NORDSTERN CAPITAL

Partnership Memo: 3rd Quarter 2021

New York, November 5th, 2021

Dear NORDSTERN CAPITAL Partners and Friends:

Playing a different game

"Once you start down the dark path, forever will it dominate your destiny. Consume you, it will."
- Yoda

The dark side of investing is to use price performance to evaluate investments. Many market participants pursue this path: investments are made, conclusions are drawn, and past decisions are judged based on the movement of stock prices. Like the 'dark side' in Star Wars, such concepts are alluring.

However, I think that assessing investments using 1,2,3, even 5-year histories of stock price movements is as futile as drawing conclusions from today's price movement. All this does is to lead its followers down the treacherous dark path. For a true long-term investor, whose yardstick is generational wealth building, only the analysis of the cash flow prospects of a business and the eventual cash distribution towards the owners is relevant. Reasonable capital allocators might differ in convictions as to what does or does not matter for estimating such future cash flows. In any case, decisions should be made based on evaluating assumptions about the business, those assumptions should, in turn, be judged based on new evidence, new developments, and KPIs.

"Winning the loser's game of beating the market is easy: Do not play it."
- Charles D. Ellis[1], former chair of Yale Endowment investment committee

Ellis presents compelling long-term data indicating that almost all institutional investment managers fail to beat the market over the long-term (multi-decades). Retail investors fare even worse than the professionals. However, in any given 12-month period about 40% of funds will 'beat the market'[1]. Ellis argues that the mere idea to try to 'beat the market' is setting investors up for long-term failure. The history and behavior of the investment management industry, on the other hand, indicates that this thought is either incomprehensible or impractical for most fiduciaries.

The Nordstern Capital partnership aims to deliver outstanding investment returns over the next 50 years. I believe that the best approach to achieve this mission is to play our own game: relationship building, business analysis, honest judgement, sound decision making, and improvement. I believe that good long-term investment returns will emerge as a natural outcome. This is our Nordstern, our North Star, the trusted light against the dark side of price performance, market excitement, FOMO, and other distractions.

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[1] Ellis, Charles. *Winning the Loser's Game – Timeless Strategies for Successful Investing. Eighth Edition.* McGraw Hill, 2021.

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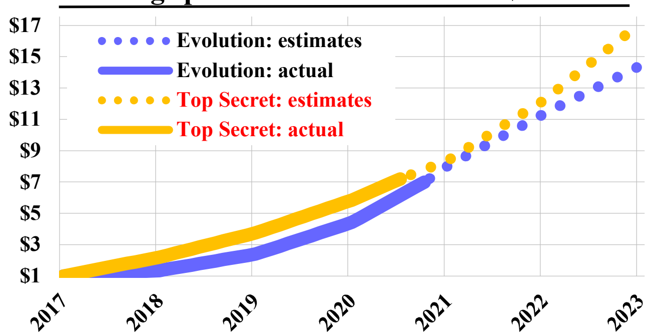
Owning the best ideas

"*All that rules in the end is the best idea. […] You don't know where the next competitors are going to come from. […] The only way we are going to lead the future is if we have better ideas. […] Two maybe three ideas a year, that's all you need.*"
- Todd Haushalter, Chief Product Officer at Evolution AB[2]

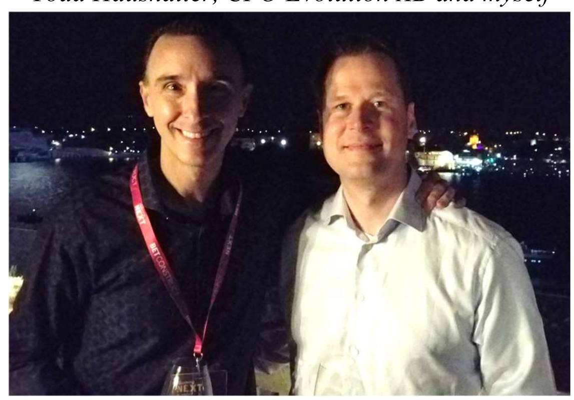
The quality of ideas is what defines long-term success for business owners. It is no secret that Evolution AB owns the best ideas in its industry by a wide margin. Nordstern Capital aspires to follow Evolution AB's example in owning the best ideas:

