

July, 2020

Dear partners,

Laughing Water Capital (“LWC”) returned 29.5% in the 2nd quarter after all fees and expenses, versus 20.5% and 25.4% for the SP500TR and R2000TR respectively. Year to date LWC has returned 3.6% net to investors, versus –3.1% and –13.0% for the SP500TR and R2000TR respectively. Individual results may vary, so please reference your personal statement. Additionally, please remember that as always, the indexes are provided only for long term comparisons as the most easily accessible investment alternatives. Simply stated, we don’t own the indexes, and thus we should not be surprised if our performance varies widely over shorter periods of time, sometimes to our benefit, and sometimes to our detriment. Despite this short-term volatility, over longer periods of time the performance of the individual businesses that we own will drive the performance of their stock prices, which will drive the performance of our portfolio.

To say that we are living in – and investing in – strange times would be an understatement. To borrow a line that Charlie Munger uttered at the 2014 Berkshire meeting, “if you think you understand, you’re not paying attention.”

I could spend pages recapping uncertainties and possible implications of: COVID19, racism and societal upheaval, trade wars, Fed policy, and the risk of inflation/deflation to name a few of the obvious risks. However, that would mostly be a waste of ink. Rest assured, I have opinions (that are expressed through our portfolio), but so do many Nobel Prize winning economists, sociologists, epidemiologists and politicians... and those opinions are often at odds with each other. The difference is that I am aware that my opinions are mostly irrelevant.

In my view, what is more important than my opinions is understanding that there is always something to worry about. That being said, it certainly feels like there is more to worry about than usual at the moment. Despite this, the vast majority of Americans are doing their best to stay healthy and just go on living their lives as best they can. Unfortunately, focusing on these people does not drive the clicks, views, likes and follows on which the modern media depends, so we are generally inundated by stories that highlight the worst elements of behavior of small subsets of our population.

History has proven time and time again that ultimately it is the vast majority who are just trying to do their best who will win, regardless of the scary headlines of the day. For this reason, almost the entirety of my and my family’s wealth remain invested in our strategy, and we increased our exposure in the 2nd quarter. I have no idea if we picked the bottom – I can think of plenty of reasons why the market might be lower next month, next quarter, or next year. But, while performance is never guaranteed, I would be astonished if our portfolio wasn’t worth significantly more looking out several years from today. Our interests are aligned.

Top 5 Positions

Historically it has been my practice to provide some sort of general portfolio commentary prior to discussing our largest investments. However, now more than ever I believe we will be best served by simply understanding what we own and why we own it, so I am going to jump right in.

Aimia Inc (AIM.TO) – Aimia has been a serious drag on our performance for some time now, yet I have added to the position because my estimate of the intrinsic value of the company has continued to grow. Most notably, in April a long and painful activist battle finally came to a close as control of the company shifted to a new management team and a new board of directors. While there is still more to be done, in the few short months they have been in control, the new team has been moving at a blistering pace to transform Aimia from a loyalty company whose board and management had zero economic incentive to do anything other than allow the company to flounder, to a holding company managed by a group whose ~25% and growing ownership of the company strongly incentivizes them to create value for the benefit of all shareholders. Most notably, the new team has:

