MO Weekly Equity Note: 08-07-2021

Earnings Blitz Hits The MO Portfolio

Operators,

Earnings season is in full swing in the MO Portfolio this week, and we have *a lot* to cover. Check out the portfolio companies that reported:

- Betterware de Mexico (BWMX)
- Nintendo (NTDOY)
- Redfin (RDFN)
- XP, Inc. (XP)

We'll review each earnings report, what it means for our long-term thesis, and how we're thinking about trade management going forward.

It's a jam-packed *Equity Note*, so grab your favorite beverage and let's dig in.

Betterware De Mexico (BWMX): Same Old (Growth) Story

Betterware De Mexico (BWMX) is a direct-to-consumer (D2C) Multi-level marketing (MLM) company that sells kitchenware products, food storage, and other products. You can read our original thesis on the company here.

There's also a great running Twitter thread from my friend @rubicon59 that you can read here.

Before we dive into the earnings report, it's crucial to understand how its distribution model works. Here's a snippet from our write-up (emphasis mine):

> *"The company's distribution model is straightforward. BWMX sells to distributors. These distributors sell to the Associates. And it's the Associates that deliver the product to the actual "customer."*
>
> *Customers can place orders over the phone, through WhatsApp/BWMX own app, or in person. This is where things get interesting. BWMX is just now rolling out its in-house phone app.*
>
> *The app allows customers to place an order and alert the closest available Associate of the purchase request. If you're thinking of the Uber delivery model, you're right.*

COPYRIGHT 2021 MACRO OPS — ALL RIGHTS RESERVED // DO NOT DISTRIBUTE // 08.07.2021

> *It feels a lot like Uber, where "customers" request a ride and the nearest available driver can snag the reward (drive time)."*

Most investors see a potentially shady MLM scheme akin to Herbalife. We see a company creating one of the largest last-mile logistics infrastructure networks in Mexico.

Alright, onto the report.

BWMX killed Q2 earnings. Here are the highlights (QoQ):

- Net Revenues increased by 81%
- EBITDA increased by 92%
- Net Income increased by 72%
- Gross Margin % Expanded 516bps to 56%
- Grew Average Associate & Distributor Base by 110%

The company exceeded expectations while raising its FY 2021 revenue (MXN 10.8B - 11.3B) and EBITDA guidance (MXN 3B - 4B). BWMX reiterated its desire to pay shareholders cash dividends of MXN 1,400 per quarter (~4.6% dividend yield around current prices).

Most of the company's capex will go towards additional equipment for its new campus, along with other technology investments. Roughly 81% of capex will go towards technology. Finally, BWMX announced that it's expanding into a second Distribution Center (or DC). The company will rent this DC, so it won't spend a ton of capex upfront.

Yet the most impressive metric from the report was the company's 516bps increase in gross margin percentage, to 56%. In other words, BWMX is growing while increasing operating leverage. Add to that the company's -38-day cash conversion cycle, and you've got a cash-generating machine.

There Is Still A Long Runway For Growth

So, where does the company go from here? BWMX has its sights set on a 40% household penetration rate by 2025. But there are other ways to flex growth.

For example, with its logistics network and last-mile delivery established, BWMX can seamlessly introduce new products and verticals to its customers at low costs. Such low prices allow BWMX to capture incremental wallet share from its existing customers.

Valuation & Mr. Market

It shocked me after crushing Q2 earnings to see BWMX trade down 10%+ during Friday's trading day. At one point, the stock was down nearly 20% before closing at -10.85%.

COPYRIGHT 2021 MACRO OPS — ALL RIGHTS RESERVED // DO NOT DISTRIBUTE // 08.07.2021

The current stock price implies a ~14x multiple on the current year's normalized FCF. This seems like a *wildly cheap* valuation given BWMX's top *and* bottom-line growth plus apparent operating leverage.

BWMX is currently in a 5% position in the portfolio. We'll use any consolidation around these lower levels to scale into a 6-8% position at cost.

Nintendo (NTDOY): Best Quarter Since '09, Yet Market Worries Over Hardware Cycle

Nintendo (NTDOY) is one of our largest holdings and a name we've followed casually since 2019 and seriously since August last year. You can read our original write-up on the company here.

Gaming investor @DomsPlaying wrote a great NTDOY earnings deep dive, which you can find here. Most of the content here is taken from that post. I highly recommend reading.