Two ideas:	Evolution	TOP SECRET
LTM P/E ratio[3]	60x	40x
Dividend Yield[3]	0.4%	0.4%

Earnings per Share – normalized to $1 in 2017



Party time in Malta:
Todd Haushalter, CPO Evolution AB and myself



The first idea is an old one for Nordstern Capital: keep owning Evolution AB for the long-term. The second idea is a fairly new one and will remain top secret (hence the name) for the time being. Why? Ask Todd…

"*Ideas when they are young, they are very fragile. They are really fragile.*"
- Todd Haushalter, Chief Product Officer at Evolution AB[2]

Durable long-term business success requires the right people, superior products, low or no competition, resilience, and continuous innovation. Those pillars of durable business success can be judged by gathering evidence, which in turn allows for estimates of future cash flow generation.

The sell-side industry is structurally hobbled by short-term thinking and provides no answers to any of the above. Nonetheless, to illustrate the potential of owning said two ideas, I would like to mention that the sell-side is forecasting a 38% earnings-per-share CAGR[4] for Evolution AB until year-end 2023 and for Top Secret 42%. Top Secret's management communicated its own expectations are to grow earnings-per-share at a CAGR of 50% over the next five years. If both ideas can deliver business success anywhere close to those predictions, then the Nordstern Capital partnership will be happy owners.

[2] Presentation at iGaming NEXT Valetta 2021
[3] CapitalIQ data
[4] CAGR = compound annual growth rate. Data from CapitalIQ

EMBRACER GROUP **Building a Platform of Trust**

"We are empowering people, and we are trusting people."
- Lars Wingefors, CEO Embracer Group[5]


Karlstad/Sweden: judging by the handshake trust is strong between Lars Wingefors (Wingeforce?) and myself

Platform businesses are the crème de la crème and market participants are paying outrageous multiples for anything that claims to be a platform business. Most successful platforms are based on technology and network effects, which can lead to substantial moats and durable profitable growth businesses, e.g. the FAANG[6] gang. The FAANG platforms are about 20 years old. Will the FAANGs still be the dominant platforms 30 years from now?

I want to argue that another type of platform could be even more powerful: a platform built on trust. Such a platform might be even more durable and ultimately more profitable. Let's call such thing a **Platform of Trust**.

The newest and latest tech companies, the smartest and youngest tech entrepreneurs are gnawing away at the FAANG's barriers every day. Who is to say that Facebook will dominate over TikTok 30 years from now? A **Platform of Trust** however can get stronger by the day. Genuine trust, genuine behavior, genuine relationships are reinforced through new episodes that are constantly adding to the experiences that led to the trust-building in the first place.

However, a **Platform of Trust** is the hardest to build. The one role model that comes to mind is, of course, Berkshire Hathaway, which powered by its **Platform of Trust** still runs among the world's top 10 largest companies and has been platforming along for way more than 50 years.

"It takes 20 years to build a reputation and five minutes to ruin it. If you think about that you'll do things differently."
- Warren Buffett, who just like Yoda does not need a title

Buffett can make great deals because the acquired companies are not foremost interested in the highest price. They sell to Buffett for other reasons as well. In addition, there are no negotiations. Buffett states his terms, take it, or leave it. The deal is made on a handshake. Why does this work? **Platform of Trust**!

Once built, a **Platform of Trust** has self-reinforcing mechanisms that strengthen the deal making: the right kind of entrepreneurs join with their businesses, the ones that you do not want to have, the short-term thinkers, the deal-price optimizers, they will self-select to go somewhere else.

