

April, 2021

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. However, as there will be some administrative changes taking place in the near future, I felt an update was necessary. In brief, we have reached a scale that requires us to register with the SEC, which is the impetus for these changes. You will find a more detailed discussion of these changes under separate cover, and below I will briefly discuss some aspects of our portfolio and the environment we are in.

Laughing Water Capital (“LWC”) returned 25.8% in the 1st quarter of 2021 after all fees and expenses, versus 6.2% and 12.7% for the SP500 and R2000 respectively. As always, I remind you that there is no reason to expect our results to mirror the indexes because we do not own the indexes. Rather, we own a specific group of businesses for specific reasons. If my assessment of these businesses, their managers, their opportunities, and their competitors is correct, then over time I expect that we will continue to outperform the indexes. However, the only guarantee is that the road in front of us will continue to be filled with potholes. At times the broad market will sell off, and drag our portfolio with it, and at times I will make individual mistakes that lead to disappointment.

Yet, if we are able to manage the emotional toll that comes with inevitable downdrafts and continue to march forward, over longer periods of times I suspect we will be well rewarded for taking the bumpy road. For this reason, almost the entirety of my and my family’s wealth remains invested in our strategy. Our interests are aligned.

Top 5 Disclosed Positions

The lineup of the top 5 is largely unchanged from our last letter, although Company 1 discussed below has entered the fray. In the interest of brevity, rather than re-hashing the top 5 here, I invite you to re-visit the [YE 2020 letter](#).

Mice.

“You can’t really make ideas... create ideas... all ideas are the same. They just wander by... its like if you have mice. If your house has mice, you never know when they’re going to show up, or how, or in which room. And great ideas are the same. They’re like mice.”

~ Jerry Seinfeld, *Comedians In Cars Getting Coffee*, w/ Sebastian Maniscalco

In our [Year End 2020 letter](#) I pointed out the many dichotomies that seem to exist in a world that is clawing its way out of Covid. In one specific example I said, “There are definite pockets of excess in the investing world, yet in my view there are still incredible bargains available.” Throughout the first quarter of 2021 these pockets of excess had the financial media foaming at the mouth. Most notable were 1) the craziness

of Gamestop (GME) which briefly became the largest company in the R2000 after rising more than 8,000%, and 2) the family office of a well-known investing personality borrowing a reported \$85 billion (*billion!!!*) to leverage their bets, which predictably ended in tears.

With all of this excitement, it can be easy to ignore the more boring corners of the market where we spend our time. As you know, we frequently invest in companies that are dealing with some sort of optical, operational, or structural problem. These opportunities can come in all sorts of different shapes and sizes, but one fact pattern that I find particularly attractive is what I call “good co. / bad co.”

Under SEC reporting rules, public companies have to report consolidated financials across multiple business lines. From a high level, this means that if a company has 2 business units, one of which is quite good, and the other of which is not, the consolidated financials will obscure the details of the good company, and only show a muddled picture to the 90% of market participants that are relying on some sort of quantitative screening tool these days.

In normal market environments it can take years – or decades - for improperly incentivized management teams to prune or otherwise transition away from their bad cos. Tales of empire building by ego driven – rather than wallet driven – boards of directors are legion. However, in part due to harsh realities imposed by Covid, a number of companies have accelerated their plans to deal with their bad cos. This will shortly allow them to be more properly valued by the market for their good – or in some cases – great cos.

As a result, Laughing Water Capital currently has a pretty severe mouse infestation. There are 4 companies that I have been actively accumulating shares in that I believe will help fuel our portfolio over the next 2, 3 or 5 years. As we are still actively buying, I will not fully disclose these positions, but I felt a teaser for two of these companies was in order.

Company 1 has become a top 5 position. This company is seen by the market as a cyclical commodity hardware producer with weak corporate governance. With a stock chart that has been flat for ~25 years, for most investors this company is a quick pass. However, the company has recently taken steps to shutter business lines that obscure the fact that their main hardware product actually operates in a niche duopoly with switching costs that are protected by strict regulations. Further, the component that this company makes is essential to the success of their customer’s product, yet represents only a small portion of the total cost of this final product, which results in significant pricing power, and look through gross margins that I believe are greater than 50%. Not what you would expect from a hardware producer.

