SUMZERO

TOP STOCKS FOR 2021

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ABOUT THE TOP STOCKS CHALLENGE

The ideas featured within this report were selected as the 15 Winners and Finalists of the 5th Top Stocks Challenge, an annual investment research competition hosted by SumZero, a global platform of nearly 20K buyside investment professionals.

SumZero members are investment professionals working at hedge funds, private equity funds, mutual funds, and family offices or are investment professionals with substantial prior fund experience. The complete research history of individuals featured in this report, as well as bios, and work history can be found on the SumZero database.

The 75+ submissions entered into this year's Challenge were independently assessed and voted on by a panel of 39 senior fund professionals and asset allocators. The following, multi-factor criteria was utilized to determine the Winners:

- VALIDITY OF THE THESIS
- STRENGTH OF THE SUPPORTING ARGUMENT
- FEASIBILITY OF THE TRADE
- ORIGINALITY

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ASIA-PACIFIC & OCEANIA

Name must be based in the Asia Pacific or Oceanic Region

WINNER
Asia

Jack Chan
Five States Capital Resources Limited

BADGES:

Razer Inc Ord

Asset: **Equity** Symbol: **1337:HK**
Idea Posted: **12/23/2020** Idea Updated: **12/26/2020**

RETURN TO DATE: 3.9%
EXPECTED RETURN: 166.67%

LONG

ATTACHMENTS	TIMEFRAME	SITUATION	MARKET CAP
	1-2 Years	Value	280.0M USD

> Razer is a well-known gaming brand. Although razer fail to win the first digital banking license in Singapore, we see a deep value investment opportunity for future digital banking business.

About Jack Chan

Jack is a Hong Kong / China equities focused Portfolio Manager with specialization on various long short strategies. Jack holds a bachelor's degree in Accounting and Finance from University of Hong Kong who has over 10 years of global investment experiences as a Chartered Alternative Investment Analyst. In 2014 - 2018, he held the position of Executive Director and Senior Portfolio Manager at Sun International Asset, Investment Director at regional multi-strategy hedge fund Silver Tree and Vice President at Alphalex Capital. Jack collaborated on this idea with his colleague, Arthur Lee, who is a Hong Kong / China equities focused Research Analyst with specialization on various long short strategies.

About Five States Capital

Five States Capital is currently a Hong Kong based licensed corporation under the Securities and Futures Ordinance ("SFO") to carry out Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities. We provide investment advisory services to professional investors and high-net-worth clients which utilize China's high-quality assets and resources. We adhere to our business philosophy, "integrity, professional, rigour and responsibility", and actively grasps the market opportunities with the aim of compounding growth through quality value investments for our partners. The best way to learn more about the Five States Capital is to read the investor letters on Five States Capital's SumZero page or visit http://www.fivestates.com.hk/.

Razer Inc Ord

Asset Class: **Equity** Symbol: **1337:HK** Updated: **12/26/2020** Submitted: **12/23/2020**

Pricing & Return Details	LONG
EXPECTED RETURN	166.67%
TARGET PRICE	6.40 HKD
INITIAL PRICE	2.31 HKD

BY:
Jack Chan

CURRENTLY AT:
Five States Capital Resources Limited

> Razer is a well-known gaming brand. Although razer fail to win the first digital banking license in Singapore, we see a deep value investment opportunity for future digital banking business.

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Value	2% - 5%	N/A	1-2 Years

INVESTMENT THESIS

INTRODUCTION

Investors are seeking for a stock with quality brand, competitive products, growing industry and innovative business model. We found Razer Inc (1337.hk) fulfills the requirements and ready to have a good time in 2021.

Razer is a well-known gamer-focused brand targeting to build an all-in-one gaming eco-system. Market's first impression on Razer is a hardware company selling gaming headset, monitor, laptop, mice, chair, keyboard and kinds of peripherals. Many investors have been led to believe that Razer is a COVID beneficial stock and should be underweight after the launch of vaccine and technology sector great-rotation. However, we will show you that Razer is not only a hardware company and COVID beneficial stock but also a Fintech new-star while dividing the investment thesis presented into hardware and Fintech parts.

Our investment thesis is simple:

- The product quality (comments and evaluation from major technology hubs), sales figure and brand loyalty of Razer is far better than major hardcore competitors (Logitech and Corsair) but the valuation does not match (Razer is significantly behind);
- The financial service penetration rate in South East Asia is trail. Razer will be the game changer in financial service and Fintech industry while in-game purchase is a good entry point for FinTech (payment) service;
- Short term selling flow caused by the failure on Singapore first digital banking license creates a good buying opportunity;
- Razer Pay GMV would keep on a high growth track;

- Razer Fintech business is the road to follow Alibaba's 3-year successful story with at least one digital banking license before 2023;
- Lessons of Gamestop indicates commission scheme is the future of gaming industry. As long as gaming hardware product edge and the launch of innovative payment and reward product Razer Gold, commission from game maker (like Microsoft, Sony and Capcom) and game operator will be a future growth driver which still does not be reflected; Certain deep value choice in 2021 with relatively low P/E to peers

HARDWARE BUSINESS

Diversified product edge with valuation comparability. To compete with Logitech and Corsair, Razer offers a richer product matrix to fulfill the signature slogan "For Gamers, By Gamers" which satisfy both professional and rookie users which demand on boarder price range and types. Of course, a richer product matrix doesn't mean certain product edge, we have to check the gross margin and sales revenue growth. The gross margin on gaming peripherals is decreasing within the industry due to the inflation on upstream materials with a key fact that Razer's gross margin is highly in line with Corsair which indicates the valuation comparability. We believe Logitech is slightly competitive on the predicted gross margin due to the production scale. The market worried on the bad sales growth in 2019, however, Razer has dropped out the unprofitable smart phone business which has not yet been reflected on the coming financial statement. Sales growth in 2021 would be proved in next part.

	2017			2018			2019		
in thousands US$	Razer	Logitech	Corsair	Razer	Logitech	Corsair	Razer	Logitech	Corsair
Sales revneue	[illegible]	[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Hardware (gaming)	$475,718			$615,525			$ 713,979		
Peripherals	$338,717	$ 491,995		$429,606	$ 648,130	$233,500	$ 444,902	$ 690,174	$ 294,100
Growth %				26.8%	31.7%		3.6%	6.5%	26.0%
Systems	$137,001			$185,919		$704,000	$ 269,077		$ 803,000
Growth %				35.7%			44.7%		14.1%
Cost of sales									
Hardware (gaming)									
Peripherals	$218,400			$292,200		$160,000	$ 327,400		$ 212,700
Systems	$125,000			$168,500		$584,800	$ 242,600		$ 660,100
Gross profit									
Peripherals	$120,317			$137,406		$ 73,500	$ 117,502		$ 81,400
Gross margin %	35.5%	33.4%		32.0%	35.2%	31.5%	26.4%	35.7%	27.7%
Systems	12,001			17,419		119,200	26,477		142,900
Gross margin %	8.76%			9.37%		16.93%	9.84%		17.80%
Hardware %	91.85%	19.17%		86.40%	23.24%	100.00%	86.99%	23.19%	100.00%

	Gaming product	Razer	Logitech	Corsair
PC/laptop	PC/laptop	✓		✓
	eGPUs	✓		
	Case	✓		
	Accessory	✓		
	CPU cooler	✓		✓
	Fan			✓
	Memory	✓		✓
	Storage (USB)			✓
Peripherals	Headset	✓	✓	✓
	Mice	✓	✓	✓
	Monitor	✓		✓
	Keyboard	✓	✓	✓
	Chair	✓	✓	✓
	Audio/Music controller	✓	✓	✓
	Controller/Joystick	✓	✓	✓
	Accessory	✓		✓
Smartphone	Smartphone	✓		
Pay & rewards	Pay & rewards	✓		

Champions on product evaluation and key date sales figure. To evaluate the real product competitiveness, the best way is to compare the comments from leading technology hubs and the sales figure on key dates. We evaluate the common products (gaming headset, monitor, laptop, mice, chair and keyboard) in peripheral category from PC Gamer, Techradar, Tom's, Gamesradar and IGN. The evaluation includes user experience, function, practicality and price while Razer has a definite advantage in gaming headset, monitor and laptop and relative advantage in keyboard. Although Logitech are well- known for mice, Razer is still the first choice for gamers while the low-end gaming keyboard successfully carve up the market with Corsair. Razer shows a product quality and edge when competing with Logitech and Corsair. Apart from product quality, Razer also wins the sales battlefield. We try to capture the sales figure during Amazon Prime day and Thanksgiving holiday which are good samples to predict whole year sales. Razer shows absolute advantage in gaming mice, keyboard, headset and controller on Amazon Prime day while dominates in gaming keyboard, mice, headset and music controller on Thanksgiving holiday among the three brands. The bright sales figure supports the growth of hardware business in 2021.

TOP TECHNOLOGY HUBS COMMENTS:

THE BEST GAMING HEADSET IN 2020

Rank	PC Gamer	Price	Techradar	Price	Tom'shardware	Price	Gamesradar	Price
1	Razer Blackshark V2	$ 99.99	Razer BlackShark V2 Pro	$ 179.99	SteelSeries Arctis 7P/7X	$ 314.99	Razer BlackShark V2	$ 99.99
2	Hyper X Cloud Alpha	$ 99.99	Corsair HS60 Haptic	$ 129.99	HyperX Cloud Stinger	$ 39.95	Astro A50	$ 299.99
3	Razer Thresher Ultimate	$ 169.99	HyperX Cloud Revolver S	$ 127.13	Razer Blackshark V2	$ 99.99	Razer Kraken Tournament Edition	$ 54.99
4	HyperX Cloud Orbit S	$ 302.40	Logitech G Pro X Wireless	$ 199.99	Logitech G Pro X	$ 129.99	Steelseries Arctis Pro + GameDAC	$ 189.99
5	Steelseries Arctis 9	$ 199.99	SteelSeries Arctis Pro	$ 179.99	SteelSeries Arctis 1 Wireless	$ 99.99	JBL Quantum One	$ 149.95
6	Razer Kraken X	$ 39.99	Astro A50 Wireless (2019)	$ 299.99	Turtle Beach Elite Atlas Aero	$ 108.18	Razer Nari Ultimate	$ 189.00
7	Creative SXFI Gamer	$ 69.99	SteelSeries Arctis 7P Wireless	$ 148.00	HyperX Cloud Alpha	$ 99.99	Alienware AW510H	$ 99.99
8	Astro A03 In-ear Monitors	$ 49.99	BeyerdynamicCustom Game	$ 154.95	SteelSeries Arctis Pro + GameDAC	$ 189.99	Turtle Beach Elite Atlas	$ 99.95
Razer	Champion		Champion		2nd runner-up		Champion	

THE BEST GAMING MONITOR IN 2020

Rank	PC Gamer	Price	Techradar	Price	Tom'shardware	Price	Gamesradar	Price
1	ASUS ROG Swift PG279Q	$ 641.99	LG UltraGear 38GN950	$2,995.00	Dell S3220DGF	$ 409.97	ASUS ROG Swift PG279Q	
2	LG 27GN950-B	$ 696.99	Samsung CRG9	$ 949.99	Razer Raptor 27	$ 699.99	ASUS TUF Gaming VG27AQ	$ 419.99
3	Pixio PX277 Prime	$ 329.99	Alienware AW3418DW	$1,799.99	Acer Nitro XV273K	$ 1,055.0	Razer Raptor 27	$ 699.99
4	BenQ EL2870U	$ 299.99	AOC Agon AG352UCG6	$1,142.00	Asus ROG Swift PG259QN	$ 999.00	BenQ EL2870U	$ 299.99
5	Acer XR382CQK	$ 899.99	BenQ PD3200U	$ 699.00	Acer XFA240		Samsung G7	$ 869.94
6	ROG STRIX XG17AHPE	$ 494.49	MSI Optix MPG341CQR	$ 799.99	Samsung Odyssey G7	$ 869.94	Dell S2721DGF monitor	
7	Alienware 25 AW2521HF	$ 384.99	Asus TUF Gaming VG289Q	$ 448.00	Gigabyte G27F	$ 245.00	AOC Agon AG273QCG	$ 926.62
8			Acer Predator CG7	$1,237.99	ViewSonicElite XG350R-C	$ 449.99	Acer Predator XB271HU	$ 449.99
Razer					Champion		2nd runner-up	

THE BEST GAMING LAPTOP IN 2020

Rank	PC Gamer	Price	Techradar	Price	Tom's guide	Price	Gamesradar	Price
1	Razer Blade 15 (2020)	$1,299.99	Asus Zephyrus G14	$1,150.00	Asus ROG Zephyrus G14	$1,150.00	ASUS TUF A15	
2	Dell G3 15	$ 749.99	Gigabyte Aorus 17X		Alienware Area 51m	$2,799.99	Razer Blade 15 (2020)	$1,299.99
3	Asus TUF A15	$ 986.99	Asus TUF A15		Acer Predator Triton 500	$1,399.99	Lenovo Legion Y740	$1,399.99
4	MSI GS66 Stealth Thin	$2,499.66	Alienware M15 R3 (2020)	$1,782.04	MSI GS66 Stealth Thin	$2,499.66	MSI GE66 Raider	
5	Acer Predator Helios 300	$1,129.99	MSI GS65 Stealth	$2,546.99	Razer Blade Pro 17	$1,739.00	Acer Predator Helios 300	$1,149.99
6	Asus ROG Zephyrus G14	$1,128.00	Razer Blade 15 (2020)	$1,299.99	Dell G5 15 SE	$ 929.00	ASUS ROG Zephyrus GA502	$1,056.00
7	Asus ROG Strix GL503VS-DH74	$2,399.00	Asus ROG Zephyrus M15 GU502	$1,399.99	Alienware m17 R2		Dell G3 15	$ 885.00
8			Alienware Area-51m	$2,799.99	Acer Nitro 5	$ 799.00	ASUS Zephyrus G14	$1,150.00
Razer	Champion		6th		5th		1st runner-up	

THE BEST GAMING MOUSE IN 2020

Rank	PC Gamer	Price	Techradar	Price	Tom's hardware	Price	Gamesradar	Price
1	Razer Deathadder V2	$ 49.99	SteelSeries Rival 710	$ 96.99	Razer Death Adder Elite	$ 57.55	Razer Naga Pro	$ 149.99
2	Logitech G203 Lightsync	$ 14.99	Razer Viper	$ 79.99	Logitech G502 Lightspeed	$ 132.99	Logitech G203 Lightsync	$ 29.99
3	Corsair Ironclaw RGB	$ 53.80	Corsair Harpoon RGB Wireless	$ 39.99	Razer Death Adder V2 Pro	$ 129.99	Razer Death Adder V2	$ 119.98
4	Razer Naga Pro	$ 149.99	Corsair Dark Core RGB Pro Wirele	$ 102.94	SteelSeries Rival 3	$ 96.99	Logitech G502 Lightspeed Wireless	$ 99.99
5	Steelseries Sensei 310	$ 43.00	SteelSeries Sensei Ten	$ 53.06	Glorious Model D-	$ 69.99	Corsair Ironclaw RGB	$ 53.80
6	Razer Viper Ultimate Wireless	$ 99.99	Razer Basilisk X Hyperspeed	$ 59.99	Corsair Ironclaw RGB	$ 53.80	Corsair Scimitar RGB Elite	$ 114.99
7	Logitech MX Vertical	$ 79.92	MSI GM30 Clutch	$ 44.99	Razer Basilisk V2	$ 59.99	Razer Viper	$ 79.99
8	Logitech G502 Lightspeed Wire	$ 99.99	Razer Basilisk V2	$ 59.99	Razer Basilisk Ultimate	$ 169.99	Roccat Kone Pure Ultra	$ 65.95
Razer	Champion		1st runner up		Champion		Champion	

THE BEST GAMING CHAIR IN 2020

Rank	PC Gamer	Price	Techradar	Price	Gamesradar	Price	IGN title
1	Secretlab Omega	$ 349.00	Secretlab Titan		Secretlab Omega 2020		Best Leather Gaming Chair
2	Noblechairs Epic Black Edition	$ 389.99	Noblechairs Epic Real Leather	$ 449.99	Secretlab Omega Softweave		
3	DXRacer Master		Autonomous ErgoChair 2	$ 369.00	Razer Iskur	$ 499.00	Best Racing Style Gaming Chair
4	NZXT x Vertagear SL5000	$ 329.99	Secretlab Omega 2020		Brazen Puma	$ 184.99	
5	Noblechairs Hero	$ 459.99	Noblechairs Hero Black Edition	$ 459.99	AK Racing Core Series EX Gaming	$ 330.80	
6	Arozzi Verona Junior	$ 249.00	Corsair T2 Road Warrior	$ 299.99	Noblechairs Hero gaming chair	$ 459.99	
7	Corsair T3 Rush	$ 299.99	Noblechairs Icon gaming chair	$ 429.99	AndaSeat Fnatic Edition gaming		
8			Edge GX1		DXRacer Classic Series		
Razer					2nd runner-up		Racing Style Champion

THE BEST GAMING KEYBOARD IN 2020

Rank	PC Gamer	Price	Techradar	Price	Tom's hardware	Price	Gamesradar	Price	IGN title
1	Corsair K100 RGB Optical	$ 229.99	SteelSeries Apex Pro	$ 243.31	HyperX Alloy Origins	$ 109.99	Corsair K95 RGB Platinum XT	$ 168.99	
2	HyperX Alloy Elite RGB		Razer Huntsman Elite	$ 182.99	Patriot Viper V765	$ 83.99	Razer Cynosa V2	$ 59.99	Best Membrane Gaming Keyboard
3	Razer Cynosa Chroma	$ 39.98	Roccat Vulcan 120 Aimo	$ 185.17	Corsair K100 RGB	$ 229.99	SteelSeries Apex 5	$ 99.99	Best Budget Gaming Keyboard
4	Logitech K840	$ 40.80	Alienware Pro Keyboard AW768	$ 194.98	Logitech G915 TKL	$ 179.99	HyperX Alloy FPS RGB	$ 134.78	
5	Asus ROG Strix Scope	$ 109.99	Cooler Master MasterSet MS120		Cooler Master CK552	$ 79.99	Corsair K57 RGB Wireless	$ 112.57	
6	Kinesis Freestyle Edge RGB	$ 199.00	Corsair K95 RGB Platinum	$ 155.35	Razer BlackWidow V3 Pro	$ 229.00	Razer Ornata V2	$ 135.99	Best Membrane-Mechanical Hybrid
7	Razer Huntsman Elite	$ 149.99	Havit Low Profile Mechanical	$ 62.99	Razer Huntsman	$ 89.99	Razer Huntsman Tournament	$ 117.99	Best Optical Gaming Keyboard
8	SteelSeries Apex Pro	$ 244.21	Razer Huntsman Tournament	$ 117.99	Corsair K95 RGB Platinum XT	$ 199.99	Roccat Vulcan 121 AIMO	$ 109.99	
Razer	2nd runner-up		1st runner-up		6th		1st runner-up		Champion

AMAZON PRIME DAY 2020 STATISTICS:

BEST GAMING MICE SELLER

	Brands	Product	Price
1	Logitech	Logitech G502 SE Hero High Performance RGB Gaming Mouse with 11 Programmable buttons	$ 55.00
2	Razer	Razer Naga Trinity Gaming Mouse: 16,000 DPI Optical Sensor - Chroma RGB Lighting	$ 51.17
3	Razer	Razer Dethadder Essential Gaming Mouse: 6400 DPI Optical Sensor - 5 Programming Buttons	$ 49.99

Razer takes 7 positions in the first 10 ranking

BEST GAMING KEYBOARD SELLER

	Brands	Product	Price
1	Razer	Razer Ornata Chroma Gaming Keyboard: Hybrid Mechnical Key Switches - Customizable Chroma RGB Lighting	$ 59.99
2	Razer	Razer Blackwindow Elite Mechnical Gaming Keyboard: Green Mechnical Switches - Tactile & Clicky	$ 129.99
3	Razer	Razer Cynosa Chroma Gaming Keyboard: 168 Individually Backlit RGB - Spill - Resistant Design	

Razer takes 8 positions in the first 10 ranking

BEST GAMING HEADSET SELLER

	Brands	Product	Price
1	Razer	Razer Kraken X Ultralight Gaming Headset: 7.1 Surround Sound - Lighweighting Aluminium Frame	$ 32.05
2	RUNMUS	RUNMUS Gaming Headset Xbox One Headset with 7.1 Surround Sound, PS4 Headset	$ 26.95
3	BENGOO	BENGOO G9000 Stereo Gaming Headset for PS4, PC, Xbox One Controller, Noise, Cancelling over Ear	

Razer takes 5 positions in the first 10 ranking

BEST GAMING CONTROLLER SELLER

	Brands	Product	Price
1	Razer	Razer Wolverine Tournament Edition Officially Licensed Xbox One Controller	$ 82.90
2	Razer	Razer Wolverine Ultimate Offically Licensed Xbox One Controller	$ 119.99
3	Be1	Wired gaming Controller Joystick Gamepad with Dual-Vibration PC Game Controller Compatible with PS3	

Razer takes 2 positions in the first 10 ranking

THANKSGIVING HOLIDAY STATISTICS

BEST GAMING KEYBOARD SELLER

	Brands	Product	Price
1	Redragon	Redragon S101 Wired Gaming Keyboard	$ 39.98
2	Redragon	Redragon K552 Mechanical Gaming Keyboard	$ 34.99
3	Razer	Razer Cynosa Chroma Gaming Keyboard	$ 47.99
4	NPET	NPET K10 Gaming Keyboard USB Wired Floating Keyboard	$ 17.19
5	Razer	Razer Huntsman Gaming Keyboard	$ 89.99
6	HyperX	HyperX Alloy Core RGB – Membrane Gaming Keyboard	$ 39.99
7	Corsair	Corsair K55 RGB Gaming Keyboard	$ 48.99
8	Redragon	Redragon S101 Wired RGB Backlit Gaming Keyboard and Mouse	$ 54.99

Razer takes 3 positions in the first 15 ranking

BEST GAMING MICE SELLER

	Brands	Product	Price
1	Logitech	Logitech G502 Hero High Performance Gaming Mouse	$ 39.99
2	Razer	Razer Mamba Wireless Gaming Mouse	$ 47.99
3	PICTEK	PICTEK Gaming Mouse Wired	$ 13.99
4	Redragon	Redragon M602 RGB Wired Gaming Mouse RGB Spectrum Backlit Ergonomic Mouse	$ 16.99
5	Razer	Razer DeathAdder Essential Gaming Mouse	$ 29.99
6	Razer	Razer DeathAdder V2 Gaming Mouse	$ 69.99
7	Razer	Razer Basilisk X HyperSpeed Wireless Gaming Mouse	$ 55.55
8	Razer	Razer DeathAdder Essential Gaming Mouse	$ 29.99

Razer takes 8 positions in the first 15 ranking

BEST GAMING HEADSET SELLER

	Brands	Product	Price
1	BENGO	BENGOO G9000 Stereo Gaming Headset	$ 41.99
2	RUNMUS	RUNMUS Gaming Headset Xbox One Headset	$ 26.95
3	HyperX	HyperX Cloud Stinger Gaming Headset	$ 39.99
4	Turtle Beach	Turtle Beach Recon 70 Gaming Headset	$ 39.99
5	RUNMUS	RUNMUS Gaming Headset for PS4 Xbox One and PC	$ 24.85
6	NUBWO	NUBWO U3 3.5mm Gaming Headset	$ 11.89
7	VANKYO	VANKYO Gaming Headset CM7000	$ 29.99
8	Razer	Razer Kraken Tournament Edition	$ 78.09

Razer takes 2 positions in the first 15 ranking

BEST GAMING GAMEPADS & STANDARD CONTROLLER SELLER

	Brands	Product	Price
1	Logitech	Logitech Gamepad F310 - Blue	$ 9.95
2	Razer	Razer Wolverine Tournament Edition Officially Licensed Xbox One Controller	$ 101.89
3	Be1	Wired Gaming Controller	$ 26.99
4	Razer	Razer Wolverine Ultimate Officially Licensed Xbox One Controller	$ 159.99
5	GameSir	GameSir T4 pro Wireless Game Controller	$ 24.89
6	Forty	Forty4 Wireless Gaming Controller	$ 34.99
7	Amazon	Luna Controller	$ 59.98
8	ZD	ZD-V+ USB Wired Gaming Controller	$ 22.99

Razer takes 3 positions in the first 15 ranking

BEST GAMING MUSIC CONTROLLER SELLER

	Brands	Product	Price
1	Razer	Razer Kiyo 1080p 30 FPS/720 p 60 FPS Streaming Webcam	$ 128.00
2	Razer	Razer Seiren Emote USB Digital Microphone and Headphone Amplifier	$ 152.92
3	Razer	Razer RZ19-02290400-R3M1 Seiren X Quartz Compact USB Condenser Microphone	$ 136.37
4	Kamileo	Mini Wireless Keyboard Touchpad	
5	Razer	Razer Seiren Elite Studio-Grade Multi-Pattern USB Digital Microphone and Headphone Amplifier	$ 267.95
6	Unknown	Hausbell Mini H7 2.4GHz Wireless Entertainment Keyboard with Touchpad	
7	Rii	Rii I8 Mini 2.4Ghz Wireless Touchpad Keyboard with Mouse	
8	Telex	Telex M 40 - Microphone	$ 5.00

Razer takes 5 positions in the first 8 ranking

LOYALTY EDGE FOR GAMERS

No matter how good the products and the sales figure are, only sticky users will create long-term brand edge. Several factors contribute to Razer's high loyalty that could not be copied by others. Leading social platform followers proved the royalty edge.

Followers (in million)	Razer	Team razer	Logitech	Corsair
Facebook	10.96	1.71	3.24	2.60
Twitter	3.30	0.57	0.71	1.40
IG	6.30	0.77	0.63	2.50
E-sport team	Yes		No	No
Forum	Razer Insider		No	Yes

CLEAR TARGET USER CYCLE

Razer targets gamers as core customers clearly to build the business. To agglomerate the gamers, Razer launches Razer Insider (a forum) to interact. Gamers may find useful tips and raise questions to other users to gain new insights, and more importantly, stay within Razer's cycle. Some may question that Corsair does the same manner to retain the users, however, Razer Insider is hotter counted by the posts updated and discussed per day. In addition, those forum users are social media active users while they like to hash tag #game #Razer related to game posts. In other words, Razer has a user activeness edge which push further on new comers.

KNOW WHAT GAMERS WANT

As proved by the sales figure, Razer know what gamers want. If a product is cheap enough but lack of quality, no users would buy it. The continuous sales successful story proved the point.

TEAM RAZER AS BRAND ICON

It is very common to see gaming peripheral producers sponsor e-sport teams during different tournaments. The idea is simple, tournament candidates will use the products and may win the tournaments using the sponsored products, thus elevating the brand name. Razer not only put resources on e-sport, like holding Razer SEA Invitational 2020 tournament, but also own a professional team. As a house brand, Team Razer use own products for training while tournament track records are stable. In other words, users can enrich Razer product experience via stable good tournament result. Moreover, Razer keeps on signing new teams with high social media followers to maintain the brand online influence. The secret behind is Team Razer will go to offline stores and events to interact with brand fans, thus enhancing brand influence.

REBATE USERS

When the social media followers reached 8 million, Razer started a rebate scheme to users. This scheme wins a positive interaction which push the brand name. We expected Razer will keep on published similar rebating scheme to acquire new users.

CERTAIN DEEP VALUE CHOICE IN 2021

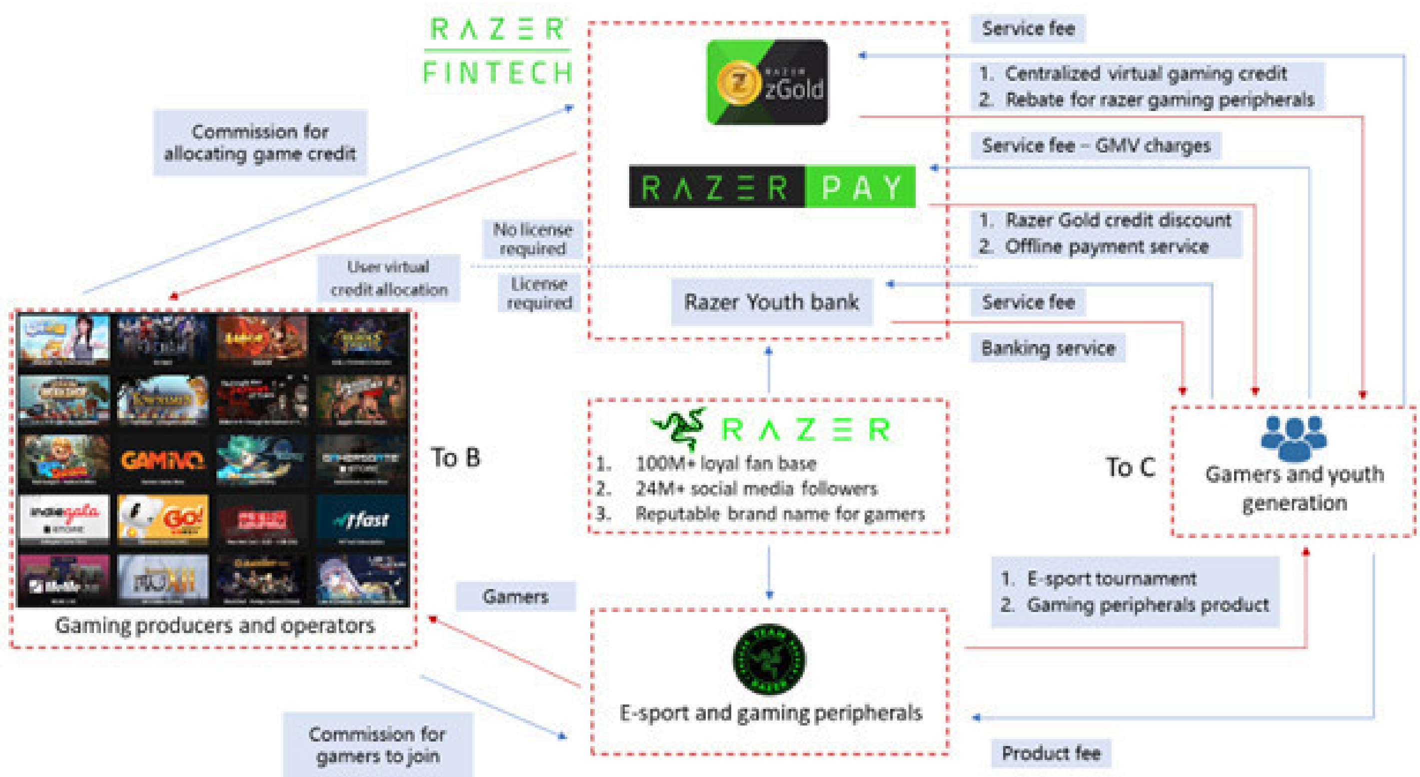
We have proven that Razer has a competitive market position, product edge and sales figure in the gaming industry. More importantly, the brand loyalty with growing gamers and followers could sustain the business which should have a similar or even better valuation multiple than the peers. However, the market is undervalued Razer while being out of the red prediction still does not reflected by the market. [figure below]

From the valuation matrix, Razer has a 15.1X implied P/E multiple while 26X for Logitech and Corsair in 2023. We believe Razer's P/E should be valued as +10% higher than Corsair while announced the predicted annualized positive net profit in 2020 H1 report. It is a good chance to capture Razer in 2021 for a certain doubled valuation.

NEW BUSINESS MODEL

Razer shows the growth quality and product competitiveness among major competitors, but the original business still doesn't lead to positive net profit as long as the size grow. In the view of this, Razer upgraded the model to two drivers, Razer FinTech and hardware, and more importantly, transformed to B2B2C from B2C model while kicking out smartphone business in 2018.

	1337 HK Equity	LOGI US Equity	CRSR US Equity	SE US Equity
Valuation summary - P/E multiple	Razer	Logitech	Corsair	SEA
2021E		23.69	30.68	
2022E		28.25	33.19	
2023E- implied P/E with current market cap	15.14	25.73	27.01	
2023E- P/S multiple				9.75



LAUNCH RAZER GOLD AS A START OF FINTECH BUSINESS

Decentralized and over scattered gaming credit is a problem in the industry which resulting in a relatively small credit purchasing amount. To solve the problem, Razer launched Razer Gold in 2017 as a trial. Once gamers purchased Razer Gold, they can connect to more than 2,500 hot games and online stores including Razer Game Store and GamersGate in the format of spending directly or exchange for a specific credit in different games with more than 1 million retail points. More importantly, gamers can rebate a versatility Razer Silver when purchasing a Razer Gold to pay for Razer Store gaming peripherals and exclusive equipment in specific games.
We believe the launch of Razer Gold may drive a +20% for peripherals sale in 2020 and at least 10% after 2020.

PAYPAL'S INSIGHT AS A START. IN NOV 2020

Paypal officially opened cryptocurrency trading on their platform while users can integrate cryptocurrency, including bitcoin, on their e-wallet for normal e-commerce transaction. We believe this is a giant positive fundamental change since Razer can refer to the same manner to add major cryptocurrency for realizing Razer Silver backed by a solid demand which means rebate could be transformed to major cryptocurrency directly. A more diverse realization channel push the use of Razer Gold, thus enhancing the motivation. The rebate scheme not only benefit the gaming credit but also another FinTech business - Razer Pay.

GAMING DEMAND AS ENTRY TO START PAYMENT BUSINESS

The launch of Razer Gold in 2017 settled the decentralized gaming credit problem while the registered users had been raised +40% in only half a year. It is obvious that the new registration is demanding for Razer Gold. In the view of this, Razer launched Razer Pay in Malaysia in 2018 and later pressed ahead in Singapore with the aim to satisfy the online payment to purchase Razer Gold. The idea is registered users would take Razer Pay as the first payment priority even outside purchasing razer Gold as they trust the brand name. After the APP update in 2019 Feb, GMV has raised +1,500%

YoY while +540% YoY for the average trading volume per month. As long as more enterprises is willing to join Razer Pay in the view of high payment users' growth, GMV has raised +114% YoY in 2020 H1 even under pandemic with more than 1 million offline payment point which become one of the largest O2O digital payment networks in SEA. We expect the payment business will has a sharpen growth in 2021 driven by 100 million Razer platform registered users with +45% YoY MAU growth.

COOPERATION WITH VISA TAKES RAZER PAYMENT TO THE NEXT LEVEL

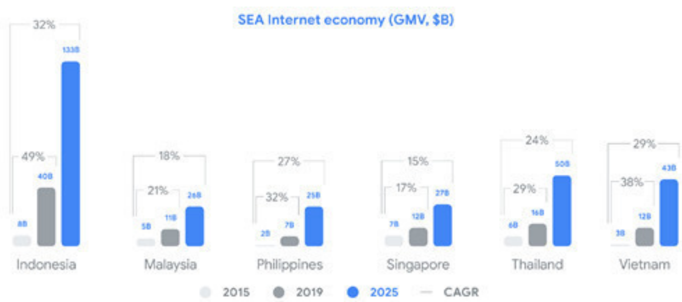
In Oct 2020, Razer cooperates with Visa to launch a credit card service with +1% cash rebate and +5% rebate on Razer Store gaming peripheral products which expands the application scenario to normal life and push the user stickiness under the high rebate scheme. We expect the credit card services drives +24% extra growth on GMV.

THE ROAD TO LICENSED FINTECH BUSINESS

On 4th Dec 2020, consortium of Razer and FWD failed to win the first digital banking license issued by Monetary Authority of Singapore. We believe the short-term selling flow is a very attractive buying point to enter. Upon the license failure, we might as well take a look on Alibaba experience.
[figure below]

Ant Group is a well-known FinTech arm of Alibaba. In actual, Alibaba started the first FinTech business, Alibaba Small and Micro Financial Services Company, in 2010 with the aim to provide digital banking (lending) service. Due to the high growth and absolute amount on GMV, Alibaba started FinTech business in response to the financial planning demand and a higher user realization efficiency. The logic is simple that Alibaba launched additional banking related services after the GMV is sufficient to cover user demand. We found that Razer is on the road now. In 2010, the internet penetration rate in only 34% in China while 61% in SEA today. In other words, the GMV has to be at least 5.5+ billion USD to get into the digital banking services today. By considering only 40% banking service penetration rate in SEA, Razer Youth Bank is an excellent growth driver after GMV reached the estimated hurdle to provide banking services while we expect Razer can complete the target before 2022. In addition, Razer is applying digital banking licenses in Malaysia and the Philippines in parallel. By considering a lack of financial market and GMV requirement than Singapore, we expect Razer can get the licenses in 2021. We believe serving the youth using gaming as the entry point is the correct way while razer is on the road.

Gigantic digital banking market in SEA. As long as the digital banking license failure in Singapore, investors may think this is the end of Razer's Fintech road because Singapore is the financial market leader in SEA. We have a completely opposite view. According to the internet economy report published by Google, Temasek and Bain & Company, Singapore is not the GMV leader in SEA.



	Alibaba	Razer
E-commerce platform	Taobao	Razer Store and offline joint stores
Internet penetration rate	34.3% in 2010 (China)	61% in 2020 H1 (SEA)
GMV	<20 billion RMB in 2010	2.1 billion USD (19 billion RMB)
Expected GMV		5.5+ billionin USD (50+ billion RMB) in 2022
First launch of banking service	2010	2020
	Alibaba Small and Micro Financial Services Company	Razer Youth Bank

The logic of digital banking is simple while GMV is the first consideration and financial market just serve as an assistant role for banking tools providing. The statistics reflected that digital banking opportunities are enormous in SEA but not only Singapore. Since Singapore is not the GMV leader in SEA while having a developed financial market, excess licenses would affect the stability of financial system in certain. Grab is supported by strong food delivery while SEA (company) is supported by strong e-commerce experience which is enough for the market acceptance in Singapore. We believe SEA countries except Singapore need more digital banking licenses and service providers to enhance the financial market backed by solid GMV. Although Razer doesn't win a digital banking license in Singapore, we believe South East Asia is waiting for Razer.

ALIBABA 3-YEAR GROWTH STORY AS REFERENCE

After the launch of Fintech business, Alibaba shows a high growth after 2012. In 2014, the Fintech business contributed 0.15% revenue of GMV while the internet penetration rate is only 47.9%. We believe Razer would follow the same successful 3-year growth story in 2012-2014.

Alibaba growth model	2010	2011	2012	2013	2014
China GMV (billion)			663	1,077	1,678
growth %				*62.44%*	*55.80%*
Alibaba GMV (billion)			549	824	1,173
Alibaba GMV (thousands)			549,000,000	824,000,000	1,173,000,000
market shares %			*82.81%*	*76.51%*	*69.90%*
2-yr CAGA growth %					*46.17%*
Fintech business revenue (thousands)			27,000	277,000	1,764,000
% of Alibaba GMV			*0.00%*	*0.03%*	*0.15%*
2-yr CAGA growth %					*708.29%*
China internet					
penetration rate %	*34.30%*	*38.30%*	*42.10%*	*45.80%*	*47.90%*

Although SEA GMV growth (estimated 20% CAGA growth) is slower than China GMV growth in 2013 and 2014, SEA shows a higher internet penetration rate and absolutely low digital banking penetration rate (predicted 9.84% in 2023) which contributes to a higher digital banking revenue realization because the statistics reflects that SEA residents need digital banking services backed by high GMV.

Industry		2019	2020E	2021E	2022E	2023E	2024E	
Internet users (thousands)								
Singapore		5,000						
Malayasia		26,000						
SEA penetration rate %		*61.00%*						
SEA GMV (for new business) (thousands)		100,000,000	120,093,696	144,224,957	173,205,081	208,008,382	249,804,953	300,000,000
CAGA growth %			*20.09%*	*20.09%*	*20.09%*	*20.09%*	*20.09%*	*20.09%*
SEA consumer payment (digital banking)								
penetration rate %		*3.70%*	*4.72%*	*6.03%*	*7.71%*	*9.84%*		
growth %			*27.70%*	*27.70%*	*27.70%*			
Razer digital banking market shares %						*20.00%*		
Singapore GMV (related sector)								
e-commerce	1,800,000	2,000,000	2,464,382	3,036,589	3,741,657	4,610,436	5,680,938	7,000,000
growth %			*23.22%*	*23.22%*	*23.22%*	*23.22%*	*23.22%*	
estimated growth%			*33.22%*	*33.22%*	*33.22%*	*33.22%*	*33.22%*	
adjusted e-commerce GMV			2,664,382	3,283,027	4,045,316	4,984,602	6,141,981	
Online media	1,300,000	1,000,000						3,000,000
Malaysia GMV (related sector)								
e-commerce	2,000,000	3,000,000	3,725,345	4,626,065	5,744,563	7,133,492	8,858,240	11,000,000
growth %			*24.18%*	*24.18%*	*24.18%*	*24.18%*	*24.18%*	
estimated growth%			*34.18%*	*34.18%*	*34.18%*	*34.18%*	*34.18%*	
adjusted e-commerce GMV			4,025,345	4,998,600	6,207,169	7,707,949	9,571,589	
Online media	1,600,000	2,000,000						3,000,000

1337.hk Valuation (3 Year-2023)		% of Total	Gross Margin %	Multiple Referenc	Premium/Discoun	Target Multiple	Target Valuation
Existing business - net profit (P/E valuation	170,930			27.0	10.00%	29.7	5,077,799
New business - revenue (P/S valuation)	266,446			9.8	0.00%	9.8	2,598,373
							7,676,172
Target price (USD)							0.82
Target price (HKD)							6.36
Upside							197%

in USD$ thousands	2017	2018	2019	2020E	2021E	2022E	2023E
Hardware-Peripherals (gaming mice, keyboard, etc)	338,717	429,606	444,902	571,172	642,062	722,707	831,113
Hardware-systems (gaming PC)	137,001	185,919	269,077	430,523	602,732	813,689	1,098,480
Software and services	10,604	49,564	77,027	138,326	219,232	335,469	468,945
Others	31,615	47,350	29,789	20,852	12,511	7,507	4,504
Revenue	**517,937**	**712,439**	**820,795**	**1,160,874**	**1,476,538**	**1,879,372**	**2,403,043**
YoY	*32.1%*	*37.6%*	*15.2%*	*41.4%*	*27.2%*	*27.3%*	*27.9%*
Cost of revenues	(366,912)	(542,361)	(652,732)	(909,331)	(1,154,893)	(1,398,892)	(1,748,740)
Gross profit	**151,025**	**170,078**	**168,063**	**251,543**	**321,645**	**480,479**	**654,303**
GPM	*29.2%*	*23.9%*	*20.5%*	*21.7%*	*21.8%*	*25.6%*	*27.2%*
Selling & marketing expenses	(90,041)	(117,995)	(112,675)	(104,479)	(132,888)	(178,540)	(216,274)
General & administrative expenese	(143,589)	(75,383)	(89,267)	(92,870)	(118,123)	(140,953)	(180,228)
R&D expenses	(80,809)	(76,298)	(52,418)	(25,154)	(48,247)	(48,048)	(65,430)
Impairment of goodwill and other assets	-	-	(9,525)	(9,525)	(9,525)	(9,525)	(9,525)
Operating loss, EBIT	**-163,414**	**-99,598**	**-95,822**	**19,515**	**12,862**	**103,413**	**182,845**
Other non-operating income/expenses	(3,147)	(1,857)	6,188	7,141	7,430	9,450	11,276
Finance income	1,985	12,218	13,193	13,193	13,193	13,193	13,193
Finance costs (interest)	(9)	(310)	(1,375)	(1,375)	(1,375)	(1,375)	(1,375)
Profit/Loss before taxation	**(164,585)**	**(89,547)**	**(77,816)**	**38,474**	**32,110**	**124,681**	**205,940**
Income tax expenses	(1,254)	(8,361)	(5,654)	(6,541)	(5,459)	(21,196)	(35,010)
Tax rate	*-0.8%*	*-9.3%*	*-7.3%*	*17.0%*	*17.0%*	*17.0%*	*17.0%*
Net profit	**(165,839)**	**(97,908)**	**(83,470)**	**31,934**	**26,651**	**103,485**	**170,930**
Margin %	*-32.0%*	*-13.7%*	*-10.2%*	*2.8%*	*1.8%*	*5.5%*	*7.1%*
Margin % growth	*-82.0%*	*-41.0%*	*-14.7%*	*-138.3%*	*-16.5%*	*288.3%*	*65.2%*
EPS	(0.03)	(0.01)	(0.01)	0.00	0.00	0.01	0.02

Software and service		e-wallet						
Company operating statistics (thousands)	2017	2018	2019	2020E	2021E	2022E	2023E	2024E
Razer platform total registered users	40,000	56,280	81,381	113,933	157,228	213,830	286,532	378,222
g%	*33%*	*41%*	*45%*	*40%*	*38%*	*36%*	*34%*	*32%*
Razer Gold 用户	4,000	11,000	19,250	32,725	55,633	89,012	133,518	200,277
g%		*175%*	*75%*	*70%*	*70%*	*60%*	*50%*	*50%*
Software and service revenue	10,604	49,564	77,027	138,326	219,232	335,469	468,945	653,425
growth %	*11062%*	*367%*	*55%*	*80%*	*58%*	*53%*	*40%*	*39%*
GMV (Fintech "TPV")	311,882	1,400,000	2,100,000	3,640,151	5,480,807	7,987,360	10,657,847	14,204,884
growth %		*349%*	*50%*	*73%*	*51%*	*46%*	*33%*	*33%*
GMV per registered users	7.80	24.88	25.80	31.95	34.86	37.35	37.20	37.56
growth %		*219.0%*	*3.7%*	*23.8%*	*9.1%*	*7.2%*	*-0.4%*	*1.0%*
implied take rate %	3.40%	3.54%	3.67%	3.80%	4.00%	4.20%	4.40%	4.60%
growth %		*4.1%*	*3.6%*	*3.6%*	*5.3%*	*5.0%*	*4.8%*	*4.5%*
e-commerce GMV (Razer pay related)		210,000	420,000	1,204,151	2,070,407	3,383,320	4,442,393	5,814,021
% of GMV		*15%*	*20%*	*33%*	*38%*	*42%*	*42%*	*41%*
market shares % of Sing and Mala		*6%*	*8%*	*18%*	*25%*	*33%*	*35%*	*37%*
e-commerce GMV per pay users								
Gaming GMV (razer gold related)	311,882	1,190,000	1,680,000	2,436,000	3,410,400	4,604,040	6,215,454	8,390,863
growth %		*282%*	*41%*	*45%*	*40%*	*35%*	*35%*	*35%*
% of GMV	*100%*	*85%*	*80%*	*67%*	*62%*	*58%*	*58%*	*59%*
market shares % of Sing and Mala								
Gaming GMV per razer gold user	77.97	108.18	87.27	74.44	61.30	51.72	46.55	41.90
Offline channels (thousands)			3,400					
Co-operated games (exact)		2,500	33,250					

Estimated +9.84% penetration rate means near 10% of GMV would be transfer to digital banking revenue. By considering Alibaba growth experience with 0.15% penetration rate, we give 2.5% to Razer's 2023 GMV for digital banking revenue which would be used for P/S valuation. If Razer could gain at least one digital banking license in SEA before 2023, the above statistics would account for the high growth of digital banking business.

LESSONS FROM GAMESTOP INDICATES EXTRA REVENUE OPPORTUNITY

As long as the launch of Xbox Games Pass in 2017, traditional gaming wholesaler faced a press. Under the new scription model on cloud gaming, the revenue of Gamestop drops significantly. To get out of the trough, Gamestop announced a strategic partnership with Microsoft in Oct 2020 while they earn commission for referring new Xbox gamers successfully. The new revenue model is clear that cross-selling is the key. For instance, Gamestop would recommend Xbox racing game if the customers are seeking for a gaming steering wheel.

This model indicates active cross-selling in offline stores since Razer is now cooperating with more than 33,000 games. We expect when customers are seeking for Razer peripherals in offline stores, salesperson will recommend the cooperated games.

VALUATION

We have proven that Razer fulfills the criteria of quality growth and deep value. To value the stock, we use P/E method for existence business with the assistance of P/S multiple for digital banking business while number of e-sport gamers, gaming laptop market size, gaming hardware market size, SEA GMV and Alibaba experience would be the key assumption for valuation. We give Razer a target price $6.36 with 197% potential upside.

BETTER BRAND NAME AND PRODUCT QUALITY THAN PEERS

Razer shows a better product edge proved by leading technology and gaming hubs. More importantly, the most updated sales figure states that Razer is the champion of gaming hardware while user stickiness is proven at the same time. We believe Razer should have a valuation at least no less than the peers. Although Fintech business is included when we use the P/E valuation to peers, it only accounts for 20% of revenue structure while 30X P/E is a reasonable valuation. It is clear that market prediction, 15X P/E, is undervalued while value would be released since 2021.

GMV IS THE KEY FOR NEW FINTECH BUSINESS

FinTech business is hard to value because only few peers could be referred in the market. We believe GMV is the key of payment and digital banking business so realization of GMV and Alibaba experience is used for prediction. SEA (company) is definitely a good peer for Razer since SEA is an e-commerce payment leader in South East Asia while winning the Singapore digital banking license already. In a long term, Razer would catch up SEA while 9.8X P/S valuation is reasonable.
$6.4 target price in 2023. Overall, we give Razer a target price $6.4 with a near 200% upside.

	1337 HK Equity	LOGI US Equity	CRSR US Equity	SE US Equity
Valuation summary - P/E multiple	Razer	Logitech	Corsair	SEA
2021E		23.69	30.68	
2022E		28.25	33.19	
2023E- implied P/E with current market cap	15.14	25.73	27.01	
2023E- P/S multiple				9.75

Hardware (In thousands)							
Global gaming peripherals	3,400,000	4,060,000	4,140,000	4,280,000	4,640,000	5,130,000	5,873,850
growth %		*19.41%*	*1.97%*	*3.38%*	*8.41%*	*10.56%*	*14.50%*
Global e-sports market size			950,600	1,100,000	1,132,371	1,165,695	1,200,000
growth %		*#DIV/0!*	*#DIV/0!*	*15.72%*	*2.94%*	*2.94%*	*2.94%*
e-sport audience	335,000	395,000	443,000	495,000	540,929	591,130	646,000
growth %		*17.91%*	*12.15%*	*11.74%*	*9.28%*	*9.28%*	*9.28%*
Enthusiasts	143,000	173,000	198,000	223,000	244,799.53	268,730.09	295,000
growth %		*20.98%*	*14.45%*	*12.63%*	*9.78%*	*9.78%*	*9.78%*
Occasional Viewers	192,000	222,000	245,000	272,000	296,129	322,400	351,000
growth %		*15.63%*	*10.36%*	*11.02%*	*8.87%*	*8.87%*	*8.87%*
Gaming laptop	10,300,000	12,050,000	14,701,000	17,935,220	21,880,968	26,694,781	32,567,633
growth %		*16.99%*	*22.00%*	*22.00%*	*22.00%*	*22.00%*	*22.00%*
Razer market shares (revenue)	*1.33%*	*1.54%*	*1.83%*	*2.40%*	*2.75%*	*3.05%*	*3.37%*

Industry		2019	2020E	2021E	2022E	2023E	2024E	2025E
Internet users (thousands)								
Singapore		5,000						
Malayasia		26,000						
SEA penetration rate %		*61.00%*						
SEA GMV (for new business) (thousands)		100,000,000	120,093,696	144,224,957	173,205,081	208,008,382	249,804,953	300,000,000
CAGA growth %			*20.09%*	*20.09%*	*20.09%*	*20.09%*	*20.09%*	*20.09%*
SEA consumer payment (digital banking)								
penetration rate %		*3.70%*	*4.72%*	*6.03%*	*7.71%*	*9.84%*		
growth %			*27.70%*	*27.70%*	*27.70%*			
Razer digital banking market shares %						*20.00%*		
Singapore GMV (related sector)								
e-commerce	1,800,000	2,000,000	2,464,382	3,036,589	3,741,657	4,610,436	5,680,938	7,000,000
growth %			*23.22%*	*23.22%*	*23.22%*	*23.22%*	*23.22%*	
estimated growth%			*33.22%*	*33.22%*	*33.22%*	*33.22%*	*33.22%*	
adjusted e-commerce GMV			2,664,382	3,283,027	4,045,316	4,984,602	6,141,981	
Online media	1,300,000	1,000,000						3,000,000
Malaysia GMV (related sector)								
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growth %			*24.18%*	*24.18%*	*24.18%*	*24.18%*	*24.18%*	
estimated growth%			*34.18%*	*34.18%*	*34.18%*	*34.18%*	*34.18%*	
adjusted e-commerce GMV			4,025,345	4,998,600	6,207,169	7,707,949	9,571,589	
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2-yr CAGA growth %					*46.17%*
Fintech business revenue (thousands)			27,000	277,000	1,764,000
% of Alibaba GMV			*0.00%*	*0.03%*	*0.15%*
2-yr CAGA growth %					*708.29%*
China internet					
penetration rate %	*34.30%*	*38.30%*	*42.10%*	*45.80%*	*47.90%*

CONCLUSION

This is a rare opportunity to own a company who will grow above 200% in the future. Despite short-term decline in share price due to the sell-flow, fundamentals of company do not get any worse, but better as shown with its sales figure and digital banking business expectation. Does it make sense when peers did get worse already rebounded in valuation, but Razer is still out of favor?

DISCLAIMER:

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FINALIST
Asia

Gokul Raj
Portfolio Manager at Bavaria Industries Group

CURRENT RANKING: **#14 All-Time**
BADGES:
148 245

Iifl Finance (iifl Holdings) Ord

Asset: **Equity**
Symbol: **IIFL:IN**
Idea Posted: **12/13/2020**
Idea Updated: **12/16/2020**

RETURN TO DATE: -1.6%

EXPECTED RETURN: 116.83%

LONG

ATTACHMENTS	TIMEFRAME	SITUATION	MARKET CAP
	2-5 Years	Growth At Reasonable Price	5.0M USD

> A granular retail credit platform run by a brilliant owner-operator with best in class operating and growth metrics available at 0.85X Book and <5X normalized profits with clear catalysts !

About Gokul Raj

Gokulraj Ponnuraj is a value investor with a focus on small and mid-cap compounders and spin-off's with a bias towards emerging markets. He has been investing in the Indian markets for more than ten years and in global markets for the last four years. Gokul manages the public equities portfolio at Bavaria Industries Group. The firm uses its balance sheet assets (permanent capital) to invest in opportunities with an attractive risk-reward trade off. Gokul holds a Master in Finance degree from London Business School and a CFA charter holder.

About Bavaria Industries Group

BAVARIA Industries Group AG is a family holding company that holds majority interests in companies showing clear potential for improvement or facing new challenges. Using our BAVARIA operating system helps the companies to identify potential cost reductions and performance enhancements and support the implementation of the measures considered necessary.

Iifl Finance (iifl Holdings) Ord

Asset Class: **Equity** Symbol: **IIFL:IN** Updated: **12/16/2020** Submitted: **12/13/2020**

Pricing & Return Details	LONG
EXPECTED RETURN	116.83%
TARGET PRICE	250.00 INR
INITIAL PRICE	117.15 INR

BY:
Gokul Raj

CURRENTLY AT:
Bavaria Industries Group

BADGES:
148 245

> A granular retail credit platform run by a brilliant owner-operator with best in class operating and growth metrics available at 0.85X Book and <5X normalized profits with clear catalysts !

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Growth At Reasonable Price	5% - 10%	Spin Off Management Change Corporate Restructuring	2-5 Years

INVESTMENT THESIS

Disclaimer: The author of this idea and the author's fund had a position in this security at the time of posting and may trade in and out of this position without informing the SumZero community.

BRIEF INVESTMENT THESIS:

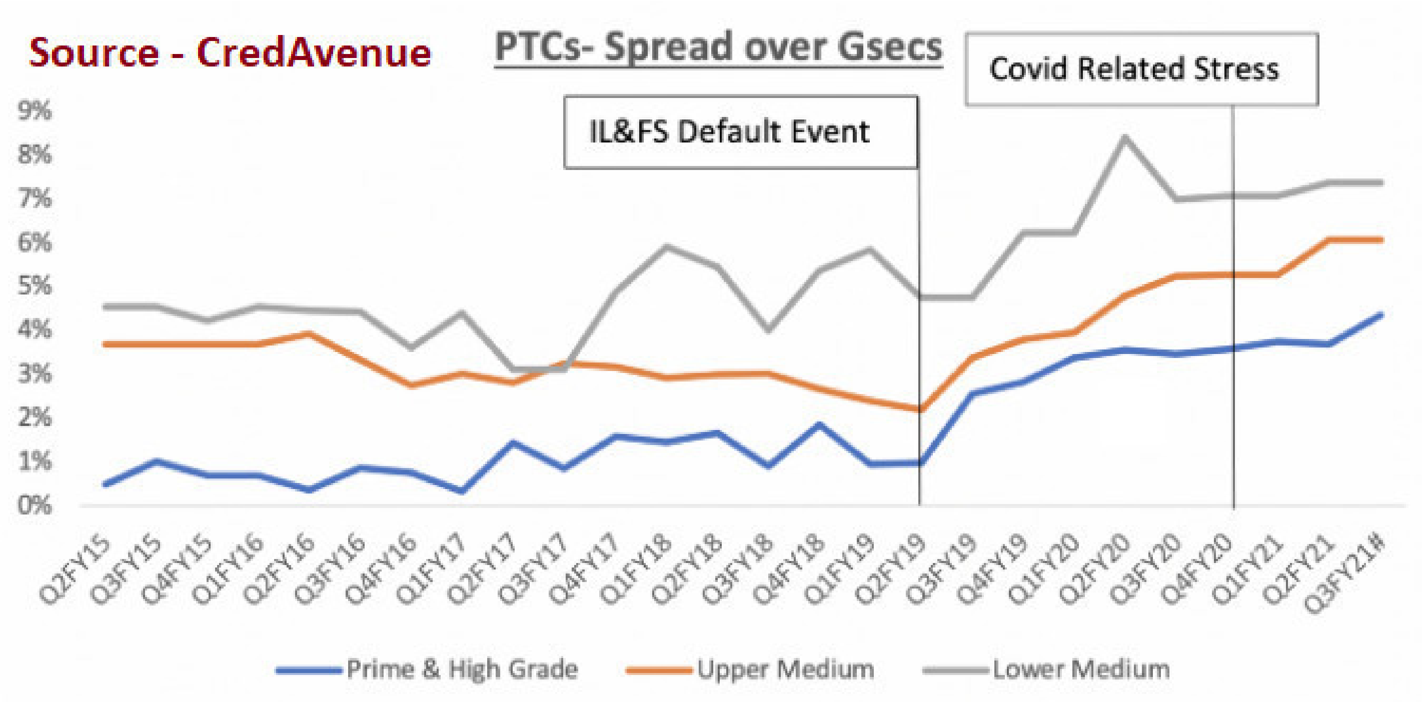
IIFL Finance is a well-run AA rated Indian NBFC that can consistently grow at 20%+ CAGR by re-investing its profits and compounding shareholder value. If the firm is able to achieve its aspirational technology pivot towards an asset-light business model through Co-Origination & Loan Assignment and also bring down its wholesale exposure substantially down from the current 11% of AUM, I believe that the firm will easily deliver multi-bagger returns in less than 3 years through sheer valuation re-rating. In the long run, investing in IIFL Finance is an opportunity to partner with a smart and ethical owner-operator who can identify and execute well on opportunities in the fast-growing Indian financial services space. The firm is uniquely positioned to ride on its large branch footprint created to support its gold loans and microfinance business to roll-out other granular retail loans like Home and Business credit in a cost-effective manner and also cross-sell fee-based products through the group's expertise.

The platform's ability to originate, underwrite, cross-sell, and collect retail loans cost-effectively at scale in sub-segments underserved by banks through better execution would be valuable in an environment in which liquidity constraints are lower. While headwinds from increased credit costs post COVID exist, I believe that there are enough tailwinds for the firm in terms of better liquidity, lower funding costs, higher assignment income, improved cross-sell fees, cyclical economic recovery, rating upgrades, etc. The competitive peer set is benign at this point as the 2-year liquidity freeze in the Indian credit markets has led to consolidation with the exit of several weak firms. While Indian NBFC's across the board (except the top 3) have been beaten down badly ever since the IL&FS crisis, I believe that nimble firms with the right portfolio exposures like IIFL Finance can compete effectively in the market place and position themselves well for the upcoming growth cycle.

