Atai Capital Management

Q1-2024 Letter

Dear Partners, **May 1st, 2024**

Atai Capital experienced a decline of 1.2% in the first quarter net of all fees. This compares to a 10.6% total return for the S&P 500, a 5.2% total return for the Russell 2000, and a 4.7% total return for the Russell Microcap.

	Atai Capital	Russell Micro	Russell 2000	S&P 500
Q1-2024	-1.2%	4.7%	5.2%	10.6%
YTD	-1.2%	4.7%	5.2%	10.6%
Since Inception	18.4%	14.4%	23.0%	39.6%
Annualized	14.6%	11.5%	18.2%	31.0%

As a reminder, we run a concentrated portfolio of mostly uncorrelated stocks (IE—not included in an index and or a minor component of one), so periods of both relative underperformance and outperformance should be expected. However, that does not make our underperformance compared to the S&P 500 any less frustrating in the short term. Nevertheless, I remain enthusiastic about our portfolio's prospective returns.

Our largest detractor for the quarter was EG7, which we will provide an update on later in this letter. I'll also introduce you to another one of our positions, Turning Point Brands.

Sticking To Small Ponds:

As I've spoken about before, I like being able to cast the widest net possible when sourcing ideas. Thus, I have planned to cap the firm's AUM since day one in order to maintain our large investible universe. Previously, I had been somewhat vague on what that amount would be, simply because I didn't have a good answer at the time, but with a year+ now firmly under my belt, I've settled on a number – we'll be closing to new outside capital once we hit $50M AUM.

Initially, I had planned on investing predominantly in the small-cap space (which would have allowed for more AUM). However, over the past year, much of our portfolio has been weighted towards sub $200M market caps, 45% of which falls into this category today. Furthermore, as I've spent more time in the Microcap space, I've realized it's an area I'd like to be able to take sizeable positions in when opportunities arise. Closing to new outside capital at $50M allows me to do that while also protecting our existing and future clients' growth runways.

Additionally, as mentioned in prior letters, I plan to sunset our Founders' class fee structure (1.50% management fee) for new clients at the end of Q2. However, I want to clarify that I don't plan on charging performance-based fees. I believe they create a conflict of interest rather than alignment (not to mention more compliance headaches – I prefer to avoid brain damage whenever possible). Moreover, if a portfolio manager puts up phenomenal returns, clients will usually benefit far less from those returns over time if they are charged performance fees. However, our fee structure will remain flexible, and we'll continue to consider performance-based fees for those who request them.

Portfolio Commentary:

We added one small tracker position throughout the quarter and increased our size materially in an undisclosed position. As for turnover, we moved quickly to sell out of a small position in Everi Holdings ("EVRI") after they announced a merger with International Game Technology ("IGT"). In short, our thesis did not play out as expected; we had owned EVRI for their growing "Fintech" business, which included casino kiosks that had previously been described as having monopoly-like power in a lawsuit from a competitor. While we believe both the combined entity and EVRI remain undervalued, we have very little interest in owning IGT assets. Furthermore, our original reason for owning EVRI (Fintech) will now be a much smaller piece of the puzzle moving forward.

Turning Point Brands. ("TPB"):

Turning Point Brands is a manufacturer, marketer, and distributor of branded consumer products. The business has three segments, which we'll discuss shortly: Stoker's, Zig-Zag, and New-Gen.

Turning Point Brands has had a somewhat hectic past with a few strategic pivots and three CEOs over the past few years. This is not a well-loved company, and many investors have gotten burned since its 2016 IPO. As a quick anecdote, nearly everyone I've spoken to seems to have a negative opinion/story about Turning Point. However, therein lies the opportunity, and we believe the company is now set up for MSD or higher consolidated top-line growth (excluding its new-gen segment) and even faster bottom-line growth.

I do want to add some additional color here. Investors who have previously lost money on Turning Point Brands usually overpaid on the back of what they assumed would be rapid growth in one of its segments. In 2018-2019, their New-Gen segment was expected to continue its rapid growth trajectory through acquisitions and organic growth, but the FDA would crack down on Vapes/E-Cigs, leaving this business in limbo to this day. From 2020-2021, Zig-Zag was over-earning, and investors wrongly extrapolated this growth into the future.

