WHITE FALCON

CAPITAL MANAGEMENT LTD.

October 21, 2024

RE: Q3 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 September 30, 2024 is as follows:

	Q3 2024	YTD 2024	2023	2022	ITD*
White Falcon (net of fees)	**6.0%**	**8.5%**	**36.0%**	**-9.26%**	**32.0%**
S&P 500 TR (CAD)	4.5%	24.1%	23.2%	-12.6%	41.6%
MSCI All Country TR (CAD)	4.9%	20.3%	18.5%	-11.9%	30.6%
S&P TSX TR	10.6%	17.3%	11.8%	-5.8%	25.3%

*Inception date is Nov 8, 2021

We had a good quarter, driven by precious metal royalty companies. From our experience, to truly outperform, an active portfolio generally needs a few standout winners. While many of our holdings have performed well this year, we haven’t had any major outliers like we did last year. On the other hand, several positions—Endava, EPAM, Perrigo, and Rentokil—seem to be in various stages of forming a bottom and should have substantial upside from these levels. In addition, we currently hold several high-quality businesses that could be attractive acquisition targets, but M&A activity is largely on hold due to the current political climate and upcoming elections.

White Falcon’s mission remains to compound capital on a risk adjusted basis over the long term. We believe that even small advantages when compounded over time can lead to big differences in outcomes. We have continually 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 reasons - 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 good quality businesses at reasonable valuations and have full confidence in the portfolio.

"Bull-markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."

- John Templeton

Although markets have been strong recently, we don't see them as significantly overvalued at this point. It is encouraging to observe a broadening of the market, where stocks outside the biggest technology companies are starting to perform well. This is usually a positive sign and points to the health of the overall market. This rally appears to be driven by a mix of economic resilience and improving corporate earnings. As always, it is important to remember that markets will have their ups and downs. Macroeconomic factors such as inflation, interest rates, and geopolitical uncertainties can quickly change market sentiment.

Another key driver of this rally, in our view, is the devaluation of currency. The markets rise is as much about the declining value of money as it is about economic growth and earnings. Equities, as real assets, can serve as a hedge against inflation and help preserve purchasing power. However, if we measure the market using gold instead of the US or Canadian dollar, we see that, in gold terms, the markets are actually down this year. As you know, gold has served as money for millennia, and this year it has been one of the top-performing assets - up 31.4% YTD.

"Gold is money, everything else is credit"

- JP Morgan (1912)

As partner's know, since the beginning of the mandate, we have had an allocation to gold in the form of precious metals royalty companies. Our rationale was that your capital is irreplaceable, and the portfolio needed a hedge to protect against macroeconomic uncertainties. Gold's performance is especially noteworthy given that real interest rates - Fed fund rates adjusted for inflation - have been positive and relatively high. Despite the fact that investors can earn real returns by holding US dollars, many are still opting to buy gold, which not only provides no yield but also incurs storage and protection costs.

"Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."

- Milton Friendman

We believe this rise in gold price is primarily driven by two factors, (a) persisting debt and deficits in the West, and (b) geopolitical tensions.

The U.S. is facing its highest levels of debt and deficits in history. Both major political parties, in their own ways, share a common desire to continue spending. Notably, in 2024, interest payments on U.S. debt surpassed defense spending for the first time. To be clear, the likelihood of a U.S. debt default is minimal, as the government issues its own currency. However, history

tells us that increased government borrowing raises borrowing costs, crowds out private investment, reduces supply, and drives up prices, ultimately slowing growth. In the worst case, this could trigger a debt spiral, with borrowing and interest rates pushing each other higher. Gold may be snuffing out such a scenario.

This situation is further intensified by two hot wars and an active cold war. These conflicts not only demand ongoing spending but also polarize the world into competing blocs. Countries that once felt secure holding their reserves in U.S. dollars may now seek to diversify, with gold being a natural alternative.

Our understanding of financial history indicates that gold has been a benchmark of value since the beginning of money. Then, every so often, when a bubble bursts, *gold serves as a standard against which currencies are devalued to manage debt.*

Our gold and silver royalty companies have done well but remain inexpensive when compared to the new and current market price of gold and silver. We own these instead of an allocation to physical gold in the form of a gold ETF as these businesses can re-invest their earnings and compound capital. Unlike mining companies, they are high quality businesses that own royalties on a portfolio of mines, offering diversification and, importantly, option value. We discussed this opportunity in our *Globe & Mail* article on Franco-Nevada (FNV) earlier this year.