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[5] Embracer Group 2Q2020 earnings call
[6] FAANG: Facebook, Apple, Amazon, Netflix, Google

Pennies

Embracer Group was essentially born in 2011 when Nordic Games acquired the assets of insolvent company JoWood, which stock-market capitalization had declined from €100m to 5€m. JoWood IPs (Spellforce, The Guild, Painkiller, …) churn out substantial cash flow for Embracer Group to this day. Even more valuable, Lars Wingefors also convinced Reinhard Pollice and Klemens Kreuzer from JoWood to join him in his journey. Both would become key in helping to scale the early business.

The next level comes in 2013 when video game giant THQ (market capitalization of $2.3bn in 2007), went belly up. The big boys of the time raided the corpse: Ubisoft, Take-Two, Sega, Gearbox, Koch Media, etc. all took over assets at the bankruptcy liquidation auction. Nordic Games was too small to get a seat at the banquet. However, some scraps from that feast were falling off the table, some games that nobody wanted. What the auction could not sell off, Lars Wingefors bought. Klemens Kreuzer and Reinhard Pollice were instrumental in revitalizing those assets with a very limited budget (the 'asset care' strategy). The IPs MXvsATV, Darksiders and Titan Quest alone racked in about €60m in sales and €40m in net contribution over the next four years[7]. And the assets keep on caring. One of those old IPs, Destroy all Humans!, was Embracer Group's best-selling game launch in the quarter just a year ago[8].

Aside from purchasing bargains, Embracer Group employs another characteristic acquisition strategy that is apparent repeatedly throughout its history: first, establish relationships, build mutual trust, gather insider knowledge, and then acquire once success is evident. E.g., in 2015 game developers started a Kickstarter campaign for 'This is the Police' and raised $35,508[9]. Nordic Games agreed to publish their game. At launch gamers loved it, 100,000 units were sold. 'This is the Police' was a proven success, trust had been established…and a few months later Lars Wingefors acquires it.

Dimes

In 2016 Nordic Games rebrands as THQ Nordic and IPOs at a stock-split adjusted SEK 3.33. The proceeds allow for moving up the ladder: bigger development budgets (up to about $15m), first attempts into self-developing IPs with the game ELEX, acquiring not only assets but also entire game studios. At this point THQ Nordic has 22 million game owners[10] on Steam[11].

In 2017 a **Platform of Trust** is starting to take shape. Studios with established relationships, proven success, and aligned interests are joining the group: Black Forest Games (developer of THQ's Titan Quest), Pieces Interactive (external contractor of THQ Nordic), Experiment101 (developer of the Gamescom award winning and THQ Nordic published game Biomutant) were all acquired.

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[7] THQ Nordic 2018 Capital Markets Day
[8] According to Nordstern Capital research
[9] https://hardcoregamer.com/videos/kickstarter-backed-this-is-the-police-receives-a-new-story-trailer/202115/
[10] THQ Nordic IPO Prospectus
[11] leading PC gaming platform

The first transformative acquisition (adding another business line) was the purchase of Koch Media Group in 2018 for €121m. Koch Media had a straight run of 23 profitable years, hundreds of employees, AAA-capable infrastructure, and owned a whole different league of IPs: Dead Island, Saints Row, Metro Exodus, etc. (the trailer for Dead Island[12] is still considered to be among the "10 mind-blowing game trailers that broke the internet"[13]). Despite Koch Media's remarkable past, 2017 had turned into a disaster. The group's huge Saints Row spin-off project Agents of Mayhem flopped and resulted in a €47m write-down. Koch Media's private owner, a game-industry outsider who was getting a bit long in the tooth, had enough. However, he also did not want to fire anyone[14]. Along comes Lars Wingefors who acquires the whole thing at 4-times EBIT[15]. Wingefors promised no major changes or layoffs and support and growth capital to the ambitious Koch Media CEO Klemens Kundratitz.

