WHITE FALCON

CAPITAL MANAGEMENT LTD.

October 12, 2023

RE: Q3 2023 Partner update letter

Dear Partners,

While individual client returns may differ based on their inception dates, consolidated performance of all accounts for the period ending September 30, 2023 is as follows:

	Q3 2023	YTD 2023	2022	ITD*
White Falcon (net of fees)	**-4.5%**	**14.7%**	**-9.3%**	**2.6%**
S&P 500 TR (CAD)	-0.9%	13.1%	-12.6%	2.0%
MSCI All Country (CAD)	-1.2%	9.6%	-11.9%	-2.0%
S&P TSX	-2.2%	3.4%	-5.8%	-3.1%

*Inception date is Nov 8, 2021 (Cumulative return)

In the third quarter, the market consolidated after a tremendous rally in the first half of the year and the portfolio gave up some of its gains. This quarter was a good reminder that market's don't move up (or down) in a straight line and volatility is part of the investment experience. Not much has changed in any of our businesses in the last three months and we made no major changes to the portfolio except taking a small position in long duration US treasuries. We are confident in our ownership of high-quality businesses at fair valuations, all of which hold the potential to grow our capital over time.

White Falcon's mission remains to compound capital on a risk adjusted basis over the long term. While we show other indices above, 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. We also manage risk/reward at a portfolio level by owning a balance of 'compounders', 'value today' and 'value tomorrow' with the relative weight of each dependent on the opportunity at hand.

Bond investors, interestingly, faced more of this volatility over the last few months than equity investors. US 10 year bond yields have increased from 0.52% after Covid to 4.8% at present. In the bond world, the price of a bond is inversely related to the yield on the bond. This means that, on a mark to market basis, bond investors are suffering heavy losses on their portfolios. In recent weeks, as US yields shot up, we observed capitulatory behavior in long duration US treasuries and initiated a position. We believe the yields on these bonds more than compensate for the inflationary risks in the economy and have the added benefit of providing a hedge if the economy weakens. Typically, US treasuries are seen as a safe haven and yields decline in recessions as disinflationary or even deflationary forces take over.

The major implication from this rise in yields has been that capital has a cost again! We seem to have exited the zero rate environment in which there was little or no alternative to owning equities. But rates are rising due to inflation and we need to call inflation for what it is - a tax:

"The arithmetic makes it plain that ***inflation is a far more devastating tax*** *than anything that has been enacted by our legislatures. It makes no difference to a widow with her savings in a 5 percent passbook account whether she pays 100 percent tax on her interest income during a period of zero inflation, or pays no income taxes during years of 5 percent inflation. Either way, she is —taxed in a manner that leaves her no real income whatsoever."*

- Warren Buffett

With the rise in yields, an obvious question comes up: what to buy: stocks or bonds?

First and foremost, it depends on an investor's objectives. If the goal is income and protection of principle, then bonds with these yields seem like a great investment. However, if the purpose is growth of capital and long term compounding then, we believe, stocks still have the edge. Let us explain.

An investor can invest $100 in a 10 year government bond yielding 5%. At the end of 10 years, the investor would have collected $50 in coupon payments and get the $100 back in principle. If these coupons are reinvested into buying more bonds then the total capital to an investor at the end of the 10 year period will be $162.89.

On the other hand, today, an investor can buy the S&P 500 at a P/E of 18x or an E/P (earnings yield) of 5.5%. In this case, for $100 invested in the S&P 500, an investor would get $5.5 in earnings. However, the big difference between the two is that bond yields are fixed while earnings yields are not. We have to assume that these earnings for the S&P will grow at some rate. According to Robert Shiller, real earnings have grown at a rate of 3.5% for the last 150 years. If we take that as a base rate and add inflation of 3% then total earnings growth comes to 6.5% per annum. With these assumptions, after 10 years, we end up with earnings of $10.32. If these earnings are capitalized at the same P/E of 18x then an investor ends up with total capital of $185.76.

In this example, and with these sets of assumptions, it appears that stocks are still a better choice. The equity multiple can also increase, giving equities tremendous optionality. In addition, equity investors have the government on their side! In Canada, capital gains receive more favorable tax treatment compared to income or dividends. Due to this, the after tax outcome for the stock investor will be much better than that for the bond investor.

