

WHITE FALCON

CAPITAL MANAGEMENT LTD.

April 14, 2024

RE: Q1 2024 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 March 31, 2024 is as follows:

	Q1 2024	2023	2022	ITD*
White Falcon (net of fees)	8.7%	36.0%	-9.26%	32.2%
S&P 500 TR (CAD)	12.8%	23.2%	-12.6%	28.7%
MSCI All Country TR (CAD)	10.5%	18.5%	-11.9%	19.9%
S&P TSX TR	6.6%	11.8%	-5.8%	13.9%

*Inception date is Nov 8, 2021

We achieved a satisfactory result on an absolute basis. It should be emphasized that the markets typically go up 8-10% per year and, with the continuation of the bull market, we were able to achieve this result in a single quarter. From hereon, it would not be unusual for the markets to exhibit higher volatility leading to fluctuations in returns.

In the first quarter, we were helped by the positive contribution of Nu Holdings, Converge, Amazon.com, AMD, and Aritzia. The big detractors this quarter were Endava and Lifecore Biomedical. We continued trimming our winners and recycling capital into small and mid capitalisation stocks. With this activity, we believe we are sowing the seeds to enhance the IRR potential of the portfolio going forward.

We must reiterate that our 'metric' for measuring success is risk adjusted absolute returns across a market cycle and not an index. Appreciation of the US dollar relative to the Canadian dollar has significantly contributed to the returns of the S&P 500 when measured in CAD, as illustrated above. For instance, since the inception of White Falcon, the S&P 500 has delivered

18.2%, while the Nasdaq has achieved a 16.9% return in USD. As a comparison, we have had, on average, about 50-55% of the portfolio in US stocks.

"The stock market is designed to transfer money from the Active to the Patient"

- Warren Buffett

In this letter, we will discuss the changing nature of the portfolio as well as our laggards - Endava and Lifecore - which have detracted ~ 350 bps from performance this quarter. In the appendix to the letter, we will delve into our investment in **Converge Technology Solution**, emphasizing the importance of deep due diligence and conviction. Converge declined from our original purchase price of \$7.2 per share in May 2022 and bottomed at \$2.3 per share in October 2023. When a stock experiences a decline like this, it's crucial for the portfolio manager to assess the situation impartially and determine whether to sell the stock, do nothing or increase the position. In the case of Converge, we opted to increase our position and average down, reducing our cost basis to under \$4 per share.

Endava was down 40% after it reported earnings in February. This was a 3% position before this decline but we have since added to the stock to make it one of the top 5 positions (by cost) in the White Falcon portfolio. Endava is a founder-led IT service provider headquartered in London, UK. It competes with the likes of Accenture and provides IT services to clients in the financial services, travel, retail, software, healthcare among other industries. We believe scaled IT service providers are good businesses as they are essentially a 'royalty' on IT spend. They are an important link between technology and corporations who increasingly need technology to transform their business. We see a favorable backdrop for businesses like Endava with rising investments in technology, growing trends in outsourcing, and the emergence of new technologies such as Artificial Intelligence (AI). Importantly, we believe that Endava has the culture, scale and competencies required to succeed.

So what happened? Endava guided for negative growth in its business for the current fiscal year (ending June 2024). On the other hand, management had made hiring decisions expecting a growth in revenues leading to a mis-match in the cost structure. Due to this, operating margins collapsed and Endava's earnings are likely to decline ~30% in FY 2024 compared to FY 2023.

"Uncertainty is the friend of buyer of long term value"

- Warren Buffett

Client projects are being delayed due to three reasons, (1) AI is new and clients require time to discern the optimal use-case scenarios, leading to a cautious "wait and see" approach; (2) IT services 'over-earned' during Covid and had a stellar performance in 2022. Some of this is now normalizing as clients 'digest' previous implementations; and (3) Endava is over-exposed to the financial sector, specifically payments, a sector that is seeing a pronounced slowdown in demand.

