05/07/2021: Earnings Review For XP, NTDOY, and RKT

We had a few portfolio companies report Q1 earnings this week -- most notably XP, Inc. (XP), Rocket Company (RKT), and Nintendo, Inc. (NTDOY). Unfortunately, as the story goes this quarter, even the most optimistic, face-ripping earnings beats ***still*** gapped lower.

The critical thing to remember is that the long-term fundamentals of each business remain unchanged, and in most cases, have improved during the quarter.

We'll see each company's earnings release, its impact on the long-term drivers of each business, and how we're thinking about allocating capital to each name going forward.

Let's start with XP, Inc.

XP, Inc (XP): Crushed Earnings & Continues To Take Market Share

XP crushed earnings. The company grew Assets Under Custody (AUC) 96% YoY to R 715B, generated R 2.68B in net revenue (+R 1B QoQ), and increased adjusted net income 104% to R 846M.

Massive growth stems from its ability to attract and retain Brazilian users as they search for ways to generate higher yield on their capital.

Our bull thesis boiled down to four main points:

- **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.**

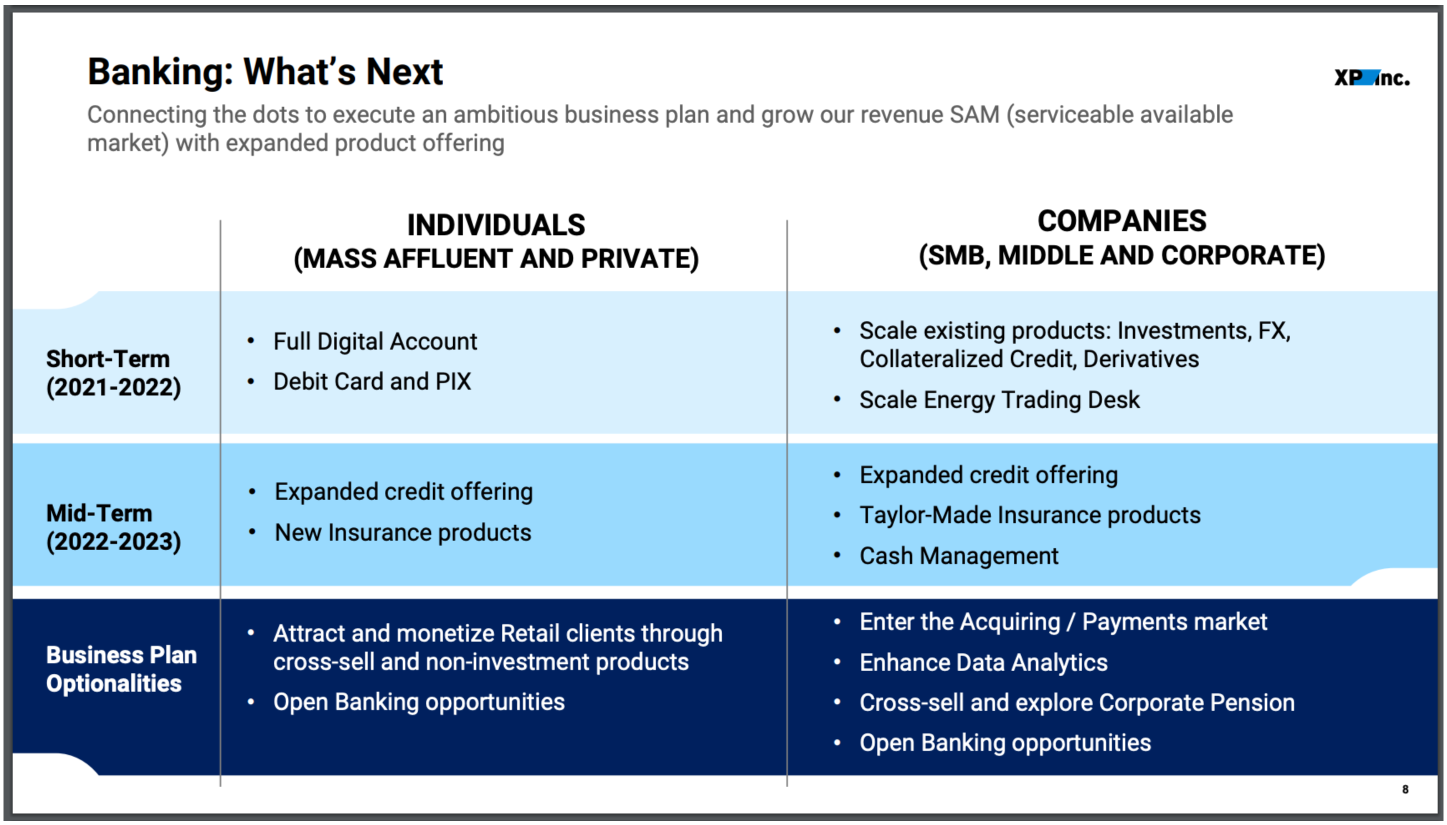
You can read our entire write-up here.

There are a few key points to highlight from this quarter's earnings. You can follow along by reading the presentation here.

Key Point 1: XP’s Banking Business Starts Strong

One of XP’s shots-on-goal is its banking division. Last year the company received its banking license, allowing its customers various banking solutions like debit/credit cards, loans, and savings accounts.

