

Dear Partners,

In the second quarter of 2023 Laughing Water Capital (“LWC”) returned approximately 13.8% after all fees and expenses. As always, returns may vary by fund, class, and timing of your investment, so please refer to your individual statements. This compares to Q2’23 returns for the SP500TR and R2000 of 8.7% and 5.2%. Year to date returns for LWC are now approximately 22.4%. Year to date the SP500TR and R2000 have returned 16.9% and 8.1%.

As you may recall, the “experts” were predicting anemic – or even negative - returns this year as a recession was sure to take hold. Of course, the final chapter on 2023 has not yet been written, but 22.4% ain’t too bad. Additionally, just because a recession has not landed yet does not mean that it won’t land soon, or next quarter, or next year. Or the year after that. Or the year after that. And so on, and so on.

Against this backdrop there are only two certainties.

The first is that a recession is inevitable.

The second is that trying to predict recessions is mostly a waste of time.

Out of a sea of examples that support these points, I will cherry pick perhaps the most recent and note the recent German experience, where the DAX hit an all-time high on May 19, and the economy entered a recession on May 25th. Even if one had forecast the start of this recession with perfect accuracy, what would have been the point? A perfect macro forecast is of little value if you do not participate in stock appreciation.

From my perspective, while recession risk should not be *completely* ignored, its importance should be a distant follower to a sober analysis of business quality and valuation. Simply stated, *fear* of recession can create opportunities that are as attractive as those opportunities that are created by actual recessions, and the key to success is finding investments that are “cheap enough” to ensure long term acceptable returns, even if the investments become cheaper still in the interim period.

Nearly all of history’s most successful investors would agree with this sentiment, yet most investors do not adhere to this philosophy for a variety of emotional and structural reasons. I credit our ability to do so to the high quality of our partners, each of whom is properly aligned, and the intentional design of our partnership. As a result of these two factors, we are better able to ignore the short-term bumps in order to reap the long-term rewards. At present I believe those future rewards appear exceptionally attractive, despite the inevitable short-term bumps we will likely encounter. For this reason, almost the entirety of my and my family’s capital remains invested alongside yours. Our interests are aligned.

Brief Market Commentary / Opportunity Set

If you have been paying attention to financial news, which I suggest you mostly ignore, you are aware that only a very small handful of the largest stocks have been responsible for the lion’s share of the indexes’ returns this year. This outperformance has caused some anomalous behavior by the wider markets, including record wide spreads between the most expensive stocks and the least expensive stocks, and a

large divergence between large companies and small. It has also “broken” the index model, in the sense that the Nasdaq100 was forced to pursue a “special rebalance” - essentially modifying the rules that govern its stock selection - after the 7 largest tech stocks became more than 50% of the index.¹ These same stocks are responsible for powering the SP500 this year as well.

We do not own any of the mega-cap tech stocks, and we have not benefited from the tailwinds that are pushing them higher. However, I think you would agree that our performance has been acceptable over this inconsequentially short period of time.

We owe this performance to our decision to mostly ignore the broader markets, and instead focus on individual businesses. Quite often, the businesses that we own will be suffering from some sort of optical, operational, or structural problem that a properly incentivized management team should be able to correct with time. I rarely have a concrete grasp on exactly how much time, accept to generally think that 3 to 5 years should be enough. At present, I believe that the opportunity set is more attractive than usual, as a great many stocks – especially smaller cap stocks – have been left behind by a market that only seems to care about exposure (or lack of exposure) to artificial intelligence and near-term recession fears. Recessionary fears are clearly different than the type of idiosyncratic problems that I normally spend time on, but in my view, at a high level these recession fears are best thought of in the same way. At some point within the next 3 to 5 years they will be a distant memory. It is of course entirely possible that they fade considerably faster.

Most importantly for us, as you will read below, despite continued calls for the most telegraphed recession ever, for the most part our management teams and our businesses have been executing well lately, and the normalized earnings power of our businesses is marching higher. At some point, I suspect that the market will appreciate this normalized earnings power, and reward our stocks with higher multiples as well. Until that time, I believe we are best served by ignoring the scary headlines of the day.

Top 6 Disclosed Positions

Depending on how the wind blows, the below list represents our top 5 disclosed investments, with two of them being close enough in size to make them interchangeable any given week.

