MIDWAY PARTNERS

CAPITAL MANAGEMENT

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midwaypartnersllc.com

Re: Year Ending December 31, 2022

Dear Partners:

2022 was a year in which the majority of stocks ended at prices below where they started. Indeed 368 of the 496 stocks[(1)] that comprise the S&P 500 were down, with the index delivering a total return of approximately negative (18.1%)[(2)] over the year. Prices were down, but what does that mean for value?

The S&P 500 is estimated to have net earnings of between $1.6-$1.7 trillion in 2022. Of that total, about 35.0%, or $550 billion, will be paid out in dividends. The remaining 65.0%, or about $1.2 trillion, will be used either for share buybacks or retained for growth (internal investment, acquisitions, etc.). Share buybacks have been favored since the Covid-19 recession in the first half of 2020 and about 50%-60% of the S&P 500's earnings are likely to be used for buybacks in 2022. That leaves only about 15.0% of earnings being retained for growth. If we assume that the S&P 500 generates an average return on equity (ROE) of between 15.0%-20.0%, then we would expect to intrinsically grow the earnings of the index by between 2.3%-3.0% for the year (retained earnings percent x ROE = earnings growth). The index has grown earnings by about 7.8% compounded annually for the last 10 years. With 90% of earnings returned to shareholders through dividends and buybacks, sustaining high single digit earnings growth in the future may be challenging. A greater percentage of retained earnings is likely necessary.

2022 Review

We see no need to replay the significant U.S. and world events that influenced asset prices over the year. In the long-term, most of these events will prove insignificant to the value of our individual investments so let's focus on the portfolio.

The Partnership ended 2022 down (13.3%) net and down (7.2%) net since inception in July 2021 (see individual monthly statements for specific returns). While not a return deserving of a standing ovation, we are pleased that over a challenging period that saw significant price drops in many stocks, we were able to reasonably protect capital with a concentrated portfolio. Also, we achieved outperformance relative to the S&P 500 with virtually no exposure to the energy sector. As the energy sector largely outperformed all other sectors, investors with significant energy sector exposure entering the year likely performed well relative to the broad index.

We ended the year with 15 long equity positions representing 87.6% of the Partnership's capital and 13.2% in cash. One of our current positions is a special situation (merger arbitrage) that we believe will close in 2023 and provide a reasonable absolute return. The other 14 positions are

(1) Excludes acquired companies no longer in the index.
(2) Estimated total return assuming dividends reinvested quarterly excluding taxes.

pure long common equity positions. The top five positions make up 48.0% of the Partnership's total capital.

Over the year, the Partnership had six positions that finished the year with a 30.7% average gain, and nine positions that finished the year with a (28.0%) average loss.   As stated, the Partnership had virtually no exposure to the energy sector.

It is important to note that the Partnership is in a strong financial position entering 2023. With 13.2% of capital in cash, the Partnership is poised to take advantage of any dramatic falls in asset prices. We are prepared to make large (relative to our Partnership's size) new investments should the opportunity arise.

The Year Ahead

No strategy change for 2023. Intrinsic value does not fluctuate as widely as stock prices. We believe that in 2023 we will find a few great opportunities to purchase certain securities below conservative estimates of intrinsic value. Our goal is to further concentrate the portfolio in 2023 into a smaller handful of quality companies purchased at attractive prices. This will likely reduce the total number of portfolio positions below 10.   This concentration may lead to increases in portfolio volatility, but we believe that it may also lead to improved long-term returns. In addition, we continue to review private company opportunities and are optimistic that we can add a private investment to the portfolio in 2023. If you run across any businesses requiring an investment of around $5 million, please let us know.

General Thoughts on Investing

We believe that professional investing has become significantly over intellectualized. There is too much jargon and reliance on complex mathematical formulas when making investment decisions and determining portfolio construction. Just because one can measure it, doesn't make it relevant.

We believe that investing should be made as simple as possible, rather than more complex. For example, if a small entrepreneur who owns a local dry-cleaning business wants to buy the local car wash, what do they do? Do they measure the beta of the local car wash? Do they perform a VAR analysis to determine how much additional risk the car wash will add to their existing business? Will they measure the investments ultimate success with the Sharpe ratio? No. In a private market transaction, that information is not only unavailable, but also irrelevant.

What does the entrepreneur do? How do they make a "smart" decision with less information than is available when evaluating a public stock? The answer is simple. They do the obvious analysis on the business, competition, and any risks that they can identify. They review what the car wash earned historically and make a judgement about what it can reasonably be expected to earn in the future. Then they apply a reasonable rate of return. That's it!