More asset care, more asset acquisitions, more studio acquisitions followed and more significant financial hits as well, such as Metro Exodus (THQ Nordics' first published AAA-game) or the cult title Wreckfest. Of course, after Wreckfest became a break-out success, developer Bugbear was acquired. THQ Nordic also published the Kickstarter-financed game Kingdom Come: Deliverance. The game was voted Best of E3 in 2015[16] and won the Best PC Game award at Gamescom in 2017[17]. It sold two million units in its first year. Sure enough, the developer Warhorse Studios joined the **Platform of Trust** in 2018.

The biggest coup of 2018, however, was the second transformative acquisition: Coffee Stain Studios, purchased for about $100m at 7-times EBIT[18]. The studio took off and Coffee Stain brewed (published) Embracer Group's highest return-on-investment games to date: Valheim, Satisfactory, Deep Rock Galactic[19]. In the three years since joining the group Coffee Stain's revenues grew 6-times. Truly galactic.

To illustrate the out-of-space quality of this studio: Valheim currently ranks #6 in Steam's All-Time peak concurrent player list, two spots behind Cyperpunk 2077, which is #4 and had development and marketing costs of $330m[20]. Valheim was overtaken last month by Amazon's big release New World, now ranked #5. Amazon provided its Game Studios a budget of $500m[21]. Valheim, however, was developed by a five-person studio and had practically no marketing budget at all. I know which return-on-investment I prefer.

Dollars

In 2019 the Wingefors machine accelerates to an extent that it becomes impractical to enumerate the laundry list of game launches, asset cares, IP and studio acquisitions. Same playbook as before, reinvest, feed the

[12] https://www.youtube.com/watch?v=lZqrG1bdGtg
[13] https://happymag.tv/10-mind-blowing-game-trailers-that-broke-the-internet/
[14] According to Nordstern Capital research
[15] https://embracer.com/wp-content/uploads/2019/09/Investor-presentation-THQ-Nordic-AB-acquires-Koch-Media-GmbH-b.pdf
[16] https://www.forbes.com/sites/erikkain/2015/06/18/best-of-e3-2015-kingdom-come-deliverance/?sh=14d9f889400e
[17] https://www.gamingnexus.com/News/39994/Kingdom-Come-earns-a-Best-PC-Game-award-at-Gamescom
[18] https://embracer.com/report/thq-nordic-ab-publ-acquires-coffee-stain/
[19] According to Nordstern Capital research
[20] https://gamerjournalist.com/how-much-did-it-cost-to-make-cyberpunk-2077/
[21] https://www.bloomberg.com/news/features/2021-01-29/amazon-game-studios-struggles-to-find-a-hit

machine, acquire trusted and proven successes for reasonable prices. Keep building a **Platform of Trust** and its reputation as the best partner in the industry for outstanding entrepreneurs.

In September 2019 THQ Nordic changes names and becomes Embracer Group and in February 2020 the first big ticket acquisition follows: Saber Interactive joins Embracer Group for more than $500m at 8.5-times EBIT[22]. Saber is highly respected for its quality work-for-hire: Halo, Quake, The Witcher. Everyone who has the slightest clue of video games has heard of these titles (btw. I can't wait for The Witcher Season 2 on Netflix[23], starting December 17). Saber owns a suite of proprietary tech solutions, for instance specializing in real-time massive player synchronization. When Saber joined the group, it employed 600 developers. Today, little more than a year later, the headcount has about tripled. Matthew Karch's own reputation and relationships resulted in a barrage of well-known studios joining the group. One of them is Aspyr, which announced the remake of the 2003 hit game Star Wars: Knights of the Old Republic (aka KOTOR) at a probable budget of $70 million[24]. KOTOR to this day is acclaimed among the best video games ever made.[25] Upon closing the deal, Saber's founders Matthew Karch and Andrey Iones became substantial shareholders in Embracer Group and today hold 13% of the voting rights (vs. 48% for Lars Wingefors).