Clients may postpone these projects temporarily, but ultimately, they will need to invest in order to maintain competitiveness. In essence, Endava (and EPAM) is currently going through a phase of cyclical weakness which, we believe, will subside in the near future leading again to strong topline growth. Importantly, Endava has a robust balance sheet and a capable management team, instilling confidence in their ability to effectively navigate these challenging circumstances. At 11x LTM EV/EBITDA and potentially 8x NTM EV/EBITDA, we believe the risk-reward is favorable for an increased allocation to Endava.

In our FY 2023 letter, we noted our less-than-ideal experience with merger-arbitrage strategies, with **Lifecore Biomedical** being the sole remaining investment of this nature in the portfolio. We anticipated a positive outcome for this particular investment but that proved too optimistic when Lifecore's board of directors decided to end the strategic process without a deal. Lifecore was also a 3% position in the portfolio and, after this announcement, the stock declined from \$7.5 to \$4.5 per share. However, unlike our other merger-arbitrage positions we had made the decision that we will be happy owning the stock if a deal does not materialize. We bought more shares at \$4.8 per share to bring Lifecore back to a 3% position. Our average cost is \$5.3 and the stock closed at \$5.8 at quarter end.

Lifecore Biomedical is a Contract Development and Manufacturing Organisation (CDMO) with expertise in specialty formulation, aseptic filling, and final packaging of complex, injectable medical drug products. Our previous experience investing in similar businesses has taught us that these are very difficult to operate assets, largely attributable to a single factor - compliance. FDA grants authorization and conducts regular inspections of facilities to ensure compliance with regulatory standards. When a pharmaceutical product is developed and manufactured by a CDMO, the FDA holds both the CDMO and the sponsor (the company that owns the drug) responsible for ensuring that the product meets regulatory requirements for safety, efficacy, and quality.

"You're looking for a mispriced gamble. That's what investing is. And you have to know enough to know whether the gamble is mispriced. That's value investing"

- Charlie Munger

Lifecore is increasing capacity from 22 mn units to 70 mn units over the next 4 years. Not all capacity can be filled at the same price, but this means that Lifecore's revenues can increase 2-3x over the next 4-5 years. This, when combined with operating leverage, will mean a rapid growth in earnings - perhaps closer to 3x. Importantly, most of this capacity is already paid for, potentially leading to a surge in free cash flow.

As we have mentioned before, our philosophy on portfolio construction is that we want to be concentrated enough to matter but diversified enough to survive. Even with dramatic drops in stock prices of Endava and Lifecore, our performance overall was not unduly affected. We manage risk at the business level and at the portfolio level by utilizing appropriate position sizing. In fact, these drops help us add capital to attractive opportunities. Even as the general

markets are at an all time high, we remain optimistic on the White Falcon portfolio due to business such as Endava and Lifecore in the portfolio, which we believe we have underwritten at very attractive IRRs.

The **top 5 positions** in the White Falcon portfolio are Nu Holdings, Converge, Amazon.com. Precious metal royalty companies, and Teck Resources. We have sold a third of our AMD position, about a fifth of our Nu Holdings position, and trimmed several other stocks. We still believe these companies have a good future but valuations leave no margin for error. As mentioned earlier, the capital from these trims is being allocated to the laggards in the portfolio as well as in initiating new positions in small and mid capitalization companies.

Due to the rally in gold, the weight of precious metal royalty companies is on the higher side of our typical 10-15% allocation to them. We recently wrote an article for the *Globe & Mail* on **Franco-Nevada Corp**, a portfolio company, that can be accessed on our [blog](#). We believe that these businesses are a better way to express an opinion on gold as they pay a dividend and have optionality on both the price of gold as well as additional discoveries by operating companies. With debt and deficits increasing by the minute and the central bank's inability to control inflation, we believe that it is prudent to have an 'outside the system' asset in the portfolio that can protect our purchasing power over time.

As we look ahead, earnings are poised to take on greater significance, especially considering that multiples have largely been responsible for driving the market's upward trajectory thus far. The US economy stands out as a notable exception, with higher interest rates serving to slow down other economies around the world. As always, we will maintain a vigilant approach, closely monitoring the earnings of both portfolio holdings and companies on our watchlist. This ongoing analysis allows us to gather valuable insights into underlying business trends which then helps us to both pick stocks and manage risks.

