September 25, 2019

2019 Limited Partner Meeting
Commentary By Matthew Sweeney, Managing Partner
Transcript Edited For Clarity

SLIDE 0

Everyone, lets get started. Maybe take a minute to grab a drink or some more food, but lets start to take seats. First, I want to thank everyone for coming today, and more than that, thank everyone for investing in Laughing Water Capital. I am going to go through some slides quickly that cover the competitive advantages we have as a partnership, which will include some demographic information, as well as some commentary on the environment we are in. Then I am going to talk a bit about our process, and an overview of how our largest investments fit within our framework. Last, we are going to talk about some of the challenges we have faced, including some mistakes I have made, and some bad outcomes that we are dealing with, that I think will ultimately prove to be transitory. Then we will have some time for Q&A.

SLIDE 1

Here is just some boiler plate, that we can breeze by.

SLIDE 2

OK - As you all know, our partnership is non-traditional and has been specifically designed to give us every possible competitive advantage in the investment world in pursuit of long term out-performance. You can see on the screen here what I think the most important advantages are, both structural, or the way our partnership has been designed, and then behavioral. And I am going to spend a few minutes going through these advantages, but it is not an accident that the first item listed is having high quality Limited Partners, so thank you again to all of you.

SLIDE 3

Earlier in my career I worked on the sell side as an institutional broker, which meant I had the opportunity to have regular conversations with dozens of fund managers. For years I knew that my ultimate goal was to manage a partnership like Laughing Water Capital, so for years I picked the brains of these fund managers asking what they thought was most important for long term success, what they thought they could have done better, and what they would change if they could. Without a doubt the best advantage an investment partnership can have is a high-quality LP base. And that is because successful investing requires behavior that is outside of the norm. if you want to have differentiated results, you have to behave differently, and that is very hard for most people. Namely, understanding that the price that the market puts on a stock is completely different than the value of the business that is behind that stock, and that quite frequently and for all kinds of reasons, the stock market does strange things, and if you are prepared to take advantage of those things, you can do quite well. So, for that reason, I have been very selective in who I have accepted as limited partners, because I am not willing to compromise on only accepting partners who have a strong understanding of what we do, and how our partnership differs from what the masses do.

You can see on the screen here the different buckets that our LPs fit into, and the idea is that each of these cohorts really understands our strategy. The largest group is other professional investors, who despite being professional investors themselves, have made an allocation to Laughing Water Capital. They have done this for a number of reasons. We have quite a few private equity professionals who clearly understand that value is different from price, and are attracted to our strategy and public equities because they realize that in private markets the seller of a business is typically the smartest person in the room, but in public markets, the seller is sometimes making a poor decision due to structural constraints, or emotional reasons.

We have a number of other current or former public equity fund managers who either have too much money to invest in the same style as we do, or work at larger institutional investment managers where the bureaucracy is an impediment to maximizing returns. What I mean by that is that in order to buy truly cheap securities, you often have to buy during a period of difficulty or controversy, and it is hard for a bureaucracy to make decisions in those cases because uncertainty makes achieving consensus a challenge. The point is however that these are people who spent their careers taking note of the difference between price and value, and recognizing that volatility is far different than risk.

The next group up is entrepreneurs, which includes a number of people who have run family businesses, or are serial entrepreneurs etcetera. And again, the idea is that if you have built a business or run a business, you have an idea of what your business is worth, and it is unlikely that you think the value of your business swings around by 20, 30, 40, or 50% a year the way that stock prices swing around every year based on every other silly headline. And this is true for the next group as well, which is those people who were formerly C suite executives. These people may not have owned the businesses they were running, but they certainly understand that the value of the businesses they were running did not swing around violently every year, despite what the stock market might say. And the last group is skilled professionals, but importantly this group is not your typical retail investor. These are not mid-western housewives or anything like that. Each of these people is well versed in the investment classics and passionate about investing, and in fact most of them could probably be professional investors if they weren't doing what they are doing now, which ranges from Doctors, to software engineers, and other similar skilled professions. But again, the point is that each of our LPs fully understands that volatility is different than risk, and that if you go around spending all your time worrying about what the stock market is doing, then you are going to have a hard time generating market beating returns over the long haul, and that is a huge advantage for us.

SLIDE 4

On to the next slide here, I just want to talk about the importance of properly aligned interests. This always amazes me, but there have been studies done that reveal that fewer than 50% of mutual fund managers have even a single dollar invested in their own fund. How confident are they if they put zero dollars to work? There is a ton of evidence to suggest that in all aspects of life, not just investing, people perform better when they are properly incentivized. So, for me, as you can see here on the slide, 24% of

AUM comes from my friends and family circle which includes my immediate family, my parents, childhood friends, former teammates, and former co-workers. And perhaps more importantly, I don't have this on the slide, but for my wife and I, just about everything we have is invested in this strategy, with the only exceptions being a small rainy day fund, my wife's 401k which is not eligible, and a 529 plan for my children which is also not eligible. But the point is that I don't want to disappoint my friends and family, and that I am all in on this strategy because I am confident that over time it is possible to produce outsized returns and that even outperforming the markets by a small amount every year over longer periods of time really makes a huge difference in the ultimate outcome. So, I know I write this in every letter I write, but our interests are truly aligned.

SLIDE 5

Next, I touched on this a bit before when talking about how important the right LPs are for our collective success, and this just illustrates how almost all of our partners have made a multi-year commitment to our strategy. And this is something I have been thinking about a lot lately, because earlier this year when I went to Omaha for the Berkshire Hathaway meeting I spoke with a bunch of different fund managers who commented on how they have been struggling because they live in fear that if they have a bad month or a bad quarter, their investors might redeem. And quite frankly, that is just completely insane. There is an enormous amount of evidence that suggests having a long term view in the stock market is the key to success, but most people are not wired that way, and most funds aren't able to think that way. It is just much much easier to find an investment where you can look at it and say, "I have no idea what it will do over the next month or the next quarter or the next year, but I am highly confident that within 3-5 years it will double in price" than it is to find an investment where you are confident that it will go up over the next month or the next quarter. And that is just because the market can do anything it wants over short periods of time. And we'll talk a little bit more about some of the things the market has done recently, and some of the things that have happened with the some of the stocks that we own, but the point is that the longer your horizon is, the less the market matters, and the more the fundamentals of the business and the motivations of our management partners matter, and it is just much better to bet on good businesses and incentivized managers than it is too bet on the madness of crowds in the stock market month to month.