In August 2020, Embracer Group marches into mobile gaming through the acquisition of DECA for about $100m at 12-times EBIT[26]. DECA traditionally specialized in a Nordic Games-type asset care strategy: acquiring relatively dated IPs albeit with a stable long-life user base, and then cost-efficiently revitalizing those games. This approach and the acquisition price paid might suggest that the DECA acquisition belongs to the previous chapter. However, DECA CEO Ken Go used the last year for an acquisition spree himself, commencing in CrazyLabs recently joining the group for around $500m. Embracer Group today serves 286 million monthly active mobile gamers (MAU)[27], more than Roblox[28], and has become one of the biggest mobile gaming companies in the world in only one year.

Next level up for Embracer Group followed in February 2021: Easybrain (sudoku.com) was acquired for $765 million at 11-times EBIT[29] and Gearbox (Borderlands franchise: >71m units sold[30]) on the same day for $1.4bn at 21-times EBIT[31]. Gearbox is a long-time partner of Take-Two Interactive (GTA franchise) and one of its most successful development studios. Gearbox had many suitors and offers from companies with market capitalizations 100-times bigger than Embracer Group. Why would a studio like that choose Embracer? **Platform of Trust**!

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[22] https://embracer.com/wp-content/uploads/2020/02/Saber-Interactive-Investor-Presentation-200219.pdf
[23] https://www.youtube.com/watch?v=TJFVV2L8GKs
[24] https://thedirect.com/gaming/star-wars-knights-of-the-old-republic-remake-aspyr-media-developer
[25] https://poptonic.com/play/video-games/kotor-revisited/
[26] https://embracer.com/wp-content/uploads/2020/08/Embracer-Group-acquires-DECA-Games.pdf
[27] Embracer Group 1Q2021 earnings report
[28] https://gamerant.com/roblox-monthly-users-record-may-2021/
[29] https://embracer.com/wp-content/uploads/2021/02/Easybrain.pdf
[30] Take-Two Interactive investor presentation August 2021
[31] https://embracer.com/wp-content/uploads/2021/02/The-Gearbox-Entertainment-Company.pdf

"We want to push boundaries […], but there is a limit to the margins of our own success. […] When we funnel resources and trust to creators […] value will emerge. And we have yet to even see how powerful this is. […] I am grateful that Lars exists. It never occurred to me that such a group could exist."
- Randy Pitchford, CEO Gearbox Entertainment[32]

Platform

Sell-side does not ascribe any significant synergies to the Embracer Group model. After an acquisition there is no cost cutting, employees and management stay the same, nothing changes. It is acknowledged by most that there could be some benefits from the group's global distribution, publishing, and marketing capabilities as well as from IP and tech and potentially resource sharing and debottlenecking. A strong argument for studios to join, access to growth capital, is also well understood. However, the sell-side and 'the market' sees Embracer Group primarily as a roll-up 'story' engaging in private-public arbitrage: buying private companies relatively cheap and paying with more expensive public shares. Aside from this supposed financial engineering, the Embracer Group model does not make much sense to such market observers.

Platform of Trust:

Embracer Group headquarters

The short-term thinkers, synergy apologists, and spreadsheet mongers lack the imagination of what a **Platform of Trust** can achieve. Every studio that self-selects to join Embracer Group is led by successful and highly ambitious entrepreneurs, all with their own strengths that made them into what they are. Saber has the best porting technology, Easybrain has the best user acquisition science, Coffee Stain's creativity is second to none, … everyone brings something unique into the federation of entrepreneurs. All become Embracer shareholders, all will pull together going forward. Weekly, monthly, and quarterly knowledge-exchange meetings are organized from Karlstad headquarters and a lot of cross-pollination happens directly from one entrepreneur to the other. Have some questions? Have some ideas? Need some help? You'll find it in the group, and everyone is happy to empower the others because all of them have a very significant amount if not most of their wealth in Embracer Group shares.