- Cut corporate costs by nearly 50%
- Moved Aimia’s loyalty assets off balance sheet by joining forces with loyalty peer Kognitiv at a valuation that equates to about C\$1.80 per Aimia share. There has been limited disclosure around Kognitiv to date which suggests a grain of salt when considering the valuation, but at a bare minimum, partnering with Kognitiv removes a cash burner from Aimia’s balance sheet. More optimistically, it seems likely that in the quarters to come disclosure will increase, likely with significant synergy estimates front and center, which should help the market more fully understand the value of this asset. It is also worth noting that Air Canada unsuccessfully attempted and failed to block this transaction, which perhaps illustrates the value that others see in this merged asset.
- Put a floor of \$400M (~C\$5.60 per share) under the valuation of Aimia’s ~49% ownership of PLM, AeroMexico’s loyalty program, by giving AeroMexico an option to buyout Aimia’s stake at 7.5x EBITDA and extending the relationship until 2050. \$400M is more than 100% higher than AeroMexico had offered to pay Aimia’s old management team for this asset, which I think by itself is indicative of the improvement in Aimia’s C-suite. However, while the near term is murky in anything travel related, it seems likely that the \$400M floor drastically under-represents the true value of this asset, as now that AeroMexico has an option to buy they are incentivized to build out the asset without simultaneously pricing themselves out of the market. Ultimately, I think that at some point in the next several years PLM will be worth multiples of Aimia’s current stock price.
- Laid the groundwork for a dividend recap at PLM, which will allow Aimia to pull somewhere around \$150M (~\$C2.00 per share) out of PLM and onto Aimia’s balance sheet
- Joined a consortium that includes Jack Ma and JC Decaux that is taking control of Clear Media, a leading player in Chinese Out-Of-Home advertising. As you may recall, LWC formerly owned shares in Clear Media, and I detailed the investment thesis in a [slide deck](#) earlier this year. The short version is, I thought the value of this business could double or triple in the coming years before one of China’s leading entrepreneurs and the largest global OOH advertising firm got involved. My confidence has only increased, and in a few years Aimia’s Clear Media investment could be worth more than \$C2.00 a share.
- Purchased the asset management business of Aimia’s largest shareholder. The related party nature of this transaction has made some shareholders suspicious, but from my perspective asset management is a great business, and much of the purchase price is contingent on Aimia’s stock more than doubling to \$C6.00/share. I suspect that if the stock doubles, no one will complain.

- Began repurchasing shares at prices that reward long term shareholders, rather than at prices that reward exiting shareholders, as was the case with the prior management team
- Established sell side research coverage from a U.S. based bank (Price Target: C\$9.50), which is likely the first of several, which will help raise investor awareness that much has changed at this underfollowed Canadian company

To be clear, there are some challenges in front of Aimia, not least of which is that AeroMexico recently declared bankruptcy. This is a somewhat shocking headline and there is clearly some uncertainty here, however, there are multiple historical examples that illustrate the value of loyalty programs to airlines, and that loyalty can continue to thrive through an airline restructuring. The fact that Aimia stock traded up on the news of AeroMexico's bankruptcy suggests we are not alone in this view. Longer term, I am of the view that Mexico will ultimately be a big winner from COVID as U.S. companies consider bringing Asian supply chains back to North America. This would clearly be a boon for Mexican air travel. Moving away from PLM, Aimia still has about two thirds of its market cap in cash, **the value of which would only increase if the economy weakens.**

API Group (APG) – API joined the portfolio as a mid-sized special situation with the potential to be a long-term compounder earlier this year. The company is the product of a London based special purpose acquisition company (SPAC) put together by Martin Franklin, who has an impressive track record of building businesses, most notably at Jarden (JAH) which enjoyed a 30% CAGR for 15 years under Franklin's watch. Recent volatility allowed us to purchase shares at a notable discount to the price at which Franklin and his related entities invested more than \$100M of their own money. Further, we were able to buy our stock prior to the company up-listing to the New York Stock Exchange and benefitting from index inclusion, which led to rapid appreciation and a move into our top 5. APG is a holding company with multiple specialty contracting businesses under its umbrella. Most notably, APG is the largest provider of fire safety systems in the U.S., with a focus on service, which is mandated by law. Regardless of whether there is a recession, building owners must maintain the fire safety systems in their buildings, which provides **defensive cash flows** in an industry that can otherwise be cyclical. Thus far the analyst community has been content to let the tail wag the dog in their discussion of APG, but as Franklin begins to run his playbook and free cash flow moves higher, the fact that APG is a better business than peers, yet much cheaper than peers, should become apparent, which should drive shares considerably higher.

Benefytt Technologies Inc. (BFYT) – A discussion of BFYT is moot at this point because after the end of the quarter and prior to the completion of this letter the company was acquired. The short version is that BFYT fit our criteria well in that it was a **recession proof business** with clear reasons to explain why we might be so lucky to purchase it cheaply. We wound up making a bit more than 50% on this large position in a few months, and these gains are not represented in the YTD numbers referenced above. I am not thrilled with the takeout price and would have been happy to hold on for the next few years, but a quick win like this is better than a stick in the eye.

