PINCHOT LANE PARTNERS, L.P.
101 Inara Court
Carrboro, NC 27510

August 8, 2023

To My Partners:

1H 2023 Performance Summary

From January 1 to June 30th, 2023, Pinchot Lane Partners LP (“PLP”, the “Fund”, the “partnership”) returned 19.5% on both a gross and net-of-fees basis (with management fees having been waived since Q2 of 2022). No incentive fees were paid for partners joining prior to 2023, as the Fund’s performance did not exceed the annualized hurdle rate required to earn them. Below is a summary of Fund performance for 1H 2023 and since inception:

		(A)	(B)	= (A)-(B)
	PLP Gross Perf	PLP Net Perf**	S&P 500 Total Return†	*Relative Performance*
1/22/18* to 12/31/18	(9.6%)	(10.3%)	(9.1%)	*(1.3%)*
1/1/19 to 12/31/19	31.1%	28.9%	31.5%	*(2.6%)*
1/1/20 to 12/31/20	128.3%	97.2%	18.4%	*78.8%*
1/1/21 to 12/31/21	(25.6%)	(26.1%)	28.7%	*(54.8%)*
1/1/22 to 12/31/22	(26.3%)	(26.4%)	(18.1%)	*(8.3%)*
1/1/23 to 6/30/23	**19.5%**	**19.5%**	**16.9%**	***2.6%***
Annualized 1/22/18*-6/30/23	**11.1%**	**7.5%**	**10.8%**	***(3.3%)***

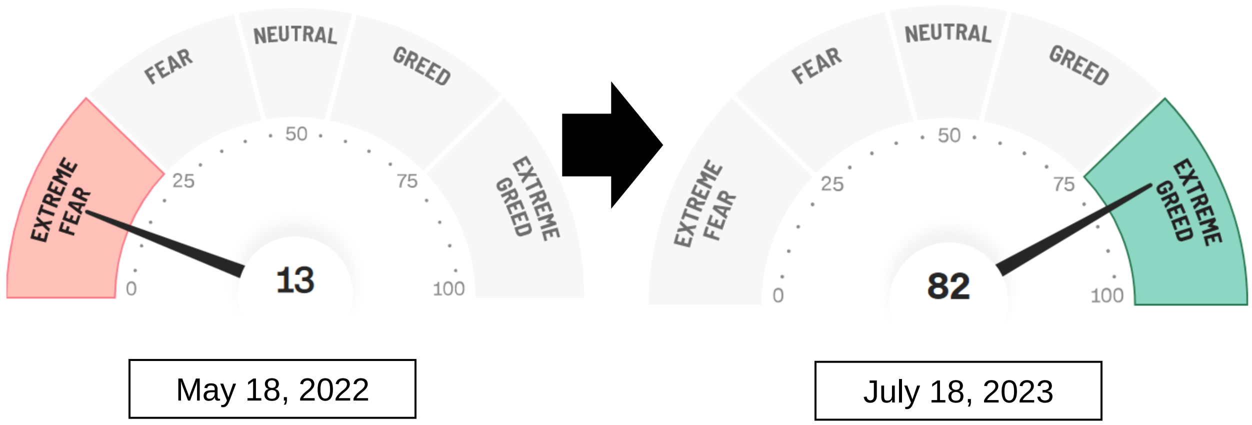
** Fund inception*
*** Management fee has been waived since 2Q 2022.*
Net performance after mgmt fee and incentive allocation (cumulative 6% hurdle subject to high water mark).
† S&P500 total return includes dividends.
Note: Individual LP returns may vary based on the date of your subscription(s).

The Benefits of Patience

To restate the obvious, the Fund’s performance in 2022 was poor. Through the first six months of last year, the Fund recorded a -30.8% net performance, against the S&P 500’s performance of -20.0%. You may remember in May of 2022, when I remarked in a note to partners:

> *I have no idea what the coming months or year will bring, but I am reasonably confident that deploying capital in the midst of a downturn will yield more than satisfactory results over the long term.*

As reported inflation metrics have gradually declined this year, and the Federal Reserve has signaled being closer to the end of its rate tightening cycle, equity markets have rallied, creating a powerful lift in the indexes. To reverse-paraphrase Dickens, “It was the worst of times, it [is] the best of times…It was the season of darkness, it [is] the season of light.” What a difference a year makes.



<u>Source</u>: CNN Fear & Greed [Index]

Clearly, PLP has been a beneficiary of this year's market largesse, though reconstituting the portfolio last year and leaning into higher quality companies has enabled us to ride this wave more confidently. Last year's market turmoil presented opportunities to reallocate funds into excellent businesses with attractive economics and growth prospects at reasonable valuations. Having more of these companies in the portfolio gives us the opportunity to improve long-term, *<u>after-tax</u>* returns by compounding our wealth through patient *ownership*, instead of *speculation*. It is a comfortably lazier approach to portfolio management. Owning higher quality assets positions us better to adhere to the wise investor adage: "Don't just do something, sit there!"

