MIDWAY PARTNERS

CAPITAL MANAGEMENT

April 12, 2022

Re: Quarter Ending March 31, 2022

Dear Partners:

2022 kicked off with a flurry of volatility as the S&P 500 index had its worst quarter since early 2020, down (4.9%) over the period (excluding accrued dividends). The decline would have been steeper had it not been for a small rally during the last two weeks of March. Our Partnership fared relatively well in the first quarter of the year, finishing down approximately (0.8%) on a net basis (please see your individual statements for results).

When prices ascend, euphoria begins to supplant investment reason, and the risk of speculation rises. When prices become choppy, the opposite occurs, and negative sentiment replaces reason and previously sound investment decisions come under assault. In these situations, we remain disciplined, using lower prices to our advantage by establishing new or adding to existing positions. As a result, we have deployed a portion of the Partnership's remaining cash in this manner leaving the cash balance at about 13% of total assets as of the quarter end.

It is important to ignore the emotions created from short-term price fluctuations in either direction as market prices are far from omnipotent. In fact, we believe that markets can be quite inefficient when it comes to the short-term pricing of individual securities and quite disconnected from intrinsic value.

An Irrational, Pricing Mechanism

To illustrate the concluding comments in the section above, we turn to a case study on the newest addition to the portfolio, Sleep Number Corporation (SNBR). We will expound on our investment rationale for SNBR in a subsequent section. For now, let's review how the "efficient" market priced SNBR over the past 24 months.

For the pre-pandemic year ending December 31, 2019, SNBR generated $112 million of pretax profit and $113 million of free cash flow (defined as operating cash flow less stock-based compensation and capital expenditures). The company had grown revenue over the prior three years at a 9% compounded growth rate and maintained stable gross margins of about 62%.

What happened next was beyond anyone's prediction. The COVID-19 virus outbreak exploded and in February/March 2020 stock markets began to fall with fears of global economic

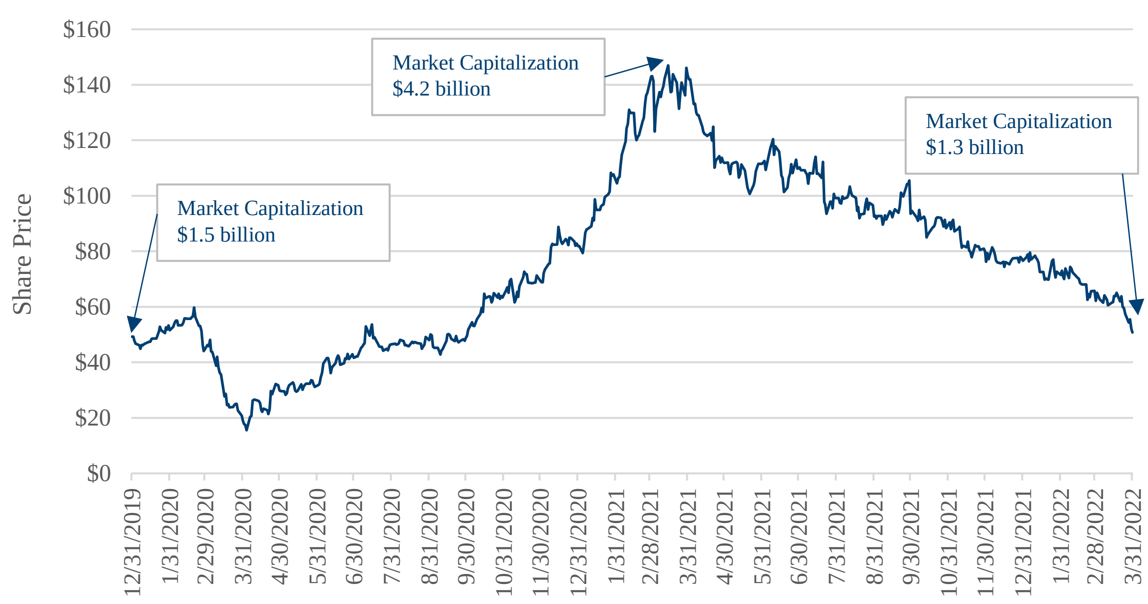
Armageddon. SNBR's stock price fell to below $16 per share. In hindsight, the result of the pandemic for many companies was the opposite of what was feared. Americans, confined to their homes, began a spending spree on goods and services to improve their quarantined homelife, resulting in a windfall of revenue and profit for many companies. SNBR was a beneficiary of this spending.

The company experienced an explosion of revenue growth and profitability ending 2020 and 2021 with $185 million and $194 million of pre-tax profit, respectively, far in excess of the normal levels in pre-pandemic 2019.

Our rational view of this two-year period of profit increase was that the excess profitability would likely be temporary and was not related to a sustainable change in the company's economics. To our knowledge no fundamental changes to the business model had occurred. The short-term windfall would ultimately add almost $200 million (the equivalent of about two years of excess profits) to value but leave the underlying long-term intrinsic value unchanged. We saw this as a conservative interpretation of the impact of the pandemic driven profitability increase. We saw similar trends in other consumer products and services companies as well.

