XP, Inc. (XP): Building The Best Independent Brazilian Brokerage

XP is the largest independent broker in Brazil. It operates a technology-driven platform providing financial products and services. They offer 750+ investment products to 2.6M+ clients with R536 B in Assets Under Custody (AUC).

Brazil is the sixth-largest global economy and home to $8.6T in investable assets. Large institutional banks control 90% of those assets. Historically, those banks provided few investments generating fixed-income like returns. And for the past decade, that wasn't an issue as Brazilian bonds commanded ~15% yields.

Yet as interest rates decline, Brazilian investors face a choice. Do they keep their assets in large banking institutions offering fewer, lower-yield products? Or do they switch to a digital-first platform offering 750+ products with higher expected yields?

The data show Brazilians choose the latter. By 2024, non-bank companies will hold ~25% of *total* investable assets or ~R3.5T. That's 30% CAGR from 2019's R900B. In comparison, non-bank institutions in the US hold ~87% of investable assets.

Moreover, a mere 2% of Brazil's economically active population invests in stocks. As Brazil's largest independent broker, XP is first-in-line to capture new clients and generate sustainably high revenues and profits for decades to come.

There are four points to our bull thesis:

- **Interest rates have declined from 15% in 2015 to 5.5%**
- **Brazilians have increased their risk appetite in the face of lower interest rates as they search for higher returns.**
- **The big banks that control 90% of investment assets can't offer the products clients want in a low-interest-rate environment.**
- **Over time, trillions of dollars in client assets will flow from the banks to independent brokers.**

The current market price allows investors to pay ~34x our estimate of 2024 retail-only profits while getting the company's institutional, issuer services, insurance, and banking businesses *for free.*

Brazil's Structural Shift In Future Asset Allocation

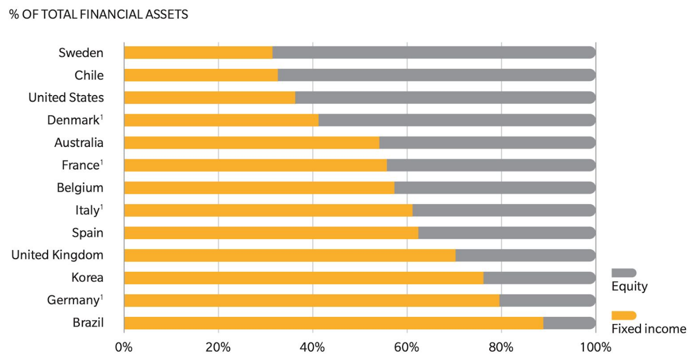
The most important aspect of the XP thesis lies in the structural changes inside Brazil's investment industry. The change will spark a **tectonic shift** in how Brazilians invest their assets and decide on investment products. The catalyst for this shift: interest rates. Historically, rates hovered around 12-15%. Those rates allowed Brazilians to invest in fixed-income products and generate above-average returns. At those rates, it made sense why so few Brazilians chose to invest in equities, given the country's above-average risk premium.

Brazil's most prominent banks thrived in this environment. They offered high-fee, fixed-income products to a captive customer base. Captive because Brazilian investors weren't happy with the big-bank product.

An Oliver Wyman report noted that in 2018 a mere 35% of respondents were satisfied with their banks' product offerings. But when you're getting 15%-per-year, why switch?

Today Brazil's interest rate sits at **5.5%**. Far from its 2015 peak of 15%. And a *much less* attractive deal to big-bank customers.

Exhibit 6: Evolution of investment asset mix – international comparison

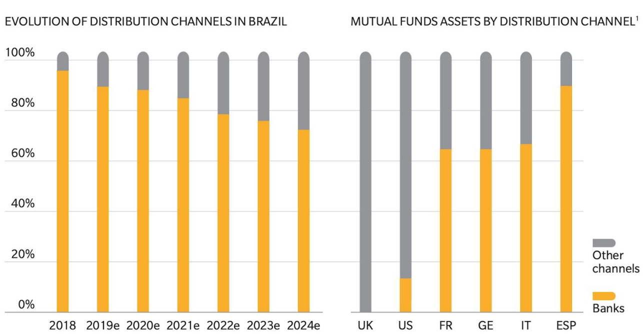


1. Data from 2017. Fixed income includes currency and deposits and securities other than equity; excludes mutual funds, pension plan and life insurance.
Source: OECD, Anbima.

Lower rates incentivize Brazilians to move from fixed-income to equity-like products. And they're doing it at a rapid pace.

