MO Weekly Equity Note: 08-28-2021

Supply-Constrained “Problems” in POWW & UP

Operators,

We like companies that have the matryoshka of conditional tailwinds at their backs. Great companies, led by great operators, with defensible competitive advantages. Even better when we can find ones that check these boxes plus a few powerful others, such as an ample supply and demand mismatch.

POWW and UP have roughly equivalent supply-constrained “problems.” Both their respective industries cannot meet existing demand with current capacity. This is an excellent *problem* to have.

This weekend, we examine both POWW and UP’s unique S&D issues, how they came about, and what it means for the valuation cases for each company.

Let’s dig in...

Ammo, Inc (POWW): New Russian Ban Strains (Already) Weak Supply

Last Friday, the US State Department issued new sanctions under the 1991 *Chemical and Biological Weapons Control and Warfare Elimination Act* restricting the sale and importation of Russian ammunition products. Here is the actual language from the updated “Facts Sheet” (emphasis mine):

> *“Restrictions on the permanent imports of certain Russian firearms. New and pending permit applications for the* ***permanent importation of firearms and ammunition manufactured or located in Russia will be subject to a policy of denial.”***
>
> *Additional Department of Commerce export restrictions on nuclear and missile-related goods and technology pursuant to the Export Control Reform Act of 2018.*

The sanctions start on September 7th and will last for *at least* 12 months. Now, there is one thing we don’t know yet, and that’s the ruling around existing Form 6s.

An ATF Form 6 (commonly known as “Form 6”) is a government license that allows the importation of firearms, Ammunition, and other “Implements of War.” You can see an example of Form 6 here.

Retailers use Form 6s to import ammunition from Russia to the US for resale at stores like Bass Pro Shops and MKS Supply.

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One common form of Russian ammunition is *Barnaul* Steel Cased Ammunition.

MKS Supply notes that *Barnaul* produces ~200 types of ammunition from hunting, sporting, and self-defense. *Barnaul* serves most firearms, including shotguns, pistols, and rifles.

There are three ways this Russian ammo ban impacts POWW:

1. Reduced supply of cheap Russian ammo will increase demand for a higher-priced product
2. Entire specialty calibers like 5.45x39mm could disappear entirely unless another manufacturer picks up the slack
3. Supply constraints will drive higher engagement on GunBroker.com for Russian-made ammunition at incrementally higher prices.

If You Can't Buy Cheap, You Buy What's Next

Shooters and gun enthusiasts love Russian-made ammunition because it's cheap and works well.

While we don't know the *actual* figures, mixed sources suggest that Russian-imported ammunition comprises anywhere between 20-40% of US supply.

So the question becomes, "how will the average consumer respond to the supply shock?"

Luckily for ammo manufacturers (like POWW), consumers seem to sport highly inelastic price demand curves.

Greg Ellifritz, a retired police officer and founder of Active Response Training, notes this inelasticity effect in his blog post *Five Consequences of the Russian Ammo Ban* (emphasis mine):

> *"When the surplus of cheap Russian ammo dries up, what do you think Cletus and his buddies are going to do? That's right,* ***they'll start buying all the brass-cased "expensive" practice ammo that you like to shoot.***
>
> *Availability of cheap Russian ammo* ***acted as a pressure release valve for the prices of brass-cased ammo produced in more developed countries****. When the regular Russian ammo shooters can't get their fix, they will start buying the stuff that the rest of us shoot. That means the gradual drop in ammo prices will come to a quick halt.* ***Ammo prices will rise across the board this year and next.****"*

Gun owners buy ammunition *regardless* of the price. There are, of course, limits to how high a price some gun enthusiasts would pay for ammo. But we don't know *how high* that is, and it's probably *significantly* higher than we think.

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This means that the increasing demand for ammo will be met with incrementally higher per-round ammunition prices, guaranteeing higher incremental margins for manufacturers like POWW.

One final thought before we move onto the second topic. We experienced a similar ammo supply shortage last year during the height of the COVID-19 pandemic. But here's a significant difference. Last year, manufacturers filled excess demand with the cheap, steel-cased Russian stuff.

Now, consumers have two choices:

- Don't buy ammunition during a period of tremendous civil unrest
- Pay extra for the security of that incremental round of ammunition

"Option 2, for $500, Mr. Trebek."

Will US-Based Ammo Producers Fill The Gap?

The second consequence of a Russian ammo ban is the potential to remove entire calibers from the supply chain.

For example, *Reason.com* notes that *"Ammunition for some specialty calibers, such as 5.45x39mm, used in specifically Russian-sourced weapons, may essentially disappear."*

If that's true, it opens the door for a US-based manufacturer to fill the gap. Enter, POWW.

The company has a chance to provide specialty ammunition to a market without supply. Not to mention the fact that POWW could theoretically name its own price on that ammunition (read: higher margins).

Yet, the product gap goes deeper than specialty calibers. *Reason* also suggests that gun-owners stockpile reloadable brass casings (emphasis mine):

> *"Now is a good time for shooters to make sure they're saving reloadable brass-cased ammunition.* ***Yes, reloading components are also in short supply. But putting aside the cases and slowly acquiring components for reloading ammunition will help gun owners insulate themselves from future ammunition shortages****, whether they're caused by supply and demand issues or by political intervention."*

Again, this is incredibly bullish for POWW's brass-casings business, *Jagemann Stamping Co.,* which should see increased demand for its products and higher subsequent margins.

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Low Supply Creates Higher-Priced Auction Marketplaces

Rounding out POWW's business segments is its online marketplace, GunBroker.com. During their last earnings call, POWW mentioned that it wanted to push *at least* $25M worth of ammunition products through GunBroker during the current fiscal year.

