FRAZIS

• CAPITAL PARTNERS •

March 2019

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Dear investors and well-wishers,

The Fund returned +6.3% in February 2019, ahead of the S&P 500 (+3.0%) and ASX 200 (+2.7%).

Top Contributors	
iQiyi	1.9%
Stanmore Coal	1.2%
Afterpay	1.1%
Carvana	1.0%
Weibo	0.6%

Top Dectractors	
Macro and FX	-1.1%
Shorts	-0.9%
Fiat	-0.8%
Amazon	-0.2%
Facebook	-0.16%

We reduced the risk profile of the fund considerably since the start of the year, cutting our long equity exposure to 82%, and our short exposure to 17%.

This gives us a net equity exposure of about 65%. This number is deliberate, as it allows us to increase our long term investments by 50% incrementally (65% to 100%) during the next sell-off, and is about half the gross exposure we were running going into October 2018. While this is defensive, but we are as excited as we have ever been about the individual opportunities in our current portfolio.

We had to make some tough decisions as to where to cut. We exited Weibo, after a strong rally from its lows, and also Alibaba, at circa 150% higher than when we first purchased in 2016.

iQiyi is our only Chinese stock at the moment. During the month iQiyi announced that paying subscribers had grown 72% to 87.4 million by the end of 2018, up from 51 million a year earlier. This was over a period where the stock nearly tripled, then lost two thirds of its value, and is now up 80% year-to-date.

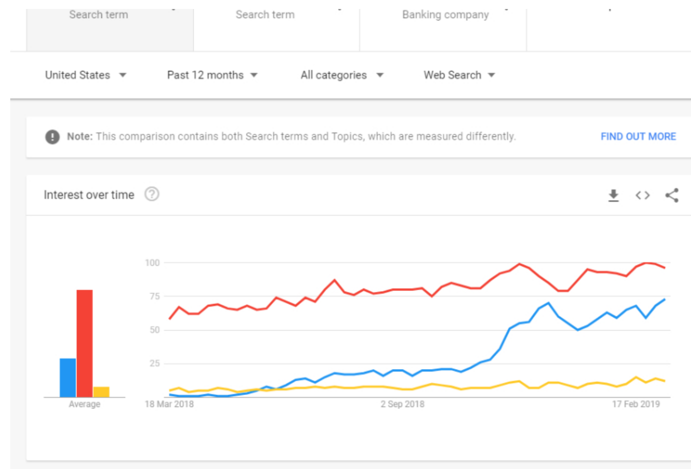
This wild volatility stands in stark contrast to the steady improvement in the underlying company. As the faster growing revenue streams (subscribers and the on-sale of content) become larger parts of the pie, there's a every chance growth actually accelerates from here.

We also note that iQiyi is adding more subscribers than Netflix in absolute numbers, is growing faster on a percentage basis, and trades at half the sales multiple.

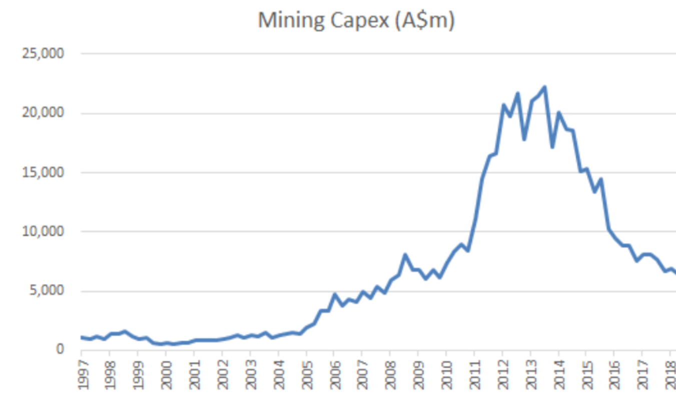
Metric	Netflix	iQiyi
Subscribers (millions)	139	87
Change on prior year (millions)	27	37
Subscriber growth yoy	25%	72%
Revenue growth yoy	21%	55%
Enterprise Value / Revenue (trailing 12m)	10	5

We continued to track Afterpay's US progress. Notably, search traffic is now above where it was in the Christmas trading period, barely two short months ago, and traffic has increased over a period where two competitors saw traffic declines.