Now let's review the market's "efficient" response. In September 2020, the price of SNBR's stock began to skyrocket. From the pre-pandemic price of about $50 in December 2019 (market capitalization of $1.5 billion), the price increased by almost 200% in under 16 months reaching a high of $146.97 (market capitalization of $4.2 billion) in March 2021 (see chart below).

SNBR Share Price (December 31, 2019 - March 31, 2022)



Note: Diluted shares outstanding reduced from 29.80mm to 24.95mm over the period
Source: Factset and company filings

Did SNBR suddenly change its operations to more than double the total amount of free cash flow expected to be generated over the life of the business? No! Did they introduce a new product that unlocked new markets or dramatically increased expected market share? No! Did the dynamics of competition within the mattress industry change giving SNBR additional growth opportunities? No! Did they discover a gold deposit under their headquarters? You get the point!

We think this is an exemplar of how share prices in the short-term reflect relative pricing metrics that often deviate significantly from intrinsic value. SNBR's trailing 2020 profit and expected 2021 profit were significantly higher than 2019's normal profit levels, so the market slapped on an unjustified P/E multiple, TEV/EBITDA multiple, etc. With all due respect to Professor Fama, the SNBR market price over the period was far from efficient. Even if it did reflect all available information, it did not interpret that information in a rational way. We avoided the company at those high prices.

We believe this illustrates why it is critical to view price and intrinsic value as completely independent of each other in the short run. It is easy to look at the stock price and think, millions of shares traded, that price must reflect underlying intrinsic value. This example reminds us that it often does not.

Since reaching highs in 2021, SNBR's price has fallen dramatically back to between $50 - $60 per share. Let's pick up the story in March 2022 when the Partnership first began to acquire shares.

New Position – SNBR

From an investment perspective, SNBR is an outstanding opportunity. The company provides mattresses with individualized firmness and technologically advanced features to improve the sleep experience of its customers. SNBR sells its products directly to customers via 648 retail locations across all 50 states. It does not sell through other mattress retailer networks. We believe that the company's brand, products, and vertical distribution strategy are highly differentiated in the market. SNBR does not sell mattresses; they sell "Sleep Numbers".

The company boasts impressive single unit retail economics and efficiencies with normalized annual revenue of about $3 million per retail unit and average store square footage of only 3,000 square feet (>$1,000 sales per square feet). Normalized same store sales growth has averaged 3% - 6% per year since 2017. More impressively is the company's capital efficiency. Inventory turns average more than 7.0x annually with gross margins greater than 60%.

The company has only invested $256 million in capital expenditures and acquisitions in excess of depreciation and amortization over the last 10 years while growing pre-tax earnings from $50 million to over $100 million. Over the same 10 years, the company has repurchased $1.5 billion of its common stock (more than its current market capitalization), reducing the diluted share count from 57 million in 2012 to 25 million outstanding on December 31, 2021. The company has only about $382 million of non-lease debt outstanding.

Given the information above, what is a conservative estimate of intrinsic value? With the company's current store footprint, near-term new lease opportunities for an additional 45 locations, and historical same store sales growth, we conservatively estimate mid-single digit revenue growth for the interim period. We believe pre-tax profit margins will normalize at an average of about 7% per year.

With these conservative income statement assumptions and the company's historical returns on incremental invested capital, the equity intrinsic value is estimated between $1.5 billion - $1.7 (after subtracting debt). Given the 24.95 million diluted shares outstanding, this implies an intrinsic value per share of between $60 - $68. Compared to the market capitalization on March 31, 2022 of about $1.2 billion or $51 per share, the discount to our conservative intrinsic value estimate is between 20% - 30%.

We began buying shares at around $61 and continue to buy as the price has fallen to around $52 as of this writing. SNBR's stock price may continue to fluctuate, giving the Partnership the opportunity to purchase additional shares at deeper discounts to our conservative estimate of intrinsic value.

Final Thoughts on Near-Term Market Movements

There is considerable uncertainty in the world, most notably rampant inflation, rising interest rates, the continued impact of the pandemic, supply chain challenges, rising commodity prices, and the Russian/Ukrainian war. This uncertainty will most likely lead to volatility in security prices in the near-term moving many prices away from their company's underlying intrinsic value.

We do not believe that any of these factors or price fluctuations have an impact on the long-term intrinsic value of our portfolio. The Partnership's portfolio companies should continue to grow and produce strong cash flow. We expect a portion of that cash flow to be reinvested at reasonable rates of return and a portion of it to be returned to shareholders in the form of dividends and buybacks.

These actions by our portfolio company are happening irrespective of stock price movements. Over the long-term, these actions should result in compounding intrinsic value at our portfolio companies which should ultimately flow through to the Partnership.

We welcome comments or questions from partners at any time

I love nothing more than discussing investing philosophy, strategy, intrinsic value, or any topic you might find interesting – give me a call!

Conclusion

The Partnership is actively taking new subscriptions from qualified clients. We welcome any referrals from current partners. Please contact info@midwaypartnersllc.com for more information.

We are honored that you have chosen to be a part of the Partnership and to entrust Midway Partners with your capital.

Sincerely,

Jordan Lampos

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