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October 12, 2018

Dear Fellow Investors,

April is the cruelest month, according to T.S. Eliot. But October has been the month that stirred the dull roots of unease this year. We're not surprised to see volatility bubble up as tariffs and inflation are both starting to bite. We remain optimistic about the long-term health of the economy, but we're prepared for a bumpy ride as the markets deal with impediments they haven't had to face in a long while.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q3 2018	2.77%	7.71%	-4.94
2018 Year to Date	4.27%	10.26%	-5.99
Annualized Return Since Inception	10.36%	10.71%	-0.35
Total Return Since Inception	174.8%	183.6%	-8.80

Data reflect total returns (including dividends) net of fees as of 9/30/2018. Inception date is 7/1/2008. Returns are unaudited. Your individual returns reported on your statements may vary from the composite depending on when you invested and upon any special instructions or restrictions applicable to your account. The composite return is the time-weighted return of all our accounts added together into one big pool. We believe it is the best indication of how the average client fared during these time periods.

Economic Uncertainty

As of this writing, not even two weeks since the end of the third quarter, the S&P 500 index is trading at the same price as at the beginning of July. That means the past few days have wiped out the whole quarter's worth of gains. We compare our performance to this index since it is a widely-used benchmark for US investments. But the fact that the return it posted last quarter is gone makes that comparison seem irrelevant now. We do think it is meaningful to note, however, that our returns have diverged from the index returns for the past two quarter because we've been taking a different approach. First of all, we believe there are a number of economic headwinds that will affect companies. The trade war and inflation are the two biggest right now and they are just starting to bite. We don't feel comfortable taking on too much risk until we see how badly the economy is affected. Second, we have been deliberately investing in non-US firms. We can see significant upside for Europe, Asia, and South America, particularly the smaller economies, if the US and

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China decide to duke it out in a prolonged trade war. You can expect us to continue down a contrarian path while the global economic situation is uncertain.

Trade Wars, Inflation, and Fritos

We've spent a lot of time on trade in our last few quarterly letters because we think the trade war is a mistake. We remain hopeful, of course, that differences with our trading partners can be resolved. The new NAFTA deal (now called the United States-Mexico-Canada Agreement) was put together fairly expeditiously and is largely the same as the old NAFTA deal. But negotiations with China appear to be at an impasse. Several quarters of tariffs are now beginning to show deleterious effects on the overall economy, particularly the China tariffs since we import more from China than from any other country.

What does the trade war mean for an average American? We found a perfect illustration from the reporters at *The Indicator* podcast.[1] The price of Fritos corn chips just went up 20%. That's a pretty big increase. If the price of everything you buy were to go up 20% over night, you'd notice. NPR reporter Scott Horsley noticed that the vending machine in the White House press corps break room suddenly charged 20% more for a bag of Fritos despite corn prices being down. The culprits are the same forces we're worried about: tariffs and inflation.

It turns out that the price of corn has very little to do with the price of corn chips. One of the biggest costs associated with getting your bag of chips to a vending machine is transportation. There is an acute shortage of truck drivers right now even though truckers' salaries have been increasing. Truck driver wages have gone up 10%-12% since last year and almost half of truckers saw their wages increase this year.[2] That has caused transportation prices to go up and companies like PepsiCo, which makes Fritos, have had to pay more to get their products to consumers. That is a textbook case of inflation. A shortage of truck drivers in a booming economy means salaries rise, costs rise, and then prices rise for the end consumer.

But wait, there's more. President Trump imposed a 10% tariff on imported aluminum earlier this year. The idea was to help American metals manufacturers. However, the vast majority of aluminum used by American companies comes from other countries. So most companies here need to pay more for imported aluminum. Of course domestic aluminum producers have raised their prices, as they can in a protected market, so everyone in the US is paying more for aluminum. That has increased the cost to produce Pepsi and other canned drinks. Pepsi needs to pass those increased costs on to consumers. However, Americans aren't as keen on canned drinks as they are on snack food. Because snack food sales are rising, while drink sales are falling, Pepsi chose to cover its increased aluminum costs by raising prices on its most popular items, like Fritos.