In 2012, investors allocated ~25% of their assets into *Poupanca* savings accounts. By 2018 that percentage dropped to 20%. The same survey found that 61% of respondents would consider *never investing* in a *Poupanca* again.

Exhibit 7: Evolution of distribution channels



1. For banks, it includes both retail and private banking branches as well as online banking; it excludes networks of IFA belonging to the groups. 2017 data.
Source: ANBIMA, Valor, Infomoney survey May/2017, Financial Times, Platforum. Oliver Wyman analysis.

Only 3% of respondents mentioned *Poupanca* as a potential investment option. Despite the negative sentiment towards these cash savings accounts, a stunning R115B remains in them.

By 2024, XP expects independent brokers to control ~25% of investment assets. And its XP that should capture most of that growth.

The flow of assets from fixed-income to equity will take decades to unwind. Compared to its international peers, Brazil sports the highest fixed-income investment rate **by a mile**. The next closest country (Germany) has an 80/20 split between fixed income and equities. Brazil's is 90/10. On the opposite end, the US sports a 13/87 split.

Let's see why XP is ready to capture these shifts.

A 30,000ft View of XP's Business

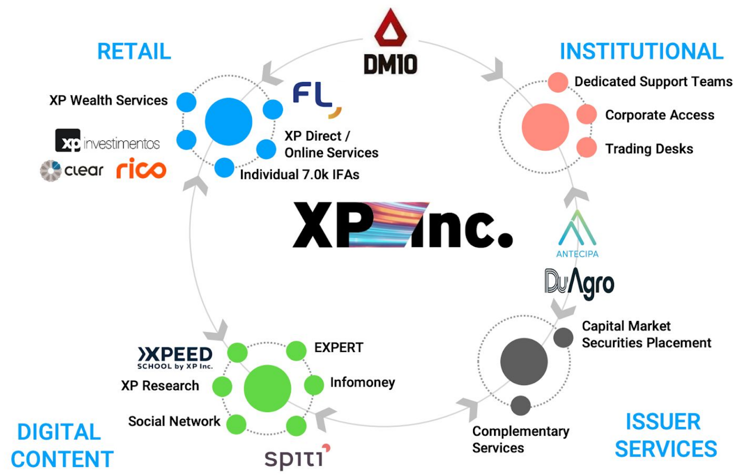
XP's core product, *XP Platform*, connects investors and advisors to 750+ investment products (not including equities). The company generates revenue through four channels: **Retail, Institutional, Issuer Services,** and **Digital Content.**

Let's talk about the company's retail segment. It's the most extensive retail trading business with a 28% market share in custody and a 57% market share in trading volume. XP splits retail into three categories: *XP Investimentos, Clear,* and Rico.

XP Investimentos caters to Brazil's growing network of independent financial advisors (IFAs). Advisors connect their company's operations to XP's backend to offer their clients a suite of 750+ investable products.

They offer traditional trading services to its 2.6M client base via *Clear* and *Rico.* Both are full-service, zero-fee trading websites.

Retail is the company's largest segment, generating 72% of total revenue in 2019. XP earns this revenue through management fees, commissions, rebates, spreads, and placement fees.



XP's Institutional business ranks first in FX & Rates products, interest rate options, corporate debt trading, to name a few.

Their clients include family offices, pension funds, insurance companies, and asset managers. The institutional business accounted for 15% of revenue generated via commissions, spreads, and placement fees.

Though a mere 6% of revenues, XP's Issuer Services segment is an industry leader. It ranks first in every major category, from REIT/FIDC structuring to securitizations and IPO structuring. Issuer Services generates revenue through underwriting/advisory fees.

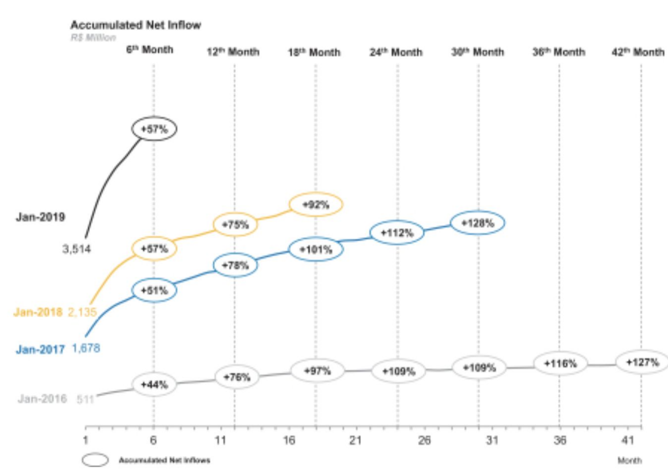
Its final segment, Digital Content, generates ~2% of revenue and acts as a low-cost customer acquisition channel via financial education content.

