier for the manufacturing business to land new customers. This is important as the business is currently only operating at ~50% capacity. This unused capacity thus represents significant operating leverage, which will drive cash flow as the company reaches scale. New customer wins have been announced recently, suggesting that in the short period we have owned shares, the company has been moving in the right direction, and I expect more wins in the quarters and years to come. If the business ultimately gets to scale, the cash flow generated by its recession resistant, recurring revenues will deserve a high multiple, and it is not hard to imagine scenarios where CDMO doubles or triples a few years down the road. CDMO was presented at the Value X Vail conference by Adam Patinkin of David Capital Partners. I have known Adam for several years, and was happy to see that a talented like minded investor such as Adam independently generated a thesis on CDMO that is inline with our own.

Camping World Holdings (CWH) – Camping World is the largest RV dealership in the country. Unlike most of our investments, CWH is cyclical. It also has very high returns on capital, an excellent management team, and a compelling valuation, which justify inclusion in the portfolio, despite the cyclicality. CWH was a growth crowd darling following its IPO a little more than a year and a half ago, with shares more than doubling. However, as is often the case, at the first sign of a few bumps in the road the growth crowd panicked and headed for the exits, causing shares to fall back toward their IPO price, at which point human psychology encourages even more selling as investors try to get out with any profit at all, regardless of price. This is the point at which we made our purchases.

The position is sized appropriately given its cyclicality, and I gained comfort on the valuation after considering historical comps. Warren Buffett purchased RV OEM Forest River and auto dealership Van Tuyl Group at more expensive prices than we paid, and Eddie Lampert first purchased shares of AutoNation (AN) at more expensive prices than we paid. In all cases, these purchases were made at a time when these businesses were near the top of their cycles, yet Buffett and Lampert have done very well. Additionally, I think that CWH has prospects for a brighter future, and may even be a better business than these comps. Perhaps more importantly, demographic and technological changes have likely made this business less cyclical than it has been in the past.

Most importantly, the company's CEO is Marcus Lemonis, who you may be familiar with through his television show, "The Profit." I admit to initially being turned off by Lemonis and his high profile persona. However, after doing significant research, I came to realize that Lemonis is someone I want working for us, as his background and track record of success are highly unusual. To reduce it to a soundbite, by the time Lemonis was in his mid 20s, he was making close to $1M a year as a regional manager for AutoNation. However, he quit, and took a job as the CEO of a struggling RV dealership for less than $100k in salary. At the time, his stock in the RV dealership was worth around $80k. Fast forward to today, and Lemonis is a billionaire that pays himself $0 salary, with a track record of successfully growing his business through industry downturns.

To be clear, if we enter a recessionary environment tomorrow, this business will suffer. However, Lemonis has been through it before, and he runs the business with one eye always on the next recession. I am certain that while CWH will suffer during a downturn, the competition will suffer significantly more, and CWH will exit the downturn much stronger than it is today. Our patient capital base allows us to take advantage of situations such as these.

I had originally intended to present CWH at the Value X Vail conference, but I was told I was too late. An anonymous fund manager who goes by @fundiescapital on twitter already planned to pitch. I have known this manager for several years, and am happy to note that he is typically even more skeptical than I am when evaluating businesses, so I think we are in good company.

Rimini (RMNI/RMNIW) – RMNI is the idea that I prepared for Value X Vail, and I have included the slide deck with this email. In short, Rimini is in the business of providing third party maintenance for enterprise software. This is a defensive, counter-cyclical business with high normalized margins that has been growing very fast. However, at the moment and for the foreseeable future RMNI is subject to uncertainty tied to litigation brought by Oracle, who Rimini is effectively undercutting on price. In the past I have said that simple common sense is often an effective path toward value creation, but I am strongly of the view that relying on common sense with anything tied to the legal system is a mistake. However, digging past the headlines and viewing the accounting through the lens of common sense rather than GAAP suggests that Rimini is markedly undervalued even considering adverse legal outcomes, and there are situations where we could see multiples of our investment returned to us in a few years, as well as situations where Rimini could continue to compound our capital for much longer periods.

