LAUGHING WATER CAPITAL

October, 2023

Dear Partners,

I hope you will forgive me clogging your inbox with this letter, as it marks the third letter this year. I ordinarily would consider this cadence excessive given the long-term nature of our strategy. That being said, with all of the noise in the main stream financial press about interest rates, inflation, government shut downs and recession, I felt that an additional touch point from me would appreciated.

In the third quarter Laughing Water Capital ("LWC") declined by approximately 11.6%, bringing our YTD returns to ~8.3%.[i] This compares to the SP500TR and R2000 which returned -3.3% and -5.1% during the quarter, and 13.1% and 2.5% YTD respectively. As always, individual results may vary, so please check your individual statement. I have been consistent in saying that quarters will not matter to our ultimate success, but clearly this was a disappointing one, and I will spend time discussing our detractors in the following pages.

As a reminder, I operate with a near singular focus on the belief that if you own businesses that can both improve their earnings power and benefit from a positive change in perception, the stock market will reward you. I consider this belief to be infallible over any reasonable period of time, as long as you don't overpay initially.

Quite frankly, these days it feels like the market disagrees.

The problem as I see it is twofold. First, the "reasonable period of time" part of our strategy is at odds with a market that only seems to care about what will happen with the macro next week, month, or quarter. In my view, this is largely due to the genetic programming within most humans that encourages them to panic first, and worry about the details later. It is also likely amplified by market structure, where more and more money is in the hands of short term focused quants and multi-manager "pod shops" that rely on near term price action and leverage for their success.

Second, the "change in perception" part of our strategy means that I am often deliberately buying businesses that are dealing with some sort of near-term problem that obscures their true earnings power. In the best cases, I am buying businesses that *look* expensive to the large portion of the market that only considers quantitative inputs, but are actually quite cheap if you take an intelligent business person's view. However, during periods of macro uncertainty, investors prefer to pay a high price for the perception of certainty rather than a lower price for temporary uncertainty.

If the theses that underlie our investments were super complex and required our management partners to jump through flaming hoops, I would likely be nervous. Adding macro uncertainty on top of business model and investment thesis uncertainty does not seem like a good idea.

However, for the most part the theses upon which our portfolio is built are painfully simple. Our management partners have well defined plans to improve earnings power and perception, and competitively advantaged businesses with which to execute. Admittedly, there is path dependency risk, and in many cases the path will have some additional twists and turns tied to the macro environment, but ultimately, I believe we will end up in the same place; higher earnings power tied to the removal of some optical, operational, or structural impediment which presently is receiving excessive attention from the market or otherwise obscuring our businesses' true earnings power.

For this reason, I remain confident in our future investment returns, and almost the entirety of my and my family's wealth remains invested right alongside your investment. I cannot tell you when, but current valuations suggest that the future will be very bright, eventually.

"The key organ in investing is the stomach, its not your brain."

~Peter Lynch

Interest rates. Inflation. Oil prices. Geopolitical concerns. Government funding. Recession. These are but a sampling of the topics that are dominating the financial landscape lately, and they are all scary in various ways.

But how relevant are they?

Will these forces stop the global trend toward biologic drugs? Will they stop small businesses from moving their operations to the cloud? Will the world no-longer need fire safety equipment due to interest rates? Will inflation erode the value of one of the world's most powerful travel brands? Will war in Ukraine (and more recently Israel/Gaza) solve the low-income housing issue in the UK?

Will dramatic changes in earnings power that are likely to happen regardless of the macro environment be ignored by the market forever because of those same macro issues?

I don't mean to be glib, and I am not suggesting that these macro issues are of no importance. However, I am suggesting that their relevance differs massively depending on your time frame.

In my view, the most important question is not what will happen next with interest rates or inflation or recession. The most important question for investment success is how able you are to take mark to market fluctuations. The headlines are scary, and with the exception of a few anointed mega cap stocks, fear has returned to the market. But in most cases I struggle to see impairment of the intrinsic value of our investments if you simply look past the horizon.

For example, take our investment in **Avid Bioservices (CDMO)**, our biologic contract drug manufacturer, which has been cut in half over the last few months after issuing disappointing near-term guidance tied to a slow down in biotech spending on early-stage projects. The near term is admittedly uncertain, but the bigger picture remains unchanged. There is still a very favorable de novo biologic drug pipeline, still a very favorable patent cliff/biosimilar pipeline, still a very favorable industry supply vs. demand dynamic, still a very favorable trend toward outsourcing among large pharma, and still very favorable forecasts from existing large customers.[ii]

Further, simply zooming out a little bit shows that after a few years of cash going out the door to fund capacity expansion, Avid is now at a pivot point, and cash should shortly be coming in the door as that capacity has been built. That cash will come with tremendous operating leverage.

