NORDSTERN CAPITAL

Partnership Memo: 3rd Quarter 2022

New York, October 31st, 2022

Dear NORDSTERN CAPITAL Partners and Friends:

The third quarter was disappointing for our partnership on the surface. The underperformance has three main reasons: 1) significant drop of Embracer Group's share price; 2) significant decline of Swedish krona vs. US Dollar; 3) commodity price weakness due to recession fears.

I am convinced that these same three themes that were strong headwinds last quarter are the foundation of strong performance over the next quarters and years.

Every investor should understand that temporary stock price underperformance is incidental. The current state of world affairs is laden with extreme risks. I am convinced that our holdings are well suited to not only withstand whatever may come, but to thrive in most scenarios that may unfold.

Future

I believe the next quarters will demonstrate the following: 1) Embracer Group will generate strong cash flows, up-list to the main stock market, and will attract a new slate of more sophisticated buyers; 2) the drop of the Swedish krona will boost the earnings of our Swedish companies, in contrast to many US-listed companies which might experience FX-related earnings downgrades[1]; 3) the world suffers from commodity shortages. Physical markets remain tight. Our commodity businesses are cash cows and can use the recession fears and depressed prices as an opportunity to buy back large amounts of their own stock.

Risks

"It is not about risks, it is about recognizing that you have to make good moves."
- Garry Kasparov, former chess world champion[2]

Every epoch has winners and losers. We are at the beginning of a new paradigm. We face severe conflicts between world powers. Central banks have long nurtured moral hazard and governments have created an economic mess.

Contrary to current financial market expectations[3], it is my firm belief that inflation will remain elevated. Money supply has been inflated globally on a grand scale. The supply of physical goods and services cannot

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[1] "*An estimated 40% of S&P500 revenues derive from offshore*", in 2022-10-05 Jefferies note: Financial Asset Deflation
[2] Interview at the Saint Louis Chess Club, 2021
[3] At the time of writing, five-year inflation expectations remain around 2%, according to https://fred.stlouisfed.org/

increase at the same pace. As a short-term remedy, the Federal Reserve (FED) is now on a mission to restrict demand.

This recipe might kill inflation in theory. However, I believe that FED action will have its limits in practice. Recession pains, mounting interest costs on (government) debt and financial market turbulences are going to pressure the FED sooner or later to change course. In my view, this is going to happen before the US can meaningfully deleverage or reduce money supply.

Nonetheless, the US is clearly the least ugly bird. The Australian Central bank already made a dovish shift[4]. The Bank of England morphed from hawk to dove to bail out the country's overleveraged pension funds[5]. Japan's central bank is desperately trying to suppress long-term yields in tandem with propping up a tumbling yen. Both tasks require actions that contradict each other.

More impossible still is the task of the European Central Bank (ECB), the most likely winner of the ugly contest. The Eurozone inflation is higher than in the US. The continent has no energy security and no political unity. Instead, it has regions with unsustainable debt, a faltering currency, and an escalating war at its door. The ECB responded by raising interest rates and preparing more bond buying to support periphery countries. A contradiction. What happens when the integrity of the euro is called into question?

China is the ugly duckling. The country is suffering the worst property market downturn since the 1990s. Covid lockdowns stifle the economy. The youth unemployment rate reached 20%. Hostilities with the US hamper trade. The recent National Congress of the Chinese Communist Party did not resolve but exacerbated reservations held by the West. Nonetheless, the country could turn into a swan: inflation is still low, monetary policy is still healthy. Or it might become a black swan: Russia invading Ukraine is bad, but China invading Taiwan could plunge the world into disaster. In any event, because of China's outsized demand and manufacturing power, this bird will determine a great deal of where global inflation is headed.

The risks are plentiful. We are likely entering an era of stagflation. It is paramount to prepare for what may happen. To find the best moves, we adhere to what we believe is fundamentally true.

Truth

"Boil things down to their fundamental truths and reason up from there."
- Elon Musk[6]

Fundamental Truth, regardless of inflation, recession, or central bank action, in our view is:

- Value = sum of present values of all future cash in/outflows received from/paid to the investment
- If price paid << value received, good returns will follow (independent of stock price movements)
- The world is short on raw materials and energy in the short and medium term
- Commodity prices are determined by supply and demand

[4] https://www.bloomberg.com/news/articles/2022-10-04/fed-telegraphs-no-aussie-style-policy-pivot-in-inflation-battle
[5] 2022-09-28 Financial Times: Bank of England launches £65bn move to calm markets
[6] 2013 TED talk

Opportunity

The world is short on raw materials and energy. Nordstern Capital has increased its exposure to raw materials and energy. Recession fears may temporarily suppress demand and prices. The fundamental issue, however, is a sustainable lack of supply, caused by decade-long underinvestment. The shortages cannot be resolved in the short to medium term.

