Idea Brunch with Matt Sweeney of Laughing Water Capital

Matt Sweeney on the path less traveled, special situations, and his top idea

Edwin Dorsey Mar 27

Welcome to Sunday's Idea Brunch, your weekly interview series with underfollowed investors and emerging managers. We are very excited to interview Matt Sweeney!

Matt is currently the managing partner and portfolio manager of Laughing Water Capital, a long-biased fund he launched in January 2016. Before launching Laughing Water Capital, Matt was a contributing author at Boyar Value Group and a director at Cantor Fitzgerald. Since its inception 6 years ago, Laughing Water Capital has compounded at 29% annualized, net of fees, compared to 15.5% for the Russell 2000.

Matt, thanks for doing Sunday's Idea Brunch! Can you please tell readers a little more about your background, why you started Laughing Water Capital, and what has contributed to your strong performance?

I was very much a late-bloomer when it comes to investing. I didn't grow up around the stock market, and I managed to graduate college as a history major having never taken a single accounting class, finance class, or business class. Despite this lack of formal education, my first real job after college was at Cantor Fitzgerald, a mid-tier brokerage and investment bank, working in the middle office of the institutional equities trading desk. If it had been normal times I would have been severely under-qualified, but this was days after 9/11 when Cantor lost more than 650 people. Within a few months, I had moved to the trading floor as an equity salesperson, where I was forced to learn in real-time.

The experience on the trading floor and as a salesperson was an excellent way to learn what NOT to do if the goal is to beat the market. This was a commission-generating

role. The best customers owned 300 stocks and churned their portfolios all the time. The job was very much inducing people to trade by pointing out companies that "missed" earnings, or when a sell-side analyst changed their opinion on a stock. The trading floor was fun and loud and exciting, but after a year or two I figured out how insane it all was. Here I was at 24 years old, with zero ability to analyze a business, calling up portfolio managers who managed billions of dollars and telling them they should buy or sell based on a one penny earnings miss or beat… and they would listen to me! I secretly knew that I had no idea what I was talking about, so why were these people listening to me?

Thankfully I got pointed in the right direction by a trader at The Royce Funds, which is a small-cap value fund. I was told that if I was smart enough to realize that running around screaming buy! Sell! Etc. every time the wind blew in a different direction was crazy, then I was smart enough to start reading Ben Graham, Warren Buffett, Joel Greenblatt, and some of the other modern masters of investing. I took the advice and dove into the investing classics with both feet, and pretty much immediately was hooked.

From there it was the better part of a decade of going home after work and spending time on weekends learning accounting, reading 10Ks, studying businesses, reading past investment pitches by great investors, going through the CFA program, studying behavioral economics, and writing up ideas and sending them to anyone who would critique them in order to help me learn and improve as an investor. Slowly but surely my own style developed and my confidence grew to the point that I was ready to launch Laughing Water Capital in early 2016.

Over the preceding decade or so I had met and read about many investors who crushed the market in no small part by putting the odds of success strongly in their favor, and I was determined to do the same with LWC. This meant deliberately choosing to stay small, ignoring the indexes, having a super high hurdle rate for inclusion in the portfolio, and being sure to only accept limited partners that fully understand the difference between the value of a business and the price that business may be afforded by the stock market. I view these attributes as sustainable competitive advantages that are

very obvious, yet unattainable for most investors. However, they are foundational to LWC and have contributed greatly to our past performance.

In your great interview with *The Acquirers Podcast* you said, "In the best case we can find an underappreciated compounder at a special situation price." Can you expand on this? What are some of the common themes that cause high-quality companies to trade cheap?

I am broadly of the view that most of the time the market is efficient. More often than not stocks are priced appropriately. However, there are certain fact patterns that are fairly reliable in terms of indicating that a security may be mispriced. The bible of this sort of special situation value investing is of course *You Can Be A Stock Market Genius* by Joel Greenblatt. Greenblatt lays out what to look for in the classic special situation setups, with spin-offs being the most well-known. Without going through the mechanics of spin-offs or other setups here, the idea is that there is some set of conditions that easily explain WHY the stock might be cheap. I am of the view that if you don't have a strong answer to the question, "why am I so lucky to find this incredible opportunity" then you are likely the patsy at the poker table. Answering this question is a big part of my process, and if the answer has anything to do with valuation, you are likely playing with fire. It amazes me how many pitches are out there that essentially boil down to, "it is trading at 16x earnings, and it should be trading at 20x" or something similar.