The **top 5 holdings** in the White Falcon portfolio are precious metals royalty basket, Endava, Amazon.com, EPAM, and Converge.

We sold half of our position in NU holdings, which has been one of our highest IRR positions. We initiated a position in NU in the fall of 2022 at $4 per share and it is now trading at $14 per share. As has been communicated by us many times, good business and good managements tend to surprise to the upside. There is an option value in good quality businesses that mediocre businesses at cheap valuation just do not provide! That has been the case with NU where the actual business performance far exceeded our expectations. While we still believe NU has the potential to do well, the current risk-reward profile suggests that trimming our position might be a prudent move.

“The only way to make sense out of change is to plunge into it, move with it, and join the dance.”

- Alan Watts

As we've discussed before, market structures have undergone significant changes over the past 10-15 years. Passive funds now account for nearly 50% of the market, and since these funds don’t consider valuations, they effectively follow a momentum strategy. So it is not surprising to observe that - either the market really likes a stock or really hates a stock - there is seldom an in-between outcome. This dynamic is further amplified by hedge funds and other short-term investors who focus on near-term results. Our advantage lies in identifying opportunities overlooked by both of these market participants. In this environment, we truly believe that stock

picking with a deep understanding of the fundamentals and a long-term perspective, is a competitive advantage.

“Whether we are buying stocks or socks, I like to buy quality merchandise when it is marked down”

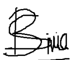
- Warren Buffett

IT services companies - Endava and EPAM - have been the main detractors for our portfolio this year. Admittedly, we have been early. However, we have checked and rechecked our work and believe these businesses are nearing their bottom. In the appendix to this letter, we outline our investment thesis for Endava and explain why we think it deserves to be our top position in the portfolio. We believe Endava (and EPAM) present a compelling opportunity due to their (1) solid position in the growing IT services sector, particularly in digital transformation and AI implementation, (2) overall business quality and founder led management teams, and (3) cheap valuation where we believe they are trading for a trough multiple of trough earnings. Despite recent revenue challenges, these businesses have maintained positive free cash flow. In fact, EPAM has been on the offensive and used its cash reserves to make four acquisitions in the last 12 months taking advantage of the weak IT spending environment. With improving IT spending and a strong management team Endava and EPAM are well-positioned for recovery and long-term growth.

We look forward to the upcoming earnings season as an opportunity to assess the performance of our portfolio companies and to gauge any developments that could impact their long-term value. Our focus remains on carefully managing risks to protect and grow your capital over time.

In closing, as we continue to grow and build long-term value for our partners, we would greatly appreciate any referrals of friends, family, or colleagues who may benefit from our approach to investing. Thank you for your continued partnership and support. 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

