WHITE FALCON

CAPITAL MANAGEMENT LTD.

July 17, 2024

RE: Q2 2024 Partner update letter

Dear Partners,

While individual returns may differ based on their inception dates, consolidated performance of all accounts for the period ending June 30, 2024 is as follows:

	Q2 2024	1H 2024	2023	2022	ITD*
White Falcon (net of fees)	**-5.9%**	**2.4%**	**36.0%**	**-9.26%**	**24.4%**
S&P 500 TR (CAD)	5.3%	18.8%	23.2%	-12.6%	32.1%
MSCI All Country TR (CAD)	3.7%	14.6%	18.5%	-11.9%	21.5%
S&P TSX TR	-0.5%	6.1%	11.8%	-5.8%	11.2%

*Inception date is Nov 8, 2021

This was a difficult quarter. The negative performance of Endava, EPAM and Converge could not be offset by strength in Amazon.com, Nu Holdings and precious metal royalty companies. The portfolio was affected by middling earnings and guidance downgrades from our IT services and software positions as corporates prioritize Artificial Intelligence (AI) related IT spending. The market itself had an excellent first half but we must point out that a lot of these gains were led by a few select stocks with the equal weighted S&P 500 up about 5.1% in the first half of the year. Towards the conclusion of this letter, we elaborate on why we perceive the current environment to be similar to the 1970s rather than the late 1990s.

We have always emphasized that our performance will always look very different when compared to the popular indices as our portfolio looks very different when compared to the popular indices. These differences are especially enhanced over shorter periods of time. There are numerous factors - sentiment, narratives, flows, factor rotations, among others - that affect the price of a stock over the very short term. However, in the long term, fundamentals rule. We believe we own some wonderful businesses and have full confidence in the portfolio. In fact, we believe that this temporary dip enhances the look-forward Internal Rate of Return (IRR) of the portfolio as it has allowed us to lower our average cost base and concentrate on our best ideas.

Investment ideas are fragile. In order to achieve market beating returns, one has to have a variant view. Most of White Falcon's positions are in companies where:

- We believe the growth, margins, or free cash flow will exceed market expectations.
- The market undervalues the business's quality or the management's capital allocation skills.
- The business is temporarily out of favor, and we anticipate the stock price will recover as these issues subside. Our longer-term perspective aids in this.
- We purchase securities from distressed investors who are selling for reasons unrelated to fundamentals.

"The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values."

\- Warren Buffett

When we make an investment, the situation is often complex and convoluted, otherwise, it wouldn't offer high risk adjusted IRRs. For example, there can be issues such as a poor quarterly performance, supply chain issues, or a longer than anticipated turnaround in business performance. Investors often acknowledge a business's quality but prefer to invest after challenging quarters have passed. On the other hand, we often try to invest at the point of maximum pessimism in the stock as that is when we can buy a good quality business at a reasonable valuation. If our analysis is correct, we are likely to profit in the long term; however, we have limited control over the situation in the interim.

In a typical quarter, we often see one or two investments - like Aritzia or Converge - experiencing a drawdown. Due to our portfolio's diversification, this drawdown does not significantly impact the portfolio's overall performance. However, during Q2, a higher-than-usual number of portfolio companies experienced drawdowns, marking a departure from the norm. I will delve into some of the reasons below, and explain why I have confidence in our portfolio.

Our portfolio is heavily tilted towards technology companies. Technology, whether in the form of railroads, electricity, radio, motor vehicles, or the internet, has consistently had the potential to disrupt existing industries and create entirely new ones. We have learned through experience that investing becomes marginally easier, and far more profitable, when done in secularly growing and good quality businesses - as long as one pays attention to valuations.

Due to this, we have positioned ourselves in businesses such as EPAM and Endava which are IT services companies that help other corporations implement new technologies. These are good quality businesses with robust economics and are led by their founder CEOs. Currently, AI is the new technology trend and investor emphasis has been on investing in hardware to support AI capabilities. As the necessary hardware becomes more widespread, the focus will likely shift towards creating and optimizing AI applications. EPAM and Endava will benefit from this cycle as they have built a reputation for executing specialized and complicated IT projects. However, AI is still a new technology, and clients need time to identify the best use cases. This has led to a cautious "wait and see" approach from clients, which is currently suppressing demand for IT services. The timing of demand revival in the sector is uncertain and, as we have discussed before, the market hates uncertainty.

