MO Weekly Equity Note: 07-03-2021

Managing Ammo, Inc. (POWW) Position & Our New Research Process

Operators,

Happy July! We at the MO team wish you a happy and safe Fourth of July Weekend for our US-based Collective members. We hope you pop some fireworks, throw good meat on a grill and enjoy time with family and friends.

This weekend we're focusing on two things:

1. Ammo, Inc. (POWW) latest earnings report
2. Our evolving equity research process

Also, be on the lookout for our quarterly portfolio review which should hit your inbox next weekend.

Grab a cup of coffee, and let's get after it.

Ammo, Inc (POWW): Another Great Quarter In The Books

POWW reported its Q4 2021 earnings last Tuesday (06/29) and killed it. Here are the highlights:

- Increased revenue 409% QoQ to $24.2M
- Expanded Gross Margin to 23%
- Increased Adjusted EBITDA 269% to $4.8M
- Increased revenue 300% YoY to $62.5M
- Operating Expenses decreased 61% YoY

The most important takeaway from POWW's earnings report is that **we're *finally* seeing operating leverage** as the company dramatically grew revenues while shrinking operating expenses.

POWW made significant investments in manufacturing to meet product demand. These one-time investments distorted short-term unit economics and made investors question whether POWW could generate industry-leading operating margins.

So far, POWW's resolved those questions with a definitive **yes**.

Speaking of investments, POWW recently completed its acquisition of GunBroker.com, the world's largest online gun marketplace. GunBroker.com is a ~75% EBITDA margin business. The more revenue POWW can generate through GunBroker.com, the higher its aggregate operating margin.

I had a chance to ask management about the company's margin runway and where they see run-rate margins going forward. Here was their answer (emphasis mine):

> *"Our margins are growing rapidly, as you can see from our financial statements and we expect them to do so in this next fiscal year, with the addition of GunBroker.* ***Historically, they were kicking off gross margins at approximately 87%. And with the growth in the margins we've had just from the loading operations over the past year, we've been able to increase our margins by 170% in the next fiscal year.*** *And to answer part two of your question, we really look at the revenue mix of our next fiscal year broken out one-third to GunBroker and two-thirds to our loaded ammo operations. And we previously announced guidance of* ***$190 million.****"*

There are many exciting opportunities with GunBroker.com, one being the low-hanging fruit of ammunition sales on the platform. Management noted that ammunition sales comprised ~3% of GunBroker's total revenue.

POWW can leverage GunBroker to sell their ammunition direct-to-consumer. In doing so, they'd remove middle-man costs from third-party retailers and generate incrementally higher margins.

We **did not** predict POWW's potential transformation into a marketplace business in our original thesis. Yet, management created such optionality. What happens when Mr. Market views POWW more as a marketplace than a commoditized manufacturer of ammunition?

The company issued guidance for ~$190M in revenue next year, giving POWW a ~10x EV/NTM Sales valuation. Should POWW hit its guidance, it would mark *another* year of 200%+ revenue growth. Moreover, the company *should* hit *full-year* EBITDA profitability for the first time this year.

Today the company comprises nearly 17% of our portfolio. And while we're increasingly bullish on the business's long-term prospects, we're mindful of this single factor risk. So, here's how we're thinking about managing the position.

Managing Our POWW Position: Trim Equity & Selling Puts

We're taking a two-factor approach to manage our POWW investment. First, we're using this week's upside volatility to trim our equity position from 17% to 10% notional exposure. Doing so locks in long-term gains and reduces our cost basis.

Next, we'll look to sell puts at significantly lower prices (think $7/share). We'll wait for a big down day to sell our puts to lock in the highest IV possible.

Selling puts creates a win-win (or Pabrai's "Heads, I win. Tails, I still win") outcome for our portfolio. Here's how.

Say we have a 10% notional position in POWW and sell puts around $7/share. If the stock trades down to $7/share, we buy shares in a business we *love* at desirable prices with a lower cost basis (share price - premium received).

The second option is the stock trades higher and never reaches our put strike price. In this scenario, we keep the premium on our puts. We enjoy significant capital appreciation on our considerable notional equity exposure.

Expect a trade alert Tuesday for our POWW equity trim.

Next, we'll discuss our new revamped investment research process at Macro Ops. In short, we've narrowed our target by focusing *only* on the three most important types of research for long-term investment success.

The MO Investment Research North Star: Hyper-Focused Only On What Matters Most

There are 64,000+ global stocks in the investable universe. Even if we narrow our focus to only North American stocks, we still have 16.8K potential investments.

Our most significant edge in such an expansive universe isn't finding the best investments but in saying "no" faster than anyone else. The quicker we say "no," the sooner we can arrive at a *truly excellent* investment opportunity.

I wrote about this idea in an essay called *Boredom: An Investor's Last Remaining Edge?*. Here's a snippet from that piece (emphasis mine):

> *"Better outcomes occur when you say "no" more and wait for the "HELL YES" ideas.*
>
> *Saying "no" takes practice. It takes patience. It takes an unnatural ability to sit in a room alone for fifteen minutes and not hurt yourself. T**he best investors aren't the best because they have a differentiated method of finding new (and better) ideas. They're the best because they can do what so many of us can't: sit with their thoughts and be okay.***
>
> *As Charlie Munger says, "It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."*
>
> *The best investors show up to the market, sit down, and don't shock themselves. **They like the boredom because they know it's the boredom that precedes the next best idea.**"*

Knowing this, we can construct an investment research process that harnesses the power of boredom while constantly studying the best companies on the planet.