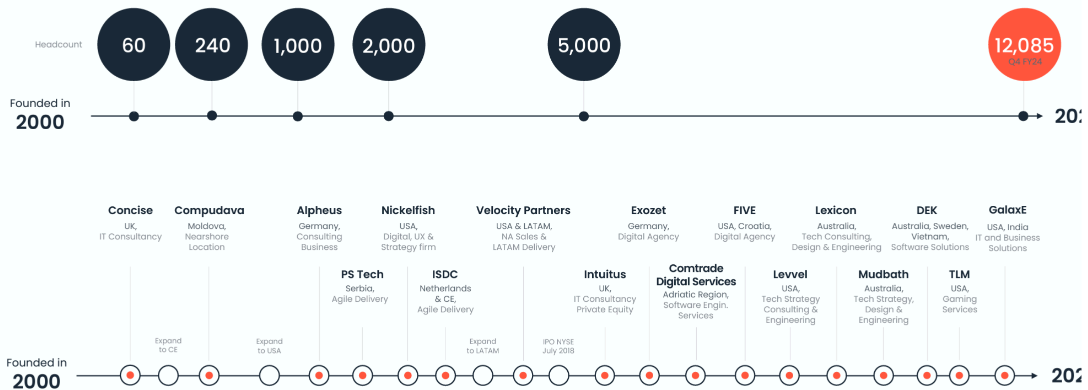
INVEST WITH US

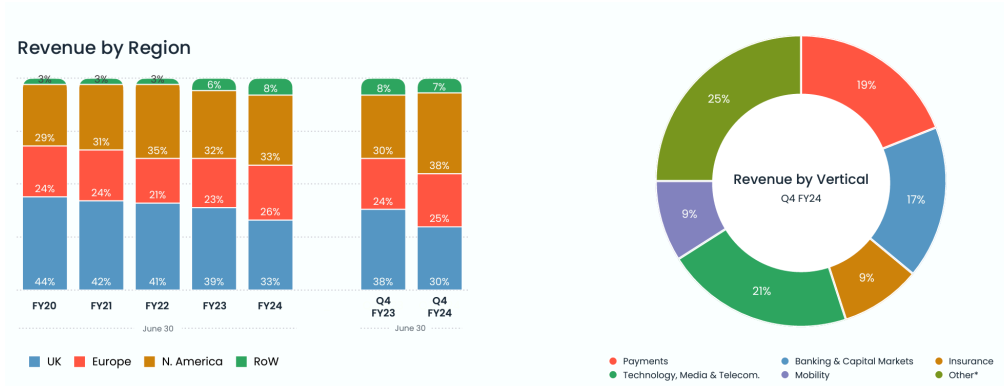
https://www.whitefalconcap.com/invest
416-770-6131
bsivia@whitefalconcap.com

Endava PLC

Endava plc (DAVA) is a London, UK based IT solutions company with $1.5 bn market capitalisation and 12,085 employees who are hired on an outsourced basis as project developers and designers for digital transformation, AI implementation, and data modernization projects across verticals including payments, financial services, healthcare and media, among others. Between 2016 and 2023, DAVA achieved an average annual revenue growth of over 30%. However, for FY24, Endava's revenues declined by 6.8%. This was primarily due to reduced IT spending, longer planning cycles (especially for AI projects), and a challenging macroeconomic environment. However, despite the downturn in spending, Endava has remained free cash flow positive and is currently trading at a trough multiple of trough earnings. White Falcon is long and believes that Endava is a good quality business operating in a secularly growing industry with substantial upside from these levels.

History and business mix:





Source: Endava Presentations

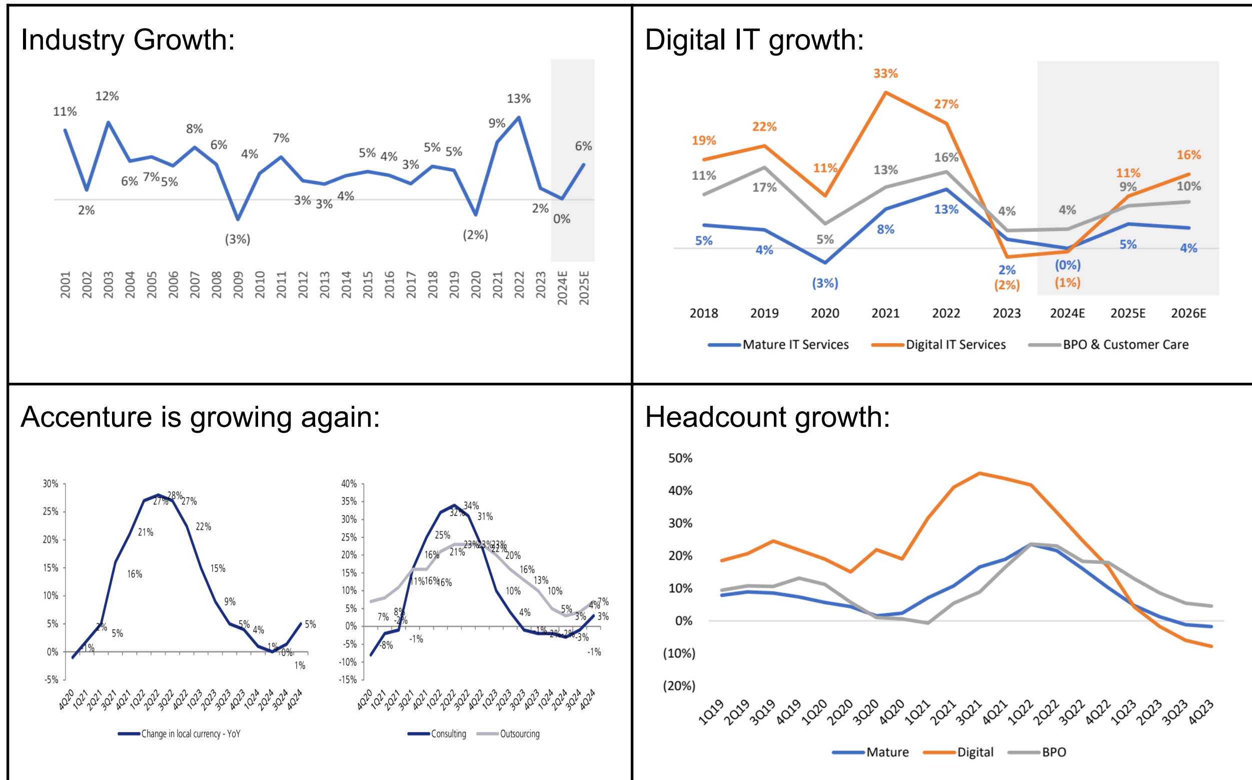
<u>Industry</u>

The IT services industry is a toll on global IT spending which itself is a function of global revenues - both of which have been trending up and to the right. Further, many businesses, unable to manage complex technological needs internally, increasingly rely on outsourcing. The industry has grown at mid single digits for the last 20 years. While seemingly homogenous at first glance, the industry is filled with nuances that distinguish potential value traps from long-term compounders. IT spending, projected to reach $5 trillion in 2024, drives this sector, with software and IT services being the fastest-growing segments.

In the 1990s, companies outsourced basic functions such as infrastructure management and application development, often to Indian providers offering lower labor costs. Over time, Indian firms moved up the value chain, taking on more specialized tasks like software development and maintenance, while Western companies shifted focus to higher-margin services such as consulting and digital transformation. By the 2010s, digital transformation became the driving force behind IT services, leading to the emergence of new players like EPAM, Endava and Globant, which specialized in end-to-end digital projects. Importantly, they offered near-shore capabilities vs. offshore capabilities so that complex projects could be delivered in a quality fashion. The rise in AI, cloud computing, and cybersecurity needs, has led corporations to allocate larger portions of their budgets to IT. In this evolving landscape, IT service providers are no longer seen merely as cost-cutting partners. Instead, they are recognized as key enablers of digital transformation, helping businesses navigate the complexities of modern technology.

The industry is very competitive with hundreds of firms competing for client business. The competitive landscape is shaped by several factors, including scale, cost, quality, relationships, expertise and regional advantages. Indian IT firms continue to benefit from lower labor costs, but companies based in Eastern Europe or Latin America, such as Endava, offer superior quality, which can ultimately reduce overall project costs despite higher wages. These businesses have distinguished themselves by focusing exclusively on digital services, in contrast to legacy providers like Accenture and Infosys, which manage a dual portfolio of shrinking legacy businesses and growing digital operations. The downside of the business

model is its cyclicality, as digital providers rely on discretionary projects, while legacy players benefit from more stable, annuity-like revenues due to their deep integration into client workflows. In addition to competing with each other, companies in the IT services industry also face competition from in-house IT departments. Interestingly, as technology gets more complex, the trend shows that the proportion of work being outsourced is steadily increasing every year.



Source: JPM & JM Financial

We are currently seeing a cyclical downturn within a secular trend of IT growth. Businesses cannot defer these projects forever and we believe things are turning for the better and remain optimistic on 2025.

Moat

Several factors drive success in the IT services sector: scale, culture, and switching costs:

- Scale is particularly important because larger firms, like Accenture with its 700,000 employees, have the resources to win big projects and absorb the costs of training and re-training their workforce on the latest technologies. This is something that smaller firms or in-house IT departments just cannot do! It allows scaled IT services firms to transition smoothly through waves of technological change, from application development to ERP implementations, to cloud migrations, and now to AI.
- In this industry, an IT services company will not get a $10 mn project from a client until they have done a $10 mn project in *that practice* in *their industry* and can provide a *good*

reference. This is further exacerbated by the legal liability taken on by IT service providers. Many times, an IT services business has to organically get to that level or acquire another company that has a good reputation in that practice and industry (scaled IT players become roll-ups due to these advantages). We have observed that it is often difficult for IT services businesses to get to $1 bn in revenues but - after they hit this milestone - their growth accelerates. Endava has just reached this milestone!

- Switching costs play an important role in this industry. Warren Buffett bought IBM as none of the Berkshire companies switched IT service providers - same is true for others!
- The management and culture of IT services companies are also crucial to their success. These businesses rely heavily on people, and having a strong culture that fosters growth and learning is essential. Firms with high employee turnover, such as Infosys during periods of management instability, struggle to deliver projects on time and within budget. In contrast, Endava low attrition rate of around 10% translates into better project outcomes and higher customer satisfaction. It is important to emphasize Endava is still run by the founder, John Coterell, who is very active in the business and has significant skin in the game (15% of s/o).