There are a few main ways XP can generate revenue:

- Offer new products to invest in the client's existing AUC on the platform.
- Get "new money" from existing clients as they gain a deeper wallet share.
- Attract new clients through their omnichannel offerings like Digital Content.

Why XP Wins: An Easy Choice For Clients

Brazil's investment clients have two choices. Choice A is investing through a traditional big-five bank offering a few fixed income products at high fees.



The banks can't help but offer inadequate products at higher costs. They must maintain asset-heavy legacy infrastructures and a plethora of brick-and-mortar branches.

This higher cost burden pushes the bank towards offering only its in-house products, like *Poupanca* accounts.

Instead of giving that margin to clients in lower fees, the bank uses it to pay overhead. What's left is a limited product assortment and a deflated customer.

Then there's Choice B. Choice B gives you 750+ potential investments at your disposal through a digital-first open platform. And if you have a large enough account, a personal financial advisor.

Choice B gives you access to higher-yielding products like equity markets and new IPOs, something your old bank didn't offer. Unlike the big banks, Choice B obsesses about their customers. The digital-first platform allows them to provide the lowest prices and pass on the savings to you, the customer.

Millions of Brazilians will make this choice in the coming decades, and the choice is clear. Clients will choose Choice B. And we see that in XP's customer data.

The company's grown active clients at a 71% CAGR and increased assets under custody at an 85% CAGR from 2016 - 2019. By the end of 2019, XP accounted for 45% of *all* non-bank investment assets in Brazil. Most important, customers are *happy* with their decision. XP has a 70 NPS rating making it the world's highest-rated broker.

What's The Size of The Prize?

Unwinding an entrenched, conservative investment philosophy takes time (years, not quarters). By 2024 XP estimates non-bank institutions will control ~25% of a *much larger* investment asset pie (~R13.8T by 2024). That gives us ~R3.45T in assets held by non-banking institutions within five years.

How much can XP grab from that 25%? In 2019 the company captured a 4.7% market share of **all** investable assets and 45% of **non-bank** investment assets (R409B AUC). In Q3 2020, XP had R563B in AUC. If we assume 2020's projections are accurate for total investment assets (R9.5T), XP's market share would've increased to ~6%.

Let's paint two potential outcomes. First, let's assume XP maintains ~6% market share in total investment assets by 2024. Doing so gets us R828B in AUC. We can estimate revenues and net income from here via take rates. XP has a ~1.2% take rate on retail assets.

Assuming they maintain that take rate, the company would do ~R10B in retail revenue alone. Suppose they do ~21% net margin (average since '16) on that revenue, and you get R2B in net profits. And remember, **that's only on retail assets**.

Our second outcome assumes XP keeps its ~45% market share in *non-bank investment assets*. That gives us **~R1.55T in AUC**. At a 1.2% take rate, the company would generate R19B in revenue and **R4B in net profits on retail assets**.

Those estimates assume 25% non-bank penetration rates. Globally that percentage skews *much higher* towards non-bank entities. For example, US non-banks control ~87% of investable assets. In other words, 25% asset share isn't a ceiling for Brazil's non-bank companies. I've extrapolated the above scenarios until 2030 for both total market share and non-bank market share, which you can see below.

Total Market Share Approach

TOTAL MARKET SHARE APPROACH							
	2024	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**
INVESTMENT ASSETS	$13,800.00	$15,042.00	$16,245.36	$17,382.54	$18,425.49	$19,346.76	$20,120.63
	10.00%	9.00%	8.00%	7.00%	6.00%	5.00%	4.00%
NON-BANK MARKET SHARE	25.00%	27.00%	29.00%	31.00%	33.00%	35.00%	37.00%
NON-BANK ASSETS	$3,450.00	$4,061.34	$4,711.15	$5,388.59	$6,080.41	$6,771.37	$7,444.63
XP TOTAL ASSET SHARE	6.00%	7.00%	8.00%	9.00%	10.00%	11.00%	12.00%
XP AUC (B)	$828.00	$1,052.94	$1,299.63	$1,564.43	$1,842.55	$2,128.14	$2,414.48
XP TAKE RATES	1.20%	1.18%	1.16%	1.14%	1.12%	1.10%	1.08%
XP REVENUE (B)	$9.94	$12.42	$15.08	$17.83	$20.64	$23.41	$26.08
XP NET MARGIN	21.00%	21.00%	21.00%	20.00%	20.00%	20.00%	20.00%
XP NET PROFITS (B)	$2.09	$2.61	$3.17	$3.57	$4.13	$4.68	$5.22