We've developed such a process at Macro Ops. Our research will revolve around three buckets:

1. **Companies with 3-5x return potential trading at currently actionable prices**
2. **The world's best (and relatively unknown) businesses trading at currently high, uninvestable prices**
3. **Case Studies and Evergreen Theory**

Let's review each bucket in greater detail.

Bucket 1: 3-5x Return Potential Trading At Actionable Prices

Life is too short to write about businesses that don't have the potential to return 3-5x our money in 3-5 years. We want ideas that generate the highest return not only on our capital but our time.

Bucket 1 pairs a potential 3-5 bagger with an attractive price *today* (or at the time of writing). We can further break down this bucket into three types of trades: **Strategic, Tactical,** and **Special Situation** Examples of these ideas include Ammo, Inc. (POWW), Redfin (RDFN), and Antero Resources (AR).

Strategic trades include potential long-term compounders with easily identifiable moats. The moats can range from patented products (POWW), structural network effects (RDFN), valuable Intellectual Property (NTDOY), or a highly scalable unit economic model (KRUS).

Tactical trades combine structural catalysts with shorter time frames. A great example of this is a commodity-linked company at the inflection point of a supercycle. Think Antero Resources (AR) and natural gas. You can achieve 3-5x returns if you time a commodity-linked inflection point with a healthy company in that industry.

Finally, **Special Situation** trades are call option-like bets in bleeding-edge companies at the frontier of their industries. Think of these trades like venture capitalists. Low win rates but extremely high payoffs.

The critical point to remember about the first bucket is these ideas trade at prices that **currently reflect a great buying opportunity.**

Bucket 2: The World's Best (And Unknown) Businesses Trading At Expensive Prices

We know 3-5x investment opportunities don't come around often. Enter Bucket 2. This bucket includes research on the world's best (and relatively unknown) businesses currently trading at high prices. We're talking about the world's best **Strategic** companies.

These stocks *should* typically trade at high prices. So why write about them? Two main reasons:

1. Develop a deep understanding of the power of these businesses
2. Allow us to identify prices we would *want* to buy them

Markets are generally efficient most of the time. But when they're not (a.k.a., March 2020), you can find terrific businesses trading at steeply discounted prices. Examples of Bucket 2 companies include Evolution Gaming (EVO.AB), Flatexdegiro (FTK), and Fortnox (FNOX), all names which we'll research over the coming months.

This means we'll spend most of our time researching and writing about these types of businesses. Thus, when downside volatility hits, we'll stand ready to pounce on potential once-in-a-decade buying opportunities.

I hope you can feel my excitement through these keystrokes.

Imagine the long-term compounded knowledge benefit we get from this exercise! Over time, we'll possess a *massive* watchlist of pre-screened, deeply researched companies operating the best economic models in the world. We will only respond **proactively** amidst market volatility and not merely **react** to any significant downturn in prices.

Bucket 3: Case Studies & Evergreen Theory

Investing is more art than science, more biology than mathematics. Businesses are micro-ecological systems with their own rules, own cultures, and specific value drivers.

Yet like ecological systems, businesses are complex structures. You can't neatly organize a company into a simple five-year DCF model.

That's why we have Bucket 3. This bucket provides the tools and mental models necessary to properly construct a best-fit future reality for any business. There are two ways we accomplish this:

- Investment Case Studies
- Evergreen Theory

Investment Case Studies allow us to see what a company did right, why it worked, and how that process might repeat in the future with another business.

Moreover, we can use case studies to red team our biases towards specific business models and frameworks. Rightmove PLC (RMV) is an example of a recent case study, which you can read here.

Each case study focuses on stocks that have returned *at least* 25-30% IRRs for *at least* 5 years. Again, life is short, and we want **big long-term** winners.

If Case Studies are the bricks in the house of mental models, Evergreen Theory is the mortar. Evergreen Theory involves deeply researched pieces on human psychology, animal behavior, history, and more. Anything that we can use to help us understand why a company works is fair game.

Recent examples of Evergreen Theory content include *Disposition Effect*, *Be Fire & Wish For The Wind*, and *Beware The Chihuahua…*

Concluding Thoughts: A Virtuous Research Cycle

The beauty of this new research process is that we've created a virtuous research cycle that squeezes the most from every second of every day.

Suppose we can't find actionable 3-5x return ideas today. In that case, we switch to researching the best unknown businesses on the planet and set price alerts where we'd like to own shares.

We can then leverage Case Study research to identify patterns in potential 3-5x investments, which provides *even more* fodder for our Bucket 1 ideas.

Finally, we research Evergreen Theory to hang each investment idea along (as Charlie Munger says) a "latticework of mental models."

I can't begin to describe how excited I am for this new research process, and I can't wait to share these ideas and thoughts with you.