PAR Technology Corp. (PAR) – PAR was introduced in our YE'19 letter. As stated previously, there are a few moving parts here, but the bulk of the value is in the company's cloud-based Point of Sale (POS) system, which to date primarily serves fast casual and quick serve restaurants. While overall COVID has been disastrous for restaurants, it seems likely that independents will be the big losers, while larger, more established chain brands will take market share going forward, which benefits PAR. Importantly, fast casual and quick serve are **recession resilient** as consumers tend to trade down during difficult times.

Further, operating through COVID has highlighted the value that PAR's offering brings to the table as restaurants have been forced to adjust their operating model on the fly, which is not possible, or is at least much more difficult, if one is using an antiquated POS system. Additionally, CEO Savneet Singh has made it clear that he plans to increase ARPU by expanding functionality, which is likely to include M&A. Given the company's strong balance sheet and the broadly stressed environment, it seems likely that M&A plans will be accelerated as less mature industry participants are ill equipped to survive this difficult period.

Undisclosed – I am still actively purchasing shares in the newest member of our top 5, and will comment on this business in the future. For now, rest assured that this company scores well in terms of being a good business with a properly incentivized management team, and it serves recession resistant end markets. Additionally, I consider this business to be a potential compounder at a special situation price, and expect near term catalysts to quickly re-rate shares higher before setting the company up for a long runway of operating leverage and growth.

Also Worth Mentioning

Avid Bioservices (CDMO) – Avid, our large molecule contract drug manufacturer, is back on track after a temporary problem with an equipment malfunction which was reported last quarter. This is a **recession proof** business that recently announced a new CEO, an expanded salesforce, and a record backlog. Perhaps more interesting, the company announced they are in the early stages of expanding their manufacturing footprint to meet increasing demand. This is especially notable as they are presently under-utilizing their existing footprint. Disclosure around Avid's clients is mostly confidential, but with a little sleuthing, one can determine that their clients have big plans, and Avid should be a natural beneficiary in the years to come. Importantly, this is not a business where supply from new competition can quickly come online, because a long-term regulatory track record cannot be built overnight.

Iteris Inc. (ITI) – Iteris took the long, long, long overdue step of exiting their cash burning venture stage Agriculture business during the quarter. From here, the company should be a cash flow positive pure play intelligent traffic control business. Importantly, the company has indicated that its current operating structure can support \$200M in revenue, meaning that the next ~100M should come with significant operating leverage. Management has indicated – and industry trends confirm – that they expect double digit organic growth going forward, and that the mix should be increasingly software centric. These factors suggest operating leverage at the segment level and at the corporate level, which should drive significant free cash flows. Further leverage is likely to present itself in the form of bolt on M&A. Importantly, with some gentle prodding, the company has begun to upgrade the quality of its board. Shareholders are becoming impatient, and if management cannot produce the long promised operating leverage in the near future, as fiduciaries the board should feel obligated to maximize equity value by realizing the strategic value of the assets through a sale.

Opportunistic Buys

The March sell off gave us an opportunity to quickly purchase shares in companies that had been on my watchlist for long periods of time at unusually low prices. Most notable of these are Camping World

Holdings (CWH) and Lamar Advertising (LAMR). These companies are similar in that while they have cyclical elements, they have absolutely dominant competitive positions, management teams with significant skin in the game, and a history of taking share during difficult periods. These stocks and others that we purchased quickly rebounded from the March lows, and I was left wishing I had purchased more as I reduced or exited the positions.

I also purchased small, or even very small positions in several companies that have the potential for multi-bagger returns assuming that the world returns to normal at some point. As with nearly all of our investments, each of these stocks is defined by a strong brand and a properly incentivized management team, but the range of potential outcomes is significantly wider than typical for our investments, which is why the position sizes are smaller than I typically like.

The net effect of these more opportunistic investments is that our portfolio is presently less top heavy than usual, and the bottom portion of our portfolio will be especially volatile on any COVID related headlines.

Pessimism, Optimism, and the World Around US

In the near 5 years since inception, LWC has compounded at ~17.1%, crushing our most relevant benchmark, the R2000TR, which has compounded at ~10.5% over this period. We have also handily outpaced the SP500TR, which has compounded at ~14.4% over this period. Where we have fallen short however has been our performance vs. the mega-cap stocks – especially FAANGM - and sexy SAAS stocks with nosebleed valuations. This is especially true over the last two years.