In closing, I want to express my enduring gratitude to each and every partner of White Falcon. Your support has been invaluable, and I am truly thankful for the partnership we share. Please feel free to get in touch with me at any time for any questions, concerns, or feedback 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>

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Converge Technology Solutions (CTS) Research Report

"If you're going to invest in stocks for the longer term, there are going to be periods when there's a lot of agony. I think you just have to learn to live through them."

- Warren Buffett



Converge Technology Solutions Corp. is a North American IT solution provider. They specialize in helping organizations modernize their IT infrastructure, leverage emerging technologies, and optimize their operations to drive business growth and innovation. Converge offers a wide range of IT services, including cloud solutions, cybersecurity, advanced analytics, digital infrastructure, and managed services.

In 2018, Converge went public with a strategy to consolidate small and medium-sized IT service providers (ITSPs). Initially successful, it attracted investors, including us, interested in both inorganic and organic business growth. However, in 2022, the M&A strategy faced challenges due to accumulated debt and a declining share price. Converge acquired well, but the problem was that it was not integrating these acquisitions and deriving revenue or cost synergies. Our initial mistake in this investment was believing that the management team was doing both things well.

Value investors typically step in as a stock declines like this, however, Converge's situation was complicated. The company had become a disparate collection of businesses through rapid M&A. In addition, Converge faced working capital problems. Capital tied up in working capital resulted in a lack of free cash flow, causing skepticism among value investors about reported earnings. There was also the issue of a reputed CFO departing just after a few months on the

job! All this contributed to a decline in the stock price from C\$12 per share in 2021 to a low of \$2.3 per share in 2023 as there were no natural buyers of the stock.

At its bottom, it was trading for 3x EV/EBITDA. We held several meetings with management, including the new CFO, Avijit Kamboj, and determined that Converge is headed in the right direction. At that point, we significantly added to the position.

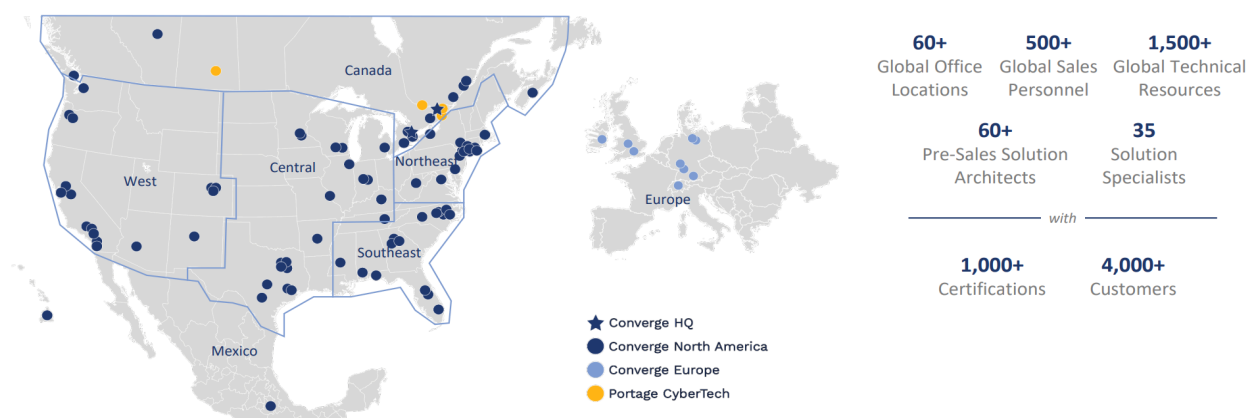
Since then, Converge has undergone significant changes including putting the M&A strategy on hold. We anticipate improvements in free cash flow conversion in 2024, along with structural changes leading to margin expansion. The outlook for 2024 and 2025 includes modest revenue growth, margin expansion, and low double-digit earnings growth. Additionally, with better free cash flow conversion, Converge aims to deleverage its balance sheet and repurchase stock. We believe all this will lead to a re-rating and narrow the gap to intrinsic value.