Headwinds

The stellar track record of compounding for Endava came to an end in 2023. What happened?

- IT spending is slow. Like many other industries, IT services also 'over earned' during covid and had a stellar performance in 2022. In addition, due to the newness of AI most corporations are uncertain on the future path of their technology roadmaps.
    - IT spending is slowly returning as seen by Accenture's results+lower rates help
- Endava has had company specific issues. It was over reliant on financial services and within it, payments in the UK market. As these clients slowed down, so did its revenues.
    - Endava acquired GalaxE for $405 mn which is a healthcare and US focused IT services firm. This acquisition added 1,650 people and ~ $150 mn in revenues.
- Overall, revenue growth in this industry is very dependent on employee growth and their productivity. These companies have not grown their net employees but the employees that do remain need to transition to learning new technologies including AI. This creates a short term margin drag.
    - 1H FY2025 will be a transition period, but growth and margins (higher utilisations) are expected to accelerate in the following quarters and beyond.

AI Risk

There is an ongoing debate among investors about whether IT services companies like Endava will be winners or losers in the AI era. The concern is that as AI increases productivity, fewer software engineers may be needed, potentially reducing demand for IT services. However, this argument overlooks the fact that implementing AI requires a significant amount of foundational work, such as cloud migration and data consolidation, which creates new opportunities for IT services companies. Furthermore, technology and productivity growth are long-term trends. As engineers become more efficient, competitive pressures will drive CTOs to identify and pursue

additional IT projects that need to be completed - as has been the case over the past 20 years. It is important to note that the IT services industry has faced false narratives before. The industry was focused on custom development and when packaged software like SAP and Oracle emerged, it was expected to hurt IT services, but the industry adapted by focusing on ERP implementations. Similarly, when cloud software gained dominance, IT services pivoted to cloud migrations and custom digital projects. We believe the current narrative that AI will harm IT services is similarly misguided.

"As you look at the business, we've been talking about the importance of core modernization to us and how that's driving activity as clients look at how they can plug AI into their core and get access to data and so on. Those are quite big projects, and it's driving a lot of pipeline activity and conversation with clients"

- **John Cotterell, CEO of Endava during Q4 earnings call**

"You may remember a previous announcement about our proprietary agentic AI solution called Morpheus. As an example, we are currently using it to help deliver the creation of code for a client in a highly regulated healthcare industry. Working with the client, we use Morpheus to create AI agents focused on assisting their teams with the delivery of complex workflows. These agents can play specific roles, access tools and collaborate to reimagine complex business processes. In a recent project for a global pharmaceuticals company, Morpheus helped <u>reduce a business process from 5 days to less than 10 minutes</u> and is expected to deliver annualized savings of more than $10 million. We believe this particular use case is applicable to over 50 similar organizations."

- **John Cotterell, CEO of Endava during Q4 earnings call**

We asked chat GPT on how AI can help businesses and here is the response:

"Here are some key areas where corporations can leverage AI for benefits: Automation and Efficiency, Decision Making and Analytics, Personalized Customer Experiences, Customer Service agents, and Risk Management and Fraud Detection and Product Development and Innovation and on and on and on……."

AI is great but how does a corporation incorporate AI into their business? As per chat GPT:

"To effectively implement machine learning, several key components and considerations are necessary. Here are the main requirements for machine learning: Quality Data, Data Preprocessing, Machine Learning Algorithms, Training Set, Model Selection and Tuning, Model Training, Model Evaluation, Deployment and Integration and finally, Monitoring and Maintenance."

In essence, what we read above is that there is a LOT of work that needs to be done in order to enable a corporation to reap the benefits of AI. All this work has to be performed by someone! We think Endava, EPAM and other engineering focused IT services providers will be the key

enablers of this move to AI. Further to this, corporations that still have their data on premises on different platforms first need to bring it to the cloud to even begin implementing AI. In essence, AI will be an accelerator of cloud migrations and this work is performed by digital IT businesses.

To be sure we are not underestimating the risks and we do not believe AI is good for all IT services companies. We believe AI is a tailwind for digitally enabled engineering led IT service companies and a headwind for business process outsourcing or lower value add providers.

There are market signals too that engineering focused IT services firms are not AI losers as the multiples of Globant or LTI Mindtree have not collapsed. We take this as assurance that investors are more concerned with specific issues with Endava rather than an extinction risk to the business model.

