April, 2019

Dear Partners,

As you know, I prefer to only write twice per year in order to discourage the negative effects that come from discussing our portfolio too frequently. However, I am failing miserably to abide by this preference, in part due to our portfolio's current tilt toward special situations (as discussed in our Q3'18 letter) which are shorter term investments by their nature, and in part due to new capital joining our partnership. Regardless, as much as I would prefer to limit communication, I feel it is important that all partners understand what we own and why we own it, so that when difficult times inevitably come, we can focus on the quality of our businesses, our management partners, and the cheap prices we pay, rather than the noise that will dominate the headlines.

Laughing Water Capital ("LWC") returned 4.5% in the 1st quarter of 2019 after all fees and expenses, versus 13.7% and 14.6% for the SP500 and R2000 respectively. In the past, when we far out performed the indexes over 3 month periods, I noted that this period is inconsequentially short. This remains true today, although I acknowledge it is easier to ignore the short term when you are outperforming than when you are underperforming. Of note, this quarter was our worst ever in terms of relative performance.

Simply stated, we don't own the index, so there is no reason to believe our returns will track the index. In fact, at present none of our stocks are in the SP500, and only a quarter are in the R2000. However, I believe that on average, our companies are cheaper than the indexes, led by more incentivized management teams than the indexes, and they have a better chance for long term operational improvement than the indexes. All of investment history suggests that this is a winning combination over time.

However, the near-term future of our companies is also less certain than many names in the index, and of course they do not benefit from the wall of buying that comes from investors who blindly buy the index. Further, investment history also makes it clear that "cheaper," "better" and "more" doesn't always work over short periods of time.

To be clear, there were some structural reasons for our poor relative performance. We started the year with a large portion of the portfolio in Radisson (discussed in the Q3'18 letter) which was essentially a cash equivalent as the market raced higher. Additionally, in some cases, the fundamentals of our businesses deteriorated a bit in the quarter, although with one possible exception the theses remain intact.

I believe the real cause of our relative underperformance was succinctly captured by a recent article from CNBC.com. The article noted that in Q1, "stocks that act more like bonds are what investors prefer at the moment," while noting the recent preference for "[stocks with] a reliable stream of cash flow and income over all others."

The stocks in our portfolio do not align well with what investors prefer at the moment. <u>This is entirely by design</u>.

As a reminder, our portfolio is concentrated in a select number of investments, each of which is presently suffering from some sort of operational, structural, or optical problem that is temporarily interrupting what is likely to be a more reliable stream of cash flow in the not too distant future. While at the moment the market is completely ignoring companies dealing with adversity, these problems are precisely why we own these businesses. Over time as our properly incentivized management teams deal with these problems, I expect we will benefit from the dual tailwinds of improving operating performance and multiple expansion, leading to above average investment returns.

There is an enormous amount of evidence to suggest that over longer periods of time, owning a concentrated portfolio of good businesses, led by incentivized managers, when they are dealing with some sort of temporary problem is the best path for investment success. We are not reinventing the wheel: this is the strategy that many of history's greatest investors followed when they managed smaller pools of capital.

Given the track record of success of this strategy, one would think that all investors would follow it… and if it worked every month and every quarter and every year, they would. But the reality is that owning businesses when they are dealing with temporary problems is difficult because the market often mistakenly equates expensive stability with safety, while forgetting the importance of price.

Now appears to be one such time, at least in context of our portfolio.

In the stock market, the idea of safety without regards to price is completely oxy moronic, and our portfolio is constructed as such. In fact, at present nearly 50% of our portfolio is trading below my estimate of liquidation value, essentially giving no credit for the idea that these businesses might actually perform reasonably well in the future. Of particular note, approximately 35% of our portfolio is in companies that have indicated they will likely return a weighted average of ~25% of their capital to investors in the coming months as our management teams are making a concerted effort to close the gap between price and value. Importantly, I believe that each of these companies will still have the potential to double or more in the next few years, even after returning this capital.

This approach is in stark contrast with what has been "working" lately on Wall Street. Utilities are near historically high multiples. Tech stocks trade at valuations that require decades of success to justify. It is entirely possible that these investments will work out well: I truly have no idea. However, investing in public equities is an exercise where long-term success can be tied to one's ability to put the odds in one's favor. For many of Wall Street's most popular stocks right now, the bar for success is high and requires inputting some leaps of faith into fancy excel models. In contrast, with many of our stocks the bar for success is, "as long as the people running it don't intentionally light the company on fire, we should do pretty well."