The intermediate term analysis here is thus a very simple exercise. When the new capacity is filled, how much free cash flow will be generated, and what multiple will it deserve? In my estimation, before long Avid will be generating something around $100M in free cash, which is attractive vs. its quarter end enterprise value of ~$700M. Looking at M&A transactions and public competitors, it seems as if the market thinks businesses such as Avid (when mature) deserve to trade at 20x-30x free cash flow, which suggests a very bright future for CDMO stock (even If multiples compress), and the potential for returns of 200-400% over the next few years.[iii]

The problem?

I can tell you with near certainty that Avid's facilities *will* be filled, but I cannot tell you *when*. That uncertainty around timing – the unknown duration – is very difficult to overcome in a market that only cares about what the macro picture will look like next week or next month.

My best guess is that it will take 4 to 5 years to reach capacity, and that the market will mostly price in success 12-18 months in advance. One may ask, "if success here is likely years away, then why not wait on the sidelines for a few years?" The answer is that there are likely to be step function advances along the way as Avid announces increases to backlog and new customer wins, and those could happen at any moment. Additionally, Avid does not even have an investor presentation. Now that they are at a clear pivot point, I think this is likely to change in the near future, which should increase interest in the name. Lastly, when the cash flow statement flips from negative to positive, surely quant based investors will take note.

If we were playing month to month or quarter to quarter stock market games, we could not own a stock like CDMO. However, as we are investing in businesses with a 3 to 5+ year view, it is worth stomaching the volatility along the way in order to capture ultimate upside that I believe is extremely likely to be realized. Insiders at Avid seem to agree, as the recent selloff has been met with insider buying.

Another example is our investment in **Thryv Inc. (THRY)** which is using its legacy Yellow Pages and other marketing businesses as a base from which to build software that allows small and medium businesses to move their operations from a system of sticky notes and excel spread sheets into the modern era. Thryv recently raised guidance, announced that margins on the SaaS side jumped 10 percentage points, and announced the release of new "centers" that should accelerate growth further.[iv]

Shares traded down ~25% in the weeks following this news.

In my mind, it is hard to think of a better development than the margin improvement. This improvement was tied to a decision to cut back on paid customer recruitment, because more than 40% of new customers are coming through referral, which is essentially free. Combined with customers that come out of the Yellow Pages "zoo," more than 80% of customers are coming with minimal acquisition costs. Why pay Google to help you find customers when you are getting so many for nearly free?

Importantly, the referral business seems to validate my thesis around what I call "the 3 plumber problem." Essentially, if you live in a town with 3 plumbers, and one of those plumbers starts using Thryv so that they can schedule appointments, update you on timing, send you a bill, receive payment and more all by text message, the other two plumbers who are still saying, "I'll be there some time next week," have a problem. They basically have to update their own operations, or customers will simply use the plumber that has brought his business into the modern world.

In my mind, proof that this dynamic is playing out – combined with the addition of new centers that broaden Thryv's capabilities and a management team that has a long history of under-promising and over-delivering – goes a long way toward suggesting that Thryv will hit their intermediate-term goal of generating $200M in EBITDA from their SaaS business. If that happens, and Thryv is valued similarly to other SMB software providers, shares could gain ~400% over the next few years.[v]

The problem?

First is the obvious: anything "small and medium business" sounds scary in the face of a potential recession. However, Thryv's average customer has been in business for 15+ years and operates a relatively recession resistant business, like plumbing. My theory is that the bigger problem is that customers of Thryv's marketing businesses are being transitioned from a 15 month renewal cycle to an 18 month renewal cycle. This changes nothing in terms of the near-term cash flow, but when Thryv reports Q3 earnings next month, GAAP revenue recognition rules will create an air pocket in Thryv's revenue and EBITDA for their marketing business. Management has been telegraphing this for a year as it does not affect cash flow, but if you are a quant relying solely on GAAP inputs, this air pocket may trigger a sell decision, and if you are a short-term trader, this can be exploited.

In any case, I can tell you with near certainty that small and medium businesses will modernize their operations and move to the cloud at some point. I can also tell you that with the ability to self-finance and the lowest customer acquisition costs out there, Thryv has real competitive advantages. Thryv also arguably has the best product at the lowest price, which is very difficult to compete with. Lastly, I can say that Thryv's intermediate term goal implies winning less than 2% of their TAM. This does not strike me as overly ambitious.

What I can't tell you with any degree of certainty is *when* these things will happen.