5 REASONS WHY THIS ASYMMETRIC INVESTMENT OPPORTUNITY EXISTS!

1. INDIA'S LEHMAN MOMENT:

Indian NBFC's (Non-Bank Financial Companies) were on a tear until 2018 when the collapse of a large financial institution (IL&FS) froze the credit markets completely. The Indian bond markets have been dislocated for over two years now as there has been a spate of large financial bankruptcies that followed: DHFL, Yes Bank, Reliance Capital, Religare, Franklin credit funds, etc. All NBFC's had to vacate the short term CP (Commercial Paper) market as firms weren't able to roll over these liabilities and shift to longer tenure funding with an increasing dependence on banks. The credit risk and term spreads have been extremely elevated since then. You can see this from the



Prime & High Grade- AAA and AA Rating Categories for Long term and A1 Rating Categories for Short term. Upper Medium- A Rating Categories for Long term and A2 Rating Categories for Short term. Lower Medium- BBB Rating Categories for Long term and A3 Rating Categories for Short term.

securitized asset trading trends below,
India's central bank and the finance ministry has put in place multiple initiatives to heal the credit markets and revive NBFC lending. As the central bank pumped in a huge liquidity surplus to tackle the market stress, there have been signs of bond markets reviving. As interest rates have fallen significantly (over 200 bps), the spread between AA bonds and AAA/ G Sec bonds has started to compress and I believe that the search for yields would flush in liquidity towards well-run AA firms like IIFL Finance.

I believe that only a few NBFC's like IIFL have come out of this crisis without any meaningful hit to their governance reputation. IIFL Finance had to reduce its commercial paper exposure from **35% of its liabilities in 2018 to almost zero now**. They were able to make this transition successfully while still growing their asset base (**10% growth even in a crisis year**) because of their ability to securitize/ assign granular liquid retail loans. IIFL's exposure towards short tenure loans like Gold loans, Micro Finance loans also helped in better asset-liability management with positive liquidity across time buckets.

2. BAD CREDIT CYCLE IN A SLOWING ECONOMY:

Indian economy had been slowing down even before COVID with 8 quarters of continuous reduction in GDP growth rates on the back of a tight monetary and fiscal policy. The country had also gone through several resets in terms of Demonetisation, GST, RERA, IBC, etc which exposed firms who were swimming naked. The credit costs across financial institutions were creeping up and the Indian financial sector as a whole has one of the largest pile-ups of non-performing loans globally. The massive COVID disruption has only added to the credit woes of financial institutions.

IIFL Finance was able to navigate this tough credit environment with little impact as its overall **Gross NPA's rose by less than 60 bps and Net NPA's by less than 30 bps during this period,** outperforming its peer set significantly. IIFL has also reported a healthy rebound in collections as the COVID-related moratorium ended. Similarly, the collateral values of its underlying loans like Gold, Home, Real estate, etc have held up well and hence even in the case of a default, the recovery would be healthy as LTV's continue to be below 65% across segments. The firm had provisioned healthily upfront for the COVID stress (**114% GNPA coverage**) and carries overall provisions of **4.2% of on-book AUM despite historical gross NPA's being lower than 2%.** The firm has healthy pre-provision profits to continue generating strong profitability (15-20% ROE) even while providing for COVID stress. I expect the credit costs to normalize in a couple of quarters as the economy seems to be bouncing back quickly.

3. SPIN-OFF DYNAMICS:

The firm used to trade as IIFL Holdings until May 2019 post which its wealth and securities business was spun off as separate listings. The combined stock had a **market cap of almost 4X of IIFL Finance's** and the wealth business has almost 2X. I believe that the stock had to undergo technical selling dynamics as with all post-spin-off shares. I believe that this corporate restructuring happened during one of the toughest periods for NBFC's and hence it hasn't been priced well by the markets. There has been very little analyst coverage on the stock and it gets clubbed with other wholesale lending or brokerage based firms that have a completely different business profile.

Similarly, IIFL Finance has undergone meaningful transition as the wealth business built its own NBFC book overtime and the firm acquired a Micro Finance institution and sold its CV lending book which makes it difficult to compare historical financials. The firm has only one standalone annual report but the investor presentation (attached here) is pretty detailed and the management call transcripts are insightful as well. I expect the market to understand the business better over time and give it the valuation it deserves.

4. EXAGGERATED CONCERNS AROUND REAL ESTATE LENDING:

Indian real estate lending firms went through a trial by fire over the last 2 years as it has been the worst hit segment in this whole liquidity crisis episode. IIFL Finance often gets clubbed with other wholesale lending peers like Edelweiss, Piramal, JM Financial, etc because of its history in funding real estate developers. While the firm initially started with construction finance at the start of the decade, it has been **defocusing that segment since early 2016** as the management believed that the better lending opportunity was in the retail segments. The firm's **wholesale lending AUM is less than 12% of its overall portfolio** but in absolute terms equals 88% of its book value.

I believe that the fears around the firm's wholesale construction financing book are exaggerated as it carries around **13%+ provisions for this book (580 Cr provisions on a 4000 Cr book**). Also, the firm has started providing detailed disclosures on this book with a large part of their exposure being towards late-stage construction projects in the affordable housing segment. The management also discloses the stress test results of this portfolio with assumptions that have clearly not turned true. It is very clear from primary data over the last few months that the Mumbai real estate market has picked up significantly post unlock especially in the affordable segment from reputed developers and hence I believe there is enough reason to believe that the firm is more than adequately provided on this portfolio.

IIFL has been prudent in ensuring that they are the sole lenders in all their projects with **proper ring-fenced structures and personal guarantees from promoters.** The biggest risk with the real estate lending portfolio is projects getting stuck midway because of liquidity constraints. In IIFL's case, the firm needs only **around 350 Cr of incremental disbursements** to complete it's under construction portfolio. The management has also been pro-active in roping in new developers, fund infusion, etc for the resolution of slow-moving projects.

Most importantly, I believe that the wholesale **lending portfolio can decrease by over 50% naturally** as they get refinanced by banks once they are near completion. So even without any management action, it should become less than **5% of overall AUM in the next 6-8 quarters** as the retail portfolio will continue to grow strongly. Meanwhile, the management has clearly stated their intention of **selling this wholesale portfolio within the next 3 months** and I believe that would be the single biggest catalyst for valuation re-rating. The management has already started negotiations with external investors for this portfolio and they don't expect any higher provisions/ write-down from this sale.

5. UNDIFFERENTIATED SPACE / COMPANY-SPECIFIC CONCERNS:

The freezing of Indian credit markets had broken the business models of several NBFC's as they didn't have access to a low- cost deposit base and became dependent on the banks to roll over their existing liabilities. This made them totally uncompetitive in any lending segment in which their primary competitor were banks or in segments where there were no natural buyers for their loans. This completely changed the investment thesis of NBFC's from nimble market share gainers to losers and thus the tremendous de-rating. The wholesale NBFC's had to move their portfolios to AIF structures or de-grow their balance sheets in absolute terms to survive the crisis.

IIFL Finance has been able to grow during this period because of its focus on granular retail loans that are liquid and are difficult to access for the banks. Even in segments like home loans where banks have a strong presence, IIFL Home Finance has focused on Tier-3 cities or on customers in niches like the self-employed segment where there is underwriting/ collections complexity. In most of its lending segments, the biggest competitor for the firm were from other NBFC's/ HFC's (Housing Finance Companies) and hence they have benefited from the reduced competitive intensity. Their pricing power can be seen from sticky NIM's that they were able to generate through this crisis. The firm's securitization/ assignment history has ensured that banks were ready buyers for these priority sector loans to fulfill their regulatory obligations.

Since IIFL's onboarding yields on all their credit segments except home loans are **upwards of 15%**, I don't believe that a few bps of higher borrowing costs breaks their business model. I believe that lending successfully to these segments is primarily a function of efficiency and the winner is usually a firm with the right people, processes, and branches to source, disburse and collect loans in a cost effective manner. For example, the total employee cost is almost **25% of the net interest income and 65% of the total fixed expenses. IIFL employs almost 17, 300 people, and the higher operational cost (50% cost/ income ratio) for banks** to replicate IIFL's employee or branch count would more than negate their borrowing cost advantage.

One of the other concerns for markets has been the relatively higher gearing of IIFL Finance (6X - Debt/ Equity) with limited room for growth. I believe that the total capital adequacy at the firm's **Holdco level is 18.7% with 15% of Tier-1 equity, but the majority of the growth (60%+) is happening at the subsidiary levels (Housing Finance subsidiary and Micro Finance subsidiary) which have 24.3% (Tier 1 - 19.4%) and 23.9% (Tier 1 - 19.5%) capital adequacy** respectively. Also, they have gold loans at the Holdco level which can be sold even in a distressed market for upfront profits to boost equity capital if required. The business generates 15%+ ROE even during a stress period and hence they would be able to grow at a healthy pace without diluting their equity capital.

5 REASONS WHY IIFL FINANCE CAN BE A LONG TERM COMPOUNDER!

1. NIMBLE MANAGEMENT WITH A HISTORY OF STRONG EXECUTION:

While IIFL Finance has been run by two professional CEOs over the last 5 years, the group's founder Chairman Mr. Nirmal Jain (age-53) who took over as CEO of the firm earlier this year has always been a hands-on manager of the credit business. He is a first-generation professional entrepreneur who foresaw the growth opportunities in the Indian financial services space and executed well to build **four well-governed publicly traded businesses with a combined market cap of over 16,000 Cr** - IIFL Wealth (India's largest wealth and alternative asset manager), IIFL Securities (Equity capital market focused broking and investment banking business), 5 Paisa (India's 3rd largest discount brokerage) and IIFL Finance. He has achieved this by being able to attract the right talent and incentivizing them through equity ownership. All the group entities are run by CEOs with substantial skin in the game and hence Nirmal is able to spend over 80%+ of his time on building IIFL Finance as the leading retail lender. He hasn't sold a single share of his since the group's listing and just clips dividends from his holdings.

IIFL Finance has executed well on scaling the retail credit business aggressively from an AUM of **<1,000 Cr in 2010** to **12,000 Cr in 2015** to **35,000 Cr in 2020**. They have managed risks well through adequate diversification by continuously adding new segments and moving into lower ticket categories (Net NPA's have consistently been below 1%). The management was prudent and ahead of its peers in shifting the business model away from wholesale lending when the easier route for AUM scale-up was to press the pedal on construction and structured finance in which IIFL had an established business. IIFL's management has not just been nimble in spotting new opportunities but also in adapting to reality quicker as they did with the disposal of their CV lending immediately post the IL&FS crisis or tapping the foreign bond markets at the right time.

While several NBFC's have quickly grown their wholesale book, I believe it is very unique for a professional entrepreneur to build a 35,000+ Cr retail lending book within a decade from scratch. Even larger NBFC's like Aditya Birla capital or L&T Finance has a smaller retail book than IIFL Finance and other well run larger ones like Bajaj, Mahindra, Sundaram, Cholamandalam, etc have an Industrial house backing and a longer operating history. With a strong base built, I believe that IIFL Finance is well placed to continue scaling up its book over the next decade by capitalizing on the credit opportunities that will arise as India grows from a 2.5 Trillion $ economy to an 8-10 Trillion $ economy.

2. RIGHT EXPOSURE TO ATTRACTIVE CREDIT SEGMENTS:

IIFL Finance's retail credit AUM break-up is as follows: H**ome Loans (36%), Gold Loans (32%), Business Loans (22%), and Micro Loans (10%).** While Home loan is a long tenure asset, business loans are medium tenure and Gold & Micro loans are shorter tenure and this diversification enables better asset-liability matching. I believe that the firm has found the right team, cost structure, and processes in each of these segments to scale up their book going forward. Indian retail credit is a huge opportunity with low household debt/ GDP and a young aspirational population. The firm doesn't need to take higher credit risks as there are enough underserved segments because of the Indian lending landscape being tilted towards PSU Banks (over 50%+ share) who are extremely inefficient as shown from their credit costs in like-to-like segments at 3X of well run NBFC's like IIFL FInance.

GOLD LOANS - I believe that IIFL's biggest execution success has been in gold loans which is a pull product with very high OPEX. While every analyst understands that Gold loan lending has tremendous tailwinds for the next few years, I don't think many realize that IIFL's gold loan book (AUM of 11,400 Cr) is the fastest-growing among scaled-up NBFC's and is **already the 3rd largest at around 60% the size of Manappuram's and 25% of Muthoot's.** The firm has recently roped in Indian cricketer 'Rohit Sharma' as its brand ambassador for its marketing campaigns. I believe there is still headroom for higher disbursements from its existing Gold loan infrastructure and the business can continue growing faster than peers for the next few years. Gold lending leaders like Muthoot and Manappuram have had a long and successful operating history in the Gold lending segment but have found it difficult to diversify into newer segments.

HOME LOANS - In home loans, IIFL Finance's average onboarding ticket size is 15 Lakh Rs and they are one of the largest processors of affordable housing subsidy targeted towards first-time buyers. While this is a yield sensitive segment unlike others, IIFL's strategy here is to assign/ securitize lower-yielding loans while generating fee income through cross-selling of other financial products to maintain 20% ROE's. Similarly, since they focus on difficult-to-access segments in terms of geography or client profile, they are able to get **almost 20% of their home book to be funded by NHB refinance** at subsidized rates, and that allows them to compete effectively against larger HFC's or banks. The churn on their home loans to refinance/ balance transfer is only 12-15% of their opening book. **With 3 of the top-5 HFC's in major trouble, the management sees them going up the market share ladder from Top-10 in the mortgage industry to Top-5 over the next few years.**

BUSINESS LOANS - The split between secured and unsecured business loans is 67% and 33% respectively. As with the other segments, IIFL Finance has continuously increased the granularity of their loans by reducing the average ticket size from **90 Lakhs in 2016 to around 18 Lakhs now.** This has allowed the firm to increase the onboarding yield from 13% to 18% during this period. Around 75% of their business loan customers are small retailers and traders and only 25% are in the manufacturing sector. I believe that the small service business owner is extremely underserved and often depends on informal financial lenders for his credit needs. They are able to assign roughly 10% of this portfolio to banks. COVID- related stress is highest in this portfolio and hopefully, the key learnings from this cycle will enable the firm to tweak its processes and scale-up this business going forward amidst weakened competition especially on the unsecured business loans.

MICRO LOANS - The firm's micro loans business is a result of its acquisition of Samasta Microfinance whose founder continues to run this segment. This business has allowed the group to expand its branches into small villages while delivering profitable growth. Currently, health insurance is the only cross-sold product from these MFI branches (560 in total) but the management has tested a few pilot projects of rolling out home and business loans out of these MFI branches which have been successful and would be scaled up going forward. The firm's MFI portfolio is well-diversified geographically and has an average loan size of 33,000 Rs.

3. ROBUST BRANCH INFRASTRUCTURE & TECHNOLOGY INVESTMENTS:

IIFL Finance has one of the most expansive branch network spread out across India with a total count of 2400 which is higher than several large NBFC's that are multiple times bigger. The management has grown its **branch count at an impressive rate with it being doubled over the last 5 years** alone. The firm hasn't rolled out all its lending products from all branches and I believe that there are still meaningful operational synergies and leverage to be extracted going forward which should help it to decrease the cost to income ratio. With 85% of its branches in Tier-2 and 3 locations, IIFL has the ability to put together a geographically diversified pool of securities that can be sold to banks and other investors.

IIFL's gold loan business would always require a physical branch in a convenient location with adequate security and vaults for their walk-in customers. This branch network enables the firm to roll out other lending products at minimal costs. For example, the **operating cost of running a gold loan business is almost 7-8% of AUM** and this can be spread over other credit products. **Gold loans as a standalone business covers the entire fixed costs of the platform**, providing tremendous advantages to its other segments. Gold loans are currently disbursed out of 1740 branches but the home & secured MSME loans are sourced only in 450 branches as they didn't want to spread themselves too thin. The management is mapping their gold branches with nearby HFC branches and this will enable them to grow distribution as the firm has completely digitized its home loan processing end-to-end.

The firm's robust branch network combined with its investment in technology would enable them to provide a far better phygital/ omnichannel experience when compared with fintech peers. The management has used the COVID crisis to dramatically overhaul its cost base by automating several processes and reducing turnaround time through process innovations. They expect all their sales leads to be generated digitally or through walk-in customers and thereby reduce the requirement of sales employees. **IIFL has made the processes for all its loans digital, paperless, and to a large extent faceless.** All these technology investments have enabled it to provide complete transparency on the loans to their bank buyers.

Indian policymaking is moving towards OCEN (open credit enablement networks) which would help the firm to access alternate user data digitally with consent from customers and this should enable digital underwriters with experience like IIFL to grow quickly over the next decade. The firm has already tied-up with several technology companies with first loss guarantees to disburse digital loans for their customers with a current book size of 400 Cr. The group has always been comfortable with large technology investments since inception as they **started their journey as an internet-based brokerage business with a strong trader terminal to cater to the DIY customer base** but lost their focus with diversification into other financial services. Nirmal Jain has learned from his mistakes in the brokerage segment in which they were late to the mobile app-based discount brokerage game and had to cede market share to upstarts like Zerodha. He doesn't want a repeat of that in the retail credit business and hence wants to keep investing heavily in technology going forward as well.

4. BUSINESS MODEL PIVOT IS HIGHLY ROE ACCRETIVE:

IIFL's management has made a pivot towards a capital-light business model that can be captured under the tagline "**Own the customer, Sell the loan**", post the IL&FS liquidity crisis and the recent corona virus disruption. They are moving more of their loans towards either a co-origination model with public sector banks (PSB's) or securitize/ assign their loan pools to transfer the balance sheet risks while clipping fee income. In the co-origination model, the customer also benefits as the borrower gets a lower blended interest rate of the two lending partners which enables a Win-Win relationship for all stakeholders.

In any liquidity crisis, money moves towards PSB's as they have the strongest liability franchise. The biggest weakness of PSB's is their bloated OPEX cost structure and lack of a good underwriting culture that makes them totally uncompetitive in the small-ticket retail lending segments. Thus IIFL Finance is an ideal partner for PSBs to grow their retail finance books by buying their asset pools. Since IIFL Finance will continue to own the customer relationship, they will have the ability to generate fee income by cross-selling investment/ insurance products (almost 10% of PAT) throughout the loan tenure using the group's financial product distribution expertise.

As of today, **IIFL Finance's on-balance sheet assets are 73% of AUM, and assigned loans are 27%.** The management believes that they will be able to shift more of the AUM towards assigned and co-originated loans which would enable them to grow faster without any equity/ debt capital constraints. The firm currently works with multiple banking/ financial institution partners but around 80% of the assignment sales is to PSB's. Almost 35% of its gold loan and home loan books are assigned to partners and the firm has been able to generate almost 6% of AUM on its assigned assets which is an indication of healthy pricing power.

One of the major concerns of the assignment model is the buyers' ability to cherry-pick the best assets which would leave the higher risk non-performing assets on IIFL's balance sheet. The firm's gross NPA's in on-balance sheet assets is definitely much higher than that of its overall AUM, but the difference isn't meaningfully large to be concerned. While it has been a buyers market over the last 2 years as several weaker players were desperate sellers of their loan books, I believe that the pricing on assignment transactions would tighten going forward as there is surplus liquidity in the system (seller's market) and the weaker players have been weeded out. NBFC's losing seasoned books/ customers to cheaper bank refinancing has always been there even in the older lending model and is nothing new to be worried about.

I also believe that some analysts wrongly believe that the co-origination and assignment models have no entry barriers. IIFL has ready buyers for its retail pools primarily because of the firm's track record. Their securitized/ assigned assets in general have performed much better than the credit expectations of buyers. All assignment transactions with NBFC's start off on small pools and, partner banks scale up their purchases only after witnessing the performance of the originator's assets across a few loan cycles. This e**volution is pretty similar to how a finance firm generally moves up the rating curve with lower borrowing costs as it executes well by managing risks across cycles.** The spread for a similarly rated pool that is originated by firms with different governance perception can be as high as 100-300 bps.

The successful execution of shifting more AUM under co-origination and assignment models would result in IIFL Finance becoming a capital-light business with sustainably high ROE's. While banks are the primary buyers of loan pools at this point, I believe that quality originators like IIFL Finance will have access to a diversified investor base in the future with the evolution of insurance firms, pension funds, alternate funds, etc. The recent reforms on creation of CDS markets, IBC, etc along with sustainably lower interest rate regime and digital distribution costs will help to create a proper high yield credit market and broaden the investor participation for loan pools.

5. JUICY VALUATIONS BACKED BY HEALTHY EARNINGS GROWTH:

I believe that the accounting around assignment transactions makes it slightly complicated to understand the normalized earnings power of IIFL Finance. In assignment transactions, the net interest margin strip between the pool's loan yield and the buyers' cap rate (the rate at which the bank wants to lend to IIFL + its credit loss expectations on the pool with a buffer) is discounted back and booked immediately in the P&L statement. Since the credit risk is entirely transferred to the buyer, the upfronting of income is fair and mandated under IFRS. Unwind of the discount rate from the NIM strip and amortization of fee income are spread over the tenure of the loan through the firm's P&L statement. IIFL Finance usually charges around 25 bps maintenance fees on assigned assets.

Currently, 65% of IIFL's fee income is from credit processing related fees and 35% is from cross-selling income. **Fee Income is incrementally around 25-30% of the firm's overall profits and the management expects it to improve it to 30-35% over the medium term. Roughly 50% of the assignment income is up-fronting of NIM from the sale of assets in that quarter and the remaining 50% is from the discount unwind of the assignment back book along with maintenance fees.** Hence there is healthy predictability in the firm's income statement and we don't need to do any major adjustments to calculate the normalized earnings power as the trend of assignments is only expected to accelerate going forward.

Even during the last quarter when there were additional provisions for COVID, the firm was able to generate over 17% ROE. IIFL Finance in H1FY21 has generated a profit before tax of almost 800 cr if you exclude the special provisions for COVID related stress. The firm's high pre-provision profits would enable it to survive even if economic stress continues for many more quarters. If the economy normalizes quickly, **I believe that the firm will generate almost 1400 Cr of profit after tax next year (3X PAT of FY 22E).** It's not very difficult to understand that the current trading valuations of 0.85X Price/ Book and <5X normalized earnings is extremely juicy for a well-run business with healthy growth prospects.

CONCLUSION - NEAR TERM CATALYSTS AND LONG TERM OPTIONALITIES:

IIFL Finance is a play on the megatrend of **'Formalization and Financialization of Indian economy'** over the next decade. Unlike developed markets, the Indian retail credit opportunity is extremely attractive as well run financiers like IIFL Finance are able to originate secure Gold or Home loans at 70% LTV ratio with a spread of over 800 bps on Gsec's. IIFL's team has navigated through several challenges over the last decade and built a strong retail credit platform to ride the next wave of growth.

I believe that the immediate near-term catalysts for the stock would be the sale of the wholesale loan book, lowering of borrowing costs, and a sustainable pick-up in home sales on the back of lower interest rates. Over the next 4-8 quarters, I believe that stabilization and possible up-gradation of its credit rating would be possible. The broader economic recovery and the declared profits of IIFL Finance over the next few quarters should in itself catch the attention of market participants. IIFL's Promoters currently own 25% of the firm while long-term investors like Fairfax and CDC own 30% and 15.5% of the firm respectively. Since almost **75% of the firm is held by strong hands, the real free float of the stock is limited** and hence any large incremental buying could re-rate the stock quickly (promoters did small creeping acquisitions in H1, 2020, but they are limited at 25% because of the open offer regulations).

In the long-term, I believe that the end game for **IIFL Finance would be to convert itself from an NBFC to a universal bank.** Since the group is focused only on financial services and has a history of transparent operations under various financial regulators like SEBI, IRDA, NHB, RBI, etc, I believe that it would face little resistance from the banking regulator to convert to a bank over the next decade. Even otherwise, I believe there could be a possibility of Fairfax backed **CSB Bank merging with IIFL Finance** as the former needs to reduce the promoter shareholding and there are synergies between CSB's liability franchise and IIFL's asset franchise. I think Nirmal Jain wants to emulate Uday Kotak in building a large financial services group with a **retail bank as the nucleus.** Anyways **an investor in IIFL Finance at the current valuations only needs a normalization in the credit environment to generate healthy returns and these long-run ambitions are just free optionalities.**

DISCLAIMER: We own around 1% of IIFL Finance and hence I am completely biased. We haven't bought or sold the stock in the last 30 days. Please consult your registered investment advisor. I have had a regulatory issue in the past because of my board membership at a previous employer and that has been resolved. We might buy/ sell shares without informing SumZero's members.

FINALIST
Asia

Eric See
Portfolio Manager at EDBI

Shangri-La Asia Limited

RETURN TO DATE: 2.49%

Asset: **Equity**
Symbol: **69:HK**
Idea Posted: **12/17/2020**
Idea Updated: **12/20/2020**

EXPECTED RETURN: 143.24%

LONG

ATTACHMENTS	TIMEFRAME	SITUATION	MARKET CAP
	2-5 Years	Event / Special Situations	3.3B USD

> Covid-19 is an opportunity to buy this well-established brand name

About EDBI

Investing since 1991, EDBI is a Singapore-based global investor in select high growth technology sectors ranging from Information & Communication Technology (ICT), Emerging Technology (ET), Healthcare (HC) and other strategic industries. As a value creating investor, EDBI assists companies achieve their ambitious goals by leveraging our broad network, resources and expertise. With our growth capital, EDBI supports companies seeking to grow in Asia and globally through Singapore.

Shangri-La Asia Limited

Asset Class: **Equity** Symbol: **69:HK** Updated: **12/20/2020** Submitted: **12/17/2020**

Pricing & Return Details	LONG
EXPECTED RETURN	143.24%
TARGET PRICE	18.00 HKD
INITIAL PRICE	7.22 HKD

BY:
Eric See

CURRENTLY AT:
EDBI

> Covid-19 is an opportunity to buy this well-established brand name

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Event / Special Situations	1%-1.5%	N/A	2-5 Years

INVESTMENT THESIS

COMPANY BACKGROUND

Shangri-La Asia Limited ("Shang"), is a hospitality group that is focused on the ownership and management of hotels under the Hong Kong-based Shangri-La Hotels and Resorts, a leading luxury hotel group. In addition to hotels, Shang also holds a portfolio of investment properties for rental and develops properties for sale.

Company has a portfolio worldwide with a total of 102 owned and/or managed hotels and owned stakes in 23 investment properties across 27 countries. Its presence is mainly in the Asia Pacific, especially within Hong Kong/ Mainland China.

BUSINESS SEGMENTS

HOTEL OWNERSHIP

Company owns and/or manages a total of 102 hotels under its registered brand names of "Shangri-La Hotels and Resorts", "Kerry Hotels", "Hotel Jen" and "Traders Hotels". These are usually 5-star deluxe hotels, located centrally in each city. , "Shangri-La Hotels and Resorts" is the marquee brand of the group.

"Kerry Hotels" cater to business travellers, combining a vibrant and relaxed environment with service and quality through integration of business, entertainment and recreation.

"Hotel Jen" is a unique brand designed to appeal to a 'New Generation' of travellers via a mix of style and service delivery.

"Traders Hotels" properties owned by SHANG have been gradually redeveloped and rebranded as "Hotel Jen", with the only 3 remaining owned by third parties.

CHINA BUSINESS TRAVEL DEMAND IS RECOVERING

According to the latest CITS American Express Global Business Travel survey, 31% of the Chinese corporate respondents expect to increase corporate travel budgets in the coming year, a jump from 17% last year. This is positive for Shangri-la as business travellers account for c. 65% of its room nights.

Unlike other hotel operators, Shang owns an asset-heavy strategy when it comes to the Hotel Properties segment, holding equity interests in 79 hotels. SHANG has a 51% or more ownership stake in 55 out of 79 of those properties. Of these, it has full ownership of 34 hotels. This accounts for a room inventory of 25,405 keys after adjusting for its proportionate ownership (from a gross total of 34,993 keys).

Hotel Management is operated via SHANG's wholly-owned subsidiary, SLIM International Limited. This is a small business of Shang.

PROPERTY RENTAL

Shang also owns properties comprising office, commercial and residential spaces, with a total GFA of ~920,000 sqm after adjustment for proportionate share which it rents out. Its property portfolio are located in strategic locations across Asia. For example, in Mainland China are situated in Tier 1 cities, Beijing, Shanghai, Tianjin, and Tier 2 cities, Dalian, Qingdao, Hangzhou, Chengdu. Meanwhile, properties in Singapore are located in prime locations near prime shopping belt Orchard Road. The properties in other countries are located in capital cities or commercial centres, with the exception of the Cairns which is a popular tourist destination in Australia.

The operating income from property rentals is expected to be anchored by China World Trade Center which accounts for 32.2% of total GFA (after adjustment for proportionate interests). China World Trade Center, the largest up-market commercial mixed-use development in the world, along with Century Towers Beijing, are both owned by China World Trade Center Company Limited ("CWTC") (listed), in which Shang owns a 50% equity interest.

PROPERTY SALES

Company traditionally held equity interests in composite developments in Mainland China, the Philippines and Sri Lanka, with its sister company, KPL.

CORPORATE STRUCTURE

INVESTMENT THESIS

SIGNIFICANCE OF THE SHANGRI-LA BRAND

Shang's brand is uniquely positioned as a leading luxury hotel group providing 5-star hotel accommodation. This brand equity creates intangible benefits to its other business segments namely in the rental as well as the property sales segment. Shang has also expanded beyond the luxury tag and entered into the mid-market segment, with its brands "Kerry Hotels" and "Hotel Jen" targeting the business and younger travellers respectively. Sales from F&B also form a significant source of revenue ~40% of revenue from hotel operations.

ASSET-HEAVY HOTEL OPERATOR WITH TANGIBLE VALUE

Shang owns 25,405 keys, representing an attributable 73% (ie: 25,405 out of 34,993 keys), which is significant versus its asset-light operators. Most of these hotels are also located at key Asian gateways like Shanghai, Shenzhen, Hong Kong, Singapore, Kuala Lumpur and Manila.

We prefer hotel operators with an asset heavy portfolio. As it forms a baseline for minority equity holders position in the company, and do not place too much emphasis in the brand value and operating experience associated with asset light operators. Hotels as an asset class are in a unique position where the brand and day-to-day management are important income drivers. Hotel-by-hotel income and valuation are not provided although number of rooms by property is provided.

IMPROVED OPERATING EFFICIENCY

Management has started to centralize some of the back-of-house functions, including procurement, IT, human resources and finance. Management sees annual cost savings potentials of US$50-100m when this ‘Shared Services’ plan is fully implemented. For example, only 10% of the group’s US$1.2bn procurement is handled at the corporate level. More importantly, management believes that creating a consistent and reliable back-of- house function can help the group win more management contracts. In terms of pricing, the group will also strictly enforce its pricing agreements with the online travel agencies (OTAs) so that they do not undercut the group’s best available rates.

COVID-19 IS AN OPPORTUNITY TO BUY THIS WELL-ESTABLISHED BRAND NAME

There are not many opportunities to be able to capture a sizeable, well established, and market leader in its segment in every industry. In hotels, it is no exception. However, due to the effects of covid-19 and travel restrictions, business performance for 2020 has been impacted. It is however, our view that this is a temporary delay of the busines by a year, or more aptly we categorically put Shang as one of the companies where 2020 has been a lost year for the company. While we are uncertain how speedy travel will resume with the approval of the vaccine, or to what magnitude will it recover to pre-covid levels, but recent quarterly results shows that it is above 70% recovery from pre-covid. Fundamentally, we believe that luxury travel will resume in a V shape recovery as consumers will tend to spend most of their discretionary spending in holidays and travel when the health situation turns for the better. However, the slowdown in the economies of the various countries do present a risk factor to the overall thesis.

VALUATION

We use a SOTP valuation to value the group. Based on the 3 business segment. We noted that the China portfolio takes up a significant portion of the hotels business. On a group basis, accounting for subsidiary and associates also form large portion of the valuation of the group.

As stated, as hotel management and property development is not a core business of the group, it presents a small portion of the overall group value. We deem this as non-core.

	# of rooms	FY20 Revpar (adjusted for Covid	Total value	% GAV
		HK$m/rm	HK$m	2020
Owned hotels				
Hong Kong	1634	2.483	4057	4%
China	14515	1.17	16983	18%
Singapore	1453	2.184	3173	3%
Philippines	2273	1.26	2864	3%
Malaysia	1369	1.02	1396	2%
Thailand	1004	1.05	1054	1%
Others	2918	0.64	1868	2%
New Hotels + Pipeline				
China	1,669	0.45	750.9	1%
Others	641	0.32	205.12	0%
Investment Property	NOI	cap rate	value	
Subsidiaries	439.98	4%	10999.5	12%
Associates	1903.08	4%	47577	51%
Development property for sale	45.76	8%	572	1%
Hotel management contracts	116.27	12.00	1395.2941182%	
Gross asset value			92895	100%
Less: net debt (cash - debt)			(34,920)	
NAV			57975	
no. of shares			3,586	
NAV/Sh			18.05	

Current price of HKD 7.22 is a discount of 60% discount to the NAV

POTENTIAL RISK

Slower than expected recovery in hotel bookings to Covid-19 levels Slowdown in economy affecting future growth in RevPar
Mark down in valuation of its portfolio assets
Unable to achieve cost optimization efficiency.
High gearing ratio, with a large proportion in fixed rates.

CONCLUSION AND RECOMMENDATION

Shang is an established hotel owner and operator, focused on the Asia-Pacific region. Its predecessor and related entities set up the first “Shangri-La” in Singapore in 1971, Hong Kong in 1981 and was an early entrant into the Mainland China luxury hotel market in 1984. It has a recurring income stream from the Hotel Properties segment. The group has shown resilience during the peak of the covid period, primarily from a strong sponsor behind the group. The current price of HKD 7.22 has a good margin of safety from the Net Asset Value. There are positive catalyst from the recovery of travel. The strong sponsor coupled with the low interest rate environment allow the group to be opportunistic during such times to be on the lookout for accretive acquisitions. If there is a lack of targets, it will also give the group an opportunity to bring down the cost of financing, through refinancing with some of the higher loan facilities, and potentially switch from fixed to floating rates in order to reduce the interest expense of the group. The action items discussed above are pockets of opportunity for the management team, introduced in 2017, to increase the value of the group to its shareholders. As such, in conclusion, we recommend a buy at current price of HKD 7.22.

MICRO CAPS

Ideas on companies whose respective market capitalizations were less than US $300M at the time of submission.

WINNER
Micro Caps

Jud Traphagen
Partner at Plough Penny Partners

BADGES:

Net 1 Ueps Technologies Inc

RETURN TO DATE: 42.51%

Asset: **Equity**
Symbol: **UEPS:US**
Idea Posted: **12/9/2020**
Idea Updated: **12/12/2020**

EXPECTED RETURN: 47.06%

LONG

ATTACHMENTS	TIMEFRAME	SITUATION	MARKET CAP
W	1-2 Years	Growth At Reasonable Price	196.0M USD

> UEPS is a "deep GARP" opportunity. Trades at a negative enterprise value. Owns stakes in several promising fintech businesses. Buying back stock and insiders are also buying.

About Jud Traphagen

Jud runs a fundamental long/short hedge fund in international internet, software and payment/fintech sectors. Long bias. Jud also makes VC investments. Formerly ran a family office heavily invested in technology. Jud worked at Paul Kazarian's investment firm Japonica Partners for roughly 7 years. On the board of the Teak Fellowship. Trustee of the Eaglebrook School. Also on the board of the Lang Center for Entrepreneurship at Columbia Business School. Graduated from Columbia Business School in 1992.

PLOUGH PENNY ADVISORS

About Plough Penny Partners

Plough Penny Partners is a NYC based equity Long/Short hedge fund focused on generating superior risk-adjusted returns by investing in the international internet, software and fintech sectors. Market capitalization agnostic. Strives to be tax efficient. Long term holding periods. The principals have roughly 30 years of investing experience in both the public and private markets. The fund was spun out of a family office that was heavily invested in technology.

Net 1 Ueps Technologies Inc

Asset Class: **Equity** Symbol: **UEPS:US** Updated: **12/12/2020** Submitted: **12/9/2020**

Pricing & Return Details	LONG
EXPECTED RETURN	47.06%
TARGET PRICE	7.00 USD
INITIAL PRICE	3.34 USD

BY:
Jud Traphagen

CURRENTLY AT:
Plough Penny Partners

BADGES:

> UEPS is a "deep GARP" opportunity. Trades at a negative enterprise value. Owns stakes in several promising fintech businesses. Buying back stock and insiders are also buying.

ASSET CLASS: Equity

SITUATION: Growth At Reasonable Price

TARGET ALLOCATION: 2% - 5%

CATALYSTS: Management Change, Insider Buying/Selling, Corporate Restructuring, Subsidiary IPO

TIMEFRAME: 1-2 Years

INVESTMENT THESIS

EXECUTIVE SUMMARY

- **Recommendation:** Long with a 6/30/21 price target of $7.00 reflecting 108% upside to the current share price of $3.36.

- **Business Overview:** Net 1 UEPS Technologies, Inc. ("Net1", "UEPS", or "the Company") provides payments and financial services in South Africa. In addition, it has a portfolio of minority stakes and VC investments in various financial and FinTech businesses ("non-core assets"). The business is headquartered in Johannesburg, South Africa and employs 2,875 globally.

EXHIBIT A: FINANCIAL & TRADING SNAPSHOT

$s in Millions Except per Share

Key Stats			
Share Price	$3.36	Market Cap.	$188.2
52 Wk. Hi - Lo	$4.45 - $2.70	Net Cash	$209.2
FDS (K)	56.0	Enterprise Value	($21.0)
Float %	63.2%	EV / 2020 Revenue	NA
Short Interest %	0.5%	EV / 2021 Revenue	NA
FYE 6/30			

Financial Snapshot	2019A	2020A	2021E
SATP	$96.0	$73.8	$71.4
ITP	148.3	71.4	5.7
FIAT	146.2	82.3	64.6
Interco. Elim.	($9.8)	($10.2)	($8.7)
Consolidated Rev.	$390.5	$227.5	$141.7
YoY Growth %	*(36.3%)*	*(41.7%)*	*(37.7%)*
Adj. EBITDA	($12.6)	($16.5)	($7.7)
Adj. EBITDA Margin	*(3.2%)*	*(7.2%)*	*(5.4%)*

- **Summary Thesis:** UEPS offers a unique, "deep GARP" opportunity. At its current share price of $3.36, UEPS trades at a negative enterprise value ($209mm net cash vs. $188mm market capitalization), implying both its core business and non-core assets are essentially worthless. Based on our Base Case valuation, in which we value the core business at 1x FY21 Revenue and the value of the non-core assets at their current carrying value, we ascribe a 6/30/21 PT of $7.00. The core business has begun to show signs of a turnaround including growing nearly 40% on a QoQ basis in FQ1 2021 and adding over 40k customers on a net basis in the month of October 2020. While the business is small for a public company, its board is sophisticated and as such is directing the business to focus its operations and return capital to investors. The Company has recently announced a $50 million stock buyback. We believe this strategy will unlock shareholder value. In addition, two board members have recently purchased stock on the open market and the largest shareholder Value Capital Partners has also been buying shares on the open market.

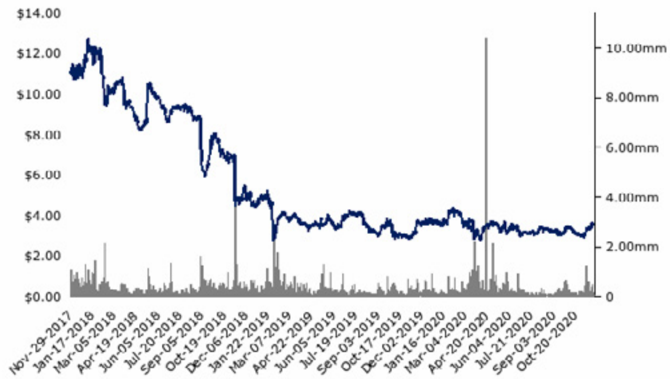
- **What the Market is Missing & Catalysts:** As a micro-cap operating in Africa, the stock is under-covered with only one analyst from a relatively small brokerage firm (B. Riley Securities) covering it. In addition, the core business is complex and investor relations messaging is confusing, thus making valuation difficult. The values of the non-core assets are difficult to determine due to limited reporting. Finally, the poor recent financial performance has driven the share price down. Institutional ownership has fallen proportionally. We have identified several potential catalysts, including sales & IPOs of non-core assets as well as the naming of a new CEO, expounded upon in Catalysts below.

- **COVID:** Primary operating business is in South Africa, which as a southern hemisphere country, is now entering summertime and thus a milder period for COVID. COVID cases peaked in July 2019 and have stabilized at about 25% of that peak.

- *Note: all currency figures will be USD, in which Net1 both trades and reports, unless otherwise noted.*

BUSINESS HISTORY & SITUATION OVERVIEW

EXHIBIT B: UEPS TRADING HISTORY



- **Business History:** UEPS was founded in 1997. In 2004 the private equity firm Brait (founded by Antony Ball whose current firm Value Capital is the largest shareholder) acquired Net1 Applied Technologies Holdings Limited, a publicly listed South African payments business. In 2004, Net1 went public on the Nasdaq. The business has made a number of acquisitions and investments over its history including the 2010 acquisition of KSNET, a payments processor in South Korea (recently divested).

- **How UEPS got so cheap/Loss of Government Contract:** UEPS won a contract in 2013 with the South African Social Security Agency ("SASSA") to electronically distribute welfare and pension payments to over 10mm South Africans. In March 2018, the contract ended, at which time the contract represented ~1/4 of revenue and ~1/3 of EBIT. This in turn necessitated a significant reorganization of the business including letting go of ~1/2 of the workforce.

- **Re-involvement of Antony Ball:** Antony Ball, whose current firm Value Capital Partners is the largest shareholder owning 16% of UEPS, was re-elected to the board in March 2020. Having taken Net1 public on the Nasdaq roughly 15 years ago, he knows this business very well. He deserves a lot but not all of the credit for the recent reorganization and burgeoning turnaround.

- **Strategic review:** Following a strategic review, the board set out to undergo a number of strategic initiatives to rationalize and streamline the business. In March of 2020, UEPS sold their Korean payments business KSNET for $237mm in cash. In April of 2020, UEPS sold its remaining stake in DNI, a provider of commerce-related services, for ~$48mm. In 2020, Net1 divested FIHRST, a provider of payroll management services, for $11.7 million. Net1 plans on divesting or otherwise shutting down other less profitable, non-African lines of business and letting go of some of the senior management involved in those businesses.

- **Board changes:** Over the past two quarters, Net1 has added 5 independent board members, including Ali Mazanderani, a FinTech veteran and StoneCo (public Brazilian FinTech company with $23bn market cap) director who is formally consulting for the company.

- **Stock buyback:** The board has earmarked $50mm of the proceeds from the divestitures for share buybacks.

- **New CEO:** In September 2020, the CEO Herman Kotze, stepped down and was replaced by the CFO, Alex Smith, on an interim basis. The Company is now searching for a long-term replacement.

- **Insider buying:** Since May 2020, Antony Ball and his firm Value Capital Partners have purchased over 2.5 million shares valued at more than $5 million on the open market. Their most recent open market purchase was on 11/24/20 at $3.39 per share, basically where the stock is today. Another board member purchased on the open market in September 2020.

CORE BUSINESS OVERVIEW

- **Summary:** Net1 has built a diverse payments and financial services business in South Africa. The Company has the opportunity to leverage its unique technology, infrastructure, and trusted brands to build a FinTech business capable of dominating the South African market.

- **Market Opportunity & TAM:** South Africa is an emerging market with a population of ~58 million and a GDP of $385 billion in 2019, making it the second largest economy in Africa. South Africa has a nascent financial infrastructure, with limited access to fundamental financial services for large geographic swathes of the country and segments of the population. At the same time, smartphone usage is common (over half the population uses mobile internet), credit card adoption is growing (13% annual growth since 2012), the educated work force is growing rapidly, and the economy has vast potential including some of the largest reserves of various rare minerals (platinum, gold, palladium, etc.). These all provide strong fundamentals for long term economic growth & FinTech penetration. Net1 focuses on providing its financial services to the underbanked in South Africa, which includes:
    - **B2C:** ~26mm low income South African consumers
    - **B2B:** 1.6mm MSME (Micro, Small and Medium Enterprises) South African merchants that are currently unable to accept electronic payments

- **Technology & Infrastructure:**
    - **UEPS Technology Protocol:** Due to the large rural population as well as intermittent infrastructure availability, there is a need in South Africa for a financial transaction processing network that works offline as well as online. Net1 built a unique technology called the Universal Electronic payment system that is at once operable with the EMV protocol (and therefore capable of working with Visa/Mastercard cards and card readers) while functioning offline. UEPS combines biometric authentication, last mile payment processing, and cash interoperability to provide secure and convenient payments infrastructure.
    - **Mobile Virtual Card:** Net1 developed a proprietary technology for sending mobile virtual cards, which enables secure payments and money transfers using 1x, unique codes.

- **Physical Branches:** The Company distributes its services through ~350 retail locations, including financial services branches, financial service express stores, and satellite branches.

- **ATM Network:** Approximately ~60% of the South African economy is transacted over cash. As such, UEPS complements its financial transaction processing business with a network of 1,500 mobile (i.e. mounted on pickup trucks, traveling with armored vehicles) and stationary ATMs. Net1 is the market share leader in this area and has a well-known brand name.

- **Products & Solutions:**

  - EasyPay: Provides card payment processing services to businesses and bill payment services to consumers. Leading bill payments services market share in South Africa. Growing rapidly – processing ~1.4mm bill payments per month (October), up from ~1.1mm per month at beginning of CY2020.

  - EasyPay Everywhere: Provides mobile banking to consumers. ~1mm active accounts, with approximately ~$30mm run rate revenue. $780mm TAM.

  - MoneyLine: Offers microloans to consumers & MSMEs. Average term life of ~6 months. Average value of a little under $100. While some of the microfinance loans are securitized, much of it remains on Net1's books. $25.6mm book value as of 9/30/20. $1.4bn consumer opportunity, $4.2bn business opportunity.

  - SmartLife: Life insurance policies, primarily issued for the purpose of covering funeral expenses. 230k paying policies. $1.6bn market opportunity.

  - Cashpaymaster Services ("CPS"): Distributes social welfare payments to over nine million beneficiaries. Currently in liquidation.

- **Strategy:**

  - Turnaround: The strategy of the core business is to leverage its existing assets, brands, and technologies to transform from a payment processor into a modern FinTech providing a comprehensive bundle of financial services to MSMEs and consumers. Through their existing distribution channels and strong brand name, they're able to acquire new customers at a much lower customer acquisition cost than competitors

  - Long Term Outlook: Given UEPS' strong brand name in South Africa, its staff of over 200 software engineers on staff, its scale relative to other South African FinTech businesses, and its indexing to a number of long-term, secular trends (formalization & card adoption of global economy, mobile payments in the emerging economy, democratization of financial services, etc.), we believe Net1 is well positioned to succeed in the long run.

NON-CORE ASSETS

- **Summary:** Prior management accumulated a significant portfolio of minority and VC investments. Generally, these investments are in hypergrowth, FinTech businesses in emerging markets. UEPS has information rights and is on the board of all of their minority investments. Besides the assets listed below, the Company has made several other minority investments which we assume are write-offs at this time. The Company discloses their investments in detail in their quarterly earnings deck.

  [See Exhibit D on following page]

EXHIBIT D: NON-CORE ASSETS SUMMARY

Numbers below as of 9/30/20

Asset Name	Description	% Ownership	Value	Notes
Bank Frick	Blockchain based banking services based in Liechtenstein	35%	$31mm	• Had been on pace to grow 40% YoY in 2020, prior to COVID. • Publishes financial statements bi- annually on its website. • Advent of bitcoin and blockchain is secular tailwind.
FinBond Group	Publicly traded consumer bank operating in South Africa	35%	$14mm	• Publicly traded on JSE with $66mm market cap • Negatively affected by COVID but still EBITDA positive and well capitalized. • Releases bi-annual financial statements.
MobiKwik	Fintech company operating in India	12%	$27mm	• One of the largest b2c fintech companies in India. • In November raised $6 million at a pre-money valuation of $375 million in Nov. 2020 from HT Media Group and a founder of Infosys. UEPS stake now worth $45 million • Partnered with American Express to launch Amex's first credit card in India. • Investors include Sequoia Capital, Intel, American Express. • 120 million consumer customers and 3 million retailer customers. • For the year ended 6/30/20: $54 million revenue, up 130% for year ended and EBITDA breakeven. • Publishes financials every year on their website. • Has formally stated they are planning on going public in 2022. • Public fintech comps like STNE, PAGS and SQ trade at 34x, 12x and 10x EV/sales respectively
Carbon	Fintech company operating in Nigeria, Kenya, and Ghana	25%	$7mm	• Neobank B2C business model. • Doing roughly $24mm of revenues, growing triple digits YOY. • Been profitable for two years. • Has won many awards as best Fintech company and best fintech app in Africa. • Publishes audited financials every year on website.
Cell C	Mobile network operator operating in South Africa	15%	$0mm	• Carried at $0mm as the business is undergoing reorganization, after which UEPS will be significantly diluted. • 2017 valuation of $150mm.
Total			$79mm	

BASIS OF REPORTING & FINANCIAL ANALYSIS

- *See Appendix A: Financial Performance and Outlook*

- **Basis of Reporting:** The Core Business is broken down into South African Transaction Processing ("SATP"), International Transaction Processing ("ITP"), and Financial Inclusion and Applied Technologies ("FIAT").

  - **SATP:** Includes EasyPay and other revenues derived from services provided to merchants. $73.8mm of FY20 revenue, forecast to be $71.4mm in FY21. $2.5mm of FY21 EBIT.

  - **ITP:** Includes card issuing, merchant acquiring, and payment services revenues in Europe, North America, and China. Included KSNET prior to divestiture. $71.4mm of FY20 revenue, forecast to be $5.7mm in FY21 (decline largely due to KSNET divestiture). ($13.5mm) of FY21 EBIT.

  - **FIAT:** Includes EasyPay Everywhere and other consumer financial services businesses. $82.3mm of FY20 revenue, forecast to be $64.6mm in FY21. $7.7mm of FY21 EBIT.

  - The non-core assets listed above are accounted for via either the equity or cost method and as such are not consolidated into the Company's operating income.

- **Historical Performance:** The core business grew to a peak of $674mm of revenue / $169mm of Adj. EBITDA in FY15. The business stalled and then deteriorated significantly following the loss of SASSA as a customer in 2018.

- **FY20 & Q1FY21 Performance:** FY20 performance was poor, due to both ongoing headwinds stemming from divestitures as well as COVID-related disruption. Q1 performance was stronger and reflected an end of COVID related disruption. Q1 revenue of $37mm reflected 39% QoQ growth and a significant beat relative to B. Riley's expectation of $30mm.

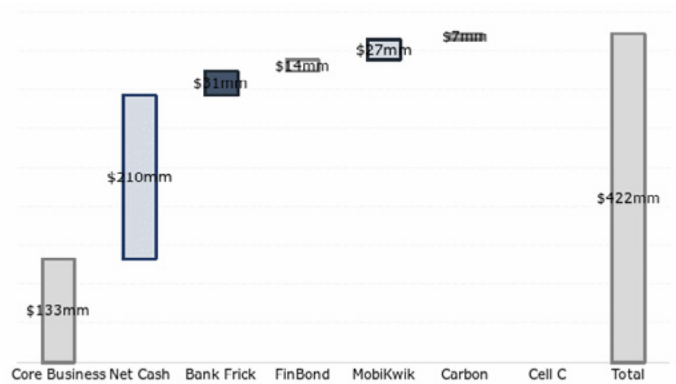
- **FY21 & Beyond Outlook:** We expect the business to continue its rebound from its 2020 performance in FY21. Because of the high margin nature of EPE customers, we believe the path to breakeven largely relies on continued net customer additions. When the Company had adequate capital, they were able to spend enough on sales & marketing to add 100k of EPE customers per month. Per their FQ1 2021 earning call, the Company added 40k net EPE customers in October, translating to ~$1.2mm in ARR. This was the first positive monthly growth of EPE customers in over two years. The Company is targeting 400k net EPE customer additions, translating to ~$12mm of ARR.

SUM-OF-THE-PARTS VALUATION & RETURNS ANALYSIS

- **Summary:** We used a sum-of-the-parts valuation method in which (i) UEPS' $209mm of net cash, (ii) the value of its core business and (iii) the value of its non-core assets are summed to determine its valuation.

- **Base Case:** In our base case, the core business drives to breakeven by FY21 and is worth 1x FY21 revenue (5x at scale EBITDA, assuming at scale EBITDA margins of 20%). Note that this valuation is significantly cheaper than other emerging markets FinTech businesses (Appendix C: Public Comparables). Non-core assets are valued at the current carrying value. This leads to equity value / share price on 6/30/2022 of $421.6mm / $7.38 per share respectively.

EXHIBIT E: BASE CASE SUM-OF-THE-PARTS



- **Bull Case:** In our bull case, the core business grows 10% faster than in the base case and trades at 1.5x FY21 revenue. MobiKwik goes public and trades at 10x ARR of $100mm, a significant discount to other hyper growth, emerging market fintech companies (StoneCo, PagSeguro, MercadoLibre; see Appendix C: Public Comparables) There is a recovery of the Cell C investment amounting to $26.3mm (15% of $175mm 2017 valuation). Other non-core assets are recovered based on their current carrying values. This leads to equity value / share price on 6/30/2022 of $634.0mm / $11.10 per share respectively. See Appendix B: Bull & Bear Case Sum-of-the-Parts.

- **Bear Case:** In our bear case, the Core business burns $20mm over the subsequent 3 quarter period and is deemed valueless. All non-core assets are also deemed valueless. In this case, the business is worth its current cash positions less the subsequent cash burn. This leads to equity value / share price on 6/30/2022 of $189.2mm / $3.31 per share respectively. See Appendix B: Bull & Bear Case Sum-of-the-Parts.

CATALYSTS

1. Naming of New CEO: We expect the market to react positively to the announcement of a suitable and well-reputed CEO.

2. Capital Allocation / Buyback: The board has announced a plan to return $50mm of cash to shareholders through share buybacks. The remaining ~$150 million of cash will be used for organic growth of the core business and potential acquisitions.

3. Core Business Turnaround: Should the operational turnaround plan succeed, and the business renew its growth, increased interest from investors would drive the share price up. We believe the business achieving breakeven operating profitability would be a significant milestone.

4. Sales & IPO of Non-Core Assets: Significant value of the business has already been unlocked via divestitures and will continue to be realized upon future divestitures. In particular, we view the potential IPO of MobiKwik to be a major potential catalyst, as they have already received a third-party valuation ~67% higher than where UEPS carries their investment and similar mobile payments businesses in other emerging markets have been extremely well received by the market.

5. Purchase of FinTech business in South Africa: Management has mentioned they may make acquisitions in South Africa. The acquisition of a pure FinTech business would add aditional digital expertise.

6. Launch of new products: We expect many pure fintech products to be rolled out over next few years.

7. Re-branding: The Company is in the process of re-branding. The website is outdated. The story for investors is unclear and messy. As the Company re-brands and makes its investor reporting clearer, the value will become clearer to Wall Street.

KEY RISKS

1. Illiquid Stock: UEPS' stock is thinly traded, with average daily volume of 0.21mm shares. In addition, there is significant ownership concentration (Value Capital Partners owns 16% and International Finance Corporation owns 14%).

2. Macroeconomic Risks: South Africa has several structural economic issues that predate COVID. GDP growth has been <2% going back to 2013, which is exceptionally low for a developing economy. Unemployment has lingered between 25-30%.

3. Currency Risk: 97% of FY20 revenue was derived from providing services within South Africa, which uses the highly volatile ZAR. Should the ZAR depreciate relative to USD at a rate greater than its historical average depreciation, the share price would fall.

4. Execution Risk: Our thesis is contingent on operational improvement within the core business and further liquidation of the non-core investments. As such, it will require strong execution. Should the Company fail to hire the right CEO, the Company may not execute well.

5. New Products Fail: The Company plans on launching new products. They may fail at doing so.

6. Non-Core Assets Fail: UEPS' non-core assets are largely high growth venture businesses, commensurate with their own risks.

7. Regulatory Risk: As a consumer finance business operating in a highly regulated economy, UEPS faces numerous regulatory risks, including potential new regulation as well as ongoing matters from existing regulation. The primary South African credit regulatory agency has applied to cancel Moneyline's credit license. This matter has been ongoing for several years and has no clear outcome at this time. In 2019, South Africa passed the National Credit Amendment Bill which provided credit relief to consumers which in turn had significant adverse effects on UEPS' Moneyline business. South Africa has made significant investments in "Postbank", a bank subsidiary of the South African Post Office that uses post office branches as bank branches. In 2017, Postbank won the SASSA contract from UEPS, which led to the loss of SASSA revenue in 2018. Finally, the Protection of Personal Information Act ("POPI") went into effect in South Africa in 2020. POPI provides various consumer data privacy restrictions, similar in spirit to GDPR in Europe. This regulation limits various data collection processes of UEPS and poses the risk of regulatory fines in the future.

8. Partner Risk: As Net1 lacks registration as a retail bank yet engages in banking activities, the Company has to partner with a registered bank, namely Grindrod bank, a South Africa based bank. UEPS therefore has risk stemming both from the partnership itself as well as the risk that Grindrod bank remains a solvent, going concern in good standing with the South African regulatory agencies.

