McIntyre Partnerships

July 11, 2022

Dear Partners,

<u>Performance and Positioning Review – H1 2022</u>

Through H1 2022, McIntyre Partnerships declined approx. -5% gross and -5% net. This compares to the Russell 2000 Value's decline including dividends of -17%. In the YTD winners column, CC, our China Tech basket, SAVE, and VAL contributed 100-500bps each. In the losers column, MSGE, Permanent Bank, OSW, GTX/GTXAP, and TPHS lost 100-500bps each. Going forward, I am going to report GTX and GTXAP separately. While their upside scenario is linked, they have substantially different downside characteristics, given GTXAP's dividend yield and seniority in the capital structure, and the vast majority of our investment is GTXAP.

Relative to our benchmark, H1 was a good period for the fund. While I am never thrilled to be down – and I will pause here to remind investors that most of my income comes from the fund's incentive fee, of which there is currently none – my primary goal is to outperform the fund's benchmark over time. By this metric, I believe I am earning my keep. In particular, I am pleased that the fund has performed relatively well in a protracted downturn.

Since the fund's inception, I have continually stressed that I believe my investment strategy is more conservative than the broader market, but that conservativism is difficult to show in rapid declines. I want to reshare my initial investor presentation's explanation of my approach to market and macro risk:

- Rapid Selloffs i.e. "Panics" – We do **<u>not</u>** trade to prevent losses in panics. Our goal is to match market performance in a rapid decline.
- Sustained Downturns i.e. "Big Picture Macro" – We care greatly about interest rates, multiples, cyclicality, end market exposures, etc., and expect outperformance in fundamental downturns.

As I have said, I consider my bottoms up research to be the fund's primary line of defense versus market and macro risk. I do not think I have any particular edge or skill in timing broader moves in the market. My approach is to select individual securities where I believe market and macro risk is already "priced in." For instance, potential changes in interest rates should always be top of mind for investors, but I find knowing exactly when the market will begin to fear increasing rates an impossible task. Instead, I prepare for rate increases by selecting businesses at a wide discount to the market and avoiding areas sensitive to small changes in rates. Entering this year, I calculated the fund's "look through" 2022 P/E ratio at roughly 7x versus the Russell 2000 Value at 17x, and the fund held no investments in particularly rate sensitive sectors, such as high-multiple tech.

However, the effort I put into preparing our portfolio for rough seas can be lost in rapid selloffs. When stocks decline rapidly, it matters less *<u>what you own</u>*, but rather *<u>who owns what you own</u>*, along with metrics like historical beta. This can cause short-term volatility in the fund, as we often own stocks where the market has a misperception that makes a security look riskier or more cyclical than it truly is. Over time though, we have a chance to disprove the market's concerns. For instance, in the days leading up to the Russian invasion, CC traded like a high-beta stock as the market fell, which is not surprising given how most investors view TiO_2's cyclicality. However, over the next four months, TiO_2 prices continued to rally despite worsening macro, and the company posted a significant beat and raise while repurchasing 3% of shares outstanding in Q1, driving shares up 30% YTD at one point. As bottoms up, fundamental investors, we need time for our ideas to play out.

In terms of portfolio turnover, Q2 was an eventful period. The biggest position changes were a significant reduction in our CC investment, which has fallen outside our top five names for the first time in three years, and a material reduction in GTX, though our GTXAP shares remain untouched. This rotation made room for a handful of new positions: record labels (UMG NA, WMG), our China Tech basket, OSW, and FBHS. This repositioning is not due to lack of faith in CC or GTX, but rather new opportunities arising from the considerable market selloff in H1. With CC and GTX flat to up 30% at points while other companies I highly regard were down 20-50%, I felt some degree of portfolio rotation made sense. I would generally categorize our newer investments as high-quality, defensive compounders where cyclical fears and crowded positioning in technology stocks have created an attractive entry point. I provide brief theses on the record labels and China Tech below, and I will discuss the others once we have built a full position.

In addition, there has been considerable activity on the M&A and spinoff fronts lately, and I expect to increase our allocation to these ideas if and when we exit names from the portfolio. After two years when COVID-19 seemed to make everything an "event driven" trade, I am happy to refocus on the bread and butter of our strategy.

Finally, MSGE had a large and unfortunately negative intra-quarter move, swinging from a small winner in Q1 to a relatively large YTD loser in Q2. I sold some shares earlier this year, and I have bought those back and added additional shares in the selloff. I do not believe any of the macro issues currently impacting stocks will be material to MSGE and my thesis is unchanged. I believe the next significant catalyst for the stock is the opening of the Las Vegas Sphere in 2023 and I plan to maintain a significant investment.