afterpay | affirm | Klarna | +

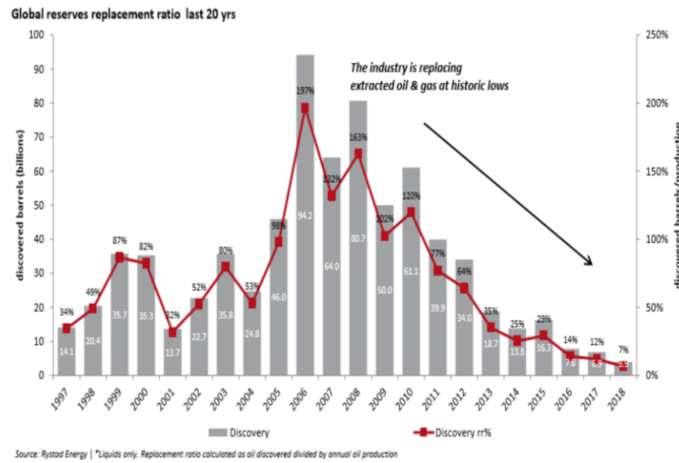


In Australia, there are a number of commodity players trading at 2-3x EBITDA. We are cautiously wondering if we may be at the start of an extended recovery in the mining sector that could see valuations drift up over the next couple of years. There drop in mining investment is striking:



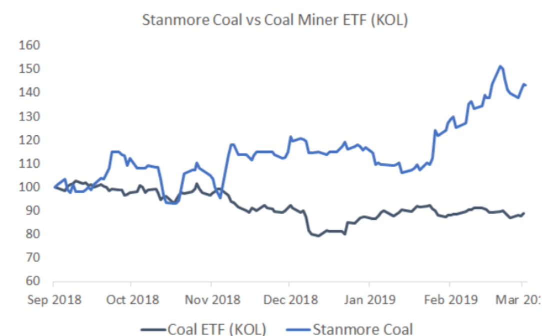
Source: ABS

This is noticeable in other sectors as well, such as oil and gas:



Stanmore and coal price risk

We've discussed Stanmore in previous letters, and the company now trades at roughly 2x FY19 forecast EBITDA. We like the net cash, valuation, growth profile and 56% operating margin, far more than the coal price exposure, so we initiated a small short position in a coal miner ETF to mitigate this. On average, the miners in the ETF have lower margins and higher net debt.



Carvana

If you bumped into me over the past few weeks you probably heard me talking about Carvana.

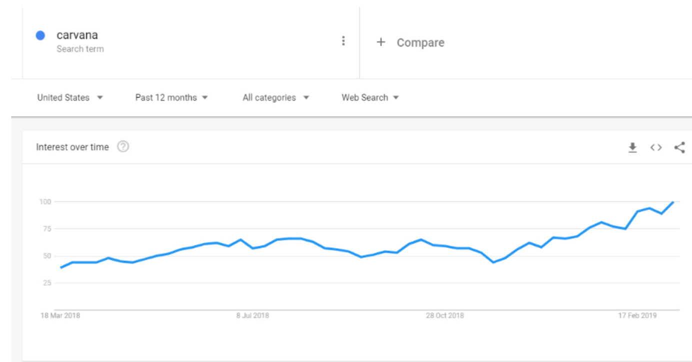
Car vending machine

Carvana offers a fully integrated way to buy a second hand car. Customers choose from a nationwide inventory, and cars are delivered using Carvana-owned logistics. You can pick up a car from one of 15 vending machines in highly visible locations and not even have to speak to anyone. Processes around trade-ins, financing, and servicing contracts are all automated.

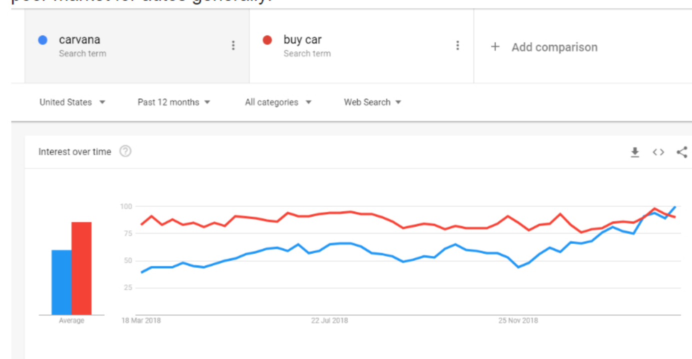
Many of these features are intrinsically superior to the existing dealer experience. Carvana can hold more inventory, can adjust it according to customer data, and can scale in a way that a traditional dealership fixed at a fixed location, servicing a local market, can not.

That the user experience is superior is not speculation on our part - the firm grew revenues organically by over 120% over the past 12 months to nearly US$2 billion, and they only cover about 60% of the United States.

This year, Carvana recently opened in New York, which may explain the large lift in traffic over the past few weeks. We tentatively suggest bodes well for March 2019 results:



This has not been due to a surge in US second hand car demand, as it has been a poor market for autos generally:



So why is Carvana's approach proving so compelling?

