Geometrica Fund

Investor Newsletter – October 2019

We seek asymmetric investment opportunities informed by the coalescence of rigorous fundamental analysis and alternative data discovery.

The Geometrica Fund aims to deliver outstanding returns to unitholders via highly targeted investments in the global mid-cap equity universe.

Overview

Net of costs and fees, the Fund closed the month of October +0.8% (Founders Class) with NTA at $1.0198 per unit.

At month end 19.6% of capital at cost had been deployed into equities.

The portfolio as it presently stands consists of 5 positions; 4 longs and 1 short. There are two other stocks quite likely to enter the portfolio in the coming month.

As we build each of the positions, we will comment on them in more detail.

Portfolio notes

GrubHub Inc.
(Ticker: GRUB.US, US$3.3bn mkt cap)

GRUB was a stock we did diligence on across September and October before investing. It is the only listed US pureplay food ordering and delivery business of any scale and competes with the likes of UberEats and Doordash.

Our initial bias was to view GRUB as a potential long. GRUB's share price had fallen over 50% from its highs and the narrative from GRUB seemed to both explain the price decline and augur for material upside. In the course of our work however, we found some glaring inconsistencies between GRUB's narrative and stark mathematical reality.

It is important to understand where GRUB came from in order to contextualise the sheer intensity of competition GRUB has faced over recent years and consequently, its related business model change.

When GRUB listed in 2014, it had already been operating for 10 years and was a profitable business focused on 7 major US cities. At that time, it was a food ordering marketplace only, *it did not deliver food to customers*. You could order from a restaurant on the GRUB platform, but if the restaurant didn't offer a delivery service, you'd have to collect the food yourself.

In the same year GRUB was listed, UberEats was launched and just one year prior to that, Doordash was formed by several Stanford University students. Both UberEats and Doordash offered a *delivery* service that they arranged. Both are investees of Softbank's Vision Fund. Both appear to be well funded and committed to "spending big" in pursuit of their respective long-dated visions. Both companies *lose money* on delivery.

The US online food ordering and delivery industry is the epitome of cut-throat competition. It is currently a bare-knuckled land grab. Most participants are looking past near-term losses and seeking to establish entrenched positions of scale.

It took a few years for Doordash and UberEats to establish a scaled US delivery footprint, but they, along with GRUB, now have efficient delivery operations and are growing active users very quickly.

When Uber filed for its IPO earlier this year, the S-1 revealed that from a standing start a few years earlier, UberEats had revenue of $1.5 billion in 2018, with approximately 57% of that from North America. GRUB posted revenue of $1.0 billion in

2018. In 2019, Doordash surpassed GRUB in revenue and underlying food sales in the US.

And then in June 2019, the competitor that everyone fears, Amazon, decided to exit food delivery and shutter the 4-year-old Amazon Restaurants delivery business.

In 2015 GRUB *changed its business model* by adding delivery as an option offered to customers who ordered food on its platform. At first it was an experiment, but by 2016 it was full steam ahead. GRUB presented credible evidence to investors that adding delivery as an option to online ordering would see existing customers order *more frequently*.

GRUB forecast an average delivery cost of $6.50 per order. GRUB also forecast that it would collectively charge the restaurant and diner $6.50, such that delivery would be zero margin to GRUB.

The logic was to perform a zero-profit activity (delivery) in order to expand profits from its core business (food ordering marketplace).

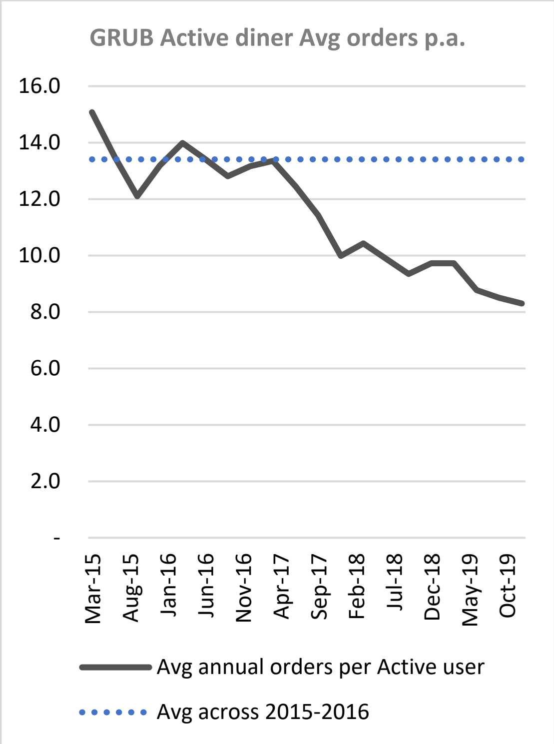
The bull case was that whilst earnings were taking a hit from the initial cost of rolling out the delivery service, total sales were rising and the roll out costs associated with the expansion of delivery to new areas would dissipate with time, resulting in a material surge in earnings into 2020. Intuitively, this seemed appealing.