In my view, multiple expansion is not a thesis. Multiple expansion can only ever be a cherry on top of either 1) some fundamental improvement to the earnings power of the business, or the perception of the earnings power of the business or 2) a cessation in forced selling by some other shareholder that is dealing with some sort of structural constraint that forces them to act irrationally.

If you can come up with a reason why the earnings power of the business is misunderstood by the market, or if you can identify why a seller is acting irrationally, then you have a great place to start. From there, for me it is then about focusing on situations with the least amount of variables in between where the business is today,

and the future state where the earnings power of the business has fundamentally improved.

There is nothing wrong at all with growth as a means to improve earnings power, but in my view, there are a lot of variables involved. You have to have the right product, at the right price, meeting the right need, with the right cost structure, and the right operating leverage. Even if you get all of that right, you are still entirely dependent on the behavior of your customers, who themselves are dealing with their own set of variables. A lot can go wrong with all of these variables, and typically if there is a perception of future growth, you are paying a high price, which means the cost of failure is high.

LWC is diversified across what I call the value spectrum, meaning that we do have some investments that are more tied to a thesis of underappreciated growth potential, but there is a heavier weighting to investments that come down to one or two key variables. In the best cases, these variables will be entirely in the hands of properly incentivized individuals who can drive earnings power by simply flicking a switch.

The example I always use to illustrate this idea is what I call "good co / bad co," where there will be one business that has two segments that are in different parts of their life cycle or are of differing quality. If one segment earns $1 a share, and the other segment loses $0.50 a share, on a consolidated basis the business earns $0.50 per share, and the market will likely put some multiple on that consolidated earnings power.

In a world where according to JP Morgan 80% of investors are relying on quantitative metrics to drive their investment decision making, it is only a small minority of investors that will take the time to look under the hood and appreciate that to an intelligent business person a stock such as this should be valued more on the earnings power of the $1 a share segment rather than on the consolidated earnings power. Putting a multiple on the consolidated number effectively capitalizes the value of the bad co as a negative value indefinitely. But that's not how it works in the real world if you have a management team that is properly incentivized.

For example, if we were talking about a business that is still 20% owned by the founding CEO, and the founding CEO has been open that he is experimenting with a new

business line (the bad co) that will likely lose money for a period of time, it is very likely that this bad co will not be a drag on the Company forever. At some point, the bad co will either reach maturity and become a net contributor to consolidated earnings power, or it will be shut down, in which case the earnings power of the good co can shine through unobstructed. In both cases the earnings power of the entity will effectively double based on this one variable, assuming that the good co has a reasonable competitive position. When this happens, not only will the consolidated earnings power effectively double, but the company will now be an easier to understand pure-play, and the market loves simplicity, which will likely contribute to multiple expansion.

"Good co / bad co" is perhaps the cleanest way to think about these types of situations, but I always keep my eyes open for other similar permutations where there is an easily understandable reason why the company might be mispriced, and a path toward increased earnings power that relies more on a single variable tied to human behavior rather than dozens of variables tied to the behavior of complex organizations like competitors and customers.

In the best cases, the good co. will have high returns on capital and a long runway for continued reinvestment in the business, so that this good co. can remain in the portfolio as a compounder for many years to come.

You have a pretty diverse portfolio – ranging from a microcap sweetener company to a U.K. homebuilder. How are you able to come up with off-the-beaten-path ideas in an industry with so much groupthink?

The key here is structural. As mentioned previously, LWC is specifically designed to ignore the broader indexes, except considering them as useful reference points over multi-year periods. There is a ton of evidence to suggest that the best managers over longer periods of time frequently underperform the markets over shorter periods of time. This is because, with the exception of the last few years where what has been most popular has performed the best, to outperform in the long run, investors have historically been best served by buying what is out of favor rather than what is most popular. If you are intentionally buying what is unpopular, it is not very likely that your portfolio will win a short-term popularity contest. There is a ton of academic evidence to

support this view, and while at only 6 years LWC's track record is arguably not yet relevant in this context to date we have only beaten the market about 50% of the time when measured on a quarterly basis.