On the flip side, those who have had success purchasing TPB did so when the "legacy" businesses were cheap (Zig-Zag / Stroker's), and that's our thesis today as well. This is also the first time the company has strongly emphasized organic growth and isn't talking about acquisitions. TPB shifted their focus to organic growth when they brought in a new CEO, Graham Purdy, in late 2022 (whom we'll talk about more later and have spoken to many times).

Stoker's (49% of Operating Income):

Stoker's has two main product offerings (Loose-Leaf Tobacco and Moist Snuff Tobacco) and a third they are working on (FRE Nicotine Pouches).

Loose-Leaf Tobacco (~32% of segment sales):

Stoker's is the market leader in the Loose-Leaf Chewing Tobacco category; they have a low 30's market share while also being the #1 discount provider. Loose-Leaf is in secular decline, and

category volumes should be expected to continue their downward trend. Loose-leaf tobacco users are mostly older and lower-to-middle class, and very few competitors are focused on this category. Because of this, Stoker's has benefitted from their strong discounted offering and has consistently taken market share each year as they continue to benefit from further consumer trade-down and competitors' general lack of focus. We believe price increases and continued market share gains should lead to Loose-Leaf seeing flattish to LSD sales declines.

Moist Snuff Tobacco (~68% of segment sales):

Stoker's has HSD market share in the Moist Snuff Tobacco ("MST") category and operates as a low-cost provider. Like Loose-Leaf Tobacco, Moist Snuff Tobacco is also in secular decline. But unlike Loose-Leaf, Stoker's has and will continue to take enough market share to offset or grow volumes while also getting the added benefit of HSD pricing each year.

Stoker's is the best discount MST you can buy, and a quick scan of tobacco-related boards/threads/reviews will generally point out that the other discount brands are inferior products to Stoker's. There is only one discount competitor worth mentioning, Longhorn – which is a deeply discounted and not well-liked MST product priced significantly below Stoker's in most markets. The better-known and higher-priced brands, such as Copenhagen, Skoal, and Grizzly, don't benefit from diluting their brands and competing for market share with Stoker's. Instead, they focus on price increases to offset their market share losses and volume declines each year.

There are also a few reasons why the more prominent brands won't start competing with Stoker's in the discount category anytime soon. Since Stoker's is a lower-cost product, it also has lower margins, and if the big guys were to start discounting their product, they would have to hope they could take enough market share to offset the substantial decline in profit dollars/margins they'd see. The large tobacco companies aren't so irrational as to shoot themselves in the foot here. While some, like Altria ("MO"), do have a few discount brands (RedSeal/Husky), they are small, lack consumer loyalty, and are losing share to Stoker's. I am not a "dipper" myself, but those who have reviewed Stoker's seemingly always rank it as the best budget dip available – plenty of dippers even like it more than Skoal, Copenhagen, and Grizzy and will make the switch once they try it. I do think it's worth mentioning that there is a surprisingly strong community/culture around both MST and Chewing Tobacco.

Furthermore, Stoker's is only in ~67% of stores by volume, so the whitespace opportunity here is real. However, they won't ever be able to get near 100% because they prefer to target high-volume stores, and a lot of lower-volume locations don't make economic sense. They are in ~79k stores today and are targeting an additional ~30k-50k locations, which should get them near 90%. However, taking advantage of this whitespace opportunity will take time as it's mostly "trench-warfare" - Stoker's enters most of these stores individually.

Moreover, Stoker's runway for price increases is long since the big guys are unlikely to stop taking significant price each year anytime soon. Stoker's is a price follower today, but given the brand

loyalty and their continued volume growth, I believe that it's likely Stoker's could continue to take HSD pricing even if the big guys were to slow down. Why aren't they taking more price then? Stoker's, for now, benefits from being a price follower because it incentivizes more customers to try the product and potentially become long-term users. If they were priced similarly to Skoal/Copenhagen/Grizz, customers would likely stick to those and not try anything new.

Additionally, each incremental price increase Stoker's takes will help expand margins since each incremental dollar mostly goes straight to the bottom line. Operating margins are in the low 40s today, while margins for Skoal and Copenhagen are north of 70%—the difference here is mostly pricing.

