

# MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

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July 11, 2012

Dear Fellow Investors,

The markets remained jittery last quarter and stock returns were slightly negative overall. We didn't see very many exciting buying or selling opportunities, though as we note below, we did take the plunge into energy stocks. We hope you enjoy reading a bit about this bright spot and its potential, even in volatile times.

## Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
<b>Q2 2012</b>	-4.28%	-2.75%	-1.53
<b>Year to Date 2012</b>	11.81%	9.49%	+2.32
<b>Annualized Return Since Inception</b>	6.08%	4.57%	+1.51
<b>Total Return Since Inception</b>	26.65%	19.59%	+7.06

Data reflect total returns (including dividends) net of fees as of 6/30/2012. 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.

## Buying Energy

This past quarter, Midway bought its first holding in the energy sector, Devon Energy (DVN). The reason we haven't bought energy before this is a matter of valuation, not because we think the sector is unattractive. To the contrary, we like the fact that energy companies aren't affected by the same forces as other sectors of the economy and we've simply been waiting for the right opportunity. We recently found this opportunity in Devon, a conservative play on an attractive sector that's suffering from a short-sighted, pessimistic outlook.

If you aren't already fascinated by energy businesses, let us give you a brief glimpse into a very compelling industry and why natural gas holds such opportunity. <sup>1</sup>

**Acres of land controlled by ExxonMobil: 78,592,000**

**Number of U.S. states smaller than this: 46**

Acreage is generally leased by oil and gas producers. The acreage above represents ExxonMobil's net onshore and offshore fields. Only about 22% of ExxonMobil's net acreage has been developed to have actual productive wells. The rest has proved reserves lying in wait for drill teams to arrive.

**Working hours required to buy a barrel of oil in 1986: 1 hour 47 minutes**

**In December 1998: 52 minutes**

**In December 2011: 5 hours, 2 minutes**

For much of the 1980s and 1990s, the price of oil didn't change much (ignoring volatile short-term swings). Meanwhile, wages grew at a steady pace. It's tough to pinpoint exactly why oil started getting so expensive in the 21<sup>st</sup> century. Some have noted increased consumption from emerging market countries like China. Others have noted an increase in the cost to produce a barrel of oil.

**Cost for Kuwait Oil Company to produce a barrel of oil in 2010: \$2.00**

**For ConocoPhillips: \$8.10**

**Production cost increase since 2000: 88%**

**Change in the cost of tuition at Harvard for the same time period: 53%**

Increased consumption and a dearth of easily recoverable oil is likely to blame for the increasing costs. OPEC producers have always had a corner on the cheapest sources of oil, but with higher prices, domestic sources and alternative plays like oil sands became profitable.

**Cost for 1 Million BTUs of oil in 2005: \$10**                      **For gas: \$8**

**Cost for 1 Million BTUs of oil in 2011: \$16**                      **For gas: \$4**

**Change in U.S. proved reserves of natural gas from 1999-2009: +62%**

For decades, the price of oil and natural gas moved in lock-step with one another. This makes perfect sense from the standpoint that oil and gas both provide energy; if oil gets expensive, people will get their energy from gas, and vice-versa.

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<sup>1</sup> Figures from the Department of Energy's Energy Information Administration. All figures are the most recent (2011) data unless noted.

Hydraulic fracturing unlocked an extraordinary amount of natural gas in the past decade. For comparison, a 62% increase in our water supply would be akin to discovering a subterranean lake the size of Wisconsin. This oversupply has put downward pressure on the price of gas. Because of the complexities in the oil-gas relationship, oil has remained expensive while gas continued to get cheaper. This can't last forever. There is already a large-scale conversion to gas in everything from heavy industry to vehicle fuel.