SLIDE 6

Next – it is just a huge competitive advantage to stay small, and of course, we are not reinventing the wheel here. I borrowed this table from one of our LPs Scott Miller who is in the room here - You can see on the screen there a young Warren Buffett, and now that he is constrained to only buying multi-billion dollar companies people forget that he started out small – in fact, very very small and in most cases here much smaller than the typical name we invest in. And the reason is simple – there is just less competition in the shallow end of the pool. Now, to be clear, when you are investing in smaller names over shorter periods of time they can be volatile – over shorter periods of time liquidity often affects a stock more than the fundamentals. But it is essential to understand that volatility is different than risk. Think of it this way – it is a fact that there is less competition in smaller names. It fails the common sense test to think that a less competitive arena can be riskier. But this ties back to what I started with, which is a high quality LP base – those that can keep true to the idea that price and value are different – can stomach the volatility and invest in smaller names and embrace lumpier but higher returns rather than smoother but lower returns.

SLIDE 7

On to the next slide – shifting more toward behavioral advantages rather than structural advantages, even though the high quality of our LPs encompasses behavioral advantages as well as structural. This slide is just to show our top 10 positions, although I have been selling one of them so the accuracy of this slide has a short shelf life, and to note that quite often our top 10 positions represent 75-85% of our capital. And first, just mathematically, the benefits of diversification break down very quickly. And an easy way to think of it is that if you have a 1 stock portfolio but then move to a 2 stock portfolio, you cut your concentration risk in half. But if you have a 10 stock portfolio and move to an 11 stock portfolio you are only cutting your concentration risk by 9%. And basically, while there is an element of randomness to investing that makes it such that what you think is your 3rd or 4th best idea may turn out to actually be your best idea, it is pretty unlikely that your 25th or 30th best idea will actually turn out to be your best idea, so holding a more diversified portfolio doesn't make much sense, as long as you have the high quality investor base that understands this, and is comfortable with this. And for me, keeping a more concentrated portfolio serves to just raise the bar for inclusion in the portfolio to the point that the standard for inclusion is that the opportunity really just has to defy reason. It really just has to make no sense. It is never a case of "this looks pretty interesting and pretty cheap, I think I am going to buy some." Rather, it is always a case of, "this seems just crazy. There is no way this valuation can hold over the next 2, 3 or 5 years if the properly incentivized people just look after their own best interest." So that's the standard for our portfolio, although perhaps Buffett said it better when he said diversification just doesn't make sense if you know what you are doing.

SLIDE 8

On the next slide – the next few slides actually – I just want to talk about the importance of disregarding the indexes. Over shorter periods of time there is no reason to think that our portfolio will behave similarly to the indexes because we don't own the indexes. We presently have zero stocks that are in the SP500 and only a handful that are in the Russell 2000. We are looking for truly anomalous opportunities, and over time whether they work or don't work is going to have nothing to do with the indexes. And as I said previously, the bar to buy something is that it really doesn't appear to make any sense how cheap it is, but I also have no idea what is going to happen in the short term. And being able to ignore what everyone else is doing in the short term is a huge advantage.

For us the idea is really to own a basket of anomalous business opportunities that over time are going to work out based on their own merits. But for us, very few of the stocks in our basket are actually in the indexes, so to think that they will track the indexes over short periods of time would be a little silly - and sometimes that will be to our benefit, and sometimes it will be to our detriment, but over reasonable periods of time, the only thing that is going to matter will be the performance of the underlying business and the underlying management team. And a few slides ago we saw a young Warren Buffett and how he focused on smaller opportunities, and how when you are fishing in ponds with smaller fish, there is just less competition. And historically, most of the best investors have really generated their highest returns when they were investing in smaller stocks. And what we can see on the screen here is just the performance of the S&P 500, the Russell 2000 and the Russell Micro cap indexes over the last 2 years or so. And to be clear, there are a number of flaws with the idea of looking at the indexes for guidance – especially with the micro cap index – but the idea is just to illustrate that over the last 2 years, smaller cap stocks have really struggled vs. the bigger stocks – starting around late last summer. And to be clear once again, we are stock pickers, so what the indexes do doesn't really matter over time, but over shorter periods of time, when there is a clear bias against smaller stocks, there is less demand for smaller stocks, so even if our businesses are performing well or relatively well, if the demand isn't there, the stock prices will be facing a headwind. This is of course frustrating, but for the patient, the time to buy is when there is a headwind, because when the pendulum swings, that will be a tailwind.

SLIDE 9

Onto the next slide –we can see here that there has been a very clear bias toward the lowest volatility names over the last year or two. And again, we don't want to take a chart like this too seriously because there are all sorts of variables at play here not least of which would be interest rates, but the point is that key to our strategy is investing in situations where there is some near term uncertainty, which often expresses itself as beta, or daily volatility vs. the indexes. And what has been happening is that the most stable names – the low volatility names – have been massively outperforming the high beta – or the most volatile names. And from our perspective, what a stock does on any given day is completely irrelevant – the only things that are going to matter over time are how well the business performs, and how well our incentivized management teams perform. But from a market perspective, we have been facing a real headwind because the market has been praising certainty – or the perception of certainty - above all else, completely ignoring Buffett's observation that you pay a very high price in the stock market for a cheery consensus. And quite frankly, while it may not be fun day to day, week to week, month to month, or quarter to quarter, the reality is that over time the market rewards you for taking on some uncertainty. The key is being able to separate that uncertainty from risk, which is what I spend most of my time trying to do.

Slide 10

On to the next slide, this illustrates what all the talking heads and underperforming value managers have been crowing about for the last decade or so, which is that value has been underperforming growth. And again, from our perspective this is not really relevant because value vs growth is a false construct designed by those who need to stuff every investment strategy into a neat little style box and simply relying on value vs growth in this sense is entirely quantitative with no real regard for the qualitative nature of businesses. For us, most of our names don't fit neatly into either the value box or the growth box because in many cases they are not optically cheap enough on a GAAP basis to be considered value by traditional metrics like low P/E or low price to book, and they are not growing fast enough to be considered growthy, but we definitely tend toward investments where a pessimistic rather than optimistic scenario is baked into the price, and that puts us more in the value camp, and that has been a real headwind. Now, as I mentioned value has been underperforming for a decade, and there are a number of managers out there who have been lamenting this for a whole decade without acknowledging that there may be some good reasons for this underperformance. And to be honest, I spend very little time thinking about this sort of thing, but someone who does spend a lot of time thinking about this sort of thing, and who has the statistical tools at his disposal to think about this sort of thing very deeply is Cliff Asness, who runs AQR investments, which is one of the largest quantitative hedge funds on earth. And Cliff Asness recently said two things that I thought were relevant. The first is that "cheap stocks usually deserve to be cheap, but people over-extrapolate and they get too cheap. You're not buying better companies, you're buying worse companies at a better price." And that is something that I am very aware of as I consider investment decisions.

