

MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

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Dear Fellow Investors,

Welcome to Midway Capital! This is the inaugural quarterly report for Midway Capital Research and Management. In this report, and subsequent letters, I will review significant new investments in our portfolios, talk about the firm's strategies and philosophy, report on performance, and generally update all of you on what's happening here from quarter to quarter. I hope you will find these interesting reading. And if they spark any questions, please do give me a call anytime.

And what a quarter it was to begin investing....

Amid falling markets and the continuing credit crisis, we began investing in mid-June. And what a quarter it has been. Fortunately for us, volatile and uncertain markets flush out rare bargains on excellent companies, and I have found several of these to invest in. The opening days of July have continued this trend and I look forward to an interesting – and profitable – summer.

That said, all our holdings are (and will be) in companies that I believe will outperform over time. We are bound to have good quarters and bad quarters, up years and down years. So when I say that I expect this summer to be profitable, my hope is that we will be able to buy stakes in a number of companies at attractive prices, regardless of whether they go up or down in the next few months or quarters. As Warren Buffett very aptly said (and I paraphrase here) anyone who is going to be a net buyer of hamburgers wants beef prices to remain low while he is buying. And by analogy, it is good for us to have periods of stock price declines so we can do our buying.

In subsequent letters I will talk about the performance of our portfolios. The results for the latter half of June are not meaningful because we have a lot of cash and have just started investing. But look for this in future letters and, of course, on your personal monthly statements.

Bargain prices on some gems

There is a silver lining when the bear market clouds gather. It gives investors a chance to own terrific assets at bargain prices. I have been watching an extraordinary bank, **East West Bancorp (EWBC)** for many years, but never saw an opportunity to pick up shares at a reasonable price until now. This bank has a trio of desirable attributes: conservative underwriting, low expenses, and high growth. In addition, it serves a niche market – Chinese-American customers – with products and services specifically tailored to its customers' needs and tastes.

Because of these extraordinary advantages, the shares of East West and its Chinese-American banking peers seldom go on sale. But the drop in California real-estate prices derailed that. East West operates primarily in California because around 85% of the Chinese-Americans live in that state. And though most of its funding come from customer deposits, three quarters of its loan book relates to real-estate: 47% of its loans are backed by commercial and industrial real-estate, 13% of loans involve residential real-estate and 17% are construction loans. It is the latter two areas that pose problems for California banks, particularly in the hard-hit Inland Empire region.

East West is not immune to these problems. But because of its conservative underwriting standards (the bank demands substantial down-payments and only lends to credit-worthy borrowers, no sub-prime) it is having fewer problems than peers. In its most recent report, the bank reported that non-performing assets were 0.63% (about 6 tenths of 1%) of total assets. During the past ten years, it has charged off an average of 0.14% (just over one tenth of 1%) of its loans each year, meaning that its credit quality has been outstanding, thanks to conservative underwriting and its focus on Chinese-American borrowers who tend to put more money down on their loans and pay them back faster than the average American.

Another point in the bank's favor is that about half its loans are backed by commercial (rather than residential) real-estate. Unlike residential, California has not experienced overbuilding of commercial properties, and rents remain high. This could change. But I have looked at East West's ability to withstand even the worst commercial real-estate downturn the country has ever seen, and thanks to its conservative positioning and long history in this line of business, the bank should be able not only to survive, but thrive. Its commercial portfolio of loans has a 55% loan-to-value ratio, meaning that borrowers put 45% down on average. The properties have substantial cash flow from existing renters and occupancy remains high, despite the recession. Even better, the new loans East West is now making are on very attractive terms for the bank because weaker lenders have left the market and there is very little competition for the best borrowers. This should mean that the bank's loan portfolio will be strengthened in the long run.

And despite all the negative news about California real estate, East West still has all of the advantages that make it an outstanding bank. Underwriting is still disciplined (and these times are when that really counts), its low expenses are still the envy of its peers, and it is still able to grow deposits from its loyal client base. This is a great example of how not all banks are created equal. And I believe the knee-jerk reaction of investors to sell every bank - regardless of quality - when a crisis hits affords us some of the best opportunities to own banks since the early 1990s.