Importantly, we were able to establish our position at very low prices due to a wrinkle in the market, almost ensuring that in the short term we would be rewarded as well. RMNI reported earnings on May 10th, and the window for employee stock trading opened at that time. While there has been small buying by insiders, rank and file employees – many of whom have been with the company for 10+ years without an opportunity to monetize their stock - began to sell en masse. The timing is important here, because May 11th was the date of record for the rebalancing of the Russell indexes, which are market cap weighted, meaning that the indexes will need to buy more shares of bigger companies (for more on why this makes little sense, see our H1'17 letter). Following the Russell record date, shares continued to trade down more than 25%, at which point we began buying, knowing that 6 weeks after the record date, the index and its followers would be buyers of shares in an amount that was determined when the price of shares was 30+% higher. This is not a fool proof plan by any means as many indexers try to get in front of index adjustments, and the ultimate success of this investment will be judged a few years from now, but Rimini is illiquid, and since the window for employees to sell would be closing just as brainless index funds would be buying, there was an exploitable imbalance in supply and demand of which we were able to take advantage.

We own both common stock and SPAC warrants, both of which have appreciated by more than 30% in little more than a month. In my view, the SPAC warrants, which are essentially long dated options, are especially attractive. I don't spend a lot of time trying to probability weight outcomes, but if one were to assume a 95% chance that the company goes to zero, and only a 5% chance that our upside target is met, mathematically, this would still be the right bet to make. In actuality, I think the chance that this company goes to zero is very small, and there are multiple ways that the warrants could return between 10x and 30x our invested capital in a few years. However, in the near term, they will be significantly more volatile than the market as they are levered securities. As always, I think that accepting short term volatility for the possibility of long term outsized returns is the right investment for a patient, long term partnership such as ours.

It should be noted that each of these investments is off to a good start, mostly because of temporary special situations that we were able to identify and exploit. Finding these temporary inefficiencies and taking advantage of them makes me feel how I imagine my 2 year old feels when he thinks he got another cookie without me noticing. However, these wrinkles should be viewed as the investing equivalent of a 20 yard head start in a sprint versus Usain Bolt. A 20 yard advantage is great, but you still have to be significantly faster than the average person to ensure victory. Just as the winner of the race will be determined not by one's starting position but rather by one's speed, our ultimate success with these investments will depend on the unique attributes of each business and its management team in the years to come. It is entirely possible that we will give back our recent gains in the near term before realizing significantly greater gains in the years to come.

Growth of our Partnership

Our partnership remains far below the level where our size will become an impediment to our returns, but the quality of our partners continues to grow. We now have partners on 3 continents, and notable new additions include a small insurance company, a number of private equity investors, entrepreneurs, and skilled professionals. My friends and family group, which includes my parents, a sibling, childhood friends, former teammates, and former coworkers remains the largest investor in the strategy, ensuring that our interests are properly aligned. For now, our minimum investment remains at a level that is accessible to most high net worth investors, but we will likely move to increase our minimum in the not too distant future. If you are aware of high quality accredited individuals that you think would be an asset to our partnership, please suggest that they visit the letters section of www.laughingwatercapital.com to see if our style resonates with them.

Looking Forward

I have no idea what the market will do in the coming months or quarters. As always, there are reasons to be negative in the near term. The possibility of trade wars and the coming mid-term elections will likely contribute to volatility. That being said, it is often difficult for the market to reflect negative news when so many people are anticipating it, and the market may continue to march higher. From our perspective, what happens to the market in the near term should mostly be ignored. Rather, the performance of our businesses and management partners over time will drive our results over time.

In that regard, it should be noted that thus far 2018 has been a rather curious year for our portfolio, as our returns have come from unexpected places. Of particular note, as of the end of the 2nd quarter, 3 of our 5 largest positions have been negative contributors on the year, despite the fact that these businesses have been performing well. It is of course possible that this negative contribution is because I am simply wrong in my evaluation of these companies and their future prospects. However, I remain optimistic, and believe that our portfolio is well positioned for success in the quarters and years to come.

Please let me know if you have any questions,

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