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Dear Fellow Investors,

The end of June marks our ninth full year of serving investors at Midway Capital and we're quite pleased to wrap it up with positive returns. Read on for a dive into market dynamics and why reports of the death of the shopping mall are greatly exaggerated.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q2 2017	4.97%	3.09%	+1.88
2017 Year to Date	10.77%	9.34%	+1.43
Annualized Return Since Inception	10.22%	9.71%	+0.51
Total Return Since Inception	140.0%	130.2%	+9.8

Data reflect total returns (including dividends) net of fees as of 6/30/2017. 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.

Market Update

Our investments have fared very well in recent market conditions, as you can see from the chart above. That inevitably brings up the questions of "what's working?" and on the other hand, "what should we be worried about?"

First, let's examine what's working. As we've mentioned in previous letters, stocks are no longer trading in lockstep as they did in the earlier part of this decade. This low correlation between individual stock prices mean that investors are once again separating the wheat from the chaff and we've seen many of our picks make outsized gains relative to the overall market. Our strategy, known as value investing, involves buying undervalued stocks and waiting for the market to value them fairly, and that is a process which takes patience and plays out over longer time horizons. Merrill Lynch recently issued a compelling piece of research which

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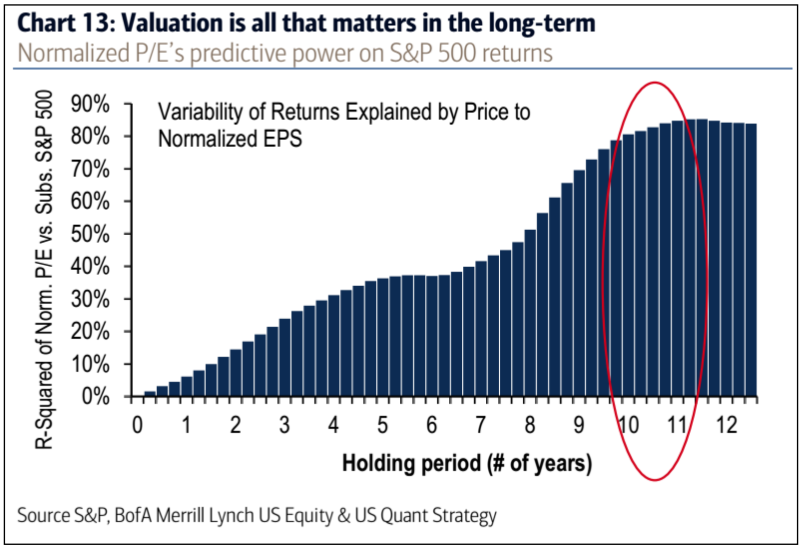
makes this point very clearly. The authors conclude that "over the long term, valuation is almost all that matters."[1] They examined a range of strategies and methods for investing that are current on Wall Street and found the only factor that strongly predicts future returns is valuation. That's value investing in a nutshell. In their case, they use a simple measure of the price of a stock relative to its normalized earnings per share. The accompanying chart shows how longer time horizons reward investors who buy stocks for less than they are worth.



Our patience has also been rewarded with emerging markets. We've believed for several years now that overseas companies, particularly in emerging markets, were seriously undervalued relative to U.S. companies. These investments have really started to pay off this year as foreign economies are improving and at the same time foreign currencies are strengthening against the U.S. dollar.

Of course any market discussion wouldn't be complete without referencing the Trump agenda. At this writing, the new Republican healthcare bill looks to be in jeopardy. Wall Street is anticipating the demise of healthcare reform and many of our healthcare holdings, particularly the biotech firms, have rallied as the uncertainty around drug pricing diminishes. We've been waiting for those clouds to clear ever since we started buying biotechnology in 2015.

What should we be worried about? We remain cautious about the overall valuation of the stock market, particularly in the U.S. We still believe equities offer better returns than other investments and there are pockets of value. However, we're putting more of our money in overseas firms where valuations are lower and where a weaker dollar could benefit investments denominated in other currencies. We also like companies that own real estate, as the rise of online shopping has created opportunities for savvy investors to reinvent old retail space.

Death of the Mall?

By now you have probably read at least one news story prophesying the death of the shopping mall. Yet among the brightest minds in the real estate business, there is no agreement about the future of the mall. We have three long-time holdings in this industry and they are pursuing different strategies. On the bullish side, Brookfield has been buying up shopping malls across America. Vornado sold all its mall operations a few years ago, and Forest City is in the process of selling its malls piecemeal.

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[1] Subramanian, Savita et al. "The most contrarian theme: long-term fundamental investing." Bank of American Merrill Lynch. March 16, 2017. http://covestreetcapital.com/wp-content/uploads/2017/03/11722669.pdf

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How can there be any room for debate when so many retailers are either failing or have already declared bankruptcy? These failures will inevitably lead to vacant stores, which will drive consumers further from the desolate mall towards a more cheerful online experience. We think the move to online purchasing is inevitable, yet we agree with Brookfield that half-vacant shopping malls have a surprisingly bright future.

