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An Equity Note

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What's Inside:

- ➢ Revisiting XP, Inc. (XP) and reviewing embedded expectations
- ➢ Cardlytics (CDLX) Q4 2021 Earnings Recap
- ➢ New SPAC Idea: Perfect Corp (PAQC)

Companies Mentioned:

- ➢ XP, Inc. (XP)
- ➢ Cardlytics (CDLX)
- ➢ Perfect Corp (PAQC)

MO Equity Note: Revisiting XP, CDLX Q4 Earnings, & A New SPAC Idea

Happy Saturday!

Another calm week in markets, right?

It's weeks like this that I'm reminded of Alex's infamous "keep your heads on a swivel" quote. How true.

We've got a few items to cover this weekend:

- ➢ **Revisiting XP, Inc. (XP)**
- ➢ **Cardlytics (CDLX) Q4 Earnings**
- ➢ **New SPAC Idea: Perfect Corp (PAQC)**

Plenty of stocks look cheap today. However, we *must* remain patient and respect the tape.

We're in a *great* spot (up ~14% YTD). To steal the words of Charlie Munger, we're just trying not to do anything stupid.

XP In Retrograde, What Gives?

XP is the largest independent broker in Brazil. It operates a technology-driven platform providing financial products and services. If Robinhood is a party-hard frat degenerate, XP is the older, much wiser brother with a wife, kids, and steady job.

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. But they don't offer the most comprehensive assortment of financial products for a lower interest-rate environment. Over time, trillions of dollars in client assets will flow from the banks to independent brokers.**

We bought a stake in the business for around $34/share. Since then, the stock's traded wildly, trading as low as $26/share during the week.

The share price decline *is not* correlated with the company's actual performance. In fact, XP is *killing* it on every critical KPI metric. You can read XP's latest earnings report here.

Here are some highlights … The company grew revenues by 34%, increased gross profit by 52%, and increased net income by 51%.

XP also maintained a 34% EBITDA margin *despite* massive technology and human capital investment.

Think about this … The company has 4'xd Net Income and generated a 52% revenue CAGR since IPO, and the stock is down ~20% from its IPO price.

So what explains the share price headwind? Forced selling from Big Banks.

Forced Selling Creates Long-Term Opportunity

When XP IPO'd in 2019, Itau owned ~20% of the company's stock. Today it owns ~14% after selling shares in 2021, with more planned sales in 2022.

It's essential to understand *why* Itau is selling its stake in XP. Luckily, every indication seems to point towards *non-fundamental* reasons. Itau CEO Alfredo Setubal explained his XP sales during Itau's latest earnings call (emphasis mine):

> *"Throughout this year we should make new sales of XP shares* ***to maximize results*** *and* ***reduce as much as possible the taxes we have to pay,"***

Itau shareholders also *love* their dividends. Setubal hinted that the company would use XP sales to finance potential dividend payments (emphasis mine):

> *We announced from the beginning that this is not a strategic investment for us. We decided* ***in the coming years to sell this stake to use this capital for other investments in other sectors or to distribute it to our shareholders.***
>
> *So we will use this capital to* ***partially increase the diversification that we have in other sectors.*** *We announced -- we don't want companies, only the bank -- Itaú Unibanco in the financial services.*
>
> *So XP is available in the coming years for sale for us. We made the sale at the end of the last year of 1.39%.* ***And most of the result of that was a distribution of us -- interest on capital to our shareholders."***

This is *good* news for XP bulls. Itau's selling pressure will hurt over the next 9-12 months as the bank unwinds its significant position. There's no hiding that. However, that also means that XP will *likely* trade lower as its business continues to improve fundamentally.

This brings us to the current stock price and embedded expectations. It's these embedded expectations that have us *so excited* about XP's long-term value creation prospects.

What's Embedded In XP's Current Stock Price?

As of writing this, XP trades at ~$27/share. The current price is *far too cheap* when you examine the embedded expectations at that price.