Having said that, we do have to acknowledge that, for the first time in 15 years, bonds are becoming a decent alternative. There are a few other factors that can favor bonds. First, stocks are likely to be way more volatile than bonds. They will test one's resolve while bonds may be easier to hold from a psychological perspective. Second, if one goes down the risk curve then BBB bonds are yielding close to 8% per annum. An investment into this bond for 10 years with interest reinvested will yield $215.89! Third, stocks are very sensitive to small changes in underlying assumptions. If the P/E declines or earnings are stagnant (perhaps due to rising interest expense, taxes or labor costs) then holding bonds can become a better option.

The debate is clearly nuanced but this is an important question as it can have profound implications on future returns.

"All of history and all of life is stuffed full of the unexpected and the unthinkable."

- Peter Bernstein

It is important to mention that it is exactly conditions like these - where bonds become a real alternative - that can, indeed, drag stocks into what we like to call "lost decades." If we take a peek back at periods like 1968-1982 or 2000-2013, it becomes clear that investors saw zero returns from their stock market investments. These lost decades were usually led by a combination of: capital flows from stocks to bonds/commodities, increasing interest rates, declining multiples, and stagnant earnings, to name a few factors. As an example, in **Appendix B** to this letter, I am attaching a chart on McDonalds which was 'the' growth stock in the 1970's.

While indexing has become very popular with investors, it is increasingly possible that these factors reverse and lead to another lost decade for the equity markets.

Yet, interestingly, those very periods that spelled doom for the stock market were a goldmine for value investors. They not only weathered the storm but thrived - achieving remarkable returns that consistently outshone their benchmarks. As active managers and bottom-up stock pickers, we pick from a 'market of stocks' and do not invest in the 'stock market'. We can pick advantaged businesses at low valuations, thus increasing the odds of a good outcome.

"When the facts change, I change my mind - what do you do, sir?"

- John Maynard Keynes

Unlike an active value manager, who can be nimble, it is difficult for the S&P 500 index to respond to a changing macroeconomic environment. We know that there is nothing as certain as change, and indexation, at its core, is essentially a 'momentum' strategy - buying more of what is already doing well. This is one reason, among many, why we prefer active management. White Falcon, in particular, has been aware of the effects of these fiscal and monetary experiments since our founding. We focus on valuations in our underwriting and have built a portfolio with low starting valuations, pricing power, margin expansion opportunity, deleveraging opportunities and low capital intensity. We also have a significant part of the portfolio invested in commodities which directly benefit from an inflationary environment. Importantly, we have an unconstrained mandate with the ability to invest in stocks or bonds or not invest at all! In essence, when the facts change, we have the ability to change our mind.

Portfolio Updates

The top 5 positions in the portfolio are: **Precious Metal Royalty companies, NU Holdings, Amazon, AMD and Rover**. Rover (ROVR) has surpassed Tech Resources to become a top 5 position in the portfolio. Rover, a pet care marketplace, is a prime example of a business that's poised for success in virtually any economic environment. It reported a set of fantastic earnings due to which its stock gained 50% and has not given up much of that gain in the recent pullback. This is a position that has been in the portfolio since September 2022 but we added to the position as we gained conviction in the thesis.

Operating as a marketplace, Rover earns a "take rate" or a kind of "toll" on every transaction occurring within its platform. In the face of inflation, as pet sitters request higher prices for their services, Rover's revenues naturally grow because its share of the transaction value increases. In addition, Rover is a category disrupter due to which its revenue growth is likely to be much higher than the average stock - it is taking share from friends and family as well as kennels. Finally, networks like Rover get more valuable over time due to which they have to spend less to attract more users on their platform. This results in operating leverage due to which its earnings are poised to grow even faster than revenues.

Rover is expected to produce $230 mn in revenues in 2023. At an average cost per share of $4.25 we bought Rover with a market capitalization of $775 million and an EV of $525 mn. Rover is currently at adj EBITDA margin of 15% and, with scale, should be able to move up to 30% in adj EBITDA margin. At that rate, it should have a ‘look-through’ adj EBITDA of $70 mn in 2023, essentially meaning that we underwrote this investment at 7.3x adj EBITDA. The stock is now ~50% higher than our cost base. However, its fundamentals are improving at an even faster pace. Next year, in 2024, according to consensus estimates, Rover is expected to do $300 mn in revenues. Due to this, Rover is now trading at 10x our estimate of $90 in ‘look-through’ adj EBITDA for 2024. We believe this is a very cheap multiple for a high quality and growing business. In **Appendix A** to this letter, we detail our thesis on **Rover (ROVR).**

“Buy good businesses, do not overpay, do nothing”

- Terry Smith

There are comparable narratives involving NU Holdings, Amazon, and Teck Resources, to name a few holdings from the White Falcon portfolio. NU Holdings generates an average monthly revenue per user of $9.3, whereas its competitors are achieving over $35, creating a significant opportunity for revenue and earnings growth. Amazon constructed its logistics network and cloud computing infrastructure using yesterday's currency, but it is poised to capitalize on this network with the inflated dollars of tomorrow. Teck Resources recently finished the construction of a copper mine in Chile, known as QB2, and due to inflation, its replacement cost will far exceed its original expense.