API Group (APG) - APG, which can be thought of as our fire safety business, continues to execute on their plan. Most notably, they are growing statutorily required, recurring, inspection work at a double-digit pace, widening margins, and paying down debt. Primary end markets of data centers, health care, and other mission critical facilities remain strong, and contrary to many investor assumptions, APG has limited exposure to new construction. The company benefits from scale in an industry where much of the competition is Mom and Pop, and should continue to take market share in the years to come. Eventually I believe shares will re-rate significantly higher as the stink of being a former SPAC wears off, last year’s acquisition of Chubb is fully integrated, and management proves they can deploy capital into high return opportunities. Additional value may be created by a separation of the company’s Safety Services business and Specialty Services business.

Avid Bioservices (CDMO) – Long time holding CDMO, our large molecule contract drug manufacturing organization, was up ~50% on the year through April, but ended the quarter ~flat on the year. There has

been a fair amount of noise from industry comps in recent months, including accounting and operational problems at large competitor Catalent (CTLT), and commentary from just about everyone that biotech spending on early-stage projects has been reigned in. CDMO is not immune from this pullback, and their recent guidance for Fiscal '24 was disappointing. At the same time, management noted that late-stage signings increased by 34%.

From my perspective, the wild swings in the stock price are largely about investor timelines. The crux of my thesis is that recent capacity additions will allow CDMO to more than double their business in the next few years. Simply stated, there is a shortage of industry capacity, and CDMO's long-term track record of success is a considerable advantage vs. upstart competitors. It is unfortunate in the near term that early-stage biotech spending has hit a speed bump because the timing on early-stage spending is typically more predictable, and short dated. However, the fastest way to fill new capacity is with late-stage projects that can quickly move to commercial production. In that regard the company appears to remain well positioned. Additionally, management recently noted that CDMO had been designated as a preferred partner to a large pharmaceutical company. Additional large pharmaceutical companies are conducting site visits and audits, which will likely lead to more large pharma wins. These are the type of customers that can soak up capacity quickly. I continue to expect that we will be well rewarded by our investment in CDMO in the intermediate and longer term, despite near term conservatism from management.ⁱⁱ

Hilton Grand Vacations (HGV) – HGV, our time share business, is continuing to make progress with its integration of unbranded time share operator Diamond Resorts, which was purchased ~ 2 years ago. Being associated with a major brand is a huge competitive advantage in the time share world, because brand recognition and the affiliated hotel network drive down customer acquisition costs. Of particular note, my thesis that HGV will become a share cannibal is intact, as in May the company authorized a new \$500M repurchase plan. This plan will likely begin when the previous \$500M plan – announced in May of 2022 – is completed. That could be as soon as this quarter depending on how aggressive the company is.ⁱⁱⁱ

Lifecore Biomedical Inc. (LFCR) – Lifecore, formerly Landec, is our fill-finish CDMO that specializes in highly viscous drugs, and prefilled syringes and vials. My last letter was devoted almost entirely to this one company, as the market was concerned about a potential bankruptcy at the time. Since then, the company has refinanced its debt, which has taken bankruptcy risk off the table. Shares have rallied more than 4x since the lows, but in my opinion, they remain severely mispriced and represent extraordinary skew. The company is presently running a sale process, and I believe the strategic value of the company's assets could lead to a buyout at a price 40-200% higher in 1-3 months. The position is sized commensurately: the outcome here is going to matter quite a bit to us. You will find a full length writeup with my latest thoughts on LFCR as a separate attachment to this email.^{iv}

Thryv Inc. (THRY) – Thryv, our small and medium software business, continues to broaden their offering by adding new capabilities, and on the Q1 conference call CEO Joe Walsh announced that the software business is now EBITDA positive globally.

