April, 2025

Dear Partners,

For the first quarter of 2025, a Class A investment in Laughing Water Capital returned approximately -13%.[i] Over the same period, the SP500TR and R2000 returned -4.3% and -9.5% respectively. Please check your individual statements for the most accurate reading of your individual return, which may vary based on fund, timing, and class. As always, I remind you that comparisons to the indexes have little value over shorter periods of time. This is always true, but especially true in quarters such as this one, where the bulk of our mark to market loss is tied to one of our companies whose share price declined for easy to understand reasons despite undeniably positive developments for the company. With time, I believe this mark to market loss will be inconsequential.

Zooming out a bit, I suspect you are all aware that the broad market weakness is largely tied to uncertainty and confusion surrounding the policies of the new administration. In brief, the market can't price in the news if the news changes every 10 minutes, as has been the case recently.

While this is of course frustrating day to day, as a reminder we do not invest based on the "news."

Rather, we invest based on competitive advantages, overcoming temporary problems, management team skill, and the ability to increase earnings power over the intermediate and longer term. Regardless of what else is happening in the world, if we can find businesses that are able to meaningfully increase their per share earnings power between today and a few years from now, I expect we will be rewarded as long as we don't overpay at the outset.

It can be difficult to stay focused on this idea when the mainstream media seems to giddily call for the next recession or bear market every chance they get. The situation is not made easier when there is a heaping side of politics adding to the fray. Yet, there is an enormous amount of evidence to suggest that staying the course rather than attempting to nimbly adjust to every political or economic headline is an effective path toward building wealth over time. For this reason, almost the entirety of my and my family's wealth is invested right alongside yours. Our interests are aligned.

Where Are We Now?

Legendary investor Peter Lynch is famous for having said, "If you spend 13 minutes a year on economics, you've wasted 10 minutes." I mostly agree with this view, despite all manner of pundits and economists tripping over themselves to apply a macro lens to explain the apparent pitfalls related to the new administration's plans around tariffs and cuts to government spending. That being said, if there is ever a time to use those 3 minutes, it is probably now.

As I see it <u>the problem today is that even if you had perfect knowledge of Trump's *current* tariff plan and how it would trickle through the economy, it is not clear to me that this information would be of any use</u>. This is because it is impossible to know how much of the rhetoric is simply posturing. The headline approach revealed on "Liberation Day" seems so absurd that in my view room for negotiation is a certainty, Trump is likely to change his mind several times between now and implementation, and the goal posts for "victory" are likely to move. Thus while pundits and economists are tripping over the macro lens to make sense of this all, I think ultimately that the micro lens will prove to be more important.

Many of our most successful investments have worked as well as they have because the key driver of these investments was not competitive advantage, or product fit, or growth, or anything like that. Rather, many of our best investments have been in companies where the path to success went directly through properly incentivized people simply doing what is in their own best interest. For example, if a company has two divisions, and one is earning one dollar per share, and the other is losing fifty cents per share, management can double earnings (gross of external costs) by simply flipping a switch and shutting down the money losing operation.

By extension, I don't think going into panic mode and drastically changing our investment approach due to potential tariffs would be the right move for our portfolio. While one can certainly object to Trump's methods – and there is risk that his jawboning will or has set in motion events that cannot be easily undone - ultimately I believe he will act in his own best interest. In this case I believe that means "don't do anything to lose the mid-term elections." It is thus not hard for me at all to believe that he will find a way to declare victory on tariffs relatively soon, with relatively little change to the status quo. In fact, in what is definitely not a base case, there is an argument that rather than facing reciprocal tariffs, other nations would be best served by taking their own tariffs lower, or perhaps to zero. In fact, as of this writing, several countries have indicated this is the path they will take. If pundits are worried that higher tariffs will wreak havoc on the U.S. and global economy, presumably the opposite would be true of lower tariffs.

All of this is to say that I am not completely ignoring the changing political-economic landscape. For the first time in ~2 years we have a double digit cash and equivalent position, and the bar for additions to the portfolio has gone up. However, panic and attempts to dramatically remake the portfolio to fit the current political-economic climate which could change on a dime would not serve us well. I remain committed to the idea that if we can find good businesses, led by good people, that are dealing with temporary problems, and that are likely to have considerably higher earnings power a few years from now, we should be able to generate acceptable investment returns.