The next thing he said – and again this is in context of someone who has all the statistical tools in the world at his disposal – is looking back over the last decade where value has underperformed, "it does feel much more like 8 years of losses were about reality, and two years of losses were about things starting to get a little crazy." And what he means is that a decade ago the growth names like Google, or Facebook etcetera, may have looked expensive, but it turns out they really are great businesses and it really was worth paying up for them. But over the last 2 years it is no longer really about if those businesses that the market thinks are great are really that great, and more about that people have figured out that the market has had a real bias toward quality for much of the last decade, so if something smells like quality, it is worth buying because the market will just assume the quality is real and bid it up before the business model actually has to prove itself. So, to some extent it seems like recently the market has been more of a voting machine than a weighing machine. And from our perspective, this is just another headwind we have kind of been dealing with because while all of our businesses are good or have the potential to be good very shortly, very few of our businesses are truly great. Most of them are pretty boring. They are just slightly worse companies at much much better prices, but the market has not cared about those better prices over the last year or two, it has only cared about that slightly lower quality. And I don't have a real view on where we are in the cycle other than to say it seems likely we are closer to the end than the beginning, and its probably not a great time to be paying high multiples for businesses that have only proven themselves during a time of record low unemployment, and bull market conditions because I suspect a fair number of them will prove to not be very durable. In contrast, our businesses are pretty boring and durable, and don't require any heroic assumptions. But lately, the market has been rewarding the heroes and ignoring the borings.

SLIDE 11

And then the last slide here under this topic – and I apologize I just cut and pasted this one and had to resize it a bit so the font is a bit off, but this shows that the exposure of hedge funds as tracked by Russell and Hedge Fund Research to small cap value is near all time lows, really just showing that our strategy is out of favor at the moment. In fact, our strategy is about as popular now as it was in the depths of the financial crisis, which of course then led to a period of tremendous performance. Now, I have no idea if a period of tremendous performance is right around the corner or not, and while I certainly hope that it is, what is important from my perspective is that when a style and or asset class is already near record levels of unpopularity, statistically it is likely to get better not worse over any reasonable period of time.

So each of the charts on the last 4 slides are really just meant to show that we have been facing some headwinds, but I also want to stress that ultimately we have no control over which way the wind is blowing, so it would be foolish to spend much time thinking about it. Over longer periods of time the direction of the wind is much less important than the quality of the boat.

SLIDE 12

And to continue the analogy, here on slide 12 we're going to talk a bit about our boat, by which I really mean our process. And of course we all discussed this as the crux of our strategy before the time of your investment, and I reference these ideas frequently in our investor letters, but going back to the last 4 slides and the reason we really shouldn't take them too seriously, is that if I am able to stick to our process, we should do just find over time. And to just briefly say a few words about each of the key elements I spend my time thinking about when I consider a potential investment, the first part is if it is a good business. And this could certainly have quantitative elements such as returns on capital etcetera, but what I really think about here is just if you can take a business, close your eyes and imagine what it will look like in ten years, and come out thinking that the business will look reasonably similar because it has some sort of competitive advantage, or fits in some unique niche, or provides some unique service that is unlikely to go away.

Next, is to consider management – by which I might mean the C suite, or the Board of Directors, or large shareholders who exert outsized influence etcetera. And there is all sorts of academic research in this area, but you don't need an academic to tell you that when people have skin in the game, they tend to perform better, so we want to partner with people who have skin in the game.

Next, is to think about what happens when something goes wrong – and that could be something macro, or that could be something industry specific, or whatever. But the point is, I want some combination of defensive revenues, or a strong balance sheet, or low price producer status, or a history of repurchasing shares when they are cheap, or taking market share when the industry is weak etcetera. Basically, just some reason to believe that when things look bad in the near term, it could actually be an opportunity for the business to increase its long term position and value. And this is important because the idea that something is going to go wrong eventually is right up there with death and taxes.

Lastly is trying to understand why the opportunity exists. And the idea here – or really the framework that I use here – is to just assume that I am the dumbest person in the room. If we are buying a stock, someone else is selling it to us, and if they know more than us, that probably isn't a good thing. At the same time, if we can figure out that they are selling it for the wrong reason – in the best cases they will be non-economic reasons like they need tax losses, or they are facing redemptions, but maybe it is just because they are excessively short term focused or something like that and near term earnings are likely to disappoint – but if we can figure out that they are only selling the stock because they have to, or because they don't have the same advantages we have as a firm, that is a good place to start in terms of being a buyer and buying at an attractive price.

So in sum, all we are trying to do is find good businesses, with properly incentivized managers, that have some aspect that will allow them to perform well or even get better during difficult periods, while having a firm understanding of why we might be so fortunate to find such an opportunity. And all of that is before we even consider price, and we only buy if we think we are able to buy at a price much lower than what we think the business could ultimately be worth, and this is important because of course I will make mistakes, so I really like to bake in a margin of safety. And none of these factors exist in a vacuum, and there are always tradeoffs between them, but zooming out, if we can put together 10 or 15 investments where the underlying business is good, management is good, the business can perform well during periods of adversity, and we can understand why the market has it wrong, we are doing everything we can do to tilt the odds in our favor.

SLIDE 13

And sticking with that idea of putting the odds in our favor, on the next slide here I just want to mention the work of Annie Duke, who was in a PhD program in behavioral psychology before dropping out to become a professional poker player, and became one of the winningest female players of all time. I was fortunate in that Scott Miller who I mentioned earlier hosted an event last year where he brought together a number of investment managers with Annie Duke to talk about decision making. And the key take away was really just that whether it is poker or investing or life, we cannot control the outcomes of our decisions, only the process that puts us in the best possible position to achieve the best possible outcomes. So a quick example in the poker world is that if you are dealt crumby cards, but then size up your bet and wind up winning the hand, just because you won the hand that does not mean that your decision to size up your bet was the proper decision. Similarly, if you have a great hand, and you size up your bet but then lose because someone else had a better hand, that does not mean that sizing up your bet was a mistake. In both cases, the odds should dictate your behavior, and over enough iterations the outcome will be in line with the odds, but on any given hand, there is an element of randomness to the outcome which cannot be controlled for. So, all you can do is try to stack the odds in your favor, and then only act when you think the odds are in your favor, and over time if the odds are favorable you will do well, but there are certain to be some bumps in the road.

SLIDE 14

Moving to the next slide, we have just our ten largest positions, and then the 4 key elements of our process. And I want to avoid talking too much about any individual name, but you can see here that with a few exceptions, in my view the process is being appropriately applied, and on those areas that are yellow, or the one red, as I said earlier there are always tradeoffs, and in those cases there are other elements that are so powerful that in my view they counterbalance the weakness. So for example, with EZ Corp, I am generally suspicious of management, but this is our pawn shop business, and it is hard to think of a business that does better when something goes wrong with the economy than pawn. And with Aimia, I believe there is about to be a broad overhaul of management, and we paid only a fraction of what the assets are worth, so I was able to get comfortable despite some areas of weakness. And similarly for Flotek, it is not the greatest business in the world, but the price we paid was extraordinarily low – although it did get lower – which we will talk more about in a few minutes. I also want to talk a little bit about What Happens When Something Goes Wrong – because that is something that I feel like the market as a whole has been disregarding lately. There are a lot of high-flying stocks out there with questionable business models that rely on the capital markets for success that are unlikely to fare well when the economy hits a speed bump. In contrast, looking at our portfolio with one exception our businesses are well positioned to deal with any kind of economic slowdown. That does not automatically mean the stock prices will do well – it only means that these businesses should continue to get stronger even if the economy slows down. For example – Aimia and Flotek are essentially cash shells. A dollar is worth more than a dollar in an economic downturn. Avid Bio and Recro Pharma – they manufacture pharmaceuticals – people don't stop needing medicine when the economy slows. Iteris – our traffic management business has mostly long term contracts, and traffic is not a problem that is going away.

