An Equity Note

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What's Inside:

- POWW News
- XP Earnings & New Long Position
- SmileDirectClub (SDC) Deep Dive
- Portfolio Updates

Companies Mentioned:

- Ammo, Inc. (POWW)
- XP, Inc. (XP)
- SmileDirectClub (SDC)

MO Equity Note: POWW News, XP Earnings & SmileDirectClub (SDC)

Happy Saturday!

Another wild week in markets. We've got a bunch to cover this weekend.

First, we're exploring some news from POWW HQ regarding FY/ upcoming earnings expectations and the company's latest buyback announcement.

Then, we'll discuss one of our latest buys: **XP, Inc. (XP)**. XP reported Q4/FY 2021 earnings this week and crushed it. There's a lot to like about the company and its potential returns over the next few years.

We also dig deep into another new investment: SmileDirectClub (SDC). SDC checks *a lot* of boxes for what we want in an investment opportunity:

- Massive addressable market
- Founder-led
- Positive operating leverage and unit economics
- Strong top-line revenue growth
- High short interest
- Left-for-dead stock price

We'll unpack SDC's value proposition, market opportunity, and why it could take share in the competitive clear aligner industry.

Finally, we'll highlight any trades made during the week in the MO Portfolio.

Let's get after it.

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POWW News: More Triple-Digit Growth + $30M Buyback

POWW made it back into our portfolio last week on a reversal at the 200MA. We currently have a 4% notional position heading into Q3 earnings.

Last week, the company announced its Q3 2022 earnings guidance with (you guessed it) more growth. Check out the release below (emphasis mine):

> *"For the third quarter period ending December 31, 2021, the Company expects revenue in excess of $64.0 million,* ***an estimated 288% year-over-year increase*** *compared to $16.6 million for the third quarter of fiscal 2021, and a* ***344% increase when compared to the nine months ending*** *December 31, 2020."*

CEO Fred Wagenhals commented on the guidance, saying, "*We see little or no slowdown in demand for our ammunition or growth in our GunBroker.com marketplace."*

POWW is increasingly becoming a bet on GunBroker.com, which is good for shareholders. GunBroker allows POWW to generate marketplace-like margins selling (what is otherwise) a commodity product.

Competitors can't match POWW's value proposition. They can't sell ammo at 40%+ gross margins because they don't have direct relationships with customers nor an online marketplace with millions of registered users.

This is important because margins will compress as more ammunition supply comes online. Margin compression hurts *a lot more* when you're making 10-20%, not 40-50%.

Additionally, GunBroker insulates POWW from its industry's typical supply-demand cycles, allowing it to capture a more stable gross margin profile over time. Higher, more stable margins should lead to an above-average market multiple.

So how is GunBroker doing lately? Let's check the data from SimilarWeb:

- Increased Global Rank by 61 slots to 2,399
- Increased Country Rank by four places to 439
- Retained #1 rank for its category

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GunBroker also increased its web traffic and engagement during the last quarter (October - December) from 16.4M monthly visitors to 17.7M. These traffic and engagement statistics dwarf any competitor. For example, check out the latest monthly traffic data from GunBroker's top competitors:

- Grabagun: 2.9M visits
- Classicfirearms: 4.9M visits
- Gunsamerica: 2.7M visits

The beauty of GunBroker's leading position is that it doesn't need to spend money acquiring visitors. 63% of visitors went directly to the website. Another 29% found GunBroker through search engines.

That's it. No paid advertising or marketing. That means GunBroker can use those extra marketing dollars to improve the marketplace, add more customer service techs, and upgrade payment portals.

Another way to check GunBroker's health is through its TrustPilot (TRST) page, which you can find here. Currently, GunBroker sports a 4.6/5 rating with nearly 18,000 reviews.

POWW's $30M Buyback Program

POWW announced a $30M share buyback program on Tuesday (02/08). The company can start buying shares after filing its Q3 2022 earnings results on February 14.

I *love* this announcement for a couple of reasons. First, $30M is ~5.5% of the company's current market cap. That's not inconsequential. Second, the buyback comes on the heels of a substantial drawdown in the company's share price.