APPENDICES

Primary Research Sources: Capital IQ; UEPS filings, press releases & websites; B Riley Securities Equity Research; Maxim Group Equity Research

APPENDIX A: FINANCIAL PERFORMANCE AND OUTLOOK

$s in Millions; FYE 6/30

	2020A				2021E			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Revenue								
South African Transaction Processing	$19.4	$20.4	$19.9	$14.2	$16.3	$17.3	$18.4	$19.4
International Transaction Processing	34.0	34.4	1.6	1.4	1.4	1.4	1.4	1.4
Financial Inclusion and Applied Technologies	30.1	22.0	17.7	12.6	14.6	15.6	16.7	17.7
Interco Eliminations	(2.8)	(2.6)	(2.6)	(2.2)	(2.2)	(2.2)	(2.2)	(2.2)
Consoidated Revenue	**$80.8**	**$74.1**	**$36.5**	**$26.0**	**$30.1**	**$32.2**	**$34.3**	**$36.4**
YoY Growth %								
South African Transaction Processing	(48.6%)	(7.4%)	14.4%	(25.2%)	(16.2%)	(14.9%)	(7.6%)	37.1%
International Transaction Processing	(13.6%)	(9.9%)	(95.4%)	(96.1%)	(95.8%)	(95.8%)	(8.7%)	0.0%
Financial Inclusion and Applied Technologies	(43.3%)	(43.3%)	(51.8%)	(28.5%)	(51.5%)	(28.9%)	(5.6%)	40.8%
Consolidated Revenue Growth	(37.1%)	54.1%	36.1%	25.2%	(22.5%)	(17.0%)	(15.9%)	0.0%
EBIT								
South African Transaction Processing	($3.4)	($3.0)	($8.7)	($4.5)	($2.4)	($0.4)	$1.7	$3.7
International Transaction Processing	3.8	2.8	(3.2)	(4.1)	(4.1)	(3.6)	(3.1)	(2.6)
Financial Inclusion and Applied Technologies	1.5	(0.9)	(0.9)	(2.4)	(0.4)	1.2	2.7	4.2
Interco Eliminations	(4.6)	(5.8)	(2.7)	(2.1)	(2.1)	(2.1)	(2.1)	(2.1)
Consolidated EBIT	**($2.7)**	**($6.9)**	**($15.4)**	**($13.2)**	**($9.0)**	**($5.0)**	**($0.9)**	**$3.2**
Operating Margin								
South African Transaction Processing	(17.4%)	(14.6%)	(43.6%)	(32.1%)	(15.0%)	(2.3%)	9.0%	19.1%
International Transaction Processing	11.1%	8.2%	(202.6%)	(289.6%)	(289.6%)	(254.6%)	(219.5%)	(184.5%)
Financial Inclusion and Applied Technologies	5.0%	(4.0%)	(5.3%)	(19.3%)	(2.5%)	7.4%	16.1%	23.8%
Consolidated EBIT Margin	(3.4%)	(9.3%)	(42.3%)	(50.7%)	(30.0%)	(15.4%)	(2.6%)	8.8%

APPENDIX B: BULL & BEAR CASE SUM-OF-THE-PARTS

$s in Millions

	Bull Case	Bear Case
Core Business	$219.4	$0.0
Net Cash (6/30)	216.3	189.2
Non-Core Assets		
Bank Frick	31.0	0.0
FinBond	14.0	0.0
MobiKwik	120.0	0.0
Carbon	7.0	0.0
Cell C	26.3	0.0
Total Non-Core Assets	198.3	0.0
Total Equity Value	**$634.0**	**$189.2**
FDS	57.1	57.1
Price per Share	**$11.10**	**$3.31**
Upside / (Downside) %	*209.1%*	*(7.7%)*

APPENDIX C: PUBLIC COMPARABLES

$s in Millions, financial figures for CY

				Revenue			EBIT		Revenue Growth %		GP %	EBIT Margin %		EV / Revenue		EV / EBIT	
Ticker	Company	Market Cap.	EV	2019	2020	2021	2020	2021	19-20	20-21	2019	2020	2021	2020	2021	2020	2021
UEPS	Net 1	$189.2	($8.2)	$280.6	$135.0	$152.2	($46.2)	($8.7)	(51.9%)	12.8%	37.8%	(34.3%)	(5.7%)	NM	(0.1x)	NM	NM
MELI	MercadoLibre	$75,802.8	$74,653.9	$2,296.3	$3,835.7	$5,222.6	$184.6	$161.1	67.0%	36.2%	56.2%	4.8%	3.1%	19.5x	14.3x	NM	NM
SQ	Square	$91,089.2	$90,876.4	$4,713.5	$9,337.1	$12,479.0	($63.5)	$59.1	98.1%	33.6%	40.2%	(0.7%)	0.5%	9.7x	7.3x	NM	NM
PAGS	PagSeguro	$15,773.6	$15,352.7	$883.2	$1,305.1	$1,749.9	$368.9	$577.6	47.8%	34.1%	22.2%	28.3%	33.0%	11.8x	8.8x	41.6x	26.6x
STNE	StoneCo	$21,833.0	$21,050.7	$274.1	$635.9	$902.4	$304.7	$420.5	132.0%	41.9%	61.3%	47.9%	46.6%	33.1x	23.3x	69.1x	50.1x
Median		**$48,817.9**	**$47,852.3**	**$1,589.8**	**$2,570.4**	**$3,486.3**	**$244.7**	**$290.8**	**82.6%**	**35.1%**	**48.2%**	**16.5%**	**18.0%**	**15.6x**	**11.5x**	**55.3x**	**38.3x**
Mean		**$51,124.7**	**$50,483.4**	**$2,041.8**	**$3,778.4**	**$5,088.5**	**$198.7**	**$304.6**	**86.2%**	**36.5%**	**45.0%**	**20.1%**	**20.8%**	**18.5x**	**13.4x**	**55.3x**	**38.3x**

Note: Data as of 12/03/20; EV / EBIT multiples deemed NM if negative or if over 75.0x
Source: Capital IQ; slight discrepancies in UEPS EV & Market Cap. with rest of document stem from diffemces in treatement of non-cash assets and liabilities and share count

FINALIST
Micro Caps

Brad Hathaway
Portfolio Manager at Far View Capital Management

CURRENT RANKING: **#5 Consumer Discretionary**
BADGES: 39 2 86

Cdon Ab

Asset: **Equity**
Symbol: **CDON:SS**
Idea Posted: **12/7/2020**
Idea Updated: **12/10/2020**

RETURN TO DATE: 63.38%
EXPECTED RETURN: 115.52%

LONG

ATTACHMENTS	TIMEFRAME	SITUATION	MARKET CAP
	2-5 Years	Growth At Reasonable Price	N/A

> Recently-spun, fast-growing e-commerce marketplace that should see massive growth in profits and is undervalued compared to peers.

About Brad Hathaway

Brad Hathaway is the Managing Partner of Far View Capital Management, an Aspen based fund that invests globally with a long-term value and special situations strategy. Prior to launching Far View, Brad worked at J Goldman & Company and Tocqueville Asset Management.

About Far View Capital Management

Far View Capital Management

Far View Partners is a concentrated, global investment fund that aims to generate attractive long-term returns while seeking to minimize permanent capital impairment. Far View's portfolio will usually consist of 10-20 positions, mainly, but not limited to, long investments in both domestic and international equities and will be highly concentrated in its top few positions. The Partnership's strategy utilizes a multi-year time horizon to focus on special situations and value investments.

Cdon Ab

Asset Class: **Equity** Symbol: **CDON:SS** Updated: **12/10/2020** Submitted: **12/7/2020**

Pricing & Return Details	LONG
EXPECTED RETURN	115.52%
TARGET PRICE	500.00 SEK
INITIAL PRICE	142.00 SEK

BY:
Brad Hathaway

CURRENTLY AT:
Far View Capital Management

CURRENT RANKING:
#5 Consumer Discretionary

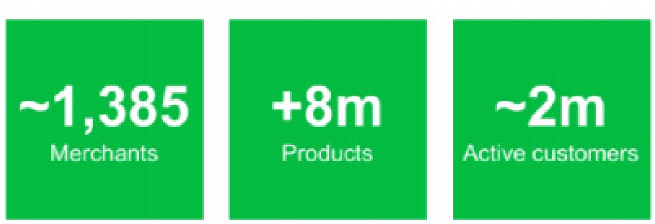
BADGES: 39 2 86

> Recently-spun, fast-growing e-commerce marketplace that should see massive growth in profits and is undervalued compared to peers.

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Growth At Reasonable Price	5% - 10%	Spin Off	2-5 Years

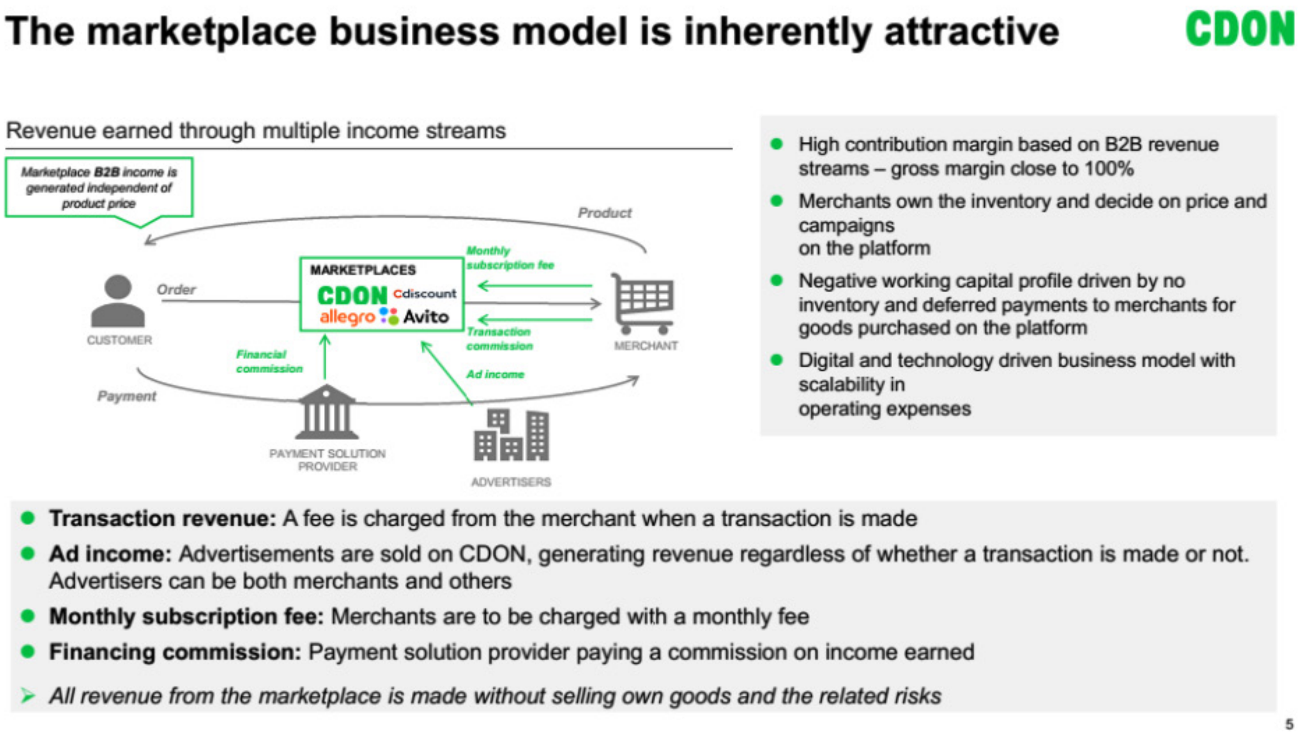
INVESTMENT THESIS

CDON AB (CDON) operates an e-commerce marketplace in the Nordics (SWE/NOR/FIN/DNK). The company mainly offers third party (3P) merchandise from over 1,300 Nordic retailers, supplemented by sales of its own first-party (1P) merchandise in legacy media categories that it feels are currently underserved. As the leading Nordic marketplace, CDON offers over 8 million products and enjoys over 28mln visits and 863k orders from over 2mln customers (~10% of Nordics shopping age population).



CDON was spun out of the Qliro Group in November 2020 in a 1 for 30 split. Qliro was then renamed Nelly AB. The spin was undertaken because it was believed that CDON had reached sufficient size to develop further on its own.

With continued strong growth (>100% growth 2020 ytd) of its high margin 3P Gross Merchandise Value (GMV) and the fixed cost structure of the marketplace business, CDON has the potential to generate a rapid increase in earnings, which should justify a share price multiples higher than current trading levels. Furthermore, analysis of the valuation of comparable European marketplaces suggests that CDON is significantly undervalued at current levels. As more global investors become aware of CDON's strong competitive position and potential for significant growth, the share price could rerate materially.



ATTRACTIVE BUSINESS MODEL

Marketplaces allow merchants to list their goods on the website in exchange for transaction fees, advertising fees, subscription fees and financing commissions. They are an inherently attractive business model as they have negative working capital (don't hold inventory) and have the potential for significant profitability as if they can generate enough volume to scale their mainly fixed technology expenses.

Marketplaces also benefit from an attractive growth flywheel. As merchants join the marketplace, they increase the supply of goods for consumers, making CDON a more attractive shopping destination as customers can acquire more of their needs in one place. As the experience improves and consumer transactions increases, the marketplace becomes a more attractive route to market for merchants.

UNDERPENETRATED MARKET

CDON currently has ~SEK 2bln GMV compared to the Nordic E-Commerce Market that is estimated at SEK 830bln in 2019.[i]

This low market penetration provides CDON with a long runway to continue growing GMV at high rates.

As CDON CEO Kristoffer Väliharju commented in a recent podcast interview (emphasis mine), ""It is very interesting to look at the behavior outside the Nordic region. Marketplaces account for more than 50% of global e-commerce sales and are still growing very fast. In the Nordic countries, it is only a couple of percent though, so there is so much left."[ii]

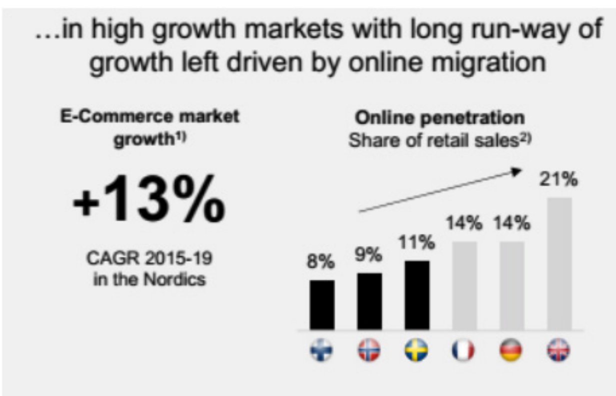
[i] *https://info.nets.se/svensk-ehandel-2019*

[ii] *Ehandelstrender Podcast Episode 154. Cdon vässar plattformen i kampen om kunder och säljare ; (https://open.spotify.com/episode/3osDlaQKkQTlEMz0Rk88mz?si=XAOybUkJRAOlY_f9IlJcSw) Translated from Swedish*

While CDON only has portion of e-commerce sales, it already has 10% of the Nordics shopping age population in its customer base. Thus, the company has a huge opportunity to grow if they can continue to grow their share of wallet so that revenue market share more closely approximates their customer market share.

CDON currently has over 1,300 merchants of the 50-60k merchants in the Nordics so there is a lot of room to continue connecting retailers to their online marketplace. As more merchants connect, customers will enjoy a larger range of goods and be able to make more purchases on the marketplace.

E-commerce overall is also relatively underpenetrated in the Nordics compared to other European markets.



STRONG COMPETITIVE POSITION

CDON benefits from its strong brand recognition, a legacy of being an online 1P retailer in the Nordics for over 20 years. As the CEO notes (emphasis mine), "There is an **incredible value to having a four- letter domain that most people in the Nordics actually know.** It takes time to build that domain and we have done that for 21 years and it is great, so **we stand for something that most people associate with e-commerce**."[iii]

CDON is the largest marketplace in the Nordics and considers itself the only local marketplace at scale. The company only sees a few other small regional players that are much smaller as well as some marketplaces in specific verticals (ex Zalando in fashion, Elgiganten in consumer electronics, Fyndiq in bargain products).

This leading Nordic position has also allowed CDON to act as a gateway to the Nordics for international retailers. In Q2 20, French marketplace CDiscount launched with CDON with over 50,000 products in the Swedish market. As Thomas Metivier, Cdiscount's International Director noted (emphasis mine), "Sweden and the Nordic countries are a very attractive market for us, but it is also a fragmented market to enter on our own. Via **CDON, we can quickly and safely expand our sales to the Nordic markets. As the largest in the market, CDON was a given choice** and it feels safe that they know how we can best market our range in a cost-effective and attractive way to consumers here."[iv]

Many investors are worried about the impact that Amazon may have on CDON's business as they launched Amazon.se in 2020. Swedish customers already shopped on Amazon, mainly through Amazon.de and having it delivered cross-border to Sweden.

However, Amazon is often not a category killer in markets it enters later. Michael Storakers, the head of the Storakers McCann advertising agency in Sweden commented (emphasis mine) that he does not expect Amazon to be able to get anything close to the market shares it has in the US, Germany and the UK, where it has been operating for more than 20 years. "They launched when the e-commerce market in general was very, very young in those markets," he says. "If you look at the recent launches, like in Australia, Turkey and the Netherlands, they have only been able to take a [small] per cent of the market. So I would say that the best guess is that they take a [small] percentage of the market here.[v]

[iii] *Ehandelstrender Podcast Episode 154. Cdon vässar plattformen i kampen om kunder och säljare ; (https://open.spotify.com/episode/3osDIaQKkQTlEM z0Rk88mz?si=XAOybUkJRAOIY_f9IlJcSw) Translated from Swedish*

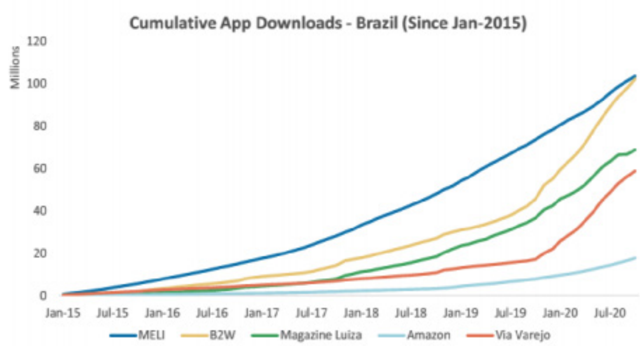
[iv] *https://www.dagenshandel.se/article/view/725534/cdon_lanserar_fransk_ehandelsjatte_i_sverige*

[v] *https://www.wired.co.uk/article/amazon-sweden-launch (https://www.wired.co.uk/article/amazon-sweden-launch)*

Boston Consulting Group estimates that Amazon will take 5-10% of the Swedish e-commerce market by 2025, leaving significant room for other players.[vi]

Other markets where Amazon has struggled as a later entry include Brazil (entered in 2012, has Prime),Singapore (Amazon still the #4 player after launching in July 2017, and Australia (launched in 2017 yet still far behind Ebay).[vii]

Exhibit 21: Amazon is yet to make headway in Brazil



Source: Sensor Tower, Morgan Stanley Research

Amazon's Swedish launch has also gone quite poorly with the company using the Argentine flag instead of the Swedish flag on the site's country picker and included prices indicated at the nearest Ere (Swedish penny) which hasn't been used in Sweden in more than a decade. Amazon also struggled with translations to Swedish (children's puzzle with yellow rapeseed flowers described as having a "sexual assault flower motif", football shirts labeled as "child sex attack shirt").[viii]

Amazon also has not launched Prime in Sweden and does not control its own logistics networks (and may never due to fear of Sweden's strong culture of unionization).[ix]

Moreover, there is a silver lining from Amazon's entry as it has driven increased awareness from Swedish merchants about the value of marketplaces. As CDON's CEO notes about Amazon (emphasis mine), "Is it a threat? I would say that Amazon is more of an opportunity. All of a sudden, 60,000 retailers in Sweden will ask themselves, 'how do we relate to marketplaces?".

Since Project Dancing Queen was announced, CDON's marketplace has actually seen, he boasts, "an accelerated intake of new merchants. Amazon is very good at taking care of the consumers, but what we hear from our merchants is that they're not as good at dealing with merchant needs. And we would like to be the merchants' best friend," he says.[x]

CDON sees itself as a local champion for Nordic merchants who want to avail themselves of the benefits of the marketplace model without succumbing to pressure from Amazon. CDON offers lower merchant fees, quicker integration, greater data for merchants, and lack of competition from 1P offerings.

[see figure on following page]

This lack of merchant friendliness has shown up in results as nearly all the sellers on Amazon's Swedish marketplace are from other European countries and less than 100 sellers are Sweden-based.[xi]

While Amazon will certainly increase its Swedish e-commerce market share with its local language launch, I believe there is more than enough addressable market for both CDON and Amazon to thrive as they expand their share of overall Swedish retail sales. In the other Nordic countries, CDON will still only face competition from non-local Amazon sites.

[vi] *https://www.dagenshandel.se/article/view/765964/analys_amazon_tar_510_procent_av_svenska_marknaden_till_2025*

[vii] *Morgan Stanley November 9 2020 Allegro Initiation Report*

[viii] *ttps://todaysecommerce.com/news/123/nordics-gets-its-first-amazon-online-store/*

[ix] *https://korii.slate.fr/biz/ecommerce-comment-suede-resiste-amazon-lancement-erreurs-traductions-logistique-prix (https://korii.slate.fr/biz/ecommerce-comment-suede-resiste-amazon-lancement-erreurs-traductions-logistique-prix)*

[x] *https://www.wired.co.uk/article/amazon-sweden-launch (https://www.wired.co.uk/article/amazon-sweden-launch)*

[xi] *https://www.marketplacepulse.com/articles/amazon-launches-in-sweden (https://www.marketplacepulse.com/articles/amazon-launches-in-sweden)*

Why merchants partner up with CDON - Comparing CDON to Amazon

CDON

Features	CDON	amazon	Why CDON
Geographical reach	Nordic	Global	Merchants looking to expand in the Nordics
Brand	Local	Global leader	Merchants wanting to leverage CDON's established local brand
Integration	Quick & easy	Cumbersome	One of the quickest and easiest integrations on the market
Merchant fees	Lower	Higher	Compelling market-led and customer-oriented fee structure - Current fees are on average ~25% lower across comparable categories
Merchants support	Personal	Automated	Dedicated Account Manager offered to all merchants on CDON's platform
Dependency on own inventory (1P)	36% of GMV[1)]	47% of GMV[2)]	Actively reducing 1P sales in favour of 3P sales
Merchants access to data	Transparent	Less transparent	100% transparent – more willing to share data with merchants since lower share 1P sales
Platform policy	Flexible	Rigid	Case-by-case judgement in dialogue with merchants

MISLEADING FINANCIALS

One reason why CDON may be mispriced is that the company's reported revenues do not accurately reflect its underlying growth. CDON is currently undergoing a shift from 1P to 3P which depresses top line revenue. While 100% of 1P GMV is recognized as revenue, a marketplace will only recognize ~10% of 3P GMV as revenue.

Since 2017 CDON 1P GMV has declined almost 60% and now represents only 26% of total GMV. Thus, while TTM 3P GMV is up over 200% since 2017 and total GMV is down only 4%, TTM revenue is down almost 50% from 2017 levels.

CDON has reached an inflection point as 3P GMV is now 80% of revenues in Q3 2020. More importantly, 3P revenue has ~95% gross margins while 1P revenue has ~10% gross margins so gross profit is much more heavily weighted to 3P GMV. Thus, continued 3P GMV growth will now generate increasingly rapid gross profit growth.

Attractive underlying profitability

LTM Q2 2020 (illustrative)	CDON Marketplace	CDON Retail
Net sales	148	867
Cost of goods	×	✓
Fulfilment costs	×	✓
Postage costs	×	✓
Freight	×	✓
Other[1)]	✓	✓
Cost of goods sold	-7	-782
Gross profit	141	85
Gross margin	95.3%	9.8%

PROJECTIONS

CDON has been growing 3p GMV >100% for 2020 ytd as merchants and customers continue grow on the platform. If we assume strong but moderating GMV growth till 2024, 3P GMV would reach SEK 6.4bln vs. SEK 2.0 bln today. Combined with a continued decline in the 1P business and 2024 revenues should be relatively flat compared to FY 2020 but gross profit should increase at a >25% CAGR. SG&A should be relatively fixed as CDON has made significant technology investments to increase the level of automation on their platform and has a highly scalable e-commerce platform.[xii] The historical financials provide evidence for this operating leverage. Q4 is the seasonally strongest portion of the year due to the holidays and Q4 2019 represented over 100% of 2019 EBITDA as the first 9 months of the year were loss-making and then more than made up for by a significant increase in Q4 volume and profitability.

Combine CDON's potential for strong GMV growth with its leverageable platform and it is possible to see EBITDA increase to ~250mln in FY 2024 from ~30mln in FY 2020.*

Please note that the following are **very rough projections** to show the scale of the opportunity here. I have laid them out clearly so that everyone can adjust the assumptions as they see fit.

** Any projections, market outlooks or estimates in this article are forward-looking statements and are based upon certain assumptions. Due to various risks and uncertainties, actual market events, opportunities or results may differ materially from those reflected in or contemplated by such forward-looking statements and any such projections, outlooks or assumptions should not be construed to be indicative of the actual events which will occur.*

		A	E	P			
Marketplace- 3P	2018	2019	2020	2021	2022	2023	2024
GMV Growth		63.1%	99.3%	50.0%	40.0%	30.0%	20.0%
Take Rate	13.2%	11.8%	10.6%	10.5%	10.5%	10.5%	10.5%
Sales Growth		45.2%	79.9%	48.4%	40.0%	30.0%	20.0%
GPM	96.6%	95.7%	95.1%	95.0%	95.0%	95.0%	95.0%
GMV	601.2	980.8	1,954.7	2,932.1	4,104.9	5,336.3	6,403.6
Net Sales	79.4	115.3	207.4	307.9	431.0	560.3	672.4
Gross Profit	76.7	110.3	197.3	292.5	409.5	532.3	638.8
Retail- 1P	2018	2019	2020	2021	2022	2023	2024
Net Sales Growth		-32.7%	-33.5%	-30.0%	-30.0%	-30.0%	-30.0%
GPM	8.8%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
Net Sales	1,480.8	996.4	662.6	463.8	324.7	227.3	159.1
Gross Profit	130.3	99.2	66.4	46.4	32.5	22.7	15.9
Total	2018	2019	2020	2021	2022	2023	2024
Net Sales	1,560.2	1,111.7	870.0	771.7	755.7	787.6	831.5
Gross Profit	207.0	209.5	263.7	338.9	441.9	555.0	654.7
SG&A	(239.4)	(209.7)	(266.7)	(306.7)	(352.7)	(405.6)	(466.5)
Other		(0.9)	-				
EBIT	**(32.4)**	**(1.1)**	**(3.0)**	**32.1**	**89.2**	**149.4**	**188.2**
D&A	11.7	16.0	34.0	39.1	45.0	51.7	59.5
EBITDA	**(20.7)**	**14.9**	**31.0**	**71.2**	**134.2**	**201.1**	**247.7**

xii *https://www.dagenshandel.se/article/view/744671/sa_ska_cdon_boosta_anslutna_ehandlarnas_forsaljning (https://www.dagenshandel.se/article/view/744671/sa_ska_cdon_boosta_anslutna_ehandlarnas_forsaljning)*

It should be noted that Polish peer Allegro's results show that a more mature marketplace can have EBITDA margins above 50%. Japanese marketplace Mercari is generating 30% adjusted operating margins and is targeting 40% in the medium term. While Allegro and Mercari Japan are obviously much further along in their trajectories, their results show that a 3P marketplace can be a highly profitable business at scale.

EUROPEAN MARKETPLACE COMPS

We have two European marketplace comps who have recently listed, Allegro in Poland and Ozon in Russia (Nasdaq listed). While they are both materially bigger in their core markets, the underlying nature of their businesses is very similar to CDON.

It should also be noted that Amazon is widely rumored to be entering Poland where it already has a strong existing warehouse network to serve its German site.[xiii]

As we can see, the relative valuations are materially different.

TTM #s, Share Price 12/4/20	**Allegro**	**Ozon**	**CDON**
EV/GMV	2.9	3.8	0.4
EV/Total Sales	25.7	6.6	0.9
EV/GP	27.1	24.1	3.4
EV/EBITDA	54.2	N/A	28.4

As an example of private market valuation, Walmart acquired Indian marketplace Flipcart in 2018 for 2.8x GMV.[xiv]

CAPITALIZATION AND VALUATION

CDON currently has 6mln shares for a SEK 869mln market cap at SEK 145. Post spin, the company has SEK 46mln of net cash for a total EV of SEK 823mln. TTM GMV is 2.2bln (0.4x), TTM sales were 957mln (0.9x) and TTM EBITDA was 29mln (28x).

If CDON can generate ~250mln of EBITDA in 2024, then the share would be worth SEK 830 at 20x (which appears reasonable for a company that would have grown EBITDA at an almost 70% CAGR over 4 years). Discount that back for 3 years at 20% and CDON would be worth ~SEK 480.

EBITDA- 2024	247.7
EV/EBITDA	20.0x
EV	4,953
Net Cash	45.5
Mkt Cap	4,999.0
Per CDON Share	**834.4**
Discount Rate	20%
Years	3.0
Discounted Share Price	**482.9**

It should be noted that a similar valuation at 1x 2024 GMV would be materially higher. It should be noted that this GMV of SEK 6.4bln would still be less than 1% of the total Nordic E-Commerce market.

3P GMV-2024	6,403.6
Multiple	1.0x
EV	6,403.6
Net Cash	45.5
Mkt Cap	6,449.1
Per CDON Share	**1,076.5**
Discount Rate	20%
Years	3.0
Discounted Share Price	**623.0**

[xiii] *https://www.parcelandpostaltechnologyinternational.com/analysis/amazons-imminent-arrival-in-poland-and-how-it- will-disrupt-the-last-mile.html (https://www.parcelandpostaltechnologyinternational.com/analysis/amazons-imminent- arrival-in-poland-and-how-it-will-disrupt-the-last-mile.html)*

[xiv] *https://corporate.walmart.com/newsroom/2018/05/09/walmart-to-invest-in-flipkart-group-indias-innovative-ecommerce-company*

Transaction Date	Name	Position	Acquistion/ Disposition	Quantity	Price	Value
25/11/2020	Carl Kristoffer Väliharju	Chief Executive Officer (CEO) / Managing Directory	Acquisition	3,800	143.38	544,844.00
25/11/2020	Niclas Bela Szieger	Chief Financial Officer (CFO)	Acquisition	1,162	140.98	163,812.95
11/11/20	Niclas Bela Szieger	Chief Financial Officer (CFO)	Acquisition	3,073	130.00	399,490.00
11/11/20	Carl Kristoffer Väliharju	Chief Executive Officer (CEO) / Managing Directory	Acquisition	400	130.98	52,392.00
6/11/20	Christoffer Häggblom	Member of the Board of Directors	Acquisition	30,000	118.30	3,549,093.00
6/11/20	Marcus Lindqvist	Chairman of the Board	Acquisition	2,000	114.67	229,340.00

		TOTAL		**40,435**	**122.15**	**4,938,972**

MANAGEMENT

CDON is being led by Kristoffer Valiharju who has been with the company for the past 3 years as COO. Previously he worked for DTC retailer Dustin and in the DTC division of Dell computer and has several years of e-commerce expertise.

Since the spin in early November, insiders have purchased almost SEK 5.0mln of stock at prices as high as SEK 143.[xv]

CDON's CEO also bought another 23k shares Qliro Group at SEK 6.03 before the split and 1 for 30 spin of CDON.[xvi]

RISKS

1) EXECUTION

CDON needs to be able to manage significant growth without issue. So far the company has managed 100% GMV growth during 2020 but it needs to continue to execute at higher GMV volumes for the next few years.

2) COMPETITION

Amazon is always a risk given their size relative to CDON. There could be some unique reason why Amazon decides to invest significant money in an attempt to dominate the Nordics more than other late-mover regions. A new marketplace competitor could emerge or enter the market and take significant share.

3) TECHNOLOGY RISK

Data breaches, platform failures and other technology issues could be a huge problem for CDON.

4) SWEDISH SMALL CAP

Stock is relatively small and illiquid with minimal broker coverage.

[xiv] *https://corporate.walmart.com/newsroom/2018/05/09/walmart-to-invest-in-flipkart-group-indias-innovative-ecommerce-company*

[xv] https://marknadssok.fi.se/Publiceringsklient/en- GB/Search

[xvi] https://marknadssok.fi.se/Publiceringsklient/en- GB/Search

ADDITIONAL DISCLOSURE

Information presented in this article is for educational purposes only and does not intend to make an offer or solicitation for the sale or purchase of any specific securities, investments, or investment strategies. Investments involve risk and unless otherwise stated, are not guaranteed. Be sure to first consult with a qualified financial adviser and/or tax professional before implementing any strategy discussed herein. Past performance is not indicative of future results.

FINALIST
Micro Caps

Christopher Campbell
Analyst at Crescent Rock Capital Management LP

CURRENT RANKING: **#32 All-Time**
BADGES: 16 20

Automatic Bank Services Ltd Ord

Asset: **Equity** Symbol: **SHVA:IT**
Idea Posted: **12/12/2020** Idea Updated: **12/31/2020**

RETURN TO DATE: -1.81%
EXPECTED RETURN: 68.58%

LONG

ATTACHMENTS	TIMEFRAME	SITUATION	MARKET CAP
	2-5 Years	Growth At Reasonable Price	34.0M USD

> Under-the-radar monopoly card payment network in Israel trading at a highly discounted valuation. 15x P/E; earnings compounding at mid-teens driven by long-duration secular tailwinds.

About Christopher Campbell

Christopher is an analyst at Crescent Rock Capital Management, a long/short hedge fund based in Summit, NJ. Prior to joining Crescent Rock, he worked at a concentrated, long-biased investment partnership and in Goldman Sachs' research division. He graduated with a BSBA (magna cum laude) from Washington University in St. Louis.

About Crescent Rock Capital Management LP

The Fund is a global, diversified equity long/short generalist fund. The Fund's investment objective is to generate absolute returns over a long-term time horizon while seeking to minimize the risk of permanent capital impairment. Strategies employed by the Fund may include deep value, transformations, compounders and special situations with the unifying theme of fundamental analysis to identify attractive risk/reward investments. Crescent Rock Capital Management, LP is managed by Co-CIOs Boris Vuchic and Michael Marone who worked together for 10 years at Pennant Capital Management as Partners. They are joined by John Rolfe (Senior Analyst), Scott Mosberg (Chief Operating Officer) and Chris Campbell (Analyst).

Automatic Bank Services Ltd Ord

Asset Class: **Equity** Symbol: **SHVA:IT** Updated: **12/31/2020** Submitted: **12/12/2020**

Pricing & Return Details	LONG
EXPECTED RETURN	68.58%
TARGET PRICE	22.00 ILS
INITIAL PRICE	13.29 ILS

BY:
Christopher Campbell

CURRENTLY AT:
Crescent Rock Capital Management LP

CURRENT RANKING: **#32 All-Time**

BADGES: 16 20

> Under-the-radar monopoly card payment network in Israel trading at a highly discounted valuation. 15x P/E; earnings compounding at mid-teens driven by long-duration secular tailwinds.

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Growth At Reasonable Price	2% - 5%	N/A	2-5 Years

INVESTMENT THESIS

EXECUTIVE SUMMARY

Automated Banking Services (otherwise known as "Shva," the Hebrew acronym for Automated Banking Services) is a **long**. Shva is the monopoly network for card payments in Israel, effectively acting as a toll booth on secularly growing digital payments in the country. Like similar businesses (V, MA, etc.), Shva benefits from long-duration tailwinds and has an exceptional business model and financial profile with 45%+ EBITDA margins and high returns on capital. Despite these qualities, the stock trades at just 8.5x EBITDA and 15x P/E, a valuation that is attractive in absolute terms and stunningly cheap when compared to the 30x+ EBITDA and ~35x+ P/E multiples that comps trade it.

The opportunity exists due to the stock's limited English language disclosures, lack of any sell-side coverage, illiquidity, and the recency of its IPO (June 2019) and consequent lack of investor discovery. Importantly, the company has recently begun to take several steps to improve investor outreach and address the factors behind its mispricing. This, in addition to the likely initiation of a meaningful dividend in the coming months, should help close the significant valuation gap that exists today.

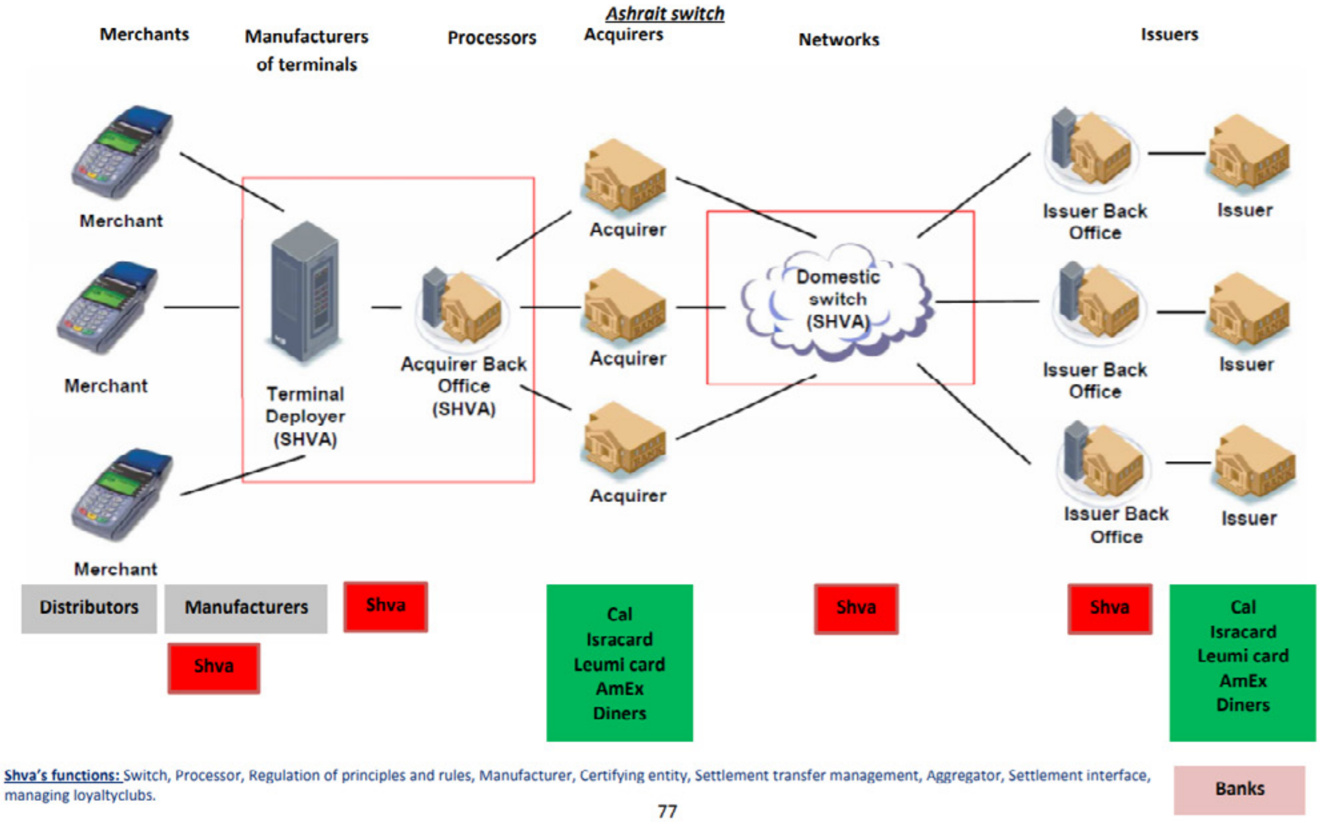
In a scenario in which the stock receives modest multiple expansion to just 12.5x EBITDA (still significantly below comps), investors can earn a 2x MOIC over the next three years (26% IRR). Even absent any multiple expansion, the stock should be able to compound at at least a high-teens annual rate driven by HSD-LDD top-line growth coupled with high incremental margins and an entry FCF yield of 6.6% (based on 2021 numbers).

Capitalization		
Current Share Price		$13.29
Total Basic Shares		40.0
Options Dilution		0.0
Convert Dilution		0.0
Total Diluted Shares		**40.0**
Market Capitalization		**$532**
Net Debt (Net Cash)		(143)
Enterprise Value		**$389**
EV / EBITDA	**Metric**	
LTM (3Q20)	37	10.4x
2020E	39	9.9x
2021E	46	8.5x
2022E	53	7.3x
P / E	**Metric**	
2019A	$0.73	18.1x
LTM (3Q20)	$0.59	22.6x
2020E	$0.64	20.8x
2021E	$0.89	15.0x
2022E	$1.04	12.7x
Levered FCF Yield	**Metric**	
2019A	28	5.3%
LTM (3Q20)	19	3.5%
2020E	24	4.5%
2021E	35	6.6%
2022E	42	7.8%
Unlevered FCF Yield to EV	**Metric**	
2019A	28	7.3%
LTM (3Q20)	19	4.8%
2020E	24	6.2%
2021E	35	9.1%
2022E	42	10.7%

**Note: Financials in cap table above are in millions of Israeli shekels. 1 NIS = 0.31 USD.*

BUSINESS OVERVIEW AND BACKGROUND

Shva operates the sole network for card payments in Israel, acting as an intermediary that connects card issuers, acquirers, and merchants in order to facilitate the processing of card transactions. Through its network, Shva "switches" (authorizes, clears, and settles) all card-based transactions in Israel, including purchases made online and through mobile payment applications such as Bit, Pepper Pay, PayBox, and Apple Pay (launching in Israel this year). Additionally, Shva is responsible for connecting terminals to its network. This is essentially identical to the role that Mastercard and Visa play in the United States (and other geographies), with the only significant difference being that MA and V also earn a meaningful portion of their revenue from cross-border fees and provide a slightly broader array of value-add services – e.g. consulting and research, fraud detection, etc. – on top of their core switching services.



The company was founded in 1978 and went public in June 2019. Similar to Mastercard, Shva was initially formed as a joint venture owned by a group of banks. The company came public as a result of legislation which required Israel's banks to reduce their respective ownership stakes in the company to no more than 10%. Today, Bank Hapoalim, Bank Leumi, Israel Discount Bank, and the First International Bank of Israel each own 10% (i.e., the maximum allowed) of the company. Notably, one of these banks, the First International Bank of Israel, owned 3.3% of the company prior to the IPO and increased its stake to 10% through open market purchases following the IPO. Additionally, Visa and Mastercard each own 10%, having purchased their stakes in November 2018 and April 2019, respectively. As a consequence, the public float is just 40% of shares outstanding.

It's worth noting that the company's position as a national monopoly wasn't granted via legislation. Rather, it is a natural consequence of network effects and the difficulty for an incremental entrant to earn an adequate return on the required infrastructure and technology investment needed to establish a competing network in a country as small as Israel. Indeed, as I understand it, Visa and Mastercard at one point contemplated building competing networks in Israel, but both had a difficult time breaking into the market and ultimately abandoned their efforts before deciding to invest in the company after the banks were forced to divest portions of their stakes.

HOW DOES SHVA MAKE MONEY?

Shva earns revenue solely from fees and does not lend or take credit risk. Its fees derive from two primary sources, each of which account for roughly half of the company's revenue.

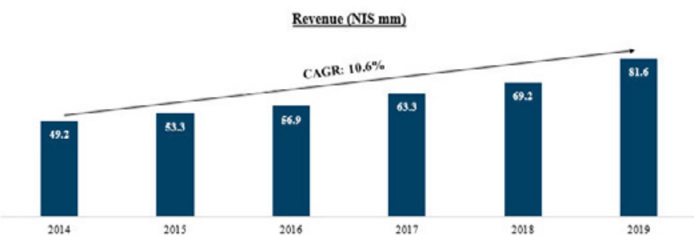
- **Transaction-based fees (44% of 2019 revenue):** Shva earns fees for each transaction that goes through its network. It earns separate fees for the settlement, authorization, and clearing of each transaction (0.6969 agorot, 1.173 agorot, and 0.9448 agorot per transaction, respectively). In 2019, average total fees per transaction was 2.14 agora (equivalent to ~0.66 US cents).

- **Infrastructure-based fees (47% of 2019 revenue):** Shva gets paid 15 shekels per month for each terminal in Israel connected to its network. If the terminal is EMV-enabled, SHVA gets an additional 4 shekels per month (19 shekels total).

THESIS DETAIL

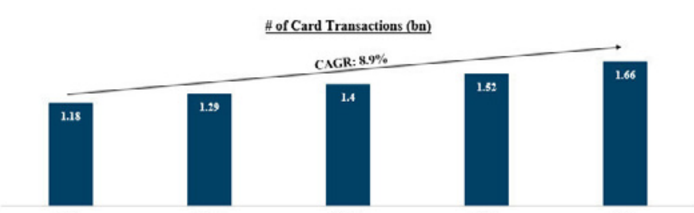
ROBUST TOP-LINE GROWTH DRIVEN BY MULTIPLE TAILWINDS

Shva has consistently grown top-line at HSD-LDD rates annually, with revenue growing at a 10.6% CAGR between 2014 and 2019. On top of this, EBITDA margins have expanded from 30.7% in 2017 to 46.3% in 2019 (and further to 48.7% in 1Q20 before COVID-related factors brought margins in 2Q20 and 3Q20 closer to 2019 levels).



CARD TRANSACTION REVENUE DRIVERS

From 2015 to 2019, the number of card transactions in Israel grew at an 8.9% CAGR. The growth in card transactions has been driven by the secular shift towards electronic payments (driven by the superior convenience of electronic payment methods, growth in ecommerce, etc.) as well as broader growth in consumer spending (leading to more transactions per person).



Importantly, there's still a long runway for the shift towards electronic payments to continue. In 2018, credit/debit card transactions constituted just 38% of payments in Israel1. Cash, checks, and bank transfers each accounted for 26%, 13%, and 19%, respectively. Moreover, these statistics measure the mix of payment method by total dollar value rather than the number of transactions. Since a disproportionate share of smaller-value transactions are made in cash rather than by card and because Shva is compensated based on fixed fees per transaction rather than as a percentage of the dollar value of transactions that go through its network, these statistics understate the magnitude of Shva's revenue opportunity from the continued growth in card usage/penetration.

[see figure on following page]

It's likely that COVID will ultimately accelerate the ongoing shift towards digital payments as more consumers embrace ecommerce and contactless payments. Additionally, the Ministry of Transportation has recently taken steps to enable the acceptance of digital payments on public transportation, which should further accelerate the shift away from cash and other payment methods.

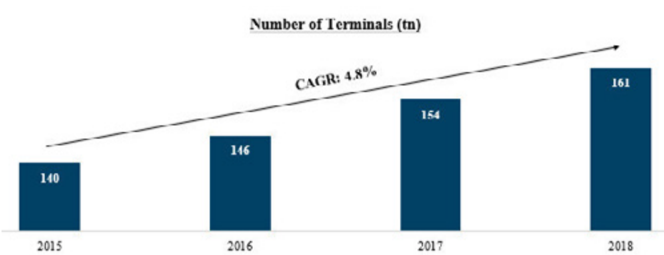
Beyond the HSD historical growth in the number of card transactions, Shva has also seen growth in the average revenue it receives per transaction. In 2019, Shva earned an average of 2.14 agorot per card transaction vs. 2.04 agorot in 2018 (4.8% growth). This growth was not driven by price increases, but rather by an increase in the proportion of transactions that go through the authorization process. Recall that Shva is paid a separate fee for each of the services that it provides (settlement, clearing, and authorization). Over time, as more transactions have required authorization, Shva's blended average revenue per transaction has grown. With Shva's average fee per transaction sitting at 2.14 agorot today vs. a maximum of 2.82 agorot for transactions that utilize all of the company's services, there's potential upside of 32% to Shva's current revenue per transaction over the long-term even before considering the impact of price increases. Additionally, there's scope to broaden the range of value-add services

Legend

Cash = 26%
Credit/Debit Cards = 38%
Checks = 13%
Bank Transfers = 19%
Other = 3%
Digital Wallet/Application = 1%

that Shva offers its customers. For example, the company is in the process of developing and rolling out dynamic currency conversion, a service that will allow tourists and other foreign visitors in Israel to pay for transactions in their local currency when paying by card.

Terminal Infrastructure Revenue Drivers
From 2015 to 2018, the number of terminals in Israel grew at a 4.8% CAGR.



In addition to growth in the number of terminals, Shva's terminal business is set to benefit from another important driver over the near/medium-term: the shift to the EMV standard in Israel. While Shva earns 15 shekels per month for each regular terminal, it earns an additional 4 shekels per month (19 shekels/month total) for terminals that are outfitted for EMV. The Bank of Israel has been actively encouraging the shift to the EMV standard. Since 2015, issuers have been prohibited from issuing non-smart cards. Additionally, **businesses with over 100mm shekels in revenue from credit cards will be required to move to the EMV standard by November 2020**, with smaller businesses having until July 2021. As a result, the proportion of terminals that are EMV-enabled has inflected significantly, **nearly doubling between August and November**[2] of this year.

Shva won't see the full impact of this in 2020 because it agreed in March 2020 to discount the 4 shekel/month surcharge for EMV terminals by 50% from March 2020 through the end of the year in order to help encourage the shift to contactless payments during COVID. However, with each terminal that's outfitted for EMV representing a 27% uplift in revenue per- terminal for Shva (19 shekels vs. 15 shekels), this will be a significant tailwind in 2021/2022. Importantly, shifting from regular terminals to EMV-enabled terminals entails essentially no incremental ongoing costs for Shva, so the vast bulk of this incremental revenue will fall through directly to the bottom line.

[1] *https://www.boi.org.il/en/NewsAndPublications/PressReleases/Pages/24-07-2019.aspx (https://www.boi.org.il/en/NewsAndPublications/PressReleases/Pages/24-07-2019.aspx)*

[2] *https://www.shva.co.il/%d7%a0%d7%aa%d7%95%d7%a0%d7%99-%d7%94%d7%98%d7%9e%d7%a2%d7%aa-%d7%9e%d7%a2%d7%a8%d7%9b%d7%aa-%d7%94emv/ (https://www.shva.co.il/%D7%A0%D7%AA%D7%95%D7%A0%D7%99- %D7%94%D7%98%D7%9E%D7%A2%D7%AA-%D7%9E%D7%A2%D7%A8%D7%9B%D7%AA-%D7%94emv/). Page is only available in Hebrew. Screenshot shown was translated using Google Translate.*

Bloomberg consensus estimates for comps; Shva figures based on my based estimates. All figures calendarized.

Name	Net Debt/ LTM EBITDA	EV / EBITDA 2020E	EV / EBITDA 2021E	EV / EBITDA 2022E	P / E 2020E	P / E 2021E	P / E 2022E	20CY to 22CY CAGR Sales	20CY to 22CY CAGR EBITDA	20CY to 22CY CAGR EPS
Payment Networks										
Mastercard Inc	0.2x	41.3x	32.9x	27.1x	56.0x	43.0x	34.2x	18.6%	23.5%	28.0%
Visa Inc	0.3x	37.2x	32.0x	27.5x	44.7x	37.4x	30.6x	14.6%	16.3%	20.8%
High-Growth Payments										
PayPal Holdings Inc	(1.2x)	44.0x	36.9x	31.2x	61.1x	51.0x	41.4x	19.1%	18.8%	21.5%
Processors										
Fidelity National Information	4.6x	20.0x	17.1x	14.8x	25.7x	21.3x	18.4x	9.3%	16.1%	18.1%
Fiserv Inc	4.2x	17.1x	15.0x	13.8x	25.6x	20.9x	17.8x	7.1%	11.5%	19.9%
Global Payments Inc	3.4x	23.1x	19.5x	17.6x	33.1x	26.3x	22.5x	10.8%	14.5%	21.2%
Isreali Financial Infrastructure										
Tel Aviv Stock Exchange Ltd	(3.5x)	15.0x	12.6x	10.8x	52.7x	37.2x	31.4x	11.9%	17.5%	29.5%
Mean	**1.1x**	**28.2x**	**23.7x**	**20.4x**	**42.7x**	**33.9x**	**28.1x**	**13.1%**	**16.9%**	**22.7%**
Median	**0.3x**	**23.1x**	**19.5x**	**17.6x**	**44.7x**	**37.2x**	**30.6x**	**11.9%**	**16.3%**	**21.2%**
Shva	**(3.8x)**	**9.9x**	**8.5x**	**7.3x**	**20.8x**	**15.0x**	**12.7x**	**10.0%**	**16.7%**	**27.9%**

HIGHLY COMPELLING VALUATION WITH SEVERAL CATALYSTS TO CLOSE THE RELATIVE VALUATION GAP

Despite a dominant competitive position, an attractive margin structure, and significant multi-year secular tailwinds, Shva trades at a highly discounted valuation. At 8.5x EBITDA, 15x P/E, and a 6.6% FCF yield on my 2021 numbers, the stock is cheap on an absolute basis. However, when viewed on a relative basis next to peers with similar business models and financial profiles, Shva is drastically mispriced.

This attractive valuation is a result of several non-fundamental factors. First, Shva's regulatory filings are published exclusively in Hebrew. Additionally, as a consequence of its small market cap (527mm shekels / 162mm USD) and thin public float owing to several large long-term holders, the stock is illiquid. Finally, the stock has no sell-side coverage, is listed on a less-visible exchange, and has only been publicly traded for ~18 months, all of which has limited investor discovery.

Importantly, the company is taking steps to address many of the factors behind its mispricing. Earlier this year, the company began publishing translated copies of its annual and quarterly reports in English (these are generally made available a few weeks after initial publication in Hebrew; though only the 2019 annual report and the 2Q20 quarterly report are currently available in English and all previous filings remain available in Hebrew only). Furthermore, the company added an English language Investor Relations section to its website last month (although content on the page is sparse today). When I spoke with IR, it was clear that Shva has received significant interest from non-Israeli investors (which came as a significant surprise to the company), including several large US institutional investors, but that the lack of English financials was a non- starter for many of these foreign investors. As such, publishing financials in English and improving efforts to reach out to non-Israeli investors would likely go a long way towards attracting incremental buyers and could potentially drive a material re-rating. Shva's relatively small market cap / float means it only takes a few incremental buyers to push the stock meaningfully higher.

On top of this, the company should soon begin paying out a meaningful dividend. Though the company's dividend policy is to pay out 50% of its net income, it is currently unable to pay dividends as a result of a temporary moratorium placed on financial institutions' dividend payments by the Bank of Israel due to COVID. However, given its strong financial position (especially relative to other financial institutions that take actual credit risk such as banks, who were the primary target of the Bank of Israel's dividend moratorium), the company has applied for approval to begin paying dividends last month and is currently awaiting approval. At today's valuation, the company's 50% payout policy would translate into a well-covered, growing ~3% dividend yield. In a low interest rate world, such a dividend would likely add significant appeal to the equity story.

As an illustration of the multiple that Shva could potentially trade at if it addressed some of these issues, it's worth noting that the publicly-traded Tel Aviv Stock Exchange (TASE IT) – which like Shva is a monopolistic financial infrastructure provider that's listed in and operates in Israel, but regularly publishes investor materials in English and already pays a dividend – trades at a mid-teens EBITDA multiple and 35x+ P/E despite its similar expected top-line growth, lower margins (~30% EBITDA margins vs. Shva's 45%+), and greater disintermediation risk (Israeli companies can bypass TASE by listing on other countries' exchanges – e.g. Check Point Software – whereas all card transactions in Israel must pass through Shva's network). **Convergence to TASE's EBITDA / P/E multiple alone (without accounting for any earnings growth) would drive upside of 37% / 136% for Shva.**

VALUATION AND RETURNS

BASE CASE *[see chart below]*

- Conservatively assume no multiple expansion despite significant valuation gap vs. peers
- 10% top-line growth
    - Fees from card transactions should grow at low double digits driven by ~9% annual growth in the number of transactions coupled with modest growth in revenue per transaction (driven by measured price increases over time, the introduction of additional value-add services beyond core switching functions, and increases in the proportion of transactions that go through authorization). Over the near-term, card transactions could grow faster than the 9% historical CAGR following the rebound from COVID.
    - Terminal fees should grow at a low-to-mid-teens rate over the next few years, driven by ~5% growth in the number of terminals and a ~20% cumulative pricing

SHVA IT Equity Returns

		FYE 12/31			
(Shekels in millions, except per share data)		**2020E**	**2021E**	**2022E**	**2023E**
LTM EBITDA		$39	$46	$53	$62
LTM Exit Multiple		10.0x	10.0x	10.0x	10.0x
Implied Forward Exit Multiple		*8.5x*	*8.6x*	*8.7x*	*n.a.*
Exit TEV		**$392**	**$460**	**$534**	**$616**
(+) Net Cash		150	167	188	212
Equity Value at Exit		**$542**	**$627**	**$722**	**$828**
Diluted Shares		40	40	40	40
Share Price at Exit		**$13.55**	**$15.68**	**$18.06**	**$20.71**
LTM Net Leverage		*-3.8x*	*-3.6x*	*-3.5x*	*-3.4x*
LTM Levered FCF Yield @ Target Price		*4.4%*	*5.6%*	*5.8%*	*5.8%*
LTM Unlevered FCF Yield @ Target Price		*6.1%*	*7.7%*	*7.8%*	*7.9%*
IRR Calculation		**2020E**	**2021E**	**2022E**	**2023E**
Entry Price		($13.29)			
Dividend		$0.00	$0.44	$0.52	$0.61
Exit Price					$20.71
Total Cash Flow		($13.29)	$0.44	$0.52	$21.32
MOIC	**1.68x**				
IRR	**19.3%**				

uplift as 100% of terminals move to the EMV standard and the discount for the EMV surcharge lapses after 2020.

- 80% incremental EBITDA margins, lower than actual incremental margins observed from 2017-2019
- 50% payout ratio (consistent with the company's dividend policy). Assume no capital deployment beyond the dividend even though the company will have cash significantly in excess of the minimum liquidity level required by the Bank of Israel. Management has stated that it will also pursue M&A where it makes sense, but I give no credit to this.
- Three-year total shareholder return of 22.28 (20.71 exit price and 1.57 in total dividends); ~70% return and ~19% IRR.

MULTIPLE EXPANSION CASE *[see chart below]*

- Operating assumptions identical to base case
- Exit multiple of 12.5x LTM EBITDA, closer to TASE's EBITDA multiple, but still a significant discount to other payments peers. 12.5x EBITDA translates to a 5% LTM levered FCF yield, still significantly cheaper than comps (including TASE).
- Three-year total shareholder return of 26.13 (24.56 exit price and 1.57 in total dividends); ~100% return and ~26% IRR

BEAR CASE *[see chart on following page]*

- Assumes end of cooperative agreement between Shva and Masav and associated incremental expenses of 15mm (see "Risk" section for details). I not only assume that the separation occurs (which for reasons articulated below I believe is unlikely), but also that Shva doesn't raise prices in order to offset the impact (which is also unlikely, as the company has already indicated that it would raise its prices in this scenario). As a result, I consider this to be a highly punitive, low- probability outcome.

SHVA IT Equity Returns

				FYE 12/31		
(Shekels in millions, except per share data)			**2020E**	**2021E**	**2022E**	**2023E**
LTM EBITDA			$39	$46	$53	$62
LTM Exit Multiple			12.5x	12.5x	12.5x	12.5x
Implied Forward Exit Multiple			*10.7x*	*10.8x*	*10.8x*	*n.a.*
Exit TEV			**$490**	**$575**	**$668**	**$770**
(+) Net Cash			150	167	188	212
Equity Value at Exit			**$640**	**$742**	**$856**	**$982**
Diluted Shares			40	40	40	40
Share Price at Exit			**$16.00**	**$18.55**	**$21.40**	**$24.56**
LTM Net Leverage			*-3.8x*	*-3.6x*	*-3.5x*	*-3.4x*
LTM Levered FCF Yield @ Target Price			*3.7%*	*4.8%*	*4.9%*	*4.9%*
LTM Unlevered FCF Yield @ Target Price			*4.9%*	*6.1%*	*6.2%*	*6.3%*
IRR Calculation			**2020E**	**2021E**	**2022E**	**2023E**
Entry Price			($13.29)			
Dividend			$0.00	$0.44	$0.52	$0.61
Exit Price						$24.56
Total Cash Flow			($13.29)	$0.44	$0.52	$25.17
MOIC	**1.97x**					
IRR	**25.9%**					

- I assume that the 15mm in incremental expenses begins flowing through in 2021, despite the fact that a separation would take a number of year in practice (and in any case wouldn't begin until well into 2021 at the earliest).

- Assume no multiple expansion. This is highly conservative not only because Shva trades at a significant discount to peers, but also because the removal of the Masav separation overhang should result in the company trading at a higher multiple than it does today when some uncertainty still exists.

- These assumptions drive 1-year target price of ~ 12.00 (~ 11.80 exit price + 0.30 dividend), representing ~10% downside. However, over a longer holding period, the underlying compounding math (double digit top-line growth, high incremental margins, and still-cheap 2021 FCF yield of 4.5% even when burdening earnings for the 15mm increase in expenses) allows an investor to earn a respectable 10% IRR through 2023 even in this draconian scenario.

- Overall, the combination of a significantly net-cash balance sheet, secular tailwinds enabling HSD-LDD top-line growth for years to come, and a cheap absolute valuation makes it highly difficult to underwrite a poor outcome.