For example, the company released its *XP Visa Infinity* credit card this year and delivered stronger than expected sign-ups. Below is XP’s short/long-term plans for its banking segment:



The exciting part about XP’s banking business is that we’re not paying for it in our estimated valuation. Here’s a snippet from our write-up explaining how (emphasis mine):

> *“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.”*

Key Point 2: EBITDA Margins Expanded 500bps

XP expanded EBITDA margins from 34% to 39% QoQ. It’s always a good sign when a company increases EBITDA margins, but XP’s is particularly telling. The company spent **gobs** of capital this year on technology, product development, and hiring.

For instance, XP increased its headcount by 64% from last year *and still* generated 500bps higher EBITDA margins. This further proves the company’s scalable business model.

Key Point 3: #1 Market Share in Retail & Growing Share in Insurance

XP maintained the #1 market share in the Retail Equity Market Share. In addition, they control 33% of the custody market and represent 56% of the total trading volume.

Second, the company is aggressively taking market share in its new insurance business. Here is Bruno Constantino dos Santos' take on the market share expansion (emphasis mine):

> *"Also, our insurance company is new. It was, as you know, established in 2019, and we have only 1.6% of market share in terms of assets under custody. But despite that -- and we are talking here about more than BRL 1 trillion segment. Despite having only 1.6% in March, for example, we had an 88% market share of the transfers in this segment. So we've been growing a lot. But still, we have a lot more to grow considering our market share in terms of custody."*

Again, we're getting this insurance business for free for what we're paying in 2024 retail business core earnings. That's nuts.

Breakout From Lower Bound Support

Against historical norms, XP *gapped up* on the upbeat earnings announcement, rising nearly 14% intraday. We haven't moved our stop-loss closer because we don't want to get stopped out by average volatility around earnings.

XP is a ~5% position at cost. Eventually, we want to make it a core, 10% position but will wait patiently for another entry point.

Nintendo, Inc (NTDOY): Conservative Projections Lead To Unwarranted Sell-off

NTDOY reported its FY results today and issued guidance for FY 2022. The company shipped 28M Nintendo Switch Units this past year. Next year they're estimating 22.25 - 25M in Switch unit sales.

It's important to note that NTDOY *habitually* underpromises its financial projections. This makes it impossible to gauge where they'll fall within the bounds they set.

The company increased revenue by 34%, operating income by 81.8%, and net profit by 85.7% with online/digital subscription revenue driving most of the YoY gains.

In addition, digital revenue is a higher-margin business than console sales. This translated into YoY increases in EBIT margins by 9.5% and NOPAT margins by 7.5%.

	FY20		FY21		Comparison	
Net sales	1,308.5	bn yen	**1,758.9**	**bn yen**	+34.4	%
Operating profit	352.3	bn yen	**640.6**	**bn yen**	+81.8	%
Operating profit ratio	26.9	%	**36.4**	**%**	+9.5	pt.
Ordinary profit	360.4	bn yen	**678.9**	**bn yen**	+88.4	%
Net profit	258.6	bn yen	**480.3**	**bn yen**	+85.7	%
Net profit ratio	19.8	%	**27.3**	**%**	+7.5	pt.

I like the fact that NTDOY underpromises projections because it allows us to potentially grab shares at lower prices. For example, today's sell-off brough the company down to ~11x ex-cash earnings. Said another way, you're paying 11x current earnings while assigning ***all the cash in the bank*** a $0 value.

It's not often you find a company with the brand/IP of a Disney (DIS), growing like an early-stage SaaS business, while trading like a beaten-down shipper. Yet NTDOY has it all.

We'll look to add if price continues higher into the end of the week/early next week. The stock is a ~6.5% position and we'd like to get it to 10-15%.

Rocket Companies (RKT): Crushes Earnings & Crushed Stock Price

RKT crushed earnings. Take a look at a few highlights:

- *Grew revenue, net to $4.6 billion, up 236% year-over-year*
- *Increased Adjusted Revenue to $4.0 billion, up 91% year-over-year*
- *Grew net income to $2.8 billion, up 28x year-over-year*
- *Increased Adjusted Net Income to $1.8 billion, up 170% year-over-year*

The company set a record for virtually every financial metric it tracks. This makes sense given the craziness we've seen in the housing market. And like I said in our original write-up, these figures are likely future quarters (even years) of pulled-forward returns.

Massive increases in revenue and earnings allow RKT to reinvest back into its core business, sales and marketing, and Partner Network development. These spending advantages put RKT *miles* ahead of its competition.

You can learn more about RKT's competitive advantages in our original write-up here.

For example, the company saw a 300% increase in visits to its Rocket Homes' real estate listings. RKT is in firm position to maintain front-of-mind market share for home buyers searching for a mortgage application service.

Here's the wild part about Mr. Market, though. He didn't care *one lick* about the above growth in revenue and income. RKT *missed* analysts' EPS estimates by $0.01 and the stock crashsed 16%!

At $19/share the company trades for ~11x one quarter's net earnings. Again, there's pull-forward returns here. But no matter which way you look this company screams **cheap**.

Given the violent price drop, I'm expecting RKT management to step up and buy shares on the open market **in droves.** Buy backs at the current price is one of the highest-returning capital allocation decisions they can make.

Another (more conservative) option is to hold the cash and ride out the inevitable mortgage cycle nightmare that will come from today's manic buying. I'm sure RKT will churn through *plenty* of bad mortgages over the next couple of years.

Looking For A Spot To Reduce Our Cost Basis

Our initial stop was wide enough to keep us in the trade despite today's -16% decline. Currently RKT is a ~3% position at cost ($24). We'd like to get that to *at least* 5% over the coming weeks. Ideally, we'd wait for consolidation at these lower levels and enter on a breakout from that range.

