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MO Equity Note: Earnings Galore (CVNA, SQ, RSKD)

An Equity Note

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What's Inside:

Companies Mentioned:

➢ Carvana (CVNA)
➢ Block, Inc. (SQ)
➢ Riskified (RSKD)

Happy Saturday!

We're in the final innings of Q4 *Earnings Blitz*. A few of our "Stand-by" companies reported this week, including:

- **Carvana (CVNA)**
- **Block (SQ)**
- **Riskified (RSKD)**

We'll dive into the earnings reports, unpack the most essential parts of each company's long-term thesis, and hypothesize about future valuations.

We'll also outline how we're thinking about adding one (or more) of the above names to the book over the coming weeks.

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

Carvana (CVNA) Q4 Earnings: Rapid Growth & New Acquisition

Carvana (CVNA) reported earnings on Thursday (02/24) with solid results. In many ways, it was a *banner* year for the company. You can read our initial write-up on the business here.

Check out some of the highlights:

➢ Bought and sold their 1,000,000th car to customers
➢ The fastest-growing eCommerce company in history
➢ Increased revenue by 129% YoY to $12.8B
➢ 7th consecutive year of 100%+ growth in customer transactions
➢ First full year of EBITDA profitability (excl. One time items)
➢ 8th consecutive year of EBITDA margin leverage

CVNA achieved its *first-ever* profitable quarter in Q2 2021.

The company went from $0 in revenue to $12.8B in less than a decade – something *very few* companies can claim.

Moreover, the company sold 10x more cars to customers *this year* than in 2017 (the year they IPO'd). And they show no signs of slowing down.

CVNA sold 425K cars in 2021, up 74% YoY. The company also increased gross profit by 143% to $1.93B. **That translates to a ~$1,285 improvement on a per-unit basis.**

A few key variables affect CVNA's long-term value creation:

- ➢ Distance to consumers
- ➢ More IRCs (Inspection & Reconditioning Centers)
- ➢ Operating leverage

Let's break down how the above variables create a powerful flywheel.

CVNA's Flywheel: Closer To Customer, Less Cost, More Profits

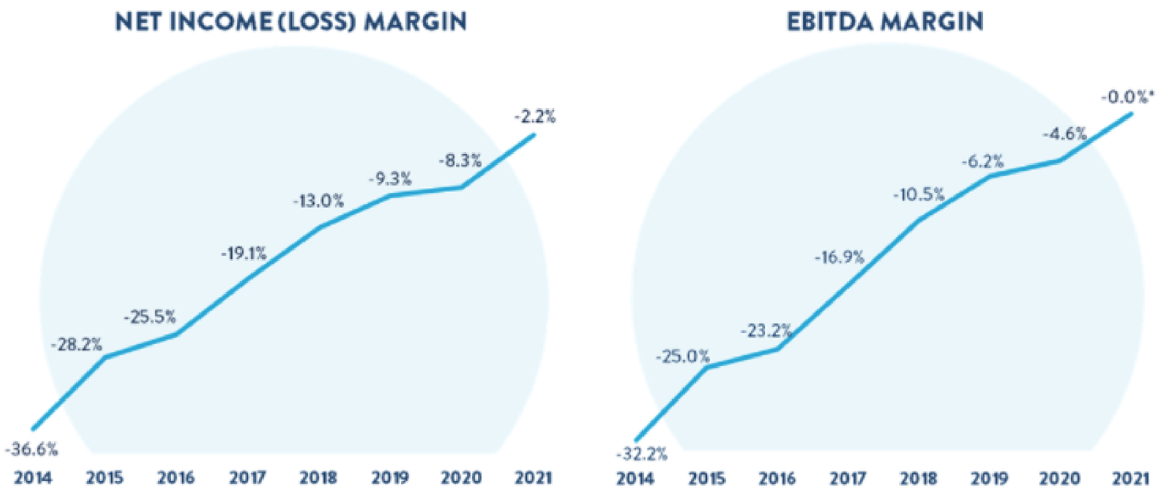
CVNA opened 45 new markets during the year, expanding its population coverage to 81% throughout the US. More markets mean more IRCs closer to customers.

