

Dear Partners,

For the third quarter, 1 Main Capital Partners, L.P. (the “Fund”) returned 1.1% net of fees and expenses<sup>1</sup>, compared to a return of (4.9%) and (2.2%) for the S&P 500 (“SPX”) and Russell 2000 (“RTY”) indexes, respectively. Year-to-date, the Fund has returned (26.9%) net, compared to (23.9%) and (25.1%) for the SPX and RTY, respectively.

Headline Q3 results for indexes and the Fund suggest the period was mundane. However, those of you that follow the market closely know that the first six weeks of the quarter were euphoric; equities rallied nearly 15%. Then, over the next six weeks sentiment soured, prompting equities to give back all the gains and then some. The cause? The Fed made clear that it would continue down its path of raising rates to quell inflation, a path that many believe will send the economy into a recession.

While recessions are of course painful, they generally have a greater impact on investor psyche than the underlying economy. In the 72 years since 1950, US real GDP has averaged more than 3% per year but has been negative nine times. In the down years, real GDP was down an average of 1.1%. In the worst year, during COVID, it declined by 2.8%. In the second worst, the great financial crisis (“GFC”), it declined by 2.6%.

Corporate profits, impacted by operating and financial leverage, have been somewhat more volatile than GDP. Despite growing over 85x since the start of 1950 to today, S&P 500 earnings declined year-over-year 19 times along the way, with an average decline of 12%. The largest peak-to-trough earnings decline was 36%, during the GFC.

At the same time, equity markets have been significantly more volatile than both GDP and corporate profits. Since 1950, the S&P 500 has seen a peak-to-trough decline in value of greater than 10% on 38 separate occasions. The average was 20%. The worst was a 57% decline in value during the GFC.

As previously mentioned, investor psychology swings significantly more than corporate profits and is a major driver of market volatility. In *Irrational Exuberance*, a book written by Yale economist Robert Shiller and named after a phrase coined by former Fed Chairman Alan Greenspan, Shiller stated:

*“Irrational exuberance is the psychological basis of a speculative bubble...a situation in which news of price increases spurs investor enthusiasm, which spreads by psychological contagion from person to person, in the process amplifying stories that might justify the price increases, and bringing in a larger and larger class of investors who, despite doubts about the real value of an investment, are drawn to it partly by envy of others’ successes and partly through a gamblers’ excitement.”*

Similarly, drawdowns tend to bring about irrational fear. The stress associated with losses often throws investors into amygdala hijack, a fight-or-flight mindset that is not particularly useful for thinking and behaving rationally. A fight mentality may cause one to trade aggressively to try to win back what they

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have lost though may increase the chances of blowing up. A flight mentality, on the other hand, may cause one to sell their investments altogether to avoid more pain, but also serves to lock in losses.

Regardless of whether we are in a period of irrational exuberance or irrational fear, it is important for long-term investors to act sensibly, which means buying businesses at valuations that imply solid future returns based on reasonable estimates of future cash flows.

As a fund with a long-term investment horizon, we should find solace in the fact that stocks are undefeated at digging their way out of drawdowns. Since 1950, the SPX has compounded at 11.2% per year and each \$1 invested in the index then would be worth ~\$2,200 today (assuming dividends reinvested). Going back further, the SPX has compounded at 9.2% per year from the day before Black Tuesday of the Great Depression; each \$1 invested then would be worth ~\$3,700 today.

The simple reason for this undefeated record is that corporate earnings grow, and stocks move with earnings over longer periods. Because the broader market always recovers its losses and because it is very difficult to consistently predict when we are at temporary peaks and troughs, it is nearly impossible to beat the index by jumping in and out of it over time.

Instead of trying to time the market, I believe that a better way to maximize long-term returns involves consistent and careful analysis used to select securities where both multiple and earnings growth can work together to amplify returns.

That means making first principles investment decisions, sometimes with the crowd, sometimes against, while continuing to update those decisions for the ever-evolving set of risks and opportunities. It involves thinking in three-to-five-year increments and it means conservatively avoiding unjustified froth as we near market highs but getting slightly more aggressive in our positioning as we approach new lows. That is the Fund's north star and one that I will continue to follow.

### **The Perfect Investment**

The perfect investment only exists in theory. In the real world, security selection is about assessing ongoing tradeoffs between price vs. risks, as well as the impact on the composition of the broader portfolio. Given the recent market volatility, I thought it would be helpful to rehash the characteristics I look for in our core positions. These are the criteria I am constantly evaluating and updating both in our existing holdings as well as for the watch list.