RISKS

- **Potential separation of Shva and Masav:** Masav is a clearing house for interbank transfers in Israel that, like Shva until its IPO, is jointly owned by the five major Israeli banks. Shva and Masav currently share significant resources with each other, including office space, technology infrastructure, and other shared services. Now that Shva has been separated from the banks, the Israeli Competition Authority has argued that the cooperation between these two entities constitutes an anticompetitive arrangement that had not received prior approval, despite Shva and Masav sharing these resources for over 35 years and providing services for different types of transactions

SHVA IT Equity Returns

		FYE 12/31			
(Shekels in millions, except per share data)		2020E	2021E	2022E	2023E
LTM EBITDA		$39	$31	$38	$47
LTM Exit Multiple		10.0x	10.0x	10.0x	10.0x
Implied Forward Exit Multiple		*12.7x*	*8.1x*	*8.2x*	*n.a.*
Exit TEV		**$392**	**$310**	**$384**	**$466**
(+) Net Cash		150	162	177	195
Equity Value at Exit		**$542**	**$471**	**$561**	**$661**
Diluted Shares		40	40	40	40
Share Price at Exit		**$13.55**	**$11.79**	**$14.02**	**$16.53**
LTM Net Leverage		*-3.8x*	*-5.2x*	*-4.6x*	*-4.2x*
LTM Levered FCF Yield @ Target Price		*4.4%*	*5.1%*	*5.4%*	*5.6%*
LTM Unlevered FCF Yield @ Target Price		*6.1%*	*7.8%*	*7.8%*	*7.9%*
IRR Calculation		**2020E**	**2021E**	**2022E**	**2023E**
Entry Price		($13.29)			
Dividend		$0.00	$0.30	$0.38	$0.46
Exit Price					$16.53
Total Cash Flow		($13.29)	$0.30	$0.38	$16.99
MOIC	**1.33x**				
IRR	**10.2%**				

(card payments and bank transfers, respectively). In response, Shva has filed a motion for approval of the relationship to the Jerusalem District Court. If Shva and Masav were no longer able to share resources, Shva has estimated that its operating costs would increase by 15.3mm shekels. While potentially meaningful, I believe this risk is mitigated by several key factors:

- The Bank of Israel (the supervisory body for financial institutions in Israel) supports Shva and Masav's position in the matter.
- Shva's legal argument is similar to the one made by Mizrahi Tefahot Bank and Union Bank when it appealed against the Competition Authority's attempt to block their proposed merger. The Jerusalem District Court ultimately rejected the Competition Authority's argument and approved the merger. Notably, the judge in Shva's case is also the same one that ruled in favor of the Mizrahi-Union merger. Furthermore, Shva has hired the same lawyer.
- If Shva and Masav separate and lose the operational efficiencies that stem from sharing infrastructure, Shva and Masav would likely raise prices in order to compensate (note that Masav's profitability would be impacted to a higher degree than Shva). Indeed, this is one of the legal arguments being made by Shva, Masav, and the Bank of Israel. Notably, the Competition Authority is only allowed to consider the impact on competition when taking an action, whereas the District Court (as the ultimate arbiter) can take into account broader considerations such as efficiency and the impact on prices and to the consumer. Shva's ability to raise prices in order to offset the impact of higher costs should minimize the impact of severing Shva and Masav's cooperative arrangement even in the event that the Competition Authority is successful in its motion (which for the reasons articulated here I believe is unlikely anyway).

- **Regulation of pricing:** Given its status as a monopoly, it's possible that politicians/regulators could seek to place limits on the rates charged by Shva in the future.
  - Mitigant: Shva has operated since 1978 and hasn't seen government action taken against the rates it charges. Shva has historically been conservative with respect to its pricing, and most studies comparing costs between different countries have found that Shva's rates are actually lower than most of its peer in other geographies.[3]
  - Mitigant: There's little political incentive to go after Shva's fees since most consumers/voters are unaware of Shva and because its fees are paid by issuers and acquirers rather than directly by consumers.

- **Disintermediation:** It's possible that in the future, payment applications that pay directly from a customer's bank account (thus bypassing Shva's network) will be developed.
  - Mitigant: Currently, all mobile payment applications in Israel (Bit, Pepper, PayBox, and Apple Pay) make use of cards.
  - Mitigant: Even in countries where such payment applications have been embraced (e.g. Sweden), they have generally been used primarily for P2P transfers and have taken a very small share of payments to businesses (where Shva derives essentially all of its revenue).

[3] *See, for example, page 32 of this report: https://www.boi.org.il/en/PaymentSystem/LawsAndRegulations/Announcements%20Document/Payment%20Card%20Trans action%20Chain%20(Final%20Report)%20Bank%20of%20Israel.pdf (https://www.boi.org.il/en/PaymentSystem/LawsAndRegulations/Announcements%20Document/Payment%20Card%20Tran saction%20Chain%20(Final%20Report)%20Bank%20of%20Israel.pdf)*

Income Statement

	FYE 12/31							LTM	FYE 12/31			
	2017A	2018A	2019A	2020E	2021E	2022E	2023E	3Q20	1Q20	2Q20	3Q20E	4Q20E
Revenue	63	69	82	85	93	102	113	84	21	20	22	22
% Growth Y/Y	*11.3%*	*9.3%*	*17.9%*	*3.8%*	*10.0%*	*10.0%*	*10.0%*		*7.2%*	*(2.1%)*	*5.0%*	*5.0%*
Opex (Ex-D&A)	(44)	(44)	(44)	(45)	(47)	(49)	(51)	(46)	(11)	(11)	(12)	(12)
EBITDA	19	25	38	39	46	53	62	37	10	9	10	10
% Growth Y/Y		*30.6%*	*48.9%*	*3.7%*	*17.3%*	*16.2%*	*15.3%*		*10.5%*	*(11.7%)*	*(2.1%)*	*22.8%*
% Margin	*30.7%*	*36.6%*	*46.3%*	*46.3%*	*49.4%*	*52.1%*	*54.7%*	*44.7%*	*48.7%*	*45.5%*	*45.5%*	*45.5%*
% Incremental Margin		*100.7%*	*100.3%*	*45.7%*	*80.0%*	*80.0%*	*80.0%*		*69.4%*	*277.0%*	*(20.8%)*	*177.4%*
D&A Expense	(4)	(5)	(6)	(6)	(6)	(6)	(6)	(6)	(2)	(2)	(1)	(1)
EBIT	15	20	32	33	40	47	55	31	9	7	9	8
Finance Income	8	3	7	7	7	8	9	7	1	3	1	2
Finance Expense	(0)	(5)	(0)	(7)	–	–	–	(7)	(7)	(0)	(0)	–
EBT	24	19	38	34	47	56	65	31	3	11	10	10
Income Tax Expense	(6)	(4)	(9)	(8)	(12)	(14)	(16)	(7)	(1)	(2)	(2)	(3)
% Tax Rate	*23.7%*	*22.7%*	*23.0%*	*23.8%*	*25.0%*	*25.0%*	*25.0%*	*24.1%*	*35.0%*	*21.1%*	*22.1%*	*25.0%*
Net Income	18	15	29	26	36	42	49	24	2	8	8	8
Diluted WASO	40	40	40	40	40	40	40	40	40	40	40	40
Diluted EPS	$0.45	$0.36	$0.73	$0.64	$0.89	$1.04	$1.22	$0.59	$0.05	$0.21	$0.19	$0.19

FCF

	FYE 12/31							LTM	FYE 12/31			
	2017A	2018A	2019A	2020E	2021E	2022E	2023E	3Q20	1Q20	2Q20	3Q20E	4Q20E
EBITDA To Levered FCF Bridge												
EBITDA	19	25	38	39	46	53	62	37	10	9	10	10
(-) Cash Interest Expense	(0)	(0)	(0)	(0)	–	–	–	(1)	(0)	(0)	(0)	–
(-) Cash Taxes	(7)	(5)	(2)	(11)	(12)	(14)	(16)	(9)	(5)	(2)	(2)	(3)
(-) Capex	(12)	(4)	(7)	(6)	(6)	(6)	(6)	(10)	(3)	(1)	(0)	(2)
(-) Increase in Net Working Capital	(0)	2	(2)	(3)	–	–	–	(2)	(3)	2	(2)	–
(+) Cash Interest Income	6	3	2	4	7	8	9	2	1	0	0	2
(+/-) Other Items	0	0	0	2	–	–	–	1	0	2	0	–
Levered FCF	7	22	28	24	35	42	48	19	0	11	6	7

SMALL CAPS

Ideas on companies whose respective market capitalizations were between US $300M and US $2B at the time of submission.

WINNER
Small Caps

Sahil Chawla
Analyst at Freddie Mac

Vital Farms

Asset: **Equity**
Idea Posted: **12/21/2020**
Symbol: **VITL: US**
Idea Updated: **12/24/2020**

RETURN TO DATE: 9.63%

EXPECTED RETURN: 50.76%

SHORT

ATTACHMENTS	TIMEFRAME	SITUATION	MARKET CAP
W X	1-2 Years	Contrarian	N/A

> The egg market will crack in 2021 as COVID demand cedes. VITL IPO'd in July with inflated financials fueling their valuation. In 2021 they will compete with Amazon and halve topline growth.

About Sahil Chawla

I'm a 22 year old investor and have been the PM of my brokerage account for 4 years. Generally, I am interested in a bit of everything - value/growth/long/short/situations and prefer conviction and concentration. I graduated from UC Berkeley in 2020 with a double major in Economics and Interdisciplinary studies. Currently I work at Freddie Mac on the Multifamily Capital Markets team. I am also pursuing my CFA. sahil.chawla@gmail.com

About Freddie Mac

Freddie Mac makes homeownership and rental housing more accessible and affordable. Operating in the secondary mortgage market, we keep mortgage capital flowing by purchasing mortgage loans from lenders so they in turn can provide more loans to qualified borrowers. Our mission to provide liquidity, stability, and affordability to the U.S. housing market in all economic conditions extends to all communities from coast to coast.

Vital Farms

Asset Class: **Equity** Symbol: **VITL: US** Updated: **12/24/2020** Submitted: **12/21/2020**

BY:
Sahil Chawla

CURRENTLY AT:
Freddie Mac

Pricing & Return Details	SHORT
EXPECTED RETURN	50.76%
TARGET PRICE	13.00 USD
INITIAL PRICE	28.46 USD

> The egg market will crack in 2021 as COVID demand cedes. VITL IPO'd in July with inflated financials fueling their valuation. In 2021 they will compete with Amazon and halve topline growth.

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Contrarian	1.5% - 2%	N/A	1-2 Years

INVESTMENT THESIS

DISCLAIMER: The author of this idea had a position in this security at the time of posting and may trade in and out of this position without informing the SumZero community.

Vital Farms is a branded egg distributor, focusing on supplying pasture-raised eggs to meet the growing trend of ethical food consumption. At its core, Vital is selling a commodity and what moat the company does have is eroding. A combination of unsustainable trends have caused the outlook of the company to be severely overstated, with multiple catalysts for a realization of a more realistic valuation.

Current Price: $26.40
Target Price: $13
Downside: 50%

THESIS SUMMARY

Vital Farms went public in July 2020. COVID-related demand from stockpiling and home-cooking as well as growth in distribution has shrouded the true operating nature of the company. At 80x 2021 EV/EBITDA, VITL is a short with multiple pathways for realizing a more realistic valuation.

1. **YOY COMPS:** COVID has disrupted the growing trend of eating out in favor of home-cooking. Stockpiling has also caused shortages of eggs in some locations. As we return to normalcy, Vital Farms will show worsening financial results. In their S-1, they attributed half of growth and 280 bps of margin to stockpiling. Further, their biggest revenue source, Whole Foods, began to compete against them at the

peak of the craze. As demand dies down, the effects will shine through Vital Farms' financials.

2. **SATURATION OF DISTRIBUTION:** During the demand craze of this year, new store growth has fallen to 5% QoQ. Prime locations for distribution are likely to have already been picked up and new additions are less accretive, driving down revenue/store compared to sellside assumptions.

3. **COMPETITION:** Currently, brand power and differentiation between conventional eggs allow for a $1-$2 markup. Vital Farms relies on mainstream (Walmart, Albertsons) and natural (Whole Foods, Sprouts) stores. In no location was Vital Farms the cheapest, losing to competing brands in the mainstream locations and store-brands in the natural locations, each offering identical pasture-raised eggs. Now that the market has been proven, big players are also beginning to enter it.

4. **REGULATION:** 7 states with 23% of US population have enacted regulation moving away from conventional methods into cage-free and above. As suppliers are forced to comply, the cage-free method will become normative, eroding the ethical moat of Vital Farms that relies on the comparison of pasture-raised to typical methods of keeping hens and inviting conventional suppliers into their market.

5. **VALUATION:** Their closest competitor Cal-Maine trades at 1.1x 2021 revenue and 13x 2021 EV/EBITDA vs 3.6x and 82x for Vital Farms. We will see why the growth premium is unwarranted even in the best-case scenario, implying ~50% downside.

CATALYST SUMMARY

In 2021 the company's results will have to answer competition on the part of their largest customer undercutting them by over $1 in almost all major metropolitan areas, a sharp decrease in egg demand as COVID's effects dissipate, and slowing new store growth. Beyond 2021 they will face the transition of the US egg supply to cage-free and how they plan to maintain market share in such an environment with growing competition.

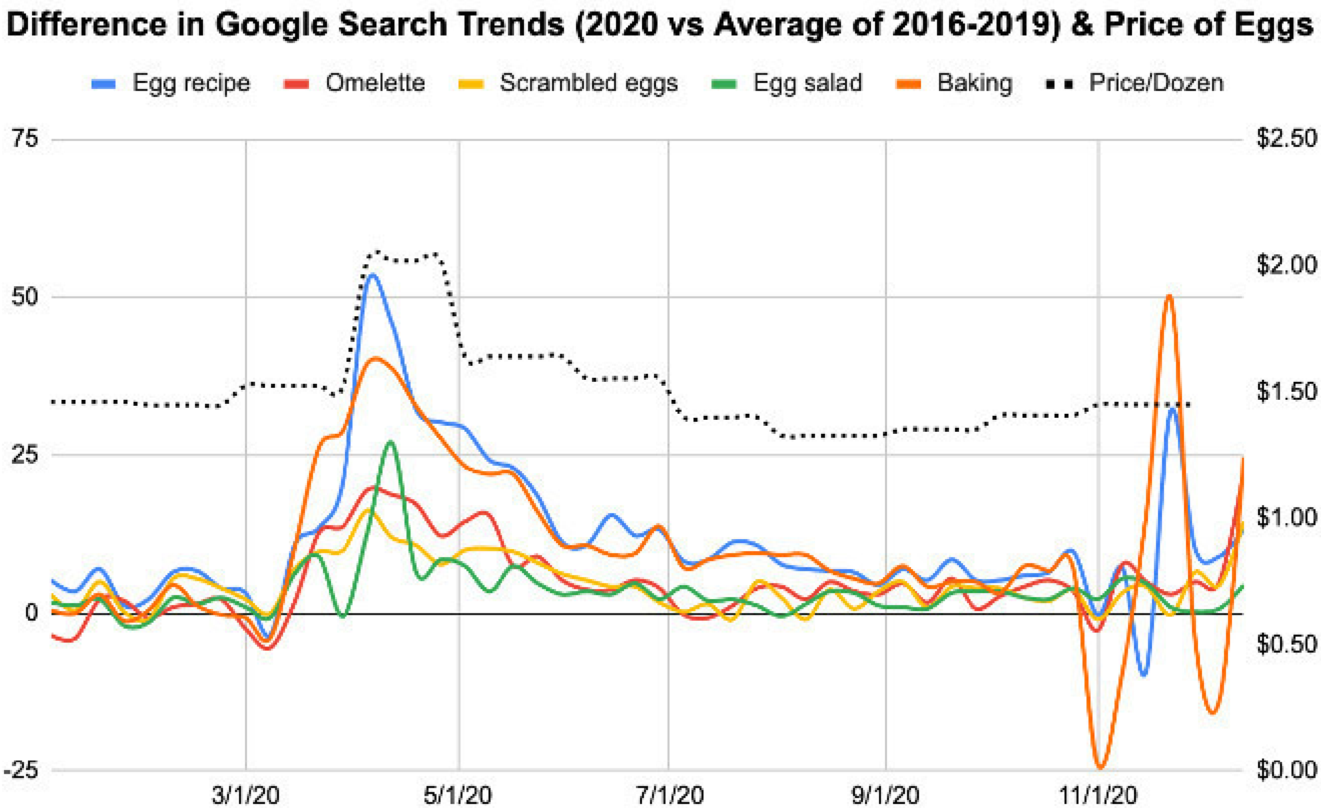
BUSINESS

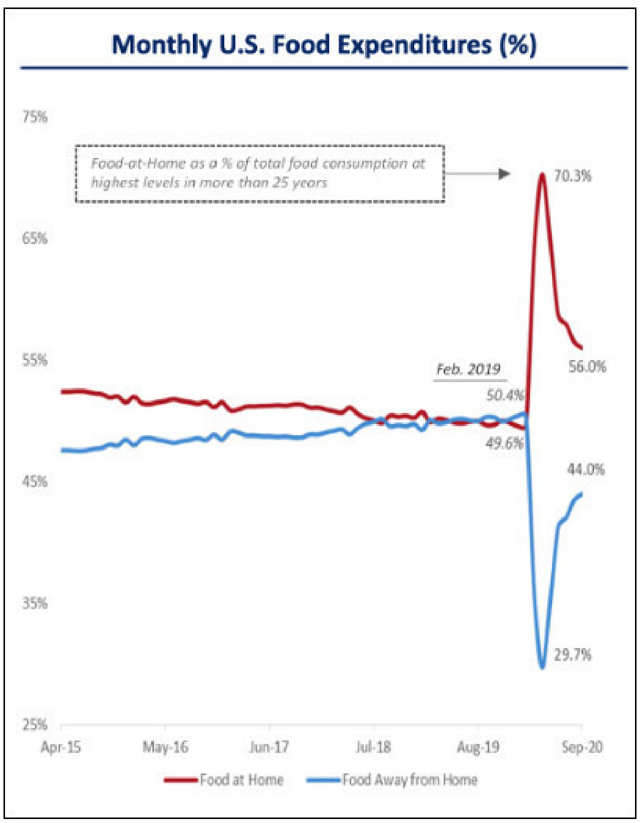
Vital Farms operates in the growing trend of ethical food consumption. Consumers show a sizable interest in understanding where their food comes from, with more than 75% attributing some weight to sustainable practice in purchasing decisions.[1]

Eggs are a ~$10Bn business in the USA. of that goes to egg products - meaning that they aren't sold as shelled eggs but rather in liquid or solid form for use in egg-based foods. The rest of the production is split between conventional, cage-free, free-range, pasture-raised, and a few other varied labels. Conventional eggs are the largest market since they are the cheapest, both in the retail and food service segments. This market is shrinking in favor of labels with less implied cruelty due to demand and regulation. The shell egg market as a whole has seen constant but slow growth over time. Segments within the shelled egg market, like pasture-raised, are gaining market share at much higher rates.

As an egg distributor, Vital Farms partners with "family farms" to sell Pasture-Raised eggs. They sign contracts with these farm owners that guarantee purchase of the eggs at a given rate while farms are responsible for all of the working capital needed to produce them. When signing these contracts, Vital Farms ensures that the conditions for the hens are enough to meet the Certified Humane definition of 108 sq ft per bird and are then able to market the eggs as such (not regulated by the USDA). Once they purchase the eggs, they send them to their processing location where they are weighed, sorted, and packaged. They have one location in Springfield, MO which they are working to double the capacity of. From there, it is shipped to retail locations around the US, sold under their brand-name.

[1] *https://sustainablebrands.com/read/stakeholder-trends-and-insights/77-of-americans-say-sustainability-factors-into-food-purchasing-decisions*





For a company that IPO'd in July, it is nice to have the best year egg demand has ever seen in your marketing materials. 2020 revenue is set to be 50% higher than the previous year, and the company is only growing still. During the first phase of lockdowns, the price of eggs doubled. This seems to be doubly due to the mania caused by the virus as well as a genuine interest in home cooking. [2]

Not only is this trend temporary, but it is actually worsening. 2019 was the first year that eating out was more popular (in $s) than eating at home - a long term trend. COVID temporarily flipped that, dropping away-from-home expenditure to 29.7%. Eggs themselves are still equally, if not more, important in the food being made due to perceived health benefits, but restaurants will seldom spring for the price differential since they're not selling the brand. Foodservice was just 1% of total revenue vs 6% for Cal-Maine.

[2] *https://calmainefoods.com/media/1173/investor_presentation_nov-2020.pdf*

Egg consumption per capita has historically grown at a rate of about 0.7% per year since 1999. From 2015-2019, the rate increased to 3.5%.[3] 2020 has been a true aberration, with half of revenue growth and 280 bps of margin improvement attributed to price and volume resulting from lockdowns.[4]

COMPETITION

What is the order of operations in choosing here? I'd argue 1. What price am I willing to pay? 2. How many do I want? 3. Should I buy a sustainable brand? And then, using the narrowed down options, maximize ethics while minimizing price. But how long are you willing to spend on this? How long does it take to find Vital Farms?

Vital farms claims in their earnings report to be the #2 Overall Egg Brand and #1 Pasture-Raised Egg Brand in the US with 80% market share.[5] This couldn't be farther from reality as they exclude private labels in their calculation, even as private labels like those of Sprouts and Whole Foods carry the same ethos of the store in being natural.

In reality, assuming their supply has grown with their demand, they are not even in the top-50 egg producers. Compared to Cal-Maine's 44m hens, Vital Farms likely has closer to 3m.[6]

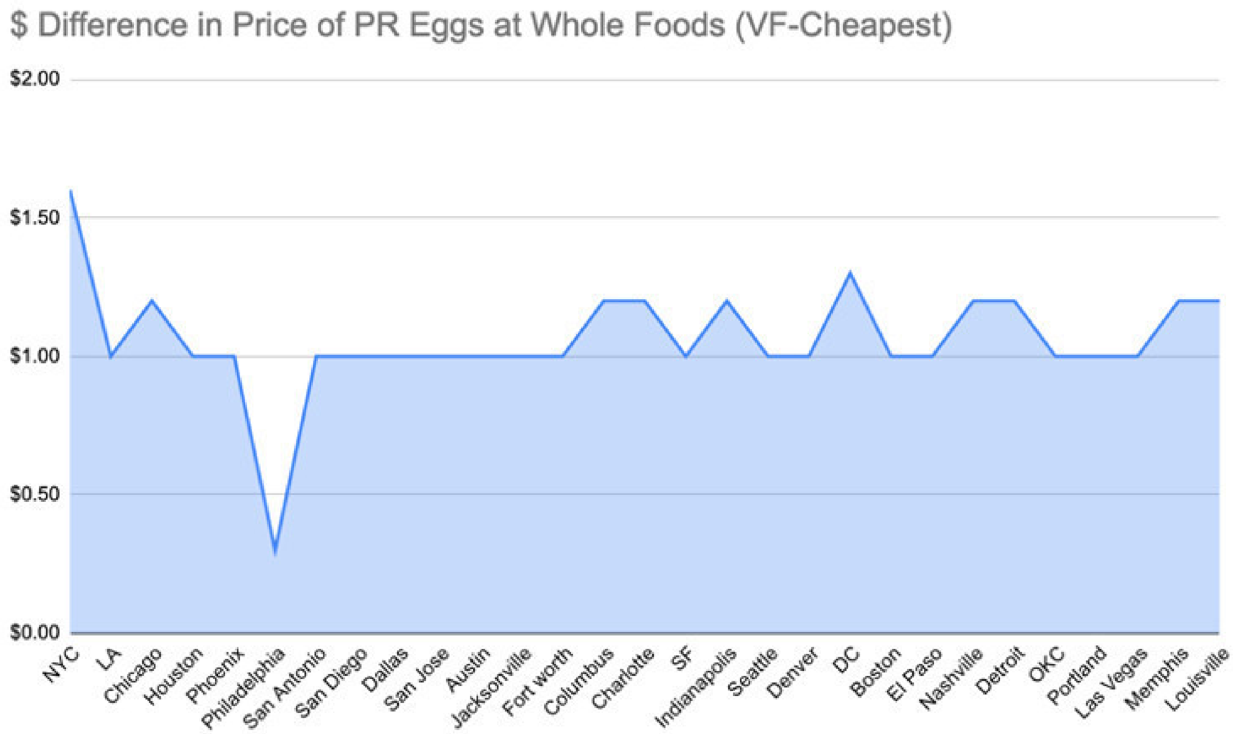
They also lose on price. Vital Farms sells their Pasture-Raised eggs for $5.99 and Organic Pasture-Raised eggs for $6.99. Whole Foods accounts for over 30% of their revenue and has undercut them on price in the Pasture-Raised category in all of the top-30 cities by population in the US according to my research. Based the earliest online reviews for Whole Foods' product, this was launched in April 2020 so results have yet to normalize the impact. Sprouts similarly carries their brand at $1 cheaper (seems to have launched in late 2019) but I have also found Organic Pasture-Raised eggs by a local (Bay Area) brand (Red Hill) for $3.99 - $2 cheaper.

[3] *https://unitedegg.com/facts-stats/*

[4] *https://investors.vitalfarms.com/static-files/5ce98856-66b2-4b85-b30c-79823bb66a9c*

[5] *https://investors.vitalfarms.com/static-files/6de2cdce-b67f-4f05-a314-126927d47d5a*

[6] *https://www.itpnews.com/uploads/2018/02/watt_eggi_201802.pdf?direct_access_media=1*



Further, in their S-1 they claim "the U.S. pasture-raised retail egg market in 2019 accounted for approximately $177.0 million in retail sales and has grown at a CAGR of 31.7% between 2017 and 2019".[7] Using this, we are able to back-out their market share to see that, even before Amazon and Sprouts entered their market, they were losing share despite their growth.

Pasture Raised Eggs	2017	2018	2019
VF Revenue	$ 66,600	$ 98,967	$ 128,579
PR Market Size	$ 77,880	$ 134,396.36	$ 177,000
VF Market Share	86%	74%	73%

These competitors have better distribution at lower costs, the same, if not better, access to Vital Farms customers, and pricing power over the company itself, given the high reliance on these concentrated revenue streams.

OTHER BETS

Vital has also begun selling products like hard boiled eggs, butter, ghee, liquid whole eggs, and egg bites. These products are more likely to be sold at Whole Foods and Sprouts vs their mainstream distribution sources (5.7 average items including eggs vs 2.8). Based on the store penetration of 1,577 for hard boiled eggs, the most successful non-butter venture, these items have far less reach and are contributing negligible amounts to revenue compared to butter at ~10% of revenue with 12,060 stores.[8]

Butter is sold only in the 8oz quantity for $3.99-4.99 and ranges from 2x as expensive (including 16oz adjusted prices) to 25% more expensive (8oz only) compared to other Pasture-Raised brands. Compared to conventional butter, Vital Farms was 2.5x the cost (16oz only). The butter market at large is also smaller, at $3.3Bn with a 2.7% CAGR from 2017-2019.[9]

[7] *https://investors.vitalfarms.com/static-files/c6d115bd-6bd6-4a72-ad76-7b0b3a8df27f*

[8] *https://investors.vitalfarms.com/static-files/6de2cdce-b67f-4f05-a314-126927d47d5a*

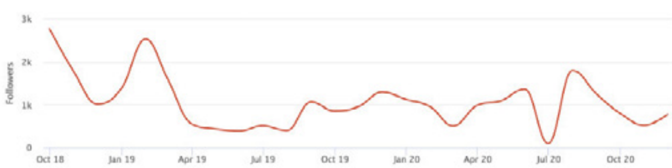
[9] *https://investors.vitalfarms.com/static-files/c6d115bd-6bd6-4a72-ad76-7b0b3a8df27f*

BRANDING

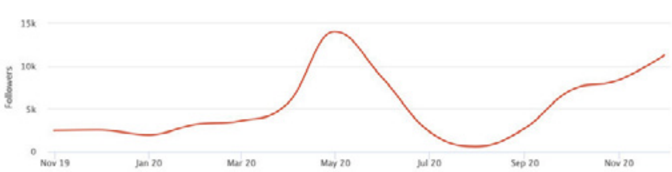
Their selling point to consumers and investors comes in the form of supposed brand power, attesting that people should, and are willing to, pay more for the eggs with the same certification so long as it is sold under the logo of Vital Farms. This only accounts for a small sect of loyal customers while many will be driven towards the competitive offerings of the private labels of grocers, who also are able to determine the real estate of the egg section.

And, for those brand-sensitive customers, Vital Farms is losing the narrative battle. With a smaller base of 89,000 Instagram followers compared to the 109,000 of Pete and Gerry's - a rival ethical egg producer - their draw is only worsening in comparison. [10]

Monthly Gained Followers for 'Vital Farms'



Monthly Gained Followers for 'Pete and Gerry's Organic Eggs'

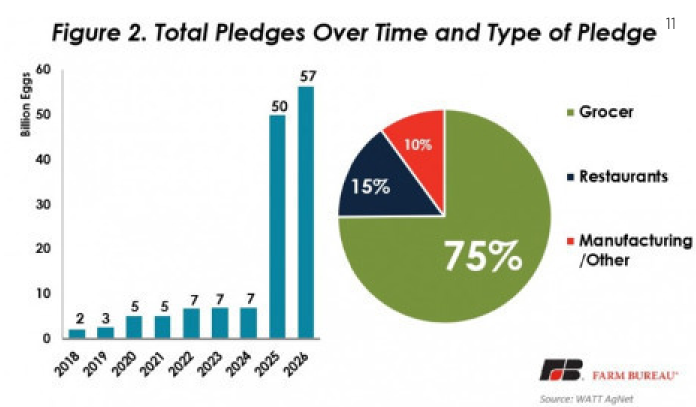


This is also as brands that may be less social media savvy offer identical products at rapid rates of increased distribution like Handsome Brook Farms and Happy Egg Co. The latter is Walmart's brand of choice - cheaper by over $1. Competitors aren't all pasture-raised but do compete for the same customer base by offering free-range and organic options. Many of the largest brands, like Cal-Maine, are currently sitting at cage-free (45% of revenue) but, as demand and regulations change, have the ability and distribution to enter higher-standard markets with force.

REGULATION

MAJOR EGG LABELS

Conventional: Chickens are treated legally
Cage-free: Chickens did not live in cages
Free Range: Access was provided to the outdoors
Pasture-Raised: Chickens spend the day outside and have indoor spaces to spend the night or winter in (up to 2 weeks)
Organic/GMO: Describes the chicken feed
This trend of ethical consumption has gone mainstream. Both Walmart and McDonalds have pledged to only use cage-free eggs by 2025. Many states already have enacted similar laws that would require all eggs sold in the state to be cage free - amounting to over 20% of the US population. In totality, to reach these goals, over half of all eggs being produced will come from cage free sources. Cage-free is becoming a de-facto norm that eventually most producers will abide by. Some consumers will lose the ethical imperative to avoid the cheapest eggs as they are less cruel.



[11]

[10] *Socialblade.com*

[11] *https://www.fb.org/market-intel/cage-free-eggs-were-once-expected-to-dominate-the-egg-market*

Producers are going to have to make this transition soon. Cal-Maine estimates that 70% of hens will need to be in cage-free facilities by 2026 and have invested over $400m to make that a reality already.[12] Most other producers will be forced to cease operations in traditional means. This can also mean graduating beyond cage-free into higher ethical certifications - like pasture-raised. It's an economic decision. If there are profits being made supplying those eggs, they will enter the market and drive down profits for existing players. In the past, conventional producers were able to operate as normal without having to make any major investments. In the coming years, they are forced to upgrade their facilities, basically being pushed into the ethical egg market at least at the lowest level by their customers, states, and consumers. The largest portion of the $10Bn TAM is going to be distributed into the different egg varieties, increasing competition at all levels.

VARIANT VIEW

The biggest problem with the sellside estimates is the use of 2020 as a base year and failure to recognize the first principles of operating as an oligopoly.

On the former: estimates tout extreme CAGR figures for a market with a hard ceiling. Pasture-Raised eggs are a growing subsect of a growing subsect (cage free+) of a mature market growing at 1-3% a year. Irrespective of the competition that has breached the castle, it's hard to see why 2021 will be a year with more growth given the aberration that 2020 has been.

On an egg-revenue per store basis (assumes 10% of revenue from other bets) the company historically has operated in the range of $10,000 +/- $2,000, even in 2020. There are about 40,000 locations in the US that sell grocery items.[13] To be in that same range of 90% of revenue from eggs and ~$10,000 per store, they would essentially need to be in every single one of these locations by 2024 (more than doubling locations and their historical location growth rate) and cannot suffer any loss in unit economics. This is taking the projected 2024 revenue as given.

Marginal store additions are likely to continue at a slower rate since demand for higher-end commodities is not ubiquitous and the best locations are likely to be already served. All of the top-30 cities by population carry their products already.

Still, if we assume a generous growth rate, bringing them to over 22,000 stores in 2024, revenue projections are hard to comprehend. At over half of US stores served, egg-revenue assumptions imply a more than doubling of revenue per store.

Further, revenue assumptions continue to assume extreme growth in the size of the market and Vital Farm's implied share. The market for pasture-raised eggs is unsustainable since the region where hens can access the pasture year-round is limited to the south due to the suitable weather.

The model demonstrates exactly how the sell side assumptions of over $500m in 2024 revenue, implying $450m from eggs, are not rooted in reality. If we keep 2020's market size as even, or write in a small decline followed by continued strong growth, and factor in a generous 50%+ market share, we are still far from the base case.

[see figure on following page]

This isn't technology. It's hard to see why the demand shifts of home-cooking and stockpiling should continue as we return to normalcy at the rate that these estimates assume. The basic problem is that projections ignore the reality faced by the company in the grocery store. Even without 2020 - the company was facing an inflection point in their ability to sustain their growth. Remember - half of their 2020 growth is due to COVID. Their multiple is going to be harder to justify when topline growth falls dramatically.

[12] *https://calmainefoods.com/media/1173/investor_presentation_nov-2020.pdf*

[13] *https://www.foodindustry.com/articles/how-many-grocery-stores-are-there-in-the-united-states/*

EOY Stores		10544	14,677.0	16,911.4	18,978.7	20,729.3	22,019.5	22,729.5	About 40,000 Grocery Stores in the USA			
Growth			39%	15%	12%	9%	6%	3%				
										Base year		
S/S Scenario 1	2017	2018	2019	2020	2021	2022	2023	2024	CAGR	2019	2020	Assumes/Implies
VF Revenue	$ 66,600	$ 98,967	$ 128,579	$ 190,921	$ 220,776	$ 278,178	$ 373,500	$ 469,800	Revenue	30%	25%	20% revenue CAGR
PR Market Size	$ 77,880	$ 134,396.36	$ 177,000	$ 265,500	$ 336,389	$ 409,385	$ 477,752	$ 533,649	Market	25%	19%	PR -> half of specialty egg (cage free) market by 2024
PR Market Growth		73%	32%	50%	27%	22%	17%	12%				No loss in market share
VF Market Share	86%	74%	73%	73%	66%	68%	78%	88%				**Sellside correct**
Revenue/Store		$ 9,386	$ 8,761	$ 11,289	$ 11,633	$ 13,420	$ 16,962	$ 20,669				
										Base year		
S/S Scenario 2	2017	2018	2019	2020	2021	2022	2023	2024	CAGR	2019	2020	Assumes/Implies
VF Revenue	$ 66,600	$ 98,967	$ 128,579	$ 212,134	$ 220,776	$ 278,178	$ 373,500	$ 469,800	Revenue	30%	22%	25% market CAGR
PR Market Size	$ 77,880	$ 134,396.36	$ 177,000	$ 290,595	$ 302,432	$ 381,066	$ 511,644	$ 643,562	Market	29%	22%	Constrant market share
PR Market Growth		73%	32%	64%	4%	26%	34%	26%				**Sellside correct**
VF Market Share	86%	74%	73%	73%	73%	73%	73%	73%				
Revenue/Store		$ 9,386	$ 8,761	$ 12,544	$ 11,633	$ 13,420	$ 16,962	$ 20,669				
										Base year		
S/S Scenario 3	2017	2018	2019	2020	2021	2022	2023	2024	CAGR	2019	2020	Assumes/Implies
VF Revenue	$ 66,600	$ 98,967	$ 128,579	$ 212,134	$ 220,776	$ 278,178	$ 373,500	$ 469,800	Revenue	30%	22%	Declining market share
PR Market Size	$ 77,880	$ 134,396.36	$ 177,000	$ 309,038	$ 341,528	$ 458,711	$ 659,387	$ 892,418	Market	38%	30%	33% market CAGR - higher than last 3 years
PR Market Growth		73%	32%	75%	11%	34%	44%	35%				**Sellside correct**
VF Market Share	86%	74%	73%	69%	65%	61%	57%	53%				
Revenue/Store		$ 9,386	$ 8,761	$ 12,544	$ 11,633	$ 13,420	$ 16,962	$ 20,669				
										Base year		
Generous Scenario	2017	2018	2019	2020	2021	2022	2023	2024	CAGR	2019	2020	Assumes/Implies
VF Revenue	$ 66,600	$ 98,967	$ 128,579	$ 212,134	$ 200,511	$ 226,664	$ 255,259	$ 286,224	Revenue	17%	8%	Market same size in 2021. Growth slows overall
PR Market Size	$ 77,880	$ 134,396.36	$ 177,000	$ 290,595	$ 290,595	$ 348,714	$ 418,457	$ 502,148	Market	23%	15%	Incereased competition = declining market share
PR Market Growth		73%	32%	64%	0%	20%	20%	20%				**Sellside wrong**
VF Market Share	86%	74%	73%	73%	69%	65%	61%	57%				
Revenue/Store		$ 9,386	$ 8,761	$ 12,544	$ 10,565	$ 10,934	$ 11,592	$ 12,593				
				Revenue Difference	(20,265.2)	(51,514.2)	(118,241.4)	(183,575.6)				
										Base year		
Realistic Scenario	2017	2018	2019	2020	2021	2022	2023	2024	CAGR	2019	2020	Assumes/Implies
VF Revenue	$ 66,600	$ 98,967	$ 128,579	$ 212,134	$ 180,459	$ 203,998	$ 220,161	$ 236,582	Revenue	13%	3%	Market same size in 2021. Growth slows as it nears saturation
PR Market Size	$ 77,880	$ 134,396.36	$ 177,000	$ 290,595	$ 261,535	$ 313,843	$ 360,919	$ 415,057	Market	19%	9%	Incereased competition = declining market share
PR Market Growth		73%	32%	64%	-10%	20%	15%	15%				**Sellside wrong**
VF Market Share	86%	74%	73%	73%	69%	65%	61%	57%				
Revenue/Store		$ 9,386	$ 8,761	$ 12,544	$ 9,509	$ 9,841	$ 9,998	$ 10,409				
				Revenue Difference	(40,316.2)	(74,180.6)	(153,339.4)	(233,217.6)				

VALUATION

As a result, to reach the price target of $13, I have modeled in some more very generous assumptions. At an 8% EBITDA margin, higher than they have ever achieved, and a 30x multiple, higher than Facebook, they are worth 40-50+% less - even using sellside estimates. Other companies that trade at more than twice their market multiple may continue to put up big numbers, growing to their valuation. For Vital Farms, 2021 and beyond should be years of reckoning for the reasons mentioned earlier. The valuation in the model is accommodating to protect from unexpected developments. It would be reasonable to expect downside below $12 absent any saving graces.

It's also worth noting that the company seems prone to tail risk. The avian influenza outbreak in 2016 reduced Cal-Maine sales by 44%. In 2019, Vital was subject to a recall in hard boiled eggs due to listeria. Vital farms has a concentrated production base and only one distribution center that they are expanding capacity on located in Springfield, MO.

EV 12/21/2020

$ 976,710	EBITDA Margin	2021 EV/EBITDA	2022 EV/EBITDA	2023 EV/EBITDA	2024 EV/EBITDA
S/S	8%	55.3	43.9	32.7	26.0
Generous	8%	60.9	53.9	47.8	42.7
Realistic	8%	67.7	59.8	55.5	51.6

2021	Margin	2021 Multiple	Implied Price	Downside
S/S	8%	30.0	$ 14.30	-46%
Generous	8%	30.0	$ 12.99	-51%
Realistic	8%	30.0	$ 11.69	-56%
2022	**Margin**	**2022 Multiple**	**Implied Price**	**Downside**
S/S	8%	30.0	$ 14.30	-46%
Generous	8%	30.0	$ 12.99	-51%
Realistic	8%	30.0	$ 11.69	-56%

RISKS

- State laws making cage-free eggs the norm can be deemed unconstitutional as it regulates interstate commerce. This has been denied by district courts and the Supreme Court refused to hear the case.

- Butter and other products can bridge the gap in projected revenue.

- There may be some permanence in lockdown trends. If people continue to cook at home it would help sustain some of the growth the egg market has seen but would still likely equate to a YoY decline.

- Possibility of a buyout by Cal-Maine sized producer. This would kill the brand ethos and is unlikely at this valuation. They are already investing in expansion for cage-free eggs and have a history of acquiring farms making them more likely to compete on contracts with farmers vs buying Vital Farms outright.

- International expansion. This would increase the number of potential customers but there are not many candidate markets that don't already have their demand met. Additionally, it would be a significant downward force on margins.

- Growth in egg consumption accelerates. If this were a concern it would be possible to turn this into a pair trade by going long Cal-Maine (CALM).

FINALIST
Small Caps

Jerome Hass

Portfolio Manager at Lightwater Partners Ltd.

CURRENT RANKING: **#2 Special Situations**

BADGES: 11 13

Cineplex Inc Com

Asset: **Equity**
Symbol: **CGX:CN**
Idea Posted: **12/23/2020**
Idea Updated: **12/27/2020**

RETURN TO DATE: 1.7%

EXPECTED RETURN: 262.86%

LONG

ATTACHMENTS	TIMEFRAME	SITUATION	MARKET CAP
	1-2 Years	**Deep Value**	**163.0M USD**

> From Long-Term Bear to Bull. Cineplex's near monopoly on movie cinemas in Canada's largest cities remains a rare gem. Cash cow should be milked, no point in trying to make it a show horse.

About Jerome Hass

Jerome joined Lightwater as a Portfolio Manager in 2007 and has over 25 years experience in the financial industry. Previously, he worked as a Portfolio Manager at a prominent Canadian hedge fund and Montrusco Bolton Investments. Mr. Hass also worked as a Portfolio Manager in London, England for Canada Life Assurance Company. He started on the buy-side at Scottish Amicable Investment Managers in Scotland. Mr. Hass also worked as a sell-side Analyst with HSBC Investment Bank in Singapore and Malaysia. He began his career as an Economist with the Ministry of Finance. He holds a Bachelor degree in Economics from the University of Western Ontario, a Master of Arts in Applied Economics from the University of Victoria as well as a Master of Science degree in Economics from the London School of Economics. He obtained the Chartered Financial Analyst ("CFA") designation in 1998.

LIGHTWATER PARTNERS LTD

About Lightwater Partners Ltd.

Lightwater Partners is an independent Toronto-based investment manager founded in 2007. We manage funds on behalf of individuals, families, Investment Advisors, family offices and corporations, both domestically and internationally. Lightwater Partners is registered in Canada with the Ontario Securities Commission as a Portfolio Manager, Investment Fund Manager, and Exempt Market Dealer. Our investment focus is mid-Cap Canadian stocks. We seek to identify "uncrowded" or under-followed companies that are under-valued or over-valued by the market. This approach has allowed Lightwater to outperform Canadian equity markets over the past 12 years while exhibiting lower risk and volatility than the market. To maintain a lower-risk profile, we have portfolio protection in place at all times: short positions are used to hedge long investments.

Cineplex Inc Com

Asset Class: **Equity** Symbol: **CGX:CN** Updated: **12/27/2020** Submitted: **12/23/2020**

Pricing & Return Details	LONG
EXPECTED RETURN	262.86%
TARGET PRICE	34.00 CAD
INITIAL PRICE	9.21 CAD

BY:
Jerome Hass

CURRENTLY AT:
Lightwater Partners Ltd.

CURRENT RANKING: **#2 Special Situations**

BADGES: 11 13

> From Long-Term Bear to Bull. Cineplex's near monopoly on movie cinemas in Canada's largest cities remains a rare gem. Cash cow should be milked, no point in trying to make it a show horse.

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Deep Value	5% - 10%	M&A/Buyout Target	1-2 Years

INVESTMENT THESIS

CINEPLEX: FROM LONG-TERM BEAR TO BULL

1. SUMMARY

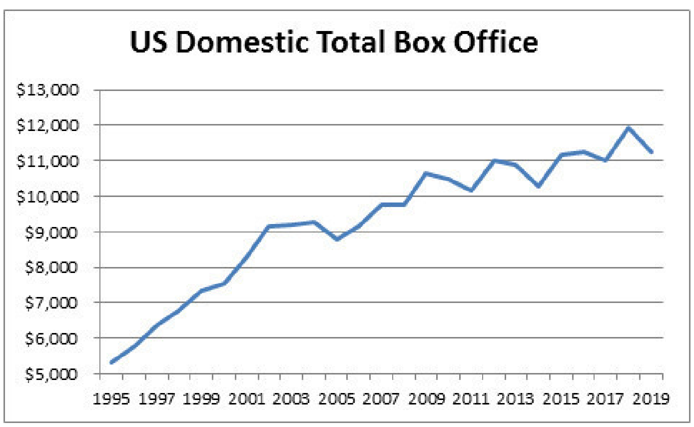
In this report we outline why we were short Cineplex in the past and why we now see the stock as extremely under-valued with a $34 per share target (250%+ upside). The film exhibition industry is widely perceived to be a sunset industry. We believe the industry data conveys a less gloomy reality than this perception. Cineplex's near monopoly on movie cinemas in Canada's largest cities remains a gold mine. The six year diversification strategy has been a disaster. A new owner would quickly ditch the capital intensive non-theatre ventures that have been a drain on the Cineplex's cashflows for years. Once streamlined and returned to its asset-light model, Cineplex would emerge as a cash cow. There is further upside from a private equity buyer, as its stable cashflows allow it to load the company with debt. Regardless of technological innovations, consumers still want to get out of their home occasionally. A night at the cinema is a cheap form of entertainment that should rebound back to normal with pent-up demand from COVID-19 restrictions. Lightwater funds own both the common shares (CGX-TSX) and listed convertible debentures (CGX.DB.B-TSX) of Cineplex. We prefer the debentures for their 5.75% coupon, low conversion price ($10.94), and superior creditor position. The author personally owns both the debentures and common shares.

2. COMPANY PROFILE

Cineplex is the dominant movie exhibitor in Canada (with 75% market share pre-pandemic). The company's size and scope create a material barrier to entry and of strategic importance to film distributors, concession suppliers, and advertisers. If a distributor wants to show a film in Canada, it needs to talk to Cineplex. It also operates a near-monopoly with its national in- theater advertising network (with 94% market share), as well as a digital signage business, and a restaurant / entertainment chain, The Rec Room. Cineplex cinemas operate only in Canada and are not affiliated with movie chains outside Canada.

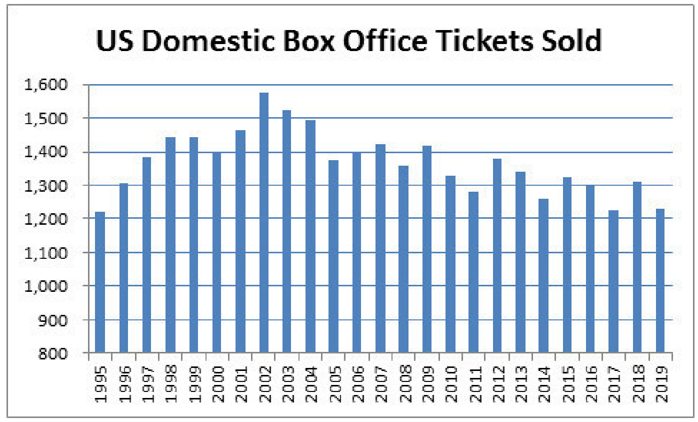
3. INDUSTRY OVERVIEW

"When is the last time you went to a movie?", a former Cineplex shareholder recently commented when asked of his views on the stock (pre-COVID-19 lockdowns). The film exhibition industry is widely perceived to be a sunset industry. We believe the industry data conveys a less dour reality than this perception. Below shows a rather healthy looking graph showing U.S. Domestic Box Office revenues over the past 25 years. It has more than doubled over the period, growing at a respectable CAGR of 3.0%.



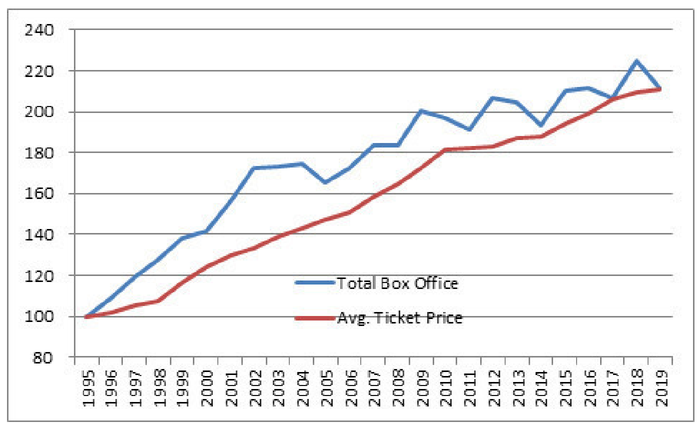
source: https://www.the-numbers.com

Critics will correctly argue that U.S. attendance has been declining for more than a decade, with a peak in 2002 (see chart below). Attendance will fluctuate year to year so we prefer to look at averages. Comparing average attendance over the last five years (2015-19) with the five years before that (2010-14), U.S. attendance dropped a relatively modest 3% or roughly 0.6% per year.



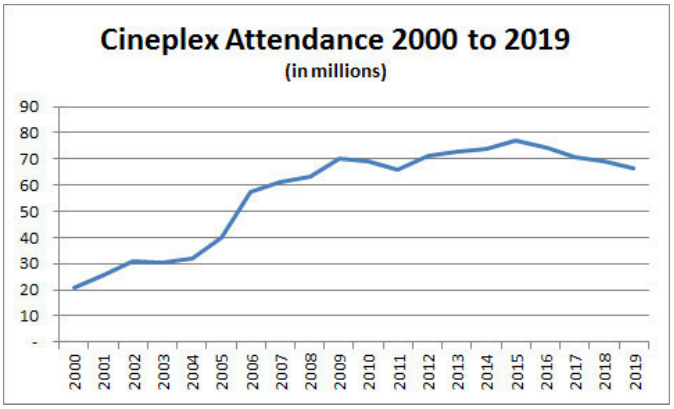
source: https://www.the-numbers.com

The drop in attendance was largely offset by increases in U.S. ticket prices. As shown by the graph below comparing growth in average U.S. ticket prices versus total box office revenues (1995-2019), both have more than doubled over the period (3.0% CAGR).



source: https://www.the-numbers.com

The story in Canada is clouded by the absence of industry-wide data. Cineplex has held a 70% to 78% market share since 2012 so its data covers the bulk of the industry. Critics tend to focus on the decline in attendance since 2015 – largely attributed to the rise in popularity of Netflix (at the end of 2019, Netflix had an estimated 6.5 million subscribers in Canada). However, with the benefit of a longer time series (20 years), one observes that attendance has been largely flat since 2009 (see chart below). We recognize the imperfections of this data; however, it clearly conveys a healthier industry profile in Canada than the U.S.A. This may be partial explained by the large market share (10%) held by independent cinema exhibitors, many of whom show 'non-Hollywood' products such as French language, Canadian or foreign films. Many provinces, such as Ontario, have programs to specifically support 'repertory' or art cinemas.



source: Cineplex investor presentations

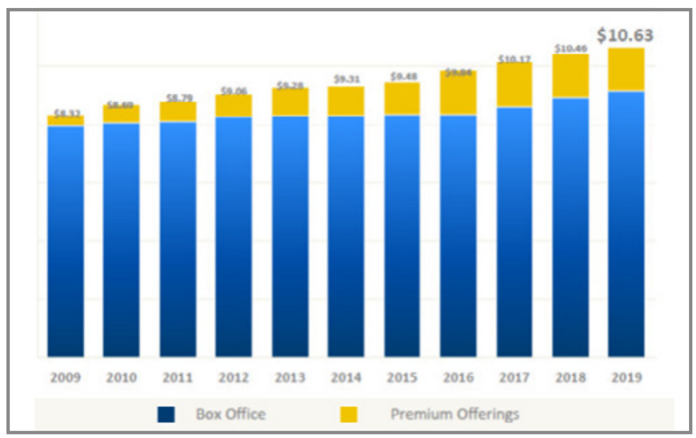
In contrast to its U.S. peers, Cineplex has not relied on prices increases to grow its box office revenues over the past ten years (see blue bars in chart below). Their strategy has been to keep its base ticket price "as affordable as possible". The modest base ticket price increases (2017-19) were directly attributable to significant hikes in the legal minimum wage (notably Ontario raised its minimum by 20% in 2018), as 90% of Cineplex's 13,000 employees earn minimum wage.

Cineplex has been effective in using its SCENE loyalty program to target additional concession sales and premium services (gold bars in chart below). The growth in its Box Office per Patron has been driven by the move to higher-priced premium offerings (such as VIP theatres, D-Box special effects, enhanced UltraAVX sound, IMAX screens, 3D movies). The VIP format has also enhanced concessions per patron, as VIP guests consume twice the average rate. The introduction of alcohol and better quality food will continue to increase basket size and act as a tailwind for further concession growth per patron.

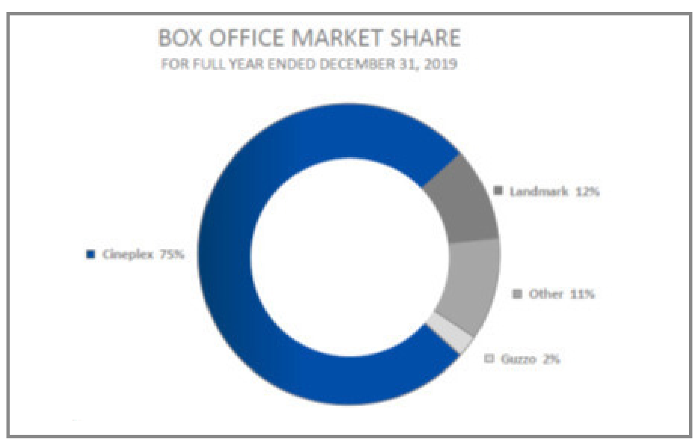
We believe Cineplex movie prices are 10% to 17% lower in general than its US peers. This is in contrast to most other consumer products and services in Canada, where prices are typical significantly higher than U.S. prices. American cinema operators may need to be more cautious on the risk of continued price increases, whereas Cineplex has more scope to do so in the future.

CINEPLEX PRICES LARGELY FLAT 2009-2019

Cineplex is the largest cinema operator in Canada with a 75% market share at the end of 2019. It has held as a high as 78% share. We suspect their market share will rise in the post COVID-19 era, as some of its smaller rivals will not survive the extended lockdown. The #2 player in Canada (Landmark) does not operate in the largest urban areas so Cineplex enjoys a near monopoly in markets such as Vancouver and Toronto. Cineplex does not operate any cinemas outside Canada.

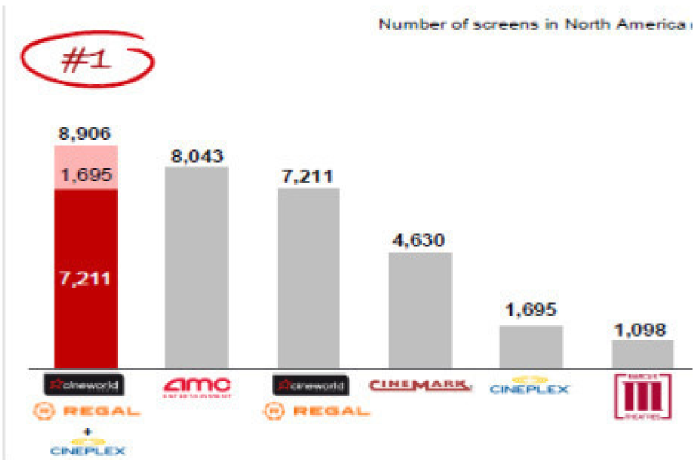


source: Cineplex presentation Q4 2010



source: Cineplex presentation Q4 2019 and Rentrak

Cineplex is the fourth largest cinema operator in North America in terms of the number of screens, behind AMC, Cineworld / Regal and Cinemark. In November 2019, Cineworld made a $34 cash bid for Cineplex. The combination of the two would have created the largest cinema chain in North America.



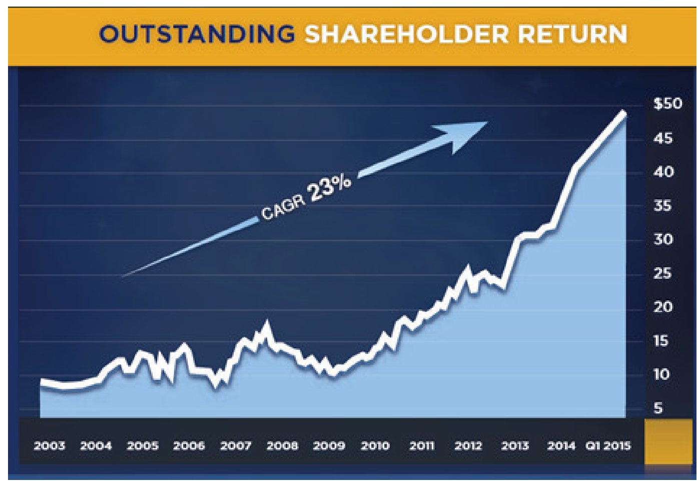
Source: Cineworld presentation, 16 December 2019

A lot of media attention has focused on Netflix and other streaming services during the pandemic. The quality of audio video systems available to consumers at home is comparable to cinema standards and the breadth and depth of content is impressive. Regardless of technological innovations, consumers still want to get out of their home occasionally. This is especially so during the COVID-19 lockdowns. Commercial cinema has survived many technological changes over the last 100 years. A night at the cinema is a cheap form of entertainment that will not disappear any time soon.

4. FROM LONG-TERM BEAR TO BULL

It may surprise our long-term investors to read that we have a long position in Cineplex. Historically, no one would accuse us of being cheerleaders for the stock; we have been out-spoken critics of the company for the past six years [see video clip link below this paragraph]. We even argued the bear case in a bull versus bear debate live on the Business News Network (BNN) against a prominent mutual fund manager. Our funds first began shorting Cineplex in 2014. Our view was due to (i) its extreme over-valuation and (ii) its much-lauded diversification strategy. There is a scarcity of stable consumer stocks in Canada so the stock was 'over-owned' by institutional managers, especially following the 2008-09 recession when the cinema business was widely viewed as 'recession-proof'. As a consequence, Cineplex was grossly over-valued relative to its larger, more profitable American peers such as Cinemark, Regal or AMC. At times, Cineplex traded at twice the valuation of its American peers.

A FORMER STOCK MARKET DARLING – UNTIL 2015



Source: Cineplex AGM presentation 2015

When analyzing Cineplex, investors and Analysts tend to focus on the upcoming slate of films. History has shown that Analysts are not particular good at picking box office winners and losers. As a hedge fund, we mitigate as much risk as possible. In this instance, the main risks to our short position were blockbuster movies and higher movie attendance. To offset this industry- specific risk, we weheld a long position in Cinemark (CNK-NYSE). Cinemas generally show the same movies north and south of the 49th parallel, so we didn't really care if the next Star Wars episode or Fast & Furious 17 was a hit or a flop because we had hedged out box-office risk. Moreover, Cinemark actually stuck to its core business of exhibiting movies unlike Cineplex, which diversified into non-cinema businesses (such as stand-alone casual dining restaurants and E-gaming tournaments) while driving up operating costs and reducing margins.

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As shown by the four-year chart [below] (1 January2015 to 31 December 2018), this pair trade worked very well. While Cinemark was flat (+1.4%) over the interval, Cineplex was down 42%. So the weakness in Cineplex's share price should not be attributed to weak industry fundamentals. The blame should be placed on its diversification strategy.

5. THE DIVERSIFICATION OR 'DI-WORSIFICATION' STRATEGY

The current CEO of Cineplex, Ellis Jacob, has held the office since 2003. From 2003 to 2015, the company was a stock market darling, generating a 23% CAGR over the period. Every institutional manager and Investment Advisor held the stock. It was also popular with grandma and grandpa due to its growing 3% dividend yield (paid monthly) and resilient business model.

