Sweetbay Capital Management, LLC

July 2021

Dear Fellow Investors,

One of the major lasting investment themes of the current generation is an effort to reduce carbon emissions in order to slow climate change, improve air quality and human health, and boost economic productivity. The Financial Times reports that nearly half of the global asset management industry has committed to a net zero emissions target. Funds are flowing to companies that are innovating in this area, so much so that market values of many environmentally focused companies are not supported by their fundamentals, in my judgment.

On the other end of the spectrum, some of the world's dirtiest companies are taking bold steps to decarbonize their operations. Their stocks languish with the stain of their carbon footprints. As these companies clean up, they should begin to attract the attention of the trillions of dollars of sustainable-focused funds. One such example is Vistra Corp, an electric utility once known as Texas Power and Light. Sweetbay began buying shares after they were battered in February by the historic Texas winter storm. Our investment thesis is described below, followed by a description of our other new holding, Roper Technologies.

New Investments

Vistra Corp (VST)

TXU/Energy Future Holdings, a Texas utility, was taken private by KKR in 2007 in what was then the largest ever leveraged buyout. The deal was 7x levered. As natural gas prices fell from $9/Mcf to $3/Mcf between '07 and'14, the company's EBITDA fell from $5 billion to $2 billion and debt swelled to $40 billion. Energy Future Holdings filed for bankruptcy in 2014 and emerged as Vistra Corp in 2017 with a clean balance sheet. Today Vistra has 4.6 million retail electricity and natural gas customers across 20 states and 38.5 gigawatts of generation capacity from natural gas, coal, nuclear, and solar. Half of its business is in Texas.

By consolidating electricity retailers and generation assets over three years through 2019, Vistra's EBITDA more than doubled on a per-share basis, and it generated $5 billion in free cash flow. But a major winter storm in February wreaked havoc on Texas, where energy infrastructure tends not to be winterized because of the typically mild temperatures. Gas, coal and wind generation assets froze, which caused the largest US blackout since 2003. The fallout has prompted political will for improvements to the power grid. In June, Texas Governor Greg Abbott signed into law two bills out of the state legislature that will, among other things, require weatherization of

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power generation assets. The Electric Reliability Council of Texas (ERCOT), which oversees the state's power grid, this month announced additional changes that will increase the resiliency of the Texas power market, including purchasing more reserve power during times of uncertain weather.

While that bodes well for the future, the storm cost Vistra $1.6 billion, or roughly half its 2020 EBITDA. The cold temperatures simultaneously led to a demand surge, and the combination of reduced supply and increased demand caused wholesale power prices to skyrocket. In its retail business, Vistra essentially bears the risk of wholesale price fluctuations while delivering a relatively stable price to its customers. Between its owned generation capacity and hedges, the company is typically able to manage an attractive spread between wholesale and retail prices. The February storm caused a dramatic inversion of that spread. More specifically, Vistra had contracted for natural gas at $3/MMBtu, but freezing temperatures hampered delivery by its third-party suppliers. Vistra was forced to pay as much as $700/MMBtu on the open market to feed its gas-fired power plants. The company spent as much on natural gas during the week of the storm as it typically spends in an entire year. Despite elevated costs, Vistra's operations performed well relative to its peers as it supplied 25-30% of power to the Texas grid during the storm, considerably more than its 18% market share prior to the storm.

The winter storm and the pandemic combined to lop off one-third of Vistra's share price, and we invested at 4x 2020 free cash flow. Including the storm-related losses, Vistra's net debt rose to 3.5x 2021 normalized EBITDA and will fall to 3.1x by year end. Compared to its US utility peers, Vistra is still 40% less leveraged and trades for half the EV/EBITDA multiple. Vistra also has $2.4 billion of available liquidity, conservatively staggered debt maturities, and nothing material due for the next two years. Because of its balance sheet strength, the board has prioritized the return of capital to shareholders. In the last three years, share repurchases and dividends together totaled $2 billion. Capital return on that scale is an intriguing element of the investment case considering the market cap was $8 billion at our purchase price.