Despite all of this evidence, most professional investors are forced into a short-term game by limited partners that may pull their money during a period of underperformance. LWC is specifically looking for the eclectic and the anomalous, which is a real luxury. We are not beholden to the indexes, so we are free to range far and wide in pursuit of truly anomalous opportunities that are not at all related to the indexes.

What is an interesting idea on your radar right now?

The world is in an uncertain place right now. Of course, I would say there is always some uncertainty, but between inflation, interest rates, supply chain problems, and war in Europe, I would argue that investors would be well served by being a bit more cautious than usual. At the same time, I have no ability to time the market, and I don't believe anyone else does either, so cowering in fear is not a good option. Despite all the uncertainty, it is still totally possible that the fearful headlines of the day will quickly fade, and the world will enter into a "roaring 20s" type period. The range of potential outcomes is very wide at the moment.

While I am hopeful that the roaring 20s are just around the corner, "hope" is not an investment strategy, and I am leaning more toward businesses and stocks that can thrive in difficult periods, yet still do well in upside scenarios. They are perhaps less likely to be "homerun investments" but they have a very high on-base percentage looking out over the intermediate-term regardless of what else happens in the world. An example would be **Countryside Partnerships** (London: CSP — GBP1.44 billion), which is a UK-based homebuilder.

What is interesting is that up until a few months ago, Countryside Partnerships was known as Countryside Properties, and they ran two businesses. One was traditional homebuilding, which is asset-intensive. You have to buy the land, permit the land, build the building, and then sell the home. This model requires tying up significant capital for

an unknown period of time, which of course reduces the return on that capital. The other business is a partnership model, which is an asset-light approach to homebuilding, similar to what NVR (NYSE: NVR) has done in the U.S. over the last few decades. For reference, NVR has been one of the best-performing stocks in the market over that period, having returned more than 20% per year.

NVR pioneered a land-option strategy in their asset-light approach, but Countryside is a bit different. Rather than optioning the land, they partner with local housing authorities to form joint ventures where the housing authority contributes the land – which has already been permitted – and Countryside contributes the home building and community development know-how. Not having to tie up capital in land for unknown periods of time allows Countryside to generate returns on capital of 40-60%. Additionally, the local authorities typically agree to retain ~40% of the homes in a development upfront, and Countryside has financial partners that agree to purchase another ~20%, meaning that Countryside only has sales risk on 30-40% of every development. This of course greatly reduces the cyclicality of the investment.

This asset-light model is simply a better business than the asset-intensive model, which is why activist investors recently took control of the company and put in place a plan to exit the asset-intensive business through a run-off, and use the proceeds to repurchase 450 million GBP of stock. They are already in motion on this plan, and at current prices would be able to shrink the float by somewhere north of 30% over the next ~2 years if the stock doesn't move higher. In other words, if the remaining business simply remains the same over the next 2 years, and the valuation multiple remains unchanged, in theory, the stock would be worth ~40% more, all else equal.

Homebuilding has more or less looked the same since the end of the Dark Ages: serious disruption is very unlikely over the next 2 years. At the same time, the Company has laid out a clear plan on how they will double their earnings potential over the next few years. To be clear, however, home building is a lumpy business and the Company is tackling ambitious plans. There will definitely be bumps in the road along the way, and in fact, their last quarterly earnings were a disappointment, and the stock was punished.

However, for patient investors like LWC, this is a blessing. Short-term stock price weakness just means that the buyback will create even more value over time. It also doesn't hurt that insiders and activists have been recent buyers on the weakness. Over time, the company will execute, the float will shrink, and the market will likely realize that a pure-play asset-light homebuilder that steers its excess cash into shrinking the float similar to NVR deserves a higher multiple than it did historically. If that comes to pass, this is a business that we could own for decades while enjoying multi-bagger returns. But the most important part is that given visibility on near and intermediate-term buybacks tied to the runoff of the asset-intensive business, any near-term share price weakness is just longer-term value creation.

