12/04/2020: Portfolio Updates & Some Ideas South Of The Border

Good morning Operators,

This week we added two names to our portfolio: Kura Sushi (KRUS) and Deutsche Bank (DB) January 2022 DOTMs. You can read our KRUS thesis here. The TL;DR version is that the stock is massively mispriced if the company executes on its plan to reach 295 US stores.

Collective members also got a kick out of the DB call play. One member said, "*This has to be one of the crazier trades I've seen in awhile!*" They're right. We snagged our calls at $0.28/contract.

In other news, Micron (MU) continues to plow ahead. It broke through $70/share and should close the week above its 2018 highs (see below):

MU had a power outage at one of its Taiwan DRAM fab locations Thursday (12/03). That's a big deal because MU's Taiwan DRAM fab represents 10% of global supply.

This hour-long outage strained supply chains and could lead to a bump in spot prices higher than previously indicated.

All good things for our MU equity and DOTM position (which has near 4x'd since our entry).

Finally, Versus Systems (VS) continues to execute on its growth strategy. The company's latest PRs include a potential uplisting on the NASDAQ and a new partnership with Sparx Technologies to provide live-TV real-world rewards.

Some Ideas South of The Border: Exploring Latin America

We *love* the Emerging Market (EM) bull thesis for Latin American countries. Alex did a *fantastic* job outlining why in his piece, *George Soros' Framework For Currency Markets*. Here's a snippet from the essay (emphasis mine):

> *"Understanding this, we'll know the time is ripe for the real start of the USD bear market when the trend in US tech begins to bend — which I suspect will come sooner rather than later.* ***That will mark the extinguishment of the final bullish USD supportive leg and the start of a new regime. One balanced by capital flows back to the periphery (RoW)*** *and a Vicious Circle for the US."*

Our bet is that we'll see capital flow from **Core** markets (US, developed, etc.) to **Periphery** markets (Emerging, Frontier, etc.). If this happens, emerging market stocks will *explode* on the back of capital inflows and multiple re-ratings.

We want our portfolio ready for this flow reversal.

That's why we're spending the next few weeks diving into Emerging Market companies in Brazil, Mexico and Argentina.

This week we'll dig into a new Brazil IPO, Companhia Brasileira de Distribuição (CBD)

Andale!

Companhia Brasileira de Distribuição (CBD): Hypermarkets, Cash and Retail

CBD is the largest Brazilian company engaged in business retailing of food, general merchandise, electronic goods, home appliances and other products from its supermarkets, hypermarkets and home appliance stores and second largest retail company in Latin America.

The company was founded in 1948 by Valentim Diniz. At age 16, Valentim immigrated to Brazil. Nineteen years later Valentim opened his own pastry shop in 1948. He named the shop Pão de Açúcar. It was the birth of what CBD is today.

From one pastry shop at 35, Valentim built the *largest* retail group in Brazil and the *second* largest retailer in Latin America.

Creating a Family Business

Like most emerging market companies, Pão de Açúcar was a family affair. Valentim's son, Alibio, started working for the company at 12. By 1959, Alibio graduated college and partnered with his father to open Pão de Açúcar's first supermarket store.

From there Alibio spent the next four months surveying European and American retail stores, learning the ins and outs of the business. Alibio returned from his trip and opened another super market. Then he bought competing supermarkets Quiko and Tip Top.

The family business innovated *well* before its time. It was the first supermarket located in a shopping mall. It was also the first supermarket to have a 24/7 pharmacy and its own data processing center.

Alibio walked away from the family business to focus on government work. He helped grow the company from one pastry shop to a small retail empire, which included:

- 8 supermarkets
- 26 hypermarkets (supermarket + retail store)
- 16 general stores
- One large warehouse

What Alibio didn't know at the time was that a few years later his father's company would need him more than ever.

Alibio's Time To Shine

Valentim, Alibio's father and founder of the family business, ran operations while his son served in the Brazilian government.

The year was 1990 when Brazilian president Fernando Collor introduced his "Collor Plan" economic reform. These new economic reforms put Valentine's company on the brink of bankruptcy. In a last ditch effort, Valentim asked his son to resurrect the flailing company.

I should note that a year before Alibio took the helm he was kidnapped in a political stunt by two Canadians. Nothing clears the mind like a good ol' kidnapping.

Alibio's first move as second-time CEO was implementing the "Cut, Concentrate and Simplify" plan. The company slashed costs wherever they could. This meant selling company headquarters and shrinking store-count by 364 (from 626 to 262).