Consumer retail has changed consistently over the generations. Just a few decades ago, pundits mourned the death of the mom-and-pop storefronts at the hands of Wal-Mart, which also claimed the Sears Catalog as one of its victims. Going back further, Marshall Field's once maintained a livery of 700 horses to make deliveries. With the invention of the car, delivery became more a convenience than a necessity, and eventually the idea that "we'll deliver a needle and we'll pick it up," fell victim to the growth in discount stores (like Sears), which offered ample parking, low prices, and a checkout line in lieu of a salesperson.

Now Wal-Mart is suffering at the hands of Amazon. Amazon holds an obvious advantage over Wal-Mart: it stocks its products in a few massive warehouses. Consumers view a pretty picture of the merchandise then decide to have the product delivered within a few days. This allows Amazon to hold less inventory and spend less on the construction and upkeep of stores.

As many have observed, Amazon's model closely mirrors the Sears catalog, which often contained more than 1,000 pages of beautiful products one could order for delivery. Conceptually, these two formats are virtually identical, save a few modern-day enhancements (for example, a search engine to thumb through the 1,000-plus pages, free two-day shipping, and customer-penned reviews.) Consider also that the Sears catalog coexisted alongside Marshall Field's massive emporium for more than a century. Field's flagship store – just a block from Midway Capital's offices – dedicated much of its floor space to social gathering spots. In addition to the well-known Walnut Room restaurant, the store offered at various points in time: a tea room, a 700-seat men's-only grill, and lounges for men and women where weary shoppers could pen a letter at a desk or even nap in a rocking chair. Thus, the Sears catalog was a pragmatic way to deliver essential goods far and wide, while Marshall Field's offered a vacation-worthy experience where one could spend hours socializing and perusing fine merchandise.

A lot of shopping malls have zeroed in on the old Marshall Field's model as a way to attract more shoppers. Mall operators have increasingly focused on dining as a way to attract visitors while also offering amenities like museums and amusement parks. Newer malls are conceived more like town centers, resembling a traditional downtown by mixing retail, office, and residential space. This model has been reasonably successful – good enough that some old, tired malls have started to redevelop following a similar blueprint.

Vornado's street-level retail is a good example of the mixed-use approach. The extravagant rents in Vornado's prime spots are unfathomable if you believe in the pending demise of brick-and-mortar retail. They recently leased 64,000 square feet (about the size of a small grocery store) to Victoria's Secret for the handsome average annualized rent of $62 million per year. The price tag makes this location as much an advertisement for Victoria's Secret as it is a profit-oriented store. That's part of the model – visitors to the store leave with an affinity for the brand, which drives online sales long after the shoppers have returned home. Using this approach, some retailers follow a pure showroom strategy. Men's clothier Bonobos (recently acquired by Wal-Mart) operates about a dozen showrooms structured like small boutiques. Purchases at the store are mailed to customers free of charge. No merchandise leaves the store.

If this is the future of retail real estate – restaurants, showrooms, and a nearby apartment building – then the mall sector is still severely overbuilt. Yet our cities are already awash with examples of failed retail

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establishments that have been redeveloped as prime real estate. Vornado controls one such property: 731 Lexington Avenue in New York was the home of Alexander's department store until its liquidation in 1992. The building was demolished in 1998, and the site now hosts an 800-foot skyscraper mixing retail, offices, and residential space.

Not every shopping mall will be replaced with a glass skyscraper, obviously. Still, we believe malls' central locations ensure whatever sits on the land will command premium rents. For about a half century, malls were the social center for much of America. They were either built in the most desirable part of town, or their arrival spawned neighboring development and became a desirable part of town. In either case, the location hasn't changed. That leaves mall sites prime for redevelopment.

Malls can even be redeveloped without being razed. The Wall Street Journal recently highlighted a Dearborn, Michigan mall that leases 240,000 square feet of what had been selling space to Ford Motor Company's engineering and purchasing departments.[2]

Converting dilapidated malls into attractive spaces for the 21st century economy will take time. This transformation will take billions of dollars and will span multiple decades. But as Brookfield CEO Bruce Flatt said in his most recent shareholder letter, "Retail real estate has always evolved, and we expect this to continue. Change presents opportunity for those that have the vision, capital, and skills to be able to capitalize on the market change. We plan to be a part of it, as great real estate always wins."[3]

Notes and Asides

If you use the new Microsoft Edge browser (now the current browser bundled with Windows 10) you may have trouble viewing your statements in the online NetXInvestor portal. The tech team is busy trying to fix this issue, but in the meantime, you will need to use another internet browser. Internet Explorer works (you can access this in Windows 10 by typing "internet explorer" in the taskbar search), as do Chrome and Firefox. If you have trouble, let us know and we can always send you an electronic version of your statements directly.

Your partners in investing,

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

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[2] https://www.wsj.com/articles/the-mall-of-the-future-will-have-no-stores-1497268801

[3] https://bam.brookfield.com/~/media/Files/B/BrookField-BAM-IR/letters-to-unitholders/2017/BAM%20Q1_2017_Ltr_to_Shareholders_FINAL.pdf

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