Is there a difference between the analysis required to buy a local car wash versus a publicly traded stock? We would argue there is not. The analyses are and should be identical. The entrepreneur does not use abstract concepts that have become standard in the analysis of publicly traded companies and portfolios.

Investing is fractal. It is the same for small companies as it is for big companies. It is the same for private companies as it is for public companies. In fact, the entrepreneur's analysis, while appearing less sophisticated, may be superior given how much of their personal wealth and livelihood is likely at risk.

If investing is fractal, what is the implication for the professional money management industry? First, clients need to be aware of what professional money managers are really doing. Are they actually investing, or are they playing a portfolio engineering game, relative pricing game, market timing game, momentum trading game, macro predicting game, statistics game, hedging game, or closet indexing game, etc.? Second, clients need to be realistic about the utility of complex measurement. Just because one can calculate a bevy of statistics on a portfolio, does not mean that they can control the outcome of that portfolio.

We believe that transparency about the game being played is important. We are playing the long-term investing game.

Portfolio Update

We wanted to shine a spotlight on one of our current portfolio positions. Legacy Housing Corporation (LEGH) ("LEGH" or the "Company") is a small capitalization stock with a $463 million market capitalization as of December 31, 2022. The Company builds, sells, and finances manufactured homes and tiny houses throughout the South and Southeast regions of the U.S. LEGH sells to consumers through a network of independent retailers and company-owned stores and sells directly to manufactured home communities.

The Company's products include tiny homes, singlewide, doublewide, oilfield/workforce, and park housing. LEGH has three manufacturing facilities – two in the greater Dallas, Texas area and one in Georgia. The Company was founded by Curtis Hodgson and Kenneth Shipley in 2005 and is headquartered in Dallas, Texas. LEGH completed its IPO in 2018. Mr. Hodgson and Mr. Shipley serve as Executive Chairman and Executive Vice President/Director, respectively. Both founders combined continue to own more than 50% of the shares outstanding.

Filter Criteria – What We Don't Do

As with all potential investments, we run LEGH through our "What We Don't Do" filter. This rubric helps us quickly identify potential investments that we want to avoid regardless of industry, business model, price, or market trend.

Filter to Avoid	**LEGH**	**Grade**
Cash Flow *Lacks consistent cash flow*	Profitable since 2016 (based on all years of public information available); generates cash flow from the sale of manufactured homes and the interest on loans	▲ Proceed
Leverage *Excessive debt*	No debt	▲ Proceed
Acquisitions *Over reliance on acquisitions for growth*	No prior acquisitions; all growth has been internally funded through capital reinvestment	▲ Proceed
Dilution *Shareholder dilution through stock-based compensation*	24.03mm diluted shares in 2016; 25.38mm diluted shares as of Sep. 2022	▲ Proceed
Secular Industry Disruption *Identified long-term decline*	None identified	▲ Proceed

LEGH easily passes our "What We Don't Do" filter. Let's look more closely at why we have added the Company to the portfolio.

<u>Why We Like the Business</u>

- *Vertical Integration Creates Virtuous Circle:* The Company (1) manufactures mobile homes, (2) transports mobile homes, (2) provides wholesale financing to dealers and mobile home parks, (3) provides retail financing to consumers, and (4) is involved in financing and developing new manufactured home communities. The ability to internally finance customers → creates demand for manufactured units → manufacturing demand for units creates the ability to internally finance customers → Rinse and Repeat!

- *Internal Financing Non-Reliant on the Capital Markets:* The Company provides in-house financing to its customers, and actually holds the loan paper! The Company has zero debt and is not reliant on the capital markets to support its internal financing operations. It does not securitize or sell its loans and thus credit market liquidity is irrelevant. Rising interest rates do not affect profitability. In relative terms, LEGH is like a bank that does not take customer deposits and is completely capitalized with equity.

- *Internal Financing Creates Compounding Machine:* The Company offers (1) floor financing to dealers, (2) chattel loans to consumers, and (3) financing to owners of manufactured housing communities for units rented to residents. All loans are made at favorable rates. The average interest rate on consumer loans is about 13.0%. Given the type of chattel loans provided to consumers, the Company does not need to adjust this rate with fluctuations in market rates. Financing for mobile home communities ranges from 6.9%-8.9%. Credit quality remains strong across the loan portfolio. The Company requires real down payments from consumers and has a strong credit record of virtually no losses in its mobile home park unit loan portfolio. The lack of balance sheet leverage means that any potential increases in non-performing loans or credit losses have a muted effect on book value.

