

NORDSTERN CAPITAL

Partnership Memo: 1st Quarter 2023

New York, May 4th, 2023

Dear **NORDSTERN CAPITAL** Partners and Friends:

Interest rates up? Dollar down? Recession coming? Banks defaulting? The geopolitical, business, and investment climate remains laden with risk and potential black swans. What helps is a long-term mindset and short-term cash flows. We expect our companies to deliver on both.

Top **NORDSTERN CAPITAL** Investments:

stone^{co} (STNE, share price increased + 1% in 1Q 2023)

“The card association in Brazil have indicated that the industry should grow between 14% and 18% this year. And we expect to continue to gain market share.”

- Thiago dos Santos Piao, Director and former CEO StoneCo Ltd¹

STNE’s transformation is progressing well. New key personnel have joined, the board and management have strengthened. Cash flows are growing, margins are increasing, the client base and market share keep expanding. The company is all set to restart its lending business in the second half of 2023.

In our view, despite all the changes, STNE still offers best-in-class service coupled with lower pricing than the industry and continues to drive high customer satisfaction.

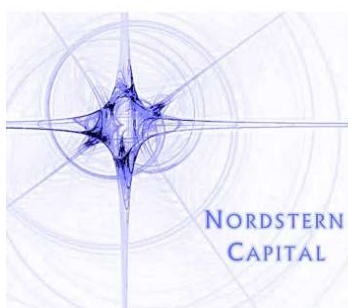
Upside for STNE might also come from external factors: STNE might save on interchange charges from prepaid card transactions, which will be capped in Brazil starting April. STNE does not intend to pass through the fee savings.² Thus, STNE’s margins should increase further. In addition, the Central Bank of Brazil is under political pressure to start lowering interest rates following the recent drop in inflation, which would lower STNE’s funding costs.

STNE’s shares currently trade at about 14-times our EV/EBIT estimates for 2023. We believe that STNE can grow EBIT per share above 20% per year for the foreseeable future.

The Stone is rolling.

¹ 2023-03-14 StoneCo Ltd 4Q2022 earnings call

² According to STNE’s senior management



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(ASTL, share price increased + 28% in 1Q 2023)

“The Infrastructure Investment Act, the Inflation Reduction Act and the Chips Act provide a combined \$975bn funding [...] an estimated 5m tons of steel is needed for every \$100bn in infrastructure spending. [...] on top of that we expect [...] 2m to 3m tons of annual steel demand for wind, solar and transmission projects.”

- Leon Topalian, CEO Nucor Corporation³

Hot-Rolled Coil (HRC) steel prices have rallied from \$700 per ton at the beginning of this year to currently around \$1,000. In April, steel giant Cleveland Cliffs raised HRC prices to \$1,300⁴. However, the shares of most steel companies do not reflect an elevated steel price environment. In fact, Algoma Steel’s CFO Rajat Marwah believes that HRC prices might drop again. He expects mid-cycle prices of \$900, which should enable ASTL to generate \$250m to \$300m in annual free cash flow (less than 3-times ASTL’s current enterprise value) once the EAF project is finished and stabilized.⁵

The EAF is expected to start mid-2024 and should enable ASTL to gravitate over the following few years towards 30% increased production and more than \$100m in cost savings per year by 2028. At present, however, capital expenditures are required. We estimate the following cash flows over the next two years:

Algoma Steel: Cash Flow Estimates next two calendar years.

<i>in million \$</i>	2023	2024
Plate Modernization Capex	\$ (15)	\$ (5)
Maintenance Capex	(75)	(75)
EAF Project Capex	(245)	(150)
Working Capital Release	75	–
Canada SIF Loan	125	–
Operating Cash Flow	335	225
FREE CASH FLOW	\$ 200	\$ (5)

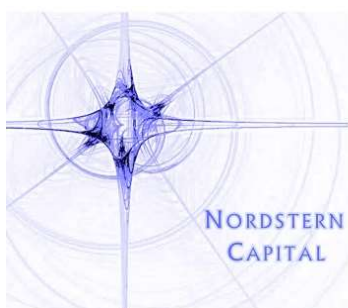
ASTL currently has about \$180m in cash and, according to Nordstern Capital’s estimates, will generate another \$200m in free cash flow in 2023. Enough cash to repurchase half the company at current share prices. Definitely plenty cash to fund the current share repurchase program to retire 5% of the share count, to complete the plate mill modernization and EAF projects, and to pay (or increase) the current 3% dividend yield.

ASTL is a steel.