So why not stay on the sidelines? Again, there are likely to be step function advances in the stock at some point. They are at the point where the operating leverage typical of software businesses could kick in aggressively, and revenue from Thryv's SaaS business is just beginning to eclipse the revenue from Thryv's legacy print business, which could attract a new class of buyers. Similar to CDMO, in my view it is worth stomaching the volatility in order to participate in the upside that could/should be several hundred percent over the next few years. Similar to CDMO, management at THRY seems to agree with my assessment, as there has been recent insider buying.

Avid Bioservices and Thryv Inc. were among our largest detractors last quarter, but interestingly they were among the names that had the most important fundamental developments over that period. I of course realize that they are longer duration investments, and longer duration investments often suffer during rising rate environments and during recessions, but in my view, these two businesses and investments are very different than the stereotypical long duration investment.

We are not talking about novel business models with unknown capital needs where success is dependent on massive scale, winner take all economics, and a friendly regulatory environment. We're just talking about filling a factory in an industry where demand is larger than supply. We're just talking about easy to use software being better for customers and operators than using sticky notes. We're also talking about operating leverage and cash flow that is a stone's throw away, without any need to change the world or bludgeon regulators. In my mind, these are low hurdles.

Drawdowns are of course frustrating, but they are also a part of longer-term success. In my view, the best path forward is a strong stomach.

Of Note:

Hilton Grand Vacations (HGV) - HGV is our time share business, which is continuing to integrate the acquisition of Diamond Resorts. The thesis is that HGV oversees a nearly impossible to replicate collection of properties under an impossible to replicate brand. That brand is a huge competitive advantage because it reduces customer acquisition costs and squeezes more value out of real estate. As the Diamond acquisition is integrated, the benefits of the Hilton brand will drive earnings power higher. Additionally, the company is committed to returning capital to shareholders in the form of buybacks, with the current authorization equating to a double-digit percentage of the outstanding shares. Perception is that this is a highly cyclical business, but prior to the Financial Crisis the business grew through every previous recession, and during the Financial Crisis revenue only dipped about 3%. In addition to cyclical fears, I believe HGV is currently suffering as a result of the well-publicized wild fires that devastated much of Maui in late August. While HGV's two Maui properties did not suffer physical damage, travel to the area was restricted. The Maui properties were responsible for ~4% of HGV's T12M sales.[vi]

In my view this is a clear temporary problem. It is also likely a long-term positive as share price weakness is attractive to a company that is effectively a buyback machine, and HGV presently trades around 7x free cash flow.[vii]

Lifecore Biomedical (LFCR) – Lifecore is our pharmaceutical fill/finish business that specializes in highly viscous materials, as well as prefilled syringes and vials. As you know from past letters, our investment here has taken quite a few twists and turns, and what was originally a longer duration story today exists as a special situation as the company is in the midst of a strategic review that I believe will likely result in a sale of the business. While shares are still up significantly from the company's flirtation with bankruptcy earlier this year, more recently shares have traded down from their interim high, which has dragged on our recent performance.

The decline seems to be primarily related to the length of the sale process, with some observers believing it is dragging on to a point where a favorable outcome is less likely. The fact that the company has delayed the release of their 10K due to issues that are non-core to Lifecore's operations does not help either. From my perspective, the length of the process is not concerning. Several bankers that have run these processes in the past have told me that 6 to 9 months would not be at all unusual, and we are just a bit past the 6 month mark from the unofficial start of the process. That being said, my upside cases of $20+ per share were tied to an ultra-competitive, fast process, so it seems less likely that the upside cases will come to fruition.

With delayed filings there is a near complete information vacuum at the moment, other than positive updates from Apellis Pharmaceuticals (APLS), who is a customer of Lifecore's, and brief commentary from the company that they have continued to add new customers to their roster. I continue to think a sale of the company is the most likely outcome in the not-too-distant future.

New Position

There are a lot of strange things happening in the market these days, often tied to the behavior of short-term focused traders that are relying entirely on the numbers rather than taking an intelligent business person's perspective on the value of a business. One such example has entered our portfolio as a small position.

In brief, the company has no debt, generates cash, has a product pipeline (including a hidden asset of sorts) that could prove to be quite valuable, and presently trades for about 50% of the cash on its balance sheet. To be fair, current cash flow is in decline, but quite simply cash flowing fifty cent dollars should not exist, yet here it is. Why is that?

If you look at the most recent 13F filings to see who the owners of this business are, you will see that by my estimation more than 50% of the owners are index funds or pure quantitative investors that are forced to follow some sort of rule set. That rule set often includes index participation or some sort of momentum guard rail. This company was removed from an index, so a huge portion of the shareholder base was likely forced to sell, without regard for valuation. Broadly speaking, that is a good time to be a buyer.

