WHITE FALCON

CAPITAL MANAGEMENT LTD.

January 10, 2022

RE: Q4 2022 and FY2022 Partners update letter

Dear Partners,

While individual client returns may differ based on their inception dates, consolidated performance of all accounts for the period ending December 30, 2022 is as follows:

	Q4 2022	2022	ITD*
White Falcon (net of fees)	**2.52%**	**-9.26%**	**-10.62%**
S&P 500 (CAD)	5.25%	-12.59%	-9.75%
MSCI All Country (CAD)	8.23%	-11.86%	-10.55%
S&P TSX	5.97%	-5.76%	-6.29%

*Inception date is Nov 8, 2021

What a year! It has been volatile but this bear market has allowed us to upgrade the quality and valuations in the portfolio. In the fourth quarter, the portfolio was up less than the market as the higher weight in technology stocks weighed on performance. This was negated by the portfolio's position in commodity stocks as well as the buyout of Maxar Technologies which was a top 10 position. We added to technology stocks in the quarter as they were weak due to tax loss realizations and fund redemptions. We are currently fully invested.

The performance this year has been a story of two halves. After a drawdown in the second quarter, we were up 14.65% in 2H 2022, due to which partners, who started with us in 2H have seen positive performance in their portfolios.

Currencies played a big part in returns this year. The US Dollar (USD) appreciated against the Canadian Dollar (CAD) by 7.2% in 2022 which helped CAD returns. In contrast to the CAD returns reported above, in USD terms, the S&P 500 returned -19.4% while the Nasdaq was down -32.8%. We had an average of 40% of the portfolio in US equities during the year due to which the USD added about 3% to yearly performance.

While we show other indices above, it is important to reiterate that White Falcon does not manage against any index. Our portfolio is an esoteric group of businesses where each company is underwritten based on expected returns and where risk is managed by buying good quality and growing businesses run by competent management teams. As value investors, we invest with a margin of safety. We are cognizant of the fact that '*what*' we buy and '*how much*' we pay for it are the only two factors we control. At the portfolio level, we manage exposures and maintain a mix of compounders, growth and value stocks as well as special situations depending on the opportunity at hand.

We are playing the long game but realize that the long term is made up of many short terms. In this letter, we look back at the year and discuss current positioning. We also present a research report on a recent investment in **Diversey Holdings (DSEY)** in the appendix to this letter.

What went right this year?

Half of the portfolio had positive realized and unrealized gains for the year. Out of these, EPAM Systems and Maxar were the largest positive contributors to performance. In addition, our weight in the commodity sector, including the precious metals hedge, produced substantial positive returns.

EPAM Systems is an IT services company. We initiated a position in EPAM after it sold off when Russia invaded Ukraine. The concern was that EPAM had a large part of its workforce in Ukraine, Belarus and Russia. Until then, EPAM had been a high quality compounder whose stock price had gone up 10x in the previous 10 years. It was a strong company that had come across some temporary headwinds and our analysis (Q1 2022 letter) confirmed that the risks are manageable. We bought the stock at $210 per share in Q1 and sold about a quarter of our position in the $400-450 range in Q3. EPAM remains a top 10 position and closed the year at $330 per share.

Maxar Technologies provides satellite images to the defense and corporate sector. The company was going to launch its new and improved Legion satellites but was faced with delays due to which investors lost patience and sold the stock. We saw a good quality company beset by temporary delays with strong FCF available for less than 10x EBITDA and bought the stock at an average price of C$35 per share. In December, Advent, a Private Equity firm, announced that they are going to buy-out Maxar and take it private at above C$70 per share. We sold our position and redeployed the cash into other attractive opportunities.

White Falcon has a position in **Gold/Precious Metals** via royalty companies. These equities performed their role as 'hedges' in a very uncertain macroeconomic environment. In addition to precious metals, our base commodity (copper, oil) exposure also added positively to returns.

What went wrong this year?

The other half of the portfolio that had negative unrealized and realized losses and the common characteristics they had was that they were either technology stocks or small caps or both! The biggest mistakes in this basket have been Farfetch and CopperLeaf Technologies.

Farfetch is the largest scaled e-commerce platform for luxury goods. In addition to being a marketplace, it has a platform solutions business (think Shopify for luxury) as well as a own brands division. Our revenue and margin estimates for Farfetch turned out to be too high when, during an investor day, management lowered their guidance for the business. The business should be able to do 20-30% EBITDA margins in a mature state but that is not looking likely due to lower realized market power and an inflated cost structure.

CopperLeaf Technologies is a software company that provides decision analytics software to the utility industry. It is a high quality company that has not lost even one customer in its history. With strong unit economics, management decided to run large operating losses in order to grow and has hit the perfect storm as these companies are being severely punished in this environment. While our research confirms that Copperleaf is a strong company (Q2 2022 letter), we were too early in our purchases and underestimated the volatility of a low liquidity small-cap Canadian stock.

Other technology positions such as Amazon.com and Converge also contributed negatively to performance. We have checked and double checked our assumptions and remain confident that the market will recognize the value of these investments in due time. The Nasdaq has been the worst performing index in the stock market and with it comes redemptions and tax loss selling due to which cheap keeps getting cheaper.