POWW's share price is down 65% YTD. A buyback at these levels shows me that management understands the power of buying back stock at accretive prices.

In other words, I don't think this is a "for show" buyback announcement. Think about it another way. POWW is still in the early stages of its growth curve. It's building new manufacturing facilities, investing in GunBroker.com, and creating new product lines.

$30M on buybacks indicates the value management sees in the current pricing of its shares.

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I plan on asking CFO Rob Wiley about his thought process for this $30M share buyback. I've documented some of my concerns over Wiley's competence/experience levels in past *Equity Notes*. His answers should provide some insight into how he thinks about the all-important topic of capital allocation.

Thinking About POWW's Valuation

After falling 60%+ YTD, POWW trades at an amusing 1.92x NTM Sales and 13x NTM normalized earnings. Remember, this is a company growing revenues 200%+ over the last few years and expanding gross margins from 12% to 46%.

The company expects to generate ~$246M in FY 2022 revenue (+294% YoY) at 30%+ EBITDA margins.

Over the next few years, POWW expects to grow revenues at a ~21% CAGR to $430M by 2025. Suppose the company generates ~20% EBIT margins (in line with estimates) by FY 2025. That gets us $85M in EBIT.

What would a private market buyer pay for that business? Remember, in a few years, POWW will likely generate *most* of its revenue from GunBroker.com at 50%+ gross margins with direct relationships with its customers.

Let's assume a 15x multiple. **That gets us $1.26B in shareholder value or $11/share** (barring any dilution). That's equal to a **42% 3YR IRR at the current stock price.**

In a few years, one could also argue that POWW deserves a **5x sales multiple** as a mostly-online marketplace business. That would get us a **$2.15B market cap or $19/share (97% 3YR IRR).**

We'll look to add to our 4% notional position on continued strength and pullbacks to the midline.

XP, Inc. (XP): Another Record-Breaking Earnings Release

We bought a starter position in XP after releasing another record-breaking earnings report highlighting both Q4 and FY 2021 results. You can check out the slide deck here.

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XP is the largest independent broker in Brazil for those unfamiliar with the company. It operates a technology-driven platform providing financial products and services. We first wrote about the company in February 2021. You can read the write-up here.

The bull thesis is simple: **Brazil's Big Banks control ~90% of investment assets yet cannot offer the most comprehensive assortment of financial products consumers want in a lower interest-rate environment. Over time, trillions of dollars in client assets will flow from the banks to independent brokers.**

As we mentioned last February, XP can capture the bulk of that giant asset transfer. XP IPO'd in 2019. At the time of IPO, the company estimated it would generate ~R 10.5B in revenue and R 2.1B in Net Income by 2021. How did they do?

They crushed it.

At the end of 2021, XP generated R 12.8B in revenue and R 4.0B in net income. Revenue grew by a **52% CAGR versus the company's 35% original estimate**.
Additionally, XP 4'xd its Net Income compared to its expectation of roughly doubling by 2021.

Let's discuss the most recent quarter's results. Check out the highlights below (YoY growth):

- Increased revenues by 34% to R 3.4B
- Improved Gross Profit by 52% to R 2.4B
- Increased Net Income by 51% to R 1.1B
- 33.3% Adjusted Net Income Margin

XP is growing its core retail business while its new verticals like Pension Funds, Credit Cards, Credit, and Insurance explode in revenue. You can see the development below.

