September 2020

Dear Partners,

As you know, I prefer to only write twice per year in order to discourage the negative effects that come from discussing our portfolio too frequently. That being said, I think we can all agree that this year has been more than a bit unusual, which I believe warrants an increased cadence. As always, I feel it is important that all partners understand what we own and why we own it, so that when difficult times arrive, we can focus on our businesses and our management partners, rather than the noise that dominates the headlines. Given our YTD performance and the market's strong rebound from the Covid induced March lows these might not qualify as difficult times, but they are certainly unusual.

Laughing Water Capital ("LWC") returned 26.4% in the third quarter of 2020 after all fees and expenses, versus 8.9% and 4.9% for the SP500TR and R2000TR respectively. Year to date, LWC has appreciated by 30.9%, versus 5.6% and -8.7% for the SP500TR and R2000TR. As always, individual results may vary, so please check your individual statements. I caution you however that it is entirely possible that our lead will diminish next month, next quarter or next year. This is because we are often deliberately investing in good businesses that are suffering from some sort of optical, operational, or structural problem. These problems cause investors without our structural and behavioral advantages to discard the stock of these companies at what we view as irrational prices.

However, by definition there is no lower bound to irrationality. As such, it is entirely possible that the prices of our businesses will decline further after we make our purchase decision. Additionally, I will inevitably make mistakes along the way.

Yet, if we are able to identify businesses of sufficient quality, and management teams of sufficient ability, I expect that our lead versus the indexes will continue to compound over time. For this reason, almost the entirety of my and my family's wealth is invested in our strategy.

The Next Five Years, and Beyond: Strengthening Our Partnership & Amended Founder's Class

February of 2021 will be an important milestone for LWC, as it will mark 5 years since the launch of the fund. I'd like to thank all of you who took a chance in the early days, when LWC was little more than a process that I believed in, and a firm belief that a fund that is committed to searching the hidden corners of the market and only accepting capital from people who understand the difference between volatility and risk can outperform the market over time. Since then, our capital has compounded at more than 22% per year after all fees and expenses, which seems to validate my initial thesis.[1] I realize of course it has been a bull market for the most part, but I would also note we have outperformed our most relevant benchmark, the R2000TR, by ~1,100 basis points per year, and this period encompasses two different 20+% drawdowns for the R2000. We have also outperformed the SP500TR by ~650 basis points per year, despite not owning any of the FAANNMG stocks that have powered returns over this period.

[1] Past performance is not indicative of future results.

As I think about the next 5 years and beyond, I am considering ways to strengthen our partnership further. Examining the mistakes I have made over the last 5 years reveals two main takeaways. First, many of the mistakes I made were tied to improperly assessing the human side of the businesses which we have owned. Second, my batting average on smaller positions is significantly lower than for larger positions.

Unfortunately, there is no magic pill that can fully eliminate the risk of repeating these mistakes going forward, but I do believe there are rather simple ways to mitigate their effect. The first problem – improperly assessing the human side of businesses – can be addressed by increasing the research and travel budget, and spending more time meeting our management partners and their employees on their own turf, where I will be better equipped to compare what is said with what actually is. The second problem – tied to batting average – is more nebulous and difficult to define, but I suspect that part of the problem is that to date, I have been handling the operational aspects of running an investment business personally, which detracts from time that can be better used researching investments.

I believe that both of these problems can be addressed by additional scale, and at present I am considering options for adding additional operational and financial resources and controls to our infrastructure in order to more formally institutionalize our processes. It is my firm belief that these resources will help drive investor comfort, as well as performance going forward. However, I also recognize that my time is best spent on investment research, and I thus have little interest in marketing the fund in an effort to recruit the additional AUM which will support these additional resources.