In essence, we believe we hold wonderful businesses with growing revenue streams and potential for operating leverage - all at reasonable valuations.

Other

Partner's have often asked about our research bandwidth. We are members of Value Investing Club (VIC) and SumZero (SZ) which are platforms where buy-side investors share investment ideas. Importantly, over the years, we have cultivated a network of like-minded investors with whom we share ideas and who act as a sounding board for your portfolio manager. Rover is a good example and showcases how our network extends our research bandwidth. The idea for Rover came from Panoramic Capital, a friend of the firm and a very competent investor, with whom we regularly discuss the investment thesis and its associated risks and rewards.

Referrals are the lifeblood of a small business such as ours. If you know someone who would be a good fit for White Falcon and can benefit from an allocation to the White Falcon portfolio please let me know and I'm happy to start a conversation.

Please feel free to get in touch with me if you have any questions or feedback.

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 $100,000.

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

Appendix A: Rover Group (ROVR) Thesis

"In our opinion, the two approaches are joined at the hip: Growth is always a component in the calculation of value."

- Warren Buffett

We want to acknowledge that Panoramic Capital, a friend of the firm, came up with the original idea and made significant contributions to this report

Rover is the world's largest network of pet sitters and dog walkers. Rover connects pet parents with pet care providers who offer overnight services, including boarding and in-home pet sitting, as well as daytime services, including doggy daycare, dog walking, and drop-in visits. The marketplace has more than 500,000 pet care providers across North America and Europe.

Rover is listed in the US and is currently trading for $6.5/share and has a market capitalization of $1.15 bn with $250 mn in cash for an EV of $900 mn. While headline valuation metrics can look expensive, we believe **Rover is under-earning.** It has the potential (and LT management guidance) to achieve 30% plus adj. EBITDA margins.

In fact, most marketplaces have very high margins as all they do is essentially collect a toll without a need to have any assets. As a marketplace scales, the two biggest expense items are (a) demand generation, and (b) supplier incentives. Once the marketplace is scaled and has both demand supply, both these expenses can be throttled back and the real economics of the business come through.

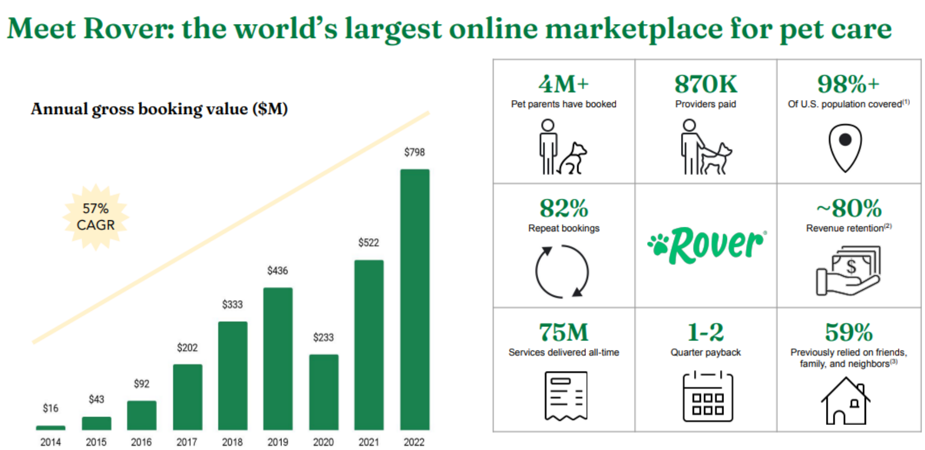
With Rover, if we assume 'look through' margins of 30% then it should have $69 mn in adj. EBITDA in 2023 and $90 mn in adj EBITDA in 2024. It is trading at **10x fwd EV/adj. EBITDA.** Now that is cheap for a dominant marketplace with a recurring revenue business!