“Everyone has the brainpower to make money in stocks. Not everyone has the stomach”

- Peter Lynch

We believe the market has overreacted and EPAM and Endava are now trading at historically low multiples of depressed earnings. Eventually, corporations will need the help of EPAM and Endava in order to design, build, test, and implement AI applications. We have added to both stocks and lowered our cost basis, which we anticipate will enhance the overall internal rate of return (IRR) of the portfolio.

Case Study: Aritzia (ATZ)

Let's look at Aritzia for a typical case study. We bought a position in Aritzia in 2022 and had an average cost base of around $36 per share. Our thesis was that Aritzia is a high-ROIC business offering essential clothing, driven by a capable management team with strong founder leadership. Importantly, there was predictable growth in the business as Aritzia was just starting to expand in the US and had plans to open ~10 stores in the US every year for the foreseeable future. However, in 2023, the business encountered difficulties due to over-ordering of inventory and rising expenses. The market's dislike of uncertainty caused the stock to be punished beyond what we considered reasonable. At the bottom, our estimate was that Aritzia was trading at less than 10x our estimate of 2026E earnings.

"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

We thoroughly reviewed and verified our work, including speaking with management, former employees, and competitors; and concluded that these issues will resolve themselves over time. We took advantage of the situation and added to our position in the $22-25 price range and brought our cost base down to $28 per share. The situation recently corrected itself when Aritzia reported a good quarter and the stock recently closed at $47.50 per share.

From our perspective, market volatility is a feature, not a bug - Aritzia experienced more than a 50% decline followed by more than a 100% increase - all within just two years!

To be clear, it is not always appropriate to add to a declining stock. This should be done selectively and only when the risk-reward is favorable. In the last two quarters, we sold our positions in Warner Bros Discovery (WBD) and Fortrea (FTRE) - both at a small loss. While both stocks remain inexpensive and could potentially recover, our analysis has reduced our confidence in their prospects. This concern was exacerbated by the high levels of leverage present in both companies.

The top 5 positions in the portfolio are: Precious Metals royalty basket, Endava, Amazon.com, Nu Holdings, and Rentokil Initial Plc. We have been communicating our strategy of shifting the portfolio increasingly towards small and mid-cap stocks where we have found valuations to be much more reasonable. In the last quarter, we noticed that several of these stocks did not gain or sustain their gains despite improvements in their fundamentals. However, following the quarter's end, we witnessed early signs of optimism as lower inflation readings and expectations of rate cuts rejuvenated small and mid-cap positions in the portfolio - including EPAM and Endava.

It is our job to position the portfolio for the future - sometimes the future is just a little bit delayed!

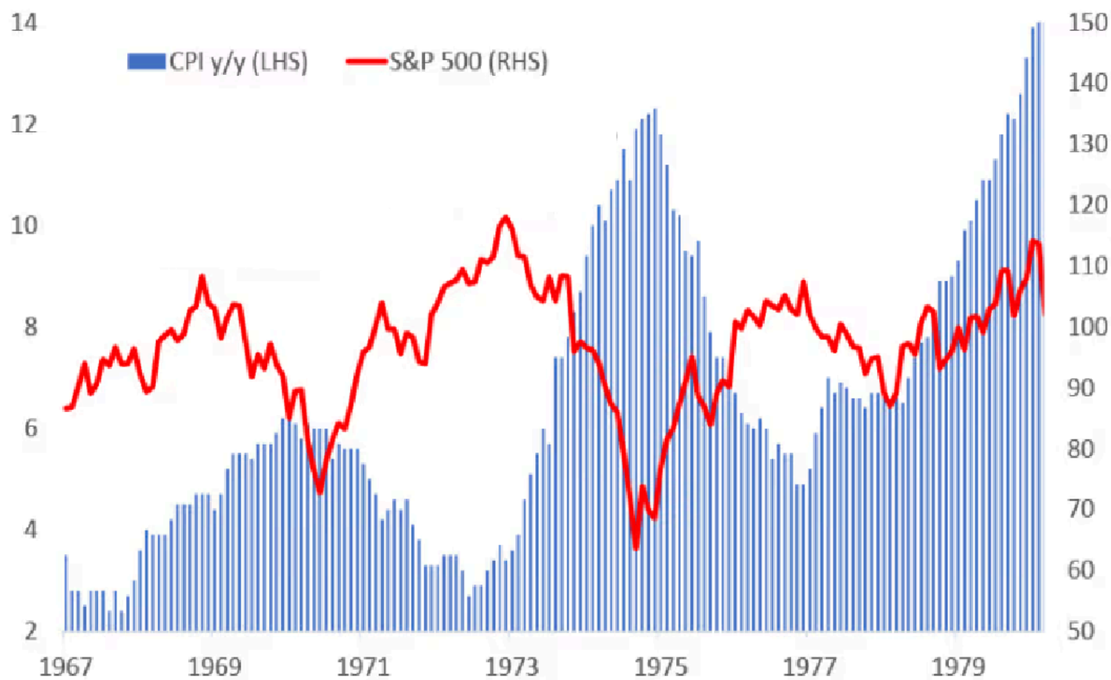
Rentokil Initial Plc (RTO) is a global business services company specializing in pest control and hygiene services. These revenue streams are relatively stable and resilient, even during economic downturns. Rentokil's moat comes from its scale, network density, technology and established brand name. Rentokil typically trades for ~25x earnings but is currently available for 19x 2024E earnings and 12x our estimate of 2026E earnings.