It seems likely that their yearly price increases, white space opportunities, and continued market share gains should lead to MST seeing HSD+ sales growth for the foreseeable future.

FRE Nicotine Pouches (De minims % of Sales):

Plenty of investors seem to think it's too late for Turning Point to enter the Nicotine Pouch market, or I've seen others claim this product has just been a total failure since we haven't seen any growth from it yet. I don't believe either is true; Turning Point is taking a similar approach to FRE as they did with Stoker's, targeting high-volume stores with the goal of slowly but steadily taking incremental market share over time.

While FRE is not a discounted product like Stoker's, it does offer an interesting value proposition by having a higher nicotine content per pouch than most competitors: they also have a Mega Tin offering that is similar to Stoker's Tub offering (basically a massive container of MST). Furthermore, Turning Point is currently executing a national rollout after testing the product in select markets over the past two years. This roll-out won't happen all at once and will be similar to the "Trench Warfare" seen at Stoker's. Turning Point already has relationships with plenty of these stores through Stoker's, and management seems to think they can get $100M+ worth of the nicotine pouch pie over time – I'm not going to give them any credit for FRE just yet, and while it is a lower-margin product than Stoker's MST, it's still an attractive opportunity.

FRE also recently went semi-viral on social media (mainly Instagram) for their Mega Tins. This led to increased demand and brand awareness across all platforms, which has led to online forums now more actively talking about FRE, and reviews have been mostly positive thus far. It's worth noting that older reviews have been mixed because of "aged" inventory that was out in the market from the initial rollout two years ago (pouches get hard and crusty over time but are still safe for consumption). And since going viral in early April, they quickly sold out of Mega-Tins. It seems like there are plenty of customers lined up to purchase the product again once it's available (plenty of people across social media are asking when they will be back in stock). Given the infancy of FRE, I don't think they were prepared to meet this increased customer demand for their Mega-Tins; some regular-sized tins are still available on their website but are mostly sold out as well. While it's important not to read into this increased demand much, it's undoubtedly

positive and provides a decent “proof of concept” that FRE could potentially be viable in the long term.

Wait, Aren’t Nicotine Pouches Going to Cannibalize MST?

While pouches have certainly impacted MST, these pouches likely expand the oral category much more than they cannibalize it. Dipping is usually seen as a masculine, tough thing that only manly men do, and proof of this is that only LSD MST users are female. However, if you look at who is using Nicotine Pouches, ~30% of all users ARE female. It’s anecdotal, but I have plenty of friends who pop these addictive white pouches constantly, and they have never or would never put a dip in. I believe it’s likely that MST and Pouches serve mainly two different customers, and I don’t see most MST users switching to Pouches.

Without giving any credit to FRE, I believe consolidated sales growth for the Stoker’s segment will be in the MSD+ range, with operating income growing HSD for many years to come.

Zig-Zag (51% of Operating Income):

The Zig-Zag segment comprises rolling papers, wraps, cones, and Clipper lighters. All of which are primarily used in Cannabis consumption. Zig-Zag is a 150-year-old brand, and you might recognize the name from songs like “Crazy Rap (Colt 45 & 2 Zig Zags!).” It’s worth noting that they don’t actually own the “IP” for the papers portion of Zig-Zag but instead license the brand through what is essentially a perpetual distribution agreement that renews every 20 years (the next renewal is 2032).

Like Stoker’s, Zig-Zag has an attractive white-space opportunity in its alternative channel (Headshops/Dispensaries). Pen is just HSD today, and management believes it’s a ~$100M opportunity over time. They also have room to expand their product offerings at existing stores (For example, less than 50% of stores that carry Zig-Zag papers also carry Zig-Zag cones).

One concern I’ve heard brought up is that as states legalize Cannabis, consumers move their consumption preference towards pre-rolls/edibles/vapes and move away from traditional rolling papers/cones/wraps. While Zig-Zag’s overall market share does decline once a state legalizes, the Cannabis pie gets a lot larger, offsetting Zig-Zag’s share losses. An interesting opportunity that Zig-Zag is working on with some MSOs (multi-state operators) is for an MSO's pre-rolls to be Zig-Zag branded. Previously, during the “Cannabis Boom” of 2020-2021, dispensaries wanted everything under their own brand/banner, but some are slowly moving away from that.