Over the last year, several high quality "stalwarts" were added to the Fund at attractive valuations, including Apple, Broadcom, Taiwan Semiconductor, Meritage Homes, and Ferguson plc. All made positive contributions to 1H 2023 performance.

> *You make most of your money in a bear market, you just don't realize it at the time.*
>
> – Shelby Cullom Davis (1909 - 1994)

<u>"Business as Unusual"</u>

While the broader economy has thus far escaped recession, make no mistake, over the past year we have been in a "rolling" recession among sectors such as logistics, manufacturing, and discretionary goods.

> *The U.S. economy may ultimately skirt a recession, but it's felt like one for months at Jon Ferrando's 103 RV dealerships. **Retail sales of recreational vehicles are on track to be the lowest since 2015**, said Ferrando, CEO and president of Fort Lauderdale, Florida-based Blue Compass RV, which operates in 33 U.S. states. There's "**definitely a recession in RVs**," he said. Blame the coronavirus pandemic. Few industries better illustrate the wild shift in U.S. spending habits that occurred during the health crisis.*

– "RV industry steers through post-pandemic US slump" (July 25, 2023)

> *The global mood isn't for the revenge buying that we experienced in 2021 and 2022, so* ***we're talking more about normalization****.*
>
> – LVMH CFO Jean-Jacques Guiony (July 25, 2023)

> *Moving onto e-commerce, you saw in the release that* ***e-commerce was at minus 10% sales decline*** *and on a comp basis…in Q3 big ticket discretionary departments notably majors, home furnishings, small electrics, jewelry, and hardware were* ***down about 20% in e-comm*** *and made up 55% of e-com sales.* ***These same departments were down about 17% in warehouse****…*
>
> – Costco fiscal 3rd quarter earnings transcript (May 25, 2023)

Compensating for a contraction in goods purchases, services spending has seen a massive increase, evidenced by the number of households I personally know who are traveling to Europe this summer. Through it all, software spending has remained resilient, with monetization of new artificial intelligence ("AI") technologies buoying the sector and leading to a bull market revival in 2023.

In the 2021 year-end Letter to Partners, I discussed how analytical investors would be flummoxed by consumption patterns during and after the pandemic's darkest phases:

> *Forecasting lasting trends as we come out of the pandemic is a particularly fraught effort, given the unprecedented nature of both the pandemic and the human response. Compounding these challenges is the fact that even company management teams are struggling to forecast, as recent demand patterns have been affected by consumer behavioral shifts and government interventions (see: Peloton).*

We're not yet out of the woods, as many sectors of the economy are *still* experiencing abnormal effects (both positive and negative) borne from the pandemic. During such unpredictable times, it is important not to focus myopically on the recent past in case we are tempted to over-extrapolate current trends. The bottom line is that "unprecedented" demand cuts both ways. Normalization may take years, but ultimately the laws of financial gravity are inescapable.

Staying Focused on the Horizon

I humbly admit to not having any special insights as to what will unfold in the markets or in our companies over the next 1-2 years. In the words of Ray Dalio, I am a "dumb shi*t, who doesn't know much relative to what I need to know," particularly about near-term events. Fortunately, successful long-term investing does not require genius. It does, however, require a deep understanding of the companies in which the Fund invests, patience, the self-awareness to identify blind spots, and the temperament needed to hold for the long run.

For investors who plan to stick around for a while, I find it far more interesting to focus on the trajectory over the next 3-5 years and beyond. With a long-term perspective, we can more confidently handicap our companies' odds of success. The degree of difficulty in making short-term predictions is best left to traders engaged in the speculative arms race that the modern hedge fund industry has become. I cannot outspend or outwork these armies of arbitrageurs, but I do have an edge that they will never possess – a willingness to compound wealth slowly.

> *Amazon founder Jeff Bezos once asked legendary investor Warren Buffett, "You're the second richest guy in the world. Your investment thesis is so simple. Why doesn't everyone just copy you?"*
> *Buffett replied, "Because nobody wants to get rich slow."*

Homebuilders in 2023

If it's cheap, we buy.
– Howard Marks

The Fund built a medium-sized position in Meritage Homes (MTH) a year ago and continues to hold the asset. Meritage is the fifth largest national homebuilder by total homes delivered in 2022. The Company specializes in building affordable, energy-efficient homes in suburban markets across the U.S. The opportunity to accumulate shares in Meritage is emblematic of one approach the Fund uses to search for value in public markets.

When PLP made its investment in Meritage last July, its share price had declined 30% since the beginning of 2022. The Company had low levels of debt and was continuing to produce excess cash given accelerated homebuying demand throughout the pandemic. Given the rising cost of labor and materials due to pervasive shortages, homebuilders had increased selling prices and achieved record gross margins, turning what had been a decent business with solid financial returns into a fantastic one, supply challenges notwithstanding. Homebuilder stocks, however, cratered in 2022 in response to the fastest pace of Federal Reserve rate increases in over four decades. The Federal Funds Rate was pegged at zero throughout the pandemic, but increased over 400 basis points in 2022 alone, pushing the 30-year fixed rate mortgage rate to 7% by the end of the year. The conventional wisdom was that high rates would drastically curtail homebuying activity. With mortgage rates doubling in a year, it was hard to argue against homebuying demand being meaningfully diminished.