Additionally, while the outcome of the current tariff uncertainty is unknowable, there are a few things I think I do know. Tariffs will not change the move toward biologic drugs. Tariffs will not prevent small businesses from moving to the cloud. Tariffs will not slow the demand for wireless spectrum. They will not keep quick serve restaurants from upgrading their technology, and they will not keep people from buying snacks and drinks from vending machines either. Similar statements can be made about nearly all of our investments. This is a painful period, but with time I believe we remain positioned for success.

Self-Flagellation

There are two items I want to call attention to, both of which reflect failings on the part of yours truly.

Xponential Fitness (XPOF) - Xponential fitness, a franchisor of boutique fitness concepts, was first introduced in our 1H'24 letter. The thesis was simple: Xponential's crown jewel, Club Pilates, was likely more valuable than the enterprise value of the entire company, essentially giving no value to the company's other fitness concepts. Shares were mispriced due to a short report – much of which was ill founded – that led to the removal of the company's founder and CEO, and a regulatory review. Future growth is very likely because several years' worth of franchise development agreements have already been sold. A new – and highly experienced – management team was brought in to right the ship, and with time the regulatory issues would be cleared, and business would return to "normal."

Our investment started as a small position, and the thesis was playing out well as the new management team began to detail the changes that needed to be made (essentially professionalizing systems and processes) and the regulatory clouds began to clear, first with the California Department of Financial Protection and Innovation closing their inquiry with a slap on the wrist, and next with hints that an SEC investigation would resolve similarly.[ii] The stock had moved up in price quite a bit, but in my view the situation had also been de-risked materially, so I increased our position size considerably, and made XPOF a top 5 position in Q1.

Status as a top 5 position however was very short lived as when XPOF reported earnings in mid-March they indicated store openings were below expectations and provided disappointing guidance going forward. Shares were quickly cut in half from where they were trading just a few weeks before.

Despite these negatives, all is not lost. Club Pilates continues to execute well, and management has shown an increasing interest in disposing of subscale brands. Further, the company will be hosting an investor day in May, which rarely happens unless a company has good news to share, so it seems possible that this was a "kitchen sink" quarter for a new management team. Nevertheless, it was a mistake to aggressively upsize the position based on positive regulatory developments while not also seeing positive operational developments.

Avid Bioserves (CDMO) – We had owned shares in Avid at various sizes for most of the existence of LWC. Most recently, I bought a large amount of shares following management's disastrous refinancing of a convertible bond in March of 2024, which I detailed in our Q1'24 letter. In February, the acquisition of Avid by private equity buyers at $12.50 per share was completed. For a few years now the thesis had been that the company had invested heavily in capacity, but capacity had not yet been filled up. As additional revenue came online, it would come with tremendous operating leverage as capacity was utilized.

Avid's proxy statement related to the acquisition contained a sensitivity analysis that projects that our thesis will play out exactly as envisioned. Specifically, the analysis shows revenue increasing by 47% and EBITDA by 100%[iii] for fiscal year 2026, which for them starts in May of 2025, and then EBITDA doubling again by fiscal 2029 (effectively calendar 2028). That would be a quadrupling of EBITDA well within our prospective investment horizon, and that EBITDA should convert to free cash flow at very high levels as the company would have been debt free (assuming conversion of convertible bonds), not have to pay much in the way of cash taxes due to the NOLs that were "earned" during our tenure, and not have much in the way of Cap Ex due to the virtually brand new facilities that were paid for during our tenure.

There is of course no guarantee the company will hit these numbers; this business can be lumpy. However, pharmaceutical companies tend to have a fairly good idea of what their ordering needs will be well in advance, and recent commentary from industry suppliers has clearly indicated that demand is accelerating. Hitting these numbers is well within the realm of possibility.

Thus in my opinion it looks like management and the board sold our company at the bottom of the cycle at a panic price. If the company executes anywhere near as well as the proxy suggests that they think they can, the private equity buyers have taken a home run out of our hands and claimed it as their own.

A key part of my investment process is related to understanding the incentives of the people involved, and in this instance I got the people wrong. When we first invested years ago there were activists involved that were theoretically protecting our interests. Those activists exited long ago, and leading up to the sale neither management nor the board had enough skin in the game to protect the interests of small common shareholders like us. Making matters worse, this sale will come with short term taxable gains for us.