Triangulating our work, here are a few relevant expert views:

Former Sr. Manager (07 Mar 2024)

Transcript Highlights

- Rates DAVA as an 8-9 out of 10 on revenue growth potential and execution.
- Thinks **the market for IT services has been soft** due to the current macro but growth can come from expanding into other verticals. Believes **larger players like DAVA tend to do better than smaller copycats in an environment** like today.
- Believes **slow conversion** is less about budget but just reprioritizing projects and also a lot of C-level changes and reassessing past plans.

Former Manager (21 Mar 2024)

Transcript Highlights

- Thinks DAVA is a highly professional company, **the macro is going through a downturn** but ~40%+ growth off a recovery is possible.
- Believes DAVA pays an average salary but has interesting projects for talent retention.
- In the expert's opinion, **GenAI could be a large driver for DAVA** and it has been investing since 2017.

Numbers and Valuation

The company is expected to return to growth this year, with management projecting a conservative 10-11.5% year-over-year revenue growth in constant currency. This guidance does not account for potential pricing adjustments or increases in customer IT budgets. We believe they have set up the year for a beat and raise cadence when considering cross-selling opportunities from the GalaxE integration, expected budget recoveries, and the shift of AI projects from planning to execution.

Period Ending	Jun-30-2020	Jun-30-2021	Jun-30-2022	Jun-30-2023	Jun-30-2024	Jun-30-2025
Sales Adjusted	452	604	702	985	984	1,075
YoY % Chg	*22%*	*27%*	*47%*	*21%*	*-7%*	*8%*
Gross Profit Adjusted	129	208	234	327	239	305
Gross Margin %	*28.5%*	*34.5%*	*33.3%*	*33.2%*	*24.3%*	*28.4%*
EBITDA Adjusted	100	153	171	241	133	161
EBITDA Adj. Margin %	*22.2%*	*25.3%*	*24.3%*	*24.4%*	*13.5%*	*14.9%*
EBIT Adjusted	81	128	151	215	101	128
EBIT Adj. Margin %	*18.0%*	*21.2%*	*21.6%*	*21.8%*	*10.3%*	*12.0%*
Net Income Adjusted	72	100	120	164	88	89
Net Income Adj. Margin %	*16%*	*17%*	*17%*	*17%*	*9%*	*8%*
EPS Adjusted	1.3	1.8	2.1	2.8	1.5	1.5
EPS GAAP	0.5	1.0	1.5	2.0	0.4	0.5
YoY % Chg	*-14%*	*100%*	*88%*	*13%*	*-82%*	*35%*

Endava's margins are higher than competitors on an adjusted basis. IT services businesses are people intensive businesses where people are your major asset. Most companies in the industry pay cash salaries and bonuses with stock options reserved for the top management. In Endava's case, the stock is more widely distributed due to which while it reports higher margins, it also has higher dilution where they issue 1-1.5 mn shares per year.

Revenues of $1.3 billion in 2026-27, combined with a normalized EBIT margin of 18%, would generate $235 million in EBIT for Endava. With a current market capitalization of $1.46 billion and $110 million in debt, its enterprise value stands at $1.57 billion. By 2026-27, this would imply an EV/EBIT multiple of 6.5x for a business with good economics and long-term growth potential. Even if the stock doesn't trade at its historical multiples or align with the 'in vogue' digital providers like Globant or LTI Mindtree (20-25x EV/EBIT), we believe a 12x EV/EBIT multiple would still result in a doubling of the share price to $50.

Comps					LTM		NTM	
		Price (14/10/2024)	**Mcap ($bn)**	**EV ($ bn)**	**EV/EBITDA**	**P/E**	**EV/EBITDA**	**P/E**
Accenture	ACN	340	226	226	19x	31x	17x	28x
EPAM Systems	EPAM	195	11	10	14x	28x	11.5x	18x
Globant	GLOB	200	9	9	24x	54x	17x	30x
LTI Mindtree	-	-	15	14	29x	42x	25x	37x
Cognizant	CTSH	76	38	37	10x	17x	10.3x	16x
Endava	DAVA	25	1.5	1.6	18x	68x	10.5x	16.7x

One can make other assumptions on timelines, margins or multiples, but it is difficult not to see upside from here.

The <u>bear case</u> to this thesis is a recession as all IT spending will slow down in such a scenario. On the other hand, the <u>blue sky</u> is multi-year growth acceleration due to core modernisation, cloud migration and AI projects, in which case, Mr. Market may again assign a hefty multiple to Endava.

Disclosure: White Falcon owns shares in Endava. Please see the disclaimers below.

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