Introduction

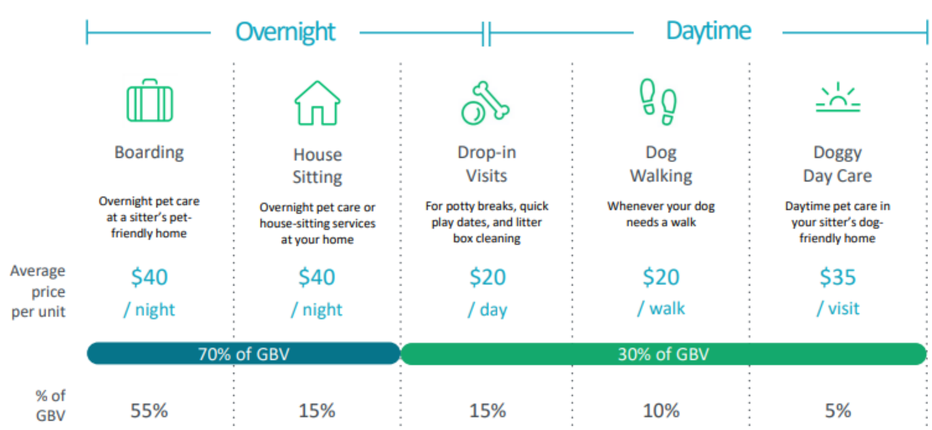
Rover was started in December 2011 by three dog lovers in Seattle's tech scene. Greg Gottesman, who spent 20 years as a venture capitalist, came up with the idea after his Labrador was mauled at a local kennel. He recruited Microsoft's former general manager Aaron Easterly to be Rover's CEO, and Philip Kimmey to be the company's director of software development.

In 2020, Rover came public through a SPAC led by True Wind Capital (ex-KKR). It was a successful SPAC in the sense that it infused Rover with a lot of capital but like all SPACs in 2022, the stock has discriminately sold. The business was also heavily affected by Covid which resulted in fewer people traveling and thus needing less pet-sitting services.

Today, Rover is the largest peer-to-peer marketplace business that connects pet parents with pet service providers. The platform is full featured. It handles everything from search, booking, chat, and payments. Rover generates revenue by charging a booking fee to pet parents and a take-rate to service providers.



While the platform allows for a variety of pet related services, the majority of the gross booking value comes from overnight bookings, as shown below.



In FY22, with the Covid-related issues in the rear view mirror, Rover has been beating expectations and firing on all cylinders.

In any technology business one has to be confident that the management is focused not just on growth, but also profitability.

> *"Aaron, the CEO, is an economist. Brent, the COO, who was my boss for a period of time there is very analytical and also has a big economics background. I think sometimes that serves the business really well, but it also makes* ***it hard to invest in longer-term plays because we were always so worried about the unit economics*** *tomorrow."*
>
> -Rover, Director of Product Management, Sept 22 - Stream Transcript

It is interesting because typically, one would expect the opposite out of a SPAC/tech company. Most of them neglect unit economics while claiming that they are maximizing for long-term growth. **Rover is different** - it's a financially well-managed technology company.

Business Quality

A two-sided marketplace is a wonderful business model. We argue below that Rover is a high quality business that meets the tests above of a successful marketplace.