For example, here are the assumptions we must make over the next five years to get to the current stock price:

- **5YR Revenue CAGR:** 13%
- **5YR Average EBITDA Margin:** 27%
- **Discount Rate:** 10%
- **Exit EV/EBITDA Multiple:** 8x

These assumptions stand opposite to XP's historical and recent financial performance. For example, the company's grown revenues at a ~46% CAGR since 2018 while sporting an average 33.5% EBITDA margin.

In other words, to arrive at today's stock price, you have to think that XP will see its revenue growth drop by 2/3rds, see ~600bps of margin compression, and trade at a modest 8x EBITDA over the next five years.

The odds of the above future happening are *very low* (<10% probability). Here's why.

First, XP is expanding into new verticals like Pensions, Insurance, and Credit Cards. All of which offer *massive* white space for organic growth.

Second, the company grew 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.

XP will continue to invest in its business, which will reduce short-term EBITDA margins. Here's CFO Bruno Constantio's explanation (emphasis mine):

> *"We say, look, we are in a high-growth business, great opportunities. And we believe* ***the right course of action here is to reinvest 100% of our profitability into our growth in new businesses."***

The company could *quickly* generate 40%+ EBITDA margins if it reduced growth spending and switched to maintenance mode.

Third, XP *will not* trade at ~8x EBITDA if it generates even a *historical* growth rate and margin profile. If anything, they'd trade somewhere around 16x.

To conclude, we don't need XP to crush it to generate incredible returns over the next few years. In fact, we just need them to do what they've always done: **provide an exceptional product to millions of customers while expanding wallet share in high-growth verticals.**

If they do that, the stock will more than *double* from the current price over the next five years (20%+ IRR).

Safe to say, we're hoping for more Itau sales over the next few months!

Q4 Earnings Recap: Cardlytics (CDLX)

CDLX currently trades at the same price it did in 2019. This is fascinating because CDLX is a *much better business* today than in 2019. Some evidence includes:

- **27% higher revenues**
- **42M more MAUs on the platform**
- **Bridg & Dosh Acquisitions**
- **Self-Service Platform**
- **SKU-level offers**

That's not to mention CDLX's soon-to-be-renewed contract with Bank of America, one that will likely give CDLX *significantly more* leverage/benefits over time.

Let's get to the 2021 FY earnings highlights:

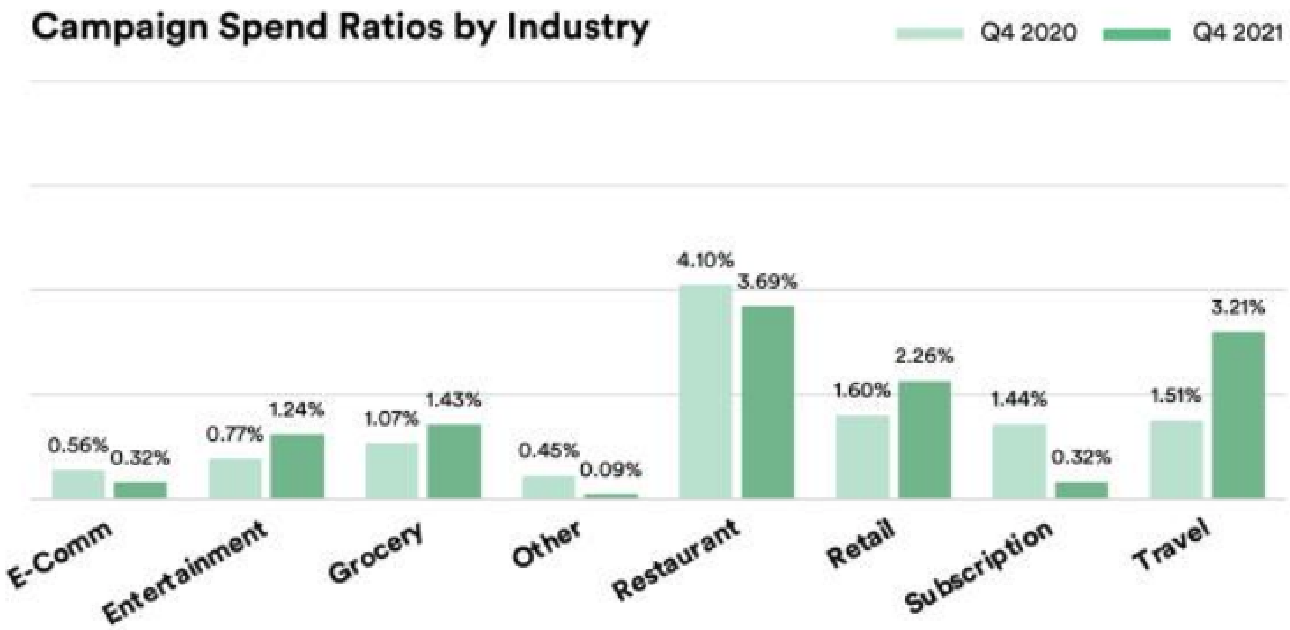
- **Revenue increased by 43% to $267M**
- **Billings increased by 50% to $263M**
- **Adjusted Contribution grew by 57% to $130m**