SLIDE 15

On the next slide – just moving to the valuation piece – there are of course a number of ways to think about valuation, and none of them are perfect, so I want to be able to think about valuation across a number of paradigms, which ties into wanting to have multiple ways to win when making an investment. And the main thing to remember here is that what this slide demonstrates is that I really think the market is out of touch with what is really going on with our investments beneath the surface. And from left to right here we have what is typically the most stable anchor of value, moving toward measures of value that are decreasingly reliable, although still important.

And you can see that in more than a few cases these investments are cheap just on their asset value as it would be seen by a rational business person, not someone who is just looking at GAAP financials, and in almost all cases they are cheap based on normalized cash flow, although none of them are realizing their true cash flow potential today. And that is precisely the point. If you are buying something when it is hitting on all cylinders, you are likely to be paying a higher price vs. if you are buying something when its true potential is not immediately apparent. And then other things to think about, although perhaps less relevant, is how these businesses are priced vs. what an informed buyer would pay, vs. what similar businesses trade for, and how these businesses had been valued in the past.

SLIDE 16

And then on the next slide, this touches on something that I didn't include in the pictogram of our process but is still essential, and that is patience. We are often intentionally buying things that are relatively undiscovered, and there is value in that discovery process. If our analysis is correct, then eventually the world will figure out what we see, and we will be rewarded by the market. But as you can see here, it is pretty rare for us to own things that appear cheap on first glance, and it is extremely rare for us to own something that is going to be clicking on all cylinders in the near term, although the long term future of our businesses should always be bright. And I am reminded of a quote by Joel Greenblatt, who is a professor at Columbia Business School. And every year, Greenblatt tells his students, "if you do good valuation work, the market will reward you. But I cannot tell you when" and that fits right into Buffett's commentary that "the stock market is a device for transferring money from the impatient to the patient."

SLIDE 17

That brings us to the next slide – what we see here is that since inception we have compounded at about 17 or 18% a year, but if you weren't here in year 1 or year 2, that is not very exciting for you because the last 2 years have not looked like the first 2 years. In fact over the last 2 years we have pretty much matched the Russell 2000. So why is that? The truth is it is impossible to say with any certainty.

But, there are some possible explanations, and in my view, the only thing that would really concern me would be if there was anything to suggest that I was improperly applying our stated process. And as we discussed earlier, the only thing we can do is try to stick to the process, and accept that over enough iterations we will be successful, but there will be some bumps in the road along the way. And as I tried to demonstrate with the heat maps, I am confident I am being faithful to our process.

Beyond that, we spent a few slides looking at market forces, but I will comment a bit more about that here. It has been frustrating because for the most part our businesses have been performing well over the last 2 years and increasing their intrinsic value, but in many cases the market has been slow to recognize the improvements. Part of the problem is just that smaller stocks are out of favor, which in many ways reflects recessionary fears. Part of the problem is about growth vs. value – which has really manifested itself in the idea that it is worth paying up for the perception of quality – for businesses that are believed to have huge potential, whereas I am reluctant to pay high prices for anything where the quality has not been proven because the price of failure is so high. And the last piece is that in my view the market has been excessively short term focused lately – even more so than usual – and several of our names have been punished because their near term future is very cloudy, even though their longer term future is bright.

A good example there which recently impacted our portfolio would be CDMO Avid Bioservices. They manufacture drugs, and are in the process of building out a second manufacturing facility. This is a very good business because the pharmaceutical company has to include their manufacturer in their FDA approval, so it is very hard for them to switch. So it makes sense to spend money to acquire customers, because once you have them, you pretty much have them for good. Almost like an annuity. And last quarter CDMO reported that revenue grew more than 20% year over year, and backlog grew more than 30% quarter over quarter, but they also reported that gross margin came down by 200 bps from 9% to 7%. And the stock sold off by about 30%. And the reason gross margin came down is because they are spending more money to bring on more customers, which will be very sticky. And they are guiding to $65M in revenue this year, and should be at $100M in a year or 2, and could be at $200M in 5 years or so, and as they grow into that revenue potential, gross margins should return to somewhere around 50%, which is where they were before they started building their second facility. And there are plenty of reasons to think they will be able to grow including industry trends, their regulatory track record, and the fact that their biggest customer is out saying that they see their drug expanding from less than $100 million in licensing fees to a billion dollars over the next 10 years or so. So when you zoom out, it seems crazy to me that the market will hit the stock by 30% over 200 bps of gross margin, when this is a recession proof business with a very bright future, but that is the market we are living in right now.

Hill International also fits in this category. Flotek and Aimia fit in this category. But the important thing is not to let the stock market guide us, but rather to track the performance of our companies and the opportunities they have in front of them, and recognize that if they continue to perform, the market will reward them eventually. But it is certainly frustrating to have a large position go down by 30% because it does affect our monthly or quarterly returns. But I am happy to deal with the near term 30% hit because over the next 3, 5, or 7 years not much has to go right for this stock to be up 100, 200, or 300%. Clearly they have to execute. But there is a lot going in their favor. And if you react to the near term noise without zooming out, you won't be around to enjoy the upside.

All that being said, as always, I have made some mistakes, and we have suffered some bad outcomes, and we'll talk about that on the next few slides.

SLIDE 18

Here I want to take a minute to look at one of our businesses, Hill International, in context of our process. And I'll go through each of the elements here quickly, and then we'll look at a chart. Hill is an asset light construction company. Essentially like a consulting model on mega projects like building a new airport. This is not a business that is going away. Amazon can't do this. And ultimately, this business is about saving the client money. That is timeless. They don't actually build the airport – they act as consultants and they oversee the contractors that do the actual building. There are of course some cyclical elements, but it is less cyclical than you would think because mega projects tend to be long term, and they don't tend to fall off a cliff when the economy slows down. Another example would be that they have overseen waste water plants for cities. If the economy slows, it doesn't matter. You still need to have water treatment facilities. They oversee the construction of hospitals. That doesn't go away when unemployment goes up. But this kind of stuff is lumpy. Revenue is not going to be smooth because its not every day that a new airport or whatever is built, and Wall Street hates lumpy versus predictable. And that is an opportunity for the patient.