<u>Portfolio Review – Exposures and Concentration</u>

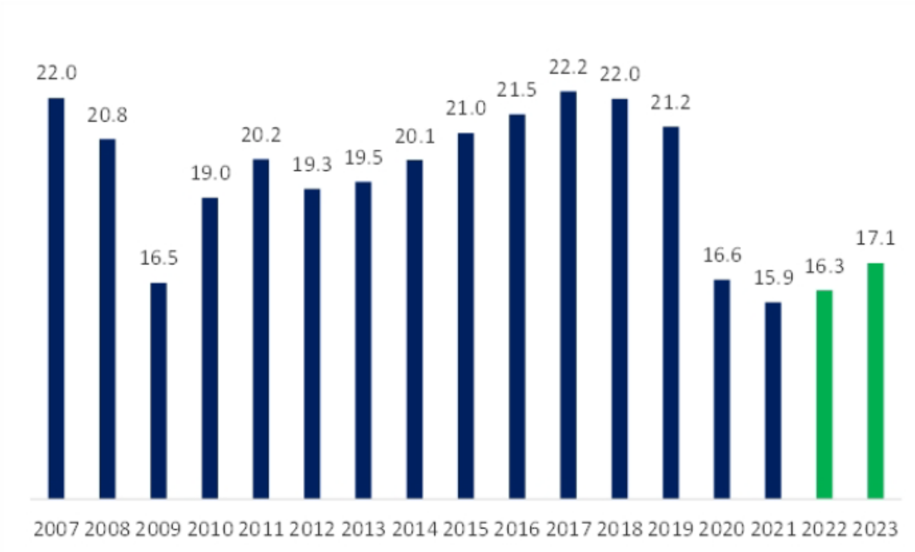
At quarter end, our exposures are 97% long, 0% short, and 97% net. Our five largest positions are GTX/GTXAP, MSGE, our China Tech basket, record labels (UMG NA, WMG), and OSW, and account for roughly 82% of assets.

<u>Portfolio Review – Existing Positions</u>

Garrett Motion (GTX/GTXAP)

There were two significant GTX developments in the quarter. First, GTX repaid HON's Preferred B shares. With HON's high-cost debt repaid and only GTX's low interest rate term loan remaining, I believe this sets the stage for accelerated capital returns later this year. Second, the slowdown in consumer electronics combined with significant increases in semiconductor fab capex appears to have finally alleviated the semi auto shortage. While I appreciate that rising interest rates, Chinese lockdowns, and gas shortages in Europe have likely weakened auto demand, I believe the significant pent-up demand for autos will result in rising production even in the case of a recession. For instance, in Europe, GTX's largest market, the last three years are three of the four worst years in the last 20 years and forward estimates remain near lows.

Exhibit 3 - Europe Production



Source: IHS, Wolfe Research

Combined with record high new and used car prices and record low dealer inventories, I believe the auto OEMs will significantly increase production as chips become available. With the worst of auto fundamentals over, I believe the stage is set for auto suppliers to rally broadly.

Portfolio Review – New Positions

Record Labels – Universal Music (UMG NA) and Warner Music (WMG)

"The best business is a royalty on the growth of others, requiring little capital itself."
– Warren Buffett

I believe the record labels are exceptionally high-quality business trading at a reasonable price, where the crash in technology stocks has created an attractive entry point. UMG and WMG have modest business differences, but for the purposes of this analysis, I am writing of them collectively. Beginning with the basics, UMG and WMG are trading roughly 15-20x 2023 consensus earnings for 10-15% topline growth, with expanding margins and arguably de minimis cyclicality. My estimates are not materially different than the Street. While I typically look for investments with a differentiated view, I believe the timeliness of the correction caused by the tech crash along with my strong belief in future growth warrants a position.

Regarding the correction, the labels are not truly "tech" investments; their bread and butter is recording and promoting new and existing music. However, the labels' current streaming distribution partners, such as SPOT, along with their "next wave" partners, such as PTON and TikTok, certainly are technology companies, and their shares have fallen significantly. In addition, the market has recently soured on streaming video services like NFLX and DIS given fear of increased churn and peak subscribers. While I understand why the labels might be grouped with these stocks, and I certainly understand there might be forced selling as certain shareholders in the space unwind, none of these issues should impact the labels long term and I consider the labels' significant correction a buying opportunity.

Regarding growth, streaming is the future of recorded music, and there is little debate that the strong growth rates will continue for at least the foreseeable future. Streaming revenues currently are 60-70% of record label revenues and are growing over 20% annually. Instead, most of the debate around the music labels surrounds margins and the future of new music. The growth of streaming has greatly eased the ability of artists to get to market. Historically, getting your CDs or records into Wal-Mart was impossible for small, independent acts, but today an act can record a song on their laptop this afternoon and upload it to Spotify and Soundcloud in minutes. With barriers falling, there are valid questions about how the economic split between artists and labels will evolve going forward. However, I believe the majority of records labels' value is their back catalog.