These highflyers have been outperforming to such a degree that they are effectively eating the indexes: the top 5 stocks in the SP500 now make up ~23% of its total market cap, while the bottom 350 stocks represent ~21% of the market cap. The impact of this can be illustrated by considering the performance of the equal weight SP500TR, which is designed to not allow any one stock or group of stocks to dominate its constituency. Since our inception, this index has compounded at ~11.4%, or a full 3% lower per year than SP500TR. These might seem like small differences today, and of course the past says nothing about the future, but over longer periods of time, small differences compound to astounding levels:

	R2000TR	SP500EWTR	SP500TR	LWC ¹
Year 0	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
CAGR	10.5%	11.4%	14.4%	17.1%
Year 30	\$20,093,203	\$25,415,851	\$56,347,910	\$112,991,020

To be clear, the past is completely irrelevant; it is the next 5 years that matters at this point, so we must continuously update our views of the world around us.

There are many factors that have contributed to this bifurcation of the market, not least of which is the fact that many of these mega cap stocks are truly fantastic businesses. Other factors to consider are the

¹ Past performance is not suggestive of future performance, and future performance cannot be guaranteed or estimated

role that indexes play in driving fund flows, low interest rates benefitting cash flows that only exist in the distant future, and recessionary fears weighing particularly heavily on small caps starting in the summer of 2018, which is when the R2000 index last reached its all-time high.

I will always invest from the bottom up, but I would be remiss if I did not notice that many of these factors have only been exacerbated by recent events. Most notably, the economic shutdown caused by COVID has led to the Fed bringing out a bazooka to avoid a full-blown recession scenario, and it seems likely that we will remain in a low interest environment for at least the near term. This is particularly frustrating for our portfolio on two levels.

First, I prefer to run a conservative portfolio in that much of my time is spent trying to ensure that our portfolio is primarily comprised of companies that should thrive during recessionary periods. Simply stated, owning defensive businesses can be a drag on performance until they have an opportunity to show their stripes, but the Fed is in zebra hunting mode. My investment philosophy is rooted in the idea that the real economy matters. There has been scant evidence to support this notion in the recent past.

Second, very low interest rates increase the value of cash flows in the very distant future. This is just math, it is impossible to argue with, and for truly wonderful businesses with sustainable competitive advantages you can pay a very high price today and still realize satisfactory investment results over time. This has led to some of the fastest growing stocks being the best performing stocks in recent years. However, the problem with depending on cash flows far in the future is that if the future does not develop as envisioned, you are likely to be disappointed. In my view, in many cases investors today are mistaking first mover advantages with sustainable competitive advantages. I am loathe to make this mistake.

It may be tempting to just jump on the band wagon at this point, abandon discipline, and just own what has worked so well for so many for what feels like so long. Yet, recent sell side research pieces have noted that the out performance of large cap growth stocks in recent months is in the 99.5th percentile vs. history, and that hedge fund crowding is at all time high levels, indicating that our more contrarian strategy is very out of favor. Ignoring business performance during the difficult part of the cycle and paying up for growth has worked well in the recent past, but “so far so good,” is not an effective long-term investment strategy, and it is not possible for the most crowded trade to go on working indefinitely. At some point, future returns will get competed away, and history is replete with fantastic businesses whose future returns were disappointing due to an excess of popularity.

To be clear, there is no sense in being contrarian just for contrarianism’s sake, but combining contrarianism with a good business led by incentivized people that are simply dealing with some sort of temporary optical, operational, or structural problem is a formula that will always work over time. With our investments, I am typically very optimistic about the ability of our management partners to improve our businesses because the bar to improvement is often comically low. Very often, the key to success can be drilled down to the level of “just stop being dumb.” For example, with Aimia, PAR, and our undisclosed position, these businesses were formerly being managed by people who were almost literally lighting money on fire. Thus, simply extinguishing the flame should lead to an acceptable outcome over time. The simplicity of this approach allows us to take a cautiously pessimistic view of the external forces that will impact our businesses, and still profit.