Diniz managed to guide the company through financial and familial turbulence. In 1993 the Diniz family structured an agreement giving Alibio majority ownership in the company. Alibio's parents got 36.5% and his sister, Lucilia had the remaining 12%. This meant the majority of the company was in the hands of a misaligned family. Diniz wanted to run the business, but his father and sister weren't interested.

Taking The Company Public & Saying Goodbye

Alibio took the once lone pastry shop public four years after steering the company out of bankruptcy. Pão de Açúcar became the first 100% national controlled company to do an IPO.

It was around this time Alibio cashed out his stake in the business to French retail conglomerate Casino Group (CO.FR). Alibio sold his majority stake to CO for a cool $860M. Diniz the younger continued as chairman of the company where he served until 2013. He was replaced by his business partner Jean-Charles Naouri.

Lessons From Humble Beginnings

It's important to learn the history of Pão de Açúcar, now CBD. The company is a Brazilian landmark and the staple of success for the last two decades. From one pastry shop the Diniz family created generational wealth and multiple billionaires.

CBD's early founders laid the foundation for what is now one of the largest retail companies in the world.

Let's dig into what the company looks like today and what we think it's worth.

Pão de Açúcar: The Largest Food Retailer in South America

What was formally Pão de Açúcar's is now Grupo Pão de Açúcar (GPA). But the company trades under the name Companhia Brasileira de Distribuição (ticker CBD) on the NYSE.

CBD owns and operates over 1,500 retail stores throughout Brazil, Colombia, Uruguay and Argentina. There's three types of stores:

- Premium: Pão de Açúcar, Minuto, Carulla Fresh Market, Devoto and Mini Libertad
- Mainstream: Mercado Extra, Exito, Geant, Libertad
- Cash & Carry (self-service, bulk items): Assai, Supre Inter, SurtiMAX

The company owns 462 premium stores, 691 mainstream stores and 353 cash & carries. They command 16% market share in Brazil, 29% share in Colombia, 41% share in Uruguay and 14% share in Argentina.

The majority (65%) of CBD's stores are located in Brazil. In fact, there's a CBD store in every district and state.

Breaking Down Sales

CBD has two main sales engines: Multivarejo and Cash & Carry. Multivarejo includes supermarkets, hypermarkets, proximity markets (corner stores) and pharmacy/gas stations. Combined, the Multivarejo segment generates 42% of CBD's sales.

That means its Cash and Carry business, Assai, generates 58% of its total sales. For us non-Latam investors, it's best to think of Assai like a Sam's Club or Costco. And CBD's Multivarejo businesses as Whole Foods, Target or Wegmans.

The company is actually planning to spin-off its Assai business into its own public company. CBD shareholders will receive shares of the spin-co upon a successful spin-off. We'll cover that later.

Long Live Brazilian Brick & Mortar (Multivarejos)

Nearly every brick-and-mortar brand grew double-digit same-store-sales (SSS) QoQ. Pão de Açúcar grew its stores 30% SSS. Mercado Extra and Compre Bem grew SSS 18% and 36% respectively. The Minuto collection of stores grew SSS 37%. Extra Hiper stores grew SSS 7%.

Let's dive into each of the Multivarejo brands.

Mercado Extra

Mercado Extra benefited from store revitalizations, higher private-label sales and increased number of customers. Mercado continues to take market share in its regions as the company saw 580bps improvement in customer satisfaction.

CBD plans to renovate another 30 stores in Q4 2020 which should bolster sales and increase market share.

Compre Bem

Compre Bem caters to lower income shoppers (B & C income segments) with regional locations and lower-than-average prices.

Think of Compre Bem like an Aldi's or LiDL. Compre Bem stores offer >7,000 products focusing on butchery, produce and bakery. They operate a low-cost logistical model with perishable food items delivered straight to the store. The company also started an online store where consumers can buy online pick-up in store (BOPIS).

Combined, Mercado Extra and Compre Bem make up 6% of CBD's revenues.

Extra Hiper (17.6% of Revenues)

Extra Hiper stores have everything a consumer needs:

- Food (Perishable/Non-perishable)
- Home appliances
- Automotive supplies
- And more

Extra Hiper is like a Walmart. It's got everything you need. Yet you probably don't want to spend your entire weekend there.

CBD has 104 Extra Hiper stores across 16 Brazilian states. Extra Hiper breaks its stores into "high profit" and "low profit" stores. There's ~75% high-profit stores in operation and 25% low-profit stores.