As we have described above, something must be going 'wrong' if a good business is available for a low multiple. Rentokil acquired Terminix, the largest pest services provider in the US, and has encountered some integration challenges. Our due diligence on Rentokil has led us to believe that they can successfully integrate Terminix and meet their targets. Importantly, the valuation discounts many of these issues, creating a 'heads I win, tails I do not lose much' scenario. In the **appendix** to this letter, we re-produce an article that we wrote for the ***Globe & Mail*** on Rentokil. While it's not our typical long-form report, we hope you'll still find it enjoyable.

Overall market comments

A few of you have inquired about the general market environment. While many commentators draw comparisons between the current surge in AI stocks, particularly Nvidia, and the late 1990s internet boom, we find the *nifty-fifty* craze of the early 1970s to be a more fitting analogy.

On a macro level, fiscally induced inflation, populist policies, increasing regulation, geopolitical risks, and increasing negotiating power of labor are some of the common themes between the two time periods. On a micro level, similar to the 1970's, a few select stocks are now considered 'one decision stocks' and investors of all stripes are having a hard time coming up with a bear case.



The above chart from *Marketwatch* shows that, in the 1970s, after the initial wave of inflation, there was a subsequent and more pronounced surge in inflation. This spike in inflation triggered the bear market of 1974-75, which resulted in the S&P 500 seeing no positive returns for almost 10 years.

Two additional points further reinforce and support this hypothesis:

First, the total return from the market is typically ~10% per year on average. This is because, in the long term, stock prices generally move in line with earnings growth, which is driven by nominal GDP and profit margins (which are already at the highest levels ever!). Over the past 15 years, since the Global Financial Crisis, S&P 500 has increased by a compound annual growth rate (CAGR) of 15.03%. To return to the historical average of 10%, forward returns will need to be significantly lower - perhaps somewhere between 1-5% - over the next 10 years.

Second, Warren Buffett is the only investor we know who actively invested capital during the 1970s. Observing his actions today, we see that he has been purchasing oil and gas companies like Occidental Petroleum and Chevron, as well as gaining exposure to commodities through holdings in Japanese trading companies.Looking back at the 1970s, the best-performing sectors were REITs, oil and gas companies, and various commodities including gold and silver - any and all real assets. Warren’s recent purchases reflect a belief that these types of investments will again prove profitable just like they did in the 1970s.

This will not be an easy environment for making money, and those crowding into US passive ETFs are likely to see minimal real returns on their investments. While we do own some of these popular stocks, we believe that, as active managers, we can be much more agile in our approach compared to a passive index. Unlike our contrarian approach, indexes act like momentum investors, buying more of what is going up. If these mega-cap stocks begin to underperform, they will likely drag the index down with them for an extended period, as reducing their weight in the indices will take time.

Traditional active managers might outperform, but charging a fee of 1%+ on assets under management (AUM) for a potential 1-5% annual return means that the fee represents 20% to 100% of potential returns, significantly reducing the net gains realized by investors.

White Falcon’s structure and alignment offer numerous advantages in such an environment.

In closing, I want to express my enduring gratitude to each and every partner of White Falcon. I'll be in Vancouver from July 29th to August 9th and in Calgary from August 12th to 24th. I'd love to meet up while I'm there, so please reach out to arrange a time.

Also, please feel free to get in touch with me at any time for any questions 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.

DIGITAL ONBOARDING

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

INVEST WITH US

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THE GLOBE AND MAIL

OPINION

Rentokil a welcome guest in multibillion-dollar pest control industry

BALKAR SIVIA
SPECIAL TO THE GLOBE AND MAIL
PUBLISHED 2 HOURS AGO

A rentokil disinfection company employee adjusts his mask after disinfecting a bus as part of measures taken to prevent the spread of the COVID-19 in Paris, on Sept. 2, 2020.
LUDOVIC MARIN/GETTY IMAGES

Imagine your home as a castle besieged by an army of unwanted guests – ants parading through the kitchen, mice darting in the walls and cockroaches skulking in the shadows.

