MACRO OPS
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An Equity Note

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What's Inside:

- Revisiting POWW Before Earnings
- Cash Flow Variance Analysis
- Inventory & A/R Management
- What To Watch Heading into Earnings

Companies Mentioned:

- Ammo, Inc. (POWW)

Equity Note: Cash Flow Variance Analysis Signals Potential Problems Ahead for POWW

This weekend, we're diving into Ammo, Inc. (POWW) ahead of next week's earnings.

POWW has real issues that could challenge the bull case in the coming quarters. Most notably, the company struggles to manage inventory and accounts receivables effectively. Both are massive drains on cash flow.

We explain how POWW can improve its inventory and A/R to generate profitable growth in the coming quarters.

New *Collective* members will find this exercise particularly insightful if they haven't had the chance to read our original research.

Seasoned *Collective* members will also benefit from updating our priors and introducing a new layer to POWW's research: **Cash Flow Variance Analysis.**

There's still little to do in markets besides sitting on our hands and waiting for a buying opportunity. Which is fine. We'll gladly sit in 85% cash while studying new investment opportunities.

Knock on wood I also see constructive bases forming in the tech/high-growth space. We'll see how well they hold.

We plan to progressively add more long exposure to the book in the coming weeks, so get that cash ready and stay tuned for any trade alerts.

Alright, let's get after it.

Revisiting Ammo, Inc. (POWW) Before Earnings

POWW is a founder-led small-cap ammunition manufacturer and online gun/ammo marketplace (via Gunbroker.com acquisition).

The company has grown revenues by over 200%+ **per year** since 2019 while expanding gross margins from ~16% to 40%. You can read more about POWW here, here, and here.

Gunbroker, POWW's online gun/ammo marketplace has helped transform the company's economics. Historically, ammo manufacturers generate ~20-30% gross margins and ~10-15% EBITDA margins.

Gunbroker generates ~80% gross margins and ~66% EBITDA margins. Over time, more Gunbroker revenue equals higher gross and EBITDA margins for the overall business.

POWW's stock has crumbled despite its strong revenue growth and margin expansion. Shares are down ~24% YTD and -51% over the past year.

POWW trades at ~1.5x NTM Sales and 10x NTM EBIT, with 12% short interest.

There are a few things I want to see in POWW's upcoming earnings report:

- **GunBroker Marketplace Growth**
- **Improved Inventory Control**
- **Improved Accounts Receivable Collections**

Let's break each down.

GunBroker Marketplace Growth

Founder/CEO Fred Wagenhals wants investors to value POWW like a marketplace business. However, for that to happen, investors must see continued Marketplace growth as a percentage of total sales.

Last quarter, Marketplace revenue accounted for 27% of total sales. I want to see this quarter's figure north of 30-35%.

Remember, the greater the percentage of revenue from Gunbroker, the higher POWW's overall gross/profit margins. Which should translate to higher valuations.

Improved Inventory Control

POWW roughly tripled its inventory QoQ, growing by 194%. Fortunately, POWW grew revenue by 290% during the same quarter. This is a good thing.

We want revenues to grow faster than inventories. Why? Inventories act as a headwind for profitability when they **outpace sales growth**. You can read more about that in my *Quality of Earnings Book Review.*

Here's what I'm watching for this quarter. I want confirmation that sales are increasing faster than inventories, which POWW has done over the past quarter.

I'm watching to see if that trend reverses. If it does, it would signal a potential major red flag for the coming quarters.

The same thing goes for Accounts Receivables, which we'll discuss next.

Improved Accounts Receivable (A/R) Collections

A/R Collections are an important part of any retailer. It shows how much cash you collect from customers for the product you deliver.

Like inventories, **we want revenues to grow faster than A/R**. If not, it means POWW's customers (like Bass Pro, Sportsman Warehouse, etc.) struggle to get the product off the shelves.

A/R increased by 407% QoQ while revenue increased by 290%.

This is a red flag and could mean a few things.

First, it could mean POWW generated 290% revenue growth on mostly customer credit (i.e., Net 30 terms, etc.).

Second, it might mean POWW has difficulty collecting cash from its customers (not good).

Third, it could signal channel stuffing from POWW to its distributors (like Bass Pro, etc.). Also, not good.

Either way, there's *clearly a slowdown in consumer* demand.

AMMO, Inc.
CONDENSED CONSOLIDATED BALANCE SHEETS

	December 31, 2021 (Unaudited)	March 31, 2021
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 27,414,571	$ 118,341,471
Accounts receivable, net	45,653,542	8,993,920

I want to see this trend reversed this quarter. I'd get *very* suspicious if A/R grows faster than revenues again.

Cash Flow Variance … Or The Importance of Inventory & A/R Management

Retail businesses live and die by inventory and A/R management. It's either a major headwind or a tailwind for cash flow generation.

We can see this by using Cash Flow Variance Analysis.

Cash Flow Variance Analysis shows the **cash impact** of both **growth** and **change** in revenues, margins, and spending.

Check out my primer on the topic in the link above. Cash Flow Variance reveals three important metrics:

- ➢ **Operating Cushion:** Percentage difference between your gross margin % and your SG&A %.
- ➢ **Core Operating Growth Profile:** Operating Cushion + Working Capital %
- ➢ **Free Cash Flow Profile:** Core Operating Growth Profile - Income Tax & Capex

The above metrics tell us how much EBIT, Core Operating Cash Flow, and Free Cash Flow a company generates *per* $1 in incremental revenue.