Business

In 2016, Shaun Maine incorporated Converge Partners to implement the roll-up strategy, targeting regional ITSPs in North America. In the beginning, the roll-up strategy at Converge, led by Shaun, generated significant shareholder value. Converge went public in 2018 and continued its M&A strategy. The idea was very simple: buy small ITSPs and derive synergies on cross-selling, costs, and managed services. Converge's affiliated companies distribute a diverse array of products and solutions, encompassing standard hardware like laptops and mobile devices, business analytic software, AI solutions, blockchain solutions, cybersecurity software, public and private cloud solutions, data centers, networking, and storage products, among others.

Most of Converge's existing customers are small-to-mid-sized enterprises or state/local governments.

Here is an overview of the business:





Source: Converge Presentation

We have talked about IT services companies before with our report on EPAM. ITSPs bridge the gap between suppliers and customers in a highly fragmented environment. Customers struggle to select vendors and manage IT spending efficiently, while even large suppliers find it challenging to reach every customer effectively. The primary role of an ITSP is to provide outsourced distribution/sales for suppliers and outsourced procurement for consumers. For context, Converge, CGI, Accenture, and CDW boast extensive vendor relationships, along with a range of in-house solutions.

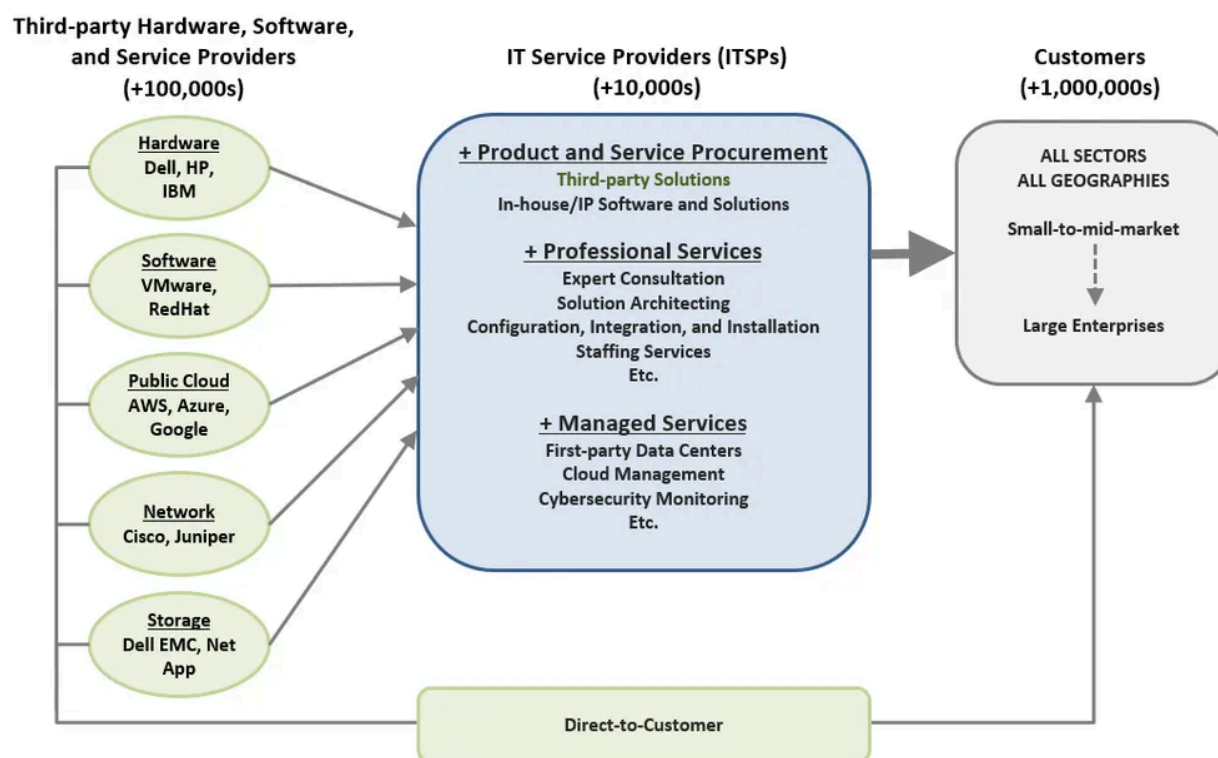
In addition to using ITSPs for procurement, many customers are increasingly turning to IT professional services for enhancing digital capabilities and implementing new IT products and services through project-based work. The growing complexity and diversity of IT solutions pose challenges for most non-experts.