Cinemas have existed as commercial enterprises for 125 years so one would be safe to describe it as a mature industry. Theatres face increasing competition from online rivals such as Netflix and Disney+. As well, by 2015 Cineplex held a

CHART COMPARING CINEPLEX VERSUS CINEMARK OVER FOUR YEARS FROM 2015 TO 2018

78% market share in Canada as it had consolidated the few remaining cinema chains. There was only two cinema chains left of any size, Landmark (10% share) and Guzzo (2% share; independents hold about 10% share), so further acquisitions were unlikely due to the threat of the Competition Bureau blocking them. Despite being the land of oligopolies and monopolies, even in Canada industry concentration has its limits.

Sell-side Analysts like growth companies because they need capital to grow, which means their employers (brokerage houses) generate deals. Conversely, companies that are cash cows and are self-sufficient in capital do not get much interest from the brokerage community. That's why CEO Ellis Jacob and the Cineplex leadership team decided the company needed to be about more than the movies.

It is not surprising that when management proposed the growth and diversification strategy, Analysts were quick to embrace the idea. As one Analyst observed at the time, "This strategy should not only lower earnings volatility, but also offer higher growth potential relative to Cineplex's traditional business". Other Analysts were worried that its core business was "at the mercy of the film slate, and is obviously quite mature and at some risk over the medium term." Management ultimately sought to have half of its revenues and EBITDA from 'non-Hollywood' products. As a result of this vision, Cineplex was lauded as having one of the best management teams in Canada.

5.1 THE WRECK ROOM

The most prominent diversification initiative is The Rec Room, although shareholders may prefer our alternative spelling, the Wreck Room, given the drain this venture has put on Cineplex's cashflows. These are stand-alone casual dining amusement gaming, and live entertainment venues, similar the Dave & Buster model. We prefer to view them as 'Chucky Cheese for millennials'.

Our biggest criticism of the diversification is that Cineplex they are capital-intensive versus its capital-light core business, lowering returns on capital and equity for the overall business mix. The Rec Room is case in point: the net cost for each facility is anywhere from $6 million-$10 million per site, depending on the size. Management aimed to open 10 to 15 locations. Analysts initially believed these facilities would earn better returns than the core cinema business to justify the capital outlay but that had not proven to be the case. Specific financial data on this segment are not disclosed but we do not believe it is close to profitable six years into the project. To date only, seven Rec Room locations have opened, an indication that even management might concede the roll-out has not been a success.

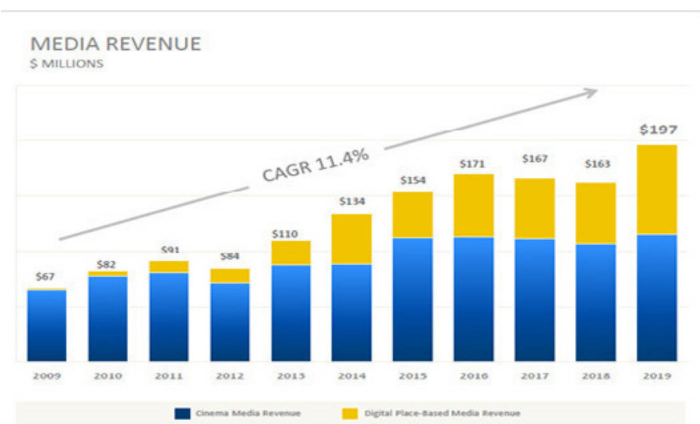
5.2 NON-CINEMA DIGITAL SIGNAGE

Cineplex's media operations consist of two segments: an in-house theatre advertising arm, (Cineplex Media) and its digital signage business (Cineplex Digital Media). While all traditional media platforms have faced advertising headwinds, its in-theatre advertising has more held up reasonably well. Given that Cineplex controls about 94% of this market in Canada, we view in-theatre advertising as part of its core cinema business and believe it should remain so, even under private equity ownership.

Conversely, we do not like the digital signage business, both as a customer and an investor. Thanks to Cineplex's new digital signs, when one goes into a Tim Hortons to buy a coffee and doughnut, the customer is greeted by a multi-media display that tells you everything but the price of the coffee and doughnut that you want to order. Cineplex also has a contract to provide digital signage at 'The Beer Store' in Ontario (the creatively named monopoly beer retailer in Ontario). Thanks to Cineplex's signage, in order for a beer customer to look up the price of a product, one has to leave the main line-up (yes, we actually have to line-up to buy beer at the monopoly store in Ontario) to walk over to the ATM-like device that apparently has pricing information. Since these machines were installed a few years ago, I have yet to see anyone actually look up a price. This is clearly a boon to breweries, as customers are now even less price-aware than in the past. This digital technology replaces the 1950's style price list that used to be clearly visible to customers while waiting in line. Few Ontario beer consumers would have positive views on Cineplex's digital signage.

Our second main criticism against the diversification strategy is that these new ventures are not 'recession-proof' like its core business. Investors may have been able to justify 40 times trailing PER ratio for the cinema business, but few would pay the same valuation multiple for an advertising or casual dining business, which are sensitive to the economic cycle. Additionally, digital signage is a capital-intensive industry, as there is generally an upfront cost of signage. We do not have separate financial data for this segment but we doubt it has ever been profitable. We view this business segment as a likely candidate for divestment.

It should be noted that most sell-side Analysts take a contrary approach to valuation: in sum of the parts analysis, typically theatre business is valued around 8x EV/EBITDA versus 10x multiple for the non-theatre businesses. We strongly disagree with the premium attached to the non-theatre businesses, especially given their dismal six year track record.



source: Cineplex presentation Q4 2019

5.3 ESPORTS FIASCO

Cineplex hoped to use eSports as a way to appeal to millennial males, a demographic that is hard to pin down and has seen declining cinema attendance. Analysts expected Cineplex to ride the explosive growth of the eSport industry. Despite Cineplex's high profile, success never materialized. After spending approximately $25 to 30 million in investments and operating losses, Cineplex quietly exited the business in November 2020 for 'nominal consideration'. The sale of eSports was a condition of the Cineworld transaction.

5.4 OTHER DIVERSIFICATION BUSINESSES

Amusement gaming is another non-theatre sideline for Cineplex. By rolling up smaller players, it has become one of the largest amusement gaming companies in North America with 2019 revenues of $178 million. It supplies and distributes arcade equipment to its own Cineplex theatres, the Rec Room, and other third party operators such as theme parks and cruise ships. While it may make economic to own or rent amusement games within its cinemas, we see little reason for owning this low- margin distribution business. It is an obvious candidate for divestment.

Last year Cineplex announced a deal with U.S.-based Topgolf Entertainment Group to open golf-themed complexes in Canada. Thankfully, this idea was terminated this year before it came to fruition and any shareholder capital was squandered.

5.5 DIVESTMENT VALUATIONS

In the tables below, we list the segment revenues (as given in the 2019 MD&A report) and our estimated EBITDAaL (EBITDA after Leases, Cineplex's preferred financial metric). Essentially, EBITDAaL equals EBITDA less cash rents. Under Accounting Standard IFRS-16 (adopted in 2019), EBITDA increases, as straight-line rent expense moves out of operating expenses. This had the greatest impact on the cinema exhibition segment, which it has 92% of the consolidated lease value.

Cineplex (CGX)			
Divestment Segment Profit & Loss (Cdn $000's)	**2019 Revenues**	**2019 EBITDAaL**	
Base Case 2019	1,665,146	230,500	13.8% EBITDAaL margin
Divestments			
Non-Theatre Food	(36,691)	(7,338)	Assumes 20% EBITDA margin
Digital Sign Media	(81,340)	0	Not yet EBITDA profitable
Amusement Gaming Distribution	(178,209)	(14,257)	Assumes 8% EBITDA margin
Rec Room and Location-Based Enter.	(50,022)	14,000	Estimated EBITDA loss of $14 million or $2m per Rec Room
Reductions Due to Divestitures	**(346,262)**	**(7,595)**	
Base Case 2022	**1,318,884**	**222,905**	**16.9% EBITDAaL margin**

In terms of divestments, it makes sense to combine non-theatre food and Rec Room / Location Based Entertainment together, even if Cineplex reports them separately. We estimate that Cineplex was losing about $2 million annually in each of its seven stores. The total capex for the seven stores we estimate as $70 million. There are additional assets involved so we believe $86 million or 1x revenues is a reasonable estimate since the centres are newly-built.

Digital sign business has high upfront costs but long-tailed revenue streams. Even if not profitable currently, the assets and revenue stream have value. We believe 3x revenues is reasonable or $244 million. We are below sell-side estimates for this asset of $260 to $325 million.

We value the gaming distribution business at 1x revenues or 7.5x estimated EBITDAaL.

The combined estimated value of the divestments is $437 million. [see figure below]

6. THE CORE THEATRE BUSINESS

We believe management has done a very good job within its core cinema business. The company has been at the forefront of numerous film exhibition industry initiatives and innovations. It remains a global leader in the industry for its execution, as illustrated by its revenue per patron and concession per patron trends.

Cineplex (CGX)				
Divestment Valuations (Cdn $000's)	**2019 Revenues**	**2019 EBITDAaL**	**Estimated Sale Value**	
Divestments				
Non-Theatre Food	36,691	7,338		
Rec Room and Location-Based Enter.	50,022	(14,000)		Total capex for 7 Rec Rooms alone is $70 million
	86,713	**(6,662)**	86,713	1x revenues
Digital Sign Media	81,340	0	244,020	3.0x revenues; sell-side estimates $260 to $325 million
				Not yet EBITDA profitable but has long-tailed revenue stream
Amusement Gaming Distribution	178,209	14,257	106,925	1x revenues; 7.5x EBITDAaL
Totals for Divestments	**346,262**	**7,595**	**437,658**	

Cineplex already has 75% market share in Canada so it is difficult to grow by selling more seats or growing by acquisition due to potential issues with the Competition Bureau. The company has offset these limitations by this by adding premium services and increasing concession spending per customer (the introduction of alcoholic beverages, started in 2019, should assist in this trend). Over the past ten years, Cineplex has managed to grow box office revenues despite declining attendance by raising its box office revenues per patron at rates above inflation, defying headwinds from competing entertainment sources (see chart [right]). Interestingly, it has done so with minimal increases in base ticket prices, in contrast to its American peer who have raised prices more consistently. We believe Cineplex movie prices are lower in general than its U.S. peers (in contrast to most other consumer items in Canada).

6.1 MONOPOLISTIC POWERS

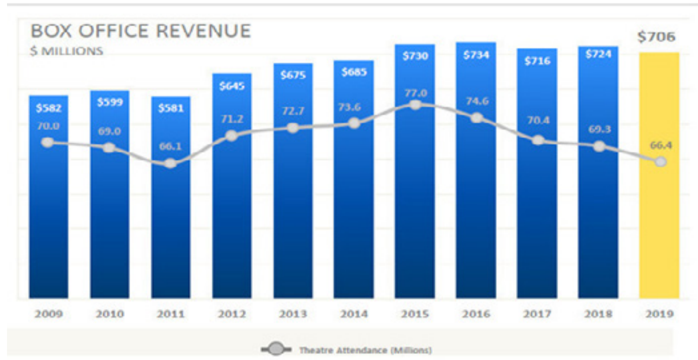
A favourite saying of ours is that 'Canada is the land that competition forgot, populated by oligopolies and monopolies.' Cineplex is a prime example. Name another country in the developed in which one company could dominate a major consumer sector (75% market share pre-pandemic). If a distributor wants to show a commercial film in Canada, it needs to talk to Cineplex. There is essentially no competition for movie theatres in major cities. Cineplex is the only option if you want to watch a first run movie. The #2 cinema chain (Landmark), mostly operates in smaller towns and cities.

The company's size and scope create a material barrier to entry and of strategic importance to film distributors, concession suppliers, and advertisers. As an example, the Network of Independent Canadian Exhibitors (NICE) alleges Cineplex keeps distributors from providing films to other theatres while they're playing at a Cineplex in that city, even if several kilometres away, for months at a time.

Cineplex also operates a near-monopoly with its national in-theater advertising network (with 94% market share). This is a very high margin business as the marginal cost of this service is close to zero.

6.2 FLATTISH BOX OFFICE REVENUES

As discussed in the Industry Overview, Cineplex has held base ticket prices relatively flat (especially compared to its US peers). Box Office Revenues have grown modestly (see chart below), largely due to the growth of premium products and services.



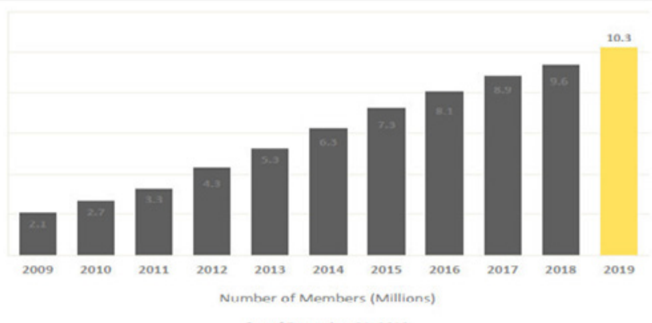
6.3 GROWTH IN THEATRE CONCESSION REVENUES

The company has done a good job in growing its concessions per patron and theatre concession revenues (the latter by a CAGR of 4.5%) over the past decade. The VIP format has also enhanced concessions per patron, as VIP guest consume twice the average rate. The introduction of alcohol (in 2019) and better quality food will continue to increase basket size and act as a tailwind for further concession growth per patron.

6.4 HIDDEN GEM: THE 'SCENE' LOYALTY PROGRAM

Cineplex has a loyalty program that puts most airlines' frequent flier programs to shame. It boasts 10.3 million members – Canada only has a population of 37.7 million, so that means 27.3% of every man, woman and child in Canada is a SCENE member. Cineplex claims that over 45% of all Canadian households have at least one SCENE member. The SCENE program has been active for more than a decade and has a very robust database that allowed the company to target offers to guests and encourage concession spending.

Notwithstanding privacy concerns, we believe there is scope to monetize this loyalty program for additional revenues streams Similarly, Air Canada very successfully spun out its Aeroplan frequent flier program as a separate stock market listing (before eventually deciding to buy it back). On 18 December 2020, Cineplex announced a deal with Bank of Nova Scotia to enhance their reward programs. As part of the deal, Scotiabank will pay Cineplex $60 million before year-end. This is at least a start towards monetarizing the hidden value of this asset.



7. SURVIVING UNTIL THE PANDEMIC ENDS

Q2 and Q3 were ugly quarters for Cineplex, Q4 and Q1 will not be much better. Surging COVID-19 cases have led to many jurisdictions imposing restrictions on public gatherings and lockdowns. Cinema operators are highly vulnerable to such lockdowns, and revenues will fall towards zero for the time being. Investors are clearly concerned about Cineplex's ability to survive until the pandemic ends. The company has done a good job managing cash flow and liquidity. We believe CGX has sufficient liquidity to bridge the next two quarters before the expected return of blockbuster films in Q2 2021.

7.1 MARKET SPOOKED BY Q1 'GOING CONCERN' LANGUAGE AND IMPAIRMENTS

The Street was clearly spooked by the inclusion of 'Going Concern' language in its Q1 earnings release on June 30th. The share price dropped 19% on the day. While we have been critical of Cineplex senior management in general, we were impressed by their candour on that day. To our knowledge, Cineplex was one of the few companies to issue such a warning in Canada, although a lot more companies should have. In Q1, Cineplex reported $46.5 million in adjusted EBITDA earnings on sales of $282 million. If the cannabis sector exhibited a similar level of conservativism in their financial reporting, most cannabis companies would be required to issue 'going concern' warnings with every quarterly report. We suspect the 'going-concern' warning was inspired by its legal counsel in order to mitigate potential personal liability for its Directors, senior management and for the company itself. The company has already completed a $315 million convertible debenture financing to fulfil a requirement for debt covenant relaxations, which permitted the removal of the 'going concern' language from its Q2 earnings release.

The company also made a number of other announcements that rattled investor confidence: (i) an amendment agreement with its lenders to immediately suspend financial covenants provided at least $250 million in new capital is raised and a portion is used to pay down debt; (ii) $173 million in non-cash impairment charges related to goodwill ($88.5 million), right-of-use assets ($50.6 million) and property, equipment and leaseholds ($33.9 million) and (iii) formal repudiation of the agreement with Cineworld ($34 cash bid to take-over Cineplex). The main cause of the write-down was a change in the discount rate of its $1.2 billion in lease assets from 3.5% at year-end to 9.5% to 11.0% in Q1 (under accounting standard IFRS-16). In view of the COVID-19 crisis, this increase in risk seems sensible. Our view is that Cineworld suffered from buyer's remorse after making a poorly timed binding cash offer for Cineplex at $34 in November 2019. The deal was schedule to close in Q2. Cineplex has commenced legal proceedings against Cineworld with the trial scheduled for September 2021.

7.2 CASH BURN AT $15 TO $20 MILLION / MONTH

Management has guided for cash burn to be in a range of $15 to $20 million per month. The company performed within those expectations in Q2 at $18 million and $16.6 million in Q3. We conservatively estimate that Q4, Q1 and Q2 cash burn will be below $15 million / month as the company will benefit from revised federal government rent and wage subsidy programs. For lockdown jurisdictions such as Toronto, the new federal rent subsidy program will cover 90% of rent or mortgage payments. As well, rent abatement deals with landlords will take full effect in Q4 and Q1. The wage and rent subsidies have been extended until the end of June 2021. Management has lowered capex to $50 million for the next 12 months (versus $150 million before COVID-19) although we would prefer to eliminate all capex. The dividend will stay suspended indefinitely.

7.3 RENT CONCESSIONS

Management also has reached agreements with landlords to receive rent abatements and convert some fixed payments into variable, based on revenue performance. Cineplex reduced its net cash lease outflow by $58 million in Q3 (including the sale of certain restrictive lease rights to landlords for $21 million), and expects further savings in Q4/20 and into Q1/21.

7.4 DEBT COVENANTS RELAXED

In November, Cineplex announced a revised credit agreement with lenders that suspends covenant tests until Q2 2021. At that time, bank debt must be at least 3.75x annualized adjusted EBITDA (decreasing to 3.0x through the following three quarters) and as well as a liquidity test. We do not view either test as onerous.

7.5 ONE-TIME CASH INFUSIONS

During its Q3 conference call, management announced that it expects to receive a tax rebate of $61.2 million in early 2021 as a result of tax loss carry-back for 2020 applied to its tax bill for the past three years. On December 22nd, the company announced the sale and leaseback of its corporate head office building in Toronto for gross proceeds of $57 million. The sale is expected to close in early January 2021. On December 18th, Cineplex announced enhancements to its SCENE loyalty program to includes rewards with the Bank of Nova Scotia's customer loyalty program. Under the agreement, Scotiabank will pay Cineplex $60 million on or before 31 December 2020. Approximately 50% of the HQ sale and Scotiabank deal ($85 million) will be used to permanently pay down their existing credit facilities. It total, Cineplex should receive $178 million in one-time cash infusions in Q1 of which $119 million will be available to Cineplex.

7.6 NO FURTHER CAPITAL RAISES

Cineplex - as a condition for the relaxation of the credit covenants – issued $315 million of convertible debentures in July 2020 (Lightwater funds participated in the deal). $100 million of the proceeds was used to permanently reduce its credit facility. We do not forecast any additional capital raises in 2021. The combination of wage and rent subsidies, leaseback of head office, and tax rebate should be sufficient to meet the cashflow requirements of the company without drawing down on its credit facilities or issuing equity or debt. Management projects a neutral impact from working capital on a forward basis. In total, we expect the company to receive $111 million in cash infusions in 1H 2021 more than offsetting the estimated cash burn of $90 million. We forecast Cineplex to return to positive FCF in Q3 2020.

7.7 CINEPLEX SURVIVES WITH NO PERMANENT DAMAGE DUE TO COVID-19

We do not foresee permanent impairments to cinema attendance or its business model as a result of the COVID-19 pandemic. The pandemic has had a dramatic impact on its current business but the stock market is a forward-looking entity and we do not believe the market is pricing in a full recovery.

8. TARGET PRICE

In our financial model of Cineplex, our fundamental assumptions are that:

1. Life returns to normal by the start of 2022; and

2 There is no permanent damage to Cineplex business operations; and

• The divestment of 'growth' assets occurs before start of 2022; and

1, There is no earnings or sales growth from 2019 to 2022; and

2. Trailing earnings from 2019 are the basis of our 2022 estimates.

The proceeds from the 'growth' divestments are $437.4 million. At the end of Q3, Cineplex had $460 million in debt (credit facilities due Nov. 2023). The sale of its corporate headquarters for $57 million and the SCENE deal announced with Bank of Nova Scotia to pay $60million before year-end will raise $117 million. Half of this amount will be used to permanently reduce debt, which would drop to $402 million. If Cineplex made the divestments as we propose, it would be able to pay off its credit facility entirely ($402 million debt vs $437.6 million from sale).

Under new Accounting Standard IFRS-16, all leases are shown as liabilities on the balance sheet. Previously, these items were 'off-balance sheet'. The $316 million in convertible debentures are convertible at a share price of $10.94. Even under our worst-case scenario, we believe these debentures will be converted prior to maturity. Hence, if divestments were made and the credit facilities paid down, Cineplex would be considered debt-free under pre-IFRS-16 accounting.

Based on the run-rate for the first 3 quarters, Cineplex should pay over $55 million in debt interest and fees in 2020. This compares with$36 million in 2019. We suspect the 2020 figure is inflated by fees and penalties, so we use the 2019 interest expense of $36 million as our benchmark. By paying down debt, Cineplex will save $36 million in interest expenses in 2022. Adding the impact of lower earnings due to divestments and lower interest expenses, our base case EBITDA for 2022 becomes $434.3 million.

Aside from Big Tech companies such as Google or Facebook (both of which face issues with competition authorities), it is difficult to find a consumer company in a developed country with as dominant market position as Cineplex. Monopolies are rare in public markets so they deserve to trade at premium valuations. Utilities, who often hold local monopolies, are the closest kin. In Canada, low growth utilities trade at about 12.5x forward EV/EBITDA valuations. Once Cineplex re- focuses on the core cinema business, it deserves to trade at similar valuations. In the interim, we use a 10x EV/EBITDA multiple for Cineplex as our base case.

In 2015, when Cineplex's diversification began, AMC, Regal and Cinemark all traded at 10x EV/EBITDA while Cineplex traded at 14x multiple. A return to Cineplex's asset-light pre-diversification model justifies at least a 10x multiple. We are comfortable with Cineplex trading a premium valuation to its U.S. peers given Cineplex's monopolistic positioning compared to the more competitive U.S. market.

[see chart on following page]

Our base case of 10x EV/EBITDA 2022 generates a share value of $34.25. Note that we increased the denominator of shares outstanding on the assumption that the $316.25 million face value of convertible debentures will be converted at $10.94, adding 28.908 million new shares. Note that our $34 valuation coincides with the $34 cash bid offered by Cineworld in November 2019.

We have also conducted this analysis based on using pre-IFRS-16 accounting (lowering EBITDA in numerator, eliminating leases in the denominator). The results are not materially different.

Cineplex (CGX)			
Share Price Valuation (Cdn $000's)	**EBITDA**	**EBITDA**	**EBITDA**
Base Case 2019	405,800	405,800	405,800
Impact of Divestments	(7,595)	(7,595)	(7,595)
Reduction in Debt Interest Expenses	36,063	36,063	36,063
Base Case 2022	**434,268**	**434,268**	**434,268**
Valuation Multiple	8	10	12
Implied EV	3,474,145	4,342,681	5,211,217
Cash	13,176	13,176	13,176
Total Debt	(402,000)	(402,000)	(402,000)
Lease Obligations	(1,232,056)	(1,232,056)	(1,232,056)
Value of Divestments	437,658	437,658	437,658
Implied Equity Value	**2,290,923**	**3,159,459**	**4,027,995**
Shares Outstanding (assuming convert, debs. converted)	92,240.92	92,240.92	92,240.92
Implied Share Value	**24.84**	**34.25**	**43.67**

9. PRIVATE EQUITY TAKE-OUT

Last month, Apollo Global Management Inc. **(NYSE: APO) announced an unsolicited $39 cash bid** for Great Canadian Gaming (GC-TSX), the largest casino operator in Canada. The bid price was a 59% premium to the 30 day VWAP. On December 21, the bid was increased to $45 cash. The offer demonstrates that private equity firms are interested in cash cow businesses, especially at bargain valuations.

Here are a few key points that a private equity owner of Cineplex would adhere to:

1. Cash cow should be milked, no point in trying to make it a show horse.

2. Abandon the 'Di-Worsification' strategy. Sell-off all 'growth initiatives' to focus on core cinema business 3. Return to an asset-light business model

4. Load up on debt. As a private entity, leverage could be increased substantially

5. Monetize its SCENE loyalty program. Scotiabank deal in December 2020 is a start

6. Slash the $80million SG&A expense (2019 figure)

7. Pursue litigation against Cineworld

8. Re-list the company a few years down the road with some lipstick.

Our base case valuation of Cineplex at $34 per share is on the basis that it continues to be a publicly-listed entity. Canadian investors are notoriously leery of high financial leverage. Given its near monopoly and stable cashflows, once removed from the glare of public markets, Cineplex has the potential to dramatically increase its debt leverage. In this era of ultra low interest rates, this is a sought-after attribute. In such a scenario, a PE firm could justify a much higher valuation for Cineplex than $34 per share.

10. CATALYSTS

There are a number of catalysts in the next twelve months:

- Easing of restrictions on large gatherings
- Positive news on a number of vaccine trial results will increased the likelihood of theatres re-opening
- Film studios announcing releases of first-run movies
- Pent Up Movie Demand; Asian demand has already rebounded
- 2021 film slate: double the usual number of releases
- End of Tax-Loss Selling in late December
- Cineworld trial starts in September
- Potential divestment of 'growth' initiatives
- Management ready to hang up 'for sale' sign again; CEO at the helm since 2003.

One potential catalyst that we do not expect to see is positive sentiment from Analysts, both sell-side and buy-side. Most of the same Analysts who were leading the cheers for management and its diversification strategy when the stock was north of $50 per share are still covering the name. Once burned, twice shy. With the stock at $9, Analysts do not appear to be willing to stick their necks out in support of this former stock market darling.

11. RISKS

We outline a number of potential risks to our thesis and Cineplex:

- Extended second wave or Third wave of COVID-19
- Additional restrictions on large-scale gatherings such as cinemas
- Failing Debt Covenant tests in Q1 and Q2
- Shorter release windows from studios
- Bankruptcy

FINALIST
Small Caps

Jeffrey Meyers
Portfolio Manager at Cobia Capital Management

CURRENT RANKING: **#5 All-Time**
BADGES: 261 310

Brightcove Inc Com

Asset: **Equity**
Symbol: **BCOV:US**
Idea Posted: **12/9/2020**
Idea Updated: **12/12/2020**

RETURN TO DATE: 5.5%

EXPECTED RETURN: 82.79%

LONG

TIMEFRAME	SITUATION	MARKET CAP
2-5 Years	Value	415.0M USD

> Brightcove is an underfollowed SaaS company with a new management team poised to accelerate revenue growth and significantly expand margins.

About Jeffrey Meyers

Jeffrey Meyers has 24 years of experience investing long and short in the small-cap technology space. Cobia has returned a cumulative net of 312% since inception versus 138% for the Russell 2000 Index and 62% for the HFRI Equity Hedge Index.

About Cobia Capital Management

Cobia Capital is a value-oriented long / short equity fund focused on the small cap technology sector. The fund has returned a cumulative 312% net since inception in January 2008 versus 138% for the Russell 2000 Index, and 62% for the HFRI Equity Hedge Index. These returns have been achieved with low net and gross exposures and limited correlation to U.S. equity indices.

Brightcove Inc Com

Asset Class: **Equity** Symbol: **BCOV:US** Updated: **12/12/2020** Submitted: **12/9/2020**

Pricing & Return Details	LONG
EXPECTED RETURN	82.79%
TARGET PRICE	33.25 USD
INITIAL PRICE	17.24 USD

BY:
Jeffrey Meyers

CURRENTLY AT:
Cobia Capital Management

CURRENT RANKING: **#5 All-Time**

BADGES: 261 310

> Brightcove is an underfollowed SaaS company with a new management team poised to accelerate revenue growth and significantly expand margins.

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Value	5% - 10%	M&A/Buyout Target	2-5 Years

INVESTMENT THESIS

Brightcove (BCOV) is a Software as a Service (SaaS) business trading well below traditional SaaS multiples. The company, which supplies video hosting and analytics services to its customers, is a turnaround situation with strong new management team and strategy. With a $750 million market cap and $30 million in net cash, its stock trades at an enterprise value to revenue ratio of 3.5x, well below the 6x to 10x of SaaS peers growing at mid-teens revenue growth rates with similar gross margins. I believe the discount arises from the perception that Brightcove is not truly a SaaS business with recurring revenue from its customers over a long period of time. It has historically served smaller businesses which can be transitory based on their own success. The company's dollar based net retention rate, a metric that is scrutinized in SaaS companies, dipped to 80% in the June quarter as many of the company's small customers failed due to Covid-19 issues. In addition to the troubles at its smaller customers, one of Brightcove's large media customers also failed in the June quarter, adding to the pressure on this metric. I believe that Brightcove's 2nd quarter retention issues were temporary, and not indicative of the company's underlying business. Retention was an issue that plagued many technology companies that catered to the small and medium sized business (SMB) base. The company's 3rd quarter metric showed much improvement which should solidify next year with renewed focus on retention.

Brightcove sells to two customer segments, media and enterprise. Media companies use Brightcove to broadcast their content to their subscriber bases. Enterprise customers use Brightcove to direct video content to either their own employees or their customers, or both. During Covid-19 with in-person events and conferences shut down, many companies decided to do virtual conferences, with Brightcove hosting the video content. An example is the South by Southwest show, that usually draws more than 100,000 attendees, went virtual this year and chose to use Brightcove to host the video after a competitive bakeoff. Historically Brightcove's media customers were small and medium sized – after they grew to a certain size and technical capability, they would leave Brightcove to handle their own hosting. Brightcove is now bidding some large media companies to take up their hosting business and let those companies focus on their core strength, which is creating content. If a large player like a Hulu, Disney+, or HBO Max decided to go with Brightcove, this would be a watershed moment for the company and, in my opinion, would immediately create multiple expansion for the stock. Brightcove's enterprise customers tend to be larger and stickier than the media customers, and their proportion within the business has been increasing over time. These enterprise customers include companies such as Ford, Adobe, and Johnson & Johnson.

CEO Jeff Ray was hired 3 years ago with a mandate to turn around Brightcove's business, and he implemented many changes to the business model so far. On the product side, Brightcove was an unfocused video platform when Jeff arrived and since then he has productized various aspects of the platform to simplify presentation to the customer and to allow for upsell to the existing base. New products include Brightcove Beacon, Brightcove Engage, and Brightcove Campaign, and all have been well received by customers and prospects. Jeff turned over about 40% of the salesforce and put in place a new head of sales who revamped the go to market approach of the company. He started a channel development team to build an indirect channel to expand the company's reach in the market. He is enacting a strategy to reduce churn with both media and enterprise customers. This broad turnaround have been brewing under the surface for the past three years and is finally beginning to show up in the numbers. The company beat revenue and earnings estimates the past two quarters and is poised to show accelerating revenue growth in 2021 and beyond. In the September quarter, Brightcove disclosed a dollar based net retention rate of 101%, which while perhaps being slightly inflated by a rash of upsells in the quarter, was much better than the 80% number in the 2nd quarter. The company thinks that the true impact of their plan to reduce churn will be seen in mid-2021 and beyond.

The video hosting business is a competitive one, with the most visible competitor now being Vimeo, a subsidiary of IAC/InterActiveCorp. Vimeo has been growing at a rapid pace and IAC is considering spinning it off now into the public markets. On the surface, it appears that Vimeo is taking share from Brightcove as it is currently growing faster. The truth is that Vimeo and Brightcove play in different segments of the market. This is demonstrated by the average annual subscription prices of each company. Vimeo's is in the $200 range, while Brightcove's is $89,000. Obviously Brightcove is addressing much larger customers with a broader product set than Vimeo. Also, in cases where Brightcove and Vimeo have gone head-to-head, Brightcove has won most of that business. A good example of this is the South by Southwest conference I mentioned earlier, where Brightcove won because its platform is much more robust than Vimeo's. I believe that a Vimeo spinoff would be good for Brightcove's stock as Vimeo would likely trade above 10x sales and this would make Brightcove's 3.5x multiple appear extremely appealing.

I believe that Brightcove will rerate in 2021 with an accelerating revenue growth profile and operating leverage leading to sharply higher margins. I believe revenue can accelerate to 15% in 2021 versus 5.5% in 2020, and EBITDA margins can rise to 12% from 9.5% in 2020. While the stock currently trades at 3.5x sales, I believe a more appropriate multiple to be 6x sales, which is on the low end of a SaaS peer group with similar revenue growth and gross margin profiles. This would imply a $33.25 stock price, or about 90% upside from current levels. If Vimeo were to go public and command a 10x revenue multiple, a similar multiple on Brightcove would imply a $55 stock price, or 210% upside from current levels. I believe catalysts for Brightcove include continuing fundamental progress in its earnings reports and the possibility that a large media player will decide to use Brightcove for its video hosting.

Risk factors for an investment in Brightcove include renewed lockdowns due to Covid, as many of Brightcove's customers are still SMBs. It is also a competitive market so Brightcove needs to keep executing on the sales side. Brightcove has benefitted from the pandemic as many events have gone virtual causing their sponsors to need its services. If the world goes back to in-person events with no video, that could hurt the company. Brightcove believes, and I agree, that future events are likely to be hybrids of in-person plus video, as companies have seen how they can reach many more people virtually. As such, there will still be a robust need for Brightcove's products.

MID CAPS

Ideas on companies whose respective market capitalizations were between US$2B and US$10B at the time of submission.

WINNER
Mid Caps

Chris Colvin
Portfolio Manager at Breach Inlet Capital Management

CURRENT RANKING: **#14 LTM**

BADGES: 12 29

Rent a Center Inc

RETURN TO DATE: 19.32%

Asset: **Equity**
Symbol: **RCII:US**
Idea Posted: **12/22/2020**
Idea Updated: **12/25/2020**

EXPECTED RETURN: 77.36%

LONG

ATTACHMENTS	TIMEFRAME	SITUATION	MARKET CAP
	2-5 Years	Growth At Reasonable Price	1.7B USD

> Recent Acquisition Transforms RCII into a High-Growth, FinTech Platform Yet Valued as No-Growth, Brick-and-Mortar Retailer

About Chris Colvin

Chris Colvin, CFA, is the Founder of Breach Inlet Capital. Prior to Breach Inlet, he was the Portfolio Manager at Freeman Group (a family office), where he launched and managed a concentrated public markets portfolio. He also led diligence and was a board member for private equity investments. Before Freeman, he was a Senior Analyst at Highland Capital Management, where he managed a portfolio of distressed credits and a long/short equity fund. He began his career as an investment banking analyst at Stephens, where he also helped evaluate private equity investments. He graduated from Wake Forest University with a BS in Business.

About Breach Inlet Capital Management

Breach Inlet Capital is a long/short manager utilizing an extensive research process to uncover mispriced small cap equities. We manage a concentrated portfolio of high-conviction investments, apply a patient perspective to capitalize on volatile public markets, and add value as engaged shareholders.

Rent a Center Inc

Asset Class: **Equity** Symbol: **RCII:US** Updated: **12/25/2020** Submitted: **12/22/2020**

Pricing & Return Details	LONG
EXPECTED RETURN	77.36%
TARGET PRICE	84.00 USD
INITIAL PRICE	39.69 USD

BY:
Chris Colvin

CURRENTLY AT:
Breach Inlet Capital Management

BADGES:
12 29

> Recent Acquisition Transforms RCII into a High-Growth, FinTech Platform Yet Valued as No-Growth, Brick-and-Mortar Retailer

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Growth At Reasonable Price	10%+	M&A/Buyout Target	2-5 Years

INVESTMENT THESIS

SUMMARY

We believe Rent-A-Center's ("RCII") transformative evolution remains under-appreciated. In January 2018, RCII brought back Mitch Fadel to be CEO. He swiftly took actions to improve the profitably of its stores that caused EBITDA to ~quadrupled from 2017 to 2020 (midpoint of guidance). With the recently announced acquisition of Acima, he has transformed RCII into a high-growth FinTech platform. As a result, we estimate RCII's cash EPS will double from ~$3 today to $6 in 2022. If accurate, RCII trades for less than 7x 2022 cash EPS. Based on the company's growth trajectory, we would argue the company is worth north of 20x earnings. But even using a more conservative 14x, we arrive at a price target of $84 and 100%+ upside (see Valuation section below).

BUSINESS DESCRIPTION

RCII provides credit-constrained consumers access to brand-name household goods through flexible lease agreements. The benefit of these transactions is that customers own the product after a prescribed number of cash rental payments, hence it is called "rent-to-own" ("RTO").

In the traditional RTO model, customers visit RTO stores to lease product. This business has many compelling dynamics. Since customers can return the product with no further obligation, RTO transactions are not considered loans and therefore not subject to usury laws. Therefore, RTO companies can earn attractive unit economics and high profit margins.

Also, customers' weekly rental payments equate to a recurring revenue stream. Third, the RTO industry is recession-resilient because it attracts incremental consumers as credit tightens in economic downturns. Finally, the traditional RTO market is effectively a duopoly between RCII and Aaron's ("AAN"). They have consistently dominated market share through reputable brands and extensive store networks.

Over the past decade, traditional RTO companies have expanded their presence at retailers' stores through a point-of-sale ("POS") solution known as virtual RTO ("VRTO"). A VRTO transaction occurs as follows: 1) customer enters a retail store (such as Ashley's Furniture), 2) customer wants to buy a $2k couch but his/her credit score is too low to use a credit card or store's financing option, 3) customer applies for an VRTO agreement through his/her mobile phone, 4) customer approved in seconds & VRTO company purchases the couch on the customer's behalf, 5) customer leaves with the couch & then makes VRTO payments over the next 12 months until customer owns the couch. VRTO is a win/win for the customer/retailer by enabling more purchases/sales. VRTO also shares the same attractive dynamics as traditional RTO, but is capital-light (no stores) and higher-growth (untapped potential).

With more and more products being purchased online, e-commerce will drive the future of the RTO industry. Traditional RTO providers lease through their own websites, while VRTO companies lease through their retail partners' websites. With that overview, let's turn to RCII's transformative evolution and how the company will accelerate growth through its FinTech platform.

2013-2017: SEVERLY IMPACTED BY MANAGEMENT MISTEPS

In January 2014, Robert Davis replaced RCII's co-founder Mark Speese as CEO. Davis, who had served as RCII's CFO since 1999, was chosen over Mitch Fadel, who had served as President since 2000. Due to a lax credit environment and lack of innovation from Speese as the long-time CEO, RCII's growth had stalled beginning in 2007 and then EBITDA declined 15% to ~$335mm in 2013.

Davis hoped to reignite growth with critical changes. Unfortunately, ideas that seemed compelling in a spreadsheet did not translate in the real world for the former CFO. The key self-inflicted mistakes included 1) a disastrous implementation of a new POS system coupled with 2) a labor initiative of replacing tenured staff with part-time employees. Traditional RTO is a relationship-driven business with customers paying weekly and often requiring extensions from store managers, so the two missteps occurring simultaneously compounded RCII's troubles. By 2017, EBITDA had fallen ~75% to ~$80mm and net leverage exceeded 7.5x. As a result, shareholders had lost patience with Davis' strategy.

2018-2020: MITCH FADEL RETURNS AS CEO

In late 2017 and early 2018, a reputable activist shareholder replaced several directors. In turn, Fadel was named CEO and RCII launched a sales process. By July 2018, RCII had agreed to sell itself for $15 per share to Vintage Capital, a private equity owner of the largest private RTO company. But in December 2018, RCII canceled the merger when Vintage forgot to provide "formal notice" to extend the merger closing (which had been delayed due to an extended FTC review). From the perspective of RCII's Board, $15 per share vastly undervalued RCII (by December 2018) given its dramatically improving results.

In 2018 and 2019, Fadel made key changes including: 1) cutting excess costs, 2) rehiring tenured employees with customer relationships, 3) introducing an elastic/inelastic pricing strategy, 4) upgrading the product mix, and 5) extending the "same as cash" price from three months to six. This last change was crucial. Customers can own product by: 1) making all rental payments (typically over 12-months) or 2) paying the "same as cash" price. By extending the latter to six months, this caused RCII's average customer to make payments for longer knowing he/she still had the "same as cash" option.

Due to Fadel's initiatives, RCII's EBITDA quickly rebounded from ~$80mm in 2017 to ~$255mm by 2019. Over this brief period, net leverage also fell from above 7.5x to below 1.0x. Entering 2020, RCII guided to EBITDA of $255-$285mm. Instead of being hurt by COVID, Fadel and his team capitalized on: 1) greater demand for home goods, 2) less credit availability for subprime consumers, and 3) struggling competitors with weaker balance sheets. By 3Q20, RCII had raised 2020 EBITDA guidance to $308-$323mm. If achieved, RCII will have ~quadrupled EBITDA since Fadel rejoined only three years ago.

2021+: ACCELERATING GROWTH VIA ACQUISITION OF ACIMA

From 2018-2020, Fadel had focused most of his efforts on RCII's stores. As a result, store profits rapidly rose and reached new highs. In fact, RCII reported its eleventh consecutive quarter of positive same store sales in 3Q20. Going forward, we think its stores can grow EBITDA 3-5% annually through digital penetration. In 3Q20, sales on rentacenter.com increased 70%+ y/y. Online orders rose from 11% of store sales in 1Q19 to 21% in 3Q20, representing a quick ascent yet leaving plenty of room to expand.

In 2020, RCII will receive ~80% of EBITDA from its US stores (and rentacenter.com), but only ~15% from its VRTO platform. After closing the acquisition of Acima in mid-2021, VRTO should represent 50%+ of RCII's EBITDA and will be RCII's primary future growth driver. Hence, VRTO will now be Fadel's focus.

Today, RCII offers VRTO through its business called Preferred Dynamix ("PD"), which is the fourth largest VRTO provider. PD recently unveiled Preferred Digital, which is a mobile app that pre-approves customers for up to $4k of credit for use at partnering retailers. The business will also launch Preferred Marketplace, which will be a website where consumers can directly lease items from various retailers without having to go to each retailer's website. Marketplace appears to be the first of its kind so could revolutionize and disrupt the VRTO market. Due to these initiatives and pipeline of potential new retail partners, RCII had guided to PD growing ~50% from 2020 to $1.2b in 2022.

Following the acquisition of Acima, pro forma VRTO revenue will vastly exceed RCII's prior 2022 target. More specifically, VRTO Revenue will immediately jump from ~$800mm to $2b+ making Acima + PD the second largest VRTO business. This scale coupled with Acima's national sales team should enable RCII to attract more large retailers and accelerate growth. Also, Acima brings its best-in-class underwriting & decision engine that drives industry-leading margins. For perspective, Acima has a four-year Revenue CAGR of ~90% and an 18% EBITDA margin (compared to 11% for the PD segment and RCII consolidated).

Furthermore, Acima's sophisticated mobile technology expands PD's e-commerce platform. Over the past year, online sales rose from 1% of orders to 15% for Acima. VRTO follows retail so more sales are shifting online. RCII will capitalize by combining Acima's digital presence with PD's e-comm initiatives.

Despite the clear benefits and value of the Acima acquisition, RCII paid ~7.5x 2020 EBITDA or ~10x FCF. When adjusting for the $200mm NPV from the associated tax step-up, RCII purchased Acima for only ~6.5x EBITDA or ~9x FCF. For reference, the largest competitor (Progressive Holdings or "PRG") trades for ~11.5x 2020 EBITDA and ~16.5x FCF. And in December, a SPAC called Finserv acquired a VRTO peer (Katapult) for ~25x 2020 EBITDA. Katapult just became profitable and has far less scale than Acima.

We believe RCII negotiated the attractive Acima purchase price because RCII was the only logical buyer. Our diligence indicates that national retailers have a strong preference for partnering with public VRTO companies. Outside of RCII, the only public company was PRG, which was in the middle of completing its spinoff from AAN and does not need to add scale.

Acima's other option was to IPO or sell to a SPAC, but our understanding is Acima's Founder/CEO Aaron Allred: 1) did not want to be a public CEO, 2) wanted to take some money off the table after primarily bootstrapping Acima's growth, and 3) wanted to retain some upside. RCII met all three criteria: 1) Allred will not have to be public CEO, 2) 75% of proceeds are in cash, and 3) 25% of proceeds are in equity. With the expansion of e-commerce and addition of new product verticals, RCII estimates that VRTO's total addressable market is $40-60b. Today, the entire VRTO industry only has $7b of Revenue so the untapped potential is immense. RCII should now be well-positioned to capitalize on this whitespace.

VALUATION

We forecast cash EPS of $6 per share in 2022 based on the following assumptions:

1. VRTO EBITDA grows 20% annually from $294mm pro forma 2020 to $423mm in 2022.
2. RCII Stores/Other EBITDA grows 4% annually from $246mm in 2020 to $266mm in 2022.
3. Combined 2022 EBITDA would then be $689mm.
4. We assume RCII's 2x leverage target and 6% interest rate to equal $83mm interest expense.
5. We estimate CapX/D&A to be $60mm in 2020 plus $20mm from Acima so $80mm total.
6. 24% tax rate implies $126mm of taxes.
7. Above implies $400mm of FCF or $6 per share based on 67mm shares (includes 10.8mm shares for the purchase of Acima).

PRG is only expected to grow EBITDA 7% annually for the next two years compared to our estimate of 13% annually for RCII. Yet again, PRG trades for ~11.5x 2020 EBITDA and ~16.5x 2020 cash EPS. For conservatism, we assume RCII should trade for ~10x EBITDA or ~14x cash EPS implying a fair value of $84 per share or more than 100% upside over the next two years.

LEADERSHIP

Fadel has generated a 55%+ IRR for shareholders since becoming CEO in early 2018. We think his acquisition of Acima may be his smartest move yet. He is certainly aligned with shareholders. In 2019, ~90% of his compensation was discretionary and ~80% of that was in equity. His current equity ownership is worth ~$20mm or ~20x his annual salary of $1mm.

Fadel also surrounded himself with talented execs, including Jason Hogg. Hogg was named EVP of PD in June 2020 and will continue to lead PD when combined with Acima. He has founded several consumer FinTech businesses and led similar divisions of larger companies. Hogg will soon have Acima's Allred to help accelerate growth. Allred successfully grew Acima from nil to $1.2b+ in seven years, while only needing $9mm of outside equity capital. Allred is incentivized with his stock locked up for three years.

RISKS & MITIGATING FACTORS

1. **RCII's acquisition of Acima is not approved by regulators.**
    2. Rejection seems unlikely since RCII's pro forma VRTO Revenue will still be below PRG's ~$2.5b.
    3. Even without Acima, we forecast RCII to earn $4 of cash EPS in 2022 implying RCII trades for only ~10x.
2. **RCII poorly integrates Acima leading to lower profits, distractions, and charge offs.**
    1. During Fadel's tenure as President and then since he became CEO in January 2018, he has proven to be an excellent operator and consistently exceeded expectations.
    2. Though much smaller, RCII appeared to seamlessly integrate its August 2019 acquisition of Merchant's Preferred.

3. RCII will be integrating its smaller Preferred Dynamix business (only $69mm EBITDA) into the much larger and well-performing Acima ($225mm EBITDA), which we think reduces operational complexity and risk.

3. Government support and stay at home trends may have inflated RCII and Acima's 2020 profits.

1. Acima's growth rate slowed in 2020, so does not seem inflated by COVID.

2. RCII offers third party insurance to cover payments for those unemployed (even those receiving unemployment benefits), but less than 1% of customers have utilized this implying most of its customers are not unemployed.

3. We assume 20% growth for RCII's VRTO, which is far lower than Acima's historical profit growth of 100%+ and RCII's prior guidance for Preferred Lease of 50%+.

4. The Acima acquisition increases RCII's leverage to 2.5x, which could become a burden.

1. RCII has a conservative management team, hence RCII had zero net debt before announcing the Acima acquisition.

2. Management has guided to reducing net leverage to < 2x net leverage by 2022. RCII's stores and VRTO generate significant FCF, so we believe this target is very achievable.

CONCLUSION

RCII trades for only ~8.5x pro forma 2020 cash EPS. It appears the company is viewed as a no-growth, brick-and-mortar retailer. In reality, RCII has transformed into a high-growth, FinTech platform serving a vast and underpenetrated market. It is increasingly rare to find well-managed growth companies trading for < 10x cash EPS, so we find this investment opportunity uniquely compelling.

We think RCII's transformation and valuation will become more apparent as RCII continues to execute its strategy and then closes the Acima acquisition. We then forecast RCII's share price to more than double. Given Fadel's track record, we believe our assumptions could prove conservative.

DISCLOSURES

current expectations, estimates, projections, opinions, and beliefs of BICM, as well as assumptions on which those statements are based. Words such as "believes," "expects," "endeavors," "anticipates," "intends," "plans," "estimates," "projects," "assumes," "potential," "should," and "objective," and variations of such words and similar words, also identify forward- looking statements. Such statements are forward-looking in nature and involve a number of known and unknown risks, uncertainties and other factors, including those described in this presentation, and accordingly, actual results may differ materially and no assurance can be given that the security presented will achieve the results discussed herein. Recipients are cautioned not to place undue reliance on any forward-looking statements or examples included in this presentation, and BICM assumes no obligation to update any statements as a result of new information, subsequent events or any other circumstances. Such statements speak only as of the date that they were originally made.

There are inherent limitations regarding hypothetical or estimated information. There can be no assurance that such values can be realized or that actual results will not differ materially from those presented. Actual returns to investors will be reduced by expenses such as performance fees. There is significant risk pro forma financials may never be realized if the assumptions are incorrect, incomplete or other intervening factors which are not contemplated in the pro forma assumptions.

FINALIST
Mid Caps

Rado Bradistilov
Managing Partner at Serdika Advisors

BADGES:

Vontier Corp

RETURN TO DATE: 2%

Asset: **Equity**
Symbol: **VNT:US**
Idea Posted: **12/23/2020**
Idea Updated: **12/28/2020**

EXPECTED RETURN: 101.03%

LONG

ATTACHMENTS	TIMEFRAME	SITUATION	MARKET CAP
	1-2 Years	Event / Special Situations	5.6B USD

> As a recent spin off from Fortive, VNT is a bone fide special situation which is mispriced due to investor base transition and largely misunderstood. We expect VNT to double in 12-24 months

About Rado Bradistilov

Founder and Managing Partner of Serdika Advisors. Rado has extensive experience in long/short equity special situations investing as well as investment banking.

Prior to founding Serdika, he was a Co-Founding Partner and Portfolio Manager of the London office for Visium, $8Bn AUM US multi-strategy hedge fund. Previously Rado was Portfolio Manager for Talisman Global Asset Management, £3bn family office in London. When he was living in New York, Rado worked for SAC Capital and was a Partner in a hedge fund start up Exton Capital as well as a Principal at Tiedemann.

Prior to launching his investment career 16 years ago, Rado worked in Equity Research at Goldman Sachs and then did Mergers and Acquisitions for the Financial Institutions Group at Morgan Stanley.

Rado has an MBA from Columbia Business School where he focused on Value Investing and Private Equity and a BA in Economics and International Studies from Macalester College, both with Honors.

In 2017 Rado was selected as the Winner of the inaugural Sohn Conference Stock picking Contest in London. Previously Rado served as Judge for Sumzero and Wharton Hedge Fund Club long/short equity competitions

Vontier Corp

Asset Class: **Equity** Symbol: **VNT:US** Updated: **12/28/2020** Submitted: **12/23/2020**

Pricing & Return Details	LONG
EXPECTED RETURN	101.03%
TARGET PRICE	70.00 USD
INITIAL PRICE	34.15 USD

BY:
Rado Bradistilov

CURRENTLY AT:
Serdika Advisors

BADGES:

> As a recent spin off from Fortive, VNT is a bone fide special situation which is mispriced due to investor base transition and largely misunderstood. We expect VNT to double in 12-24 months

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Event / Special Situations	10%+	M&A/Buyout Target and Spin Off	1-2 Years

INVESTMENT THESIS

THESIS: LONG VONTIER (VNT US), MARKET CAP: $5.8BN, EV OF $7.3BN

We consider Vontier to be one of the most attractive investments for 2021 as it ticks a myriad of boxes which simultaneously provide both very attractive upside optionality and margin of safety/negligible chance for permanent loss of capital, regardless of the macro environment:

1. As a recent spin off from Fortive, VNT is a bone fide special situation which is mispriced due to an ongoing investor base transition and largely misunderstood

2. VNT is a high-quality compounder with leading market shares in attractive, recession- prone niche businesses evidenced by consistent revenue growth, high ROIC, and impressive FCF generation

3. VNT is also a genuine value investment as its core business trades at a 10.2% pro forma 2022 FCF yield and at a significant discount to its peer group, and that is before taking into account its strategic stakes in highly attractive minority investments

4. In 2021 VNT is about to become a major disruptor in the hyper-growth EV space via ongoing investments which can potentially represent half of its current market value

5. Through its Vontier Business System (VBS) and an optimized balance sheet, VNT is about to engage in game-changing M&A which together with consistent operational performance should help significantly re-rate the stock

As a result, we expect VNT to double in the next 18-24 months

BUSINESS DESCRIPTION

VNT is a market leader in global mobility technologies with $2.7bn of sales as follows: 68% from North America, 18% from Emerging Markets, 10% from Europe, 4% from RoW. The overall business is recession-resistant, has a large installed base, and limited cyclicality. Historically, VNT has exhibited a 6% top line CAGR (2005-2019) and never had a down top- line year with the exception of 2009 (-6%). Revenue tends to grow at 'GDP+' rates (due to leading market positions, 20% recurring revenue, and significant exposure to EM). VNT has attractive 42-44% gross margin, 20%+ improving EBIT Margins, and 100%+ FCF conversion.

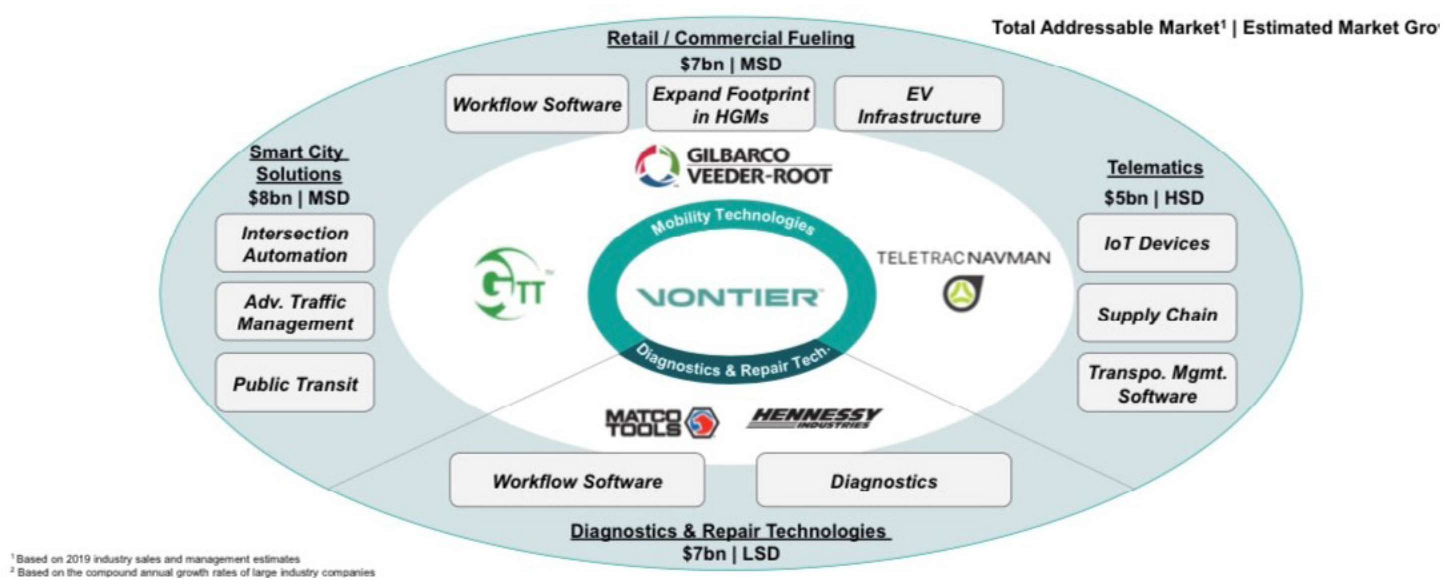
CHART 1: VONTIER'S PRODUCT MAP AND ADDRESSABLE MARKET *[see image below]*

MOBILITY TECHNOLOGIES:

Gilbarco Veeder Root ($1.9bn of 2019 sales, 69% of total revenue, 20%+ EBIT margin) is the global leader in gas station fueling equipment and services. GVR provides fuel dispensers, POS software and payment systems, cloud services, tank monitoring systems, and aftermarket services (#1 in the US with 27% market share ahead of #2 Dover with ~20%). GVR is the only global provider of full-service c-store solutions.

Through its GVR (developed markets) and Orpak (emerging markets) brands, VNT serves owners and operators of over 260,000 retail fuel stations and convenience stores globally. VNT's POS payment system has an installed base of approximately 650,000 pay-at-pump devices and 69,000 convenience stores.

This is a very sticky, oligopolistic market with high barriers to entry driven by a large installed base, environmental and payments regulation and a full-service offering with a $7bn global TAM growing at MSD (aided by 14% EM growth CAGR since 2009). The business combines hardware, sensors, software, analytics, payment and innovative mobility infrastructure solutions and increasingly benefits from recurring sales.



Here is a recent photo of the GVR product taken from our 'local' petrol station in London:

Teletrac Navman ($200m or 7% of total revenue) is a niche software-as-a-service (SaaS) telematics provider that leverages location-based (GPS) technology and services for managing mobile assets. This business benefits from structural tailwinds as fleet managers are looking to cut costs and improve efficiencies through the use of technology. This cloud-based fleet tracking software is used to track over 480,000 vehicles for more than 40,000 companies including service vehicles (60%), highway freight (30%), construction and mining (10%). The business is present globally with NA at 49%, EU 33%, and RoW 18% of sales. The division is in the midst of a turnaround led by a new management team and characterized by the introduction of its new technology platform TN360 which is quite differentiated due to real- time sensor data and AI-based analytics. Its early impact has been to lower churn, grow average revenue per unit 30%+ with 75% contract margins where over 50% of sales are to new customers. This is a high-recurring revenue business with $5bn TAM, growing at HSD, which is currently 'close to break-even' according to VNT management. The main competitor to TN is Trimble.

Global Traffic Technologies (GTT) is currently <2% of total revenue. GTT is a provider of intelligent traffic control systems primarily for emergency response and transit agencies (e.g., bus, rail) due to its best-in-class algorithms and application expertise. It has an installed base of 90,000 intersections across 3,100 customers. It benefits from structural trends such as 'smart cities' while constantly adding new verticals. The TAM is $8bn with MSD growth driven by sensor and AI traffic management while tolling and parking technologies are targeted adjacencies. Mobile payments and direct payment from the vehicle are expected to increase, and GTT technology helps manage payment complexity. GTT's growing subscription business reduces upfront investment and broadens the target customer base. GTT is highly profitable with estimated ~30% EBITA margins. GTT was the only asset that did not originate within Danaher and was purchased in 2016 by Fortive post its spin.

DIAGNOSTICS AND REPAIR TECHNOLOGIES

Matco Tools (<20% of total revenue, 2.5% CAGR 2010-2019) is a leading manufacturer and distributor of auto repair tools and diagnostic equipment and software via 1,800 franchisees across North America. It allows repair technicians to drive productivity and deal with the increasing complexity and digitalization of repairs. Matco transacts with 140,000 repair shops and 600,000 technicians. It provides financing to both franchisees and to technicians. Its premium quality, service, and lifetime warranty command brand strength and customer loyalty. Matco focuses on product innovation, digital workflow solutions, and a shift to software and service which drive continuous margin improvement. The Matco Tools App allows customers to order products directly online. Matco benefits from predictable growth and commands the highest segment EBITDA margins within the group at 30%+.