This segment was over-earning during the COVID era since everyone stayed indoors, worked from home, and thus had more time to consume Cannabis. This also led to elevated distributor inventory to meet the increased demand and avoid supply chain issues. However, the papers and wraps business has now stabilized and should be growing sequentially moving forward.

Zig-Zag has historically had an older audience, but that is changing as the company works to target a younger demographic through social media. They are also working on turning Zig-Zag

into more of a lifestyle brand, recently partnering with the clothing store Zumiez, and are actively looking for other similar partnerships. These partnerships essentially function as profitable marketing for Zig-Zag.

Clipper is a Cannabis centric lighter where customers frequently use its flint system to pack Cannabis. Clipper Lighters was a brand Turning Point picked up through a distribution agreement they signed in 2022. Clipper is the #1 reusable and #2 overall lighter globally but has very little presence in North America today, controlling just a 3% share of a ~$500M market.

There are a few main growth drivers here, so you have Clipper, E-commerce, the alternative channel, more states legalizing Cannabis, and new product introductions. I think a reasonable assumption is that these add up to Zig-Zag growing MSD going forward.

New-Gen (De minims % of Operating Income):

This is primarily a vape distribution business that we view as nothing more than a call option. It's EBITDA breakeven, not growing, and seems likely to be divested in the coming months/years. This segment used to represent a material portion of Turning Point's business, but after FDA regulatory scrutiny, I am assigning zero value to the business. However, In the rare event that the FDA actually does its job and cracks down on the selling of illegal Chinese vapes sometime in the near future, and if Turning Point were to get PMTA approvals for some of its vape products, this segment could eventually prove to be valuable.

Putting It All Together / Final Thoughts:

We've owned TPB for over a year, and over that time, it's grown from a small starter position to a double-digit allocation for us (through both share price appreciation and several additions over our holding period). During our time as owners, we've spoken to Graham Purdy (CEO) several times, including meeting with him in person in November of last year at the Southwest Ideas Conference over in Dallas (where we also caught up with the management teams of two of our other largest positions AstroNova and Bel Fuse). Graham has worked at Turning Point for nearly two decades and played a crucial role in building the Stoker's MST business and expanding Zig-Zag's product lines. Our conversations with Graham have been positive; it's apparent that he is very passionate about both the Zig-Zag and Stoker's businesses, he's not afraid to tell you about the past marketing/product mistakes he's made, and we believe the role he's played in growing both Zig-Zag and Stoker's over the years makes him an excellent fit for the company moving forward, and his performance thus far has been encouraging. We're also looking forward to meeting the new CFO, Andrew Flynn, after their first-quarter earnings call later this week.

Turning Point is going to generate a good amount of cash over the next two years and is working to address its convertible notes due in July of this year (They have ~$120M left). After that is knocked out, the company is likely to either pursue buybacks or pay down its $250M senior notes due in February 2026. Whichever takes priority (buybacks/debt pay down) will depend on the rate environment at that time, but I believe we likely get a combination of both starting later this year.

In conclusion, I see them doing $105M+ of EBITDA in 2025 (2024 EBITDA guide of $95M-$100M) on what I consider to be reasonable assumptions. The company is already run-rating near $100M in EBITDA today before any additional cost savings they've been working on. Zig-Zag appears to have stabilized as of the most recent quarter and should return to solid growth soon. Moreover, the continued margin expansion in the Stoker's business will help accelerate the bottom line faster than the top line, and the company has two FRE call options (pun intended) with Nicotine Pouches and New-Gen, which we aren't assigning any value to.

Given Turning Point's growth opportunities and very low cyclicality, a 10.00x EBITDA multiple (HSD FCF yield) seems fair for TPB. Using this multiple and giving no credit for incremental cash flow or working capital release gets us to $46/share and attractive IRRs on what we consider to be both reasonable 2025 estimates and undemanding multiples.