Converge is a little different than full service IT services companies and contributes value to customers in three key ways:

- Offer software, hardware, and services either as resellers or directly.
- Provide project-based professional services encompassing design, configuration, integration, installation, and implementation
- Offer ongoing managed services, essentially functioning as outsourced IT. This is the highest margin and most recurring revenue part of the business.

Managed IT services are gaining popularity as IT service providers take on ongoing responsibilities. Outsourcing IT functions to external experts proves cost-effective and reliable, especially for small-to-mid-market clients. For example, overseeing a customer's cloud requirements, managing cybersecurity, managing networks etc. The key variables are uptime and how fast the IT services company responds to tickets or problems faced by the customer. Converge's focus has now been on growing this part of the business. They have consolidated

the operations in Mexico and standardizing processes so that they can increase the profitability of this division.



Source: 10th man deep dives

There is a [really good report](#) on Converge by 'The 10th Man'. Anyone interested in reading in detail about the business, industry, M&A strategy should give that report a read.

The investment thesis is as follows:

Converge will increase margins by integrating the front and back end of all its acquisitions thereby deriving synergies. In addition, free cash flow conversation will normalize that will then help Converge to pay down debt and buy-back stock. All these factors will force the market to re-rate the company closer to its peers.

"Our focus continues to be reinvesting back in our business, our innovations and on completing the integration of previous acquisitions, all in addition to paying down our debt and repurchasing our stock. We are capable of pulling several levers simultaneously with the cash we expect to generate from operations."

- CFO (Q3 Earnings Call)

Margins

Converge was good at acquiring businesses but was not very good at integrating them. A lot of its current problems stem from this fact!

The organizational landscape became increasingly complex as they focused on M&A. The acquisitions were made across verticals and across geographies. In fact, I would go as far as some acquisitions had no strategic rationale and were only made because they could be had for a decent multiple. Converge acknowledged challenges in encouraging Value-Added Reseller (VAR) salespeople to sell services. This issue is attributed to the relationship-oriented individual model, making it difficult to transition them into service-oriented sales roles.

Once M&A stopped and management understood that they had to execute for organic growth, they changed tack and started integrating the acquired companies.

“So our North America integration is the fastest integration continues to be on track. As I mentioned on last quarter's call, our front office is primarily integrated with our back office as we're working on this new ERP, which goes live mid next year, that's where you'll probably see the biggest synergies and operational efficiencies. We continue to look at how we're going to integrate our European business, given that there are 2 separate restrictions. We are on a path to integrate the 2 businesses, distinct businesses that we bought in Germany into one Converge Germany.”

- Greg Berard (Q3 Earnings Call)

Today, they are largely done integrating the front end. They significantly changed the sales organization and their incentive structure to align with the new priorities. The sales organization is now compensated on gross margins, cash conversation and sales of managed services. To provide some more detail, the current approach involves organizing regional structures led by VPs, with an emphasis on consolidating sales individuals within these structures. The transformation involves categorizing them into practice areas, enabling Converge to track the number of practice areas each sales representative is managing. Currently, 60% of sales reps are handling sales across four practice areas.

On the back end, Converge has decided to implement NetSuite as the new ERP solution. The primary objective is to unify all North American operations on a single, effective system. In addition, Converge will be able to seamlessly integrate and consolidate all relevant data for improved efficiency and accuracy in the operations.

The other factor that will help with margins is managed services. As we have mentioned before, the whole organization is now focused on growing the services, and specifically, managed services business.