³ 2023-04-20 Nucor Corporation 1Q2023 earnings call

⁴ 2023-04-03 Cleveland Cliffs news release

⁵ Conversation with Nordstern Capital



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EMBRACER⁺
GROUP

(EMBRAC, share price increased + 2% in 1Q 2023)

EMBRAC is facing a streak of rough quarters: a series of underperforming game releases, delays, reduced guidance, promised but yet-to-close partnership deals, and recently a series of short seller reports coupled with a Financial Times article⁶ that questioned EMBRAC's business model, profitability, and accounting.

One page of a short seller's playbook is called hit-and-run. Throw dirt and spin a damning narrative around a company to scare retail investors into selling, after which the short seller covers his position. EMBRAC was an easy target. The company has a large retail shareholder base, complicated financial statements, recent accounting changes, a unique business model, a declining stock price and negative sentiment. Kind of perfect.

A group of short sellers fed their narrative to the Financial Times and the journalists fell for the 'click bait' arguments. For instance, Embracer educates its investors to exclude contingent consideration to employees from adjusted profits. This is highly unusual and easy to call outrageous on a whim: employee salaries should not be treated as expenses? How ridiculous.

Before any quick judgement, however, let's understand the facts. EMBRAC's acquisition model is unique in that EMBRAC keeps managements and employees of acquired companies. In fact, Embracer offers large and long earn-out packages to former owners of said companies. These earn-outs will be settled in the future, partly in shares and/or partly in cash, if the acquired companies prove highly profitable. In some cases, EMBRAC issued the shares immediately, but subject to future clawback rights.

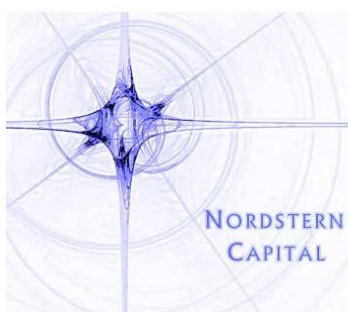
A common valuation metric is enterprise value (EV) divided by EBIT (EV/EBIT). Enterprise value equals share price times number of shares, plus debt, minus cash. To calculate EMBRAC's enterprise value, one could count all potentially dilutive shares from earn-outs and increase EMBRAC's debt by all potential future cash-payments from earn-outs. However, then it would be double-counting to subtract these same earn-out expenses from EBIT once more.

The newly adopted IFRS accounting rules require in some cases that EMBRAC treats former owners of purchased companies as employees. What essentially is reimbursement for selling the company must instead be treated as salary. In fact, for IFRS accounting rules it is not even essential that the owners indeed stay with EMBRAC, what counts is alone the language of the purchase contract.

A simplistic Gedankenexperiment to illustrate the core of the above:

- Assume that EG buys GG and EG will pay \$10 per year over the next ten years to the owners of GG.
- If the former owners of GG part ways with EG, then the purchase price for GG is \$100 and EG's balance sheet debt is \$100.
- If the former owners of GG instead stay with EG, then they become employees and the purchase price for GG is \$0 and EG's balance sheet debt is \$0. EG's profits, however, must be reduced by \$10 over each of the next 10 years.

⁶ "Embracer:gaming 'roll-up' battles claims of aggressive accounting." Financial Times, London, March 28, 2023



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From a business owner's point of view, these are two different methods of counting the same beans. Even if IFRS accounting rules were to require EG to deduct \$10 from profits every year, would it not be legitimate to argue that for the benefit of standardization the \$10 should be added back to 'adjusted profits' each year and instead the entire \$100 should be added to debt?

In any event, if one claims that EG should not adjust profits for the \$10 'salary', then one must consider that EG's enterprise value must be calculated using \$0 debt. Short sellers, of course, might prefer to just drop half of the equation.

EMBRAC's financial statements are complicated. This is a reality that won't change so easily. In addition, the current quarterly filings cannot build upon an IFRS-based Annual Report. EMBRAC's next annual filings will change that and allow for more clarity going forward. Nonetheless, with EMBRAC as with any other business, investors need to understand the 'true' economics of the business (Warren Buffett calls it 'owner's earnings') and should adjust for 'bizarro world accounting', as one of my mentors likes to call it.

The Financial Times article not only drilled on accounting, but also indicated that EMBRAC's acquisitions might not only have no synergies but might actually be worth far less than the sum of its parts. No argument is provided to support the hypothesis. EMBRAC's acquisitions don't change management, don't change employees, don't change the businesses. Why should these acquisitions be worth significantly less than stand-alone? The only argument seems to be: the stock price says so! EMBRAC's stock price leads to an enterprise value significantly lower than the sum of its parts, and the stock price can't be wrong, QED.