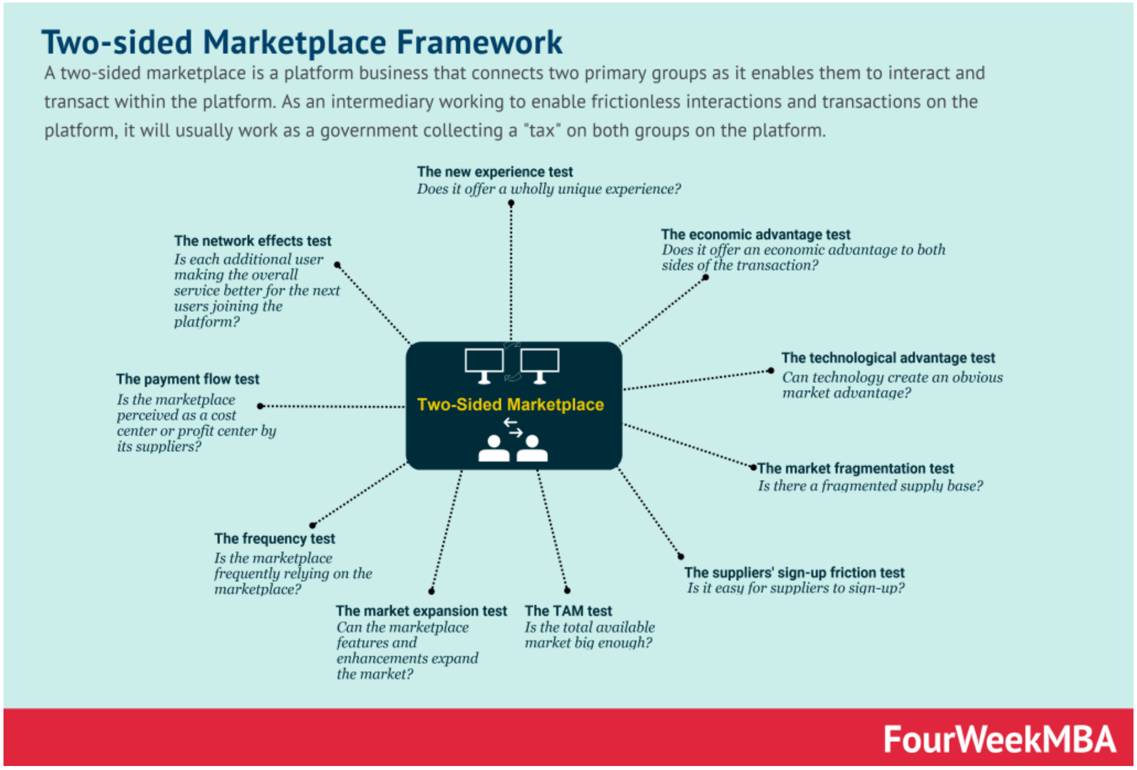
Rover is a high quality marketplace business

Fragmented demand and supply: Rover sits at the center of a very fragmented supplier and user base. As of 2022, Rover connected ~1m+ pet parents to more than 320k service providers. 98% of service providers are non-professionals that are doing it to earn a bit of extra income (~$2.2k/yr on avg).

Dominant: Rover is "the" marketplace for pet sitting. The company's closest competitor is Wag!, whose GBV is <1/8th of Rover's. Wag! is also a business that is focused on on-demand dog walking (lower TAM/ASP) vs overnight boarding.

No good alternatives: Neither pet parents nor service providers have good alternatives.

- Think of it this way: For pet parents, Rover is akin to AirBnB for pets…if OTAs didn't exist (Wag! is the only other website); hotels were like prisons (look up photos of kennels); and the only alternative was to beg your parents or friends to let you stay with them.
- Even if you have a willing friend/family member, they need to live somewhere that can accommodate your pet, and be free the entire time you're gone. You'll also feel awkward sending specific care instructions to someone doing you a favor. (Ever tried asking your in-laws to brush your dog's teeth every night?)
- For service providers, while there are alternate advertising channels available, it will be much more difficult to find pet parents who are willing to pay you to board their pets (issue of trust)



In essence, this network effect becomes the moat:

> *"You need heavy supply before you can even consider pricing. And the reality is if you have a very limited supply of pet service providers, you're not going to be able to even come close to competing on a pricing front. And that is just the first barrier to entry. It is pricing. People care about experience, safety, credibility, all those things, which just comes with volume."*
>
> -Wag! Senior FP&A Analyst, October 2021 - Stream Transcript

No labor issues: Unlike Uber or Doordash, Rover doesn't rely on the "gig economy", and doesn't face similar labor issues.

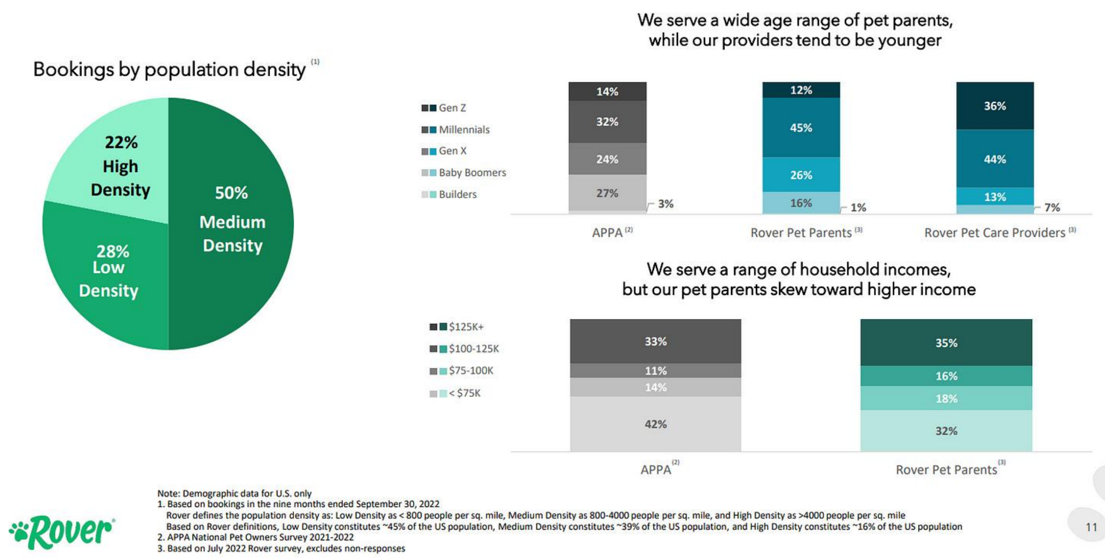
Rover is growing very quickly, with a long runway ahead