As far as management, there has been a transition over the last few years where activist investors removed the founding family, and at this point insider ownership is up around almost 40% - it has been climbing because insiders are buying. So with almost 40% insider ownership, with much of it from activists that are in the business of shareholder value, we are in good hands. The opportunity exists because the stock was kicked out of the indexes, so all the index funds, and all the quant models had to sell. They didn't have a choice. They didn't think about valuation. They were irrational. And that happened because there was an accounting problem. That never sounds good, but this was as benign as it gets. Basically they made some mistakes on foreign currency translation which had no real actual dollar impact, but they did have to go back and restate all their financials, so they got kicked off the New York Stock Exchange. In the real world, for real business, value is tied to profits and revenue, and sellers only sell their businesses when they think they are getting value for their profits and revenue and opportunity. But here we had a case where there was an obvious split between why sellers in the real world sell a business, and why sellers on the stock market sell their business. It was for the wrong reason.

What happens when something goes wrong – we touched on this with the good business part – there are long term contracts, so there is definitely some cyclicality, but not as bad as you would think. But more than that, they are a scale player. They are the 8th largest construction management firm in the U.S., and there are a ton of smaller players, and when something goes wrong – macro weakness etcetera, the smaller players have a harder time surviving, and the bigger players can buy them up for pennies on the dollar. That is what happened here through the financial crisis, where Hill grew revenues straight through the crisis despite their cyclical exposure.

Moving to valuation – first, Hill has some under-scaled international operations that are a reliable drag on profitability. So they don't contribute to GAAP earnings, but they are not worth less than zero, which is essentially what the market is saying when it puts an average multiple on artificially depressed GAAP earnings. As for cash flow, the controlling family that was running the show were bad managers. The activists came in and cleaned up the business to the extant that the business should be run rating at somewhere like $20 or $25 million in EBITDA, but the trailing GAAP financials make it look like its basically losing money. Now, it is important to note here we are not talking about a massive turn around effort. We are not talking about redesigning a factory to save money, or reworking supply chains to save money. We are talking about a founding family that was paying themselves and their cronies a couple million bucks for basically no show jobs. A few years ago a full 50% of profits went into the pockets of the founding family. We are talking about not one company car, but 2 company cars. We are talking about golf club memberships being run through the corporate P&L. Those are low hurdles to clear. Much less complicated than redesigning a factory.

On transaction value, we never want to hang our hat on a take out scenario, but this is a pretty interesting case. Over the last 15 or 20 years, the slowest year on record for M&A in the construction industry was 2009, and there were 300 something transactions that year. There is a pretty liquid secondary market here, so the signposts that we can read there have relevance. And they are especially relevant when insiders own almost 40%, and have publicly stated that eventually this company is going to get sold. I think they just want to clean it up first. So you can look at transaction multiples, and look at the business and say even at a 30 or 40% discount to transaction multiples, there should be 60 or 70% upside to the valuation here, and that is not including the idea that the business might actually execute well for a year or two before a sale. As for comparable value, I mentioned there is some cyclicality here, and there are some fears that we are in the later stages of the cycle today, but you can look at comps and see that they are still getting robust multiples, and if you put a comp multiple on the normalized cash flow here, you should have 60 or 70% upside. And that is assuming they don't do anything smart in the meantime. That is assuming they just kind of tick along, which is conservative when we know there are incentivized people here going to work every day trying to make this business better. But they are likely to make it better.

Going back to the benefits of scale, and M&A, and having under-scaled international operations, there is an opportunity to drive real value creation here through bolt on acquisitions, so there are multiple ways to win. Because if you think of the economics of the business, it is a consulting model, so if you have people that are not actively deployed on projects, they are essentially a cost center. And if you think about different industry verticals, there are specialized people at the top, so the guy who runs their transportation practice is primarily a transportation guy, but further down the food chain there are bodies that can be deployed across different verticals to really increase utilization rates, which increases margins, which creates value. And there is value in regional density across verticals, and there is room to bolt on regionally specific area expertise within different verticals. Conversely, there are other levers for them to pull with some of the under-scaled operations and the capital structure that I think could ultimately lead to 200% upside a few years out. They could sell some of the under-scaled stuff and then pay down debt, or repurchase stock, etcetera, so there are multiple ways to win.

Lastly, this company is completely underfollowed by Wall Street. There is no sell side research coverage, and at a market cap of something like $160 million, it is un-investible for larger funds. And the trailing GAAP earnings are essentially meaningless because over the last year and change they were going through a massive cost cutting exercise that required some spending up front, so margins have been temporarily depressed, and they don't really issue guidance. And if you believe JP Morgan, 80% of the market these days is in index funds, ETFs, and quant models, but this company is completely invisible to the quants because the trailing numbers are meaningless, and there are no forward numbers, which is a good set up because as the quarters tick by, the trailing numbers will normalize, and eventually the quants and mechanical screeners will pick up on what is really happening here, so that is just time arbitrage. Patience is the key.

SLIDE 19

So I think the setup here is very attractive with a good business, very strongly aligned insiders, multiple ways to win whether it is simply time arbitrage, or growth through bolt ons, or ultimately a sale of the business, and a very low valuation because the sellers that beat the stock down were completely irrational. But as we look at the chart here, we can see that thus far this investment has been a meaningful drag on our performance. Now, over an investing life time, I think that if you invest in these sort of situations, you are likely to do very well. But what has happened here so far is that shortly after our initial purchases the company relisted, but at that time one of the large holders started dumping shares, and the whisper is that they were facing redemption requests going into year end, so they were once again forced sellers. And on the weakness there has been a bunch of insider buying which from a business point of view is great to see, but from a short term stock market point of view, when you get up to 30 or 40% insider ownership the insider buying can be a near term headwind because the indexes are float adjusted, and in this case only sixty-ish percent of the market cap is free floating, which means they are penalized by the indexes. So basically the largest buyers of shares – the indexes - are forced to buy less of this company because the insiders have so much confidence and own so much stock. And in this case, the insiders have bought so much that it did not qualify to be added back to the indexes. And fundamentally, stepping back and taking an intelligent business person's view of the situation, it should be obvious that it is better to own a company where the insiders have bought a bunch of stock and are seemingly very confident, but that is not how it works in the stock market which just doesn't make sense over any reasonable period of time.

So the takeaway here is really just that so far this investment has been a drag on our results, but I remain confident that if we can be patient for another year or three, we will ultimately be very well rewarded for dealing with these short term set backs.

SLIDE 20

Next we will talk about Flotek, which I wrote about in the last investor letter. Flotek is in the oil field services industry, so overall it is not a great business, but its not terrible either. In fact, there is actually a good business where they have a unique patent protected product which can drive ROIs for drillers, but they also have another completion fluid business which is more of a commodity service which is not so great. However, despite the lower quality of the business, I chose to invest due to the other factors, and notably the price we paid was so low that we were almost getting the business for free.