As I don't believe we are partnered with arsonists, I am confident that over any reasonable amount of time our returns will be satisfactory, regardless of what the market does. For this reason, the vast majority of and my family's net worth remains invested in our strategy. Our interests are aligned.

Omaha

For current and prospective partners, if you will be in Omaha between May 2nd and May 5th for the Berkshire Hathaway meeting and would like to meet, please email me at msweeney@laughingwatercapital.com. I would note that I will be participating in a panel discussion led by our friends at Willow Oak Asset Management titled, "Value Investing in a Volatile Environment" on

May 4th following the Berkshire meeting. If you are interested in attending, please register with Willow Oak in advance.

Thoughts on Management Engagement

As you know, I recently made public two letters that we sent to the board of Aimia, Inc. (AIM.TO), in which I called for certain members of the board of directors to step down. This was an unusual step, as broadly speaking I believe it is a better strategy to partner with properly incentivized executives than it is to push for change. That being said, in my view there are some structural problems that can make proper board representation at smaller public companies difficult, and occasionally our interests will be best suited by more aggressively engaging with our management partners and boards of directors.

The potential problem with boards at small public companies is directly tied to one of our greatest advantages as a small partnership. Because of our small size, we can invest in smaller companies that are inaccessible to larger institutional investors. However, the costs to challenge the board of directors at a small company through a proxy contest can run into the hundreds of thousands or even millions of dollars, which is not all that much different on a dollar basis than the costs to challenge the board of directors at larger companies. The difference is that while hundreds of thousands of dollars is a drop in a bucket for large institutional investors, for smaller investors this sum can be material, meaning that boards of directors at smaller companies often effectively have no real oversight. When these directors do not own stock in the company they are overseeing, their incentives are such that they may be more focused on keeping their board seat than doing what is best for all shareholders.

We frequently engage in constructive dialogue with our management partners, and increasingly with our boards of directors in private. There is one other situation in our portfolio at the moment that may eventually become public, although I am hopeful that will not be necessary. In any case, publicly policing our boards is not core to our strategy, and I expect will be rare.

Comments on Select Investments

Aimia, Inc (AIM.TO) – Aimia, referenced above, is now a top 5 position, and was the recipient of our public letters to the board. While I think it would be foolish to claim credit, subsequent to our first letter the incumbent chairman and one other board member stepped down from the company, which is a step in the right direction. The company also announced that they will be pursuing what I consider to be a venture capital strategy and making acquisitions in the loyalty space. While I think this strategy would be a poor use of shareholder capital, in my view it seems likely that the current board will be replaced at this year's annual general meeting, or shortly thereafter via a proxy contest in July.

Aimia is a small cap Canadian stock that is difficult to understand due to a hodge podge of assets and recent major changes in the business. It should therefore be no surprise that it trailed the indexes considerably in the first quarter. However, with cash greater than the market cap, no debt, and preferred securities whose dividends are covered by regular distributions from a ~50% ownership stake in Club Premier (Aeromexico's loyalty program), investors are getting Aimia's existing ILS business, a ~$64M stake in Cardlytics (CDLX), a 20% stake in BIG Loyalty (AirAsia's loyalty program), a few other odds and ends, ~$800M in tax assets, significant upside from Club Premier in the form of special dividends and growth that is all but guaranteed by demographics, as well as the potential for world class capital allocators to deploy the cash in the future, all for free. In sum, while Aimia trailed the indexes this quarter, it appears that the stock has essentially zero downside, with the potential for substantial upside. Some of this upside will be crystalized in the near term, as the company has announced a tender offer for ~25% of shares outstanding at current prices. Taking a longer view, I remain confident that owning stocks with this sort of skew is a sure path to investment success over time, even if they don't perform well every quarter.

Iteris, Inc (ITI) – Iteris is our traffic management business and should by now be familiar as we have owned it for more than 3 years and it remains a top 5 position. While 2018 was a difficult year due to a series of events that were out of management's control, in my view intrinsic value and strategic value have continued to grow. Of note, during the quarter the company announced a strategic partnership with Cisco (CSCO) to integrate Iteris's technology into CSCO's smart city platform. Iteris has a touch point with one third of all signalized intersections in the United States, and in my view, that will become incredibly valuable as the move toward smart cities only accelerates in the years to come.