- *Demonstrated Ability to Increase Price:* The manufactured housing industry has been able to increase prices significantly in 2022 to keep pace with cost inflation. As of September 30, 2022, LEGH had implemented seven price increases since the third quarter of 2021. Since manufactured houses are significantly more affordable than traditional site-built homes, significant price increases have not produced an offsetting decrease in unit demand.

- *Manufactured Housing Industry May Benefit from Economic Challenges:* As the affordability of site-built homes increases due to rising home prices, construction cost inflation, or increasing interest rates, manufactured housing may become an attractive alternative for consumers. In addition, as stated in previous letters, the Partnership has a position in ITIC, a real estate title insurance business. As ITIC's profitability is linked to the value and volume of real estate transactions, LEGH may provide a quasi-countercyclical portfolio hedge against a slow down in the traditional housing market.

- *Significant Management Ownership:* The founders and managers of the business hold a meaningful percentage of the shares outstanding. We believe that the managers are likely to continue to behave like owners because they are owners. We believe that management has demonstrated cost discipline historically and is focused on compounding the value of the business without taking unnecessary risks. LEGH generates satisfactory growth and returns on capital without the need for excessive leverage, overpriced acquisitions, etc.

Industry

LEGH is about the fifth largest manufacturer in the industry behind (1) Clayton Homes (owned by BRK), (2) Skyline Champion (SKY), and (3) Cavco Industries (CVCO). The total number of manufactured homes in 2022 is estimated to be about 110,000. LEGH will manufacture about 3,000 units. The estimated average cost for a manufactured home in 2019 was $57/sf versus traditional site built homes at $119/sf[(3)].

The manufactured housing industry is competitive with several large, well-funded companies commanding a large share of the market. We believe the reason to be excited about this industry and LEGH is not the profit or returns from the manufacturing operations, nor do we believe that less expensive manufactured homes are going to be the solution to any housing crisis. LEGH is exciting because of the returns it generates from its internal financing operations. LEGH earns more than 10% returns on capital from its loan portfolio unlevered. Even with a marginally profitable manufacturing operation, these economics are compelling.

Risks and Challenges

No business is without its risks and challenges. In March 2022, the Company announced that it would not be able to file its 2021 annual report on time and the CFO departed the Company.

(3) U.S. Census Bureau, the Institute for Building Technology and Safety, and the Manufactured Housing Institute.

Whenever an announcement like this occurs, one must worry about the credibility of historical financials and profitability. Especially with this type of business, the revenue recognition of unit sales and gross margin entangled with the financing and credit loss provisions of the loan book could provide the opportunity for material accounting mistakes or worse. We sold the shares owned by the Partnership after the announcement at a negligible profit as noted in a prior letter. We have no room in the portfolio for investments with potential material accounting issues.

Fast forward to August 2022, LEGH issued a press release detailing the accounting issues and adjustments that it would be making to its 2020 and 2021 financial statements and stated that it would issue its annual report at the end of the month. Upon review of these adjustments, we concluded that while there were numerous changes, they were immaterial to historical profitability and our estimate of the intrinsic value of the business. We immediately began buying shares.

LEGH is still in many ways operated like a family-owned business – in fact, we prefer it that way. While that does not excuse accounting mistakes, it explains why small issues may occur as is the case with the accounting of many small businesses. Management has been careful not to overspend on expenses and did not bend their rule in the accounting area. We had the opportunity to attend the annual shareholder's meeting and spend time with Mr. Hodgson in November 2022. We liked the direct way Mr. Hodgson answered questions and his views on running the business in a conservative manner. Following the meeting, we believe that the Company is well managed, and the accounting department has received the additional investment necessary.

Value

Turning to our estimate of intrinsic value, we break the business into two separate parts – the manufacturing operations and financing operations.

- *Manufacturing Operations:* We estimate that the Company's manufacturing operations will generate conservatively between $20 million and $30 million of pre-tax earnings in the foreseeable future. This is extremely conservative given that the manufacturing operations will likely generate more than $30 million in pre-tax earnings in calendar 2022. Given the required capital and growth opportunities for the manufacturing operations, we believe a value between $200 and $250 million is reasonable.