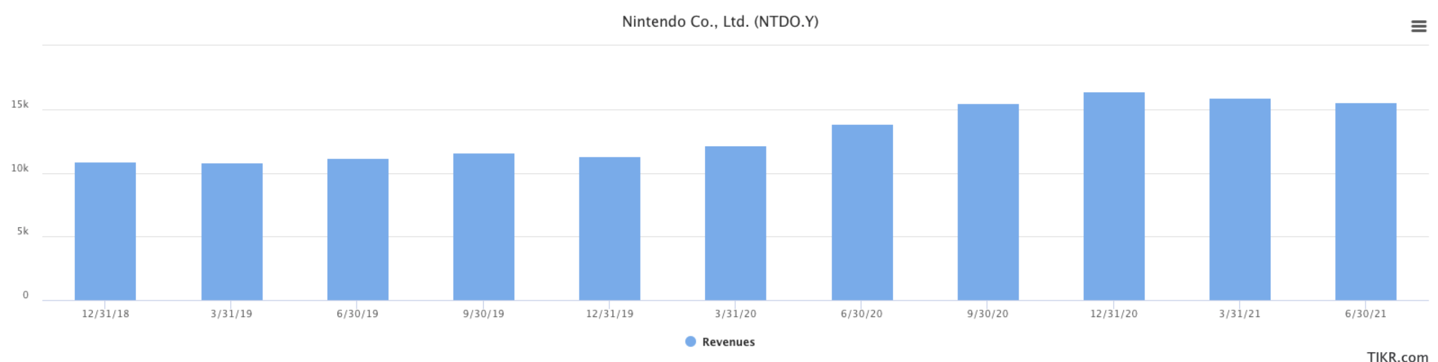
And if you want more NTDOY content, check out Ensemble Capital's latest thoughts here.

Q2 2021 was arguably the most brutal comp quarter in NTDOY's history. Specifically, the company (like most video game businesses) faced COVID-19 lockdown comps -- a time when people had *nothing else to do* but play video games indoors.

Despite the monstrous comp, NTDOY booked its best quarter since 2009. Here are some highlights:

- Net Sales of $2.91B, down 10% QoQ
- Operating Profit of $1.08B, down 17% QoQ
- Sold 4.45M Nintendo Switch devices, down 22% YoY

I know, those sound like alarming figures. But remember, NTDOY is coming off the most challenging comparable quarter in its history. Expand the timeframe, and things look good. For example, if we take an LTM (Last Twelve Months) approach to revenue, we get a *much* smoother picture (via TIKR).



COPYRIGHT 2021 MACRO OPS — ALL RIGHTS RESERVED // DO NOT DISTRIBUTE

Let's move to the positives.

First, the company's flagship hardware device, The Nintendo Switch Original, is still going strong. Of the 4.45M devices sold, 3.31 were original Nintendo Switches. In total, the company's sold 89M Switch devices, not far from its Wii record of 102M (which it will break).

Next, there are content releases, like *Mario Golf*, which sold ~1.34M copies since its release on June 25th. Though available for only a week, the game has sold almost as many copies as NTDOY's original *Mario Golf* version.

Other notable releases include *Animal Crossings* and *Mario Kart 8 Deluxe*.

The positive earnings update wasn't enough to prop up the stock price. Shares were down 9% this week and 15% over the last three weeks. There are a few reasons for the decline.

NTDOY Is More Like Roku/Disney Than Xbox or Playstation

Most investors see a video game company trapped inside a cyclical hardware sales cycle. If that premise is true, then yes, NTDOY doesn't deserve to trade like a Disney (DIS) or a software company.

Yet, in five years, NTDOY won't be a cyclical hardware company. It'll look more like a combination of Roku with Disney-like Intellectual Property (IP). Here's what I mean.

Roku sells hardware at cost then sells a subscription-based streaming service through the device. NTDOY does the same thing with the Switch. The Switch is NTDOY's ticket to unlocking higher-margin recurring SaaS revenue via digital gaming and mobile-based play.

In other words, investors that focus on hardware sales miss the larger picture of NTDOY's transformation. It would be like valuing Roku's business only on its hardware sales figures.

Yes, hardware sales matter in the short term (i.e., to reach the largest addressable market possible). But in the long run the only thing that will matter is if people buy digital goods and games from those embedded devices.

All this to say that NTDOY is *just now selling* tickets to its Nintendo World amusement parks. While we won't know official statistics until later, I have no doubt that the parks will make a killing.

It's easy to miss the forest through the trees when short-term price action drives a company narrative. The long-term thesis remains intact, and we'll continue to focus on the long-term drivers of shareholder value to guide our decision-making process.

COPYRIGHT 2021 MACRO OPS — ALL RIGHTS RESERVED // DO NOT DISTRIBUTE // 08.07.2021

Redfin (RDFN): Strong Quarter As Housing Growth Continues

Redfin (RDFN) is a residential real estate brokerage that helps people buy and sell homes. The company's mission is to redefine real estate in the consumer's favor. This means offering the lowest fees of any real estate brokerage in the country.

The RDFN bull thesis revolves around two key hypotheses:

1. Real estate commissions will go to zero.
2. The way consumers buy/sell homes in ten years will look vastly different than today.