The closer the IRC is to the customer, the lower the logistics costs *and* the quicker the customer receives the car. Those lower logistics costs flow right to the bottom line.

Also, shorter delivery times translate to more car sales.This drives more car inventory on the platform, enhancing the customer value proposition.

CVNA expects to open an additional 6 IRCs in 2022, leading to ~1.2M+ units of annual capacity by year-end.

Historically, more IRCs and shorter distances to consumers have led to *significant* operating leverage (as shown below from the CVNA 2021 Investor Letter).



Then there are CVNA's impressive cohort growth trends.

CVNA's Cohort Data Signals Increased Market Penetration

Let's take CVNA's oldest market cohort, Atlanta, for example. During the year, Atlanta grew by 51% to 3.53% market penetration.

CVNA also noted that **95%** of their 311 markets are ramping faster than Atlanta was at the same age, with *many* markets crossing critical market penetration thresholds.

There are roughly 40M used cars sold annually in the United States. Let's assume that CVNA *eventually* reaches the same penetration in the US as its oldest cohort, Atlanta. **That's 1.4M** cars sold, or ~3.3x larger than CVNA's current unit sales.

Finally, let's examine CVNA's recently announced acquisition of ADESA.

Why CVNA Bought ADESA

ADESA is the nation's second-largest auction company with 56 locations and ~1M transactions per year.

This acquisition is a **big** deal. Earlier, we noted how location to customers was a critical factor in CVNA's value-creation flywheel. ADESA gets CVNA much closer to that goal.

Here's how founder/CEO Ernie Garcia explains the benefits of closer proximity (emphasis mine):

> *"We will move from currently having inspection centers within 200 miles of 56% of the U.S. population to* ***eventually being within 200 miles of 94% of the U.S.***

> ***population.*** *Demonstrating the quality of these locations, we will move from being* ***within 50 miles of 16% of the U.S. population to being within 50 miles of 58% of the population.*** *This will reduce shipping times to our customers nationwide and lays the foundation for* ***eventually offering same-day delivery*** *to many of our customers."d*

Closer IRCs translate to higher unit economics. For example, customers within 200 miles (or less) of an IRC generate $750 *higher* unit economics than the average transaction.

The ADESA acquisition is exciting because **CVNA's unit economics *drastically* improve with each incremental IRC added to the market.**

Finally, let's think about valuation.

Paying 1x NTM Sales For A 30%+ Organic Grower

CVNA currently trades at a $16B Enterprise Value and ~1x NTM sales. The company generated $12.8B in revenue last year, so they only need 27% growth to reach that $16B sales figure in 2022.

Should CVNA's operating leverage continue, we could see 5-8% EBITDA margins over the next five years.

Here's the deal. Ernie is going all-in on owning the second-hand car market in the US. This is a $160B gross profit market. He's an experienced operator, with skin in the game, who has so proven himself at every step of the way.

The potential cash generation for CVNA is enormous if it can continue to execute. No doubt that's still to be seen. The complexities behind the logistics of the customer problem they're trying to solve are immense (ie, having to coordinate digitally with each and every state's registration and DMV, etc...).

But, if they can solve these large-scale coordination problems at size, then their scale and network create an almost insurmountable moat. A moat that incrementally continues to improve the customer's experience and add more value at each and every step of the painful and cumbersome car buying process.

The risk is they fail and the large amounts of leverage on their BS drags them under and ends in share dilution.

Here's why I think those odds are low. CVNA has a *massive* head start in building the asset-heavy infrastructure to position itself as the best way to buy a used car in America. The cash burn is a *rear view mirror* problem as the company will likely hit EBITDA breakeven this year.