Looking Forward

As always, neither I nor anyone else knows what to expect in the near term. But if you believe that business fundamentals and valuations matter over reasonable periods of time – and have the ability to be patient - this is a good time to be an investor. Over the last 5 years, the R2000 is almost flat. The P/E multiple of the earning companies in the R2000 has compressed to levels not seen since the Financial Crisis.[viii] Small caps are trending toward their third consecutive year of underperformance vs. large caps, and the worst three year stretch since the tech bubble.[ix] The spread between large caps and small caps is record wide. All of these things are positives for our strategy when looking past the horizon.

I can't tell you what will happen next with macro, and I can't tell you how more short-term focused market participants will react. I can tell you that market participants that react to every macro headline create fantastic opportunities for investors who take a longer-term view. Eventually, the sun will rise again and dramatic improvements in earnings power will be rewarded.

As I have said in the past, I am aware that much of my confidence in our investments is rooted in a sort of naïve optimism. I have also noted that naïve optimism is undefeated over reasonable periods of time. That is as true today as it has ever been. As the market creates opportunities, I will attempt to take advantage of them, and upgrade our portfolio along the way.

Please let me know if you have any questions,

Matt S

MSweeney@LaughingWaterCapital.com
917-306-0461

Disclaimer: This document, which is being provided on a confidential basis, shall not constitute an offer to sell or the solicitation of any offer to buy which may only be made at the time a qualified offeree receives a confidential private offering memorandum ("CPOM") / confidential explanatory memorandum ("CEM"), which contains important information (including investment objective, policies, risk factors, fees, tax implications and relevant qualifications), and only in those jurisdictions where permitted by law. In the case of any inconsistency between the descriptions or terms in this document and the CPOM/CEM, the CPOM/CEM shall control. These securities shall not be offered or sold in any jurisdiction in which such offer, solicitation or sale would be unlawful until the requirements of the laws of such jurisdiction have been satisfied. This document is not intended for public use or distribution. While all the information prepared in this document is believed to be accurate, Laughing Water Capital, LP , Laughing Water Capital II LP and LW Capital Management, LLC make no express warranty as to the completeness or accuracy, nor can they accept responsibility for errors appearing in the document. An investment in the fund/partnership is speculative and involves a high degree of risk. Opportunities for withdrawal/redemption and transferability of interests are restricted, so investors may not have access to capital when it is needed. There is no secondary market for the interests and none is expected to develop. The portfolio is under the sole trading authority of the general partner/investment manager. A portion of the trades executed may take place on non-U.S. exchanges. Leverage may be employed in the portfolio, which can make investment performance volatile. The portfolio is concentrated, which leads to increased volatility. An investor should not make an investment, unless it is prepared to lose all or a substantial portion of its investment. The fees and expenses charged in connection with this investment may be higher than the fees and expenses of other investment alternatives and may offset profits. There is no guarantee that the investment objective will be achieved. Moreover, the past performance of the investment team should not be construed as an indicator of future performance. Any projections, market outlooks or estimates in this document are forward-looking statements and are based upon certain assumptions. Other events which were not taken into account may occur and may significantly affect the returns or performance of the fund/partnership. Any projections, outlooks or assumptions should not be construed to be indicative of the actual events which will occur. The enclosed material is confidential and not to be reproduced or redistributed in whole or in part without the prior written consent of LW Capital Management, LLC. The information in this material is only current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Statements concerning financial market trends are based on current market conditions, which will fluctuate. Any statements of opinion constitute only current opinions of Laughing Water Capital LP and Laughing Water Capital II LP, which are subject to change and which Laughing Water Capital LP and Laughing Water Capital II LP do not undertake to update. Due to, among other things, the volatile nature of the markets, an investment in the fund/partnership may only be suitable for certain investors. Parties should independently investigate any investment strategy or manager, and should consult with qualified investment, legal and tax professionals before making any investment. The fund/partnership is not registered under the investment company act of 1940, as amended, in reliance on an exemption there under. Interests in the fund/partnership have not been registered under the securities act of 1933, as amended, or the securities laws of any state and are being offered and sold in reliance on exemptions from the registration requirements of said act and laws. The S&P 500 and Russell 2000 are indices of US equities. They are included for informational purposes only and may not be representative of the type of investments made by the fund.

---

[i] Laughing Water Capital and "LWC" refer to Class A investments in Laughing Water Capital, LP, and Laughing Water Capital II, LP.

[ii] See commentary from RBC's 2023 CDMO conference, company conference calls, and HALO projections.

[iii] LWC estimates

[iv] Thryv Q2'23 conference call

[v] Thryv Investor Relations, LWC estimates

[vi] 9/5/23 company press release

[vii] LWC estimate

[viii] https://www.royceinvest.com/insights/small-cap-recap
[ix] According to Charles Schwab Chief Strategist