Management's interests are very important here because Flotek is essentially a cash shell. And the big risk when you are buying a box of cash is that the people running that box are going to find a way to put the cash in their own pockets, rather than use that cash for the benefit of shareholders. The Chairman of the Board here – the newly installed Chairman of the Board here – is a guy named David Nierenberg, and he is a pretty interesting character. Earlier in his career he worked at Bain directly with Mitt Romney, and in fact, later on in life he ran fund raising operations for Romney's presidential campaign in the Pacific Northwest. So that tells you a few things. First, he is no dummy. And in the oil and gas world where lighting money on fire is typically par for the course, that means something. Second, he has real experience understanding how businesses are built and operated. And third, he doesn't need the stipend he gets for acting as Chairman. In fact, after he left Bain he set up an investment partnership that is very similar to Laughing Water, and he has spent the last 2 or 3 decades investing in small stocks, often taking an activist role, so he understands and is incentivized to think about per share value creation here. It is also worth noting that Nierenberg is someone whose reputational capital is substantial. When you are running fund raising for a presidential campaign at the regional level, you are coordinating dinners and events etcetera with all sorts of very important and very wealthy people. He is also on the board of the Washington state pension fund. He is on the board of Glass Lewis, the proxy advisory firm with an international profile. He is on the board of the corporate governance committee at Columbia University. He travels in pretty sophisticated circles, and we can surmise that he is independently wealthy, so it just wouldn't be worth it to him to try to plunder the cash at Flotek because of the reputational damage it would do, but also because he owns a substantial amount of the stock personally, and he can make a lot more money by focusing on the share price than he could by trying to take advantage of the balance sheet for personal gains.

SLIDE 21

As for why the opportunity exists, I will actually flip forward to the chart here on the next slide. You can see that back in January the stock jumped by more than 100%. And what happened is that at the end of last year they had 2 business lines, and an $80M market cap, and about $45M in net debt for an enterprise value of about $125M dollars, and then they sold 1 of their two divisions for $170 million dollars. And I have said this before, but if you believe in efficient markets, that is about as crazy as it gets. Now, unfortunately we didn't make our purchases until after this deal was announced. But I still bought stock because the cash had not yet hit the balance sheet, which means that anyone – or any mechanical screener or quant - that was looking at the stock thought they had $45M in debt, when in reality they had about $120M in net cash, which was a bit more than two thirds of their market cap at the time. And part of my reasoning was that when the next 10Q hit, the world – or rather all the mechanical screeners would wake up to the fact that what they thought had $45M in debt actually had $120M in cash, they would automatically buy stock, and that is basically what happened, so the shares moved up 25% in a few months, and we took the position size down quite a bit. Interestingly, as we were selling at $3.50 or $3.60 or so, David Nierenberg was actually buying.

Now, all things equal, I'd rather not be playing these little games with mechanical screeners and buying something and then quickly selling it a few months later. I'd rather be buying better businesses and holding them for longer periods. But when the stars are aligned – and this sort of set up is very rare – you can make a quick profit. And while this special situation angle was a large part of the analysis, the business itself is better than most realize, and the incentives are in the right place, so its not the end of the world if we wind up holding for longer than the special situation itself might dictate.

And that is what happened here. Shares rallied quickly, I sold a bit, shares came back down, and I bought more shares because there was a very heavy indication that a meaningful part of the company's cash hoard would be returned to shareholders in the very near future. There were multiple comments made on the company's conference call that they were considering returning capital, and Nierenberg had bought shares 20% higher, which seemed to be a good sign, but then the company announced they were not in fact going to return capital via a tender offer, and shares sold off by more than 30%. And that 30% sell off is from a base that was already well below where Nierenberg – the guy who knows more about this business than anyone, and the guy who is pulling the strings on this business – bought shares just a few weeks ago, so all of a sudden shares are at a level where it would require an 80% move higher just to get back to where the most informed party thought they were cheap.

Now, over an investing lifetime, if you are buying cash heavy balance sheets attached to decent if not great businesses that are being managed by impressive people, you should do very well. Buying that sort of set up tilts the odds heavily in your favor. But to be fair, it was likely a mistake to size this as large as I did. I think I got a little too cute factoring in the likely return of capital more heavily than the idea of owning the business for a year or three or more, especially because it is clear now that the whole market was factoring in that return of capital, which is why the stock traded off 30% when they didn't return the capital.

And to be clear, that changes the calculus, because the reason they didn't return the capital is because they – and I really mean Nierenberg – thinks that a dollar in their hands is worth substantially more than a dollar back in the hands of equity owners, because the oil and gas space is so starved for capital right now. So they believe that they will be able to make some small bolt on acquisitions for pennies on the dollar, and use the core business – the specialized part of the business – as a base to build from. And again, that changes the calculus because before I was envisioning a quick capital return that did not come with any operational risk, and there is of course operational risk when you are talking about trying to clean up this business and grow this business. And it was a mistake to not properly weight the possibility of incurring that operational risk when I originally sized the position.

However, the incentives here are very powerful, and I think Nierenberg deserves some benefit of the doubt. As outsiders we are operating with limited imperfect information. But he is on the inside, and he can see the whole picture. He of course is not infallible – he would be the first person to tell you that he makes mistakes too. But the hurdle for success is very very low when you are not paying much more than the value of the cash on the balance sheet. And the hurdle is even lower when you can look at past management, and recognize they were not doing a very good job managing their business. For example, I mentioned that they sold their other business at the end of 2018, and the buyers paid something like 23 times EBITDA for that business. And the only reason a buyer pays that kind of multiple is because they think they can take out a ton of cost, and they can take out a ton of cost because the business was poorly managed. And my research – talking to industry folks, talking to employees, etcetera suggested that there is a lot of cost that can come out of the core business as well. For example, I have heard that the sales force was formerly incentivized on revenue. So what was happening at times was that the sales force would make a sale – and they are selling barrels or buckets of liquid – and then they would agree to ship the product overnight by FedEx or whatever, so the company would wind up actually losing money on the sale, but the sales force didn't care because they were paid on revenue. And there were no controls around that, which is a pretty easy problem to fix. Just stop selling product at a loss. And upgrading the salesforce is a major focus now where the old sales model was kind of a steak and beer entertaining the client at the well site, and the new sales model is having chemical engineers going into the corporate office of the driller and explaining the chemistry to the corporate level geologists and engineers on the customer side, and presenting the data that demonstrates that using Flotek's products actually drives ROIs for drillers by increasing the productivity of the well through customizing the approach to each specific geology.