This means that while others rush to compete by destroying their existing business model and cost structure, CVNA will gush supernormal profits – because they changed the game to *their* operating model.

So, it's not unreasonable to assume CVNA captures 10-20% of the used car buying market (4M cars sold). At 4M cars, CVNA would generate $16B in gross profits at ~8% EBITDA margins. Slap a modest 7x multiple on gross profits and you have an $110B+ business, 5x higher than the current market value.

Block, Inc. (SQ): Reinforcing Strong Network Effects

Jack Dorsey's SQ reported earnings Thursday. You can read our initial thoughts on the company **here**.

The company produced *another* quarter of strong revenue and gross profit growth. Check out the full-year highlights:

- Increased gross profit by 62% to $4.42B (53% 2YR CAGR)
- Increased Adjusted EBITDA by 114% to $1.01B
- Generated $166M in Net Income

We can bifurcate SQ's business into two main segments: Cash App and Square. Both businesses benefit from increasing network effects as they scale and add users.

Let's start with Cash App's performance.

Cash App Continues To Crush It

More consumers than ever are using Cash App. For example, Cash App generated 44M monthly transacting activities in December, increasing 22% YoY.

SQ invested in new features like sending bitcoin and fractional stock shares to friends/family.

Cash App adds more features, the stickier the product becomes to its users. Greater stickiness also results in higher LTVs and greater ROI from CAC.

It cost Cash App ~$10 to acquire a customer in 2021. The payback on CAC is <1 year, with gross profit per monthly active customer reaching ~$47 in Q4 2021.

Historically, Cash App has generated a 6x or higher return on customer acquisition.

A great way to track Cash App's improvement is Inflows (or money deposited in a customer's Cash App). As management noted in the Q4 report:

"*Despite a roll-off in government disbursements in the fourth quarter,* ***we saw strength in recurring paycheck deposits, which we view as a key barometer of customers using Cash App for their primary banking needs****.*"

SQ reduced inflow frictions by allowing customers to directly log in to their employer or payroll provider within the app. Between product improvements in peer-to-peer and customer inflows, SQ reinforces the app's network effect by:

1. **Making it easier than ever to deposit money (routinely) into Cash App**
2. **Building services that improve the customer experience inside the app**

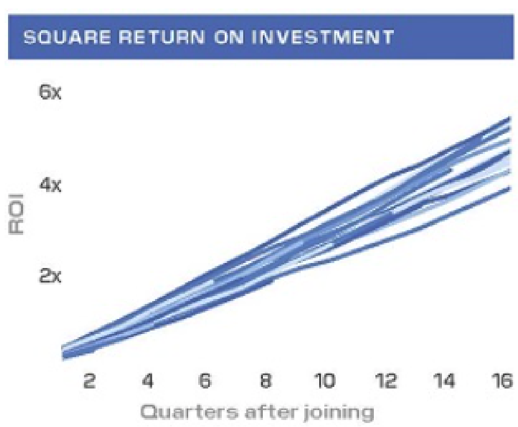
Cash App generated $518M in gross profit during the quarter, up 37% YoY. Meanwhile, there were 13M+ Cash Card monthly actives as of December, representing >30% of Cash App's monthly user base.

Square: Enhancing Product Ecosystem

More sellers are using Square products than ever before, reinforcing SQ's massive network effects with customers.

The company's earnings report highlights the increased network effects (emphasis mine):

> *"In 2021, 38% of Square's gross profit came from sellers using four or more products, up from 10% five years ago."*



In other words, the more products SQ develops, the more products its sellers use to sell their goods/services. Over time, this results in an even stickier customer.

The company is also growing SQ internationally, with international gross profits representing 9% of total GP.

SQ expanded into Spain during Q4, which should provide further international gross profits as Spain is Europe's third-largest and fastest-growing eCommerce market.