1. **Good business.** If you ask five people what makes a good business, you may get five different answers. To me, a good business is one that is simple enough to understand such that it is predictable over longer periods. It is one that plays in an end market that is growing (and will continue to grow) at least as fast as the broader economy, if not faster, with a market leadership position that allows it to outgrow its end market. It should enjoy either high returns on capital or strong unit economics that make the path to high returns apparent. Of course, it should also be free of major customer or supplier concentration. The business also needs a moat that allows those returns to be sustained over time. Lastly, it should be well regarded by its major stakeholders including employees, customers, suppliers, capital partners and regulators.

2. **Competent / aligned management.** Management teams are the stewards of any business. They make decisions on behalf of stakeholders daily. That doesn't mean every decision they make will turn out to have been the right one in hindsight, but it is important to believe they were thoughtful and rational based on all the information available to them at the time they pulled the trigger (process over outcomes). In terms of alignment, the ideal capital structure is one where

management has a high portion of their net worth invested alongside minority equity holders and expects to retain its ownership indefinitely. Management shouldn't have special security classes or majority control that often comes with unchecked power and incentives that may diverge from the minority.

**3. Well capitalized.** The best defense is a good offense. During periods of market or economic uncertainty, there are often opportunities to create meaningful long-term value by making acquisitions or competing aggressively for market share while competition retreats. It is best to avoid companies that during downturns are likely to be forced to take actions that will destroy value such as raising expensive / dilutive capital, selling crown jewel assets, or retreating from opportunities that have strong potential.

**4. Margin of safety.** Valuation matters because all companies eventually trade at or below the market multiple. The market, after all, is a collection of businesses so definitionally cannot be outgrown, disintermediated, or competed away in the long run. Having line of site to meaningful unlevered earnings or free cash flow is imperative for long-term investors. Lastly, using conservative underwriting assumptions for profitability and exit multiples in businesses that are durable, cash generative and growing, leaves room to be off in some areas while still earning respectable IRRs.

Since there is no such thing as the perfect investment, my job is to weigh all the above characteristics and make quantitative and qualitative judgements on the compromises we are making by owning one security over the other. The bigger the compromise, the wider the range of expected outcomes, the higher the hurdle rate needs to be for the Fund to hold the investment.

There are times when accepting a wider range of outcomes seems to come with little reward. Fortunately, now is not such a time. As in many other periods of market volatility, the current backdrop has led to a great environment for me to add to existing positions while rotating some of the Fund's capital into investments that I believe will provide higher than average go-forward returns.

Said another way, it is periods like we are in right now where we have the chance to sow the seeds for strong future returns. While I am not sure which direction the next 15% market move is going, I feel confident that the next 50% move in our portfolio will be higher.

### **Top 5 Positions**

As of September 30<sup>th</sup>, the Fund's top 5 positions were The Joint ([JYNT](#)), KKR & Co ([KKR](#)), Mastech Digital ([MHH](#)), Pershing Square Holdings ([PSH](#)) and RCI Hospitality ([RICK](#)). Together, these holdings accounted for nearly 50% of the Fund's capital. I have written about these positions at length in the past (links above) but am always happy to discuss any of our holdings so if you have questions please reach out.

During the quarter, I reduced the Fund's positions in GOOG and BFIT. Both held up well when compared to our other holdings and names on the watch list that became increasingly compelling. I also increased our exposure to JYNT and added several new core positions, including IWG PLC (IWG), which offered us higher go-forward IRRs after selling off more than 40% YTD.

### **IWG - New Position**

IWG is global leader in flexible office space, with a footprint built over the last 30 years that today is nearly 5x the size of its younger rival WeWork. The company is run by founder and CEO Mark Dixon, who still owns nearly 1/3 of the equity.

The flex office market is attractive, large, and growing. The commercial office market was transitioning towards flex pre-COVID, but the pandemic caused a permanent acceleration in the shift where employees are now looking for hybrid work environments and where employers are looking to attract talent, reduce costs and retain flexibility with shorter commitments

Around 3% of global office space is flex currently. However, that figure will grow to 10-30% in the coming decade, according to various industry experts. In the recently published The Future of Work Survey 2022 by JLL, 77% of employers agreed that offering remote/hybrid working will be critical to attracting and retaining talent, while 53% expect to make remote work permanently available to all employees by 2025.