Enad Global 7. ("STO: EG7") Update:

Enad has been the firm's largest detractor, experiencing a ~30% decline year to date. This decline can likely be attributed to portions of EG7's live-service game portfolio declining faster than I and the market had initially anticipated. However, this was always possible, and the current share price remains more than unwarranted. Enad is still guiding to $1B-SEK in EBITDA for 2026 on an enterprise value of just ~$750M-SEK today, and even a decent-sized miss would still make Enad a more than attractive opportunity. It's worth noting that there are some very real costs in that EBITDA number, but FCF conversion should still translate to around 50% or higher. I also believe many investors are overlooking the fact that the existing portfolio of live-service games requires very little investment, and most of the development-related costs are expensed when they happen rather than capitalized.

Moreover, the gaming industry continues to exhibit weakness, and we're seeing numerous layoffs and project cancelations industry-wide. In 2023, the gaming market saw job losses exceeding 10,000, and there has been an additional 8,000+ since just the start of this year. While the current backdrop isn't great, Ji Ham (CEO) has proven himself more than capable of capitalizing when opportunities arise from distress. Enad is actively looking for M&A deals and live service agreements (like the one they struck for Magic the Gathering Online), and given management's track record, I believe if some deal or agreement is eventually announced, it will likely be very accretive with favorable terms.

Management has also continued to demonstrate they are intelligent operators by selling the Planetside IP for ~$6M earlier this year while shuttering and or transferring the studio in charge to the new owners. While not stated in any press release, we can come to this conclusion since the development and maintenance of Planetside 2 has been shifted to ToadMan Studios. This leaves us with two possibilities: one, Enad has retained control of Planetside 2 while cutting costs (closing the prior studio in charge, Rogue Planet Games, and moving development over to ToadMan, who has excess development capacity), or two, the new owners of the Planetside IP are paying

ToadMan to manage the game for them. I am unsure which conclusion is actually correct because ToadMan lists the game as "work for hire" on their website, but Planetside 2 also remains a part of Daybreak's all-access pass. However, both possibilities would demonstrate thoughtful capital allocation.

While we have some concerns, such as the potential cancellation of the H1Z1 game, management has routinely been making intelligent decisions, and with an enterprise value that is now less than its 2026 EBITDA guide, Enad remains severely undervalued.

Conclusion:

Despite the sluggish start this year, I remain optimistic about our portfolio's prospective returns. Our businesses are performing well, and we're choosing to be selective in deploying our remaining cash, focusing solely on the best opportunities available.

As a reminder, we are open to new clients, and if you know someone who might be a good fit, please feel free to pass along my contact information. Our Founders' class fee structure will be available to all new clients until our next quarterly letter is released.

As always, I am humbled by and grateful for the opportunity to invest your capital alongside my own, and I will continue to make every effort to compound that capital at attractive rates.

Cordially,

Brandon Daniel
Founder & Portfolio Manager
Atai Capital Management, LLC
bdaniel@ataicap.com

"The stock market is a giant distraction from the business of investing."
– Jack Bogle

Disclaimer:

This letter expresses the views of the author as of the date cited, and such views are subject to change at any time without notice. The information contained in this letter should not be construed as investment advice, and Atai Capital Management, LLC ("Atai Capital") has no duty or obligation to update the information contained herein. This letter may also contain information derived from independent third-party sources. Atai Capital believes that the sources from which such information is derived are reliable; however, Atai Capital does not and cannot guarantee the accuracy of such information. References to stocks, securities, or investments in this letter should not be considered investment recommendations or financial advice of any sort.

Any return amounts that are reported within this letter are estimated by Atai Capital on an unaudited basis and are subject to revision. Atai Capital's returns are calculated net of a 1.50% annual management fee and reflect a client's performance who would have joined the firm on its inception date (01/03/2023). Actual Individual investor returns will vary based on the timing of their initial investment, the impacts of additions and withdrawals from their account, and their individually negotiated fee structure. Atai Capital believes showing returns net of a 1.50% management fee better reflects actual performance as of 05/01/2024 since no account that Atai Capital currently manages is charged a fee more than the stated 1.50% management fee. Past performance is no guarantee of future results.

Index returns referenced in this letter include the S&P500, Russell Microcap, and Russell 2000. Atai Capital's returns are likely to differ from those of any referenced index. These returns are calculated from the respective provider's websites, spglobal.com for the S&P500 and ftserussell.com for the Russell Microcap and Russell 2000, and include the reinvestment of all dividends in both cases.