During 2021, the Square ecosystem generated $5.19B in revenue and $2.32B in gross profit, up 47% and 54% YoY, respectively.

Square has historically captured a 3x ROI on customer spend over the last three years. Yet for its new cohorts onboarded in 2020, Square recognized a payback period of <5 quarters. That's *after* they increased spending in sales and marketing.

Finally, there are Square's profits. The company is heavily investing through the income statement in products and people. However, SQ's 2020 and 2021 cohorts reveal *impressive* profitability. Here are CFO Amrita Ahuja's comments on EBITDA profitability (emphasis mine):

> *"Square's 2020 and 2021 cohorts are pacing towards compelling returns on investment of 3x over 4 years.* ***With these cohort economics, we delivered incremental adjusted EBITDA margins of 32% in 2021****, which was driven by ramping* ***profitability in both Square and Cash App*** *and illustrates the potential structural profitability in our business that we're investing behind."*

Square generated 30%+ EBITDA margins for its 2020 and 2021 Square + Cash App customers. Over time, Square should generate significantly higher EBITDA margins than it does today (~6%).

What about valuation?

SQ's Undemanding Valuation

Currently, you can buy SQ for a ~$55B Enterprise Value or **<3x NTM sales.**

We believe Dorsey is the most underrated tech operator in the game today. People discount him because he wears tie-die, retreats to the mountains, and is a total weirdo.

Wait a second – I know a guy like that!

Nevertheless, we think he's building a digital JPMorgan (JPM). Something that all the big IBs say they want to create but can't and won't because they (1) don't have the cultural know-how and (2) they're held prisoner to existing profitable business segments that they would naturally have to destroy by building what Jack is building.

SQ is quickly becoming the WeChat of finance, where everything a millennial needs in regards to money, will be within the SQ ecosystem: PoS for their business, books for managing their finances, cash payment app, broker, taxes, crypto, etc.

They control the money millennial relationship in a way that nobody else even comes close to. It's difficult to value a company that has so much upside and such a long runway, so it's just easier to look at the downside and say less than 3x next year's sales is nuts and a total steal for this call option on the future of finance and money.

Suppose SQ grows revenues by ~30% over the next few years and reaches $41B in sales by 2025. A 5x sales multiple seems reasonable, maybe even conservative.

That gets us ~$200B in Shareholder Value or ~$350/share, a 200%+ upside from the current stock price.

Riskified (RSKD): Growing It's Competitive Advantage & Adding Blue-Chip Customers

Riskified helps eCommerce companies reduce fraud, improve chargeback ratios, and capture more sales from customers. You can read our original deep dive on the company **here**. We also published updated thoughts on the business **here** and **here**.

RSKD put out another solid quarter and the pieces of the puzzle are falling into place, giving solace to the concerns we've had around PSD2, and raises our conviction that this is a 3x opportunity + that's trading at 2x cash with no long-term debt.

Let's start with headline figures:

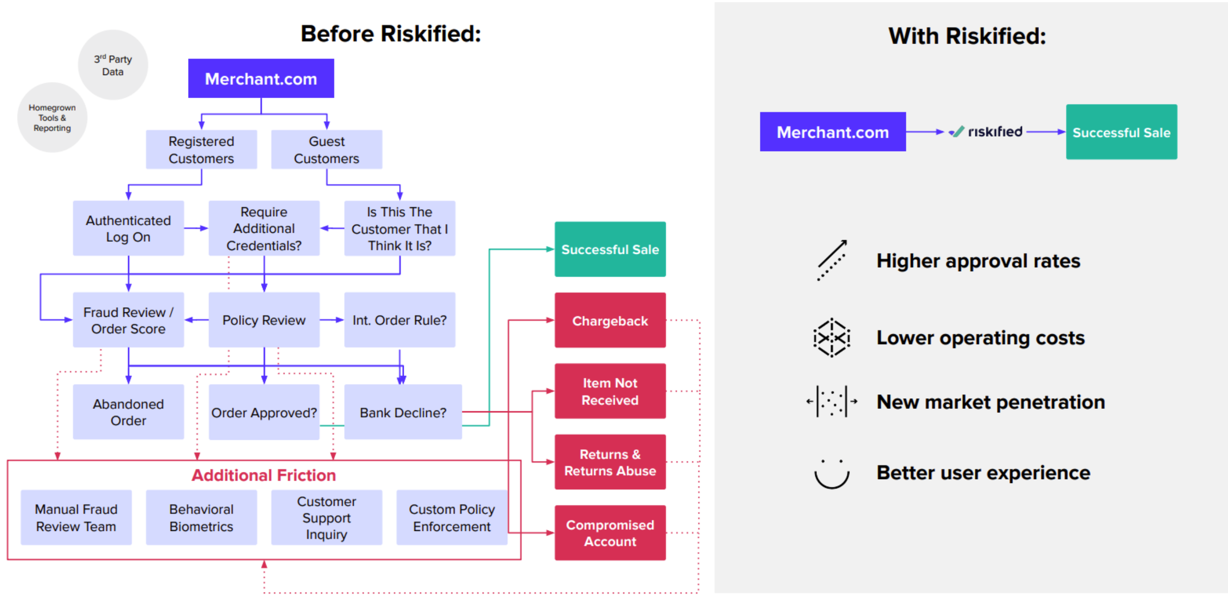
- ➢ GMV increased by 40% YoY to $89B
- ➢ Revenue increased by 35% YoY to $229M
- ➢ Gross Profit increased by 32% to $123M (54% margin)

For FY 2022, RSKD expects to generate ~$254-$257M in revenue and -$69M in EBITDA.

The company delivered 99% gross annual dollar retention during 2021 while adding *numerous* blue-chip customers. Check out some of the businesses they added:

- ➢ Saks OFF 5TH
- ➢ Binance
- ➢ Global Remittance & Payments Company w/ $5B in Annual Revenues
- ➢ One of the world's five largest omnichannel retailers
- ➢ One of the world's five largest travel retailers

During the year, RSKD expanded its chargeback guarantee to support ACH payments. ACH allows RSKD to accept a broader range of payment options alongside credit/debit and PayPal. The company also screened *billions of dollars* in GMV through its new *Policy Protect* products.



RSKD & PSD2: What Happens?

PSD2 is the ever-present danger for RSKD's long-term terminal value. Before PSD2 and Strong Factor Authentication (SFA), merchants faced two choices, which RSKD outlined below in its Q4 earnings presentation.

In the above scenario, merchants either (barely) manage fraud internally, spending hundreds of thousands of dollars on something that's *not* a core competency. Or they outsource it to RSKD and get back to doing what actually makes them money.

As I explained back in late December, PSD2 adds a third option to the historically binary fraud decision of yes (approve), no (decline), and now maybe (2FA).

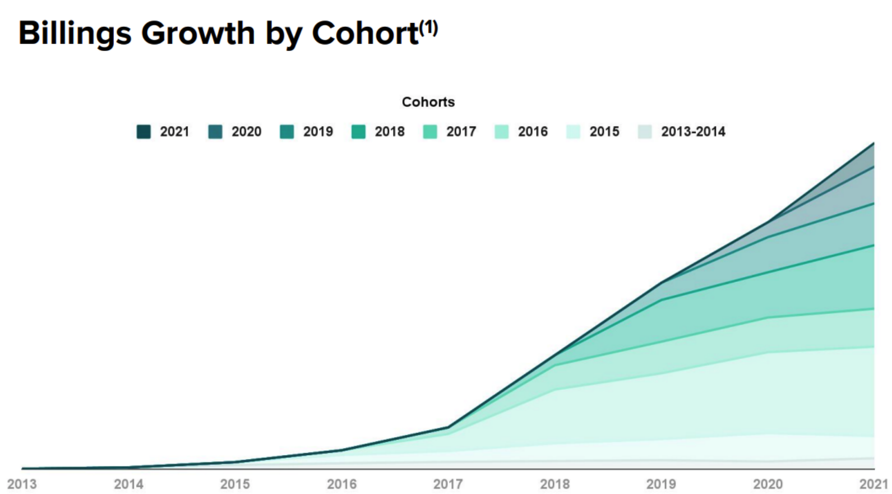
There are a couple of things we should see if PSD2 is gaining traction amongst merchants:

- Lower transaction volumes through RSKD's platform
- Steady decline in European revenue and number of customers

We saw the **opposite** of that in Q4.

That said, we still need more time to determine the effects of PSD2 on RSKD's business. Going back to my December 26 *Equity Note*, there are three reasons why customers would choose RSKD despite the availability of PSD2 and SFA:

- Merchants don't fully understand PSD2, and how it impacts their business with consumers
- Merchants DO understand PSD2 and how it will impact their business yet STILL choose to partner with RSKD
- Techniques to use PSD2 to work around RSKD haven't been made available yet but will be

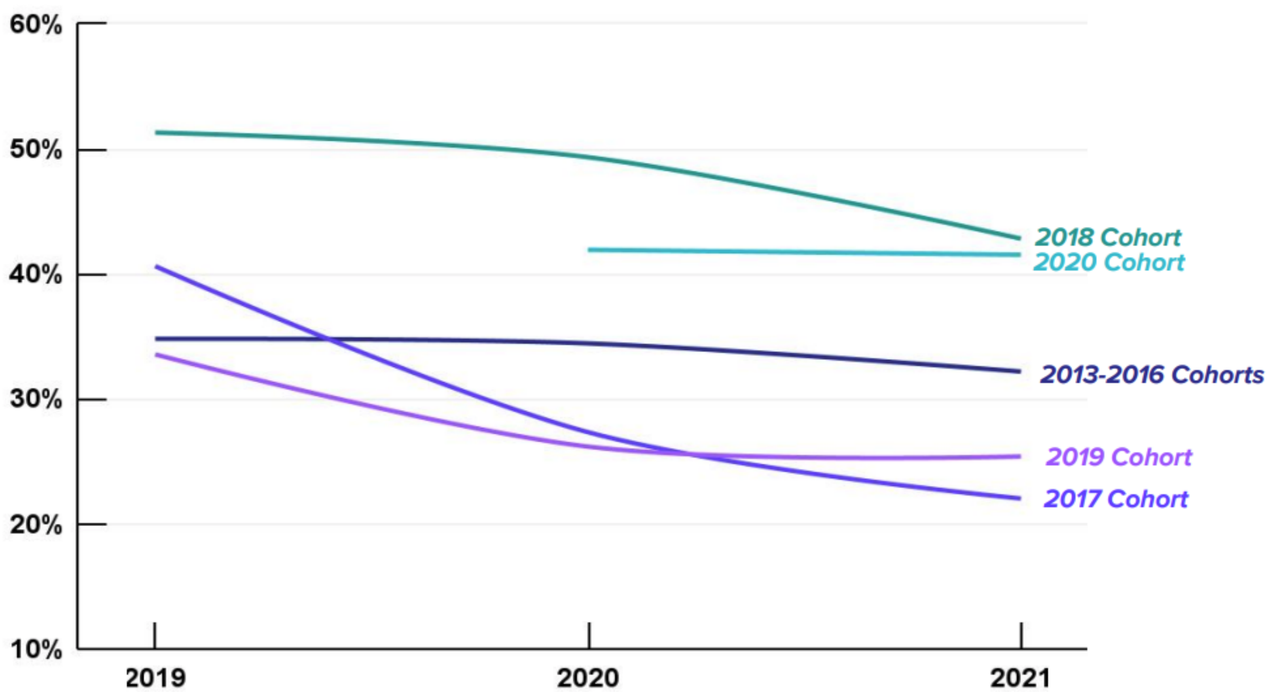


There were a few encouraging data points from RSKD's Q4 investor presentation. First, the company has increased billings from their mature cohorts (2013-2017) by 200%.