Today, 2/3 of the company's 3k locations are in a conventional format – which is where the company signs a long-term lease, builds out the space and then re-rents it to clients on a short-term basis. However, over 80% of new center signings since 2020 have been in capital light format, where the company provides its knowhow and brands under a franchise or partnership arrangement with partners.

As such, IWG believes that it can grow to 30k locations over time, nearly 10x its current size, but with almost all the growth from capital light locations. The company has also been selling some of its conventional locations to franchisees for upfront cash and continued royalties. This shift is reducing the company's capital intensity and will significantly improve margins and returns on capital with time.

Additionally, the company is building an Airbnb-style marketplace for office space, which allows landlords to list excess space on the platform. When bookings occur, its Instant Group division earns fees. Instant Group is expected to generate approximately \$50 million of EBITDA this year and could exit next year at a \$100 million run-rate at which point it will likely be listed as a standalone company and eventually be spun off.

Currently, IWG is viewed as a levered cyclical - exactly the type of business that has been shunned by investors of late. However, its balance sheet is cleaner than it appears. While new accounting rules now require IWG to classify billions of its lease liabilities as debt, 96% of its leases are either cancellable at the company's option or are signed by segregated subsidiaries and non-recourse to the parent company. It should also be less impacted by a slowing economy than investors fear. In contrast to traditional office buildings which are seeing vacancies rise, IWG and its peers are seeing continued demand for flex space with strong gains in occupancy and pricing.

Pre-pandemic, mature center EBITDA margins were around 30% but in an inflationary environment they could surpass that level since the company's revenues will re-price more frequently than its lease liabilities.

Currently, the company's shares are down more than 50% and impute a value of less than 5x this year's EBITDA. However, with continued growth in location count, higher mature center margins, a mix shift towards the capital light model, and the rapid expansion of the Instant Group, IWG earnings and free cash flow should rapidly recover and eventually exceed pre-pandemic levels. If that happens, the multiple should also expand quite a bit, which would mean a likely multibagger. I am excited to see what the future has in store for IWG.

### **KKR – Additional Thoughts**

Following the release of the Fund’s Q2 letter, where I discussed doubling down on KKR, I fielded many questions and spent a fair amount of time in Q3 talking to people about the differences between public market strategies and private ones. In those conversations, many explained to me that just because Alts refuse to acknowledge paper losses in their portfolios when markets are down, doesn’t mean the losses aren’t real.

Because of the frequency of those conversations, I wanted to clarify something: losses are only real when you realize them and the Alts, unlike many hedge funds, are almost never forced sellers. In fact, Alts are typically able to give their holdings time to continue generating cash, grow organically and average down during market volatility by deploying fresh capital at attractive prices. With the luxury of time, they can wait to exit when enough value has been created and investor sentiment is less pessimistic, increasing the chances of a favorable outcome.

In public markets, on the other hand, prices are set by the marginal buyers and sellers and there are many times where there could be forced selling (divorce, death, illness) at times when there is very little appetite or ability for buyers to step in.

Almost every one of these conversations has reinforced my belief that investors in private strategies benefit significantly from illiquidity in the form of improved psychology surrounding their investments. Even investors that own *both* public securities and private investments feel less angst about their private holdings than their public ones in periods like we are in right now – assuming a fair entry valuation and performance that is in-line with expectations.

At the end of the day, Alts have a favorable structure with which to invest: longer duration, available dry powder to average down, lack of mark to market volatility, control of investments leading to competent / aligned management. I remain convinced that secular flows to the leaders in this space will be durable even if public markets at times offer greater mispricing, higher returns, and better liquidity.