Rover is still in its fast growth phase. For FY22, it grew revenues 58%.

In 2023, growth will decelerate. Management's 2023 guidance implies 21% revenue growth (an estimate that we think they will beat). FY22 growth included quite a bit of average booking value growth, due to service providers raising prices in line with inflation. Nevertheless, booking volumes are still growing at high teens+ rates, and saturation point seems long way off:

- 90% of pet care is still provided by friends and family. While they will remain the primary choice, there's plenty of room for Rover to grow while still being a "niche solution"

- Rover’s services are broadly used across city, age, and income brackets, as per the slide below:



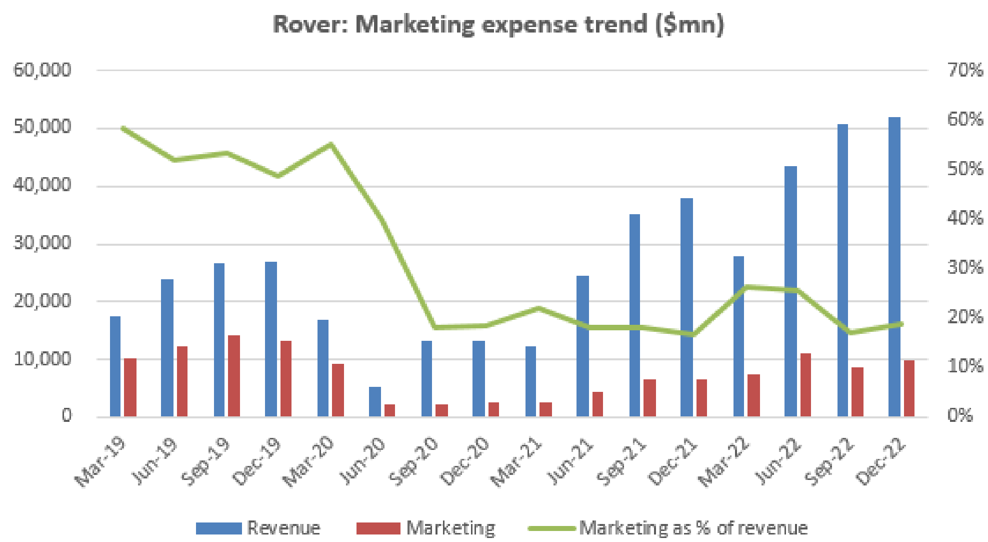
- Rover launched in the UK / Europe in 2018, and is currently growing at 100% YoY, albeit off of a small base.

Economics of a mature, dominant marketplace business is extremely attractive

High-value add marketplaces with dominant market shares are essentially license to print money, for a few reasons:

- High gross margins: marketplaces don’t really “sell” anything - it’s a media business, and as such, typically sport very high gross margins.
- Operating Leverage: Marketplaces are simple operations with high operating leverage. Marketplace businesses are simple operations. Once you become “the place to go”, you just have to maintain the status quo. **A hallmark of a great marketplace business** is that marketing costs decline rapidly as you become the dominant player, as network effect ensures that buyers and sellers naturally gravitate toward the platform.
- Low capex intensity: Marketplaces typically do not need to own assets to serve its customers - both buyers and sellers.

The Op leverage due to marketing expenses is shown below:



- Pricing Power: There's a fair bit of pricing power. As the only player in town, you can charge high prices for using the platform. Rover has a take rate of 22% and there is still a fair bit of room for Rover to optimize and increase its take rate.