Top 5 Investments

Cash and Equivalents – For the first time in a long time we find ourselves with a meaningful cash position. Much of this cash is the result of the previously mentioned buyout of Avid Bioservices, and another of our new investments – Playa Hotels & Resorts NV (PLYA) – is also in the process of being bought out from under us. Given current macro uncertainty, this cash provides optionality and safety. Rest assured though that I will not hesitate to put this cash to work regardless of the macro headlines when I find the right opportunity, and in fact I have recently been adding to some of our investments.

Lifecore Biomedical Inc (LFCR) - Lifecore, our fill-finish CDMO, remains an ugly duckling. However, new leadership has fixed up under-managed CDMOs in the past, and is making progress. The balance sheet has been strengthened, the sales force has been improved, and new customer wins are being announced. As management continues to execute, capacity utilization will improve, and with it will come tremendous operating leverage and ultimately free cash flow. A recent filing from the company indicates that internally they believe there is an 80% chance the business will be sold within the next 3 years. There is an argument that Lifecore deserves a higher multiple than what Avid Bioservices was recently purchased for, but if Lifecore were to trade at the same multiple as the Avid transaction, shares would be in the low to mid double digits today. Theoretically Lifecore should be a beneficiary of tariffs.

NextNav Inc. (NN) - NextNav, our next generation GPS / wireless spectrum investment is our largest position, and was the largest drag on our performance over the last few months. This is not overly surprising, as I mentioned in our YE'24 letter that I believed that two different venture capital funds that owned NextNav stock – one a 2005 vintage, and one a 2012 vintage – had reached the end of their fund lives, and were thus aggressively selling shares. Likely also contributing to the recent weakness is the fact that NextNav's GAAP financials give no indication of the value of the Company's spectrum licenses. In fact, the GAAP financials are a mess, and likely cause NextNav to appear on any quantitative screen meant to identify candidates for short selling. Given recent market turmoil, I suspect quite a few of those screens are being run. This type of selling – and the resulting stock price weakness – should not concern us.

Rather, we should stay focused on NextNav's relationship with the Federal Communications Commission, and the Company's efforts to change the rules that govern the 900 MHz spectrum band. On that front, recent developments have been undeniably positive, and in my view, the odds that NextNav's petition for rule making is approved have gone up considerably.

First, in early March newly appointed FCC Chairman Brendan Carr published a blog post called "Boosting GPS and 911 for the USA" that detailed plans to explore alternatives to GPS and improve the accuracy of the 911 system by strengthening the vertical location accuracy requirements. While Nextnav was not mentioned by name, Nextnav is the only company whose technology focuses on these two things. Carr also noted that there is bi-partisan support for these measures and indicated that a Notice of Inquiry (NOI) would be voted on in the March FCC meeting.

Nextnav is mentioned specifically by name in that NOI, and support at the meeting from the FCC commissioners was unanimous, with each of them noting the need for a "system of systems" to address the United States' GPS problem. While not unique to NextNav, this is the same term that the company uses, and it clearly indicates that this is a problem without a sole source solution. In other words, NextNav does not have to "win" all alone at the expense of other options. They only need to be part of a solution that may also include other options. This increases the odds of success for NextNav.

Importantly, following the meeting Chairman Carr posted on "X" / twitter that he intended to "move on Trump Time" to implement his agenda. In my view, the NOI and the reference to "Trump Time" are both extremely important, because historically the big risk when dealing with the FCC has been that perhaps your proposal winds up stuck in a drawer for five years.

That is clearly not the case here.

In fact, the timing of the NOI suggests that Carr put this process in motion during his first week on the job: this is a clear priority for him. My best guess going forward is that inclusive of the time required for the NOI process and drafting a Notice of Proposed Rule Making (NPRM), we could see a

NPRM by early fall of this year. However, if we are really on Trump Time, it is possible that the NPRM process could run concurrent to the NOI process and accelerate the timeline significantly. I would not be surprised to see NextNav shares double or more on the filing of an NPRM, as this would be a clear sign that NextNav will be well positioned to monetize its spectrum in the not-too-distant future. There is reason to believe that this spectrum could be worth anywhere from 3-5x where NN stock is valued.