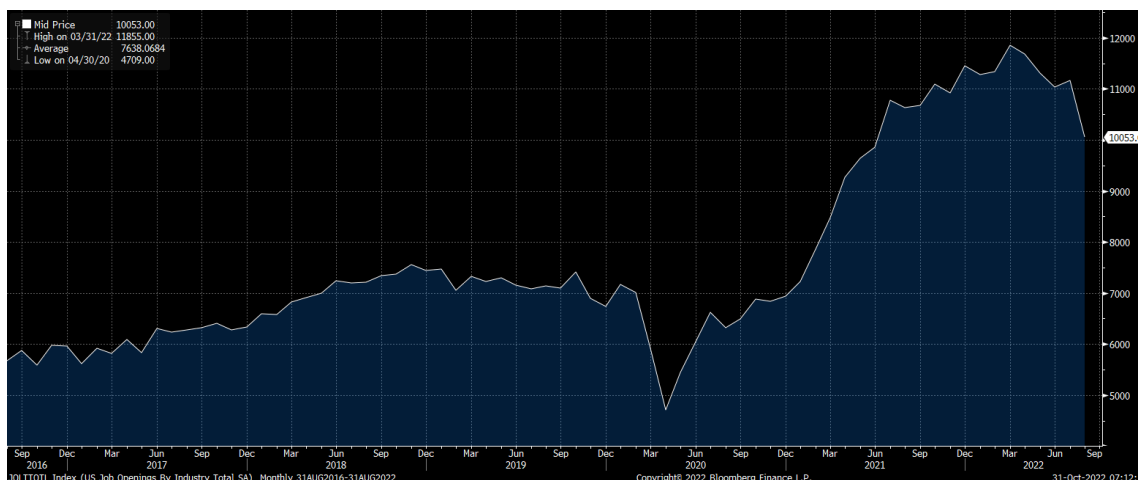
### **Outlook**

Since the start of the year, 30-year treasury yields have increased from under 2% to over 4%. Short term rates have also risen dramatically over the period. While this absolute level of rate increases is something that was within the reasonable range of expectations of most investors, the speed at which it occurred has been surprising and an obvious headwind to valuations.

Additionally, the labor market has remained tight, causing an acceleration in wage growth. This means that the Fed will keep tightening. Their primary objective is to slow demand and cool off the labor market enough to ease inflation. This is the right thing to do for the economy long-term and what you should be hoping for them to accomplish, whether you are labor or capital.

While lower demand typically comes with spikes in unemployment and reduced economic output, the Fed is trying to accomplish its objective without causing a deep recession. Most put the chances of their success at slim.

However, it is remotely possible that they can slow demand enough to cause businesses to stop hiring but also not so much where they fire their existing employees. Total job openings in the US (chart below) have come down in recent months without a commensurate increase in unemployment. This is a good sign. We are in uncharted territory though and won’t know what success or failure looks like until we are looking in the rearview mirror.



Asset prices have come down this year to account for the much-anticipated slowdown. While the overall market valuation is at a much more reasonable place than it was 9 months ago, it is still not cheap by historical standards. Fortunately for us, we don't own the market. Our portfolio is filled with what I view to be great value at current prices.

As always, I will continue to try to own the best collection of businesses that can outgrow inflation in any environment, trading at reasonable valuations, with strong balance sheets and competent / aligned management. I am confident that this recipe will yield success with time.

Thank you for your continued support and confidence. Please reach out with any questions at [yaron@1maincapital.com](mailto:yaron@1maincapital.com) or 305-710-8509.

Sincerely,  
Yaron Naymark

**Monthly Performance Summary<sup>2</sup>**

2022	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
1 Main Capital Partners - Gross	-7.3%	-0.9%	-3.2%	-6.8%	-2.9%	-9.5%	11.8%	1.5%	-10.6%				-26.0%
1 Main Capital Partners - Net	-7.4%	-1.0%	-3.4%	-6.9%	-3.0%	-9.6%	11.7%	1.4%	-10.7%				-26.9%
S&P 500 index - incl dividends	-5.2%	-3.0%	3.7%	-8.7%	0.2%	-8.3%	9.2%	-4.1%	-9.2%				-23.9%
Russell 2000 - incl dividends	-9.6%	1.1%	1.2%	-9.9%	0.1%	-8.2%	10.4%	-2.0%	-9.6%				-25.1%

	One Year	Three Year	Since Inception	Inception Annualized
1 Main Capital Partners - Gross	-21.9%	37.8%	163.9%	23.1%
1 Main Capital Partners - Net	-23.5%	27.9%	106.0%	16.7%
S&P 500 index - incl dividends	-15.5%	8.1%	37.9%	7.1%
Russell 2000 - incl dividends	-23.5%	4.3%	11.8%	2.4%

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***Risk of loss.*** An investment in the Fund will be highly speculative, and there can be no assurance that the Fund’s investment objective will be achieved. Investors must be prepared to bear the risk of a total loss of their invested capital.

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