But there was incongruence, between the narrative and competitor experience on the one hand, and the narrative and a proprietary dataset we had collected on the other.

GRUB's assumption of zero cost delivery contrasted dramatically to the reality of UberEats and Doordash's ongoing losses and Amazon's market exit. And as the delivery service ramped up as a percentage of gross food sales, GRUB contended that their customers' "*ordering habits [were] stable.*"

This seemed inconsistent with the initial premise of offering delivery as a mechanism to *grow* order frequency per customer.

More alarmingly, further examination indicated that average order frequency, across all customers was *declining*, not growing or even staying stable. This had been the case since 2017.



Source: Company data, Geometrica analysis.

It was plausible that new cohorts were ordering less than existing ones; you'd expect some annualisation plus the effect of new areas having lower sales productivity given GRUB and its competitors would have mined the most densely populated and thus most lucrative geographies first.

But when we held constant the order frequency of existing customer cohorts and backed into the implied ordering frequency of new customers, it implied a *negative* order rate for new customers.

It was clearly not credible that new customers were, on average throughout the year, *sending* food to restaurants rather than having it delivered.

The only plausible explanation was that GRUB's existing customers were ordering *less* every year. Logically, if GRUB's back book of existing customers ordered *less* every year, then GRUB was earning *less* every year from them.

The inescapable conclusion was that GRUB's existing business was declining in value.

We postulate that GRUB may have faced an invidious choice in 2017 or 2018:

1) Admit to the market that the backbook of existing customers were exhibiting declining sales and earnings trends.

   or

2) Try to grow out of the problem by offering delivery in more new areas in order to offset the lost sales with new sales…and hope that the arguably irrational competitive pressures would subside.

The issue with the first choice, given that the equity market has valued GRUB at an historical average of ~8x sales during its listed life, appears painfully obvious.

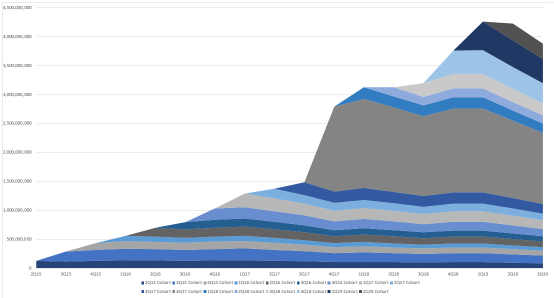
GRUB may have chosen the latter course. However, in a state of continuing competitive intensity, this had to catch up to GRUB.

Because all customer cohorts appeared to be ordering *less* each year from GRUB, to maintain growth in total underlying food sales, GRUB had to acquire an ever-increasing number of customers each year. But, because the acquired customers were hostage to the same pattern of decline whilst competition remained intense, it meant that GRUB had to *accelerate* its acquisition of customers in order to maintain a facade of sales growth.

This is possible, but it comes at a steep cost, because entering new geographies is expensive and the latter areas typically offer lower delivery density.

Our analysis showed that a tipping point was approaching, where gross food sales, if competitive pressures persisted, were likely to commence a decline.

Modelled Gross Food Sales by Cohort (Annualised)



Source: Company data, Geometrica analysis.

So, rather than buying GRUB, we short sold the stock during October, before it fell 43% on 29 October after reporting 3Q 2019 earnings.

We have since covered the bulk of the short but maintain a sliver of a position in anticipation of getting a second bite at the cherry.

If irrational competition persists, where competitors continue to sustain losses in order to eat GRUB's proverbial lunch, then GRUB is a stock trading north of 25x 2021 consensus forecast EBITDA with negative like-for-like sales trends and quite likely significant downside.

As an example, a delivery company with stable earnings trends that focuses on non-food verticals by the name of UPS trades on 11x.

However, if the Vision Fund and other investors funding Uber and Doordash reassess their cost of capital, then competitive intensity might abate, and an opportunity to own GRUB at a time when it offers significant upside might present itself.

This one appears path dependent which increases the importance of our ongoing bespoke monitoring of industry data.