Let's explore synergies. Let's ask CEO Lars Wingefors: what if EMBRAC would do a deal with Netflix...

"We could make 10 or 20 games together with them, a number of TV series, a number of mobile games, a number of board games, we could do merchandising with them...Embracer could be the most important tool they could find to achieve their strategic goals. This goes for a company like Netflix, but there are many others like it."

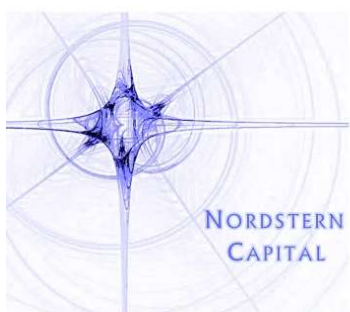
"With some patience it will be much clearer that actually Embracer makes total sense and that we are able to create more value out of the combined group than the individual pieces."

"We have built the largest capacity of games development in the industry and we have one of the largest portfolio of IPs."

- Lars Wingefors⁷

Nordstern Capital believes that EMBRAC should be worth at least the sum of its parts. In fact, we believe it is probable that EMBRAC's various parts can profit from each other's knowledge, contacts, experience, IPs, resources, and all kinds of things. However, regardless of any soft synergies, there lies major power in the sheer scale of the combined group.

⁷ Conversation with Nordstern Capital

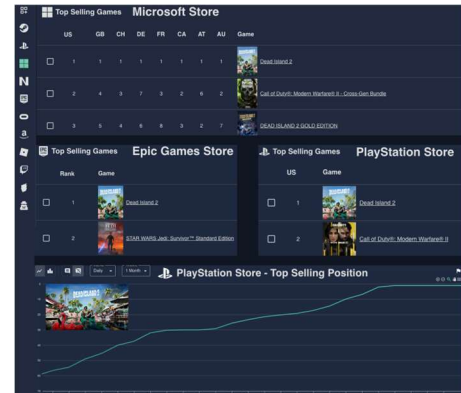


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EMBRAC's scale makes the group attractive for partnerships with leading platforms, game engines, and media houses. Transmedia is the perfect strategy to further build and enhance EMBRAC's IP values together with those partners in a structured and efficient way. In addition, such partnerships could provide predictable cashflows and help to maximize risk adjusted returns.

One powerful IP is Dead Island. The recently released AAA-sequel Dead Island 2 is currently topping the US video game sales charts⁸ and disproving the often-voiced opinion that mid-size AAA games will be crowded out by big budget megahits.

The CMA report issued in conjunction with the decision to block the Activision takeover by Microsoft reveals that some games now have budgets of over \$1bn⁹. The budget for Dead Island 2 was 20-times smaller. EMBRAC is the developer, publisher, physical distributor, and IP owner. From a return-on-investment perspective I prefer EMBRAC's strategy.



Dead Island 2: #1 on Xbox, PS, Epic.
Database provided by Lakrixx (@Lakrixx)

That said, EMBRAC is undertaking a few larger budget productions as well. However, the development of the next Tomb Raider game is paid for by Amazon. EMBRAC received \$45m for the early game development so far and will receive payments from Amazon for another 10-12 more milestones. It is rumored that TakeTwo is pumping \$2bn of its own capital into the next GTA6 game. From a cashflow perspective I prefer EMBRAC's strategy.

Cash flows will be strong in the coming quarters. More money from Amazon, cash from other strategic partnership deals, normalization of Asmodee's working capital, significant Dead Island 2 revenue, etc. In addition, many upcoming game releases are from studios that traditionally deliver higher-ROI projects, while recent underperformers in the group will likely receive reduced reinvestment.

EMBRAC will probably use the excess cash to reduce debt in the near term. However, Nordstern Capital would not be surprised if a share buyback program is on the agenda, at the very latest at the next Annual Meeting.

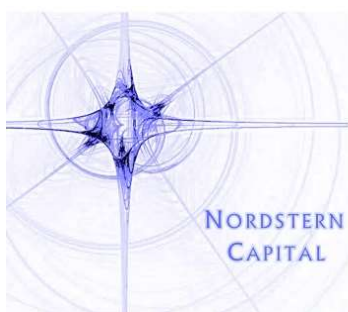
I am accounting on Embracer.

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.

⁸ "Dead Island 2 is a huge success with 1 million copies sold in 3 days." TweakTown, April 25, 2023

⁹ "Anticipated acquisition by Microsoft of Activision Blizzard, Inc. Final Report" CMA, April 26, 2023



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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

This report is based on the views and opinions of Dr. Johannes Arnold, which are subject to change at any time without notice.

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