“We want to get to \$1 bn in managed services. We have 10K IBM reps selling our solutions. Most pure play do not have this channel. Mid market companies cannot manage their network. Can we do it for you? Yes! Demand is very strong. We also do analytics on the cloud.”

- Shain Maine (CEO)

In essence, the margin lift comes from,

- Front-end and back-end integration
- Higher proportion of professional and managed services

Converge has been making EBITDA margins of ~5-6% but has the potential to make margins of 7-8% over the longer term. We believe we will see snippets of this in 2024 with margins approaching 8% in 2025. Converge has made these margins in the past and this will be in-line with its peer group.

Cash Conversion

Converge was a negative working capital company in 2020/21 but this flipped 180 degrees in 2022/23.

With so much M&A, there is always a risk that target companies inflated their revenues and that the actual cash from these revenues may not materialize. This remains a risk with Converge and some part of the revenue may never come back but, (a) Converge has not made a new acquisition recently and all past acquisitions have now been more or less integrated, and (b) Incentive structures have been changed and policies have been put in place to convert earnings into cash flow.

This cash conversion problem was made worse by the fact that Converge produced an ‘adj free cash flow’ metric. When a business has leverage on the balance sheet and needs to pay interest expense, then it can only be paid with real free cash flow and not ‘adj free cash flow’. I think the management understands this now.

Converge started compensating sales executives with payments tied to invoicing rather than cash receipts. However, there has been a recent shift in the commission structure. All incentives are now set to cash. To reinforce this, regional VPs regularly convene on calls, underscoring the importance of customer payments as a fundamental aspect of their operations. The message is clear: customers must fulfill their payment obligations. This is already bearing fruit and Converge had a fantastic Q3 from a cash collection perspective.

“The snapback in cash generation this quarter was driven by moving swiftly to implement improved receivables and payables processes across the company with disciplined measures

being put in place to better define terms and parameters for our contracts and operating hurdles for our operation. Implementation of these improvements is in progress and will continue.”

- CFO (Q3 Earnings Call)

With maturation of acquisitions, new ERP, and change in incentives we believe cash conversion will increasingly get better. The CFO has a target of 55-60% cash conversion between EBITDA and FCF and we believe this number.

Financials

	2020	2021	2022	2023	2024	2025	2026
Total	949	1,330	2,032	2,739	2,876	3,019	3,170
Growth		40.15%	52.78%	34.78%	5.00%	5.00%	5.00%
Gross Profit	233	346	551	693	743	795	852
GPM	24.55%	26.02%	27.12%	25.32%	25.82%	26.34%	26.87%
EBITDA	55	91	137	195	213	233	254
EBITDA Margin	5.80%	6.84%	6.74%	7.12%	7.41%	7.70%	8.01%
FCF	39	79	30	115	128	153	179
FCF Conversion	72%	87%	22%	59%	60%	66%	70%

As we can see FCF conversion suffered in 2022 and this was all due to the \$77 mn in working capital. In addition, actual cash conversion also suffered from ‘one time items’ related to M&A and increasing interest expense as all of Converge’s debt is floating rate.

	2023	2024	2025	2026
Stock Price	4.1	5.5	5.5	5.5
Shares Out	207	207	207	207
Market Cap	849	1,139	1,139	1,139
Debt	307	243	167	77
EV	1,156	1,382	1,305	1,216
EV/EBITDA	5.93	6.49	5.61	4.79
FCF Yield	9.95%	9.26%	11.69%	14.72%

The net debt concluded the quarter at around \$307.5 million, leading to a leverage ratio of 1.84x of TTM EBITDA. Converge has about \$292 million in available capital encompassing cash reserves and the available capacity under the credit facility. It will likely use about 50% of its

FCF to pay down debt and the balance reserved for investments in the business and share buybacks.

Converge is currently valued at 6.5x EV/EBITDA and we believe this is extremely cheap for the quality of the business. As investors realize that the cash conversion is real and as Converge pays down debt and buys back stock, we believe that the market will value Converge closer to 10x EV/EBITDA which means the stock can double in 3 years from these levels.

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

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