This quarter we also had an opportunity to pick up shares of **Sotheby's (BID)** at a steep discount to what I believe they're worth. Sotheby's is the type of business I love to own. It operates an art auction business in a market with only one real competitor, Christie's (privately held). Sotheby's and Christie's have each held around 50% of the market share for art auctions for the past two decades and the growth prospects for this industry are robust.

The barriers to entry in this market are formidable. Any new competitor would have to demonstrate considerable skills in appraising fine art and collectibles and gain the trust of collectors worldwide. It would also need to navigate the tricky waters of verifying provenance and identity of ownership, something Sotheby's has been engaged in for more than 100 years. As one of only two major players, Sotheby's has the built-in liquidity advantage that all major exchanges or auction houses enjoy (think eBay or the New York Stock Exchange) – sellers go where the most buyers, are and buyers desire the best selection.

Sotheby's auction sales totaled \$5.4 billion in 2007. In return for its services, the firm retained 15% of that value in commissions and other auction revenue. The lucrative business of serving as agent and auctioneer entails very little financial risk for the company. And even when Sotheby's does guarantee a minimum auction price, as it does for some very high-end consignments, the firm has never lost money in its guarantee portfolio in any year since it began this practice.

Though the business model is very attractive, it can be cyclical. In global economic downturns, the art auction market can be less active and I believe this is why other investors have sold off Sotheby's shares during the past six months. I don't have any special insight into the volume of art sales in the coming quarters and I certainly can't predict what the global economy has in store. But I do believe that the art

auction business will remain an attractive one for many years to come. Regardless of economic ups and downs, art sales will still continue to be driven by the four D's (As Sotheby's likes to call them): Death, Divorce, Discretion, and Debt. There is no shortage of wealthy individuals worldwide who enjoy collecting and I believe that emerging markets (particularly Russia, China, and India) will help swell Sotheby's client base. Since 2003, the number of countries represented by top art buyers (those spending more than \$500,000 on a lot) more than doubled and I expect this trend to continue as wealth become more global.

We will continue to pick up Sotheby's shares as long as they remain attractively priced and I hope to own this name in our portfolios for many years.

A few words on oil and investing philosophy

A number of you have asked me about whether we're investing in oil and/or commodities. The answer is "no", at least not directly. Certainly, oil and commodity prices affect other industries and the ramifications of soaring prices can scarcely leave any company or country untouched. But I have not invested in any instrument that will directly benefit from the rise (or fall) of oil prices.

The reason for sitting on the sidelines is not that I have some particular insight on oil. But rather, I simply do not want to invest in commodity-driven companies. I believe that any company whose future hangs on the price of a commodity is an inherently poor investment. There are some very good minds on both sides of the oil debate and I've heard convincing arguments from both camps. But despite all the ink spilled on the subject, I'm not convinced that anyone has the ability to predict oil prices. So this type of investment is rather more like a gamble.

I prefer, instead, companies that are not slaves to macro-economic factors like oil prices or interest rates. For our portfolios I have selected, and will continue to select, businesses with substantial competitive advantages. These advantages – inherent in the business model – will drive growth and profitability at the companies across a variety of markets and cycles. (These companies could be in the oil business – but only if their long-term prosperity is independent of whether oil is at \$75 or \$150 a barrel.) And this means, of course, that I'm very picky when it comes to selecting the right companies and I only buy things that we would want to hold for five years or longer.

Fortunately for us, the market has served up a lot of bargains over the past quarter. The last time such high quality companies were trading at such attractive prices was in 2003, and in some cases, 1990. As we continue to see attractive opportunities to pick up a dollar for fifty cents, we will do so. And we will let the economists and the journalists debate what the price of oil will be next week.

Yours,

Rachel Barnard
Manager