There are perhaps three good reasons:

1. The firm offers a 7 day return policy, effectively a long test drive.
2. There is a 100 day warranty, which reduces buyer's inertia and the fear of landing a dud. Carvana guarantees their cars haven't been in an accident.
3. Most of all, you don't need to speak to a sleazy car salesman.

The stock has (also) had a wild run, trading up to 6x sales in mid 2018. We first purchased at $36, when the stock had roughly halved from its peak. Over that period

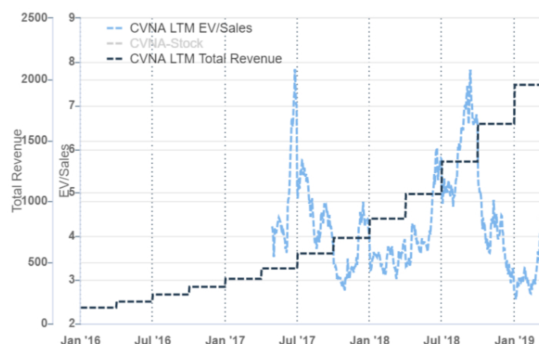
revenue increased from $1.3 billion to $2.0 billion, so the multiple compressed even more.

These numbers compare well to more well-known growth names:

	Growth	EV Sales
Shopify	59%	19
MongoDB	61%	21
Wisetech	44%	24
Nearmap	32%	17
Altium	26%	20
Xero	38%	16
Hubspot	37%	13
Atlassian	41%	25
Carvana	**128%**	**3**

Year-on-year growth rate & current EV / last 12m revenue. Carvana multiple at initial purchase was ~2.5x

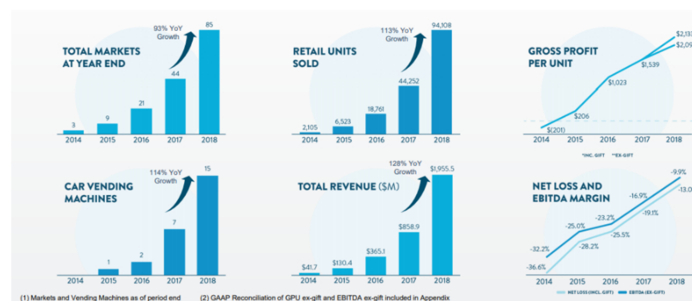
We don't use sales multiples to actually value companies, but they can be more illuminating than stock prices, which don't reflect changes the underlying company (in this case rapid sales growth).



The chart above shows broadly what we are looking for: a steady increase in fundamentals that we can ride for several years. Now that we've entered at an attractive price on an absolute and relative basis, we'll ignore the inevitable impending price volatility.

Profitability

The company clearly has compelling advantages over incumbents, and the organic revenue growth is striking, but what of profits? The company is still losing money on a NPAT basis, but has demonstrated significant operating leverage with every update:



Most of their gross profit comes from financing and selling vehicle service contracts and the like. Some have raised this as a negative - but we actually like the approach, as it makes competing very difficult. Carvana's striking operating leverage is evident along all key cost items, which have steadily declined as a percentage of revenue.