Let's examine POWW's Cash Flow Variance for 2020, 2021, and the LTM 2022.

Core Operating Profile			
Metrics	**2022 LTM**	**2021**	**2020**
GM%	40.11%	19.24%	-28.57%
SG&A%	15.93%	24.05%	64.29%
Op. Cushion%	***24.18%***	***-4.81%***	***-92.86%***
A/R%	-25.27%	-15.46%	-21.43%
Inventory%	-25.27%	-27.49%	-31.50%
A/P%	-13.42%	-7.51%	-37.14%
Prepaids%	0.00%	0.00%	0.00%
Accruals%	0.00%	0.00%	0.00%
Deferred Revenue%	0.00%	0.00%	0.00%
WC%	**-63.97%**	**-50.46%**	**-90.07%**
Core Op. Profile%	**-39.80%**	**-55.27%**	**-182.93%**
$ Generated (Lost) for $1 I	-$0.40	-$0.55	-$1.83
FCF Growth Profile			
Metric	**2022 LTM**	**2021**	**2020**
Core Op. profile%	-39.80%	-55.27%	-182.93%
Tax%	0.00%	0.00%	0.00%
Cap Exp%	-8.79%	-4.64%	-16.14%
Free cash%	**-48.59%**	**-59.91%**	**-199.07%**

First, notice POWW's Operating Cushion %. It's *improved* from -93% in 2020 to +24.18% LTM 2022. The company used both levers (Gross Margin and SG&A) to expand its Operating Cushion, which is a great sign.

Then there's POWW's Core Operating Profile %, which has improved from -183% in 2020 to -40% in LTM 2022. In other words, POWW lost ~$1.84 for every $1 of incremental revenue growth in 2020. Today, they're *only* losing $0.40 for every $1 of incremental revenue growth.

That's a *huge* improvement. But it's still negative. Why?

Enter Inventory and A/R Management.

Inventory & A/R: Headwinds For FCF Generation

Last year, POWW tied up ~46% of its revenue in A/R and Inventory. This turned its (already negative) Operating Cushion into a -55% Core Operating Profile.

In other words, POWW lost $0.55 for every $1 it generated in incremental revenue growth.

Failure to effectively manage inventory and A/R means less cash for the business to do other things, like reinvest in technology or equipment, pay dividends, or buy back stock.

POWW's LTM 2022 is an improvement, but Inventory and A/R management remain an issue. For example, **50%+ of the company's revenue** is tied up in Inventory and A/R as of LTM 2022.

So despite POWW's +24% Operating Cushion, it *still* loses ~$0.40 for every $1 in revenue growth.

In other words, POWW **consumes** cash as it grows, albeit at a lower rate than two years ago.

The first question you should ask yourself is, "why is this happening?" POWW is a rapidly growing manufacturing company. Manufacturing companies *need* inventory and A/R to grow, the same way a bodybuilder needs excess calories to gain muscle for a competition.

One should *expect* negative Operating Cushion from early-stage growth companies as they build capacity and leverage fixed costs. And that's what we're seeing with POWW. The company shrank its Operating Cushion from losing nearly $2 for every $1 in growth, to only $0.40.

In other words, it's not the *absolute* number we care about, but the trend in Operating Cushion over time.

That said, POWW *must* generate positive Operating Cushion at scale or it will be forced to issue equity or debt to finance its future growth.

What Can POWW Do?

There are various levers POWW can pull to reduce its cash consumption and even generate cash as it grows.

First, they can increase Operating Cushion by shifting more revenue from ammunition to the marketplace.

Second, POWW can reduce its A/R balance by collecting more revenue from its customers quicker (bringing more cash into the door sooner).

They can accomplish this by reducing customer credit terms or increasing demand from retail customers (reducing time on the shelf from intermediaries).

Finally, POWW can improve its inventory management by holding fewer raw materials, finished goods, etc.

Wrapping Up: POWW Has Clearly Defined Targets

The thing I love about Cash Flow Variance Analysis is that we know *exactly* what we need to see in POWW's upcoming earnings report. We know how the company needs to improve and what it can do to get there.

There are *clear* red flags with POWW, most notably its massive A/R growth rates, which is undoubtedly a big reason it has a nearly 12% short interest.

Yes, POWW is growing fast, and sometimes the penalty for rapid revenue growth is expanding inventory and A/R. That doesn't bother me.

What bothers me is that A/R grew nearly twice as much as revenues. **That trend needs to change, or it's further downside for POWW.**

Bulls need confirmation that management can improve A/R and Inventory, which will improve cash flow conversion and give POWW a chance to *generate* cash as it grows.

We'll update you on POWW after the company's earnings on the 29th.

Portfolio Moves

Buys

- **BOUGHT STARTER LONG** in Carvana (CVNA)
- **BOUGHT** Long Bonds (ZBU2022)

Sells

- **SOLD FULL POSITION** in Ethereum (ETHUSD) Short
- **SOLD FULL POSITION** in Crude Oil (CLZ2023) Long