If we're right on those two assumptions, RDFN stands as the clear winner in real estate over the next decade.

You can read our write-up on the company here.

RDFN reported strong Q2 earnings on the heels of continued housing sector strength. Some highlights include:

- Increased Revenue 121% YoY to $471M
- Increased Gross Profit 174% YoY to $126M
- Improved Real Estate Service GP 90% YoY to $88M
- Increased Market Share by 24bps to 1.18%
- Lost $27.9M compared to a net loss of $6.6M in Q2 2020

This was also the first quarter with contributed revenue from its RentPath acquisition. RentPath is a holding company that owns various listing websites like rent.com, apartmentguide.com, and rentals.com. The acquisition contributed roughly $45M in revenue and $35M in gross profit.

Twitter user @plantmath1 wrote an excellent Q2 earnings review, which you can read here.

There are a few lowlights to mention. First, first-year real estate agent churn remains high. Annual attrition rates rose to 37% in Q2, up from 31% in Q1. More concerning, however, is the doubling of 2-year agent attrition rates, from 9% to 18%.

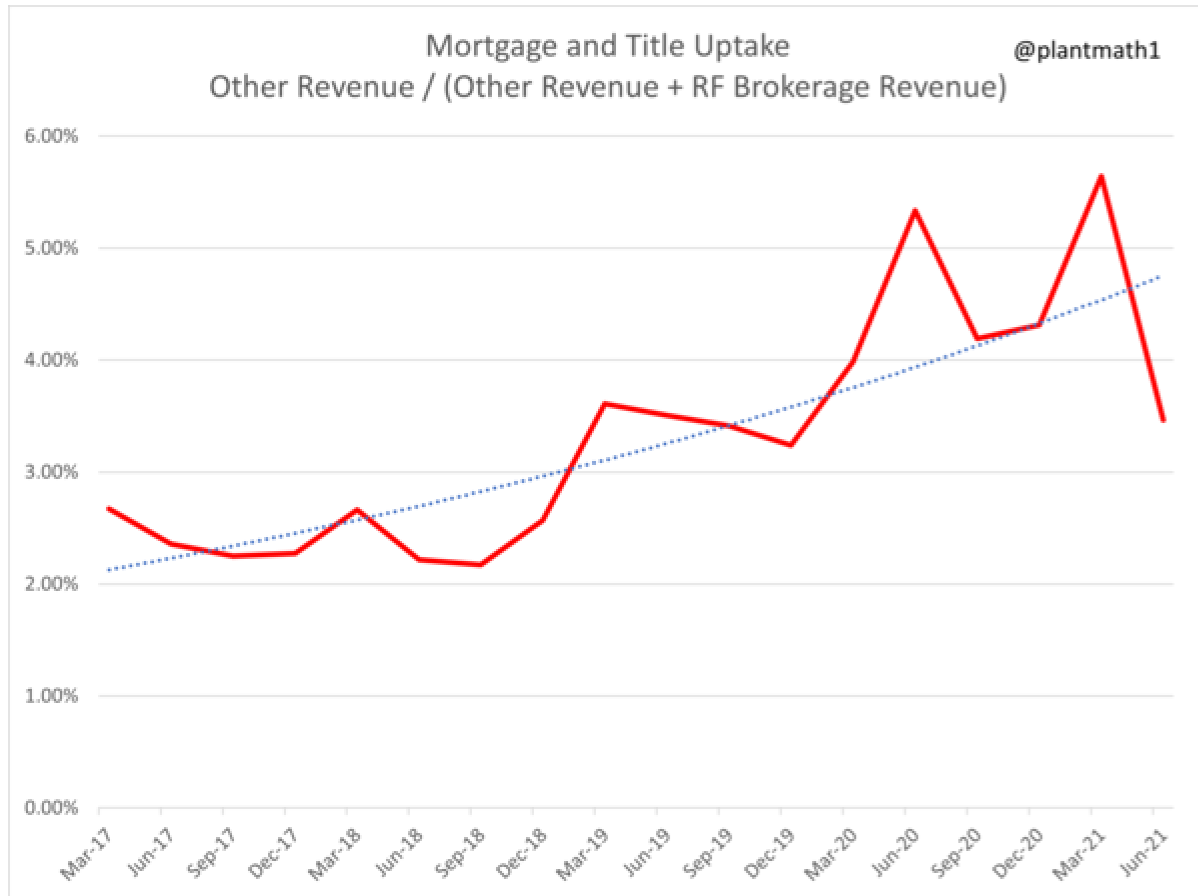
CEO Glenn Kelman explained the recent attrition rate hikes in the conference call (emphasis mine):

> *"A major cause of higher attrition in the first half of 2021 was fast hiring. New agents are already the group most likely to leave Redfin, and we haven't had such a high proportion of new agents in years.* ***Because we've been eager to return to market share growth, we probably also made more hiring mistakes,*** *nearly half the people who left in the second quarter are people we wouldn't choose to hire again."*

COPYRIGHT 2021 MACRO OPS — ALL RIGHTS RESERVED // DO NOT DISTRIBUTE // 08.07.2021

Kelman's honest assessment of RDFN's decisions is a breath of fresh air and one of the main reasons we parked nearly 10% of the fund in the company.