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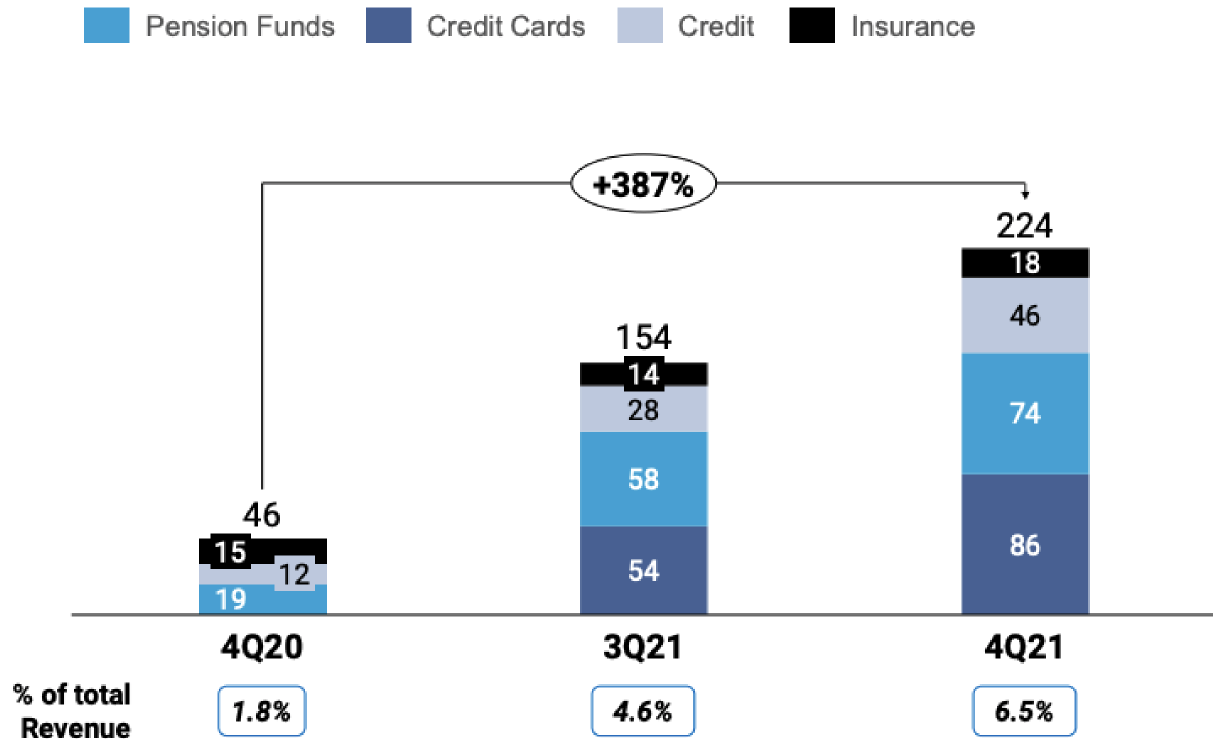

New verticals grew from ~2% of total revenue to 6.5%, mainly driven by credit card growth. What's equally impressive is XP's ability to take market share in these new verticals.

Let's take Private Pension as an example. When XP launched its Private Pension product in 2019, it had a 6.4% Net New Money (NNM) market share. Think of NNM as new capital inflows into the market.

Today, **XP captures ~53% share of NNM.** That's an 8x increase in three years! XP went from #5 in its market to #1 in three years.

There are other reasons to get excited about Private Pension. Despite increasing the share of NNM by eight-fold, **XP still only has ~3% market share of total AUM.**

Then there's Credit Card, which XP introduced in Q1 2021. Since its launch, XP Credit Card has grown 5x from 0.1% TPV market share to 0.5%. Said differently, **XP went from zero to R 10B+ in Total Payment Volume (TPV) in three quarters.**

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Operating Leverage Despite Massive OpEx Investments

While the above achievements are impressive, it pales compared to XP's operating leverage story. The company expanded its adjusted EBITDA margin from 37% to 43% YoY. This margin expansion came *despite* XP increasing its OpEx by 38% after adding 2,500 new employees and investments in technology.

In other words, XP could likely generate 50%+ EBITDA margins if it just slowed investment in people and maintained regular technology CAPEX. XP won't (and shouldn't) do that, however. Management has repeatedly said they will leverage their EBITDA margins to invest heavily in technology and people.

We can see this in XP's new vertical results.

XP's Executives Think Like Long-Term Owners

The last thing I want to highlight is that XP is run by long-term owner-oriented operators. Each earnings call is infected with long-term mindsets, entrepreneurial thinking, and a desire to create something bigger than any one individual.