In the near term, in what I view as a positive development for the stock, Lloyd Miller's estate sold ~2.5 million shares in a negotiated transaction at a discount to market prices, dropping their ownership of ITI down below 5%, from more than 15% when we purchased shares. I have no idea if the estate continued to sell shares after this trade as they are now below the SEC reporting threshold, but the fact that shares did not rally back from the discounted trade price suggests this is at least possible. What is more important from our perspective is that for the last year there has been an overhang on the stock because buyers were reluctant to buy in the face of the estate selling. That overhang should now be removed.

In terms of valuation, in 2016 when I first introduced the stock I conservatively valued the traffic business at a market multiple of free cash flow, and valued the smaller, venture like agriculture business at $0, while noting that it had the potential to be worth multiples of the entire market cap if it worked out well. Since that time, normalized free cash flow from the traffic business has grown, and it is clear that this segment deserves much more than a market multiple based on a recent comp transaction that took place at 4.7x sales. This certainly seems like a full multiple, but given that controlling street lights will be vital to the future of smart cities, the strategic value here is likely very high for anyone who is interested in this future. This list likely includes traditional E&C companies (ACM, JEC, etc.), as well as telecom companies (VZ, CMCSA etc.), and especially big data companies (CSCO, GOOG, etc.). If relevant, this comp would suggest a value of ~$15 per share for ITI, assuming $0 for agriculture.

As for the agriculture business, it seems clear at this point that the upside scenarios I initially thought were possible are off the table, but at the same time, my base case valuation of $0 seems completely inappropriate. In 2016 I also noted that in my view, one of the key risks to the thesis was that management would continue to finance losses at the agriculture business beyond 2019. In my discussions with management it seems clear they are aware that the transportation opportunity is now greater than anyone realized a few years ago, while at the same time, the agriculture opportunity is less than what had been hoped for. It thus seems likely that strategic options for the agriculture business will be considered at some point, although to date no plans have been announced, and I do not think a fire sale approach would be in anyone's best interest.

It should also be mentioned that this stock screens terribly due to the nature of GAAP accounting that combines the money losing agriculture business with the traffic business. As such, it is possible – perhaps even likely - that this business will fail to participate in any additional rapid moves upward in the stock market absent a structural change. However, given that I believe the traffic business is worth multiples of its current market value today, and that intrinsic value will only continue to grow as traffic is not a problem that will go away any time soon, I think that continuing to ignore the indexes while focusing on the fundamentals of the business will be very profitable for us with time.

New Positions

We added 1 new large position and 1 new mid-sized position in the first quarter of 2019. For the time being the large position will remain undisclosed as I believe this company is likely to repurchase a third or more of its market cap in the coming weeks, and it will be in our best interest if the price is as low as possible going into that presumptive event. While these 2 positions are new, the mental models at work should be familiar as in both cases we have travelled different currents in the same stream in the past.

History Rhymes: GAIA, Beauty Contests, and the Terminator - An Undisclosed Position

"You still don't get it, do you?! He'll find her! That's what he does! That's *all* he does!"

~Kyle Reese, *The Terminator*, 1984

In the 2016 year end letter I introduced GAIA as a large position. The initial attraction to GAIA was based on the fact that pro forma for the recent sale of one of the company's segments, the stock was trading below my estimate of the company's liquidation value, with a cash rich balance sheet, and properly incentivized executives in the driver's seat. However, due to a lag in the reporting of the cash on the company's 10Q filings, the stock did not appropriately react to the pro forma balance sheet until the filings were updated, and the mechanical screeners that dominate the markets were able to take note. While our new position is involved with a different industry than GAIA, the rest of the story fits almost perfectly, and we suspect that the market will respond positively when filings are updated. As I think it is in our best interest to keep the name of the company quiet for the time being, I will spend a minute on the context.