Matt, what are some of the first things you do when researching a potential investment? What does that first hour of research look like for you? Do you do anything that few others do?

The goal is always to get to "no" as quickly as possible. My process is centered around four key questions that I attempt to answer before I ever think about price or value. The questions are:

1) Is this a good business?

This is an intentionally broad question, and can include anything from quantitative metrics like ROIC to bigger picture questions like if the business is likely to look reasonably similar in 10 years. It is definitely possible to buy crappy businesses and make money when they become slightly less crappy, but I am more looking for businesses that I could hold onto if the market theoretically closed for 5 years. They don't have to be great, but they have to be good enough to sleep well at night, and they should be increasing their intrinsic value over time.

2) Who are we partnered with?

Skin in the game matters, especially in small cap companies. I like to see some combination of a management, board, or activist shareholders with large investments in the company. These people should be up at night worrying, so that I don't have to.

If they are incentivized to maximize value, the odds of success go up vs. investing with a team or board that are just their to collect paychecks.

3) How does the business perform through a cycle?

I want to understand how the business will do during a difficult period, which will inevitably happen eventually. I am looking for some combination of a rock solid balance sheet, defensive revenues, an ability to take share during a down turn due to some structural advantage, a management team with a history of intelligent capital allocation during a downturn, etc. Just something to suggest that when a difficult period comes, the company can get stronger. Again, this just increases the odds of success, and reduces the odds that the investment has to be timed perfectly to be successful.

4) Why is the stock cheap?

As mentioned earlier, I want to understand why I might be so lucky to find an incredible bargain. This is really a non-quantitative margin of safety. If you can understand why the seller is selling, or in the best case if you are buying from a forced seller, then you are tilting the odds of future success heavily in your favor. By definition, a forced seller is acting irrationally, and with time, rationality will return, which puts the odds of success in our favor.

In the early stages of any new idea, I spend a few minutes on each of the above questions. That typically means glancing at the 10K, the proxy, and whatever conference call took place closest to whenever the stock chart turned south to see what issue the market was concerned with at that time. I'll also look at the recent investor decks and press releases to see if there have been any events in the not-too-distant past that might indicate that the future will look different than the past. I'd say that 90% of anything I look at is dead in the first 5 minutes based on the above questions, and very few make it past the first hour. If I'm still going at that point, then I am really looking for more nuance around the above questions, which includes a longer financial history and how margins have evolved over time, looking at competitors and industry

structure, talking to ex-employees, competitors, consultants, management, and really anyone else who might have something to say.

All of those are important, but I really think how I spend the first hour or so is what helps separate me from others. There is a view in small-cap land that it is possible to know the companies better than anyone else. That is true to some small extent, but I spend less of my time trying to understand every SKU that a company sells, and more of my time trying to find opportunities where you don't have to understand every SKU to do well. I am looking to identify investment opportunities that can be drilled down to one or maybe two major variables that will drive the outcome of the investment. This is in line with Greenblatt's advice to take a view from 40,000 feet to see what is really going to matter. If I can identify one major variable that is really going to drive the outcome, then understanding the elements that are going to affect that one variable is more important than understanding the nitty-gritty of every last detail of the company. It is very much a case of not missing the forest for the trees. In the best cases, that one variable lies in the hands of human beings with well-defined incentives, such as the "good co – bad co" example above. All of the SKU level analysis in the world is not going to be as important to the outcome as if a well-incentivized management team decides to simply shut down the bad co., which will effectively double earnings.

What would you like Laughing Water Capital to look like 10 years from now?

I am competitive, so it all comes back to my track record. I want to continue to do everything I can from a structural standpoint to put the odds of success heavily in our favor. That means staying boutique, which may mean returning capital at some point, although we are still small enough that we are not at that point.

Matt, thank you for the great interview! What is the best way for readers to follow or connect with you?

Edwin, thank you so much for having me on Sunday's Idea Brunch. Interested readers can visit laughingwatercapital.com, follow me on Twitter @LaughingH20Cap, or email me directly at msweeney@laughingwatercapital.com

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