Another red flag worth monitoring is the recent decline in RDFN's mortgage business. @plantman1's graph below shows the cause for concern:



As the author says, RDFN's mortgage business is a beacon showcasing the company's flywheel effects' validity (or invalidity). Remember, the long-term bet we're making here is that RDFN removes almost *all* friction from the home-buying process. That includes mortgage and title.

During the earnings call, Kelman explained potential reasons for RDFN's mortgage revenue decline (emphasis mine):

> *"Mortgage revenue grew 47% year-over-year as compared with nearly 200% in the first quarter. Some of this revenue deceleration was expected.* ***We deferred hiring Redfin Mortgage salespeople in February and March to focus on improving service quality.****"*

To conclude, RDFN had a *great* quarter. The company's growing like gangbusters during a strong housing market. RDFN's guiding Q3 revenue between $530M - $541, up 126% YoY.

COPYRIGHT 2021 MACRO OPS — ALL RIGHTS RESERVED // DO NOT DISTRIBUTE // 08.07.2021

Despite the great quarter, RDFN's stock fell nearly 10% the next trading day. Since we already have a ~9% position at cost, we're fine with riding out the short-term volatility. We'll use any continued downside reactions to increase exposure.

The company is playing its own game while forcing the rest of the industry to adapt to its rules. This bet, if it works, will take time to play out.

That said, RDFN built its business model to succeed in the world it's creating, which gives the company a head start against the competition. Finally, the company is run by one of the most honest, transparent, and genuine CEOs we've seen.

XP, Inc. (XP): Another Record-Beating Quarter & The Market Noticed

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 R 800B+ in Assets Under Custody (AUC).

You can read our original write-up on the company here.

Our bull thesis hinges on four main points:

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

Those four points remain our North Star when analyzing quarterly performance results.

And this quarter, XP knocked the cover off the baseball.

There are three ways to judge XP's performance: **Investments, Banking,** and **Financials.**

Let's start with Investments. The company increased AUC 88% YoY to R 817B, grew active clients by 33% to 3.1M, and generated R 75B in net inflows, representing 159% YoY growth.

XP's Banking Business performed equally well. The company 17x'd its credit portfolio YoY to R 6.8B, 4x'd its Credit Card TPV (Total Purchase Volume) QoQ to R 2.1B while maintaining a 0% Non-Performing-Loans (NPL).

COPYRIGHT 2021 MACRO OPS — ALL RIGHTS RESERVED // DO NOT DISTRIBUTE // 08.07.2021

Such successes translated to massive revenue and earnings growth. The company grew revenue 57% YoY to R 3.2B, increased EBITDA by 77% YoY to R 1.2B, and grew Net Income by 83% YoY to R 1.0B.

77% of XP's revenue comes from its Retail business. Two key drivers of Retail revenue growth included **Financial Products** and **Fixed Income.** Financial Products include things like credit cards and other forms of personal credit. The great thing about these credit products is that the customer uses their AUC as collateral (which explains the 0% NPL rate).

More impressive, however, is the company's operating leverage. XP increased EBITDA and Net Income margin by 463bps and 485bps, respectively. Despite an 18% increase in SG&A spending and expanding company headcount from 2K in 2019 to nearly 5K today.

As we mentioned earlier, trillions of dollars will flow from Brazil's most prominent banks into the hands of independent brokerages. XP is the best-positioned company to capture these new equity flows and its showing in the earnings reports.

The company is growing topline revenue at a 40% CAGR while generating 40% EBITDA margins and mid-20% Net Income margins. It's also one of our portfolio's more "optically" expensive stocks, trading at nearly 9x NTM revenues.

Yet if you look two years out, you can buy this business, the one growing topline 40% with 40% EBITDA margins, for roughly 23x 2022E EBITDA. That is cheap.

Institutions are starting to catch on to XP's clear undervaluation. The company spent the next three trading days hitting new incremental highs on *solid* volume. Check out the chart to the right.

The stock remains in a tight post-IPO base but looks poised to break the $50/share resistance line over the next few weeks. XP is now a top-five position in the portfolio through price appreciation alone, representing 7% notional exposure.

We'll look to add to our core position on any retracements towards the 100 EMA or the lower range of its rectangle pattern.

Your Value Operator,

Brandon

COPYRIGHT 2021 MACRO OPS — ALL RIGHTS RESERVED // DO NOT DISTRIBUTE // 08.07.2021