More importantly, CDLX increased ARPU by 26% to $1.51 while MAUs reached an all-time high of 175.4M.

Co-founder/CEO Lynne Laube reaffirmed her confidence in CDLX's ability to generate ~30% top-line growth over the next few years. There are a couple levers CDLX can pull to fulfill that 30%+ expectation.

First, advertisers still only use a fraction of their marketing spend on the CDLX platform. Check out the graphic below. Advertisers allocate ~1.56% of their marketing budget across CDLX's eight industry verticals.

CDLX can grow 30%+ by simply capturing a greater percentage of ad spending from its current customers.



Second, CDLX *recently* launched its self-service platform for ad agencies. Ad agencies offer *massive* revenue potential as most brands use agencies to direct their marketing spend.

Ad agency spending grew 100%+ in Q4 2021 compared to Q4 2020, representing 10% of total ad spending. I wouldn't be surprised to see ad agency spending represent 20-30%+ of total spending over time.

Laube commented on the power of ad agency spending on the earnings call (emphasis mine):

> *"Speaking of agency and our self-service initiatives, we secured our largest annual agency agreement to date in Q4.* ***This multimillion-dollar contract brings 90-plus potential advertisers to the table for Cardlytics and is indicative of the broader trend we're seeing.***
>
> ***Agencies are increasingly turning to the Cardlytics platform*** *due to the performance-based outcomes we can provide for their clients and the self-service capabilities we're building. In Q4, agencies more than doubled their ad budgets with us year-over-year. Throughout 2021, we added over 30 advertisers through more than 10 new agency relationships.* ***We expect these tailwinds to continue as ad agencies focus their strategy on achievable, measurable outcomes."***

Self-service also expands CDLX's addressable market to small local businesses that otherwise wouldn't have the ad budgets to support CDLX's historic white-glove offering.

Third, product-level offers which should increase CDLX's ARPU over time as companies pay more for hyper-targeted, product-specific rewards. SKU-level offers makes CDLX's platform more attractive to large CPG companies like Procter & Gamble, etc.

Laube commented in a December 2021 Investor Day that expanding into product-level offers "*doubles our TAM.*"

Remember, *CDLX is in the first inning of product-level offers.*

CDLX possesses three *serious* growth levers it can pull over the next five years. Let's see how that translates to potential valuation.

You can buy CDLX today (03/08) for a ~$1.74B market cap, with ~$36M in net cash on the balance sheet. What are the embedded expectations at the current price?

Not much.

CDLX is still losing money, so we based our assumptions on Year 5 exit EV/Sales multiples.

That said, to get to the current price, you'd need to assume:

- ~22% 5YR Revenue Growth
- 10% Discount Rate
- 3x exit EV/Sales Multiple

Those are simple assumptions but think about the growth levers we mentioned above. I find it hard to paint a reality where CDLX *doesn't* generate *at least* 30%+ top-line revenue growth.