- *Financing Operations:* The Company's financing operations have a total loan book value of $299 million as of September 30, 2022. The book is comprised of $134 million in consumer loans and the remaining $164 million in dealer, mobile home park, and other loans. We value the dealer, mobile home park, and other loans at their book value of $164 million. The consumer loans have an interest rate of about 13.0%. Given the credit quality of the loans and the prevailing mortgage rates for single-family residences, we believe that the value of the consumer loans is greater than their book value. If we conservatively apply an 8.0% to 9.0% rate of return, the consumer loan book is worth between $194 million and $218 million. We want to be conservative here given that these are chattel loans while still representing a premium return relative to current single-family mortgage rates.

Assets	Midway Partners' Equity Value Estimate	Per Share (25.38mm shares)
Operations ($20 - $30 million pre-tax profit)	$225 million	
Dealer, MHP, and Other Loans (Book value of $164 million)	$164 million	
Consumer Loans (Book value of $134 million)	$206 million	
Total Estimated Intrinsic Value	**$595 million**	**$23.44**
Market Price at 8/30/2022	$432 million (28% discount to est. value)	$17.01
Market Price at 12/31/2022	$481 million (19% discount to est. value)	$18.95

It is important to note that tangible book value as of September 30, 2022 was $362 million or $14.26 per diluted share. Also, the Company has no debt and no material excess cash as of that date.

<u>LEGH Conclusion</u>

LEGH is a highly profitable financing operation sandwiched inside of a manufacturing business. We believe that the management team has done a terrific job managing and growing the business. They think like owners because they are owners and control the majority of the shares outstanding. Given the discount to our conservative estimate of intrinsic value, we believe that LEGH presents a compelling long-term investment opportunity.

Thoughts on Crypto Currency

We have some thoughts on the emergence of crypto currency that we think are worth jotting down now (and probably should have earlier). We will start with the technical issues and finish with the philosophical. Before we start, we want to point out that blockchain technology may have utility in many areas of business security, data storage, etc. The technology is not where we take issue. We have no interest in crypto currencies or any assets, virtual or real, that lack intrinsic value. Here is an overview of our thoughts.

1. We find it peculiar that swaths of investors, professional and retail alike, believe that they can successfully trade crypto currency. Most do not trade or have experience trading other standard currencies, e.g. the dollar, the euro, the yen, etc. With no experience in currency trading, the idea of making sustainable profits trading crypto currency seems irrational. Why are these purchases being made in the first place? As a great man once said, "The world isn't driven by greed, its driven by envy."

2. Moving to our bread and butter, intrinsic value. All currency, whether virtual or fiat, does not have intrinsic value. Therefore, **currencies cannot be valued**. They can only be priced relative to other currencies or assets. This is the case for all non-productive assets that do not generate cash flow. If you own a cellar of expensive wine (or other collectibles such as tulips), after a year goes by all you have is bunch of wine still sitting in the dark. You do not have any new bottles of wine. It may be possible to sell the wine for more dollars, but that is supply and demand driven.

   In contrast, if you swap that wine for a profitable company, after a year goes by you will have the company plus the pile of cash that it generated. You can then use that cash to buy more companies that produce even more cash and so on. Supply and demand set the **price** of non-productive assets, whereas cash flow sets the **value** of productive assets. Crypto currency falls into the non-productive category. It is impossible to estimate an intrinsic value, so we avoid it.

3. To expand on #2, if an asset cannot be valued, then purchasing it does not fall into the category of investing. It should best be described as speculation. One might say that the definition of investing versus speculation comes down to semantics, but we think it is important to draw a bright line between their meanings. When entering any financial market, it is most import to know (or better yet to be honest about) the game you are playing. As we have said before, we aim to play the long-term investing game.

4. As for those advocating for new financial paradigms built on crypto currency, time will be the judge. There is a notion that, if only the monetary system worked in a new way, the world would be a better place. It is unlikely that any monetary system will ever be perfect. We find it naive to think that a system designed by people, will not retain the fallibility of its creators or patrons. Approaching such monumental shifts with a drop of humility might save a boat load of actual U.S. dollars.

In summary, trading currencies (virtual or otherwise) is not investing, nor is it a strategy that makes any sense to us. We will stick with investing real dollars in real quality companies. There is enough opportunity there to keep plenty busy.

Conclusion

The Partnership is actively taking new subscriptions from qualified clients who share our common views on investing. We are looking to grow the assets of the Partnership both through returns and through new investors. We welcome any referrals from current Partners. Please contact info@midwaypartnersllc.com for more information.

As always, we are honored that you have chosen to be a part of our Partnership.

Sincerely,

Jordan Lampos

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