While this fact pattern alone would be reason to take notice, the company has also been developing a new business line that is Software as a Service focused with a razor/razor blade component. This new business line is starting from a small base, but has been growing 100% YoY into recession resistant end-markets. If they are simply able to fully penetrate already announced customer wins the entire enterprise would be trading at ~3x revenue, assuming zero value for the legacy business, which is a (admittedly lumpy) cash cow that I estimate is actually worth ~75% of the current market cap.

Of course, there is no guarantee that this new business line will fully penetrate existing customers, but as the company just recently partnered with a brand name consumer tech company on hardware to help with distribution of the software, the odds seem to be tilted toward winning an increasing number of customers. To be clear, there is a consumables element to this business, and it is not pure enterprise software so this business does not deserve to trade at 30+x revenues as other pure software companies

do. However, in my view 3x recurring revenues that seem highly attainable in a few years provides an enormous margin of safety, and should the company decide to sell off their cash cow legacy hardware business, I believe the pro forma entity would be trading at ~0.6x recurring revenue looking out a few years. Simply stated, these days recurring revenue is valued above all else by the stock market, and if things progress even close to how I have described above, we could be looking at multi-bagger returns. Importantly, I expect this recurring revenue to produce significant FCF in the not-too-distant future.

Company 2 has historically been thought of as a melting ice cube as its legacy business is clearly in decline, and the company went through a long bankruptcy process a few years back. However, despite being in decline, the legacy business gushes cash which a talented and properly incentivized management team has been using to aggressively pay down debt, and invest into a business that sells payment-enabled software for small businesses on a recurring basis. Of note, the legacy business also acts as a sales funnel for the new software business, and a recent acquisition should provide additional cash flow for the legacy business, as well as act as a launch pad for the software business in a new geography. To be fair, this business does have more cyclical exposure than many of our other companies, but the long-term trend of small businesses adopting software to assist their workflow and drive efficiency will lift any future troughs. With time, I expect that the market will come to appreciate that this business is evolving from a melting ice cube to a recurring revenue software story, and it is hard to imagine that this won't result in a significant re-rating of shares.

In sum, it seems obvious that in the world today there are still pockets of excess, and I would not argue that the broad market is historically cheap. However, much of our past success has been tied to investing in businesses in transition, and at present there are many opportunities in this arena. To be clear, the management teams of these companies have work to do in order for the theses to play out, and there will certainly be setbacks along the way. Further, during broad market selloffs businesses in transition may be punished more than the broad markets due to the lack of clarity during the transitional period. However, with patience I believe the odds for success in these new additions to our portfolio are heavily tilted in our favor. With growing revenues and widening margins the businesses are getting better. With increased focus the stories are getting cleaner. The management teams have skin in the game. Valuations are favorable as the market is distracted by business lines that are being exited or deemphasized. I believe this set of facts positions these companies and their stocks for success even if things don't go exactly as planned. As always, patience is the key.

New-old Position

Rimini Street (RMNI) - Rimini was first introduced to the partnership in the summer of 2018 via a [slide deck](#) that I put together for the Value X Vail conference. Had we held shares straight through from that time we would have earned perhaps a low teens CAGR. However, in the interim it became clear that my initial assumptions around growth were considerably misguided, and I previously sold shares at a loss. This is particularly painful because I feel as if I am the only person to manage to lose money on a recurring revenue tech stock over the last decade. Nevertheless, despite my error around growth assumptions, I believe my analysis of the quality of the business and its competitive position were sound, and I once again made Rimini a mid-sized position early this year, with more sensible growth estimates in mind.

In brief, Rimini primarily provides third party maintenance for Oracle, SAP, and other software. Rimini's business model is essentially "better service at a lower price," which is very difficult to compete against. Oracle is known to be perhaps the most litigious corporate entity on the planet, and Rimini and Oracle have been locked in litigation for years. While this litigation has been an enormous drain on Rimini resources and capital, it has also acted as a nearly impenetrable moat because potential competitors have been unwilling to deal with the threat of litigation. As a result, Rimini now commands a near 90% market share position in a market that Gartner estimates will continue to grow at a near 30% rate for the next few years, and likely beyond. As for the litigation, the court has already ruled that Rimini has the right to provide third party support; only the manner in which it is provided is in question. As such it seems as if the risk is primarily around potential margin contraction should Rimini need to amend its processes. While this would clearly not be ideal, given the dominant competitive position, continued market expansion, and clear pricing advantage vs. the software OEMs, it seems as if Rimini is well positioned to deal with the potential for margin compression. Following the removal of the litigation overhang I would expect shares to re-rate considerably higher to reflect the recession resistant recurring nature of the company's revenues, its dominant competitive position, and its long runway for growth.