So you can look at all that, and you can look at Nierenberg and he has managed a small cap value focused hedge fund for 20 or 30 years. He doesn't buy stocks unless he thinks they can go up by a lot, and with his knowledge as Chairman he was buying shares at $3.60, and then the public markets who don't know anything and who are completely fickle sell shares down to the $2.00 range, and what is happening is that the company is burning some cash, and the public markets – and it is human nature – the public markets are over extrapolating that the cash burn will last forever, and asking why would you want to own a money losing energy company when you can buy a sexy fast growing tech stock or whatever. And the answer is that while this is not the best company in the world, it is being priced like it is the absolute worst company in the world, but it really isn't that bad. In fact, there are reasons to believe it could be pretty good, commodity cycles aside. But as we saw back on the slides that showed what has been happening in the market lately, the market doesn't want to own less good businesses at cheaper prices these days. The market wants to own businesses that have the potential for blue sky scenarios, and the market is ok with paying blue sky prices for them.

And with Flotek, sticking with valuation for another minute, we have an escape hatch too. There are multiple ways to win. Right now it seems like the plan is to clean up the business and then try to grow the business, but if it seems like that is too hard, or isn't working, there is an escape hatch in that this business could be sold too. In fact, if you look in the proxy statement, over the last year or so three of the eight peer companies that they list have been acquired at 1x sales, while FTK was trading at about .25 or .3 sales when we first bought it, and at about .1 sales now. That is not to say that 1x sales is necessarily the right price because as I said part of the business is more commodity chemicals, and a buyer might not want to pay much for that, but at the same time you can look at this business and say that up until a year ago Haliburton was a major distributor, but then Flotek made the decision to go direct and basically cut Haliburton out of the picture. But Haliburton or any of the other majors, or any of the other fluids companies could buy Flotek and basically cut out almost the entire cost structure because those companies already have sales and operations folks, and they could just layer Flotek's products on as additional SKUs for their existing sales effort. And if the incentives weren't inline, if instead of Nierenberg we had a real born and bred wildcatter making the decisions then I would weight the probability of a sale at zero, but Nierenberg is rational – he has no ego tied up in this – he thinks like an equity owner because that is the business he is in – so if the current plan to clean up the business and make some acquisitions doesn't work, he'll look out for his best interest, which is the same as our best interest, and push to sell the company and we'll do fine. But I have no idea what will happen tomorrow or next month. I just know that over an investing lifetime, if you are buying cash balance sheets with businesses attached and the guy minding the cash is an A+ in terms of incentives, then you are likely to do pretty well. But thus far, we have suffered on this one. And I have no idea what is going to happen with oil prices, but if you look at the attack in Saudi Arabia a week or two ago, and if you just look at history broadly, there is a non zero chance that oil prices could really jump up over the next year or three, and if that happens, we have a free option on multi bagger returns. The business is different now and the oil world is different now, but 5 years ago this was a $30 stock, and now it is a $2 stock, so an oil spike isn't factored into the base analysis, but free options never hurt.

SLIDE 22

Here we are going to talk about our pawn shop company, EZ Corp, which is actually on the way out of the portfolio. As for this being a good business, it is a 3,000 year old business model that is never going away, and it is recession proof, and incremental margins on the lending side are extremely high, and there is a long run way for growth because the industry has a lot of mom and pop operators. The problem we have here is with management's interests. There is a controlling shareholder named Phil Cohen that owns about 6% of the stock, but he controls 100% of the vote, and he treats this like his personal company, often disregarding minority owners like ourselves. Now, when I phrase it like that, it seems like this should be an easy pass, but going back in history, I will explain how I got comfortable investing alongside someone who would not necessarily be a good shepherd for our interests. So, Cohen took this company public in the early '90s, and for a long time he used it as a vehicle to pay himself consulting fees, essentially taking cash out of the company and putting it in his own pocket, to the detriment of common shareholders. At the end he was pulling out $6 or $7 million a year. But shortly before we purchased shares, that consulting arrangement was eliminated, and an impressive new CEO was brought on board. So, I believed that absent being able to take cash out of the business, the only way for Cohen to benefit was to focus on the share price, which is why he brought in the impressive new CEO. And also at this time the company was just emerging from a period of pretty serious operational blunders. There were some bad acquisitions made, and the former CEO had steered the company away from their core competency by trying to shift the model toward being like the eBay of pawn.

And if you think of the economics of pawn lending, there are two sides to the business, the lending side, and the retail side. Meaning that if you lend money against someone's collateral and they don't pick it up, then you sell that item retail. And the key to understanding pawn is understanding the dynamic between those two sides of the business because your LTV – your loan to value – essentially becomes your COGS – your cost of goods sold – if and when the transaction evolves from a loan to a forfeiture and retail sale. In other words, if you think you are going to wind up selling the item, you want your COGS to be as low as possible because that is your retail gross margin, and when the former CEO moved in the direction of being the eBay of pawn, clearly his focus was on the retail side, which meant he was focusing on COGS. The problem there however is that if you are focusing on COGS, you are focusing on lower LTVs, and if you are focusing on lower LTVs, your customers are not happy. They are not going to be happy pawning their item to you for sixty cents on the dollar so that you can sell it on eBay when they can go to another pawnbroker and get seventy cents on the dollar. So, the eBay of pawn idea didn't work, and they brought in a new CEO to get back to basics, and the new CEO kitchen sinked a few bad acquisitions and other things and wrote them down to zero, which basically destroyed the stock price, and that is when we were buying.

Going back to the economics of pawn, and thinking about the lending side, this can be a really good business if you do it well because the incremental margins on higher LTVs are extremely high, assuming you have a good handle on the quality of your customer and you don't wind up with inventory you don't want. In other words, if you have a customer that comes into your store wearing clothes that have paint splatter all over them, and it is clear he is a professional painter, and he wants to pawn his painting gear – his air pump and spray gun etcetera – he is probably a pretty good credit because he needs that equipment for his job, so you can increase the LTV. And operationally if you are lending sixty cents on the dollar or eighty cents on the dollar it costs you the same, but if you are lending 80 cents rather than sixty cents you are collecting more interest, and that delta is basically pure profit. So the bottom line is that the lending side of pawn is much better than the retail side, but they got away from it for a bit, and the stock got really punished, but getting back to basics in that situation should not require herculean efforts.

SLIDE 23

And moving to the next slide here we can see the chart, and I wrote about this one I believe in the Q1'2016 investor letter, and I basically thought at the time we were first buying that we were paying something like 1x EBIT for the business. A recession proof business. And the new CEO came in, and he was executing, and a growth story started to emerge because there is a real opportunity to grow the pawn business through taking out Mom and Pops in the U.S., although that is slow going and there is a wide range in quality, but even more so there is a real opportunity to grow the business in Mexico and Latin America where pawn is really just a normal part of life for people who often have limited access to banks and credit. I actually lived in Central America doing volunteer work with impoverished communities for awhile so I was able to see first hand the importance of pawn to life in that part of the world.