Remember, GunBroker generates revenue by taking a percentage of each online transaction. The higher the transaction price, the greater the revenue.

POWW should *quickly* clear $25M in ammunition sales under the new Russian ammo sanctions. In turn, this will lead to higher GunBroker-related revenue, which will raise total gross and EBITDA margins to come year-end.

The company generated ~43% gross profit margins last quarter. Under the new restrictions, we could see 50% GM next quarter.

The Perfect Storm For Higher Margins & Demand

POWW entered this supply-restricted dynamic with ~$238M in the existing backlog. It will be interesting to see how high that rises.

The company is perfectly positioned to generate higher margins for the next 12-24 months. Investors can trace how the stars align:

Supply restrictions → higher product demand at higher prices → increased engagement on GunBroker.com marketplace at higher prices → higher margins for ammo sales and marketplace revenue

Last week, we added a second tranche to our core POWW position, increasing our notional exposure to ~14.20%.

Wheels Up Experience (UP): Growing While Others Stay Stagnant

UP is our latest position to enter the MO portfolio. We bought a ~3% starter position on Thursday after PIPE-related selling allowed us to buy the business at a <$2B market price.

The company is the third-largest private aviation company logging 81.4K flight hours in 2021 and capturing a 3.60% market share of flights.

Like ammunition, there is an ever-increasing demand for private aviation. This week, NetJets announced that it will not issue cards to new members.

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Now, most customers choose one of the "Big Three" to meet their private flight needs:

- NetJets (a subsidiary of Berkshire Hathaway)
- FlexJet
- Wheels Up

Here's the multi-billion dollar question: **Which private aviation company is best suited to meet such excess demand?**

The answer is easy -- whichever company has the best business model to meet customer demands.

Our bet is UP. But let's see why.

Fractional Ownership vs. Marketplace Model

NetJets operates a fractional ownership model. In other words, customers buy a *fractional* ownership stake in a private jet. This stake entitles the customer to certain privileges like guaranteed rates and jet availability, minimum flight hours per year, and other perks.

Along with the fractional stake, customers pay monthly maintenance fees and an hourly flight occupancy fee while they fly.

The final result is a high upfront cost with myriad fees that create an expensive and cumbersome customer experience. You have to "own" the aircraft to use it.

Wheels Up simplifies the private aviation process to create a seamless (even elegant) booking experience.

UP offers private aviation services for both members and non-members through its online marketplace of 1,200+ available jets.

Like NetJets, UP sports a fleet of owned and operated aircraft (roughly 170 planes). Yet that's where the similarities end. UP's "secret sauce" is its third-party network of 1,200+ aircraft available on its marketplace platform.

A third-party network of aircraft connecting unused planes with willing-to-pay customers is a game-changer for one reason. **It allows UP to scale faster than NetJets to meet the current demand surge.**

Instead of buying hundreds of planes to meet demand, UP can tap the existing supply to provide aircraft at a *fraction* of the upfront cost.

Let's compare UP and NetJet's model using an asset more available to most investors: cars.

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If we were operating a private car transportation business, which model would you choose? With NetJets, customers must buy a fractional share of ownership in the car and pay for monthly maintenance fees like oil changes and tire rotations on top of the hourly rate.

Moreover, if you want to expand your business, you must *buy* more vehicles.

UP is like Uber in this example. Uber doesn't own cars. It connects available drivers (who own the cars) with people who need a ride from point A to B.

Back to UP's pricing model. The company offers both member and non-membership options. As a non-member, customers can visit the Wheels Up app, choose where they're flying, and instantly reserve an aircraft at the designated hourly rate. That's it.

Of course, non-members aren't privy to member-like perks, including guaranteed rates, access to high-profile social events, and the ability to share flights with other passengers at significantly lower hourly rates.

Wheels Up offers three membership options:

- Connect: $2,995 one-time initiation fee and $2,495 annual dues
- Core: $17,500 one-time initiation fee and $8,500 annual dues
- Business: $29,500 one-time initiation fee and $14,500 annual dues

Regardless of what member/non-member option you choose, one thing stays the same: **the ease and elegance of UP's user experience in booking a private flight**

Increased Demand Will Flow To The Best User Experience

With NetJets halting new business, where will customers turn? Our bet is that they'll choose the company with the best, most seamless user experience. Once they do, they'll become a customer for life.

UP Founder/CEO Ken Dichter agrees, which is why he's aggressively investing while others in the space (i.e., NetJets) shelter-in-place. Here are Dichter's comments from the company's first earnings report (emphasis mine):

> *"We have made the **strategic decision to invest in the growth of our business while some industry participants are pulling back.** This gives us even more conviction and confidence to pull forward."*

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Dichter can now leverage all the public company tools at his disposal to capture market share as a public company. This means spending more *today* to capture the bulk of the market and reap *tomorrow's* monopoly-like profits.

Dichter's bets manifest in UP's FY2021 guidance. The company raised its revenue guidance to $1.05-1.1B while anticipating negative EBITDA and a net loss of ~$150M. Dichter understands that winning tomorrow means servicing demand today. And that requires more aircraft, both owned and via its third-party network.

As we've mentioned in prior UP notes, the company *should* lose money over the next few years to build its marketplace dominance.

UP is Building The Better Business

UP is building a superior business model, full stop. Moreover, UP's business benefits from network effects. Its marketplace improves with each incremental aircraft and passenger added to the platform.

More aircraft on the platform drive more users to book flights through UP. In turn, a more extensive passenger base incentivizes more aircraft to list their planes on the UP marketplace. Combined, this creates more available flights to more passengers in more places at a greater frequency.

And to think that we get all this for less than $2B market cap.

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