SHARING THOUGHTS
NORDSTERN CAPITAL in conversation with **Martin Fewings**, Head of IR, at **Glencore:**

It is hard to see any solutions in the near term that reset energy costs back to lower historical levels. We are short of energy and any solution will take quite some time.

Any recovery from recession is going to involve some kind of stimulus, which will increase demand again. Nothing has been done to solve the supply side.

No one invests in the next generation of mine supply. There is a huge gap in supply versus future demand and still no one is doing anything about it. Glencore is giving back cash.

One cannot choose where natural resources are, but even trying to build refining or processing capacity in the West is very difficult.

Currently suppressed stock prices offer a wonderful opportunity for our commodity businesses to buy back their own shares. For instance, Algoma Steel Group (ASTL) reduced its diluted share count this year from 177 million to 111 million. Nonetheless, ASTL's share price has come down 50%, because US HRC steel prices per ton declined in the past year from $2,000 to currently $713[7].

SHARING THOUGHTS
NORDSTERN CAPITAL in conversation with **Rajar Marwah**, CFO at **Algoma Steel Group:**

ASTL anticipates US HRC steel prices per ton to average $800 over the longer term. At this price, once EAF is completed, ASTL expects to produce $450m in EBITDA, and $250m in free cash flow.

Today, ASTL has $500m in net cash and a market capitalization of about $700m. The company is profitable even in the current recessionary environment. The CFO expects annual mid-cycle free cash flow generation greater than the current ASTL enterprise value.

This is one illustrative example. ASTL is not alone. Many present-day commodity businesses are cash and earnings rich and can use weak stock prices for aggressive buybacks. Stelco Holdings (STLC) recently offered to buy back 48% of its company's shares in one swoop. The company started two attempts and offered above-market prices, but most shareholders did not want to sell. STLC only managed to buy back 20.5% of its shares, the rest of the money might be returned in the form of dividends.

The more stock prices drop, the more shares these companies can buy back and the better the future cash flows to its investors will be.

[7] As of Monday October 31, 2022

Buyers incoming

"My experience is that difficult times create the greatest opportunities."
- Lars Wingefors, CEO Embracer Group[8]

Embracer Group (Embracer) has completed more than 80 acquisitions since its IPO in 2016. The company spent more than $10bn on these acquisitions altogether. In addition, Embracer spent close to $1bn on game development projects. Thus, the group invested more than $11bn over the last six years. However, at today's stock price, the market values the enterprise at around $8bn.

Either the market massively undervalues Embracer Group, or CEO Lars Wingefors managed to destroy 30% of the invested capital over the last six years. Which is true?

Acquisition multiples of operative units (including undiscounted out-year earnouts) average around 10-times EV/EBIT. Acquired IPs include evergreens such as The Lord of the Rings, Tomb Raider, or Sudoku.com. The operating groups grew EBIT at 32% since joining Embracer.[8] Older acquisitions can be well assessed today. For instance, Coffee Stain: acquired for $100m in 2018, sold more than $200m of the game Valheim alone. Milestone: acquired for $90m in 2019, sold about 1.5 million units of the premium game (price $49.99) Hot Wheels Unleashed within the last year alone[9], not counting sales of the 71(!!) DLCs. High returns on the purchase prices of almost all acquisitions that closed more than two years ago are obvious.

Embracer's average return on new game releases is about 3-times the investment.[10] For recent games, however, that average has dropped. AAA-game Saint's Row, Embracer's most expensive development to-date, was a disappointment. Acquisitions made over the last two years have had higher price tags and are harder to judge. For instance, the Western studios of Square Enix were bought in August for $300m but are not expected to contribute any profits over the following two years[11].

Uncertainty regarding the newer **acquisitions**, **performance** of recent releases, and doubts about **synergies** in Embracer's decentralized model led short-sighted shareholders to sell Embracer's stock.

SHARING THOUGHTS
NORDSTERN CAPITAL in conversation with **Lars Wingefors**, CEO at **Embracer Group:**

Acquisitions:
Every acquisition has a business plan and assumptions about future cash flows. Execution is continuously evaluated regarding the plan and the capex invested.

Embracer acquires businesses based on their stand-alone cashflows, not based on future synergies. Embracer did not pay premium for IP rights (except for The Lord of the Rings). For instance, Dark Horse came with hundreds of IPs and has a lot of additional potential upside from transmedia,

[8] 2022-09-21 Embracer Group Annual General Meeting presentation
[9] https://www.autoevolution.com/news/hot-wheels-unleashed-gets-a-surprising-game-of-the-year-edition-200006.html
[10] 2022-08-18 Embracer Group Interim Report Q1, April-June 2022 presentation
[11] 2022-05-02 Embracer acquires Eidos, Chrystal Dynamics, and Square Enix Montreal presentation

guidebooks, etc. However, the purchase price for Dark Horse was based on a reasonable multiple of the current cash flow.