Second, in mid-March NextNav announced they had re-financed their debt with a $190M 5% convertible note and related warrants that would allow them to repay their existing $70M 10% notes due in December of 2026. Quite frankly, I was surprised by the timing of this transaction as in theory an NPRM should drop with plenty of time to complete a refinancing before the maturity of the existing debt. At the same time, this extra capital provides NextNav with a war chest which can be used to deal with any opposition to their spectrum goals: effectively by paying the opposition to go away. This too theoretically accelerates the timeline.

Additionally, the investors that participated – including insiders – are very strong strategic investors that bring more to this transaction than just capital. For example, consider M-Corp, Michael Milken's family office, which is led by Josh Lobel, who was recently named to Trump's National Intelligence Advisory Board. The national security and economic case for using NextNav's technology to improve the United States' GPS system is clear by itself, but it can only help to have someone in Trump's inner circle as part of the NextNav ecosystem.

In sum, our investment in NextNav is responsible for a large portion of our year-to-date decline. However, the fundamental developments here have been undeniably positive, and have set us on an accelerated timeline toward success. It is also worth noting that this investment has very little attachment to the real economy, and over time should prove to be completely uncorrelated to the stock market. Those are attractive qualities during times of uncertainty.

Vistry Group PLC (VTY.L) - Vistry, our UK based homebuilder that is in the midst of becoming a pure play asset light "partnerships" business concluded a difficult year that was marred by accounting problems in their legacy business, which they are in the process of exiting. Quite frankly, there has not been much to like here of late. Capital returns have been slower than expected, the balance sheet remains weaker than expected, and sales rates have been uninspiring. That being said, these problems can be mostly linked to the aforementioned accounting problems which will fade into the background before long, and a gap in government financing for affordable homes in the UK as we have been in year 5 of a 5 year plan. However, the Labour government has committed to creating 1.5 million new homes, and recently announced plans for more than £2 billion in (unlevered) investments in affordable housing. In my view, the stock implies that recent cost overruns will last forever, which is demonstrably false, and that the UK housing market will never rebound, despite the government dedicating resources to ensure that it will.

This has been a frustrating period, but I believe that while the timeline has shifted to the right, the thesis remains intact. With time, Vistry's intermediate term goal remains achievable, and even if they fall short, at current prices there should be plenty of upside. Insiders own a considerable amount of stock here, and the company continues to repurchase shares in the open market. Additionally, CEO Greg Fitzgerald made a large open market purchase of shares to start Q2. Notably, historically the Partnerships business has continued to grow through recessionary periods.

PAR Technology Corp (PAR) – PAR, our restaurant software business had a strong year with annual recurring revenue (ARR) and the number of customer doors both doubling or more during the year. This level of growth is unlikely to be repeated, but management has a high level of visibility into their pipeline, and the company has indicated that ~20% organic growth should continue in the near term. This is in part due to past M&A which has recently seen the company expand their TAM into convenience stores and international markets, and management has further indicated that the M&A pipeline is more full now than it is has ever been. Importantly, revenue has been growing significantly faster than expenses for some time now, and the operating leverage is becoming apparent.

Also Of Note:

Cantaloupe (CTLP) – Cantaloupe, our software / payments business focused on vending machines and other unattended retail has traded down, likely due to general small cap weakness, and more specifically fears that a slowing economy will hurt payment processing names as payments are a volume business. That being said, vending machines and "snacks" more broadly have historically proven to be resilient as people still need to eat, even if the economy slows.

More interestingly however, Reuters has reported that the company is running a sale process.[iv] Quite frankly, I am not convinced that now is the right time to sell as the company only recently began gaining operating leverage on their costs, which is leading free cash flow to rocket higher. That being said, insider alignment is strong here, and if we can get paid today for a bright future that has not yet been fully baked, there is nothing wrong with that. Historically verticalized software / payments players have sold for 4-6x revenue, while presently CTLP stock trades for less than 3x revenue. At the mid-point of this range, shares would be worth approximately double where they trade today, suggesting plenty of upside should a sale be finalized. If a sale does not materialize in the near term, the company has reached a scale that allows them to realize leverage on their costs, and the free cash flow generating ability of this formerly money losing business will be increasingly difficult for the market to ignore.