As you know, the stock market can do very strange things over shorter periods of time. Economist John Maynard Keynes used the analogy of a newspaper-based beauty contest to describe these movements. In this Keynesian beauty contest, participants are asked to pick the six pictures that will be chosen as most attractive by the game's other participants. The wrinkle of course is that to win the contest, a participant should not pick the pictures that they personally find most attractive, but rather the pictures that they believe most other participants will find most attractive. This analogy seems especially apt in the Q1 investment market, where many cheap out of favor companies were left behind, while more popular, more expensive stocks rocketed ahead.

The problem is that there is no reliable way to repeat success when attempting to guess what other people will guess. Ben Graham, the father of modern value investing and Warren Buffett's teacher, had a common sense approach to handling this conundrum: he simply chose not to participate in the beauty contest.

Rather, Graham largely relied on a statistical approach, whereby he would simply identify and purchase companies trading below two thirds of their net current assets (current assets, minus all liabilities= NCAV). His reasoning was that if you were buying a stock below NCAV, you were essentially just buying the balance sheet, and getting the business for free. Graham believed that it just doesn't make sense that market participants should be able to buy a business for free, so it doesn't really matter what the other beauty contest participants think about the stock in the near term: eventually it will rerate higher.

Of course, Graham was operating at a time when computers had not yet taken over the investing world, and these statistical bargains were relatively commonplace. In today's world, quantitative investing strategies can be programmed to effectively turn over every rock and begin buying a stock well before it approaches a discount to NCAV, ensuring that market cap rarely dips below this level. In fact, at the time of this writing, out of the more than 7,000 stocks in the U.S. and Canada, only 2 of them show up on a screen where NCAV > market cap, market cap > $100M, and T12M revenue > $10M. However, when our company releases pro forma financials reflecting the recent sale of a segment with its next 10Q, there will be a third stock on this list. Importantly, unlike the other 2, this company is led by incentivized people, and has a relevant product.

As always when we buy a stock, there are some things to not like; this company's revenues are tied to commodity end markets, and a recent change in go to market strategy has temporarily negatively impacted sales. At the same time, there are positives as well. Notably, the product this company sells represents a low single digit percent of its customers' cost of goods sold, while at the same time, significantly improving IRRs for its customers. Additionally, while revenues are tied to commodity cycles, the products themselves are highly specialized and patent protected. Further, recent large customer wins suggest that adoption by the industry is still in the early stages. The company has also implemented a cost cutting program, and my diligence suggests there is a lot of fat to trim, which bodes well for future margins. Lastly, the newly installed chairman of the board is a known capital allocator with skin in the game, the newly recruited CFO appears to be a hired gun of sorts as her CV reveals a career of short stints at companies undergoing change, and the CEO has agreed to a 70% cut to his compensation, seemingly illustrating his commitment to not wasting the cash which is now in the company's hands.

At the moment, the company is undergoing a strategic review and attempting to chart the course for its future. What seems clear to me however is that as the company presently has two thirds of its market cap in cash (as yet unbeknownst to the quant models), some large portion of this cash is likely to be returned to shareholders in the near future. What is less clear is if the company should continue as a stand-alone entity, or if the interests of stakeholders would be best served through a sale of the company to a strategic buyer who could eliminate corporate operating expenses while flexing operating leverage in their own R&D and sales organizations. As part of the strategic review the company has hired an investment bank, suggesting a near term sale is a real possibility. Notably, 3 of the peers listed in the company's proxy form have been acquired at 1.2x trailing sales over the last year or so, while pro forma for the recent segment sale this company is trading closer to 0.3x trailing sales. Further, I believe trailing sales are currently depressed due to the aforementioned change in go to market strategy. If this is indeed the case, and assuming an acquiror could realize significant synergies, the stock may be worth more than 200% of its present market price in short order, before considering upside commodity cycle scenarios. It also doesn't hurt the sale case that the CEO has a ~$7M golden parachute that would be triggered by a change in control.

In my view however, all of the above considerations pale in importance to the downside protection we have based on what will happen when the company releases its updated balance sheet with the filing of their Q1'19 10Q. When that happens, the quant driven strategies that dominate the markets will realize that while they thought they had been looking at an indebted company struggling to make a profit during a cyclical downturn, they are actually looking at a company with ~66% of its market cap in net cash, trading below the value of its NCAV. Importantly, the company's long-term assets, which we are getting for free, are not accounting fictions like goodwill. Rather, these assets are patents and other items with real determinable value that can drive real earnings power. Shifting to the top line, on an EV/revenue basis, the stock will instantly register as trading at a near 75% discount to pre forma levels and comps.