High profit stores have unique characteristics like:

- High traffic locations
- High repeat purchases of perishables
- Simplified operating processes
- Optimized assortment of products

With the low-profit stores, the company either closes down or converts Extra Hipers into Assai shops.

Pao de Acucar (10.7% of Revenues)

CBD's Pao de Acucar stores are in the middle of complete renovation. This includes remodeling the physical stores and giving them an online presence / grocery delivery service.

So far the face lift is working. Refurbished stores generated 900bps *more* sales, 700bps *greater* volume and 500bps *more* customers.

The 46 renovated stores account for 41% of sales and 66% of EBITDA.

Proximity Stores (2.8% of Revenues)

CBD's Proximity Stores include:

- 86 Minuto Pão de Açúcars
- 153 Mini Extras
- 104 drugstores
- 74 gas stations
- Two smaller general stores

CBD saw solid growth from this consortium of stores in 2019. Revenues increased 15% on 3% customer growth while gaining 100bps in market share.

How can CBD's proximity stores generate 15% sales increases while growing customers 3%? Private label branding. The company sold 30% more private-label products through its proximity stores YoY.

Multivarejo Growth Levers

There's a few ways to grow sales and profits according to the company's latest Investor Presentation. On the sales side, CBD can expand stores into greenfield locations and rehab its existing stores. There's also e-commerce and food delivery which the company is *just starting to* implement. Finally, CBD's Multivarejo stores can sell more private-label products. 20% of their sales came from private-label last year. They should do >23% this year.

CBD can pull a few levers to grow profit margins, including:

- Converting/Remodeling old stores (+30bps increase)
- Reducing assortment of goods and optimize supply chain practices (+50bps)
- Close underperforming stores or convert those into Assai stores

Cash & Carry Business: Assai Spin-off Potential

The company announced a proposed spin-off of its Cash & Carry Business, Assai in September 2020.

Before we dive into the spin-off specifics, let's look at Assai's business economics.

Put simply, Assai is a tremendous business. The company needs little capital to grow, generates high profit margins and has a long runway to reinvest in its business at above-average rates of return.
Assai's grown sales 3.4x from 9B Real in 2014 to 30.3B Real in 2019. During that time they've expanded EBITDA margins from 4.2% to 6.3% and grow market share 740bps to 28.4%

What makes Assai a great business is that their stores get better as they age. For example, mature stores generate nearly 200bps *more* EBITDA margin. Couple this with CBD's new model design for the store and you have a twin engine of growth. New mature model stores generate 5.5M Real *more* per month in revenue than old model stores.

Assai wants to build another 60 stores in the next three years. They'll have ~196 stores by the end of 2020. So another 60 puts us at 256 stores throughout Brazil.

In doing so, Assai expects to reach 50B Real in revenue by 2022 (or $9B USD).

If all goes well, CBD investors will receive shares of Assai in Q1 2021.

A Call Option on Digital Retail Transformation

CBD was one of the first companies to introduce food delivery (1995) and loyalty programs (2000) in Brazilian retail. Thanks to COVID, the company's reaping the rewards of their digital-first strategy. CBD uses a 1P (first-party) and 3P (third-party) strategy:

- 1P: E-commerce via Multivarejo stores (Pao De Acucar & Clue Extra)
- 3P: GPA Marketplace

First Shot on Goal: 1P E-commerce

CBD has an excellent direct-to-consumer E-commerce business. They provide shoppers with next-day, same-day, BOPIS and next-hour food delivery. The company's E-commerce business accounts for 76.6% of Brazil's self-service market share. They've seen 240% YTD growth in E-commerce with a 202% increase in the number of new customers.

What's interesting about their 1P E-commerce business is the *James* app. *James* is Brazil's UberEats, DoorDash and GrubHub. *James'* vertical retail business has experienced *massive* COVID-growth, including:

- 1,238% GMV growth QoQ
- 689% increase in number of orders QoQ
- 70% growth in average ticket value

Second Shot on Goal: Apps

CBD has 14.5M downloads and 170M visits on its apps Cliente Mais and Clube Extra. This gives them a tremendous competitive advantage in the D2C E-commerce business as other food retailers can't match their customer base.

As exciting as their food e-commerce and app businesses are, they're not as exciting as CBD's 3P Platform.

Third Shot on Goal: The GPA Marketplace

GPA's Marketplace message is simple: "We have the greatest number of active and engaged customers in retail and you can sell more of your product if you partner with us on our platform."