It's bound to be a tough battle where you will need the assistance and expertise offered by companies such as Rentokil Initial PLC RTO-N, which is a global leader in pest control with a significant presence in Canada and the U.S. It also happens to be a high-quality business that is currently being overlooked and undervalued by the market. The company is headquartered and listed in England and its American depositary shares (ADS) trade on the New York Stock Exchange.

Pest-control companies are capitalizing on key trends fuelling industry expansion. The rise in urbanization and population density, particularly evident as more people inhabit close quarters, fosters an environment conducive to pest proliferation. Climate change exacerbates this phenomenon, prompting shifts in pest populations and behaviours, necessitating professional intervention. Furthermore, increased emphasis on health and safety standards, coupled with stricter regulations and reputational concerns, drive both residential and commercial customers to prioritize routine pest-control services.

Rentokil is a highly advantaged business as it benefits from network and route density based competitive moats. This advantage arises from serving a high concentration of customers or service points within a defined region. Shorter travel distances reduce transportation costs and boost operational efficiency of service technicians. Moreover, regional market concentration and scale improve marketing effectiveness, especially in online channels.

Importantly, serving a dense customer base also enables companies to gather valuable data on local preferences and trends. Owing to these factors, we've witnessed industry consolidation, with larger companies like Rentokil and Rollins Inc. ROL-N investing capital in acquiring smaller regional players, thereby improving their growth and economics.

In addition to structural growth and strong competitive advantages, pest-control companies also benefit from a recurring revenue business model, often offering subscription plans such as yearly or multiyear contracts. Through these arrangements, Rentokil provides continuing pest-control services to ensure pests never become a problem for their clients. During previous economic downturns, revenues in the pest-control industry remained resilient, highlighting the indispensable nature of these services.

These characteristics facilitated Rentokil's ability to achieve compound annual growth rates (CAGR) of a remarkable 18.5 per cent annually from 2013 to 2023.

In 2021, Rentokil completed its largest acquisition yet by acquiring Terminix in a deal worth US$6.7-billion. This strategic move was aimed at strengthening Rentokil's position in the U.S. market. It complemented Rentokil's strength in the commercial market with Terminix's strength in the residential market and in termite control.

However, the integration process has encountered challenges, leading to a decline in organic growth. Further, the timeline for full integration has been extended from 2025 to 2026. Investors, predictability, have responded by penalizing Rentokil's shares. Nonetheless, for the long-term investor, this setback is a potential buying opportunity in an advantaged business with a history of compounded growth.

In the pest-control industry, there's a golden rule: Happy technicians often lead to satisfied customers. The churn in technicians at Terminix has led to a churn in customers. Churn is a vital metric for subscription-based businesses, affecting both financial performance and brand perception.

Rentokil's management is keenly aware of this pivotal metric, and Terminix has seen its employee-retention climb to 70 per cent in the latest quarter (from less than 60 per cent before the deal). As this figure remains well below Rentokil's 83 per cent, continuing efforts are being made to enhance this metric, including increasing pay for Terminix technicians.

Rentokil offers what we call the trifecta – revenue growth, margin expansion and multiple rerating potential. In addition to rising urbanization, climate change and heightened health and safety standards, Rentokil's growth is also driven by acquisition of small regional pest-control companies. These structural forces should help Rentokil achieve high single-digit revenue growth.

This, when combined with margin expansion from Terminix synergies and operating leverage, has the potential to produce double-digit growth in earnings and free cash flow per share. Finally, once Rentokil resolves its integration challenges and demonstrates enhanced organic growth, the market may rerate the stock, potentially valuing Rentokil more comparably to its peers, which typically trade at 20 to 25 times earnings.

White Falcon believes that Rentokil remains a compelling investment with its advantaged business model, strong growth prospects and substantial reinvestment opportunities. While the market remains cautious owing to integration challenges, Rentokil's management has a clear plan to address these issues and capitalize on its leading market position. So next time you see a cockroach doing the cha-cha in your kitchen, take a moment to appreciate the multibillion-dollar industry it inadvertently supports.

Disclosure: The author and the accounts he manages at White Falcon own shares in Rentokil Initial PLC.

Balkar Sivia is the founder and portfolio manager of White Falcon Capital Management Ltd. (www.whitefalconcap.com)

More from Investing

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