As such, as an inducement to attract additional LPs to our partnership, **I intend to amend the terms of the Founder's Class in the not too distant future**. I will provide an update on exact timing in a future communication, but existing investors and investors who elect to join us before the amendment will continue to benefit from our current terms, which include our lowest fee option. Those investors who only choose to join us after our enhanced infrastructure is in place will be subject to performance fees that are inline with industry standard. I would note however that in all cases I remain committed to our low management fee and to our aggressive hurdle rate. I believe this is especially notable in today's climate when market "experts" believe that over the next decade, the SP500 is likely to return somewhere between 0 and 4% per year. Thus, I will only receive performance compensation if we significantly outperform projected forward returns. In order to participate in the Founder's Class and realize our lowest fee option, subsequent to the amendment, prospective LPs will be asked to agree to an extended commitment period. I believe that having a semi-permanent capital base is an enormous structural advantage, thus it makes sense to leave our lowest fee option accessible to those who make a longer commitment.

Rest assured, I have no intention to grow the fund past a size where I think being larger would benefit our returns. As a reminder, my wife and I are collectively the second largest investor in the fund, we continue to add to the fund (as recently as this month), and as my compensation is clearly tilted toward performance, I have every incentive to maintain a measured focus on returns above collecting assets. However, we remain significantly below the point where our AUM is likely to hinder our results, and I invite you to consider recommending Laughing Water Capital to your friends and family, so that we can ensure the high quality of our LP base is not diluted by future investors. The best way for them to learn about the competitive advantages we share as a partnership is to visit the "Letters" section of www.laughingwatercapital.com. Please remind them that incentive fees will be moving up toward industry standard in the not too distant future.

New Positions: Ducks, Swans, Forced Sellers, and Forced Buyers

My almost 5 year old son has become fond of saying, "if it looks like a duck, and quacks like a duck, it's a duck!" when we visit the pond that is not far from our house. While at this point in his life he believes that the function of this expression is humor, as he matures he will come to realize that it is a very useful mental model for most things in life.

However, in the investing world identifying ducks that look and act like ducks is rarely profitable. The money is made through variant perception, and in my view the more apt metaphor is the "ugly duckling" that is actually a swan. This is especially true in today's world, where so much of the market is dominated by quantitative strategies that have no choice but to fill their spreadsheets with that which is readily visible.

The two businesses described below certainly appear to be ugly ducklings. One is recovering from an accounting restatement and exchange delisting after churning through five CFOs in quick succession. The other has a history of too much leverage and under-investment. Yet, in my view looking past the headlines shows a lot to like. Both businesses are attached to recession resistant end markets, both businesses have steady and growing revenue streams, and both businesses are likely to experience margin expansion in the quarters and years to come. Importantly, following recent change, both businesses are now run by people that have had tremendous previous public company success, and have chosen to put their own capital to work to help nurture these ugly ducklings into swans. Further, both businesses were available to us at low prices due to easy to understand constraints faced by non-economic sellers. Lastly, while both businesses have the potential to develop into compounders that feed our portfolio for years to come, in the near term, both stocks are likely to see a wave of forced buying as they are added to indexes and ETFs.

USA Technologies (USAT) – USAT is the undisclosed top 5 position that I mentioned in the 1H'20 letter. I have included a full length writeup (that is now somewhat dated) under separate cover, but in brief, USAT provides end to end services including cashless payment services and enterprise software to the vending and other unattended retail space. The vending machine industry is not very sexy, but sales are generally recession resistant as if people are hungry or thirsty, they will still spend a buck or two on a snack or drink, regardless of the economy. USAT's services are considered best in class, but historically the company had been poorly managed, most notably going through 5 CFOs in rapid succession, which led to accounting irregularities, an inability to promptly file financial statements with the SEC, and then a de-listing from the Nasdaq stock exchange. This very messy situation explains why the stock traded down from a high of more than $15 to below $4, as the delisting forced many owners to sell due to structural constraints.