Hennessy Industries (<5% of total revenue) is a leading manufacturer of aftermarket wheel- service equipment (e.g., tire changers, wheel balancers and weights, and brake lathes). Customers are based in the US and Canada and include professional mechanics and auto technicians through the same 1,800 franchisee network as well as independent auto after-market customers such as tire dealers and big-box retailers. With the exception of Teletrac Navman, Hennessy has the lowest segment EBITA margins at <10% but also benefits from predictable growth and is synergistic to VNT's full service offering to its franchisees.

Matco and Hennessy's combined TAM is $7bn and market growth is expected to continue in the LSD. US SAAR should stage a recovery post Covid-19 which will be a tailwind to growth in 2021. Structural growth is tied to auto after-market activity (i.e., the growing age of the US auto fleet and miles driven). In addition, today's cars feature 100m lines of code and that number is expected to grow 2-3x, driving the ongoing need for diagnostics and digital workflow improvements. Franchisee growth can continue at similar pace in North America as current geographic coverage is <70%.

REASONS FOR DISCOUNT/ VARIANT PERCEPTION

VNT was just recently spun off tax-free from Fortive (FTV) in October 2020. FTV was itself spun out of Danaher in 2016. Under the FTV umbrella, the VNT business was arguably increasingly viewed as non-core evidenced by the fact that historically less than 5% of Fortive's capital was deployed in mobility infrastructure while VNT represented over 1/3 of pre-spin FTV revenue. The Danaher and Fortive corporate culture have always been of active corporate value creation so the VNT spin is consistent with the Danaher playbook. Fortive is now free to focus on its professional instrumentation segments which measure and monitor business processes and grow its related software business while VNT is unconstrained to re- invest its high FCF into its own growth opportunities. FTV still owns 19.9% of VNT shares.

As per the usual spin-off dynamics, FTV investors dumped the perceived as lower-growth and smaller VNT spinco at a when-issued price of $35. In the early weeks post the spin the share price dropped to the high $20's due to the technical dislocation and hence provided a great entry point while the shareholder base was actively churning. Currently VNT shares trade around $34, which is still below the when-issued price.

We strongly believe that at current levels VNT still provides a compelling entry as we shall discuss in the valuation section below.

Let us quickly address the elephant in the room: what was left unsaid by FTV and is perhaps the main reason for the spin is VNT's reliance on the internal combustion engine (ICE) market and investor perception that any business related to ICE is increasingly a melting ice cube. FTV investors may have been concerned that over time VNT will drag down its own premium multiple or FTV management may have decided to pre-empt such a debate.

Our own variant perception is that a 'melting ice cube' scenario as it pertains to VNT's collection of businesses is decidedly false. VNT benefits from multiple secular growth drivers such as population growth, urbanization, traffic congestion, safety regulations, clean and efficient mobility solutions, vehicle and supply chain complexity. It has multi-decade sticky relationships with fueling stations which will continue to innovate to retain customers whether they drive ICE vehicles or EVs.

There is no debate that the aggregate global car park will continue to grow and the fleet age is rising. VNT has produced a chart which indexes the density of fueling stations to population in Europe to 100 and in the US to 229, while the equivalent number is only 33 in China and 24 in India, providing a long tailwind of structural growth mainly from EM and to some extent from Europe. For example, VNT expects the station count in India to double in the next five years.

Normally, only a third of a gas station profits are derived from selling fuel, which is a lower margin business than in-store sales. VNT is embedded outside and inside the store and it helps operators transition from a 'gas station' to a 'retailer' mindset.

It is easy to see how a perfunctory look at GVR's business may discard it as undesirable as everyone sees that EV sales projections are constantly rising. However, focusing on EV sales misses the forest for the trees as the % of ICE vehicles in the aggregate car park is the key variable. EVs still represent less than 1% of the global car park and ICE vehicles are expected to still be >90% of the global car park through 2030. At this rate, this transition represents 1% annual headwind to VNT's business for the next 10 years, which is hardly a game changer.

Finally, and perhaps still unbeknownst to the market, VNT will likely play a leading role in its customers' transition from petrol fueling equipment to electric chargers. This will likely be a game changer for investor perception while specific catalysts drive a re-rating starting in 2021.

TRITIUM: HIDDEN VALUE AND A POTENTIAL GAME CHANGER

Tritium is an Australian-based technology leader and manufacturer of high-speed chargers for EVs (also known as DC chargers). The company developed its first product, a motor inverter for solar vehicle racing in 1999, accumulating decades of valuable IP long before the EV market came into existence. In 2012 Tritium provided the battery management system for the Deepsea Challenger that James Cameron took to the bottom of the Mariana Trench.

The difference between AC and DC chargers is drastic in terms of the miles range per charge as well as the timing it take to complete a charge. As EVs continue to improve their range, AC chargers become obsolete while the high value-add DC chargers become the industry standard. The smallest 50kw DC charger today delivers 80 miles of range with a 20-munute charge. The sweet spot is currently in the 150-175kw category which can deliver 150km range with a 10-minute charge, if the car is able to take that much power. Tritium currently makes 350kw professional chargers which deliver 350km range quickly and are suitable for highway rest stops and heavy-duty mining vehicles. Tritium is also developing a 1GW charger for heavy-duty trucks so it is at the forefront of next-generation technology. The chargers are sold to fleets and charging station network operators.

Tritium has a global footprint, with installations in over 30 countries, and is a leader in the European market with approximately 2,700 high-speed chargers deployed globally as of 2019; we estimate that at the moment the number of deployed Tritium chargers is likely >4,000. Tritium has been in business for twenty years and has established itself at the forefront of the market with an estimated 20% global share, second only to ABB's Terra. Tritium has 90% share in its native Australia, 50% share in Norway, 25% in the US, and 20% in the UK. While Tesla operates its own closed-loop system with 20,000 internally-produced superchargers in over 2,000 stations worldwide, Tritium DC chargers are capable of charging Tesla vehicles with a special connector.

Tritium is the exclusive provider of DC chargers for Chargepoint, the world's largest EV charging network. Interestingly, Chargepoint makes AC chargers but it does not have the technological know-how to produce its own DC charger so it gave exclusivity to Tritium. Tritium together with ABB is also the exclusive supplier of DC chargers to IONITY, the #1 charging network in Europe, a JV of BMW, Daimler, VW, and Ford. Porsche unveiled its next generation charger also engineered and produced by Tritium. Blink Charging, another publicly-traded US charging network also uses Tritium DC chargers.

Chargepoint recently went public via a $2.4bn SPAC and both Chargepoint and Blink currently have $1bn+ valuations for what seems like a very commoditized offering with no barriers to entry, unlike Tritium which has a proven technological moat. Last month Tritium unveiled its third-generation DC charging system, the RTM75, which is more compact, easier and cheaper to install and maintain than any other DC charger on the market. Tritium chargers have 'plug and charge' functionality, i.e., no need to pre-register to a network. As a point of reference, a 50kw unit sells for $30,000 while the 350kw is sold for $100,000.

How is any of this relevant to VNT? In September 2018 FTV acquired a 19.3% stake in Tritium for $49m which is now held by VNT as an equity investment and carried at cost in Other Assets on the balance sheet. It is interesting that in the VNT 82-page investor presentation concurrent with the spin off, there is no mention of Tritium. However, management disclosed that VNT has an option to buy the entire company in 2021.

We have pieced together scarcely available public information to determine that FTV probably paid ~10x 2018 Revenue for its minority stake and we know that Tritium sales more than doubled in 2019. Our 'quick and dirty' DCF assumes Tritium will grow close to 80% in 2020, 50% in 2021 and that VNT will pay 12x 2021 Revenue (unlikely to be higher than the 10x initial entry, but we are trying to be conservative) to buy the entire business, which is roughly a cash outlay of $1.5bn. If we assume sales grow at a 40% clip until 2030, then the Tritium units sold would be very roughly 50,000. By 2030, the world will have 40 million EV charging points, according to GTM research, so this number feels like a drop in the bucket and entirely achievable. We make certain assumptions on normalized margins and ROIC to get to an NPV for Tritium of $1.8bn, or $10.76 per VNT share, more than 30% of VNT's current market value, which is significant hidden value and a strategic game changer.

The partnership between GVR and Tritium is a testament to FTV/VNT management's forward thinking. It is a huge win-win as Tritium can use the GVR channel to go to market and start installing DC chargers throughout its global fueling station network. China will be by far the largest EV market in the world and the GVR/Tritium partnership is incredibly well positioned to participate in that growth given GVR's pedigree in the fueling station market.

Outside of the significant financial implications, the Tritium partnership addresses the key structural issue that may be plaguing VNT shares. As the transition from ICE vehicles to EV progresses, VNT is actually incredibly well positioned to lead the charge and be invaluable to its customers and avoid the eventual growth de-acceleration that the decline in ICE vehicle usage would have eventually brought.

DRIIVZ: MORE VALUE CAPTURE POTENTIAL FOR VNT IN THE EV ECO-SYSTEM

Driivz is an Israeli cloud-based EV charging network management software company. Driivz supports EV charging operations, energy management, and billing and maintains relationships with some of the largest networks of public EV fast charging stations in the US, currently managing tens of thousands of stations. Its aim is to become the embedded OS for EV charging stations. GVR announced a minority investment in Driivz, part of a US$11M funding round co-led by Centrica Innovations in 2020, and has an option to buy the entire company in 2022. Little is available publicly about its financials; however, we have put together a framework which values Driivz at less than $0.50 per VNT share today, which could grow to about $5 per share by 2030 and highlights how well positioned VNT is to capture value in the EV eco-system.

FINANCIALS AND VALUATION SUMMARY

VNT has a market cap of $5.8bn and an EV of $7.3bn, pro forma for $84m of cash due from its former parent that is to hit VNT's balance sheet in 4Q20.

Vontier (VNT US)	
$ mm	
Price	34.15
Shrs	168.4
Options	1.7
Adj	-1.3
FD Shrs	168.8
Mkt Cap	5763.7
Adj Cash	287.8
Debt	1800.0
Net Debt	1512.2
EV	7275.9

	2017	2018	2019	2020	2021	2022
MT		2026	2134	2067	2088	2172
yoy chg			*5.3%*	*-3.1%*	*1.0%*	*4.0%*
D&RT		640	638	609	615	634
yoy chg			*-0.3%*	*-4.5%*	*1.0%*	*3.0%*
Revenue	2498	2666	2772	2677	2703	2805
yoy chg		*6.7%*	*4.0%*	*-3.4%*	*1.0%*	*3.8%*
COGS	1425	1531	1581	1490	1505	1546
Gross Profit	1073	1135	1191	1186	1198	1260
GM	*43.0%*	*42.6%*	*43.0%*	*44.3%*	*44.3%*	*44.9%*
IM		*36.9%*	*52.8%*	*4.9%*	*45.0%*	*60.0%*
SG&A	446	499	491	474	465	466
% of Sales	*17.9%*	*18.7%*	*17.7%*	*17.7%*	*17.2%*	*16.6%*
R&D	126	136	136	129	135	140
% of Sales	*5.0%*	*5.1%*	*4.9%*	*4.8%*	*5.0%*	*5.0%*
EBITA	501	500	563	584	598	654
EBITA	*20.1%*	*18.8%*	*20.3%*	*21.8%*	*22.1%*	*23.3%*
Amort	25	31	32	32	32	32
Restr/Oth	3	3	6	0	0	0
Public Co Cost	48	47	45	45	45	45
Adj EBITA	481	487	556	571	585	641
Adj EBITA	*19.26%*	*18.27%*	*20.06%*	*21.32%*	*21.65%*	*22.84%*
Depr	41	56	53	53	54	55
D&A	66	87	85	85	86	87
% of Sales	*2.6%*	*3.3%*	*3.1%*	*3.2%*	*3.2%*	*3.1%*
Adj EBITDA	**522**	**543**	**609**	**624**	**639**	**696**
Adj EBITDA	***20.9%***	***20.4%***	***22.0%***	***23.3%***	***23.6%***	***24.8%***
EV/EBITDA				***11.7***	***11.4***	***10.5***

VNT trades at 11.4x EV/2021 EBITDA, a significant discount to DOV at 15.0x (despite superior operating metrics in the fueling station segment) and FELE (a smaller competitor to GVR) at 17.5x.

VNT also trades at 13.6x 2021 P/E vs. DOV at 20.1x and FELE at 28.6x, again a sizeable discount.

VNT also trades at similar discount to the broader industrial comps despite often better margins and FCF conversion.

In addition, based on our ROIC/WACC methodology and assuming top line growth of 3%, we estimate VNT's intrinsic value (IV) should reach $70 in 12-24 months, resulting in 100% upside. This includes the aforementioned values for Tritium and Driivz.

	2017	2018	2019	2020	2021	2022
Interst Expense			45	45	45	45
PBT			511	526	540	596
Tax Rate			*21%*	*22.0%*	*21.5%*	*21.0%*
Taxes			107	116	116	125
Adj Net Income			404	410	424	471
Adj EPS			**2.40**	**2.44**	**2.52**	**2.79**
Adj P/E			***14.2***	***14.0***	***13.6***	***12.2***
Chg in WC			10	75	-52	-9
CAPX	68	42	38	35	36	36
% of Sales	*2.7%*	*1.6%*	*1.4%*	*1.3%*	*1.4%*	*1.3%*
FCF			**461**	**535**	**421**	**512**
FCF/sh				**3.18**	**2.50**	**3.04**
FCF Yld			***8.0%***	***9.3%***	***7.3%***	***8.9%***
FCF conversion				*131%*	*99%*	*109%*
UFCF ex WC				495	509	557
EV/UFCF				***14.7***	***14.3***	***13.1***
ROIC				***33.7%***	***34.6%***	***37.9%***
r				*3.0%*	*3.0%*	*3.0%*
wacc				*8.0%*	*8.0%*	*8.0%*
Multiplier				6.1	6.3	7.0
Impl EV				9025	9296	10250
ND				1386	965	453
Tritium 19.3% Stake in 2020/100% in 2021/22				640	960	1812
Driivz NPV				70	93	125
Equity				8349	9384	11733
Intrinsic Value				**49.59**	**55.73**	**69.68**
U/(D)				***45%***	***63%***	***104%***
NPV				**49.59**	**46.45**	**48.39**
U/(D)				***45%***	***36%***	***42%***
Implied EV/EBITDA				***14.5***	***14.5***	***14.7***
Implied EV/UFCF				***18.2***	***18.3***	***18.4***
Implied P/E				***20.4***	***22.1***	***24.9***
Implied FCF Yld				***6.4%***	***4.5%***	***4.4%***

The $70 intrinsic value would imply EV/EBITDA multiple of 14.7x, consistent with the broader peer group at 15.0x, and implied P/E of 24.9x, again consistent with the peer group. It is worth pointing out that if Tritium is consolidated by then, it will have a significant positive effect on aggregate top line growth, therefore a premium to the comps may be warranted.

As mentioned earlier, Teletrac Navman is currently close to break-even and GTT, despite its high margins, is still quite small. Therefore, their contribution is non-existent in the historical FCF and vastly understated in the near-term projections. Both are growing, predictable recurring revenue businesses with margin potential higher than the group average. Their respective growth tailwinds and positive mix impact on VNT margins are still quite misunderstood. According the one sell-side analyst the NPV of Telematics and GTT is $10 and $8 per share, respectively, which is more than 50% of the current share price on a SOTP basis.

M&A AND BALANCE SHEET CAPACITY

According to management, VNT will be managed to a 3x ND/EBITDA leverage ratio and any extra cash will be invested in M&A. 2020 has been a very strong year in terms of FCF generation and based on management's recent comments, 4Q20 FCF generation will be exceptional which will de-lever the balance sheet to 2.2x at YE20, likely ahead of consensus expectations. 2021 FCF generation will be strong but cash tax spill over from 2020 and a working capital build will mean that FCF is likely lower than in 2020, yet leverage will likely go down to 1.5x by YE21. 2022 FCF will be back to normal, therefore leverage at YE22 will likely by around 0.7x, in the absence of any M&A in the meantime.

	2020	2021	2022
Actual Leverage	*2.2*	*1.5*	*0.7*
Tgt Leverage	*3.0*	*3.0*	*3.0*
Aggregate M&A Firepower	485	953	1634

Aggregate M&A Firepower	485	953	1634
M&A Multiple		***12.0***	***12.0***
Incr EBITDA		79.4	136.2
Implied Rev	15%	529	908
Synergies	10%	45.0	77.2
PF EBITDA		124.4	213.3
D&A		31.8	54.5
EBIT		47.6	81.7
Int Exp		23.8	40.8
PBT		23.8	40.8
Tax		5.1	8.6
Net Income		18.7	32.3
Accretion		4.4%	6.9%
CAPX	1.2%	6.4	10.9
FCF		**44.1**	**75.8**
FCF/Sh		**0.26**	**0.45**
Accretion		***10%***	***15%***
PF FCF/sh		**2.76**	**3.49**
PF 2022 FCF Yield		***8.1%***	***10.2%***

Re-levering the balance sheet back to 3.0x would imply $1.6bn of M&A firepower by YE22 based on our projections, slightly ahead of management's $1.5bn guidance. It is interesting that this M&A capacity will likely match the cash outlays required to buy 100% of Tritium and Driivz in 2021 and 2022, respectively.

In a theoretical case, where VNT instead engages in more traditional bolt-on M&A deals at 12x EV/EBITDA multiple on average, the likely FCF accretion will be 15% or pro-forma FCF in 2022 will reach $3.50 per share, as shown below. Therefore, buying VNT today at 10.2% 2022 FCF yield qualifies as a value investment when the broader peer group trades at more than twice its FCF multiple. To say it another way, it is easy to see how VNT stock ought to double if they continue to execute operationally according to the VBS system (adopted from the vaunted Danaher Business System), part of which is fully optimizing the balance sheet to engage in accretive M&A.

RISKS

ICE to EV transition: clearly this is the #1 strategic issue but as we have discussed at length, VNT is well prepared to benefit from the transition to EV via its Tritium/Driivz stakes

EMV related slowdown: EMV developed and managed by American Express, Discover, JCB, Mastercard, UnionPay, and Visa is a global standard for credit cards that use computer chips to authenticate chip-card transactions. Pre-EMV VNT grew top line at a 5% CAGR, while it has grown at 6% in the 2015-19 period due to regulated EMV adoption. The EMV adoption sunset means that 2021 and 2022 will be re-set years, with a $150-200m aggregate hit well flagged by management and in consensus numbers. In our model aggregate top line growth in 2021 is only 1% while DOV sees 1-2% fueling station growth in 2021, therefore VNT management and our model could turn out to be conservative. 2022/23 growth rate should normalize to a 'GDP+' historical rates + any benefit from future M&A

Teletrac churn: something to monitor although the early signs from the introduction of the new TN360 platform have been encouraging and should help Teletrac turn cash flow positive

Matco financing: the bad debt trend related to Matco extending financing to both franchisees and customers although immaterial, bears watching

Lack of segment profitability: ideally management should report segment profitability and hopefully disclosure will improve over time, although the market already has a decent idea of segment margins as we pointed out in the business description.

Overhang from FTV stake sale: the market may be concerned with any technical overhang from future FTV share sales but given FTV's own experience with spin offs, it should be sophisticated enough to handle the process well. In addition, as the upside optionality laid out here becomes better understood, placing the shares becomes easier.

CATALYSTS

We feel that management has decent visibility into the backlog for the first half of 2021. The key catalysts will revolve around M&A, in particular the exercise of the 2021 Tritium option which if it materializes as we expect, will be a game changer for the shares.

HEDGE

We believe VNT is such an idiosyncratic and underpinned situation that a hedge is not required but being short a basket of gas stations will protect against further ICE-driven de-rating while a pair of long VNT/short DOV will lock in VNT's material multiple discount

About Serdika Advisors

Serdika is a fundamental long/short equity special situations fund launched in London in December 2019. Serdika's strategy is to own equities that benefit from and sell short equities that are impaired by special situations, corporate transformation, and secular disruption catalysts, often expressed with an activist value maximization mindset.

The goal is to consistently produce robust absolute returns via long and short single-stock alpha generation and sophisticated risk management, regardless of market conditions and with negligible net exposure in the -10% to 20% range. The performance target is to generate uncorrelated annual net returns of 15-20% with no down years and with below average volatility.

Serdika also offers co-investment opportunities in companies with material corporate transformation potential or an activist angle via SPVs or bespoke advisory arrangements.

Serdika is run by Rado Bradistilov, winner of the 2017 Sohn London Conference Stock Picking Contest

FINALIST
Mid Caps

Alex Agostino
Chief Executive Officer at Kinsman Oak Capital Partners Inc.

BADGES:

Colliers International Sub Vtg Com

Asset: **Equity**
Symbol: **CIGI:CN**
Idea Posted: **12/19/2020**
Idea Updated: **12/22/2020**

RETURN TO DATE: -3.2%

EXPECTED RETURN: 26.10%

LONG

ATTACHMENTS	TIMEFRAME	SITUATION	MARKET CAP
	1-2 Years	Value	1.8B USD

> Colliers is a high-quality compounder hiding in plain sight. A long overdue multiple re-rating combined with strong organic growth, margin expansion, and M&A suggests many ways to win.

About Alex Agostino

Alex is the sole portfolio manager of the Kinsman Oak Equity Fund. Prior to founding Kinsman Oak Capital Partners, he was on the investment team at Venator Capital Management from 2013 to 2019. He focused primarily on North American long/short equity investment opportunities during that time. Alex is a CFA charterholder and received his Bachelor of Business Administration degree from Wilfrid Laurier University where he graduated with distinction.

About Kinsman Oak Capital Partners Inc.

Kinsman Oak Capital Partners Inc. is an independent Toronto-based boutique investment firm that strives to generate superior long-term results over multiple market cycles, net of fees. The firm was founded in 2020 by Alexander Agostino and its sole focus is managing the Kinsman Oak Equity Fund. Long-term outperformance is driven by adhering to a disciplined, consistent and repeatable investment process. Our investment philosophy is to buy securities at a significant discount to intrinsic value. Markets are generally efficient but, in rare circumstances, attractive investment opportunities can present themselves. Market inefficiencies are uncommon, so we relentlessly hunt for them.

Colliers International Sub Vtg Com

Asset Class: **Lorem** Symbol: **CIGI:CN** Updated: **12/22/2020** Submitted: **12/19/2020**

Pricing & Return Details	LONG
EXPECTED RETURN	26.10%
TARGET PRICE	140.00 CAD
INITIAL PRICE	114.75 CAD

BY:
Alex Agostino

CURRENTLY AT:
Kinsman Oak Capital Partners Inc.

BADGES:

> Colliers is a high-quality compounder hiding in plain sight. A long overdue multiple re-rating combined with strong organic growth, margin expansion, and M&A suggests many ways to win.

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Value	5% - 10%	N/A	1-2 Years

INVESTMENT THESIS

1. Multiple re-rating candidate. The core business has transformed its revenue composition from primarily cyclical, low-margin sources to high-margin, recurring value-added services. CIGI is a prime candidate for a multiple re-rating given close to 60% of forward EBITDA will come from recurring revenue streams.

2. Strategic investments provide runway for long-term growth. CIGI is creating a unique platform of numerous commercial real estate and related offerings. Combining adjacent and new market verticals can create revenue synergies by cross-selling services between these subsidiaries. Further, the new verticals have highly fragmented end markets where Colliers can take share and pursue tuck-in acquisitions to enhance its growth profile.

3. High insider ownership and long history of creating shareholder value. Insiders own approximately 25% of the economic interest and 54% of the voting share. Shareholder value creation has been unlocked in a variety of ways including organic growth, strategic acquisitions, and spin-offs. Jay Hennick, Chairman and CEO, has demonstrated a commitment to maximizing shareholder value for decades.

INTRODUCTION

Colliers is a deeply underappreciated high-quality compounder, in our view. The company is dual listed on the TSX and Nasdaq under the symbol CIGI. Our thesis is relatively straightforward.

In short, the business has undergone a multi-year strategic shift and has transformed itself from a low-margin, cyclical, and commoditized business into a business that generates 50% of sales, and more than 55% of EBITDA, from high margin, recurring revenue streams.

We feel this strategic shift is overlooked by investors and, as the business continues to grow its recurring revenue segments, a pending change in perception will warrant a multiple re-rating. Going forward, we estimate more than 50% sales and almost 60% of EBITDA will be recurring in nature, which suggests this tipping point may be soon.

Long-term we believe the business has significant growth opportunities ahead of it. CIGI is building out a unique platform of numerous commercial real estate related services which deepen its economic moat and provide growth opportunities in both adjacent markets and new market verticals.

COMPANY BACKGROUND

Colliers was founded by Jay Hennick, who still serves as the CEO and Chairman. Hennick owns all of the outstanding multi-voting shares and controls 43% of the total votes. He has proven to make shareholder friendly decisions in the past, such as the spin-off of FirstService Corporation (FSV) in 2015. Hennick, along with the other insiders, own an economic interest of 25% and control 54% of the total votes.

Historically, the company relied heavily on its commercial real estate **Sales & Lease Brokerage business**. Colliers was successful at building a name for itself and has grown sales from $340 million in 2000 to $3 billion in 2019 (plus an additional $2.4 billion if you count FSV).

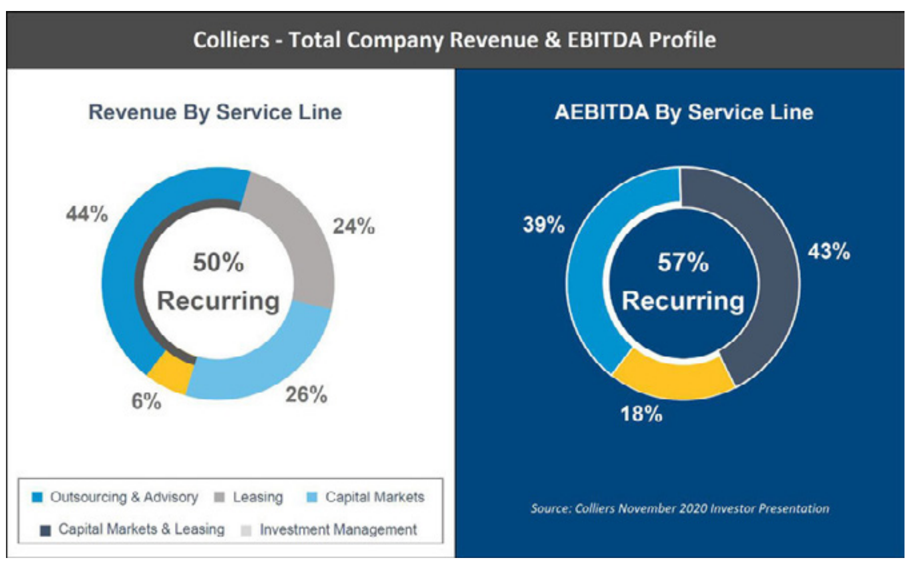
Sales & Lease Brokerage is generally a low-margin, cyclical, and commoditized business that warrants a relatively low valuation multiple. Colliers has undergone a strategic shift to focus their business on higher margin, recurring revenue streams such as **Outsourcing & Advisory** and **Investment Management**.

The street still views Colliers as the same business it used to be, and this misconception presents an opportunity for those willing to dig beneath the surface to really understand the vision Colliers has of their future.

BUSINESS SEGMENTS

Colliers primarily operates in three business segments:

1. Sales & Lease Brokerage (50% of sales) – Leasing, Capital Markets
2. Outsourcing and Advisory (44% of sales) – Project Mgmt., Valuation, Prop. Mgmt., Loan Servicing
3. Investment Management (6% of sales) – Advisory, Incentive Fees, Transaction & Other



SEGMENT #1 – SALES & LEASE BROKERAGE

This segment is what investors typically think of when they hear the name "Colliers." This segment tends to be lower margin and very cyclical. It has been hit hard from Covid-19. Colliers does not break out EBITDA by segment, but we estimate normalized margins to be ~11%.

SEGMENT #2 – OUTSOURCING AND ADVISORY

This segment is significantly underappreciated by investors, in our view. This segment posted 2.7% y/y growth in 9 months ended September 2020, despite Covid-19. We believe this speaks volumes to the recurring and non-cyclical nature of its revenue streams. Colliers does not break out EBITDA by segment, but we estimate normalized margins to be ~14%.

[see Figure A below]

SEGMENT #3 – INVESTMENT MANAGEMENT

The Investment Management segment is relatively new, and Colliers entered the space by acquiring Harrison Street in 2018. Colliers does not break out EBITDA by segment, but we estimate normalized margins to be ~36%.

[see Figure B below]

SEGMENT GROWTH RATES

The Outsourcing & Advisory Segment grew top-line sales at an annualized rate of 16% between 2015-2019. It's difficult to parse out segmented data going further back than 2014 because Colliers' reported revenues included FirstService. The Outsourcing & Advisory segment also managed to post low-single-digit growth this year amidst a global pandemic, a feat we feel reflects well on the company's management team.

[see chart on following page]

Figure A

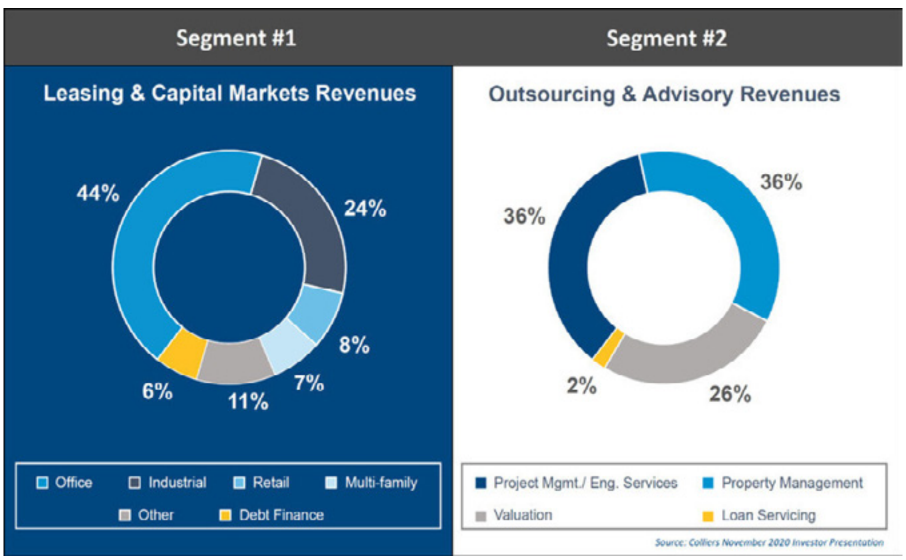
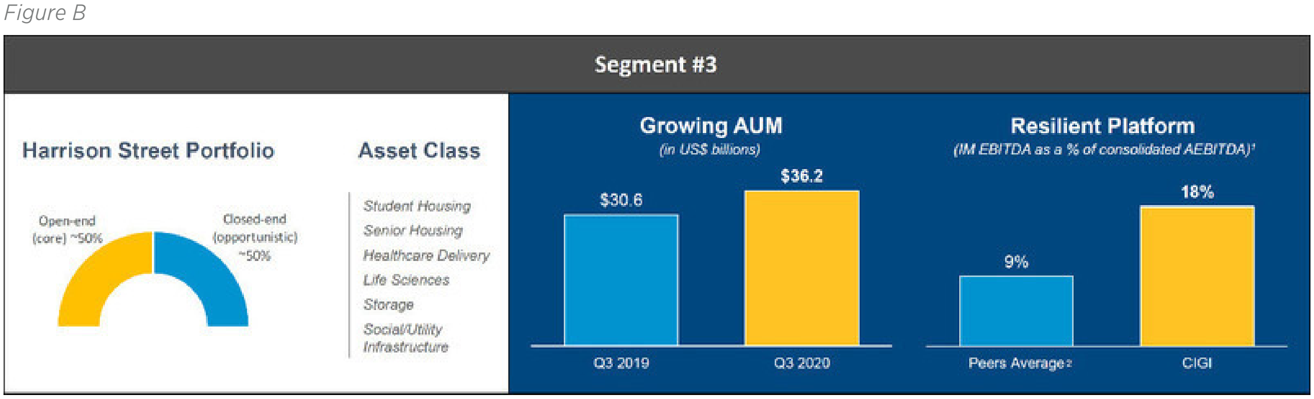


Figure B



Revenue by Segment ($)	2014	2015	2016	2017	2018	2019
Sales and Lease Brokerage	$ 1,047,155	$ 1,087,390	$ 1,178,867	$ 1,492,676	$ 1,684,831	$ 1,722,308
Outsourcing & Advisory	$ 535,116	$ 634,596	$ 717,857	$ 892,792	$ 1,021,444	$ 1,111,307
Investment Management	$ -	$ -	$ -	$ 12,647	$ 76,021	$ 174,588
Other	$ -	$ -	$ -	$ 37,085	$ 43,131	$ 37,608
Total	$ 1,582,271	$ 1,721,986	$ 1,896,724	$ 2,435,200	$ 2,825,427	$ 3,045,811

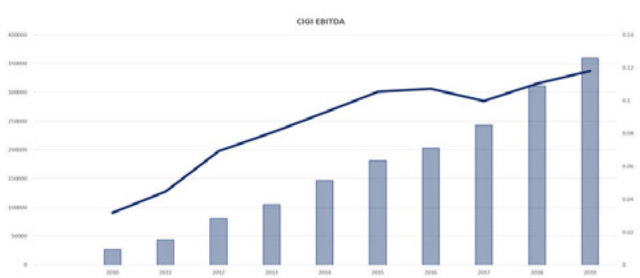
Growth	2015	2016	2017	2018	2019	9M20
Sales and Lease Brokerage	3.8%	8.4%	26.6%	12.9%	2.2%	-23.5%
Outsourcing & Advisory	18.6%	13.1%	24.4%	14.4%	8.8%	2.7%
Investment Management				501.1%	129.7%	-0.7%
Other				16.3%	-12.8%	41.0%
Total	8.8%	10.1%	28.4%	16.0%	7.8%	-11.5%

Outsourcing & Advisory and Investment Management not only possess more attractive investment characteristics from a revenue reliability, EBITDA margin, and cyclicality standpoint, but both were growing at a faster rate than Sales & Lease Brokerage before the pandemic as well. This shift in revenue composition is no accident.

Colliers increased EBITDA from $27 million in 2010 (3.2% margin) to $359 million in 2019 (11.8% margin). Increasing EBITDA dollars 13x while quadrupling EBITDA margins over the past ten years is impressive on its own, but the company also managed to grow the recurring portion from 31% in 2017 to 57% in 2020.

STRATEGIC TRANSFORMATION

CIGI's strategic shift has been underway for years and we believe the revenue and margin profile of the business is approaching a tipping point where the successful transformation will be impossible to ignore. The progress since 2010 is undeniable and analyzing the company's EBITDA margin paints a clean picture.



EBITDA margin expansion combined with the increased portion of recurring EBITDA is driven largely by the company's changing revenue sources. Sales & Lease Brokerage comprised of 66% of revenues in 2014 vs. 50% today. Outsourcing & Advisory comprised of 34% of revenues in 2014 vs. 44% today. Investment Management accounted for zero revenues in 2014 and comprises of 6% of revenues today. See below.

Revenue by Segment ($)	2014	2015	2016	2017	2018	2019	NOV Pres
Sales and Lease Brokerage	66%	63%	62%	61%	60%	57%	50%
Outsourcing & Advisory	34%	37%	38%	37%	36%	36%	44%
Investment Management	0%	0%	0%	1%	3%	6%	6%
Other	0%	0%	0%	2%	2%	1%	0%
Total	100%	100%	100%	100%	100%	100%	100%
Recurring	34%	37%	38%	37%	39%	42%	50%

Colliers is far less geared towards the underlying real estate than it used to be, especially since adding Harrison Street, Dougherty, and Maser Consulting to their platform. Most of the CRE business is now recurring as well.

This trend in revenue mix shift is still ongoing and, in our view, has a long runway ahead of it. As a larger portion of the company's revenue and EBITDA come from recurring sources, analysts will be forced to value the entire entity on a sum-of-the-parts basis and assign a more appropriate valuation multiple to each segment.

Today, most analysts assign a price target based on a company-wide EV/EBITDA multiple derived from CIGI's historical trading range which does not appropriately reflect the positive fundamental changes to the business model over the years. We believe assigning a price target today, when recurring revenues are 50% of revenues, based on the stock's previous trading range, when recurring revenues were only 34% of revenues, significantly undervalues two out of three business segments.

LONGER-TERM VISION

Colliers does not explicitly lay out their strategic vision for the next 5-10 years, so this section is mainly our interpretation from reading between the lines. The company is clearly gravitating towards higher value-added services that carry better margins, have less cyclicality, and minimal capex requirements.

It appears to us Colliers has already laid the foundation to build out a platform of related commercial real estate services that can drive meaningful revenue synergies going forward. Cross-selling is probably not the right word but offering services in adjacent markets allows them to increase revenue capture with existing clients.

Long-term, Colliers' decision to enter new market verticals goes beyond revenue synergies from complimentary service offerings. These new market verticals provide a valuable growth engine for the company going forward. We believe the management team intends to take share in highly fragmented markets and pursue tuck-ins to further enhance the growth profile of the overall business.

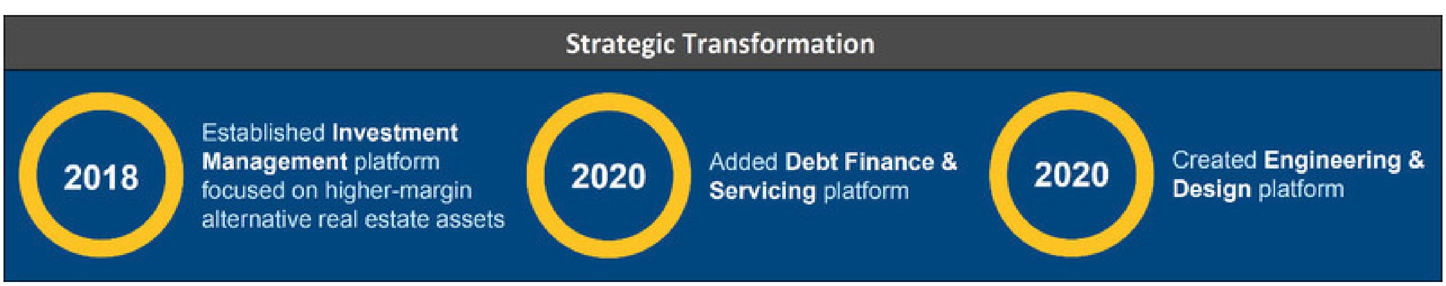
SHAREHOLDER VALUE CREATION THROUGH M&A

Colliers "big three" strategic investments over the past few years were (1) Harrison Street, (2) four subsidiaries of Dougherty Financial, and (3) Maser Consulting. These acquisitions, explored in more detail below, provide Colliers with a suite of new service offerings and give Colliers a foothold in a variety of new end markets.

[see figure below]

HARRISON STREET

Harrison Street appears to be the most transformative deal. The recurring nature of the business's revenue stream is underappreciated, in our view. Roughly 50% of AUM is in open-end evergreen funds, meaning revenue generated from these perpetual structure vehicles are truly recurring, provided there are no significant redemptions. The other 50% of AUM is derived from closed-end funds with average fund lives between 8-10 years. Harrison Street is consistently raising money for new closed-end funds to offset maturing funds.



Growing AUM is only the first step to unlocking shareholder value from this acquisition. Real estate assets managed by Harrison Street provide Colliers with an enormous pipeline to drive growth in the rest of their segments.

Colliers can offer services when any underlying assets need to be purchased, sold, or leased; needs a valuation opinion or property management services; requires a loan or debt financing; or if any assets need consulting/engineering services. Integrating these businesses and leveraging this unique platform could unlock meaningful shareholder value long-term.

DOUGHERTY FINANCIAL SUBSIDIARIES

Colliers acquired four subsidiaries from Dougherty Financial, a debt finance and loan servicing platform. The interesting part is this acquisition came with a DUS license (Delegated Underwriting & Servicing). The DUS Program grants approved lenders the ability to underwrite, close, and sell loans on multifamily and senior living properties to Fannie Mae without prior Fannie Mae review.

The opportunity for Colliers, specifically, is this license grants them the ability to provide debt for all the transactions they do in the multifamily, senior living, student housing, and affordable housing space. So, on top of getting a brokerage fee on the placement of that debt, Colliers can also earn fees to originate the debt and then additional revenue from servicing it over the following 20 years. The cross-selling opportunity is enormous on its own. The additional sticky revenue generated from servicing Fannie Mae loans for the next two decades is the real kicker.

MASER CONSULTING

Maser Consulting provides a variety of engineering and design services in real estate and infrastructure end markets. We believe the decision to enter this new market vertical gives Colliers an incredible growth opportunity that is largely neglected by investors. Beyond the obvious revenue synergies from integrating Maser into Colliers' platform, this acquisition presents an opportunity to take market share and pursue tuck-ins in highly fragmented end markets.

Colliers has already demonstrated their ability to create value by organically taking share in fragmented industries and bolstering that process with shrewd tuck-ins. The potential growth runway is long and, if Colliers can successfully run the same playbook with Maser, this segment could provide a tailwind to earnings growth for many years.

UNIQUE PLATFORM

Without getting too lost in the weeds about each individual acquisition, the main point is this. Colliers has a strategic vision for the future of their business. The management team is deepening the business's economic moat, improving growth prospects, and increasing the reliability of its cash flows as activities are diversified away from the traditional commercial real estate sales and leasing brokerage.

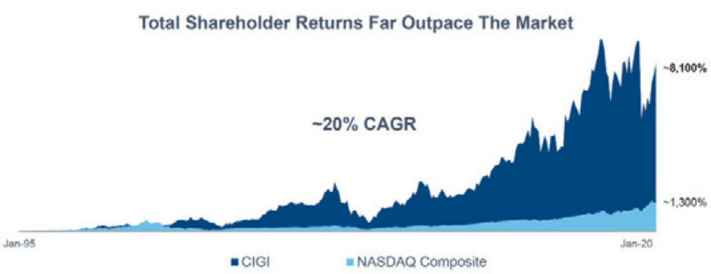
This symbiotic relationship between the base business and the above acquisition targets will improve revenue synergies short-term. But the real opportunity is longer-term in nature. Colliers is transforming its business; its future growth prospects are bright, and investors continue to underestimate the company's long-term earnings potential. The Colliers of yesteryear was transactionally focused on commercial real estate deals. Colliers is de-emphasizing that part of the business as they become closer to a one-stop-shop for anything real estate related.

COMPOUNDER WITH HIGH INSIDE OWNERSHIP

We believe the management team possesses the necessary expertise to successfully implement this long-term strategic vision. Key decision makers appear to be properly incentivized to execute effectively.

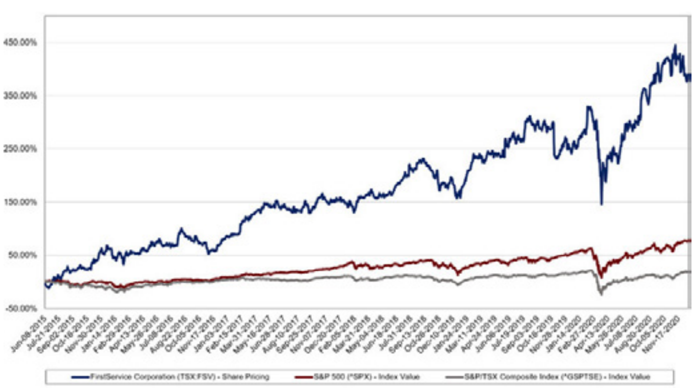
COLLIERS IS A TRADITIONAL COMPOUNDER

Any way you spin it, Colliers has been a compounder for decades, and Jay Hennick has been at the helm the entire time. Most long ideas are complimentary of existing management teams and reference anecdotal or qualitative data. But, in this case, the results speak volumes.



FIRSTSERVICE CORPORATION SPIN-OFF

Not only has Hennick demonstrated his ability to compound capital but, just as importantly, he has demonstrated a willingness to prioritize what is best for shareholders. Colliers made the decision to spin-off FirstService Corporation into a standalone entity in 2015 and appoint a separate CEO to lead the business. Below illustrates how well FirstService has performed post-spin.



INSIDE OWNERSHIP

Hennick, along with the rest of the management team and board members, have significant skin in the game. We feel this aligns their interests with those of the shareholders. Key decision makers at the firm have a vested interest in driving the share price higher. High inside ownership alone does not eliminate certain risks such as overpaying for acquisition targets, excessive use of leverage, or engaging in other value destructive behaviour.

But, when combined with other elements of our thesis and a strong corporate culture, it leads us to believe the management team is far less likely to recklessly swing for the fences to goose annual performance bonuses.

CIGI Ownership Summary	% of Common Shares	% of Total Votes
Jay Hennick	7.5%	43.3%
Spruce House	15.0%	9.2%
Employees	2.8%	1.7%
Total	**25.3%**	**54.2%**

It is worth noting Hennick owns 100% of the outstanding multiple voting shares (1,325,694 shares outstanding). Spruce House is an investment management firm with board representation through Benjamin Stein. Another large investment firm, BloombergSen, owns another 5% of the shares outstanding according to their most recent 13-F filing. This concentrated ownership situation reduces the shares available for float.

VALUATION

We believe CIGI should be valued on a SOTP basis by assigning different multiples to their (1) Sales & Lease Brokerage segment and (2) Outsourcing & Advisory and Investment Management segments.

Sales & Lease Brokerage: The closest public company comparable for this segment is Marcus and Millichap (MMI). MMI is skewed more toward investment sales, more profitable during the good times and less profitable than the bad times. We believe CIGI's Sales & Lease Brokerage segment should trade roughly in line with MMI at **10x EBITDA.**

Outsourcing & Advisory and Investment Management: Finding a clean comparable for this segment is more difficult. Instead, we gauge its worth by its underlying investment characteristics. These segments grow organically at mid-to-high single digits plus tuck-ins, have recurring revenue during recessions, strong EBITDA margins, and generate a ton of FCF due to minimal capex requirements. We believe, given today's ultra-low-rate environment and pricey stock market, this segment should trade for at least 16x **EBITDA.**

ESTIMATES

Below are our forward estimates for Colliers.

KEY ASSUMPTIONS

We estimate the Sales & Lease Brokerage segment will fully recover by 2023. This assumption may prove to be overly conservative but, given there is so little available information about the trajectory of the recovery, we prefer to model conservatively and be surprised to the upside.

We anticipate the Outsourcing & Advisory / IM segments will rebound quickly next year, and that momentum should carry forward for the next two years with a combination of organic growth and tuck-in acquisitions.

Our margin assumption for the Sales & Lease Brokerage business is 11% and a blended 15% margin for the Outsourcing & Advisory and Investment Management segments. We feel this assumption is realistic and we are not pricing in overly aggressive margin expansion in the coming years.

It is worth noting that our estimates are fairly in line with sell-side expectations. We believe there is a degree of conservatism in these forward numbers and any surprises are more likely to be to the upside than the downside.

PRICE TARGET

Below is our sum-of-the-parts analysis for approximating a fair value for CIGI shares in CAD. We believe upside is substantial given the low prospective return investment landscape. Further, it's not often that high-quality compounders have more than 20% upside in one year and almost 40% upside over a two year holding period.

SOTP	One-Year	Two-Year
Sales & Lease Brokerage @ 10x fwd EBITDA	1,844	1,954
Outsourcing & Advisory / IM @ 16x fwd EBITDA	4,170	4,503
Enterprise Value	6,014	6,458
Covert to CAD	7,818	8,395
Current EV in CAD	6,721	6,721
Delta	1,096	1,674
Market Cap	4,575	4,575
Current Share Price	$114	$114
% Upside	24.0%	36.6%
Share Price CAD	$143	$158

CATALYSTS

1. **Multiple re-rating.** We believe the primary catalyst for CIGI will be a change in investor / sell-side perception of the business. Again, the "Colliers" brand is still perceived to be a low-margin, cyclical sales & leasing business. When recurring revenue contributes more than 50% of revenue and almost 60% of EBITDA, this misconception becomes practically impossible to ignore.

Forward Estimates	2020	2021	2022	2023
Sales & Lease Brokerage	1,464	1,566	1,676	1,777
Outsourcing & Advisory / IM	1,337	1,551	1,737	1,876
Total Revenue	**2,801**	**3,118**	**3,414**	**3,653**
Sales & Lease Brokerage @ 11%	117	172	184	195
Outsourcing & Advisory / IM @ 15%	201	233	261	281
Total EBITDA	**324**	**405**	**445**	**477**
Company-Wide Margin	*11.6%*	*13.0%*	*13.0%*	*13.1%*

2. Continued earnings growth and M&A.
Continued organic earnings growth and additional value creation from M&A activity. Colliers has been busy in the M&A market and tends to make shrewd deals, in our opinion. We believe the company is more likely to make tuck-in acquisitions to bolster top-line revenue growth, rather than large transformative acquisitions.

3. Recovery in Sales & Lease Brokerage segment.
Additional potential upside from a faster than expected recovery in the Sales & Lease Brokerage segment. We have no view of where commercial real estate prices are going in the short-to-medium term. That said, Colliers is less geared towards the underlying asset value. Sales and leasing volume – not price – is the critical factor. The company gets paid when activity occurs, regardless of transaction price. Even if commercial real estate value declines, we believe the volumes will eventually return.

"The Colliers Way"

Internal Growth
- Decentralized operations
- Multiple growth engines
- Scale for investments in talent & technology

Acquisitions
- Target, acquire, integrate
- More than $2.0B invested
- Historical record of 15%+ ROIC

RISKS

- Continued weakness in the Sales & Leasing Brokerage segment. A second wave of the virus could potentially result in a continued impact on transaction volumes throughout 2021.

- **Execution risk.** There is always execution risk any time a business is undergoing a strategic transformation. That said, we feel the management team has done a fantastic job so far which bodes well for the future.

- **Potential value trap.** A key tenet of our thesis is a pending multiple re-rating. There is no guarantee the investment community will share the same opinion on the quality of the Outsourcing & Advisory or Investment Management segments. In that instance, a multiple re-rating would be unlikely.

- **Slowing growth in Outsourcing & Advisory and Investment** Management segments. Should these segments stop growing, due to company-specific or market related factors, the valuation multiple applied to the whole business could contract.

- **Low float can result in choppy trading patterns.** We estimate a significant percentage of common shares outstanding are closely held and do not frequently trade. This can cause volatility uncorrelated to the market.

LARGE/MEGA CAPS

Ideas on companies whose respective market capitalizations were US$10B or greater at the time of submission.

WINNER
Large/Mega Caps

Aubrey Brocklebank
Analyst at Mayar Capital Management

BADGES:

Electronic Arts Inc

RETURN TO DATE: 1.3%

Asset: **Equity**
Symbol: **EA:US**
Idea Posted: **12/22/2020**
Idea Updated:**1/8/2021**

EXPECTED RETURN: 63.72%

LONG

ATTACHMENTS	TIMEFRAME	SITUATION	MARKET CAP
	2-5 Years	Growth At Reasonable Price	36.0B USD

> EA is high-quality & trading at a reasonable valuation. Growth prospects are excellent and will benefit from the console replacement cycle which provides an earnings catalyst over next 2yrs.

About Aubrey Brocklebank

Aubrey is the Senior Analyst and a Director at Mayar Capital where he joined in 2015 from Odey Asset Management, where he had worked for two years as an Analyst with coverage of Software and Chemicals on a global basis. Aubrey began his investing career at Rathbones in 2007 and has a first in Law and a masters in Competition Law from UCL.

About Mayar Capital Management

Mayar Capital was established to provide investment advisory and asset management services to institutions, family offices, and high net-worth individuals globally. Mayar Capital manages a single long-only Responsible Global Equity single. Investors can access the strategy through the flagship Mayar Fund, which was launched in May 2011. Mayar Capital have also offered the strategy in Separately Managed Accounts since 2013. Mayar Capital underlined the commitment to responsible investing by becoming a signatory of the UN-backed Principles for Responsible Investing in 2019.

Electronic Arts Inc

Asset Class: **Equity** Symbol: **EA:US** Updated: **1/8/2021** Submitted: **1/8/2021**

Pricing & Return Details	LONG
EXPECTED RETURN	63.72%
TARGET PRICE	231.20 USD
INITIAL PRICE	139.43 USD

BY:
Aubrey Brocklebank

CURRENTLY AT:
Mayar Capital Management

BADGES:

> EA is high-quality & trading at a reasonable valuation. Growth prospects are excellent and will benefit from the console replacement cycle which provides an earnings catalyst over next 2yrs.

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Growth At Reasonable Price	2% - 5%	Regulatory Change	2-5 Years

INVESTMENT THESIS

BUSINESS QUALITY

- Exceptionally High Quality Business; only form of entertainment to improve over time
- Scale Advantage as games become bigger and more complex
- Data collection will give them an unassailable AI advantage, especially in sports
- Multiplayer games have Network Effect and switching costs (in terms of time spent)
- Excellent customer economics - Cheapest form of entertainment by the hour

COMPANY QUALITY & ROBUSTNESS

- No accounting manipulation red flags raised
- High Returns on Capital, and Excellent Cash Conversion
- However - highly operationally leveraged (double edged sword)
- Micro Transactions and Lootboxes pose the greatest risk to this investment

MID TO LONG TERM GROWTH OUTLOOK

- Console cycle and release of PS5 and new XBOX

- Big 'real world' events - NFL e-sports & World Cup 2022 E-Sport Optionality

- Under-monetized, cheapest entertainment per hour
    - Many ways for this to be increased (such as advertising (see Burger King)

- Transition to Digital is Margin Enhancing
    - Even though 80% is already digital (though less by volumes), that is still an gross margin increase of 5pts from 75%to 80%

- Inclusion of Female teams in FIFA, and increase in girls football (soccer) can double TAM

VALUATION

- Undemanding Multiples
    - 17x EBIT (2022)
    - 5% FCF is undemanding

- DCF offers over 50% upside (and over 100% in my bull case) A positive upgrade cycle can easily see this be revised upward Similar valuation to peers, but benefits from...
    - Female adoption
    - Equity Bond like returns for FIFA and Madden

RISKS

- A potential blockbuster could flop
    - Games have become established franchises Sports have prove bond like returns

- Competitive threat from Mobile Gaming
    - Not really the same product, an opportunity more than anything

- Regulatory risk re: Lootboxes
    - Many jurisdictions are against regulations
    - Laws in the USA have been proposed to protect computer games

WHAT IS EA

Electronic Arts produce computer games for PC and Console, and to a limited extent Mobile.

For many years (much to my chagrin not) I dismissed computer games as an industry as I believed that they were a blockbuster/hit driven business that was inherently unpredictable.

However, many of EA's games are in fact franchises that are decades old.

FIFA began in 1993; and possibly generates around 40% of EAs revenue. Every year they bring out a new version with all the latest football stars licenced. And every year (almost) is more successful than the last.

Battlefront is a Star Wars game which was launched in 2004, and has been successful since then.

The Sims and SimCity began in 1989 and has sold over 200 million games since then.

And Madden Football (the American variety) is where it all began in 1988, and has sold over 250 million copies since then.

One of the successful elements that, founder, Trip Hawkins discovered was that by licencing the brands of real teams and players he had a game that sold better, and also had great repeat sales. As new players join in real life, they create a need for an update in the game.

CONTINUOUS IMPROVEMENT IN TECHNOLOGY

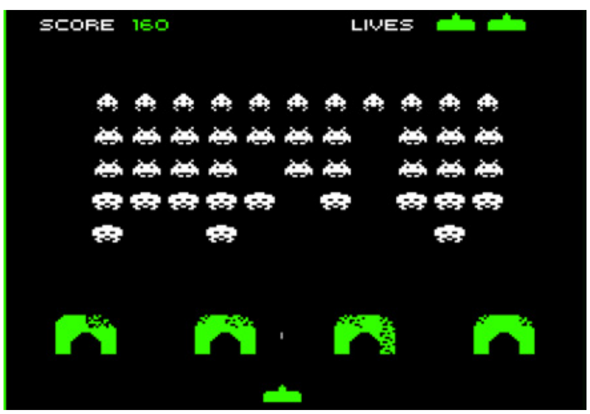
Computer games are a unique form of entertainment as they are probably the only form that genuinely improves over time.

If you are a movie studio and you are producing a gangster/mobster movie you have to compete with this:

It is hard to believe that this movie is almost 50 years old. Yet (other than part 2) there has not been a better movie made on the subject. And the Irishman does not come close!

Yet computer games will almost certainly be better (with the exception of GoldenEye and MarioKart for the N64 which will always be the two best games ever made).

In the same year that the Godfather was made this seminal computer game was released:



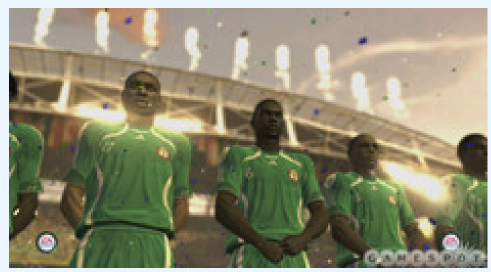
And if we want to look at FIFA through the ages we can see just how dramatic this improvement has been.

These improvements are not just limited to the graphics, but also to the gameplay, the sounds, and not to mention the ability to play massive multiplayer games with millions of people across the globe.

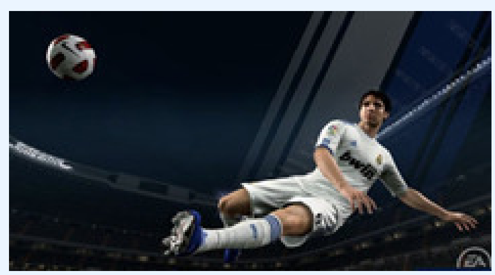
FIFA 94

FIFA 2000

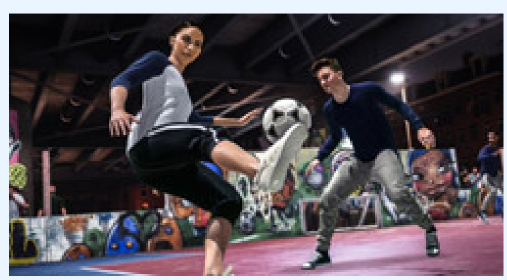
FIFA 2006



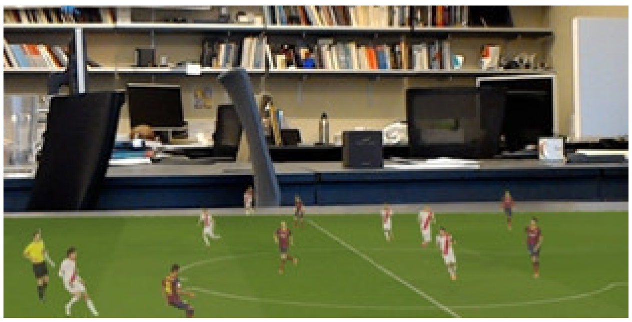
FIFA 2011



FIFA 20



Virtual and augmented reality are likely to play a part in future gaming.



Maybe one day you could play a football game on your desk or coffee table!

And maybe most excitingly AI will advent the rise of personalised gaming. As the machine analyses each player it will be able to optimise multiplayer opponents and partners. It will be able to create AI opponents which are more realistic and engaging.

Personalised gaming could lead to far better gameplay and user engagement. Not to mention monetisation, AI can be used to enhance game recommendations and better direct retention rate marketing.Article on AI and Personalised Gaming (https://knowledge.wharton.upenn.edu/article/telling-data-story-behind-video-gaming/)

Furthermore, it favours the incumbents as AI is predicate on large datasets. Thus, whoever has the best dataset wins.

INCREASING COMPLEXITY

The increasing quality of games is matched by the increasing complexity and difficult in producing a AAA blockbuster game.

Over the last ten years EA have significantly reduced the number of titles released annually and increased the spend on each title.