Take CFO Bruno dos Santos's remarks from the Q4 report (emphasis mine):

> *"Because at the end of the day, again, **our business is not selling one product or other product. Our business is about establishing this deep long-term relationship with our clients.** And if our core business is investment, investment depending independently of the macro-environment is something that you have to consider always what to do with your portfolio, how to allocate. And that's exactly our business."*

XP's management has big dreams for the company, and so far, they've executed flawlessly. However, check out CEO Thiago Maffra's response to the question: "Do you feel comfortable with your 2025 targets?"

> *"Tito, **we are never comfortable,** okay, because -- one of our key values is a big dream, okay? **So we always have very challenging dreams and goals for the team … So it's not comfortable**. **And if it gets comfortable during the journey, we will increase the internal goals**, okay? So -- it's never easy for us to beat the internal goals that we have because we have big dreams, okay?*

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> *We like to say that we prefer people that have difficult to achieve goals and reach maybe 60%, 70% of these goals, than people that have very weak ones and reach 150% of the goal, okay? So that's the way we think here."*

I love the line, *"and if it gets comfortable during the journey, we will increase the internal goals."* XP isn't resting on its laurels.

Thinking About Valuation

XP has done nothing but crush it since its IPO in 2019. However, its stock price is only up ~8% since then. Think about that. The company has 4'xd Net Income and generated a 52% revenue CAGR since IPO, and the stock has barely budged.

Today, you can buy XP for a ~7% FCF yield and 28x NTM normalized earnings. I know, 28x earnings don't scream cheap. But the company expects to grow EPS by 30%+ over the next few years, giving us a ~1x PEG ratio.

Let's assume XP increases EPS by ~30% into 2025 to get us ~$3/share in earnings. What would a reasonable buyer pay for a 30%+ EBIT margin business growing profits 30%+ per year? Suppose it's 25x earnings. **That gets us a $75/share price tag and a 40% 3YR IRR from our $34 purchase price.**

SmileDirectClub (SDC): David vs. Goliath & The $900B Battle

SmileDirectClub (SDC) is the leading direct-to-consumer provider of clear aligner treatments for general malocclusion dental cases.

The customer value proposition is simple. SDC helps customers get straighter teeth for 60% of the cost of Invisalign without physically needing to travel to the dentist.

The company went public in 2019 at ~$20/share. Today, shares are down 80%+ at <$2.50/share. Despite the share price calamities, the business has improved over the last three years.

Revenues are up over 3.5x from $145M to $656M. Gross margin has expanded from 56% to 70%.

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Moreover, the company aggressively invested ahead of demand by building a 100% redundant manufacturing plant in Texas.

The market has *seemingly* good reasons for its bearish stance. The company faces competition from other DTC clear aligner brands, not to mention the $80B Goliath Align Technologies (ALGN). SDC has yet to post EBIT profitability while they burn through cash.

Yet just like the Biblical story, **we believe this David will ultimately slay Goliath**.

SDC has created the **best customer value proposition** for those that want to straighten their teeth without breaking the bank. Customers pay (on average) 60% less for SDC aligners than traditional Invisalign products.

Additionally, the company **vertically integrated every step of the sales process** from manufacturing to marketing to distribution and consumer financing. Such vertical integration will allow SDC to gain superior operating leverage over its fixed cost base, translating into 15-20% run-rate EBITDA margins.

Finally, **ALGN simply cannot compete with SDC on the direct-to-consumer business model** without *significantly* destroying its existing sales pipelines. ALGN's entire business model hinges on its ability to sell clear aligners to orthodontists. ALGN would destroy its orthodontist relationship and its revenue base by going direct to consumers.

Our long-term bet on SDC requires us to answer one question: **"Will consumers choose to pay 60% less for 90-95% of the results they would receive by choosing an in-doctor, Invisalign option for $6,000-$8,000 that insurance won't likely cover?"**

If the answer to the above question is "yes," then SDC is likely worth 10-15x more than what it's trading for today.