In Summary,

What worked in 2022 for White Falcon,

- Investing in good quality companies going through temporary dislocation
- Risk and position management really helped from a portfolio management perspective
- Exposure to precious metal royalty companies and to cheap base commodity (copper/oil) companies which, we believe, have structural tailwinds due to supply constraints

What did not work in 2022 for White Falcon,

- Investing in business that were over earning due to Covid/lockdowns
- Exposure to higher growth and higher multiple stocks

One of the difficult things in this business is learning the *right* lessons. The bigger mistake this year has been buying long duration/technology stocks too soon. We started building positions in Q2 while it would have been much more advantageous if we had waited until Q3 or Q4. This is not a timing strategy but just a realization that bigger the bubble -> bigger the bust. Having said that, it is important to mention that losses are part of the game - the trick is making fewer of them and keeping them small! It is important to mention that we have taken our losses where we lost conviction and added to positions and lowered our average cost in businesses that offer attractive risk-rewards.

How are we currently positioned?

Our underlying operational principle is that, as long as the business is within our circle of competence, we invest as attractive risk-rewards opportunities appear. In a normal market environment, we are lucky to find a few good ideas but this market environment has presented us with many good risk-reward opportunities. Our portfolio and your capital is invested in high quality companies that have been bought at significant discounts to their intrinsic values.

“The choice is not between value and growth, but between value today and value tomorrow.”

- Howard Marks

As of December 30, 2022, we are positioned as follows:

By Sector	Weight (%)
Technology	45.72
Commodities	28.92
Retail	9.60
Financials	5.90
Other	8.11
Total Equities	98.25

By Style	Weight (%)
Compounders	32.42
Value Now	32.40
Value Tomorrow	33.43
Total Equities	98.25

By MarketCap	Weight (%)
Large Cap (> $20 bn)	38.51
Mid-Cap (> $1 bn < $20 bn)	40.19
Small-Cap (<$1 bn)	19.54
Total Equities	98.25

Out of all the different ways of looking at the portfolio, the most relevant way for us to look at them is Compounders, Value Now and Value Tomorrow. After that, the businesses can fall in any sector and any market capitalization. **Compounders** are good quality companies with high returns on capital, a long runway for growth, and run by competent management teams. **Value Now** companies are the typical value investments available for low multiples of current earnings. **Value Tomorrow** companies are structural growth businesses where the stock may not be cheap based on this year's earnings but cheapens significantly with the passage of time due to growth in revenues or margins or both. The relative weight of these buckets, at any one time, depends on the opportunity at hand. This year, we have allocated more to the 'Value Tomorrow' bucket as these businesses became cheaper. In many cases, these are sticky software or dominant marketplace businesses with a net cash balance sheet and a long runway of growth. If we have picked the right stocks then we have likely set White Falcon for high compounding performance in the future.

There is an exciting addition to the top 5 positions. We added **Advanced Micro Devices (AMD)** during the quarter. The other positions remain the same - Precious Metals royalty basket, Converge, NU Holdings, and Amazon.com. AMD is a fabless semiconductor company that, under CEO Lisa Su, has been growing structurally with the chip market and taking market share from competitors. It is interesting that in 2020/21, semiconductor stocks such as AMD were revered and deemed to be structural winners due to which they were given high multiples. Today, at 17-18x earnings (and these earnings have already been cut several times), there is very little interest in AMD as investors worry about further short-term revisions. We view AMD as a structural grower with a clean balance sheet and a fantastic management team.

Earnings for portfolio companies were not as positive as last quarter. Technology companies have been slow to cut costs and that is hurting their bottom line. We see some green shoots here and remain optimistic about the longer term. We also know that markets are forward looking and discount future conditions. Importantly, as discussed in other letters throughout this year, our base case is that the higher interests are not an anathema to technology stocks and that they should do well over time due to their structural growth and increasing free cash flow profiles.

In Closing

This has been one of the more tumultuous years in the markets. We started White Falcon with the belief that a simple indexation strategy will not be enough and a nimble and opportunistic investment manager is needed to navigate this market environment. We are even more convinced of this view than when we started White Falcon. This bear market has set up well for the future by giving us a tremendous opportunity to better the quality and valuation of the portfolio.

From an operations perspective, Interactive Brokers has been a good platform. With our SMA structure, you, our partners, only pay for commissions on transactions. In a fund structure, at our current AUM level, costs would have been much higher (custody, audit, legal) taking away from the compounding of capital. This year the total cost of commissions was less than 0.18% of AUM and we expect this to decline to less than 0.10% of AUM next year. Importantly, NAV for incentive fees is calculated after deducting these commissions.

I remain forever grateful to all the partners at White Falcon. Please feel free to forward this to anyone who you think will be a good potential partner for White Falcon. Also, please feel free to get in touch with me for any questions or feedback that you may have.

With gratitude,

Balkar Sivia, CFA
Founder and Portfolio Manager
White Falcon Capital Management Ltd.

WHITE FALCON

CAPITAL MANAGEMENT LTD.