Heck, the increased allocation from existing customers' ad budgets would get us there. In other words, you're not paying for any additional growth from self-service, product-level SKU offers, and small/local business offers.

Here's what we know. CDLX is just a better business than it was three years ago. They're adding product-level offers, they're improving their UI/UX, and they're expanding ARPUs on top of an all-time high MAU base.

The more services CDLX offers to its bank partners, the harder it becomes for banks to switch providers or cancel the program. Banks that use CDLX see customers open the app ~10x per month with strong activation rates across each industry vertical.

Customers love it, banks love it, advertisers love it. Eventually, shareholders will win, too.

Now, what if CDLX generates 30%+ top-line growth while leveraging its fixed costs to achieve profitability? A company like that should trade *at least* for 5-7x sales.

That gets us nearly $130/share or 140% higher than the current price for a 28% IRR.

CDLX remains on our standby list as the company recently broke long-term support and will likely trade lower in the coming months.

New SPAC Brief: Perfect Corp (PAQC)

SPACs present an exciting opportunity during market downturns. On the one hand, there's *tons* of garbage in the space. Enough to make you scapegoat the entire idea of SPACs.

This leads most investors to disregard *any* SPAC IPO, regardless of the underlying fundamentals/business models.

One such company is Perfect Corp, which will IPO in Q3 via Providence Acquisition Corp (PAQC).

Perfect uses AI/AR to help beauty shoppers virtually "try-on" makeup, eyeliner, eyeshadow, lipstick, new hair colors, fashion accessories (like watches), and more. They're the clear industry leader attacking a $14B+ industry.

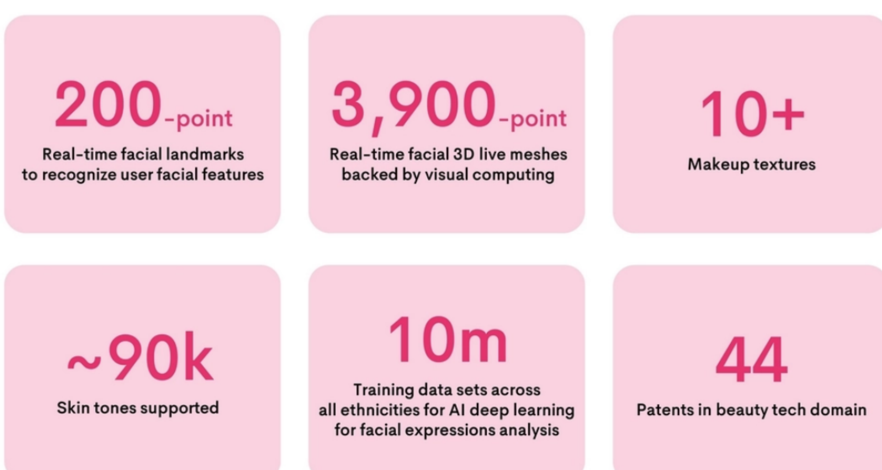
The company is growing like a weed (60%+ CAGR from 2018-2020) while commanding 95% gross margins and 150%+ Net Dollar Retention Rates.

Perfect has a powerful bull case: **To become the infrastructure for how beauty retailers do commerce with Gen-Z shoppers**.

Like most AI/AR companies, the competitive advantage *is not* in the technology itself. Rather, it's in the partnerships the company makes with dozens of brands, allowing Perfect to *better train* its AI/AR algorithms.

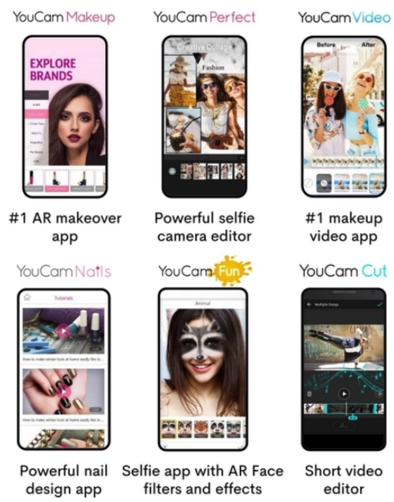
Over time, the more data points Perfect feeds into its algorithms, the better it gets at reading faces, matching colors, and creating the most life-like virtual try-on experience. This is what we call a "defensible dataset", which we've written about here.