In my mind, the most important KPI for this business is growth through referrals. The thesis is that if you are in a three plumber town, and one plumber starts to use Thryv, the other two plumbers have a problem. Customers will simply prefer to deal with the plumber who can schedule appointments, provide real time updates on arrival time, send invoices and accept payment all by text message rather than dealing with a plumber who has not modernized their business. The other two plumbers will essentially be forced to

upgrade, and if THRY is working for their local competition, why try to reinvent the wheel rather than just trying THRY themselves? Management had previously stated that approximately 33% of their new business was through referral. However, more recently I believe this number has moved up to ~40%, suggesting that the thesis is playing out. Recent insider buying and what was effectively a recent buyback demonstrate that management remains confident in the long-term story.^v

Vistry Group PLC (VTY-L) – Vistry, our U.K. based homebuilder, was up more than 30% through May, but more recently has dropped to a point where it is essentially flat on the year. This puts it approximately in line with the FTSE 100, which Morgan Stanley recently called the cheapest stocks in the world.^{vi}

Management continues to execute against a difficult macro environment, with U.K. mortgage rates recently hitting a 15 year high. The real prize here is Vistry's asset light Partnerships business, that sees Vistry partner with Local Housing Authorities to develop low income housing. The Housing Authorities contribute land, and Vistry contributes development and construction know how. The Partnerships business is mostly removed from macro concerns as funding is effectively backstopped by the government, and the majority of units are pre-sold. Despite macro concerns, CEO Greg Fitzgerald recently stated that he was "flabbergasted" by the amount of opportunity he is seeing in the Partnerships market. The company is presently reviewing their capital allocation priorities, and I suspect the outcome of this review will be a move toward aggressive share repurchases. This view is bolstered by the recent addition of Paul Whetsell to Vistry's Board. Mr. Whetsell previously spent a decade on the board of U.S. based asset light homebuilder NVR Inc (NVR). NVR has compounded at ~20+% a year for decades by combining the high returns on capital that come with asset light homebuilding with a commitment to repurchase shares. It may be worth mentioning that Mr. Whetsell is also on the board of HGV.^{vii}

Also of Note

TransAct Technologies Inc. (TACT) - TACT is the leading manufacturer of slot machine printers, and has also been developing a restaurant back-of-house software product called BOHA!. In April it was announced that after 27 years, there would be a change to Transact's CEO. I cannot be certain, but I believe this was a result of pressure from activists, and in my view, it was past time for a change. My estimate of the value of BOHA! has admittedly come down as interest rates have gone up and software multiples everywhere have declined. However, my estimate of the value of the slot printer business has gone up as Transact has been taking share from their only real competitor, who has been facing production issues. From here, I think it is likely that the activists attempt to sell one or both businesses in the not-too-distant future in order to unlock value.

New Investments

As mentioned previously, I think the opportunity set is rich at the moment, and a few new names have entered our portfolio. However, as I may still be actively trading these stocks, I will refrain commenting at this time. Please stay tuned.

Mistakes and Bad Outcomes

As investors, all we can do is try to put the odds as heavily in our favor as we can, and then hope for the best. Unfortunately, at times despite a very favorable setup we will be the victim of unforeseen circumstances. My favorite example of this comes from super-investor Joel Greenblatt, who early in his career made a large bet on Florida Cypress Gardens, a small amusement park. Despite what Greenblatt viewed as very favorable odds for success, his investment was de-railed when the earth opened up into a sink hole, and swallowed Florida Cypress Gardens.

This brings us to our recent investment in Enzo Biochem Inc. (ENZ). I have been following ENZ for a few years, as activist investors attempted to oust a poor management team in order to maximize value for shareholders. In March, it was announced that the Company would be selling the larger of its two businesses (the largest clinical lab in the NY tri-state area) to Lab Corp (LH) for an estimated ~\$2.60 per share. Shares rallied hard on the news, but remained below the value of the cash which the Company would shortly be receiving, which meant that a buyer would be buying a pile of cash at a (slight) discount, and getting the remaining Life Sciences business for free. As such, I made ENZ a small position.

To be sure, with ~\$30M of revenue the Life Sciences business is subscale, but I believed there were multiple ways to win. First, a newly installed CEO had previously 5x'd the revenue of a very similar business. Enzo thus represents an opportunity to repeat this success through some combination of growing organically by pulling some very obvious levers that the previous, less capable management team failed to pull, and/or growing through bolt on M&A that would allow Enzo to quickly add scale. If the board determined that these options were not attractive, Enzo could sell the Life Sciences business to a bigger player for maybe \$2 per share or so.

I was thinking this was a classic case of heads I win, tails I don't lose because it would be hard to lose money when buying below cash value, and there was a path toward multi-bagger returns if the CEO could repeat his past success with the remain-co. In the worst case, the activists would elect to sell the remain-co, and we would go home with a quick win.