Another underestimated aspect of Embracer Group's model lies in the capital allocation superpowers of Lars Wingefors. It is widely understood that a significant contributor to Berkshire Hathaway's enduring success is that Warren Buffett pools all cash flows at headquarters and rules over capital allocation decisions of the empire. Well, the same happens at Embracer Group: every capital allocation decision over SEK 50 million (about $6m), be it game development or acquisitions or whatnot goes through Lars Wingefors, whose capital allocation track record thus far easily holds up to (…dare I say it?...) W.B. And just like in the oracle's empire, good ideas at the Embracer Group get access to practically unlimited capital, trust, resources, encouragement, and empowerment as well as full independence and responsibility. Every entrepreneur's dream.

Outsiders might not get it, but the insiders do. Easybrain, whose products easily range among the highest-margin and longest-duration mobile games in the industry, was shopping around for a cash-out, an IPO, or

[32] https://www.youtube.com/watch?v=UCPTe4Ycsvw&t=852s

the like. Higher purchase prices were presented to them than the one from Embracer Group. In addition, Lars Wingefors offered 50% cash and 50% Embracer stock. Then, days before the closing, Easybrain's CEO Oleg Grushevich calls up Lars and changes his entire premise for doing a deal in the first place: "Lars, we have known you now for four months. We don't want cash anymore. Please pay us 100% in Embracer shares"[33]. Deal!

"I think all of the entrepreneurs who are joining Embracer are not seeing it as an exit. They are seeing it as a launching pad."

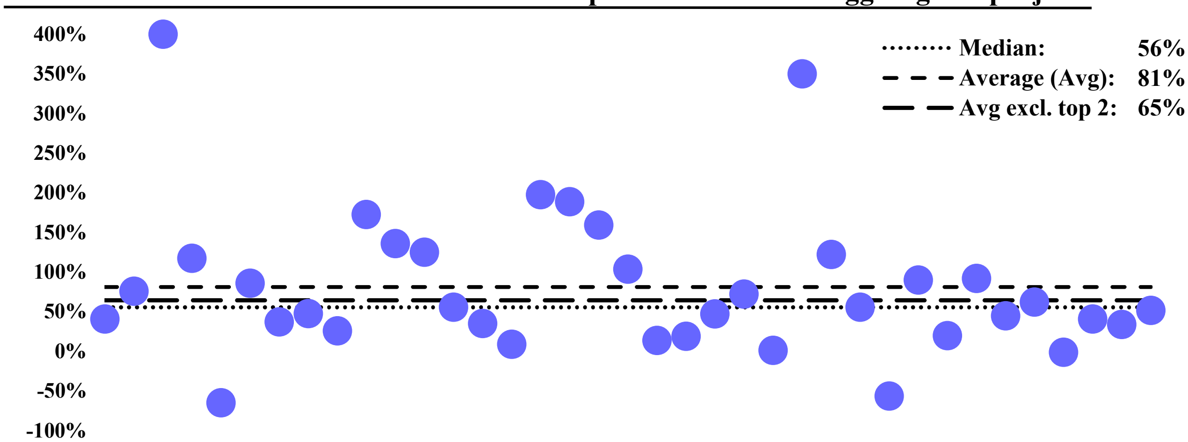
- Ken Go, CEO DECA Games[34]

Economics

Naval Ravikant outlined a recipe for building wealth: you need leverage. There are four forms of leverage: 1) labor (people working for you), 2) capital, 3) media, 4) code. Code and media have no marginal cost of replication and are the leverage behind many of the newly rich, but employing any of the four types of leverage can work wonders to create tremendous wealth.[35]

The video game business lends itself to exceptional unit economics. A video game company can make use of all four forms of leverage. As for Embracer Group, the unit economics are excellent. If we use the Embracer Group communicated[36] weighted average project contribution ROI[37] of 3.2 for the 37 biggest game projects, and simply assume three years of equally distributed development costs plus two years of profits after launch with 75% of the profits realized in year one, then the project IRR equals about 63%. Nordstern Capital estimates the median project IRR for the largest 37 projects to be close to 60%.