So anyway, things were going great, and the stock performed very well, but through all of this time they were still trading at a drastic discount to their public competitor which is called First Cash. And First Cash is basically the same business except it is bigger, it has more of a tilt toward Latin America although EZ Corp has been closing that gap, and EZ Corp has been operating much better. So, the company did a convertible bond offering in order to strengthen their balance sheet, and the stock sold off hard on that news, and I added to our position thinking that the sell off was just tied to the typical dynamics that exist during a convert where convert holders will hedge their position by being short the stock against the convert. And this was a mistake. I knew it at the time but was slow – very slow – to understand that the reason they were doing the convert was that traditional equity capital markets and even credit markets were just closed to them because the banks and markets viewed Phil Cohen as a bad guy, so their cost of capital is just through the roof. I think First Cash pays something like 6% on their debt, and EZ Corp would have had to have paid something like 12%, which is just crazy for a business with recession proof cash flows.

And that is the market saying that Phil Cohen is a bad guy, he won't protect minority shareholders, and I didn't or couldn't hear that message. I basically looked past that message because of the intangibles that this business has. It is counter cyclical. It is levered to gold. And from a portfolio perspective, I was looking at those attributes and weighing them more heavily than the fact that we were partnered with someone who did not deserve our trust, and that was a mistake. And to cut to the chase as I know we are getting short on time, just last week they issued an 8K announcing that Phil Cohen was taking over as Chairman, and would once again be paying himself a couple million bucks a year, basically siphoning that money out of the company. And if you look at First Cash, which is much much bigger than EZ Corp, their Chairman gets paid I think $250 grand a year, and Cohen will be getting paid something like $3 million a year. In addition, the growth story hasn't materialized because prices for acquisitions have gotten too elevated, and because Cohen is a bad guy he won't repurchase EZ Corp shares even though the EZ Corp stores are by far the cheapest pawn assets on the planet because he doesn't think it is worth it to buy back non-voting shares. For reference, EZ Corp is trading at something like maybe 7 times normalized free cash flow right now, while First Cash is trading at something like 30 times. So, maybe First Cash is too expensive – but maybe not, because these are recession proof cash flows, and they return capital to shareholders, and they grow. But either way, these are literally the same business so the valuation discrepancy there is just huge, and for awhile I was able to look past Cohen's poor behavior, but I have decided to exit the position because there is just no reason to partner with someone who is not going to look out for us in a concentrated portfolio. Yes its crazy cheap, yes it is recession proof, and it is very frustrating to think that someone who owns a fair amount of stock just doesn't care - or even is actively doing things to hurt the stock – so that was a failure on my part.

SLIDE 24

Next I want to talk briefly about a company I looked at back in December or January, and decided to pass on. The Joint Corp is basically franchised chiropractor's offices, and it is cash pay, and the average appointment is only something like 15 or 20 minutes. So a different model than a traditional chiropractor, but not rocket science. And if you believe the bull case, it is a subscription business because you can pay for a year's worth of visits in advance, and this is all the rage on Wall Street these days. But zooming out, there are about 100,000 chiropractors in the U.S., and depending on the source, something like 25 to 40% of chiropractor's offices fail, and attrition among chiropractors is something like 30% because people realize they just can't make a living cracking backs. And keep in mind too, that if a chiropractor is good, and can really fix your back, then that's it. You stop going. So the economics of a subscription model are working against you. As for the idea that this is a subscription business, I think that is a complete perversion. Now, subscription businesses – true subscription businesses – are excellent business. But that is things like if you are subscribing to Microsoft Office. Or other things that your business literally cannot function without. Your business needs them like oxygen, and that is great.

But, I looked at this and said "I pay my landscapers in advance, does that mean that my landscapers have a subscription business?" because you can look at gym memberships, you can look at Peloton's S-1, you can look at a lot of things that are consumer facing, and you can see that the churn rates are just very high. And this is a consumer business born in a 4% unemployment environment. I don't think it works if there is a speed bump in the economy. All of a sudden people realize that while this has been priced as a subscription business, there is nothing here that is mission critical. Revenue will likely drop off a cliff at the box level, and then your whole business model withers and dies. And just a few days ago Larry Ellison from Oracle had some comments that it doesn't make sense to burn cash trying to grow fast when there is no customer loyalty. And in a business where there are zero barriers to entry, and the secret sauce is wide open for anyone who walks in the door to see, burning money to grow fast just doesn't seem to make much sense. Any chiropractor in America can move to a cash pay, quick appointment model tomorrow. There is no real brand value here. And I get it, there is some subset of the population that will go to the chiropractor once a week for the rest of their lives, but if you do the research, some sources say that over the last ten or twenty years the number of patients that come back to a chiropractor for repeat visits has dropped from 12% to 8%, and that makes sense because who in their right mind really wants to go to the chiropractor? Yes you can get relief, but you are still working toward not going. The goal is to get better. It is not like a gym membership where you never actually reach your goal, and churn at gyms is very high, so logic suggests churn here should be even higher. And I get it, it is a franchise model, and the franchise model is broadly speaking a very good model, but at the same time, I think this has among the worst ratios in terms of franchisee costs to brand value. Franchisees wind up paying something north of 10% of sales all in if I remember correctly, and this does not have the brand value of McDonalds or something like that. So I look at this, and think about if it is a good business, and I can't come up with a reason why this business should exist. Or why it is sustainable. There are zero barriers to entry, and historically chiropractors have a high failure rate.

SLIDE 25

So like I said, I decided to pass on this, and as we see here, it has since gone up something like 250 or 300%, while the previous examples I went through have had a pretty rough go lately. So I guess kudos to those who bought this. There are some smart investors whose work I really respect that have bought this. But from my perspective, zooming out, over an investment lifetime, I think if you are paying 90 times earnings and 4 or 5 times sales for a business that is likely going to drop off a cliff at the first sign of recession, you are really counting on greater fools. It is kind of like playing Russian roulette for $10 million per trigger pull. You can make a lot of money until you lose it all. But this is an example of the kind of stuff the market has been rewarding lately while our boring slower growing less exciting but very cheap stocks have languished. And I don't want to say that the Joint is a short, and I don't want to say there is a bubble in these sort of things. I just want to say that we are playing for the long haul, and that means we should focus more on the durability of the business and the incentives of our managers than on the price action of the stock, and it is ok to miss these big winners.

So looking at this and seeing how it has performed, it certainly feels like it was a mistake of omission, but just like you shouldn't celebrate if you go all in on a pair of twos and win in poker, this was not a mistake of omission. But it is I think useful as an example as a contrast to our style of investing.

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Lastly before some Q and A, I just want to take a second to talk about the best path forward. And the bottom line is that nothing works all the time in the investing world. If it did, then everyone would do it, and then it wouldn't work. That being said, I think we need to just keep doing what we are doing. It is really just common sense that over time if you are buying good – maybe not great, but good – businesses, and partnering with properly incentivized managers, and paying low or very low prices, we will do just fine. But the key is patience because for a lot of our stocks, they might go nowhere for 2 or 3 years and then go up 50 or 60 or 100 percent in a matter of weeks or months, and the ultimate return will be fine. But sitting still is the hard part.

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So, any questions?

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