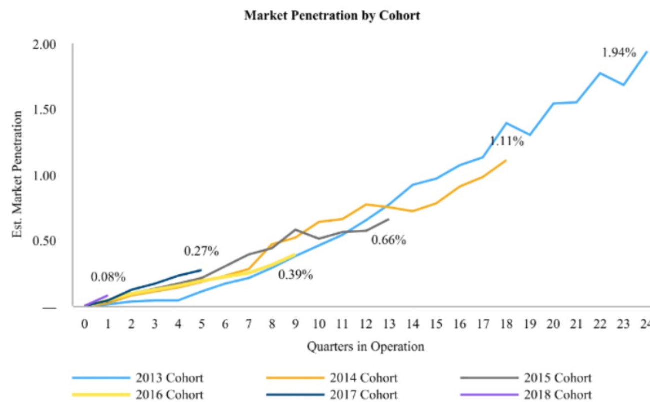
LONG TERM FINANCIAL GOALS

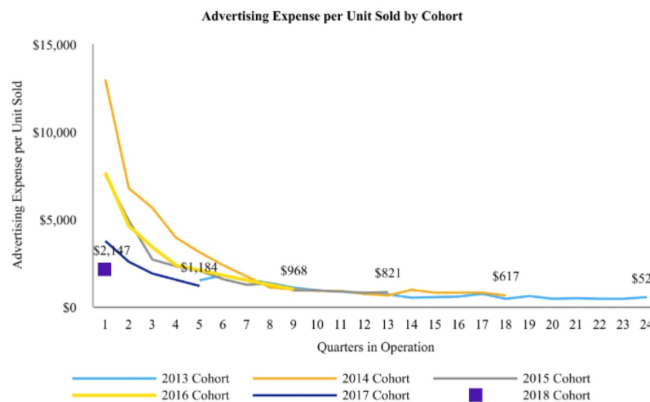
	FY 2016	FY 2017	FY 2018	Long Term Target
YoY Revenue Growth	180%	135%	128%	-
Gross Margin (incl. Gift / ex-Gift)	5.3%	7.9%	10.1% / 10.3%	15 – 19%
Advertising	7.4%	6.5%	5.7%	1.0 – 1.5%
SG&A ex. Advertising and D&A (incl. Gift / ex-Gift)	21.1%	18.2%	14.9% / 14.5%	4.5 – 5.5%
D&A	1.3%	1.3%	1.2%	0.5 – 1.0%
SG&A Total as % of Revenue (incl. Gift / ex-Gift)	29.8%	26.0%	21.7% / 21.3%	6 – 8%
Net Loss Margin (incl. Gift / ex-Gift)	(25.5)%	(19.1)%	(13.0)%/(12.4)%	-
EBITDA Margin (ex-Gift)	(23.2%)	(16.9%)	(9.9%)	8 – 13.5%

The firm has achieved a 2% market share in their original market. Carvana is targeting an 8-15% final EBITDA margin, and given the operating leverage shown above, 8% seems possible and in line with traditional dealerships.

If so, a simple calculation shows the company could be worth $10 billion for every 1% market penetration they achieve, vs our initial purchase valuation of ~$5 billion. The firm is issuing equity to fund growth, but minor dilution for >100% growth is worth paying.

Carvana value for every 1% market share	
Market size	43,000,000
%	0.01
Cars	430,000
Average car value (US$)	$19,000
Revenue (US$m)	$8,170
EBITDA margin	8%
EBITDA	$654
EBITDA multiple	15
Value per 1% of market penetration	$9,804





There's significant short interest as investors positioned for a downturn in US autos, as well as governance risk, as the founders exercise full control. The firm was spun out of their auto dealership, and there are continued commercial relationships. The short interest is over 50% of the free float.

We like this, as when the price rises, shorts with risk management processes in place will be forced to buy their shorts back.

Carvana's genesis from an actual dealership is a positive in our view, as it will be hard for the US tech companies like Amazon to enter the space without the expertise and infrastructure. In fact, if they did so, they might well decide to buy Carvana.

There have been plenty of attack pieces written on Carvana which remain on the internet. The management team has done exactly what we'd like them to do: keep quiet, release additional information where required, and grind out operating performance to force the shorts to buy back at higher and higher prices. Many of these reports have aged badly.

We noticed a similar dynamic in place in Afterpay, where short interest rose during a period where we actually gained higher conviction, and sure enough, as the operating updates rolled in, the stock reacted explosively to the upside.

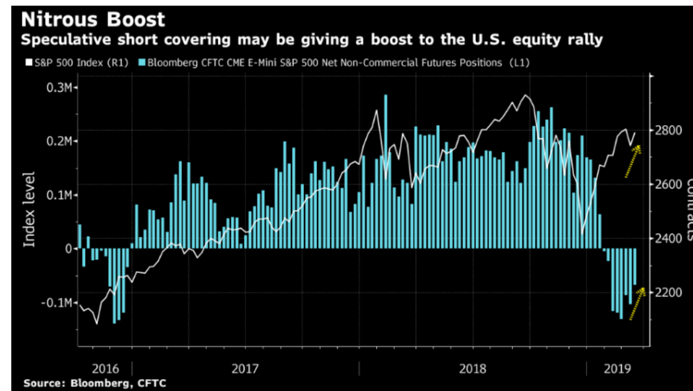
Podcast on Google, IPG Photonics and Carvana

Last week we recorded a podcast with Harvey Migotti, who recently moved to Australia from London. Harvey has over a ten years experience in buy-side roles, in private equity (Apax) and public markets (Balyasny & Amia). We discussed Google, IPG Photonics and Carvana.

Available from Apple podcasts here and other major platforms here.

Outlook

Earlier in the year we ventured forth the opinion that the conditions were in place for a strong equity rally, and the chart below shows speculators were long through the fall and short through the rally. We've now taken the opportunity to reduce exposure, while remaining invested in our highest conviction, long term investments. We are well placed to take advantage of any opportunities that arise over the coming months.



A warm thank you to those who have entrusted us with their capital.

Best wishes

Michael

Our fund is available to wholesale clients, and the online form can be accessed using the button below. Please feel free to contact me directly for further information.

Invest

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