Rover exhibits all of these features - Gross margins are high (75-80%), marketing costs are falling rapidly, with a strong source of “free” customer acquisition and we’ve seen fixed costs such as G&A and R&D costs start to fall as % of revenue recently.

The company is currently at 15% adj EBITDA margins and is aiming for 30%+ adj. EBITDA margins. We think it can do a lot higher. Check out these EBITDA margins for other, mature, dominant marketplace businesses.

- Rightmove, UK property portal: 75%
- Hemnet, Swedish property portal: 54%
- Adevinta France, a general classified site: 47%
- AutoTrader UK, UK used car marketplace: 71%

Whatever the number ends up being, **Rover is very likely to be a highly profitable business**. As mentioned previously, given the quality, growth, and potential margins, Rover is trading at a very low price today.

A dominant marketplace that is inflecting on margins should trade at a much higher valuation. We believe the current valuation of 10x ‘look through’ adj EBITDA will prove to be very cheap in hindsight.

It seems like the management agrees with us and has instituted a **$50 mn buyback program** which should support the stock price in a highly volatile market environment.

Risks

1.) Competition

Wag! is a small but fierce competitor. It has gone through various phases in its life including a phase where it was funded by Softbank which encouraged it to ‘go for it’. Wag! too came public via a SPAC - but in 2022 when it was a little too late; due to this, the SPAC could not raise ***any*** capital as it came to the market and had some debt to boot. While we think the management team here is competent, they have been dealt a very difficult hand.

It is important to note that the economics for Wag! are achieved by taking a 40-60% take rate. To further emphasize, Wag! takes $40-60 for every $100 transaction while Rover takes $22. While this can temporarily boost profitability (which they need to service their high cost debt), we believe this is to the detriment of long term profits and business sustainability.

Unlike Rover, Wag! has a different business model:

> *“People associate Wag with on-demand. Think of it as like an Uber. You need a service. Who's the quickest person? When can they get here? Versus Rover, which was traditionally associated with more of a Yelp kind of marketplace, where you are going to source things not necessarily on demand”*
>
> -Wag! Senior FP&A Analyst, October 2021 - Stream Transcript

In essence, with the Rover model, a pet parent has control and with the Wag! model it is an algo matching the pet-parent with a caregiver. We think Rover has clear advantages in this industry:

> *“I think with sitting and boarding, the control aspect made sense because **I think there is really no need** for on-demand sitting and boarding unless it's like an emergency. And sitting and boarding is usually for a lot longer time than like a 20, 30-minute walk. And so **the risks of you** putting your pet in the hands of a stranger for that amount of time are just inherently greater than you trusting a stranger for 30 minutes to take your dog on a walk.”*
>
> -Wag! Director of Product, April 2022 - Stream Transcript

There is currently a large gap between Rover and Wag!’s take rates - we see it as a free option for Rover to incrementally and strategically take its take rate up over the next few years.

2.) Travel-dependence

Rover’s revenue model is bookings driven. The main driver of its services is vacation related travel.

If we hit another lengthy mass travel disruption event in the US, it’s going to be ugly.

3.) Margin achievability

While theoretically, Rover should be highly profitable, this depends on management's spending discipline and shareholder treatment. The company is currently ramping up margins, and it's hard to imagine Rover blowing through its balance sheet right after coming out of COVID. Nevertheless, as much of the spending is discretionary, we won't know what mature margins look like until we get there.

SBC is definitely a factor when considering terminal margins. The company reserved 17m shares (<9% of shares outstanding) for its 2021 equity incentive plan and ran through about 60% of it in the last 7 quarters, so overall dilution isn't a deal breaker, but something to watch out for.

4.) Service provider onboarding and churn

Disintermediation, where a pet owner and pet care provider transact offline becomes a risk. While Rover isn't a gig economy company, it still relies on a new breed of suppliers - those that are willing to take care of other people's pets for a bit of extra income. Rover has to create supply by onboarding service providers. Unfortunately, Rover does not report supplier churn numbers. However, this is expected to be high. Rover notes that over 800k care providers have been paid, with there being 320k active providers today.

Conclusion

Rover is the leading pet services marketplace in the US, Canada, and Europe. We know that people love their pets. This pet ownership has grown on a secular basis including during periods of macro weakness - the US pet industry grew during the 2008-10 recession.