INVESTMENT PHILOSOPHY

White Falcon's mission is to compound capital on a risk adjusted basis with a value investing philosophy.

We believe in active stock picking and draw inspiration from the teachings of Warren Buffett and Charlie Munger.

Our process is to take advantage of volatility and opportunistically invest in good quality and growing businesses that have durable competitive advantages and are run by aligned management teams.

With our research intensive strategy and a mandate to invest across geographies and sectors, we are focused on generating absolute returns.

We invest with a margin of safety. We are opportunistic and price sensitive buyers of securities.

NO MANAGEMENT FEE

Incentive fee of 15% on profits, with a high water mark - inspired by Warren Buffett's partnership structure

ALIGNED

All general partner capital invested alongside limited partners capital

EXPERIENCED

Balkar has 15 years of investment management experience. He was a Vice President at Burgundy Asset Management and an Analyst at McElvaine Investment Management. He is a CFA charterholder and has an engineering degree from UBC.

SIMPLE STRUCTURE

Separately managed accounts (SMA) with Interactive Brokers. Full transparency on portfolio and balances. No leverage. Minimum investment of $50,000.

DIGITAL ONBOARDING

Three step onboarding starts with filling out the 'Invest' form on our website

INVEST WITH US

https://www.whitefalconcap.com/invest
416-770-6131
bsivia@whitefalconcap.com

Diversey (DSEY) Research Report

“The best thing that happens...is when a great company gets into temporary trouble…We want to buy them when they're on the operating table.”

- Warren Buffett

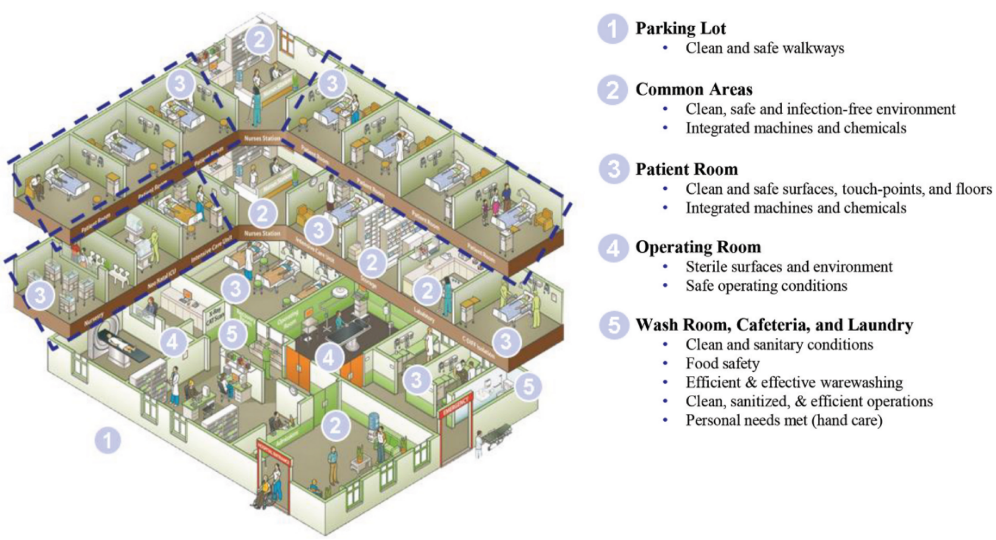
Executive Summary

- Diversey is a cleaning and sanitation products and services provider to institutional customers such as hospitals, hotels, and good and beverage producers.
- Ecolab and Diversey are the two largest competitors in this $32 bn market. Diversey is strong in Europe and Emerging Markets while Ecolab is strong in the US.
- Diversey is the quintessential ‘small cost but high impact’ business where cleaning and sanitation is a very important process for clients and its relative cost is very low.
- Competition is based on technical prowess and service levels and economics are dependent on scale in a particular geographic area. Diversey is #1 or #2 in most of the markets in which it operates.
- Diversey was bought by Bain Capital from Sealed Air in 2017. In 2021, Diversey came to the market in an IPO at $14 per share.
- In the last 12 months the stock price has declined from $14-18 to $4.35 (our average cost) due to a severe margin compression (from 15.7% in 2021 to 11.6% in 2022) led by high raw material prices and a strong USD. This coupled with high debt levels and a small float has seen this stock mercilessly sold.
- White Falcon believes that the margin issues are temporary - Diversey is passing price increases, Bain Capital has led some structural changes which should improve margins, and the USD seems to have topped. We believe the headwinds of 2022 will turn into tailwinds going into 2023.
- At $4.35 per share, Diversey trades at 10x 2022 depressed EBITDA or 7x 2025E normalized EBITDA of $450 mn. At 10-12x EBITDA multiple, the stock is worth $9-12 per share in 3 years.
- Our average cost base is $4.35 per share but due to risks from leverage - both operational and financial - we have decided to keep the position size at half of a full position.