From my perspective, while this history of mismanagement is scary, the competitive position of the company was largely unaffected by all of the drama. More importantly, a significantly more experienced and sophisticated team has come in and taken over the company following an activist battle. Combined with other insiders, the activist group – Hudson Executive Capital (HEC) – owns almost 20% of shares outstanding, and is led by Doug Braunstein, the former CFO of JP Morgan. Presumably this qualifies him to ensure that the company's accounting functions are up to speed. Braunstein's partner and now chairman of USAT is Douglas Bergeron, who is one of the most successful payments executives globally, having previously taken Verifone from an enterprise value of $50M to $5B. Additionally, HEC has installed Sean Feeney, a software savvy CEO known for his focus on company culture, to lead USAT going forward.

Feeney has made it clear that his focus will be on the company's best in class SAAS offering and profitable growth, rather than growing payments connections regardless of profitability, as was the case with the prior team.

The simple changing of the guard has caused shares to re-rate higher, but in my view, considerable upside remains as Feeney and his team execute their plan. Importantly, there are several easily available levers to pull that will improve operating efficiency. For example, the company had previously been overly reliant on expensive consultants to help them manage their day to day affairs. With a more capable management team in charge, these consultants will be replaced by full time employees at a fraction of the cost of the consultants. These changes combined with the simple lapping of expenses tied to the accounting restatement and activist battle basically guarantee that a year from now the trailing GAAP financials will be significantly better than they are today, which when combined with an already improved balance sheet should attract attention from investors. If on top of these simple developments the team is able to execute as planned and grow their high margin SAAS business both domestically and abroad, USAT could be a contributor to our portfolio for years to come.

At this point, the full details of management's plan have not been revealed as their first priority is rightfully establishing a firm foundation and level setting expectations after a period of extended mismanagement. From my perspective however, they are well positioned to follow the roadmap laid out by Savneet Singh at PAR Technologies (PAR), which remains a top 5 position for us. PAR is focused on restaurant POS software, but from a high level the similarities between the two investments are striking. Just like USAT, PAR was formerly mismanaged before pressure from activists led to Singh taking the reins, rebuilding the culture around ROIC, and emphasizing the company's best in class software. To date the results have been a 4x in the stock price since Singh took over.

Similar to PAR, USAT has a clear opportunity to drive ARPU through additional functionality, and increase customer count through a best in class product and service. Interestingly, PAR just recently entered the payments space, where they are distinguishing themselves by being fully transparent with their customers, which is unusual in the payments world. USAT has an opportunity here as well.

My conversations with vending machine owners reveal that in most cases they don't distinguish between how their spend with USAT is divvied up: they just know that they pay USAT $X per month. This is especially true among the smaller players that dominate the market with perhaps a few dozen machines. However, revenue mix is all important for USAT as I believe that revenue attached to payments comes with a single digit gross margin, while revenue attached to the company's SAAS offerings comes with gross margins in the ~70% range, with incremental gross margins being higher still. It seems logical that USAT will attempt to shift their revenue mix toward software by offering improved payments terms as an inducement to customers to also use USAT software. For the customer, if a balance can be struck the bill will still be $X per month, but for USAT, the gross margin dollars should be multiples higher. Following this plan would of course introduce cannibalization risk with existing customers that already rely on USAT for payments and enterprise SAAS, although that risk would be mitigated if large customers are already receiving discounted terms on their payments, which I believe they are. Regardless, if some amount of cannibalization is the price to pay to gain high margin software revenue from the ~50% of USAT's customer base that does not presently use their software, it will likely be worth it. If this plan works and USAT is granted a fast growing SAAS multiple by the markets, USAT has multi-bagger potential in the intermediate term, even before expanding horizontally by adding additional functionality to their software suite, executing on their plans to enter additional verticals, and expanding internationally.

This big picture strategy is well and good, but in the near term, special situation dynamics related to relisting to Nasdaq, and then being eligible for the forced buying that comes with index inclusion at the very least contributes to a margin of safety, and quite possibly will lead to shares appreciating significantly. As of now, the exact timing around relisting is uncertain. I do however find it curious that HEC recently launched a Special Purpose Acquisition Company ("SPAC") that includes the former CEO and Chairman of Nasdaq as a director. Presumably this can only help grease the wheels for USAT's re-listing.