In other words, RSKD's earliest customers are sending *more* transaction volume through RSKD than ever before. This goes against the hypothesis that PSD2 would *reduce* RSKD's transaction volume.

RSKD's machine learning platform is also constantly improving, resulting in more transactions through the platform, higher revenues for customers, and lower chargeback costs.

Check out the graph below highlighting the Chargeback-to-Billings (CTB) Ratio by cohort over the past three years:



The better the algorithm, the fewer the chargebacks. The fewer the chargebacks, the greater the ROI for merchants. The greater the ROI, the more incentive merchants, have to send more transactions through the platform.

This, of course, makes the platform *even better*, resulting in fewer chargebacks, more significant ROIs, and more revenue for RSKD.

RSKD's $300B Current Opportunity w/ 20%+ Margins

RSKD has a $300B market opportunity from its existing customer base. In other words, the company can generate $300B in GMV just by having its current customers send more transactions through the platform.

Combining existing customer transaction volumes and new customers should result in 25-30%+ organic revenue growth.

RSKD sees a *massive* runway for organic growth and makes those investments *today* to capture the *long-term* market opportunity.

Founder/CEO Eido Gal explained the dichotomy between short-term profitability and long-term market expansion (emphasis mine):

> *"We feel we have full visibility into our spend, the expected output of that spend, and very rigorous in how we invest and what we expect to see from those investments.*
>
> ***When we think back to some of the earlier cohorts, geographies, we think they're incredibly profitable** and **we're certain that they can lead to kind of a 20% EBITDA margins longer term**, as we shared. **We're balancing that with the opportunity and the growth that we see ahead of us.***
>
> *Having said that, we're obviously mindful of spend, and we do anticipate that **this would be the largest investment year in terms of EBITDA loss that we would have.** And then we would kind of transition into some of those longer-term targets that we mentioned."*

The founder is certainly putting his money where his mouth is, too. Both co-founders (Eido and Assaf) haven't sold a share of stock since IPO, owning ~16% of the Common A stock.

Thinking About Valuation

RSKD currently trades at **~2.5x NTM EV/Sales.**

The company has a fortress balance sheet with half its market cap in cash and no debt. Eido has already told shareholders that 2022 will be the most significant investment year in the company's history.

They lost $20M in cash from operations in 2021 and are guiding for -$66M in EBITDA losses in 2022.

However, RSKD has enough cash to last **four years at a $100M cash burn rate.**

As they showed in 2020, RSKD can turn profitable whenever they want. They're highly confident in their mature cohort 20%+ EBITDA margin profiles.

<u>If RSKD can grow revenues at a 20% CAGR for the next five years, they'd generate nearly their entire market cap in revenue by 2026.</u>

I'm scheduling another call with Noa Sella, Head of FP&A, to get more information on PSD2 and any updates from management on how they view the long-term implications of those regulations. I'll update you with my notes from that call.

Portfolio Updates

Buys and Sells

- **BUY** Wheat Futures (ZWK2022)
- **BUY MORE** Sprott Uranium (U.UN)
- **BUY AND SELL** Natural Gas (NGZ2022) for 47bps profit
- **SHORT & COVERED** Tesla (TSLA) for 6bps profit
- **SHORT & COVERED** Nasdaq (MNQH2022) for 61bps profit
- **SHORT & COVERED** Second Leg of Russell 2000 (RTYH2022) for 5bps profit
- **BUY AND SELL** 10YR Treasury (ZNH2022) for breakeven
- **SHORT** Dax Futures (FDAXH2022)
- **SELL** Full position in BIOX, ARLP, NRP, DAC, DSRT