Speaking of data points …



Perfect is the market leader when it comes to its AI/AR algorithms. The company boasts 10M training data sets across *all* ethnicities, supports ~90K skin tones, and uses 200 facial landmarks to construct the most accurate virtual reality possible.

The company captures this data advantage via its portfolio of consumer-based social apps like *YouCam Makeup, YouCam Perfect, YouCamNails,* and more.



Take *YouCam Makeup,* for example. It's the #1 AR makeup app on both Apple/Google Play Stores.

A mind-boggling 4.1M users have [reviewed the app on Google Play] with an average of 4.5 stars.

An additional 115K have reviewed the app on the Apple Store with an average of 4.8 stars.

Consumer apps are the *perfect* hotbed for testing new products/features while gathering *critical* data to train Perfect's AI/AR algorithms.

Perfect uses its apps and 40M+ monthly users to reinforce its defensible dataset while in turn creating exceptional value for beauty brands and partners.

YouCam Makeup offers live streaming, real-time tutorials, and social commerce capabilities.

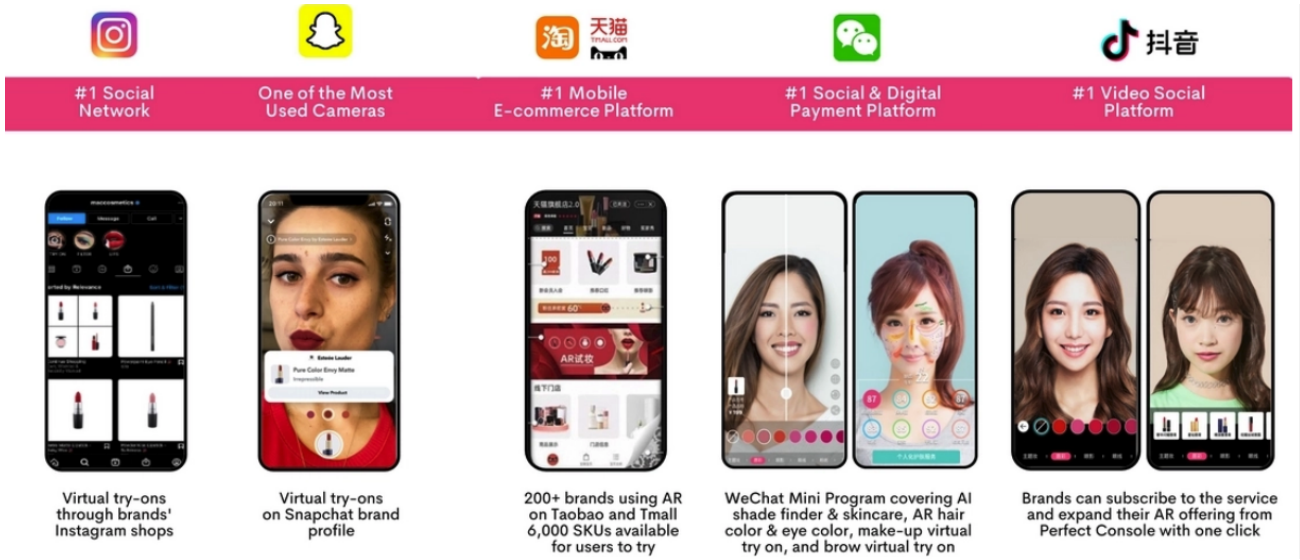
Check out this video here if you want to understand the power of Perfect's *YouCam* technology. Which brings us to Perfect's customer value proposition.

The Perfect Fit For Beauty Commerce

There are a couple of key benefits of Perfect's AI/AR virtual try-on technology. First, customers can "try-on" different shades of makeup, eyeliner, and eyeshadow at *zero* cost to the retailer.