This stock is a top 5 position for us, and has significantly lagged the indexes since we purchased it in Q1, but in my view in light of the distribution of potential returns, this short-term underperformance is well worth it. On the upside, the company is likely to return significant capital to shareholders, and could be worth ~200% more to a strategic buyer. At the same time, betting on the downside is akin to betting against the Terminator. When the updated filings hit, the computers that drive an estimated 80% of investment activity these days will find and buy this stock. That's what they do. It's *all* that they do.

History Rhymes: CDMO and Good Co. / Bad Co. – Recro Pharma (REPH)

In the 1H'18 letter we introduced Avid Bioservices (CDMO) to the partnership. At one time, Avid had been working on commercializing pharmaceuticals, but their core business is that of a contract drug manufacturing organization (CDMO – also their ticker). This is a recession proof business characterized by switching costs that are very high. Specifically, when a pharmaceutical company seeks FDA approval for a drug, details on the manufacturing facility are included in the application. Changing manufacturing facilities thus requires FDA approval. To quote from the 1H'18 letter, "The crux of the [CDMO] 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)."

Through our ownership of Avid, I became familiar with Recro Pharma (REPH), which is also a CDMO business that had been attempting to commercialize a drug. I have no ability to probability weight FDA approval for a development stage drug, however, there have been a number of recent transactions in which CDMOs were purchased, leaving clear guidelines on how they are valued. On March 22nd it was announced that the company's application for an IV non-opioid pain relief drug had been rejected by the FDA, which caused shares to trade down by more than 50% in the coming days. At these prices, I reasoned that the value of the CDMO business would be worth more than double the stock price looking out a year or two. The risk of course would be that the company continued to burn cash in pursuit of FDA approval for the development stage drug, but the fact that insiders own ~25% of the company tempered that risk, and I made REPH a midsized position. In the early days of Q2 the stock appreciated by ~40% after the company announced that the cost to shut down the drug business would be lower than expected, and revenue and profit for the CDMO business would be higher than expected, which makes it feels like I should have sized it larger. Despite this rapid move higher, I believe REPH remains materially undervalued.

First, on a multiple basis, the company is trading significantly below where recent comp transactions have taken place. To be fair, REPH likely deserves some kind of discount due to a more concentrated customer base than peers, but the business is operating well below full capacity, and as new customers join concentration fears will fade. Additionally, increasing utilization should come with operating leverage, leading to increasing margins, and an increasing multiple. This won't happen tomorrow as the sales cycle in this business can be inordinately long, but as the company is cheap on current metrics and the revenues are recession proof, I believe our patience will be well rewarded.

Annual Meeting

I am in the process of organizing a meeting for limited partners in New York. The date has not been finalized, but I am looking at the last week of September. Please let me know if you plan to attend as soon as possible so that I can make the appropriate arrangements.

Looking Forward

As always, I have no idea what the market will do in the near term. What I do know is that my preference for owning securities where the downside appears to be limited by some combination of balance sheet and private market value, while the upside appears to be substantial due to a presumptive normalization of earnings power at some point in the next few years has not been in favor of late. Yet, from my perspective, if the goal is to own a portfolio of businesses where the downside is well protected and the upside is substantial, I believe we are currently in excellent position. While nothing is guaranteed, it is nearly impossible for me to imagine scenarios where properly incentivized (or soon to be properly incentivized, as in the case of Aimia) management teams do not deliver exceptional investment results from businesses that are trading below liquidation value. I cannot say that with the same level of confidence for those that believe that oxy moronically paying high prices for the presumption of certainty and safety is an appropriate strategy for long term investment success, even if it has worked lately.

In my view, what is most important during periods such as these where we are left behind by the indexes is to simply continue doing what we always do: partner with incentivized management teams that are steering their companies through some kind of temporary optical, structural, or operational problem, confident that if we are correct in our analysis, eventually we will be rewarded. The biggest risk for us is not that we trail the market over shorter periods of time. Rather, the biggest risk is that we abandon what always works over the long term, in order to chase what is presently working over the short term. Patience is the key.

Please let me know if you have any questions,

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