Comments On Select Positions:

PAR Technologies (PAR) – PAR, our restaurant software business, made a \$500M acquisition of Punchh, the leading provider of Loyalty solutions. PAR now has the leading Point of Sale offering for enterprise customers, the leading back office offering, and the leading Loyalty solution. Shares do not scream cheap, but in a market that has historically seen restaurants mix and match across various vendors, an integrated offering of arguably the best in class in all major process areas presents a very strong competitive position facing down a large and growing total addressable market.

Iteris Inc (ITI) - In early March, Iteris, our intelligent traffic management business, received a takeover proposal that valued the stock between \$8.15 and \$8.50 per share. The board rejected this proposal and elected to run a formal sale process which is on-going. Shares remain ~25% below the rejected bid.

For several years I have written in these letters that I believed Iteris has enormous strategic value, and would ultimately be sold to a larger player. This view has been informed by conversations with industry experts, as well as comparable transaction analysis that has seen reasonably similar companies trade hands at more than 4x revenue and high teens EBITDA multiples, while subscale Iteris has lingered at less than 2x revenue and an EBITDA multiple that is essentially meaningless as Iteris has been unable to get leverage on their corporate level costs.

Iteris has a touchpoint with half of the signalized intersections in America through their traffic sensors and systems, and the data that their products produce and collect should be valuable to any company that is interested in the future of smart cities. While not directly comparable, for a point of reference in December Amazon announced they would be partnering with BlackBerry's automotive data platform, and BlackBerry's stock added more than \$1 billion to its market cap on the news. Auctions for other companies in the space have been attended by everyone from tech giants, to cable companies, to traditional engineering & consulting companies. Based on recent transactions and some reasonable guesses regarding the potential for synergies, I would expect that Iteris could fetch between \$9 - \$12 and bring this 5+ year investment to a close at some point in the next 6-12 months.

Looking Forward

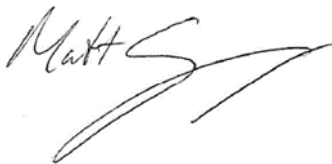
As always, I have no idea what the market will do in the near term, and I suggest that you regard anyone who claims to have the answer as a liar or a fool. Jamie Dimon, CEO of JP Morgan, recently commented that consumers currently have \$2 *trillion* more in their checking accounts than they did at the onset of Covid, which suggests that the economy will be firing on all cylinders as the world returns to normal. At the moment, the competing narratives remain the case for a “roaring ‘20s” period on one hand, and the possibility of an inflationary shock on the other hand. With little trouble we could all find a Nobel Prize winning economist to support either position, so I am not spending much time pondering the question. What matters to the market is not whether or not a roaring ‘20s period is upon us, but rather if a roaring ‘20s period is already priced into the market.

I have no doubt that in the months and quarters to come there will be companies that post record earnings on the back of those bloated checking accounts. What is harder to know is if those record earnings will be sustainable, or just a one-time or two-time post Covid bump. These are hard questions whose answers will only be known with hindsight. However, in my view, any attempt at the answer must be made on a company by company basis, as the broad indexes are not designed to separate the wheat from the chaff.

For a concentrated equity strategy such as LWC, this is an attractive environment to operate in, and at the moment we are fully invested on the long side as I have more ideas than capital. However, I have also put some temporary index hedges in place, as I feel that there is analyzable market risk tied to the lapping of an enormous market run, and the tax implications that come with such a move. More specifically, I suspect many market participants are eagerly awaiting the 1 year mark and the long term tax treatment that comes with it before they choose to hit the sell button. Additionally, it is no secret that the last year saw a huge increase in the activity of retail traders, some of whom are presently realizing that they have to pay taxes on their activity, and thus must sell stock to cover these bills. Consider the extreme [example](#) of one individual who incurred an \$800,000 tax bill on his way to generating \$45,000 in net trading profits. More broadly, as the economy continues to reopen, I would expect that elevated levels of retail participation that the market has seen during lockdown will recede.

As always, it is entirely possible that we go through a market pullback in the near or intermediate term. However, I believe our businesses and our properly incentivized management partners are well equipped to substantially improve their earnings power over the next few years regardless of any interim ups and downs. If this is the case, I believe we will be well-rewarded in due time.

Please let me know if you have any questions,



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