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[1] "The Case of the Pricey Frito", The Indicator from Planet Money, NPR podcast September 28, 2018, https://www.npr.org/podcasts/510325/the-indicator-from-planet-money.

[2] Premack, Rachel, "Truck drivers' salaries are experiencing an 'unprecedented' jump, but it's not enough to end the driver shortage that's making everything more expensive," *Business Insider*. August 4, 2018, https://www.businessinsider.com/trucking-shortage-eld-mandate-cdl-truck-driver-salary-2018-6.

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This is an excellent example of the unexpected ways that tariffs and inflation can worm their way into all aspects of the economy. The cost of protecting our markets from imports will be higher prices in almost every sphere. That could be very hard on companies which import goods from China and transport them to consumers. Firms like Amazon.com, which is also raising the wages of its employees, will face a tough decision between passing higher prices onto customers or making less money – or perhaps they will do both. We have a strong economy now. But by setting up trade barriers we've punctured one of the tires on our economic car, and it will be impossible to drive at full speed until it's mended.

Portfolio Updates

A few of you have asked for updates on our long-time holdings. As our clients know, we send out reports explaining our investment case when we make new investments. We aim to buy great companies and hold them forever, but occasionally we buy a turnaround. The following is a brief update on some interesting changes that have taken place since we made our original purchases.

Forest City

To call Forest City (FCE.A) a long-time holding is an understatement. The first purchase was in September, 2008 – roughly three months after Midway opened its doors. Forest City has always been unique among our real-estate holdings because it develops many of its buildings. Most real estate firms buy and sell completed buildings rather than starting from the ground up.

This unique attribute became a nightmare during the financial crisis. The firm found itself developing more buildings than the market could absorb while concurrently facing a deluge of construction loans coming due. In addition, Forest City's boardroom was controlled by the Ratner family, who founded the firm in 1920. The family had a long history of financing personal hobbies with company funds. At one point, Forest City owned a large stake in the Brooklyn Nets.

Forest City was never the type of stock you could buy and hold forever. The company's managers – the C-level executives in charge of the day-to-day operations – did a great job despite ineptitude at the board level. But because of its lousy directors, Forest City always traded at a discount to the value of its assets. The shares hit a crisis-era low of $3.50 per share in 2009. Even after subtracting the excessive debt, that works out to about 18% of the original cost of the buildings. The company deserved a haircut. The market gave it an amputation and we bought more shares betting on a turnaround.

After the crisis, the company cleaned up its act. Management made steady progress towards paying down debt. They sold the Nets. They equalized voting control and simplified the corporate structure and eventually paid shareholders a significant dividend. By the end of 2017, the stock price was up to $24. We put a fair value of $27.50 on the company's assets. The company hadn't just turned around, it had grown into a well-run firm with lucrative assets.

This year, however, has not been kind to real estate firms. Property owners take out loans to buy their buildings. With interest rates rising, borrowing costs are increasing. And for the first time in nearly a decade, income-hungry investors can get paid a decent interest rate for owning bonds. When bonds yielded next to nothing, many investors switched to better-yielding real estate and utility stocks. Now they're switching back

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to bonds and selling real estate stocks. This confluence of events knocked Forest City's stock price back down to about $20 by the end of May.

Enter Brookfield Asset Management (BAM), also a long-time holding of ours. Always on the lookout for a deal, Brookfield offered $25.35 per share in cash for Forest City and the board accepted. Members of the Ratner family reportedly wanted to reject the offer, but they were outvoted.