[see chart below]

As can be seen the number of employees taken to produce a AAA game has doubled, and the R&D per game as increased by almost 10x.

This makes it increasingly difficult for competitors. And it makes it nigh on impossible to start-up a new games company from scratch to compete with these titles.

NETWORK EFFECT

The evolution of online multiplayer games has created a network effect, that we believe is particularly effective in Sports Titles.

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
AAA Game Launches	54	35	22	13	11	9	9	8	8	8	8
EA Revenue	4,159	3,828	4,186	3,793	4,021	4,319	4,566	4,742	5,180	4,950	5,537
EA - R&D	1,229	1,153	1,212	1,176	1,125	1,094	1,109	1,205	1,320	1,433	1,559
EA - S&M	730	747	853	769	680	647	622	673	641	702	631
EA Employees			9,200	9,300	-	8,400	8,500	8,800	9,300	9,700	9,800
Revenue Per Game	77	109	190	292	366	480	507	593	648	619	692
R&D per Game	23	33	55	90	102	122	123	151	165	179	195
S&M per Game	14	21	39	59	62	72	69	84	80	88	79
Eployees per Game	-	-	418	715	-	933	944	1,100	1,163	1,213	1,225

> Here are a few key examples. We've delivered eight new games so far this year, and our network has grown to more than 330 million unique accounts as 10 of millions of new players have joined to enjoy more of our amazing games and content. EA SPORTS continues to be a leader in sports interactive entertainment. Madden NFL 20 was the most successful game in franchise history last year. And now, Madden NFL 21, already has nearly 30% more players year-over-year from launch.
>
> Our FIFA franchise is engaging more than a 100 million players globally. Even prior to launching FIFA21. Our FIFA franchise is having the biggest calendar year ever, with our business across all platforms up 26% year-over-year in net bookings. FIFA-20 has reached nearly 35 million players on console and PC. FIFA mobile continues to perform well and FIFA online Asia broke engagement records across China and Korea in Q2.
>
> We just launched FIFA Mobile in Japan in October as we continue to see significant international expansion opportunities for our FIFA franchise. We continue to have an outstanding relationship with Disney and Lucasfilms. Star Wars Squadrons launched a great feedback from critics and the community and has performed above our expectations.
>
> This is clearly a special game for fans and continues the extraordinary success we've had bringing great games to life with this IP, including Star Wars Jedi. Fallen order, Star Wars Galaxy of Heroes, Star Wars the Old Republic and the Star Wars Battlefront franchise.
>
> Our live services are among the most succesful in the industry and our live services net bookings have grown more than 28% fiscal year, over year-to-date. EA Sports ultimate team has more than 30 million players so far this year, up 25% year-over-year.

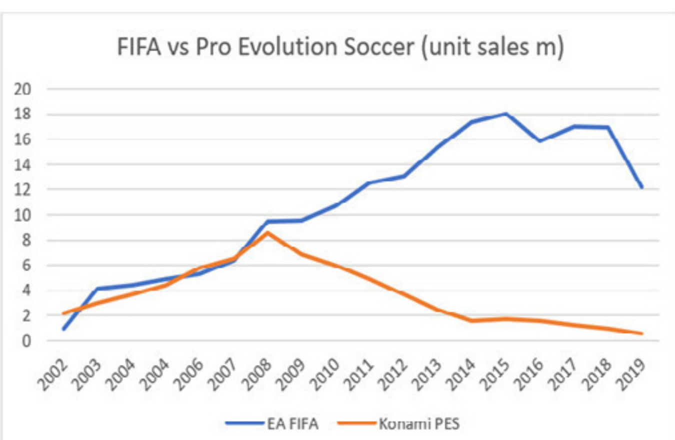
According to the last earnings call EA has 330 unique accounts playing across their titles; and FIFA has 100 million players globally.

[see image above]

What this means is that whenever you want to play a game online (any time night or day) you will probably find somebody to play against (in any geography/language). But more importantly all your friends (real world and online) that play will be using this game.

This effectively makes sports games "winner take all". This is because if you want to play a Football game you play FIFA – who plays PES anymore?

If we look at FIFA sales vs PES (sales per title not per year) we can see how Konami has gone from being a serious challenger to FIFA to a non-entity. (these figures are as of mid 2019 hence the low 2019 numbers)



Source vgchartz.com

There will always be more that one shooter game, but when it comes to multiplayer sports it is hard to see how this network effect gets broken. EA would have to make some very significant unforced errors in order to lose this lead.

DATA AND AI

Google is in an enviable position: it does not matter how much money a competitor brings to the table they will not be able to replicate the data that google has amassed and thus is always at a disadvantage.

Whenever we find a business that could not be replicated no matter how much is thrown at it we must realise that we have found something very special.

EA could become one such business (if it is not already). The data collected on the 100m FIFA players and the 30m online Ultimate Team players gives them a very significant advantage over other sports game developers.

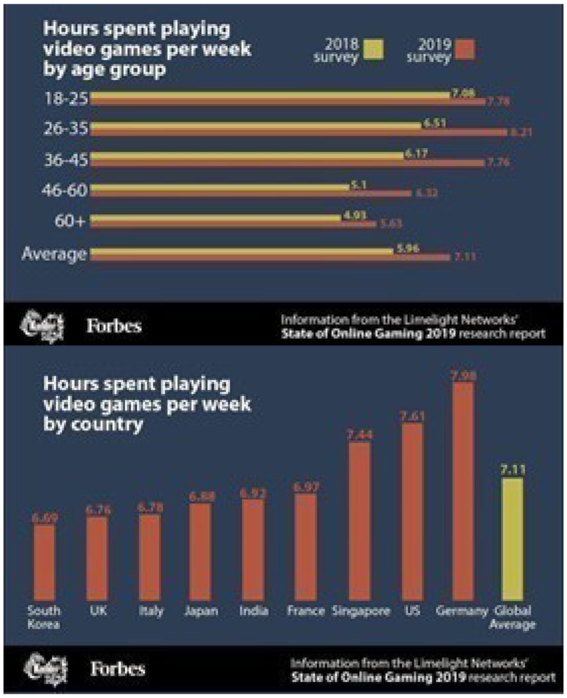
There are very few other games developers with as many players, and the resources to crunch all that data. And even fewer competitors in EA's sphere. A sports game does not necessarily compete with a shooter game, and the data from one may not necessarily be applied to the other. So, this means that EA can completely lock in their advantage in Football and many other sports.

A final consideration regarding Network Effect and AI/Data is that this is an expanding moat. Data collection is only going to improve and this will be a virtuous cycle that may well ensure that their franchises continue to dominate their respective niches.

Customer Economics

Gaming is one of the cheapest forms of entertainment when measured on an hourly basis.

The average gamer spends around 7 hours a week playing games.



According to Sony they had sold 91.6m PS4 units between 2013 and 2019; whilst there were 876m games for the PS4 sold. This equates to around 9-10 games sold per console; and the average age of a console is maybe 3-5 years. Thus we can assume the average person buys around 2-3 games a year.

Let us assume 2.5 games a year at $50, and one console every 5 years at $300. This equates to $0.51 per hour.

Computer Games	0.51
TV Streaming	0.61
Cable	0.75
Movie Rental	2.25
Drinks at the Bar	10.00
Music Concert	20.00
Football Game	40.00

Let us compare to cable or streaming. The average household has 2.6 streaming platforms, and that costs $14pcm (Netflix current price). Whilst the average household watches 3 hours of television per day it is hard to attribute all that to streaming as even a complete cord-cutter may watch free-to-air news. Hence we have assumed two hours a day of television (for both cable and streaming). And for cable we have assumed a cost of $50pcm.

We can argue the toss over several of these inputs, however the point remains that gaming is a very cheap form of entertainment. Not only that it is probably the most engaging form of entertainment.

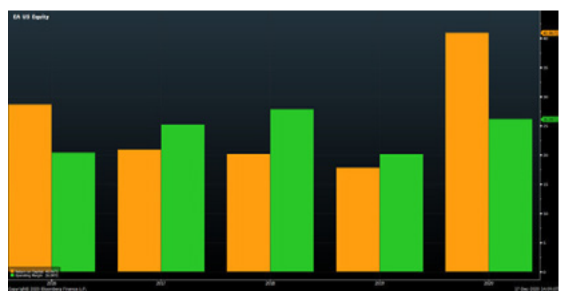
As a result of this we believe that it is higher under-monetised and could benefit from price increases, as well as further monetisation from advertising.

The other benefit from having excellent customer economics is that the price elasticity can really help with volume growth.

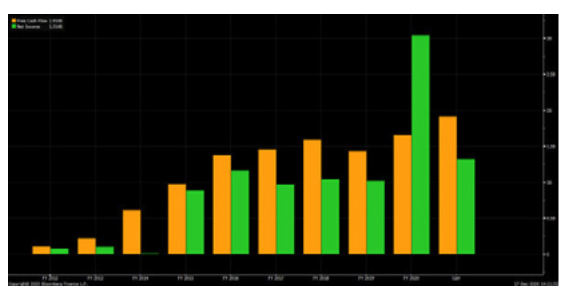
COMPANY QUALITY

RETURNS

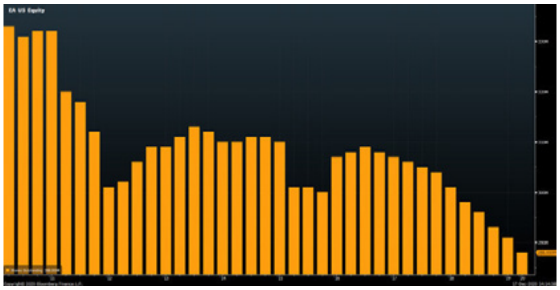
This is a high return, high margin business



With excellent Free Cash Conversion



The company has also rewarded shareholders with buybacks (as can be seen in the chart of shares outstanding)



And the company has just recently started paying out a dividend.

Given the high quality nature of this business, and its economic moat, we believe that these returns are sustainable. And we will detail later why we believe the economics of EA to be able to improve from here.

MANAGEMENT

Andrew Wilson has been the CEO of EA for 7 years, and prior to that he was head of EA Sports.

In that time returns have improved and acquisitions have been small bolt-on acquisitions. That is until last week when EA entered a competitive tender to bid for Codemasters (CDM LN).

They produce the F1 game as well as Dirt (a rally game). This is a natural fit into the EA Sports portfolio. It plays absolutely to the strengths of the team in respect to licencing etc.

Whilst entering a competing bid at 30x EBIT (2022) may seem like an expensive acquisition there should be an awful lot of synergies for both cost and revenues.

However, given that the acquisition represents 3.3% of EV this is still a pretty small deal.

LEVERAGE

This company runs a healthy net cash position; whilst there is a small amount of debt on the balance sheet that is outweighed by the $6bn of cash (less the one and a half for the CDM LN acquisition).

[see figure below]

HOWEVER this is a business that has a lot of fixed costs. The result of this is that the business is operationally leveraged.

This can clearly be seen by looking at the Margin profile of EA and also by looking at the growth in revenue compared with the growth in fixed costs. *[see figure on following page]*

At 14:43 d Vol 244,640 O 141.95Q H 142.495D L 141.31D Val 34.716M

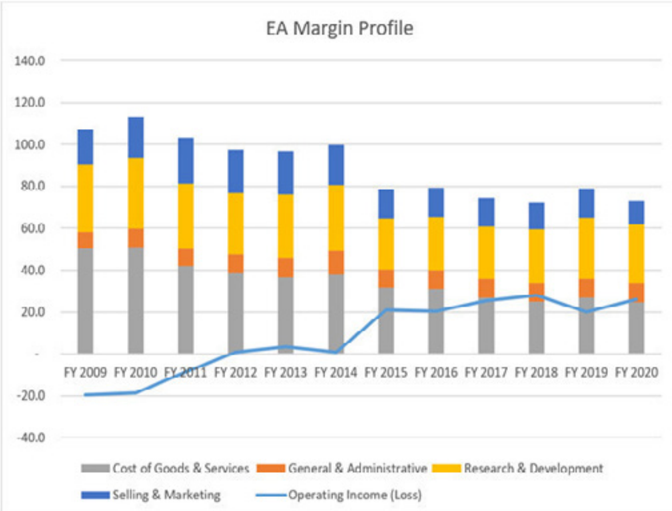
EA US Equity | Actions | Export | Settings

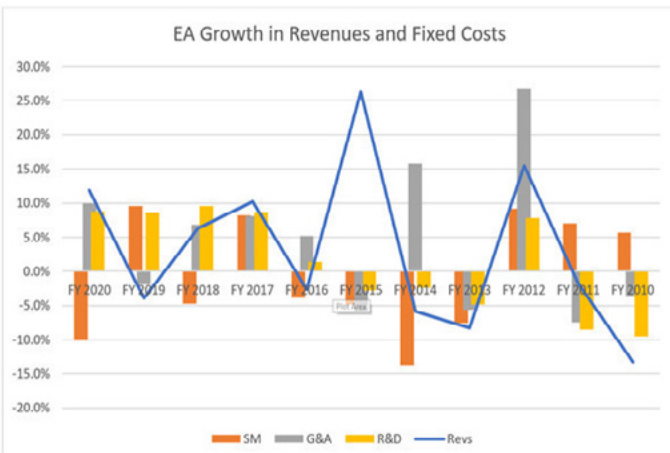
Electronic Arts Inc ASC 842 | BQL | Periods 10 | Annuals | Cur FRC (USD)

Key Stats | I/S | B/S | C/F | Ratios | Segments | Addl | ESG | Custom

Profitability | Growth | Credit | Credit Ex Operating Leases | Liquidity | Working Capital | Yield Analysis | DuPont Analysis

In Millions of USD except Per Share	2011 Y	2012 Y	2013 Y	2014 Y	2015 Y	2016 Y	2017 Y	2018 Y	2019 Y	2020 Y
12 Months Ending	03/31/2011	03/31/2012	03/31/2013	03/31/2014	03/31/2015	03/31/2016	03/31/2017	03/31/2018	03/31/2019	03/31/2020
IFRS 16/ASC 842 Adoption	No	No	No	No	No	No	No	No	No	Yes
Total Debt	0.0	539.0	559.0	580.0	602.0	1,150.0	990.0	992.0	994.0	996.0
Short-Term Debt	0.0	0.0	0.0	0.0	602.0	161.0	0.0	0.0	0.0	599.0
Long Term Debt	0.0	539.0	559.0	580.0	0.0	989.0	990.0	992.0	994.0	397.0
Total Debt/T12M EBITDA	—	2.15	1.45	2.23	0.52	1.05	0.71	0.63	0.87	0.62
Net Debt/EBITDA	—	-5.22	-2.91	-6.87	-2.07	-2.45	-2.54	-2.76	-3.90	-2.97
Total Debt/EBIT	—	15.40	4.62	17.58	0.64	1.28	0.81	0.69	1.00	0.69
Net Debt/EBIT	—	-37.43	-9.26	-54.09	-2.55	-2.99	-2.89	-3.03	-4.47	-3.28
EBITDA to Interest Expense	—	—	13.28	8.67	37.68	39.11	29.70	35.68	25.36	36.25
EBITDA-CapEx/Interest Expense	—	—	9.62	5.43	34.61	35.79	27.09	33.25	22.71	33.07
EBIT to Interest Expense	—	—	4.17	1.10	30.58	32.07	26.04	32.59	22.13	32.84





Assuming last years data to hold consistent then a 1% change in revenue should equal a 2% change in EBIT. Of course, costs such as R&D and Sales and Marketing may be fixed of the short term, but they can be quickly contained if necessary.

This does highlight the danger of lootboxes. Microtransactions for both FIFA and Madden represent around 20% of group revenue.

KEY RISK OF LOOTBOXES

As we have just explained lootboxes could be 20% of revenues, and given the high drop through rate were they to go to zero this could cause a very significant drop in profitability. Assuming a 90% drop through this could be a 50% impact on profitability.

The issue is that many jurisdictions are currently trying to decide what to make of lootboxes. Are they gambling or not? We do not believe them to be gambling. Gambling requires a stake of value, a risk, and a reward of value. LootBoxes do not require a stake because purchase guarantees value, and the reward has no monetary value. Thus is can't meet the definition of gambling. How is it any different to these:

[image below]

The Netherlands Gambling commission has stated that lootboxes should be illegal under gambling laws, as have Belgium, Japan have said that SOME lootboxes COULD be considered to be 'prizes'.

However New Zealand has stated that virtual items of no realisable value can not be gambling, the UK had agreed (though are now reviewing this issue), and France has also stated the same.

The USA is currently undergoing a review and given that this is EA's largest market is weighing upon the stock price. However, these fears may prove to be unfounded.

Senator Josh Hawley (youngest senator and republican) has brought a bill (with bipartisan support) that would seek to regulate lootboxes. Interestingly enough, he has not gone down the 'gambling route'. He has instead sought to outlaw "pay- to-win" transactions.

A BILL

To regulate certain pay-to-win microtransactions and sales of loot boxes in interactive digital entertainment products, and for other purposes.

This, I believe, will be the downfall of this bill. Had it sought to classify such transactions as gambling then it may be easier to gain support of the house. However, this is a very draconian and interventionist piece of legislation that will unlikely sit easily in a liberal free-market country like America.

(As an aside it is the 'pay-to-win' nature that seems to have people upset; though it flummoxes me as to why: Lewis Hamilton is the best driver - but he also has a pretty good car! it is well known in any competitive sport that in order to be the best one needs the best equipment too. Is this really so contraversial?)

Of course, trying to classify microtransactions as gambling would be very difficult given the 9th circuit decision (Kater v. Churchill Downs Inc., No. C15-612MJP, 2015 WL 9839755, at *4 (W.D. Wash. Nov. 19, 2015)) it was held that a game cannot be gambling "due to its lack of real-world monetary capability".

Furthermore the State of Washington has introduced House Bill 2720 and Senate Bill 6568 which aim to protect microtransactions and specifically exclude them from being considered as gambling.

Sec. 2. RCW 4.24.070 and 1957 c 7 s 2 are each amended to read as follows:

(1) All persons losing money or anything of value at or on any illegal gambling games shall have a cause of action to recover from the dealer or player winning, or from the proprietor for whose benefit such game was played or dealt, or such money or things of value won, the amount of the money or the value of the thing so lost.

(2) For purposes of this section, "illegal gambling games" does not include online games of chance when played solely for entertainment purposes with virtual items if such virtual items may be used only for gameplay and may not be, per the terms of service of the game, transferred, exchanged, or redeemed for money or property.

--- END ---

http://lawfilesext.leg.wa.gov/biennium/2019-20/Pdf/Bills/House%20Bills/2720.pdf?q=20201123052103

And the Senate bill makes clear their reasoning

NEW SECTION. **Sec. 1.** The legislature finds that the state has made it a priority to grow clean, high-wage jobs by encouraging firms engaged in mobile game development to invest and grow in the state. The state has been successful in its efforts. However, recent court cases filed in federal district court in Washington have created economic uncertainty for mobile game companies located in Washington state, or offering games to players located in the state, by raising the possibility that the legality surrounding these games will be decided differently than similar issues raised and decided in other states, such as Illinois, Maryland, and Ohio.

The legislature further finds that, of the recent lawsuits filed, two mobile game companies based in Washington are subject to these class action lawsuits. These lawsuits, if decided adversely to the game companies, pose a substantial financial risk for mobile game development in the state. The further possibility exists that companies based in Washington will move their base of operations to

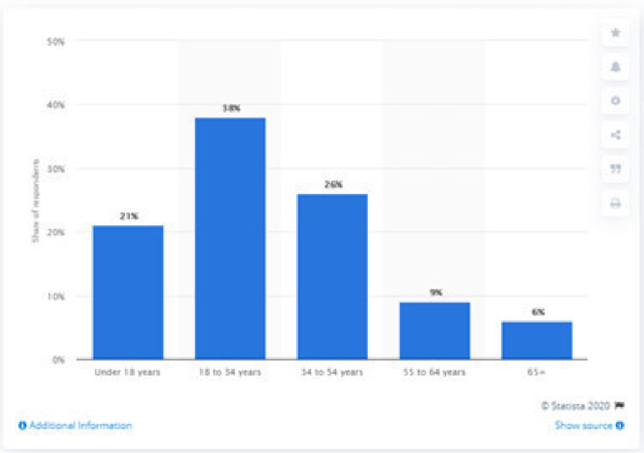
http://lawfilesext.leg.wa.gov/biennium/2019-20/Pdf/Bills/Senate%20Bills/6568.pdf?q=20201218084213

As such it seems unlikely that the US will enact a full prohibition on microtransactions, and if they do then it would seem likely that it would be a half measure similar to the Japanese Gacha ban which seems to have had little effect on microtransactions. See here (https://www.eurogamer.net/articles/2017-10-19-what-the-uk-can-learn-from-the-far-easts-battle-with-loot-boxes)

It strikes me that the bear case here is that games are forced to come with a "Parental Advisory" label. It seems reminiscent of the Tipper Gore's filthy fifteen! (https://www.rollingstone.com/music/music-lists/pmrcs-filthy-15-where-are-they-now-60601/)

IF this is the case then the economic harm to EA is likely to be minimal given that under 18s represent around 20% of gamers. And they are unlikely to be the big spenders on such microtransactions.

Age breakdown of video game players in the United States in 2020



And given that USA, whilst the largest market for FIFA is still only 25% of FIFA we can be fairly assured that the impact will not be that severe.

Let's assume that microtransactions (25% of revenues) are restricted for 35% of the world for 20% of the market (under 18s) with a 90% drop through on 35% EBITDA margins. Then this would be less than a 5% hit to EBITDA.

This then also assumes that EA do not change their mechanics so as to avoid any regulations. Such changes could include disabling the ability to trade players, or removing part of the element of surprise.

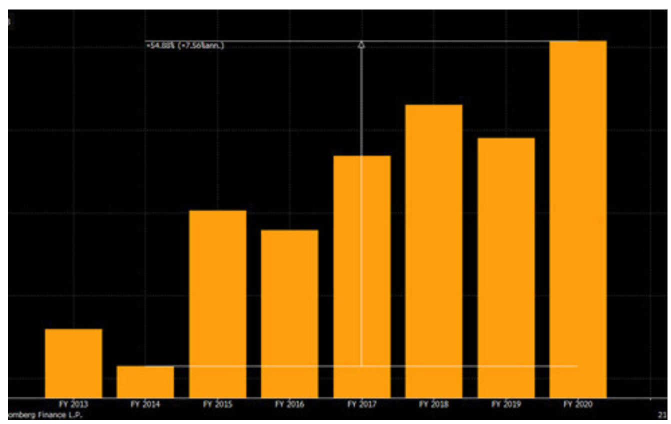
GROWTH AND ECONOMICS

TOP LINE

EA has many growth opportunities; and these here are my growth assumptions.

	FY2020	10yr Growth	FY2030e
Console Market	45,200	5.0%	73,626
EA - Console	3,774	8.9%	8,835
EA Market Share	8.3%		12.0%
PC Market	33,900	2.5%	43,395
EA - PC Sales	1,036	5.3%	1,736
EA Market Share	3.1%		4.0%
Mobile	77,200	7.5%	159,112
EA - Mobile Sales	727	15.9%	3,182
EA Market Share	0.9%		2.0%
Market	156,300	5.9%	276,133
Electronic Arts	5,537	9.5%	13,753
EA Market Share	3.5%		5.0%

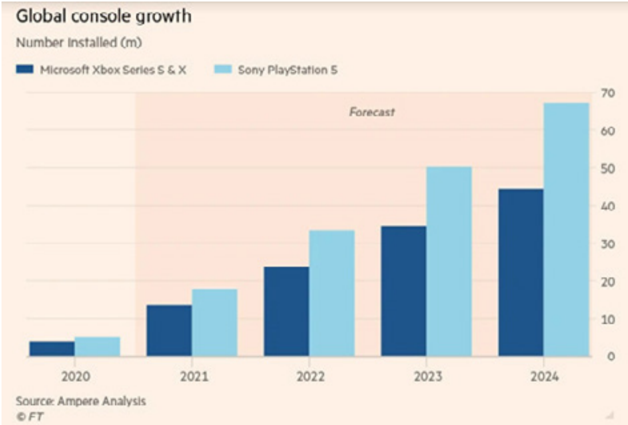
10% may seem a little punchy given that the growth from the last console cycle was 7.5% CAGR.



However, there are many reasons that I believe that the top line should be stronger this time.

CONSOLE CYCLE

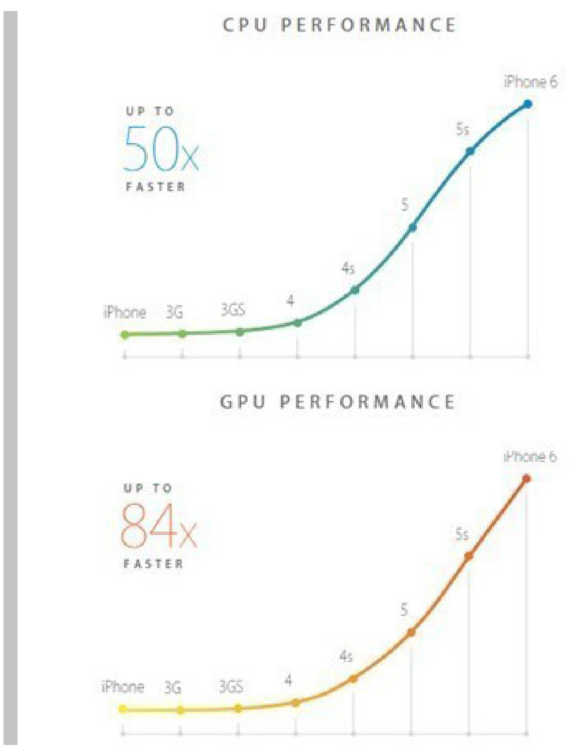
The last console cycle was in 2013 and the PS4 sold 110m units over seven years. However analysts are figuring that the PS5 will sell 120-170m units over 5 years. That is over 50% more per year than the last cycle. This rumour has been supported by sources in the supply chain in this article (https://www.digitimes.com/news/a20200727PD211.html):



Covid is certainly not hurting this prediction. Not just because more people have been at home; but also because creators have been staying at home there will be less live music, less movies, less competing forms of entertainment.

HARDWARE IMPROVEMENT

This is not just console hardware. But mobile.



And we are now on iPhone 12! I do not know if the 12 is 84x faster than the 6; however we can be sure that the multiple is still a big number.

The point of this is that EA has been underperforming in mobile compared with console.

This is because AAA blockbuster games are best suited to consoles, and mobiles simply have not had the power to run AAA games.

So the big point here is just simply that as mobile computing power catches up with consoles then EA should be able to take much greater share. As they currently only have 1% of the mobile market it is really not difficult to imagine them doubling their market share in the next ten years or less.

This is especially plausible given the success they have on other platforms especially with their licenced content.

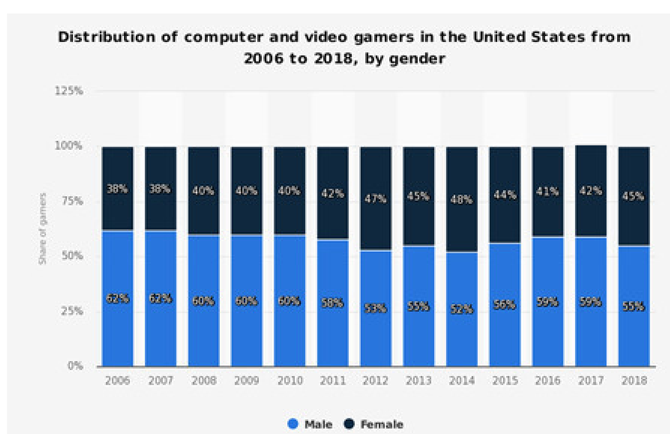
REDUCED BARRIERS TO GAMING

Over the last ten years in order to play EA games a gamer needed either a games console or a specced out PC. Games Streaming has the effect of lowering the barriers to entry for potential gamers.

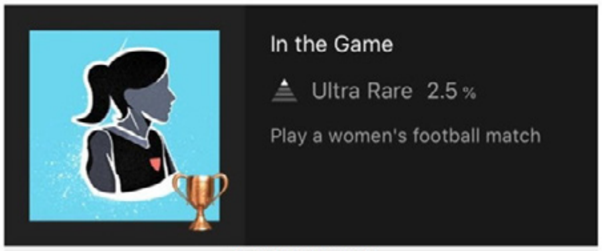
By outsourcing the computing power to the cloud it means that gamers do not need to spend that initial outlay. This will naturally enable more gamers.

CAN FIFA OFFER EQUAL OPPORTUNITIES?

Female gaming has been growing in popularity

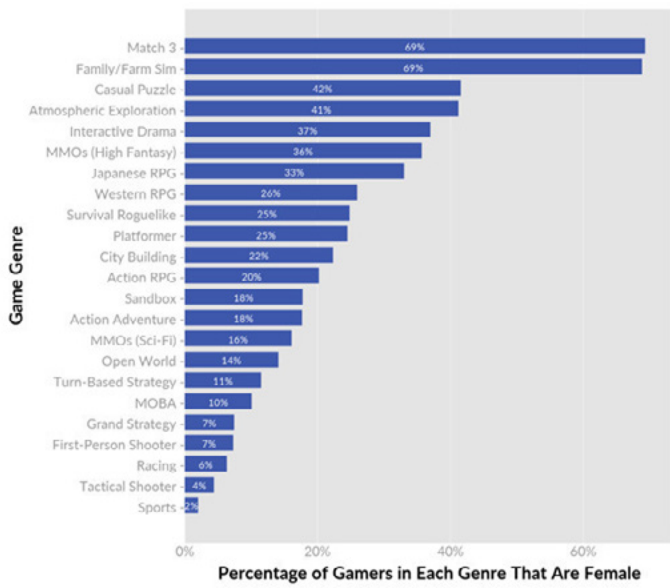


However this does not paint the whole picture. IT would seem according to the games 'Trophy' system that only 2.5% of games played are with women's teams.



Credit: Reddit/ icharlie17

Of course many girls could be playing mens teams; but the opposite might be true given these statistics:



https://quanticfoundry.com/2017/01/19/female-gamers-by-genre/ (https://quanticfoundry.com/2017/01/19/female-gamers-by- genre/

However according to FIFA (https://www.fifa.com/who-we-are/news/fifa-survey-approximately-250-million-footballers-worldwide-88048) (the actual sport association) In 2001 20% of the 250 million actual football players were women. And 80% of them were juniors.

Given that in England there has been a 54% increase in girls football teams; and a 715% increase in "wildcats centres (https://www.theguardian.com/football/2020/may/14/fa-hits-target-to-double-womens-football-participation-in-three-years- england-gameplan-for-growth)" for girls aged 5-11.

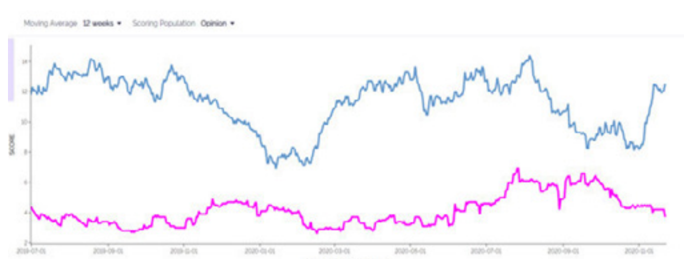
It would seem that there is a mismatch between girls that play football and girls that play football games; even compared with games such as Star Wars where 29% of gamers are girls (compared with 16% for the genre average (https://quanticfoundry.com/2017/01/19/female-gamers-by-genre/))

2016 EA introduced female teams to the game; but only at a national level and not at a club level. Investor Relations tell me that so far they have not been gaining much traction. But it strikes me that over the next ten year it is inevitable that this number increases substantially. And that EA will have succesfully negotiated club licencing.

Should it take another ten years, and FIFA achieves a similar level to the Star Wars games then that would be an incremental 2.5% growth to FIFA, which could in itself add 1%+ CAGR to EA as a group.

However these things tend to snowball, and when they take off the growth could be more meaningful.

Furthermore looking at female purchase intent (according to YouGov surveys) we saw an interesting spike in September, and also levels are higher than historically, and also higher than 2%!



PRICING

For the last 15 years computer games have been static. According to an article by Bloomberg (https://www.bloomberg.com/news/articles/2020-11-09/game-prices-go-up-to-70-the-first-increase-in-15-years) Nintendo set many

■ **Game & Network Services segment sales breakdown**

(Millions of yen)	FY18	FY19					FY20				
		Q1	Q2	Q3	Q4	FY	Q1	Q2	Q3	Q4	FY
Hardware[1]	527,701	101,614	78,850	148,472	42,975	371,910	55,622	41,701			
Game Software	1,293,744	241,311	255,563	347,079	282,816	1,126,769	432,479	330,989			
Physical Software[2]	191,513	25,347	28,674	42,097	20,354	116,473	37,841	33,928			
Digital Software[3]	1,102,231	66,051	82,930	130,602	96,837	376,420	147,730	125,513			
Add-on Content[4]		149,913	143,958	174,380	165,624	633,876	246,907	171,547			
Network Services[5]	326,525	83,606	84,377	85,484	83,797	337,265	93,295	95,898			
Others[6]	162,903	30,930	35,600	51,095	23,981	141,607	24,714	38,051			
Segment Total Sales	2,310,873	457,461	454,390	632,130	433,569	1,977,551	606,109	506,638			

■ **PlayStation®4 (PS4™) hardware and software unit sales**

(Million units)	FY18	FY19					FY20				
		Q1	Q2	Q3	Q4	FY	Q1	Q2	Q3	Q4	FY
PS4™ hardware[7]	17.8	3.2	2.8	6.0	1.4	13.5	1.9	1.5			
PS4™ full game software[8]	287.9	49.9	70.6	83.3	64.9	268.6	91.0	80.9			
First party titles	50.6	11.7	6.3	16.3	9.1	43.3	18.5	12.4			
PS4 ™ full game software digital download ratio[9]	43%	60%	45%	50%	68%	55%	74%	59%			

games cartridges at $60. And they have stayed that price ever since. Had they kept up with inflation they would be around $110.

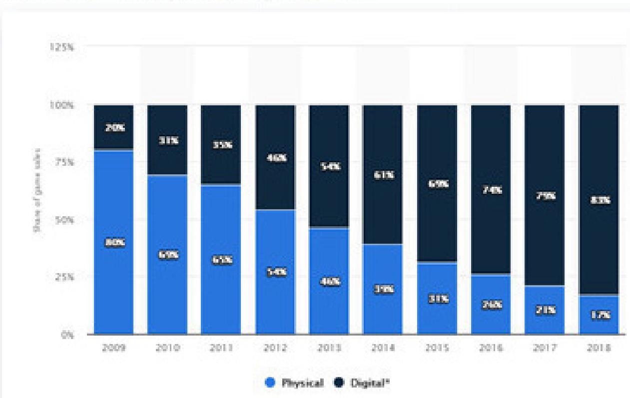
It appears that prices are now being increased to $70. This will inevitably have a positive impact on revenues, and also the bottom line.

BOTTOM LINE

Digital shift is margin enhancing. As physical stores such as GameStop are disintermediated the develoeprs see a significantly improved economics.

OF course much of the digital shift has happened:

Breakdown of U.S. computer and video game sales from 2009 to 2017, by delivery format



But that includes mobile gaming. When we just look at consoles (or PlayStation games) we see a different picture. It was not until FY19Q1 that digital delivery became the norm. As of Q2 that was at 59% (with Covid being an accelerant).

[See figure above]

I believe that there is still more runway for this trend, and this should prove to further enhance EA's margins. The below table shows just by how much it could affect margins, and growth. It has also included the aforementioned price increase too.

	Physical	Digital	Physical	Digital
Consumer Pays	60	60	70	70
Retail Margin	-20	-18	-23.333	-21
Price to Publisher	40	42	46.6667	49
Packaging/Delivery	-12	-5	-12	-5
Gross Profit	28	37	34.6667	44
Gross Margin	70.0%	88.1%	74.3%	89.8%
MicroTransactions	0	5	5	5
Contribution Margins	28	42	39.6667	49
%age of Consumer Spend	46.7%	70.0%	56.7%	70.0%
Physical	40%	11.2	10%	3.966667
Digital	60%	25.2	90%	44.1
Total		36.4		48.06667
Growth				32.1%
5yr CAGR				5.7%

	NHL	MLB	NBA	NFL	**Total**	Esports
Unique annual viewers	79m	118m	133m	326m	**656m**	143m
League revenue	$3.7b	$9.0b	$5.0b	$11.2b	**$28.9b**	$655.0m
Revenue per viewer	$46.8	$76.3	$37.6	$34.4	**$44.1**	$4.6

OTHER ISSUES

Potential reduction in platform fee. Apple recently reduced their platform fees from 30 to 15% for many apps (https://www.ft.com/content/fbabedb0-3ed2-4c47-94f2-f165bd15edb3) as the games industry consolidates they will gain power of the platforms. And some (EA included) may also become the platforms themselves (EA is currently experimenting with its own streaming service).
The move to subscription could be as powerful for EA as it was for Adobe. This could be especially potent given their high sales and marketing spend.

e-Sports is obviously another massive source of optionality. I have not addressed this issue yet because it is not important to my investment case; and it is pure speculation as there is simply not enough evidence for me to make this my case for owning EA.

That being said, I am very happy to have such optionality. And it could be big. We just have to look at the revenue per view amongst other sports to start dreaming of what could happen...

VALUATION

On a very simplistic basis this is a business that trades at around a 5% FCF yield, and can grow FCF at at least 10% for the foreseeable future. This should provide an IRR of around 15% - which in a zero interest rate environment should be valued at infinity! ;)

Alternatively, please see my attached DCF. I have used three scenarios. The first being my base case which gives us 65% upside and a target price of 231.2

My bull case (which has revenues growing at 10% to 2025) and also has a full margin uplift has 130% upside.

For the bear case I have imagined fixed costs remain fixed, and COGS fall 5% whilst revenues fall 25%. This is to try and simulate what might happen if LootBoxes are forcibly removed. It then takes until 2025 for earnings to recover to 2020 levels in this scenario. In this fairly extreme scenario there is only 20% downside.

Of course if this does happen I expect the stock to over-react just a little bit.

FINALIST
Large/Mega Caps

Evgeny Vostretsov
Analyst at Falcon Edge Capital

CURRENT RANKING: **#15 All-Time**
BADGES: 9 30

Airbus Se Ord

Asset: **Equity** Symbol: **AIR.PA**
Idea Posted: **12/13/2020** Idea Updated: **12/17/2020**

RETURN TO DATE: -2.3%

EXPECTED RETURN: 99.78%

LONG

TIMEFRAME	SITUATION	MARKET CAP
2-5 Years	Value	67.7B USD

> Airlines need to replace 3K+ single-aisle planes that are parked and will be retired. Airbus' A320 program will take share from 737s and yield 30-40% higher profit per aircraft post-COVID.

About Evgeny Vostretsov

I'm an Investment Analyst at Falcon Edge Capital, a long/short equity hedge fund based out of NYC. I work on global investment opportunities across several sectors. I typically focus on situations where I find a clear reason for a stock price dislocation and a possible catalyst. Prior to joining Falcon Edge, I worked as an Analyst at Caro-Kann Capital, where I focused on equity event-driven investment opportunities globally. I graduated with an MBA degree and concentrations in Analytic Finance and Economics from The University of Chicago Booth School of Business. I'm also a CFA and CAIA charterholder.

FALCON EDGE CAPITAL

About Falcon Edge Capital

Falcon Edge Capital is a diversified global alternative asset manager with about half of the AUM is managed in a global long/short equity strategy. In public markets portfolio, Falcon Edge Capital typically has several "core" concentrated high-conviction positions and uses hedges to manage risk.

Airbus Se Ord

Asset Class: **Equity** Symbol: **AIR.PA** Updated: **12/17/2020** Submitted: **12/13/2020**

BY:
Evgeny Vostretsov

CURRENTLY AT:
Falcon Edge Capital

CURRENT RANKING: **#15 All-Time**

BADGES: 9 30

Pricing & Return Details	LONG
EXPECTED RETURN	99.78%
TARGET PRICE	180.00 EUR
INITIAL PRICE	92.19 EUR

> Airlines need to replace 3K+ single-aisle planes that are parked and will be retired. Airbus' A320 program will take share from 737s and yield 30-40% higher profit per aircraft post-COVID.

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Value	10%+	N/A	2-5 Years

INVESTMENT THESIS

ELEVATOR PITCH:

- Deliveries of new narrow-body airplanes are likely to be higher that the market estimates now because 3K+ narrow-body airplanes are likely to never fly again in a post COVID world.
- Airbus should take market share from Boeing in narrow-body market because Airbus has a better narrow-body product.
- Airbus will have significantly higher profit per airplane in 2023 compared to that in 2019.

Airbus has 100%+ FCF Yield and P/E on 2024 estimates.

COMMERCIAL NARROW-BODY AIRPLANE DELIVERIES ARE LIKELY TO EXCEED MARKET EXPECTATIONS

Airline passenger traffic is expected to recover to 2019 level roughly around 2024. Domestic traffic is expected to recover faster than transcontinental traffic. It means that traffic on NB airplanes will recover a little faster.

I focus my discussion on narrow-body market starting from here because Airbus' narrow-body program, A320 family, largely determines the profitability of the whole company.

I focus my discussion on narrow-body market starting from here because Airbus' narrow-body program, A320 family, largely determines the profitability of the whole company.

Airlines would need to have at least the same size of NB fleet as they had in 2019. Before COVID, active commercial narrow-body airplane fleet was ~18K aircraft. Now only ~12-13K of these airplanes fly. There are only two ways to satisfy the requirements for the fleet in 2023-2024: (1) re-introduce parked airplanes back into the fleet or (2) take deliveries of new airplanes.

Airlines are likely to retire airplanes that are not being flown for several months, yet alone for couple of years. Here is why:

- The option of bringing an old airplane is not great and is expensive
    - It is expensive to keep an airplane in airworthy condition if it is not flying and generating revenue.
        - The maintenance checks must be performed at the specific age intervals even when airplane is not flown. Heavy maintenance checks on airframe and engines are typically performed every 5-6 years, although this interval has become a bit longer for airplanes made in the recent years. Cost of a heavy check and engine overhaul for a narrow body aircraft runs in a range of ~$2m for airframe and $3.5-5m for each engine.
        - **=> Airlines would not perform such maintenance of the airplane that does not fly and generate revenue.**
    - Bringing back an airplane that was not properly maintained is expensive and can be unsafe.
        - All the maintenance that was skipped would have to be performed. After a long time in storage it is likely to be both airframe checks and engine overhauls.
        - An airplane after a long storage would require very thorough check of all systems even if it was not yet time for some of such checks because otherwise if might not be safe to return it to service. Once even a minor issue found during such check it needs to be fixed even if otherwise airplane could have safely flown for years until a major check before it is found. It created a risk of additional costs that an airline cannot predict before it commits to sending an aircraft for maintenance.
        - Additionally, airlines "manage green time" of the engines, i.e. if an airline has an airplane that requires engine maintenance but not any heavy airframe maintenance, airlines will swap engines from one of the parked airplanes. Such practice allows an airline to save cash on maintenance. Therefore, an airplane that was parked for long time is likely to be stripped of engines and possibly some other parts that would need to be reinstalled before an airplane can fly again.

          Feedback from industry experts who manage fleets at airlines and aircraft leasing companies suggests that smaller versions of airplanes (A319, 737-700) are likely be donors of engines, so that even a 10+ years old airplanes can be stripped of engines and retired.
        - **=> In any case, at is likely to cost $12-15mm of cash upfront to bring the airplane back. However, an airline will still end up with an old airplane that is less fuel-efficient and more expensive to maintain.**
    - Alternative is too good:
        - An airline can get a sale-leaseback deal on a new aircraft. The airline typically would be able to unfreeze the capital tied up in the pre-delivery payments that it made for the aircraft.
        - A new aircraft is on warranty for the first 5 years, so it does not require any maintenance costs. It

is also at least 15%+ more fuel efficient than the aircraft it replaces.

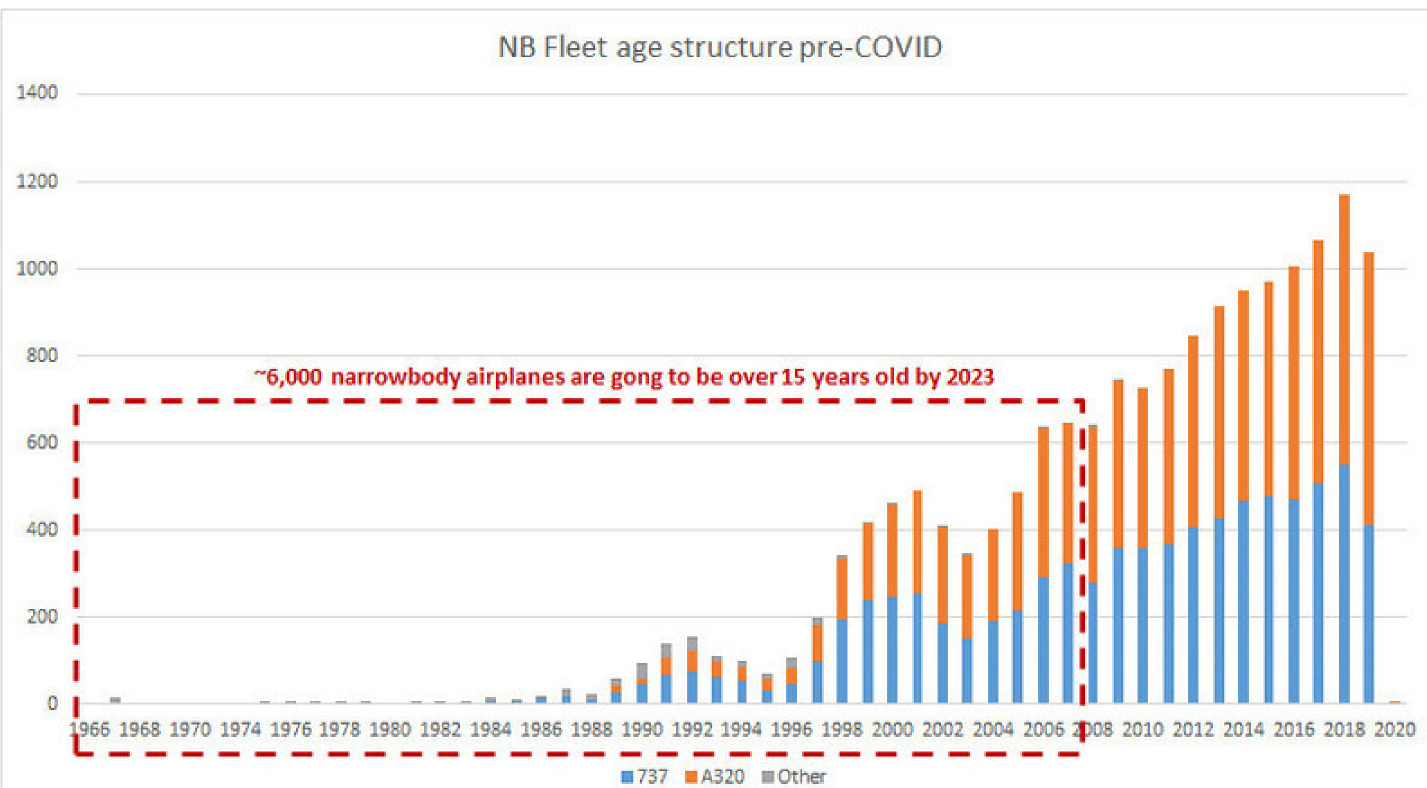
- Old aircraft airframe and engines can later be monetized once the market for used serviceable material comes back.
- **=> this alternative is both (1) good for an airline's current cash position and (2) allows the airline to have newer equipment and hence lower costs per seat-mile post COVID.**

Therefore, unless an older airplane had the major maintenance and engine overhaul just recently before COVID, it is likely to be parked for a long time and eventually retired.

We can expect ~3,000+ of airplanes to be retired. There are several ways to get to this number:

- One top-down way to estimate it is:
    - ~6K airplanes that will be 15+ years by 2023
    - Major maintenance is due every 5-6 years.
    - **=> about half of these airplanes are likely to require significant maintenance within 2-3 years. These are the ones that are likely to be parked and eventually retired.**
- Another way is to look at the data:
    - Currently, 5,000+ narrow-body airplanes are parked and 4,000+ of them have not flown for >3 months.
    - It compares to <2,000 parked in the beginning of 2020, during low season.
    - Of the 4,000 that are not flown, most will likely not fly again. If an airline intends to retain an airplane in the fleet, the airline will typically fly it 1-2 times every 1-2 weeks.
    - **=> Up to 4,000+ are likely to be retired.**

Consensus (compiled by Visible Alpha) implies ~2,100 deliveries of NB airplanes from the beginning of the pandemic and before 2023. Consensus implies that 3,000 deliveries of narrow after the beginning of the pandemic will happen only by early 2024.



AIRBUS HAS THE BEST NARROW-BODY PRODUCT AND IS IN POSITION TO MAKE AIRLINES TAKE DELIVERIES

Airbus is likely to take larger share of market in narrow-body segment. Airbus A321, the larger aircraft in A320 family, is a superior product that provides better economics for the airlines. That is especially true for the LR, long-range, and XLR, extra-ling-range, versions. Boeing does not have a product that could be a rival. 737-Max-8 variant offers competitive economics for short-haul missions, but 737-MAX cannot offer that for longer-range missions. That is an objective advantage that is separate from the question of how much the safety and negative publicity of 737-Max will be an issue in the long- term.

In a world where there is less transcontinental travel, A321xlr can serve a long-haul mission with narrow-body economics. The very same airplane can be used on a busy short-haul line that requires a larger narrow-body. The only small disadvantage of using an XLR on a short mission additional weight of extra fuel tanks that would be left empty. A321xlr provides necessary flexibility of missions and is well-suited for a post-pandemic world.

Airbus has a much better starting position to negotiate the timing of deliveries with the airlines. For the airline industry and specific airlines, it is much easier to walk away from Boeing 737-MAX deliveries because the deliveries are delayed already by more than a year. 12 months of delay of a delivery allows an airline to cancel the delivery without any penalties. In case of Airbus that did not have such delays, airlines cannot just walk away. Airbus has collected pre-delivery payments and legally could retain those if an airline does not take delivery.

Obviously, Airbus does not want to destroy the relationships with customers, so it allowed deferrals of deliveries. The catch is that if an airline wants to defer deliveries it will move the whole skyline of deliveries to the right. Additionally, Airbus cannot give any airline all the delivery it wants just in 2023 or 2024 when the traffic is expected to recover. Hence, if you are an airline and you need new airplanes by 2023-2024 you have to take them gradually throughout 2020-2024. This way Airbus secured its delivery skyline even for the years of low traffic.

AIRBUS WILL HAVE HIGHER PROFIT PER NARROW-BODY AIRPLANE IN 2024 THAN IT HAD IN 2019

There are several key reasons why profit per aircraft would significantly improve in Airbus' A320 program between 2019 and 2024 from ~EUR 12-13mm (based on EBIT before R&D) to ~EUR 17m.

- In 2019, Airbus was still delivering A320 CEO (conventional engine option, an old version).
    - These we ~15% of deliveries in 2019. Neos would bring ~EUR 1.5mm more margin.
    - => ~EUR 0.2mm avg. margin impact.
- In 2019, only ~30% of delivered A320 airplanes were A321s and in 2024 at to 50% can be A321s.
    - A321 is essentially the same plane with the same equipment and engines but longer body and more seats so it is priced higher. That brings at least ~EUR 2-3mm per airplane
    - => ~EUR 0.5mm avg. margin impact.
- Up to half of A321s can be XLRs. That is up to 25%
    - XLT does not have any direct competition, so likely can bring up to additional EUR 5mm of margin over a standard A321.
    - => ~EUR 1.2mm avg. margin impact.
- Airbus has taken steps to resolve previous production issues. Optimization can save up to EUR 1B in run-rate costs once all the A320 facilities come back to scale.

    - => ~EUR 1.5mm avg. margin impact.

- Operating leverage will contribute the rest
    - When the traffic recovers, Airbus would necessarily be at a higher production rates in A320 program than it had in 2019
    - When the airline industry fleet size comes back to pre-COVID level it would need approximately the same # of airplane for growth as it needed in 2019 but Airbus will have higher market share because of its superior product.
    - Spreading the fixed costs of A320 program over 5-20% more airplanes.
    - => ~EUR 0.5–1.5mm avg. margin impact.

VALUATION ON 2024 ESTIMATES

Airbus can be delivering ~70 A320s per months in 2024:

- Assumption: traffic and active fleet of narrow-body airplanes comes back to 2019 level and 5% long term traffic growth from that level. In other words, it's an L-shaped recovery ~15-18% below previous trajectory.
- NB traffic continues to grow a little faster, giving this market additional 100 bps of growth.
- Retirements will be lower than normal because of the wave of retirements in 2020-2024. Assume ~1% of fleet in retirements compared to normal 2-3%
- => ~1260 NB airplanes per year.
- Assuming Airbus takes 2/3 of this market, it will deliver 840 airplanes, or 70/month.

2024 EBIT assumptions:

- With 840 deliveries and EUR 17mm on EBIT per airplane we get EUR 14.3B of EBIT from A320 program.
- I assume that WB programs (A330 and A350) are back to breakeven or small profit. A220 program should be close to breakeven or turning to profit around 2024. Services continue bringing ~EUR 0.2B. I assume R&D expense of EUR 3B in 2024.
- I assume EBIT of Airbus Defense, Helicopters, Corporate and HQ expenses, as well as FX to be in line with consensus estimates.
- => it brings be to EUR 12.7B of EBIT for Airbus.

That's about EUR 9.0-9.2B of Adj. Net profit. It implies ~EUR 11.7 of Adj. EPS. It puts Airbus on 7.9x 2024 P/E.

As Airbus continues to amortize the equipment and tooling and collecting PDPs (Pre-delivery payments) on growing deliveries, it can translate to ~EUR 10B+ of FCF (before customer financing and M&A). It implies ~EUR 12.8 of FCF/share. It puts Airbus on 13.8% 2024 FCF yield today.

Pre-COVID of ~18x P/E and 7% FCF Yield give the price target of EUR 180-210 in 2-3 years.

RISKS:

- Trajectory and timing passenger traffic recovery is a risk factor.
    - Given the roll-out of several vaccines in 2021, we can expect the pandemic to be under control by the end of 2021 or beginning of 2022.
    - Therefore, expectation of short-haul traffic recovery in 2023 and transcontinental traffic in late 2024 or 2025 seems reasonable.

- A new R&D cycle by the OEMs
    - Airplanes are designed with the specific power plant design in mind.
    - Therefore, in absence of new engine technology it does not make sense for Boeing to start a new

program that would risk being outdated soon after entrance to service. Even if such program would have started, it would take 7+ years to begin deliveries.

    - The risk is a very remote possibility at this point. We are likely to see new engine technology being developed before this risk becomes an issue at all.

- Capital allocation by Airbus is another risk. Airbus can be influenced by European governments to deploy capital in pursuing projects that can prove value-destructive.
    - At this point, it is a remote possibility because Airbus is getting government funding for projects such as new fuel airplanes rather than is made to allocate capital towards that.
    - That is an item to watch on Airbus in the long-term.

FINALIST
Large/Mega Caps

Richard Chu
Analyst at Luca Capital, LLC

GoodRx Holdings, Inc. Class a

Asset: **Equity**
Symbol: **GDRX:US**
Idea Posted: **12/14/2020**
Idea Updated: **12/17/2020**

RETURN TO DATE:
-3.73%

EXPECTED RETURN:
38.47%

LONG

TIMEFRAME	SITUATION	MARKET CAP
1-2 Years	Growth	N/A

> Prescription drug savings platform building the front-door to healthcare. Amazon's entry has created a compelling entry point as user growth begins to normalize post-reopening.

About Richard Chu

Richard Chu is an Analyst at Luca Capital, LLC, an investment firm that manages separate accounts for clients and the parent company of Saga Partners, LLC. You can find him on Twitter @richard_chu97. Prior to joining Luca Capital, Richard worked as a technology consultant at EY. He graduated with a BComm from Queen's University in Canada in 2019.

About Luca Capital, LLC

Luca Capital manages fundamental, long-only equity portfolios with the goal of providing net returns above the general market over the long-term by investing in leading companies in industries with high secular growth. It concentrates in its highest conviction ideas, typically holding 10-15 positions.

GoodRx Holdings, Inc. Class a

Asset Class: Equity   Symbol: **GDRX:US**   Updated: **12/17/2020**   Submitted: **12/14/2020**

BY:
Richard Chu

CURRENTLY AT:
Luca Capital, LLC

Pricing & Return Details	LONG
EXPECTED RETURN	38.47%
TARGET PRICE	60.00 USD
INITIAL PRICE	45.01 USD

> Prescription drug savings platform building the front-door to healthcare. Amazon's entry has created a compelling entry point as user growth begins to normalize post-reopening.

ASSET CLASS:	SITUATION:	TARGET ALLOCATION:	CATALYSTS:	TIMEFRAME:
Equity	Growth	5% - 10%	N/A	1-2 Years

INVESTMENT THESIS

- GoodRx is a health tech company focused on making healthcare affordable through its prescription drug pricing comparison and savings platform and its telemedicine offering
- They are the category leader in a massive, untapped market with over 4.9M monthly active consumers
- Their competitive position is secure as they continue to gain bargaining power over PBMs with scale and source cheaper pricing through data network effects
- Amazon's entry has created a compelling entry point as user growth begins to normalize post-reopening

INTRODUCTION

Why do Americans spend twice as much per capita on healthcare compared to citizens from other OECD countries but rank among last in numerous quality of care rankings such as obesity or chronic disease? Why is it that affordable healthcare coverage still remains out of reach for over 10% of Americans, which led to ~66% of all personal bankruptcies between 2013 and 2016? Why should 64% of Americans make the decision to risk their health by avoiding or delaying medical care because of the cost?

Doug Hirsch and Trevor Bezdek asked themselves the same questions and founded GoodRx as the answer. Today, 4.9 million Americans a month rely on GoodRx in order to find affordable healthcare and it has saved a cumulative $25 billion since 2011. When 70% of consumers still do not know that they can price shop for their prescriptions, I think GoodRx is just getting started.

BUSINESS

GoodRx started out as a price comparison tool for prescriptions and that remains at the core of what they do today (~90% of total revenues); however, they've been able to leverage the dominance they've achieved in this market to expand into adjacencies including subscriptions, pharmaceutical manufacturer solutions, and telehealth. *[See image below]*

PRESCRIPTIONS

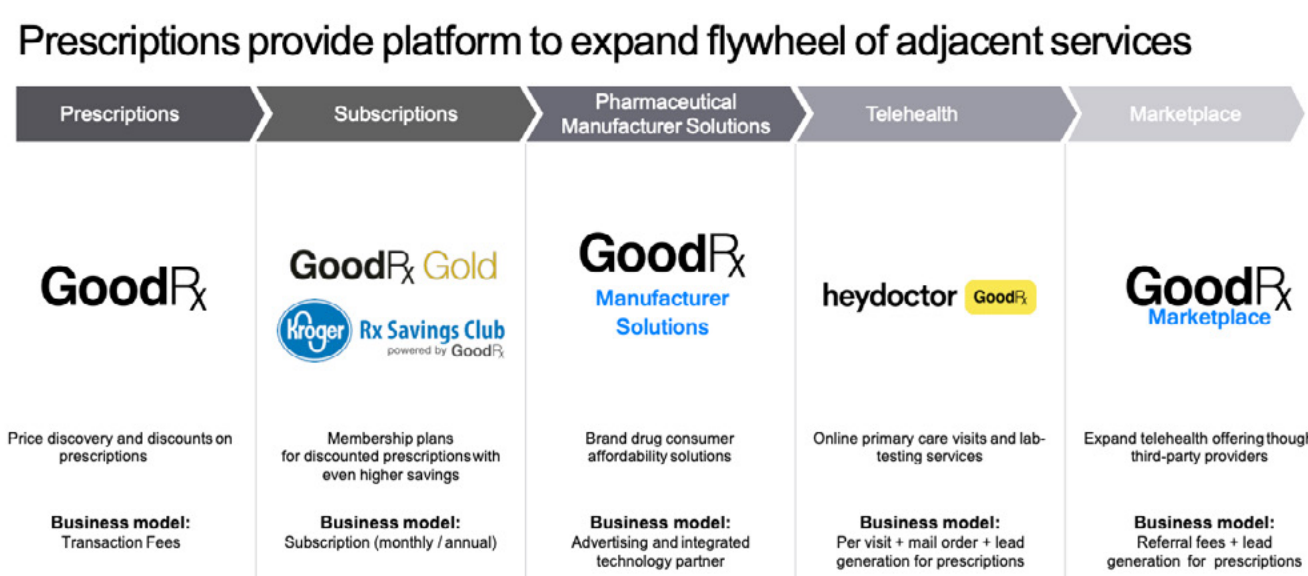
Through GoodRx's app or website, consumers access coupons or sign up for a discount card which significantly reduces their cost of medication (average discount to list price is >70%). GoodRx claims that consumers are 50-70% more likely to afford and fill a prescription and thus follow through with their prescribed treatment plan due to its offering.