NORDSTERN CAPITAL estimates: Embracer Group's IRRs of the 37 biggest game projects



based on Embracer Group's June 2021 ROI data and Nordstern Capital's estimates for development and monetization profiles of each individual game.

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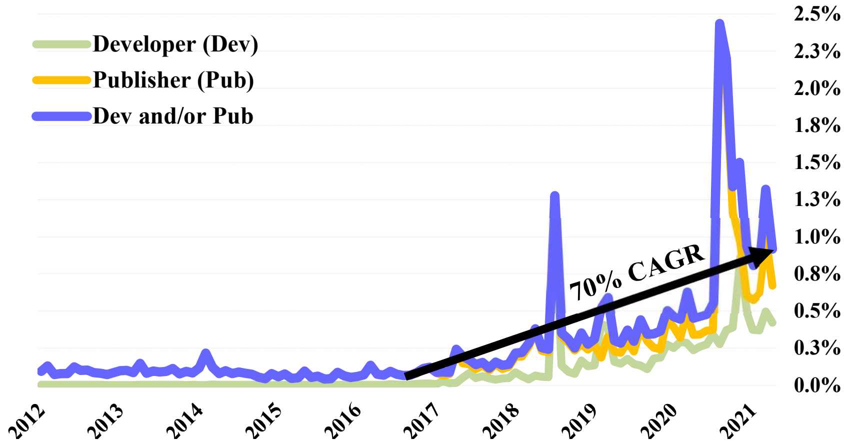
[33] According to Nordstern Capital research
[34] https://www.youtube.com/watch?v=UCPTe4Ycsvw&t=718s
[35] Jorgensen, Eric. *The Almanack of Naval Ravikant*. Magrathea Publishing, 2020
[36] Embracer Group 1Q2022 earnings presentation
[37] gross profit less marketing expenses / capitalized development costs

Newzoo estimates that the global video game TAM is $176bn in 2021 and will grow at around 9% CAGR[38]. Embracer Group's trailing twelve-month game revenue puts it at 0.5% market share. However, Embracer Group has close to zero exposure to the Chinese mobile gaming market. The history of Embracer Group's Steam player base gives some insights into its market share development.

NORDSTERN CAPITAL estimates: Embracer Group's Steam player share



Steam player share = Embracer peak players divided by total Steam peak players.

Close to 1% of all gamers on Steam were playing a game either developed or digitally published by Embracer in October 2021 on Steam.

Since January 2017 Embracer has been increasing player share on Steam by 70% per year.

It is apparent that Embracer is growing fast and still has a long way to go in its TAM.

Embracer Group's earnings per share have grown 14-times since its IPO five years ago, shares currently trade at 25-times last year's earnings. Revenues are expected to grow about 100% until March 2022.

Embracer Group has established a **Platform of Trust**. Its business exhibits excellent underlying unit economics and outstanding growth, and it has a humongous TAM runway ahead. In addition, Embracer Group demonstrates superb capital allocation…the force is strong with this one.

NORDSTERN CAPITAL

Nordstern Capital can flourish through our partner's trust, which is empowering Nordstern Capital to focus on decision making for long-term investment success, to ignore the market and stock price volatility. I am convinced that the dedicated focus on the long-term cash flow prospects of our businesses will result in better long-term investment returns, which will further increase our partner's trust into Nordstern Capital.

I encourage truly long-term oriented accredited investors to self-select into becoming partners in our own platform of trust.

May the force be with you,

Johannes Arnold

Johannes Arnold, Nordstern Capital Investors LLC

[38] https://newzoo.com/products/reports/global-games-market-report/

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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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