**Cost for 1 gallon of highway diesel fuel: \$3.84**

**For an equivalent amount of liquefied natural gas (LNG): \$3.05**

**Change in amount of natural gas used as vehicle fuel over the past decade: +125%**

The theoretical relationship between gas and oil still holds. The investment required to convert an 18-wheeler to run on natural gas will pay for itself within 3 years based on current projections. More truckers aren't converting their vehicles because conversions are costly, and natural gas fueling stations aren't positioned conveniently from coast to coast the way diesel stations are. Intrepid entrepreneurs should see this as an opportunity. We're betting they will. So does veteran investor Jeremy Grantham, who thinks that "everyone who has a brain should be thinking of how to make money on [the price disparity between oil and gas] longer term."<sup>2</sup>

**Average price of LNG in Japan (1 million BTU): \$16.66 In the U.S.: \$4**

**Change in U.S. LNG exports over the past 10 years: +7% In the price: +138%**

**Percent of U.S. natural gas consumption imported from Canada: 13%**

**Year in which United States will become a net exporter of natural gas: 2022**

With gas prices so high in Asian countries, places like the U.S. and Canada have been racing to export our overabundant gas to countries that need it. The problem is that LNG export terminals can easily run \$15 billion each. Moreover, they require substantial infrastructure investments in pipelines to transport the gas to the terminal, power generation facilities to run the terminals, and harbor facilities for the tankers. All this gets bogged down in red tape. Meanwhile, Australia has four export terminals under construction with more being considered. There is one in North America.

**Pre-tax profit earned per minute by ExxonMobil: \$139,377**

**By Apple: \$65,078**

**By the five largest airlines, combined: \$91**

Bottom line: energy is a very profitable business.

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<sup>2</sup> GMO February 2012 Letter to Shareholders  
[http://www.gmo.com/websitecontent/JGLetter\\_LongestLetterEver\\_4Q11.pdf](http://www.gmo.com/websitecontent/JGLetter_LongestLetterEver_4Q11.pdf)

## News from our Portfolio: Dolby Labs (DLB)

After all that energy data, let's turn to something lighter – the movies. The next time you stroll into your local movie house, you might be amazed by the sound quality you experience. Dolby's new sound-mixing platform, Atmos, uses 64 individual speakers placed throughout the entire theater, each with its own audio channel. This means that filmmakers can achieve the type of realistic sound that was never possible before. The results should make it worth going out to the movies.

To appreciate what a leap in cinema sound Atmos represents, it's good to start with a brief history. When the first talkies debuted in the 1920s, there was a single source of sound in the center. The advent of stereo kept the center channel and added speakers on the left and right. Dolby Laboratories introduced 5.1 surround in 1994. This added two rear channels to the existing configuration, as well as a subwoofer for deeper base. Altogether, that's five speakers and one subwoofer, thus, 5.1. In 2010, *Toy Story 3* was the first film to incorporate 7.1 surround, which added dedicated side channels. Atmos can be described as 62.2 surround.

This is really quite a leap forward. Atmos incorporates speakers all around the listener, including on the ceiling. It made its debut in *Brave*, a Disney-Pixar film. Viewers have often commented about a scene set in a rainstorm where the sound of raindrops overhead is eerily realistic. Thus far, media mentions of Atmos have been overwhelmingly positive, with many commentators – both critics and filmmakers – eagerly anticipating new ways to utilize the tools Atmos offers.

While Atmos has been a technical success so far, it also needs to achieve commercial success. There is currently only one movie that uses Atmos. Its run is almost over. Dolby needs make sure filmmakers remain excited the possibilities that the new platform offers. But even if filmmakers start churning out Atmos-mixed films by the hundreds, theaters might still decide against upgrading their systems if they don't see the financial benefit. Atmos systems cost tens of thousands of dollars to install so theater owners need to believe the superior sound will draw more theatergoers.

We believe that Atmos ultimately will be a big success. Dolby estimates that by the end of 2013, it will have installed 1,000 Atmos systems. Theaters see an opportunity to offer moviegoers something they can't get at home – 62.2 surround sound. As more theaters install Atmos, more filmmakers will opt to mix their sound using Atmos technology.

One key advantage of Dolby technology, including Atmos, is that it can deliver either a deluge or trickle of data, depending on how much a system can handle. Too much data can overwhelm older systems, while not enough leaves high-tech systems sounding flat. Dolby has created a language that can mimic a rainstorm with eerie reality if 64 speakers are available – as they are in a cinema – while also sending just the right amount of raindrop effect to the headphones of a user watching on his cell phone. Given this versatility that can please audiophiles and casual users alike, we expect device makers will find more incentive to include Dolby patents. As owners of the firm, that sounds good to us.

Yours,



Rachel Barnard, PhD  
and the Midway Capital team