Through GoodRx's app or website, consumers access coupons or sign up for a discount card which significantly reduces their cost of medication (average discount to list price is >70%). GoodRx claims that consumers are 50-70% more likely to afford and fill a prescription and thus follow through with their prescribed treatment plan due to its offering.

In order to understand where these cost savings come from, we need to take a step back and understand how drug pricing works. Pharmacies establish Usual and Customary (U&C) prices for prescriptions which is the price that uninsured consumers are asked to pay. These often differ dramatically between pharmacies and are usually significantly inflated. Pharmacies do this because they have contracts with Pharmacy Benefit Managers (PBMs) which themselves help insurance companies manage drug costs.

In these contracts, PBMs agree to pay the pharmacy the lesser of (http://www.thethrivingpharmacist.com/2016/11/27/the-art-of-the-claw-back/):

1. The Average Wholesale Price (AWP) minus a percentage plus a dispensing fee
2. The Maximum Allowable Cost (MAC) plus a dispensing fee
3. The pharmacy's U&C price



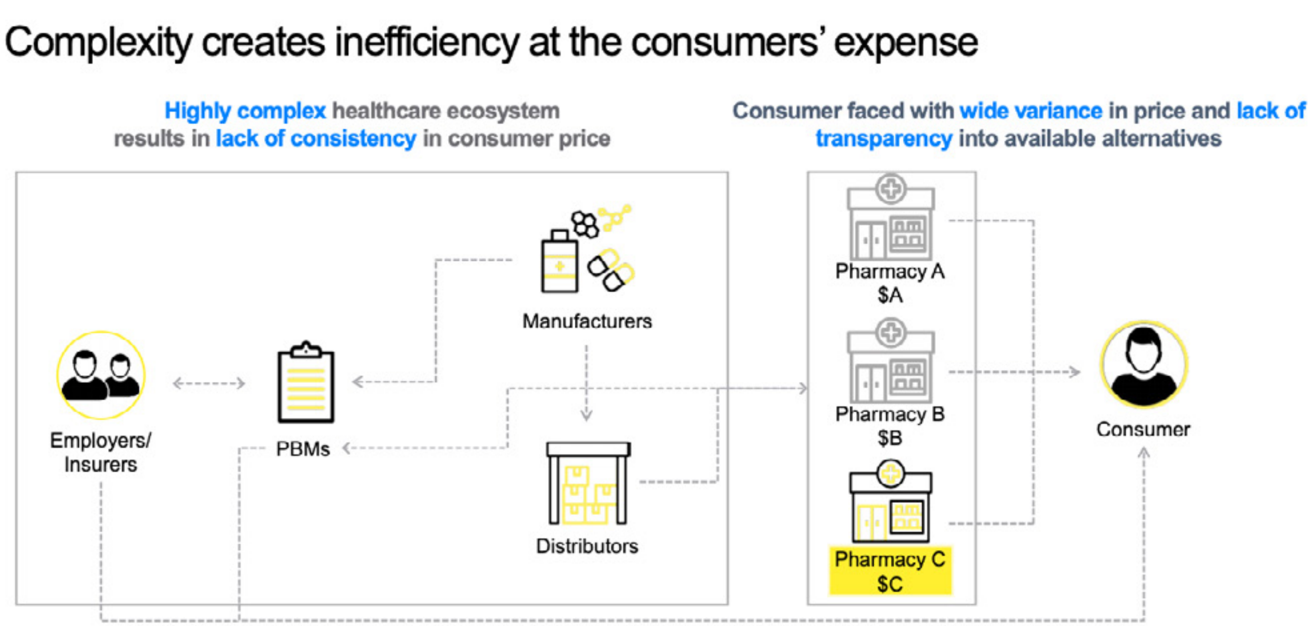
Source: GoodRx Investor Presentation (https://investors.goodrx.com/static-files/271f2a2f-3bb5-4a77-8292-047ab8853cc2)

AWP is the price that the pharmacy pays to buy the drug from the wholesaler plus a markup of usually around 20%. MAC is the maximum price that a PBM will pay for generic drugs or brand name drugs with generic versions available. PBMs have free reign over determining these prices, thereby forcing pharmacies to acquire drugs at more favourable prices, while using another higher set of prices when they sell to their clients, pocketing the difference. This leads to artificially high U&C prices which have to be set above the maximum allowable reimbursement from any payer so as to not potentially miss out on profits.

[see image below]

Since the PBM industry is itself disjointed with multiple MAC lists each with different drugs and prices, it becomes impossible to adjust U&C prices slightly above every single MAC price. Thus, if a pharmacy wanted to be competitive in the cash market, they would need to sacrifice their reimbursement margins which is a terrible trade-off as it forms the vast majority of their revenue, and PBMs are incentivized to lower MAC further overtime which further makes such a strategy untenable.

So, with that in mind, PBMs are able to negotiate "discounted pricing" via their MAC lists which end up being significantly lower than U&C prices. The pharmacies that are under the PBM's network accept these prices to access the plan's members. GoodRx partners with PBMs like Express Scripts and OptumRx that share their negotiated rates. For uninsured consumers, the value proposition is clear as they are no longer forced to pay the artificially high U&C prices. For insured consumers, which form ~74% of GoodRx's userbase (34% Medicare, 4% Medicaid, and 36% commercial), since MAC rates can vary dramatically across PBMs, 40% of the time for the top 100 drugs, GoodRx is cheaper than insurance co-pays. In both of these cases, PBMs benefit from accessing previously out-of-reach uninsured consumers as well as saving money by having consumers pay the entire cost out-of-pocket. The pharmacy collects a per-prescription fee which is paid to the PBM which then shares it with GoodRx for finding the customer, leading to a take rate of 14-15% on generics. This has steadily increased as more volume is transacted through GoodRx, and I'd expect this rate to continue to remain stable as there are no competitors that come close to GoodRx's scale.



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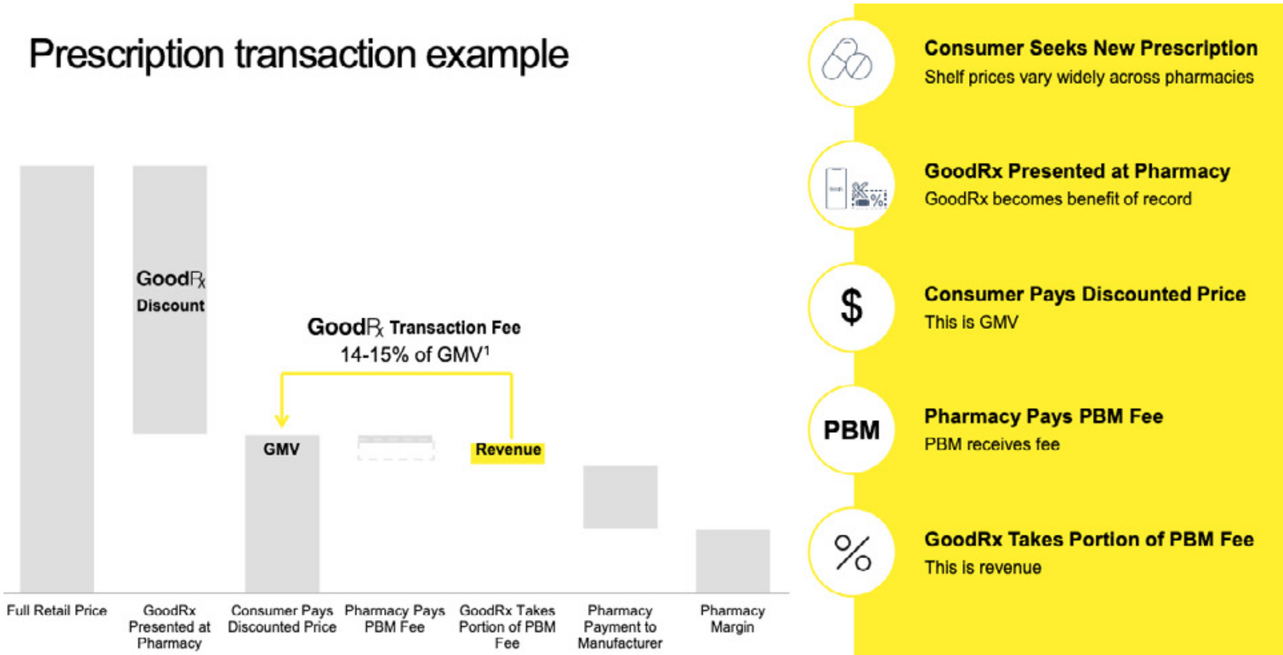
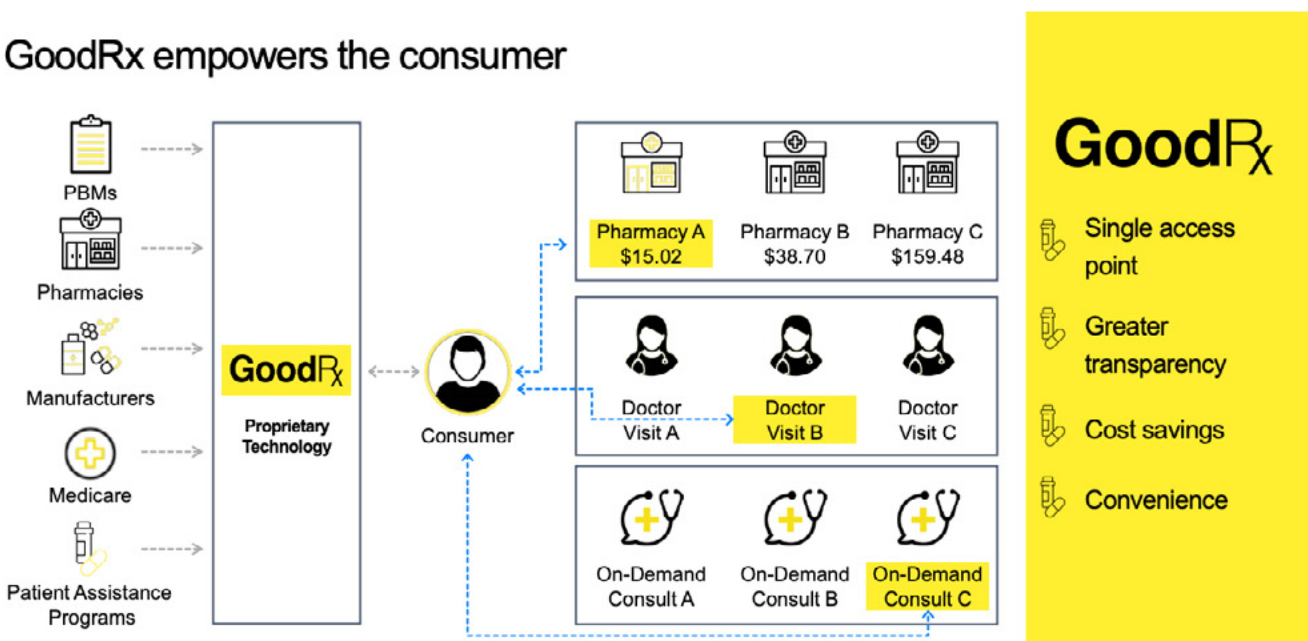


Source: GoodRx Investor Presentation (https://investors.goodrx.com/static-files/271f2a2f-3bb5-4a77-8292-047ab8853cc2)

Each day, GoodRx aggregates 150 billion prescription data points from PBMs, pharmacies, pharmaceutical manufacturers, patient assistance programs, and Medicare to always find the best prices for consumers. GoodRx's first-to-scale advantage is a big moat here, since they maintain the largest database of pricing information, they are able to consistently find lower prices than competitors which in turn, attracts more consumers and more PBMs, which contribute more data to drive lower pricing.



Source: GoodRx Investor Presentation (https://investors.goodrx.com/static-files/271f2a2f-3bb5-4a77-8292-047ab8853cc2)

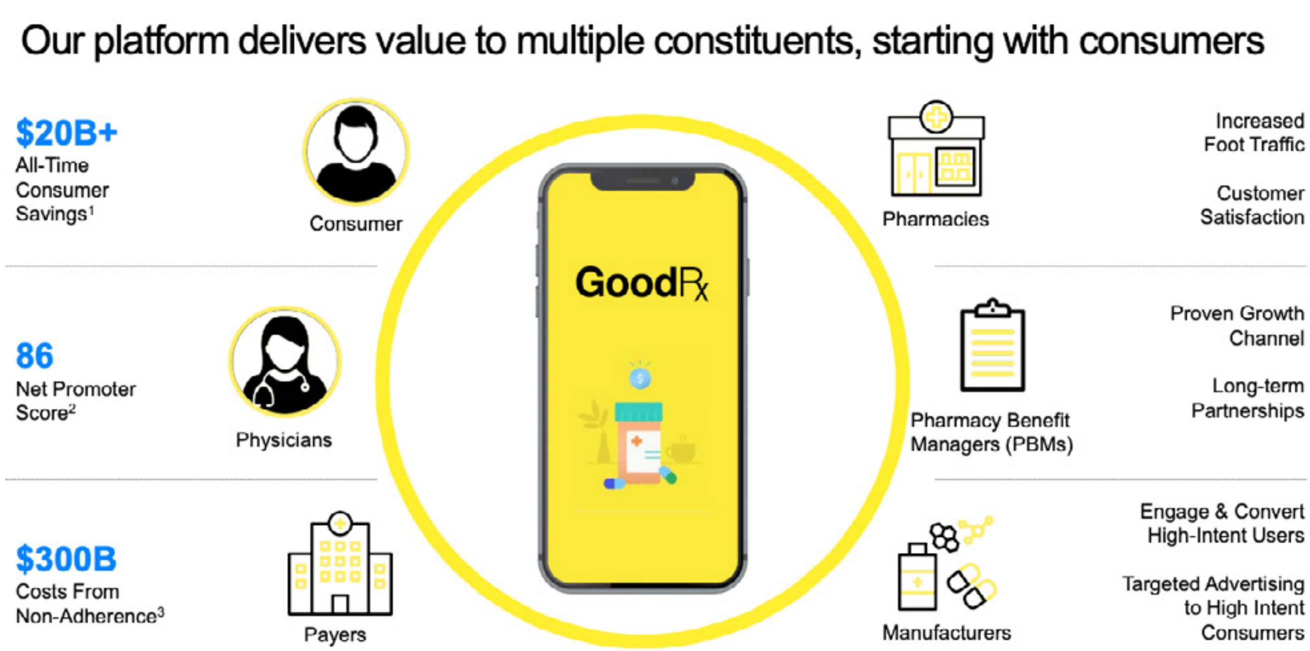
The value proposition to the consumer is clear, they are able to easily compare prices across over 70,000 pharmacies (nearly all in the US) and access GoodRx coupons for free through its user-friendly platform. Once a code is used, it's registered in the pharmacy's database and is automatically applied for future refills and in many cases, additional prescriptions. This introduces predictability to GoodRx's revenue base as over 80% of its transactions are from repeat activity (majority of prescriptions are for chronic medication) as well as driving future business to the pharmacy. GoodRx boasts an incredible NPS of +90 with consumers.

The benefit to PBMs is also evident as GoodRx is oftentimes their only significant direct-to-consumer channel, where they offer their network rates to GoodRx's userbase and earn a share of the per-prescription fee. As a result, GoodRx has never lost a PBM client.

GoodRx claims to benefit pharmacies by reducing the 20-30% of prescriptions written that are not filled due to cost, and increasing foot traffic and the likelihood of consumers purchasing high margin non-pharmacy items. Although in practice, pharmacies' margins get squeezed and even turn negative in some cases, and they are forced to pay the administrative fee per transaction when the customer may have visited their pharmacy regardless. This has led some pharmacies to attempt to disintermediate GoodRx by offering the discounted price directly to consumers through local coupon programs and not paying the fee. However, their PBM contracts forbid this, and it's hard to see this taking off at a widespread level before PBMs intervene; ultimately, it's the PBMs and GoodRx that have the bargaining power because they control the demand. This also seems to mostly happen at independent pharmacies, which form around 37% of the total.

SUBSCRIPTIONS

Another area where both pharmacies and GoodRx benefit is in driving repeat visits with GoodRx even partnering with Kroger, the fourth largest US retail pharmacy chain, to provide co-branded subscription products such as Kroger Rx Savings Club. Consumers pay an annual fee of $36 for individuals and $72 for families which is shared with GoodRx and they can access even lower prescription prices at all Kroger locations including over 100 common generics for free. GoodRx also partners with pharmacies to drive increased flu vaccinations which they've expanded from two to eight chains this year.



Source: GoodRx Investor Presentation (https://investors.goodrx.com/static-files/271f2a2f-3bb5-4a77-8292-047ab8853cc2)

GoodRx also offers their own subscription savings program called GoodRx Gold where frequent users of the app can again pay a $6 monthly fee for individuals and $10 for families to get over 1,000 prescriptions for under $10, as well as other features like free mail order delivery, refill reminders, and price alerts. These customers are substantially more profitable than prescription consumers with two times the revenue contribution in year one and the amount of subscribers has grown 15x from the end of 2018 to June 30, 2020.

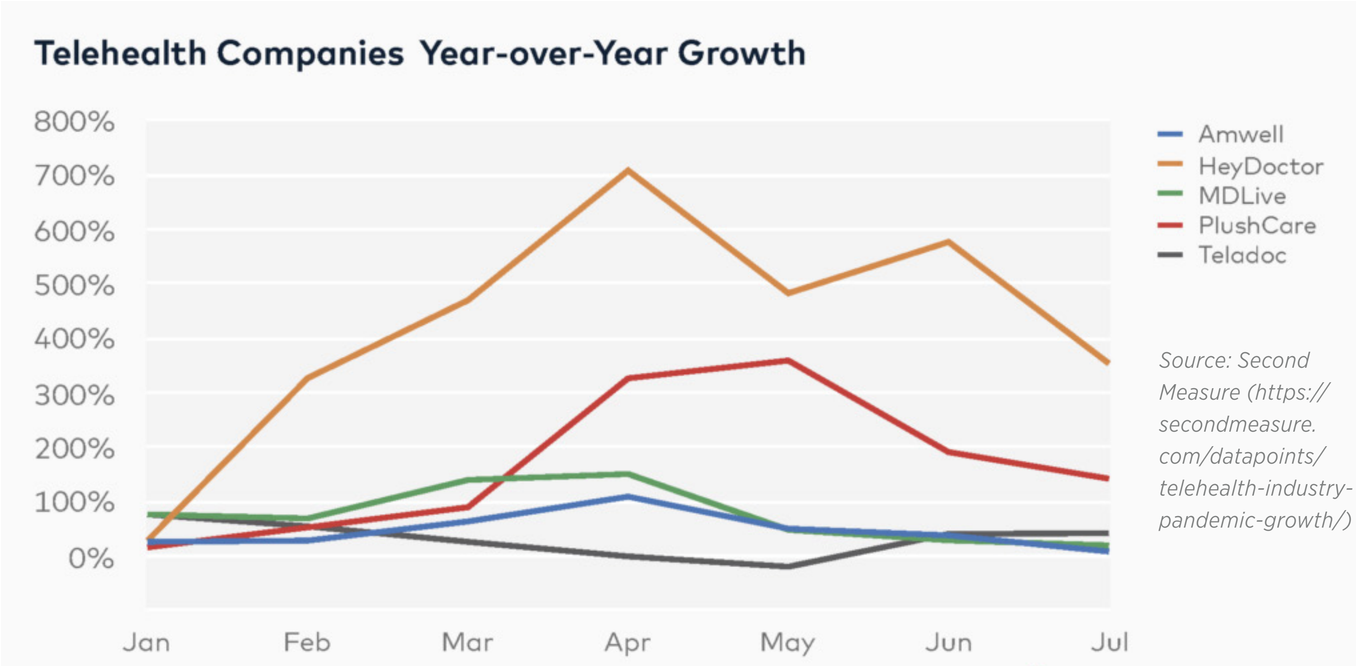
PHARMACEUTICAL MANUFACTURER SOLUTIONS

GoodRx is increasingly moving into brand medications which formed 80% of prescription spend in 2019 by partnering with pharmaceutical manufacturers that pay them to integrate their affordability solutions such as co-pay cards, patient assistance programs, and more for brand medications. Since brand medications are around six times more expensive as generics and coverage is complicated, GoodRx is an important channel to reach consumers as brand drugs form 20% of searches on its platform. It is reasonable to expect a lower take rate, however, as margins on brand medications are significantly lower than generics.

TELEHEALTH

This is all great but as with every DTC business, acquiring consumers cost-effectively is a challenge as CAC will continue to rise over time and Google becomes the real winner. However, GoodRx is able to circumvent traditional marketing channels and acquire customers at a fraction of the cost that other DTC digital health companies like Hims & Hers do by partnering with providers. In a recent survey, GoodRx found that 68% of providers have recommended GoodRx to their patients and 17% of its website visitors are healthcare professionals. Improving affordability leads to improved medication adherence which leads to better outcomes and lower overall costs. Non-adherence is estimated (https://www.sec.gov/Archives/edgar/data/1809519/000119312520234662/d949310ds1.htm#rom949310_11) to result in a patient death every four minutes in the US and can cost up to $300 billion per year in incremental healthcare expenses. When consumers use GoodRx, they are 50-70% more likely to afford and fill a prescription and thus follow through with their prescribed treatment plan, which reduces the burden on health systems and emergency rooms, so providers are very happy to recommend GoodRx and have an NPS of +86. In order to facilitate this, GoodRx provides physical cards for in- office use and launched a GoodRx Pro app (has an App Store rating of 4.8/5.0) for healthcare professionals to facilitate electronic prescriptions. GoodRx also works with leading electronic health record (EHR) providers to integrate its pricing tool directly into prescribing workflows.

This win-win-win for consumers, PBMs, and providers has culminated in an unmatched value proposition that has propelled GoodRx to become the second most popular medical app on the App Store, a testament to being the “front door of healthcare”. Furthermore, GoodRx is increasingly leveraging this massive userbase by expanding into adjacent markets. One such example is their foray into telemedicine in 2019 with their acquisition of HeyDoctor. Customers are paired with either an in-house provider or one from the various physician networks that GoodRx contracts with who cover 25 conditions with visits starting at $20 across all 50 states. Recently, GoodRx paired their prescription offering with HeyDoctor to offer discounted prices on drugs that can be fulfilled either through mail order (processed by a third-party partner) or a retail pharmacy. Since launching this feature, 10% of HeyDoctor consumers have taken advantage of GoodRx codes and there is room to grow as 20% of consumers who search for medication on GoodRx do not have a prescription. This direct-to- consumer telemedicine offering competes directly with digital pharmacies like Hims & Hers and Ro, as well as larger telemedicine companies like Teladoc or Amwell. Although HeyDoctor only sees a fraction of the visits that established competitors do, it has been growing significantly faster, demonstrating the value of GoodRx’s unique position as the leading prescription drug price comparison platform.



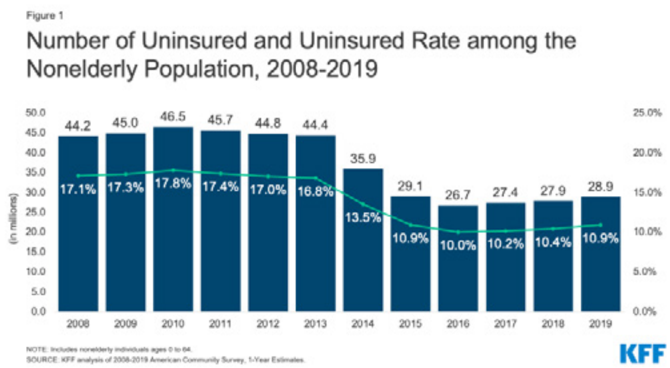
Lastly, GoodRx also operates a Telehealth Marketplace which allows consumers to access third-party providers of telehealth and lab tests, covering 150 conditions and offering transparency on pricing, services, and prescription delivery options. GoodRx again earns a fee here from referrals and partners with some providers to allow consumers to use its prescription offering post-visit.Top of Form

MARKET OPPORTUNITY

The healthcare industry has historically been resistant to disruption because it doesn't operate as a free-market should. This is especially evident in the pharmacy industry for cash-pay customers. Because pharmacies' pricing is largely dictated by payers, since that's where most of their business is derived from as I explained in the previous section, they are not able to introduce competitive pricing for the small base of cash-pay consumers. This misalignment has created opportunities for new players like Hims & Hers, Ro, or GoodRx to effectively serve this segment with a unique counter-position. Digital pharmacies where consumers without insurance can set up on-demand telemedicine consultations with providers and get their prescriptions delivered introduce affordability, convenience, and transparency that existing players can't match.

Whereas Teladoc is empowering health plans, self-insured employers, and health systems to reduce costs and improve outcomes with its virtual care platform, GoodRx is going directly to consumers and making their healthcare more affordable. Cost is a major factor in why 20% to 30% of prescriptions are left at the pharmacy counter, and the resulting non-adherence results in a death every four minutes in the US and cost up to $300 billion per year in incremental healthcare expenses. Americans want change, with 62% saying (https://www.realclearpolitics.com/articles/2019/05/17/health_care_voters_may_surprise_us__140350.html) that healthcare is the most or second most important issue; however, although drug pricing has consistently been a topic in every US election, little progress has been made.

In 2017 alone, Americans spent $334 billion (https://health.usnews.com/health-care/for-better/articles/2019-02-06/why-are- prescription-drug-prices-rising) on prescription drugs, up 41% from 2007, significantly outpacing other countries. Furthermore, consumers are taking on a larger burden of the cost, with the average premium for family coverage increasing 54% (https://www.cnbc.com/2019/09/26/health-insurance-premiums-increased-more-than-wages-this-year.html) over the past decade, significantly more than either workers' wages or inflation. And although the implementation of the Affordable Care Act (ACA) in 2010 led to a significant increase in Americans covered by insurance, that trend has reversed in recent years. In 2019, 10.9% of Americans (https://www.kff.org/uninsured/issue-brief/key-facts-about-the-uninsured-population/#:~:text=However%2C%20beginning%20in%202017%2C%20the,2016%20to%2010.9%25%20in%202019.) under 65 were uninsured, and 73.7% of them cited a lack of affordability as the main factor.



Source: KFF (https://www.kff.org/uninsured/issue-brief/key-facts-about-the-uninsured- population/#:~:text=However%2C%20beginning%20in%202017%2C%20the,2016%20to%2010.9%25%20in%202019.)

It's clear that Americans want solutions but awareness, in general, has been low due to a significant lack of transparency. As previously mentioned, according to GoodRx, 70% of consumers do not know that the price of a prescription can vary widely across pharmacies, sometimes by over 100 times for the same medication! Common healthcare services and surgical procedures can also vary greatly in price, with differences of up to 39 times for the same service within similar geographies. Hemant Taneja, a managing director at the VC firm General Catalyst touches on this in his book UnHealthcare. It's that misalignment of incentives where who decides the treatment, who pays for it, and who benefits are all different. This has resulted in an utter lack of transparency for consumers that is unique to healthcare. Why can we price shop on Amazon for something as inconsequential as a smartphone case when we can't do the same for provider visits or essential medications?

Through its prescription price comparison tool and telehealth marketplace, GoodRx is bringing prices down across the board and creating the same consumer-focused experience that we've come to expect in every other industry. This is a massive opportunity no matter how you frame it, in fact, GoodRx advertises an $800 billion TAM.

[see image below]

In reality, though, this figure seems a bit inflated as GoodRx cannot realistically capture the entire market. Let's calculate the serviceable addressable market.

Source: GoodRx Investor Presentation (https://investors.goodrx.com/static-files/271f2a2f-3bb5-4a77-8292-047ab8853cc2)

PRESCRIPTION OPPORTUNITY

According to CMS, the US prescription market is expected to reach $360 billion in 2020, with an additional $164 billion in unfilled prescriptions. However, 20% of prescription spending was for generics in 2019. Therefore, we can imply the generics market is worth $105 billion and brand $419 billion. It is reasonable to expect that GoodRx can capture the unfilled prescription opportunity as it claims consumers are 50-70% more likely to afford and fill a prescription with its platform. However, branded medications have historically only formed 5% of GoodRx's revenue base. Applying GoodRx's 14-15% take rate to the $105 billion generics market leads to a $15.75 billion opportunity. Generic spend is expected to grow at an 11% CAGR through 2024. GoodRx also charges for a subscription offering through GoodRx Gold, which is $5.99/month for individuals. Since the uninsured population would benefit the most from the discounts, let's assume that GoodRx can potentially capture the 28.9 million uninsured Americans, leading to another $2.08 billion.

PHARMACEUTICAL MANUFACTURER SOLUTIONS OPPORTUNITY

Pharmaceutical manufacturers spent $30 billion (https://apnews.com/article/f44a7baa710d458ca50edd66affc1b91) on medical marketing and advertising in the US in 2016. The majority of it went to health professionals in paying for free drug samples but consumer-focused ads are growing significantly faster, accounting for one-third of overall spending (from 12% in 1997) or $10 billion. This is the market that GoodRx can hope to capture.

TELEHEALTH OPPORTUNITY

It's no surprise that telehealth has seen a significant boost from the pandemic, with consumer adoption tripling (https://blog.zoom.us/transforming-medical-landscape-telehealth-before-during-after-covid-19/) from 11% in 2019 to 46% as of April 2020. In the US, there were 879.6 million outpatient visits in 2018, and McKinsey estimated that 24% of these visits could be delivered virtually, leading to 211.1 million visits a year. If we multiply that by HeyDoctor's $35 average visit fee, then we get a market size of $7.39 billion. It should also be considered that GoodRx gets referral fees with its telehealth marketplace.

This all leads us to a serviceable addressable market of $35.2 billion which is a far cry from the $800 billion TAM that GoodRx advertises but still significantly larger than most companies.

COMPETITION

There are numerous other prescription price comparison tools; however, GoodRx is by far the largest with SingleCare and RxSaver as its closest competitors. GoodRx's dominance is clearly evident when looking at App Store rankings: GoodRx is second, SingleCare is 24th and RxSaver is 26th as of the time of writing. RxSaver by RetailMeNot, like GoodRx, partners with a number of PBMs whereas SingleCare is a wholly owned subsidiary of RxSense. SingleCare's vertical integration means that they negotiate directly with pharmacies and don't have to share their fee with third-party PBMs; however, this also means they only work with about half the number of PBMs as GoodRx.

When comparing discounts for the top 10 most popular prescription medications (https://www.goodrx.com/drug-guide) on GoodRx in New York City, GoodRx's pricing advantage is clear, with lower prices than both SingleCare and RxSaver for 6 of the top 10 drugs.

Drug	GoodRx	SingleCare	RxSaver	GDRX % Above Low
Atorvastatin Tablet 40mg 30ct	$8.25	$15.00	$9.23	0%
Lisinopril Tablet 10mg 30ct	$3.69	$8.33	$4.00	0%
Albuterol Vial 3ml of 2.5mg/3ml 25ct	$8.73	$9.40	$8.17	7%
Levothyroxine Tablet 50mg 30ct	$4	$4.00	$4.00	0%
Amlodipine Tablet 10mg 30ct	$6.86	$19	$7.54	0%
Gabapentin Capsule 300mg 60ct	$9.67	$21.66	$8.64	12%
Omeprazole Capsule 40mg 30ct	$8.43	$41.47	$8.63	0%
Metformin Tablet 500mg 60ct	$2.96	$13.91	$4	0%
Losartan Tablet 100mg 30ct	$9	$24.29	$8.21	10%
Hydrocodone / Acetaminophen Tablet 5mg/325mg 60ct	$14.58	$22.75	$5.67	157%

Source: Company Websites

There are also various PBM-owned prescription savings programs such as Optum Perks by Optum, ReducedRx by CVS, or InsideRx by Express Scripts, but because they are limited to their own networks, they are not able to offer the same levels of savings. GoodRx's massive userbase means they have the most bargaining power and hence can negotiate better margins and work with more pharmacies and PBMs. Pharmacies also compete directly against GoodRx with their own savings programs but again, they are limited in the discounts they are able to formally offer because lowering U&C prices would encroach on the vast majority of their revenue base.

In terms of its telemedicine offering, HeyDoctor did over 1,000 visits a day in Q2, which is far cry from the 2.8M visits that industry giant Teladoc processed in the quarter. However, GoodRx has a unique relationship with patients. On average, Americans see their primary care physicians about four times a year (https://www.commonwealthfund.org/international-health-policy-center/system-stats/annual-physician-visits) whereas they visit a pharmacy about 35 times (https://blog.prescribewellness.com/community-pharmacist-key-medication-adherence/). The frequency at which consumers depend on GoodRx's app means that there is a significant opportunity to bolt on additional offerings to become the one-stop- shop for healthcare. I thought it was smart for them to launch a telehealth marketplace back in March 2020 as that industry, like with pharmaceuticals, is increasingly fragmented with over 260 providers (https://www.beckershospitalreview.com/lists/260-telehealth-companies-to-know-2020.html) in the US. Consumers can depend on GoodRx to help them parse through an increasing number of options and get discounts on some services while telemedicine providers see it as an important channel for customer acquisition. I mentioned in my Teladoc thesis that I see telemedicine largely as a commoditized service, and GoodRx's entry will no doubt continue to pressure per-visit margins down over time as they've done with prescriptions. I believe that the larger providers are somewhat insulated from this and especially Teladoc with its Livongo acquisition.

Lastly, GoodRx competes against digital pharmacies. This could be the likes of Amazon Pharmacy or Capsule which both offer free delivery after patients send them their prescriptions or integrated players like Hims & Hers or Ro where patients can chat with providers and get prescriptions written for them and regularly delivered in discrete packaging.

I think that GoodRx has a superior competitive position vis-à-vis both of these players. Capsule delivers same day but only in New York City, Boston, Chicago, and Twin Cities. Hims & Hers and Ro benefit from vertical integration and their main selling point is the convenience of seeing a doctor via telehealth and their unique branding. However, they are increasingly competing on price to attract customers. Ro, for example, recently launched Ro Pharmacy which is similar to GoodRx Gold in that consumers pay $5 per month per medication (for over 300 generic medications in 23 states). This is disruptive to traditional pharmacies that can't afford to compete on U&C pricing.

Where GoodRx wins is by offering lower prices, higher variety, and cheaper and more sustainable CAC. Instead of building out their own distribution networks, GoodRx can just leverage their relationships with multiple PBMs that compete with each other and drive down prices for GoodRx's userbase while offering the most diverse array of medications. They will always have the advantage in users which they can then cross and upsell into, aided by their provider relationships, making for more attractive unit economics.

Amazon has made a lot of news lately (https://press.aboutamazon.com/news-releases/news-release-details/introducing- amazon-pharmacy-prescription-medications-delivered) when they announced Amazon Pharmacy, an extension of their 2018 PillPack acquisition, where Prime members can now receive free two-day delivery and five-day delivery for everyone else. They also announced a prescription savings benefit where Prime members can save up to 80% discounts on generics and 40% for brand without insurance at over 50,000 pharmacies including Rite Aid, CVS, Walmart, and Walgreens. They are partnering with InsideRx (Express Scripts) which also works with GoodRx to provide the benefit.

The Pharmacy offering isn't likely to affect GoodRx significantly, as mail order only forms around 4.9% of prescriptions (https://www.politico.com/newsletters/prescription-pulse/2020/08/18/postal-service-pressure-turns-to-prescriptions-789999). COVID-19 had some brief impact with mail-order prescriptions rising 21% YoY (https://www.pharmacist.com/article/mail-order-drug-delivery-rises-during-coronavirus-lockdowns) during the last week of March to bring their share to 5.8%, but this bump was short-lived. People can even use the GoodRx coupons at Amazon Pharmacy, just like at every other pharmacy.

However, the discount card should be considered a direct competitor. Doug tried to assuage investor concerns by pointing out that regulations require that Amazon offer a discount card in order to publish drug prices and its main focus is on its mail order pharmacy. In addition, because Amazon is only working with a single PBM, it is unlikely they will be able to match GoodRx's discounts in the near term. GoodRx has access to 13 PBMs competing against each other to offer their cash network rates so it has a higher chance of finding cheaper prices. Retail pharmacies and PBMs will also likely be reluctant to work with Amazon, similar what happened after they acquired PillPack (https://www.insurancejournal.com/news/national/2019/09/19/540432.htm) which might push them closer to GoodRx.

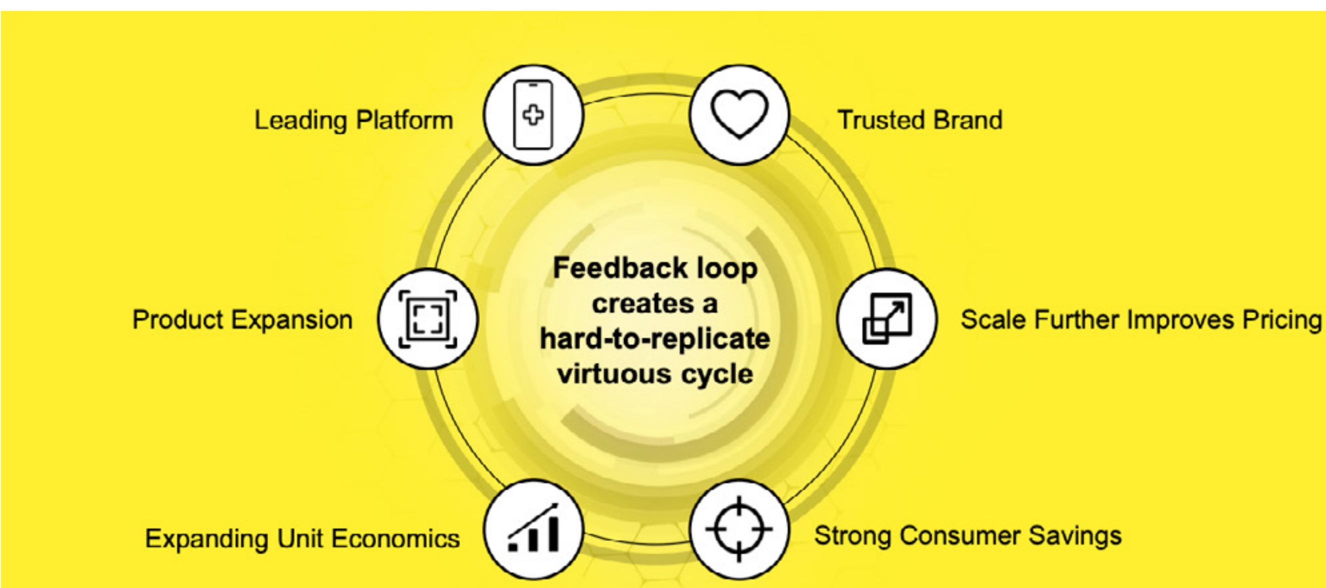
I believe the market overreacted to the announcement and discount cards and mail order aren't new and Amazon will face significant hurdles in adoption with both. Although Amazon might be able to overcome its pricing disadvantage through its scale, it would be premature to count GoodRx out. In the end, Amazon's entry might just broaden the market for everyone; Doug has previously said that their real competitor is the 70% of consumers who don't realize that prices differ across pharmacies.

COMPETITIVE ADVANTAGES

1. NETWORK EFFECTS

GoodRx's larger userbase means that they become a more attractive partner to PBMs, which results in access to the most data points, thereby increasing the likelihood that they will be able to find lower prices than competitors and driving further user growth.

The same dynamic occurs with telehealth where telemedicine providers partner with GoodRx and increasingly compete against each other by offering discounts to GoodRx users with the goal of making it up with increased volume.



Source: GoodRx Investor Presentation (https://investors.goodrx.com/static-files/271f2a2f-3bb5-4a77-8292-047ab8853cc2)

2. BRANDING

GoodRx is the leading prescription pricing tool in the US, and spent $177 million in marketing last year, approximately 45.6% of total revenue. With an NPS of +90 among patients and +86 among providers, as well as a 4.8/5.0 rating on the App Store and Play Store over 743,000 reviews and being the second most popular medical app, it's clear that GoodRx has established significant mindshare.

3. SCALE ECONOMIES

Providers actively champion GoodRx with over 68% having recommended GoodRx before. Combined with GoodRx's brand and lower prices and they are able to acquire users at a fraction of the cost as competitors with an under 8-month payback period. Besides SingleCare and RxSaver, other programs have struggled to get the same traction and new upstarts would have to spend significantly on user acquisition and subsidizing drug costs in order to match GoodRx's value proposition.

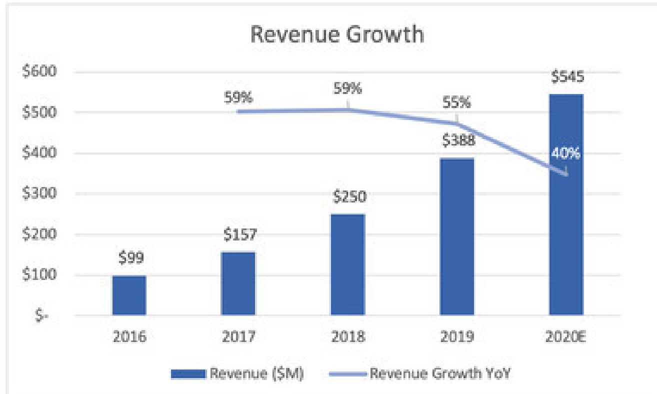
4. COUNTER-POSITIONING

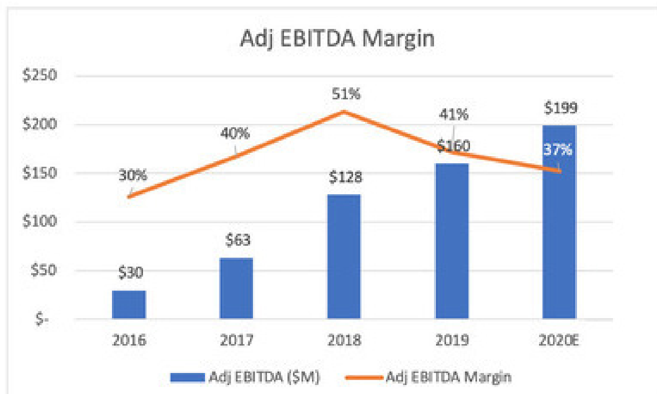
Pharmacies cannot lower cash prices significantly without damaging their core business, placing GoodRx in a unique position to serve an increasing number of cash-pay patients.

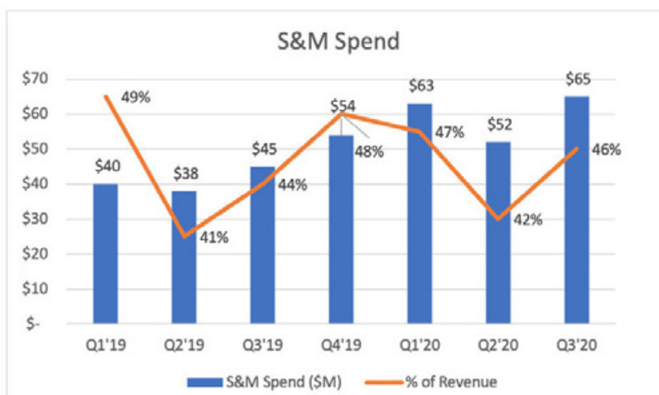
FINANCIALS

GoodRx has grown revenues at a steady 57% CAGR between 2016 and 2019, driven by monthly active consumers (MAC) and gross merchandise value (GMV) which grew at a 59% and 52% CAGR respectively. It has unheard of 95% gross margins and is already quite profitable with adjusted EBITDA growing at a 75% CAGR from 2016 to 2019.

GoodRx recently reported strong Q3'20 results. They achieved $140.5 million in revenue (+38% YoY), maintained extraordinary 94.6% gross margins, achieved a 37.8% adjusted EBITDA margin and grew net income by 53% YoY. Spending on sales and marketing remained consistent at 46% of revenue but an increase in R&D and G&A (mostly due to IPO) spending led to a 460 basis point decrease in adjusted EBITDA margin YoY. They logged a record 4.9 million monthly active consumers, up 29% YoY (MAC only includes prescription customers).



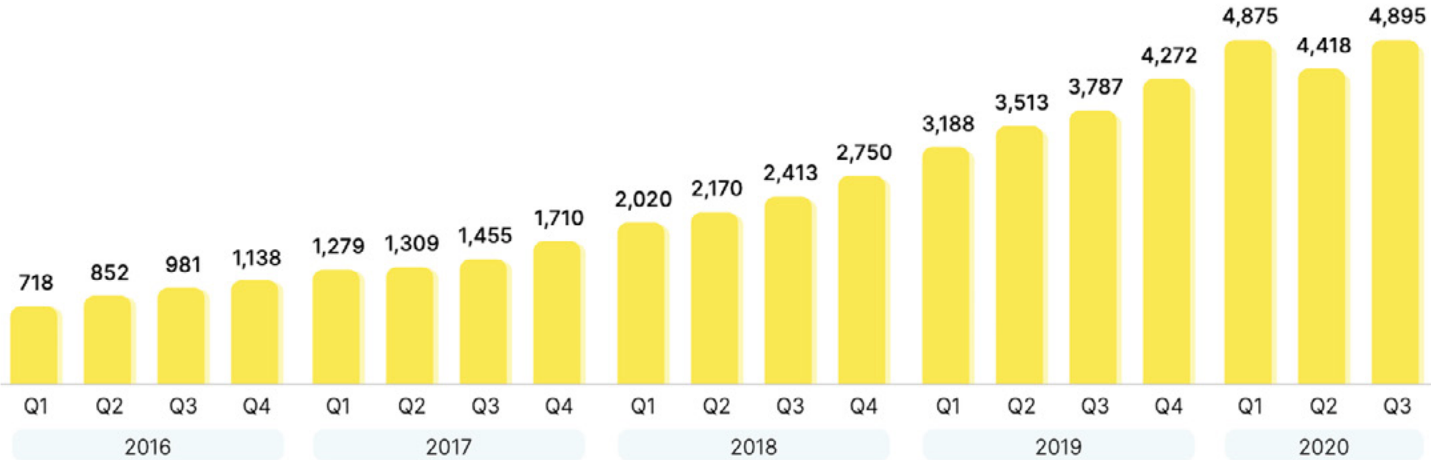




Source: Company Filings

Monthly Active Consumers

(in thousands)



Source: Q3'20 Shareholder Letter (https://investors.goodrx.com/static-files/6e0553ce-6096-4ec7-8f53-5a6c7f24533d)

Prescription transaction revenue grew 30% YoY to $124.4 million and other revenue, including their subscription, pharmaceutical manufacturer, and telehealth business lines, grew 170% YoY to $16.1 million. They also launched over 30 new manufacturer partnerships as they continue to expand into brand medications and signed a multi-year extension of their Kroger Rx Savings Club partnership. They issued Q4'20 guidance of 31% YoY revenue growth, adjusted EBITDA margin of 30-31%, and MAC growth of 4-5% sequentially. They attribute the deceleration in revenue and MAC growth to COVID- 19 having a negative impact on the provider visit volume and hence the number of prescriptions being issued, although the 80%+ repeat activity rate should preclude them from significant volatility. Moreover, subscription customers are not included in the MAC count which is increasingly significant as the number of subscribers increased 15x from December 2018 to June 2020. The decline in Q4 adjusted EBITDA margins is due to increased investment in S&M with a shift of spend from the third quarter. Long-term EBITDA margins targets are ~40%.

					Sales ($mm)			Sales Growth Y/Y %			EV/Gross Profit	
Ticker	Name	Price	Market Cap ($Bn)	Enterprise Value ($Bn)	CY2019	CY2020	2021e	CY2020	CY2021	Gross Margin %	CY2020	CY2021
Healthcare Disruptors												
TDOC	Teladoc	$ 199.58	33.10	33.58	$ 723	$ 1,356	$ 1,953	87.6%	44.0%	67.0%	36.96	17.19
AMWL	Amwell	$ 31.63	8.45	8.93	$ 149	$ 238	$ 264	59.7%	10.8%	43.0%	87.31	33.88
ONEM	One Medical	$ 38.47	5.77	5.34	$ 276	$ 363	$ 472	31.3%	30.2%	35.1%	41.95	11.31
ACCD	Accolade	$ 59.28	3.36	3.13	$ 132	$ 156	$ 193	18.2%	23.7%	43.7%	45.99	16.24
HCAT	Health Catalyst	$ 39.88	1.82	1.63	$ 155	$ 188	$ 226	21.3%	20.2%	49.6%	17.48	7.21
GDRX	GoodRx	$ 42.71	17.45	18.02	$ 388	$ 545	$ 737	40.5%	35.2%	95.6%	34.59	24.45
Median			**7.11**	**7.14**	**$ 216**	**$ 300**	**$ 368**	**35.9%**	**27.0%**	**46.7%**	**39.46**	**16.72**
Average			**11.66**	**11.77**	**$ 304**	**$ 474**	**$ 641**	**43.1%**	**27.4%**	**55.7%**	**44.04**	**18.38**
High-Growth SaaS												
TWLO	Twilio	$ 342.41	57.97	55.99	$ 1,134	$ 1,668	$ 2,194	47.1%	31.5%	52.8%	63.57	48.33
DOCU	Docusign	$ 225.40	45.91	45.72	$ 951	$ 1,350	$ 1,782	42.0%	32.0%	74.7%	45.34	34.35
COUP	Coupa Software	$ 318.43	24.06	24.07	$ 379	$ 490	$ 619	29.3%	26.3%	63.2%	77.74	61.54
TEAM	Atlassian	$ 232.01	60.25	58.99	$ 1,755	$ 2,058	$ 2,518	17.3%	22.4%	83.3%	34.41	28.12
OKTA	Okta	$ 252.35	36.41	35.58	$ 570	$ 784	$ 1,021	37.5%	30.2%	73.7%	61.58	47.29
VEEV	Veeva Systems	$ 264.05	43.17	41.68	$ 1,084	$ 1,394	$ 1,672	28.6%	19.9%	72.0%	41.52	34.62
Median			**44.54**	**43.70**	**$ 1,018**	**$ 1,372**	**$ 1,727**	**33.4%**	**28.3%**	**72.9%**	**53.46**	**40.95**
Average			**44.63**	**43.67**	**$ 979**	**$ 1,291**	**$ 1,634**	**33.6%**	**27.1%**	**70.0%**	**54.03**	**42.37**

Source: Factset

RISKS

GoodRx faces three primary risks: PBM concentration, margin contraction from an increasing mix shift towards their lower margin telehealth offering, and healthcare reform.

GoodRx's top three PBM partners accounted for 48% of revenue in H1'20, down from 55% in 2019 and they now work with over a dozen PBMs in total. However, GoodRx is a value-add for these PBMs because they can leverage the cash-network rates they negotiate with their pharmacy networks to access GoodRx's userbase. Thus, there is not much rationale not to work with GoodRx and as such, they have never lost a PBM partner. PBMs might feel threatened in the future, as more volumes pass through GoodRx, but even if they do cancel their contract, GoodRx would still get paid in perpetuity for the transactions they generate and just divert those revenues to another PBM's rates. In fact, GoodRx already mix shifts between PBMs depending on which one is most favourable to them in terms of margins (advantage of operating in a fragmented industry and owning the customer!). If the industries that GoodRx competes in see increasing consolidation, it would be a threat to GoodRx's take rates however as suppliers gain bargaining power. At the same time, the larger GoodRx gets, the less control any single PBM would have over them because they would make up a larger portion of their overall volumes.

GoodRx's telehealth services also operate at significantly lower contribution margins than their prescription business (HeyDoctor at breakeven) which will pressure their margins as it is growing significantly faster. I believe that the investment is worth it though, as it will allow GoodRx to further monetize their customer base and make the platform stickier for both patients and physicians. In addition, the core prescription business works against itself longer term, because as prices start to come down across the board, then the need for a GoodRx will start to diminish. The telehealth market is developing fast and very much still in land-grab mode, so although this will continue to be a drag on margins for GoodRx right now, it will lead to stronger revenue growth over the longer term. It should also be noted that telehealth only formed ~17% of other revenues and 2% of total revenues in H1'20 so it is very early. Contribution margins with manufacturer solutions are also significantly higher at ~80%, and comparable to their prescription business so how fast that grows relative to telehealth will be important to consider.

Lastly, reform on prescription drug pricing is been a frequent issue every election but no substantial change has been achieved. Doug even said that he wants the government to solve this and that GoodRx shouldn't have to exist (https://www.protocol.com/manuals/health-care-revolution/prescriptions-goodrx-coronavirus-interview). Medicare Part D, which covers prescription drug costs, was enacted by George W. Bush in 2006 and has met opposition ever since (https://www.politifact.com/factchecks/2017/jan/17/tammy-baldwin/tammy-baldwin-federal-government-prohibited-negoti/) because the government can't negotiate prices with drug manufacturers but efforts to repeal this have fallen flat. Besides that, Trump recently signed four executive orders (https://www.cnn.com/2020/07/24/politics/trump-drug-prices/index.html) aimed at lowering drug prices:

1. Set Medicare reimbursement levels for certain drugs based on the rates that other developed countries pay, a "most- favoured-nation-price"
2. Allowing pharmacies and drug wholesalers to import drugs from Canada where prices are lower
3. Directing Federally Qualified Health Centers to pass along discounts on insulin and EpiPens to their patients
4. Banning drug manufacturers from providing rebates to PBMs and insurers for people who have prescription drug coverage under Medicare Part D and passing those discounts to consumers directly

However, signing these orders is just the first step in making these changes into reality, which would face intense opposition in the courts, and even if implemented, would not make a substantial difference in drug prices. For example, drug manufacturers negotiate rebates with PBMs for better coverage, with the goal of encouraging patients to choose their brand name drugs. If the patient buys that drug, PBMs receive a rebate which they share with insurance companies. The proposal to ban rebates was originally dismissed because it would lead to higher costs for insurance companies, higher premiums for patients, and higher Medicare spending by the government. Furthermore, as I mentioned, branded medications have historically only formed 5% of GoodRx's revenue base. Overall, significant disruption to GoodRx's business model is unlikely to happen in the near-term.

CONCLUSION

American healthcare has never been more unaffordable and COVID-19 exacerbated the issue by leaving millions more without coverage. When the government's hands continue to be tied as a result of political gridlock and intense lobbying by powerful industry stakeholders against any significant change, GoodRx has never been more important. Its business model is a **win-win-win** for PBMs/insurers, healthcare consumers, and providers and quite literally saves lives. It's clear the importance of this mission reverberates through the company as well with a 4.6/5.0 Glassdoor rating (https://www.glassdoor.ca/Reviews/GoodRx-Reviews-E1138304.htm) and 98% approval of the co-CEOs.

Doug and Trevor are on a mission to build the leading consumer-focused digital health platform in the US. By helping users filter PBM's negotiated rates and telemedicine offerings, they are putting the power back in the consumer's hands just like it is in every other industry and becoming the **first stop on any health journey**.

Once GoodRx establishes themselves as the consumer-facing platform where most drugs are purchased through, they will have the pricing power to push both PBM and pharmacy margins down and maintain a high take rate because the alternative to not using GoodRx would be a materially higher drug price for the consumer.

ABOUT SUMZERO

SumZero is the world's largest community of investment professionals working with the industry's most prominent hedge funds, mutual funds and private equity funds. With more than 20,000+ pre-screened professionals collaborating on a fully transparent platform, SumZero provides direct access to thousands of proprietary investment reports every year and fosters on-going communication within the network.

The research on SumZero cuts through the noise that pervades the industry and provides its community with in-depth, actionable investment research and data. The platform further enables members to build a track record, expand their networks in relevant capacities, and identify further professional opportunities within the industry.

SumZero offers several ancillary services in support of our research platform. These services include capital introduction, buyside career placement, media placement and more.

THE COMMUNITY

SumZero's carefully vetted community of members is currently 20,000+ and growing globally. Driven by a network effect, the community's ongoing growth stimulates platform interaction and engagement - steadily building a robust collection of data that continuously delivers value to its users.

20,000+

MEMBERS GLOBALLY

300+

AVERAGE NUMBER OF NEW CONTRIBUTING ANALYSTS EACH YEAR

THE RESEARCH

SumZero provides investment professionals access to continuous idea generation and allows them to monitor what their peers are saying about names in which they're currently invested, or looking to invest in.

There is no other community-driven platform or network from which an investment professional can derive more direct value.

5,700+

COMPANIES COVERED

2,400

AVERAGE WRITE UP WORD LENGTH

14,000+

PROPRIETARY RESEARCH REPORTS

1,200+

AVERAGE NUMBER OF NEW RESEARCH REPORTS PER YEAR

CAP INTRO

SumZero Cap Intro is a reverse-solicitation platform that connects eligible funds with pre-qualified institutional LPs for the mutual purpose of capital allocation. Cap Intro is available on an opt-in basis to all hedge funds, private equity funds, and other asset managers that are actively fundraising.

Using Cap Intro, fund managers leverage direct exposure to a community of more than 400 pre-vetted allocators by presenting their strategy and performance via a self-curated fund profile. In turn, allocators use these profiles to discover, screen, and initiate direct conversations with funds.

SUCCESS METRICS

While SumZero Cap Intro never guarantees the placement of capital to any individual firm, the platform can guarantee recurring exposure to a highly selective group of institutional LPs with active mandates associated with fund allocations. Some success metrics follow.

UNIQUE ALLOCATOR INQUIRIES TO FUNDS

2014	86
2015	101
2016	190
2017	117
2018	356
2019	593
2020	260

OF DOWNLOADED ATTACHMENTS BY TYPE

INVESTOR LETTER	4,600+
PITCHBOOK	3,400+
RETURNS	490+
CASE STUDY/ WHITEPAPER	470+
OTHER	1,050+

CROSS BORDER INQUIRIES TO FUNDS	150+

COMMUNITY FEEDBACK

SumZero provides investment professionals access to continuous idea generation and allows them to monitor what their peers are saying about names in which they're currently invested, or looking to invest in.

There is no other community-driven platform or network from which an investment professional can derive more direct value.

> SumZero is the industry thought leader attracting research from vetted buyside analysts/PMs at funds operating around the world, from New York, to London, Hong Kong and Singapore. Transparent, actionable investments ideas with a focus on primary research, rigorous valuation work, and contrarian opportunities.

SIDDHARTH CHORARIA
HEAD OF ANALYSIS, AMIRAL GESTION

> SumZero is a phenomenal resource, providing access to an army of PMs and buyside analysts.

JOHN ROLFE
FOUNDER/PM, ARGAND CAPITAL ADVISORS

> SumZero has been beyond helpful to my hedge fund career, giving me the exposure that eventually led me directly into not one, but two hedge fund jobs. For anyone who works on the buyside, if you can post your ideas on SumZero, I highly encourage you to do so as it's an increasingly competitive investment in your personal brand. As loyal and grateful as I am to Wharton, I have often said that SumZero has done more for my hedge fund career than my MBA ever did. I simply cannot thank you guys enough for this and for giving me the chance to compete for eight years in the world's biggest, most legit online community of hedge fund investors.

VICTOR BONILLA
PORTFOLIO MANAGER, ALLIANCEBERNSTEIN

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