In the following pages, we'll explore:

- ALGN vs. SDC Business Models
- Consumer Behaviors Between ALGN & SDC
- The Size of The Prize
- SDC's Unit Economics
- The Right To Win
- How Big Can SDC Get If We're Right?

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We are currently long SDC but with a tight stop loss ahead of earnings. There's a decent chance we get shaken out of the trade before earnings, which is fine. We'd gladly risk 25bps to reduce FOMO while gaining exposure to a name we think can become a long-term mega-winner.

Suitable For Doctors vs. Good For Consumers

Why clear aligners in the first place? Why not use metal and wire braces? Two key reasons. First, clear aligners allow dentists to see more patients per hour than metal and wire braces. Second, dentists make *significantly* more money at scale using clear aligners than metal braces.

Let's explore ALGN and SDC's business models.

ALGN sells its clear aligners directly to orthodontists and dentists. The company offers discounted prices for large-volume operations, allowing the dentist to extract further profit from its patients.

The company charges dentists anywhere between $900-$1,200 for the aligners. Dentists turn around and charge their patients between $6,000-$8,000 for the Invisalign treatment. You can see why dentists love Invisalign as they can charge 5x their cost.

Patients usually require 10-15 orthodontic visits per year over a 12-24 month treatment course. Most health insurance providers don't cover Invisalign treatments (aesthetic, etc.). Patients either pay out-of-pocket with cash/credit card or through a financing option (usually barred by credit requirements).

Then there's the SDC model. SDC sells its clear aligners directly to consumers. There are a couple of ways consumers interact with SDC. One way is through ordering an impression kit, which allows the "patient" to make a PVC mold and ship it to SDC's manufacturing facility.

Customers can also visit SDC's Smile Shops to get a 3D scan of their teeth from a licensed dentist/ortho.

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After receiving the mold or scan, SDC ships the aligners to the customer's home. Treatment usually takes between 5-10 months on average. Customers can check in with dentists/orthos via remote teledentistry and send progress pictures through the SDC portal.

Customers pay $1,950 or ~$89/month for 24 months with $250 down. SDC saves customers on average 60% from traditional Invisalign aligners. It's important to note that SDC vertically integrated its captive financing. This allows them to approve every consumer and keep a credit card on file.

Consumer Choice: Pay 60% Less For 90% of The Result

SDC's ability to capture its addressable market hinges on one consumer decision: **"Do I pay 60% less for 90-95% of the result?"**

For cases where SDC isn't applicable, consumers opt for the traditional Invisalign route. They'd schedule routine orthodontist visits and pay the $6,000 because it's still better than metal braces. Historically, those were the only two options.

Now there's a third, direct-to-consumer. With a DTC offering like SDC, consumers can get 90% of the way to a perfect smile for 60% less cost. It's a compelling choice for ***a large portion** of* malocclusion patients. So what's the rub?

Over time, consumers will likely choose SDC over Invisalign for two reasons:

- **The 60% cost savings are too high to ignore a third alternative (vs. Invisalign or metal braces)**
- **Most people don't care/couldn't tell a "100% perfect" smile from a 90%-95% perfect smile**

The second reason is important. If consumers *deeply* cared about receiving a "perfect" smile, they'd choose Invisalign every time. But they don't. They just want straight teeth for an upcoming wedding, an anniversary, or because they lost/broke their retainers (see: yours truly).

It's why SDC says in their marketing and on their website that they *don't promise* a perfect smile. They promise a great smile and straighter teeth. Remember, 60% of the cost for 90% of the result.

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But how big is this market anyways?

SDC's $900B+ Market Opportunity

SDC operates in a massive $900B+ market. When deciding on SDC's addressable market, there are three factors: malocclusion rates, income threshold, and age.

Let's start with the United States:

- Population (2020): 331M
- Malocclusion Rate: 91% (301M)
- 12-64 Years Old: 70% (211M)
- Income Threshold (>$30K): 59% (124M)

That's ~124M cases within the US. To find the dollar value, we simply multiply 124M by SDC's cost ($1,950) to get **$242B in US Addressable Market Value**.