I admittedly was counting chickens before they hatched, as the cash from the sale of the Labs business was not yet in hand. However, I reasoned that receipt of this cash was highly likely because the buyer (LH) essentially operates in a duopoly with Quest Diagnostics (DGX) that sees both of them trying to roll up the industry; they are likely head to head on nearly every acquisition that they make. Due to this market dynamic I believed that LH would place a high value on their reputation as a dependable buyer. If they became known for backing out of deals, then DGX would have a distinct advantage during every competitive bid process.

Despite this logic, my best laid plans were forcibly derailed when shortly after I purchased stock the Company announced they had fallen victim to a modern day sinkhole in the form of a ransom-ware attack that saw the confidential medical information and social security numbers of 2.5M patients stolen. This, combined with a balance sheet that was badly in need of the cash from the sale, led to LH re-cutting their deal to buy the Labs business at a price that was ~\$33M lower than the initial agreement. This of course reduces my estimate of fair value, and at present we are sitting on a sizeable percentage loss. However, shares remain below my estimate of the cash that will soon be on the balance sheet, and there are still ways to win going forward.

Looking Forward

As always, I have no idea what the market will do in the near term. As I am sure you are aware, all eyes remain focused on the macro, with the debate being between the case for a soft landing, and the case for recession. As stated previously, the recession case is guaranteed to be right... eventually. And to be clear, “eventually” could happen quickly. At the same time, “eventually” could be years from now, and a lot of money can be made between now and then.

Timing these sorts of things is impossible, but a few positive factors to consider are that the collapse of Silicon Valley Bank seems to be just a memory at this point, consumer spending remains resilient, there is a lot of dry powder on the sidelines, the labor market remains healthy, and inflation has undeniably cooled. In fact, the “Misery Index,” which combines unemployment and inflation, is at the lowest level since before the pandemic.

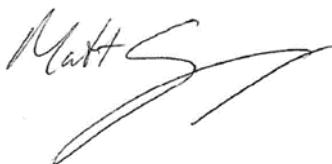
There are many counters to these positives, with the most notable perhaps being that a yield curve inversion has a great track record when it comes to predicting recessions. This is true, but the counter to the counter is that a yield curve inversion has never before come on the heels of a pandemic and all of the associated liquidity, not to mention bottled up animal spirits.

There are plenty of prognosticators out there going around and around in circles hashing and rehashing the counters and the counter-counters. From my perspective this is mostly a waste of time.

For us, the best path forward is to continue to do what we always do; own good businesses, led by incentivized people, when they are cheap for understandable reasons. Frequently these reasons will be unique to each business, but broad fear of recession qualifies as well. If I can identify easy to understand reasons that the normalized earnings power of these businesses will be considerably higher a few years from today, we should be rewarded with time due to the dual forces of increasing earnings power, and improving perception.

As always, the road between now and then will not be smooth. That being said, in my view it is increasingly likely that at some point we will pick up a tailwind to help power us on our journey. Simply stated, all of market history demonstrates that a chosen few mega cap stocks cannot dominate the markets forever. At some point, the pendulum will swing the other way, and small cap stocks will once again be in favor. In fact, market breadth is already widening. We will be ready when small caps get their day in the sun.

Please let me know if you have any questions,



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“The goal of investment is to find situations where it is safe not to diversify” ~Charlie Munger

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ⁱ [https://www.bloomberg.com/news/articles/2023-07-10/big-tech-s-dominance-in-stock-market-hits-breaking-point-for-nasdaq-](https://www.bloomberg.com/news/articles/2023-07-10/big-tech-s-dominance-in-stock-market-hits-breaking-point-for-nasdaq-100?utm_source=website&utm_medium=share&utm_campaign=linkedin?sref=rFR8gON5#xj4y7vzkg)

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ⁱⁱ Q4'2023 company conference call, LWC estimates.

ⁱⁱⁱ Company press release 5/8/2023, LWC estimates.

^{iv} LWC estimates

^v Company form 4 & 8k

^{vi} <https://www.telegraph.co.uk/business/2023/07/10/uk-companies-are-cheapest-in-world-gloomy-view-of-britain/>

^{vii} FY'22 company conference call