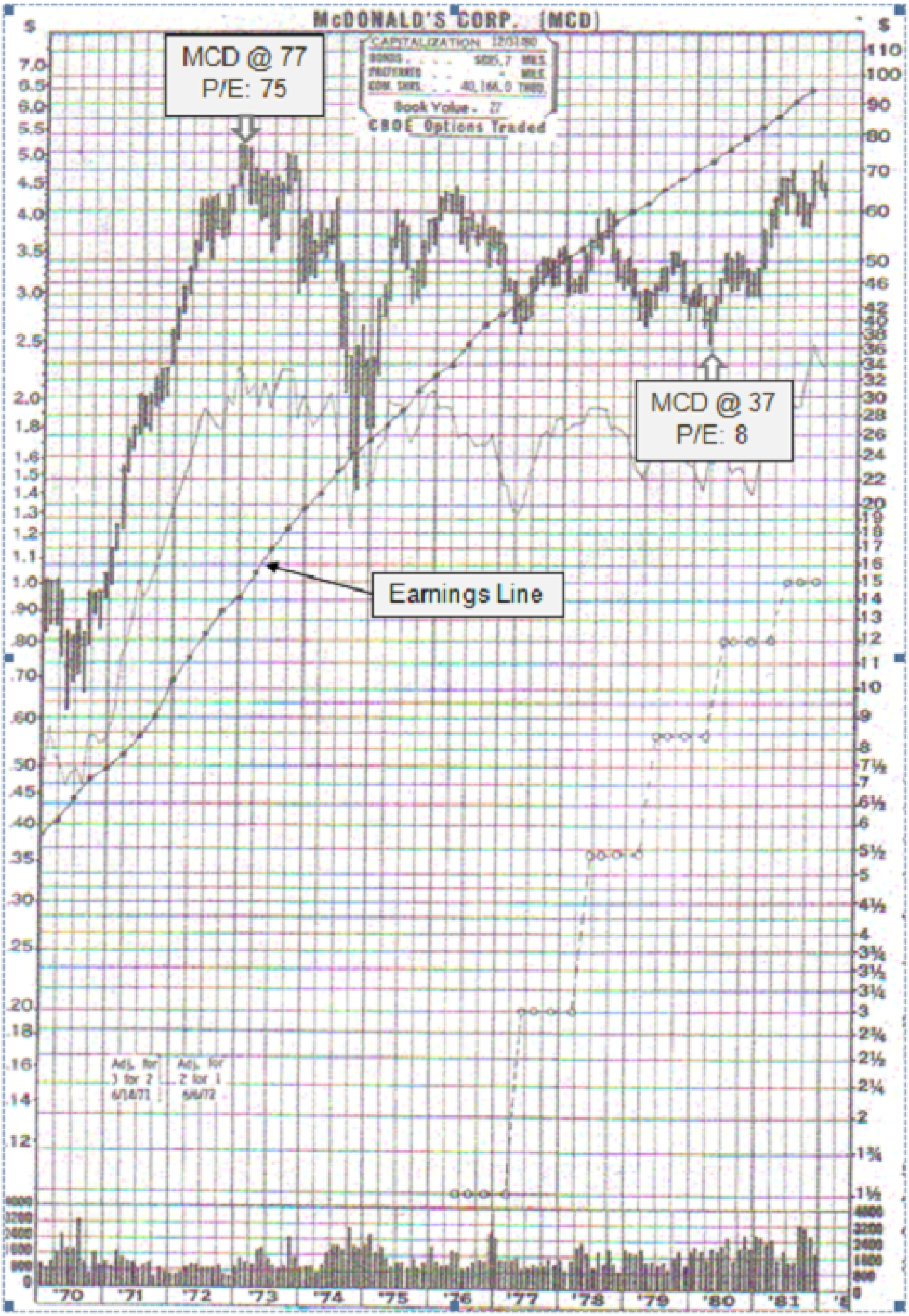
Rover is the clear category leader with ~10x+ more scale than its closest competitor, and possesses the attributes of a high quality marketplace business. Rover turned profitable in 2022, and in our view is well positioned to drive significant profit growth through operating leverage. There are also a number of 'free options' opportunities such as international expansion and new service/pet offerings.

When we combine the above with low valuations and a net-cash balance sheet, we find a stock with the ability to compound at attractive rates.

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

Appendix B: McDonalds in the 1970's

Earnings increased from $0.60 per share in 1971-72 to $6.5 in 1981-82 - a 10x increase - but the stock price is unchanged at $70 per share with significant drawdown and volatility.



Source: Walter Deemer

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