Corporate Travel Management Limited

(Ticker: CTD.AU, mkt cap A$2.1bn)

In the lead up to CTD's AGM on 6 November 2019, we built a position, which we explained in our last newsletter.

In a nutshell, the stock was "rangebound" and historically cheap due to a mixture of macroeconomic concerns and a heightened level of emotional bias impacting the market's perception of CTD's credibility.

On the day of CTD's AGM, after reaffirming earnings guidance and providing greater granularity, the stock rallied 10% higher.

Given some aspects of the AGM guidance, specifically the US commentary, were *weaker* than what CTD had previously articulated, the stock's performance on the day seemed to confirm that negative sentiment had overshot to the downside.

We continue to hold the position.

Sezzle Inc.

(Ticker: SZL.AU, mkt cap A$461m)

We have built a position in Sezzle, a buy now pay later (BNPL) operator with a business model that is almost identical to Afterpay's.

We believe that Sezzle is materially undervalued.

We were initially attracted to Sezzle due to strong, early indicators in our proprietary data collection. From here, we delved deep into Sezzle's fundamentals and became increasingly more positive.

We think that there are four key points worth summarising; comparisons to Afterpay, profitability, the second derivate growth rate and more generally, market qualms.

The Comparison Game

It will be impossible for Sezzle to avoid comparison to Afterpay and while comparing the developmental paths of Afterpay and Sezzle is a useful endeavour, particularly in terms of valuation, it is not the be-all and end-all since there are a handful of idiosyncrasies for each of them.

Sezzle is clearly targeting a different sub-segment of the online retail market in the US with a focus on small to medium businesses to date which is similar to how Afterpay entered the Australian market back in 2016.

The range of retailers that Sezzle onboards is quite diverse in contrast to other BNPL providers who seem to gravitate towards fashion merchants.

Sezzle's variable cost base is different to Afterpay's with a much higher, and growing, merchant rate in the US offset by higher financing and processing fees.

Also, Sezzle's users have smaller basket sizes on average, reflecting Sezzle's tilt towards small to medium sized merchants, with the positive corollary of higher merchant rates.

Sezzle has a slightly longer repayment period on average (c. 1 week) due to a rescheduling option that customers can pay for, which is an interesting feature of the business model.

We contend that compared with Afterpay's initial foray into the BNPL industry, Sezzle is mostly ahead on fundamentals at this juncture based on a few key milestones. We do not suggest that this is a purely apples-to-apples comparison. Nonetheless, it's a useful tool to evaluate what we see as an inefficiency in the market's valuation of Sezzle.

The first milestone is that Sezzle's UMV, or underlying gross merchandise value processed, is ~30% ahead as at 30 September 2019 and with a higher merchant rate, versus where Afterpay was at in December 2016. At this juncture, Afterpay's average UMV per merchant was similar to Sezzle's due to their focus on small to medium businesses at that time as well. Despite greater comparable UMV, market valuation at the respective points in time is almost identical.

Secondly, Sezzle's NTM, or net transaction margin, in first half calendar 2019 was -0.3% which compares favourably to other US BNPL operator margins at their debut. It is below Afterpay Australia's maiden business largely due to structurally lower interchange fees in Australia, but regardless and as discussed below, there is a clear path to NTM profitability within the near-term for Sezzle.

Finally, Sezzle's incremental, or second derivative, growth rate to 1H19A is in-line with Afterpay's initial growth in Australia through the same period.

Sezzle's incremental net merchant additions were growing at 110% on average every 6 months. However, SZL's Q3'19 update implies that with 0% QoQ growth in incremental net additions in the final quarter of the calendar 2019 reporting period, their second derivative growth in merchants will grow by 249.5%. This is over twice the incremental growth that Afterpay experienced at this stage of their operations in Australia. The US market is indeed a gargantuan opportunity when compared to Australia.

Profitability

With continued growth in recurring customers, a metric which is inversely correlated to the level of net transaction losses (NTL), the outsourcing of payment processing to a lower cost provider and a near-term tailwind in their merchant rate, the math suggests that Sezzle is on the cusp of a positive NTM.

We have some level of confidence around this as the merchant rate is largely endogenous at this early stage of the BNPL market and, to a lesser degree, so are finance costs and processing fees. NTL is the question.

If you held the merchant rate flat QoQ into Q4'19, annualised the implied effective cost of financing (which is an incremental drag), increased the mix of debt funded UMV to 60% (another drag) and modestly improved processing fees by c.10bps to reflect a full half of the lower cost 3rd party processor, NTL would only have to decline by c.20bps for Sezzle to reach a breakeven NTM.