Shoppers don't physically apply a shade of lipstick, for example. This allows the customer to try *more* products in *less* time while greatly increasing the chances of higher average order values.

The second (and most important) benefit of Perfect's technology is the ability to virtually try-on products while browsing social apps like Instagram, Snapchat, or TikTok. Whether that's virtually shopping a brand's Instagram page or using a brand-sponsored Snapchat filter to change lipstick colors (see below).



So far, brands love it. Perfect's customer list resembles a "who's who" of beauty and includes *Chanel, LVMH, Revlon, Estee Lauder, Unilever, Kose,* and more.

In fact, 19 out of the Top 20 Beauty Groups use at least one Perfect product. That represents ~$158B in annual sales and accounts for 57% of the total beauty market revenues.

Perfect has diversified its revenue base away from the Top 20 brands. Today, roughly 32% of revenues come from beauty's Top 10 brands.

Let's discuss customer growth. Customers usually start with one product feature and scale Perfect's use cases expand as the brand grows. Let's look at two use cases from the company's pitch deck.

One brand (Brand A) started with 840 SKUs in 2016. Last year, that brand had 26,000+ SKUs on the Perfect platform and increased Annual Recurring Revenue (ARR) by 45x during that time.

Another brand (Brand B) started with 160 SKUs in 2016 and ended 2020 with 37,000+ SKUs. Brand B also increased ARR by 489x from 2016 to 2020.

Perfect's Massive Growth Runway

There are three levers Perfect can use to increase revenue and gross profits *all within* its Top 20 Beauty Group cohort:

- ➢ **Add more brands**
- ➢ **Add more SKUs**
- ➢ **Add more countries**

Currently, Perfect works with 123 brands. That means there are ~312 brands up for grabs within the Top 20 Beauty Group or 3.5x more than they have today.

Then there are total SKUs, of which Perfect has ~266K today. However, an additional 1.5M SKUs are available (6x higher than current value) within the Top 20 Beauty Group that Perfect can add to its platform over time.

Finally, Perfect's current brands span ~6 countries on average. Perfect estimates that it can reach 80 countries with its existing customer base, or 13x more countries than today.

That's what Perfect can do with their existing customer base. What about new customers?

Enter the **Indie Beauty Market**. Indie beauty brands (non-brand name) generate ~$119B in combined revenue and command ~43% market share. There are 200K+ global indie beauty brands.

Most importantly, **<1% of these Indie brands use AI/AR in their sales process.**

Here's why Perfect is a logical choice for indie brands. Indie brands can't leverage industrial-sized distribution channels like the LVMHs and L'oreal's of the world. Instead, they rely on word-of-mouth distribution from social apps like Instagram, TikTok, and Snapchat.

Perfect is a plug-and-play solution that **meets both the Indie brand *and* Gen-Z shopper where they are**, on Instagram, Snapchat, or TikTok.

The last growth avenue will come from new verticals beyond beauty/makeup. These include things like watches, facial accessories, jewelry, men's grooming (beards, etc.), clothing, haircuts, and more.

Perfect will de-SPAC sometime during Q3 2022. The company will likely IPO around 16x NTM sales, which is a bit rich for my blood. That said, management estimates they'll generate ~30% EBITDA margins within five years at $150M+ revenue base.

The company's led by its founder, Alice Chang. Alice created Perfect during her stint as CEO of Cyberlink. You can listen to a great interview with her here.

Perfect has the potential to become the infrastructure on which all future commerce will occur. Commerce built on socialization and engagement, where customers can see how something looks before buying.

On a long enough time horizon, beauty companies can't afford to *not* have Perfect embedded in their online shopping experience.

Portfolio Updates

Buys

- **BOUGHT** Tactical Long in NMM
- **BOUGHT** Tactical Long in CTVA

Sells

- **EXIT** Full BFIT Long
- **EXIT** Full ASAN Long
- **SOLD SHORT** Second Leg in RTY
- **SOLD** Half position in Soybean Oil
- **SOLD** Full position in Corn