Introduction

Diversey Holdings is a provider of cleaning and hygiene products in the hospitality, healthcare, food and beverage, food service, retail, and facility management sectors. Their suite of solutions combines patented chemicals, dosing and dispensing equipment, cleaning machines, and services. Headquartered in the US, Diversey is a multinational serving more than 85,000 customers in over 80 countries with a network of 8,500 employees. It has a market capitalization of $1.4 bn, an EV of $3.2 bn and is 73% owned by Bain Capital. The company is currently trading at 10x depressed 2022A EBITDA or 7.0x normalized 2025E EBITDA.

While we buy our detergents and cleaning products from the supermarkets, commercial customers need institutional suppliers. Furthermore, these customers have very unique needs. As an example, a brewery has to clean its equipment after certain production cycles. The chemicals used to clean this equipment need to be safe - for the cleaning personnel, the life of the equipment, as well as the customers consuming products from this brewery. More importantly, while the equipment is being cleaned, it cannot produce due to which the time to complete the cleaning process is important. Moreover, with most businesses committing to increasing ESG commitments, lower water and energy consumption in this cleaning cycle is increasingly important. Chemical companies such as Diversey and Ecolab visit these facilities with their technicians, formulate the chemicals, decide on a cleaning and maintenance schedule and install dosing and dispensing equipment. The facility is then supplied regularly and service and maintenance personnel need to be on call in-case of emergencies as the cost of stoppage is too high. As an example, Diversey gives the example of a hospital in its S1:



Source: Diversey prospectus

“Let's say you're cleaning a very high-profile customer, Amazon, Microsoft..you don't want a glass cleaner, a multi-surface cleaner, or a disinfectant to harm one of your client's employees or damages some kind of substrate, so risk mitigation”

- Stream Transcript

Diversey and Ecolab operate in this $32 bn global market where they have the following attributes:

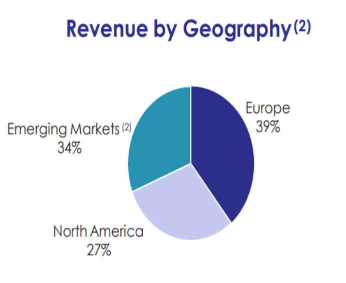
- Provides essential services to their customers without which they would not be able to run their business
- The spend on their services is small relative to the total cost of running the business for the customer. This is an essential part of business for the customer if they are to maintain compliance with regulators. Due to this, this business is relatively recession resistant.

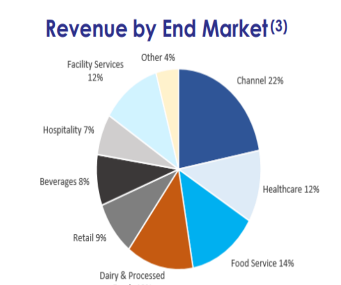
- Razor and razor blade model where Diversey and Ecolab install dosing and dispensing equipment at the customer site locking in business but most of the margin is made from consumable chemicals.
- Scale is needed in the business in order to profitably serve the customer. Density and route to market are important variables. Although these are classified as chemical companies, the services aspect of the business is more important. Due to this, this industry lends itself to an oligopoly structure.
  - Smaller companies can have high market shares in certain geographies and both Diversey and Ecolab have been busy acquiring them and consolidating the industry.
- Cleaning and sanitation services have a newfound importance after Covid-19. Many businesses are taking steps to further their standards in cleaning and hygiene which benefits Diversey and Ecolab.

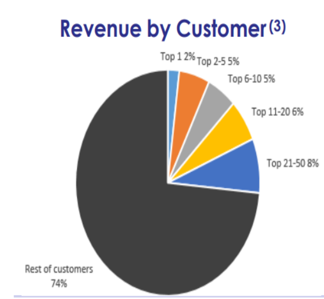
A Diversey salesperson will pitch the customer on how its solutions will help them save money on chemical, water, and energy use over time. Diversey breaks down its business in two segments - institutional and food and beverage:

Source: Diversey Presentation

Diversey is a smaller competitor than Ecolab with less scale in the US but competes head to head with Ecolab in Europe and Emerging Markets. In fact, Diversey has leading market shares in countries such as the UK, India and Indonesia (which were strong Unilever markets).







Soure: Diversey Presentation

Recently Diversey's share price has declined precipitously to $4.35 per share (where we initiated a position) from highs of $14-19 per share in 2021. Diversey is facing some temporary headwinds due to high raw material costs and USD strength. Further, it has high debt levels. We believe these headwinds are temporary and Diversey should be able to overcome that in the next few years and de-lever its balance sheet. If this is the case, the stock can appreciate markedly within the next 2-3 years.

Industry Dynamics and Competition

Diversey's main competitor is Ecolab. Ecolab has been a compounder and has done really well for shareholders. Due to its stable growth profile, high ROIC and shareholder friendly policies it regularly trades at 16-20x EV/EBITDA and 30x P/E. Ecolab has a large market share in the US which is the largest sanitation and hygiene market in the world due to which it benefits from economies of scale.