Sezzle would need to achieve 216% QoQ revenue growth to break-even on EBITDA in 2H19. Sezzle's quarterly cash overheads were $4.9m as at Q3'19 and are expected to rise to $9.9m in 4Q'19.

We do not expect Sezzle to break-even on EBITDA at the group-level until FY21.

At this juncture, we are completely comfortable with this since Sezzle's incremental growth rate is extremely strong.

Sezzle's 2H18 / 1H19 incremental merchant additions were 698 / 1,407 and in Q3'19, Sezzle added an additional 2,459 merchants which, with 0% QoQ growth, implies an incremental 4,918 merchants for 2H19 or, as previously mentioned, incremental growth of 249.5%.

If sales can genuinely be compounded at this rate, then reinvestment is the number one priority given a clear path to profitability. Take, for example the analysis which was first presented by John Huber of Saber Capital Management, LLC (overleaf).

	Reinvestment Corp.	Undervalued Corp.
Current Earnings Power	$100	$100
Beginning Multiple	20x	10x
Current Valuation	**$2,000**	**$1,000**
% of Earnings Reinvested	100%	50%
Returns on Retained Earnings	25%	10%
Cumulative Dividends	$0	$629
Year 10 Earnings Power	$931	$163
Year 10 Multiple	15x	15x
Year 10 Valuation	**$13,970**	**$2,443**
IRR	21.5%	13.6%
Multiple on Investment	7.0x	3.0x

This is a beautiful example of the power of compounding with three glaring caveats:

1) The growth needs to be sustainable during an investor's holding period.
2) The growth needs to result in returns significantly above the cost of capital.
3) You need to be the first to sell should the growth ever become unsustainable.

We believe that through our access to data, we have mitigated a good portion of these risks.

Market Qualms

A key concern the market seems to have for Sezzle is underlying merchant quality and as an extension; credit and regulatory risks.

There is no way to side-step the fact that Sezzle supports some colourful merchants in the US. In addition to mainstream merchants like Tobi, Get Your Guide, Greyhound Travel or their pilot program with Target, if it so happened that you would like to BNPL your purchase of certain "smoking glassware", a Sezzle funded merchant can oblige.

The more risqué products funded by Sezzle are legal in America. The money of a customer buying them via Sezzle looks the same. Data is also supportive of similar collectability, or credit risk.

Further, the US regulatory environment, especially around consumer credit, is both laxer and more fragmented than for Australia.

Overall

The key driver of upside for Sezzle from here is going to be sales growth in excess of market expectations, accompanied by no deterioration in credit metrics.

So far, we are on track. Sezzle noted positive credit trends in its recent 3Q 2019 release and its underlying merchant sales materially exceeded sell side expectations and met ours.

This makes sense, as a good BNPL operator dynamically permissions purchases across product, geography and other identifiers based on real time credit performance.

We have spent a substantial amount of time looking at proxies for Sezzle's volumetric growth. We think that from here, sell side analyst forward sales and earnings forecasts are overly pessimistic as they point to incremental merchant growth approaching zero in just 2.5 half-year periods. This is materially inconsistent with the data that we monitor.

If we are right in this analysis, then Sezzle is 2 to 3 quarters away from showing significant sales and earnings-based upside.

14 November 2019.

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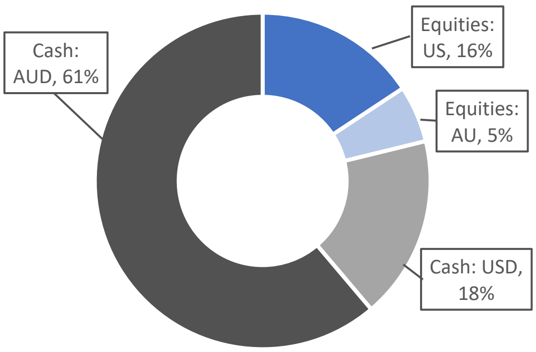
Fund Overview (Alpha Units)

Fund	Geometrica Fund	Investor Eligibility	Wholesale only
Structure	Wholesale unit trust	Minimum Investment	A$250,000
Mandate	Global long short Mid-cap focus	Fees	1.5% management (+GST) 20% performance (+GST)
Gross exposure range	0 - 200%	Benchmark	RBA Cash Rate
Net exposure range	1 - 100%	High water mark	Yes
Single stock long limit	15% at cost	Liquidity	Monthly
Single stock short limit	5% at cost	Admin & custody	Mainstream Fund Services
Buy / Sell Spread	Nil / 0.25%	Platforms	Ausmaq

Asset Allocation at month end



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