We construct the exact breakdown as above for the International market:

- Population (2020): 7.43B
- Malocclusion Rate: 86% (6.4B)
- 12-64 Years Old: 72% (4.6B)
- Income Threshold (>$30K): 8.2% (377M)

SDC sees an additional 377M potential cases outside the US. Multiply that by $1,950, and you get a **$736B Addressable Market Value.**

That brings SDC's total addressable market to **~ $978B**

To put things in perspective, SDC generated $650M in revenue in 2020 or **0.07% of its addressable market.**

Let's shift to SDC's unit economics to gain a clearer picture of the company's long-term potential value creation.

SDC's Unit Economics: 30%+ Contribution Margins

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SDC is the largest DTC player in the clear aligner space with ~95% market share (2019). Its size allows the company to generate higher contribution margins than competitors trying to enter the same market.

You can see the unit economic breakdown on the right. On average, SDC generates ~$590 per aligner order for a 32% contribution margin.

Aligner Price	$	1,950.00
Cancellation Reserve	$	(100.00)
Net Aligner Price	$	1,850.00
Gross Profit	**$**	**1,572.50**
% Margin		*85.00%*
SG&A Costs	$	925.00
% of ASP		*50.00%*
Proessing Fee	$	55.50
% of ASP		*3.00%*
Contribution Margin	**$**	**592.00**
% Margin		*32.00%*

There are multiple levers the company can pull to improve those margins over time, thanks to SDC's vertical integration efforts.

For instance, SDC is investing heavily in automation technology to reduce labor costs at their manufacturing facilities. Any incremental improvements there would reduce COGS and raise bottom-line margins.

SDC could also reduce marketing spending as more customers recognize the SDC brand and choose it over start-up competitors. In other words, there are a lot of levers to use when you're the leading DTC brand in the space.

The Sweet Spot: SDC & The Right To Win

As we mentioned earlier, SDC has a right-to-win path in its $900B+ addressable market. The company's direct-to-consumer model makes it difficult for incumbents like ALGN to compete (without destroying existing business models) profitably.

However, SDC also has an edge against its DTC competitors. Most competitors *do not have* SDC's vertical integration, and they *certainly* don't have SDC's market share.

New entrants usually outsource varying parts of their process, resulting in lower per-unit margins. For example, where SDC generates ~85% gross profit per aligner, new entrants might generate 50-60% to have a third party manufacture the product.

Then there's the sales and marketing spend issues. New entrants *must* spend more on marketing per dollar of revenue than SDC to gain market share and brand awareness. SDC, for instance, spends ~50% of revenue on SG&A. Start-ups, on the other hand, must spend 70%+ in SG&A just to stay relevant.

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What's left is a negative contribution margin for DTC competitors and a business model the largest incumbent can't match. **That is an attractive place to be!**

How Big Can SDC Get & Can They Get There?

The upside will take care of itself. SDC just has to get there. There's no hiding that SDC *must grow* to survive.

SDC is currently burning cash with $700M+ in long-term debt on the balance sheet. If they show signs of 20-30% top-line growth, they won't have issues raising necessary capital before turning profitable.

SDC's potential long-term value creation is enormous. Capturing 1% of the company's addressable market makes SDC a $9.4B run-rate revenue business. Assuming a meager 1x sales multiple on 1% market share, **we'd get nearly $80/share in shareholder value or ~32x higher than the current stock price.**

We believe the current price of <1x NTM sales offers an attractive risk/reward opportunity.

Portfolio Updates

Buys and Sells

- **Sold** 25% of PANR long to take profits in a 30%+ up day
- **Shorted & covered** TSLA for small loss
- **Exited** remaining GME short for small profit
- **Bought** starter position in XP
- **Bought** Soybean Oil on a breakout from the midline reversal
- **Bought** starter position in SmileDirectClub (SDC)
- **Sold** remaining Soybean long position at 15% above cost
- **Shorted** Russell 2000 and Nasdaq

Updated Stop-Losses

- **NTDOY:** $56.50
- **DAC:** $87.21
- **ARLP:** $12.80 (full position)
- **Corn (ZCH2022):** $6.10 (full position)

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