In its core segment of sanitation, competition in the industry is not just based on price but also on product and service:

"When a customer is evaluating a company like Diversey or a category that Diversey and Ecolab would compete in, yes. Is price important? Of course, it is. Diversey and Ecolab compete against each other but also the broader market with chemistry and competencies around the chemistry. How can you make the most concentrated chemical possible that's still safe and that still has a high efficacy? How can you put it into a dispensing or dosing platform that is equally safe, that cannot be tampered with, that cannot break, that cannot accidentally injure someone? You have a 256:1 or 512:1 dilution ratio on a cleaning chemical. If you get that in your eye, that doesn't feel very good. How can they assure the customer that those dispensaries are getting installed properly, on time, ready to go, literally on this exact date?"

- Stream Transcript

Importantly, the industry has high switching costs:

"Especially if you think about the customers having a large site, it is not easy to switch. Why? I just told you that if you have a large site such as Sodexo, you need them to let in that new supplier. The old dispensing system of the previous one needs to get dismounted from the wall. The new guys have to come in, mount a new dispensing system, and give training again. Before you're going to change a supplier and especially if you need these dosing systems, like in big food service locations, you're going to think twice. You really have to be that you're not happy about service-level agreements or whatever happens in the relationship with your supplier, but it's not something you're going to change each contract cycle. That is too cumbersome."

- Stream Transcript

The contracts are typically 3 years in length with renewals based on prior performance. Unless there has been a problem with service, the customer does not switch. Over time, this customer becomes more and more profitable. Due to this, it has been increasingly difficult for Diversey to gain market share from Ecolab in the US. However, given the growth in the industry and the market share controlled by independent operators, there is enough of a runway for both Ecolab and Diversey. It is important to understand that together, they hold a small portion of the total market.

As we discussed above, competition in the core sanitation and cleaning segment is based on economics of scale, service levels, as well as switching costs. However, there is another division called water treatment that is big business at Ecolab. In 2011 and 2012 Ecolab made two transformative acquisitions. The first was Nalco Holding, a water treatment business serving the mining, energy, and paper industries. The second was Champion Technologies, a specialty chemicals company that produces water treatment for oil drillers and products that prevent oilfield equipment corrosion. While these assets increased Ecolab's scale and diversified its revenue stream, they had the effect of introducing some cyclicality. The key difference between Ecolab and Diversey is that Diversey has a very small part of its revenues that come from water treatment. Although Ecolab is a $13-14 bn sales company, about half of these sales come from 'water solutions' and not pure-play sanitation and hygiene. In total, the top two players have sales of $8-9 bn in a $32 bn market (Ecolab is 2.5x bigger on an apples to apples comparison).

Diversey has partnered with Solenis to offer water treatment products and cross sell these to its food and beverage customers. While it is currently a small portion of revenues (about 20% of F&B revenues), management is confident that it can penetrate more customers with this service.

History

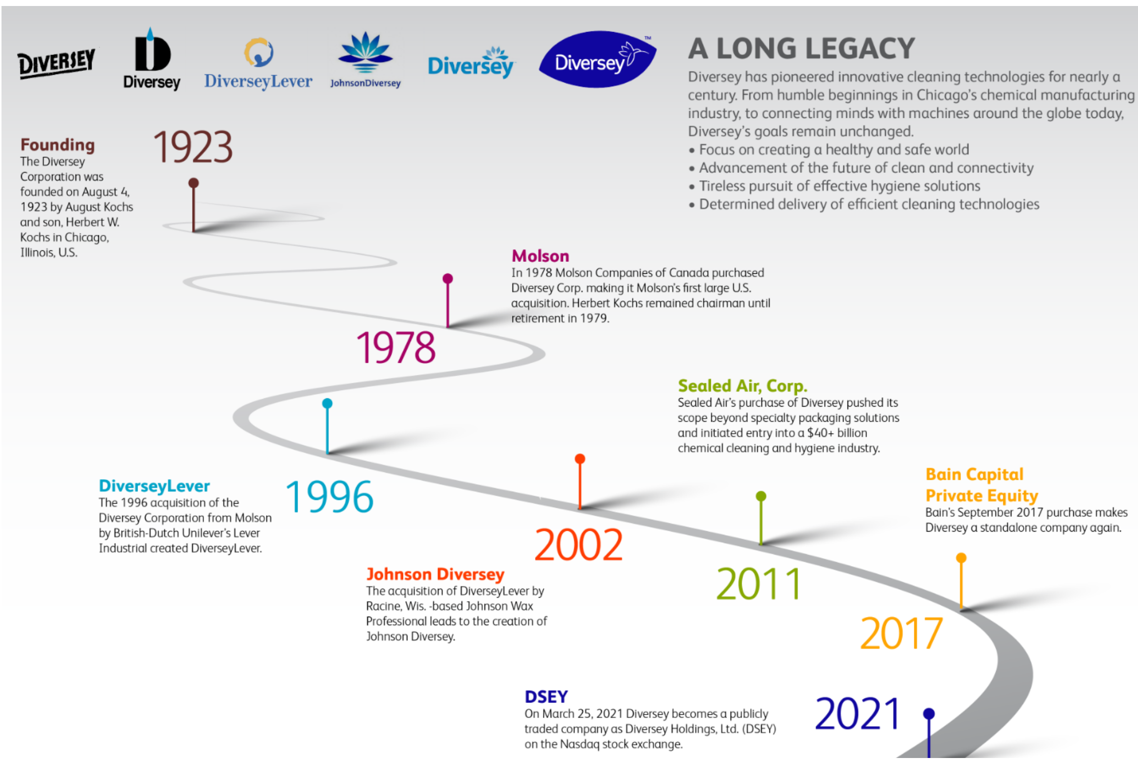
Diversey has a long history and has been in business since 1923. In 1978 it was bought by Molson which owned it for a long time until partly divesting it in 1996 to Unilever and then fully divesting it in 2003. In 2002, Diversey was sold to a subsidiary of SC Johnson. In 2009, Clayton, Dubilier & Rice acquired 46% of JohnsonDiversey from the SC Johnson family. In June 2011, Sealed Air purchased 100% of Diversey Holdings for $4.3 billion (9.7x LTM EBITDA). It was a sizable acquisition for Sealed Air:

Fiscal Year Ended December 31, 2010 ($ in millions)	Sealed Air	Diversey	*Pro Forma Combined* [3]
Net Sales	$4,490	$3,128	$7,618
Adjusted EBITDA [1]	$732	$453	$1,235 [4]
Adjusted EBITDA Margin [1]	16.3%	14.5%	16.2%

Source: Sealed Air Presentation

In 2016, Sealed Air decided to pursue a tax-free spin-off of Diversey in order to simplify its core business and reduce debt (it had lost a contract to sell SC Johnson products affecting revenues and op income).

However, in March 2017, Bain Capital bought Diversey for $3.2 billion from Sealed Air with the intention of running Diversey as a standalone company. In March 2021, the company came to the market with an IPO at $14 per share with Bain Capital owning 75% of the shares outstanding. Later that year, they did a secondary stock offering diluting Bain to 73% of the company. Furthermore, since Bain acquired Diversey in 2017, it has gone through 4 CEO's. However, the current CEO, Phil Weiland, has been serving in his position since July 2020.



Source: Diversey Website

It is interesting that some problems never get solved! Molson had to get rid of Diversey to Unilever as its US operations were not profitable and because Molson was in a de-conglomerate mode. Under Unilever, Diversey thrived in Europe and Emerging Markets where Unilever itself had strong market shares. With so many owners over so many years, Diversey lost a bit of its soul and got stripped of their asset base. With increasing leverage, owners could not spend on the long term growth initiatives. However, in all this time, Diversey retained its brand and reputation. Clients and regulators trust Diversey.

"So in New York, for example, they (Ecolab) have three times the amount of salespeople that Diversey does, just in the state of New York. Whereas, Diversey in the UK has probably three times the amount of salespeople that Ecolab has."

- Stream Transcript

Under Bain, some long needed changes were made. As an example, Bain spent capital on sales training and IT infrastructure including installing a CRM system. Most importantly, Diversey, under Bain, has been building a production facility and distribution warehouse in Kentucky in order to own more of its production and consolidate its disparate supply chain network. Management expects to add 100 bps to EBITDA with this facility completing construction in Q1 2023. Given that it's a scale business, there is a chicken and an egg problem with Diversey in the US - without scale it cannot get margins and without a willingness to invest in the business it cannot get scale. Some of this is being corrected with Bain - Diversey won a big contract with Aramark and the recent consolidation of production and supply chain both ensure better US margins.

"Scale's pretty simple. U.S. is full of big companies with lots of assets in lots of states. Moving around chemicals is expensive, and moving around people is expensive. If you've only got 10 people in all of the West Coast and the competitor has got thousands, those numbers I just picked out of the air, then that would suggest the competitor's got much more credibility with the customer... It was just as brutally simple as that. It was nothing more complicated than the cost to serve and when you take into account people and chemicals."

- Stream Transcript

The current CEO stated Diversey's objective at the IPO as follows:

"We look forward to building on the estimated long-term market growth of around 3%, with market share gains. We target to grow another 2% per annum through accretive M&A. And we target to expand adjusted EBITDA margin to 20% at the average rate of 50 to 100 basis points per annum through our improved sourcing, strategic pricing, supply chain improvements and operational excellence through SG&A cost initiatives. This should generate strong free cash flow that we can use to de-lever over time with a medium-term net debt goal of 3x adjusted EBITDA"

Diversey was making really good progress on margins in 2020 and 2021 with adj EBITDA margins at 15.7% in 2021. However, 2022 has proven to be much more treacherous. As a chemical company, Diversey's cleaning chemicals are derived from crude and crude derivatives. With crude prices rising and unavailability of some chemicals due to supply chain, Diversey had to reformulate some products but still make sure they were available for their customers so as not to halt their operations. This had both gross margin and operating expense consequences. Furthermore, Diversey is more of an international business with 73% of its revenues coming from countries other than the US. This year, the USD has been on a tear (DXY up 21%!) due to which Diversey's reported numbers in USD look awful. Its Adj EBITDA margins declined to 11.6% this year.