In recent years, success in many of the top performing stocks has largely looked like the exact opposite of this approach. Paying very high prices from day 1 requires extreme optimism that everything in the future

will go as planned. Thus far the market has made all speculators in this arena look like geniuses, which has led to a rampant outbreak of what poker star/behavioral psychologist Annie Duke calls “resulting,” or believing that because the outcome has been positive, the process was correct. I remain convinced that for us, the best approach is to stick with the process that has served us well over the last 5 years, even if insisting on being disciplined on price acts as a headwind.

Short Book

Over the last ~2 years a large portion of our short book has been dedicated to the idea that being short high yield ETFs represented asymmetric risk reward because with rates at record lows, spreads at record highs, and defaults at record lows, it was difficult to imagine a scenario where HY would scream higher. At the same time, any weakening of the economy could blow out spreads and increase defaults, leading to weakness. The machinations of the ETF structure would then force portfolio managers to sell their best credits, reducing the quality of the overall portfolio, which would then have the effect of making the portfolio less attractive, and lead to more selling. However, what made perfect sense intuitively was blown out of the water when the Fed announced they would be buying bond ETFs, and I closed the position, just as I was hoping that it would really begin to work.

We remain short a number of companies whose business models were suspect before COVID, and whose business models are likely destroyed in a COVID world.

Partners’ Meeting

I had been planning to once again host a meeting for LPs in the fall, but given virus concerns etcetera, I have not yet tried to formalize any details. Please stay tuned.

Looking Forward

As always, I have no idea what will happen in the near term. Neither do any of the epidemiologists or economists who litter the world with their opinions. What seems clear however is that there is a massive disconnect between the stock market and the real economy. Of particular concern to me are the ideas that:

- Taxes will be going up, which will reduce after cash tax flow available to businesses, and tighten consumer’s belts
- Nearly every company in the world – certainly every old economy company – will likely need to strengthen their balance sheet at some point, which will likely mean reductions to capex and R&D
 - One company’s capex is another company’s revenue
 - Lowering R&D lowers future earnings power
- Global supply chains are likely to be unwound to some extent, which will reduce margins
- Inventories will be bulked up, which will reduce ROEs

- If we now know that working remotely is a viable option for most people, why would non-client facing middle and back office jobs across America not migrate overseas to lower cost locales, resulting in a wave of white collar layoffs?

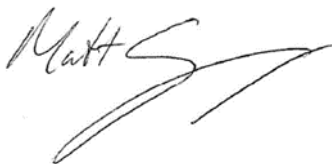
Thus far, paying attention to any of these real economy factors has been a drag on performance, as the only thing that has mattered is faith in Fed stimulus. It is not clear to me that putting all of one's egg in the Fed's basket is a wise strategy. At the same time, none of the fears I listed above are new, original, or otherwise unknown, and each of them is largely reflective of first level thinking. Taking each of them further down the logic trail suggests that they may not be as concerning as they first sound. For example, the market has been fueled by large tech companies who don't pay much in taxes as it is, re-shoring supply chains could lead to an increase in good jobs, and the offshoring of white collar jobs would be good for margins, although obviously bad for consumer spending... which would be good for Fed stimulus, which would be good for stocks until... it isn't. The circle goes round and round, where it stops, nobody knows.

Other areas of concern are what seems like clear speculative behavior by market participants, in particular:

- record levels of small ticket option trading, suggesting retail speculation,
- bankrupt companies like HTZ being among the top performing stocks,
- story stocks with no attachment to reality reaching new highs every day on no news
- innovative business models receiving outrageous multiples before there is any hint of long-term viability of the model.

There is no way to know how or when these factors will play out, and it is impossible to guarantee that our portfolio will be immune to them day to day, week to week, and month to month. Yet, I still think they should be acknowledged, and our portfolio remains defensively positioned. To the extent possible, the businesses we own are largely isolated from these factors, and/or already pricing in bad outcomes. As such, and as always, I believe our best path forward is to simply follow our process by partnering with good businesses, led by good people, that should do well during difficult periods, when they are on sale for understandable reasons, while simultaneously remaining skeptical of the world around us. History has shown that when the market is bifurcated to the extent that it is today, investors who are willing to stick to their discipline around valuations will ultimately be rewarded. I see no reason why this time should be different, although I cannot predict when the reward will come.

Please let me know if you have any questions,



Matthew Sweeney, CFA
MSweeney@LaughingWaterCapital.Com

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 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, which are subject to change and which Laughing Water Capital LP does 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.