Whole Earth Brands (FREE) – FREE is a packaged foods and flavorings company that recently came public through a SPAC, and joined our portfolio as a top five position. SPACs have a terrible track record for value creation in the early years, but there are rare gems available for those willing to sift through the rubble. I believe that FREE is one such gem.

The business operates in two segments and features dependable, recession resistant revenues tied to non-sugar sweeteners (think little blue packets of Equal and natural stevia based sweeteners) and licorice extract that is primarily used to flavor tobacco. Where it gets more interesting is why we were able to buy our shares at a very low price.

Ron Pereleman, formerly the 47th richest person in the world, has been in the news quite a bit lately because his fortune was built on a mountain of debt, leaving him with a liquidity crisis. Notable headlines have included that he is trying to sell his Hamptons estate for $180M, his art collection for hundreds of millions, and that he has agreed to sell his stake in casino gaming company Scientific Games (SGMS) for $1.5B. He also sold two smaller portfolio companies, Merisant and MafCo, which have been relabeled as Whole Earth Brands. Of particular note, the deal was originally arranged prior to the onset of Corona virus, but was then subsequently renegotiated to a lower price on two separate occasions as Perelman's liquidity problems were exacerbated by the pandemic, and he seemingly became more desperate to raise cash. Curiously, Perelman may have recognized that the deal price was very low because he subsequently bought more than 3 million shares in the open market, presumably because he expected shares to rally upon the close of the transaction.

When shares did not rally, he aggressively reversed course, and began to sell these shares in the open market, driving the price down to where we bought our shares. SPACs have a bad reputation for a multitude of reasons, but one of the most often cited problems is that SPAC sponsors are incentivized to just get a deal done at any price. That may be true, although with a two year runway, presumably sponsors have ample time to consider attractive options. Regardless, in the case of FREE, even today shares are wallowing at a roughly 50% discount to the original deal price, which suggests a large margin of safety to where a knowledgeable buyer was willing to purchase the company.

Importantly, not only were these assets available at fire sale prices, the trailing GAAP financials do not accurately represent the true earnings power of the business. Under Perelman, cash generated by these businesses was primarily used to service debt, rather than to reinvest in the businesses for efficiency and productivity gains. For example, there were two accounting departments, two IT departments, and two packaging procurement groups, all of which are in the process of being rationalized. Additionally, there was room to rationalize the company's manufacturing footprint, which is also in progress, and when these steps are complete, the company's margins and free cash flow should be significantly improved.

Also of note, FREE is now being overseen by a board chairman with an unusual level of experience for a company of this size. The SPAC that purchased these assets was known as Act II Global Acquisition, and was sponsored by Irwin Simon, who previously started Hain Celestial (HAIN) from scratch by mortgaging his apartment. Under Simon's leadership, HAIN grew from nothing into a company with more than $2.5B in revenue. It seems clear from the name of the SPAC that there are growth ambitions here as well, and this assumption is fortified by the fact that the bulk of the founder's shares are locked up until the stock price reaches $20 per share. However, thus far the company seems to realize that their capital is best spent repurchasing their own shares rather than seeking acquisitions, as they have recently authorized a buyback plan, and several executives and board members have been buying shares on the open market.

As the overhang from Perelman selling his shares dissipates and as the company executes on their very easily achievable operational improvement plan, shrinks the float, and begins to publicize their story, shares should re-rate significantly higher. The fact that the company is very likely to be added to the small cap indexes in the spring is also a positive as it would result in a wave of forced buying, and in my view, shares could double in the years to come and still be cheap next to peer packaged food and ingredients businesses. When factoring in that many of these peers are no/low growth and that FREE has the balance sheet to support more meaningful growth, I would not be surprised to see FREE trade at a premium to the group over time. There is also the possibility that shares become wildly expensive as alternative natural foods are very on trend at the moment, as evidenced by shares of alternative natural creamer company Laird Superfood (LSF) which trades at ~20x revenue for reasons that are a puzzle to me. I owe a thank you to friend of LWC Dan Roller at Maran Capital, who prompted me to investigate FREE.