Allocating $3bn to acquire Asmodee and putting debt on the balance sheet increased the group's overall business risk. In hindsight timing might not have been optimal.

Lars Wingefors refuses to account for any potential synergies in valuing deals, however, he does believe that there is added value in leveraging the combined group. The verdict is still out. If Embracer were to fail to deliver on that promise, then shareholders might have to discuss in the future whether breaking up the group or selling assets would create higher value.

So far, in general, acquisitions are performing according to expectations.

Performance:
Certain studios have been underperforming. There are various options, for instance a change in management, putting labels together, reducing capital allocation. Capital allocation needs to be based on performance.

Embracer needs to ensure that companies, particularly those that have tighter margins and higher cost bases, safeguard their margins.

Embracer promised earnouts based on organic growth. If studios don't deliver, then the group will claw back equity. If a team of people cannot make money, then the group will make adjustments.

Synergies:
One of the strategic reasons to acquire all these IPs and assets is the belief that the combined pipeline of games is worth something for other stakeholders and platforms.

There is value in securing an amount of content for the coming years. If Embracer were to sign 15% of the industry's content to one customer, then that would be a problem for the other platforms.

Embracer is in a unique position and can sign a lot of titles. Platforms might pay premium for the average outcome of such a pipeline.

A platform deal with one or several parties could mean for Embracer: higher margins, more predictable cash flows, greater profitability, lower capex and more revenues.

Embracer is targeting to release 110 new PC/console games this financial year, has a pipeline of 222 PC/console games in development, has an unprecedented depth and breadth in the video games industry, is currently operating more than a dozen franchises that return more than 5-times the invested capital, and has a history of exceptionally successful acquisitions.

Embracer has 1,235 million shares outstanding, 1,343 million if the maximum potential future earnouts and all recent acquisitions are included. The company has about $2bn in debt at 1% annual interest rate[12]. Compare this rate with the junk of so-called "unprofitable tech" companies. Telling. Embracer's net debt is about $2.3bn, including future cash earnouts and all recent acquisitions.

[12] 2022-07-08 Embracer Group Annual Report 2021/2022

Embracer provided EBIT forecasts for the next two financial years. The company targets to return to a net debt/EBIT ratio of less than one. Thus, some free cash flow will probably be used for debt reduction. Embracer's game development investments over the last eight quarters average three times the game development amortization expense. We estimate that maintenance capex for the PC/console segment is approximately equal to the game development amortization expense.

To value Embracer we use the maximum dilutive share count and assume that 50% of the free cash flow over the next three years will be used for debt reduction (and 33% for "maintenance capex", and 17% for "growth capex"). The company is releasing two AAA-games in the current financial year. Embracer is expected to release an average of at least eight AAA-games per year (!!) in the following years in order to reach the stated goal of "over 25 AAA-titles until March 2026"[13]. This pipeline indicates substantial long-term organic growth. For the financial year 2025, we use the company's EBIT forecasts for recent acquisitions and 13% EBIT growth over FY2024 for the rest of the group.

Embracer Group valuation: Enterprise Value to operational EBIT

@53SEK per share	March 2023	March 2024	March 2025
EV / EBIT	8x	7x	5x
EBIT growth		25%	20%

Embracer Group forecasts and Nordstern Capital estimates.

Embracer is expected to continue double digit organic growth. Management expects to keep taking market share in the video games industry. Embracer's share price today values this cash flow machine 2.5 years out at 5-times EV/EBIT. We are buyers.

However, we won't be the only ones. Before this year is out, Embracer is expected to up-list to the main Swedish stock market. This will bring new buyers. Several funds are restricted from buying Embracer as long as the shares are listed on a 'mickey mouse' stock exchange. This is about to change. Furthermore, Embracer might become a candidate for various index funds following the up-listing. Inclusion into the OMX30 would certainly mean another spurt of buyers.

Embracer invested $11bn, enterprise value today is $8bn. Is Lars Wingefors just a miserable capital allocator? The financial markets have a clear answer to this question right now. We take the other side. Time will tell.

[13] 2022-07-08 Embracer Group Annual Report 2021/2022

NORDSTERN CAPITAL

Trust

The NORDSTERN CAPITAL partnership can flourish thanks to our partners' trust, which empowers us to ignore short-term stock price volatility and to focus on decision making for long-term investment success. I am convinced that the dedicated focus on the long-term cash flow prospects of our investments will result in better long-term returns.

Long-term oriented accredited investors who are not partners yet are encouraged to apply. Looking forward to hearing from all of you.

Sincerely,

Johannes Arnold

Johannes Arnold, Nordstern Capital Investors LLC