Investors are clamoring for climate-forward companies and that sentiment is reflected to varying degrees in share prices. But changes by the heaviest polluters are equally important. According to the Sierra Club, Vistra is "the #1 emitter of climate-warming pollution in the US power sector." But its announced coal plant retirements are also the industry's biggest in history. It has already closed 16 coal and gas plants over the last decade, and it will shut two-thirds of its remaining coal capacity by 2027. Coal will fall from 29% of its generation capacity to 9% by 2030, and the company has set a target of net-zero carbon emissions by 2050. Its sites of decommissioned coal and gas plants are also valuable; many can be repurposed into cleaner forms of power generation using existing long-term interconnection agreements with grid operators that otherwise would be difficult to obtain.

Vistra is simultaneously becoming one of the leading battery storage companies in the world. Battery storage is an essential component of continued growth in wind and solar power generation because of their intermittency. Stored power can address peak demand when the wind isn't blowing and the sun isn't shining. At its power plant on the Monterey Bay in California,

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Vistra is currently building the world's single largest battery storage system, as part of a permitted expansion to 1.5GW of storage. That roughly equals all of the industry's combined installed battery storage in the US.

Management expects low-single-digit growth in EBITDA through the decade. That implies Vistra will be generating $4 billion of EBITDA in a few years, and perhaps with 25% fewer shares resulting from its allocation to share buybacks. It seems reasonable to expect a higher multiple as the stock is re-rated due to its improved carbon footprint. In that scenario, if it trades in line with large US utilities, each Vistra share would be worth multiples of the current price.

Roper Technologies (ROP)

Roper Technologies owns and operates a diverse collection of software and analytical solutions businesses and measurement and testing products businesses that serve niche end markets. Roper's larger businesses include Vertafore, the biggest software provider to the property and casualty industry; Deltek, the leading global provider of enterprise software to government contractors; and Managed Health Care Associates, the largest provider of software and analytics to long-term care facilities and pharmacies. Management believes most of the company's businesses have the #1 or #2 share in their respective markets. The total addressable markets for these businesses range from $100 million to $1.5 billion. Because of the small size of these markets, they are mostly left alone by large competitors. There are limited incentives to attempt to unseat entrenched providers of compliance software, or control valves for industrial refrigeration equipment, or timekeeping and billing software for law firms, or infection control products for ultrasound procedures.

CEO Neil Hunn and his team seek to acquire, in his words, "niche market leaders, [with] high gross margins, high levels of recurring revenue, and the ability to grow without consuming capital." Ultimately, management's goal is to compound cash flow by recycling cash generated by the portfolio companies into acquisitions of other businesses that meet Hunn's criteria. Rather than dilute the stock, the board typically uses cash and debt for acquisitions. Net debt / EBITDA is 3.8x due to a large acquisition in 2020, but the company's prolific cash flow generation will allow for quick deleveraging, as has occurred in the past. The leverage ratio should return to the long-term range of 2-3x within two years, depending on the pace of additional acquisitions. That Roper's CEO and CFO both have about 95% of their net worth in the stock is an incentive for effective capital allocation and a governor on risk. Roper retains management of its acquired companies, and fosters accountability by operating in a decentralized fashion, which keeps these management teams as close as possible to their end customers and to their operating costs. Roper compensates these management teams based on growth in EBITDA and improvement in balance sheet metrics for their respective businesses.

The strategy has been effective; Roper has realized 170% cumulative growth in earnings per share over the past decade compared to 63% for the S&P 500. Importantly, the portfolio has proven resilient during recessions. Free cash flow declined 15% and grew 5% in the 2009 and 2020

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economic contractions, respectively. Management has steadily improved the quality of the portfolio, most evident by converting 27% of revenue to free cash flow in 2020, up from 20% in 2010. That has culminated in per-share free cash flow growth of 11% annually over that time span.

At our purchase price, the shares traded for 23x estimates for 2021 free cash flow, in-line with their five-year average, but rich compared to their longer-term average. Part of the increased cash flow multiple is due to Roper's growing mix of software businesses in the portfolio, and part is due to rising stock multiples generally as a consequence of low interest rates. History has shown that benefits tend to accrue to businesses with these characteristics. We have established a position and we will use any weakness in the share price to increase our investment with the intent to hold for the long haul.

Please reach out to me directly with any questions about your account(s). Also note that Sweetbay is moving in August. Our new address is in the footer.

Cordially,
Ted Crawford

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