The company wants to create a one-stop-shop platform for customers to purchase food and non-food items. Here's CEO of Multivarejas segment, Jorge Faical on the platform (emphasis mine):

> *"We have already signed more than a* ***dozen contracts with leaders in the Brazilian retail market, especially in terms of vertical categories, baby care, for example, automotive products, furniture, kitchen utensils, bed, bath and more.*** *And this, of course, will complement our proposal for food. So the marketplace will become a* ***very strong center of gravity****, and we are going to invite you for a presentation of our marketplace and how this will be impacting GPA going forward."*

The platform will combine specialty and generalist product desires. You can buy tires as easily as baby food. All in one place.

The glue that will hold this platform together is GPA's My Rewards loyalty program. It's all about creating positive virtuous cycles. GPA's Marketplace virtuous cycle looks like this:

Greater number of customers on platform → greater number of partnered retailers → greater assortment of products → greater number of customers on the platform

The company expects the platform to *start* at 240M visits. They'll have 10x more sellers on the platform in 2021 than they'll have in 2020. Finally, the company's estimating >400K products offered over the next 12 months.

Launching a 3P platform marketplace when you have 76% market share in digital food commerce is a good idea. The company has to do *very little* customer acquisition. Which means increased profits and greater margins than their competitors.

Culture & Leadership

GPA has a 3.7/5 rating on Glassdoor. 77% of employees would recommend the company to their friends. More importantly, 97% of employees approve of CEO Peter Estermann.

Estermann is a retail whiz with a passion for digital transformation. For example, Estermann became CEO of Via Varejo in 2015. The company was on the verge of losing billions. Estermann brought a digital-first mindset and prioritized e-commerce.

Over the next three years, Estermann took the stock from 1.03BRL/share to 8.81BRL/share. A cool 700% return.

Financials (September 2020) & Valuation

The company's revenue grew from 48.26% YoY to 79B Real. They did 21.45% Gross Margins for 16.95B Real with 3.37B Real in Operating profit (4.2% margin).

The last three quarters have seen LTM YoY revenue growth of 48.26%, 37% and 25.33%. We don't think they'll maintain these growth rates as COVID-related adoptions subside.

Let's look at the balance sheet. GPA has 7B Real in Cash, 11B Real in long-term debt and another 9B Real in lease obligations. This gets them ~13B Real in Net Debt and 3x Net Debt/EBITDA.

This is a good business. Is it leveraged higher than I'd like? Yes. But the company also has the largest food retail business in Brazil, millions of customers and ample insights into purchasing frequency. Given they not only survived, but *thrived* through COVID, their balance sheet seems safe.

That's why I was pleasantly surprised to find this business trading for 0.5 EV/Sales and 7.6x EV/EBITDA. It's surprising to see the largest food retailer with 76% market share in online food commerce trade for 0.5x sales.

Viewed another way, you can buy GPA's Multivarejo business segment (generating 33.34B Real in revenue) for 1.29 EV/Sales. That means you get the Assai business *for free*. It's a free call option on GPA's Cash and Carry business.

Risks

The largest risk with the long CBD thesis is that the Assai spin-off will be net-negative to shareholders. James Cherry wrote a good short pitch on Seeking Alpha. In it, he suggested the combined corporate expense of both separate companies will be higher than the current co's corporate expenses. Thus, shareholders lose in the end. While this may be true, the fact is shareholders will have two ways to play two dominant brands in Brazil.

Another risk related with the spin-off includes cannibalization of sales. GPA already has a plan in place to turn failing Extra Hiper stores into Assai stores. What's to stop the separate Assai company from taking greater market share from Multivarejo's collection of brands?

Finally there's country risk. A bet on CBD is a bet on Brazil's economy. The company generates nearly 75% of their revenue from Brazil. The remaining 25% is split between Colombia (19%), Argentina (2%) and Uruguay (5%).

Concluding Thoughts

CBD is Brazil's largest retailer and second largest retailer in South America. The company has over 14M customers using its digital apps and plans to roll-out a unique 3rd party omnichannel commerce platform with 400K SKUs. The company has 76% market share in digital commerce and has a footprint in every state and district in Brazil.

CBD is led by digital-first e-commerce specialist Peter Estermann. He's created an environment where 77% of employees would recommend their business and 97% of them favor the executive officer.

The company does have higher-than-average leverage, but we believe shareholders are more than compensated for that risk at the current 0.5x EV/Sales and 7x EV/EBITDA valuation. At the current market price, you can buy CBD's Multivarejo businesses for 1.29x sales and get the Assai business (one of the best Cash and Carry operations in Brazil) for free.