For some definitions, new music refers to music less than 18 months old and catalog refers to anything older. While new music grabs most of the headlines, most music consumption is back catalog, which is almost entirely owned by the major labels. In 2021, catalog represented 70% or more total consumption, a share I expect to continue to grow as older consumers adopt streaming. Unlike film or TV, where consumers consistently seek out new movies and shows, most consumers' music tastes are largely set by age 30. They typically return to the same artists and songs again and again over the rest of their lives. (Yours truly would again like to pause and inform you this does not apply to me, I am in fact forever young, and I swear I like the new Doja Cat album.) In previous eras, this meant acquiring a collection of physical recordings in one-time purchases, which were maybe repurchased infrequently as technology improved or more convenient greatest hit albums were released. In the streaming era where consumers pay a monthly fee for unlimited access but with no ability to save songs once a subscription ends, older music recordings have effectively turned into recurring royalty streams, which given streaming's software distribution model comes with exceptionally high margins. The record labels currently have operating margins around 20%, and I believe the labels will see incremental margins of at least 50% on legacy product. Combined with the opportunity for price increases discussed below, I believe the royalty nature of catalog will drive record label margins higher over time even if new music becomes more competitive.

Finally, I believe the price of music streaming services significantly undervalues their value proposition. In addition to making the services less cyclical – I doubt there is a significant uptick in churn in a recession – this dynamic leaves room for price increases over time. The current $9.99 monthly price for streaming services is 20 years old and was originally set to be equal to Blockbuster Video's monthly membership fee. Inflation adjusted, a streaming customer is paying 30-50% less than the average music consumers' spend in the 1990s. Yet, instead of getting 10-15 CDs with 15 songs per album of which three they actually wanted, the consumer gets *every song ever recorded*. The average person listens to three hours of music per day, and once a consumer adopts streaming, they consume the majority of their music through the service. This compares to the legacy cable TV bundle, to which 80% of American households used to subscribe, at a price of over $100/month with roughly 5 hours of daily consumption, admittedly across multiple household members. For now, with growth plentiful, the labels are not pushing the streaming services for price increases. Over time, however, I believe the price of streaming will increase and the labels are clear beneficiaries.

China Tech Basket – Alibaba (BABA), Tencent Music (TME) and Others

Our China Tech basket is less about company specifics, though I do like the fundamentals of our holdings, but rather a large sector bet. While I have followed China and Chinese tech companies for many years, I have historically been cautious. China is a large, entrepreneurial place with a different language, legal system, and technology ecosystem than I am used to. My view is that as an American in New York City, I am in no position to figure out nuanced, subtle shifts in Chinese tech trends, and any investment requiring such expertise is a non-starter. That does not necessarily mean all investments in China tech are automatically in the too hard bucket, but they do require a significantly wider margin of safety.

During H1, in response to the broad crash in technology stocks, the Russia-Ukraine conflict, and renewed COVID lockdowns in China, shares of Chinese technology companies fell precipitously, with one sell side analyst going so far as to declare all of China "uninvestable." Despite the headlines, the crash created what I believed were attractive entry prices. Unlike the US tech bust, where market leaders like MSFT and AAPL remain at elevated multiples, the China tech crash saw even blue-chip technology companies down over 50%, with many trading at or below their cash on balance sheet despite generating significant positive free cash flows. When cash flow positive stocks trade at or below cash on balance sheet, the importance of nuanced and subtle business changes fades and a more easily understandable set of criteria comes up, such as "Is the money real?" and "Are they going to return it to you?" I believe I have I have identified a number of Chinese tech investments that fit this description.

In general, our China Tech backet consists of leading Chinese technology companies with dominant positions in their core markets and a significant percentage of their market cap in cash or other securities. In addition, I have focused on securities with an active stock repurchase program. Since our initial purchases, some of the stocks have rallied significantly and I have exited or trimmed several. The fund retains a significant position, but as the stocks rally beyond their cash value, the nuanced fundamentals begin to matter and my overarching caution is likely to limit our position sizing.

As always, please feel free to contact me with any questions.

Sincerely,

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(1) The Returns from January through August 2017 represent the performance results of a personal proprietary trading account managed by the Founder with a strategy similar to the strategy of the Fund. This information is presented for illustrative purposes only, the above results do not reflect the actual results of the Fund or the composition of its portfolio. From September 2017 onwards, returns are from the Fund. All net returns are calculated using a 1.5% management fee, 20% incentive fee, and 5% hard hurdle.