Non-Bank Share Approach

NON-BANK MARKET SHARE APPROACH							
	2024	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**
INVESTMENT ASSETS	$13,800.00	$15,042.00	$16,245.36	$17,382.54	$18,425.49	$19,346.76	$20,120.63
	10.00%	9.00%	8.00%	7.00%	6.00%	5.00%	4.00%
NON-BANK MARKET SHARE	25.00%	27.00%	29.00%	31.00%	33.00%	35.00%	37.00%
NON-BANK ASSETS	$3,450.00	$4,061.34	$4,711.15	$5,388.59	$6,080.41	$6,771.37	$7,444.63
XP NON-BANK ASSET SHARE	45.00%	44.00%	43.00%	42.00%	41.00%	40.00%	39.00%
XP AUC (B)	$1,552.50	$1,786.99	$2,025.80	$2,263.21	$2,492.97	$2,708.55	$2,903.41
XP TAKE RATES	1.20%	1.18%	1.16%	1.14%	1.12%	1.10%	1.08%
XP REVENUE (B)	$18.63	$21.09	$23.50	$25.80	$27.92	$29.79	$31.36
XP NET MARGIN	21.00%	21.00%	21.00%	20.00%	20.00%	20.00%	20.00%
XP NET PROFITS (B)	$3.91	$4.43	$4.93	$5.16	$5.58	$5.96	$6.27

Averaging the 2030 results gets us ~R30B in revenue and ~R5.75B in net profits.

XP's Other Shots on Goal: Insurance & Digital Banking

XP has two other shots-on-goal that, if successful, could become monster businesses on their own. Those shots are **insurance** and **digital banking**. In 2019 the company created its own insurance business for pension, life, and other insurance products.

They quickly scaled to R10B in AUC while receiving 20% of new market inflows. Said another way, XP's insurance arm has captured $0.20 for every $1 of new insurance flows. Another driver for the insurance business is the transfer market. Transfer clients move investment products between insurance companies.

Since its inception, XP has captured ~55% of the total transfer market. That's $0.55 for every $1 of transfer insurance investment assets. Brazil's insurance industry is an R1T market. XP has ~1% market share while the leading player commands 30%.

Our second shot on goal is XP's banking business. The company received its full banking license during 2H 2019. XP will create new products like credit cards, cash solutions, and digital payments. Credit cards alone are an R284B business, and the top five banks hold 80% of the market.

Together, XP's other shots represent an extra R5.3T market opportunity.

What Do We Get At The Current Market Price?

You're paying ~33.75x our 2024 estimate of retail net profits at the company's current R135B EV. In other words, you get XP's institutional, issuer services, insurance, *and* banking businesses **for free**. XP's other companies *are certainly* worth more than $0. But the right-tail of that distribution remains impossible to measure with any level of precision.

Concluding Thoughts

Bearish commentators fixate on relative valuation to US-based peers. This over-valuation argument fails for a couple of reasons. First, Brazil's brokerage industry is proliferating while US peers reach maturity. Also, XP's brand commands more considerable customer mindshare than its US peers. When Brazilians think brokerage, they think XP. In the US, the word "brokerage" triggers 3-5 different companies.

Our XP thesis is simple:

- **Interest rates have declined from 15% in 2015 to 5.5%**
- **Brazilians have increased their risk appetite in the face of lower interest rates as they search for higher returns.**
- **The big banks that control 90% of investment assets can't offer the products clients want in a low-interest-rate environment.**
- **Over time, trillions of dollars in client assets will flow from the banks to independent brokers.**

One potential gripe with this thesis is that we're "betting on interest rates." After all, it is our first domino in the sequence.

Interest rates are the catalyst that will spark the transition from fixed-income, bank-led products to higher-yielding independent investment offerings.

And since clients can invest in fixed-income products within XP's platform, rising interest rates shouldn't increase customer churn. Why go back to the big banks when you can get the *same* fixed-income product at a fraction of the cost?

To conclude, XP is at the forefront of a country-wide shift in asset allocation. As Brazil's largest independent broker, the company is well-positioned to capture most of this asset flow. If correct, XP will generate significant revenue and earnings at high CAGRs for years to come.