Hilton Grand Vacations (HGV) – HGV, our Hilton branded time share business continues to trade at 4 to 5x free cash flow, and nobody cares. Nobody except management that is. The company recently announced they would be increasing their buyback authorization by 50%, bringing it to $600M per year. Importantly, they have proven that they are not afraid to use this authorization, and at this pace I expect that the company will be able to retire nearly half of its shares over the next 3 years. It is hard to think that the stock won't benefit if that happens. Importantly, historically this business has been recession resilient, and in fact grew through every recession prior to the financial crisis.

Thryv Inc (THRY) – Thryv, our SMB software business that is also running off its legacy Yellow Pages business, had a great year in 2024, with highlights being: grew SaaS revenue 25%, reached rule of 40 status, added new centers, increased the number of customers using multiple centers, brought net dollar retention to 100%, and made the business majority SaaS. This last item should lead to the stock shortly being reclassified from "marketing" to "software" under the GICS system, which in theory should make it visible to a new universe of investors.

However, all of these positives have not prevented the market from punishing Thryv recently, likely due to its perceived economic sensitivity. A slowing of the economy will not be great for Thryv's small business customers, but ultimately the pending retirement of baby-boomer business owners will be what really matters, as the next generation of business owners is likely to embrace software in ways that their predecessors did not. At present, the business trades at ~1.8x 2025 SaaS revenue guidance, and 12.5x 2025 SaaS EBITDA guidance. This is before giving any credit for the ~$275 million in cash the company believes the legacy business will kick off between now and 2030. Meanwhile, larger peers command double digit sales multiples and EBITDA multiples north of 50x. During the quarter the Chairman-CEO, President, and lead independent director all bought shares.

Looking Forward

As always, I do not have a strong opinion on what the market will do in the near term. Uncertainty caused by tariffs and cuts to government spending could of course lead to further declines. At the same time, as of this writing, small cap stocks as measured by the R2000 are already in a bear market (and flat to where they were in December of 2020) and bearish sentiment readings from AAII have reached the most extreme levels since the 2009 financial crisis. Further, the yield on 10 year treasuries has been coming down, and the odds of rate cuts in the near future have gone up, both of which are presumably good for the United States, as we need to refinance $9 trillion in debt this year. This backdrop would likely provide a reasonable foundation for the market should the administration back off from their current tariff stance in the coming months. As mentioned above, I am mostly of the view that this is likely to happen 12 to 15 months in advance of the midterm elections.

What I believe is most important for us is that for the most part, our businesses are recession resilient, and have strong tailwinds improving their individual near term prospects, as well as strong tailwinds improving their industry prospects. The businesses themselves are well suited to navigate the unknown future macro environment, and with time should be able to drive their normalized earnings power higher.

This of course says nothing about the multiples at which they will trade in the market day to day, as price is set by the market participant with the weakest hand, and many market participants choose to indiscriminately sell small cap stocks regardless of whatever tailwinds they have at the first sign of clouds on the horizon. This despite the fact that clouds often clear. Further mark to market risk comes from the idea that for many of our businesses their true normalized earnings power only becomes apparent after significant diligence. This is by design, and helps explain why the opportunities exist, but in times when fear rules the day, the market tends to shoot first and wait for positive developments later.

If we were starting at high normalized valuation levels and concerned with our portfolio's performance every day, month, or quarter, this would be a problem. However, the foundation on which Laughing Water Capital is built is the idea that if you own good businesses, run by properly incentivized people, during times of near-term uncertainty (macro or micro), you will be rewarded over reasonable periods of time as long as you do not overpay going in. Nothing in the current headlines suggests to me that this idea needs to be altered, and I am busy investigating new opportunities that the current uncertainty is revealing. As always, patience will be the key. Personally, I intend to increase my exposure to our strategy in the near future.

Please let me know if you have any questions,

Matt S

Matthew Sweeney
Managing Partner

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[i] Laughing Water Capital refers to Laughing Water Capital, LP, Laughing Water Capital II, LP and other associated entities managed by LW Capital Management LLC

[ii] https://dfpi.ca.gov/wp-content/uploads/2024/11/Consent-Order-Xpotential-Fitness-Inc.pdf

[iii] Company Proxy, January 23, 2025

[iv] https://www.reuters.com/markets/deals/us-payments-firm-cantaloupe-exploring-options-including-sale-sources-say-2025-02-25/