MIDWAY PARTNERS

CAPITAL MANAGEMENT

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midwaypartnersllc.com

Re: Quarter Ending September 30, 2022

Dear Partners:

Q3 2022 was a terrible quarter for stock prices, adding to an already rough year-to-date period. The S&P 500 ended September down about 23.8% for the year, inclusive of dividends, while the Fund was down about 17.9% (please review your individual statement for results). Therefore, we thought it would be timely in this letter to review our thoughts and philosophy on markets and securities prices.

Review

Although financially painful to investor accounts, the repricing of stocks based on higher and more normal short- and long-term interest rates is a good thing for financial markets. We do not believe it is healthy to have near zero interest rates and seemingly endless monetary stimulus from the central bank as we did in 2020 and 2021. The deluge of liquidity contributed to several undesirable financial market phenomena, including inflation concerns with the June 2022 CPI hitting a year-over-year level not seen in 40 years[1], skyrocketing home prices, 861 new public SPACs in 2020 and 2021 (for context there were only 226 in the prior ten years from 2000 to 2019)[2], and asset price bubbles for some companies fueled by anomalous pandemic demand that was imprudently extrapolated as sustainable growth (think Peloton, Zoom and even Target, Google, etc.). We do not make macro predictions on the market, but we support the continued quashing of inflation by the Federal Reserve and more normalized asset prices in the meantime.

The benchmark 10-year treasury yield started the year at about 1.5% and finished Q3 2022 at about 3.8%. The CPI appeared to peak at 9.1% year-over-year in June. While most finance textbooks would list interest rates and inflation as risk factors for fixed income investments, equity securities are absolutely exposed to them as well. Riskier assets, like stocks, are simply not worth as much if the yield on less risky assets (e.g., Treasury bonds, secured debt, debentures) moves higher. They are also not worth as much if real returns, after accounting for inflation, move lower as they have since inflation's recent assent began in May 2020. The punchline is that if less risky investments yield more, then the price of riskier investments must fall so that they too yield more. The good news is that if new investments are made at the lower prices, they should provide higher overall returns/yields in the future.

Strategy

Our strategy for the Fund in this environment continues to be <u>preparation</u> rather than <u>prediction</u>. We cannot predict short-term prices, but we can prepare for lower prices by holding cash. As

[1] U.S. Bureau of Labor Statistics
[2] www.spacanalytics.com

prices move down, we have begun to increase positions in several companies (as mentioned in prior letters). This was the tactic in August and September, as we invested a portion of our cash balance. We continue to hold about 11% in cash and equivalents and have begun to take advantage of attractive short-term treasury yields for a portion of that cash. We do receive dividends from our holdings that will add to cash or investments as opportunities dictate.

Valuation Methodology

As we noted above, typically as interest rates rise, asset prices fall. However, we do not use market interest rates to determine the discount rates used in our valuations of equity securities. We use discount rates that represent the minimum rate of return we find acceptable for the investment. This is not based on security price volatility (beta) or prior artificially low treasury yields. Also, we do not extrapolate growth rates or profitability when faced with one or two exceptional years of company results. We work to be disciplined when estimating growth rates and use conservative, sustainable profit margins informed by industry averages in combination with individual company competitive characteristics. A good example of this discipline can be found in the ITIC analysis outlined in the December 31, 2021 letter. Exceptional profits in 2020 and 2021 were ignored and normalized profitably based on 2016 to 2019 was utilized to estimate intrinsic value.

While this process does not make our portfolio immune to downward market price movements, it does give us comfort that we have not relied on unreasonable or extreme projections to arrive at our intrinsic valuation estimates. Our projections will likely be wrong, as the future is inherently unknown – maybe a company will execute poorly, or competitive market dynamics may change (outcomes could also be better than estimated). We believe that our conservatism does provide a margin of safety over the long-term.

Liquidity Shouldn't Change Ownership Behavior

Ownership of a business should be treated the same whether the business is private or public. This seems logical and obvious, but it is a curious concept, given the way some investors behave in a declining market. We think about it this way. An entrepreneur who owns a private business, would not immediately look to sell their business if they were told the price of the business went down. They know what the business has earned them in the past and what it may reasonably earn them in the future. They are familiar with management (in this case themselves) and are not trying to profit from short-term swings in the price of the business. They know what the business is "worth" to them (its intrinsic value), regardless of outside opinions of price.

The ownership mindset seems to disappear in some public market minority shareholders from time to time. Shareholders all too often look to the market price for information about what a business is "worth", believing that the market price is "efficient" and indicative of value. Although management has not made any significant changes and has performed well, the public market shareholder feels like a declining stock price indicates trouble ahead (or even evidence of mismanagement) and believes they must properly time price changes to make a profit or avoid loss. Given the liquidity provided in the public markets, when the market price declines, they often sell their shares to avoid anticipated further losses.

The public market investor has violated an immutable rule of investing. Liquidity should not change the behavior of a business owner or minority shareholder. A true investor approaches their public investments with the same demeanor as a private business owner approaches theirs, with a patient, long-term mindset.

Midway Partners works to behave like a business owner. While it is never easy to stand idly by while stock prices move lower, we don't invest in businesses with a trading mindset. We do not believe that we can properly time price moves to avoid negative short-term results. We believe that we know what our companies have earned in the past and have conservative opinions about what they may probably earn in the future. With this in mind, <u>we estimate an intrinsic value as if we were the sole owner of the business and let that value alone influence our investment decisions</u>. Our estimate of intrinsic value is independent of the current market price. Our goal is to behave as a true business owner, one who would not sell in the face of short-term price declines.

More Bear Market Thoughts

As stewards of your capital, we find falling stock prices gut wrenching regardless of our long-term, business-owner mindset. We understand that losses can wear investor patience thin. We don't see short-term price changes as any indication of long-term company or stock price performance. It is important to note that if no material changes have occurred at our businesses or within their industries, etc. short-term price movements do not reflect a change in intrinsic value. We are confident that our companies continue to do the following:

- Produce operating earnings and free cash flow (even if temporarily depressed);
- Reinvest their earnings, or a portion thereof, back into their business in the form of working capital, capital expenditures, or acquisitions with the goal of producing incremental earnings; and
- Return a portion of their capital to shareholders by either repurchasing their own stock or paying dividends, or both.

This means that our businesses continue to push forward regardless of the macro-economic climate or sentiment. Their capital investments grow fueling their future earnings. This growth unfortunately is not a straight line up and to the right, but we believe that the trend is in the right direction.

It is important to note that share repurchases done at depressed prices are advantageous to existing shareholders and often provide the best use of capital for managers. This could also take the form of dividends received from companies reinvested in shares at lower prices. Either way, the results are fungible to the shareholder (excluding tax impact), a greater ownership percentage of the underlying company.

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 our Partnership.

Sincerely,

Jordan Lampos

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