In recent quarters, Diversey is passing on rising raw material costs to its customers and has taken pricing as well as surcharges to protect its gross margins. Importantly, we see that crude prices have stabilized, supply chains are better and the USD has topped. All the headwinds in 2022 are turning into tailwinds going into 2023. We believe that Diversey's numbers will surprise to the upside in 2023-2025.

At this stock price, we don't have to believe that Diversey's margins will go to 20% or that they will gain scale in the US. If the margins return to their previous 2021 high at 16% (we will have the Kentucky facility come online in Q1 2023) then there is substantial upside potential in the shares.

More on Margins

On a more secular basis,

Ecolab makes a margin of 20-21% on a consolidated basis while still investing in its business. In the US, Ecolab has had a bit of a free reign as Diversey was distracted by different owners and different CEO's. This pricing umbrella provides Diversey an opportunity to better its position.

One of the important things to understand about this business is that margins get better over time. As an example, when Diversey wins a contract it has to install the dosing and dispensing equipment, the costs of which can only be recouped over time. Due to this, the business will show a little bit of a margin contraction if it is growing too fast.

Diversey is now also selling water treatment to its customers. This is a 'add on' service that should help not only revenue growth but also margins in the long term.

Since the IPO, Diversey has made 5 acquisitions. They acquired Sanechem in Poland; Avmor in Canada; Tasman in Australia; Birko in the U.S. and Shorrock Trichem in the U.K. These acquisitions enhance their scale and competitive position in the global food and beverage market which is a strategic priority and a higher margin business (vs. institutional business). Each of these acquisitions either gives Diversey customers, distribution channels or integration of the back end. Diversey has paused M&A until its debt/EBITDA comes in-line, but, after that, we can expect value accretion with this tuck-in M&A strategy.

On a more cyclical basis,

- Revenues actually declined in 2020 even as health and hygiene were given increasing importance as a lot of client premises such as hotels were closed. Management estimates a decline of $400 mn (Ecolab reported something similar).
- After Covid, Diversey managed freight issues where they had to airfreight some products and maintain higher inventory levels. They also went through a difficult and fast-changing raw material landscape where their R&D teams had to reformulate products. All of this was done to limit the impact on customers.
- In Europe, where traditionally inflation is much lower it took the clients some time to accept the need to take continuous price increases but these price increases as well as surcharges are now being accepted. Diversey is taking double digit price increases (10-12% total in 2022) as seen by constant current growth in the last two quarters.

    - The important point to emphasize is that prices are sticky on the upside. If/when raw material prices ease, Diversey does not have to pass this on to the customer retaining the incremental margin.
- As mentioned above, USD, as represented by the DXY index, was up 21% from the beginning of the year to September 2022. This essentially means that like for like 73% of Diversey's reported revenue and EBITDA were down 21% just based on the currency. The fact that, on an absolute basis, revenues have held up because of the price and volume increases as mentioned above is remarkable.

We believe all these issues are temporary. As and when these issues are resolved or are lapped up by YoY comparables, we believe that Diversey will be seen as a stable consumer company.

On Debt:

(in millions)	September 30, 2022	December 31, 2021
Senior Secured Credit Facilities		
2021 U.S. Dollar Term Loan	$ 1,488.7	$ 1,500.0
Revolving Credit Facility	—	—
2021 Senior Notes	500.0	500.0
Short-term borrowings	6.6	10.7
Finance lease obligations	9.6	4.4
Financing obligations	21.9	23.1
Unamortized deferred financing costs	(31.4)	(35.3)
Unamortized original issue discount	(7.4)	(8.3)
Total debt	1,988.0	1,994.6
Less: Current portion of long-term debt	(11.5)	(10.9)
Short-term borrowings	(6.6)	(10.7)
Long-term debt	$ 1,969.9	$ 1,973.0

Source: Diversey 10-Q

Debt is a real issue at Diversey. The business has debt in USD and Euro and last quarter its debt/adj EBITDA was over 5x. Diversey has cash of $250 mn resulting in a net debt number of $1.72 bn. If we look at actual EBITDA with all 'one-time' items included then the situation is even worse! Management can report adjusted numbers all they want but if they have debt on the balance sheet that needs to be serviced then one needs to produce the cash flow to service it! We believe that the situation is stretched but under control.

Bain fixed the debt in Sept 2021 due to which servicing the debt has not gotten any more expensive this year even though rates have gone up. Currently more 2/3rd of their debt is at fixed rates and termed out - term loan to 2026 and senior notes to 2029. In fact, in 2022, Diversey was able to monetize USD floating to EURO fixed swaps and credit a gain of $186 mn. We are not fans of financial engineering but believe cash interest costs of ~$100 mn should be manageable for Diversey.

In order to manage debt level management has paused any incremental M&A. Further, we believe that there will be a working capital release that will help cash flow in 2023.

At a forecasted EBITDA level of $450 mn, net debt/EBITDA comes down to 3.8x and down from there as Diversey uses cash to pay down debt.