That leaves us in an interesting spot. The stock was trading around $20. We thought it was worth $27.50. And in July, a buyer offered $25.35. That's a 25% premium to where the stock was trading, but it's still about 10% below our estimate of fair value. Should we be happy to sell our shares for 90 cents on the dollar if it means instant gratification? Since we own Brookfield, we'll probably vote in favor of the deal since we can maintain our ownership in Forest City that way. Brookfield is reaping millions of dollars buying a stock that was clearly undervalued. Forest City's shareholders seem content with the immediate price spike even if they're leaving a few dollars on the table. Brookfield noticed the same thing we did – the cheapest way to buy buildings in today's market is to buy stock.

Florida Real Estate: A Tale of Two Coasts

Until recently, we owned two very similar companies based in Florida. St. Joe (JOE) started as a timber company in the panhandle. Consolidated-Tomoka (CTO) was primarily focused on agriculture around Daytona Beach on the Atlantic coast. Both companies own vast acres of land in a fast-growing state, and we owned both firms for a number of years. But recently, their paths have diverged; we sold one, but we believe the other's future remains bright.

St. Joe owned more than a half-million acres in the Panhandle ten years ago. Most of the land was used for forestry operations, but a good portion was located near tourist destinations along the Gulf Coast. St. Joe's plan was to slowly sell lots and help the area develop. A decent-sized airport opened in 2009, which increased the number of tourists visiting the area and also helped boost jobs in aerospace.

In 2010, a short seller garnered a lot of press by alleging St. Joe was worth between $7-10 per share, which would work out about half the value of farmland in the area. The short-seller alleged assets were booked at inflated values; this led to a SEC investigation. St. Joe's largest shareholder, mutual fund manager Bruce Berkowitz, made the unusual move of stepping in as chairman of the board. He fired Joe's management and brought in a new group.

But as the attacks in the press continued, the pressure to produce results grew. Berkowitz was honored as Morningstar's Fund Manager of the Decade for 2000-2010. The short seller, David Einhorn, had a penchant for making bombastic statements to the media. St. Joe found itself the unlikely battleground between two heavyweight egos.

Berkowitz and his team sold nearly 80% of the land – essentially all the forestry operations – for $568 million. They used $300 million to repurchase a quarter of the shares outstanding, but the stock price didn't budge. Joe published a 50-year plan to develop an active adult community on the remaining land, but investors showed little interest in a project that will reward shareholders in 2068. Management continued making inept and self-serving decisions and we finally sold in 2017 and went looking for greener pastures.

Heading over to the other side of the state, we find Consolidated Tomoka. For decades in Daytona Beach, Interstate 95 has served as a dividing line between rural and urban. Most of Tomoka's land is west of the

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interstate. But as the city sprawled further inland, Tomoka's land was clearly becoming more useful as residential and commercial real estate than it was as farmland. The company has been slowly selling its acreage and currently has 64% of its remaining land under contract. Plans for development range from residential properties, to medical buildings to car dealers.

When Tomoka receives money from a land sale, the company reinvests the proceeds in a new building of some kind. Previously it owned property only in the Southeast, but in the past few years, it's expanded to own properties from California to Massachusetts, with a mix of office and retail, single tenant (like a standalone bank branch) or multitenant. Tax rules allow real estate owners who promptly reinvest sales proceeds to defer capital gains tax on the sale. Tomoka estimates it has avoided $50 million in tax bills this way. Most importantly, the new office and retail buildings produce regular income, while raw land is just lying in wait. Rental income was $9.7 million in the second quarter of 2018 compared with $3.3 million in the same quarter five years ago.

We think management has made excellent choices regarding how and when to monetize its land bank. Even if only half the current contracts close, we expect the company to realize close to $100 million in proceeds. Reinvesting that money means Tomoka's rental income is set to double again in short order. Today's shareholders are in line to reap their rewards in a few short years.

The thread that ties these real estate names together is that they all have valuable assets, but it takes the right team of managers to make the most of them.

Your partners in investing,

Rachel Barnard, PhD, Todd Schrade, CPA, and the Midway Capital Team

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