In summary, these two new additions to our portfolio fit very well within our framework, although they perhaps stand out a bit more than usual due to the unusual reasons that they are available at discount prices. Simply stated, it is not every day that a self-made multi-hundred millionaire engages in an encore performance by taking control of a public company, and it is exceedingly rare for us as minority investors to be able to participate in the encore at fire sale prices due to the sellers' constraints. The fact that we were presented with two such opportunities in quick succession is an anomaly unlikely to be repeated soon.

As always, there are certainly things that can go wrong. While the respective chairmen of both of these companies have had impressive past success, their track records are not spotless. However, newly high insider ownership, defensive revenues, margin expansion, and thoughtful growth are the elements that increase *business* value in the intermediate and long term, and a low purchase price and near-term structural catalysts tied to a relisting and index inclusion are the elements that can increase *stock* price in the near term. Together, they are likely to be a winning combination and I think that we will be well rewarded by these investments in the quarters and years to come.

Looking Forward

As always, I remain confident in our future success, although as always, our path is uncertain. At present there are obvious concerns with the economy in the wake of COVID19, and the specter of next month's election hangs heavy in the air. I remind you however that there are always things to worry about in the near term. This is why we focus on the intermediate and long term.

From my perspective, examining COVID data rather than reading the headlines presented by the click-hungry media suggests that the light at the end of the tunnel is approaching, although it would be premature to declare, "all clear," and derailment is possible. As for the election, the predominant assumption seems to be that a Biden victory will lead to higher taxes and regulation, which will be bad for the stock market, and the polls seem to indicate that a Biden victory is the most likely outcome. Yet, at present, even these seeming negatives appear to be overshadowed by the simple prospect of moving past the election, regardless of who wins. The fact is that markets crave certainty above all else, and regardless of who wins, the finality of that outcome – even if it takes a few weeks - will bring certainty.

Further, if the prevailing wisdom is that Biden will win, then in theory that outcome should already be reflected in stock prices to some extent. Additionally, if Biden wins, let us not forget that the traditional criticism of Democrats is that they like to spend, which is good for the economy. Further, this spending would be likely to take the shape of fiscal stimulus, rather than just monetary stimulus, which in theory would be good for out of favor "value" stocks, and likely come at the expense of expensive "growth" stocks. This would likely be a net benefit to our portfolio.

Regardless of the near-term impact of the election, I think we are very well positioned for the intermediate and long term. While the stock market as a whole does not scream "cheap" at the moment, the bifurcation between what is popular and what is unpopular is at extreme levels. We make our money in the hidden corners of the market, and are thus theoretically primed to benefit from this arrangement at some point.

It is important to remember that people do not think about presidential politics when they buy a soda from a vending machine. People do not think about presidential politics when they sweeten their morning coffee. The same can be said about nearly all of our other investments as well. We own a collection of good businesses, led by well incentivized people, that for the most part are not presently operating at optimal levels of efficiency for easily identifiable reasons.

Therefore, over reasonable periods of time what matters most for us will be whether our highly incentivized management partners can move past the easily fixable problems that they face. I have no doubt that there will be stumbles along the way, but I am confident that the reward for enduring these stumbles is the potential for outsized returns over time. Assuming reasonable levels of execution by our management partners, at some point in the next two to five years the value of our businesses and portfolio should be substantially higher. At that time, it is unlikely that any of us will look back and believe that our success was tied in any way to correctly predicting the outcome of the Presidential election. For this reason, my family and I continue to increase our investment in Laughing Water Capital. Our interests are aligned.

Please let me know if you have any questions,

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