Despite the homebuilding sector's challenges, Meritage stood out as a compelling investment opportunity with limited downside for several reasons:

- The U.S. has experienced a shortage of new home supply for much of the last decade, with a large wave of millennials reaching household formation age
- An entry-level home is typically considered a "need-to-have" purchase, as opposed to a "nice-to-have" luxury

- Meritage's assets are predominantly comprised of real estate inventory (finished homes, homes under construction, developed lots, and raw land) and liquid cash (collectively, "hard assets")
- The Company's liabilities were well-covered by its assets with no near-term debt maturities
- Through much of 2022, Meritage was trading well below its *tangible book value* - the value of its hard assets less all its liabilities
- Tangible book value had not yet reflected the substantial profits from ordered, to-be-delivered homes
- Meritage had made a strategic pivot in 2016 toward entry-level homes, enhancing capital efficiency and long-term margins. COVID acted as an accelerant to this strategy

In fact, a rough analysis suggested that only an *extreme* impairment to the value of developed lots and raw land of 50% could justify the depressed market value of Meritage shares. Considering the overall housing shortage and my confidence that the disastrous housing cycle of 2005-08 would not be repeated (prevented by tighter lending standards and a larger, more qualified pool of homebuyers), an investment in Meritage shares seemed like a bet well worth making. In the event of a serious recession, the Company might stop building as many homes, sit on its land assets and wait for a recovery. Even in this scenario, it was difficult to see substantial downside in Meritage's equity.

An asymmetrical return opportunity, where one can "be a little right and make a lot, or be a lot wrong and lose a little" is a value investor's dream. The market *rarely* provides occasions to own good companies at bargain prices. When these opportunities present themselves, buying with both hands is the best course of action.

Exiting Viasat

Our investments performed well in the first half of 2023, but a situation that unfolded quite abruptly and poorly post-Q2 was our long-held investment in Viasat.

On July 12, 2023, the Company announced that a deployment issue on their first-of-three mega-satellites "may materially impact the performance of the Viasat-3 Americas satellite." The Company had spent the better part of a decade on development of these next-generation satellites with R&D efforts pre-dating the launch of the prior generation Viasat-2 satellite in June 2017. Each satellite in the Viasat-3 constellation was claimed to offer nearly 5 times the capacity of the prior generation at a cost of only 2.5 times, enabled by a large "reflector" deployed after each satellite reached orbit. Since the company designed and launched its first satellite (Viasat-1) in 2011, I recognized the potential for Viasat to deliver superior satellite economics in an industry that had seen only incremental innovation, nothing of the sort of step-change enabled by Viasat's proprietary designs. If you have enjoyed fast wi-fi connections on JetBlue, United, American Airlines, Delta, and most recently Southwest, you can thank Viasat for developing the innovations required to deliver streaming-quality bandwidth to your seat for a low price (often free).

The Company's announcement stated that "Viasat and its reflector provider are conducting a rigorous review of the development and deployment of the affected reflector to determine its impact and potential remedial measures." Spending most of a decade on a "bet the farm" investment that does not work calls into question the credibility of the Company's growth objectives, since Viasat-3 was intended to be the foundation for expansion of global services. Our investment in Viasat was never intended to underwrite science projects - these pursuits are best left to venture capitalists and centi-billionaires. Yet, Viasat-3's apparent reflector anomaly convinced me that this is what I have been doing all along. Unfortunately for Viasat and its continuing shareholders, the future roadmap just got a lot more uncertain. Given these uncertainties and the fact that I no longer felt equipped to understand the path forward for the Company, the better part of valor was to exit our investment. Our realized loss in shares of Viasat, though not substantial compared to our average cost basis in the stock, reduced the Fund's performance by 2.2% since the June 30^{th} close.

As I have often communicated to Partners over the last year, I am determined to shift our Fund composition toward higher quality, proven, and more resilient companies, which will de-risk our portfolio so that it can better withstand a range of adverse economic developments, such as recessions, climate change, plagues, etc. We will not make investments in "bet-the-company" experiments.

Lessons Learned

Candor about the Fund's performance is what I owe you – not just during the good times, but also when things go badly. Most importantly, you deserve to know what I learned from these experiences.

To repeat a quote I've used before, "experience is what you get when you didn't get what you wanted." My objective going forward is to manage your capital with much less chasing, much less turnover, and much more focus on quality with duration.

> *"I believe strongly that success carries within itself the seeds of failure. And failure carries the seeds of success…I think that success teaches terrible lessons, because it plays to our egos. And I think you learn more from your failures. And hopefully, you learn humility."*
>
> – Howard Marks

As always, my line is open should you have questions and/or comments.

Sincerely,

Drew Peng