Numbers and Valuation

	2018	2019	2020	2021	2022E
Institutional Revenue	2,024	1,979	1,995	1,918	1,949
Growth %		*-2.22%*	*0.81%*	*-3.86%*	*1.63%*
Food & Beverage Revenue	664	645	634	700	804
Growth %		*-2.86%*	*-1.71%*	*10.41%*	*14.86%*
Adj Institutional EBITDA	280	296	341	320	267
Margin	13.83%	14.96%	17.09%	16.68%	13.68%
Adj Food & Beverage EBITDA	100	102	114	135	97
Margin	15.06%	15.81%	18.04%	19.29%	12.11%
Corp EBITDA	(50)	(59)	(47)	(43)	(44)
Adj Consol EBITDA	330	340	408	412	320
Adj consol EBITDA Margin	**12.28%**	**12.94%**	**15.53%**	**15.73%**	**11.62%**

Given the ‘turnaround’ nature of the investment, there are a lot of ‘one-time’ costs that have been muddying the income statement. For example, Diversey is taking ~$80 mn in restructuring costs to consolidate its supply chain and is slowly charging it to the income statement. After last quarter, only $27 mn is left which will be taken in Q4 2022. From next year on, the financials should be fairly clean.

Regardless, the thesis rests on the assumption that this 11.62% margin is temporary and Diversey can go back to the 15-16% level it achieved in 2020-2021. As mentioned above, we believe that this will be increasingly possible with the Kentucky facility (which should help 100 bps) as well as an easing in crude and DXY. With some growth in the business, the actual EBITDA number is closer to $450 mn in 2024-2025 compared to $320 mn in 2022. With capex of about 3% of sales ($80-100 mn), cash taxes of $50 mn and interest costs at $100 mn, we are looking at free cash flow of about $200 mn per year.

Ecolab trades at 16-20x EBITDA. It is a much better business than Diversey so perhaps Diversey deserves to trade at a discount. We believe a 12x EBITDA multiple is justified given the stability and financial profile of the business. At 12x multiple and a $450 mn EBITDA we get an EV of $5.4 bn. Assuming that Diversey uses $150 mn of the $200 mn per year in FCF to pay off debt, it should have about $1.4 bn in net debt in 2-3 years. Subtracting this net debt number from the enterprise value gives us an equity value of $4.0 bn.

At 330 mn shares outstanding, the resulting stock price should be closer to $12 per share compared to the current stock price of $4.35 per share. At a more conservative 10x EBITDA we get to a per share value of $9.4 per share which is also more than double the current market price.

Risks

- Clients can go to base chemicals and choose not to use specialty chemicals
- Ecolab can initiate a price war in response to Diversey's increasing attempts to gain market share in the US. It is important to note that even Ecolab has been struggling this year and has not met financial targets. Ecolab too has been taking pricing and is expected to do better going forward.
- Diversey has a lot of intangible assets on its balance sheet which came from Bain's purchase of the company. Customer relationships and brand value is the majority of the $2.3 bn in intangible assets recorded on the balance sheet. It amortizes these assets and a non-cash expense runs through the income statement. It has very low PP&E but 8,500 people. Its balance sheet makeup is essentially that of a 'distribution' business - which at its core - is what it is. Although Diversey is confident in these intangible assets, any write downs here can be unpleasant.
- Bain Capital
    - Bain owns 73% of the company and has effective control. So far, Bain has been taking actions to increase the LT value of this investment which is positive for minority owners. An investment in Diversey is essentially a 'side-car' investment with Bain. The risk is a take under by Bain.
    - With a low float, stock prices can move drastically to the downside (as they have) and to the upside.
    - Bain also engages in a fair bit of financial engineering. The swaps on debt as well as securitizing some of the receivables, while not out of the ordinary, create some complexity to the business and financials.
- Debt is a double edged sword.
    - It can enhance returns but if the business environment turns south or there is a Diversey specific issue, then it can be debilitating for the business.
- Recession
    - While Diversey is fairly recession proof, it is not completely recession proof. During hard times, customers look at all aspects of their P&L and will likely ask Diversey for concessions which can affect pricing and therefore, margins. Given high debt levels, Diversey is especially vulnerable to negative operating leverage.

Our belief is that while these risks are real, none of them takes away from the core thesis. **However, due to these risks, an investment in Diversey has to be sized smaller.**

Conclusion

A lot of strategists are suggesting 'Emerging Markets' exposure in 2023. The emerging markets index has a lot of China exposure and we believe playing this theme with a business such as

Diversey makes more sense. More than 73% of its revenue comes from countries outside the United States, making it effectively an international business.

Diversey participates in a consolidated global industry structure in which Ecolab and Diversey are the two market share leaders focused on cleaning chemicals. This market for cleaning chemicals should increase at a 2% to 4% longer-term organic rate in addition to which Diversey is growing with price increases, water treatment as well as acquisitions. We believe the margin issues experienced by Diversey are temporary and that, over time, as these issues abate the market will see a fairly stable services company that can grow, like Ecolab, at a stable pace for a long period of time.

In order to make a substantial return on investment, one does not need to believe in management's 20% EBITDA goal but a 15-16% EBITDA margin will suffice. No investment comes without risks and Diversey's risks force us to take a smaller position even as the upside potential is enormous.

Disclosure: White Falcon has a long position in the shares of Diversey.

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